Bateleur Flexible Prescient Fund

First quarter 2022 commentary

bateleur capital

Bateleur Flexible Prescient Fund – 2022 first quarter report back to unitholders

The fund was marginally negative over the first quarter (-0.9%). Over the same period, the JSE All Share Index appreciated 3.8% (including dividends reinvested), SA bonds (ALBI) gained 1.9% and cash (STeFI) returned 0.9%.

Attribution by strategy and the top contributors and detractors are shown in table 1. SA listed equities contributed 3.0%, while foreign listed equities detracted 3.3% when measured in Rands.

The top individual contributors were diversified miners African Rainbow Minerals and Anglo American; and financials – FirstRand and RMI. Detractors were Naspers/Prosus and select foreign equities.

Table 1 – Fund attribution by strategy and top individual contributors and detractors

Attribution by strategy	Q1 2022	Top contributors	Top detractors
JSE listed equities	3.0%	African Rainbow Minerals	Naspers/Prosus
Foreign listed equities	-3.3%	FirstRand	Sony
SA bonds	0.1%	Anglo American	Dollar General
Costs (and other)	-0.7%	RMI	Amazon
Total	-0.9%		

Three months into the year is too short a period to draw any relevant conclusions in terms of absolute or relative performance of the fund. However, we would make the following observations:

1. The relative stability of the fund masks the negative performance of global risk assets.

The MSCI world equity index declined 5.5% in US Dollars ('USD') over the first quarter, while the Nasdaq fell 9.1% after being down as much as 17.9% during February (chart 1). Developed market bonds also suffered a major sell-off with the FTSE world government bond index and US government bond index down 6.5% and 5.6% respectively (chart 2).

Chart 1: Global equity indices Q1 22 returns (USD)

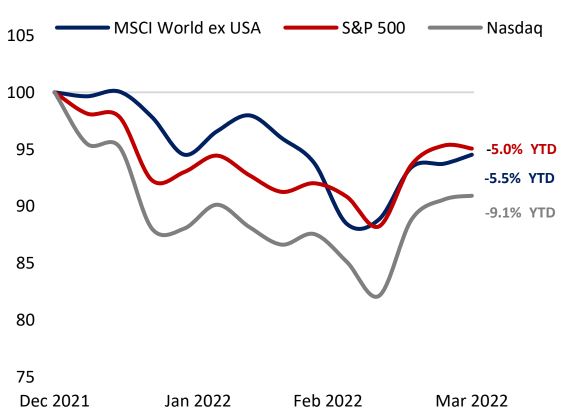
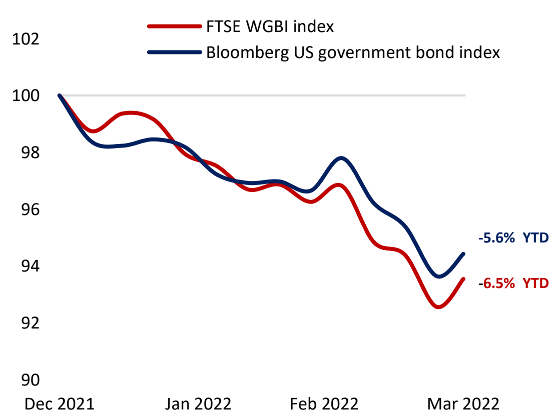


Chart 2: Global bond indices Q1 22 returns (USD)



Source: Bateleur Capital, Bloomberg

2. SA capital markets were substantial outperformers in the first quarter, with the country increasingly viewed as a relative 'haven' in emerging markets.

The buoyancy in commodity prices has continued to benefit SA's fiscal position from increased mining royalties and tax receipts (chart 3). More recently, the Russia/Ukraine conflict and comprehensive Russian sanctions have further tightened commodity markets to SA's advantage. Russia is a major global supplier of diamonds, PGM's, gas, oil, gold, wheat, nickel, aluminium, coal and copper (chart 4).

Chart 3: Improved SA tax collections (Rbn)

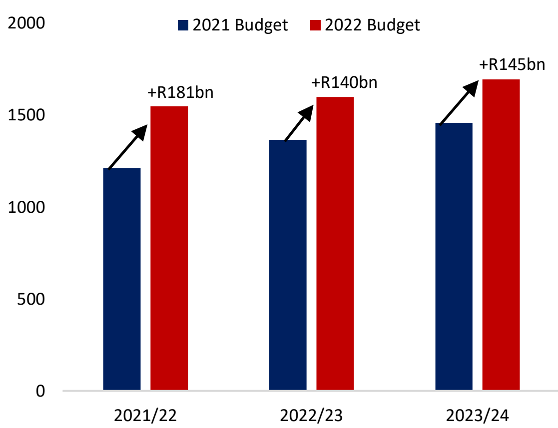
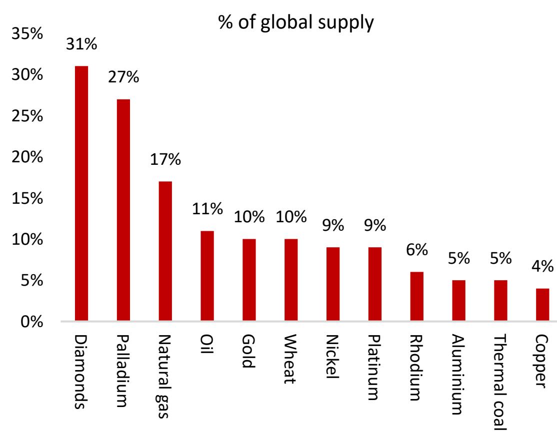


Chart 4: Russia is a large commodity exporter



Source: Bateleur Capital, Bloomberg, SA Treasury, JP Morgan

Russian equities had a weight of approximately 4% in the MSCI emerging market index at the beginning of 2022. With the collapse of Russian equity prices and MSCI recently excluding Russia from the index, this has declined to zero.

Chinese equities, the largest weighting in the MSCI emerging market index at 30%, have also fared poorly with investors concerned over Chinese growth expectations and Beijing's 'common prosperity' directive.

SA (along with Brazil) has by default found itself in the position of being one of the least 'ugly ducklings' in the emerging markets universe. This is evidenced in SA enjoying USD 2bn in net inflows from foreign investors YTD – the first net inflows for several years (chart 5).

The strong commodity influence in the SA equity market and improving domestic earnings outlook has led to SA equities outperforming the MSCI world equity index by 17.0% over the first quarter when measured in USD (chart 6).

Chart 5: Foreign flows into SA equities

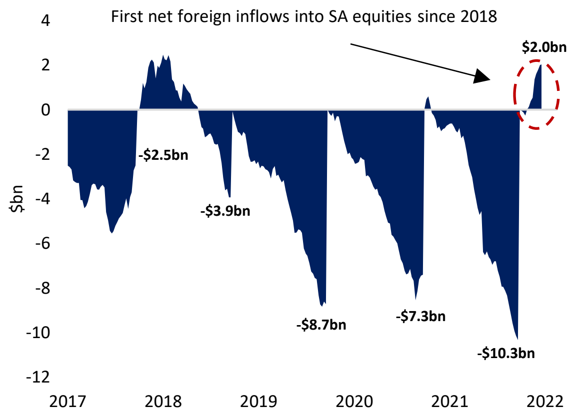
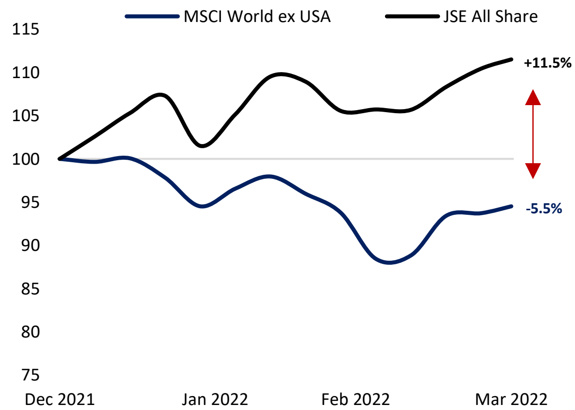


Chart 6: SA outperforming global equities (USD)



Source: Bateleur Capital, Bloomberg

3. Global inflation remaining elevated means a quicker US rate tightening cycle now expected.

It is well documented that strong global demand combined with supply chain bottlenecks and surging commodity and other input prices - has led to inflation running well ahead of expectations. The March CPI inflation reading in the US of 8.5% was the highest in forty years while inflation data from the US going back to 1800 clearly highlights how inflationary wars are (chart 7).

The US Federal Reserve is behind the curve in raising rates and will need to move faster to address rampant inflation. Market consensus has recently adjusted to reflect this and is now pricing in the quickest US rate hiking cycle in decades (chart 8) - with 225bp of rate hikes expected over the remainder of this year. ***Historically, fast rate hiking cycles are negative for equity markets***.

Chart 7: Wars are inflationary (CPI %)

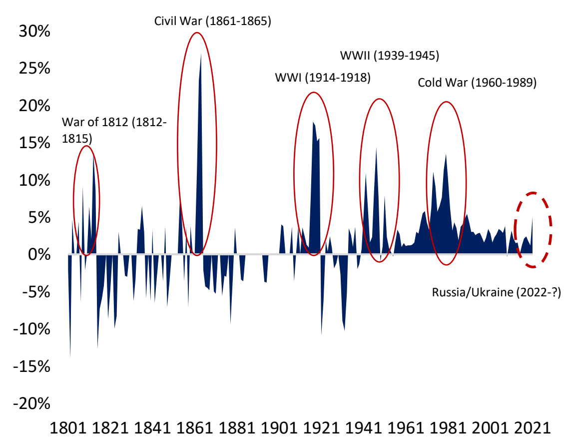
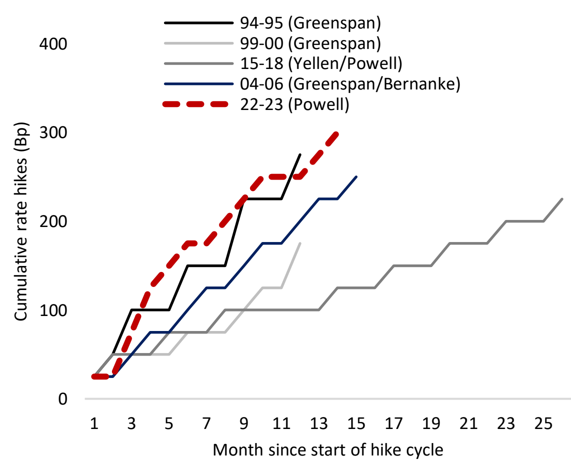


Chart 8: Current rate hike cycle - fastest since '94



Source: Bateleur Capital, Bloomberg, Philadelphia Fed

4. US corporate margins and earnings forecasts are still too high.

Bloomberg consensus expectations are still pricing in earnings per share (‘EPS’) growth of 8%, 10% and 11% for the S&P 500 over the next three years respectively. Given the already high base, input cost pressures and rising interest rates, this appears optimistic. ***Leading indicators already point to a substantial slowdown in earnings growth (chart 9) – a negative readthrough for equity markets.***

30-year mortgage rates in the US recently spiked to 5% from just over 3% at the start of the year (chart 10). This will lead to homeowners having to spend more money to service their mortgage bond, and by implication, they will have less available to spend on other goods and services. The increase in mortgage rates, if sustained, will inevitably lead to a slowdown in new home builds and lower economic activity.

Chart 9: Lead indicators point to slowing earnings

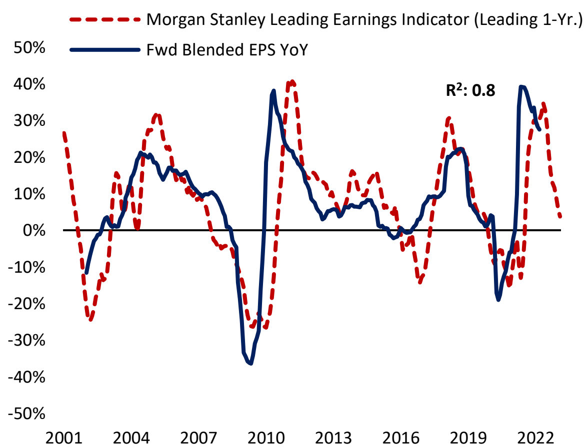
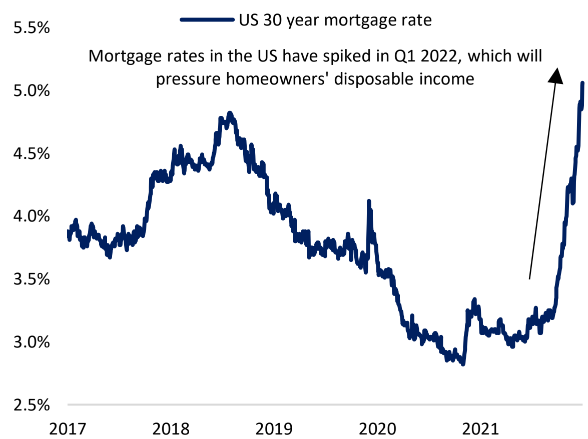


Chart 10: US 30-year mortgage rate (%)



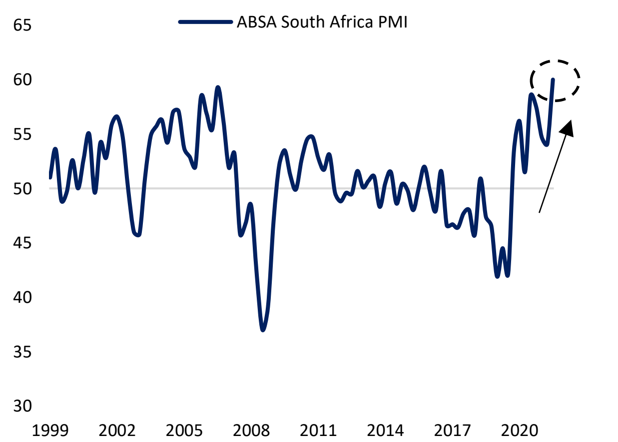
Source: Bateleur Capital, Bloomberg, Morgan Stanley

5. SA seeing positive earnings revisions and improving manufacturing activity.

SA corporates are experiencing positive earnings revisions (chart 11) across a broad array of sectors including resources, banks and general industrials. The traditional ‘big four’ banks have all commented on improving business conditions in their most recent results and are starting to extend credit at an increased rate. The ABSA purchasers managers index (‘PMI’) – a measure of the health of the manufacturing sector – recently hit a fresh high, a positive readthrough for GDP growth (chart 12).

Chart 11: SA equities seeing EPS upgrades

Chart 12: Record high ABSA PMI reading in March



Source: Bateleur Capital, Bloomberg, Morgan Stanley

6. Foreign equity valuations de-rated but still high; SA equity valuations screen well vs. history.

Although the forward P/E multiple of the S&P 500 has declined from above 25.0 times to 19.8 times (driven by a combination of earnings growth and price declines) it is still above the long-term average (16.7 times) and remains vulnerable – especially into a rising interest rate environment. Excluding the US, world equity markets have de-rated to 13.4 times and are back to trend valuations (chart 13).

The JSE All Share forward P/E multiple of 10.3 times is still at a discount to its own history of 13.1 times and the MSCI emerging markets index of 11.3 times (chart 14). Emerging markets have de-rated considerably on negative price movements in Chinese and other Asian equity markets.

Chart 13: Developed market multiples contracting

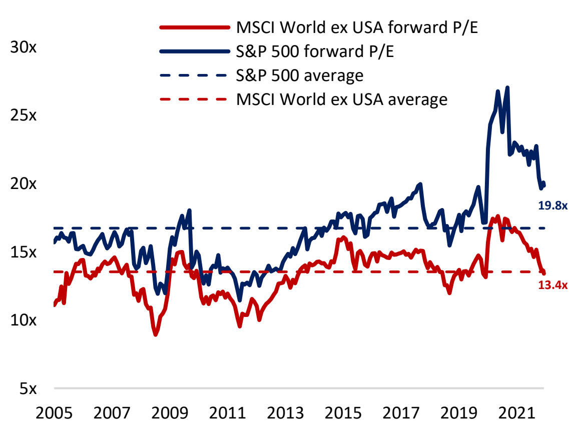
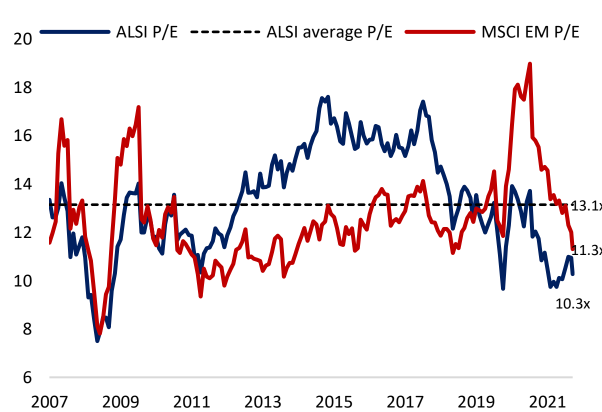


Chart 14: SA equity multiples remain cheap



Source: Bateleur Capital, Bloomberg

Current fund positioning

The observations highlighted above anecdotally reinforce our conservative fund stance and cautious outlook for global capital markets in 2022 - that was detailed in our January report back.

Viewed collectively, the latest data paints a more negative picture for global equities and bonds than at the start of the year (higher inflation, slower growth, still high valuations) and a more positive picture for SA equities (firm commodity prices, strong PMI readings and positive earnings revisions).

The fund's offshore allocation at quarter end was 24.3% (all in individual equities) - well below the recently increased maximum allowed allocation of 45.0%. We do not envision the offshore allocation increasing in the short-term unless there is a further de-rating of global equites.

Over the longer-term we expect the global equity allocation to increase from the current level given the wider investment opportunity set available and the diversification benefits that offshore offers.

During the review period the fund exited holdings in Nestle and Procter & Gamble on valuation grounds. Weightings were increased in Visa and Universal Music following strong results and subdued price action; and decreased in Lundin Energy as the share traded above our estimate of fair value.

The composition of foreign equities includes a mix of defensive companies (Dollar General, Merck, Johnson & Johnson, Philip Morris and Swedish Match) and those with pricing power, wide moats and good long-term prospects (Universal Music, Amazon, Alphabet and Visa).

The fund has no foreign bond or property holdings and negligible foreign cash as these asset classes remain unattractive on a risk/return basis.

The fund's JSE listed equity exposure at period end was 56.8%. During the first quarter, new equity positions were initiated in AVI and Newgold. Weightings were increased in British American Tobacco ('BAT') and Spar; and reduced in BHP.

The composition of JSE listed equities include a mix of diversified miners (Anglo American, African Rainbow Minerals), select financials (banks, RMI), defensives (AVI, Spar and BAT), and domestic stock specific mid capitalisation counters (Adcock Ingram, AECI and Italtile).

Naspers was the largest individual detractor to fund performance over the review period and continues to underperform its largest investment - Tencent. This again calls into question the convoluted crossholding structure put into place by the Naspers/Prosus board a year ago that was balked at by the investment community. The company is expected to face a barrage of questioning from investors (including us) when they release their year-end results at the end of June.

We remain constructive on the investment case for Tencent as the group enters a period of more sustainable profit growth in its core businesses of gaming, platform advertising, fintech and cloud. The company has recently scaled back on an expensive land grab strategy across a myriad of new technology industries - which is positive for margin expansion and group profitability.

We estimate that Tencent trades on a December 2022 forward P/E multiple of 17 times excluding portfolio investments – a sizable discount to its long-term average in excess of 30 times.

Naspers current discount to Tencent is 55% (an all-time high) while its March 2023 estimated forward P/E is a lowly 8.3 times. The substantial discount combined with our positive investment thesis on Tencent - explains why the fund continues to hold an investment in Naspers.

The fund positioning by strategy at quarter end is depicted below.

Fund positioning by strategy - 31 March 2022	**%**
JSE listed equities	56.8%
Domestic facing holdings	32.6%
Dual listed/Rand hedge	24.2%
Foreign listed equities	24.3%
Total equity exposure	**81.1%**
SA government bond (SAGB 2030)	9.9%
Cash & money market	9.0%
Total	**100.0%**

Sincerely

Kevin Williams

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