Prescient Multi-Asset

Monthly Commentary

END JANUARY 2021

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INVESTMENT MANAGEMENT

GLOBAL MACROECONOMICS

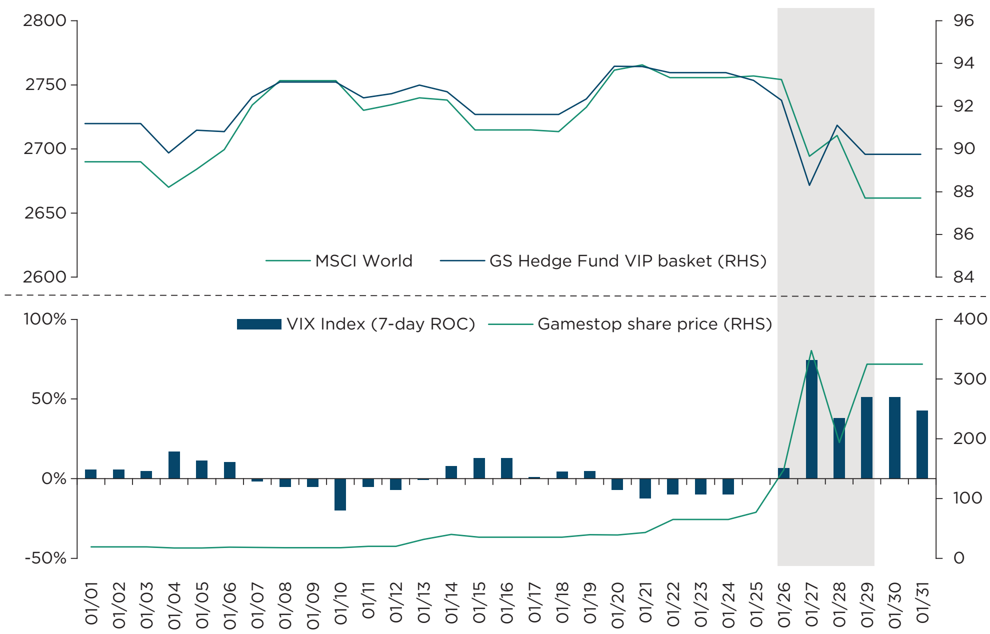
> The prevailing reflationary narrative in the market has been a potent driver of asset prices

January 2021: A tale of two halves

The first couple of weeks of January saw a continuation of the rally in risk markets – which started when Joe Biden won the US presidential election in Q4 last year. Bond yields rose, and value and other cyclical elements that encompass risk-on positioning (e.g. commodities) took off. Indeed, the prevailing reflationary narrative in the market has been a potent driver of asset prices over the past three months or so.

Many of these risk-on trades however suffered a setback toward the end of the month and gave back most of the earlier gains. It all came to a head during the last week of the month due to massive short squeezes in a handful of counters with elevated short interest as a percentage of share float – which led to significant de-grossing by over-levered hedge funds. The bottom panel of the chart *Short squeeze impact on broader equity markets* illustrates how the seven-day rate of change on the VIX spiked in tandem with the parabolic rise in the share price of GameStop (which had the highest short interest) as hedge funds finding themselves on the wrong side of the trade became forced sellers of their long positions to fund exponentially increasing margin calls.

Short squeeze impact on broader equity markets



Source: Bloomberg (as at end January 2021)

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One might wonder why a systematic top-down manager like Prescient would be bothered by short squeezes in a small number of small-cap stocks. Well, from a macro perspective, we were paying particularly close attention to the persistence of the volatility spillover to broader risk markets. The top panel of the chart Short squeeze *impact on broader equity markets* shows how drawdowns in the Goldman Sachs Hedge Fund VIP basket ETF led global equities (as represented by the MSCI World Index) lower. Moreover, these types of disorderly spikes in volatility lead to risk aversion on the part of central counterparties like clearing houses, which in turn carries the non-negligible risk of disrupting the flow of collateral and funding in the plumbing of an antiquated financial system as margin requirements are increased on short notice.

Seen through this lens, it becomes clear how seemingly isolated events like this may carry outsized risks for the market as a whole – particularly when parties involved employ leverage as a cornerstone of their investment processes, as most hedge funds do.

> "Our portfolios' overall positioning reflects a constructive view of risk assets"

Our systematic view on global markets

From a tactical standpoint, our portfolios' overall positioning reflects a constructive view of risk assets. The funds are positioned to benefit from the expected rebound in inflation, recovering global economic activity and continued policy support (both monetary and fiscal). However, we've scaled back on the bearish USD view that we held coming into the new year by closing out the high conviction short USD positions against G10 currencies (EUR, GBP and JPY), while maintaining the long ZAR position. The positive view on the local currency is mainly driven by continued strength in commodity prices, which augurs well for tax revenues and, by extension, SA's fiscal dynamics.

	Strong Underweight	Moderate Underweight	Neutral	Moderate Overweight	Strong Overweight
Equities					
South Africa				Overweight	
United States			Neutral		
European Union			Neutral		
Emerging Markets			Neutral		
DM Small Caps			Neutral		
EM Small Caps			Neutral		
Bonds					
South Africa					Overweight
United States			Neutral		
European Union	Underweight				
EM (USD)			Neutral		
EM (Local)				Overweight	
Credit					
South Africa				Overweight	
DM Investment Grade			Neutral		
DM High Yield			Neutral		
EM (USD)			Neutral		
Real Assets					
SA Property					Overweight
SA Preference Shares					Overweight
SA ILBs					Overweight
DM Property				Overweight	
FX					
Euro				Overweight	
British Pound				Overweight	
Japanese Yen				Overweight	
SA Rand					Overweight

Although the SA government bond curve experienced aggressive bull-flattening with the recent surprise tax revenue overshoot as a catalyst, only the ALBI's *average* yield has returned to pre-pandemic levels – while the shape of the curve is significantly steeper due to a marked deterioration in SA's fiscus over the past year. We continue to hold long-duration positions relative to the ALBI, which should benefit from a further flattening of the yield curve.

Conversely, our view on EU bonds is less constructive. The recent uptick in inflation has pushed real yields deeper into negative territory against a backdrop of an economic recovery that is gaining momentum. The negative nominal yields offered by EU bonds are unlikely to provide a sufficient margin of safety in an environment where inflation expectations are rising.

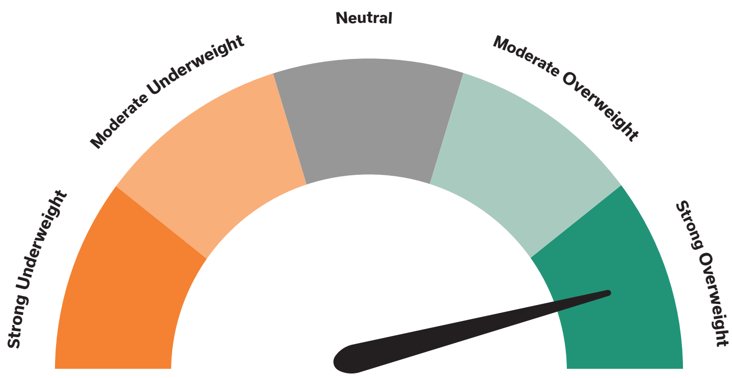
UNPACKING OUR SYSTEMATIC VIEW ON SA PROPERTY

Where we currently stand

South African property delivered a healthy 30% return over the three-month period ending in January 2021. However, the JSE's Listed Property Index remains approximately 25% below its pre-pandemic base. Admittedly, the impact of COVID-19 presented numerous operational and financial headwinds for the sector – with the pace and extent of the recovery heavily reliant on a successful vaccine roll-out/the unhindered reopening of the economy. While the path to normalisation is clouded in opacity due to the structural challenges that the economy and property sector are facing, we take comfort in the margin of safety provided by relatively cheap valuations in a sector that is unloved by the market, as well as the broader picture across our three other factors (Economics, Financial Conditions and Sentiment) – which are often precursors to increased occupancy and growth.

> "Improvement in leading indicators point to an economic recovery momentum"

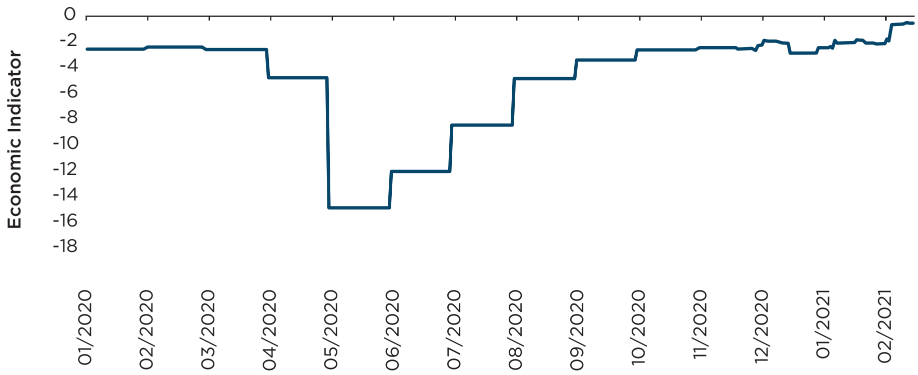
Although the SA property sector's attractiveness from a valuations standpoint has deteriorated somewhat given its strong performance over the past couple of months, improvement in leading indicators (consumer and business sentiment) point to an economic recovery momentum that will gain traction over the short to medium term.



Value	Economics	Financial Conditions	Sentiment
Dividend Yield	Prescient Economic Indicator	Monetary Policy	Business Sentiment
Relative Yield	Economic Surprise Index	Credit Spreads	Consumer Sentiment
Yield Spread	Yield Curve	Funding Pressure	Investor Sentiment
	Labour Market	Cross-Currency Basis	

Moreover, as confirmation of the positive signals generated by the "soft data", the Prescient Economic Indicator (which measures nowcasted economic activity vs long-term trend growth) shows a steep recovery over the past six months after its precipitous drop early in 2020.

Prescient Economic Indicator: South Africa



Source: Prescient, Bloomberg (as at end January 2021)

In addition to this positive thesis, incoming economic data releases continue to surprise on the upside. Adding ultra-easy global financial conditions to this cocktail of bullish signals increases the likelihood of the asset class being propelled back to pre-pandemic levels in the not-too-distant future.

Looking at the negatives, the recent rally has resulted in a dramatic compression of SA property dividend yield vs government bond yields – the spread now rests comfortably in negative territory. With that said, there is a silver lining: should our positive outlook on SA bonds materialise, it will likely coincide with the upliftment of bond proxies such as property.

WHAT TO LOOK OUT FOR

Risks and fortifications to our views

Long-term inflation vs near-term deflationary risk

So far this year, we've seen a gradual increase in inflation expectations in an environment where policymakers at key central banks are committed to keeping rates at (or below) the zero-lower bound (ZLB). Indeed, the cyclical factors leading to the current inflation impetus present a challenge to the well-entrenched secular view for lower interest rates for longer. However, one needs to be cognisant of the fact that the market has a poor track record in terms of predicting future inflation.

Nonetheless, should inflation materialise, it poses the risk of forcing the hand of central bankers when it comes to timing the policy rate lift-off from the ZLB – prematurely tightening financial conditions in the process. Undoubtedly, this scenario will likely trigger an unwind of risk-on trades as market participants recalibrate positions to reflect a higher interest rate environment. As such, we will continue to keep a close eye on the evolution of upcoming CPI prints vs the market's inflation expectations, and establish whether the current rise in inflation is persistent in nature or just a function of the low base effects from last year (which is transitory and should be looked through).

> SA bonds have rallied aggressively on the back of tax revenue overshoots

National budget

Given our high conviction bet on SA bonds, it's only fitting that we highlight some of the key risks for the position. As pointed out earlier, SA bonds have rallied aggressively on the back of tax revenue overshoots. More specifically, market participants are pricing in the increased likelihood of a reduction of supply in the weekly government bond auctions. However, in his State of the Nation Address, President Cyril Ramaphosa announced that the special COVID-19 grant of R350 per month will be extended by a further three months to April; and TERS benefits will be paid out by the UIF until March 2021. However, this will only apply to sectors that have not been able to operate. From an issuance perspective, if it's not done in a deficit-neutral manner, this may negate the need to reduce bond supply as the extension of grants was not factored into spending estimates that were tabled at the Medium-Term Budget Policy Statement (MTBPS). The flipside of the coin is that if the market deems the upcoming National Budget a disappointment, the path of least resistance for the shape of the bond curve points in the direction of bear steepness. We continue to monitor both scenarios.

BRINGING IT ALL TOGETHER

Staying on the plane – but seated right next to the exit

As risk markets continue to climb the proverbial wall of worry, we continue to scour the investment landscape for opportunities to bolster our funds' antifragility, while maintaining healthy exposure to risk assets. An interesting fact about the market is that the price investors pay for protection is usually cheapest when it's needed the most – so the price of optionality is typically lowest at the height of complacency.
But this time around is different and although global markets are running at levels that are higher than ever before, the cost of insurance via options is currently near all-time low levels. Should an unforeseen risk event materialise, a position like this will create liquidity in the funds, allowing the funds to redeploy capital at bargain-basement prices.
This, in conjunction with the speed at which our models are expected to turn negative once the market turns bearish, leaves us with a degree of comfort to stick with the process while having the flexibility to take advantage of opportunities should they arise.

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