CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

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Invest For The Future

Q2 July 2022

Global economic prospects are less bright than previously anticipated, driven by concerns of an accelerated interest rate-hiking cycle and the continued war in Ukraine. Inflation continues to surprise to the upside, and in some countries, inflation has reached levels not seen in 40 years. Due to both Russia's and Ukraine's contribution to the global commodities markets, the war is likely to push commodity prices higher, thereby propelling further inflationary pressures. Added to this, the Chinese zero Covid policy of lockdowns amplifies global economic pressures and is exacerbating supply chain disruptions, further fuelling inflation.

Of concern, higher inflation has the potential to prompt central banks to raise rates too aggressively, thus further derailing the global recovery and adding to concerns of a global recession.

Consequently, navigating uncharted waters requires a steady hand at the tiller. In these times of uncertainty, one needs a guiding set of principles to navigate through uncertainty. To achieve this requires a disciplined and well-honed process that focuses on what is important and relevant, through the good times and the tough times.

During this period of uncertainty, we remain focused on protecting our clients from permanent capital loss. We do this by investing in good quality businesses with strong cash-flow generation and low leverage as the cost of capital rises, combined with more reasonably valued structural growth stories.

Adrian Meager – Managing Director

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Source: Morningstar | Performance reported for A Class net of fees in ZAR as at 30/06/2022 (ASISA) South African IB Money Market, Inception: 01/03/2006 | Annualised return is the weighted average compound growth rate over the period measured | Benchmark: STeFI Composite ZAR, Category Rank is against the (ASISA) South African IB Money Market Category | Highest Annual Return 12.27%; Lowest Annual Return 4.40%

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At Cadiz Asset Management, our first rule is, 'DON'T LOSE CAPITAL'

This focuses our attention on where to start when analysing any business. Understanding a business's balance sheet, its debt levels and when debt repayment is due, is vital to understanding whether a business will survive these tough times. During this structural shift to a more normalised world of higher interest rates caused by elevated inflation, corporate balance sheets and earnings will be tested.

At Cadiz, we continue to interrogate the company's balance sheet for each of our investments, stress-testing their ability to manage their debt obligations and cash requirements. 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, there is initially indiscriminate selling. Over time, investors distinguish between 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 business will endure. We focus on understanding the following:

- 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?

Superior quality businesses usually trade at a premium. As equity prices fall, however, this creates an opportunity to buy these quality businesses at an attractive valuation.

We use these opportunities to increase our exposure to good quality businesses by either adding to existing positions, or adding quality counters to the portfolio. This will strengthen the portfolio's ability to weather the storm and compound returns over time once the world economy recovers.

Maintain a diversified portfolio

After the stellar market rally in 2021 in which the local FTSE/JSE All-Share Index (Alsi) hit new highs (up 24% for the year and global markets up over 30% (MSCI World Index) in SA rands), 2022 has seen a sharp reversal in global market returns. Year-to-date, the S&P 500 and the MSCI World Index are down over 21% in USD. The South African market has fared a little better than its global peers, however, - down 13% in USD. This reversal is temporary and is not all bad news.

When international markets strengthen, 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.

South African Local Market Overview Q2 2022

The local market saw a 12.3% decline for the second quarter of 2022, as recessionary fears and rising rates both locally and internationally continue to have an impact on world economies.

Resources

The JSE Resources 10 index (RESI10) saw a significant pullback, losing just shy of 22% for the period, and was the worst performing sector for the second quarter of 2022. This was largely attributable to an effective decrease in international resource prices. We saw the palladium

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price down by 14.5%, the platinum price down by 9.1%, and gold weaker by 6.7%. The price of brent Crude oil was up almost 6.5% due to a tightening of sanctions against Russian supply, together with a cut in Libyan oil production.

Weakness in the resources sector was broad-based, with Anglo-American (AGL) down 24%, BHP Billiton (BHP) down 22%, African Rainbow Minerals (ARI) down 25%. Gold and platinum counters were also not spared the rod with AngloGold (ANG) weaker by 30%, Harmony (HAR) -30%, Goldfields (GFI) -33%, Amplats (AMS) -30%, Impala (IMP) -20%, Northam (NHM) -36% and Royal Bafokeng (RBP) -9%.

Stronger showings in the sector came from shares benefiting from the uncertainty caused by the war in Ukraine. Sasol (SOL) was up 5% for the quarter and 45% for the year on the back of the strong oil price, and Thungela Resources (TGA) up another 26% for the quarter and 185% for the year, as the pressure on oil and gas supplies and the impact on electricity supply, saw a fallback to coal powered power stations for electricity supply and demand.

Industrials

Industrials also experienced a weaker Q2 with the FTSE JSE Industrials 25 (INDI25) declining by some 3%. The big news in the sector over the period was two areas of corporate activity. The first was Mediclinic (MEI), which received an unsolicited buyout offer from local investment company Remgro (REM), in a consortium with Mediterranean Shipping Company. The board of Mediclinic recommended rejecting the bid as being both opportunistic and undervaluing the Company. On the back of this, the Mediclinic share price was up around 20% for June and up around 30% for the quarter, as the expectation for an improved offer lingered.

The second was an announcement by the boards of Naspers (NPN) and Prosus (PRX) that they had received approval to sell down shares of their biggest holding, Tencent Holdings and would use the proceeds to buy back their owns shares with the objective of closing the sizeable discount gap of the respective companies. Both companies saw their share prices up by 38% (NPN), and 30% (PRX), for June and 42% and 33% for the quarter respectively.

Additional shares showing strength in the sector were Trencor (TRE) 16%, Pick n Pay (PIK) 5%, British American Tobacco (BTI) 14%, while weakness was seen in Woolworths (WHL) -6%, Anglo Vaal Industries (AVI) -9%, Nampak (NPK) -35%, MTN (MTN) -31%, Vodacom (VOD) -18%, and Telkom (TKG) -18%.

Financials

Financials were the second worst performing sector for the second quarter of 2022, with the FSTE JSE Financials 15 (FINI15) index returning -17%, adding to the woes of the FTSE JSE All share Index. The impact of rising interest rates worldwide together with increasing living costs on an already longsuffering consumer and could potentially lead to increasing defaults and rising bad debts. This has filtered through to the local banks, with FirstRand Limited (FSR) down by 19%, ABSA Group (ABG) also down 19%, Standard Bank (SBK) -15% and Nedbank Limited -11%. We have also seen weakness in the diversified financials, with Old Mutual (OMU) weaker by 20%, Sanlam (SLM) -27%, Santam (SNT) -13%, and Transaction Capital (TCP) -26%.

Property sector weakness persisted through Q2, with Hammerson (HMN) -40%, Growthpoint (GRT), - 16%, Redefine (RDF) – 21%, Attacq (ATT) weaker by 25%, Hyprop (HYP) -5% as slower rental increases and vacancies continues to weigh on the sector. Nonetheless, property values have started to stabilise, with a recovery in earnings off a low base and improving balance sheets.

Local currency

The rand depreciated by 11,5% over the second quarter of 2022, with the USD/ZAR exchange rate at 14,62 at the start of the quarter and closing at 16.29. The rand also weakened by around 5.6% against the Euro and ended as the fifth worst performing currency from its Emerging Market (EM) peer group for the period in question.

Sidney Mckinnon – Head of Fixed Income

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Significantly, the South African Reserve Bank's (SARB's) target inflation band of 3% - 6% was breached during May, with local CPI coming in at 6.5% against an expected 6.1% (as released in June), breaching the upper 6% limit for the first time since 2017. We expect the SARB to aggressively manage the inflationary trend and are expecting another 0.50% rate hike at the next Monetary Policy Committee (MPC) Meeting at the end of July.

Local Fixed Income Review

The key themes of the first quarter continued to dominate market movements during the second quarter of 2022. The ongoing war in Ukraine and global supply chain disruptions continue to hamper economic growth and have caused widespread inflationary pressures.

The conversation in markets has now transitioned from one focussing on heightened inflation to one of impending recession across global markets. Major global central bankers have been seen as increasingly hawkish as they reiterate their commitment to taming inflation. This has propelled risk averse investor behaviour, resulting in a tough quarter for most markets.

The South African central bank was no exception and raised interest rates by 50 bps in its May meeting. The heightened pace was somewhat surprising as the inflationary pressures in the country are caused more by supply constraints than excess demand. The move by the central bank is widely seen as an effort to keep pace with developed market central bankers who have put in place serious measures to contain runaway inflation.

Short-end money market rates remained fairly stable until the rate increase, jumping on the day of the policy announcement, before stabilising somewhat. Longer dated money market instruments showed general yield increases over the quarter, resulting in further curve steepening.

The bond curve did not escape the pain experienced in other income bearing assets. The general risk-off shift resulted in South African government bonds selling off toward the end of the quarter, leading to upward pressure on the yield curve. Longer dated bonds were slightly worse off, resulting in a mild steepening of the curve.

The reserve bank has also announced that the transition to its new monetary policy implementation framework, which would see the local banking system shift to a tiered floor surplus system from a shortage system. This will give the reserve bank more tools to shore up the banking system in the event of another large exogenous shock such as the liquidity shortage seen in the midst of the Covid 19 pandemic. The effect of this for investors hinges on the SARB's patience in unwinding assets on its balance sheet which it no longer needs to artificially create a liquidity shortage in the money market. The most notable of these are the large amounts of FX-swaps that the SARB used to sterilize foreign currency flows into the country.

The bond market (JSE All Bond Total Return Index) was down 3.76% for Q2 2022.

International Markets Review

The drawdown in both equity and bond markets over the past six months has been one of the most severe on record, with 80% of the decline taking place in Q2. At the end of June, both the US and global equity markets had fallen by more than 20%, and global bonds by an aggregate -14% (all in $ terms).

While worries about global growth have increased in recent months, the magnitude of the declines in equity and bond prices is as much a reflection of their prior overvaluation, enabled by easy money, than deteriorating economic conditions. Stubbornly high inflation data during the past quarter has contributed to increased anxiety that the need to tighten rates to combat this may lead to a recession in 2023. These concerns led to a significant sell-off in more economically sensitive sectors during the final two weeks of June.

At present, the key issue for investors is whether central banks can reduce inflation materially in the coming months without triggering an economic recession, and markets are likely to be on 'recession watch' for the remainder of 2022. Any weaker-than-expected economic data or declines in copper/oil prices, or a flattening of the U.S. 2/10 yield curve, will be interpreted as evidence that a recession is brewing. The implication is that weak economic data will be beneficial for longer-maturity bonds, but initially bearish for corporate earnings expectations and equities (until markets conclude the Fed and other central banks will have to halt or reverse their tightening cycles).

One positive is that the decline in asset prices this year has significantly unwound the valuation excesses that were present at the start of 2022, with 12-month forward P/E ratios for global stocks falling from a peak of 20 to below 15 times, which improves the risk-reward outlook materially. This level of drawdown is consistent with a correction caused by a growth slowdown, but not a full

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We expect global growth to slow further, but the resilience of the global economy is likely being underestimated, and the health of the US and European private sector should prevent a recession.

recession. The latest US data (including the MRB recession checklist indicator) suggests that this is the current most likely outcome, although softer data is expected in future months as well as downgrades to year-end earnings estimates.

In summary, our investment thinking for the remainder of 2022 is based on the following assumptions:

- We expect global growth to slow further, but the resilience of the global economy is likely being underestimated, and the health of the US and European private sector should prevent a recession.
- Headline and core inflation in the U.S. and euro area should gradually ease in the coming months, albeit less than central banks or the consensus anticipate. Nonetheless, the easing will provide relief for capital markets.
- Having already de-rated markedly and discounted at least some downgrading of corporate earnings expectations, stocks will likely remain choppy in the near term but another meaningful upleg is probable on a 6/12-month horizon.
- G7 government bonds and parts of the credit market remain oversold (although the former has rallied strongly from mid-June). Easing inflation concerns in the next two quarters should allow yields to decline further.
- Portfolio returns should improve on a 6/12-month horizon, initially reflecting more stable bond returns (which will support Balanced mandates) and ultimately better equity returns.

Physical Address: Alphen Estate, Alphen Drive, Constantia 7848, Cape Town / **www.cadiz.co.za**

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