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Gold and Black Gold in the frame

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Equity markets are a continuous series of unanswered questions or unsolved problems. Framing questions easily extended to include the decision on whether Machine or Man is best suited for subsequent analysis. The bedrock of good investment decision-making is matching the correct data, with the correct question(s). In this article, we will provide some context, and thereafter, we will explore the four key questions that matter at this current juncture in markets.

The Context:

Twelve months is a long time in financial markets. Long-term and short-term equity investors are similarly overconfident, rooted in a bias of underestimation. A long-term perspective underestimates the inherent difficulty and unpredictability of business. A short-term perspective underestimates how much can happen within one year. For example, let’s cast our minds to a year ago – the second week of March 2023.

Source: People queue up outside the headquarters of Silicon Valley Bank to withdraw their funds on March 13, 2023, in Santa Clara, California. (Photo by Liu Guanguan/China News Service/VCG via Getty Images)

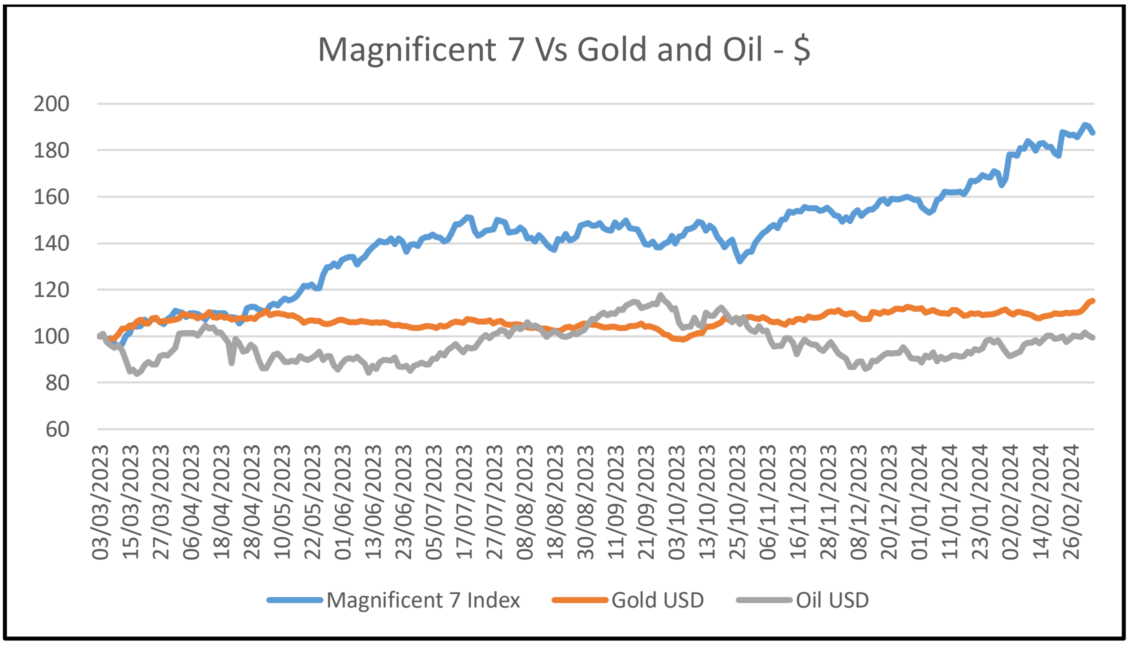
Exactly a year ago, the US experienced the second biggest bank failure in its history. The vexing questions at the time were,

- “Is this the next GFC?”
- “How will Policymakers respond?”
- “Will the Fed be forced to Pivot on interest rates?”
- “Will the US tip into a hard landing?”

A year later, we all know the answers. Contrary to initial expectations, Policymakers stepped in to provide a backstop for Depositors. A clear “Risk-On” signal that set-in motion a dramatic disparity in equity markets. Investors crowded into a narrow group of advantaged beneficiaries, and a month later, the moniker “Magnificent Seven” made its first appearance in the lexicon of modern finance.

On the opposite side of the spectrum - Commodities did not respond as favourably to the same ‘Risk-On’ signal. Gold and Oil were among the few standout performers within a struggling commodity complex [see Graph 1].

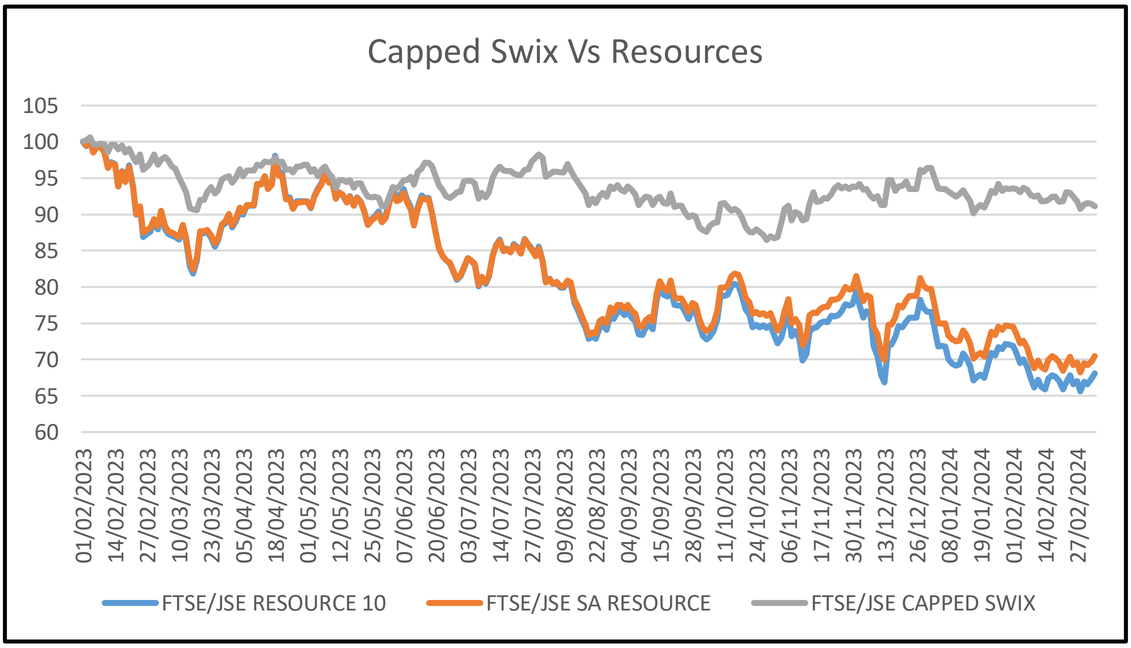
Graph 1: Magnificent Seven versus Commodity prices



Source: Refinitiv Differential Research

Almost to the day, South African Resource shares started a steady descent, that dragged the overall index down with it. [see Graph 2]

Graph 2: Resources drag down the Index



Source: Refinitiv Differential Research

Looking back provides an interesting history lesson- for investors, it is the next 12 months that matter most. Asking the right questions will help to frame the correct positioning. Finding answers is never easy. For this reason, we recommend a healthy dose of humility. It also helps to stay open-minded and flexible, in the face of the incoming data.

What could happen next? The four questions to consider*.*

1. How should we think about AI and the future of the Magnificent Seven?
2. Are SA Resource shares – in a continued downward spiral or in a turnaround?
3. Is the current rally in the $ Gold price sustainable? What does this mean for SA Gold shares?
4. Black Gold? Could the Oil price rally again? What does this mean for Sasol?

The Magnificent Seven

Financial media narratives enjoy their own "circle of life". Narratives follow price action- in that order and always in that order. If that world's a stage and each narrative merely an actor, then some of the players (like Tesla and a few more) have already left the limelight. When the music fades, NVIDIA appears set to face the curtain call, alone. Embedded expectations are very high. The ending of any market narrative is never glorious - there is no grand funeral - it is just the start of a new narrative.

Investors have to decide if the AI themed rally is a stock-market story, or a real-world story, or both. If the real-world hype is well-founded, then a reversal in the stock market could cause less contagion.

The reversal of one narrative paves the way for the emergence of a new one. Positioning ahead is the key to staying ahead of the market.

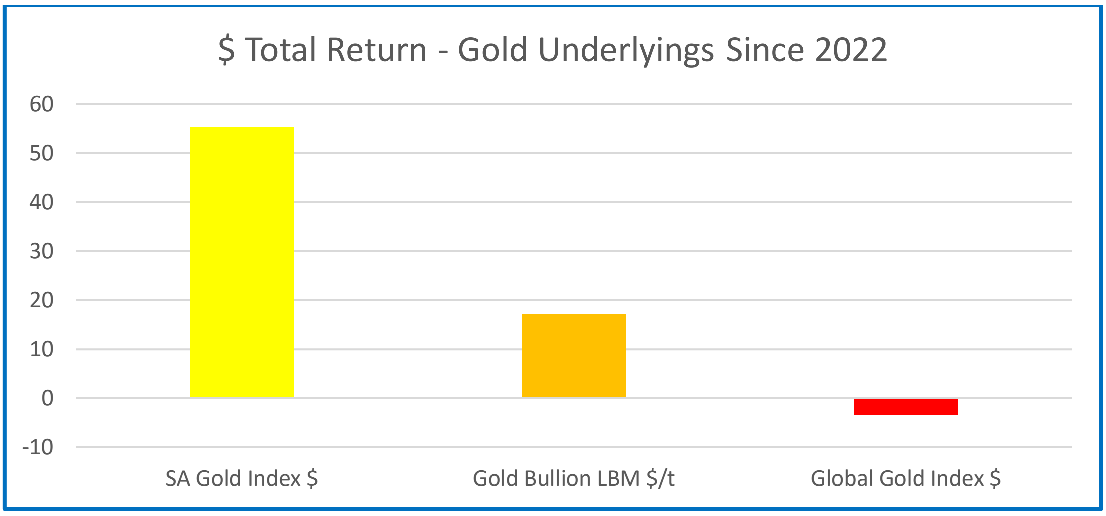
Commodities and SA Resource shares

For the last 2 years and especially since April 2023, Commodities have been the worst-performing sector in global equities. In contrast to the AI theme, commodities and related stocks have been universally disdained. The negative trend presented a persistent headwind for domestic investors, given the market's high weighting in resources [see Graph 2]. In particular, the platinum sector and copper-related equities were the hardest hit. The tide has turned for both copper and platinum. The signals are clear and getting stronger. Investors have to decide to get on board now or wait for confirmation. Time will tell.

Gold and Gold shares

The $ Gold price continues to hit all-time highs. The nascent rally that started in October 2023, has now gone parabolic. In the global gold sector, South African gold shares are the undisputed winners [see Graph 3].

Graph 3: Gold shares vs Gold

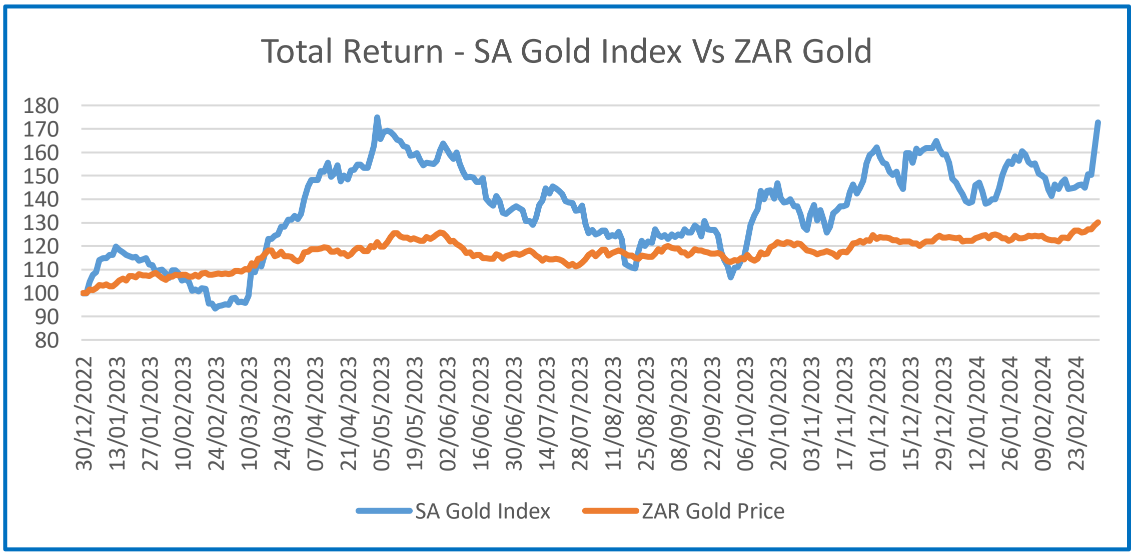


Source: Refinitiv Differential Research

Gold equities offer leveraged exposure to the upside in the metal price. Unfortunately, the lag in gold equities has been a feature since the previous peak in August 2020. The outlier has been SA Gold equities over the last year [see Graph 3]. In fact, SA Gold shares have outstripped the Rand Gold price for most of the last 15 months [see Graph 4].

For the moment, share prices have run ahead of positive earnings revisions. It comes at a time when the aggregate weight of Gold in the Index is very high (more than 7%), and institutional investors are more underweight than they were a year ago. The relative weight of SA Golds versus Platinum within precious metals is hovering near previous peaks. If SA Institutional investors feel compelled to chase the current rally and close the underweight, then share prices can diverge from fundamentals for a while.

Graph 4: SA Gold shares vs the Rand Gold price



Source: Refinitiv Differential Research

Investors need to decide if the $ Gold price rally is sustainable. Simultaneously, SA investors need to decide whether domestic gold shares can continue to outperform fundamentals.

A word of caution is warranted. Gold and Gold shares are fickle. The sector is not for the faint-hearted. Fundamental and market signals can change very quickly, making a long-term perspective less effective.

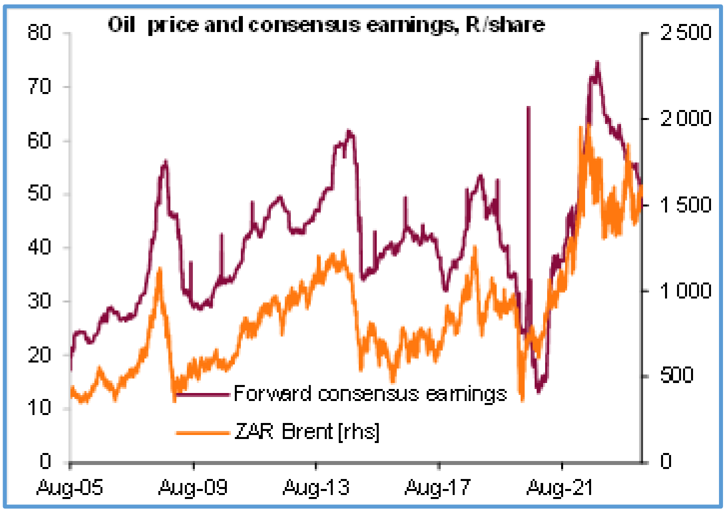
Oil and Sasol

Commodity shares don't always follow metal prices. The commodity signal is just one part of the investment decision, albeit the most crucial in a directional sense. The energy sector provides a good example of this in practice.

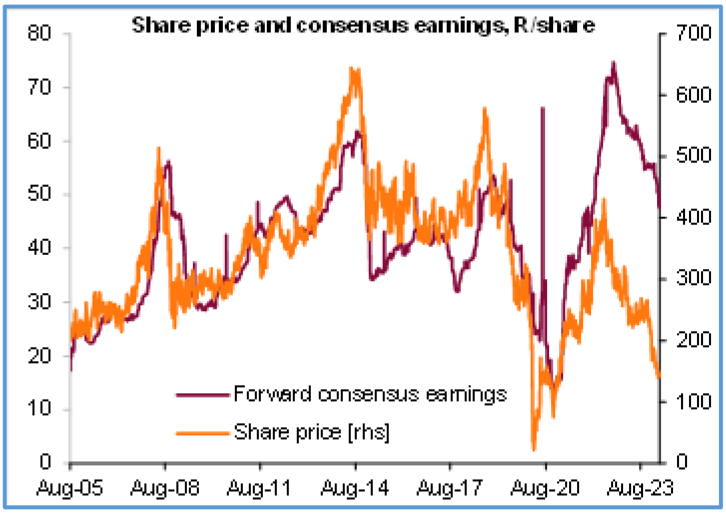
2022 was a glorious year for Oil and energy stocks. In the first half of 2022, Energy zigged upward when virtually all asset classes went south. Last year was less stellar – the oil price moved sideways in 2023 [see graph 1]. Die-hard energy bulls were able to participate in a short-lived rally from June to early October 2023. Since then, energy has reverted to laggard status, despite the Oil price holding steady.

2023 was even worse for domestic investors with respect to oil. For the longest time, Sasol has been the only way to gain correlated exposure to oil prices. That was then – in 2023 and even more so today, Sasol has morphed into a different story. The excellent work by Absa Securities analyst Gerhard Engelbrecht shows how the most recent divergence in the Sasol share price is indicative of a deeper fundamental challenge.

For the longest time, Sasol's earnings tracked the trajectory of the Rand-Oil price. A rising $ Oil price, combined with a weakening Rand, was the perfect cocktail for rising earnings and the Sasol share price.

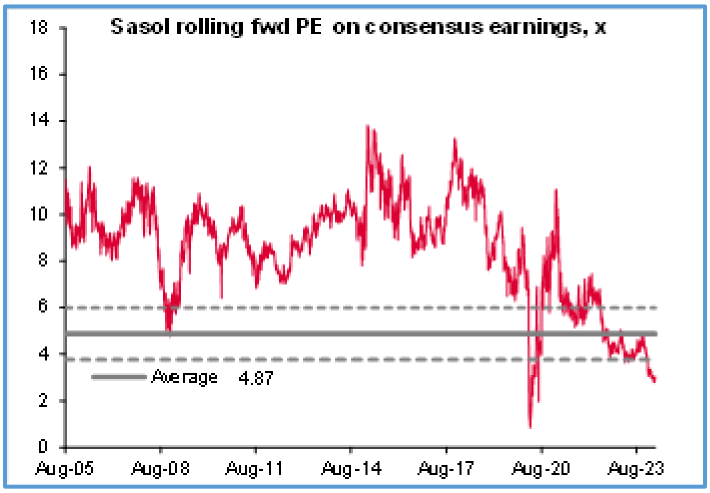


Source: Absa Securities



Source: Absa Securities

In 2022, this comfortable relationship changes. The signal that worked for so many years failed, and Sasol has since become one of the worst underperformers in SA equities. The signal failed because Sasol faces fundamental challenges in terms of free-cash earnings growth, weaker chemical prices, and the ability to sustain high dividends. Spot EPS is no longer as meaningful as it has been in the past. The signal broke down.



Source: Absa Securities

Today, Sasol appears optically cheap. The valuation suggests a lower risk if the future turns out worse than expected. The challenges are not trivial. Investors need to decide if the $ Oil price can rally from here. Thereafter, SA investors need to decide whether Sasol is positioned to participate. If not, an alternative means of participating will have to be found.

Concluding remarks

Making sense of markets is never easy. There are growing signs that a resurgence in commodities and related shares is underway. Resources could become the new market leadership. After all, a new narrative needs to take the baton from the current AI themed leaders.

Glacier Research would like to thank Sam Houlie for contributing to this week's *Funds on Friday.*

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Sam holds the position of Director at Differential Capital and fulfils the role of Co-Chief Investment Officer, overseeing fundamentals. With nearly thirty years of experience as an analyst and portfolio manager in both global and South African financial markets, Sam's career has evolved significantly. In 2022, he made a substantial investment in Differential, an innovative investment manager utilising Data Science, Machine Learning, and AI techniques. A qualified Chartered Accountant and CFA Charter holder, Sam has a rich professional background, having previously contributed to the success of renowned firms such as Allan Gray, Ninety-One, and Counterpoint Asset Management, where he managed award-winning funds across the entire asset class spectrum.