OCTOBER 2019

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ASSET MANAGEMENT

Quarterly Market Commentary

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The 3rd quarter of 2019 has brought the South African economy to a crossroads. We are one month away from the Medium Term Budget Policy Statement (MTBPS) that will define whether South Africa reverses its current course, and makes the difficult choices required to regain Investment Grade credit ratings (by all Ratings Agencies), or whether South Africans are condemned to the mediocrity of being Junk, defined as Sub-Investment Grade ratings from all of the big three agencies. The MTBPS will be delivered by Finance Minister Tito Mboweni on the 30th October, and of late, his controversial economic proposals have been endorsed by the ANC NEC, and more importantly, by President Cyril Ramaphosa.

In this quarter, bond markets were characterized by the continuation of the aggressive rally (decline) in G7 bond yields. With this backdrop, even though SA is plagued by atrocious economic growth outcomes, bond yields also fell, although there was a mid-quarter sell-off to contend with as well. The Rand weakened to a worst print of R15.50 to the US Dollar this quarter but recovered during September. The R186 hit a low in yield of 7.96%, rose to a high of 8.48% and closed the quarter stronger, at around 8.30%. Concerns about the debt burden at ESKOM were underlined by a management roadshow reporting their results - an eye watering story which continues to threaten the very fabric of the South African economy. In a nutshell, ESKOM has now been classified "too big to fail", but there is a complete lack of urgency from both management of the power utility and the State, in terms of resolving the crisis. No clear solutions are in sight, but one positive step is that Mr Freeman Nomvalo was appointed as the Eskom Chief Restructuring Officer. Now we wait for him to build a team and announce the restructuring proposal, subject to the various ISDA constraints that the many derivative contracts written on ESKOM's debt imply. According to government, any restructuring of ESKOM will be done so as not to trigger a technical default / credit rating default. Mr Nomvalo certainly has his work cut out for him.

In keeping with the aggressive rally in G7 yields, the Fed Funds rate was cut by 25bp by the Federal Reserve to a new range of 1.75% to 2.00%. The US 10yr treasury yield reached a low of 1.43% in August, having started the quarter around 2.22%, as the Fed rate cuts were priced in. The 10yr German Bund yield traded as low as -0.74%, but corrected to -0.43%, closing the quarter at -0.57%. At their most recent Monetary Policy meeting, the ECB resolved to resume Quantitative Easing, a complete about-face from the supposed rate hikes after summer 2019.

The SARB cut rates by 25bps at the July 2019 MPC meeting, but decided not to cut again at the September meeting, contrary to the Cadiz house view. We continue to call for another 25bp cut, which we now expect at the November 2019 meeting. This has become possible due to CPI inflation outcomes surprising to the downside, inflation expectations continuing to fall, and generally subdued and below potential growth outcomes. The high frequency economic data for the South African economy that we track suggests a lack of confidence and likely continued subdued growth. Market events that will be top of mind in the 4th quarter include the October 30th MTBPS, the November MPC meeting of the SARB, and the critical Q3 2019 GDP data releases. We remain concerned that the budget deficit will balloon further, due to the Eskom appropriation bill, collapsing revenues due to State Capture and the hollowing out of SARS, and generally poor growth outcomes. This means many companies are suffering from reduced turnover, several have reported loss making financial years, and many SMEs are experiencing difficulties. This is not a good environment for a tax authority to collect revenues.

The bond market (All Bond Index) returned +0.78% for Q3 2019. Equity markets (represented by the JSE ALSI) were down -4.57% and Inflation Linked Bonds (ILBs) returned +0.25% for the quarter. Cash returned +1.83% for the quarter. Rolling 12 month returns for bonds were +11.48%, equities have returned +1.86%, and ILBs a paltry +3.97% with cash returning +7.38% over the last 12 months.

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