# Bateleur Equity Prescient Fund

Third quarter 2022 commentary

bateleur capital

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**20 October 2022**

**Dear Investor**

**Bateleur Equity Fund ("the fund") – 2022 third quarter report back to investors**

The fund returned 1.2% year to date - compared to the JSE Capped shareholder weighted Index (CAPI) return of -7.0%.

During the reporting period, the fund benefitted from positioning in the resources sector (overweight diversified miners and energy relative to underweight PGM and gold miners), a large absolute position in RMI Holdings (RMI) and underweight exposure to MTN. The fund's stock specific investments in Mpact, AECI, Spar and Italtile detracted a combined 2.5%.

A summary of the top contributors and detractors is illustrated in Table 1 below.

**Table 1: Top relative individual contributors and detractors year to date**

| Contributors (relative) | Under/Overweight | YTD 2022 | Detractors (relative) | Under/Overweight | YTD 2022 |
|---|---|---|---|---|---|
| MTN | UW | 1.5% | Mpact | OW | -1.0% |
| RMI | OW | 1.4% | AECI | OW | -0.7% |
| African Rainbow Minerals | OW | 0.5% | Thungela | UW | -0.4% |
| Richemont | UW | 0.8% | Spar | OW | -0.4% |
| Sasol | OW | 0.8% | Italtile | OW | -0.4% |

**Source: Bateleur**

Global capital markets lost significant value as investors incorporated more restrictive monetary and fiscal policies into their valuations. Equity markets recorded their worst nine-month start since 2002, with the MSCI world equity index declining 25.4% and the technology heavy Nasdaq down 32.0% (Chart 1). Similarly, bond markets suffered their largest decline in decades as the FTSE world government bond index (WGBI) lost 21.3% year to date (Chart 2).

**Chart 1: Select equity indices YTD returns (USD)**

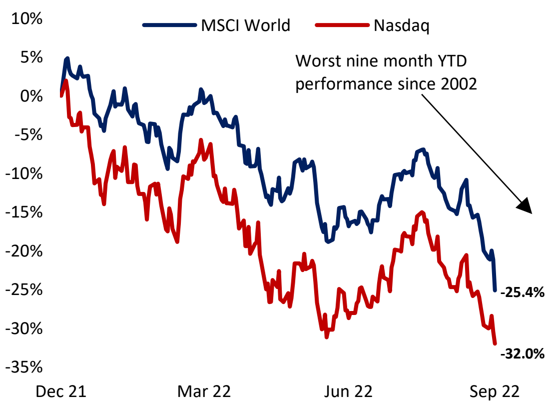
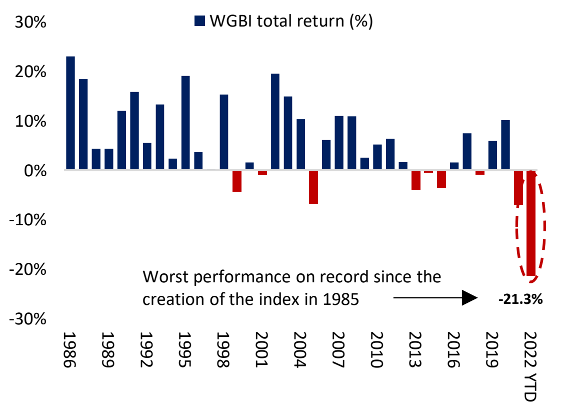



**Chart 2: Global bond index annual return (USD)**




**Source: Bateleur; Bloomberg**

Central banks are raising interest rates at the fastest pace in more than 40 years, with the US Federal Reserve (Fed) leading the charge. In addition, policymakers are moving from a period of loose monetary policy (quantitative easing) to quantitative tightening, albeit at a more measured pace.

These actions aim to slow economic and asset price growth and, more importantly, inflation that has remained stubbornly high. The impact of these policy changes is visible in the decline of global GDP growth forecasts accompanied by an increased risk of recession in developed market (DM) economies (Charts 3 & 4). Central banks were slow to react to inflation and now run the risk of overshooting on interest rates – leading to negative economic repercussions.

**Chart 3: GDP growth forecasts (%)**

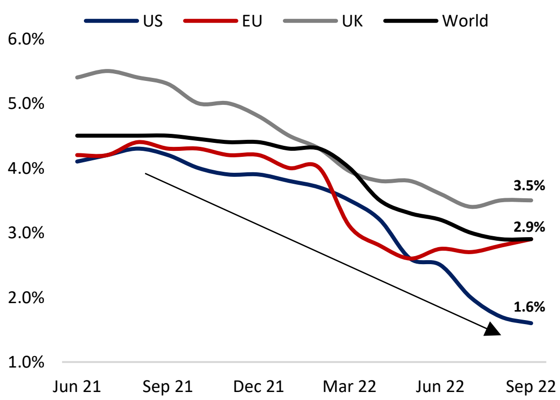
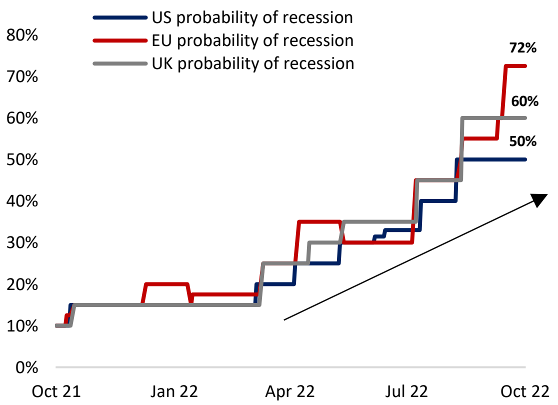



**Chart 4: Probability of a DM recession (%)**




**Source: Bateleur; Bloomberg**

Inflation has likely peaked in the US but it is expected to remain elevated due to historically tight labour market conditions characterised by low levels of unemployment and a record number of job openings (Chart 5). As illustrated in Chart 6, the pace of wage growth has historically led services inflation and will need to moderate from currently elevated levels, to tame inflation.

Concerningly, there are increasing signs that inflation is becoming entrenched - for example, US railroads and unions reached a tentative wage agreement during September which includes a 24% salary increase over 5 years including 14.1% effective immediately. This points to an environment where wage growth, and possibly inflation, could remain above the Fed's desired levels for longer than expected.

**Chart 5: US job openings elevated**

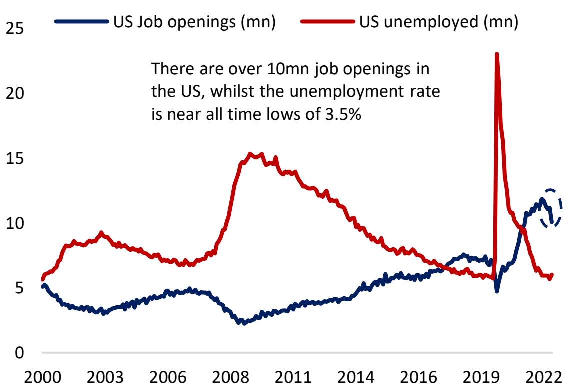
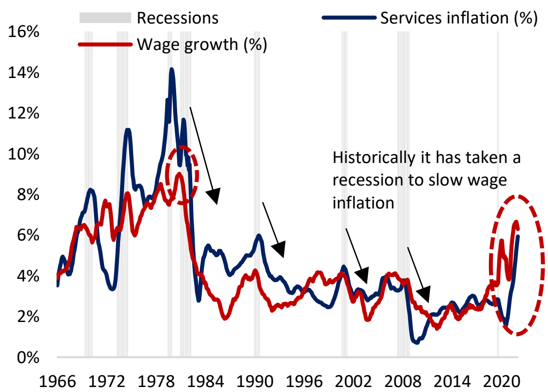



**Chart 6: Wage growth leads services inflation**




**Source: Bateleur; Bloomberg**

Consensus forecasts are for the S&P 500 to grow earnings by 8.2% and 8.5% in 2023 and 2024 respectively. These growth rates are unrealistic given: 1) slowing demand (and therefore revenue) as interest rate increases take effect; 2) an expected decline in operating profit margins from rising input costs (especially wages, transport, packaging & distribution); and 3) an increase in corporate finance charges due to higher interest rates on new debt issuances.

S&P 500 earnings have historically declined on average by 17% during a recession (Chart 7). If the US does enter a recession in 2023 and the average earnings decline holds, then earnings estimates could be overstated by up to 25%. Under this scenario, the 2023 forward P/E multiple of the S&P 500 is no longer the projected 15.6 times (Chart 8) but rather 19.6 times – well above the long-term average.

Our expectations are for a slowdown in US and global corporate earnings and volatile equity markets in the foreseeable future with the likelihood of further capital losses.

**Chart 7: S&P EPS decline during recessions**

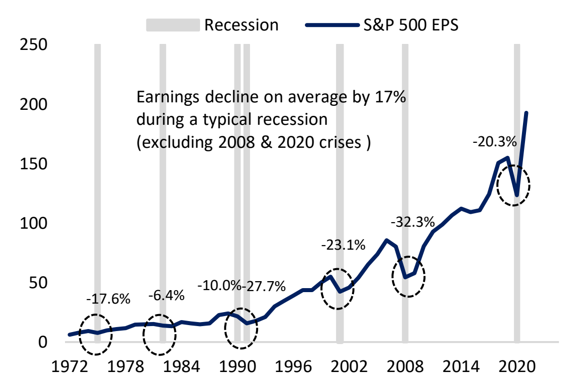
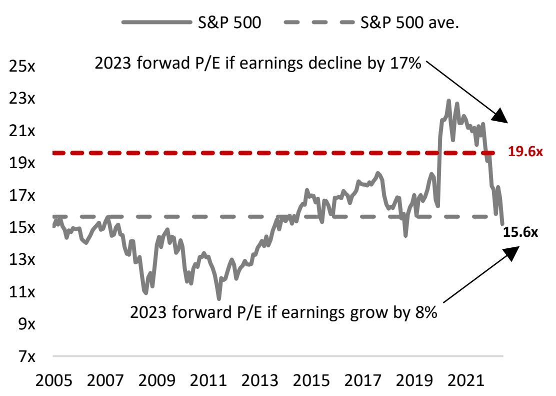



**Chart 8: S&P 2023 P/E on differing EPS profiles**




**Source: Bateleur; Bloomberg**

Under the circumstances, SA capital markets held up reasonably well, with the JSE All Share Index declining 10.1% in Rands over the review period, while a basket of SA government bonds (ALBI) declined 1.3%. At the start of the year, SA companies already traded at low valuation multiples and investor sentiment has been weak for an extended period.

Furthermore, the JSE earnings base is low as it has not been inflated by any stimulus induced benefits like developed markets (Chart 9). Corporates are confident, executing well and growing market share. Balance sheets are generally strong, and leverage is limited. Importantly, valuations remain attractive in absolute terms and are currently at the lowest level since the financial crisis of 2008 (Chart 10).

**Chart 9: SA EBIT margins below trend (%)**

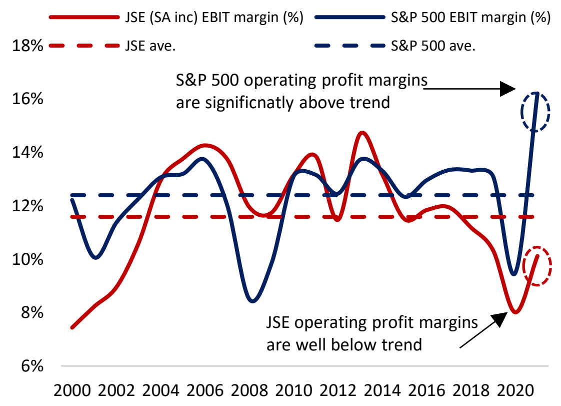
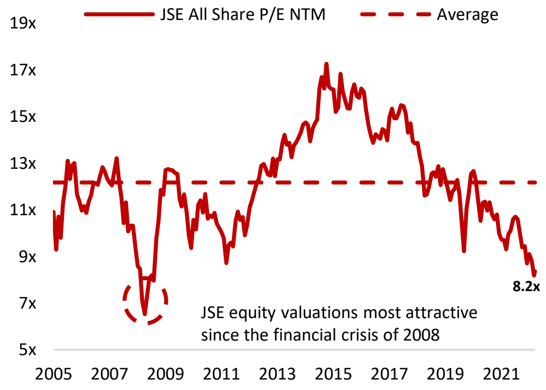



**Chart 10: SA P/E multiple at multi year low**




**Source: Bateleur; Bloomberg**

## Fund positioning

The fund's positioning remains anchored across five key investment themes.

1. **Resource** exposure is premised on a constructive view of the outlook for energy (coal, oil & gas) and future facing metals which enable a green transition (copper, nickel, manganese, zinc & aluminium). Capital underinvestment by major miners over the last 5 years suggests that certain commodities could move into a structural deficit as demand for future facing commodities increases without a timely supply response. Furthermore, to date management teams have been disciplined, prioritising capital returns over volume growth to the benefit of shareholders via share buybacks and dividends.

   Fund exposure to resources is held through diversified miners - African Rainbow Minerals, Anglo American, Glencore and South32 while energy exposure is via Sasol.

2. The fund is invested in **quality industrials** that are displaying operational resilience and producing credible financial results. These companies continue to gain market share through deliberate management actions and have aligned themselves to areas of the economy that are expected to grow. Holdings include AVI, Bidcorp, Bidvest, Mr Price and Shoprite.

3. Continued corporate activity within the **mid-capitalisation sector** should not be overlooked and exemplifies the value on offer on the JSE. The fund continues to hold exposure to Adcock, AECI, Hudaco, Italtile and Mpact – all of which have a lengthy track record of successful operational and financial execution. We remain patient investors.

4. SA **banks** present an attractive investment opportunity with supportive medium-term earnings drivers. It is expected that banks will release earnings (from provisions) as credit loss ratios normalise. In addition, higher interest rates are supportive of earnings via the endowment effect. A third tailwind to earnings is the moderate acceleration of loan growth seen year to date, albeit from a low base.

The fund has maintained exposure to FirstRand and Standard Bank - and initiated a new position in Absa based on its compelling valuation and the removal of the overhang caused by Barclays sale of its remaining shares in Absa.

5. The fund is invested in Naspers and Remgro which can be acquired at **substantial discounts to net asset value.** In both instances, there are numerous permutations that could unlock substantial value for shareholders. We will continue to engage management and press their leadership to follow sensible strategies to create value for shareholders.

The fund invested **89% of assets across the 5 key themes** explained above. The portfolio trades at an average forward P/E multiple of 8.6 times and is expected to grow earnings 9% in the year ahead.

**Conclusion**

The fund has been active over the quarter, adding to existing positions in Growthpoint, Mr Price and Truworths whilst reducing exposure in African Rainbow Minerals. New positions in ABSA and Bidcorp were initiated.

Elevated market volatility is expected to continue until developed market inflation meaningfully declines from current levels. In addition, the change in the interest rate regime is yet to be felt in the real economy and is not fully priced into global valuations and earnings prospects.

Valuations of South African equities remain very attractive on an absolute and relative basis. The fund is invested in quality companies, trading at low valuation metrics with solid earnings growth prospects that are expected to produce pleasing returns. We are encouraged by the wide opportunity set available.

Kind regards

Charl Gous Warren Riley Bheki Mthethwa

Co-Fund managers

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