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Letters to the Editor

Gray Rhino strikes: Global stocks tank on interest rate worry

Investment Insight

Ryk de Klerk

GLOBAL stocks all of a sudden found themselves in a free fall and wiped out nearly all the gains since the end of December.

The JP Morgan Global and Services Purchasing Managers Index (PMI) was released on Monday afternoon and indicated global economic growth at a 40-month high in January, while forward-looking indicators suggested that the strong growth will be maintained for some time.

Although global government bond rates have been in a strong upward trend since December the PMI indicated that the global economic situation is consistent with above potential real gross domestic product growth and that the danger of overheating is real.

Stocks, and especially economically cyclical equities in developed markets, are at risk due to rising interest rates that will undoubtedly threaten the rich valuations of equities, especially in the US markets.

While a cut in company tax rates in the US is likely to underscore earnings growth, the big question is whether the global economy will catch up with the current levels of global equity markets.

The Chicago Board of Exchange's volatility indicator VIX – also termed the "fear" indicator by the market – swung to 37 points on Monday from 13 points last Friday. Yes, from euphoria to fear.

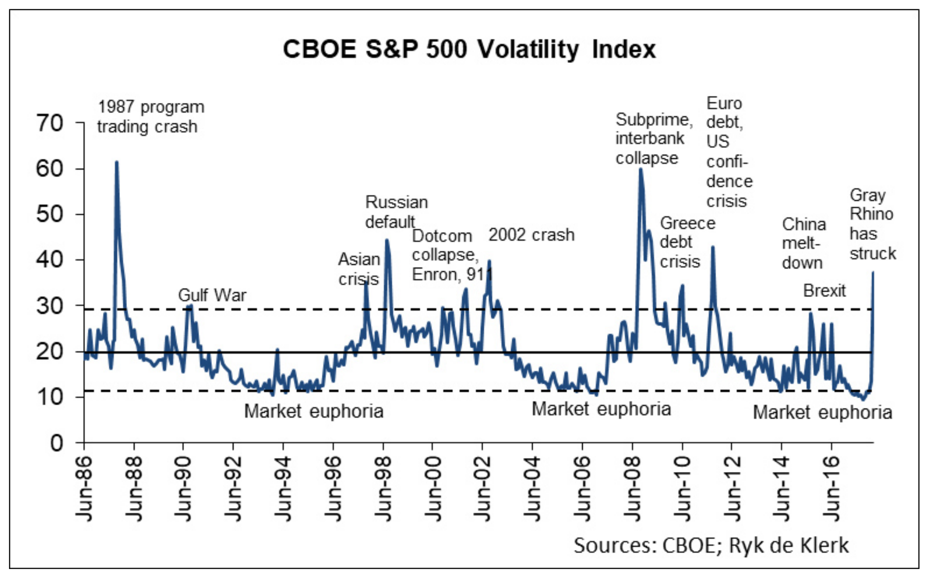
Investors' optimism has reached a point where they were and still are euphoric that the above-average returns will continue for ever.

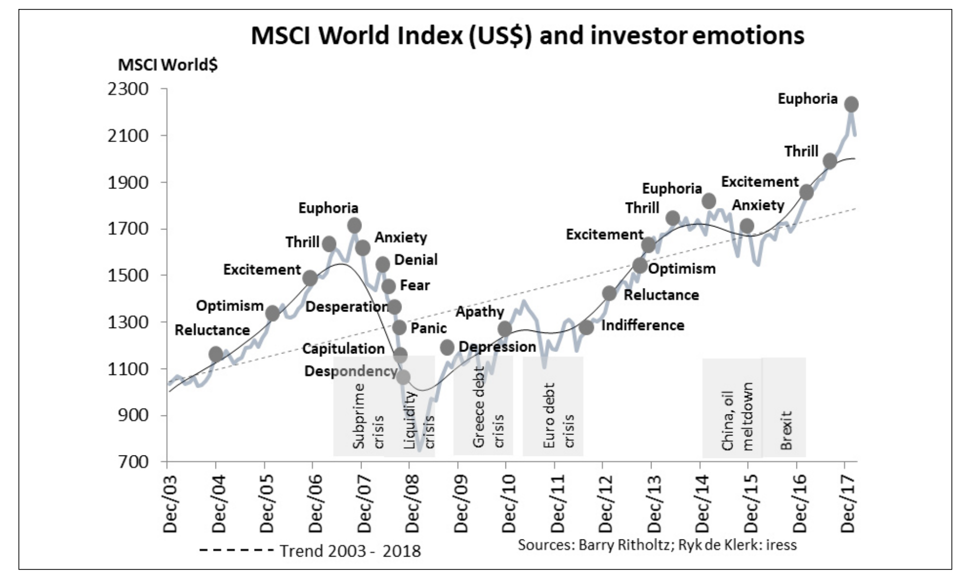
This feeling good stage is the stage when investors face maximum financial risk.

Turning points in the markets are mostly event-driven such as Gray Rhinos or Black Swans. The anxiety caused by the events makes investors unsure as to where the market is heading next and they opt to rather sit it out.

Currently it is a Gray Rhino, a term coined by Michele Wucker, where in simple terms she means why "do we ignore problems when the costs and consequences of failing to act are obvious?"

Everybody knew that interest rates, long and short-term, will eventually rise, but the question was when. The hawkish stance by central bankers in developed economies is likely to gain momentum as inflation expectations are likely to increase.





The normalisation of monetary policy, especially in the euro zone, will probably be brought forward.

The US economy is currently in "full employment". In normal circumstances the Fed would have started to raise interest rates quite aggressively, but at this stage they are still dovish.

Furthermore, the US is still pump priming the economy as real short-term interest rates (nominal interest rates adjusted for inflation) are still negative.

With inflationary pressures rising (commodity prices, increased demand for goods and services in the euro zone and China) and the prospect of higher wage demands in the US, the next step will be to hike the Fedfunds rate by as much as 100 basis points during the course of the year with the same or half of it to come in the first half of next year.

We are entering the late stage cycle in the US economy.

Whether the markets will recover and by how much is unknown or denial, fear and panic.

The reality is that we should expect more volatility and difficulty in meeting our investment return goals this year, and next. Revert to the mean, they say.

Ryk de Klerk was co-founder of PlexCrown Fund Ratings and is currently a consultant for PlexCrown Fund Ratings.

Junior miners could drive the revival of South Africa's resources sector

POSITIVE THINKING

Errol Smart

The Johannesburg Stock Exchange (JSE) in Sandton has a track record of ensuring good governance and also provides access to international financial markets for capital raising, says the writer. PHOTO: TIMOTHY BERNARD

THE DOMINANT sentiment about mining in South Africa over the past few years has been overwhelmingly negative.

Confidence in the country's regulatory framework, according to local and international bankers, analysts, major and junior mining executives, and other industry commentators, has all but vanished. While South Africa is still described as a country with one of the richest mineral endowments in the world, meaningful exploration has not been evident for decades.

Updated and modern exploration techniques using newly developed technology has not yet been applied to any meaningful extent to replace the known reserves which have been largely exhausted.

And the JSE has fewer than 30 active, contributing mining, resource and exploration companies currently listed, a fraction when compared to the eighties. Canada and Australia each have more than 200 junior companies listed on their boards, vying for attention, with many of them exploring for projects on our continent.

Many people have argued that South African mining was ultimately a sunset industry, and it was only a matter of time before the last mines closed their doors/shut down their shafts. That sentiment has now shifted dramatically, as we are seeing a new dawn for commodities, following rapid advances in technology with a voracious appetite for base metals.

More specifically, I believe that this has again turned the spotlight to South Africa, where we are seeing the beginnings of a long-awaited revival of the country's junior mining and exploration sector. With the right support and alignment of priorities, we can turn our rich mineral endowment into the cornerstone of a growing economy that it deserves to be.

Recent confidence in the junior mining and exploration sector in this country can largely be attributed to four key factors: the potential quantum of mineral deposits still to be discovered; general sentiment towards juniors; trends in supply and demand; and – more recently – South Africa's changing political climate.

Cyril Ramaphosa's election to party president at the ANC's elective conference in December was a pivotal moment in terms of business and investment confidence, evidenced by a strong rally in the rand versus the US dollar.

A Goldman Sachs report prepared in early January in the wake of the ANC conference identified South Africa as the "big emerging market story" of 2018, especially given the possibility of declining interest rates and strengthening rand.

This positive sentiment was further shored up during the World Economic Forum in Davos where Ramaphosa, a former union leader, promised to deliver economic policy change, saying that South Africa did not want to miss out on a commodity boom and if the Mining Charter is "holding us back we must deal with that".

South Africa has not recently attracted significant foreign direct investment (FDI) due to slow economic growth, policy uncertainty, allegations of corruption and higher labour costs. According to data from UN trade and development agency Unctad, South Africa recorded FDI inflows of $2.3 billion (R27.7bn) in 2016 against outflows of $3.4bn. Ten years ago average annual inflows were almost double that, at $4.5bn against outflows of $3.3bn.

In the mining sector, policy uncertainty related to the third iteration of the Mining Charter knocked R51bn off the value of listed mining stocks on the JSE when it was introduced and caused deep unhappiness across the sector, which argued it was unworkable, impractical and poorly drafted, and lacking in proper industry consultation.

Potential

The political will to provide an investment-friendly regulatory climate will be key to a mining sector that has the potential to attract FDI – and the junior and mid-tier miners stand poised to unlock that potential in South African and on the continent. We are already seeing overseas juniors with dual listings on the JSE, which has a track record of ensuring good governance and also provides access to international financial markets for capital raising.

Speaking at the Geological Society of South Africa's Exploration Showcase, held in Johannesburg last year, respected resources consultant Dr John Bristow said that while another major find such as the Witwatersrand Basin or the Bushveld Complex was unlikely, the country's "geological and minerals jewel box" was under-explored and he believes there are at least six to 10 mid-tier deposits to be found.

"We need the leadership to look at where we take this industry, and it's a resources industry and not just mining. We need to go back to the value curve and we need to go and work on the front of the value curve, which is exploring and finding new ore bodies," he said.

Our own experience supports these views and we believe that there is an urgent need to explore, develop and revive a vibrant junior culture in South Africa's resources sector.

Which is why, as Orion Minerals, we are making one of the largest investments in green- and brownfields exploration this country has seen for at least 30 years. Having raised funding of some A$12m (R113.8m) in the last two quarters of 2017 alone, mainly for advancing its South African portfolio, this FDI demonstrates our belief in the country and the sector. We estimate we contributed some R200m to South Africa's FDI during the 2017 calendar year.

Ours is but one example of a plethora of opportunities where we, and other junior explorers and developers, are choosing to invest. As South Africa under Ramaphosa's guidance desperately needs to attract the interest of explorers and developers, we will be competing with other jurisdictions, actively making changes to attract the expertise and investors funds.

For example, India is also looking to international mining juniors to fill the void in private investment.

Soon after India's Mines Ministry propagated private-public-partnership (PPP) model contracts to boost private capital into mineral exploration in mid-2017, India's government started preparing to invite 30 to 40 mining juniors to submit proposals to float PPP special purpose vehicles for exploration projects.

And even in the first world and one of the leading mining countries in the world, the Australian resources sector saw an A$100m investment by the federal government to encourage greenfields mineral exploration in September last year.

The key benefit to exploring multi-commodity mineral deposits is that these activities will feed the increasing industrial demand created by accelerating technological innovation. This demand is reflected in the ongoing upward trend in the prices of copper, zinc, nickel and cobalt – metals found in abundance at our Northern Cape project.

The electric vehicle (EV) revolution, for example, is expected to have a disruptive effect on world commodity markets.

Commodities trading giant Glencore has said that forecast EV-related metal demand becomes significant from as early as 2020 – estimates are an additional 390 000 tons of copper; 85 000 tons of nickel and 24 000 tons of cobalt will be needed.

The additional forecast metal requirements by 2030 amount to 4.1 million tons of copper (equivalent to 18 percent of 2016 supply), some 1.1 million tons of nickel (56 percent of 2016 supply), and 314 000 tons of cobalt (equivalent to 314 percent of 2016 supply). Meanwhile, global zinc stocks are predicted to fall to critically low levels by the second half of this year, propelling prices to highs of above $4 000 a ton according to research by consultants Wood Mackenzie. The metal is mainly used in galvanising steel.

Zinc consumption

The current annual consumption of zinc for car bodies alone is roughly 120 000 tons, according to the IZA, and China and India are only now starting to introduce zinc in their car body manufacture to match Western quality standards. In China there are more than 20 million car bodies that will need to be replaced with higher quality galvanised, erosion-resistant models over the next decade.

These four factors combined – a political environment-boosting investor confidence in South Africa, a wealth of unexplored minerals, a greater appreciation for the role of the junior explorers in the mining sector, and surging demand for base metals based on EV and EV batteries, among other innovations – give us the greatest confidence in the South African junior mining sector.

We believe junior miners have come of age and, with the right incentives, government and investor backing, can comfortably compete with the majors in terms of finding new mineral deposits and generating wealth, while being significant contributors to job creation.

Errol Smart is the chief executive of Orion Minerals.

Boards' success or failure has huge impact on economic performance

SKILL SETS

Tryphosa Ramano

GOVERNANCE and leadership are the yin and the yang of successful organisations. If you have leadership without governance you risk tyranny, fraud and personal fiefdoms. If you have governance without leadership you risk atrophy, bureaucracy and indifference," Mark Goyder, a British author and governance expert once said.

For many years the boards of state-owned enterprises (SOEs) felt like they were part of a social experiment, centres of "tyranny, fraud and personal fiefdoms" and even some reality show, gobbling taxpayers' money while the nation's bounds of loyalty and logic were being tested

No wonder Deputy President and ANC president Cyril Ramaphosa recently said at the 106th anniversary of the ANC in East London: "We need also to act with urgency and purpose to restore SOEs as drivers of economic growth and development. Several key SOEs are in financial distress, threatening not only their own operations, but the national fiscus…

"Corruption in SOEs and other public institutions has undermined the government's programmes to address poverty and unemployment, weakened key institutions, discouraged investment and contributed to division within the ANC and the alliance."

Positive traits

So, what are the positive traits which make the difference between an ordinary and a good board?

For me, it is the confluence of qualifications, talent, experience, industry expertise and personality, the board's relationship with the management team and ultimately shareholders or owner.

Like an engine of a car, a board of directors is the sum of its parts. Directors should have complementary and engine-like humming talents and ooze and demonstrate integrity, ability to think strategically, intuition, vision and capacity to make effective decisions, good interactive skills and ability to handle conflict. What it comes down to is having the appropriate skill sets and strength of character to do the right thing for the SOE, even if it's not always popular.

Appropriate skill sets and strength of character to do the right thing should then be accompanied by accountability.

Accountability requires an effective evaluation process and a culture of candour. For example, board members should complete an annual review of each other's performance and ensure the evaluation process has integrity. Here a chairperson with strong leadership skills can help create a culture of honest feedback.

SOEs should require board members to complete continuing education on topics such as corporate governance, fiduciary responsibilities, risk management, ethics, auditing, anti-money laundering and others.

Management should not believe that the board is a rubber-stamp pushover and should be open to ideas and criticism from its board. After all, management runs the company, but in the end the board has the power to replace management.

To thrive, prosper and be profitable, companies and organisations should adhere to good corporate governance. Good governance depends on good relationships between the management and the board.

Indeed, the most prized attribute of a director is his or her adherence to governance procedures, particularly the Public Finance Management Act (PFMA), which provides strict rules and guidelines on how boards should function, and other checks and balances.

Also, companies and organisations should adopt a rotation and specific term policy to avoid deadwood remaining in the board for ever. All in all, board members must act with loyalty toward the company and use their authority in good faith.

It means, among other things, not misusing their corporate position for personal gain or interfering with management and impair their own independence. It also means disclosing personal interests in any proposed company transaction or business opportunity.

So, why are these needs such a challenge for many companies and organisations? Because good governance depends on good relationships.

Dysfunctional

Of course, boards can be susceptible to a wide range of dysfunctional practices, like when the chief executive sees the board as a necessary evil, a burden on management and thus keeps directors in the dark. These kind of behaviours have led to corporate scandals that eventually collapsed.

Indeed, there could be instances when directors violate norms of boardroom debate by aggressively challenging corporate leadership.

At the same time a board that is beholden to management cannot be effective. This doesn't mean a board hand-picked by a government department is doomed to failure. But the board, at the same time, cannot be subservient to the department to the detriment of management.

That is why robust nomination to bring in the right board talent is critical, and a nominating committee comprising strong, independent directors can make the difference.

As much as there is the PFMA that governs how boards should be nominated, it is prudent that the government adopts a process whereby the nominations committee of the board recommends names to the shareholder by applying a particular approved process in order to ensure continuity.

Of course, in many cases political interference has been the gravest risk facing members of the board followed closely by the risk of regulatory over-reaction.

It is this interference – including attempts to influence which companies are awarded contracts and the appointment of senior managers – that have seen instability in many public or private companies.

The success or failure of SOE boards of directors has a major impact on South Africa's economic performance and it's about time that the boards are held accountable and be given a clear mandate in terms of the law.

Tryphosa Ramano is the chief financial officer of PPC and a former board member of SAA.