April 2018

Monthly Investment Overview

MelvilleDouglas
A Member of Standard Bank Group

'Cyril Spring' breathes life into the economy, with markets likely to perk up too

South Africa has made significant progress in a short period since Cyril Ramaphosa was elected President in February. Investors thus far have little to show for it, however, as trade war threats, unsupportive politics and tighter monetary policies in developed economies generated significant headwinds for global markets. But a stronger rand, low inflation and political certainty will assist the economy in finding its feet again after years of pedestrian growth.

Jerome O'Regan

Chief Investment Officer

Bernard Drotschie

Deputy Chief
Investment Officer

Market Performance %

March 2018

EQUITY	MAR	QTR	12M
All Share Index	-4.2	-6.0	9.6
Resources	-2.1	-3.8	10.4
Financials	-3.1	-3.6	17.6
Industrials	-5.5	-8.0	5.7
All Bond index	2.0	8.1	16.2
MSCI US	-2.1	-4.9	0.8
MSCI UK	0.0	-8.0	-1.0
MSCI Emerging	-1.5	-2.9	10.8

US DOLLAR RETURNS	MAR	QTR	12M
MSCI US	-2.4	-0.6	14.0
MSCI UK	-0.3	-3.9	12.0
MSCI Japan	-1.4	-1.1	16.4
MSCI Emerging	-1.8	1.5	25.4
MSCI AC World	-2.1	-0.8	15.4
Currency vs. US Dollar			
Rand	-0.4	4.5	13.2
Euro	0.8	2.4	15.0
Yen	0.3	5.9	4.8
Sterling	1.8	3.7	12.2

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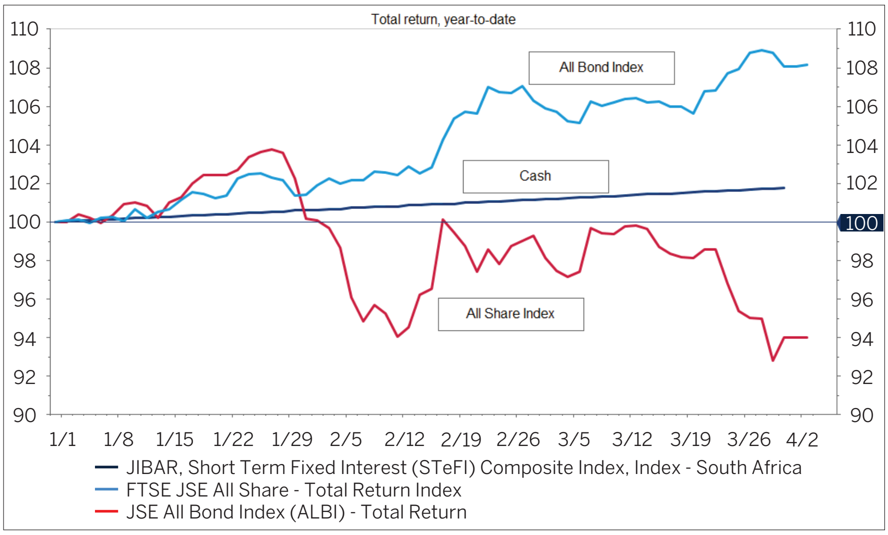
> "Mr Ramaphosa has been able to turn sentiment and confidence around."

South Africa's growth rate is likely to improve and investors will once again focus on fundamentals after a period plagued by political uncertainty. The global economy is strong and earnings momentum is positive and South Africa is well positioned to benefit. Domestic markets have started to adjust to this new sense of optimism and foreign investors have returned. The first quarter, however, was certainly disappointing for equity investors as the JSE All-share index followed global markets lower, volatility picking up sharply. It wasn't all negative, though, as domestic bonds rallied strongly in tune with rand appreciation and inflation continued its downward trend. The decision by Moody's, meanwhile, to adjust South Africa's sovereign credit rating outlook from negative to stable provided additional support. The share prices of domestic orientated companies such as banks and retailers also benefited from these developments and have performed very strongly in anticipation of lower interest rates and improved growth prospects.

SA ASSET CLASS PERFORMANCE



Source: Factset Research System

Mr. Ramaphosa has been able to turn sentiment and confidence around in SA after a prolonged period of mismanagement and policy uncertainty. Under his leadership, the government has begun to address the poor governance and management at State Owned Enterprises, supported fiscal consolidation, introduced measures to eradicate corruption and opened the door for renewed dialogue and collaboration with the private sector. The country still has a long way to go to deal with some of the structural challenges such as unemployment, large income disparities and economic transformation, but we are at least heading in the right direction without the added burden of having our sovereign credit rated as junk.

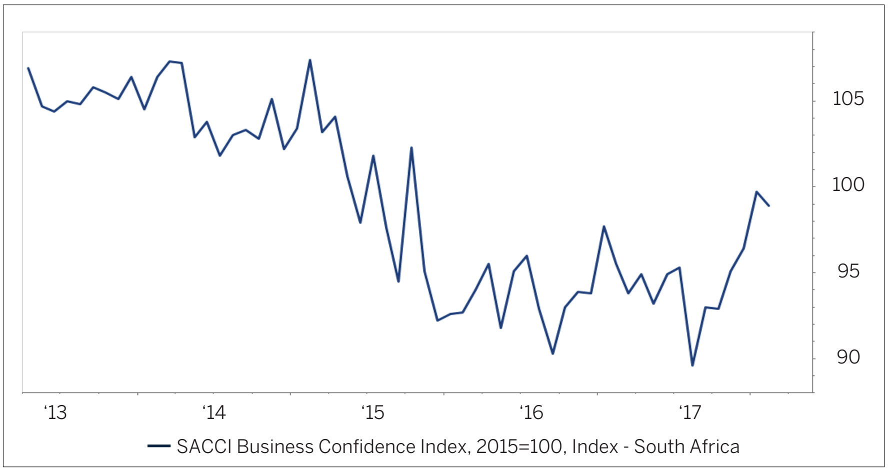
It is little surprise economists have revised their growth outlook after the release of fourth-quarter GDP numbers. Growth was much stronger than expected at 3.1% as consumer and investment spending picked up and growth from agriculture continued to surprise positively. Revised numbers from Statistics South Africa also confirmed that the economy did not enter a technical recession in early 2017

> "It was heartening to see that business confidence turned the corner."

as was previously thought.

Consumer spending should continue providing support to GDP growth due to higher real wages, higher consumer confidence and an improvement in household balance sheets. Higher domestic demand will lead to higher investment in

SA BUSINESS CONFIDENCE



Source: Factset Research System

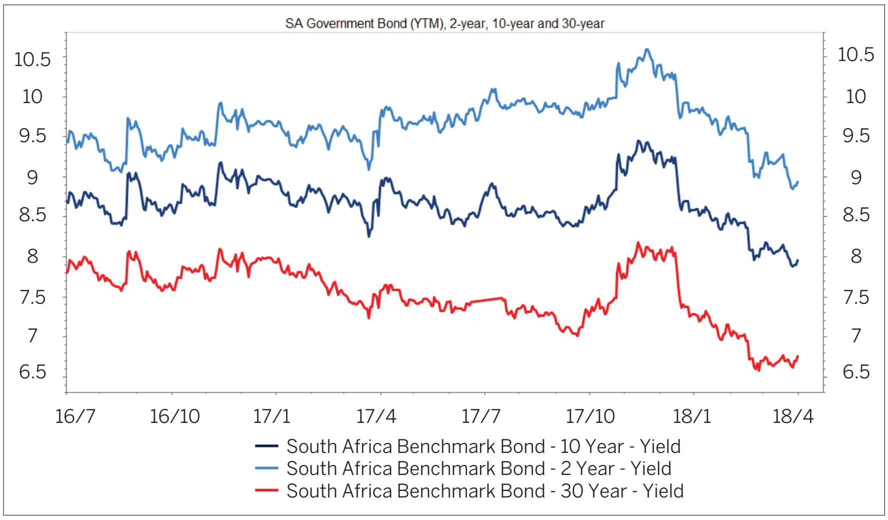
inventory and ultimately capital expenditures, which will underpin a medium-term recovery in economic growth.

Investment spending has been declining in the recent past primarily due to policy uncertainty. In aggregate, companies have not been spending enough to maintain capacity, and have not been willing to make long-term investment commitments. It was therefore heartening to see that business confidence appears to have turned the corner in Q1, as this development could lend support to a renewed private sector fixed investment cycle and add impetus to the economic recovery. The fixed investment recovery could, however, be delayed or at worst not materialise as expected should the investigation into a possible constitutional amendment to effect land expropriation without compensation reintroduce uncertainty among investors.

South Africa averted a credit downgrade in March when credit ratings agency Moody's announced that they would keep the country's sovereign credit rating unchanged and also adjusted the outlook to stable from negative. The stable outlook effectively means that the country is probably two (as opposed to one) rating actions away from non-investment grade and exclusion from global bond indexes. South African government bonds immediately reacted positively to this development and pushed yields lower. This is the first significant sign that the

"Further rate cuts will depend on the trajectory of inflation and inflation expectations."

SA INTEREST RATES



Source: Factset Research System

trough of the deterioration may have passed. The resulting reduction in the cost of capital will make investment decisions easier, but only the passage of time will embed the improvement.

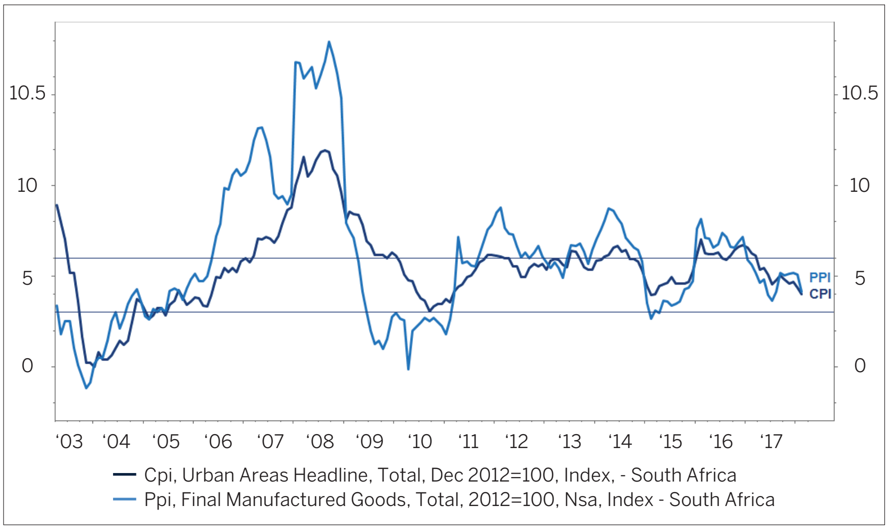
Moody's mentioned that "the recovery of the country's institutions will, if sustained, gradually support a corresponding recovery in its economy, along with a stabilisation of fiscal strength". There were three reasons Moody's improved the outlook assessment. Firstly, a halt in the deterioration of SA's institutional framework, with specific reference to the changes made at SARS, National Treasury and SOEs and the strength and independence of the Reserve Bank and the judiciary. Moody's also praised the speed with which important leadership changes were made in key institutions. Secondly, they referred to improved growth performance and prospects of structural improvements. And finally, the commitment from government in the recent budget to address fiscal slippage and eventually reduce the debt burden.

Risks remain, such as the finalisation of a productive Mining Charter and the land expropriation without compensation debate. Moody's will monitor these developments very closely. The key message is that growth should be the country's primary focus as this will boost revenue growth and improve the fiscal ratios, which will ultimately result in an improved sovereign rating.

These developments, alongside well-behaved inflation and a relatively strong rand, paved the way for the Governor of the Reserve Bank to cut the repurchase interest rate by 25 basis points to 6.5 percent in March. It was a close decision as four MPC members voted in favour of a reduction and three members preferred an unchanged stance. Further interest rate cuts will depend on the

> "Low inflation reduces the cost of capital."

SA INFLATION RATES



Source: Factset Research System

trajectory of inflation and inflation expectations alongside real GDP. The Reserve Bank is forecasting one hike next year and two in 2020, based on their inflation expectations, which incorporates a negative impact on inflation from the 1% increase in VAT.

The Governor has done a tremendous job in navigating the Reserve Bank and monetary policy through an extremely challenging political environment, and he is determined to ensure that inflation expectations are anchored closer to the midpoint of the target band of 3-6 percent. Low inflation is preferable for economies as it reduces the cost of capital as well as the cost of doing business, allows management teams to plan with confidence and protects the poor, who are most vulnerable when inflation spikes.

The hawkishness of the Reserve Bank has already led some economists to conclude that the interest rate cutting cycle is already over – one and done, as it

“Renewed optimism is not a reason to abandon the basic principles of sound investing.”

were. But as long as SA’s output remains below potential, and inflation remains benign, there has to be further scope for rate cuts. There will continue to be tough talk in order to anchor expectations at lower levels, but that does not mean no more cuts.

Conclusion

South Africa has achieved a lot in a short period since the favourable outcome from the ANC’s National Elective Conference in December 2017 and subsequent resignation of the embattled President Zuma in February. Interventions by the new president, Cyril Ramaphosa, have resulted in the country averting a sovereign credit downgrade, improved business and consumer confidence and established an environment within which the Reserve Bank was afforded an opportunity to cut interest rates. There are many challenges and risks ahead, not least the financial condition of some of the country’s largest state-owned enterprises, such as Eskom and South African Airways, but significant changes have been made.

Much is still required to get the economy on to a sustainable path of recovery, but a start has been made. Renewed vigour and optimism in public and economic life certainly ought to bring significant benefits to households and companies. But that is not a reason to abandon the basic principles of sound investing. Investors need to keep in mind that the global situation is less certain than it was, and should continue to pay close attention to valuations and ensure that the required margin of safety is attained while portfolios are positioned to benefit from a renewed period of optimism.

Global

> "Elevated equity valuations adjusted to a more uncertain environment."

After a strong start to the year, investors had to be content with negative returns at the end of the first quarter as a combination of elevated valuations, rising interest rates and renewed fears of a full-blown trade war weighed heavily.

After a prolonged period of relatively low volatility and positive returns in equity markets, investors had to moderate their return expectations as the reality of higher global inflation, accompanied by higher interest rates and reduced liquidity, became key challenges. Elevated equity valuations, which provided little room for error, adjusted to a more uncertain environment.

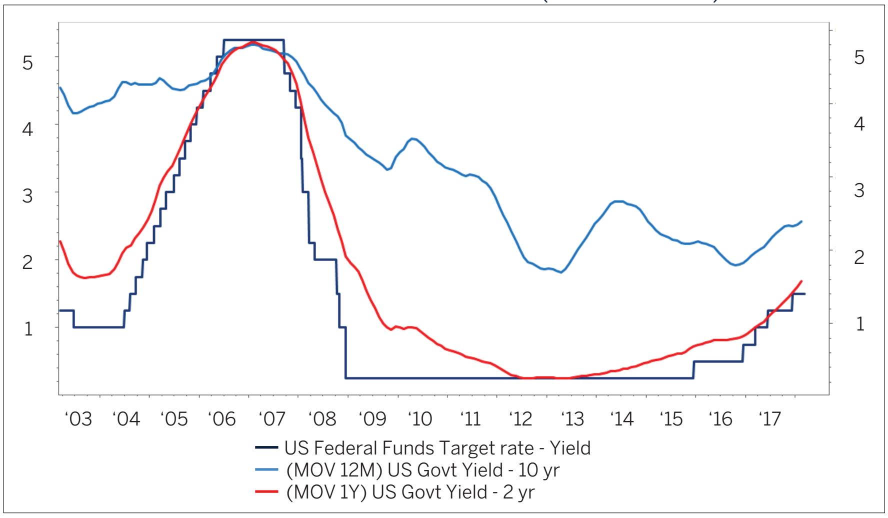
MSCI ACWI - PRICE EARNINGS (NTM)

Source: Factset Research System

Global growth is strong and expectations are that 2018/2019 will generate above-average economic growth as higher wages and an uptick in investment spending provide support to economic activity. Lower taxes and fiscal expansion in the US will also provide and underpin for growth at least in the immediate future. It is therefore understandable that central banks have become more comfortable to signal that less monetary support is required as the economic cycle becomes more sustainable. But herein lies the risk. Interest rates have been kept artificially low for so long, and have been a key driver behind the improvement in global growth and investment market returns. In time, higher interest rates are set to reveal some of the unintended consequences from a prolonged period of risk taking and ultra-accommodative monetary policy.

"It's a long time since the world had to deal with such an uncoordinated and unilateral approach to trade."

FED FUND RATE VS US 10YR AND 2YR T/B (MOVING AVERAGE)



Source: Factset Research System

Equity investors have therefore adjusted to the reality of higher interest rates and high dividend yielding sectors (predominantly defensive companies) such as telco's, staples and real estate which have felt the brunt of the underperformance this year. Share prices of information technology companies with unique secular growth opportunities have continued their outperformance over the rest of the market, but are also susceptible to selling pressure, as the recent fallout from the Facebook data saga has illustrated.

The tension between higher interest rates and market valuations will persist as monetary policy becomes less supportive of growth. Higher interest rates are initially perceived to have very little effect on an expanding economy, but once the rate reaches a certain inflection point and beyond, investors start to discount the increased risk of the next economic downturn and equity markets react negatively.

But it wasn't just the threat of higher interest rates that unnerved global investors. Investment markets reacted negatively to Donald Trump's announced plans to introduce new trade tariffs on imports of steel and aluminium. The argument was that the levies were necessary for national security (a permissible but infrequently invoked reason under WTO rules) and that there would be a fair process. Officials from China and Europe immediately responded and threatened retaliation. The Europeans hinted at introducing countermeasures, such as import tariffs on US jeans, motorcycles and bourbon should Trump go ahead with his plans. Some countries and regions were exempted, either permanently or temporarily, from the tariffs.

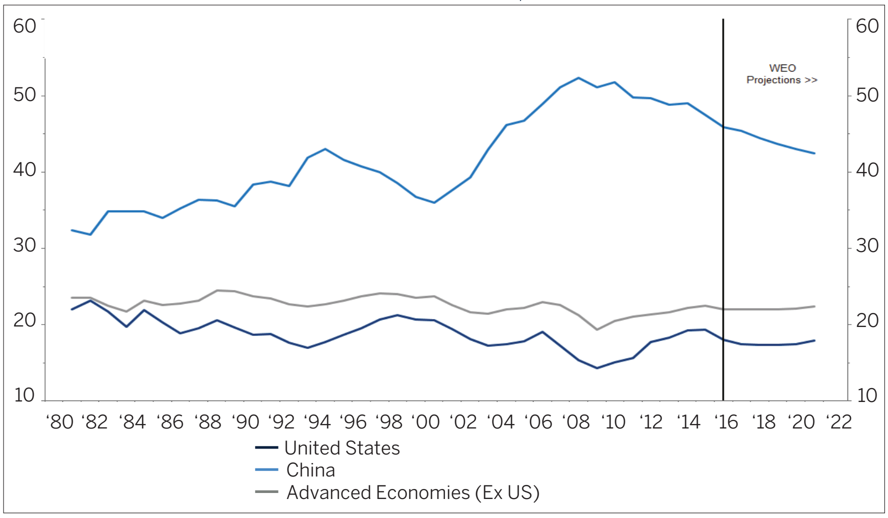
It's a long time since the world had to deal with such an uncoordinated and unilateral approach. Markets are thus concerned that the capriciousness of the implementation and the responses will have uncontrollable outcomes. It wasn't just US trading partners that expressed dissatisfaction - senior Republicans such as Paul Ryan, the House Speaker, warned about the unintended consequences of enforcing such tariffs and viewed it as a tax on US manufacturers and consumers. Gary Cohn, a trusted economic advisor to the administration, announced his resignation shortly after Trump's announcement.

> "The US trade deficit is structural and is a function of a low savings rate."

Part of the focus was on protecting US intellectual property and the metal industry from "unfair" trade practices in China. The plans announced, which later also included tariffs on products such as robots, technology and pharmaceuticals, were deemed necessary to address the $375bn trade deficit with China. Trump also planned to introduce restrictions of Chinese foreign investment on "strategic" sectors in the US. So far, the Chinese reaction has been measured and more precisely targeted.

Differences in trade barriers between the US and its trading partners are only part of the reason for significant trade imbalances. Import tariffs in China have been coming down, but are still higher than US import tariffs overall. Non-tariff trade barriers for US imports into the EU are generally higher than for EU imports to the US, across a wide variety of industries. But the US trade deficit is structural, and is a function of the US's low savings rate (and high levels of consumption), in stark contrast with the historically high savings and investment rate in China. This is a situation which is unlikely to change anytime soon.

GROSS NATIONAL SAVINGS, % OF GDP



Source: Factset Research System

In the end, common sense ought to prevail: the US has a material interest in China's success. The income generated by companies such as Apple and General Motors in China is very substantial. Revenues of US companies operating in China were estimated at $223bn in 2015. General Motors manufactures and sells more vehicles in China than it does in the US. A retaliation by the Chinese authorities against US subsidiaries doing business in China could clearly have detrimental consequences to the long-term growth prospects for these companies.

But the threat for investment markets is that long-term trade relations between the US and its most important trading partners are bungled to such an extent that large-scale economic damage is done. At the worst, sanctions are instituted against specific companies.

"Investors should position themselves for lower and more volatile returns."

If global trade 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 won't 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 from the protected domestic industries over time as they become less incentivised to invest in new technologies and innovation.

"Trade wars are good and easy to win" asserted Mr Trump via Twitter. They are neither.

Conclusion

Economic fundamentals remain positive and the outlook for earnings growth above trend, but some of the growth vectors such as interest rates and global trade have changed direction. Valuations have corrected somewhat, but the margin of safety at current levels remains relatively unattractive.

Investors should position themselves for lower and more volatile returns than what they have been accustomed to over the past few years. Portfolios are well diversified and we stand ready to participate in investment opportunities as they unveil themselves.

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