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FIRST AVENUE
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Market Report

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Closer to the truth

Does the performance of the Johannesburg Securities Exchange reflect the triumph of the national imperative over the shareholder imperatives?

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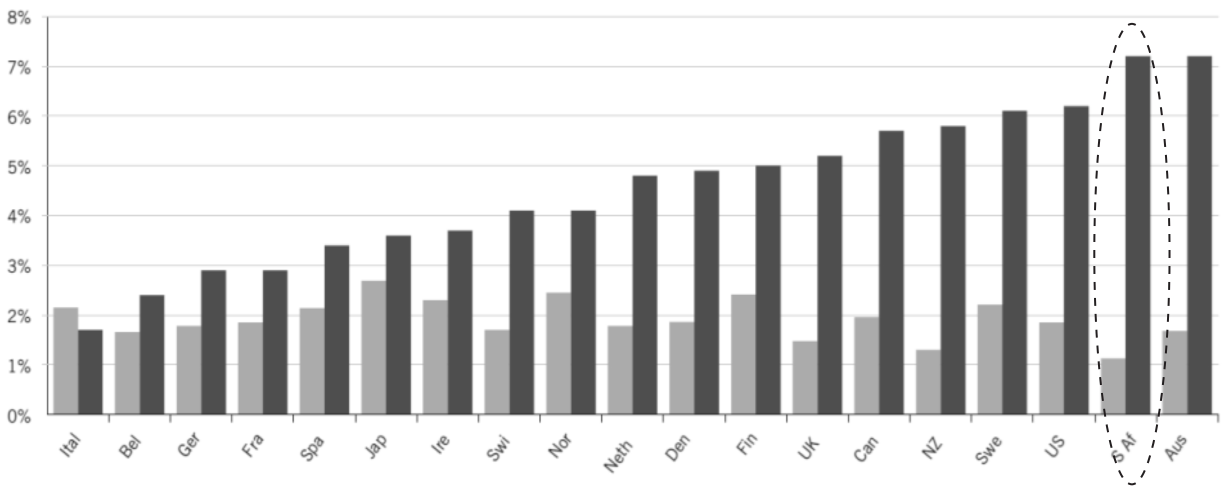
South Africa's legislative competency in giving life to a national imperative is at odds with the shareholder imperative. That is, the legislative framework lacks the creativity to give birth to South African Dynamism in much the same way as economically vibrant countries such as the United States do through American Dynamism.

Analysis by Elroy Dimson, Paul Marsh, and Mike Staunton of London Business School of 19 major stock exchanges between 1900 and 2011 shows that the Johannesburg Securities Exchange ("JSE") punches above its weight against 18 Developed Market (DM) stock exchanges. The JSE was in the top three (3) performing stock exchanges in US dollar terms. In the period under review (111 years), the leadership of the 19 exchanges under review alternated between South Africa, the United States, and Australia.

Chart 1: Real Equity Return (black) and Real GDP per Capita Growth (grey): 1900-2011



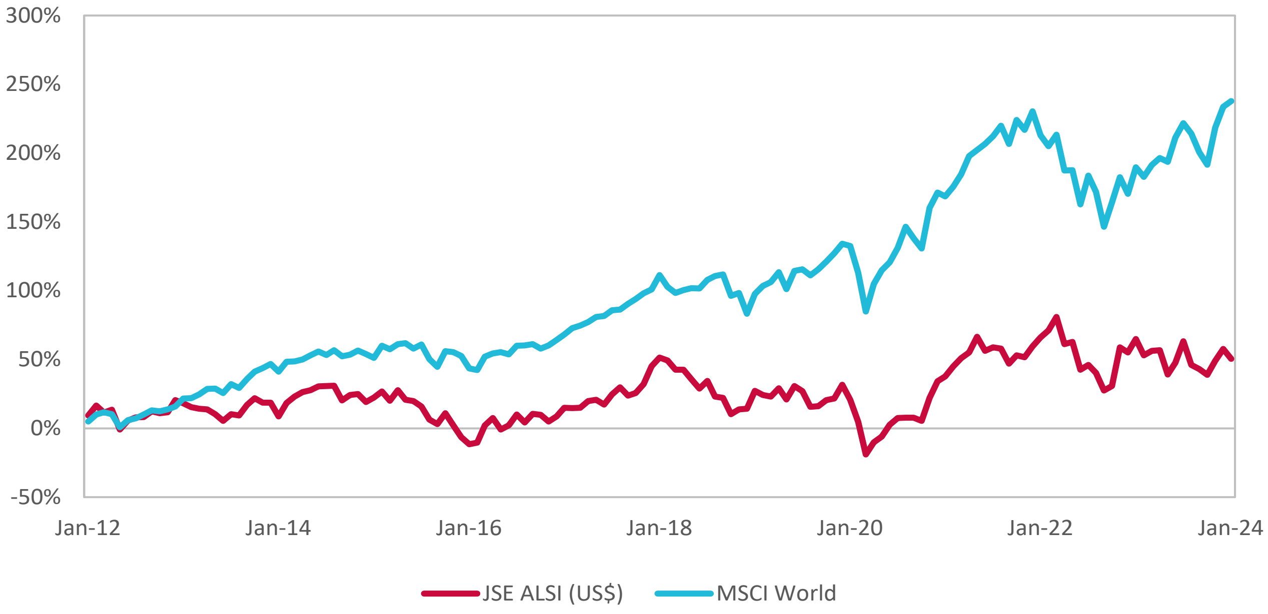
Source: Triumph of the Optimists, 2011

It is notable that (i) South Africa registers world leading outperformance of 17 Developed Market exchanges in real terms (that is, adjusted for inflation - higher than Developed Markets by the way) and (ii) the lowest real GDP growth in the group.

The beginning of the underperformance of the JSE relative to developed markets

Since 2011, South Africa's real GDP has remained painfully anemic, and its returns (both nominal and real) lag those of DMs materially. From January 2012 to February 2024 in USD terms, The MSCI World Index outperformed the JSE substantially, posting 252% compared to 42% for the JSE. In fact, the country's economic growth on a per capita basis has been in recession since 2011.

Chart 2: South Africa vs. MSCI World (January 2012 – February 2024)



Source First Avenue, Bloomberg and JSE as at 29 February 2024

While local commentators easily find and lay fault at the hands of the government, we think managements of South African companies have not demonstrated adequate ingenuity to overcome the unintended consequences of the national imperative on generating competitive shareholder and market returns. The following is an illustration.

A national imperative to foster close linkages with the sub region (SADC)

The South African Development Community Free Trade Agreement of 1996, as amended in 2010, is one of the most important legal instruments guiding SADC's work on trade. It is an agreement between 12 SADC Member States to reduce customs duties and other barriers to trade on imported products among SADC Member States. The SADC Free Trade Area seeks to meet the following needs of the private sector and other regional stakeholders: Increased domestic production; greater business opportunities; and higher regional imports and exports. So, this piece of legislation purports to align the shareholder imperative with the national imperative.

At the expense of creation of economic value in South Africa

In 2017 a leading retailer of mostly imported high end ceramic tiles, Italtile, acquired the balance of shares it did not already own in a manufacturer of lower end floor tiles, Ceramic Tiles, for R3.492bn. In 2018, the company invested a further R680m to both increase capacity and modernize the acquired manufacturing facility to substitute imports with domestic production. The aim was to reduce long lead times, and currency uncertainty, associated with imports. As we all know, out of date stock is as good as a lost sale. Thanks to the SADC Free Trade Protocol, what should have been leadership in short manufacturing runs in response to style trends has turned into a nightmare. International players have set up manufacturing facilities in the SADC Free Trade Area (Zambia) and are exporting product into South Africa. The latest instalment of this is a Chinese manufacturer who has set up similar nameplate capacity as Italtile in Mozambique for the sole purpose of exporting into South Africa's large consumer market.

These players are arbitraging differentials in labor costs, tax rates, investment incentives, energy costs, and currency convertibility between South Africa and its neighbours in the Free Trade Area. For instance, the Mozambiquan competitor benefits from gas royalties (access to the country's vast reserves of natural gas at favourable prices) to power its kilns and furnaces. On the other hand Italtile not only pays commercial rates from Sasol Gas (sole importer into the country), but has also recently suffered uncertain supply as disputes on pricing led to Sasol announcing an imminent retreat from importing gas into South Africa. In the absence of another gas supplier stepping into the breach, Italtile may very well have to toggle to the next best option, namely, more expensive coal fired kilns and furnaces. This would not only drive costs of production up relative to its Mozambican (gas) and Zambian (hydro) competitors, but place Italtile at a comparative disadvantage.

The question is why did Italtile not see it fit to set up manufacturing facilities in the most beneficial country in the Free Trade Area to avoid structural disadvantages in South Africa's operating conditions? Let's be clear, besides benefiting from South Africa's consumer market, competitors in the Free Trade Area also benefit from the easy convertibility of the South African rand into US dollars for repatriation back home. The local unit is the third most liquid and convertible currency in the world (after the USD and Euro). In fact, what currently stops Italtile from moving its manufacturing capability to Mozambique under the same attractive terms its Chinese competitor enjoys? Is it the national imperative of keeping jobs in the country? Paying tax to the fiscus in South Africa rather than Mozambique (if any)? Isn't contributing to lower inflation by importing lower priced goods into the country a national imperative as well? Italtile boasts R1.5bn in cash on its balance sheet. Why not use it to reposition itself in a competitive position? Perhaps, why not unbundle or sell the manufacturing facility and source cost competitively priced tiles from anywhere in the Free Trade Area?

At R11.8bn, Italtile's market capitalization today is less than it was in 2017 (R12.3bn) when the company integrated vertically by acquiring Ceramic Tiles. Of course, a material reduction in interest rates could flatter the company's fortunes (and result in a material rise in market capitalization). But the company's competitors would enjoy greater profitability than Italtile. Why can't Italtile put its shareholders in a position to benefit from what shareholders of its competitors in Mozambique and Zambia enjoy?

Disruption of the comfortable kind leads to more pain

Talking of contributing to structurally lower inflation, the clothing retail industry in South Africa is suffering from a similarly debilitating arbitrage from Shein and now Temu, albeit with different fingerprints. The Foschini Group (TFG), Truworths, and Woolworths have all spent billions of rands acquiring traditional brick-and-mortar assets mostly in the United Kingdom and Australia. Pepkor looked to a bricks-and-mortar retailer in Brazil to escape the low growth trap in South Africa. Again, at the time these acquisitions were made, e-commerce as a route to market was a proven capability in the developed world, and rapidly taking root in the Middle Kingdom, China. Today, the cost structure of local clothing retailers is woefully deleterious relative to Chinese e-commerce companies exporting clothes in South Africa. Chinese e commerce competitors are using China's global comparative advantage to manufacturer textiles and apparel and export to the rest of the world. Try as they might, local clothing retailers cannot come close to both the price points and fashion-ability of products shipped by Shien and Temu.

What could have served as a deterrent (45% import tariff) to cheap imports is the customs and excise tax code. Yet, the excise tax code has a loophole as porous as South Africa's borders. Shein and Temu ship ordered goods in packages whose weight falls below the threshold for full duties (45%). So, a customer often receives multiple packages under the same order. Practices like this can easily be defended as tax efficiency rather than tax avoidance. The Minister of Trade and Industry acknowledges that Shein and Temu are using lower duties in ways not intended, resulting in an unfair playing field. The onus, however, is on the government to change the tax code to reflect full duty even on a single item. This may take years, if not decades, if challenged at the World Trade Organization (WTO).

The mother of all battles has not even begun

Even if the government enacts a change in tariffs in favour of the clothing retail industry, retailers will only live to fight the mother of all battles against Amazon, the global leader in e-commerce, launching in April this year. One thing for certain, operating margins enjoyed by clothing retailers in South Africa are attractive enough for a company that prides itself, not in arbitraging import tariffs, but in investing cost savings in price to drive volumes to asphyxiate category leaders. If Amazon retail lost money in the US for 20 years straight to establish unimpeachable market share and scale, how long do you think it can do it for in South Africa to bring operating margins of clothing retailers to 5%? After all, Amazon Web Services, Amazon Advertising, and Amazon Freight could very well be profitable during that period as they are much higher margin businesses. For instance, AWS has about a fifth of the revenue generated by retail but produces greater operating profit. That margins for Amazon retail are around 3% should scare local retailers. There is plenty of runway for structurally sound ideas like Amazon, and those “tariff efficient” businesses like Shein, and Temu.

Nearly three quarters of the population of South Africa has internet access, and more people live in concentrated urban areas than in most other nations in the region. Yet e-commerce makes up about 4% of retail in the country, meaning there are potential riches to be won. What is benefiting international operators here is that emerging markets have shown an ability to leapfrog when it comes to technology whether its online banking or insurance. Shein, for instance, is the most downloaded shopping app on South Africa’s Google Play store. Soon Amazon.co.za will be. The courier company used by both Shein and Temu, Buffalo Express, seamless integrates with the South African customs system, local banking system, and several other express companies for delivery overflow. Buffalo Express boasts a fleet of three hundred self-owned transportation vehicles, and a 25,000-square-meter sorting centre with a 6,000-square-meter bonded warehouse in October 2022. These rival those of local retailers.

There is no such thing as "South African dynamism" to compete in manufacturing the future

It is disappointing that at the core of the complaints by clothing retailers, labor unions, and government officials is a concern about job security. Globalization saw America’s manufacturing base hallowed out by companies that offshored jobs to low-cost geographies (first Taiwan, then China, and now Malaysia and Indonesia) while the American worker moved up the value chain to more profitable areas such as research and development, and industrial design. Rather than resort to complaints, we encourage:

- Management of South African companies move the enterprises they steward up the value chain to compete for a greater share of the value of global trade.
- Government incentivizes local industry to invest more in intellectual capital than in basic manufacturing to sustain and grow enterprise value, and the economy.

This way, management teams can decide which parts of the business to outsource to the Free Trade Area and which parts to keep in South Africa enroute to creating high value-added goods for domestic consumption and export. Our diagnosis is that managements of South African companies are too comfortable to radically disrupt themselves.

Interconnected fortunes: US policies and their broad impact on South Africa's economy

Mark Seymour
Director Fixed Income

This article delves into the significant influence of the United States fiscal and monetary policies on commodity prices and the consequent impact on South Africa's crucial mining sector and the broader economy. South Africa is a bastion of diverse economic activities rooted deeply in mining, agriculture, and tourism, and its economic narrative has been resilient and adaptable to various global and local challenges. The piece explores how the fluctuations in the U.S. money supply have historically correlated with shifts in commodity prices, shedding light on a critical aspect that directly affects the profitability and sustainability of South Africa's mining industry.

Overview of South Africa's economic landscape

South Africa's economy, with its deep historical roots in mining, agriculture, and tourism, showcases a rich tapestry of strengths that have evolved over the years. From the discovery of diamonds and gold in the 19th century, which positioned it as a global mining giant, to its modern advancements in technology and finance, South Africa has demonstrated remarkable resilience and adaptability. The country's diversified economy now also thrives on agriculture, which benefits from fertile lands, and a booming tourism sector, celebrated for its breathtaking landscapes and cultural heritage.

The mining sector: a cornerstone of South Africa's economy

At the heart of its economic prowess, the mining industry remains vital, contributing significantly to GDP and employment. However, this sector's fortunes remain closely tied to the impact of United States monetary and fiscal policies. The strength of the U.S. dollar, along with U.S. interest rates, significantly influences commodity prices and, consequently, the profitability of South Africa's mining exports. This dependency underscores the interconnectedness of global economies, highlighting the importance of strategic economic planning and international cooperation for South Africa's sustained growth and prosperity.

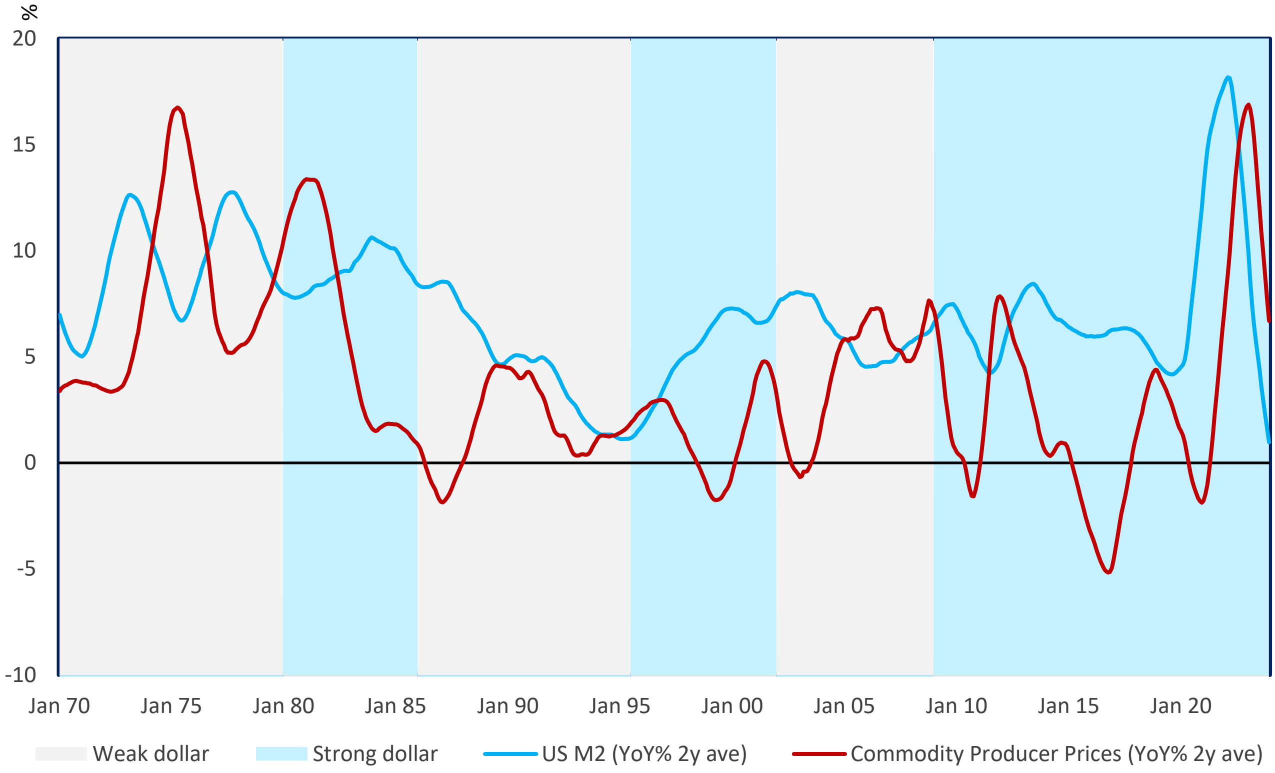
Analysing the impact of U.S. monetary policy on South African Mining

The chart that follows highlights the link between the U.S. M2 money supply and commodity prices, outlining significant patterns:

1. Periods of increased money supply, such as during the 1970s and the Covid crisis, are followed by surges in commodity prices,
2. A slower expansion of money supply, observed from the 1980s to 2000, is associated with moribund and volatile commodity prices, and
3. The strength or weakness of the dollar has an inverse effect on the demand for commodities and consequently prices.

These observations offer valuable perspectives on the potential direction of the local mining industry.

Chart 3: Influencing SA's economy: US M2 and commodity prices



Source: Federal Reserve, dated as at: 31 Jan 2024

Global economic repurcussions and South Africa's mining outlook

Global markets are still grappling with the extensive impact of the monetary and fiscal policy response to the Covid crisis, with South Africa's mining sector experiencing significant effects. Initially, the Federal Reserve responded by cutting interest rates to historically low levels, embarking on massive asset purchases, and the Treasury ramped up its spending. These actions led to an unprecedented increase in money supply, naturally driving a sharp rise in commodity and general asset prices. As a result, inflation in the United States surged to 9.2%, compelling the Fed to undertake corrective action by aggressively raising interest rates in March 2022 and balance sheet reductions in June 2022.

The Fed's response to inflation and its effect on commodity prices

Twenty-three months into these adjustments, the Fed Funds rate has risen from 0.25% to 5.5%, and the Fed has trimmed its balance sheet from $9 trillion to $7.7 trillion. Despite the ongoing pressures from sustained government spending, which saw the deficit increase from $1.38 trillion to $1.7 trillion over the past year, the Federal Reserve's measures have led to a significant reduction in the money supply, resulting in downward pressure on commodity prices.

Future monetary policy trends and their implications for South Africa

Consequently, inflation has moderated below the Fed Funds rate and closer to the 2% target, allowing the Federal Reserve to consider reducing rates. While opinions on when these cuts will occur differ, recent estimates suggest that there will be three rate cuts by the end of the year, beginning in the latter half of 2024. Furthermore, the Fed plans to continue reducing its balance sheet by approximately $90 billion per month, resulting in an end-of-year target of around $6.8 trillion and bringing a close to this round of quantitative tightening.

Meanwhile, U.S. government spending is on an upward trajectory, with projections indicating that the budget deficit of 6%-to-GDP won't narrow for the foreseeable future.

Amid the prevailing monetary policy dynamics, the economy remains stable, indicated by low unemployment (3.7% in December) and moderating inflation (3.1% in January). The Fed remains confident in its ability to sidestep a recession.

Significantly, after persistent declines in M2 since April 2022, the money supply has started to increase again. This dynamic coincided with a recent low in oil prices and other commodities, which have since risen.

The convergence of three key factors, the peak of interest rates, the foreseeable conclusion of quantitative tightening, and the positive shift in money supply after a 16-month downturn present a hint of optimism that commodity prices might be stabilising, suggesting the bulk of declines are in the past.

Challenges and prospects for South Africa's mining industry

Despite the potential for future improvements in commodity prices, South African mining companies continue to grapple with a host of enduring challenges, marking a critical period for the sector and spotlighting Gwede Mantashe's pivotal role.

The critical role of government leadership in mining sector stability

The landscape is fraught with regulatory uncertainties, infrastructure inadequacies, and strained labour relations, severely testing the sector's resilience and adaptability. These issues, compounded by the imperative for environmental sustainability and the impacts of global economic shifts and currency volatility, demand strategic foresight and robust solutions.

The guidance of the Minister of Mineral Resources and Energy is pivotal in navigating the industry through its challenges, ensuring not only the preservation of its legacy but also fostering the expansion and progress of broader sectors. Without proactive and supportive national government input into this sector, South Africa could miss out on any improvement in a somewhat stressed commodity cycle.

Meet The Team

Sahil Gyanda
Senior Analyst

When did your interest in financial markets start?
My interest in financial markets started during high school, when my Grade 10 accounting teacher spoke about the achievements of Warren Buffet, and how he enjoys reading company's annual reports and financial statements. This, together with my love for accounting, piqued my interests in the world of investments. Being able to work with financial statements whilst not being in the characteristically "boring" accounting industry excited me.

What did you study and why?
I studied a Bachelor of Business Science with honours in Finance and majoring in Economics, as I believed these qualifications would give me a good foundation in terms of understanding businesses, investments generally, and how these have an impact on the economies of the world. I then studied a double MSc in Finance and Investment at international universities to further expand my knowledge, especially as it relates to the workings of the global economy and the role played by various types of investments in the Global Capital Markets.

What do you think equips you to do this job properly?
My extensive knowledge gained through studying and attention to detail, combined with my natural inquisitive nature, I think, provides me with the basis to continuously study and investigate the myriad of factors that influence a company's operations. I believe this positions me well to be able to reasonably predict the financial performance of companies through the economic cycle.

What do you love about investing?
The field for self-education is limitless, as investing is not a static environment. We, as analysts, are exposed to different companies, in different regions, in different industries on an on-going basis, and this allows for continuous information gathering.

What do you find the most challenging part of your role to be?
In my opinion, the most challenging part of my job happens when recommending an investment, and with so many different minds working towards the same goal it is difficult to get everyone on the same page, at times.

Why do you think clients will do well at Northstar and First Avenue?
The historical successes of the Brands, that are Northstar and First Avenue, coupled with the focus of a vibrant and knowledgeable investment team that engages in investing in Quality assets will ensure that our successes are maintained, to the benefit of our clients.

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