Capricorn Asset Management
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Economic Update

Just as the third wave of Covid-19 infections peaked, hopes of economic recovery in our corner of the world have been dealt another blow. This time by political and criminal elements in South Africa that exploited the socioeconomic hardships in the country to instigate unrest, violence, rioting and looting hitherto unseen.

The physical damage to property, stores and inventory can be repaired over time, the total cost of which is estimated at R50bn or nearly 1% of GDP. However, the damage to confidence is costlier and more inestimable. Fixed Investment decisions will in all probability now be postponed, if not totally scrapped. Confidence is the golden thread that runs through a modern economy, and currently is in short supply. This goes for consumers, businesses, investors and voters.

The likely impact on policy-determined interest rates is that they will remain exceptionally low for an even more extended period to assist the economy to heal. We do not foresee interest rate hikes in a soggy macroeconomic environment where the demand for credit is weak and slowing, while unemployment is high and rising.

This means that returns from the Money Market will remain subdued around the current historically low levels for another year or even longer. Combined with our view that inflation, albeit contained, will drift up over the next 12 to 18 months, it implies virtually no real returns (returns above inflation) from the Money Market, which imply that investors will have to accept higher degrees of risk to ensure they grow their investments in real terms.

Market reactions to the rioting were relatively muted, because one, the socioeconomic fault lines of the SA economy is already largely baked into asset prices and two, some weakness was already evident in the currency. The latter had depreciated by 4% in the prior month and then depreciated by a further 3.6% in July. Bear in mind that currency moves of -1.1% to +1.1% per day is very common. We think that one could still over-weight one's offshore holdings at USDNAD below 15.00.

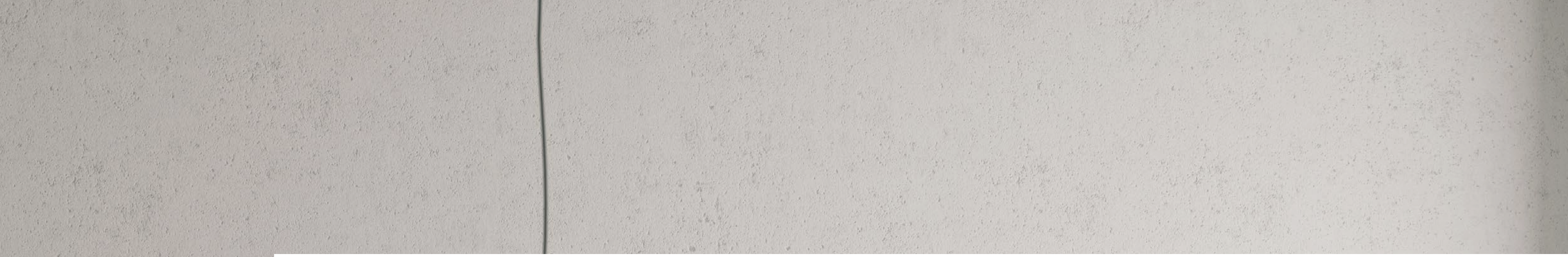
Over the past twelve months domestic equity returned 25% and beat offshore equity returns of 15% very handsomely. Financials, most exposed to domestic macro conditions, were down 1% in July, but that came at the tail end of a 33% run. Resources, most exposed to global macro conditions, compensated with +1.6%, adding to a 28% return for the year. Industrials, with a good mix of offshore and domestic exposure, are down 0.5%; the effects of unpredictable Chinese regulations on Naspers having as great impact.

Physical damage to malls and other property, brought the weak fundamentals of the listed real estate sector to the fore. By fundamentals we mean high vacancies, downward pressure on rentals received, and upward pressure in costs. The dividend yield has normalised at around 5% in the wake of distributions having been cut by two thirds. We advocate an underweight stance, but not a zero weight. This asset class can easily surprise to the upside.

The RSA 10-year generic long bond yield briefly broke through 9% in the wake of the riots, but is currently only 8bp higher for the month. Our view is that the current running yield on Namibian nominal- and fat spreads on inflation linked bonds, means that double digit returns can be expected from this asset class on a twelve-month view.

We keep a close eye on two things – counter party risk and inflation. The creditworthiness of the Namibian and South African Governments have been deteriorating. However, we do not foresee defaults by either. Fiscal pressure will remain high for as long as the economy remains in a slump, hence counter party risk is at the forefront. Still, this makes for a very steep yield curve and attractive yields on longer dated maturities which should be considered by even ultra conservative clients to be included to some extend in their portfolios.

Similarly, inflation bears a close watch therein that it has the potential to change the interest rate outlook if it proves to be higher and more stubborn than currently expected. Consumer inflation in the USA reached 5.4%, in SA 4.9%, in Namibia 4.1% and in Botswana 8.2%, largely, but not exclusively, on the back of sharply rising oil, energy and hence, transport, inflation. Possible second round effects from rising transport costs, as



well as other price pressures due to bottlenecks and shortages, will keep markets on edge.

However, Central Banks, watching unemployment closely, are likely to be more tolerant of inflation than in the past, given a patchy and frail general economic outlook. Therefore, any adjustments to accommodative monetary policy settings will, in all probability, be gradual and slow, with unchanged rates over the foreseeable future highly likely.

Real rewards in Inflation Linked Bonds

Any sensible investment must have the ability to provide growth above inflation over the long term. If not, the investor will at some point come to realise that the purchasing power of their investment portfolio has declined and that they have in fact grown poorer. This is especially true for those investors that are dependent on the distributions from their investment in order to sustain their standard of living. As a result, the pursuit for real returns (returns in excess of inflation) has been one of the key aspects of any well thought through long term investment goal.

Unfortunately, in normal market conditions, such investments have been a double edged sword. Investment instruments that have a proven ability to provide attractive real growth over the long term are also considered to be riskier investments due to their short-term volatility in value. The moment investors venture into the sphere of expecting inflation beating returns, they usually have to part from the notion of investing in conservative investments. Attractive returns above inflation are historically reserved for risky assets classes such as listed equity and property, both local and offshore. These asset classes have a proven historical track record of rendering decent returns above inflation however, not without the cost of much volatility that is often too severe for the more conservative investors to stomach.

Alas, these investors were obliged to steer clear of such investments and stick to shorter-term interest-bearing investments, which has little or no volatility only to end up with low, none or even negative real returns.

Fortunately, there is now such an investment opportunity available to Namibian individuals that has both the ability to provide really attractive growth above inflation without the risk that is normally associated with listed investments. Inflation linked bonds currently trades at levels in excess of 7% above Namibia inflation depending on the term of the investment. With inflation in Namibia officially at 4.1%, such bonds currently offer annual returns above 11% which is truly attractive. In addition, these investments are tax-free in terms of current legislation.

These inflation linked bonds differ from the more prominent “fixed rated bonds” in that their returns are not fixed but rather moves in line with Namibian inflation. If inflation should rise, the investor will earn a higher return and should inflation decline, the returns will follow suit however the investor is assured of a decent margin above inflation.

The positive correlation between interest rates and inflation would suggest that investors can expect the returns of such inflation linked bonds to be very much in line with interest rate movements, however as we expect a higher tolerance for higher inflation it may mean that inflation rise in the short term faster than interest rates which will be beneficial to investors in inflation linked bonds. Investors, ever in search for attractive growth above inflation, can therefor simply invest in these bonds for a part of their investment portfolio.

Please note that the minimum direct investment in these bonds is N$250 000.

For more information about these products please contact us at 061-299 1950 or cam.service@capricorn.com.na