Bateleur Flexible Prescient Fund

First half 2024 commentary

bateleur capital

Bateleur Flexible Prescient Fund – 2024 first half report back to unitholders

The fund appreciated 7.0% net of fees over the first half of 2024[i]. As comparatives, the JSE All Share Index rose 5.8%, a basket of SA government bonds (ALBI) gained 5.6%, while cash (STeFI) returned 4.0%.

Attribution by strategy and the top contributors and detractors for the period are displayed in Table 1. Foreign listed equities added 4.1% to returns, JSE listed equities 2.8%, and government bonds 0.4%.

Table 1: First half 2024 - Fund attribution by strategy and top contributors and detractors

Strategy	Return (%)	Top contributors	%	Top detractors	%
Foreign listed equities	4.1%	TSMC	1.1%	Remgro	-0.5%
JSE listed equities	2.8%	Amazon	1.0%	Vinci	-0.3%
SA Government bonds	0.3%	African Rainbow Minerals (ARI)	0.8%	Glencore	-0.2%
US 2YR T.Bills	0.1%	Naspers/Prosus	0.7%	Aker BP	-0.2%
Costs (and other)	-0.3%	Alphabet (Google)	0.6%	Mpact	-0.2%
Total	7.0%	ASML	0.6%	Heineken	-0.1%

Source: Bateleur

The fund continued to benefit from its offshore technology holdings - especially in the semiconductor sector, with the share prices of TSMC (+67% in USD) and ASML (+37% in USD) appreciating meaningfully.

Both companies reported strong second quarter results, with TSMC upgrading its full year earnings and margin guidance on strong AI chip demand. ASML's healthy forward order book for its lithography machines is expected to translate into material earnings growth for the group in 2025.

Despite strong fundamentals, the share price of both TSMC and ASML have come under pressure post results on rising geopolitical concerns - specifically around the US attempting to enforce a tighter ban on the export of advanced chip and chipmaking equipment into China. No changes have been made to the fund's semiconductor holdings at this stage.

JSE listed equities (ALSI +4.1%) and SA government bonds (ALBI +5.2%) staged a strong rebound in June off a depressed base - following the market friendly election outcome and formation of Government of National Unity (GNU). The fund's domestic equity holdings also benefited from the election catalyst, with solid gains registered by FirstRand, Standard Bank, Shoprite and Bidvest.

Detractors over the review period were limited, with only Remgro and Vinci negatively impacting the fund by more than 0.2% individually.

The investment case for Remgro has been comprehensively detailed in prior report backs. Encouragingly, there have been recent tentative steps towards tidying up the group's investment portfolio. These include: 1) the sale of its Momentum Metropolitan stake for R2.7bn, 2) the simplification of its RCL Foods investment via the unbundling and separate listing of Rainbow Chicken, and 3) the appointment of Carel Vosloo as head of investments and an alternative director to current CEO, Jannie Durand.

We are cautiously optimistic that Vosloo's appointment will bring a fresh perspective to Remgro's portfolio management and capital allocation strategies. With the company trading at a large (c.45%) discount to intrinsic NAV, there remains scope for substantial value unlock.

Vinci's share price declined sharply during the second quarter – largely attributed to the announcement of a snap election in France and the potential risk of France's far right RN party winning an outright majority in parliament. This risk appears to have dissipated post elections with the RN party underperforming, and no party securing an outright majority.

Vinci remains a high-quality concessions operator that should continue to deliver consistent earnings growth over the medium-term. The share is attractively valued, trading on a one year forward P/E multiple of 11.8 times and a dividend yield of 4.8%.

Outlook and current fund positioning:

Recent economic data points to a notable cooling of the US economy and a further decline in inflation. This is evidenced in slowing payroll additions and an uptick in unemployment (chart 1), while nominal wage growth is easing from 2022 highs (chart 2).

Chart 1: US Payroll gains and unemployment rate

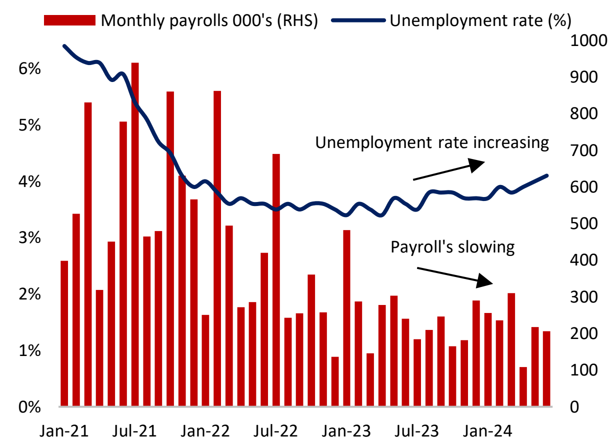
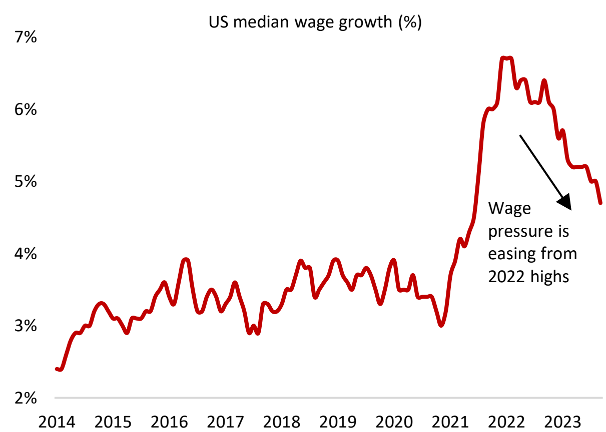


Chart 2: US nominal wage growth easing



Source: Bateleur, Bloomberg, Factset

Moderating economic growth and declining inflation paves the way for interest rate cuts to commence from September (chart 3 overleaf).

Bloomberg consensus forecasts are for the US Federal Reserve (Fed) to cut seven times (25bp each) over the next eighteen months, or a cumulative 175bp – providing a favourable backdrop for government bonds as well as equities that benefit from a low-rate environment (cyclicals and companies linked to the US economy).

There has already been some rotation out of the winning technology sector into the more neglected areas of the market. This is reflected in the recent outperformance of the Russell 2000 (index of smaller US companies) relative to the Nasdaq (chart 4 overleaf). Despite the recent gains of the Russell 2000, the long-term trend of Nasdaq outperformance remains intact.

Chart 3: US PCE inflation vs Fed funds rate (%)

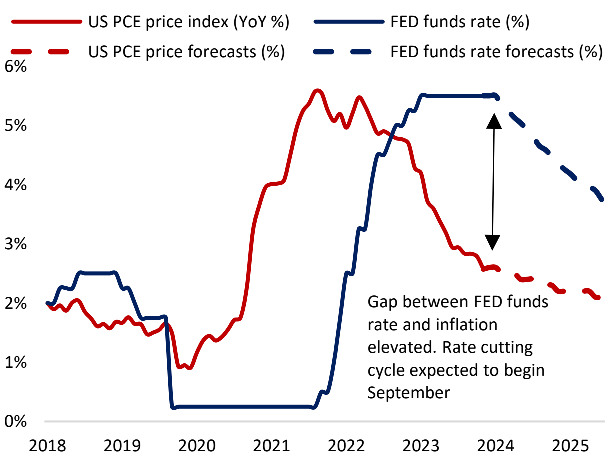
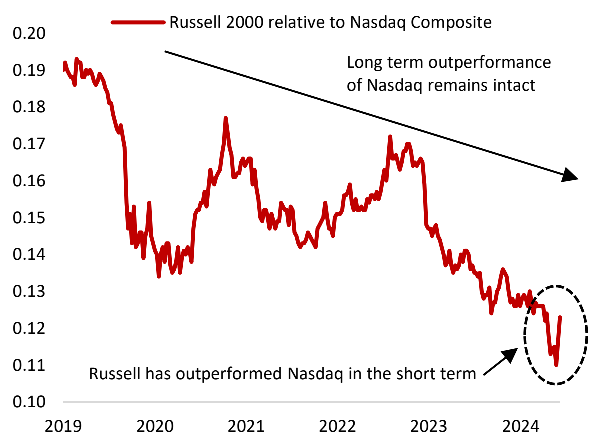


Chart 4: Russell 2000 recently outperformed Nasdaq



Source: Bateleur, Bloomberg, Factset

The fund's foreign equity portfolio comprises a balanced mix of quality growth and defensive companies, many of which are industry leaders.

On the growth side, these include Alphabet, Amazon, ASML, Microsoft, Novo Nordisk, TSMC, and Visa.

The quality defensive group includes Amgen, Heineken, J&J, Merck, Philip Morris, and Vinci.

We do not anticipate a material rotation out of the current portfolio into cyclical's based solely on a declining interest rate outlook. Cyclical additions will only be considered if the company investment case stacks up on fundamentals, and the valuation is compelling.

Although global equity returns have been dominated by the outperformance of large cap technology companies (Mag 7*) over the past five years (chart 5), this has been justified on the superior earnings growth from this segment (chart 6). Forward earnings growth estimates for the select technology group are still forecast to exceed the rest of the market through 2025, albeit at a narrower differential.

Chart 5: US equity returns dominated by Mag 7

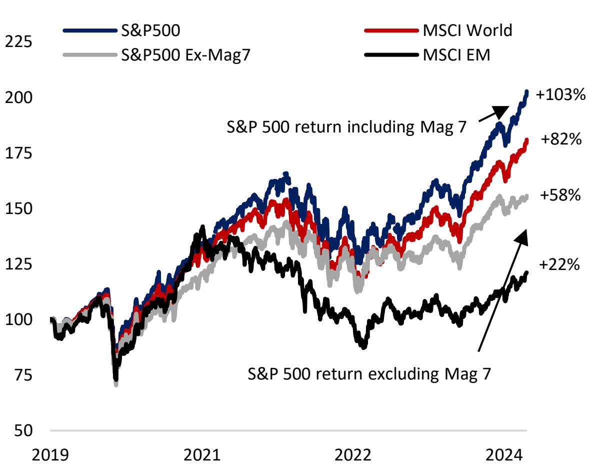
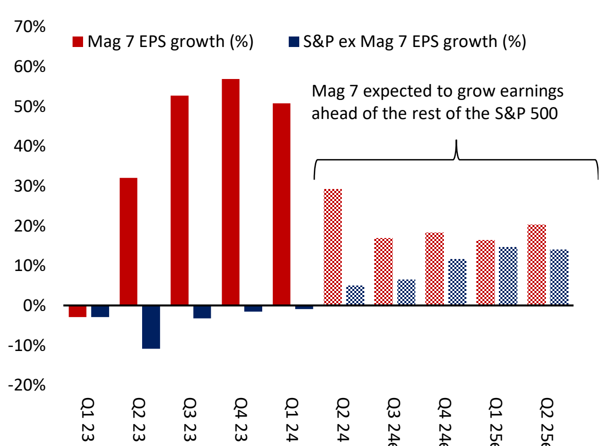


Chart 6: Mag 7 EPS growth superior to rest of S&P 500



Source: Bateleur, Bloomberg, Factset *Mag 7 refers to Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla

Turning to SA, the short-term outlook for domestic equities and government bonds has improved following: 1) the positive election outcome; 2) a tentative recovery in key state-owned enterprises (SOE's), notably Eskom; and 3) expectations for SA interest rate cuts to also commence from September.

With domestic fund manager weightings in SA equities at historically low levels (chart 7), and valuations cheap relative to history (chart 8) – this provides a favourable backdrop for an equity market re-rating.

Chart 7: SA managers allocation to domestic equities

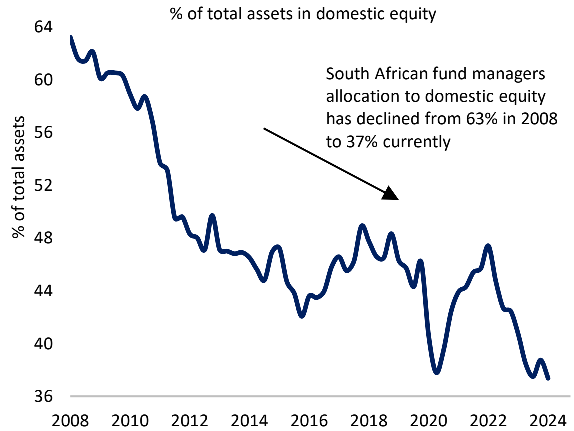
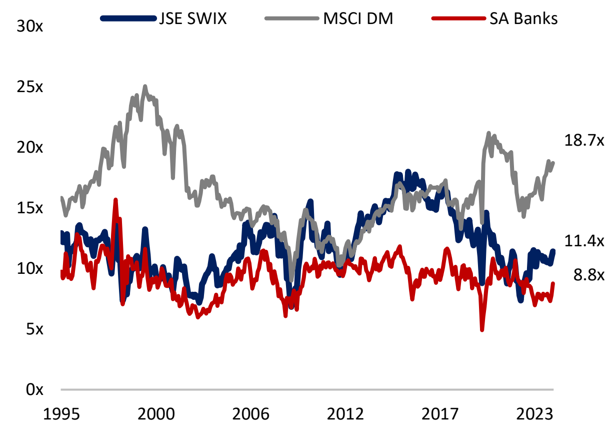


Chart 8: JSE is cheap vs. history and peers



Source: Bateleur, Bloomberg, Factset

During 2023, SA endured 335 days of loadshedding detracting 1.5% from GDP according to the SA Reserve Bank (SARB)*. At the time of writing there has been no loadshedding in SA for 121 consecutive days due to improved energy availability and fewer unplanned outages (chart 9). If these grid improvements are sustainable, there will be a sharp improvement in SA GDP growth in 2024/2025 merely from a non-repeat of 2023's loadshedding.

Changes implemented at Transnet under new leadership – that encompass a more constructive dialogue with business - are being reflected in improved commodity railage and better handling at the ports (chart 10). Increased exports of hard and soft commodities are clearly positive for SA's mining and agricultural industries. National Treasury estimates that an improvement in the functioning of the rail and ports off the current depressed base could add at least 0.3% to SA's annual GDP growth.

Chart 9: Eskom EAF and unplanned outages

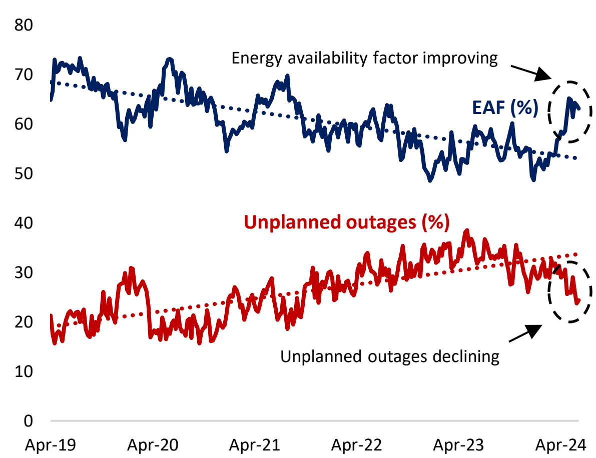
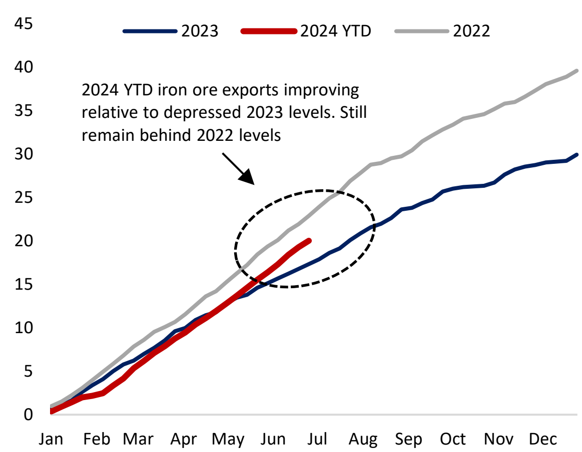


Chart 10: Cumulative SA iron ore exports (Mt)



Source: Bateleur, Bloomberg, RMB MS *SARB statement of the monetary policy committee – July 2024

The recent stability of the rand combined with declining inflation expectations provide a favourable environment for cutting interest rates. Bloomberg consensus is for the SA Reserve Bank to follow the US's lead and cut by 25bp at its next meeting in September. A cumulative 125bp in rate cuts is forecast by the end of 2025, taking the repo rate from the current 8.25% to 7.0%.

Lower interest rates reduce debt servicing costs, increase household consumption, and stimulate credit extension. Since 2009, private credit extension in SA has increased by only 5% a year, well below the 14% average growth preceding this period (chart 11).

The combination of these factors could result in SA GDP growth reaching 2.5% to 3.0% in 2025, well ahead of the 0.7% average since 2015 (chart 12), providing much needed impetus to corporate earnings growth.

Chart 11: SA private credit extension

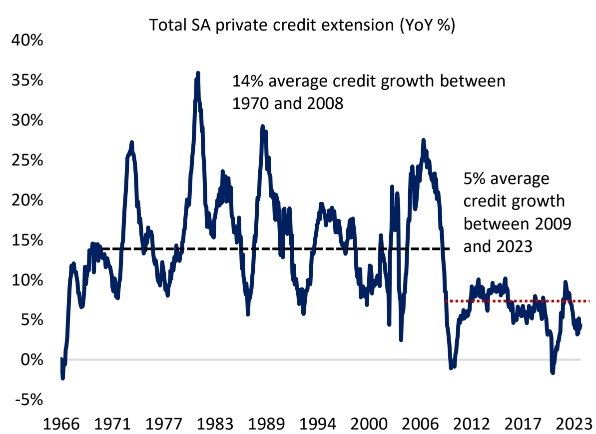
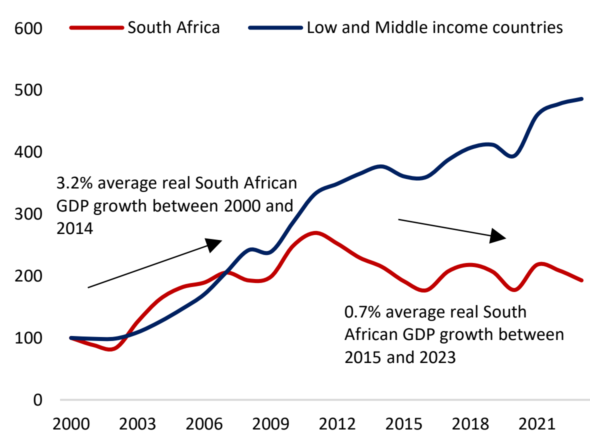


Chart 12: SA GDP per capita (indexed)



Source: Bateleur, Bloomberg, National Treasury

The positive short-term outlook led to the fund upweighting its exposure to both domestic equities and domestic bonds in June. Holdings were increased in FirstRand, Standard Bank, Shoprite, Remgro and Italtile, while a new investment in AVI was initiated.

Fixed income exposure was increased through the purchase of SA government bonds maturing in 2035.

The increased weightings in SA domestic equities and government bonds were funded from SA cash resources and not from the foreign listed portfolio. Allocation changes are summarised in Table 2.

Table 2: Fund allocation changes between Q1 and end Q2

	Q1 2024 allocation (%)	Current allocation (%)	Change	Commentary
Domestic Equities	38%	44%	↑	Increased exposure post positive election outcome - quality focus
Foreign Equities	37%	35%	↓	Reduced due to Rand strength and recent domestic equity outperformance
Total Equities	**75%**	**79%**	↑	
Cash	13%	8%	↓	Rotated out of cash into domestic government bonds & equities
Domestic government bonds	8%	10%	↑	Increased exposure - SA bonds attractive relative to cash
Offshore government bonds	4%	4%	→	Have maintained exposure to US short term government bonds
Total Cash & Fixed Income	**25%**	**21%**	↓	

Over the medium to long-term more concrete steps will be required for SA to achieve sustainable GDP growth of 3.0%. In a recent publication, The Bureau of Economic Research (BER) presented its glide path to 3.5% GDP growth by 2029 (chart 13). The report identified economic reform, private sector fixed investment, and improved sentiment that lifts consumer spending, as the required drivers.

At Bateleur, we have created our own growth flywheel for SA (chart 14). Once again, the start point is structural reform – which includes functioning government departments with effective leadership; a sustainable improvement in energy, ports and rail; improved dialogue between government and business; a reduction in bureaucratic red tape; a reduction in, and accountability for corruption; and sensible foreign policy.

Should these reforms materialise, we are certain it will lead to an improvement in business and consumer confidence - "the cheapest form of stimulus".

Increased confidence will, in turn, lead to increased investment (both public and private), which for a country like SA is the easiest way to bolster employment levels. Newly elected Public Works and Infrastructure Minister Dean Macpherson recently communicated "My number one priority is to invest in infrastructure and turn SA into a massive construction site under the theme LetsBuildSA."

Increased employment and wage growth would lead to a further increase in credit extension (both consumer and corporate) which has a multiplier effect on GDP growth – and so the flywheel continues.

Chart 13: BER glide path to 3.5% GDP growth

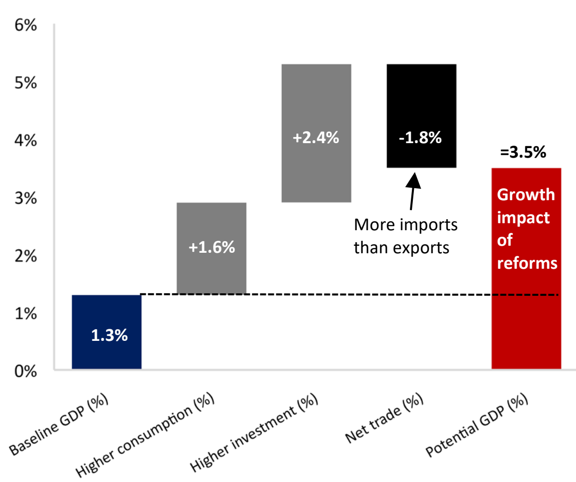
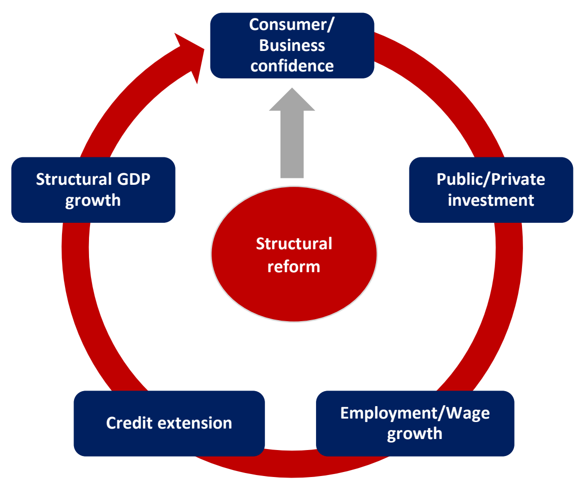


Chart 14: Bateleur flywheel to structural growth



Source: Bateleur, Bloomberg, BER – redefining South Africa's economic trajectory – June 2024

This is merely a hypothetical path to structural growth. Given past disappointments, which are numerous, SA remains a "show me" story. However, it does indicate the potential for outsized returns from SA public markets – should structural reform policies be successfully implemented.

Sincerely,

Kevin Williams
29 July 2024

[i] A1 Class Performance:
1 Year: Fund 14% |Benchmark 9.2%
10 Year : Fund 10.2% | Benchmark 9.0%
Highest rolling 1 year return 39.0%, Lowest rolling 1 year return -7.2%.

Bateleur Capital (Pty) Ltd

Authorised financial services provider
FSP no 18123
—
Block H, The Terraces
Steenberg Business Park
Westlake
7945
—
T +27 (0)21 681 5060
F +27 86 649 1794
—
E funds@bateleurcapital.com
W bateleurcapital.com