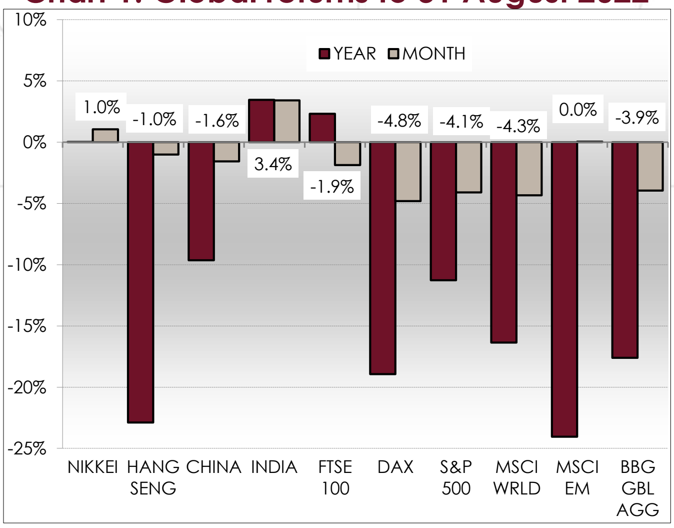
INTERMEZZO
INVESTMENT LETTER
September 2022

Orchestrating Your Wealth
MAESTRO
Masters of Investment

August in perspective – global markets

Global equity markets rallied strongly between 16 June and 16 August, at which stage they experienced a sharp setback and ended August with significant negative returns. The catalysts were twofold: firstly, on 26 August the US Federal Reserve (the Fed) Governor Jerome Powell presented a speech which made it very clear just how serious the Fed is in continuing to raise US interest rates until such time as inflation has been tamed. Secondly, that speech led to a very sharp rise in US bond yields (interest rates) and a commensurate decline in prices; the US 10-year bond yield started the month at 2.6% and ended close to 3.3%. This sharp rise in yields spooked global equity markets and contributed to their wholesale decline. All in all, August proved to be another month where there was "no place to hide" other than in the safety of US dollar cash; the dollar continued to firm against all other currencies in anticipation of higher US interest rates in the months to come.

Chart 1: Global returns to 31 August 2022



Looking at the numbers, the Bloomberg Global Aggregate Bond index declined 4.0% in August, continuing what has been the worst "start" to a year on record. The latter index has now declined 17.6% and 15.6% during the past year and year-to-date respectively, shocking investors who have long regarded bonds as a stable asset class and a secure destination in times of crisis. Developed bond market movements so far this year have wreaked havoc with returns, especially those of retirement funds, which traditionally seek refuge in large bond allocations during times of crisis. That approach has certainly not worked during the past year.

Global equity markets did not fare much better in August, although surprisingly, emerging markets held up quite well during the month. The MSCI World index declined 4.3% in August, but the MSCI Emerging Market index *rose* 0.3%. The year-to-date returns of these two indices are now roughly the same, around -19.0%. The German equity market declined 4.8% and the US market 4.1%. The tech-heavy NASDAQ fell 4.6% and the traditionally defensive Swiss market lost 2.6%. Within the emerging market universe the Chinese equity market lost 1.6% but the Indian market rose 3.4%, bringing its annual return to 3.5% - one of only a few markets to have posted positive returns during the past year. The Russian equity market rose 11.4% (although I would hardly trust that market under the current circumstances) and the Brazilian market rose 6.2%. The Turkish equity market rose 22.3%. Bear in mind Turkey is going through its own crisis at present – annual inflation is way above 80% and the authorities are consciously interfering in their markets as a matter of policy – so any Turkish return needs to be treated with a large bag of salt.

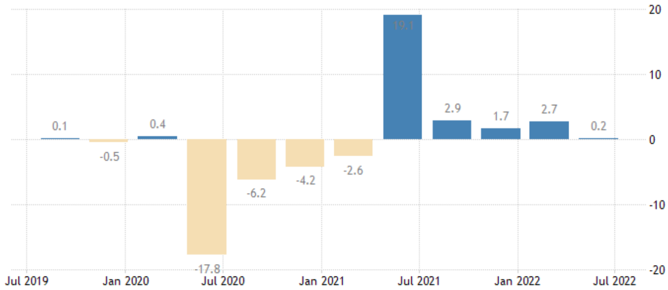
The dollar was very strong during August, rising 2.6% to bring its annual gains against most trading partners, as encapsulated by the "DXY" dollar index, to 17.4%. Its strength put commodity prices under pressure. The iron ore price fell 17.4% during August, and the oil price lost 7.4%, but the price of coal continues to surge, rising 3.4% in the face of the Ukraine War-induced energy crisis. It is worth highlighting the August decline of 49.1% in the Baltic Dry index, an index used to track the cost of shipping dry goods (like coal and iron ore). Global supply chains remain disrupted, with the War in Europe and the ongoing lockdowns in China creating a great deal of uncertainty with respect to global trade.

What's on our radar screen?

Here is a summary of the things we have been keeping an eye on:

- *The SA economy:* South Africa's economy shrank by 0.7% quarter-on-quarter during the second quarter (Q2) of this year. The economy grew by only 0.2% on an annual basis (so Q2 2021 to Q2 2022), significantly lower than the annual growth rate of 2.7% in Q1. Frequent bouts of load-shredding – Eskom instituted load-shredding over more than half the days during the quarter – and devastating floods in KwaZulu Natal contributed to the decline. Although the Q2 declines were widespread across all sectors of the economy, those that shrank the most included the manufacturing, agriculture, trade and mining sectors.

Chart 2: SA annual economic growth (%)

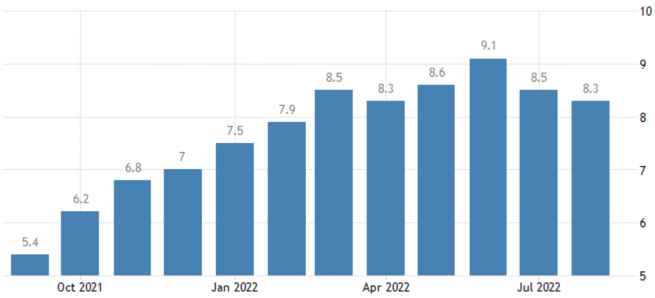


Source: Tradingeconomics.com

The headline inflation rate declined from 7.8% in July to 7.6% in August, thanks in large part to a decline in the fuel price during the month. The monthly increase in prices was only 0.2% versus the 1.5% in July. The core inflation rate i.e. price increases excluding those of food and energy, declined from 4.6% in July to 4.4% in August. Largely in response to the ongoing increase in prices, the SA Reserve Bank increased their key interest rate by 0.75%, from 5.5% to 6.25%, at their September meeting, echoing global central banks' recent activity. That brings to 2.5% the increase in interest rates so far this year.

- *US economy:* It is fair to say that all seasoned investors' eyes are keenly focussed on the US inflation releases. If they are in any way "unexpected", whether it be positive or negative, global investment markets are bound to react violently. As so it was with the August inflation release. Although there was a decline in the inflation rate, it was not as great a decline as the market expected, and the equity market reacted promptly by posting one of its worst down days ever. That is the world in which we now find ourselves. To the numbers now: the annual headline inflation rate declined from 8.5% in July to 8.3% in August, although the core inflation rate rose more than expected, from 5.9% in July to 6.4% in August. Lower energy prices were the key reason the headline rate declined but a stronger-than-expected increase in rental inflation exerted upward pressure on the headline rate.

Chart 3: US headline inflation rate (%)



Source: Tradingeconomics.com

As widely expected and against the backdrop of ongoing increases in prices, the US Federal Reserve (the Fed) increased its Fed Fund target range to 3.0% to 3.25%, an effective interest rate hike of 0.75% - the third consecutive rate increase. While the extent of the rate hike was widely expected, the same can't be said for the "dot plot" forecast which was tabled simultaneously. The dot plot provides an indication of the Fed's expectations regarding future interest rate increases. Whereas in June the Fed's forecast indicated that interest rates might peak at 3.25% in 2023 with a possible easing in interest rates next year, their forecasts now indicate that next year could see rates rise to 4.6% with no decline in the interest rate. As if to reinforce that message, Governor Jerome Powell indicated that the Fed would be prepared to tolerate a recession if that is what was necessary to bring down inflation. Consequently, the Fed also reduced its "growth" forecast for the US economy, which is already in a technical recession, to 0.2% in 2022 and 1.7% in 2023. All in all, no one can doubt the Fed's determination to end the current inflation uptrend. This attitude is very supportive of further dollar strength. Partly on the back of higher-than-expected interest rates, the dollar duly rose to a 2-decade high. Finally, for what it is worth, US retail sales rose unexpectedly in August, by 0.3% month-on-month, from a revised decline of 0.4% in July.

- *Developed economies*:
  The Swiss economy grew by 0.3% during Q2 on a quarter-on-quarter basis, driven by private consumption, following the repeal of all Covid-related restrictions, and weaker exports. The economy grew 0.5% during Q1. Given their plentiful supply of energy, Switzerland hasn't suffered from

the energy-driven surge in prices this year, which has helped in keeping inflation at a reasonable level. The annual rate of inflation in Switzerland was 3.5% in August (that rate is still shockingly high for the Swiss, though) while core inflation remained at 2.0%. The 2021 growth rate of the Swiss economy was revised higher, from 3.7% to 4.2%. At its September meeting the Swiss National Bank (SNB) raised interest rates by 0.75%, to 0.5%, thereby exiting a 7-year long period of negative interest rates.

Despite acknowledging that its economy is in a recession, the Bank of England (BoE) raised its interest rates by 0.5% to a 14-year high of 2.25%.

Turning to the Eurozone, the European Central Bank (ECB) raised its interest rate from 0.0% to 0.75%, and signalled that more rate hikes would follow. The ECB increased its 2023 inflation forecast to 5.5% from 3.5% previously and for 2024 to 2.3%. It now also expects a significant growth slowdown to only 0.9% in 2023, although this growth rate looks optimistic relative to other prevailing forecasts, and 1.9% in 2024. The ECB forecasts an average inflation rate for 2023 and 2024 of 5.5% (from 3.5% previously) and 2.3% respectively which, to be honest, just looks too low. In line with other central banks, the central bank of Canada (BoC) also raised its interest rate, by 0.7% to 3.25%. It noted its belief that prices are likely to rise further (Canada's headline August inflation rate was 7.0%) and consequently warned of further increases to come. The Japanese economy grew at an annualised rate of 3.5% during Q2, boosted by the lifting of Covid restrictions. This was an increase from Q1's 0.2%.

- *Emerging economies*: For a change let's start with that purveyor of unorthodox economic policy (I think of it more as political interference based on ignorance). The Turkish central bank reduced interest rates by 1.0% to 12.0%, its second rate cut in two months. The reduction comes despite a headline inflation rate of 80.2%, and a core inflation rate of 66.1%. Besides, in all that we have written in these pages in recent months, how many other global central banks have you seen cutting interest rates? Er, ja well … no fine. Each to his own I guess, but let's revisit the Turkish economy, and the lira, and its unique characteristics in a few years' time. The rate cut put the lira under even more pressure, and it is rapidly making even the rand look respectable.

Bank Indonesia (BI) raised its interest rate by 0.5% to 4.25% in the face of higher inflationary pressures. The BI said the move was "front-loaded, pre-emptive, and a forward looking step". Inflation has eased slightly, to 4.7%, but is likely to increase sharply now that government has increased the subsidised fuel price by 30.0%. BI now expects headline inflation to rise to 6.0% by year end and core inflation to 4.6%.

While Brazil left its interest rates unchanged (at 13.75%) at its latest meeting – Brazil is only days away from a general election – Chile hiked its rate by 1.0% to 10.75%. As is Indonesia, the central bank hinted that the action was front-end loaded and that the end of the tightening cycle may be in sight if inflation moved in line with their projections. That looks a bit hopeful in light of the current 3% inflation target and the August headline inflation rate of 14.1%.

The monthly release of Chinese economic data showed that industrial production rose at an annual rate of 4.2% in August, from July's 3.8%. Retail sales rose at an annual rate of 5.4%, up from July's 2.7%, while fixed asset investment rose at a rate of 6.4%, up from July's 3.6%. Subsequent to these readings, China has imposed severe lock-downs on a number of cities again; it is fair to say that the Chinese economy is now growing at a very low rate, if at all. Most economists are revising their 2022 growth forecasts lower in the face of the global energy crisis and China's self-induced Covid pandemic-related crisis. They are also struggling with a property crisis at present. Headline inflation in China rose at an annual rate of 2.5% in August, down from July's 2-year high rate of 2.7%, with core inflation remaining steady at 0.8%. Producer inflation (PPI) rose at an annual rate of 2.3% in August, down from 4.2% in July.

Charts of the month

The rampant greenback

Global equity and bond markets have been weak for a long time now. The main cause of this weakness have been investor fears about the future level of inflation. The latter has escalated sharply and central banks have moved swiftly to increase interest rates. This in turn has driven bond yields higher (and prices lower). As one of the most widely used safe havens, investors have been piling into the dollar, which is looking increasingly attractive as US bonds scale new peaks and prices plummet to new lows. At the time of writing the Bloomberg US Aggregated Bond index has declined 13.8% so far this year – its worst start to a year in decades. Hawkish talk by the Fed and the likelihood of higher interest rates continues to drive the dollar higher, as Chart 4 shows. I have shown the 10-year history on the DXY index, below, to place the dollar's recent strength into perspective.

Chart 4: The rampant dollar – no end in sight

The DXY trade-weighted dollar index

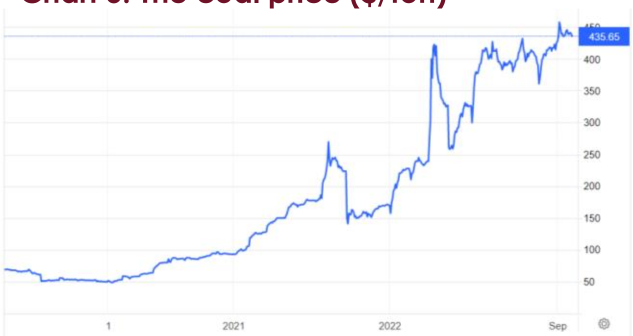
Source: Tradingeconomics.com

The coal price – up, up and away

One of the negative consequences of Russia's invasion of Ukraine, has been the effect on energy prices. Of course, the energy complex is, well, complex, and consists of many elements. Even within one form, there are multiple grades, of say coal, oil or gas. Despite all the aspirations for a cleaner environment, many significant nations and users of "dirty" energy are having no choice but, in light of the dramatic increase in energy prices, and supply constraints, to revert to sources of dirty energy such as coal.

We have alluded to it a few times in the past, but for now draw your attention again to the sharp escalation in the coal price. The higher price is bad for users and indirectly for everyone, given coal's unfriendly environmental nature. South Africa however, as a big exporter of coal, is reaping great benefit from the higher price. It increases the value of SA's exports and consequently increases our current account.

Chart 5: The coal price ($/ton)



Source: Julius Bär

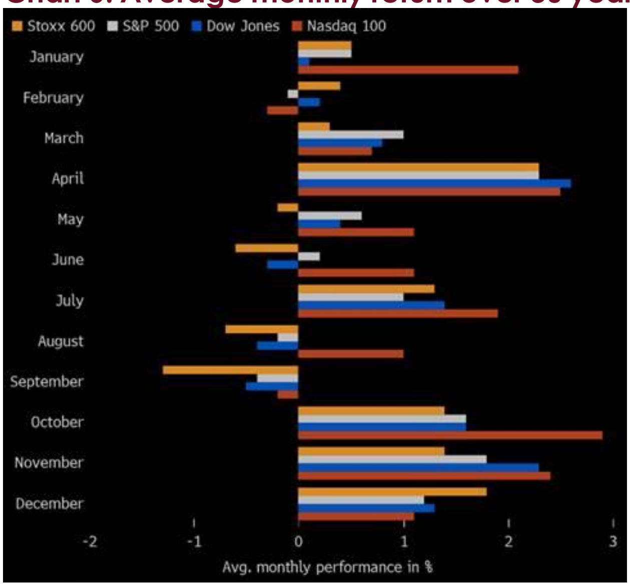
China is also a big importer and user of coal. The drought there in recent months has reduced the amount of available hydroelectricity and China has had to resort to using more coal, exacerbating an already tight coal market.

Equity market seasonality

Speaking of weak markets, although we are aware of what is driving bond and equity markets lower, it is worth pointing out that we are currently in the seasonally weak time of the year. Two charts will support that view.

The first chart, Chart 6, drawn on 1 September, depicts the average return of various indices over the past 30 years. It is clear from the chart that US and European markets' weakest months of the year are August and September.

Chart 6: Average monthly return over 30 years



Source: Baader Bank/Bloomberg

Chart 7, shown below, shows a similar story. It depicts the average monthly return over the past 25 years of the Stoxx Euro 600 index of leading European companies. The chart was drawn on 1 August. It may be cold comfort in light of the huge declines so far this year, but it is never-theless clear that we are exiting the seasonally weak months in markets, and heading into one of the seasonally stronger periods, being October, November and December.

Chart 7: August and September – the worst

Source: Julius Bär

Bye, or goodbye; sell or excel?

What then, are we to make of the current weakness and what action should we be taking in light of the extreme market weakness; and it has been extreme, make no mistake. These are not normal times. For most seasoned market watchers and in all likelihood all investment managers, the message is clear: now is <u>not</u> the time to be selling out of the equity market. Most would go further and say that now is probably the <u>worst</u> time to reduce equity exposure. No doubt, you can be forgiven for greeting this advice with skepticism, for two reasons: firstly such advice is admittedly biased, and secondly, there is no certainty that markets are likely to improve in the immediate future. So then, what action should you be taking?

My thoughts are as follows: if you are young and have time to wait out the prevailing market storm, you should certainly <u>not</u> be reducing your equity exposure. On the contrary, if you have investable capital currently "sitting on the sidelines" it makes sense to *slowly* start adding to your portfolio. However, if you do not have another five or more years to recover from the current losses, it might be appropriate to start reducing your equity exposure *slowly*. This is particularly true for those who are still paying off mortgage bonds, where the price of those bonds, being the prevailing interest rates, has risen sharply and is likely to rise further.

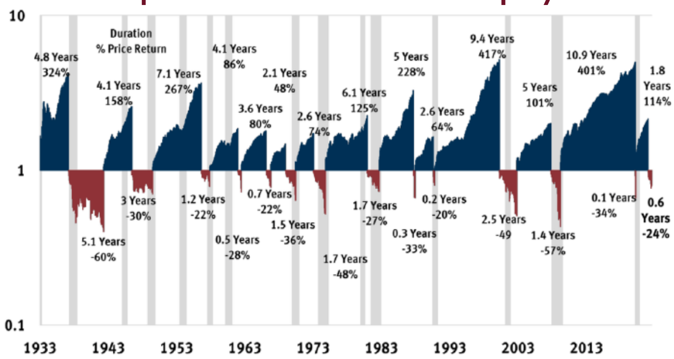
Let me be clear: my comment and thoughts should not be construed as a market forecast. I have no idea what markets are going to do during the next few months – if anything I suspect they will *continue to be weak*. However, my views are fashioned by market history, which shows very clearly that *firstly*, equity markets rise over time, and by significantly more than they decline, and *secondly*, that "selling out" during periods of market weakness is one of the best ways to <u>lose</u> money and experience what we call "a permanent loss of capital".

There is no "one size fits all" market advice. Each of our respective circumstances is different, and for that reason you need to assess your own circumstances and reach your own unique decision. A few certainties can be relied on when making these important decisions: firstly <u>no one</u>, no matter how clever he or she is, or how much experience he has, <u>knows the future</u>, and by default knows what the market is going to do in the short-term. Secondly, no one "rings the bell" when markets have reached their trough, or weakest point in the economy cyclical. We can only establish this after the event, and in most cases at least a year or more after the event.

Consequently, *it is unreasonable to expect anyone, even investment managers, to know when markets are going to turn or what their short-term direction will be*. The third certainty is that equity markets rise over the long-term and have proved to be one of the most powerful means to wealth generation *over time*. Note the "over time" in the last sentence. We don't know when the best time to invest is (other than perhaps when markets are weak, like now, although that offers no security that they will not weaken further before the start rising), but we do know from history that if you invest in the equity market over many years i.e. you don't try and be clever and move your money in and out of the markets, you are likely to generate substantial wealth for yourself. Let me back up these comments with two simply charts.

Chart 8 was drawn on 5 September. I apologize for its size, but I need lots of history to illustrate my point. It depicts the bull (up) and bear (down) market cycles of the US equity market. It depicts the duration of each up and down cycle as well as the extent of the movements since 1933. Shaded portions on the chart indicate US recession. Even a casual glance will show that the up markets have been <u>longer</u> and <u>significantly greater</u> than the down markets. It also places the current market downturn into perspective. It is clear that investors who have "hung in there" and retained their market exposure, have benefitted significantly over time, notwithstanding periods of weak and down markets. Once again, the caveat emptor is that one has sufficient time to withstand the down markets and recover from the losses.

Chart 8: Ups and downs of the US equity market

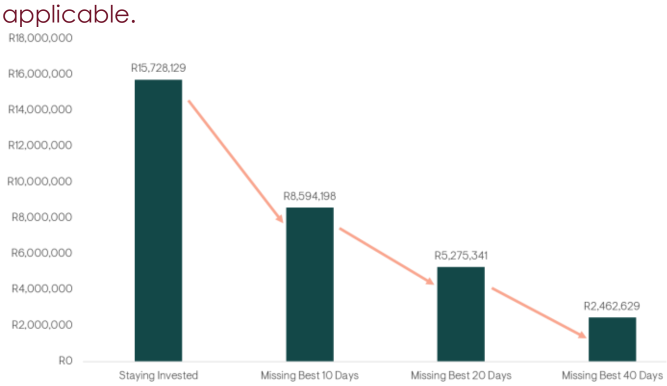


Source: Ninety One

The second chart I offer by way of explanation of my views and comments is Chart 9, which again comes courtesy of Ninety One. It shows the effect of missing out on the best performing days on the SA equity market. I know this is a bit of an academic exercise, but its message is clear and powerful: if you want to achieve the best returns the market has to offer, don't try and be clever and "time the market". Rather, hold the faith, remain invested through thick and thin, and stay the course. The difference between the results of the latter approach and trying to time the market, are too significant and powerful to ignore! The chart below shows that switching out of the market when it has underperformed can mean that you miss out on the best performing days. We say it all the time but the message bears repeating: <u>time in the market</u> is more important than trying to <u>time the market.</u>

Chart 9: Time in the market vs timing the market

R1m invested 20 years ago, daily data of the All Share Index to 30 June 2022; performance figures based on a lump sum investment. Start date 1 March 2001, no fees applicable.



Source: Ninety One and Morningstar

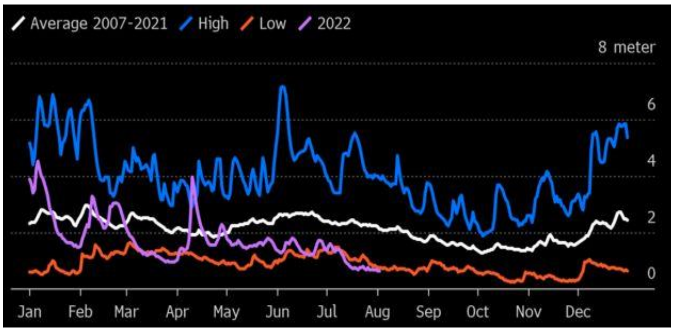
How low can you go?

I recently had the privilege of staying in a small Swiss village called Splügen. A tiny river runs through the town. Whilst pretty, it can be easily over-looked, were it not for the fact that it is actually the mighty Rhine River, close to its source. That called to mind the current low levels of the Rhine River. You are surely aware by now that the Rhine is running at near-record low levels. This is presenting major transportation problems for businesses that rely on the river for vital transport and supply links, and yet another aspect of the problematic "supply chain" issues being experience around the world post-pandemic.

Chart 10 places the current low level into perspective. When presenting this chart on 3 August, Baader Bank commented as follows: "Water levels on the Rhine River are set to fall perilously close to the point at which it would effectively close, putting the trade of huge quantities of goods at risk as the continent seeks to stave off an economic crisis. The river at Kaub, Germany, a key waypoint for the shipment of commodities, is set to drop to 47cm by the weekend. That would take it to within 7cm of being all but impassable. Snaking roughly 1 288km from Switzerland to the North Sea, the Rhine is vital for deliveries and exports of heating oil, gasoline, coal and other commodities.

"On Tuesday, the water level at Kaub fell to its lowest since 2018, a year that saw widespread disruption for key industrial users. It's now a little over 60cm and is forecast to drop to 47cm on Saturday, according to the German Federal Waterways and Shipping Administration".

Chart 10: Rhine levels below 2018 heat wave



Source: Baader Bank/Bloomberg

Life in the US – not quite what it used to be!

New government data has found that Americans' life spans are getting shorter. Where life expectancy at birth was calculated at 79 in 2019, this dropped to 76.1 in 2021. According to data from the Center for Disease Control and Prevention (CDC), Covid was the main cause for about 50% of the decline between 2020 and 2021, and as much as 74% of the decline between 2019 and 2020.

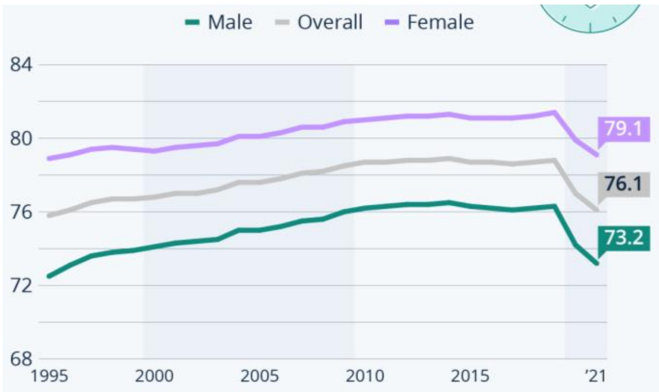
The new figure marks the lowest life expectancy estimates since 1996 and is the biggest two-year fall in nearly a century. As Chart 11 shows, the estimate today is significantly lower than the overall peak in 2014, when life expectancy at birth was 78.9 years.

While Covid is the main cause for the decline, it is not the sole reason. Unintentional injuries, which encapsulates those dying from overdoses and accidents, are on the rise in the US, reaching peaks in 2021 and making up 15.9% of the total decline. Heart disease, chronic liver disease and suicide also contributed to the decline.

When breaking down the data into sub-categories, further disparities become clear. Most notably, American Indian and Indigenous Alaskan people saw life expectancy rates fall from 71.8 years in 2019 to 65.2 years in 2021 – that's a decline of 6.6 years over a period of just two years. At the same time, Asian Americans' life expectancy fell by about two years, to hit 83.5 years.

Chart 11: US Life expectancy: lowest since 1996

Overall life expectancy at birth in years



Source: Statista

For the record

Table 1 lists the latest returns of the mutual and retirement funds under Maestro's care. Returns include income and are presented *after* fees have been charged. Fund Summaries for each respective fund listed in the table, as well as all the historic returns, are available on our website.

Table 1: The returns of funds in Maestro's care

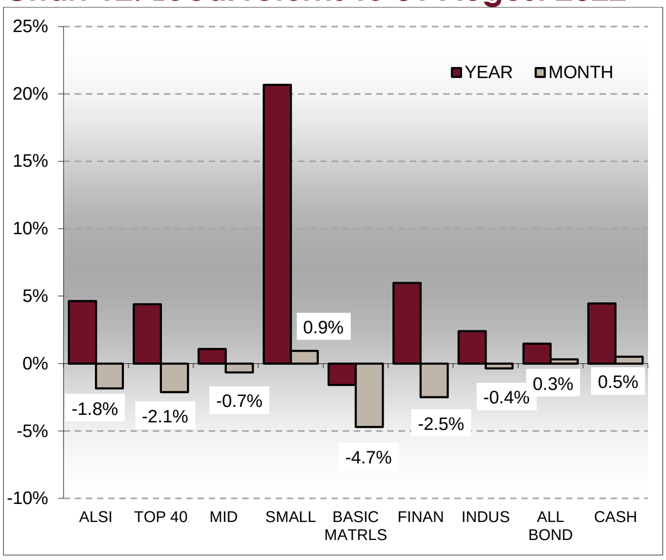
	Period ended	Month	Year to date	Year
Maestro Equity Prescient Fund	**Aug**	**-1.5%**	**-10.7%**	**-1.4%**
JSE All Share Index	*Aug*	*-1.8%*	*-6.2%*	*4.6%*
Morningstar sector ave	*Aug*	*-0.3%*	*-3.1%*	*4.5%*
Maestro Growth Fund	**Aug**	**-1.3%**	**-7.3%**	**-2.7%**
Fund Benchmark	*Aug*	*-1.2%*	*-4.4%*	*3.5%*
Morningstar sector ave	*Aug*	*0.0%*	*-3.7%*	*2.7%*
Maestro Balanced Fund	**Aug**	**-1.3%**	**-6.7%**	**-2.3%**
Fund Benchmark	*Aug*	*-1.0%*	*-3.5%*	*3.5%*
Morningstar sector ave	*Aug*	*0.1%*	*-3.1%*	*2.8%*
Maestro Global Balanced Fund	**Aug**	**-3.0%**	**-20.4%**	**-18.0%**
Benchmark	*Aug*	*-2.0%*	*-11.9%*	*-1.8%*
*Sector average **	*Aug*	*0.6%*	*-10.0%*	*-1.3%*

* Morningstar Global Multi Asset Flexible Category

August in perspective – local markets

Turning to the South Africa equity market, the All Share index lost 1.8% during August. The strong dollar saw the rand decline 2.3% on the month, while weak commodity prices were largely behind the 4.7% decline in the Basic Materials index. The Financial Index fell 2.5% and the Industrial index lost 0.4%. The All Bond index rose 0.3% despite the carnage across global bond markets. The relatively high yield on SA bonds continues to support their performance; the 0.8% year-to-date return of the All Bond index stands in strong contrast to the -15.6% year-to-date return of the Bloomberg Global Aggregate bond index.

Chart 12: Local returns to 31 August 2022



Despite markets having lost a fair amount of ground during the past year, we continue to believe we are currently in the midst of the storm. A great deal of uncertainty lies ahead and characterizes any reasonable attempt to see into the future, even just a few months ahead. That said, and notwithstanding the European crisis caused by Russia's invasion of Ukraine, the future levels of inflation and the action taken by global central banks to combat rising prices remains the key focal point of all investors. It is our humble view that stability – and hopefully some positive returns – will only return to global equity markets once there is concrete evidence of a sustainable decline in prices. Markets might start to recover when *the rate of price increases* starts to abate, but we would look to a *sustainable* abatement in the rate of price rises before declaring the "storm to be over". Given our current outlook, I don't believe we are close to that point yet. Having said that, equity markets have declined sharply already and a lot of pain is now "in the price". Markets are poised like a stretched elastic; any good news will be met with a sharp upward movement in markets, which will also be accompanied by a lot of market volatility.

Under these circumstances we continue to seek out and invest in companies that are likely to weather the current economic storm better than most. In this regard we were encouraged by the recent second quarter results. With a few exceptions, most companies met or exceeded expectations with regard to earnings growth, which should provide some comfort that we are at least invested in quality companies. Of course, even turkeys fly in a hurricane, meaning that when markets do surge, it is usually the lowest quality companies which rise the most. So we must temper expectations of a dramatic near-term recovery. As always our focus remains long-term and we will continue to invest in companies which are going to be around and maintain their market leadership for years to come.

So what's with the pics?

I have never been a great fan of the UK monarchy and I am conscious of the divided opinions of the UK held by various sections of the South African population. However, the sad passing of Queen Elizabeth, provides one with pomp and ceremony not seen for decades. One was also aware of how loved she was by the British people at large. Her life will surely stand as a hallmark of service, loyalty, decorum and sheer humanity. The world has lost one of its iconic and most respected leaders.

Add to that my fascination with state funerals (underwritten by four years in the Army Band, where I played at more military funerals I care to imagine) and I felt it fitting to include in this month's edition of Intermezzo, a selection of photos from the Queen's official funeral. They are all sourced from a greater selection, presented by the Daily Maverick.