Letter to Clients on CoVid19 Market Volatility

Date: 17 March 2019

Dear Client

Since the beginning of 2020, the Benguela team undertook to share, in detail, its views on capital markets at least once a quarter. However, a special letter is warranted to put things into perspective for our clients given how the rapid global spread of the Corona virus (hereinafter, "CoVid19") has spawned a new-fangled financial market crisis festooned with extreme downside price volatility. To put the recent turbulence into perspective, we note that as of the 16th of March 2020 the FTSE/JSE All Share, in South African Rand terms, declined -20.7% and -29.0% for the month-to-date and year-to-date periods respectively. In US Dollar terms, the FTSE/JSE is down -25% and -40% for the month-to-date and year-to-date periods respectively. Furthermore, the MSCI All Country World Index declined by -20.1% and -27.5% for the month-to-date and year-to-date periods respectively.

It is quite easy for investors' nerves to become rattled by the size of the recent market movements. The Benguela Team is excited about the quality stock bargains that emerged in the current crisis. In my experience, the indiscriminate market selloff experienced in the past two weeks is offering us, on behalf of our clients, a fantastic opportunity to enhance both the quality profile and future return prospects of the portfolios. Our calmness comes not from overconfidence, but our reliance on a tried and tested investment process implemented with great discipline, guided by proven senior team experience to comfortably handle a crisis like this. While the upswing may not occur for another six to twelve months if the CoVid19 virus is not brought under control, we are confident that the world never ends from a crisis like this. There has been many a crisis before, be it financial or a health pandemic but the human fighting spirit always triumphed over them.

In addition to giving economic context on the CoVid-19, in this letter we hope to provide our clients with a quick update of how our quality focused investment approach and disciplined investment process have

helped us deliver on our promise to limit their portfolios' downside risk during these turbulent markets. We believe that we have not only delivered on our promise to clients but demonstrated one of the key differentiators between active and passive fund management. As of the 16th of March 2020, our flagship global equity product was well ahead of benchmark by +1.8% and +3.3% for month-to-date and year-to-date respectively. Our largest portfolio, the South African equity product delivered similarly superior performance in a turbulent market delivering outperformances of +1.9% and +2.4% for month-to-date and year-to-date respectively. We will provide longer term performance updates in a few weeks' time.

The CoVid19 Crisis and the Political Response

The first recorded case of novel CoronaVirus (CoVid19) was identified in Wuhan, Hubei, China in December 2019. According to the World Health Organisation (WHO) the virus spreads between people, primarily, via respiratory droplets from coughing or sneezing in a way similar to influenza. According to data from the China National Tourism Administration, the country welcomed 4.7 million foreign visitors in December 2019 and an average of 5 million per month from October to December 2019. This large cross-border human traffic explains why the CoVid-19 virus spread so quickly from China into other countries such that by the 11th of March 2020 when it was declared a global pandemic by the WHO, it had already reached 118,000 cases in 114 countries with 4,291 people having lost their lives. As of the 16th of March 2020, cases had reached 174 893 people worldwide with 6 687 recorded deaths[1].

The World political leaders had to react fast to stem the wildfire-like spread of the virus within their respective countries. While the race for a vaccine heated up in the global pharmaceutical industry, the most sensible approach adopted by most countries was the restriction of cross-border human movement ("lockdown") and implementation of stringent quarantine/isolation protocols. These have since been followed with intra-country lockdowns. Despite these drastic steps taken around the world, the global peak in transmission rates may still be months way and for financially weak countries the effects of CoVid19 may be short-term economic ruin.

The CoVid-19 Economic Linkages

A key effect of the restriction of human movement has been felt in the global supply chains. The rise of China as a global manufacturing hub for the rest of the world has meant the world had unwittingly placed most of its manufacturing eggs in the Chinese basket. As a result of this high concentration of global manufacturing, when China went into a CoVid19-induced lockdown most global supply chains ground to a halt. As the virus spread worldwide the rest of the world had to follow suit by implementing some form of lockdown and quarantines. The ultimate effect of these lockdowns is that they hurt three of the four key drivers of the global economy [From basic economics, we would recall that GDP = Private Consumption + Investment + Government Consumption Expenditure + Trade (Exports minus Imports)]:

- Household consumption is the biggest component of global GDP at 58% of global GDP (Source: World Bank, 2018). Private Consumption slows down because people can't move around, and firms can't manufacture at normal rates as workers are in a lockdown to avoid human contact. In my opinion, this creates the biggest risk for a slump in consumption is such a significant component of the global economy.

[1] Source: https://www.worldometers.info/coronavirus/

- **Capital investments:** when capital investors lack visibility of future profits against the required capital investment, they tend to delay capital allocation. In economic terms, such an investment deferral would put a material dent on the global growth outlook given that gross fixed capital formation accounts for 24% of global GDP (Source: World Bank, 2018).

- **Government expenditure**, which accounts for 17% of global GDP (Source: World Bank, 2018) is the only GDP component that can be ramped up by the bureaucrats to stem the fallout of the virus. Various governments, including the USA declared emergencies to unlock stimulus packages to support the private sector during this time of hardship. While countries like the US have the financial wherewithal to implement colossal stimulation packages as they can print money, many other governments don't have such luxury without causing severe currency weaknesses.

- **Trade:** Global trade in goods and services serves as a growth enabler for most global economies. At a global level, aggregate trade is not a significant component of GDP because aggregate imports are exactly equal to aggregate exports. However, at individual country level it may be material as the gross value of global exports equates to 29% of global GDP. A result of a multi-country CoVid19-induced lockdown means is that a large part of the global economy becomes dysfunctional. Take for example a supply chain like this: a cost competitive vehicle component manufacturer in Japan supplies a vehicle manufacture in Germany, who in turn exports the complete vehicle to the United States. In this example, the effects of lockdowns become very clear as the Japanese component manufacturer can't produce or ship the components to the German automaker who can't sell an incomplete vehicle to the US. Even more worrying is the impact of the lockdown on daily basic essentials which has immediately sparked a worldwide hoarding purchases.

Capital Markets Implications of CoVid-19 Economic Effects

Having "seen this movie before" in the 2008 global financial crises, we believe that this simple analysis of the GDP helps to contextualise why capital markets "freaked out" over the past four weeks:

1) Because of China's estimated real growth of 6.1% in 2019, in a world that manages only 2.1% real growth, China accounted for an estimated 30% of global GDP growth in 2019. A CoVid19-induced lockdown would therefore have significant negative ramifications for the global economic outlook which was already under pressure. As highlighted, in the introduction to previous section of this letter, the high concentration of manufacturing in China and the subsequent lockdown of that country's manufacturing hubs puts global growth at risk in its entirety. Prior Monday the 16th of March 2020 the official line was that things were not looking too bad in China, the unconventional research conducted by the Benguela Team at the end of February uncovered multiple pieces of evidence that China's manufacturing capacity was at a standstill. This evidence included: (a) satellite images of emissions above China, (b) electricity and coal consumption data, and (c) container ship congestion on the Outer Pearl River Delta. Our conclusion was that the market was right to panic about the Chinese growth outlook.

   A secondary effect of a Chinese economic slowdown in 1Q2020, would be the decline in global commodity prices. Indeed, since peaking on the 7th of January 2020, the Thomson Reuters/Core

Commodity CRB Index has dropped by -29.3%. This decline reflects commodity market fears over a possible global supply chain bottleneck in the coming months.

2) The initial assessments from the US and EU suggested that, at peak levels, the CoVid19 pandemic would require emergency healthcare facilities that are significantly above existing capacity. This would, in turn, translate into high death rates and wreak havoc to economic fundamentals. Judging from the extreme measure taken in Italy recently to control the spread of the virus, it is clear if the US and EU were to adopt similar stringent lockdowns the global economy would promptly slip into a recession because these two private-consumption led economies account for 44% of the global GDP. (US= 24% & EU=24%, Source: World Bank data, 2018).

3) To cap off the market jitters, OPEC+ crude oil supply side discipline fell apart over disagreements on strategies to prevent further market share losses to US shale producers. This sparked a price war between Russia (opponents of supply cuts) and Saudi Arabia (proponents of supply cuts) which promptly saw crude oil price decline from \$52 a barrel to \$36 over three trading days. With a significantly lower oil price translating to lower future revenues, highly indebted energy companies like Sasol were severely punished. Fears of widespread bankruptcies in the energy sector gripped the market that had, up to the start of 2020, been chasing high-yielding debt as sovereign bond yield spreads got more compressed. From the 04th of March 2020 to the 16th of March 2020, Sasol lost 76% of its market value in Rands terms.

4) Developed market valuation multiples were already stretched well above their long-term averages (read extremely low risk premiums and/or extremely high earnings growth/return expectations). In the 1Q2020 detailed portfolio commentary, we warned clients about the high valuation risks in developed markets and how EM stocks would suffer collateral damage in a DM-driven correction. For equity markets, a slowing global economy or a risk of a recession often means sharp downward revisions to earnings/profitability expectations and by extension, a sharp recalibration of valuation multiples. The combination resulted in outsized market movements that saw some of the world's largest equity markets hitting their circuit breakers multiple times.

5) The panic selling of global equities and emerging market bonds translated into a massive cash inflow into safe haven bonds like US, Japan and Switzerland, as well as money market funds. We saw, as a result, sharp compression of safe haven country sovereign bond yields while EM sovereign bond spreads widened from +300bps in Feb 2020 to over +500bps currently. For example, the yield on the South African 10-year sovereign bond increased from 9.0% on the 4th of March 2020 to 10.7% on the 16th of March 2020, thereby delivering a 6.8% decline in value. Strange enough the much-vaunted safe haven asset of gold started falling alongside risk assets.

Government Stimulus Efforts to Fight the CoVid19 Crisis and is it Enough?

In response to this serious risk posed by the CoVid19 crisis on the global economy, governments and central banks all over the world have enacted fiscal and monetary stimulus measures to counteract the disruption.

Overleaf we highlight the stimulation efforts of the world's largest economies:

United States: In most cases the monetary stimulation efforts came in the form of aggressive rate cuts and quantitative easing in which the central banks provide liquidity to banks to keep money markets adequately supplied. The US Federal Reserve Bank ("the Fed", in short) stood out with two emergency rate cuts on 03rd of March and 15th of March of 0.5% and 1.0%, respectively. In addition, the Fed expanded the reverse repurchase operations by $2.0 trillion over the two dates and resumed quantitative easing to by purchasing $500 billion in treasuries and $200 billion in mortgage-backed securities. A reverse repurchase agreement is a short-term money market instrument in which a lending institution agrees to purchase securities with the agreement to sell them back to the issuer at a higher price at a specific future date. On the fiscal side, the Democrat-led US House of Representatives passed a stimulus bill, but the Republican-controlled Senate has yet to ratify it. On March 13, President Trump also announced a state of emergency, which enabled the Federal Government to distribute up to $50 billion in aid to states, cities, and territories.

Germany: The state-run bank, KfW, (not central bank), was authorised to lend out as much as $610 billion to companies impacted by the CoVid19.

China: Between 3rd of February and 13 March 2020, China increased its reverse repo operations by $244 billion, cut rates by 0.05% - 0.10% depending on term and lowered bank reserve requirements, thereby freeing up $79 billion for lending activities. Other than asking banks to extend the terms of business/commercial loans, China has yet to implement colossal fiscal stimulus.

Japan: Japan has passed two packages of small business loans, one $4.6 billion package in February, and a $15 billion one on the 11th of March 2020. On the monetary side of things, the Bank of Japan announced a significant increase in QE on March 16 by doubling the rate at which it purchased ETFs from $56 billion a year to $112 billion, and increased purchases of corporate bonds and commercial paper. Additionally, it announced a 0% interest loan programme for businesses affected by the virus.

South Africa (for comparative purposes): South Africa has, so far, only announced cross-border and intra-country lockdowns. No fiscal stimulation yet as government finances are severely constrained ahead of the possible credit downgrade by Moody's. A credit rating downgrade is likely to open the floodgates for some of remaining foreign investors to exit our bond markets. We expect, at the very least, the South Africa Reserve Bank will announce a minimum rate cut of 50bps to support the local economy.

While the US announced the largest stimulation package in the world, the market seemed to read through this as an indicator of severe downturn ahead. Since the Fed's first emergency rate cut on the 03rd of March 2020, the S&P500 Composite declined by 21%. Three of the largest declines occurred the 09th of March (-7.6%) , 12th of March (-9.5%) and to cap it all off a -12% decline on the 16th March (a day after Sunday, the 15th of March emergency rate cut of 1.0%). In line with the US market, the MSCI ACWI dropped by 22% in US dollar terms in the past two weeks.

It would appear that the message from the above market price movements is clear: *despite the humongous stimulus packages, the global economy is facing some serious challenges in the months ahead as more countries adopt stringent lockdowns. The crisis is not about money supply but about the effects restricted human movement on private sector consumption and fixed investment, the largest part of global GDP.*

As a result, our view is that there is more volatility ahead until such time as a vaccine is found, or the virus blows over as a result of the lockdowns. 0

Where to From Here and how Benguela is Positioning Itself?

The global economic governance structures have responded with huge amounts of money. From a Benguela perspective, we believe that there is still a lot of market risk in the months ahead.

For the benefit of our clients we are focused on implementing our proven investment process with diligence. While the results are encouraging so far, we remain vigilant and risk conscious in how we allocate or re-allocate capital in this market. We often tell clients that there are only three possible sources of active returns in the market: (a) accurate forecasts – which are unsustainable for any market participant, (b) adopting a longer time horizon than most market participants - this comes with the risk of time value of money erosion if implemented carelessly; and (c) behavioural discipline – this is the only free lunch available in markets.

Our ability to control our emotions in good and bad times has been a key contributor to the value add we provided to our clients in the past two and half months. As an example, a few months ago our portfolios came under pressure as a result of sky-rocketing low-quality gold and platinum on the back of unsustainable commodity price rallies. While painful at the time, we didn't flinch by changing our investment strategy or abandoning our investment discipline of insisting on business quality and enough upside above the concomitant margin of safety. We nonetheless always ask ourselves the following questions:

(a) "What if we are wrong in our assessments of quality and valuation?"
(b) "If we are, indeed, wrong what would be the impact on our clients' portfolios?"

These questions reflect the humility with which the Benguela team approaches the market. We realised a long time ago that we cannot possibly be right about every assessment or possess the greatest pearls of market wisdom. As a result, we can minimise the risk of making outsized mistakes through robust team debates and risk conscious portfolio construction. With a solid research team supporting an experienced portfolio management team, we expect to get all our clients safely to their investment destinations.

Closing off with Business Sustainability:

Last week we highlighted measures taken by Benguela to ensure we are able serve our clients and continue operating responsibly through this CoVid19 crisis. Benguela has had a very detailed business continuity plan in place that has been tested regularly. The biggest operational impact has been the need

to operate remotely, for employees as well as with clients. So far our processes, systems and service providers have proven their mettle, and we look forward to continue serving our clients with dependable service levels into this uncertain time of crisis.

In terms of financial sustainability, we have already seen several companies in our investable universe come under severe cash flow strain in the past few months (particularly those with levels of indebtedness and insufficient reserves). Benguela is in a fortunate position where we have no external debt, and in fact, over the past years built a sufficient capital buffer against potential headwinds such as this CoVid19 crisis. We can thus confirm to our clients that even after the significant market drawdowns, that resulted in reduced revenues for a business such as ours, we remain in a strong financial position to continue operating (at our current cost base) for the foreseeable future.

We hope that our successful navigation through this crisis will stand us and our clients in good stead in the future.

Kind regards,

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