July 2018

Monthly Investment Overview

MelvilleDouglas
A Member of Standard Bank Group

Domestic
Patience needed

‘Ramaphoria’ dented as EM knocked by global growth concerns

‘Ramaphoria’ has been placed on the backburner as the cost of cleaning up after Zuma and renewed global growth concerns and trade tensions weigh on emerging markets. SA valuations have adjusted to levels that we find attractive and which have historically rewarded long-term investors.

Bernard Drotschie

Chief Investment Officer

Jerome O’Regan

Executive Director

Market Performance %

June 2018

EQUITY	JUNE	QTR	12M
All Share Index	2.8	4.5	15.0
Resources	6.0	19.6	42.1
Financials	-2.9	-6.0	10.5
Industrials	4.2	4.0	7.5
All Bond Index	-1.2	-3.8	10.2
MSCI US	9.0	19.8	19.8
MSCI UK	7.2	19.1	15.2
MSCI Emerging	3.8	6.6	13.6
MSCI AC World	7.7	16.5	16.4

US DOLLAR RETURNS	JUNE	QTR	12M
MSCI US	0.7	3.5	14.5
MSCI UK	-1.0	3.0	10.1
MSCI Japan	-2.5	-2.8	10.9
MSCI Emerging	-4.1	-7.9	8.6
MSCI AC World	-0.5	0.7	11.3
Citigroup WGB Index	-0.5	-2.3	1.6
Currency vs. US dollar			
Rand	-7.6	-13.6	-4.4
Euro	0.0	-5.1	2.4
Yen	-1.9	-4.0	1.4
Sterling	-0.8	-5.9	1.6

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> "The US's trade tariffs and threats pose a challenge to global trade and economic growth."

The 'Ramaphoria' that swept the nation in the wake of President Cyril Ramaphosa's election as head of the ruling African National Congress (ANC) in December has given way as an emerging markets rout complicates the already tricky task facing local policymakers. Trying to balance domestic political considerations with South Africa's structural economic realities has certainly become a lot tougher in current conditions.

South African assets were not immune to the effects on emerging markets that began in April when the US Dollar, which had been trading near the weakest levels since 2015, suddenly reversed course on the back of improving US economics and signs that growth momentum in Europe and Japan was slowing.

Currency Concerns

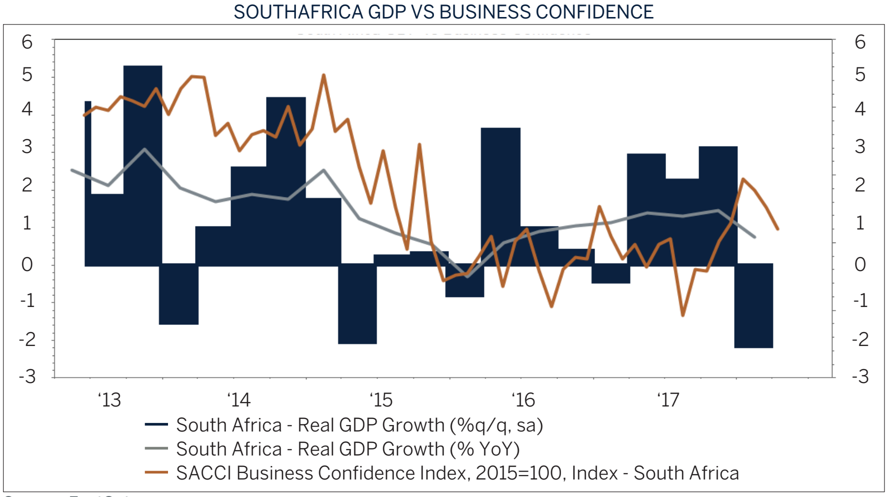
An improving dollar and rising US interest rates caused financial conditions to tighten in countries such as Argentina and Turkey, both of which are highly reliant on external USD funding. This resulted in the currencies of both nations to depreciate sharply, forcing their central banks to raise interest rates in an attempt to prevent a flare-up in domestic inflationary pressures. Political uncertainties in certain emerging markets such as Mexico and Brazil also didn't help investor sentiment towards developing economies. However, these were not the only factors at play.

The US's trade tariffs and threats pose a challenge to global trade and economic growth. Because there is little certainty of the outcome, financial markets are pricing in not only the immediate impact of tariffs but the risk of more. This was enough to prompt many global investors to shift money from fragile emerging markets back to safe-haven assets such as US treasuries.

Business Confidence Wanes

After a positive start to the year, South African asset prices began losing momentum as growth in the economy disappointed and business confidence deflated somewhat from the levels achieved earlier in the year. The latest RMB/BER survey indicates that close to three fifths of local businesses regard prevailing business conditions as unsatisfactory.

SOUTHAFRICA GDP VS BUSINESS CONFIDENCE



Source: FactSet

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> "The funding of insolvent SOEs will require a more sustainable financing solution than their current reliance on government."

The first quarter GDP data presented a very bleak picture of the domestic economy, indicating a contraction of more than 2% in real terms from the previous quarter. As the chart shows, this was a sharp reversal from Q4. The causes were a sharp decline in agriculture caused by the drought in the Western Cape and a well-telegraphed slowdown in mining (from a high base) as well as manufacturing (due to planned refinery outages). The terms of trade would also have been a negative influence as the price of oil accelerated at a much faster rate than the prices of South Africa's key commodity exports. In other words, much of the slowdown was the result of one-off events rather than a definitive shift in trend. Something similar happened last year, and in spite of the bad quarter-on-quarter numbers, output in Q1 2018 was 0.9% higher than in the same period in 2017.

It is also clear that domestic demand has weakened this year. A raft of indicators - retail sales, private sector credit extension and inflation - all point to weak underlying demand trends. This is a stark reminder of the challenges facing President Ramaphosa and his policymakers.

Although the president has made some progress by focusing on the most relevant issues, such as corruption and poor governance at state-owned entities (SOEs), challenges remain. The funding of insolvent SOEs will require a more sustainable financing solution than their current reliance on government (and by extension taxpayers). Wage negotiations are a friction point and indicate the complexity that government faces in trying to achieve its financial objectives. Eskom's revenue is regulated, and the only way to improve profitability and sustainability is to cut costs, as funders have been promised. A combination of wage restraint and layoffs is required to achieve a point of self-financed sustainability, among other adjustments. Access to credit markets depends on it.

> "We are thus increasingly doubtful that monetary policy will be a source of stimulus, leaving the economy much more dependent on external factors."

Inflationary Surprises

It should now be clear that monetary policy will remain restrictive. That may be hard to fathom while the economy is struggling to make ground and inflation continues to surprise on the downside (and well within the South African Reserve Bank's inflation target) - an environment ordinarily conducive to lower interest rates. However, the recent depreciation of the rand, combined with large scale capital outflows (not unique to South Africa) and higher fuel prices, have probably closed any window of opportunity for the central bank to consider lowering its policy rate in the near term. Although the inflation has stabilised inside the target range since the financial crisis, and could be maintained without the high real rates that prevail now, the Reserve Bank views high real interest rates as an important tool in maintaining financial stability, particularly in periods of capital flight from emerging markets. We are thus increasingly doubtful that monetary policy will be a source of stimulus, leaving the economy much more dependent on external factors.

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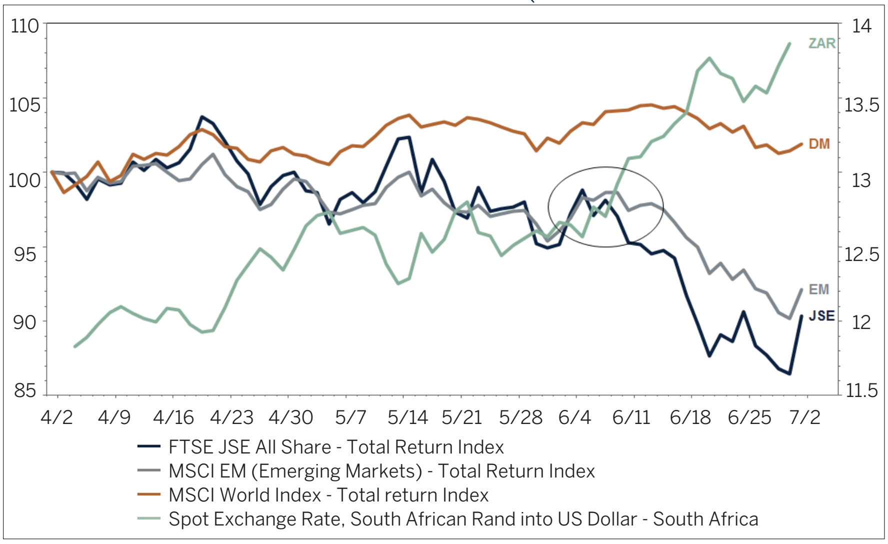
> "..equity valuations have changed substantially without a material undermining of the earnings outlook."

Market Outflows Weigh

SA equity held up reasonably well compared to other emerging markets until the release of disappointing economic data in June as the chart below shows (note it is in USD terms). Investors have increasingly realised that the "new dawn" promised by Mr Ramaphosa may be some time away, and so a combination of poor economic news and worries about other structural disruptions such as the Mining Charter and land reform have dominated.

ALSI JSE AND USDZAR VS MSCI EM AND MSCI DM (TOTAL RETURN BASED TO 100



Source: FactSet

South African equity and bond markets experienced record outflows as a result, albeit not dissimilar from what other emerging markets experienced during the month. The outflows have resulted in a sharp adjustment to market pricing and ratings and yields are now below the trough reached in the run up to the ANC's national elective conference in December, when political uncertainty was arguably at its highest in years.

Sell-off Appears Overdone

The path to normalisation was never going to be a simple one, but it's turning out very difficult. Getting rid of bad eggs is one thing, but cleaning the henhouse is another. On top of that the government has taken on some extraordinarily challenging structural issues such as land reform. All just as the world growth starts to falter, leaving financial markets in doubt that it can all work out. But it is early days for the new administration, which is running into obstruction precisely because it is trying to change things. The external factors we can do nothing about, but they will defer the delivery of the required goals. Meanwhile, equity valuations have changed substantially without a material undermining of the earnings outlook so far. In real terms the rand has weakened to levels that will boost export earnings and activity (weaker levels than this are associated historically only with the worst of the Zuma era or global recession). Equity ratings have dropped sharply and what was an expensive market earlier in the year is producing some interesting valuations. Investors need to pay attention but will require patience.

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> "A real concern for the valuations of risk assets that have benefited from an extended period of abnormally low interest rates."

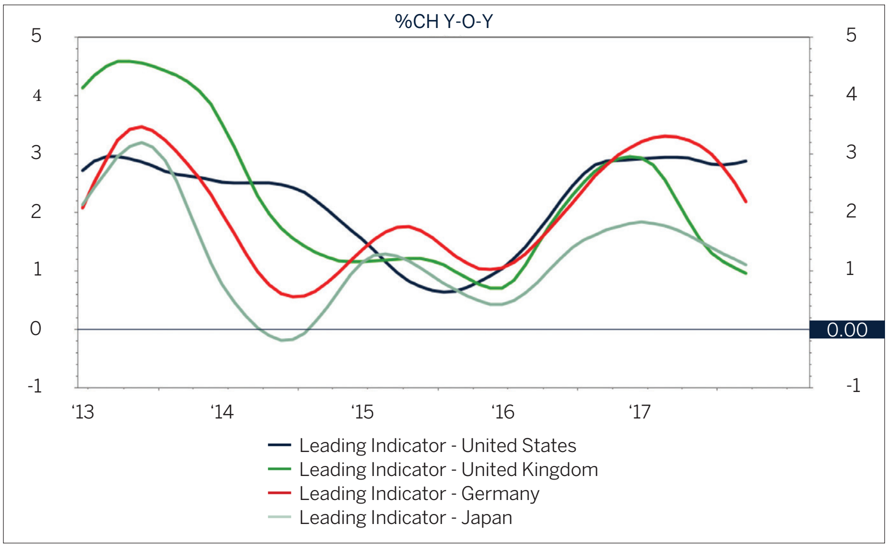
Global

Volatility in global markets continued in the second quarter and is expected to remain a feature of 2018 as US monetary policy normalisation gathers momentum, leading economic indicators slow and President Trump's belligerent trade policies threaten to disrupt global trade. Emerging markets have been most exposed whilst the US dollar has benefited from the risk-off trade. Is the extended multi-year equity bull market rapidly coming to a conclusion?

After initially starting the year with strong gains, equity market returns have fizzled out. The prospect of another year of synchronised global growth appeared promising, but much of the good news was already reflected in asset valuations after a prolonged 'risk-on' period. Volatility, as expected, has picked up and looks set to continue as the year progresses.

Markets are now starting to discount both the fact that higher wage growth in the US poses a threat to inflation and stricter monetary policy – a real concern for the valuations of risk assets that have benefited from an extended period of abnormally low interest rates. Furthermore, cyclical divergence between the US economy - fueled by tax cuts and investment spending - and most other countries has challenged the expectation that global growth will remain synchronised. These concerns are supported by a number of leading economic indicators, which are pointing to a possible loss in momentum outside of the US, as shown below:

LEADING INDICATORS US, UK, GERMANY, JAPAN



Source: FactSet

"Increased competition globally has resulted in more choice for consumers at lower prices and improved quality. The opposite can be expected from increased protectionism."

However, the slowdown in momentum is generally perceived to be temporary. Europe's economy, which is very reliant on exports and global trade, is currently adjusting to the impacts of a sharp appreciation in its currency and an overhang in inventory which resulted from the strong growth experienced towards the latter part of last year. Notwithstanding an increase in political risk and uncertainties related to the impact of Brexit and Italy, economic fundamentals remain positive. Consumer spending supported by employment and income growth, remains robust, consumer sentiment and business confidence are at historic highs, and high levels of capacity utilisation bodes well for investment spending. Expectations are that growth should rebound during the second half of the year.

Trade Wars

We have previously written about the risks associated with an escalation in protectionist measures which are seen to threaten the open multilateral trading system that has served the global economy so well. Increased competition globally has resulted in more choice for consumers at lower prices and improved quality. The opposite can be expected from increased protectionism. Although the protected domestic industries would initially benefit from this development, the rest of the supply chain will not as they become less competitive globally, which will ultimately result in large layoffs, reduced incomes and a contraction in economic activity. Furthermore, history suggests we should expect reduced productivity and higher inflation from the protected domestic industries as they become less incentivised to invest in new technologies and innovation due to lowered levels of competition.

The recent escalation in protectionist rhetoric and actions does not bode well and is already showing signs of inhibiting investment spending. The Trump administration is in the process of implementing a 25% tariff on $50bn of Chinese imports from 6 July. President Trump has indicated that the US will implement further tariffs should the Chinese retaliate. He has proposed an additional 10% import tariff on a further $400bn of imports from China. Effectively, this works out to be an effective 12% rate on $450bn of imports. He also indicated that his administration is considering implementing 25% tariffs on all imported vehicles and vehicle parts - worth an estimated $340bn - and further announced plans to introduce restrictions of Chinese foreign investment on "strategic" sectors in the US. These proposed tariffs are in addition to the tariffs already implemented on steel and aluminum imports from Europe, Canada, Mexico. These three trading partners vowed to impose 'dollar-for-dollar' retaliatory tariffs on the U.S.

We cannot be certain that any of the new proposed tariffs will be approved by the administration in Washington, and even so, will take significant time before they are implemented. However, the risk for investment markets is that trade relations are harmed to such an extent that large-scale economic damage is done, even though economists estimate that the direct cost to the global economy will be less than 0.5% should all the proposed tariffs come to fruition. The indirect impact will be less measurable, but tariffs impose a cost of doing business that will raise required rates of return and thus undoubtedly will affect businesses' profitability and willingness to invest.

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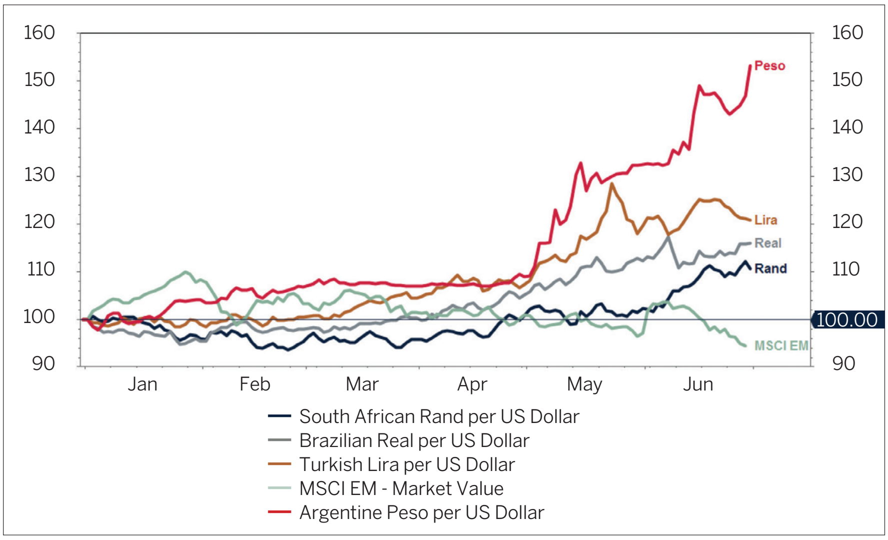
> "The stronger dollar will be beneficial for export orientated economies such as Europe, but has, in conjunction with higher long-term interest rates, resulted in an abrupt tightening of financial conditions in emerging economies."

Emerging Markets

The US dollar has changed course this year as growth and interest rate differentials widened between the US and the rest of the developed economies. The stronger dollar will be beneficial for export orientated economies such as Europe, but has, in conjunction with higher long-term interest rates, resulted in an abrupt tightening of financial conditions in emerging economies. Economies with weak current account and/or fiscal positions experienced large capital outflows. Signs of stress first emerged in countries such as Turkey and Argentina. Both are reliant on large scale US dollar funding and are particularly vulnerable to dollar appreciation. This phenomenon later spread to other emerging markets as foreign investors became increasingly concerned about the impact on growth from higher policy rates as central banks tried to defend their currencies and, in some cases, safeguard financial stability. Certain central banks had to abandon planned rate cuts given the change in sentiment towards emerging markets. Further dollar appreciation combined with the renewed risk of a slowdown in global trade could materially affect the growth outlook for these regions in the near term. However, many of these concerns are already reflected in valuations. Some improvement in growth momentum and/or risk appetite will surely attract foreign investors again, barring an outright trade war.

EMERGING MARKET CURRENCIES VS USD AND MSCI EMERGING MARKET EQUITY INDEX



Source: FactSet

> "The medium-term outlook for global economic growth remains favourable and is still expected to exceed long run potential output."

Conclusion

Both the prolonged economic and stock market cycles would appear to be entering their final chapters and therefore investors should tread more carefully and expect future returns to be lower and more volatile than what they have been accustomed to over the past few years. However, despite a softer economic backdrop during the first half of this year, apprehension in emerging markets and trade fears, the medium-term outlook for global economic growth remains favourable and is still expected to exceed long run potential output, whilst inflation looks to pick up only moderately. Our work shows that rising economic uncertainty and the trade spat have reduced the price investors must pay for some quality businesses and as such, some attractive long-term opportunities are arising. In addition, there are plenty of companies that will be completely unaffected by trade issues, direct or indirect. We therefore remain with neutral weighting to Equities and expect them to still deliver superior returns relative to other asset classes.

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