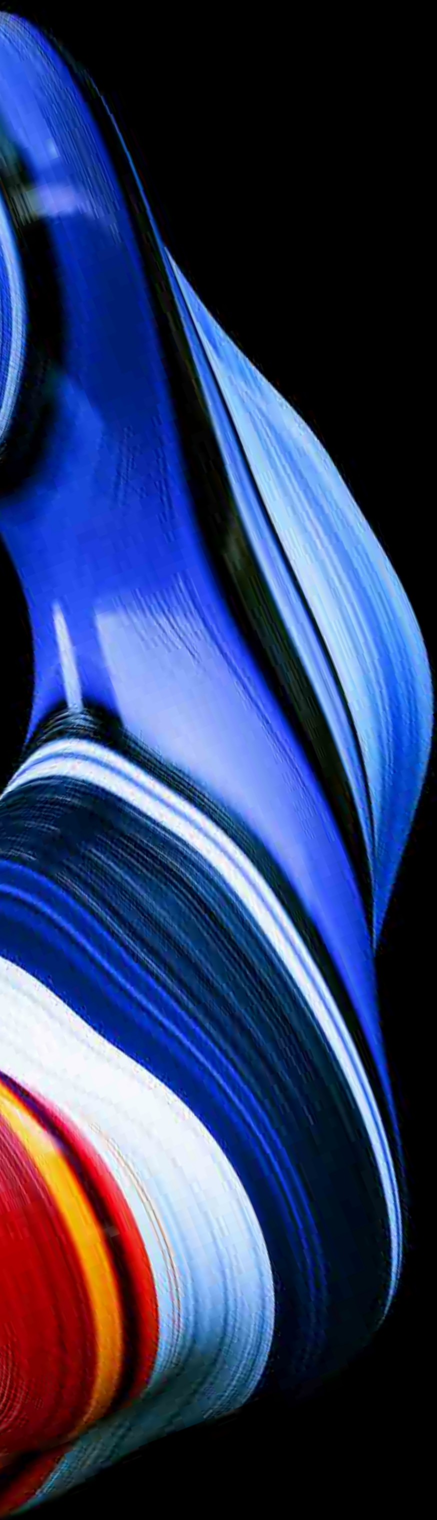


NORTHSTAR
ASSET MANAGEMENT

QUARTER 2, 2022 MARKET REPORT

Closer to the truth

Three warnings for markets from company CEOs

Adrian Clayton, CIO

Presentations at a US investment conference identified a number of common themes that indicate significant societal shifts, which we believe will have meaningful implications for financial markets in the future.

A combination of societal mood and the raw facts emanating from the presentations of 60 CEO's which we have just met at a US investment conference catalysed an unusual discomfort for me. It was something I have not felt during my previous US visits.

They brought to mind lyrics from Bob Dylan's great song The Times They Are A-Changin:

> "Come mothers and fathers throughout the land
> And don't criticize what you can't understand
> Your sons and your daughters are beyond your command
> Your old road is rapidly agin'...
> For the times they are a-changin'."

There were common themes that weaved their way into many of the CEOs' presentations. We cover three in detail below, but there were others:
- Inflation is persistent, structural and toxic to businesses with thin gross margins
- Many are concerned about a hard landing
- There are ideological fissures between business and the Biden administration
- Financial firms are arguing that they are well prepared for any financial crisis
- A mismanaged green economy transition is forcing us back into hydrocarbons

The three most notable themes, however, were these:

Great management teams blind-sided by demand shifts
Walmart, the US's largest retailer with over 230 million global customers reported results from the first quarter of its 2023 financial year on 17 May. Consolidated operating income fell 23% versus the first quarter last year, caused by higher input costs and demand shifts as consumers moved from higher margin merchandise to lower margin necessities such as food. CEO Doug McMillon described the operating environment as 'unusual' and the poor profit performance as 'unexpected'.

Throughout its 2021 financial year, Amazon was enjoying insatiable demand but struggling to fill orders due to labour shortages. So it doubled the size of its workforce during the pandemic. It also increased physical capacity at its fulfillment centres. But Amazon's Covid demand boom came to a shuddering halt in 2022 (the first quarter of its 2023 financial year). Net sales for Amazon's online store 'unexpectedly' declined 3% year-over-year versus the first quarter of last year. CFO Brian Olsavsky best summed it up on Amazon's earnings call: 'The issue has switched from disruption to productivity losses, to overcapacity on labour'.

To prove the point, Target issued two profit warnings within the last four weeks. The reason is shifts in product demand from consumers.

A culture of work reluctance and rising wage inflation

An ill-tempered James Foot, CEO of CSX Corporation (one of North America's leading rail transport suppliers) lamented at the conference that his 40 years of railroad experience ill-prepared him for a pandemic.

Mr. Foot's disquiet is due to his mid-2020 decision, during the height of Covid, to lay-off staff arguing that CSX's customers' businesses had stalled, reducing rail demand. What Mr. Foot could not and did not know was that consumer demand for goods would subsequently skyrocket as lockdowns starved consumers from spending on services.

CSX experiences a natural labour attrition rate of 7% a year. Since Covid, this has risen to 10%. But the real problem is that the company is struggling to find hires. In Foot's own words: 'In 2020, due to extreme stress, I laid off employees and now they don't want to come back'. The result has been a collapse in rail service levels and congressional hearings with CSX in the eye of the storm. Most CEOs complained that their greatest challenge is sourcing labour.

The next big opportunity is in infrastructure

In 2021, the American Society for Civil Engineers gave the US a score of C-minus for infrastructure. It warned that 43% of roads were in mediocre condition. Their assessment was no better for bridges on the interstate highway system, constructed during the Eisenhower administration, which are nearing the end of their useful lives. Infrastructure disrepair is most severe in those places outside the voters' view – tunnels, rail lines, dams, water, and electricity systems.

The requirement for infrastructural renewal is not in question. The political appetite to fund less sexy and less visible projects is. In addition, there is a labour shortage. The American Welding Society estimates that the US will be short of 400,000 welders by 2024. The average age of a welder is currently fifty-five. The National Homebuilders' Association Spring 2021 Market Report found the US requires double its current number of plumbers, and the US Bureau of Labour Statistics estimates that 7,000 electricians join the field annually while 10,000 retire.

CEOs presenting at the conference whose businesses manage large-scale infrastructure projects were upbeat – they are waiting for a big pay day. And each day that passes, the odds are stacking in their favour!

Conclusion

We are witnessing tectonic societal shifts, which we believe will have meaningful implications for financial markets. Under-appreciating and miscalculating these could have dire consequences for investors' capital.

Beyond inflation: The impact of weaker global trade on global equities

Marco Barbieri, Director of SA Equities

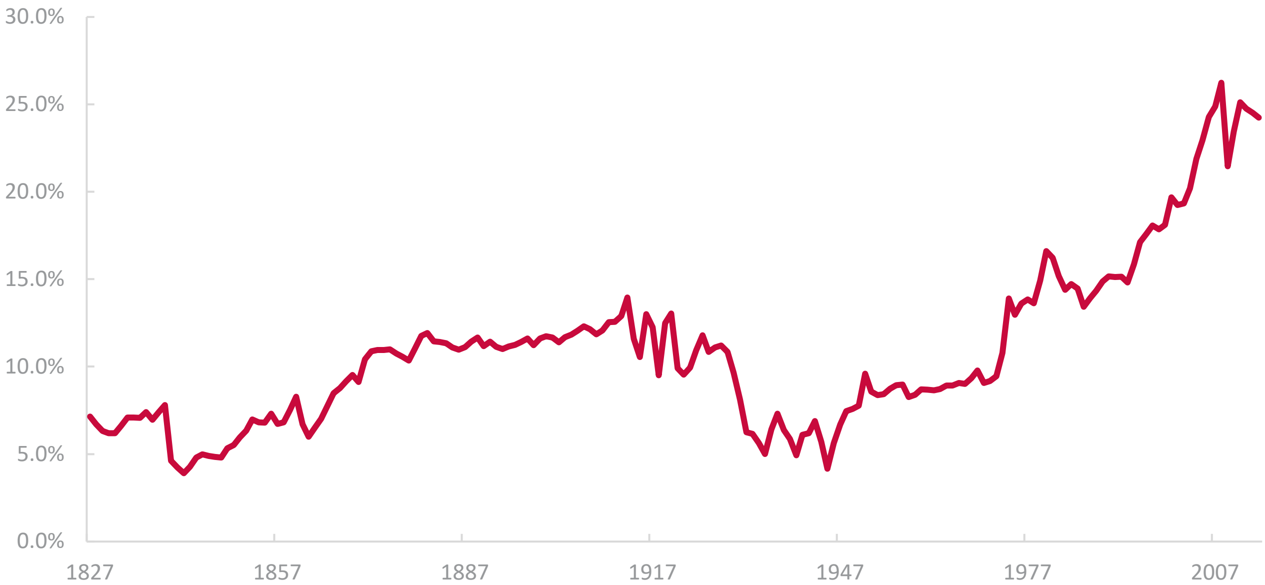
Whether deglobalisation is entrenched or a temporary phenomenon, the short-term impact on asset prices is profound. While US equity markets appear to be forecasting a fairly rapid normalisation of inflation, unusually high risks to inflation could potentially derail equity returns further, even after the latest correction.

While the latest global trade data does not suggest a slowdown in globalisation levels (trade interdependence), the impact of US-China tensions, the Covid-19 pandemic and more recently the War in Ukraine, have had a significant impact on global trade. These dynamics are likely to further weaken trade cooperation between countries as policymakers look to re-consider the balance between economic efficiency and supply chain security.
The impact on inflation and long-term equity prospective returns could be meaningful.

How entrenched is the deglobalisation trend?

Since the Industrial Revolution, world economies have sought to strengthen economic ties and work towards higher levels of economic integration. The level of globalisation experienced a strong acceleration during the three decades post World War II (1945-1975) as the United States and Western Europe in particular sought to improve economic ties, reduce trade protectionism and increase the scale and scope of trade agreements. From the 1980's, globalisation accelerated even further as China and India, historically closed economies, started to reduce trade barriers with the West. The collapse of the Soviet bloc in 1991 and its subsequent democratisation marked a further step in global integration with trade volumes as a percentage of GDP eventually peaking in 2008 (Chart 1).

Chart 1: Value of global exported goods as share of GDP, 1827 to 2014 (exports-to-GDP-ratio)



Source: Klasing and Milionis (2014), Penn World Tables 9.1, World Bank, Northstar AM | Data as at 2014

The global financial crisis (GFC) in 2008 marked a turning point in the level of global economic integration. Over the past decade we have seen significant shifts in policy such as the US withdrawing from the Trans-Pacific partnership, China refocusing its reform agenda on the promotion of local industries, and India developing a 'self-reliance' strategy.

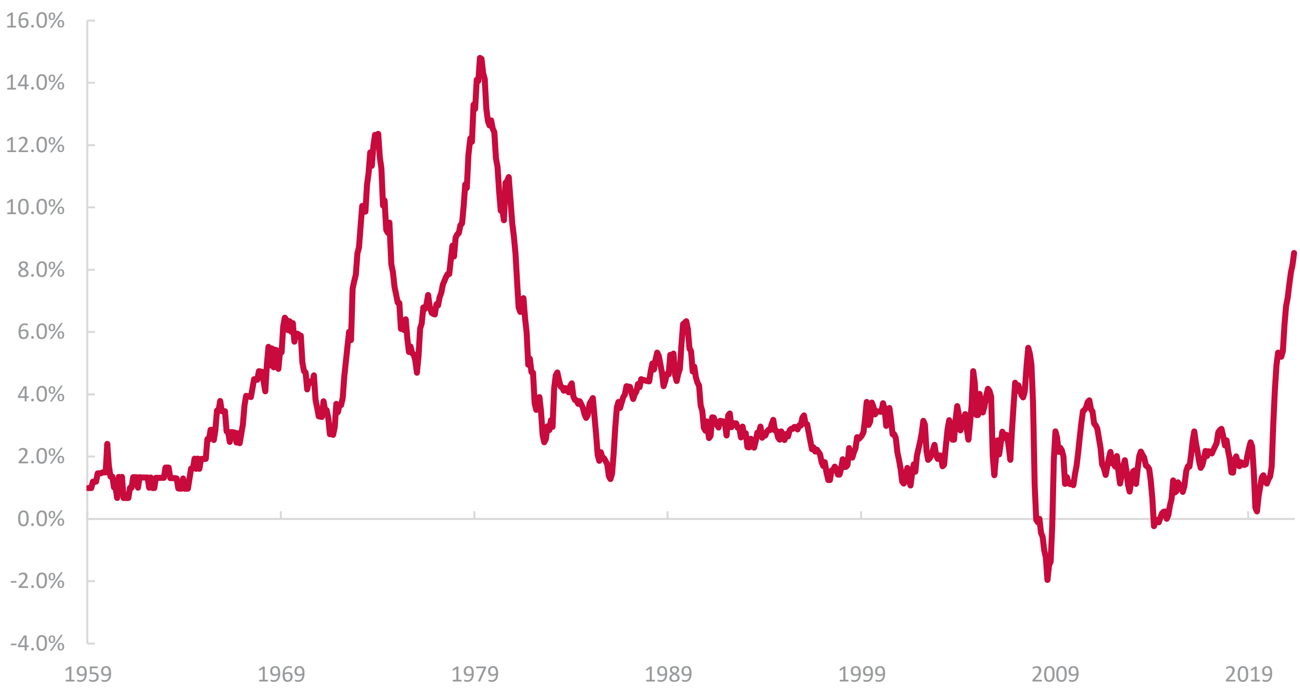
Covid-19 pandemic and geopolitical tensions

There seems to be no consensus on whether deglobalisation trends are entrenched or rather temporary and aggravated by the Covid pandemic and the Ukraine conflict. However, the negative impact of these developments on inflation adds to already deep global supply chain disruptions and ongoing global production reconfiguration.

The long-term impact of these dynamics is complex to model, but over the short term there is clear evidence that the pandemic and the Ukraine conflict, in particular, have had a profound impact on asset prices. Inflation in the US (Chart 2) and Europe has spiked to multi-decade highs as the combined effects of supply chain bottlenecks, commodity price shocks and trade tensions have weighed on asset prices.

Not surprisingly, global equities and bonds alike have come under significant pressure, with central banks around the world becoming increasingly hawkish and markets more negative on the prospects of a 'soft landing'.

Chart 2: US inflation



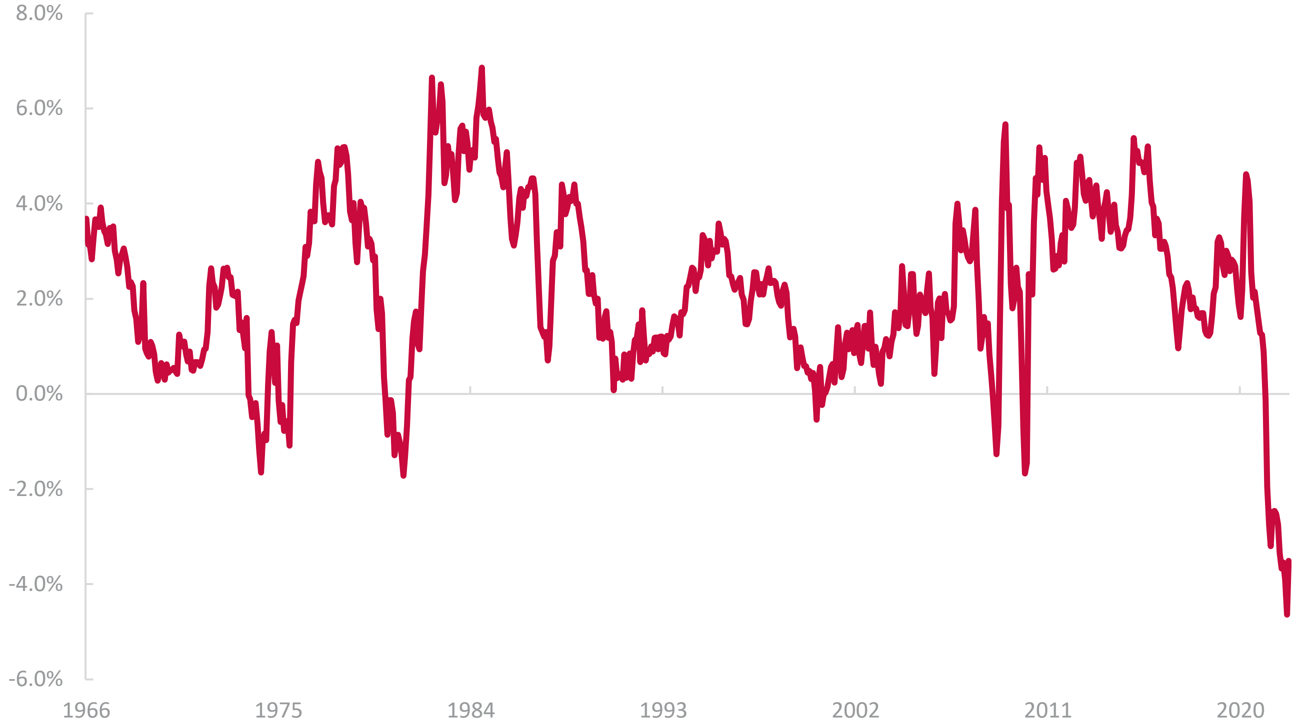
Source: Bloomberg, Northstar Asset Management | Data as at May 2022

Impact on equities

The relationship between inflation and corporate earnings is not always straightforward. An analysis of US earnings cycles reveals that corporate earnings will generally benefit from increasing inflation levels as input cost pressure is passed on to consumers to some extent. During periods of extreme and protracted pricing pressure however, such as those experienced during the 1970s, earnings have seldomly grown ahead of inflation and thus contracted in real terms.

Negative real earnings growth is in our opinion the key risk equity markets face at present as this significantly increases the likelihood of further market multiple deratings. An analysis of the S&P500 real earnings yield highlights such risks.

Chart 3: S&P 500 real earnings yield



Source: IRESS, Northstar AM | Data as at May 2022

Based on current inflation levels, the S&P 500 is trading on a real earnings yield of -3.5% – far off a long-term average of 2.3% (Chart 3). Based on our calculations, and assuming that Bloomberg consensus earnings growth for the index materialises, the S&P 500 would require inflation to be closer to 3% in 2023 and 2% in 2024 to justify its current rating.

In other words, the equity market appears to be discounting a fairly rapid normalisation in inflation levels broadly in-line with consensus economic forecasts. In the event that global inflationary pressures remain stubbornly higher for longer, even if a recession is avoided, we think that equity markets could come under further pricing pressure. While we believe the risk-return prospects for global equities are more balanced after the latest correction, we remain of the view that unusually high short- and long-term risks to inflation could potentially derail equity returns further.

Generating real returns with lower risk – The Northstar SCI Income Fund

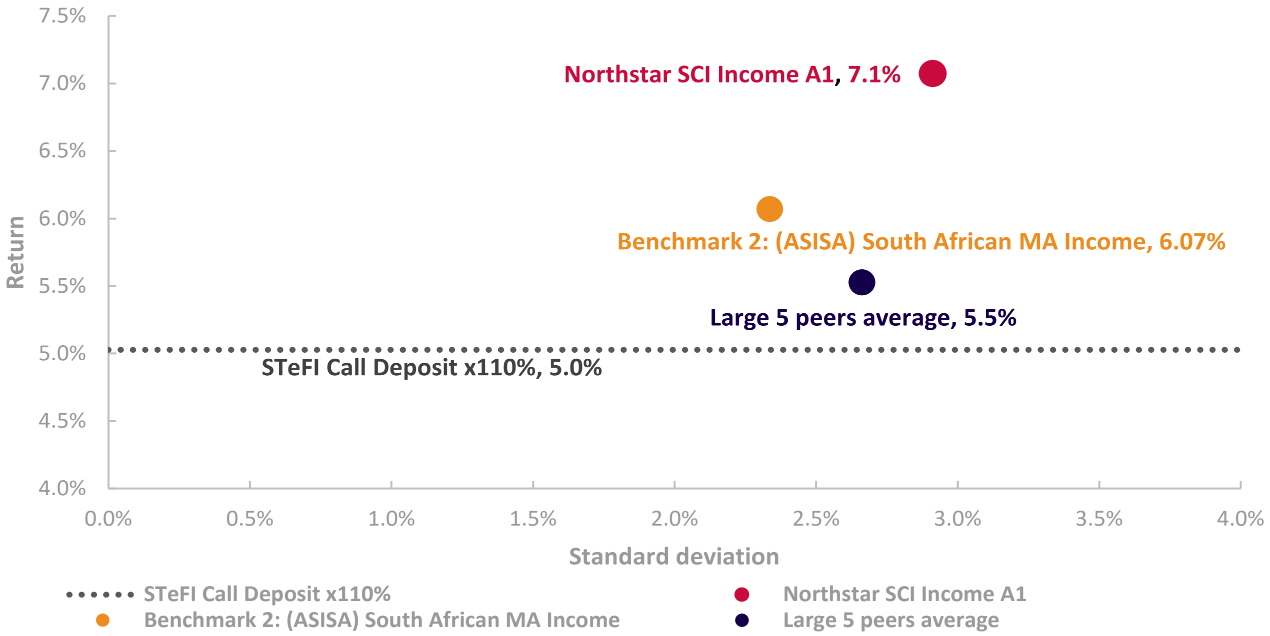
Mark Seymour, Director Fixed Income

We discuss how the Northstar SCI Income Fund has managed to deliver three-year real returns well ahead of its benchmark and peers, while keeping risk within our parameters. We also touch on how Northstar's approach helps the Fund to stand out from its peer group and how it is currently positioned.

The Northstar SCI Income Fund aims to provide investors with regular and stable income that beats inflation over the long term, while managing the risk of capital loss in the short term. This presents a challenge familiar to all investors – that of managing the risk/reward trade-off: how to generate consistent inflation-beating returns while keeping risk low.

As managers, we are occupied with maintaining real purchasing power for our clients and target a 2% return above inflation (real return). Over the past three years, the Fund delivered a 7.2% return, a real return of 2.6%, which is comfortably above its benchmark (the STeFI Call Deposit rate x 110%) and ahead of large, well-supported peer income funds, new competitors and the SA Income Fund benchmark return.

Chart 4: Annualised three-year return vs standard deviation



Source: Morningstar, Bloomberg & Northstar Asset Management | Data as at May 2022

This return was achieved while keeping the Fund's primary risk parameters – standard deviation and modified duration - below their target threshold of 3%. The Fund's current standard deviation of 2.9% is around 20% of the risk investors are exposed to in the equity market.

Active management and an emphasis on fundamental research

Northstar's obsession for research includes ongoing monitoring of developments in relevant metrics such as interest rates, inflation and fiscal risk as well as significant time invested in studying how assets behaved at key periods in the past. This includes the degree of correlation between assets so that risk exposure can be further diversified. The output from the research process is used to model the risk of large drawdowns and position the portfolio accordingly.

The Fund's holdings are primarily through government paper and senior bank bonds - the highest credit quality instruments available in the South African market. These instruments are also highly liquid, meaning that investors can withdraw funds quickly and easily. While lower-quality credit has higher yields, it carries significantly higher credit risk and is less liquid, and major market-moving events can result in significant drawdowns and a far higher probability of default.

The benefits of holding higher quality paper was demonstrated in the Covid crisis, an extreme event during which credit spreads in lower quality Tier 1 credit widened from around 400 basis points to 550 or even 600 basis points, resulting in a drawdown of almost 6%. While higher quality credit was also affected, it was affected to much lesser degree.

Table 1: Performance during the Covid-19 liquidity-related drawdown (mid-March to 30 April 2020)

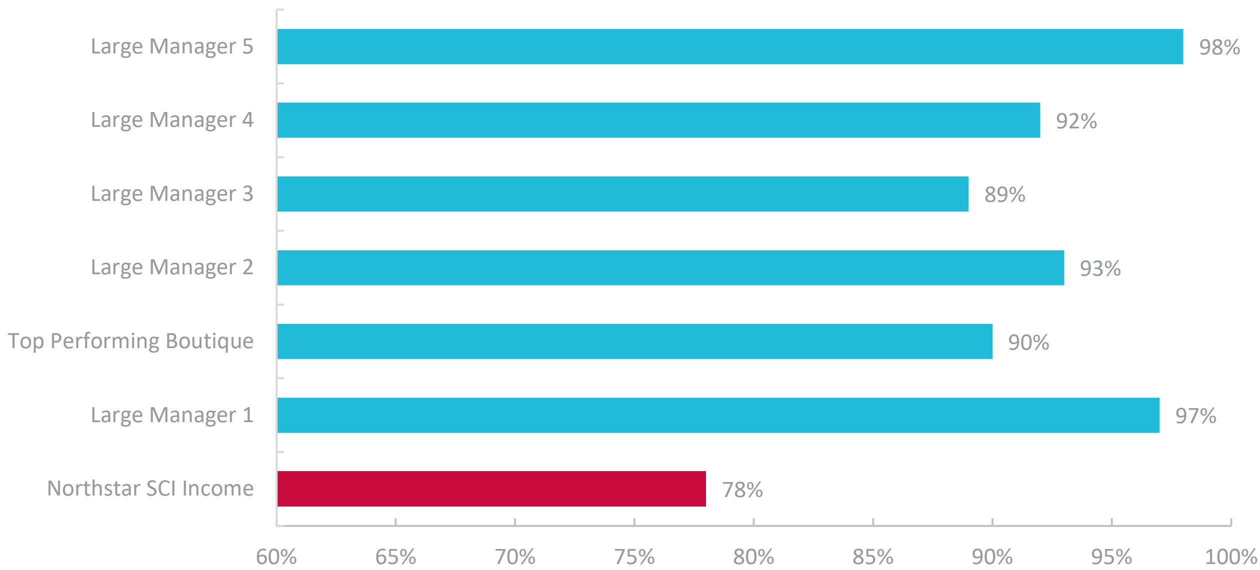
Type	Maturity date	Average years to maturity at maximum drawdown	Covid crisis drawdown
South African Fixed Bond (R2023)	28/2/23	2.9 years	-4.3%
South African Inflation Linked Bond (R197)	7/12/23	3.7 years	-4.4%
Subordinated Additional Tier 1 (average of 4 issues)	13/3/23	2.9 years	-5.8%

Source: Iress and Northstar Asset Management I Data as at 30 April 2020

A different approach that makes us stand out from our peers

Northstar's active management and flexible mandate allows the Fund to adapt to developments in the market, such as changes in the interest rate cycle. Combined with our deep research process, this helps us to unearth opportunities less obvious to others, which means that our portfolio and returns are differentiated from the pack. While peer funds have correlations of 90% and above to the South African Multi-Asset Income index, the Northstar SCI Income Fund has a correlation of 78%, making it an excellent option for diversified portfolios, while delivering above-average returns.

Chart 5: Correlation to the ASISA South Africa Multi-Asset Income index (3yr)



Source: Morningstar | Data as at May 2022

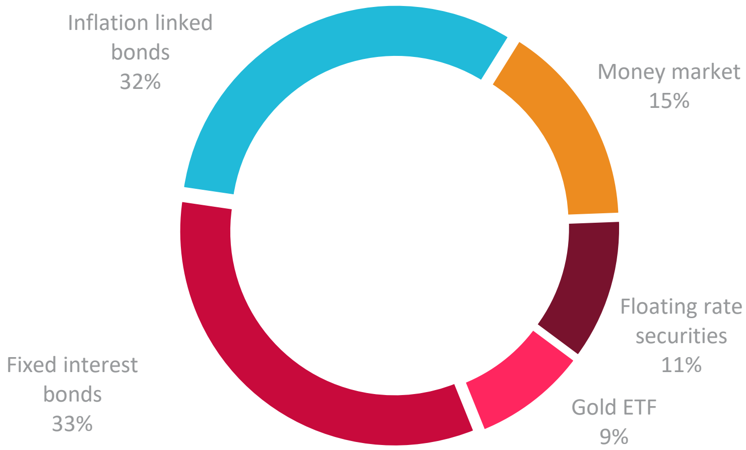
High inflation and low interest rates create a challenging environment for cash

The current high inflation and low interest rates create a challenging environment for generating real returns and money held in cash is currently earning a negative real return.

The yield curve, which maps out the yield and maturities of credit instruments, is markedly steeper now than in previous rising interest rate cycles, when bonds were significantly more expensive. The 10-year point on the yield curve is currently yielding more than 5% above the repo rate.

Our modelling indicates that this steep pitch is discounting future interest rate hikes and pricing in both a sufficient cushion for expected inflation and elevated levels of fiscal risk. The Fund consequently has the majority of its exposure to bonds in the 7 to 15 year space, with yields of 9% to 10.5%, and is holding very little cash or floating rate bonds.

Chart 6: Northstar SCI Income Fund holdings (31 May 2022)



Source: Maitland Fund Services | Data as at May 2022

In addition the fund holds nearly 9% in gold ETFs, providing diversification in an asset that we believe is at a historically attractive valuation.

With inflation spiking and central banks responding slowly from current low interest rate levels, real returns will be harder to achieve from fixed income, while keeping risk within acceptable levels going forward. We remain confident that our active approach and the opportunities in the middle of the yield curve will continue to deliver sound real returns at very low risk, providing investors with security very close to cash but at a return above inflation.

Meet the team

Joshua Reed
Analyst

When did your interest in financial markets start?
My interest in financial markets started during high school accounting, leading me to pursue a finance focused degree, Bachelor of Business Science. I was intrigued by the intricacy and occasional absurdity of markets, and the idea of allocating capital appropriately makes a lot of sense. My internship at Northstar cemented my passion for investing.

What did you study and why?
My degree helped me appreciate how businesses are managed. I was most interested in the investment component and subsequently pursued a M Com in Finance in the field of Investment Management.

What do you think equips you to do this job properly?
I believe my natural curiosity, eager work ethic, and analytical mindset work well within Northstar's research led investment process. These are key skills required to produce informed and unbiased investment cases. I continually work to expand my knowledge of financial markets and learn from dynamic market conditions to propel better decisions over time.

What do you love about investing?
I love gaining deep insights into companies, industries and the world in general to better understand the dynamics impacting investment outcomes and to try piece together where companies and the world could be heading. It is rewarding to know that doing the work I am passionate about can contribute to building wealth for clients through appropriate investment decisions.

What do you find the most challenging part of your role to be?
It can be challenging to discern structural and temporary changes to industry dynamics and a company's relative competitiveness. We take a long-term view in an unpredictable future, and therefore need to make informed judgements based on available information, avoiding near-term noise and unjustified sentiment changes. It is important to assess each company in an analytical and unbiased way, and to be aware of any behavioral biases which may be influencing perceptions and decisions.

Why do you think clients will do well at Northstar?
We have a highly skilled and dedicated team focused on offering superior service and investment performance to clients. We follow a robust investment process to produce high quality research and investment decisions that should create value for clients over time. Clients can have peace of mind knowing that they are at the heart of what we do.

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NORTHSTAR ASSET MANAGEMENT

Northstar Asset Management (Pty) Ltd
Registration No. 1996/001423/07 | FSP number 601
Suite 1A, Madison Place, Alphen Office Park, Constantia Road,
Constantia PostNet Suite #784, Private Bag X16, Constantia 7848
Tel +27 (0)21 810 8400 | Fax +27 (0)21 794 2885
info@northstar.co.za | www.northstar.co.za

SANLAM COLLECTIVE INVESTMENTS

Sanlam Collective Investments (RF) (Pty) Ltd
Registration No. 1967/002865/07
2 Strand Street Bellville, 7530 PO Box 30, Sanlamhof, Bellville, 7532
Tel +27 (0)21 916 1800 Fax +27 (0)21 947 8224
service@sci.sanlam.com, www.sanlaminvestments.com
Please refer to our website for directors & company secretary details

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