NEDGROUP INVESTMENTS

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Nedgroup Investments Balanced Fund

Quarter Two, 2022

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Performance to 30 June 2022 (ZAR net return)	3 months	6 months	1year (annualised)	5 years (annualised)	10 years (annualised)
Nedgroup Investments Balanced Fund A-class	-0.80	0.36	7.53	9.07	10.92
ASISA category average	-5.68	-6.52	2.83	6.06	7.91

Source: Morningstar

Market overview

Global market outlook

There seems to be a consensus that Europe, and the UK, will be in a recession for the rest of the year, given their energy crisis. The US economy will continue to slow in the second half of 2022, and the probability of entering a recession in 2023 is rising, even though US consumers and corporate balance sheets are in good shape and the labour market remains strong. The Chinese economy remains under significant strain due to Covid-induced lockdowns. However, based on recent survey data, stimulus measures seem to be helping and we have seen improving PMI numbers. Unlike other countries, China is not struggling with high inflation and has substantial scope to cut interest rates and provide fiscal support to its economy. China is the only major economy moving into a stimulus phase while the rest of the world tightens its policy to deal with rising inflation expectations.

Earnings expectations for Europe and the US continue to soar, excluding the energy sector, which appears at odds with the numerous headwinds these markets face. Above trend, durable goods orders, industrial production, company inventory levels and high wage growth are some of the headwinds for the S&P 500 earnings. Additionally, over a quarter of these companies derive their earnings from economies outside the US that are in a worse economic state, and they earn profits in currencies that have depreciated against the US dollar.

In the case of Europe, high energy costs and a looming recession do not seem to be reflected in continual earnings upgrades. Valuations are more reasonable in Europe relative to history, but this could be justified by the risk of more significant earnings downgrades. Although valuations look reasonable, with the US forward-PE trading in line with its long-run levels of 15-16X, expected profit margins remain at record highs.

The valuation underpinned by easy monetary policy and quantitative easing has faded as central banks have committed to stamping out inflation. Consequently, the loftier valuations we've seen post-Covid are not justified. Essentially, bonds are cheaper and offer compelling returns so, competing asset classes like equities will have to offer even more compelling returns to attract investors. The risk is that the market has not yet adequately discounted the negative earnings revisions expected during the next quarter.

The Chinese market has been recovering and has outperformed the global market in the last two months - in line with an improvement in their economic outlook due to continued stimulus efforts and, at least for the time being, an absence of anti-market friendly rhetoric from the government. Improvements in statistics like electricity consumption should help drive the Chinese market higher, while the long-term outlook, which is highly dependent on regulatory policy, remains uncertain.

Commodities are under pressure as the global economy slows

Most commodities, barring energy, have come under considerable pressure over the last month. Persistent lockdowns and a struggling property market explain China's inability to revive its economy; however, with the expectation of an improvement in the Chinese economy, the fortunes of commodities might see a reversal in the latter part of 2022. The economic slump in the rest of the world has also weighed on commodity demand and prices. A meaningful portion of copper is used in consumer goods, and given over-stocking and excess levels of consumer goods demand, a falloff in demand is to be expected. The long-term outlook for base metals, such as copper, remains positive given their use in the pivot to green energy, which has become more urgent post the war in Ukraine. A lack of copper supply growth two years down the line should buoy prices in the medium term.

Energy prices are expected to remain elevated

European gas prices have once again surged post a severe reduction in volumes via Nord Stream 1, which have decreased by 60% of Q1 levels. Substantially higher imports of liquefied natural gas (LNG) are covering these shortages, supported by the low demand for LNG from China, given their current slow-down. When Chinese economic growth picks up, additional LNG demand will place further pressure on gas prices. Additional LNG capacity is only expected to come online in 2025 and 2026. Should the reduced flowthrough in Nord stream 1 continue, Morgan Stanley anticipates severe volume demand destruction of 7% and 5% over the next 1 and 2 years to balance markets. This would require extremely high pricing given the inelasticity and stability of gas demand.

The surge in gas prices is keeping coal prices elevated. Coal has benefited from under-investment due to its “non-green” status; however, due to extreme gas shortages, some European countries are now reverting back to coal, at least for the short to medium term. These factors, coupled with Russian sanctions should keep coal prices elevated for the next few years.

Oil supply should remain tight due to underinvestment from the oil majors and several OPEC countries falling short of their production quotas. Moreover, an eventual recovery in China should offset the negative demand impact of a European recession. In addition to the underinvestment in the upstream production of crude, there has also been a lack of investment into refining capacity, evidenced by high refining margins. This further benefits oil companies like Sasol that generate turnover from the price of refined fuel as opposed to merely the price of crude oil.

Valuations in the energy sector remain compelling, with companies returning cash to shareholders via share buybacks and dividends. Although energy prices are elevated based on long-term fundamentals, if they remain at this level for one to two years, this should be sufficient to extract a reasonable return from certain shares. Glencore currently derives over 60% of its profit from coal and trades on a free cash flow yield of over 34%, while Thungela currently trades on a 1X earnings multiple at spot prices. Within the mining and resource space, we have been, and remain primarily exposed to the energy sector.

The global slow-down coupled with country-specific concerns are weighing on the South African financial and currency markets

Higher global interest rates and a reversal of the commodity cycle are both negative for South African markets. Lower commodity prices worsen our trade account and increases the budget deficit as less tax is collected from mining and resource companies. Usually, higher global interest rates result in money flowing out of emerging markets like South Africa and back into developed markets. Additionally, the recent increase in frequency and extent of load shedding will weigh on industrial production and consumer sentiment. The outlook for SA has worsened since the first quarter. However, our view on finding domestic opportunities remains the same. We favour companies with a self-help narrative and companies which are pricing in a depressed economic outlook. After last quarter’s underperformance, we are finding opportunities in the latter camp with over half our universe of shares trading below a 9X PE and dividend yield of above 6%. We are also seeing increased corporate activity in the local equity market which is further evidence of cheap domestic valuations as private equity and trade buyers take listed companies private.

Naspers/Prosus management finally gained traction in reducing the massive discount on which their companies trade relative to their underlying holdings. An announcement of sales of Tencent to be used for share buybacks resulted in their prices increasing by almost 50%. A full unbundling, which should see a closure of the discount, remains elusive; however, it seems that management will not engage in further value-destructive corporate deals for the time being. The Funds benefited from our recent meaningful increase in holdings in Naspers given its overly large discount to its holding in Tencent and due to a less negative outlook towards Chinese equity markets.

South African fixed income markets have diminished in line with the weaker domestic equity and currency markets. Our double-digit fixed-rate yields and generous real yields are compelling compared to the rest of the world. The Fund maintains a moderate exposure to domestic medium-term duration bonds.

Portfolio positioning

We increased our exposure to Naspers due to the share trading at a large discount to its underlying investment in Tencent and due to being less negative on the outlook for the Chinese market. We increased our exposure to domestic financials and industrials which sold off to compelling valuation levels. We increased our offshore exposure to Chinese equities and the energy sector.

We reduced our exposure to some of the miners - Mediclinic, RMI, and Raubex. They performed strongly over the period. We reduced our Stellantis exposure due to increased recessionary concerns.

Performance commentary

Buoyant energy prices benefited Thungela and Royal Dutch Shell. Being defensive, British American Tobacco benefited from the risk-off environment. Mediclinic advanced due to a takeover offer from Remgro. Naspers and Prosus benefited from the announcement to sell down a portion of their Tencent holdings and deploy the proceeds into share buybacks. Swedish Match rose significantly on a takeover offer from PMI. An improved outlook for the Chinese economy resulted in an uplift in our Chinese equity positions.

The underperformance of metal prices negatively impacted the miners other than those with a predominant energy exposure. Financials underperformed as domestic sectors were sold off in line with other emerging markets which underperformed in the risk-off environment. MTN underperformed due to a weakening of the Naira and a general sell-off in global fintech.

Top contributors	Average weight (%)	Performance contribution (%)	Top detractors	Average weight (%)	Performance contribution (%)
Naspers Ltd	2.75	1.72	Absa Group Ltd	4.91	-0.86
British American Tobacco	6.04	0.78	Sibanye Stillwater Ltd	1.77	-0.61
Thungela Resources Ltd	1.92	0.48	MTN Group Ltd	1.67	-0.55
Mediclinic International Plc	1.60	0.38	Glencore Plc	5.94	-0.44
Royal Dutch Shell	1.76	0.19	Impala Platinum Holdings	1.48	-0.30

Disclaimer

WHO WE ARE
Nedgroup Collective Investments (RF) Proprietary Limited is an authorised Collective Investment Scheme and the representative of Nedgroup Investments Funds PLC in terms of the Collective Investment Schemes Control Act. It is a member of the Association of Savings & Investment South Africa (ASISA)..

OUR TRUSTEE
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HOW ARE OUR FUNDS PRICED
Funds are valued daily at 15:00. Instructions must reach us before 14:00 (12:00 for Nedgroup Money Market Fund) to ensure same day value. Prices are published daily on our website and in selected major newspapers.

FEES
A schedule of fees and charges is available on request from Nedgroup Investments. One can also obtain additional information on Nedgroup Investments products on our website.

DISCLAIMER

Unit trusts are generally medium to long-term investments. The value of your investment may go down as well as up. Past performance is not necessarily a guide to future performance. Nedgroup Investments does not guarantee the performance of your investment and even if forecasts about the expected future performance are included you will carry the investment and market risk, which includes the possibility of losing capital. Our funds are traded at ruling prices and can engage in borrowing and scrip lending.

Some funds may hold foreign securities including foreign CIS funds. As a result, the fund may face material risks, which could include foreign exchange risks, market conditions and macro-economic and political conditions.

A fund of funds may only invest in other funds, and a feeder fund may only invest in another single fund, both will have funds that levy their own charges, which could result in a higher fee structure.

The Nedgroup Investments Money Market Fund offering aims to maintain a constant price of 100 cents per unit. A money market fund is not a bank deposit. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument held. In most cases the return will merely have the effect of increasing or decreasing the daily yield, but in an extreme case it can have the effect of a capital loss. Excessive withdrawals from the fund may place the fund under liquidity pressures and that in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed. The yield is calculated using an annualised seven day rolling average as at the relevant dates provided for in the fund fact sheet. Nedgroup Investments has the right to close its funds to new investors in order to manage it more efficiently.

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