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NEDGROUP INVESTMENTS MINING & RESOURCES FUND

Quarter Two, 2019

For the period ended 30 June 2019

NEDGROUP INVESTMENTS MINING & RESOURCES FUND

Performance to 30 June 2019	Nedgroup Mining & Resources Fund[1]	ASISA SA Equity Resources & Basic Industries
Q2 2019	-0.4%	1.7%
12 month	18.5%	25.0%
YTD	16.9%	16.0%

Market Commentary

The second quarter of 2019 was a true rollercoaster for investors around the world. Market sentiment seemed to whipsaw from positive to negative on the back of ever-changing US-China trade news and evolving central bank policy. April's solid equity gains turned into sharp losses in May, only to rebound again in June, leaving investors with good returns across the board, although not as strong as those recorded in the first quarter. Propelling gains were the easier monetary outlooks adopted by many central banks in the face of building evidence of a growth slowdown, as well as better news on US-China trade negotiations outweighing the negative news on that front by the end of the quarter. Emerging markets also benefitted somewhat from the more bullish sentiment and the lower global interest rate outlook.

For South African investors, local equities and bonds posted decent gains in rand terms, and the rand managed to rally against all the major currencies for the quarter thanks to a rebound in June after some weakness in May. Developments were mixed over the quarter. First, the first quarter GDP surprised by contracting 3.2% (quarter-on-quarter annualised), the largest downturn in a decade. As a consequence, many institutions – including the South African Reserve Bank (SARB), IMF and Moody's – downgraded the country's 2019 growth forecast to only 1.0%. With CPI under control at 4.5% year-on-year in May, the SARB left interest rates on hold and lowered its interest rate outlook to include one 25bp rate cut by the first quarter of 2020. Still, it remains concerned about future inflationary pressures arising from the weaker rand, as well as higher costs from fuel and electricity, among other sources.

The ANC's comfortable 57.5% win in the national elections boosted investor confidence that President Cyril Ramaphosa would be able to pursue a course including difficult structural reforms and curbing corruption. The new cabinet was well received as well, although investors were disappointed by the lack of detail in plans to reform Eskom and deal with its high debt levels in the President's State of the Nation Address. Detracting from the positive sentiment were contradictory ANC statements around the independence of the SARB which undermined investor confidence.

After a 27% rise in the previous quarter, the price of Brent crude oil weakened by 2.7% in the second quarter on the back of slowing global growth concerns and rising US production. The fall was mitigated by a renewed OPEC and Russia pact to extend supply cuts through the end of 2019, as well as fears of supply disruptions in the Strait of Hormuz and Iran after ship bombings in the Strait and additional sanctions affecting the latter. After starting the quarter at around US$67 per barrel, it ended around US$65. In other commodity moves, industrial metals like nickel, copper, aluminium, and zinc lost ground on deteriorating global growth, but gold gained on its safe-haven status amid the trade war and the palladium price also rose on good demand.

The FTSE/JSE ALSI returned 3.9% for the quarter, led by Financials with 5.4%, which were bolstered by the easier interest rate outlook. Industrial counters delivered 4.0%, Resources produced 2.4% and Listed Property returned 1.5%.

[1] Net return for the Nedgroup Mining & Resources Fund, A class. Source: Morningstar (monthly data series).

Portfolio Commentary

The fund's top five performing positions added 4.6% to returns over the second quarter while the bottom five detracted -6.4%.

Winners	Ave.weight	Performance contribution	Losers	Ave.weight	Performance Contribution
Impala Platinum	10.5%	1.4%	Sasol	15.1%	-4.2%
AngloGold Ashanti	2.2%	1.0%	Glencore	5.5%	-1.2%
Anglo American	22.0%	0.9%	Sappi	3.1%	-0.7%
Exxaro Resources	7.4%	0.7%	Merafe Resources	1.6%	-0.2%
Gold Fields	1.0%	0.6%	Northam	0.5%	0.0%
		4.6%			**-6.4%**

Current positioning and outlook

The demand cycle is weak for industrial commodities. Pricing support is dependent on supply constraint, cost curve support, and Chinese supply-side reform. On balance, the demand cycle for base and bulk commodities (with the main exception of iron ore) appears to have rolled over. Iron ore remains underpinned by the supply/demand tightness created by Vale's issues in Brazil and oligopolistic supply, but this cannot hold indefinitely. Non-mining resources are facing a similar threat – especially chemicals and paper products which, in addition, don't appear to have the supply-side constraints as in mining. So broadly we view the cycle as having rolled over.

Resource equities have some benefits namely: relatively attractive valuations (vs history and vs global equities), still relatively good cost support (although benefits of efficiency gains are ending) and steepening commodity cost curves (this benefits the low-cost producers at the expense of the high-cost producers). Companies that are lower on the cost curve and able to maintain or grow supply in a supply-constrained market look to be the winners on a relative and an absolute basis – free cash flow generation for the general miners remains remarkably healthy for this point in the commodity cycle.

It would appear that the progress of the commodity cycle will continue to favour precious metals over industrial commodities, as the former's industry cycle still appears relatively early. Specifically, gold rather than platinum as the latter appears to be oversupplied, although the platinum group metal miners are benefitting from a recovered basket price arising from tightness in palladium and rhodium.

The rand is a bit of a wild card, as is global policy. Policies that the sector is beholden to, in an environment of depressed fundamental support, include global trade policy, Chinese stimulus, and the Fed's rate policy. These can swing the balance in favour of risk-on (industrial commodities) or risk-off (safe-haven precious metals) but broadly the cycle seems to be mature and favouring precious metals.

The challenge is to find the precious metal equities that will benefit from this move given a historically poor track record of seeing a higher gold price translate into sustained shareholder returns (i.e. more than just a tactical rally). On balance we still favour good free cash flow yields (cash generation plus valuation) from higher-quality diversified (commodity and geography) general miners but acknowledge that the balance is shifting.

During the quarter we switched our Gold Fields position into AngloGold Ashanti on relative outperformance and added to Impala Platinum and Royal Bafokeng Platinum by trimming Anglo American and Glencore, reflecting a shift at the margin to precious metals over industrial commodities.

Responsible Investing

Sasol was the largest detractor from performance over the quarter after its share price came under pressure. Sasol’s performance has been particularly disappointing, falling 22% in the second quarter. The disappointing performance of Sasol has not been ESG specific, but rather the legacy disappointment from the first quarter adjustment to expectations on the Lake Charles Chemical Project (LCCP). Sasol has faced significant execution challenges in bringing the LCCP to successful completion and in May it reported a major $1 billion overrun in costs for the project, placing additional strain on the balance sheet. In a detailed analysis of the investment case we adjusted two pillars of our investment case, viz. diminished re-rating opportunity as peer global chemicals stocks have de-rated. This compounded Sasol's challenge for investor flow due to its status as a very high carbon emitter, and also took a more cautious view on the demand outlook for oil and petrochemicals. We still find the valuation and the growth opportunity from the LCCP to be compelling (we expect a significant “cash flow inflection point” for Sasol when positive operating profit from the LCCP replaces the significant Capex to build the plant) but consider the return package to be lower than previously estimated.

We also conducted a detailed review of our Glencore position. The stock de-rated on governance concerns, in particular arising from the US Department of Justice subpoena (July 2018) into its activities in the DRC, Venezuela, and Nigeria in relation to the Foreign Corrupt Practices Act (FCPA) and US money-laundering laws. Initially this de-rating enhanced the FCF yield and boosted share buy-backs, but subsequently, its commodity basket price has underperformed that of its general mining peers (due to a lack of iron ore) and thus eroded the apparent free cash yield uplift. On the combination of basket price underperformance and ESG overhang, we have more actively trimmed our position.

DISCLAIMER

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Nedgroup Collective Investments (RF) Proprietary Limited, is the company that is authorised in terms of the Collective Investment Schemes Control Act to administer the Nedgroup Investments unit trust funds. It is a member of the Association of Savings & Investment South Africa (ASISA).

OUR TRUSTEE
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