ASSET MANAGEMENT HouseView

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On a personal note to all our clients during this COVID-19 pandemic, we wish you good health, safety and fortitude.

This Month's Focus

Navigating uncharted waters requires a steady hand at the tiller

Benjamin Franklin once said, *"By failing to prepare, you are preparing to fail."*

In these times of uncertainty, one needs a guiding set of principles to steer the course through the unknown. This requires a disciplined and well-practiced process that keeps a focus on what is important and relevant, through the good times and the through times.

During this global COVID-19 pandemic, we remain focused on protecting our clients from permanent capital loss, while investing in good businesses that should compound your wealth over time.

At Cadiz Asset Management, our first rule is, 'Don't lose capital'

This focuses our attention on where to start when analyzing any business. Understanding a business's balance sheet, its debt levels and when debt repayment is due is vital to understanding if a business will survive the tough times. During this global COVID-19 pandemic, as countries remain in lockdown and economic activity has largely ground to a halt, corporate balance sheets and liquidity needs are being tested like never before.

A case in point is Sasol. Entering 2020, we had no Sasol exposure as we deemed the financial risk too high as the Company failed to meet our investment criteria. During the COVID-19 pandemic and the subsequent collapse in the oil price, it became apparent that Sasol was going to struggle to pay its debt and interest costs due in the next one to two years. During March this year Sasol lost 70% of its value, announcing that it needed to raise capital, by a combination of selling assets, restructuring costs and holding a rights issue, in order to pay down its debt.

At Cadiz, we have re-interrogated the company's balance sheet for each of our investments, stress-testing their ability to manage their debt obligations and cash requirements under extreme operating scenarios. We are pleased to report that we are comfortable with the balance sheets for all the investments we hold.

Invest in quality businesses, that have proven track-records and compound returns over time

When equity markets fall as hard as they did during March, there is initially indiscriminate selling. As time goes on, investors start to distinguish between the quality stocks that are likely to survive these turbulent times and the poorer quality stocks that are often highly leveraged with weak business models. At Cadiz, we focus much of our attention on understanding the qualitative characteristics of a business, in order to assess the risks of whether a business will endure. We focus on understanding:

- How does the business make its money and what are its competitive advantages? Are these competitive advantages likely to persist, or could they be eroded over time?
- Does it have too much debt and can it repay the debt?
- Does it have a competent management team aligned to shareholders' interests?
- Does it have a proven track-record of generating superior returns on capital, and are these returns likely to persist?
- Where is the company in its business cycle - capital cycle and earnings cycle?

Good quality businesses usually trade at a premium. As equity prices have fallen during the COVID-19 crisis, however, we have used this opportunity to increase our exposure to these good quality businesses by either adding to existing positions or adding one or two quality counters to the portfolio. This will strengthen the portfolio's ability to weather the storm and compound returns over time when the world economy recovers.

Maintain a diversified portfolio

With the sudden drop in economic activity, the demand for cash for companies to pay their staff, supply chains, rent, interest costs and taxes has been unprecedented. This has led to excessive disinvestments by companies and individuals from money market funds, income funds, bonds and equity funds globally. Foreigners have also repatriated their money out of South Africa. Consequently, this has caused the dollar-rand, credit, bonds and equity prices to fall, forcing correlations to rise towards one.

This is temporary, however and not all is bad news. For example, year-to-date, MSCI World USD has fallen -20%, while the rand has depreciated 27%. For a South African investor, the rand has more than cushioned the blow to foreign investments.

Our portfolios have also enjoyed the benefits of diversification in global businesses listed on the South African stock exchange and other rand hedge stocks. For example, Naspers and Prosus are predominantly exposed to Tencent, British American Tobacco, and AngloGold Ashanti. Besides these stocks, the portfolios are also exposed to defensive businesses, including Shoprite and Mediclinic, along with other US pharmaceutical and healthcare stocks (CVS Health, Gilead Sciences and Walgreen Boots Alliance). All these stocks have different growth drivers and have held up well during this crisis, providing good diversification for the funds.

When the world finally overcomes the COVID-19 pandemic and global economies recover, some industries will recover faster than others. While it is difficult to tell which industries or stocks will be winners in the short term, we believe that the portfolio of diverse businesses our clients are invested in have solid long-term growth prospects. This combined with highly attractive valuations, sets up our portfolios for good long-term returns. Markets can be very volatile over the short-term, but history has shown that those that are willing to be patient and invest for the long-term will be handsomely rewarded.

International Market Overview

As we look back, many of us will not regret waving goodbye to the end of potentially the most tumultuous quarter of all time, namely the first quarter of 2020. Initial fears of a US-Iran conflict were very quickly brushed aside by the entrance stage left of the virulent coronavirus (COVID-19) pandemic, with JPMorgan estimating that it will have pushed the world economy into a 12% contraction in Q1. This vicious quarter has now possibly seen the most brutal global equity collapse since the Great Depression of 1929.

The aura of doom was further exacerbated by 1) a developing oil war between OPEC, led by Saudi Arabia, and Russia as a result of a stalemate to decrease production in response to COVID-19, which has resulted in a precipitous fall in the underlying oil price as the Saudi's ramped up production, and 2) the 'necessity' of lockdowns being instituted by various governments (China, South Korea, United Kingdom, Italy and South Africa for 21 days from midnight on Thursday 26 March.

United States of America

US markets ended March 2020 aggressively negative as the world absorbed the all-encompassing effects of COVID-19, with the Dow Jones ending the quarter down by 23.2%, the S&P 500 down by 20%, and the Nasdaq down by 14.2% as the pandemic took effect and the world started assessing its economic impact. As a result, US markets experienced their worst month since the Great Depression. The US Federal Reserve (The Fed), once again intervened in the markets by announcing two emergency cuts of the lending rate, a total of 100 basis points, bringing the overnight bank borrowing rate back to near zero again. The Fed also commenced an almost weekly rollout of other emergency measures, which has included the relaunching of their large-scale asset repurchases programme, better known as quantitative easing (QE).

The initial response to the COVID-19 pandemic by the Trump administration, deemed anaemic by most, has continued to come in for sever criticism as the US is now the new epicentre of the pandemic, as their death and infection rates continue to spike. As a result, the US Congress has put in place a massive $2trillion economic stimulus package to mitigate the effects of the COVID-19 impact on the economy, as well as investigating any additional steps to manage the ever-increasing impact on society. A drag in business sentiment as a result of disruptions in the global supply chains, is expected to have a negative impact on growth, however, especially as the manufacturing sector remains weak.

An important indicator in the quarterly data, the US Jobless claims numbers, hit a record of 3.3 million in the last week of March, with surveyed economists anticipating potentially a further 2.7 million claims to be filed during the first week in April, as struggling businesses continue to lay-off workers. That number came in at a massive 6.6 million, which, added to the figure of 3.3 million the previous week, equates to almost 10 million new unemployment claims in just two weeks - a figure which was only reached after 19 weeks during the previous financial crisis.

Europe

European markets also suffered a negative quarter, as COVID-19 extended its reach across the world, with the FTSE 100 down by 24.8% for the quarter (delivering its worst quarter since 1987), the DAX 30 down by 25.01% for the quarter and the CAC 40 down by 26.46%. The monthly falls in the European markets were directly related to the zone (specifically Spain and Italy), becoming the global virus epicentre during the early weeks in March. This was borne out by data showing that economic activity had dropped to record lows as steep declines in manufacturing and services were seen. Furthermore, data from the March manufacturing PMI fell to 44.5, from 49.2 in February, which is a seven-year low (bear in mind that levels above 50 point to expansion, while levels below that shows contraction). The takeaway from the data was that the sharp decline was directly attributed to shutdowns as a result of COVID-19. The European Central Bank has implemented its own raft of stimulatory measures by announcing that it will enter the market and buy an additional €750bn of bonds, be it sovereign or corporate debt, over the following nine months.

The UK saw any positive sentiment due to reduced Brexit uncertainty post the election in December 2019 decimated as a result of the COVID-19 pandemic, with the disruption in global supply chains, as well as the economic prospects in the Eurozone, decreasing. This has had a profound effect on growth as the impact of social distancing puts a dampener on business and consumer spending. As a result, the Bank of England (BoE) announced an emergency 50 basis point (0.50%) cut, as well as a £32billion stimulus package in the face of the COVID-19 pandemic, as well as term-lending facilities for small businesses and credit guarantees in the hope of easing the effects the pandemic on the economy.

Asia

Asian markets, similar to the rest of the world, endured a torrid first quarter, with the Nikkei down by 20.04%, the Hang Seng weaker by 16.27% and the Shanghai Composite lower by 9.83%, with the latter market being seen as the only major market not to find itself in bear territory (according to the South China Morning Post). Economic data for the month of March showed an effective recovery in the Chinese Manufacturing PMI, versus the February numbers, during which month China was effectively on lock-down due to COVID-19.

Japan had already seen growth momentum on the weak side on the back of a sales tax instituted and a typhoon in the fourth quarter of 2020. Moreover, the Japanese government has encouraged its people to reduce their movement which is expected to impact economic activity, as is the expected lower demand from their trading partners. The effect of negative interest rates on the margins of the Japanese banks has prevented any interest rate cuts by the Bank of Japan, but they have mitigated this by the announcement of a new one-year lending facility, as well as providing an increase in the limit of securities purchases by private individuals.

In China, although seemingly on the road to recovery from the pandemic and having brought the disease under control, questions remain about the long-term effects of the disease. As we are seeing in other countries, the travel restrictions imposed by the Chinese government have severely impacted the country's manufacturing and consumption activity. In areas where the virus has been 'contained', we are seeing a return to normal economic activity as the amount of new cases decreases significantly. We anticipate that the Chinese government will announce further interest rate cuts, which will assist the already substantive fiscal easing measures, targeted credit easing and plans to ramp-up manufacturing.

Local Market Overview

Local Equities

Resources

Despite reaching a loss of 42.47% on 19 March in the first quarter, resources have recovered, ending at -24.46%. The unknown quantum of the impact of COVID-19 on the global economy, and China in particular placed immense downward pressure on commodity prices. The Bloomberg Commodity Index lost 23.29% over the period, showing a broad sell-off across all commodities. Despite ending the quarter at USD 1577.18, gold has been incredibly volatile, losing its status as a safe haven asset amidst the pandemonium. Transportation constraints and a rush for liquidity put gold on the backfoot, falling 12.45% between the 9th and the 19th of March, before recovering to end the quarter up 3.95% in USD.

Industrials

The INDI25 has been the strongest performing index on the local market in 2020, and has, in fact, held up remarkably well given the rapid plunge we have seen on global stock markets. Year to date, the INDI25 has fallen 6.3% (well off its lows of c.-20% in mid-March). Any company that sells discretionary goods, and/or has a hint of balance sheet concerns has seen their share price come under enormous pressure recently. Apparel retailers such as TFG (-54.7%), Truworths (-46.2%), Woolies (-41.7%), and Mr Price (-37.5%) were among some of the worst performers in the first quarter. MTN's share price plummeted 41% as investors worry about the combined impact that COVID-19 and the drop in oil price, may have on the economies and currencies of their African operations. The weaker rand benefitted some of the multinationals, however, with Prosus (+17.2%), Naspers (+11.5%) and British American Tobacco (+2.4%) all finishing the quarter in the green.

Financials

The FINI15 dropped an incredible 40.05% in the first quarter (only the property index performed worse). Indeed, share prices of the local banks have come under enormous pressure, as the banking industry is strongly correlated to the performance of the economy, which is heading for a deeper recession. Added to this, the unemployment is set to rise sharply, and many individuals and businesses will struggle to pay back debt or will not be able to take on debt in the future. This will lead to a rise in credit impairments, and potentially lower growth prospects in the future. Moreover, during the quarter, the South African Reserve Bank cut interest rates by 125 basis points, which will add further pressure to the banks' profit margins. To add salt to the wound, both Moody's and Fitch lowered the credit ratings of SA's five largest banks in March. Of the local banks, Nedbank (-61.4%), Absa (-49.8%), and Capitec (-39.2%) were the worst performers. Redefine Properties (one of three property counters in the index) was the worst performing stock on the FINI15, losing 68.7% of its value during the quarter. Insurers, Old Mutual, Sanlam and Discovery also declined 39.7%, 35.4% and 34.6%, respectively.

Local currency

The rand has seen extra-ordinary volatility over the last quarter as an emerging market sell-off pushed the currency to new lows against major global currencies. The search for yield took a back seat as fears over liquidity sent the market flocking into US treasuries and the dollar. The South African Reserve Bank fell in line with a 100bps cut in the repo rate, joining most major central banks who cut aggressively to try and save their economies from a recession. To add to the woes, Moody's finally buckled and downgraded South Africa's debt status to junk, which was largely already reflected in the currency. The rand ended the quarter at USDZAR 17.84, a depreciation of 21.51%.

Local Fixed Income

Market Review

The first quarter of the year was characterised by extreme volatility as markets grappled with the rapid spread of Covid-19, disrupting economies across the globe. Fear translated into panic buying of perceived safe-haven assets despite a move by central banks to implement significant monetary and fiscal measures to stem the heightened unpredictability of market movements. Global bonds initially got off to a strong start at the beginning of the quarter as demand increased. The 10-year generic US yield dropped from 1.51% at the start, ending the period at 0.67%. European bond yields reversed their gains later in the quarter, however, as attention remained heavily focussed on the US and its bond market.

Although the local bond market started the year in positive territory on the back of substantial foreign buying, this initial strength was short-lived as the Covid-19 crisis hit sending local yields skyrocketing about 200bp higher at the start of March, before clawing back some of the losses as the month wore on. The local market was served a double whammy as Moody's decided to downgrade our sovereign rating at the end of the period under review. The effect was somewhat muted by the prevailing global conditions and the level of weakness that had already been priced in in anticipation of the downgrade.

Inflation-Linked Bonds were not spared from the weakness playing out in the local markets. This asset class was down more than 6.6% for the quarter.

Our fixed income outlook for the coming months is detailed as follows:

- Economic growth remains low with no sign of substantive recovery.
- Currency volatility continues to be fueled largely by international factors.
- Monetary policy intervention is set to intensify with further rate cuts expected.
- The sovereign downgrade is now behind us, but growth and fiscal metrics remain weak which does not rule out the possibility for future downgrades.
- Foreign flows are negative, and the economy remains vulnerable.
- Short- and long-term technical trends are negative.
- Local sentiment is cautious.

We continue to seek value along the yield curve with careful duration risk positioning of our portfolios.

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