

The Bear Trap?

The market bear has been stalking South African roads for much of the past decade and prices are uniformly depressed across the equity market, much in line with investor sentiment. So, is now the time to buy, or do investors run the risk of falling into a bear trap where prices remain low and future returns disappoint?

To explore this question and what it means for portfolios, let's start with a look across the pond to other equity markets to gauge how the JSE has fared.

Equity Markets	Local Currency	US\$ Currency	Dollar Impact
South Africa	10.3	4.0	-6.3
Germany	7.1	5.1	-2.0
France	9.8	7.8	-2.0
UK	5.5	3.7	-1.7
China	5.1	3.5	-1.6
Japan	9.4	5.5	-3.8
US	12.0	12.0	0.0

10-year annualized returns to 31.07.2023; Source: FE Analytics

Three things stand out here and are important to note:

1. South Africa has performed well for local investors, delivering a market return of 10.3% annually. This achievement stands 5% above inflation, and while slightly below the long-run historical average, it still contributes significantly to the accumulation of meaningful wealth.
2. Misery loves company. We are ahead of the UK and China, and not too far behind Japan and Germany when it comes to hard currency US\$ wealth creation. We are not alone in considering the home market bear trap.
3. The US is streets ahead, both due to its equity returns, as well as the impact of a strong US\$ currency. The strong dollar has cut returns in other markets by between 1.6% and 3.8% per year for a decade.

So perhaps this is more to this story than meets the eye. Let's take a look at what is driving the local equity opportunity so that we can better understand whether the bears have a case and to what extent SA could be a value trap.

Within SA Equity there are Rand hedge stocks

These are companies listed on the JSE; however, the majority of their earnings are generated offshore and are not reliant on the South African political or economic conditions. This makes up just over 50% of the market and includes businesses such as Naspers, Richemont, British American Tobacco, Anheuser Busch InBev, mining companies such as Anglo, Goldfields and BHP, as well as Sasol. In the case of the mining companies and Sasol, these businesses do have mines in SA which exposes them to SA domestic risk, however, the revenue is tied to commodity prices which are priced in US dollars, and which allows these businesses to do well when the Rand weakens. These businesses also have most of their mines outside of SA, barring a few counters such as the platinum, coal and iron ore miners.

The mining companies have performed well in absolute terms, but relative to global equities have underperformed as markets have been driven predominantly by large US-listed businesses such as Apple, Microsoft and Alphabet.

Naspers/Prosus is SA's technology investment as it holds a large stake in Tencent which is the largest Tech company in China. For a long time, this counter was driving the performance of the JSE until the Chinese government implemented strict regulatory action against the sector in 2021 which has caused this investment to underperform. Some of the other large Rand hedge stocks have also had company specific problems.

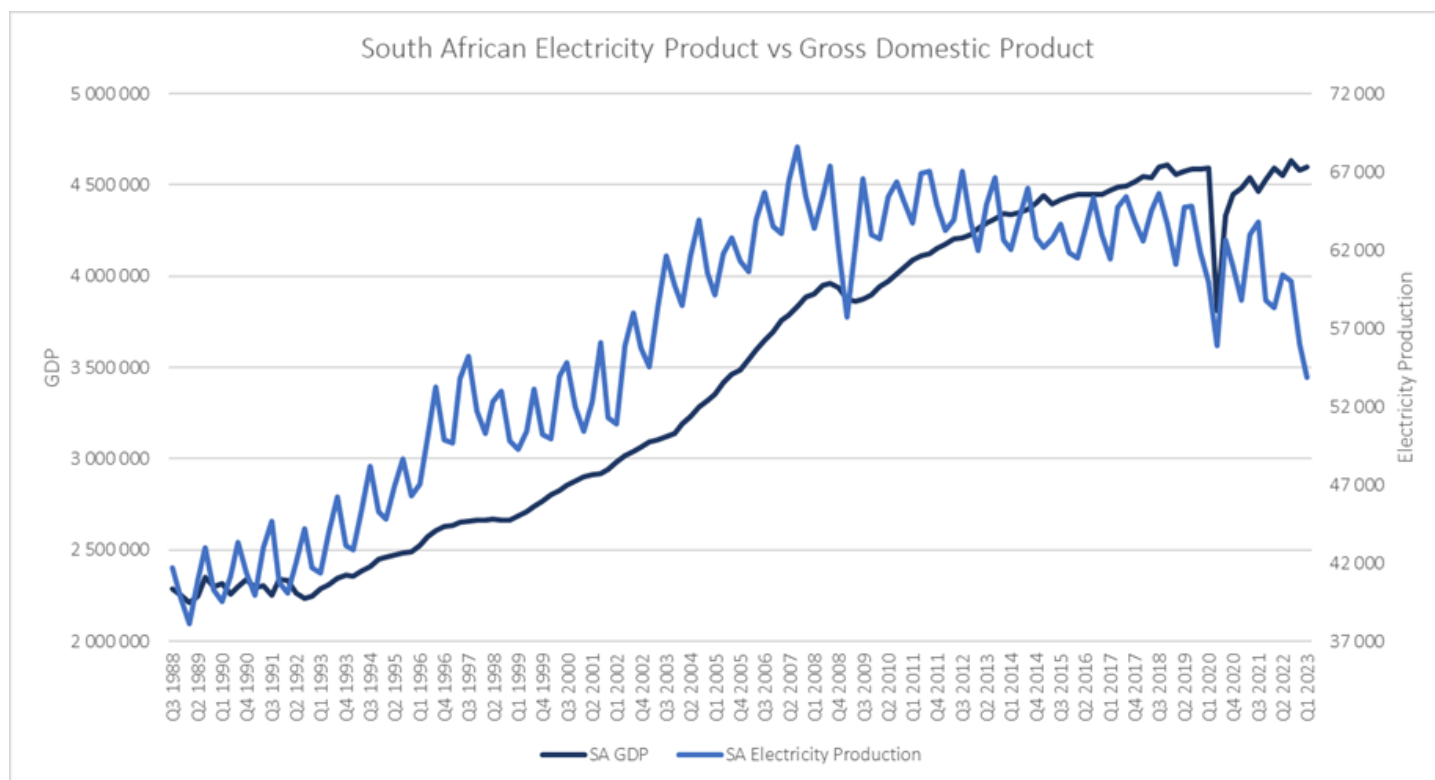
- AB InBev has seen a shift in consumption patterns away from beer and had too much debt from the acquisition of SA Breweries.
- Trading at an 8% dividend yield in Sterling, British American Tobacco is currently offering its most appealing dividend yield to date. This comes against the backdrop of reduced interest in the tobacco industry and regulatory uncertainties affecting its operations in the US.
- Sasol's share price has been adversely affected by a combination of factors, including a sharp decline in oil demand during the Covid-19 pandemic, challenges associated with the Lake Charles chemicals project in the US, and an excessive debt burden that raised the possibility of requiring additional funding from shareholders. Moreover, Sasol's significant contribution to emissions makes it a prominent target of environmental scrutiny, leading investors to exhibit caution and reluctance towards the stock due to pressing ESG (Environmental, Social, and Governance) concerns.

Although SA has good quality Rand hedge stocks listed on the JSE, most of these companies have been out of favour which has not assisted the JSE's performance.

There are many reasons for not investing in 'SA Inc' companies

SA Inc companies rely predominantly on South Africa and its surrounds for conducting their operations. These are businesses with limited (<10%) operations in other global economies.

First on the list of reasons to avoid SA is the severe load shedding which is increasing the cost of doing business in SA and is holding back economic growth. The chart below illustrates the level of electricity production compared to real GDP growth. It is evident that the economy has been negatively impacted by the decreased electricity supply, resulting in a drag on its performance. Added to this is the inability of Transnet to keep our rail infrastructure intact and move goods across the country.



Source: Refinitiv

The negative impact of these factors is coming through in company results where we have seen Arcelor Mittal go from making a net profit of R3 billion for the half year to June 2022, to a net loss of R450 million for the half year to June 2023. This caused its share price to drop from R3.50 to R2.00 on the day the trading update was released, a 43% loss. Manufacturing businesses rely on producing goods at optimal volumes to spread the high level of fixed costs across more units which lowers the cost per unit. The electricity supply disruptions introduce inefficiencies in manufacturing which increases the cost of production. This eventually must be passed onto consumers which has a knock-on impact on inflation. Although much effort is being put into improving the supply of electricity, we are unlikely to see significant improvement before the end of 2024.

Pick n Pay has also recently released their financial results for the year end 26 February 2023, and it makes for sombre reading. Profit before tax grew 7% from 2022 to 2023, which seems reasonable, but inflation was higher than the earnings growth so in real terms the business went backwards. The 7% growth was also quoted before factoring in R430m of additional costs incurred due to load shedding, which resulted in a reduction in profit of -15%.

Pick n Pay's management anticipates that the outcomes for 2024 are likely to resemble those of 2023, with a higher likelihood of being lower. This projection directly stems from the increased levels of load shedding, which has been ongoing since March 2023 and is projected to persist throughout 2024. The share price declined from R43 in May when the trading update was released and went as low as R31 by 1 June when the financial results were released.

We are also struggling with rail, roads, and port infrastructure. Transnet is in as bad shape as Eskom and has also underinvested in SA's logistical infrastructure network. The operational capacity of South Africa's rail infrastructure has been significantly compromised due to the widespread occurrence of cable theft and locomotive vandalism. As a result, mining companies, the one industry facing robust global demand, are confronted with substantial difficulties in efficiently exporting their minerals. Exxaro, a coal mining company, lost R5 billion of exports with 4 million tons of coal stockpiled at the mine due to Transnet inefficiencies. Chris Schutte, CEO of SA's largest chicken producer, Astral, said that 95% of Astral's raw materials used to be transported by Transnet. "It is now only 5%. We now do it by trucking at four times the cost."

Crime and corruption have moved from the public sector into broader society where we find “Construction Mafias” violently disrupting building sites and demanding protection money. Violent protests and looting took place when Jacob Zuma was arrested in July 2021.

There is also an argument that SA Inc stocks are not giving you sufficient return compared to SA government bonds. The earnings yield is the current profit divided by the share price and is a proxy for the expected return from stocks. The small difference in the earnings yield compared to the government bond yield indicates that SA Inc should be cheaper as the extra return you get from stocks is not enough relative to SA bonds.

We have also had steep interest rate hikes by the SA Reserve Bank to bring down inflation, which in the past has led to recessions. With the lack of electricity, it is likely that SA will be in recession in 2023 or 2024, which normally reduces company profits and could lead to further stock market weakness.

Besides this, we have seen the ANC-led government score several own goals on the political front with an increasingly close relationship with Russia. This could lead to SA being ousted from the AGOA free trade agreement with the USA. There is also a national election in 2024, which potentially has the ANC losing its majority position and needing coalition partners to govern SA. Heightened political uncertainty, poor economic growth and poor economic policy with large social imbalances and risk of violent protest action are more than enough reasons to be bearish on SA Inc stocks.

These problems make it difficult for the economy to recover, which will constrain business activity and make it difficult for SA Inc businesses to grow their earnings. This is the classic value trap, where an investment which looks cheap sees its intrinsic value diminish over time as it is unable to grow.

What would the optimists say?

Operation Vulindlela is focused on accelerating the implementation of 35 priority reforms to turn the economy around. These reforms are targeted at alleviating the problems at Eskom and Transnet, enhancing water supply and quality, and refining both the cost-effectiveness and quality of communication. There is also a drive to attract skilled immigrants by making it easier for them to obtain work permits. Private sector investment is being encouraged in electricity generation and the operation of rail and port infrastructure. There is also a drive to support the hemp industry as a new sector targeted at clothing manufacturing which is better for the environment. At the end of Q1 2023, eleven reforms have been completed, with a further 14 reforms on track with good progress for completion by the end of Q1 2024. 6 reforms face significant challenges, and 1 remains critical and unlikely to be achieved (the EAF, or energy availability factor, rising to >70%).

We have seen Transnet start a rail leasing company with a request for proposal (RFP) issued for a private sector partner. By the end of October 2023, it plans to create an infrastructure manager to allow private companies to run trains on key freight tracks. Transnet also announced that an international terminal operator, International Container Terminal Services Inc, has entered into a 25-year partnership to run and expand the Durban container terminal.

Tax incentives have been created to encourage rooftop solar installations. Imports of solar panels hit an all-time high in the first quarter of this year. R3.6 billion worth of solar panels were imported into South Africa in Q1 2023 which was three times as much as the previous quarter and more than half of what was imported in the whole of 2022. Eskom estimates that 4.4MW of new solar installations have been added in the 12 months to 30 June 2023.

There are also good checks and balances that have held firm and protected SA's constitution and democracy. This includes the media, which, despite enduring vigorous attacks, has predominantly retained its freedom to operate and to unveil news stories that played a pivotal role in exposing the extensive corruption spanning across both public and private sectors. The judiciary's substantial independence has effectively thwarted numerous attempts to undermine the Constitution through various attacks. We have also seen a drive to fix the National Prosecuting Authority (NPA) and rebuild the Hawks (the special investigating arm of the police). Progress has been slow, but it is moving in the right direction.

The election results of 2024 could potentially result in the ANC losing its majority. This shift could heighten risks but, paradoxically,

might also usher in a more balanced political landscape. This could prompt politicians to recognise that future election success hinges on prioritizing service delivery and job creation.

We have seen businesses getting more vocal about government failings and are actively getting involved with the government to address the major issues as outlined above. There appears to be a change in attitude by the government from being antagonistic towards business to a realization that the private sector is needed to resolve the ills of the country.

A strong, vibrant democracy with independent and free media and a movement towards privatization of state-owned entities that are not performing, is the silver lining in the cloud of darkness blanketing SA.

What are fund managers doing?

Although SA Inc stocks are trading at low prices, the market still appears to have underestimated the impact of load shedding on share prices. There are not many businesses in SA which remain unaffected by these issues. Nevertheless, we have seen fund managers gravitate to banks (Absa and Standard Bank) and insurance companies (Momentum and Discovery) where the impact of load shedding is less and the cost to mitigate against load shedding is lower.

Some fund managers are investing in retailers (Pepkor) that cater to lower-income consumers as the poor economic environment causes consumers to trade down to more cost-effective retailers. The other way SA fund managers are taking advantage of the lower prices is to invest in industrial businesses (e.g. Omnia) which have decent sized offshore business exposure but have been priced as SA-reliant businesses. Other businesses include beneficiaries of load shedding as they supply solutions to load shedding (Reunert) and to a certain extent food franchisors (Famous Brands and Spur) who are seeing an increase in business volumes as consumers are forced to buy food rather than cook when there is no power.

The South African listed equity market has undergone a reduction in size, leaving approximately 100 sizable businesses that qualify as investable options for a majority of mid to large fund managers. As a result, fund managers are actively exploring the opportunity to maximize their offshore allocation allowances, aiming to achieve greater portfolio diversification.

Overall, fund managers are circumspect and looking for lower-risk ways to get exposure to the attractively priced SA equity market. They are cognisant of the value trap risks and are positioning their portfolios to benefit from an improvement in SA, but at the same time are not too exposed should the situation deteriorate. SA equity is still investable but there are smart ways to get exposure without taking undue risk.

Considering the broad discount which other global markets are trading at relative to the US, as well as the strong US dollar, there may also be future tailwinds for local equities should the US weaken relative to other markets.

MARKET REPORT

31/07/2023

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	1.3%	10.1%	19.3%	16.7%	10.5%	10.3%	16.9%	14.0%
FTSE/JSE SA Listed Property	ZAR	-2.3%	-2.2%	3.4%	13.4%	-3.0%	2.1%	26.9%	21.4%
SA All Bond Index (ALBI)	ZAR	1.9%	4.2%	8.1%	8.2%	7.4%	7.7%	8.4%	8.1%
SA Cash Index (SteFI)	ZAR	2.0%	4.4%	7.1%	5.1%	5.8%	6.3%	0.4%	0.4%
Balanced Benchmark	ZAR	1.5%	9.8%	15.3%	12.5%	9.8%	10.0%	11.6%	9.5%
SA Inflation (1 month lag)	ZAR	0.7%	2.8%	5.4%	6.1%	4.9%	5.2%	1.4%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	8.7%	19.3%	14.1%	12.2%	9.7%	9.9%	18.3%	14.6%
Emerging Markets Equity (Datastream EM)	USD	8.6%	11.7%	8.8%	1.9%	2.1%	3.9%	19.0%	17.0%
Global Property	USD	1.3%	4.0%	-9.6%	3.3%	2.5%	4.9%	19.5%	16.1%
Global Bonds (Barclays Global Bond Index)	USD	-1.3%	2.1%	-2.7%	-5.7%	-0.9%	0.1%	8.6%	7.3%
Global Cash	USD	1.4%	3.1%	4.8%	1.9%	1.9%	1.4%	0.5%	0.4%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	1.3%	10.1%	19.3%	16.7%	10.5%	10.3%	16.9%	14.0%
Global Equity (Datastream World)	ZAR	5.7%	24.7%	21.8%	13.8%	16.6%	16.5%	16.8%	15.1%
Emerging Markets Equity (Datastream EM)	ZAR	5.6%	16.8%	16.2%	3.3%	8.5%	10.1%	14.1%	13.2%
Global Property	ZAR	-1.5%	8.7%	-3.5%	4.8%	9.0%	11.2%	19.1%	17.3%
SA All Bond Index (ALBI)	ZAR	1.9%	4.2%	8.1%	8.2%	7.4%	7.7%	8.4%	8.1%
Global Bonds (Barclays Global Bond Index)	ZAR	-4.0%	6.7%	3.9%	-4.4%	5.3%	6.2%	15.2%	13.7%
COMMODITIES									
Gold (US Dollars)	USD	-1.1%	8.4%	11.6%	-0.1%	10.0%	4.2%	13.9%	13.9%
Gold (Rands)	ZAR	-3.8%	13.3%	19.1%	1.3%	16.9%	10.4%		
CURRENCIES									
Rand / Dollar	ZAR	2.7%	-4.5%	-6.7%	-1.5%	-6.3%	-6.0%	16.1%	15.0%
Rand / GBP Pound	ZAR	0.4%	-11.8%	-12.9%	-0.8%	-5.9%	-4.3%	13.9%	14.7%
Rand / Euro	ZAR	2.9%	-8.0%	-15.4%	0.9%	-5.1%	-4.1%	13.7%	13.2%
Spot Rates									
		31-Jul-23	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago		
CURRENCIES									
Rand/US\$	Rand	17.8	18.9	16.7	13.2	9.8	7.4		
Rand/GBP	Rand	22.9	24.0	20.3	17.3	15.1	11.9		
Rand/EUR	Rand	19.6	20.6	17.0	15.4	13.0	8.3		
RATES									
Libor 6m \$	US\$	5.9	5.8	3.3	2.5	0.4	1.1		
Repo Rate	Rand	8.25	8.25	5.50	6.50	5.00	12.00		
Prime	Rand	11.75	11.75	9.00	10.00	8.50	17.00		
All Bond Index Yield	Rand	10.3	10.5	11.6	9.2	8.2	9.7		
COMMODITIES									
Gold (\$/oz)	US\$	1 968.4	1 916.0	1 764.2	1 224.3	1 329.7	354.7		
Platinum	US\$	949.0	897.0	889.0	826.0	1 436.0	684.0		
Oil (Brent Crude) \$	US\$	85.6	74.5	110.1	75.0	108.5	28.6		
INFLATION									
SA Inflation	%	5.4	6.3	7.8	5.2	6.3	9.4		

data provided by FE Analytics

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