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SNAKES AND RIVERS AND GLOBAL MARKETS

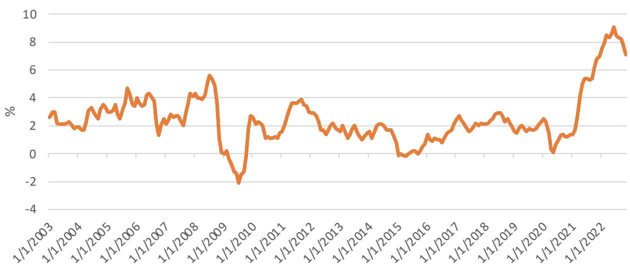
Sometimes analogies are helpful in explaining otherwise dry and complex issues such as financial markets. When water flows, it seeks the lowest path with the least resistance. Rivers follow this principle and throughout history, important cities have been built and flourished along riverbanks. Rivers can, however, be very destructive in nature when they routinely flood and on occasion, suddenly change course.

These sudden changes in direction, called avulsions, can be catastrophic even claiming many human lives as history has taught us. A slow buildup of sediment is often the culprit that reaches a point which forces the river to burst its banks and change course permanently. Environments and eco-systems then must adapt to accommodate the change.

Financial markets can be thought to be similar in nature, where a change is brought about by a slow buildup of underlying factors that suddenly force an adaption in trading styles, risk management, investment philosophies and investment processes. Looking back on the past year, one can certainly think of a few world events that could be considered "avulsions" in the realm of investments and global finance.

Global inflation surged on the back of interest rate cuts enforced by the Covid pandemic. Supply chain disruptions, the war in Ukraine and supply shortages of everything from cars to computer microchips drove prices higher. Food prices remained high and inflation measures reached highs last seen decades ago. Central bankers were forced to act and started hiking rates aggressively to try and stem the tide. As is the case with rate hikes, it takes time for the effects to be felt, which meant that we only saw signs of inflation abating in the latter part of 2022. This phenomenon is depicted in the graph below.

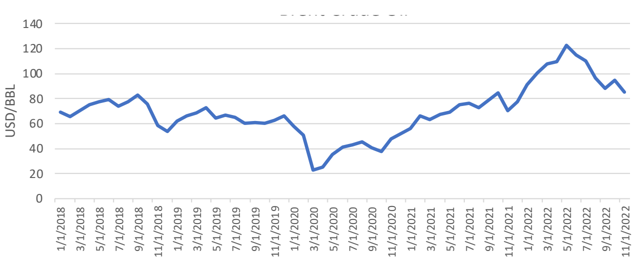
Figure 1: US CPI - YoY Index



Source: Bloomberg, Cadiz Asset Management

The war in Ukraine, coupled with the spread of new Covid 19 variants, seriously hampered the healing of critical supply chains, compounding recession worries and sending oil prices to multi-year highs. Countries responded by agreeing to release strategic oil reserves and to reduce the reliance on Russian natural gas. The conflict thus required the world to consider a new course and adapt to changes in global economic activity and event risk. This came at a price, however, as bonds weakened in response to higher interest rates and forex markets experienced turbulent waters as the conflict continued.

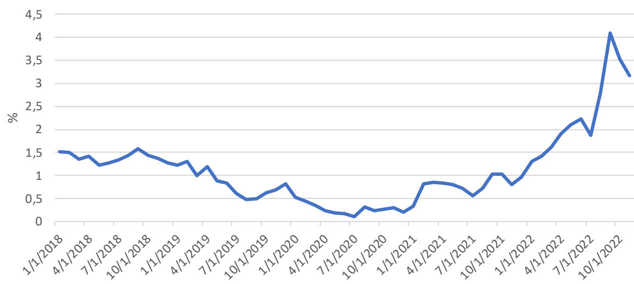
Figure 2: Brent Crude Oil



Source: Bloomberg, Cadiz Asset Management

Another blip on the 2022 calendar, which led to a sudden change in the UK bond and forex market, was the unfunded spending splurge proposed by the short-lived government of Prime Minister, Liz Truss. This caused a slump in bonds and a collapse in the pound sterling that sent shockwaves through the rest of the world. It did not take long for the UK to realise that the 'river' had changed its course and swift action was needed. Liz Truss's resignation helped to bring matters back on track, but no sooner had calmer waters returned, than the death of Queen Elizabeth II was announced. Another troubled episode in British history.

Figure 3: UK 10yr Generic Bond Yield



Source: Bloomberg, Cadiz Asset Management

Technology companies struggled to navigate the volatility in the markets with most technology stocks losing substantial ground as the tide in rates continued to rise and reports that fell short of Wall Street estimates continued to surface. This forced analyst to review their valuation methodologies as the parameters of earnings calculations changed. Technology companies had to downsize as the digital offerings, buoyed by the pandemic, saturated the market reducing demand in this sector.

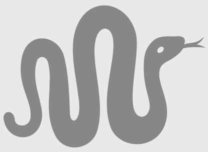
Within this broad global context, an interesting development is the increase in hybrid work. Employees are demanding more flexibility as technology has now provided them with the tools to work from home and negotiate more time out of the office. Consequently, companies are having to adjust their talent retention strategies in line with this trend.

Panic, which is never a good thing, gripped the cryptocurrency market as investors realised that they may be all at sea without a life vest when FTX, one of the biggest crypto exchanges, faced questions about its solvency. Investors had to hastily review their risk strategies to protect their investments as this market went into freefall. After its collapse, most investments into FTX private equity have now been written down to zero.

That was the world at a glance for the year 2022 illustrating a few "avulsions" that resulted in a change to the way in which the market responded and adapted to new challenges.

Financial markets are most certainly complex, but at the same time, they are adaptive, dynamic, and ever-changing to produce efficient outcomes.

There is a story that goes as follows:



Once a upon a time in British India, the city of Delhi was overrun by cobra snakes. To solve the problem, the authorities enrolled the general public and offered a cash reward for every dead cobra snake brought to them. This plan worked very well for a while, but then the authorities sensed that something was wrong. By then all the cobra snakes should been eradicated from the city. What happened was that the people realised that dead cobras equated to cash rewards, thus they started breeding snakes in their back yards. The authorities soon cancelled the scheme, leaving the people with no choice but to release the snakes back into the streets. The city was once again overrun with cobras, much worse than before.

This story clearly demonstrates the law of unintended consequences, but it also shows that a system will adapt to change. Financial systems change and adapt as the environment changes. This was evident last year, and the year ahead will be no different.

Last year the International Monetary Fund projected world output to be at 2.7% for the year 2023. By all measures, this is still a very weak growth profile reflective of the risks still endemic in financial markets and global economies. The World Economic Forum, held in January 2023, warns "This is the year of the 'polycrisis', where risks are more interdependent and reciprocally damaging than ever". Should certain risk events coincide, the effect could be acutely felt.

Source: World Economic Forum, Global Risks Perception Survey 2022-2023

The global energy supply crisis triggered initially by the war in Ukraine is set to persist. This may very well accelerate the move by governments toward more sustainable and secure energy systems. We are already seeing changes to policies and laws such as the European Union's Fit for 55 package, Japan's Green Transformation program and China's ambitious green energy targets. The 'river' is changing course, but who will be nimble enough to adapt and accommodate the change?

Geopolitical risks and economic uncertainties are exacerbating the risk of global recessions as interest rates stay higher for longer. Central banks will once again play a crucial role this year in applying monetary policy appropriately and timeously.

China's reopening of its economy could lead to higher commodity prices which, in turn, will support an upward trend in inflation.

Most market participants expect the US Federal Reserve (Fed) to keep raising interest rates incrementally in early 2023 and then pause. The path that then gets taken is largely dependent on the path of inflation. A key question is whether the IMF forecast of 6.5% for global inflation will hold in 2023, or are there risks at play which will cause inflation to remain at elevated levels?

The local scene is not without its specific risks. South Africa still faces a low growth environment where unemployment is high, consumer confidence is low and socio-political tensions are running high. Inflationary pressures are abating, but food and transport prices remain stubbornly high.

The currency displays constant volatility as one of the most liquid currencies in the world. As an emerging market though, South Africa does stand out as an investment destination with lucrative real yields relative to its counterparts.

Local interest rates are still being raised and clear evidence of inflation declining is needed before the South African Reserve Bank (SARB) is prepared to stop or pause on the hiking cycle. It is widely thought that the SARB will pause in the second quarter of 2023 should inflationary pressures both local and global subside sufficiently.

As we set off on our investment journey in 2023, let's be aware that it is not yet over as far as market volatility, currency volatility, interest rate hikes and inflationary pressures are concerned. Be vigilant for the changes in market direction caused by risk events. It is never easy to spot these changes early as markets are complex, yet they adapt. To be open to change and adapting to the change, whatever turn the river of financial markets takes, can provide the opportunity for new and potentially lucrative investment opportunities.

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