NEWSLETTER

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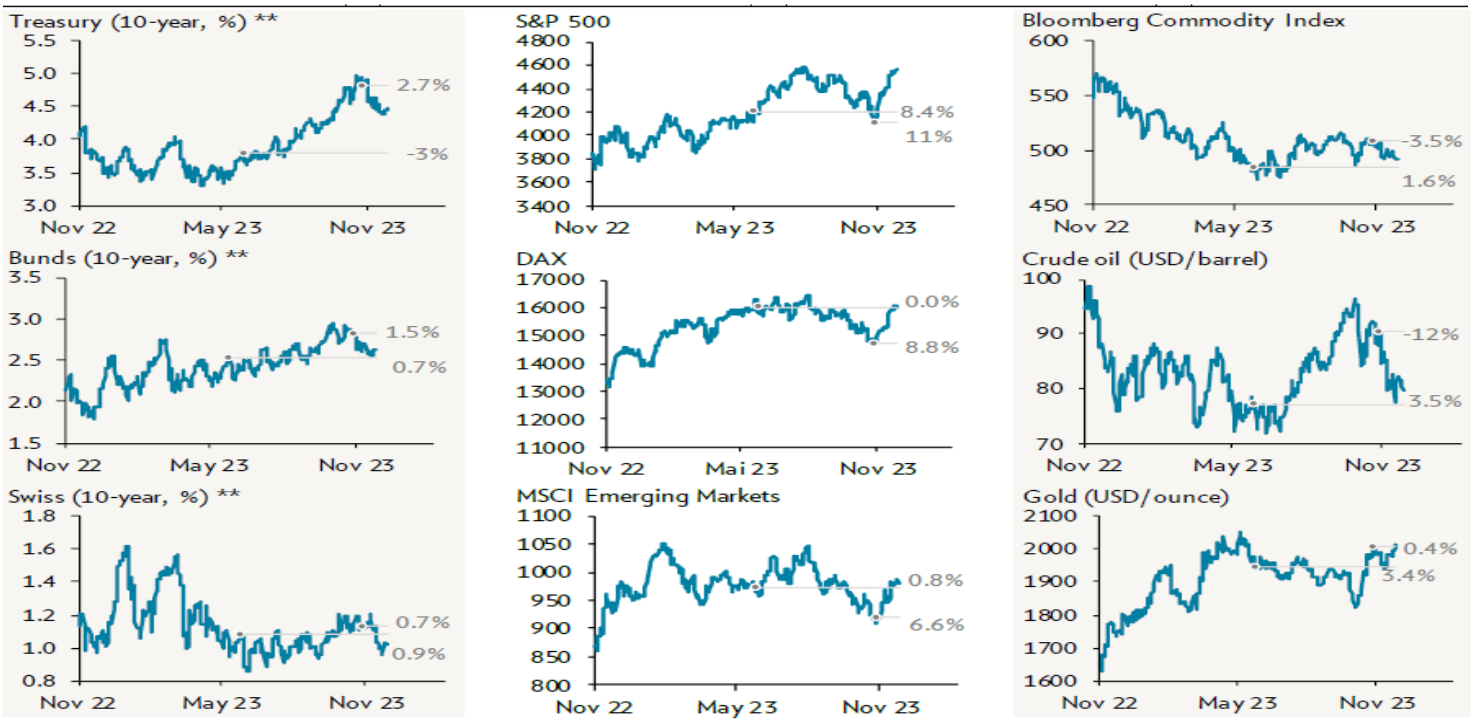
IN THIS MONTH'S NEWSLETTER

- Market overview
- Share of the month: Northrop Grumman
- Graph of the month

"The big money is not in the buying or selling, but in the waiting."
- Charlie Munger

MARKET OVERVIEW

Review (1-month and 6-month performance)



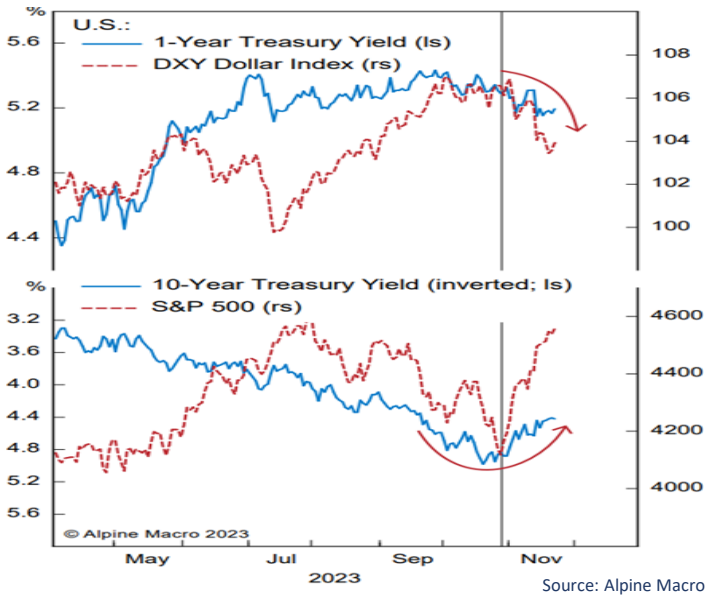
Source: Julius Bear, 27/11/2023

30/11/2023	Last	Month %	YTD %	5Y ann. %
MSCI World	695	9.11	14.75	7.23
S&P 500	4568	9.62	19.45	11.65
NASDAQ 100	15948	10.67	46.81	14.18
EURO STOXX 50	4382	7.91	15.52	6.67
MSCI EM	987	7.86	3.21	-0.14
HANG SENG	16911	-0.41	-14.51	-8.60
US Equities Volatility Index (VIX)	12.92			

Source: Edmond De Rothschild

Since late October financial markets have made rapid moves to discount a softer labour market and persistent disinflation. Stocks and bonds have rallied, while the dollar has weakened (figure 1). Previously termed as "reflation trades" in pre-pandemic periods, these market behaviours are presently more aligned with anticipated shifts in the Federal Reserve policy. These trades are now characterized as "pivot trades."

Figure 1: US yields vs the US dollar index and the S&P 500



Source: Alpine Macro

Over the past year investor sentiment experienced significant fluctuations. Heightened uncertainty prevailed regarding the trajectory of inflation and how central banks would navigate persistent inflationary pressures without causing an economic slowdown. Consequently, markets remained volatile, with each release of Consumer Price Index (CPI) data or central bank interest rate decision impacting asset prices. As we approach 2024 it's evident that uncertainties persist, indicating that we have not completely overcome these challenges. However, compared to the beginning of 2023, there is more visibility regarding inflation, interest rates and economic growth. This enhanced certainty provides a more stable foundation for market expectations moving forward.

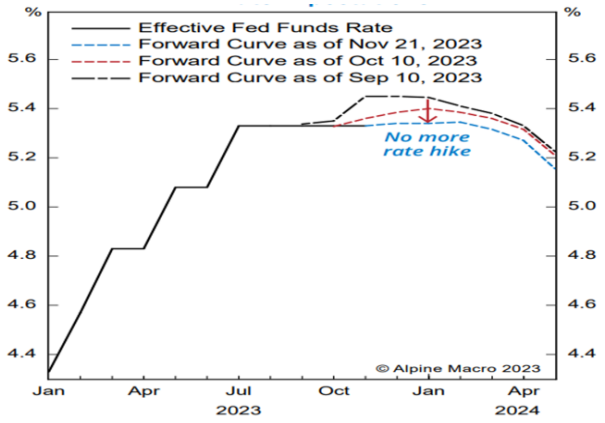
2023 also turned out to be a stock picker's year. The return of the S&P 500 excluding the top seven companies (Apple, Amazon, Google, Meta, Microsoft, Nvidia and Tesla) was flat year to date. However, the return of the S&P 500 including these companies were around 19% year to date.

Our base case scenario for 2024

In recent weeks there have been notably positive economic data reported across the US, Europe and the United Kingdom. Inflation rates are declining at a faster pace than initially projected in most economies, accompanied by a cooling labour market. These factors collectively suggest that central banks now have leeway to implement a more dovish monetary policy.

Markets have started to price in a more accommodative interest rate path and this led to a rebound in bonds and equities. Chart 2 illustrate the interest rate expectations for the US. The chart indicates that back in September 2023, the market was foreseeing interest rates in January 2024 to be roughly 20 basis points higher than the current revised expectations.

Figure 2: US interest rate expectations



Source: Alpine Macro

Our base case scenario remains that inflation will continue to decline which will result in lower interest rates. The US economy will be in a much better position than that of Europe and the UK. The economic strength of the US relative to Europe and the UK are priced into the market. If our base case scenario plays out, we expect equities and bonds to perform well. Moreover, the US dollar is also expected to depreciate, which will be beneficial for US companies as well as most global companies.

Risk to our base case scenario - An escalation of the Middle East conflict could trigger a significant rise in oil prices. Such increase in oil price tend to elevate global inflation rates, potentially compelling central banks to adopt a more hawkish stance, keeping interest rates at higher levels. Should this scenario unfold, both bonds and equity markets could experience downward pressure. Consequently, seeking refuge in cash, alternative investments and investments within the oil production sector might become more appealing options.

Summary

There have been many false starts to the "pivot trade" since early this year. Investing is all about taking calculated risks. We are strategically positioning portfolios to capitalize on the potential opportunities presented by the "pivot trade," while remaining mindful of associated risks. Additionally, our portfolios are being partially hedged to mitigate the impact of an inflationary shock in the event of an escalation of the conflict in the Middle East.

SOUTH AFRICA

30/11/2023	Last	Month %	YTD %	5Y ann. %
JSE All Share	75534	8.44	3.40	8.32
JSE Resources	58304	5.86	-17.66	9.85
South Africa 10Y Bond	9.98%			
CPI	5.60%			
Prime Rate	11.75%			
USDZAR	18.7328	0.37	-11.03	-6.30
EURZAR	20.5059	-2.56	-13.31	-5.52

Source: RMB

Following three consecutive months of negative performance, the JSE All-share followed global markets higher in November, achieving an 8.4% return, marking the most substantial monthly gain for the year 2023.

Figure 1: Resources and energy sector performance

Share	Ticker	Total return			
		1 month	YTD	3 years	5 years
Afrimat	AFT	9%	12%	37%	104%
Anglo Platinum	AMS	28%	-44%	-29%	79%
BHP Billiton	BHG	8%	9%	61%	118%
Exxaro	EXX	-3%	-14%	53%	45%
Impala Platinum	IMP	-2%	-64%	-53%	132%
Northam Platinum	NPH	9%	-35%	-32%	202%
Pan Africa	PAN	13%	22%	-9%	165%
Sasol	SOL	-11%	-22%	79%	-48%
Sibanye Stillwater	SSW	-10%	-53%	-61%	145%
Thungela	TGA	-13%	-50%		
Wesizwe Platinum	WEZ	-35%	-54%	14%	17%

Source: Moneyweb

The platinum group metals (PGM) sector has faced a challenging year thus far, marked by persistent headwinds. November underscored the ongoing struggles encountered by PGM miners. Several mining companies announced intentions to reduce employment levels amid a downturn in commodities and escalating inefficiencies at South African ports. Key global PGM miners in South Africa—Anglo American Platinum, Impala Platinum and Sibanye Stillwater—are all in the process of restructuring their operations in response to the decline in metal prices.

Wesizwe Platinum (WEZ) recently disclosed plans that could lead to the retrenchment of approximately 571 employees out of a total workforce of 761 (75% of its staff) at its Bakubung mine in the North West. This decision follows three labor stoppages, the latest being an unprotected strike, which significantly impeded the company's mine development progress.

Impala Platinum (IMP) faced a tragic incident at its Rustenburg operations, resulting in the loss of 12 workers' lives, with an additional 74 workers hospitalized. The incident occurred at 11 Shaft, a shaft reaching depths of 1,000 meters across 20 levels.

Sibanye Stillwater Ltd (SSW) experienced a significant decline, the most since March 2020, subsequent to the South African miner's announcement of its intention to raise $500 million by issuing convertible bonds, thereby diluting existing investors' holdings.

A dash for cash might be on the cards for South Africa's hemorrhaging PGM sector if current spot prices persist for much longer. That's the thinking of industry executives, who also expect production cuts to intensify as the sector seeks to minimise margin pressure.

The prices of Platinum Group Metals (PGMs), predominantly employed by automotive manufacturers to reduce emissions, have experienced a substantial decline over the previous year due to apprehensions regarding global economic expansion. Palladium and platinum prices have plummeted 44% and 13% YtD, significantly impacted by diminished demand in China.

Outlook for 2024

The base case scenario – South Africa faces a tough H1 in 2024 as election uncertainty holds back investment and high-interest rates curtail consumption, while SA exports have to contend with challenges at Transnet, weakening prices in the face of USD strength and slowing global growth. By the second half of 2024 the backdrop starts to improve:

- The conclusion of elections, likely occurring around May 2024, alleviates uncertainty (with polls indicating a potential ANC support below 50% for the first time since 1994, potentially signaling the advent of coalition politics).
- The trajectory for domestic growth and earnings is expected to improve due to the influence of rate reductions and lower inflation.
- A reduction in power outages is anticipated as increased private sector investment in renewable energy becomes operational.
- Interest rate cuts and decreased inflation pave the way for the next phase in global growth.

The bull case scenario - an optimistic outlook where there is a soft landing in the US alongside a cyclical recovery in China, plus a national election result that raises expectations of enhanced structural reform of SOEs.

The bear case scenario - envisages a decline in global growth coupled with a market-negative confidence shock triggered by the elections, potentially steering SA bond and equity returns into negative territory

May this festive season be filled with joy, laughter and cherished moments with your loved ones. Let the magic of Christmas bring warmth to your hearts and homes and may the New Year ahead be brimming with success, prosperity and endless opportunities.

Company Overview

Northrop Grumman (NOC) is a prominent holding within the portfolios of the Invesco Aerospace & Defense ETF (PPA), iShares U.S. Aerospace & Defense ETF (ITA) and SPDR S&P Aerospace & Defense ETF (XAR), in which we are invested. With a focused emphasis on manufacturing hardware for classified programs, Northrop Grumman presently enjoys involvement in substantial military development initiatives at their early stages.

The allocation of the defense budget constitutes a political process inherently challenging to forecast. Our preference lies with companies exhibiting tangible growth trajectories driven by a consistent influx of contract successes, preferably extending across multi-decade fulfillment timelines.

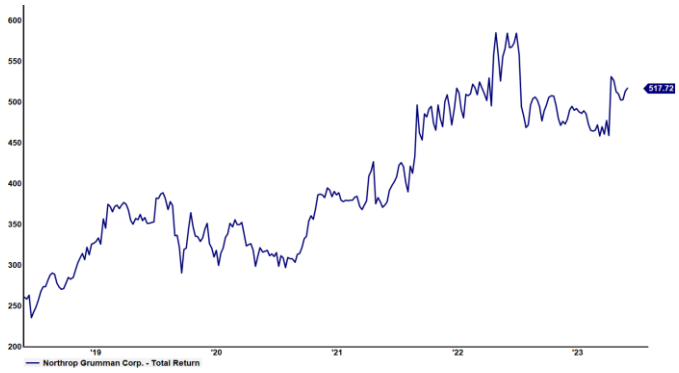
Regulated margins, mature market landscapes, customer-funded research and development and sustained long-term revenue visibility collectively empower defense contractors to generate substantial cash flow for their shareholders. Defense budgets tend to fluctuate in accordance with a nation's economic prosperity and its perception of imminent threats.

Within the United States, both these factors have shown an upward trajectory and several allied nations, notably Germany and Japan, are experiencing geopolitical shifts driving the allocation of larger military budgets.

Estimations indicate that segments of the U.S. defense budget pertinent to contractors such as Northrop and its counterparts, including subcontractors, experienced a decline averaging 3.7% annually between 2011 and 2016.

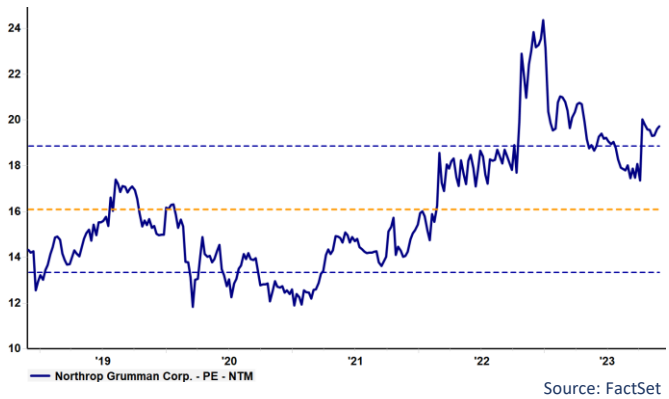
Contrastingly these budgets showcased an annualized growth rate of 6.5% between 2016 and 2021. Given the current geopolitical backdrop, growth rates of more than 10% are envisaged.

Performance



Source: FactSet

12-month forward P/E



Source: FactSet

Key competitors

	Price	Market Cap (M)	PE (NTM)	PEG (NTM)	ROE (%)
Northrop Grumman	475,16	71 651	19,7	8,6	31,3
Lockheed Martin	447,77	111 091	16,7	1,9	65,6
Boeing	231,63	140 131	66,7 -	-	
RTX	81,48	117 160	15,1	1,6	4,6
General Dynamics	246,97	67 397	16,8	1,6	17,6
Honeywell International	195,92	129 160	19,8	2,4	31,0
Kratos Defense & Sec Sol	19,05	2 456	42,3 -		-2,1

Source: FactSet

Figure 4: Financials and ratios

Highlights (US$m)	12/20	12/21	12/22	12/23E	12/24E	12/25E	12/26E	12/27E
Revenues	36,799	35,667	36,602	39,052	41,509	44,063	46,478	49,265
EBIT (UBS)	4,065	3,863	3,601	4,039	4,529	5,027	5,383	5,748
Net earnings (UBS)	3,189	4,123	3,974	3,537	3,740	4,145	4,467	4,789
EPS (UBS, diluted) (US$)	19.03	25.62	25.54	23.25	24.89	27.96	30.56	33.29
DPS (net) (US$)	5.67	6.16	6.76	7.34	7.76	8.15	8.56	8.98
Net (debt) / cash	(9,354)	(9,247)	(9,228)	(10,564)	(10,722)	(10,363)	(9,711)	(9,071)

Profitability/valuation	12/20	12/21	12/22	12/23E	12/24E	12/25E	12/26E	12/27E
EBIT (UBS) margin %	11.0	10.8	9.8	10.3	10.9	11.4	11.6	11.7
ROIC (EBIT) %	20.7	18.3	15.4	15.7	16.4	17.5	18.1	18.9
EV/EBITDA (UBS core) x	12.1	12.9	16.6	15.2	13.4	12.0	10.9	9.9
P/E (UBS, diluted) x	17.2	13.6	18.3	20.3	19.0	16.9	15.5	14.2
Equity FCF (UBS) yield %	5.3	3.8	2.0	3.0	3.5	4.5	5.3	5.9
Dividend yield (net) %	1.7	1.8	1.4	1.6	1.6	1.7	1.8	1.9

Source: UBS estimates

Business strategy and outlook

The segments we see as having the most potential going forward are those with the most difficult-to-replicate products with the longest production and upgrade cycles. These segments include:

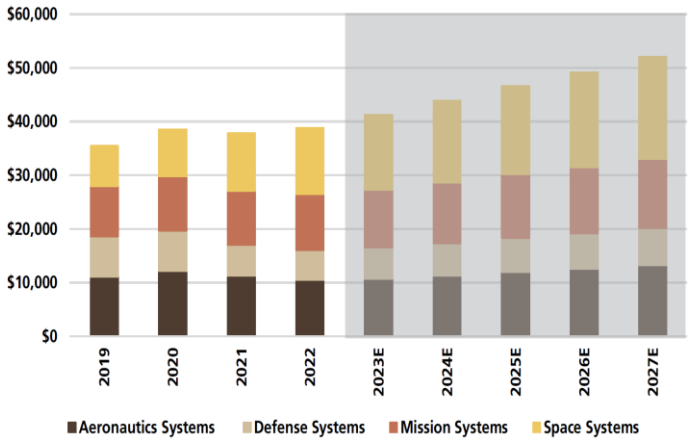
1. **Aeronautics segment** (27% of the total revenue) - holds substantial exposure to crucial, long-term programs, particularly within its manned aircraft subcategory. As the exclusive provider of Lockheed's F-35 fuselage, Northrop has showcased its ability to attain favourable margins at the subcontractor level. The expected U.S. government orders for additional F-35s alone are anticipated to cover production for about 12 years, disregarding international demand, replacement orders, and long-term maintenance, projected to extend until 2070. Northrop's role as the **primary contractor for the B-21 bomber** promises extensive revenue streams from development, production, and maintenance over numerous decades. The inherent complexities in developing stealth aircraft and existing production contracts serve as formidable barriers to entry.

2. **Defense systems segment** (14% of the total revenue) - poses significant challenges for potential replication due to its technical complexity. The high stakes involved in potential failure reinforce the likelihood of contractors consistently sourcing from established incumbents. Despite munitions having shorter contracting life spans, Northrop's offerings encompass upgrade kits and integrations with enduring platforms. The maintenance aspect of this segment highlights the robust connection between technical intricacy and formidable switching costs, creating a strong moat. Original manufacturers like Northrop, as seen with their Global Hawk surveillance drones, dictate the service schedule and maintenance standards, restricting these services to approved providers throughout the program's service life, presenting substantial barriers for alternative providers.

3. **Missions systems segment** (27% of the total revenue) - predominantly specializes in high-end sensors for military vehicles, pivotal for functions like surveillance, targeting, and navigation. While significant technical expertise safeguards these products, the stronger moat stems from the formidable switching costs resulting from their deep integration across various platforms. Ensuring these sensors' accuracy is critical for the military's strategic objectives; any targeting system errors could yield catastrophic outcomes.

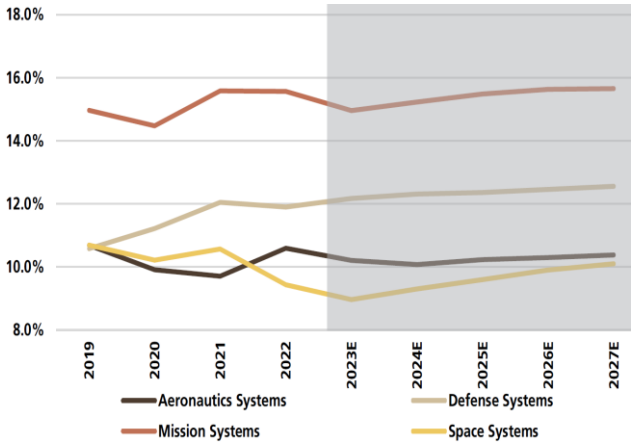
4. **Space systems segment** (32% of the total revenue) - encompasses the production of intricate satellites, satellite sensors, subsystems for satellite launches, strategic missiles and solid rocket motors. Within the missile subcategory, long-term contracts are in place for the development of the United States Ground Based Strategic Deterrent, expected to serve until 2075. Furthermore, one of the robust competitive advantages lies in the missile division acquired from Orbital ATK. The production of solid rocket engines, crucial for medium- and long-range missiles, remains highly exclusive within the U.S.

Figure 5: NOC revenue by segment



Source: UBS

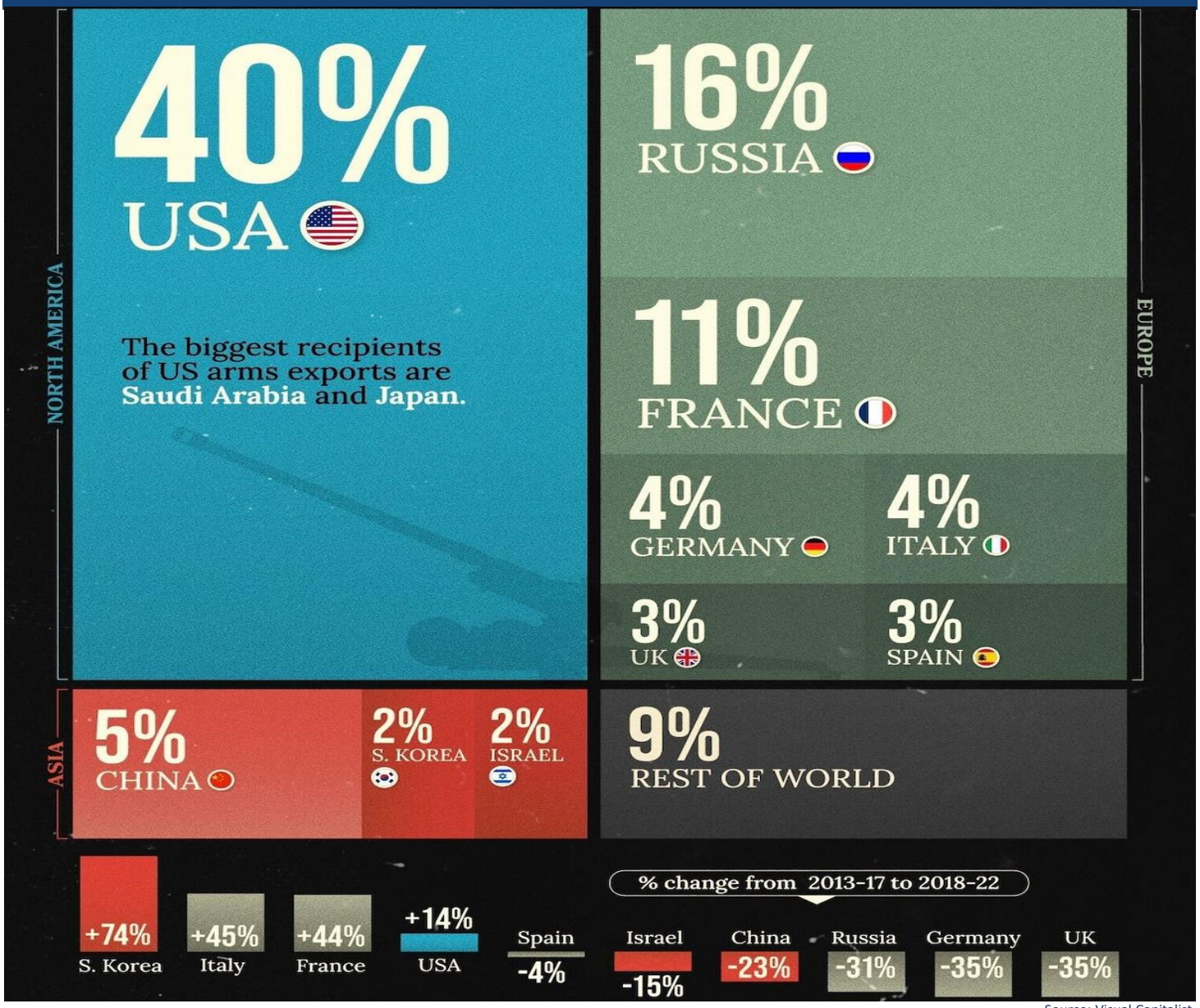
Figure 6: NOC EBIT by segment



Source: UBS

The bulk of forthcoming revenue growth within Northrop's $13 billion space systems business stems from two predominant programs. Firstly, the ground-based strategic deterrent, referred to as Sentinel, focuses on long-range ballistic nuclear missiles launched from land. Secondly, the next-generation interceptor is a missile defense system designed to counter long-range ballistic missiles. Both initiatives entail significant financial investments, amounting to tens of billions of dollars, and are currently at an early stage within their extensive operational life spans, projected well into the 2030s.

GRAPH OF THE MONTH: WORLD'S LARGEST ARMS EXPORTERS (2018-2022)



Source: Visual Capitalist

SOURCES

Sources: Alpine Macro, Bloomberg, BNY Mellon, Charlie Bilello, Credit Suisse, Compound Advisors, Edmond De Rothschild, ETFMG, FactSet, Haver Analytics, JP Morgan, Julius Baer, Morgan Stanley, Refinitive, RMB, Statista, Sygnia, Strategas, UBS

CONTACT US

Francois Du Plessis, CFP
082 492 9199
fduplessis@vegacapital.co.za

Louis Storm, CFA
083 552 2343
lstorm@vegacapital.co.za

Abrie Smit
082 087 0883
asmit@vegacapital.co.za

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