March 2018

Monthly Investment Overview

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Market Performance %

Feb 2018

EQUITY	FEB	QTR	12M
All Share Index	-2.0	-2.2	17.4
Resources	-4.8	-2.2	16.1
Financials	2.6	7.9	20.5
Industrials	-3.0	-6.6	16.6
All Bond index	3.9	-3.6	21.6
MSCI US	-4.2	-10.9	5.6
MSCI UK	-6.9	-12.4	3.1
MSCI Emerging	-5.2	-7.3	18.2

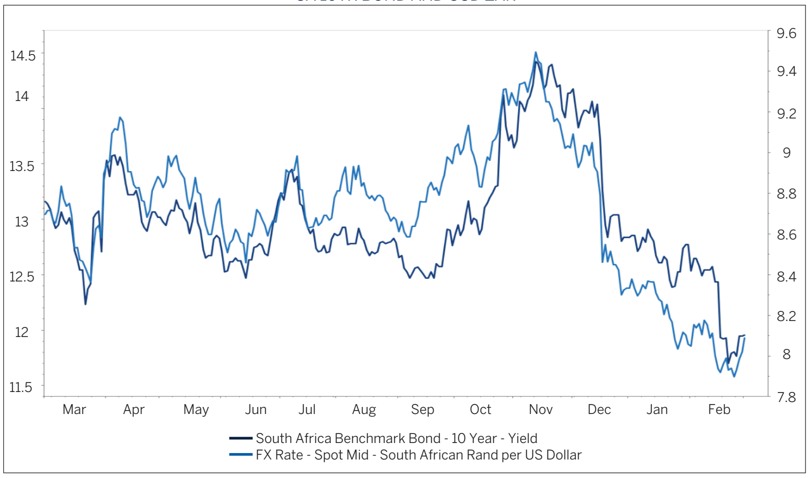
US DOLLAR RETURNS	FEB	QTR	12M
MSCI US	-3.7	3.0	17.0
MSCI UK	-6.4	1.3	14.2
MSCI Japan	-1.5	3.8	22.2
MSCI Emerging	-4.6	7.1	31.0
MSCI AC World	-4.2	2.9	19.4
Citigroup WGB Index	-0.6	0.6	4.5
Currency vs. US dollar			
Euro	-2.1	2.3	14.8
Yen	2.3	4.9	4.9
Sterling	-3.1	1.8	10.7

Investment Environment

What a difference a month makes. February 2018 will surely be remembered as one of the most eventful and historically important months in South Africa's young democracy.

In one week, President Zuma resigned, Mr Ramaphosa was instated as the new president, the State of the Nation Address was given, and the National Budget was presented. This was shortly followed by a major cabinet reshuffle. Investment markets approved, with the rand appreciating to levels last seen three years ago, bond yields falling and the share prices of domestic companies rallying sharply.

SA 10YR BOND AND USD ZAR



Source: Factset Research System

Mr Ramaphosa delivered a hopeful State of the Nation Address for which he received a standing ovation. It was telling that, for the first time in years, the SONA was delivered in an environment of relative calm, with opposition parties welcoming his address. His speech struck all the right chords, with a focus on building a new sense of purpose for the nation, creating employment, tackling corruption, and ensuring that transformation becomes front of mind for many corporates, to name but a few key takeaways.

He promised decisive interventions to "stabilise and revitalise" state-owned enterprises by implementing further changes to their boards and management. In that respect, the personnel changes at Eskom and SAA have been very encouraging. Ramaphosa spoke about the importance of providing an environment of policy certainty and working more closely with the private sector to ensure that progress is made. It is therefore encouraging that the president has, in a short period of time, already met with members of the Chamber of Mines in an effort "to resolve the impasse over the Mining Charter and to facilitate a process of developing a New Mining Charter that all stakeholders can support and defend".

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> "National Treasury presented a vastly improved budget by making tough decisions to accelerate fiscal discipline."

This year's National Budget Speech was always going to be a closely watched event, as it was important to lay the foundation of the country's newly established economic recovery through stabilising government's finances and averting the risk of an imminent credit-rating downgrade from Moody's. A shortfall of R50 billion for 2017/2018 had been predicted in the Medium-Term Budget, and this was before president Zuma's fee-free tertiary education pledge. Mr Gigaba provided little hope of any improvement during his Medium-Term Budget Speech in October 2017, as it appeared that government had relinquished its commitment to fiscal discipline and economic growth.

Considering this, National Treasury presented a vastly improved budget by making tough decisions to accelerate fiscal discipline, while, at the same time, accommodating the promised roll-out of free tertiary education. These decisions needed to be carefully balanced with government's renewed commitment to stimulate economic growth.

The deficit improvement will be achieved primarily through an increase in VAT from 14% to 15%, and by allowing inflation to carry taxpayers into higher tax brackets ("fiscal drag" is usually neutralised by adjusting the tax brackets). There were the usual increases to sin taxes, the fuel levy and the introduction of a health promotion levy. Corporate and dividend taxes were left unchanged. This was explicitly put in the context of the lower tax rates in SA's major trading partners, with specific mention of the recent corporate tax reduction in the US from 35% to 21%. "At 28%, South Africa is becoming an outlier, providing an incentive for companies to shift profits abroad." Estate duty was increased but won't create much revenue (see table).

Where the additional revenue comes from 2018/19 budget

	Rm	%
Direct taxes	7310	20%
Personal income tax	7510	21%
- Partial bracket creep	6810	19%
- Medical tax credit	700	2%
Corporate tax	-350	-1%
Estate duty increase	150	0%
Indirect taxes	28690	80%
VAT	22900	64%
Fuel levy	1220	3%
Sin taxes	1330	4%
Other ad valorem excise duties	1030	3%
Environmental taxes	280	1%
Health promotion levy	1930	5%
Total		36000

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As to credibility, Treasury revised the economic growth forecasts only slightly upward to achieve the new numbers – and in our view the numbers used in the Medium-Term Budget Policy statement were extremely low given buoyant global demand. Gross government debt is now expected to stabilise at 56% of GDP in fiscal 2022 instead of blowing out to 60%, as was predicted previously. Finally, the budget deficit is shown to fall to 3.5% of GDP. This will be encouraging for rating agencies, but of course it isn't the only criterion.

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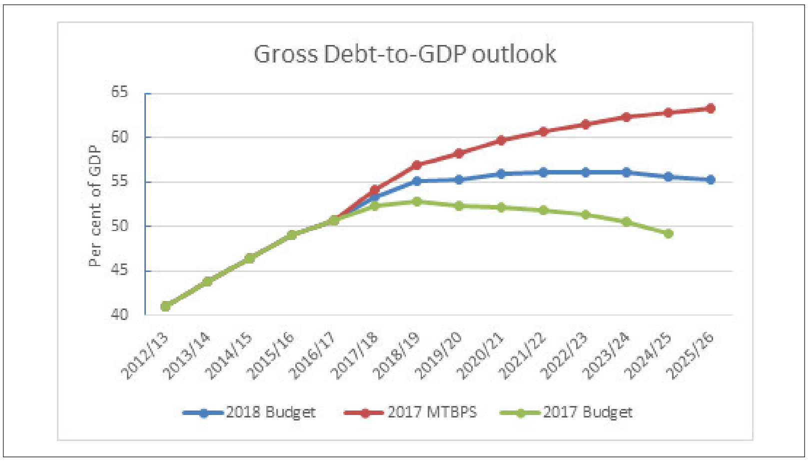

Source: Factset Research System

The increase in VAT was more than a source of revenue for the fiscus. Most commentators believed it would be politically unacceptable, so it was also a significant signal of the priority of fiscal sustainability for the new administration.

The necessary reduction in government expenditure was disappointing given that most of the cuts were infrastructure related.

One of the key risks to SA's public finances remains the poor state of governance and finances at state-owned enterprises, something that National Treasury is acutely aware of and which was highlighted by Mr Gigaba in his speech. Many SOE business models are not sustainable in their current format and they "cannot borrow their way out of financial difficulties". All stakeholders, including the private sector, will be consulted to find long-term sustainable solutions. New equity will have to be injected by selling state assets. The word "privatisation" was not used, but the measures required look remarkably like it.

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The cabinet reshuffle was more of a mixed bag, resulting in what was called "a transitional Cabinet". Compromise was necessary, but deployed to good effect. The focus was on making changes to the key positions in government. Pravin Gordhan returned as minister of public enterprises, Nhlanhla Nene as minister of finance, and Derek Hanekom as minister of tourism; Gwede Mantashe was appointed minister of mineral resources. Several underperforming ministers were removed altogether, some were moved out of strategic portfolios to ones of lesser importance. Mr Ramaphosa has promised a smaller, more efficient cabinet, so more changes are likely.

Conclusion

"A foundation has now been created for the economy to move to higher growth, underpinned by reforms and the promise of policy certainty."

Some confidence has returned and has been reflected in market prices. A foundation has now been created for the economy to move to higher growth, underpinned by reforms and the promise of policy certainty. Now it's up to execution, but there will be significant obstacles to overcome from previous mismanagement. A revival of economic growth will help consumers and businesses overcome the higher taxes and levies in the near term, and there is significant potential for the Reserve Bank to stimulate demand. None of this is going to be plain sailing, regardless of recovery. Serious structural issues remain, and the big test will be whether the new administration uses the cyclical opportunity to longer-term advantage.

Although investors have much to cheer about, they should not lose focus on valuation. Bonds have rallied, the rand has sharply appreciated, and certain share prices have run ahead of themselves. We will continue to look for attractive investments, while at the same time ensuring that portfolios are well diversified to cater for unexpected events.

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Global

The world economy has not been this strong and synchronised since the global financial crisis, but after suffering the first monthly pullback in a year at the end of February investors should expect more volatility in financial markets as the tug-of-war between economic growth and higher interest rates plays out.

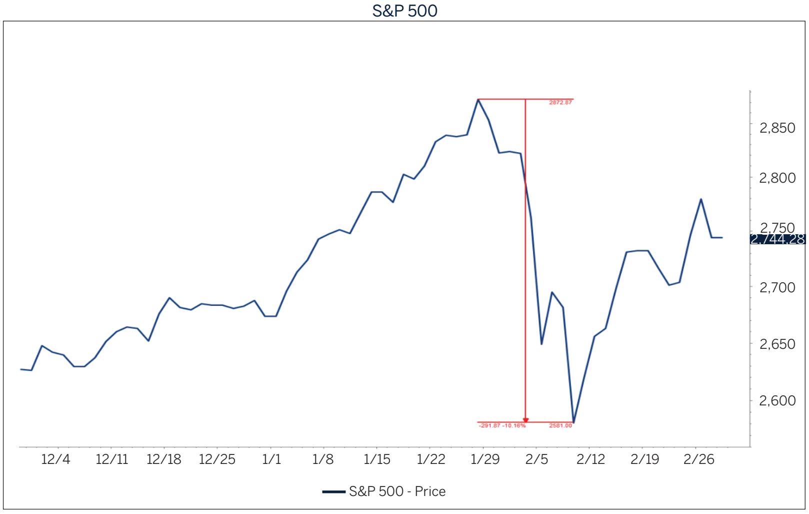
> "...diversification is essential with the recent bout of volatility in equity markets."

In this climate, diversification is essential with the recent bout of volatility in equity markets also serving as a timely reminder for investors to keep a close eye on valuations.

The US economy has certainly been leading the way until now, with levels of unemployment well below the projected longer-run natural rate. The rest of the world has caught up, with economists revising their growth outlook higher. Europe is likely to grow faster than the US this year. As a result, Global GDP is expected to grow above-trend this year and potentially again in 2019. Recently enacted tax legislation has contributed to the lift in consumer and business confidence in the US, as this is usually associated with strong economic growth. Companies have been guiding profits higher and another year of double digit earnings per share growth is expected worldwide.

This begs the question as to what caused the recent sharp correction in equity markets. The S&P500, contracted by 10% from peak to trough, as illustrated below, and global markets followed to varying degrees.

S&P 500



Source: Factset Research System

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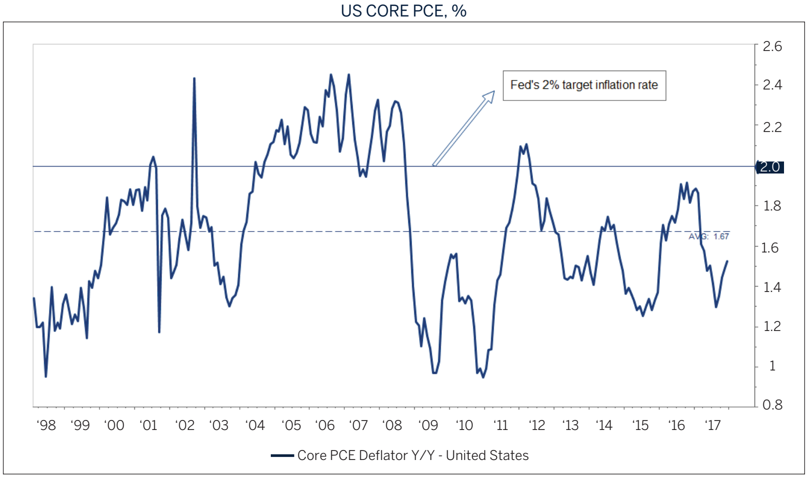
> "The increase in inflation, albeit from low levels, should not be a surprise given the backdrop of improving global growth, higher commodity prices and a depreciating dollar."

Higher US inflation has been cited as one of the possible reasons. Wage growth and core inflation came in stronger than expected and raised renewed fears that the Federal Reserve (Fed) might be forced to increase interest rates faster than had previously been forecast to prevent the economy from overheating. The increase in inflation, albeit from low levels, should not be a surprise given the backdrop of improving global growth, higher commodity prices and a depreciating dollar.

Although inflation expectations have been moving gradually upwards, long-term inflation expectations in the US have been anchored around 2%, a level with which the Fed would be comfortable. Their preferred measure of inflation is still relatively low (see chart below), but importantly they expect the pick-up in inflation to be "somewhat faster than 2017". Companies tend to benefit from modest levels of inflation when the economy expands, and demand improves, resulting in revenue growth and favourable profit margins. It is also interesting that many companies have used the windfall from lower taxes to announce one-off payments to employees instead of increasing wages and that certain companies have indicated that they would use the boon to strengthen their competitive position by lowering prices. Note that a tax cut is a one-off change: properly managed it ought not to lead to persistently higher inflation. The catch now is that the tax cut is being implemented at a time of an already strong cycle and, as such, the inflationary outcome is uncertain.

The Federal Reserve Bank of San Francisco recently released a paper on US inflation and argued that underlying price data reveals that low inflation is the result of categories of prices that are relatively insensitive to overall economic conditions. This trend is not expected to change. The research shows that "procyclical inflation has steadily returned to its pre-recession level, in line with improvements in economic conditions and a tightening labor market." In other words, inflation is mostly behaving normally, but categories such as healthcare are expected to be sustainably lower than in the past.

US CORE PCE, %



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> "Although yields are still low by historical standards, a sharp movement nonetheless acts as a headwind to equity valuations, and makes income earning assets such as bonds and cash relatively more attractive than before."

Even so, US rates have moved higher, as they need to. The US 10-year bond yield has increased from 1.4% in 2016, to 2% in September 2017, and is now nearly 3%. Although yields are still low by historical standards, a sharp movement nonetheless acts as a headwind to equity valuations, and makes income earning assets such as bonds and cash relatively more attractive than before. Still, buoyant economies are unlikely to be derailed until interest rates are much higher than they are now, but high market valuations mean asset prices are very sensitive to changes.

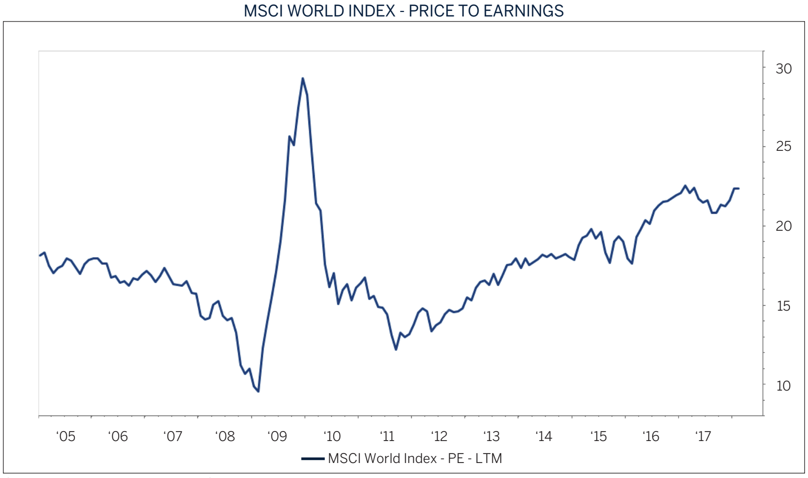
Credit risk for private sector companies is measured by the additional required rate of return or 'spread' over the rate investors can earn on US treasuries. They are a useful gauge of risk appetite. Spreads usually narrow when companies are doing well, and economies are growing. Spreads widen when the 'growth' outlook deteriorates because corporate cash flow becomes less certain. Credit spreads are now at historically low levels (expensive), but reacted only slightly to the correction in global equity markets. This is an indication that market participants are not overly concerned about the near-term outlook for growth and profitability of companies.

So, if investors are not overly concerned about the path for economic growth and inflation, what has caused the meaningful sell-off in global equities?

The answer is a combination of factors, but can primarily be ascribed to the recalibration of inflationary expectations at a time of stretched equity valuations. Equity markets have experienced complacency and an unusually long period of positive monthly returns. Given the lack of alternatives during a prolonged period of abnormally low interest rates and an improved growth outlook, investors have been willing to take on more risk, by paying a higher price for each level of earnings.

Although valuations can remain elevated for a period, the margin of safety has diminished, which will make the asset class more vulnerable to unexpected events, such as a sharp increase in interest rates/inflation or weaker than expected growth.

MSCI WORLD INDEX - PRICE TO EARNINGS

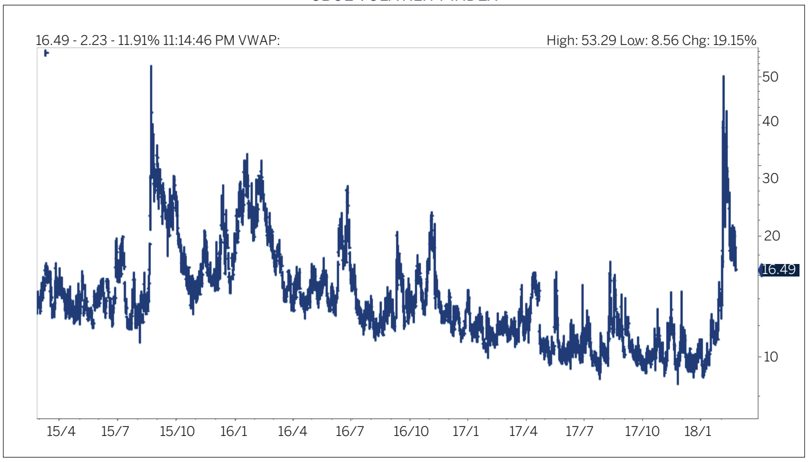


Source: Factset Research System

"Equities have recovered from their lows as investors turned their attention to fundamentals.."

One illustration of how complacency has become embedded in financial markets is a measure called the "VIX" index. The index measures the US stock market's expectation of future volatility and has been trending lower for a prolonged period. Lower levels of volatility are usually associated with higher valuations. Investors, including the public and a few pension funds, have literally been betting on lower levels of volatility using complicated derivative products. During the past two years this trade has paid handsome dividends for investors, because there has been a persistent trend decline in volatility. However, this all came to an abrupt end when confronted with higher wage growth, higher US inflation and adverse commentary from the European Central Bank. A necessary and long overdue correction was amplified by investors and market makers being forced to unwind their highly-geared, volatility-linked derivative positions very fast.

CBOE VOLATILITY INDEX



Source: Factset Research System

"...but the correction has shown that the combination of less easy money and high valuations will startle investors out of complacency."

Equities have recovered from their lows as investors turned their attention to favourable economic fundamentals, but the correction has shown that the combination of less easy monetary policy and high valuations leaves the door open for volatility to return in the months ahead.

Conclusion

The global economic backdrop is strong and economists have been revising their forecasts upwards. Global inflation is expected to move higher as economies grow and labour markets tighten, but most commentators believe that future inflation will remain in check and in line with long-term trends, allowing central banks to gradually remove excess liquidity by increasing interest rates to more normalised levels.

Nevertheless, we think it would be foolish to ignore the recent correction, or to write it off to the excesses of a few traders in obscure corners of the market. The inflation and wage numbers that supposedly triggered the event were a surprise, but within the range of possible outcomes embedded in market expectations. The response – inflation is under control, so the correction must be market irrationality - could be misleading: what the Fed does is usually reactive. Markets are ahead of the Fed, and the longer it takes the imbalances to build, the larger the potential dislocation if there is a real surprise. So, investors need to treat the February wobble as a warning sign: don't write it off as irrational. This was a warning that "easy-money" conditions have created risk-chasing behaviour that may no longer be sustainable as those conditions change. In addition, the fallout from excess in obscure assets can have significant effects on much larger asset classes.

Diversification is essential, and the recent bout of volatility was a timely reminder for investors to keep a close eye on valuation, and to ensure that they stay well within their defined risk parameters.

"Markets are ahead of the Fed, and the longer it takes the imbalance to build, the larger the potential dislocation if there is a real surprise."

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