TANTALUM CAPITAL

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COVID - 19 and the Oil Market

Our Response | March 2020

Market volatility has risen dramatically in recent weeks following the Covid-19 pandemic. There is much specialist literature on the medical aspects of the virus: its likely spread/infectiousness and specialist estimates of its potential human toll/mortality. It is not our intention to restate these views here, suffice to say that we will continue to follow all sources of intelligence and reports with intensity and diligence in our attempt to stay abreast of a highly fluid situation. We are most especially trying to understand the severity and mortality impact of the virus on various age cohorts, and on those patients with or without pre-existing medical conditions. We are also closely observing the success or failure of containment strategies adopted across the globe.

In assessing the medical and human data points attached to Covid-19, our focus as analysts is to identify the ultimate economic and market impact of the virus. At this relatively early stage of the outbreak, the range of potential economic outcomes is unfortunately still incredibly wide. As a result, we judge that markets have begun to err on the side of caution and are factoring in a pessimistic outcome: prolonged travel restrictions and urban quarantines, and above 1% total patient mortality rates (the current level is 3% but includes a significant cohort of aged patients and patients with pre-existing medical conditions – it is closer to 1% for the balance of the population). Forecasts of global GDP growth have been severely reduced, and corporate revenues likewise cut.

At this juncture, it is worth highlighting that we have been raising concerns about the elevated level of global equity market valuations before this point. In our funds that contain global assets, we have been steadily reducing offshore equity exposure to below 10% of fund, and in addition had taken out derivative put protection against 5% of this at very opportune levels in early February. We had done this as many stocks in our portfolio had rallied to levels that we could no longer justify as offering good risk-adjusted upside in a slowing global economy.

On the local front (in contrast), we have been becoming more bullish on local equities, identifying many stocks that provide a compelling longer-term upside. Nevertheless, the local economic and political outlook remains severely challenging and unclear, and we have thus been very deliberate and cautious in allocating capital to these opportunities, as is our style.

One of the most obvious economic effects of reduced mobility, trade and travel, is the reduced demand for oil. The oil market is a "flow" market, produced and consumed day-by-day in a continuous supply chain (in contrast with say a metal, which is produced and consumed as a "stock', and which can be stored more easily). The Covid-induced reduction in demand hit oil prices, and subsequently heightened tensions amongst the major oil producers. This past weekend then saw the collapse of co-operation between the major producers (Saudi Arabia and Russia). A flood of new supply is now being pumped into an already over-supplied market. The resulting collapse of the oil price (to below $30/bl at a point) has added a significant new economic consequence to the Covid-19 activity deferral. It is a powerful deflationary force. It has been coupled with the obvious monetary policy reaction of an emergency 50bp rate cut by the now-dovish US Federal Reserve, wanting to ensure liquidity remains high in a constrained market system. Unfortunately, we have not owned any US long bonds, which have been the immediate beneficiaries of this deflationary trade.

In the immediate aftermath of these developments, global risk aversion has also pressured the Rand and our local stocks and bonds in a classic global "flight to safety". We know from previous experience that a knee-jerk trade following this herd mentality is generally futile and value-destroying. Our portfolios have benefited from our biggest weightings being in unaffected, fairly defensive shares that have held up well. These include our sizeable exposure to British American Tobacco, Naspers, and our preferred gold miner Anglogold. Northam, our preferred platinum miner has also held up very well, as the demand thirst for its PGM product remains largely unquenched. In an extraordinary twist to the platinum tale, the shortage of PGM metals has now been exacerbated by a supply disruption at competitor Amplats. We are indirectly exposed to Amplats through our holding in Anglo American, which has detracted from performance to some degree, but we have been using the severe weakness in the Amplats share price to build up a new direct position in a stock that should be well-placed once the production facility is reinstated (in about 80 days' time).

We judge that the Rand has been oversold based on the current facts. Keep in mind that the SA terms of trade should ordinarily be much better off with a declining oil price, one of our largest imports. However, we also know from prior experience of crisis that the risk-aversion trade is a powerful one, and we are careful not to position our portfolio too aggressively based on fast-money macro flows. We are therefore disciplined in adding to our chosen local stock names only where fundamentals remain intact.

In our local balanced portfolios, we have added to our 5 year bond exposure, judging that the yield pressure (price appreciation) from falling global short-term interest rates is enough to offset the risk-off flows out of SA. We come from a neutral bond positioning, which has given us a sound initial base from which to invest. We had been cautious on SA bonds going into the Moody's meeting cycle and remain appropriately weighted given the elevated risk of a ratings downgrade (which is still our base case assumption at this point).

In our global funds we have begun to re-invest slowly into some new and some old shares that have been severely sold-off. However, we are in no rush to employ capital as we see a prolonged period of uncertainty and low-growth ahead.

Our biggest portfolio loss in this past period has been from Sasol. Sasol has already been under balance sheet pressure from its expensive and late Lake Charles cracker. We were disappointed to learn that management has failed to hedge any portion of their oil revenues during this period of plant ramp-up, something which they have generally done in the past. As a result, the market and ourselves have had to factor in a potentially dilutive rights issue, just at the time that the oil market is being hit by the Saudi-Russia price war. To say that we are disappointed by this new turn of events would be an understatement. While there is clear and compelling value to be found in the share at current levels, we are taking time to consider the path of events (and cashflow) in more detail before we commit more capital to this investment. Our current Sasol equity weighting is 1.5%.

The global economy is facing huge uncertainty in terms of both the trajectory and impact of the Covid-19 pandemic, as well as the outcome of the oil price war. In addition, the deflationary impulse will inevitably expose any highly indebted company or investment structure and destroy significant value. We need a fresh, co-ordinated and sizeable fiscal kickstart to overcome the Covid-19 demand destruction. This requires immense political leadership, something which is in short supply globally.

In conclusion, our experience of previous episodes of extreme market volatility such as this has taught us to be measured and deliberate in our portfolio actions through times of stress. While our portfolio has been carefully balanced, precisely to carry us through times like this, there is not a position that we do not debate or investigate internally. However, we do not and will not act in haste or in desperation. We remain available to clients and potential clients at any time should you have any questions. As always, we are extremely grateful for the support and commitment shown to us.