The Navigator

Strategy and Asset Allocation Report
3rd Quarter 2021

ANCHOR | NAVIGATING CHANGE

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Introduction

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South Africa (SA) has continued on its path of Renaissance that we discussed last quarter. The trade balance remains positive, buoying both the currency and tax collection. The sentiment around local politics is less dire, the vaccination drive is underway (albeit slowly), Eskom debt levels are gradually coming down, and the energy reforms went further than we had expected. One does tend to focus on the negatives (of which there were a few) however, overall, this past quarter was a positive one for the long-term trajectory of our country. While sentiment is gradually improving, it is still not at a high enough level to spark the investment that is sorely needed and many corporates that we speak to remain hesitant to invest in long-term capital projects. While we acknowledge that much has been done, we also admit that more remains to be accomplished before SA is able to unlock its true economic potential.

The global environment has been favourable with accommodative monetary policy from all major central banks, higher commodity prices, and positive emerging market (EM) sentiment as we rebound from the COVID-19 crisis of a year ago. As the global unlock gathers pace, we are seeing spikes in both economic growth rates and inflation across the globe. Economists are at pains to decide what inflation is transitory and what is permanent. While we believe that most of the current inflation is clearly transitory, how much is permanent remains to be seen. In this context, we expect that central banks will pare back their support and markets will become more volatile as returns slow a little from those that we saw over the past year. Some of the tailwinds for both investments and for the SA economic rebirth will dissipate. Still, we expect that the momentum is such that both will continue with their positive trajectories.

More remains to be accomplished before SA is able to unlock its true economic potential.

Looking towards investments, risks are ever-present, and we are cognisant that the shape of the investment landscape is rapidly changing. Often index level returns tell one story, yet a deeper dive into the index constituents tells another, with some really appealing opportunities and attractive companies being available both locally and abroad. In this context, now is the time for active asset management.

We remain proponents of a balanced portfolio and we caution investors to remain diversified across different asset classes. We also advise that if you have not looked at offshore diversification yet, then now is the time to do so.

Asset Allocation

The following table illustrates our house view on different asset classes. This view is based on our estimate of the risk and return properties of each asset class in question. As individual Anchor portfolios have specific strategies and distinct risk profiles, they may differ from the more generic house view illustrated here.

Asset class	Current stance			Expected returns (local currency) (%)
	Negative	Neutral	Positive	
LOCAL				
Equity			●	14.0
Bonds		●		8.8
Listed property		●		11.0
Cash	●			4.2
Alternatives*			●	10 to 15
Rand/US$ (rand marginally weaker)				2.2
GLOBAL				
Equity		●		6.0
Government bonds	●			-2.3
Corporate credit	●			-1.0
Listed property		●		5.0
Cash	●			0.1
Alternatives*			●	5 to 10

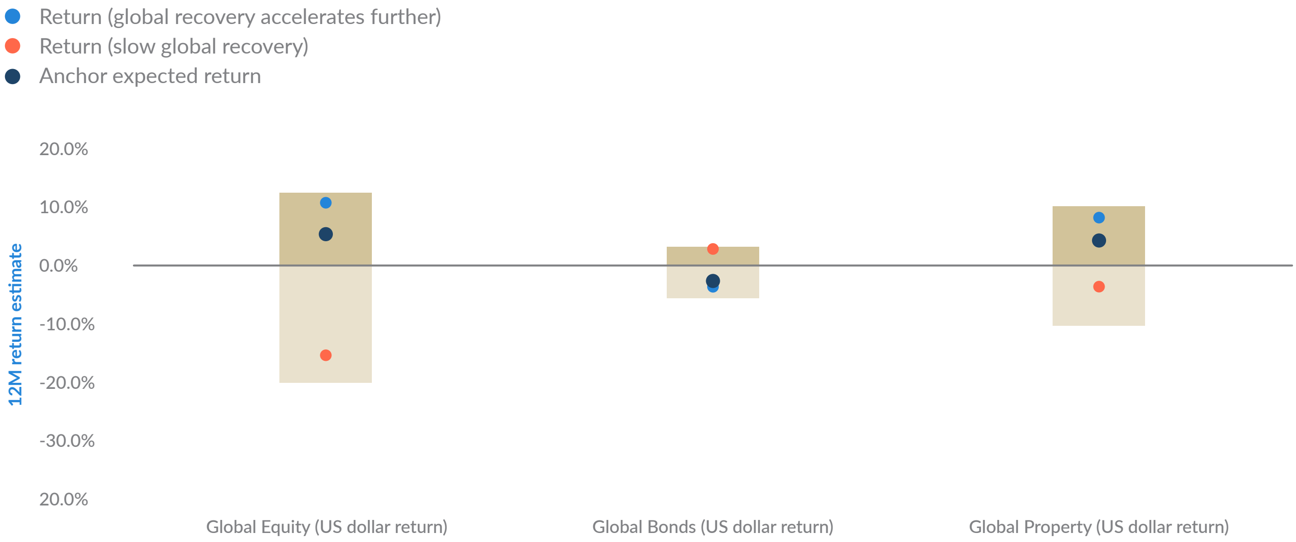
*Alternatives includes hedge funds, protected equity structured products, and physical property.

Asset Allocation Summary

The recovery continues to be well underway. The global vaccination drive and the unlocking of economies have been uneven and, likewise, we see an uneven recovery across the different regions. We display the possible outcomes as a series of graphs below. Anchor's base case is somewhere between the scenario of growth accelerating from current expectations and the scenario of an economic speedbump slowing growth rates in the near term.

There are remarkably few changes since our last *Navigator – Anchor's Strategy and Asset Allocation*, 2Q21 report was published on 9 April, although we are incrementally more bullish on JSE-listed shares, and we maintain our overweight view based on the skew of risks to the upside as the current environment is likely to continue. The index level returns might seem fairly pedestrian; however, we expect that there might be quite significant swings in the performance of the shares underlying the index. In *Figure 1* below, we highlight the US dollar return outlook for various global asset classes. The bar in *Figure 1*, represents the reasonable range of possible outcomes, with the dots representing our estimate of what the outcome will be in the various scenarios. From a global perspective, equity is the most attractive asset class although downside risks remain.

Figure 1: 12M return scenarios for various asset classes in US dollar terms
Source: Anchor



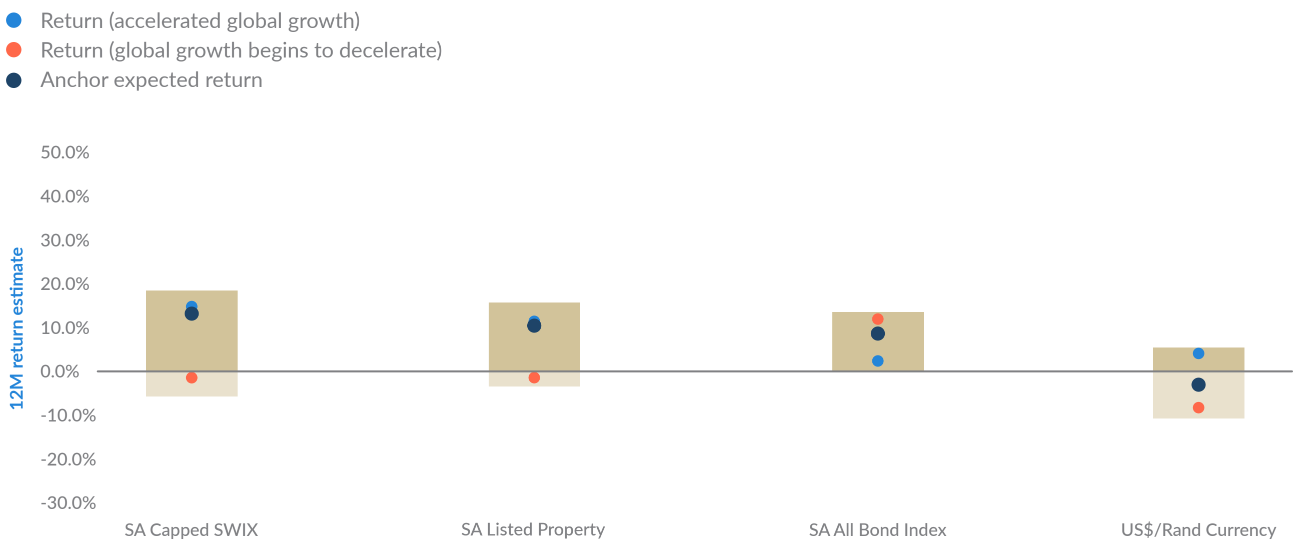
Globally, we believe that the equity bull run is still in its infancy in terms of age and there is scope for it to carry on if earnings expectations continue to be met or exceeded. The risk is that expectations are high, and an earnings miss will be met with disappointment that could be expensive. Bonds are uninteresting, while property is a middle-of-the-road asset class given the difficult dynamics.

Figure 2: Anchor expected return by offshore asset class
Source: Anchor

	Global equity	Global bonds	Global property
Anchor expected return (in US dollar)	6.0%	-1.7%	5.0%

In *Figure 3* below, we highlight the rand return outlook for several domestic asset classes. The bar represents the reasonable range of possible outcomes, with the dots representing our estimate of what the outcome will be under the various scenarios. From a domestic investor perspective, equity markets are increasingly compelling.

Figure 3: 12M return scenarios for various asset classes in rand terms
Source: Anchor



Domestically, we think that this is a positive investment environment, where the risks are skewed towards the upside. All asset classes are rather positive but the pro-risk environment favours equities the most. We see more scope for rand depreciation rather than appreciation, although our base case is that this will be relatively modest.

Figure 4: Anchor expected return for domestic asset classes
Source: Anchor

	Domestic equity	Domestic bonds	Domestic property	US$/rand
Anchor expected return (in rand)	14.0%	8.8%	11.0%	-2.2%

Strategy and Asset Allocation

ECONOMICS

As we enter the second half of 2021, (and notably a year and a half since the onset of the COVID-19 pandemic), the global economy is poised to stage its most robust post-recession recovery in 80 years. However, the rebound is expected to be uneven across countries, as major economies look set to register strong growth even as many developing economies lag. The key risk to global growth prospects continues to be the pandemic. The rapid spread of the more transmissible Delta variant across the globe is a cause for concern. However, evidence suggests that vaccinations are an effective tool against this new variant, breaking the link between infections and hospitalisations. Despite the rapidly evolving risks, economic sentiment continues to track higher, resulting in some central banks heading towards monetary tightening. The US and China are each expected to contribute about one quarter of global growth in 2021. The US economy has been bolstered by massive fiscal support and a rapid vaccine drive under President Joe Biden's administration. Subsequently, growth is expected to reach c. 6.8% this year - the fastest pace since 1984. China's economy (which did not contract last year) is expected to grow by a solid c. 8.5% YoY in 2021 and then moderate as the country's focus shifts to reducing financial stability risks.

Locally, SA's third wave of the pandemic was always a likely event, and indeed a fourth and even a fifth wave as well.

Growth among EM and developing economies is also expected to accelerate, assisted by increased external demand and higher commodity prices. However, the recovery of many countries is constrained by resurgences of COVID-19, uneven vaccinations, and a partial withdrawal of government economic support measures. Regionally, the recovery is expected to be strongest in East Asia and the Pacific, largely due to the strength of China's recovery. In South Asia, recovery has been hampered by serious renewed outbreaks of the virus in India and Nepal. The Middle East, North Africa, Latin America, and the Caribbean are expected to post growth too shallow to offset 2020's contraction. Sub-Saharan Africa's recovery, despite being boosted by spillovers from the global recovery, is expected to remain fragile given the slow pace of vaccination and delays to major investments in infrastructure and the extractives sectors.

Amidst the global easing of social restrictions and strengthening demand, one market segment that has seen some notable moves has been commodities. For example, YTD, oil and gas prices have witnessed gains of 47% and 42%, respectively, whilst other hard commodities such as iron ore and copper, amongst others, have also seen double-digit gains. The sharp rebound in activity is pushing up commodity prices, driven by factors such as supply shortages and logistical bottlenecks. Ultimately, this is showing up in various inflation figures, albeit on a temporary basis. Despite clear evidence of price pressures within the US economy, Federal Reserve (Fed) Chair Jerome Powell has remained committed to the message that this upward momentum in prices is transitory in nature. Markets are pricing in a slightly more aggressive Fed in the near term, while appearing more convinced that inflation will be under control. Our baseline expectation is that inflationary pressures will indeed subside, although we do acknowledge the risk of more persistent price rises than first envisioned.

Locally, SA's third wave of the pandemic was always a likely event, and indeed a fourth and even a fifth wave as well, given the very slow pace of vaccine rollout - which only started to accelerate in June. Whilst notable downward risks remain, economic recovery is still progressing fairly well. Nonetheless, SA's economic activity will be patchy, with this unevenness between sectors influenced by lockdown levels. Positively, SA has seen a recent quickening in its pace of growth-enhancing economic reforms (and notably a strong and committed anti-corruption drive), which supports the view of a longer-term acceleration in economic growth once the distorting effect from last year's base effects dissipates.

Concerningly, unemployment sits at a record high of 32.6%, with 1.4mn South Africans, who were previously employed before the harsh lockdown restrictions of level 5 last year, still out of work. This has set SA's job creation back by seven years. With some EMs hiking interest rates, SA will follow suit, although likely only from next year onwards. The rand has seen marked strength but will not see the same extreme appreciation it has since April 2020. Whilst consumer spending has rebounded soundly thus far, further growth will be dependent on consumer confidence, employment, access to credit, the effects of inflation, as well as disposable incomes (which could suffer in 3Q21 amid the third wave of the pandemic), with light lockdown restrictions key to the overall outlook.

SA EQUITIES

After a strong first quarter performance at an index level for the JSE, 2Q21 proved to be more challenging, with the FTSE/JSE Capped SWIX only managing to eke out a marginally positive return (+0.6% for the quarter), bringing the YTD number to a 13.3% gain. Looking through the headline number, 2Q21 brought about a big sectoral shift in leadership, with the most notable being the outperformance of domestically focussed counters over the basic materials producers and rand-hedge industrials. The latter's returns being somewhat suppressed by the appreciation of the rand by c. 3% QoQ against most major trading currencies.

Much has transpired over the past quarter for investors on the JSE, including better-than-forecast operating results from large economically sensitive bellwether companies, which provided an underpin to the domestic bourse's outperformance. Commodity prices, even though they are off their recent highs, remain at levels far higher than the consensus forecasts are currently expecting over the next 12 months. The increased earnings expectations 12-months out, coupled with a roughly flat quarter for the index, has resulted in our one-year forward, total return expectation increasing to 14%, up from the 12% we were expecting in 1Q21. The key risks to our return forecast remain the disappointingly slow vaccine rollout in SA, and the onset of a devasting third wave of COVID-19 and the much more contagious Delta variant. However, these factors remain a more serious humanitarian concern than necessarily one for the stock market, which will once again most likely be more influenced by outside events linked to the rapid improvement of the US economy, which will influence the global cost of capital, and the demand for key commodities from our largest commodity trading partners - China and Europe.

Not since the change in the ANC leadership at the end of 2017 (when Cyril Ramaphosa became president of the party), have we seen such a sharp outperformance of domestic counters on the JSE. We note that, not only has sentiment seen a marked shift in the right direction but, for the first time in many years, the outperformance of these stocks has been underpinned by better-than-expected financial performances across the board (from banks to retailers to industrial businesses) and positive earnings revisions, not merely multiples expanding. The onset of President Cyril Ramaphosa's New Dawn brought about much hope, but not a lot in the way of positive earnings revisions, and the outperformance of JSE-listed shares faded relatively quickly. This time round, with earnings expectations too low and some high-quality operational performances across the various sectors, the outperformance has been more fundamentally driven than merely sentiment driven.

Nevertheless, as the third wave of the pandemic ravages the country it is difficult to conclude that, at the margin, on the ground, conditions locally are incrementally better than they were at the start of this year. However, from our interaction with many stakeholders and continuously better-than-expected hard data points and company results, this does seem to be the case. Market participants have once again been reminded of just how important the commodity cycle is for the country, not necessarily the direct GDP impact (this remains relatively small at c. 8% of overall GDP), but more the second- and third-order impacts that tend to permeate across most spheres of the economy.

Unfortunately, commodity markets and cycles are notoriously fickle and, in the short term, are clearly masking the deep structural challenges faced by SA. Unemployment and the lack of fiscal flexibility, underpinned by inefficient policy, has become more self-fulfilling as many of the companies we analyse and speak to remain unwilling to deploy meaningful capex that would not only provide a kicker to earnings but would also kick-start the economic flywheel. Still, we are particularly encouraged by government's decision to allow independent power producers (IPPs) to produce up to 100 megawatts of power, up from the initially suggested 1 MW.

Arguably the most disappointing event that has transpired for investors over the past quarter was Naspers and Prosus' underwhelming proposal to, in effect, increase the cross holding between the two companies, reducing the shares in issues via an accounting technicality and thereby, according to management, increasing the NAV per share by roughly 9%. As investors in these companies (like most investors on the JSE), we have been waiting for management to come up with a sustainable solution to addressing the "distractingly" high discount to NAV at which the stock is trading. However, the proposed solution does not go nearly far enough to incentivise shareholders to rerate the counter, in our view. We use the term "distractingly" high because we feel the discount remains too much of an issue for investors to look past it and focus on the strong operating performances of the investment portfolio and the exciting prospects of the businesses in which they are investing billions of dollars.

It has become clear that there is not enough incentive for management to do whatever is necessary to close the discount, namely unbundle Tencent and have it as a separate listing on the JSE and collapsing the control structure at a Naspers level. Outside of that, we cannot see any other sustainable solution to addressing the discount (although we concede that we do not have the intricate detail of the structures and the range of potential possibilities available to us). We do, however, feel that the most recent bout of investor fatigue has seen the discount shoot out to extreme levels and Naspers/Prosus remains one of our top picks for the upcoming quarter, largely driven by our optimism for the prospects of Tencent, relative to the domestic opportunity set.

Analysing and investing in this space requires a different set of disciplines (more top-down), than what we would typically apply.

The recent underperformance of the basic materials sector on the JSE (a 2% drag on the index over 2Q21) and corresponding positive earnings revisions should intuitively result in an incrementally more positive outlook over the coming quarter (3Q21) relative to 2Q21. Global inflation concerns, and supply chain issues over the quarter seemed to result in elevated levels of speculative activity in many commodity markets, however in recent months these appear to have eased. Company balance sheets remain strong, and we have not yet seen the signs of poor capital discipline that has plagued previous cycles. However, front of mind for us when forming a view on the sector, once again, has very little to do with the supply/demand of the commodities and more to do with the expected glide path of asset tapering in the US and the impact that this will have on sentiment towards the US dollar and, potentially, the relative levels of certain commodity markets (and certain EMs).

Working on correlations such as these, once again reminds us that analysing and investing in this space requires a different set of disciplines (more top-down), than what we would typically apply (more bottom-up), when analysing and investing in businesses. We remain sceptical of optically low P/E multiples in the context of near peak-of-cycle margins. However, after having reflected on the various scenarios, our view is that, over the near term, enough support exists to maintain most of the basket prices of the businesses in our investment universe and, with the recent pullback in equities, we have been increasing our exposure to both platinum group metals (PGMs) and the diversified mining sector.

SA LISTED PROPERTY

SA listed property has been the best-performing asset class this year, with a 19% return from the FTSE/JSE SA Listed Property Index (SAPY) for the first six months of 2021. While on the ground property remains under considerable pressure, share prices at the beginning of the year were pricing in a dire outcome. It has not turned out as badly as the market had anticipated.

The reason for this is that the local market was positively impacted by:

- The recovery in economic activity, which has been stronger than we had expected,
- rural and township retail, which has been very resilient (there have also been some signs of an improvement in urban retail),
- liquidity both from debt and equity sources has been more robust than our expectations,
- the appetite towards this asset class seems to continue to improve (although it remains somewhat “fragile”), and
- balance sheet repair has been faster paced than our initial expectations.

All of the above are positive, but our forecast of an 11% return over the next 12 months is only just above the forecast dividend yield (dividends yields are difficult to forecast, especially given the range of outcomes and payout ratios, but should be in the region of 8% and 10%, with our official projection at 8.6%). Listed property companies are now generally only paying out 75%-90% of earnings, compared to 100% in the past. Some of the more leveraged players are not paying any dividends.

Property companies have mostly abandoned giving forward projections, compared to the tradition of prior years, when the certainty of rentals enabled these companies to provide tight forecast dividends for the coming year.

SA listed property is optically still cheap, with discounts to book net asset value of 20%-40%. However, we believe that physical property will remain under pressure for the next few years as rentals adjust downwards to reflect the high level of vacancies. We expect book net asset values to continue being written down to reflect the market’s more appropriate assessment of actual underlying value.

In its latest trading update, bellwether Growthpoint reported negative retail rental reversions of 15.2% for the leases that ended, and its office vacancies currently stand at 19.2% (vs the SA Property Owners Association’s [SAPOA’s] average of 15% vacancies). An indication of the future is Polish retailer EPP, which in May reported its current footfall rate at 82% of pre-COVID levels – this for a country which is at an advanced stage of the vaccine rollout.

While there will be structural pressure on earnings for the next few years, in the shorter term (over 12-18 months), there will be some positive rebounds to bolster earnings as the economy opens again and tourism returns (in the case of Growthpoint, the V&A Waterfront is driven by inbound tourists). SA’s third wave of the virus (the more contagious Delta variant), will have a material negative short-term impact, but both tenants and landlords have more experience of how to deal with this.

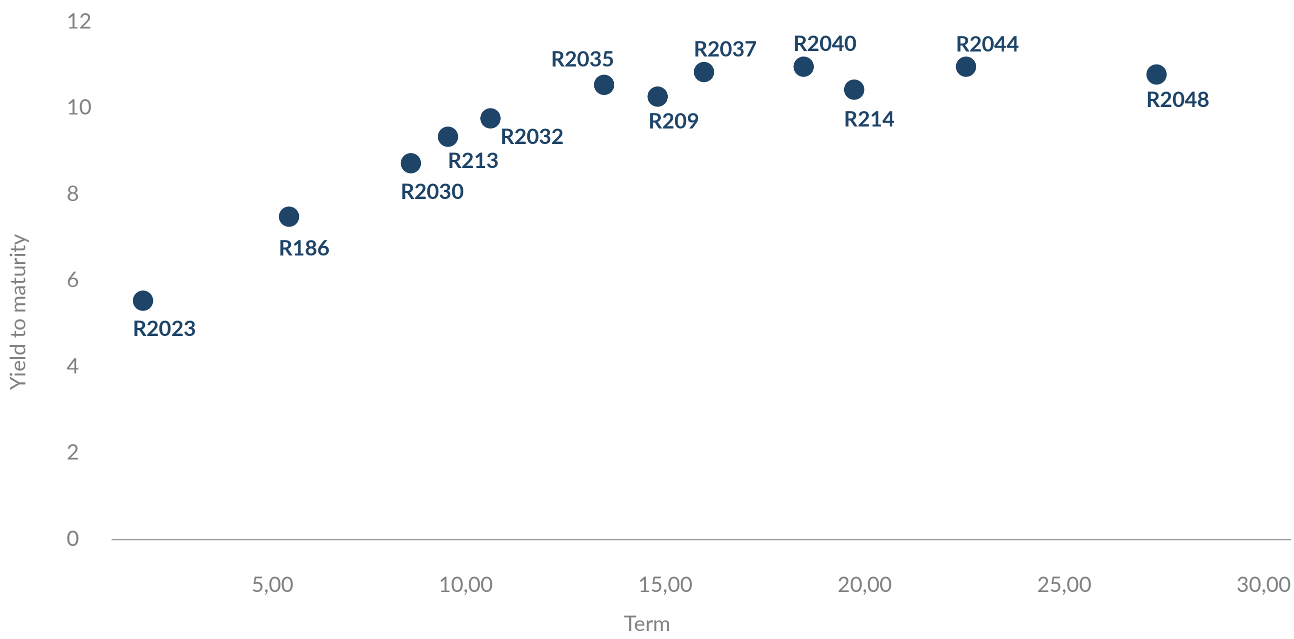
DOMESTIC BONDS

After 1Q21 ended with a period of weakness for SA government bonds (driven by the increase in US 10-year treasury yields), 2Q21 has been far less active in terms of yield movements. Whereas 1Q21 experienced yield highs of 7.76% and lows of 6.57% on the R186, 2Q21 saw 7.55% and 7.10%, respectively (a range of 1.19% in 1Q21 and only a 45-bpt range in 2Q21).

As we approach 2H21, we expect the key consideration going forward to be the SA Reserve Bank's (SARB's) Monetary Policy Committee's (MPC) decisions on the repo rate. Currently the repo rate is at 3.5% - a record low. It has been at this level since the start of the COVID-19 crisis in March 2020. The forward rate agreement (FRA) rates are currently pricing in 200 bpts of rate hikes over the next 21 months, with 100 bpts in rate hikes being priced-in over the next 9 months. We think that these rate-hike expectations are excessive for the local economy and we therefore see some prospect of capital gains in short-dated bonds.

This rate-hiking environment has the most substantial impacts on shorter-dated SA government bonds, where the front of the curve is pegged down by the repo rate. Currently the R186 yields 7.445% - a spread of nearly 4% vs the repo rate (for taking on 5.5 years of government debt). Given these dynamics, SA bonds remain attractive instruments, most particularly the "belly bonds" (the "belly" is the central portion of the curve – in our case the 10- to 20-year bonds). These bonds currently offer the most attractive yield-to-term dynamics and we retain a material and strategic overweight on these bonds (the R2030, R213, R2032, R2035, and the R2037).

Figure 1: Yield dynamics of various SA government bonds
Source: Anchor, Thomson Reuters



As *Figure 1* above shows, the attractiveness of long-term debt is constrained, with the steepness (or yield difference) between the R2048 (27 years to maturity, the longest SA government bond [SAGB]) and the R2037 (16 years to maturity, the "belly") being 13 bpts – for an additional 11 years of term to maturity. Conversely, an accommodative SARB MPC has resulted in short-end bonds offering anaemic yields (the short-end R2023, for example, yields 5.3% at present).

Overall, 1H21 has offered SAGB investors a good outcome. Central banks are likely to reduce their stimulus over the next year and, while this will act as a drag on our bonds, we expect SA bonds to move broadly sideways. The index itself yields approximately 9% at present, which would give a one-year return for an All Bond Index (ALBI) investor of just under 9%.

THE RAND

Strong exports of both commodities and manufactured items such as motor cars have seen SA's trade balance average a surplus of just over a R50bn per month for 2021. The trade balance has been exacerbated by both the lockdowns and the poor domestic economy, which has seen imports being below what we had expected. The net result is that foreigners are buying R50bn of local currency per month to pay for our exports. This has given a solid boost to the rand, which traded firmer at R13.75/US$1 for a period.

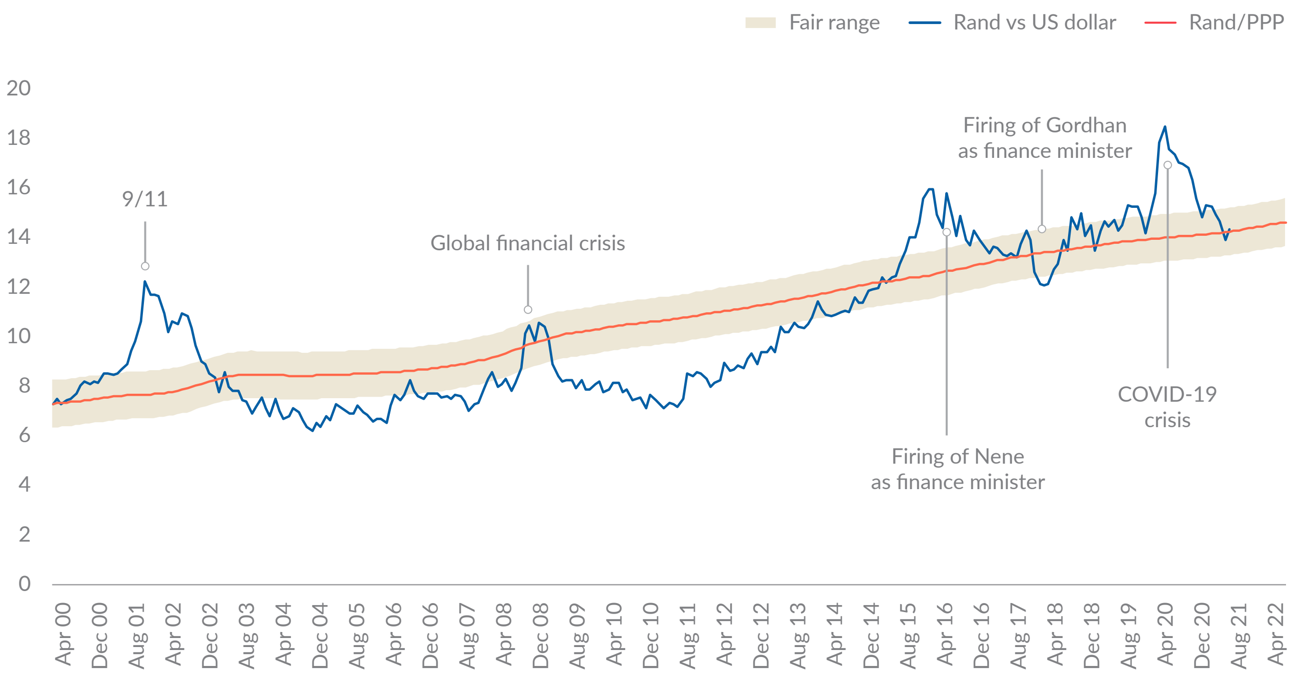
Towards the end of the quarter, fears that the US Fed would begin to taper bond purchases has pushed the rand slightly weaker. In the chart below (*Figure 2*), you will see that the rand is essentially at the midpoint of our fair value range.

Projecting the rand's value in a year's time is a fool's errand. The rand vs US dollar exchange rate is one of the world's most volatile currency pairs and trades well away from any modelled fair value for long periods. We note, however, that the rand trades within a R2.50 range to the US dollar in most 12-month periods.

We retain our purchasing power parity (PPP) based model for estimating the fair value of the rand and we have extended this out by three months since the publication of *The Navigator – Anchor's Strategy and Asset Allocation, 2Q21* report on 9 April 2021. Our PPP-modelled value for the rand vs US dollar at the end of the next 12 months is R14.45/US$1 (See *Figure 2*). We apply a R2.00 range around this to get to a fair value range of between R13.45 and R15.45/US$1.

We expect the rand to remain particularly volatile even though we do think that it may continue to trade with a strengthening bias, while the trade balance remains supportive.

Figure 2: Actual rand/US dollar exchange rate vs rand PPP model
Source: Thomson Reuters, Anchor



GLOBAL EQUITIES

Global equity markets have hit record highs at the 2021 half-year mark, as company earnings materially exceed expectations of six months ago. We expect this bull market to continue in the short term but, on a 12-month view, the risk is that the earnings rebound might well have already been priced in. We look for our returns at the company level, where quality growth companies are still accessible at reasonable prices.

The behaviour of the US stock market can best be explained by *Figure 3* below, which shows projected 2021 earnings of the S&P (USc191), 16% higher than pre-pandemic 2019 (USc152), implying stronger businesses than pre-COVID. Importantly, another 11% earnings growth is projected in 2022 (to USc213), suggesting that the momentum can be sustained.

Figure 3: US S&P earnings expectations, 2003 and beyond
Source: Bloomberg, Anchor

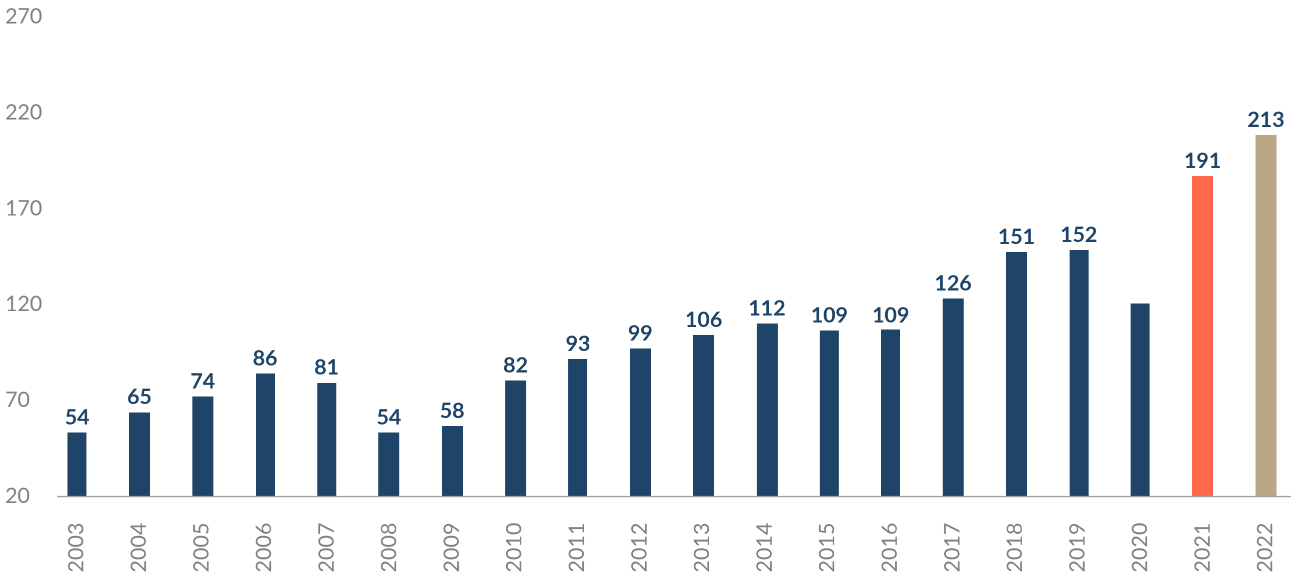
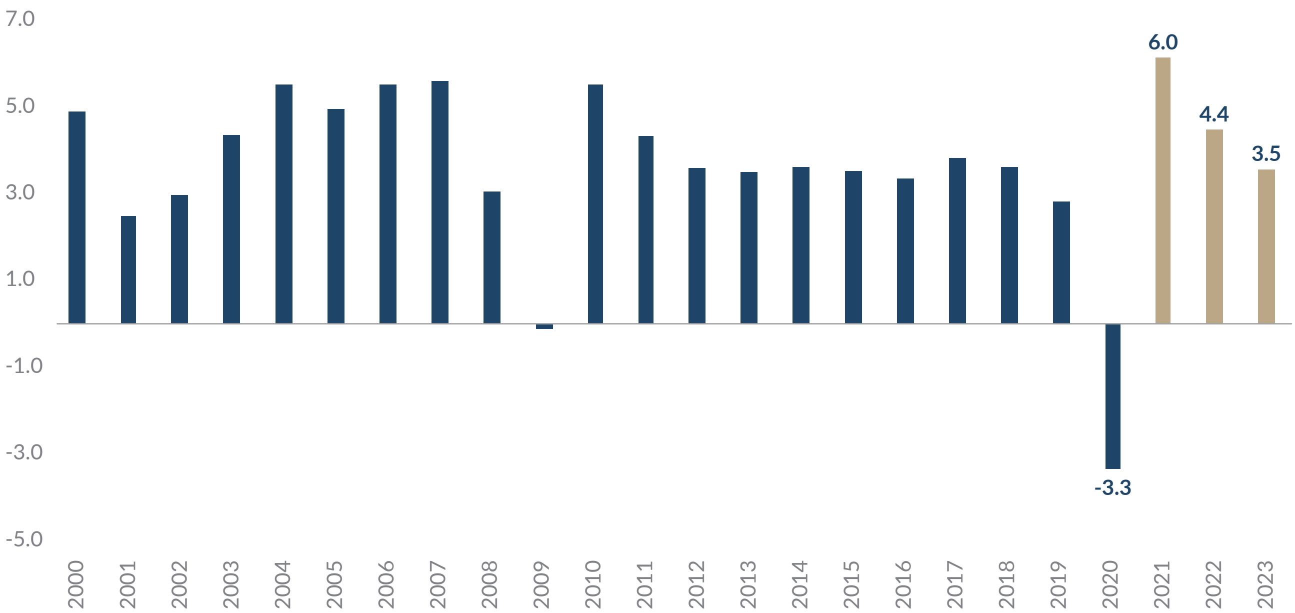


Figure 4 below tells the same story, with global GDP (the primary driver of earnings growth) looking strong in 2021 (+6% YoY) and 2022 (+4.4% YoY). Governments have stepped in to counter the COVID-19 pandemic, with massive fiscal stimulus, free money, and low interest rates. Consumers have responded with a massive spending spree and the majority of listed businesses have leveraged off the rebounding spend.

Figure 4: Global GDP growth
Source: IMF, Anchor

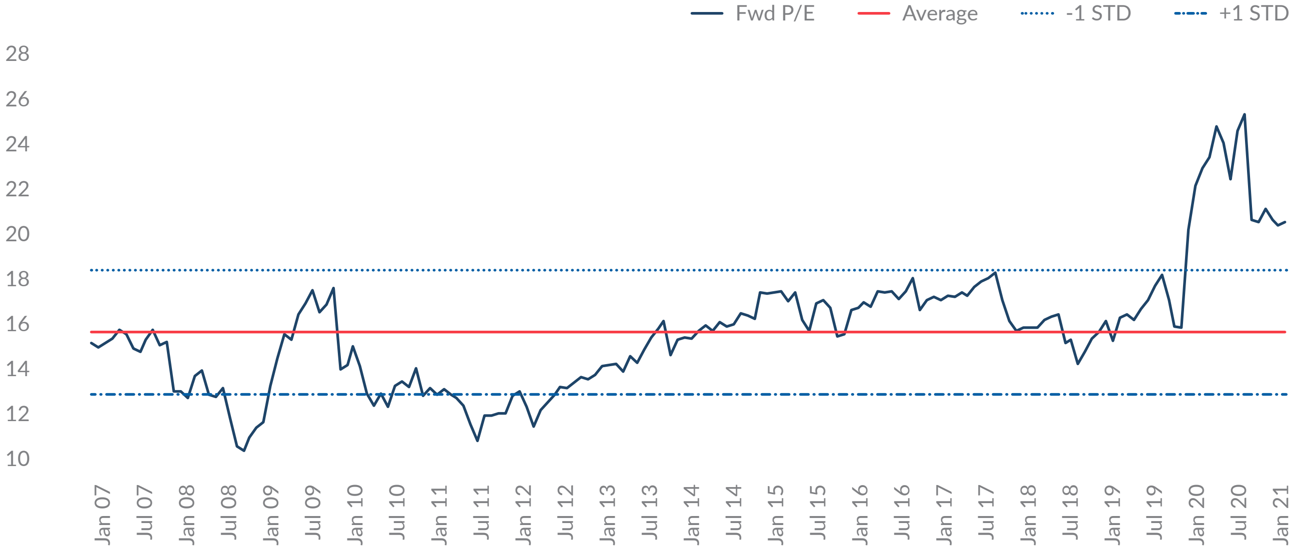


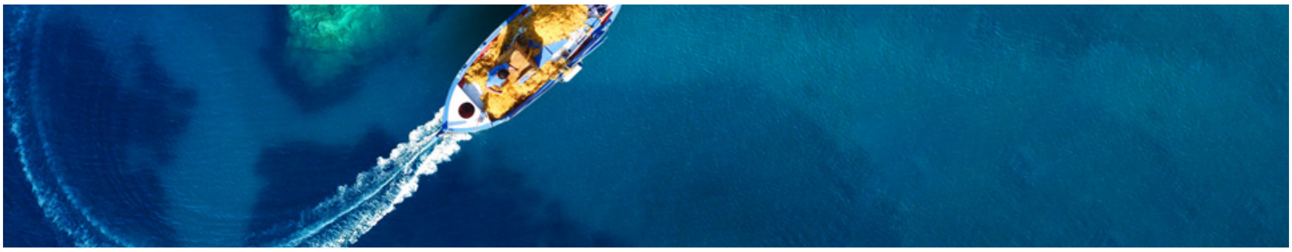
Stock markets are a barometer for future expectations. The March 2020 crash priced-in the potential for a horror pandemic outcome, but the subsequent generous reaction of governments and the realisation that the pandemic would be managed, set the markets off on an unstoppable upward path. This was aided by ever-increasing earnings growth forecasts, higher commodity prices, and new cash being hurtled into the market. Global equity markets returned 16% in 2020 and the scorecard shows a 12% return for the first six months of 2021. A healthy portion of the earnings growth and market returns have been driven by the improving outlooks and re-ratings of technology shares, many of whom had their futures accelerated by 2-5 years as consumers shopped on their laptops rather than in malls and embraced a digital future.

Figure 5: The S&P 500 daily price performance, July 2019 to date
Source: Bloomberg, Anchor

This has resulted in a material rerating of each dollar of earnings, as reflected in *Figure 6* below, which shows the world forward P/E multiple (incorporating the recovery for the next 12 months) at a lofty 21x - 25% ahead of the average over the past 15 years.

Figure 6: MSCI World forward P/E
Source: Bloomberg, Anchor





The above is further illustrated in the table below *(Figure 7)*, breaking down the numbers by territory/market.

Figure 7: Select global indices, earnings growth, and forward P/Es
Source: Anchor, Iress

	Earnings growth		FWD P/E	
Name	**YR1**	**YR2**	**YR1**	**YR2**
MSCI World Index	49.0%	8.9%	19.6	18.0
MSCI EM Index	34.2%	10.0%	14.0	12.8
MSCI All Country World Index (10% EM)	45.7%	8.2%	18.8	17.4
S&P 500 Index	42.5%	10.7%	21.2	19.1

While economic and earnings prospects look good, the market looks expensive. Back in January our equity view was overweight ("do not fight the bull market"), but we were measured in our return expectation (5% for 2021) to reflect valuations which were even higher than today (they have been brought down by c. 50% earnings growth in the US YTD). Since then, the market has continued on an inexorable upward trajectory, albeit with the baton changing hands from value to growth a few times.

The primary change in the past six months has been better-than-expected earnings and increasing earnings forecasts, which probably justifies the performance ahead of our more measured expectations.

So where to from here? In our view, the biggest drivers of the market are likely to be:

- **The future change in earnings expectations:** Expectations are now already high, after continual upward revisions for the past year and the risk is that, over the next six months, certain sectors might see earnings downgrades as life returns to normal and spikes in pent-up demand spending normalise.

- **Inflation and the future course of the US Fed:** Bond markets have thus far supported the Fed's expectation that US inflation is transitory and the market will be watching closely. A low cost of money supports higher share valuations and conversely a change in this expectation will put pressure on share prices. We got a small taste of this in markets over a month ago.

- **The path of the pandemic if things worsen materially again:** In aggregate, we do not expect this, as global vaccine doses now exceed 3bn and the rollout globally continues at a pace of 40mn/day. However, we have learnt that the pandemic can surprise, and the road may be bumpy going forward.

- **Other surprises?** There are always numerous other potential sources for surprises, including Chinese aggression, other geopolitical risks, anti-trust regulation, and other regulatory moves.

After 15 months of almost uninterrupted upward momentum, the market feels comfortable, which can make investors complacent. With a positive macro picture, it seems likely to us that the short-term path will continue to be positive, but risks get higher as the market continues to move upwards.

We are not calling an end to the bull market at this point, but share selection becomes increasingly important at this stage of the market. We remain alert to the following at a level below the index:

- As overall index levels rise, we are conscious that certain shares become overvalued as overoptimism prevails, and the risk/return trade-off is just not attractive anymore. We seek to identify and avoid these, even if they are great companies.

- The world is going through unprecedented change and certain big technology-driven businesses are growing apace and their path of growth will be driven by their fundamentals rather than interest rates and macro moves. This is likely to be a major source of returns for some time to come.

- Opportunities remain in the reopening trade, where there are still counters trading at levels below that of early 2020.

- The banking sector still offers some value and an increase in rates will be positive for returns on bank capital and widen margins.

- There are always bottom-up opportunities, where the market is skeptical about a company we believe in and it is not pricing in the prospects – we actively seek these out.

- Chinese shares and, more specifically, Chinese tech companies, stand out as offering value relative to growth prospects. Government regulation has seen this sector come under pressure, but history shows these bouts of anxiety tend to fade and the market returns to valuing growth appropriately.

EMs have generally been far behind developed markets (DMs) from a vaccine perspective and COVID-19 might provide a drag on a relative basis. EMs are very commodity heavy and, given the SA weighting to commodities, our approach to EMs is to identify fast-growing quality businesses, which are exposed to the attractive demographics of their territories. There are some very exciting investments in these areas.

The US remains our choice destination for investment, especially given the technology-centric bias of that market compared to, for example, Europe. The latter, together with the UK, has a more industrial/banking/energy bias, which does offer positive shorter-term prospects.

GLOBAL BONDS

Global bonds have been one of the beneficiaries of the pandemic thanks to aggressive central bank efforts to maintain high levels of monetary support and liquidity throughout the crisis. While European and Japanese 10-year government bond yields are still anchored at around 0%, US yields are c. 0.4% below their pre-pandemic levels. With economic activity beginning to normalise, investors are laser-focussed on when and how the fiscal and monetary stimulus will reverse and how tightening liquidity conditions will impact generally stretched valuations for bonds (and stocks).

Figure 8: Major DM governments have taken on significant debt – much of it purchased by their central banks – to limit the economic fallout of the pandemic.
Source: Anchor, Bloomberg

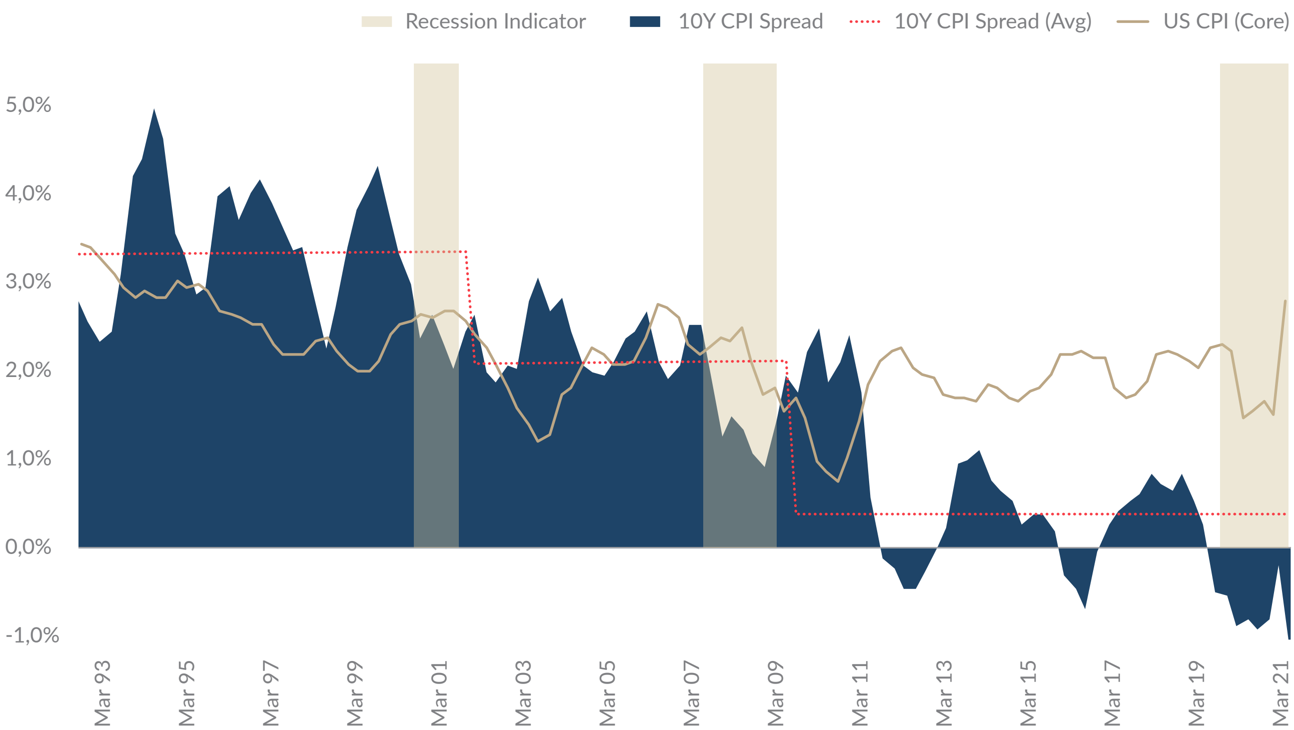
	Pre-pandemic (Dec 2019)	Current	Change
Central bank balance sheets (US$trn)	**15**	**24**	**62%**
US	4	8	94%
EU	5	9	78%
Japan	5	6	22%
10-year government bond yields (%)			
US	1,9%	1,5%	-0,4%
EU	-0,2%	-0,2%	0,0%
Japan	0,0%	0,1%	0,1%
Government debt to GDP (%)			
US	102%	123%	21%
EU	84%	98%	17%
Japan	204%	224%	10%
Core inflation (%)			
US	2,3%	3,8%	1,5%
EU	1,3%	0,9%	-0,4%
Japan	0,7%	0,1%	-0,6%
	2019	**2021 (forecast)**	**Change**
Nominal GDP (US$trn)	40,3	42,4	5,3%
US	21,7	23,1	6,0%
EU	13,4	14,3	6,5%
Japan	5,1	5,1	-0,8%

The EU and Japan do not appear to have an imminent inflation problem and it is likely that their central banks will be in less of a rush to rein in liquidity, so in this section we focus on the US' response.

Our typical approach to forecasting US 10-year bond yields focusses on:

1. **Real yields:** This requires some assumptions about the path of inflation and what impact quantitative easing (QE) will have on the prospects of investors earning positive real yields. We think inflation will still be experiencing some transitory impacts as well as the prospects of slightly higher shelter inflation towards the end of our forecast horizon. Regarding QE, we expect the Fed to start tapering its bond purchases early next year (with an increasing possibility that it may start sooner) and so, by the end of our forecast horizon, we expect tapering to be well underway. Despite the tapering, we think that real yields will remain negative over our forecast horizon, with both inflation and 10-year yields moving higher at a roughly similar quantum, albeit a slightly different pace. We expect real yields to turn positive only once inflation settles below 2% again and economic growth has enough momentum to sustain a shrinking Fed balance sheet (at least relative to currency in issue) – we do not believe either of those conditions will exist over the next twelve months.

Figure 9: We expect US inflation and 10-year yields to both be slightly higher in twelve months, keeping real rates in negative territory
Source: Anchor, Bloomberg

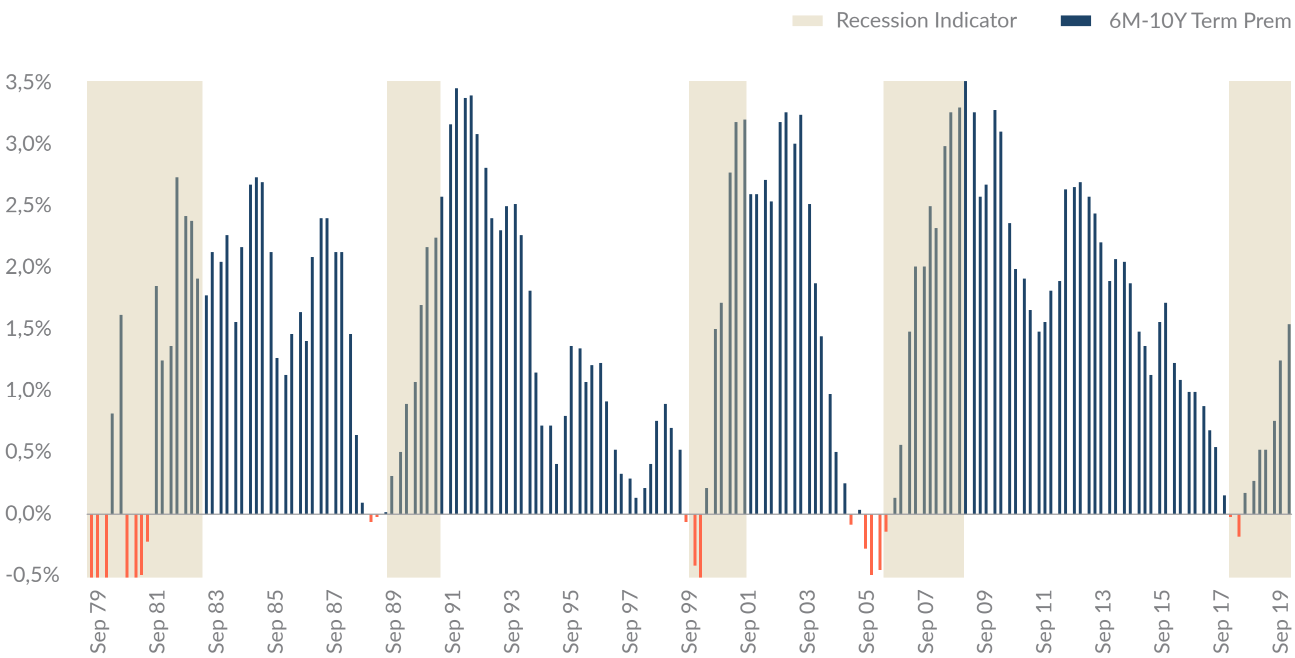


2. **Term premium:** Investors would typically expect a premium over short-term rates because of the uncertainty of lending money for such an extended period. Here, there are two components at play:

    a. *Short-term rates* – despite the Fed members becoming increasingly concerned about upside inflation surprises, even the most hawkish of them do not expect to start hiking rates before late 2022 (well past the forecast horizon which we are focussing on here).

    b. *Term premium* – which the Fed has controlled via QE and investors have tended to not demand much of a term premium over the past decade because of extremely low inflation uncertainty/ volatility and the Fed's willingness to respond rapidly and aggressively to uncertainty with QE. With the prospect of higher uncertainty around inflation and the Fed beginning tapering over our forecast horizon, we expect upward pressure on term premium. This could be slightly offset by concerns around how tightening liquidity conditions might act as a headwind to growth. The term premium will be in relation to short-term rates which, even towards the end of our forecast horizon (in mid-2022), should still be very close to 0%.

Figure 10: Increasing uncertainty about the path of inflation and Fed tapering should start to put upward pressure on term premiums
Source: Anchor, Bloomberg



Combining the forecasts from the two approaches above, we expect US 10-year bond yields to be c. 1.9% by mid-2022. This will give investors a total return loss of about 2.3% in US dollar terms if they own those bonds for the next year.

Figure 11: US 10-year yield forecast for mid-2022
Source: Anchor, Bloomberg

	Jun 22
US 6M rates	0.38%
Term premium	1.65%
10Y yield forecast	2.03%
CPI	2.5%
Real return	-0.75%
10Y yield forecast	1.75%
Combined 10Y yield forecast	1.89%

Moving higher up the yield spectrum, towards US dollar investment-grade corporate bonds, we find ourselves in a familiar situation to most asset classes with credit spreads as tight as they have been in 25 years.

Figure 12: US investment-grade credit spreads are at the low-end of their historical range
Source: Anchor, Bloomberg

Despite seemingly stretched valuations, we find reasons to believe that credit spreads can maintain, or even improve, these levels over the next year.

1. The central bank's willingness to step in as a buyer of last resort in investment-grade corporate credit, should allow investors to feel more comfortable with the liquidity of this asset class. This is particularly so in an environment where post-global financial crisis (GFC) regulations have meant that banks are restricted in the role they historically fulfilled as a liquidity provider to the asset class.

2. While credit spreads are stretched relative to the past 30 years, the current yield starved environment should see the "search for yield" provide an underpin to those levels.

3. Yields have historically been able to settle at extremely tight levels for extended periods, particularly from early in an economic cycle, such as the one it appears we currently find ourselves in.

Based on the above factors, we see credit spreads tightening slightly over the next 12 months to 0.75%. With government yields backing up a little, that should leave US investment-grade corporate bonds trading at an aggregate yield of c. 2.45% by mid-2022, leaving investors in that asset class with a negative total return over the period of about 1%.

GLOBAL PROPERTY

Retail property has experienced a painful structural change over the course of the past decade as changing shopping behaviour has rendered large swathes of retail space redundant. Although US commercial real estate services and investment firm, *CBRE* suggests that the US still needs to shed up to 20% of additional retail real estate inventory by 2025, it is fair to say that the sector is already well down the path of reinventing itself and digesting excess supply.

The pandemic has now thrust two new sectors into the spotlight of potential structural change – office and residential sectors (collectively about one-third of global real estate investment trusts' [REITs] market cap) – as new work-from-home (WFH) trends have left office space with escalating vacancies and shrinking demand. Commercial real estate systems specialist, *Kastle Systems*, has aggregated data from office access systems of the c. 2,600 buildings it services across the US and the data suggest that most major metros are still seeing offices operating with less than one-third of their staff being physically present.

Figure 13: Offices in major US metros are still operating at around one-third of pre-pandemic capacity
Source: Anchor, Bloomberg, Kastle Systems

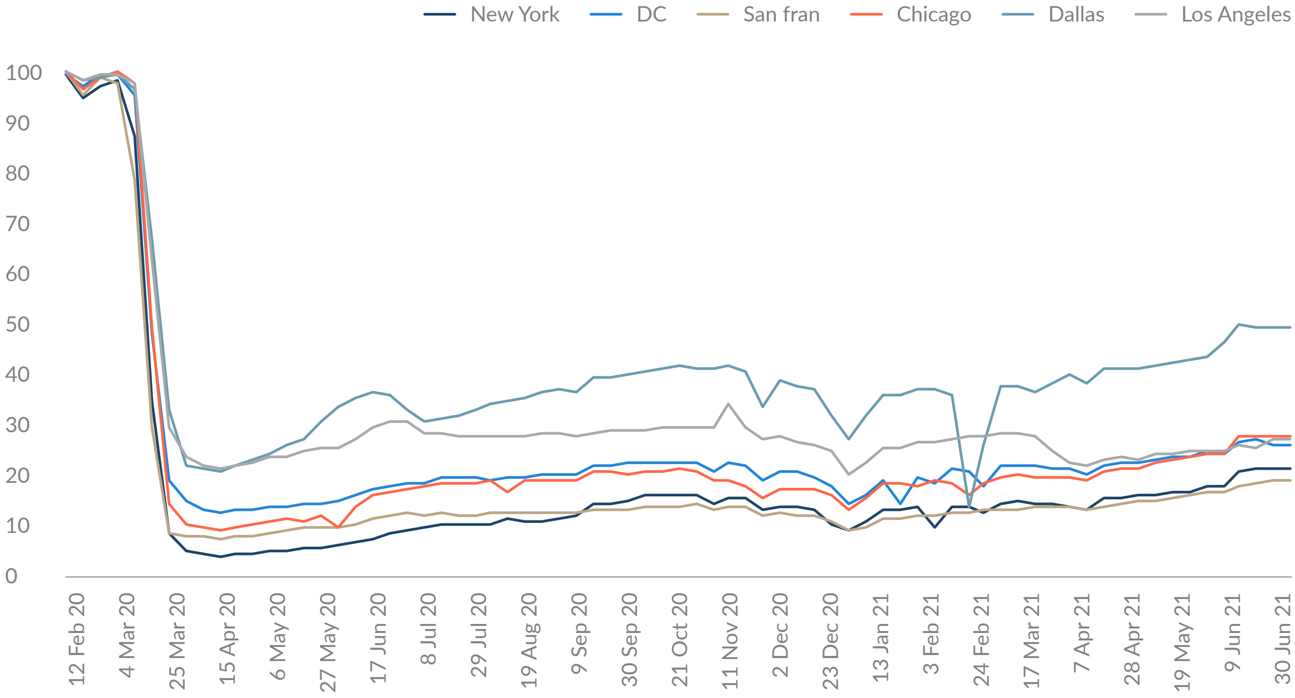


Figure 14: US commercial property vacancies - WFH trends have catalysed increasing vacancies in office space
Source: Anchor, NAREIT, Bloomberg

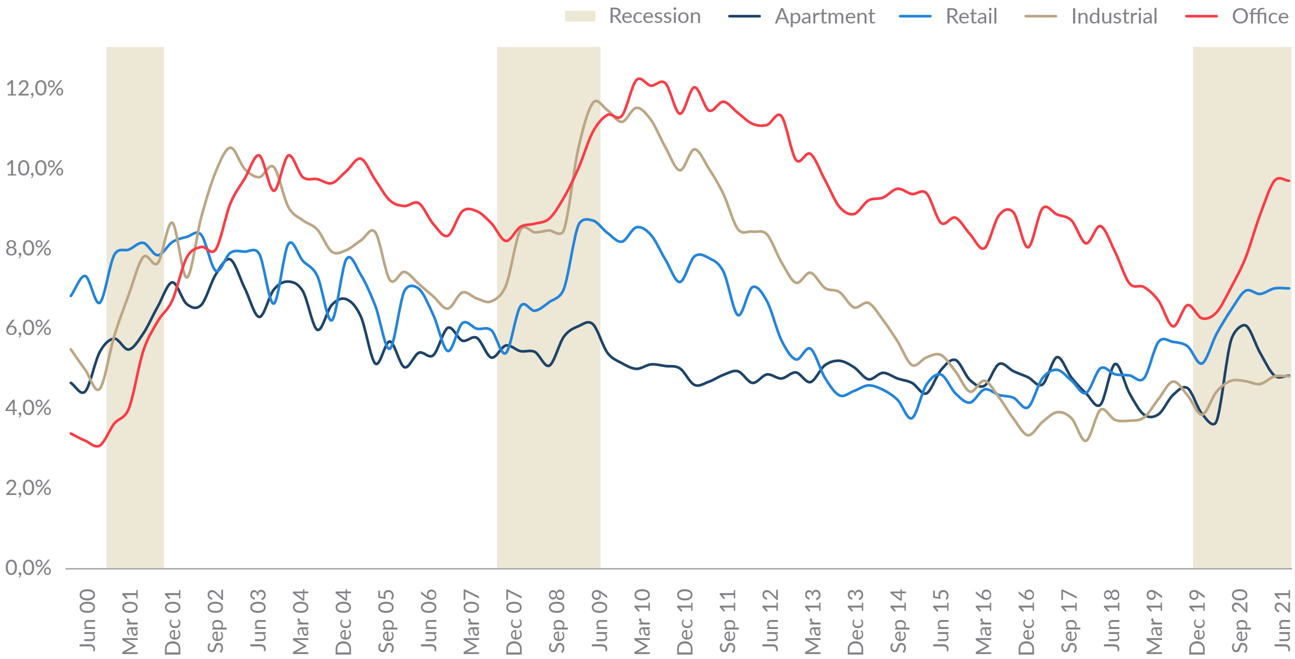
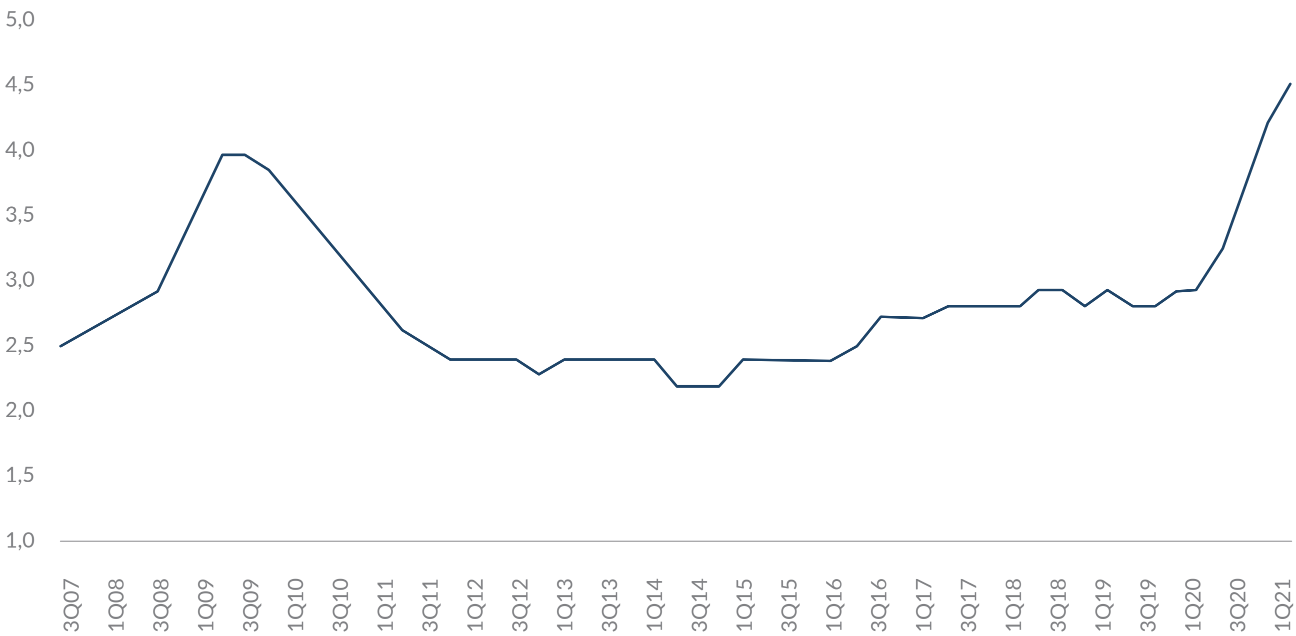


Figure 15: The percentage of US office space available for sublet - companies are actively looking to reduce their existing office floor space
Source: CBRE EA, Morgan Stanley Research



While WFH has put office space under pressure it has also increased demand for residential space as younger adults, in particular, look for larger living spaces in suburban and less densely populated urban areas.

Figure 16: US relocation trends since the pandemic - a significant number of young adults have taken the opportunity to relocate, many of them permanently
Source: Alphawise, Morgan Stanley Research

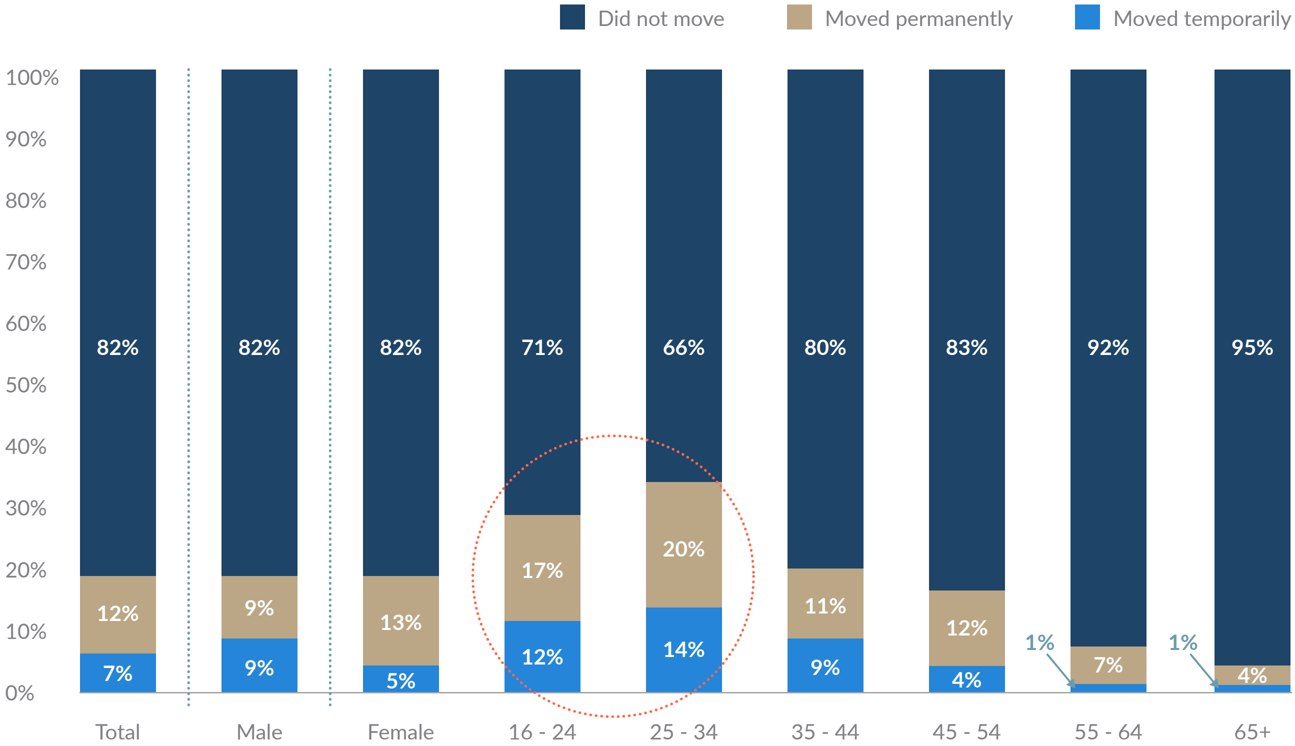
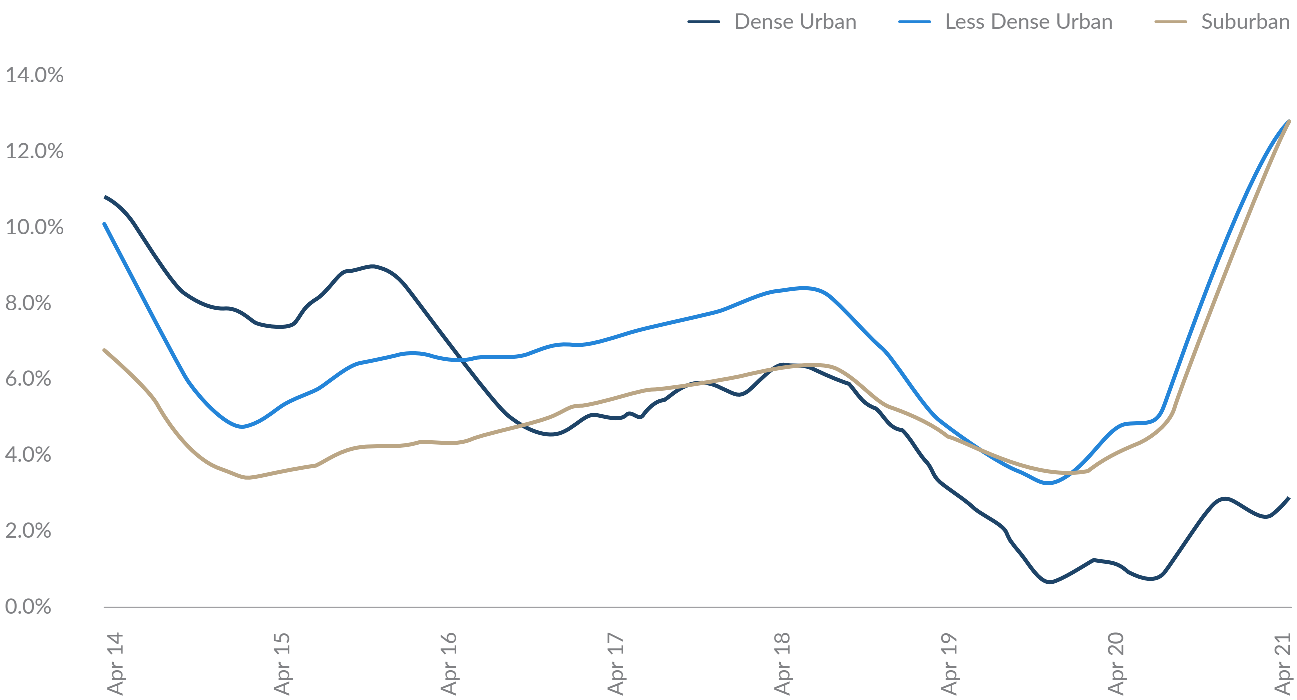


Figure 17: Trends in YoY house price appreciation suggest that most of the relocated demand is showing up in areas with more space
Source: Zillow, Morgan Stanley Research



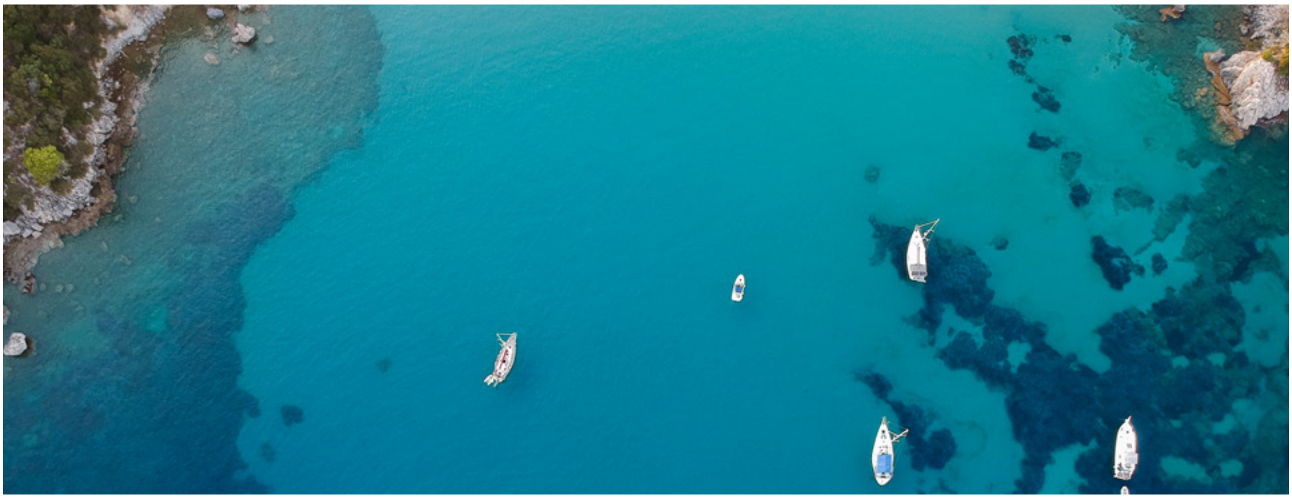
We expect growth in retail property income to remain somewhat muted for the foreseeable future, while the trends in WFH should have a roughly offsetting impact in office and residential property income growth. Those three sectors account for around half of global REIT market cap and, in aggregate, should be largely ex-growth over our twelve-month forecast horizon. The remaining half of market cap is dominated by industrial and specialised REITs, which are likely to continue to see growth in demand, albeit being increasingly met by accelerating supply. So, at the industry level, we expect an aggregate growth of rental income in the low-single digits.

With REITs already below their pre-pandemic levels (even after adjusting for the lower-yield environment), we see limited prospects for a re-rating in the sector at the aggregate level.

Figure 18: Forward dividend yields for most US REIT categories are below their pre-pandemic levels, even after adjusting for the lower-yield environment in the broader market
Source: Bloomberg, Anchor

Sector	Current fwd yield	Yield change (since pre-pandemic)	Adjusted for change in 10-year yield
Retail	4.0%	-1.2%	-0.7%
Industrial	2.3%	-0.3%	0.2%
Residential	2.6%	-0.1%	0.4%
Office	3.4%	0.2%	0.7%
Specialised	2.9%	-1.3%	-0.8%
Diversified	4.4%	-0.4%	0.1%
Healthcare	4.2%	-0.8%	-0.3%
Hotels & Resorts	0.7%	-5.1%	-4.6%
Total	3.1%	-0.9%	-0.4%
US 10-year bond yield	1.4%	-0.5%	

The net impact is likely to be a total return for investors in global listed property of about 5% over the next 12 months, with 60% of that in the form of yield and the rest from income growth.



ANCHOR INSIGHTS

In this section, staff from across Anchor provide insights into our thinking, strategy, and view of the world. This quarter, Henry Biddlecombe discusses the current investing environment and available opportunities in an article entitled Taking stock and picking stocks, Seleho Tsatsi asks the question as to whether the post-pandemic commodities boom will last, David Gibb discusses Anchor's tech strategy, specifically relating to Chinese vs US tech counters, and Peter Little provides insights into global inflation.

Taking stock and picking stocks

Written By:

Henry Biddlecombe
Fund Management

After working in the corporate finance team at Pinnacle Technology Holdings (JSE: PNC), Henry joined the Anchor investment team in 2015, initially as an equities analyst (contributing to both the local and offshore investment processes), and now as fund manager (he is co-manager of the Anchor BCI Global Technology Fund). Henry is a CFA Charterholder and holds a BCom Investment Management from the University of Johannesburg.

Somewhat paradoxically, it is when markets reflect the most uncertainty that it is easiest to take a certain stance on markets. Panic or exuberance are far easier to recognise and respond to with conviction than ambivalence, which requires a far more nuanced approach.

After the market-wide collapse in March of last year, there were several clear trades at play. Technology (tech) companies became the lifeline of the global economy, physical operations faced extinction and global central banks almost certainly had to intervene in what would likely be one of the deepest recessions in history.

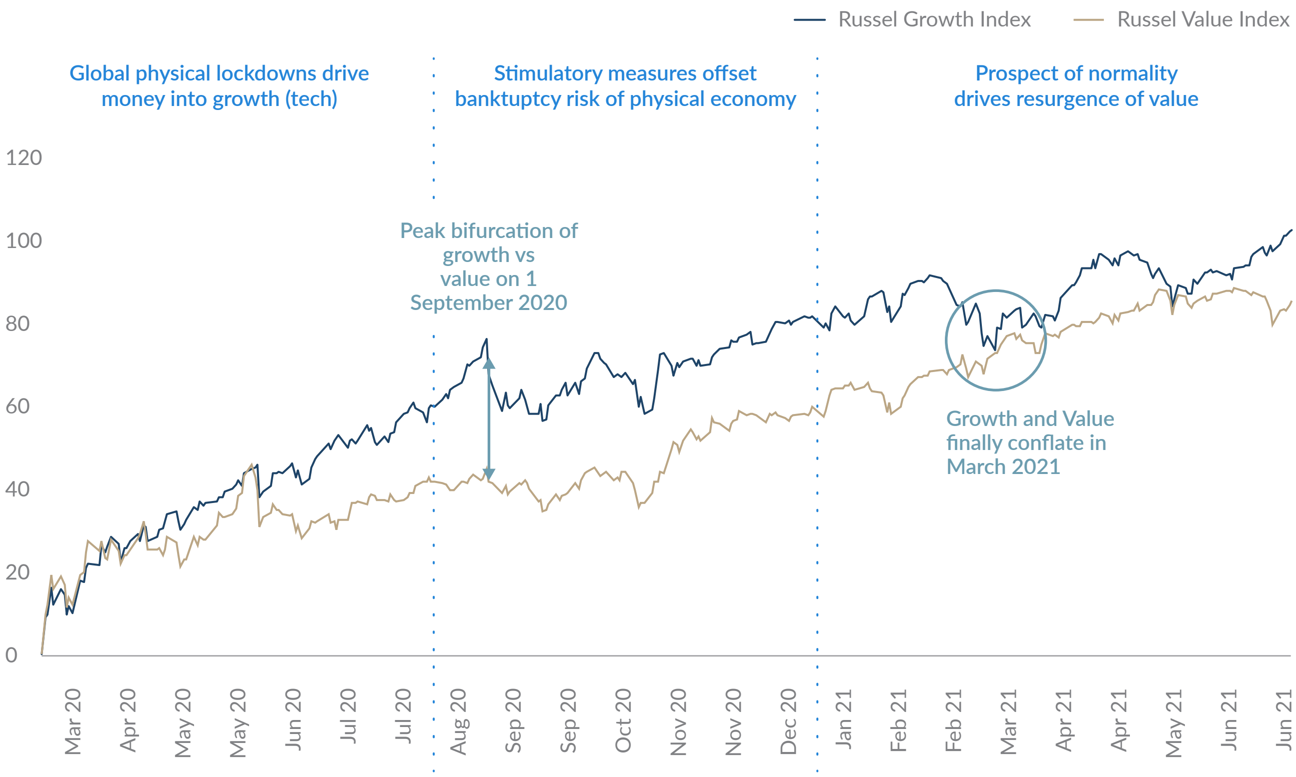
Panic or exuberance are far easier to recognise and respond to with conviction than ambivalence

Nobody knew exactly what the world would look like in a year's time (the vantage point we have today), but taking a view at that point also meant that you were spoiled for choice on how to express it.

The next six months bore witness to a historical bifurcation of the market, as growth shares (tech) tore away from value shares (physical economy stocks). Growth reached its relative zenith on 1 September 2020, having outperformed value by over 32% (as measured by the Russell 1000 Growth Index vs the Russell 1000 Value Index) since 23 March 2020 (when the S&P 500 bottomed) and driving shares like Tesla to US$883 *(+916% over same period)* or Zoom to US$568 *(+256% over same period)*.

As the crisis wore on, so the massively accommodative response from governments and central banks would begin to take effect – giving pause to investors who had, until then, ignored physical economy stocks that were pricing in bankruptcy risk despite the impending tsunami of fiscal and monetary support. Further spurned by promising vaccines, value would then stage a monumental comeback in November 2020 – finally conflating perfectly with growth in mid-March 2021.

Figure 1: Growth vs value since the S&P 500 bottomed on 23 March 2020 (as measured by the Russel 1000 Growth vs Russel 1000 Value indices)
Source: Bloomberg, Anchor



SO WHAT?

Regardless of the tilt of your portfolio, you have likely done well given the absolute direction of the market in aggregate over the past 12 months. Whether you bet it all on tech, caught the value trade, or simply held the S&P 500 – your absolute return likely stands several standard deviations above your longer-term average.

First, as with many previous crises, this reminds us of the importance of embracing the first principle of investing – and that is to stay invested. The cost of panic selling last year, and sitting in cash over the proceeding months, would have had hugely negative ramifications for near-term relative performance and painfully significant implications for your long-term performance once future compounding is considered.

Second, it is a reminder that active managers are well-positioned to leverage the significant dislocations in equities that often crop up because of the unexpected. The broader, passive marketing machine has been effective in cutting the argument short at the fee level even before performance is considered, but this completely ignores the value of the flexibility of an active mandate.

The Anchor Global Equity Fund for example, which invests in some of the world's most exciting growth stories, came into its own last year as several secular trends (e.g., ecommerce) were accelerated – returning 81% in US dollar terms for the year. We also introduced a Recovery Portfolio in April 2020, positioned to leverage the apparent overreaction in physical economy stocks, which has since returned 92% in US dollar terms as compared to the S&P 500's 49% return over the same period.

The appropriate inclusion of such active strategies in your portfolio can deliver meaningful alpha through time, and hence certainly warrant consideration on the basis of sensibility of strategy and thematic factors. Their unilateral exclusion in the pursuit of cost savings carries an opportunity cost that can dwarf the fees saved.

SO WHERE TO FROM HERE?

There is no getting around the fact that the market has not just fully recovered after last year's sell-off but has rallied and become more expensive. This is true of every sector (from tech to energy), and every factor (whether growth or value). Although we are still able to identify several instances of excessive pessimism, equities in general are no longer pricing in catastrophe and investment opportunities are both fewer and less attractive relative to last year.

We have likely entered a phase of consolidation, where the market in aggregate will not find meaningful direction as we transition from the earlier stages of a recovery to post-crisis normality. Finding alpha in a low beta year will always be a more difficult task, but with a little pragmatism and proactivity we still think it will be possible.

Let us discuss how...

OPPORTUNITY AT THE LOWER END OF THE QUALITY SPECTRUM

The market is a risk pricing machine. **[Outcome] x [probability] = [Price]** is a neat, if not grossly oversimplified, representation of how equities are priced.

In the earliest stages of the pandemic, any business that depended on the physical movement of people looked to be in dire straits. Even a high-quality, relatively unindebted franchise such as Starbucks at one point saw its share price down almost 40%, which would only go on to fully recover 8 months later.

As central bank liquidity measures and fiscal support programmes came online, and as the physical movement of consumers began to restart, so investors would begin to price in the prospect of a return to normal trading conditions. In fact, as we will explore later in this article, the best operators in a segment (like Starbucks) would go on to command premium valuations.

Per the equation above, Starbucks' share price reflects the now apparent reality that the business of serving premium coffee at convenient locations has a bright future – but of course, not all physical businesses have yet reached this point.

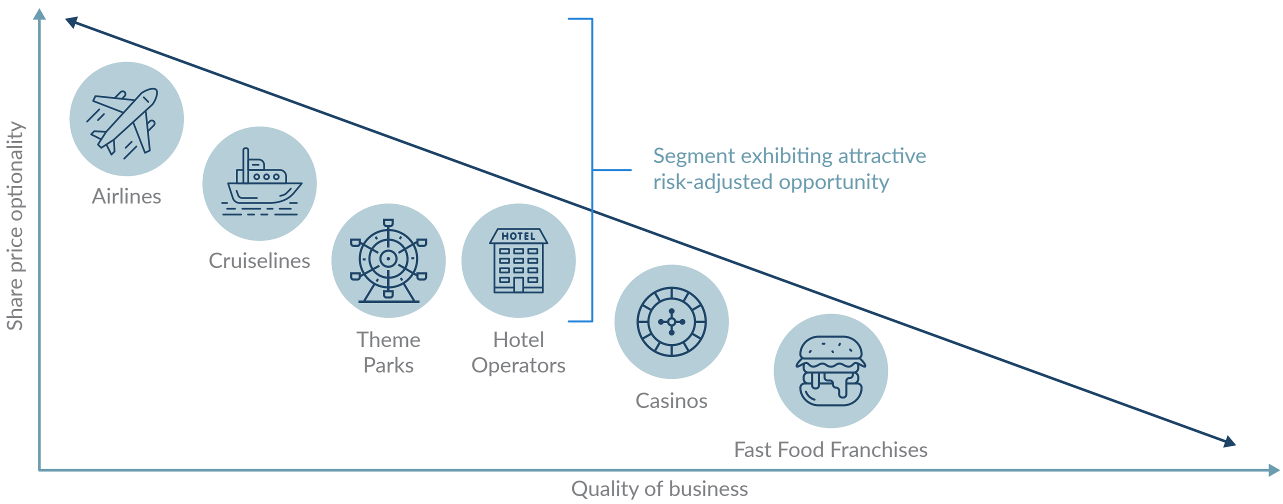
While Starbucks is now able to serve its consumers in-store again, the airlines, cruise lines, and the hotels and casinos that service these travellers have not yet staged a meaningful recovery. Adding insult to injury, it is these same, more cyclical businesses which demand a much higher level of capital investment and structural debt - thus exacerbating the negative impact of a loss of revenue on their solvency.

By way of example, Carnival Corporation's (a cruise line operator) market cap is still 23% lower vs 1 January 2020, even though the S&P 500 sits a heady 32% above the level it traded at on the same date. Although the broader market is pricing in the probability of vastly improved trading conditions, lower-quality businesses, which still face near-term operating challenges, have been left behind – and we feel this is probably a good investment opportunity.

Sticking with Carnival as the example, its monthly cash burn rate sits at US$500mn per month against total liquidity of US$9.3bn, meaning that the company will likely be able to return to full fleet operations by next year without further shareholder dilution.

Given that cumulative bookings for 2022 sit meaningfully ahead of 2019 (pre-pandemic) levels, we believe that in twelve months' time sentiment towards Carnival (and other similarly afflicted stocks) will have improved markedly - and their stock prices will gain accordingly as the market starts to price in a higher probability of a better outcome as compared to the status quo.

Figure 2: Lower-quality cyclicals exhibit a higher level of share price optionality
Source: Anchor



- Low returns on capital
- High capital intensity
- High debt levels
- Revenue less certain

- High returns on capital
- Low capital intensity
- Low debt levels
- Revenue has recovered

OWN THE WINNERS …

The pandemic has acted as both a catalyst and an accelerant for change, where many secular shifts and trends have experienced a multi-year progression in less than 12 months. Global ecommerce penetration shot up from c. 15% of total retail trade to 20% (equal to 5–6 years of progress at previous rates), social media user growth rates almost doubled, and digital advertising spending actually grew in a year when total advertising spend shrank by almost 5%.

If the markets were sprint hurdles, the companies positioned ahead of these shifts have cleared two in a single leap, while those left behind have just crashed into the bar and have little prospect of getting back into the race.

Competitive sectors will likely become more concentrated, with the winners likely to command premium valuations and, from an investor's perspective, it is important to position yourself accordingly.

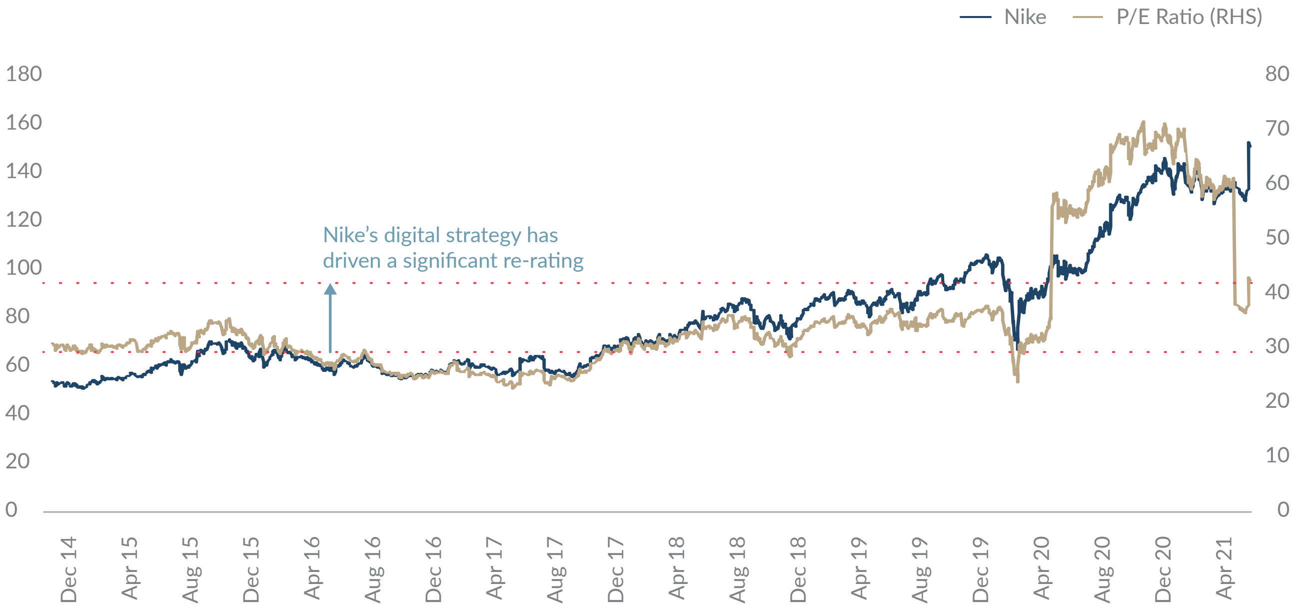
Nike is a great example. In 2015, the company announced the mass closure of 95% of its wholesaler accounts (including Amazon!) and it committed to investing in an ambitious direct-to-consumer strategy that would give Nike complete control over its brand – from factory to foot. At that point, Nike's wholesale business accounted for 76% of revenues and digital sales for just 4%. Fast forward to today, and digital sales now account for > 33% of sales – with that statistic expected to surpass 50% by 2023.

The effect of this sales mix shift has a tremendously positive impact on Nike's profitability, with higher realised average selling prices (ASPs) set to drive gross margins from 45% to closer to 50% over the next few years. More importantly, however, Nike has successfully transitioned to Retail v2.0 – in the process future-proofing the brand's go-to-market strategy and taking direct ownership of the relationship with its customers.

The thing is, Nike was not exactly a value stock in 2015 – on average trading at 30x trailing earnings. This, combined with its 10%-15% earnings growth profile, certainly would not have suggested that the stock would return 200% over the next 5 years. But it has.

This is likely a harbinger of things to come in the markets over the next decade. Those firms that have spent the past decade transforming their business models to suit Business v2.0 will not just outperform their competitors, they will usurp them. Their multi-year head starts have earned premium ratings (i.e., an ultra-low cost of capital) that will allow for continued investment at a pace and scale that will not be possible to compete with.

Figure 3: Nike's transformation has delivered outsized returns … 5-year share price vs P/E
Source: Bloomberg, Anchor



The narrative is similar for winners in other segments including Amazon, PayPal, Alphabet, Facebook, Netflix and Apple. These names will continue to be meaningful positions across Anchor's various mandates for this reason, as we expect the returns which these companies will generate for shareholders will again beat the market, in aggregate, by a significant margin.

WAITING FOR THE GREAT GROWTH PULLBACK …

Over the past 18 months, the market has certainly been conducive for the IPO of a great growth story. Many that were already listed have also come into their own over the same period, and for good reason.

Historically low interest rates (i.e., low discount rates!) and a once-in-a-lifetime global physical lockdown, both coming into effect at the same time, is the financial equivalent of a shot of adrenaline for high-growth tech companies which are destined to become highly profitable in years to come should they sustain their revenue momentum.

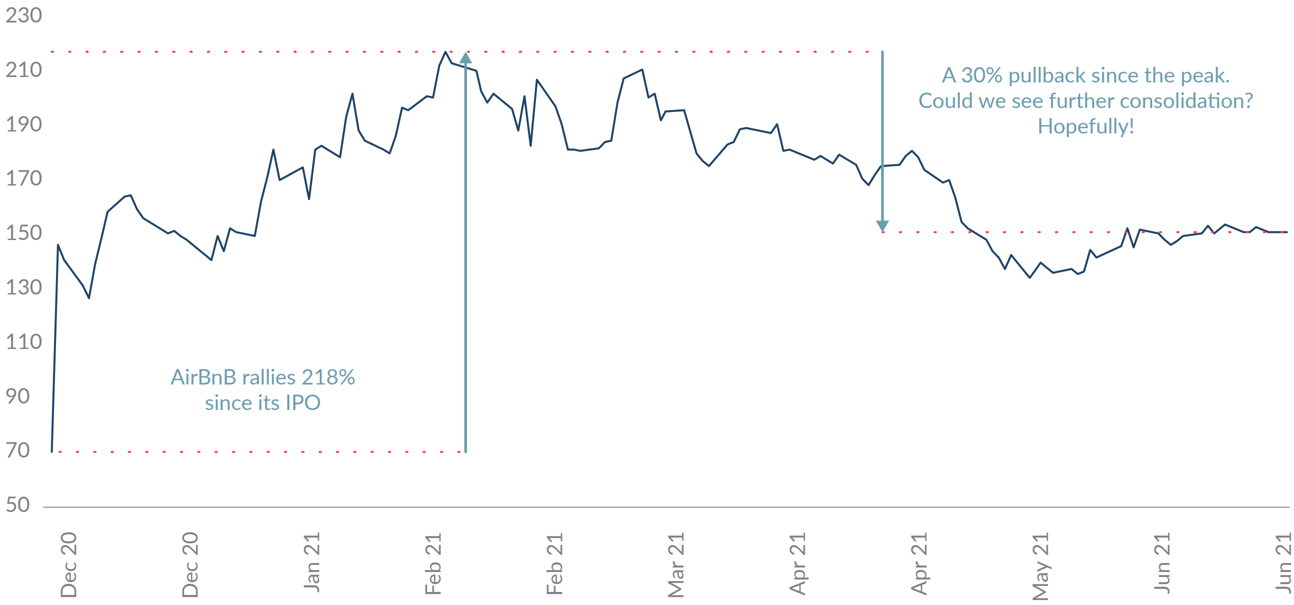
Some will make it there, but many will not – and the current valuations in the growth space mean that the stakes for investors are high. The counteracting forces of powerful secular acceleration, and current stock prices which discount the cash flows many years out, create a tricky path for market participants to navigate.

We are by our nature growth-oriented investors. The empirical evidence from decades of capital market activity suggests that we are in the right camp, as the overwhelming driver of returns over time is earnings growth and not valuation. However, valuation is how you control risk – and we prefer to take reasonable risks rather than buying growth at any price.

It is not an exact science. The best we can do is to build a view of the future using reasonable assumptions, and to discount the outcome at a reasonable discount rate. If the resultant valuation compares favourably with the firm's current market price, we will be buyers.

As you will observe from *Figure 1* above, the prospect of monetary and fiscal normalisation has already tugged at growth valuations twice since January. As yields continue to normalise from abnormally low levels, we believe that at some point in the near future, growth stocks will look an order of magnitude more attractive than they do now. This will be an opportune time to buy the names we are watching but cannot quite justify for inclusion just yet (see the AirBnB share price in *Figure* 4 below!).

Figure 4: AirBnB - an incredible story with an even more incredible valuation, share price performance since its December 2020 IPO
Source: Bloomberg, Anchor



PROCEEDING PRAGMATICALLY, AND PROACTIVELY

The transitionary phase in which the market currently finds itself, brings with it a tension between shorter-term trades and longer-term investments as they compete for space in our portfolios, and achieving the appropriate blend requires a healthy degree of pragmatism.

As physical economy stocks continue to rebound, and while the best growth names consolidate, we will maintain a proactive approach in shifting our factor exposures as these conditions evolve.

Currently, the apparent optionality in lower-quality cyclicals is attractive in the context of a relatively expensive market – especially as the headwinds of the pandemic start to fade and pent-up consumer demand starts to flow.

Additionally, and much as was the case in the now bygone decade, the dominant players who have restyled their business models to suit the new digital landscape will further assert their already considerable dominance.

Lastly, when good stories command even better valuations, we believe it prudent to be patient – and such patience may well pay off over the next few months as global liquidity normalises and speculation gives way to a slightly more risk-averse atmosphere.

As always, we will endeavour to recognise trends early and to react decisively.

The post-pandemic commodities boom: Will it last?

Written By:

Seleho Tsatsi
Investment Analyst

In 2013, Seleho completed his BCom in Economics and Finance at Wits University, where he received the SASFIN Securities Prize. The next year, he was awarded the Postgraduate Merit Award upon enrolment for Honours. He joined Cannon Asset Managers in January 2015 and moved to Anchor in November 2015. Seleho covers the basic materials sector locally and co-manages the Anchor BCI Global Technology fund. He is a CFA charterholder.

SUMMARY

Mining shares and commodity prices have been incredibly strong since the lows of the COVID-19 induced selloff in March 2020. In this article, we examine the investment case for basic materials businesses following their strong performance over the past year. We find that mining shares are generally trading at low multiples of near-term earnings and dividends. These low multiples reflect market caution over the sustainability of current commodity prices. The longer-term outlook for commodities is not homogenous. Some, like iron ore, appear to have weaker, longer-term outlooks than others such as copper or nickel.

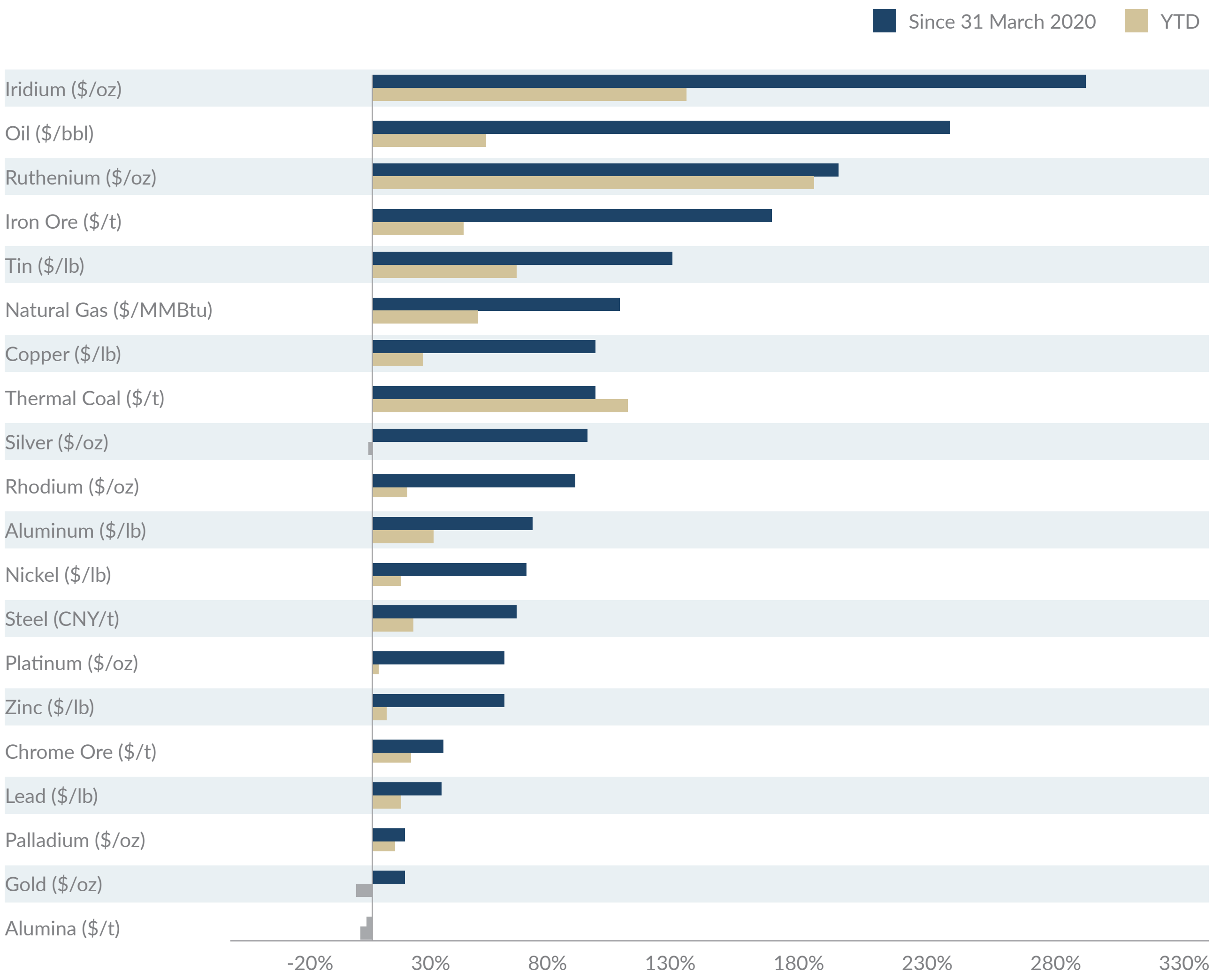
We expect companies in the sector to prioritise cash returns to shareholders in the short term. In certain cases, cash returns justify investment in the sector, but caution is warranted especially given the volatility of equity markets and underlying prices and we note that the outlook may change quickly. A buy-and-hold approach is therefore not advised.

Caution is warranted especially given the volatility of equity markets and underlying prices.

A COMMODITIES BULL MARKET

Commodity prices have performed exceptionally well since March 2020, with perhaps the most striking feature of this commodities bull market being its breadth. Energy, metals, and agricultural commodities have all rallied strongly. Iron ore, palladium, rhodium, copper, and lumber have reached all-time highs. Other commodities such as corn and soybeans have also reached their highest levels in years. Unsurprisingly, equities have followed suit. On the JSE, the FTSE JSE Resource 20 Index has returned c. 81% from 31 March 2020 to end June 2021, compared to a 55% return for the Capped Swix over the same period.

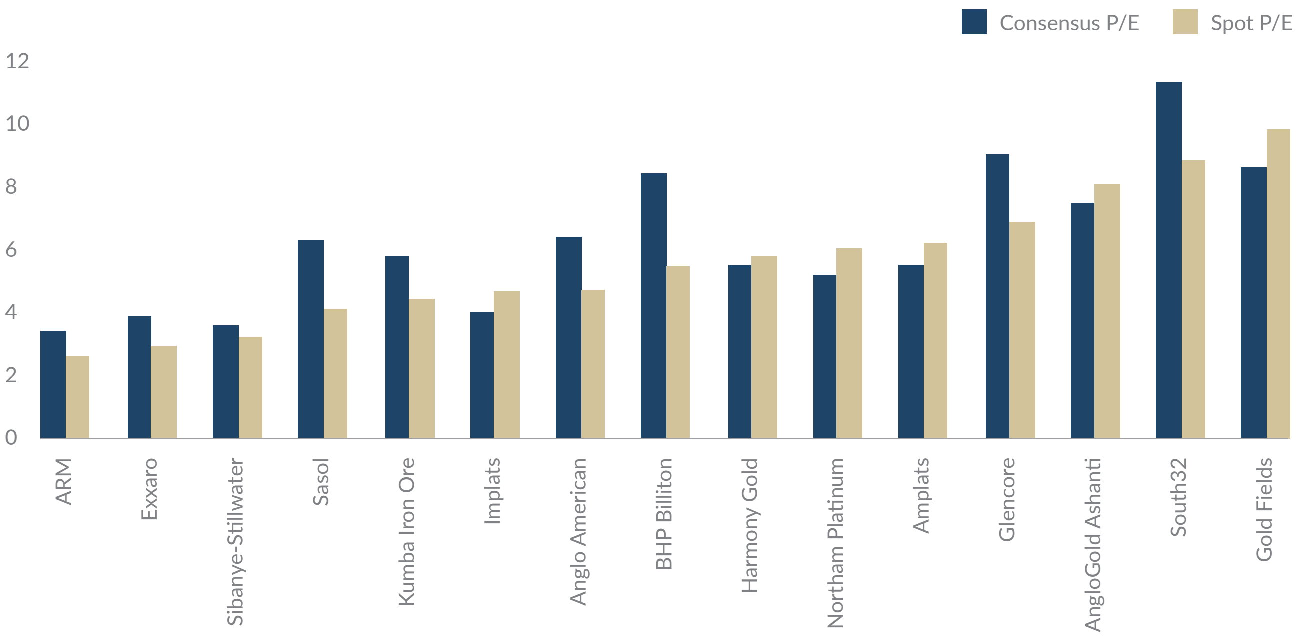
Figure 1: Commodity price performance, YTD, and 31 March 2020 to date
Source: Bloomberg, Anchor



Mining shares are generally trading at low multiples of near-term earnings and dividends. These low multiples can be interpreted as market caution over the sustainability of current commodity prices. Furthermore, profitability across the sector is at cyclical highs. So, we can infer that the market is discounting a normalisation of commodity prices, a subsequent decline in margins, and a reduction in earnings for the sector. We would generally share the market's caution over the sustainability of current prices. Commodity prices have been spurred by supply disruptions since the onset of the pandemic. A combination of low inventory levels coming into the COVID-19 pandemic, supply disruptions, and swift recoveries in demand have led to surprisingly strong prices. We believe these factors have been the main drivers of recent commodity price strength.

However, the sector is not homogenous and the argument for some commodities may be more compelling than for others. We are cautious over iron ore, for example. We estimate that at current prices, with a couple of exceptions, iron ore contributes at least fifty percent of earnings for diversified mining companies listed on the JSE. Iron ore is therefore a big driver of the sector. The iron ore price currently exceeds $200/t. The entire industry, including very high-cost marginal producers, make good margins at these prices. Assuming supply disruptions ease over time, we would expect prices to normalise to lower levels. Nevertheless, we say that whilst keeping in mind that a year ago we certainly would not have thought that a $200/t iron ore price was on the cards.

Figure 2: Resource company P/E multiples, spot vs Bloomberg consensus forecasts
Source: Anchor, Bloomberg, Renaissance Capital, Investec Securities



Other commodities like copper appear to have more fundamental support over the long term. Copper is one of several metals that could be important as the world transitions to a greener economy. The copper market totaled nearly 30 mt in 2019. New sources of demand in the form of renewable energy (solar and wind) and electric vehicles (EVs) could bring the copper market into a sizeable deficit. Glencore modelled commodity demand under the assumption of a rapid transition to a lower-emission economy, where the world limits the increase in the global average temperature to 1.5°C above pre-industrial levels. Under this scenario (see *Figure 3*), copper demand could double from 30 mt in 2019 to 60 mt in 2050. It is important to keep in mind that this forecast assumes aggressive global climate policy and a lot can happen between now and 2050 that changes this outlook. Still, it gives an idea of the potential demand growth. Under more conservative assumptions, we could still see deficits in the copper market of 5 mt to 10 mt by the end of this decade (2030). There are other commodities such as cobalt, nickel, and zinc that are similarly affected by the transition to a greener economy. The short-term picture is likely to be volatile, but we believe that the long-term, supply-demand outlook for these metals is better than for a commodity such as, say, iron ore.

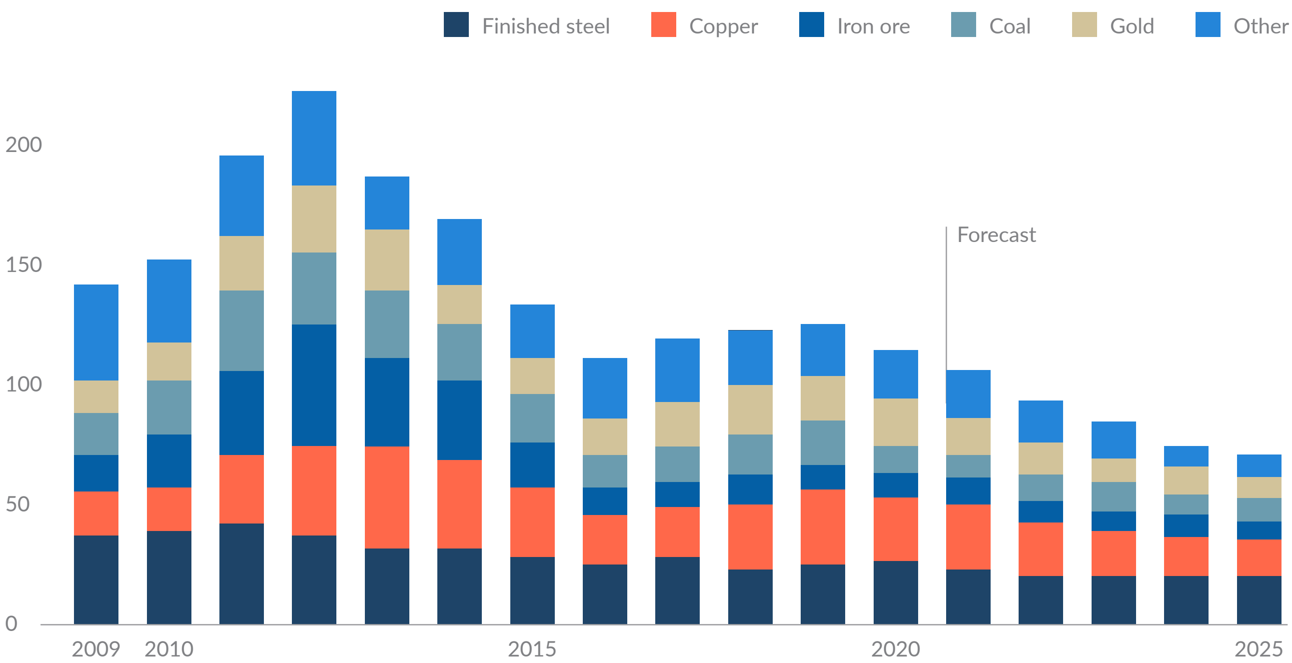
Figure 3: Commodity demand under a rapid transition scenario (where the rise in global temperatures is limited to 1.5°C)
Source: Glencore

	2010 - 2019	2020 - 2050F	2019	2050F
Copper	0.5Mt p.a.	1.0Mt p.a.	29.6Mt	60.1Mt
Nickel	111kt p.a.	225kt p.a.	2.5Mt	9.2Mt
Cobalt	7kt p.a.	13kt p.a.	129kt	507kt
Zinc	262kt p.a.	523kt p.a.	13.9Mt	28.8Mt

We expect companies in the sector to prioritise cash returns to shareholders over the short term as free cash flow generation in the sector is very strong at the moment. Furthermore, although we have seen a rise in capex recently, capital spending is still below the levels reached during the previous commodities supercycle. Many companies in the sector have established clear dividend policies. These policies are usually a percentage of earnings or free cash flow that the company commits to pay out in dividends. Rather than focus on large expansionary capex or M&A, companies until now have used this opportunity to strengthen their balance sheets. The combination of strong balance sheets and free cash flow generation opens the possibility of abnormally strong cash returns to shareholders via special dividends and buybacks.

Many businesses in the diversified mining and platinum group metal (PGM) spaces are trading at free cash flow yields of 15% to 25%, or more. In several cases, we estimate that dividend yields will be close to free cash flow yields because most of the free cash flow will be returned to shareholders via dividends. Investors may have the 2015 resources bear market fresh in mind when they tell management teams that they want mining companies to return cash to shareholders. Barrick Gold CEO Mark Bristow recently criticised capital markets for what he deems to be short-term thinking focused on dividends. Nevertheless, regardless of how you assess the sector's capital allocation, it appears probable that the sector will be aggressive in the return of cash to its shareholders.

Figure 4: Mining capital expenditure, mined commodities, US$bn
Source: Wood Mackenzie, FT



CONCLUSION

Although valuations in the mining sector look optically cheap, we believe caution is warranted. The run-up in commodity prices since March 2020 has been spurred by supply disruptions, low inventories, and a quick recovery in demand. We find it more useful to look at individual commodities rather than the market as a whole, because it is not homogenous. Certain commodities, such as iron ore, have less compelling long-term outlooks than other metals that should benefit from a transition to a lower-emission economy. We do have exposure in the sector and our decision to be invested is driven, in part, by what we see as a compelling cash return story in the near term. Dividends and share buybacks are expected to be prioritised over big acquisitions or capex drives. Given the volatility of both commodity and equity prices, the outlook can change quickly. We therefore do not view our holdings in the sector as buy-and-hold positions.

Anchor 1H21 tech strategy: China vs US tech counters

Written By:

David Gibb
Fund Management

David has managed the Anchor Worldwide Flexible Fund since its inception in May 2013 and has co-managed the Anchor Global Technology Fund since inception in June 2019. He joined the investment industry in 1994, as an equity analyst at Libam. David has a BSc (Med) degree from UCT and is a CA (SA) and CFA charterholder.

With a strong economic recovery underway, the tech sector has slightly lagged global markets in 1H21, with the performance gap between tech and the broader market getting smaller as we head towards the end of 1H21. However, this initial lag is not surprising to us, especially considering the strong economic recovery underway, which has encouraged investors to look elsewhere in more cyclical areas of the stock market that offer higher earnings growth at lower P/E multiples. Sector rotation typically always happens when there is a new economic cycle – investors shift from growth companies into value companies to buy earnings growth on the cheap. COVID-19 has provided the depressed base off which cyclical companies may grow strongly. But, as the recovery slows, we believe that tech will eventually return to favour and the superior, long-term growth prospects of this sector will once again become clear. We note though that inflation could unsettle the tech sector - and other growth shares - if it remains high for an extended period.

In this report we take a deep dive into the tech sector to understand what happened in 1H21.

Figure 1: 1H21 Select indices' performance highlights*

Source: Bloomberg, Anchor

*Updated to close on 30 June 2021.

FTSE All World	11.4%
S&P 500	15.3%
Nasdaq	12.5%
Hang Seng Tech	-3.4%

In 1H21, tech slightly lagged both the FTSE All World and the S&P 500 indices. US tech shares have, however, performed far better than Chinese tech counters, which is not surprising considering the heightened scrutiny that large Chinese companies are currently receiving from the Chinese authorities.

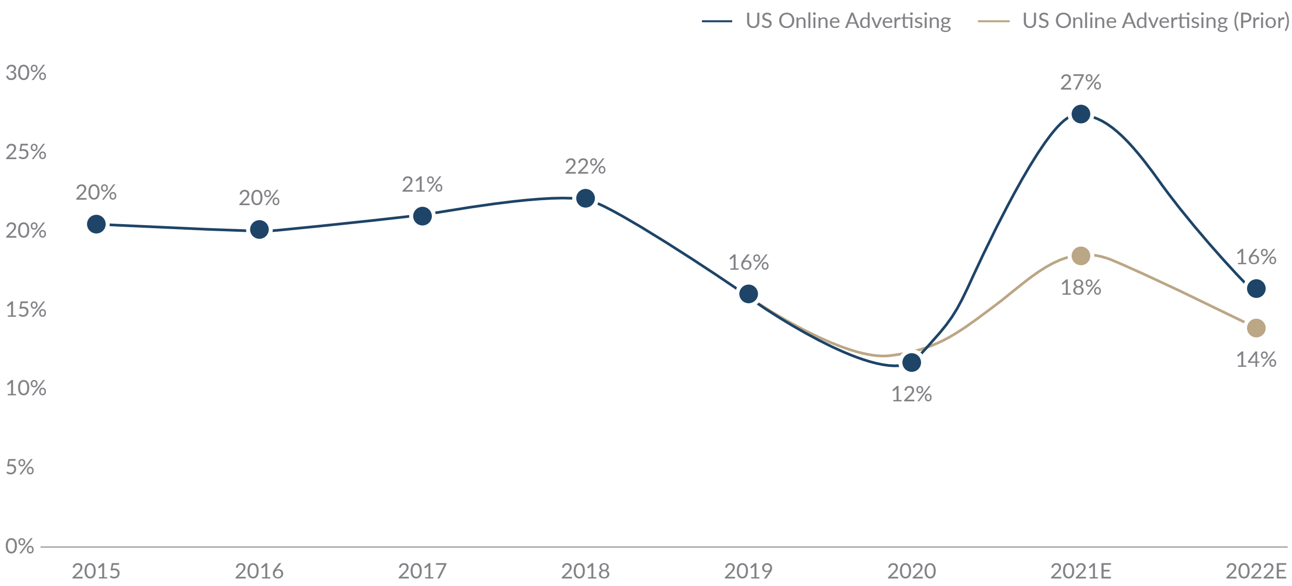
Figure 2: 1H21 Select tech shares' price performances*
Source: Bloomberg, Anchor
*Updated to close on 30 June 2021

Facebook	27.3%
Amazon	5.6%
Apple	3.2%
Netflix	-2.3%
Alphabet	39.3%
Microsoft	21.8%

Among the large US companies (i.e., the FAANGMs - Facebook, Amazon, Apple, Netflix, Google/Alphabet, and Microsoft), the online advertising giants (Alphabet followed by Facebook) have been the star performers, while Netflix and Apple have been the laggards in 1H21. The recovery in advertising (especially online) since 3Q20 has surprised us all but it is entirely consistent with an economic recovery. Netflix has some indigestion after strong subscriber growth during the height of the COVID-19 pandemic and it is also no longer the only game in town in terms of streaming services. The Walt Disney Co. (Disney) is making great strides in this increasingly three-player streaming market (Netflix, Disney, and Amazon). Apple performed very strongly last year, as appears to be the typical pattern leading up to the launch of a major new product cycle (5G phones were launched in late 2020). To complete the picture, Microsoft continues to perform steadily as its unstoppable cloud business now accounts for over 40% of the company's total revenue, while Amazon, much like Netflix, possibly has a period of slower growth ahead in 2H21, following the brisk 38% YoY revenue growth recorded in FY20.

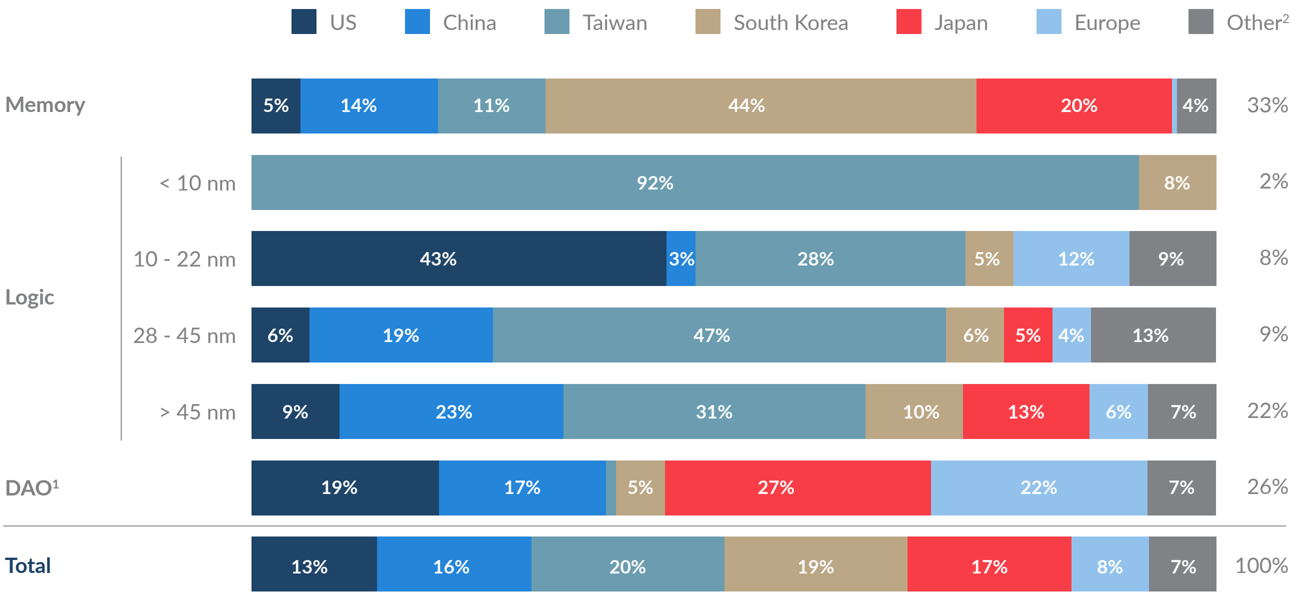
If we delve deeper into the various tech sub-sectors, social media, and search together with semiconductors have led the way in 1H21. Snapchat, Facebook, and Alphabet have performed well because of solid upward revisions to their respective earnings as the advertising upcycle gained momentum. The chart by Morgan Stanley in *Figure 3* below, shows by just how much its US online advertising forecasts have increased for 2021. After a strong 1Q21, we expect another cracking quarter from Alphabet and Facebook in 2Q21 before growth begins to normalise somewhat. Global online advertising continues to gain market share despite approaching 60% of total global advertising spend. It appears that TV advertising will face more and more pressure from online – US TV advertising has been stuck at the c. US$65bn-US$70bn p.a. level for several years.

Figure 3: US online advertising YoY growth – Morgan Stanley's current and prior forecasts
Source: Morgan Stanley



The semiconductor sector also had a strong 1H21. As we have seen in many industries in 2021, the recovery of the global economy has resulted in a mad scramble for commodities and imported goods as businesses try to meet the surging demand from their customers. Semiconductor manufacturing (i.e., chips), a heavily concentrated industry where Asian companies dominate (e.g., Taiwan Semiconductor Manufacturing Company [TSMC] and Samsung in South Korea), is in the eye of the storm. The current chip shortage is expected to last into 2022, affecting car production, as well as a range of other manufacturing industries that are heavy consumers of logic and memory chips. Memory prices (e.g., DRAM) have accordingly surged this year – and the major producers are increasing their capex plans to meet, what is expected to be, a higher level of demand going forward. The shares prices of many of the major players in the industry, including semi-equipment companies like ASML Holdings, have performed extremely well in 2021.

Figure 4: Breakdown of global wafer fabrication capacity by region, 2019 (% of global capacity)
Source: BCG analysis with data from SEMI fab database

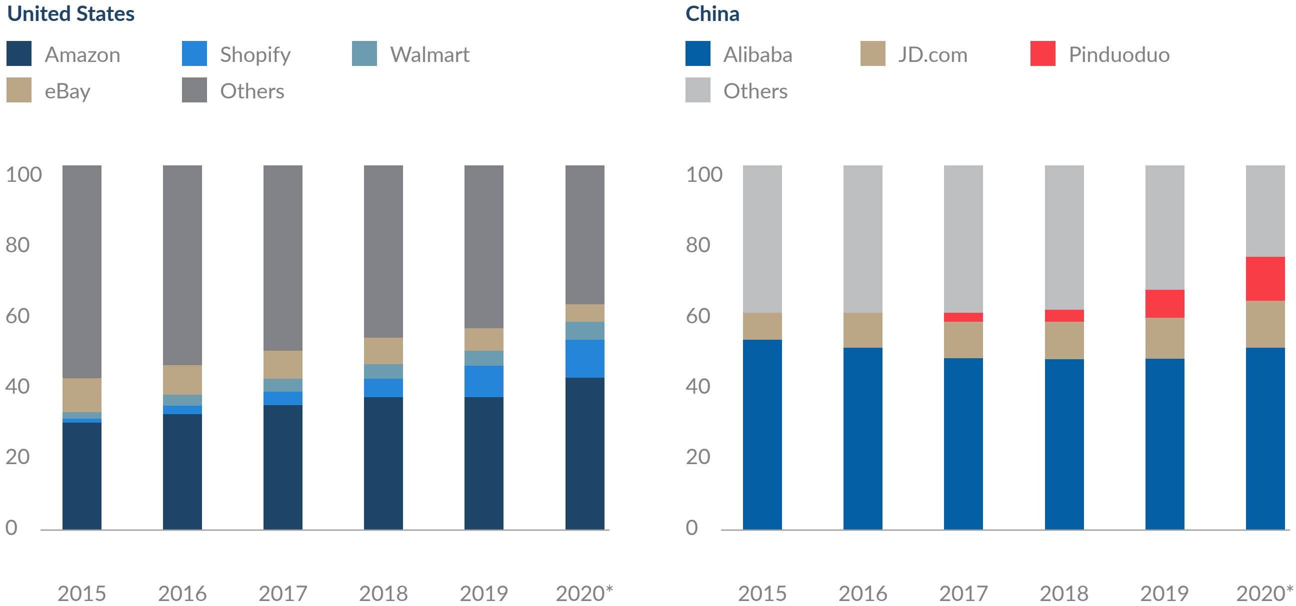


1. Discreet, analog, and optoelectronics and sensors.
2. Other includes Israel, Singapore, and the rest of the world.

The laggards in 1H21 have been EM e-commerce (especially Chinese), food delivery, hydrogen fuel cell, and a range of earlier-stage, loss-making tech companies (including special purpose acquisition companies [SPACs]).

Not only has regulatory oversight of the Chinese internet market been switched to maximum since Jack Ma's infamous speech on 24 October 2020 (pre the aborted Ant Group listing), but the competitive situation has also moved up a notch or two. This has shaken local giant, Alibaba, the leading e-commerce, and cloud company in China.

Figure 5: Different giants, online retail market share, %
Source: Bloomberg, CLSA, The Economist



**estimate.*

Alibaba and JD.com have long dominated the Chinese e-commerce market and the competition between these companies has been fierce, albeit somewhat predictable. In recent years however, a new entrant called Pinduoduo has disrupted the market by introducing a form of value-based shopping combined with light entertainment (an online blend of Costco and Disney) – and this has become known as social e-commerce. Pinduoduo's mobile-only app has rapidly gained traction and, astonishingly, it now has the same number of active users as Alibaba. The new retail format has spawned copycats from the old guard. 2021 will witness an almighty fightback from Alibaba, and if you consider the plans for all the major internet companies (including Tencent, Meituan Dianping, and the EV players), we are in for a heavy investment phase in the Chinese internet industry. Profits will be slightly depressed for the next while.

Food delivery companies have also had a tough 1H21. The land-grab phase in food delivery apps appeared to be closer to the end than the beginning, but now that they are expanding into adjacent areas such as grocery delivery, they are having to deal with competitors from those areas too. For now, investors appear to be uncertain how attractive this business model will eventually be. It may be too early to comment.

EARNINGS

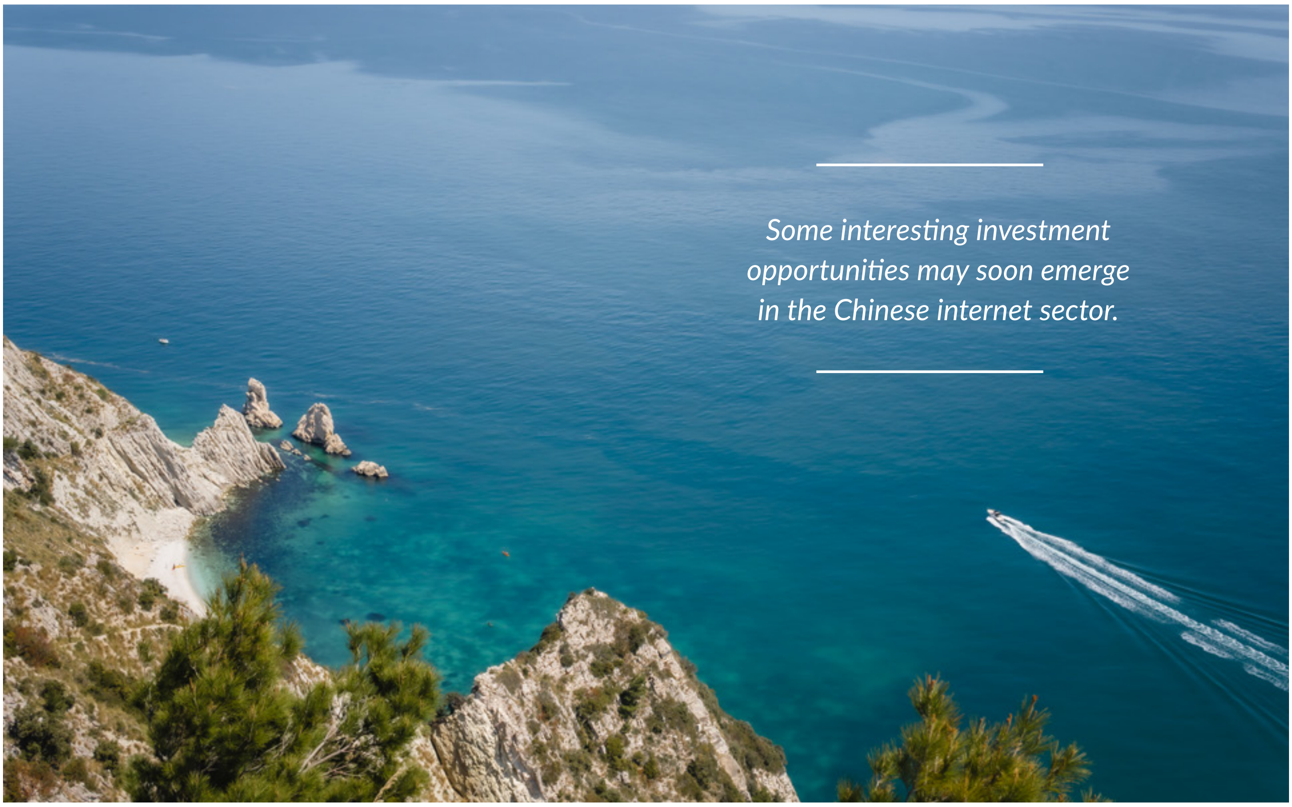
The earnings outlook for the US tech sector looks promising, with consistent earnings upgrades during 1H21. The Nasdaq Composite is expected to grow earnings at a compound annual growth rate (CAGR) of 40% over the next 3 years! However, Chinese tech has seen consistent downgrades to earnings – for the reasons given above. The Hang Seng Tech Index is expecting earnings growth of only 13% over the next 3 years (on a CAGR basis).

Figure 6: Earnings forecasts for major global indices and FAANGM stocks
Source: Bloomberg, Anchor

	Year-0	Year-1	Year-2	Year-3	3-year CAGR
FTSE All World Index, US$	14	25	28	31	30%
S&P 500, US$	122	189	211	234	24%
NASDAQ Composite, US$	217	430	508	592	40%
FAANGM, US$mn	248 091	295 186	322 039	369 176	14%
Facebook	33 740	39 703	46 407	52 426	16%
Apple	76 311	87 431	86 350	87 692	5%
Amazon	26 903	37 394	47 672	61 847	32%
Netflix	3 759	5 194	6 248	7 904	28%
Google	51 363	66 356	71 904	86 669	19%
Microsoft	56 015	59 110	63 458	72 638	9%
Hang Seng Tech, US$	226	171	247	326	13%

The forecasts in *Figure 6* above can be compared with a CAGR over the next three years of 30% and 24% for the FTSE All World Index and the S&P 500 Index, respectively.

Sentiment is clearly more negative in Chinese tech, and in shares like Naspers, and Softbank, while investors are generally bidding up for Alphabet, Facebook, Microsoft, Adobe, Nvidia, the gene-editing companies, and Illumina.



CONCLUSION

The Chinese tech sector scores very well on P/E multiples and potential upside to our discounted cash flow (DCF) valuations. But there is heightened competition in this market, and we do not know how long it will last. Interestingly, many of the Chinese e-commerce upstarts are backed by Tencent, which is Alibaba's archrival in China, while Tencent's own operations are likely to be the least impacted by the tougher environment even though it is also committing to higher spending (on businesses services, gaming, and short-form video content). Our conclusion in this regard is that some interesting investment opportunities may soon emerge in the Chinese internet sector.

In the semiconductor segment, Intel is undergoing a transformation under the leadership of Pat Gelsinger, the new CEO. Having fallen behind TSMC in the production of the highest end nodes (i.e., <10nm transistors), Gelsinger needs to restore Intel's manufacturing prowess so that it becomes a market leader once again. It is probably too early to judge whether he will succeed or not, but clearly if he does Intel offers significant upside for investors.

Delivery Hero is another interesting prospect. We believe that this high-growth, food delivery company under the excellent leadership of Niklas Östberg is establishing dominance in several large markets and, although the market is still evolving rapidly, the company appears to be making the right moves.

Barring a prolonged period of high inflation (i.e., not transitory), we would expect the tech sector to perform well over the long term, relative to the broader stock market. This is purely a function of superior earnings prospects for the sector – partly driven by the digital transformation of the global economy. Over the shorter term however, we have a slightly different take. Our theme for tech investing in 2021 is 'adjusting for risk'. And this is what we feel investors need to do while global liquidity remains high and market sentiment is strong – avoid taking undue risks.

The Anchor Capital BCI Global Technology Fund is worthy of your consideration. Managed by a dedicated investment team headed up by David Gibb, the fund returned 32.1% p.a. in its first two years to the end of June 2021, as compared to the S&P 500's return at 22.9% and the MSCI World's 20.1% return over the same period. If you would like to find out more about the fund, please contact your financial advisor or email sales@anchorcapital.co.za.

Global Inflation: What is all the fuss about?

Written By:

Peter Little
Fund Management

Peter manages the Anchor Global Stable Fund and the Anchor BCI Managed Fund and has been with Anchor since 2013. Prior to joining Anchor, Peter worked for several global investment banks in London and New York including JP Morgan, Barclays, and Royal Bank of Scotland. Prior to joining Anchor, he was head of fund management for Credit Suisse's liquid hedge fund business. Peter is a CFA Charterholder.

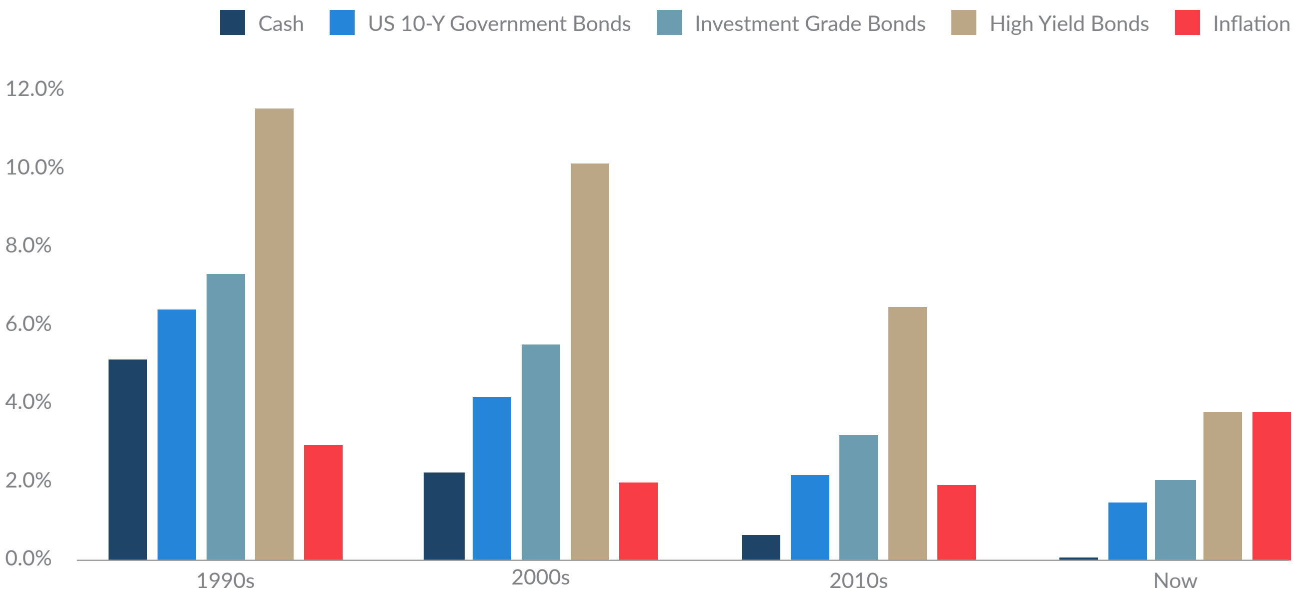
Since late 2020, when the rollout of effective COVID-19 vaccines started, investors have been concerned that demand from normalising economic activity, at a time of unprecedented fiscal and monetary stimulus, will result in runaway inflation (primarily in the US). Inflation itself is not necessarily what scares investors but rather the fact that central banks will need to drain liquidity from the system to fight rising inflation and that will theoretically have dire consequences for asset prices.

Declining yields have forced investors to take on more risk to achieve the same outcome. Below we highlight how investors have been able to **achieve a 4% average yield by decade (from the 1990s to date):**

- **1990s:** Cash (5.2%).
- **2000s:** US 10-year government bonds (4.2%).
- **2010s:** US investment-grade corporate bonds would not get you there (only 3.2%) and investors would have had to add some junk bonds (6.5%).
- **Now:** US junk bonds will not get you there (3.9%) and instead it has to be equities?

The above is true even though US inflation has not really changed dramatically over the abovementioned periods (it averaged 3% in the 1990s).

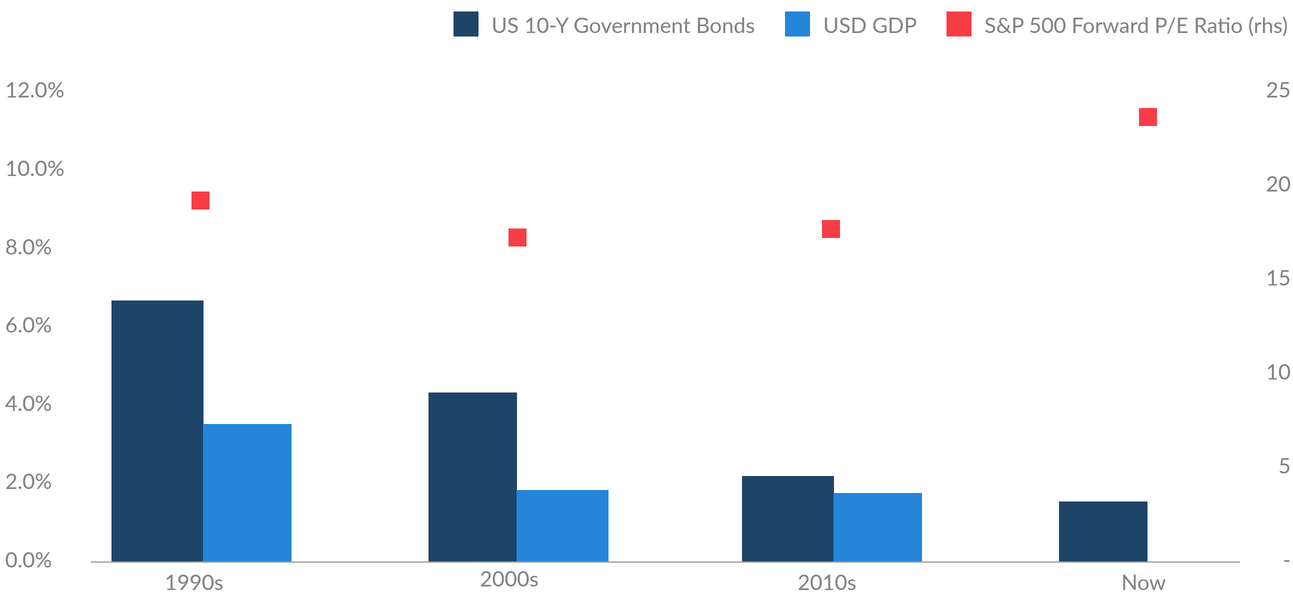
Figure 1: The search for yield - over the past few decades US dollar investors have needed to take an increasing amount of risk to achieve the same nominal yield
Source: Anchor, Bloomberg



The theory is that, if US monetary policy reverses and drives yields higher, investors can shift back into less risky assets to achieve their investment goals and that reversing the search for yield will put downward pressure on equities, which are trading at above-average ratings.

Ironically, despite the twenty-first century being a tough one to achieve US dollar yields, the price investors have paid for corporate earnings has been below the average price investors paid for those same corporate earnings in the 1990s. This is perhaps because economic growth has also been lower for the past couple of decades.

Figure 2: Despite a 30-year trend of declining yields, US stock market ratings have only recently started to reflect the search for yield
Source: Anchor, Bloomberg



In this note we briefly explore two questions:

1. How likely are we to see persistently higher US inflation?

2. How likely are we to see meaningfully higher US rates/yields?

For the purposes of this note, we focus on yields and inflation in the US market, which is not only perceived as the most likely to see higher inflation and yields but is also by far the largest financial market in the world. The US dollar also tends to form the starting point against which most assets are valued, at least for the foreseeable future.

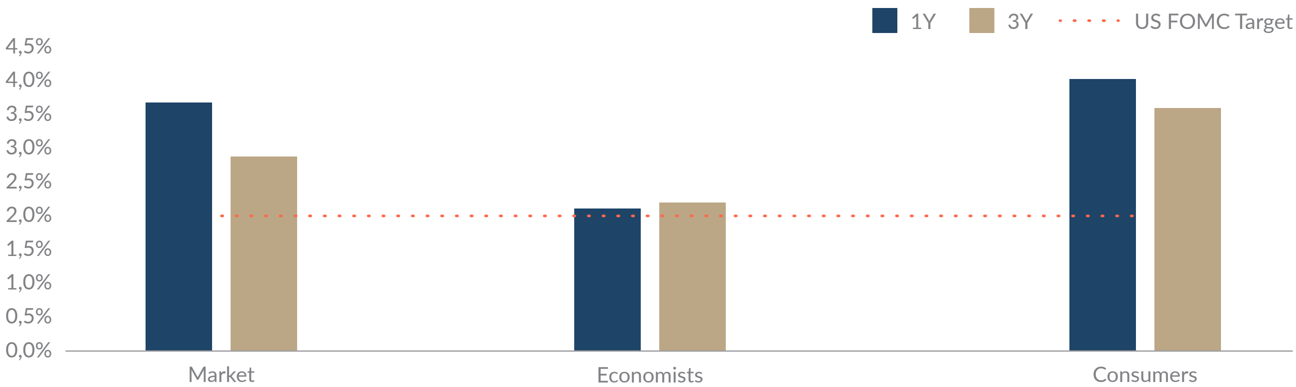
HOW LIKELY ARE WE TO SEE PERSISTENTLY HIGHER US INFLATION?

Inflation forecasts generally fall into three categories:

- **Economists** – generally qualified professionals using econometric models.
- **Consumers** – usually based on surveys.
- **Market-implied** – inflation expectations derived from financial instruments such as inflation swaps or inflation-linked bonds.

Among the abovementioned three categories, only economists have a fair degree of faith in the Fed's ability to maintain inflation at around its 2% target level for the next few years:

Figure 3: Investors and consumers expect inflation to remain elevated for the next few years
Source: Anchor, Bloomberg



For context though we also highlight the following:

- **Consumers** have, **on average, overestimated inflation by 1%** in the twenty-first century (to date).
- **Market-implied forecasts of inflation are around 2.5 times more volatile than actual inflation** and these forecasts have missed one-year inflation expectations in excess of 1%, more than 20% of the time over the past 15 years.
- **Economists tend to be fairly conservative with their forecasts,** generally assuming that inflation will remain roughly stable and, as such, their **forecasts are around half as volatile as actual inflation.**

Below we consider the Fed's preferred measure of inflation (core personal consumption expenditure [PCE] inflation) and we divide the basket into three main categories:

1. *Inflation temporarily elevated due to base effects* – these are those inflation categories where the pandemic forced big pricing discounts that are now unwinding.

2. *Inflation temporarily elevated due to supply chain issues* – those categories where the pandemic has caused bottlenecks in supply of either goods or labour in certain sectors.

3. All other items.

In the two former categories, we believe inflation will be transitory and, as such, will be ignored by the Fed.

Figure 4: Elevated inflation is generally isolated to categories experiencing transitory inflation
Source: Anchor, Bloomberg, Bureau of Economic Activity

CATEGORY	% OF SPEND	MAY 21	YTD	1Y AVG	3Y AVG	5Y AVG	10Y AVG	20Y AVG
Supply chain issues	**10.8%**	**7.1%**	**5.3%**	**2.7%**	**0.8%**	**0.1%**	**0.2%**	**-0.2%**
Cars	4.2%	9.9%	9.0%	6.1%	2.1%	0.8%	0.7%	0.4%
Clothes	3.1%	4.4%	1.0%	-2.8%	-2.2%	-1.4%	-0.2%	-0.6%
Furniture & household durables	2.8%	5.0%	4.2%	2.9%	1.1%	-0.4%	-1.1%	-1.3%
Household maintenance	0.7%	10.2%	7.2%	4.7%	4.0%	3.8%	3.1%	2.9%
Unfavourable base effects	**15.2%**	**3.4%**	**2.6%**	**1.6%**	**2.0%**	**2.0%**	**2.1%**	**2.4%**
Food services	6.3%	2.5%	2.9%	3.4%	3.0%	2.8%	2.7%	2.8%
Recreation services	4.2%	3.0%	2.7%	2.5%	2.2%	2.4%	2.2%	2.3%
Transportation services	3.6%	3.7%	2.6%	-0.2%	1.0%	1.1%	1.2%	1.8%
Accommodation Services	1.1%	8.9%	1.0%	-5.8%	-1.9%	-0.6%	1.1%	1.6%
Other	**74.0%**	**2.4%**	**2.2%**	**1.8%**	**1.9%**	**2.0%**	**1.8%**	**1.9%**
Health care	18.8%	2.8%	3.3%	3.0%	2.2%	1.9%	1.6%	2.3%
Housing	18.5%	1.9%	2.0%	2.3%	3.0%	3.2%	2.9%	2.7%
Financial services	5.8%	5.8%	4.6%	2.2%	3.3%	4.7%	5.2%	3.5%
Recreational goods	4.9%	2.7%	1.1%	-1.2%	-3.3%	-3.7%	-4.3%	-5.2%
Pharma	4.3%	-1.9%	-1.9%	-0.9%	0.0%	1.3%	2.0%	2.6%
Non-profit services	3.7%	7.5%	5.0%	3.0%	2.8%	3.0%	2.7%	1.3%
Insurance	3.5%	-0.8%	-0.6%	0.4%	1.9%	2.4%	2.2%	2.7%
Education	2.3%	0.3%	0.5%	1.0%	2.0%	2.1%	3.0%	4.6%
Communication services	2.0%	-0.3%	-1.0%	-1.3%	-1.7%	-2.9%	-2.2%	-1.1%
Other durables	1.7%	2.0%	0.3%	-1.7%	-2.1%	-1.7%	-1.8%	-0.8%
Social services	1.6%	3.8%	4.0%	4.1%	3.5%	3.2%	2.7%	2.7%
Professional services	1.6%	1.3%	1.1%	1.3%	1.9%	2.5%	2.5%	3.2%
Personal care services	1.2%	2.4%	2.9%	3.7%	3.7%	2.8%	2.5%	2.8%
Household supplies	1.2%	0.0%	1.3%	2.9%	1.7%	0.5%	-0.2%	-0.2%
Personal care prod	1.1%	0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.1%	0.1%
Utilities (water)	0.9%	3.3%	3.6%	3.4%	3.4%	3.3%	3.9%	4.4%
Tobacco	0.8%	6.3%	6.9%	6.0%	5.0%	5.1%	3.9%	5.5%
TOTAL	**100.0%**	**3.0%**	**2.6%**	**1.9%**	**1.8%**	**1.8%**	**1.7%**	**1.7%**

Ignoring those categories that we believe are experiencing transitory inflation, the only other categories where we see concerning US inflation trends are:

- *Financial services*: Where the biggest component is a theoretical assumption of the implied cost of bank deposits, which is ironically mostly impacted by higher rates. Still, we expect the Fed to ignore this category.

- *Non-profit services:* Where the biggest component is related to the co-payment Americans make for insured medical claims. This component is too small to lose sleep over and it is generally too complex to come to any meaningful conclusions about its trajectory.

On balance, **we are sanguine about the prospect of inflation remaining elevated for extended periods** but with **two important caveats:**

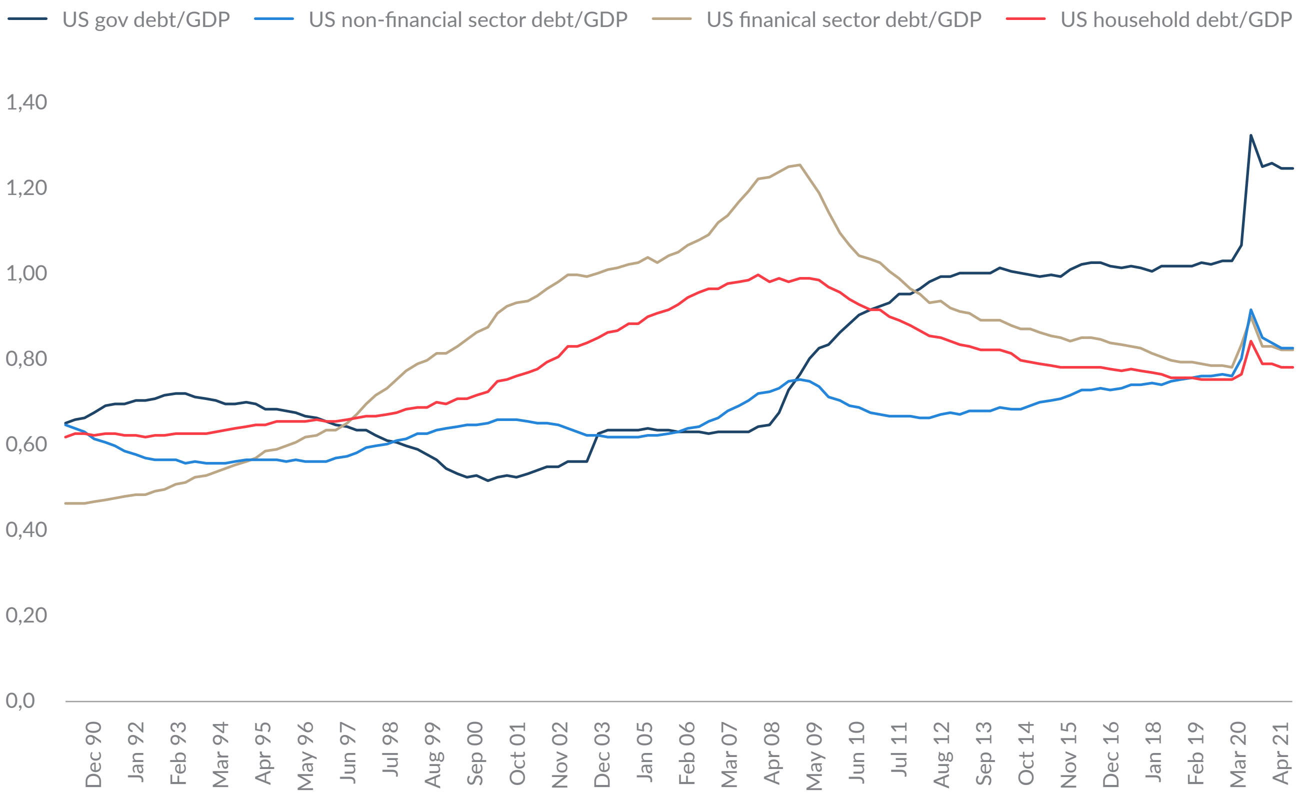
1. **Inflation is notoriously tricky to forecast!**

2. Somewhat related to point one, we also note that **the medium-term trajectory of inflation is determined to a large extent by psychology –** if economic actors believe inflation will be higher, that can become a self-fulfilling prophecy. Think of our own experience in SA, where workers' base case is that inflation is 6% and they thus expect salary negotiations to kick off at around that level, as do landlords, who have been accustomed to pencilling in 6%-plus annual rental escalations. Businesses pre-empt the cost-push inflation from those two categories and pass that inflation on to their customers and so the cycle perpetuates itself.

HOW LIKELY ARE WE TO SEE MEANINGFULLY HIGHER RATES/YIELDS?

The COVID-19 induced recession was an unusual one in many respects including the depth of the contraction and the pace of the recovery. However, perhaps the most stark for the US economy, which is generally held up as the model of capitalism, was the extent to which the government shouldered the burden of the economic contraction, leaving private sector balance sheets relatively unscathed.

Figure 5: The US government has shouldered balance sheet damage resulting from the pandemic
Source: Anchor, Bloomberg, US Federal Reserve



US households and the US financial sector went into this crisis in much better shape than they went into the 2008 GFC, entering the COVID-19 pandemic with 38% and 25% less leverage relative to GDP, respectively. Importantly, they collectively took on negligible additional debt to survive the pandemic, thanks largely to the US government's efforts. If employment normalises relatively quickly, that leaves the private sector reasonably immune to higher rates. Even non-financial corporates, who have been steadily increasing debt over recent years, entered the COVID-19 crisis with a similar amount of leverage relative to US economic output than they took into the GFC. While these non-financial corporates slightly increased leverage to survive the pandemic, much of that leverage will be in fixed-rate debt and with historically low interest rates, they are (at least collectively) likely fairly immune to higher rates.

The US government, however, is the exception, having more than doubled its leverage relative to the level it took into the GFC and so it is in the context of the government's dramatically higher leverage that we consider the impact of higher rates. The US as the custodian of the world's reserve currency (at least for the foreseeable future) has arguably unlimited access to debt, so that is certainly not an imminently limiting factor. It is also likely to want to grow its way out of the additional debt (via higher GDP rather than lower debt) instead of tightening its belt to achieve lower gearing through fiscal austerity. It does though seem reasonable to assume that it has run out of runway to keep US long-term rates artificially low via quantitative easing (QE), with economists now forecasting that the Fed will stop expanding its balance later this year.

However, the Fed is also unlikely to start shrinking its balance sheet anytime soon and, in fact, towards the end of 2019 (about a year into the previous efforts to shrink its balance sheet) the Fed reversed course on the basis of a new theory that it should expand its balance sheet at the pace of nominal GDP just to keep it from tightening monetary conditions. So, with tapering as the most imminent threat to higher funding rates, we compare the current conditions to the last taper tantrum in 2013, when the Fed's announcement of its intention to stop QE resulted in US 10-year bond yields spiking by over 1%.

Figure 6: Comparing the current position of the US Treasury market to its status entering the 2013 taper tantrum
Source: Anchor, Bloomberg

	May 2013	Now
Fed ownership of US Treasuries	26%	34%
US 10-year yield	1.92%	1.48%
Change in previous 6 months	0.26%	0.55%
Change in previous 12 months	0.18%	0.85%
Monthly purchases	$90bn	$120bn
Percentage of monthly issuance purchased	15%	6%

In our view, the biggest positives currently, relative to the 2013 taper tantrum are:

- We have already experienced a Fed taper so there is less uncertainty about what might happen. It is also unlikely that we will see some of the clumsy exit mistakes which we experienced previously.
- The current rate of QE, although larger than in 2013, is absorbing a much smaller portion of new issuances, so the removal of the Fed as a buyer leaves a smaller hole this time around.
- Rates have already backed up by a decent amount (c. 0.85%) in the 6–12 months leading to this taper and thus the market has potentially already pre-empted some of the impact.

Conversely, we believe that the biggest negatives currently, relative to the 2013 taper tantrum are:

- Rates are starting from a lower base this time around; and
- the supply of US Treasuries is almost double what it was in 2013.

CONCLUSION

- We believe that the latest bout of above-average US inflation is likely to be mostly transitory and is unlikely to result in the Fed having to act too aggressively in its response.
- We expect US long-bond rates should drift higher as the Fed tapers QE later this year, but likely at only half of the sell-off we saw in 2013 and at a more subdued pace.
- In our view, the higher rates are unlikely to cause too much indigestion for most categories of US borrowers, who are in much better shape than they were during the GFC.
- The current above-average US stock market multiples are unlikely to come under significant pressure from the slightly higher US rates in the context of those rates still being significantly below the level seen in recent decades. We expect the “search for yield” to moderate as rates drift higher but not to disappear and, as such, it will still provide some support for elevated stock market multiples.

Performance Summary

	FUND PERFORMANCE							BENCHMARK PERFORMANCE					
	Start date	Annualised p.a. (%)	Since inception (%)	12-month (%)	6-month (%)	3-month (%)	June 21 (%)	Since inception (%)	12-month (%)	6-month (%)	3-month (%)	June 21 (%)	Performance vs Benchmark (%)
UNIT TRUSTS													
Anchor BCI Equity Fund	Apr-13	10.0	119.1	24.1	13.4	0.3	-1.1	87.1	27.6	13.3	0.6	-3.0	32.0
Anchor BCI Flexible Income Fund	Jun-15	7.4	54.1	6.4	2.5	2.0	0.5	50.9	4.5	2.2	1.1	0.4	3.2
Anchor BCI Managed Fund	Jan-15	5.2	38.1	16.2	8.5	2.1	0.4	43.2	17.3	9.4	1.8	0.1	-5.1
Anchor BCI Worldwide Flexible Fund	May-13	11.0	134.6	10.5	3.2	0.1	3.5	98.1	9.2	4.6	2.4	0.4	36.5
Anchor BCI Property Fund	Nov-15	-5.1	-25.8	20.7	15.4	8.4	1.4	-28.2	25.2	19.3	12.1	3.4	2.4
Anchor BCI Global Equity Feeder	Nov-15	19.7	176.9	29.7	5.8	14.2	18.1	101.9	14.7	9.6	4.2	5.5	75.0
Anchor BCI Bond Fund	Feb-16	9.9	66.2	12.2	4.8	7.0	1.2	64.8	13.7	5.0	6.9	1.1	1.4
Anchor BCI Diversified Stable Fund	Feb-16	6.9	43.2	11.0	6.1	2.1	0.9	38.8	10.9	6.0	2.4	0.7	4.4
Anchor BCI Diversified Moderate Fund	Feb-16	6.0	37.3	14.3	7.9	1.9	0.6	37.8	13.9	7.7	2.1	0.4	-0.5
Anchor BCI Diversified Growth Fund	Feb-16	5.2	31.9	17.5	9.5	1.9	0.1	38.6	17.3	9.4	1.8	0.1	-6.7
Anchor BCI Africa Flexible Income	Mar-16	7.1	44.2	4.3	0.0	1.9	1.7	55.8	6.0	2.8	1.4	0.5	-11.6
Anchor BCI Global Technology Fund	Jun-19	30.7	74.1	16.5	6.2	4.4	11.4	92.9	20.0	9.4	6.9	10.3	-18.9
Anchor BCI Flexible Fund	Jul-13	11.6	140.8	14.7	11.2	9.4	8.9	9.9	10.2	5.1	2.6	0.5	131.0
Anchoe BCI Core Income Fund	Aug-20	4.3	3.9	N/A	1.2	0.0	-0.8	3.2	N/A	1.8	0.9	0.3	0.7
Anchor BCI Global Flexible Income Fund (B Class)	Sep-20	-13.5	-10.8	N/A	-2.6	-2.0	3.9	-14.1	N/A	-1.3	-1.9	0.0	3.3
EQUITY NOTES & SEGREGATED MANDATES													
Anchor Equity Segregated Mandate	Jul-13	8.1	87.1	30.6	15.4	3.8	-1.1	85.7	27.6	13.3	0.6	-3.0	1.4
HEDGE FUNDS													
Anchor Accelerator SNN QI Hedge Fund	Feb-16	12.4	86.1	16.5	6.9	0.8	-0.5	34.7	27.6	13.3	0.6	-3.0	51.4
OFFSHORE													
Anchor Global High Street Equity Portfolio (USD)	Jun-12	14.1	226.9	38.6	10.7	6.7	3.1	204.2	39.7	13.3	7.9	1.5	22.7
Anchor Global High Street Equity Portfolio (R)	Jun-12	21.3	470.9	13.9	7.8	3.2	7.3	431.9	15.1	10.6	4.6	5.7	39.0
Anchor Global Balanced Portfolio (USD)	Jun-12	10.8	152.1	26.8	8.0	5.3	2.2	106.7	23.5	6.3	5.1	0.5	45.3
Anchor Global Balanced Portfolio (R)	Jun-12	17.9	339.4	4.2	5.1	1.9	6.3	261.4	1.7	3.6	1.9	4.7	78.1
Anchor Global Dividend Yield Equity (USD)	Jan-14	8.9	88.5	31.0	11.1	5.1	-0.2	126.1	39.7	13.3	7.9	1.5	-37.7
Anchor Global Dividend Yield Equity (R)	Jan-14	12.7	142.1	7.6	8.2	1.7	3.9	191.1	15.1	10.6	4.6	5.7	-49.0
Anchor Global Stable Fund (USD)	May-15	2.7	17.5	10.9	3.6	2.9	0.5	17.5	2.5	1.3	0.7	0.2	0.1
Anchor Global Stable Fund (R)	May-15	5.5	38.5	-8.6	1.1	-0.2	4.7	38.2	-15.7	-1.6	-2.7	4.2	0.3
Anchor Global Equity Fund (USD)	May-15	20.5	210.9	64.6	10.9	14.5	13.6	84.7	39.3	12.3	7.4	1.3	126.2
Anchor Global Equity Fund (R)	May-15	23.7	266.2	35.6	8.3	11.0	18.3	117.6	14.7	9.6	4.2	5.5	148.7
RCI UNIT TRUSTS													
RCI BCI Flexible Growth Fund	Sep-16	15.1	95.5	23.5	3.6	5.6	8.6	52.8	10.2	5.1	2.6	0.5	42.7
RCI BCI Worldwide Flexible Fund	Dec-16	12.3	70.0	7.7	8.7	5.8	7.9	43.9	9.2	4.6	2.4	0.4	26.1

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