

ARC QUARTERLY REPORT

31 March 2022



Executive Summary:

The first quarter of 2022 unexpectedly saw high levels of financial market volatility as uncertainty over global inflation and interest rate policy, and risk-off investor sentiment, were reflected in broad weakness across both global equities and bonds. Then the tragic and destructive Russian invasion of Ukraine in the last week of February, and the unprecedented level of sanctions imposed against Russia, created even further uncertainty, along with rocketing commodity prices. This combination meant that many global asset returns, even from usual safe havens like US Treasuries, were in the red.

Commodity-producer South Africa was a beneficiary of the ensuing spikes in precious metals and other commodity prices. However, this was offset to some extent in March by global risk-off investor sentiment and weakness in Naspers/Prosus shares resulting from a further sell-off in Tencent amid a renewed Chinese government regulatory crackdown. The South African Reserve Bank (SARB) also hiked interest rates by 50bps during the quarter, following in the wake of the US Federal Reserve.

With events like the Russian invasion of Ukraine, we do not position our portfolios to benefit from only a narrow range of possible outcomes, since we don't pretend to know what the future will hold. We rather focus on constructing portfolios with many investment ideas, all of which we believe have favourable pay-off profiles. In turbulent periods such as these, the value of diversification is evident, although there was no escaping the poor global returns.

Despite all of the headwinds we faced during the first quarter, the ARC portfolios performed well when compared to their peers. Looking forward, we believe that investing in attractively positioned funds, along with appropriate diversification, should help limit the downside that comes with volatile market conditions. As the war grinds on we are still convinced that our portfolios are well-positioned to add above-market value to portfolio returns over the medium to long term.

For those members who do not want to read the whole report, you can go to **paragraph 4** below for a short overview of the first quarter's investment returns.

1. Russia Ukraine Conflict:

1.1. What is the war about?

Russian President Vladimir Putin is unhappy with North Atlantic Treaty Organisation (NATO) forces encroaching on Russia's western border. The Ukraine represents the last major buffer between NATO members and Russia. The Ukraine government is pushing for closer ties with the West.

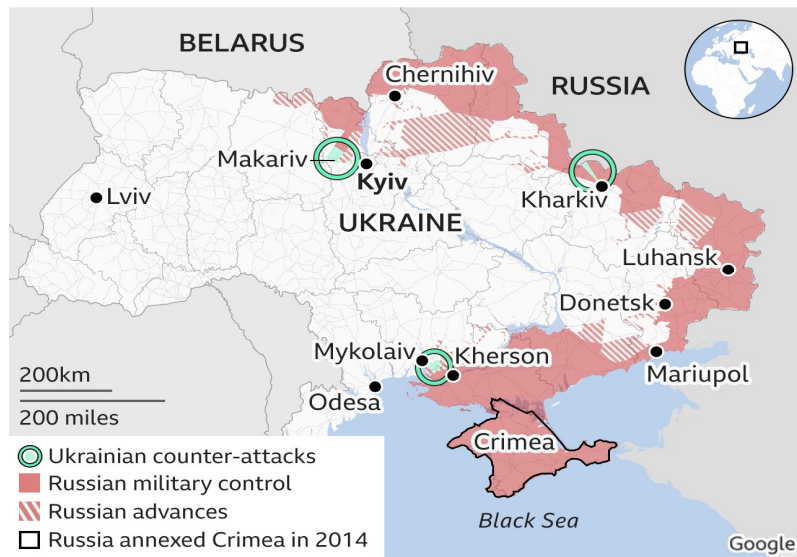
Since Ukraine achieved independence in 1991, as the Soviet Union collapsed, it has gradually veered its alliance towards the West - both the European Union (EU) and NATO.

Putin aims to reverse that, seeing the fall of the Soviet Union as the "disintegration of historical Russia". He has claimed Russians and Ukrainians are one people and denied Ukraine its long history.

The Russian leader's initial aim was to overrun Ukraine and depose of its government, ending for good its desire to join the Western defensive alliance, NATO. But the invasion has become bogged down and he appears to have scaled back his ambitions.

Launching the invasion on 24 February he told the Russian people his goal was to "demilitarise and de-Nazify Ukraine", to protect people subjected to what he called eight years of bullying and genocide by Ukraine's government. "It is not our plan to occupy the Ukrainian territory. We do not intend to impose anything on anyone by force," he insisted.

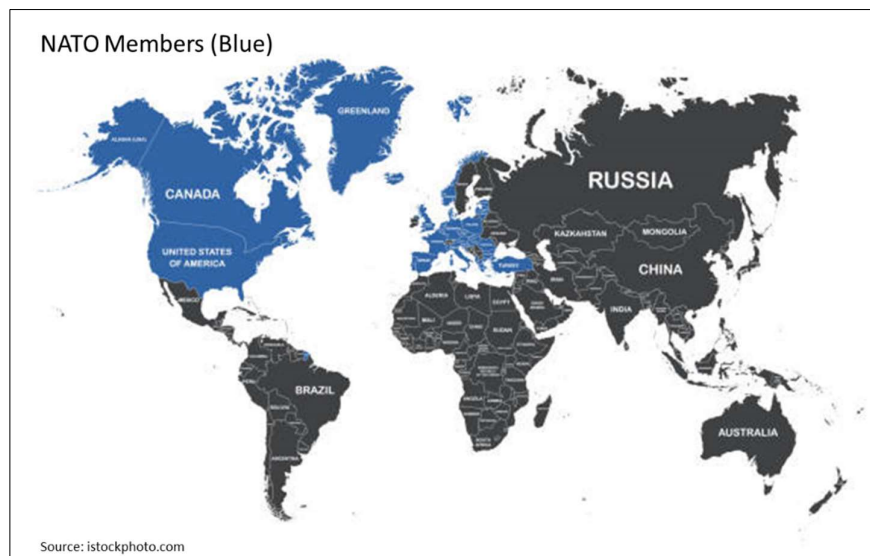
Ukrainians attempting to push back Russians



1.2. Who or what is NATO?

NATO is the security alliance founded in 1949 to protect Europe against Soviet attack during the Cold War. Membership has expanded from the original 12 members to 30 members currently, including the addition of more than a dozen former Eastern bloc countries allied to the former Soviet Republic. NATO has come to represent an underlying partnership between North America and Europe, based on shared political and economic values.

Ukraine and Georgia have both applied to become NATO members, but NATO has also made it clear that having “unresolved external territorial disputes” weighs against being admitted, a consideration that gives Putin an edge, since Russian forces occupy internationally recognised parts of Georgia (Abkhazia and South Ossetia) and Ukraine (Crimea). Germany and France insist that as long as Russian troops are in Ukraine, membership is not going to be granted. The Kremlin wants Ukraine’s restive regions to gain autonomy which gives them an effective veto over major shifts in Ukraine’s orientation.



1.3. Does Putin have plans beyond Ukraine?

If he has, his military setbacks in Ukraine may have put a damper on any wider ambitions beyond Ukraine, for now at least.

After hours of conversations with Russia's authoritarian leader, German Chancellor Olaf Scholz concluded: "Putin wants to build a Russian empire". He wants to fundamentally redefine the status quo within Europe in line with his own vision. And he has no qualms about using military force to do so." Having witnessed Putin's willingness to lay waste European cities to achieve his aims, Western leaders are now under no illusion. President Joe Biden has labelled him a war criminal and the leaders of both Germany and France see this war as a turning point in the history of Europe.

1.4. Impact on Financial Markets

We initially saw a broadly negative global market reaction as global equities and bonds weakened amid higher risk-off investor sentiment, with South African bonds selling off 20-30bps across the curve and the rand depreciating against the major global currencies. However, the SA weakness has been nowhere near the magnitude seen during previous crises like Coronavirus or the Global Financial Crisis. Global markets have had a tough start to 2022, with developed markets (DMs) down almost 6% year-to-date (YTD). However, most of this decline is **unrelated** to the conflict with UBS estimating that about 3%-5% of the S&P 500's negative performance YTD is related to the conflict, with markets mostly selling-off on concerns around inflationary pressures and central banks tightening monetary policy in response to inflation. Russia's equity market performance stands out, having lost about 50% of its value YTD, with investors expecting the impact of the conflict to be most acutely felt in Russia, with limited broader effects.

Meanwhile, global precious metal prices, including gold and platinum group metals (PGMs), as well as oil and gas prices, jumped on the back of supply uncertainties, given that the severity and types of some of the sanctions still to be imposed, and their longevity, remain unclear. If sustained, these could ultimately feed through into higher headline inflation rates.

The changes in market valuations and risks haven't been significant enough within the context of our portfolios for us to change our portfolio positioning in specific securities, or our asset allocation views. We continue to believe valuations on South African assets are priced favourably considering their medium- to longer-term fundamentals. Also note that from a valuation perspective, we would anticipate that the relative attractiveness of our local asset valuations (both equities and bonds) could provide some downside buffer over the medium-term.

South Africa hasn't been able to escape the shorter-term impact on global investor risk appetite, nor will it avoid the possible future ramifications of extended high oil prices, but for now we believe it is too early to determine what the longer-term impact might be on company earnings, or on global and local growth and long-term inflation.

The Russian economy represents only 2% of the global economy but does have an outsize influence on global commodity markets, particularly oil and gas. If Russian oil and/or gas supplies are excluded from the global supply chain on a protracted basis, as part of further sanctions for example, then we could see a further spike in global energy prices and a larger impact on inflation than previously forecast. This, in our view, is the primary risk to the global economy and financial markets. However, as yet there have been no suggestions that this option is part of the menu of sanctions foreign governments are considering, and in our view would be very difficult to implement given that some

40% of European gas and 25% of their oil comes from Russia. Russia and Ukraine are also meaningful contributors to the global food chain, representing approximately:

- 25% of the total global trade in wheat;
- 20% of global corn sales; and
- 80% of all sunflower oil exports.

Going forward we will be keeping an extremely close eye on developments for signs of lasting effects. We will, however, seek to take advantage of any opportunities that might emerge to add value to our portfolios, and to protect client portfolios from any new or rising risks. We are in regular discussions with our industry peers and keeping a close eye on any new facts as they come about.

1.5. Inflation and rates

It is likely that concerns around energy supply from Russia will keep the prices of energy commodities elevated for the foreseeable future. We expect this to be somewhat mitigated by the release of strategic reserves by major global economies. Ultimately, we expect the supply response to normalise, and any headline inflation created to reverse in due course.

We also expect the conflict to avoid the critical agricultural production areas and the planting season to go ahead as normal in the coming months, with a limited impact on yields. Concerns around supply disruptions are likely to keep grain prices elevated in the near term, adding to headline inflationary pressures, but this too should be transitory and reverse in due course.

At its meeting on 16 March, the US Federal Reserve (Fed) hiked rates by 0.25% and committed itself to chase inflation over the next two years. While much has been made of the 'dot plot' that shows six US rate hikes in 2022, with more hikes next year, in some ways, this was the Fed catching up to what the market was already saying.

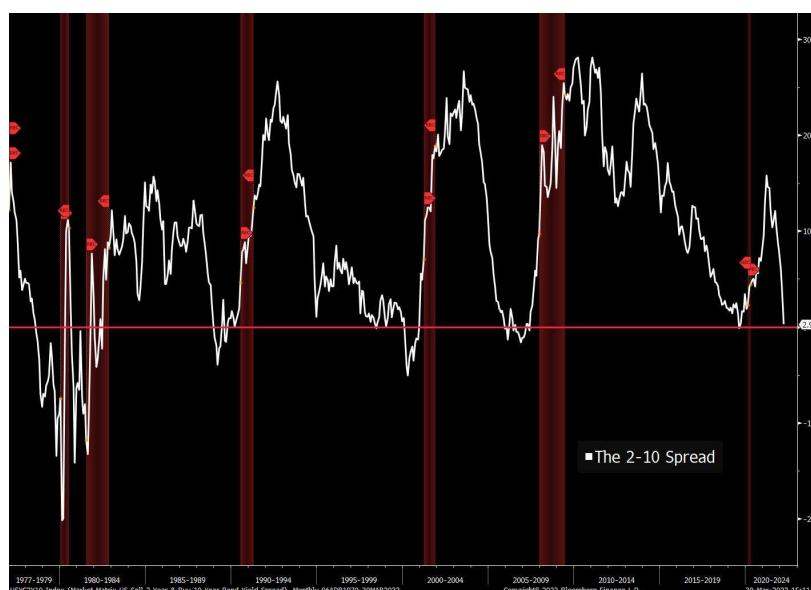
Given the transitory nature of these inflationary pressures, and the fact that central banks typically ignore food and energy inflation when setting monetary policy, we think it is highly unlikely that global central banks will add additional monetary policy tightening measures in response to the likely near-term inflationary impact of higher food and energy prices. On the contrary, we expect major central banks to potentially proceed in a more measured way, while the prospect of a military conflict weighs on sentiment and likely reduces some demand-pull inflationary pressure.

Focusing on SA inflation and interest rates, the South African Reserve Bank (SARB) did not print money during the COVID-19 crises and SA's inflation rate (5.7% YoY) is currently below that of the US (7.5% YoY). We expect that local inflation will skirt the upper end of the SARB's target band (3% to 6%) for the next few months, before dropping towards the middle. Best estimates at this stage are that annual headline inflation, as measured by the consumer price index (CPI), will average 5.5% in 2022 and 4.8% in 2023. The US needs to chase inflation, SA does not. That said, the US does set the price of money on a global basis, and we believe that its rapid rate hikes will make the SARB more trigger happy when it comes to SA's own rate hikes. We think that SA will see 0.75% more rate hikes for 2022 and a further 1% of rate hikes in 2023, taking the repo rate to 6%. If we see oil prices push towards US\$150/bbl, then we expect SA to get an extra 0.5% of rate hikes in each of 2022 and 2023. The SARB will be more inclined than not to hike for the next while as seen by the Monetary Policy Committee (MPC) meeting which was concluded on 24 March where interest rates were raised by 25bps, with two members

voting for a 50bps increase. SA consumers are under pressure and the rate hikes that we project will likely put the local economy close to a recession. We may also find that SA inflation falls faster than in other regions.

2. Inverted yield curve – What does it mean?

The yield curve in this case is with specific reference to the US 2-year and 10-year government bond yield curve. The graph below shows that when the 2-10 spread turns negative, which means that when the yield on 2-year government bonds is higher than the yield on 10-year government bonds, a recession (shaded in red) usually follows.



Why should this line have any predictive power or be a signal of anything? One way to think about Treasury yields is that they reflect the expectations of the Fed policy path over the length of their maturity. Thus, if the 2-year is trading at 2.32%, it means the market is expecting that on average, over the next two years, the Fed's policy rate will be 2.32%. If the 10-year yield is at 2.35%, that reflects market expectations that Fed policy will average 2.35% over the next 10 years. There might be some other factors, but this is the core of what government rates are telling you.

Hence, if you get into a situation where the long-term rate is lower than the short-term rate, and you accept the premise that rates are the market's expectation of policy, then that means the market is pricing in rate cuts at some point in the future. And the primary reason the Fed would cut rates is because it's worried about a recession. It stands to reason that if the market is pricing in rate cuts, and rate cuts occur due to recession fears, then the market is on some level predicting a recession. Thus, beyond the mere fact that inversions tend to precede recessions, there's also at least some reasonable theory behind it. The main issue is that while the yield curve may have a decent track record, currently it does not look like an economy that's headed for recession. The US labour market is growing rapidly, spending remains robust and households have great balance sheets. Where's the recession?

On the other hand, consumer sentiment is close to all-time lows right now. It seems plausible that this negative sentiment will filter down into consumer spending. Energy prices have soared, many categories of goods have become less affordable and on top of that, you have a Fed that's absolutely committed now to getting inflation down. If inflation is largely due to transitory factors, then maybe the Fed won't have to slam the brakes on the economy to hit its goals, and everything will be smooth. But if inflation is more entrenched, and spreading across categories, due to a snowballing effect of spending and income growth begetting spending and income growth, then the Fed might have to really work hard to bring inflation down to the target. The most straightforward way that the Fed policy can bring inflation down is by weakening the labour market and household incomes. It all depends on how far the Fed must go to get inflation down to target.

In conclusion, when it comes to the yield curve, it has a decent history of foreshadowing recessions. There's sound theory for why an inversion signals recession, and even though the economy is growing rapidly, there are certainly some headwinds looming. As such, it's worth taking a potential inversion seriously if it does occur on any kind of sustained basis.

3. Market Performance Q1 2022:

3.1. Local

Equity markets in South Africa, along with those in Brazil and India, were the only major global markets to deliver a positive return for 1Q22, with the local bourse continuing a string of six consecutive positive monthly returns dating back to October 2021. Mining shares have been a key driver of performance year to date (YTD), as elevated commodity prices have supported earnings, but the sector delivered a mixed performance in March. Diversified miners were amongst the best-performing mining shares (+6% for the month), helped by a 12% rally in the price of iron ore, which is now 25% higher YTD. Gold shares (+3% for the month) followed the gold price marginally higher and Sasol's share price was also up (+1.3% for the month) on stronger oil prices. Platinum miners were the biggest disappointment in March (-16% for the month), hampered by weak platinum group metal prices (platinum -6% for the month, palladium -9% for the month, rhodium -1% for the month) on concerns around softness in global vehicle manufacturing, as supply chain disruptions continue to hound the auto industry.

JSE-listed shares exposed to the domestic economy were the key drivers of March's local market performance, particularly the financial companies (banks +14% for the month, insurers +10.5%) and clothing retailers (The Foschini Group +18% for the month and Woolworths +16%). Naspers (-14% for the month) and Prosus (-15% for the month) continued their poor run as the performance of their largest underlying investment (Chinese tech company, Tencent [-23% in YTD when measured in rand]) continued to be held back by poor sentiment towards Chinese investments, initially as a result of the recent regulatory crackdown on Chinese corporates and more recently related to prospects of China's possible support of the Russian invasion of Ukraine. The pair's performance appeared significantly worse mid-month (-23% month to date) before the Chinese government came out with a message pledging support for the beleaguered Chinese tech companies.



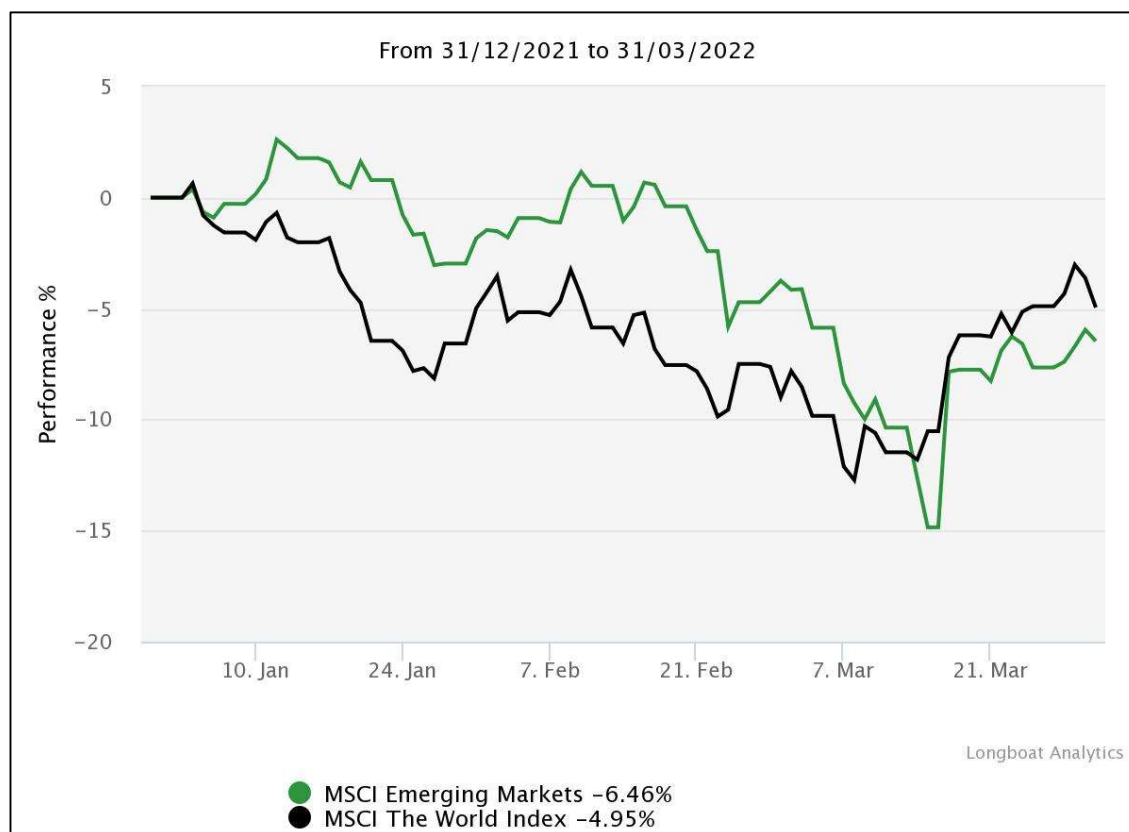
The South African Reserve Bank (SARB) delivered a much-anticipated 0.25% interest rate hike at its March meeting. This was its third consecutive hike of this tightening cycle, though the current repo rate (4.25%) remains 2% below the level set by the SARB going into the pandemic. Headline inflation (+5.8% year on year), which includes the volatile food and energy categories, is closer to the top-end of the range and is expected to breach that level as the Ukraine conflict puts pressure on food and energy prices.

3.2. Global

The conflict in Ukraine remained the key driver of news headlines in March but, despite this, developed market (DM) equities ended the month higher (MSCI World +2.8% for the month). Amongst DM equities, European bourses fared the worst, their proximity to the conflict, and reliance on Russian energy exports exposing them most directly to the fallout from the conflict. Uncertainty about the impact of Russian sanctions, particularly with respect to how it might affect exports of Russia's significant commodity production, remained a key driver of asset prices. The price of Brent crude oil rose briefly above \$130/bbl during the month (the first breach of that level since 2007), but as negotiations between Russia and Ukraine ushered in the prospect of a negotiated settlement, panic-buying of oil subsided somewhat and Brent crude oil ended the month at US\$108/bbl.

Emerging market stocks (EMs) had another torrid month (MSCI EM -2.3% for the month) and, much like in February, the fortunes of the various EM countries were starkly different. The MSCI Russia Index (constituted from foreign-listed Russian companies) was marked down to zero and trading in the stocks was suspended. Even though a limited amount of trading in domestically listed Russian stocks

resumed in the latter part of March, there remains material uncertainty around when, if ever, foreign investors will be able to participate in the trading of Russian securities. China was the other major talking point on the emerging market radar in March. Sentiment turned considerably negative on Chinese companies in March due to uncertainty about whether the Chinese government would support Russia's invasion of Ukraine. The prospect of sanctions being extended to China left foreign investors in Chinese companies scrambling to avoid a similar outcome to that experienced by Russia's foreign investors.



Global central banks were also very much in focus during March. The US Federal Reserve (Fed), hiked rates for the first time since 2018 (as expected) and Fed chair, Jerome Powell, delivered a message suggesting that Fed members were becoming incrementally bearish about 2022 economic growth and inflation prospects, requiring them to accelerate rate hikes and bring forward the shrinking of their balance sheet as they ramped up their fight against inflation. The European Central Bank (ECB), delivered a similar message, also alluding to an accelerated shift from accommodative to restrictive monetary policy as concerns around the lingering effects of elevated inflation trumped concerns around slowing economic growth.

4. Portfolio Performance:

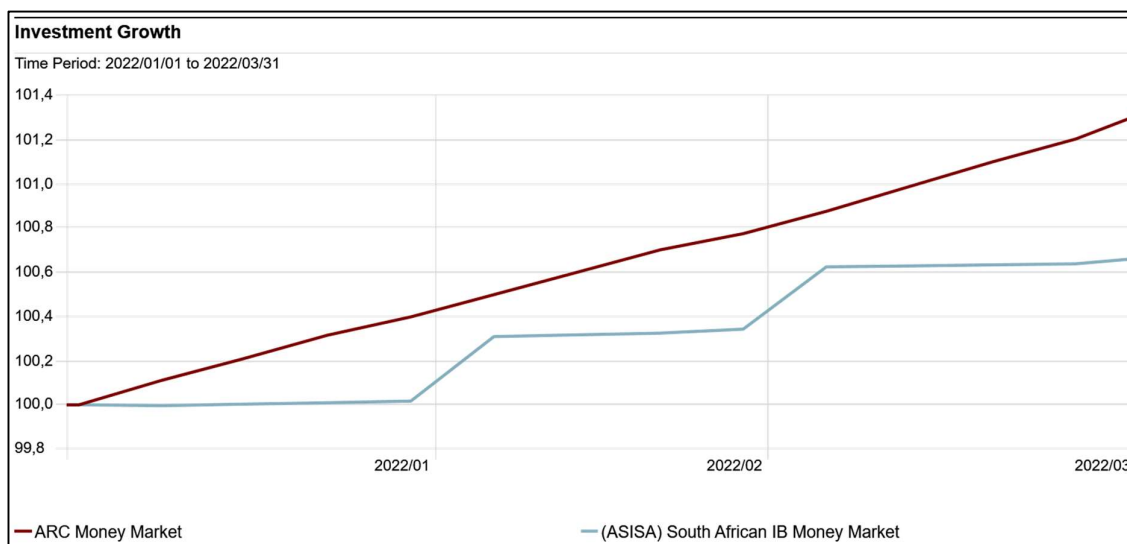
We don't pretend to know what the future will hold and therefore do not position our portfolios to benefit from only a narrow range of possible outcomes, for example with the Russian invasion of Ukraine. We rather look to construct portfolios with many investment ideas, all of which we believe have favourable pay-off profiles. In turbulent periods such as these, diversification is even more

important than under “normal circumstances”. Global returns however did not escape the all-around turmoil.

Despite all of the headwinds we faced during the first quarter, the ARC portfolios performed well when compared to their peers, see below:

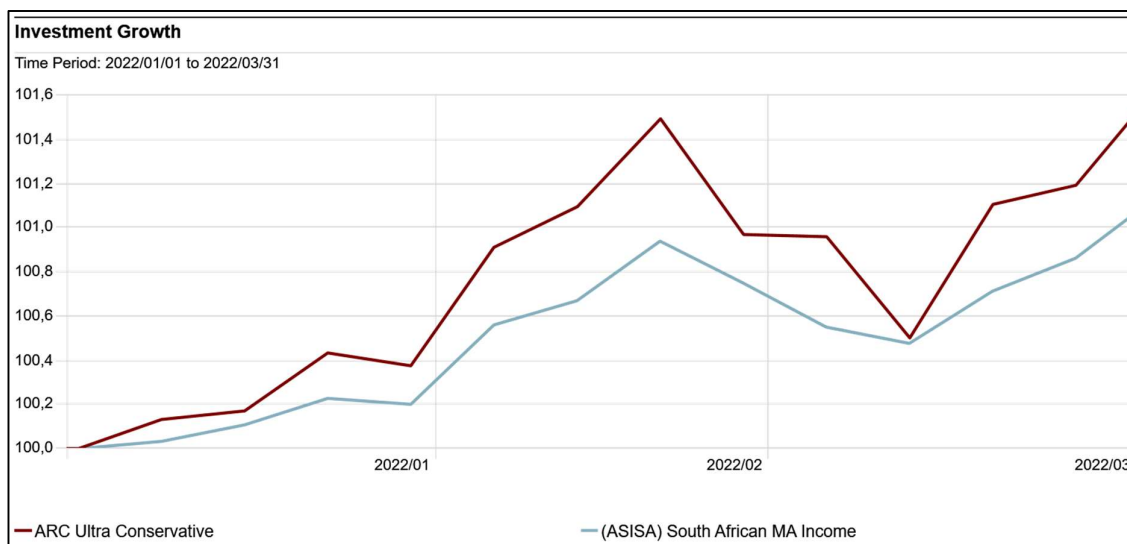
4.1. ARC Money Market

The ARC Money Market portfolio delivered top quartile performance for the 1st quarter ending 31 March 2022, delivering 1.30% versus the category average of 1.08%.



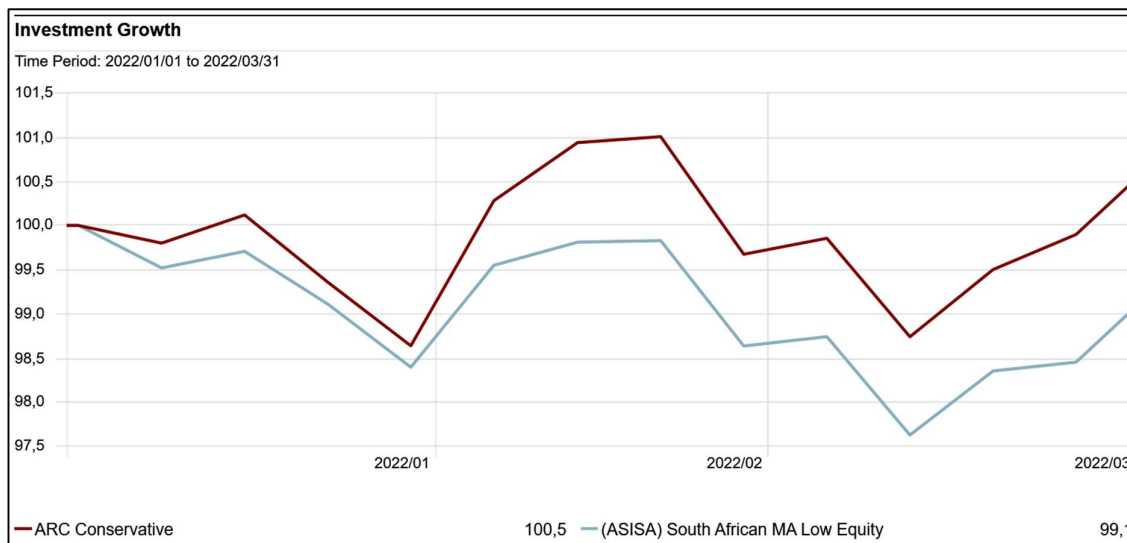
4.2. ARC Ultra Conservative

The ARC Conservative portfolio delivered top quartile performance for the 1st quarter ending 31 March 2022, delivering 1.51% versus the category average of 1.03%.



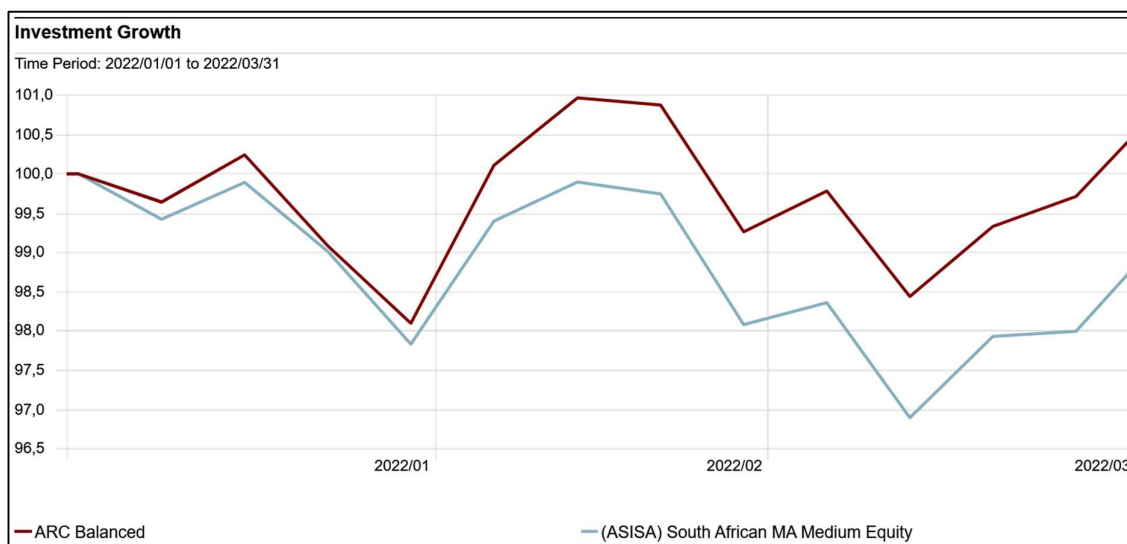
4.3. ARC Conservative

The ARC Conservative portfolio delivered top quartile performance for the 1st quarter ending 31 March 2022, delivering 0.52% versus the category average of -0.90%.



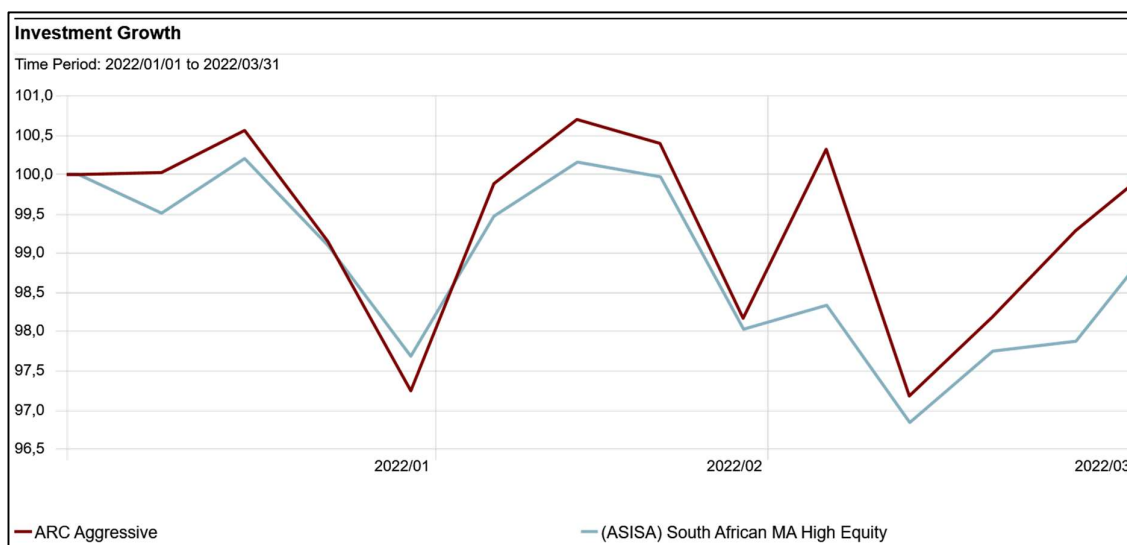
4.4. ARC Balanced

The ARC Balanced portfolio delivered top quartile performance for the 1st quarter ending 31 March 2022, delivering 0.51% versus the category average of -1.16%.



4.5. ARC Aggressive

The ARC Aggressive portfolio finished in the second quartile for the 1st quarter (up from 3rd quartile previously). For the month of March 2022, however, the Aggressive portfolio delivered 1st quartile performance and ended the month in the top 10% of the SA Multi-Asset High Equity category. This portfolio delivered -0.10% (versus the category average of -0.86%) for the quarter and 1.06% (versus the category average of -0.18%) for March.



5. Looking Forward:

We believe that investing in attractively positioned funds, along with appropriate diversification, should help to limit the downside that comes with volatile market conditions. As the war grinds on we are still convinced that our portfolios are well-positioned to add above-market value to portfolio returns over the medium to long term. This view is based predominantly on the fact that most SA asset class valuations started 2022 very cheap, on both an historic and relative basis, and these valuations have not changed significantly during the market turmoil. In our view, the market remains overly pessimistic about SA companies' expected performances - there are many excellent businesses in South Africa like banks, retailers and miners that have demonstrated solid long-term profitability, and we believe many have the potential to deliver strong results going forward, with earnings and dividends showing a robust return to growth over the medium term.

Our analysis also indicates that local nominal bond yields present investors with an attractive opportunity to earn lucrative real returns over time. Although the SARB has forecast local inflation rising to approximately 5.9% in the coming months, with the market predicting that inflation could rise above the SARB upper band of 6%, this should be temporary, in our view.

As such, we continue to prefer local equities and bonds in our multi-asset portfolios. Our equity exposure is highly diversified both locally and offshore, with SA holdings tilted towards defensive stocks and sectors with relatively high earnings yields such as Resources and Financials, where rising inflation and interest rates have less impact on earnings.

We will remain focused on the fundamentals in the months ahead, and on ensuring that we actively manage portfolios to mitigate any new risks and exploit developing opportunities that may emerge amid the uncertainty. Members should remember to stick with their longer-term investment solutions and not look to traditional low-risk options like cash, as real cash returns remain poor and holding risk assets like equities will help portfolios to outperform rising inflation over the medium to long term.

6. Am I on track with my retirement savings?

A member's projected Net Replacement Ratio (NRR) can be used to determine if he/she is saving enough towards retirement. Since you will save on some expenses after retirement, it is not necessary to have a 100% NRR. According to industry standards a 75% NRR is sufficient to provide you with a comfortable retirement.

If you would like to receive a free personal *Financial Freedom Audit* to determine your current NRR and optimised savings options available, please send us an email at info@arcpf.co.za and one of our approved financial advisors at Quantum Wealth Management will contact you.

Definition of Net Replacement Ratio (NRR):

The percentage of your income at the date of retirement that can be covered by your pension.

Example: If your income at the date of retirement is R800 000 and the pension you can generate with your retirement capital is R600 000, you have a 75% NRR.

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