TANTALUM CAPITAL

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Market Commentary | March 2020

We live in extraordinary times. March 2020 will be remembered for a long time as the month when Covid-19, the coronavirus disease which originated from Wuhan in China, became a global human pandemic that infected all world economies and markets. Covid-19 has shown itself to be highly contagious, and lethal to the medically vulnerable, especially the elderly where mortality rates of well over 15% have been reported. The political and social response to the pandemic has varied from country to country, but in most areas has required significant lockdowns and restrictions on human movement, curtailing commercial endeavour, and destroying capital value. Initially affecting mainly China and South Korea, the spread of Covid-19 infection into the Middle East and Italy and then onward through Europe and America to almost every country worldwide has caused disruption to social and economic order not seen since World War II, and capital losses comparable to the Great Financial Crisis (GFC) of 2008 and the Great Depression of 1929. As we write this report, we do not yet have the luxury of hindsight, that will ultimately judge whether the large-scale asset and commodity price destruction has been excessive or appropriate. The ultimate outcome in human lives lost is wholly dependant on behavioural compliance with isolation and distancing measures, and on medical interventions (diagnosis and testing, treatment, and a potentially preventative vaccination down the line). To date, only the success or failure of distancing and isolation measures is guiding political actions. It is still too early in the pandemic's infection path to determine our fate in human and economic terms.

The market returns for March 2020 make for depressing reading. The MSCI World Index lost 13.7% in $ in the month, with the major DM stock indices down between -8% and -17%. Commodity markets were not spared, with oil being the main pressure point, Brent crude falling 57% as Saudi Arabia and Russia disagreed about balancing supply with falling demand and tried to retain their respective market shares. This oil price war is not over yet, and oil producer economies face an existential crisis going into the second half of 2020.

To counter significant near-term damage to their economies, policy makers across the G10 nations have already reacted more rapidly, and on a greater scale, than they did during the global financial crisis (GFC). With limited interest rate firepower, global central banks reduced rates as much as possible to their effective lower bounds. Central bank efforts have largely been focused on addressing liquidity dislocations and smooth market functioning, including further QE initiatives. The economic stimulus burden has mainly fallen on fiscal authorities, with the US unveiling a substantial $2 trillion fiscal support package, representing 4% of GDP (more than double the stimulus act passed in 2009 during the GFC). Notably, despite implementing an array of monetary and fiscal interventions, China authorities are unlikely to revisit the scale of stimulus provided during the GFC and seem on track to accept the loss in activity in the first quarter, focusing their efforts instead on returning the economy to production in a measured fashion as the virus spread is eradicated.

On the domestic SA front, the JSE All Share Index lost -12.1% in the month, and the ALBI returned -9.7%. Covid-19 pressure battered an economy already teetering from Eskom load-shedding, lost business confidence, and a growing fiscal debt crisis. The resultant weakening of the ZAR by almost 13% against the $ in the month was fairly mild versus what could have happened in the absence of the boost to the SA trade balance from the massive fall in the oil price.

The imposition of a minimum 21 day lockdown by President Ramaphosa, announced when infection rates were still very low as a pre-emptive move to get ahead of the curve, comes at a huge economic cost, but necessitated by the urgency of not overburdening the healthcare system. By implementing these actions, President Ramaphosa has demonstrated decisive and firm leadership (in sharp contrast to the lack of leadership seen in many developed countries) and has received unified support across the political spectrum as well as public and private sectors. Should these measures be successful in containing the spread of infection, the President will emerge from this crisis in a strong political position, with a track record of implementing tough decisions, and with decision-making having notably shifted from ANC headquarters to the Presidency and Cabinet.

Given their contained inflation outlook, the MPC cut rates by a larger than expected 100bps at their March meeting, with the market forecasting further cuts in the near term. The SARB noted exceptional constraints in money market liquidity as well as dysfunction in the bond market and implemented a range of measures to address these in line with their mandate. The measures adopted included both liquidity support via the repo market, as well as announcing an intention to buy bonds in the secondary market across the curve when they sense dislocations and feel a need to provide stability. The SARB were careful to point out that their actions were designed to support market functioning and reduce excessive volatility, and to ensure that prices are set in an orderly manner. The SARB also released a raft of policy directives for the banking sector easing restrictions and allowing them to draw on their capital buffers to provide support to their customers over this extraordinary period.

In the midst of the crisis, Moodys downgraded South Africa's rating to non-investment grade at their March review at the end of the month, citing fiscal pressures and persistently low economic growth as the primary reasons behind their decision. This move had been largely anticipated, but still resulted in further immediate rand and bond market pressure, although this weakness was quickly unwound with markets trading back at levels pre the announcement. Given the announcement that WGBI rebalancing will only likely occur at the end of April (due to poor market liquidity), there may still be some pressure on the market at month end. National Treasury and government have vowed to continue with their plans to enact structural reforms in the economy, and a new unit named Vulindlela will be established in the Finance Ministry to drive the structural reform process (with Minister Mboweni at the helm).

TANTALUM FUND PERFORMANCE

The Tantalum funds did not emerge unscathed from this dramatic period. Funds that had offshore exposure were better off than local-only funds as we had built up a fair buffer of US dollar cash, having sold down offshore stocks that had met our fair value targets, and having hedged a fair proportion of the remaining offshore equity exposure at very good levels early in February. Unfortunately in the SA-only funds, we had been finding better value in SA shares and had begun accumulating positions on a measured basis in shares like Remgro, Barlows, RMH and Truworths, and these positions unfortunately cost the fund performance in the month. The most significant detractor from returns was Sasol, which fell sharply with the oil price collapse, and is facing a potential rights issue at the worst possible time as its Lake Charles capex has only just come to an end. Positive contributors to performance in the month were few and far between. Naspers and Prosus held up very well (although our funds hold quite a lot less than benchmarks would dictate), while funds also benefited from holdings in Assore (only recently added and which received an offer to buy out minorities), Anglogold, and BHP.

Our material equity actions during the month included the following: we sold out of Barlows completely around R80 as we judged that recent management actions (notably buying Tongaat's starch and glucose business) compromised our thesis of improved capital allocation; we sold out of Aspen completely after sound results; we sold out of a nursery position in Shoprite as it held up well despite ongoing uncertainty regarding its sub-Saharan African stores and outlook. On the buy side, we bought shares in Amplats, Life Healthcare and Netcare, and added to existing positions in Remgro, AVI, Sasol and BHP. We also bought and sold a small position in Goldfields intramonth. On the global side, we could be opportunistic given our very low net equity starting position. We sold our S&P put options at good levels and also sold long-held outperformer Nestle. We bought formerly held positions in Nike, Unilever, Deutsche Post, and initiated new positions in Johnson & Johnson, Gilead, and Siemens AG, at what look like compelling long-term prices.

Given anticipated earnings pressure, bank share prices fell significantly in the month, and pressure was evident across debt instruments that form part of their capital structures (such as AT1 notes and subordinated debt), with some early signs of pressure on senior unsecured spreads. We have been cautious of spreads on offer on these instruments for some time, deliberately keeping our exposure in the shorter area of the curve (out to three years). The majority of our subordinated bank debt exposure matures this year and next, and any AT1 exposure in the portfolio matures either next year or the following year. Although we view the current widening in spreads to be a rational response, banks are entering the crisis very well capitalised, and credit loss ratios would need to rise significantly above GFC levels before there is regulatory risk to the servicing of coupons.

We have been conservative for some time in the corporate bond market, with exposures limited to highly rated corporate issuers as well the lowest risk tranches of securitisations (with substantial credit enhancement), and concentrated in near dated maturities out to three years. We will look for opportunities in the current market to take advantage of wider spreads in shorter dated maturities in names that we favour.

The nominal bond market had a torrid month, with large outflows from foreigners (as much as R56bn in March according to Bloomberg data) and poor market liquidity leading to a significant shift higher in yields across the curve. We increased nominal bond exposure during the month, concentrating on the area out to 6 years (R186 bonds) as well as some exposure out to 10 year maturities, which we anticipated would benefit from interest rate cuts. Lack of market liquidity has left this area of the curve particularly steep relative to the short end, with roll down on these bonds looking very attractive. Looking through near term risk aversion, the level of SA yields stands out relative to our peers, particularly when adjusted for inflation expectations, and relative to low cash rates (which are expected to fall even further in the coming months).

We fully expect that the path of recovery from Covid-19 and its economic damage will be long and arduous. We acknowledge that monetary stimulus from central banks across almost all economies has limited traction to assist in this process. We acknowledge that fiscal support across the globe is important, and is being implemented, but we recognize that it will be harder to enact, and will likely have only intermittent success. Our global economy, indeed our civil society, is in the hands of compliance with human lockdowns, and those of the medical scientists, searching desperately for mitigating treatments and a vaccine against future infections. These factors are inherently uncertain and possibly unforecastable. As a result, we remain committed to maintaining highly liquid positions, and a cautious and disciplined strategy as is our method. We will be as nimble as ever, but we will mainly add shares with strong balance sheets that can ride out a prolonged recession and that have commercial franchises that are highly valuable.

Our investment debates and processes (working remotely online from home) remain as disciplined as ever. We have been through numerous market crises before (we listed them in previous correspondence) but it is fair to say that this crisis feels different in that the economic reflexes of low prices or capital shortages are not the dominant factors governing the market recovery – we are in medical and human hands for now.

FUND	MAR '20 RETURN	ROLLING 12MTH RETURN
Tantalum BCI Strategic Income Fund	-2.1%	4.4%
Tantalum IDS MNC Retail Hedge Fund	-9.2%	-12.4%
Tantalum Absolute Return Fund	-11.3%	-13.9%
Tantalum Balanced Fund (Local Only)	-13.2%	-17.0%
Tantalum BCI Balanced Fund (incl. Offshore)	-8.6%	-8.5%
Tantalum Equity Fund	-18.8%	-27.4%
PPS Stable Growth Fund	-6.1%	-5.8%

* All performance numbers are estimates until final approval by administrator