Newsletter | February 2022

Capricorn Asset Management
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Budgets & Bullets

The theme for this month. While the Ministers of Finance of SA and Namibia present their countries' respective budgets, war is breaking out on the eastern flank of Europe. Russian President Putin appears determined to destabilise Ukraine to keep it out of the hands of NATO (North Atlantic Treaty Organisation) and the EU. He does not want NATO bases and missiles on his doorstep. In international politics might is right and security is key.

Financial markets were already volatile in the build-up, but the invasion sent them into a tailspin. Movements over the past day or two added to the downdraft in global equities. Year-to-date the S&P500, 70% of the global market, is down -12%, the Nasdaq -17% and the Russel 2000 -14%. In Europe, over the same period, the STOXX600 is -11%, the DAX -12% and the CAC40 -9%. The UK's FTSE100 is down "only" -2%, thanks to the large oil companies in the index. These have been major beneficiaries of the surging oil price, which is up 42% so far this year.

In our previous newsletter, we already started to talk about the "correction" that global equities were undergoing, following three stellar years of 22% p.a. growth in USD terms. We advocated an underweight, even while thinking that Putin will never actually invade Ukraine. Now it adds another headwind to those already evident, especially the prospect of higher interest rates.

To recap, interest rates affect equity prices in three ways:

1. The discount rate of future profits: the higher the rate, the lower the present value is of an income stream
2. Cost of funding in the Income Statement: the higher the cost, the lower the bottom line, and
3. The multiple of earnings (the PE ratio) investors are prepared to pay for a given income stream. This means that 2022 is unlikely to be another stellar year.

The JSE, after having dropped on the invasion news, is flat YTD, thanks to the large mining houses that are major beneficiaries of the widespread surge in their commodities. The industrial sector is down -2% YTD, with Naspers having crashed -18% in February, but financials and resources are holding up well even considering the knock of past few days up to the time of writing – they are up 3% and 4% YTD. This goes to show that local is sometimes lekker. We are overweight in JSE equities in our multi-asset funds on the grounds of valuation and earnings outlook.

It also appears that the domestic equity, bond and currency markets are benefiting from a swing away from Russia to other Emerging Markets. Remember that Russia is one of the so-called BRICS countries. Its equity market collapsed by 33% on the day of the invasion, which brought the YTD move to -50%. The domestic markets did not escape completely, but moves were relatively more muted than in other EM's.

South Africa Budget Overview

Perhaps the Budget presented by Minister Godongwana in South Africa helped investors realise that sanity will prevail in our neck of the woods. The strong Revenue overrun in FY22 led to a sigh of relief that the fiscal house is not collapsing. The outlook for revenue growth is also reasonable, albeit much slower than the 25% surge of the past fiscal year. A total of R1.8tn is expected for the coming fiscal year, even though virtually no tax changes were announced other than compensation for fiscal drag, sin taxes, carbon tax and sugar tax.

However, the self-congratulatory atmosphere that surrounded the Budget presentation was premature, in our view. Much demand is being exerted on the Expenditure side of the Budget via subsidies to households, a fast-growing interest bill and the threat of a showdown with unions. The latter calls the envisaged tight control of the wage bill into question – it amounts to R683bn, equal to 39% of total revenue.

Total Expenditure will come to R2tn, leaving a deficit of nearly R400bn, or 6% of GDP. It shrinks over the next two years, but overall, the deficits remain too high, in our view. It is encouraging, though, that the primary deficit will turn into a small surplus next year. This is the deficit before interest payments. It means that the debt trajectory should stabilise over the next few years and that SA is not in a debt trap. In fact, this ratio should now peak at around 75%, where previously it was projected to reach 90% plus.

The SA Budget is credit rating neutral in our view, that is it will not trigger a rating change either way. The credit raters will continue to warn against rising spending pressures, high deficits and slow revenue growth in a hamstrung economy and keep their rating non-investment grade for a while yet. This means that bonds will continue to offer attractive yields to investors that compensates for the perceived risks.

Namibia Budget Overview

Similarly, the Namibian Budget presented by Minister Iipumbu, helped to assuage the "sense of crisis" that pervaded the Namibian fiscal projections. But we are by no means out of the woods yet. For FY23 Revenue growth of nearly 12% is envisaged. However, looking under the hood, N$3.4bn is included in Revenue from NPTH, arising from the semi-privatisation of MTC. If excluded Revenue growth is 5%. However, there are other chunky bits affecting Revenue. SACU revenue of potentially N$19bn is reduced by a N$5bn refund that Namibia must make due to revenue formula adjustments. For next year, a surge of 24% to N$17.6bn is envisaged, bolstered by a jump in the SACU payments budgeted by SA. At least, the other major sources of Revenue, individual- and corporate income tax, VAT and the fuel levy are stable and growing somewhat.

The Expenditure side remains plagued by a large wage bill of N$30bn, which amounts to 54% of Revenue, a rising interest bill equal to 16% of Revenue and pressure for more subsidies. The latter amounts to N$18.5bn and consists of transfers to Government organisations, individuals, public- and private enterprises.

As it stands, the deficit amounts to N$11bn, equal to 5.6% of GDP, still too high, but quite a way down from N$14bn and N$16bn in the previous two years. The funding requirement from the domestic market is still quite high, but, in our view, not extremely onerous. Yields will remain attractive for us as investors. A running yield of 10% on bonds is an attractive beacon in the current volatile and uncertain investment landscape.

Inflation Expectations

One of the main trends in the wake of the Ukraine invasion is the surge in energy prices, including oil. Russia supplies a huge chunk of Europe's gas needs. This means that there will continue to be upward pressure on inflation, globally and domestically. This is why we continue to like Inflation Linked bonds for our portfolios and clients. It protects against rising inflation and pricing is very attractive, promising high real returns over and above inflation.

Inflation rates in Namibia (latest 4.6%) and the RSA (latest 5.7%) are on a rising trend. Both rates seem set to breach or come close to the current upper band of 6.0% of the SARB targeting framework during the year before drifting down again. We think the SARB will lift its Repo Rate by another 0.50bp to 4.5% by year-end. The BoN is also likely to increase its Repo Rate and, playing "catch-up", will probably hike by a total of 1% to 4.75%. This means that the Prime Rate in Namibia is likely to rise from 7.50%, the lowest its ever been, to 8.50% by year-end.

Therefore, returns generated in the money markets, that is from short-term, safe, interest-bearing assets, are improving steadily. It remains a haven in the current turmoil for risk-averse investors. We envisage returns of 5% to 6% in this asset class with little to no volatility.

JSE Listed Property is exposed to Europe, and by extension, our Property Fund as such. Fundamentals remain poor in terms of vacancies, low rental escalations and increasing cost pressures, with hikes in electricity and municipal rates and taxes. Yet, it is still a value proposition. Rising interest rates will be another headwind for the sector. We remain on the side-line for now but will be looking to top-up to full weight once the war drums die down.