Performance

The Fund returned -0.6% for the quarter and 29.7% for the last 12 months. Its long-term performance remains pleasing against both the peer group and benchmark.

Contributors to relative return were our overweight positions in Glencore, Textainer and Exxaro. Unfortunately for the quarter these were not enough to offset the continued sell off in Northam and our BHP underweight. Large movements in the quarter include adding EOG and TECK to the Fund at the expense of Sasol and Exxaro.

Fund positioning

The US Federal Reserve's increasingly strong commitment to tighter monetary policy and the continued weakness of the Chinese economy weighed on commodity prices and returns for the quarter. The energy crisis, high inflation and a global monetary response to this are increasing the risks of recession in the short term, and this has been reflected in asset prices. We think that despite the risk of recession, commodity prices stand to remain elevated over the medium to longer term. The Fund has healthy positions in the platinum group metals (PGM) sector, energy commodities and copper.

Commodity prices remain elevated to varying degrees across the entire spectrum. Lithium is probably the most extreme, given rampant growth in battery electric vehicles this year compared to a constrained supply base. We are also witnessing record thermal coal prices thanks to the European energy shortage, again coming up against a constrained supply base. Even in metals, where realised demand has been softer than anticipated in 2022, we continue to see prices above cost support and producers enjoying healthy margins. The key driver of strong prices in a soft demand environment is the other side of the equation: supply. A key leg of our thesis on commodities has been the general lack of investment in supply through the last eight years. Maintenance and expansion capital were reduced heavily in the downcycle. While this capital is now increasing, a lot has been catch-up in nature and recently driven by higher inflation.

Mine interruptions in the 2020 and 2021 calendar years, thanks to Covid protocols, also saw capital spend reduced and, in some cases, short-term decisions were taken to keep the mines running at the expense of future development. This has come through quite pointedly in the copper industry, and 2022 has been a particularly disappointing year from a supply perspective. Importantly for long-term market balances, exploration spend and new discoveries have come off meaningfully in this time frame. The lead time from exploration to development is very long and any success in the short term will take many years to come to market. On balance, we expect supply to be playing catchup to demand over the next decade.

Despite the increasing global macro risk in the short term, we are optimistic on prices due to the abovementioned supply issues and the fact that China's commodity demand has been very weak in 2022. Physical markets remain tight as evidenced by prices, backwardation in a number of commodities and low inventory levels. Historical evidence has shown that the lower inventory levels are going into a recession the quicker the snap back when economies recover. The largest commodity consuming sector in the world, Chinese property, is declining outright and prices have turned negative for the first time since 2015 on the back of a weak economy and what has been a few years of authorities tightening up credit availability in the real estate sector. We expect property and other commodity-consuming sectors in China to recover in time. Timing will, of course, be uncertain and likely linked to the end of the current zero-Covid strategy being implemented by the government. A return to more normal levels of consumption in China will coincide with continued strained supply as well as low inventories, potentially proving very positive for commodity markets.

In the quarter, we diversified our hydrocarbon exposure through selling down Sasol and buying EOGs and Woodside Energy Group. Sasol remains a 5.7% position in the Fund but we are able to diversify our company-specific risk by selecting multiple counters through which to achieve exposure to energy commodities. We've written in the past about the long-term issues in Sasol's business as they deal with being one of the largest emitters of carbon dioxide in the world, struggle with declining gas reserves and try to reduce their reliance on coal in the longer term – which is their key competitive advantage. The valuation is very attractive, but we feel the risk is relatively high and believe diversification is appropriate. EOG is a high-quality oil/gas producer based in the USA and the business is growing its production responsibility with strict capital allocation criteria and returning the bulk of excess free cash flow to shareholders in the form of dividends. Woodside is the company with which BHP Billiton merged its old petroleum assets and is a large producer of LNG (liquefied natural gas) as well. We have a very positive view on global LNG markets in the next five years as Europe scrambles to meet its energy needs. Importantly again, supply is very constrained with at least two years before any meaningful supply is added.

Outlook

We are happy with the Fund positioning and believe that the risk-adjusted returns off current valuation levels will prove to be compelling.

Portfolio managers
Nicholas Stein and Nicholas Hops
as at 30 September 2022