Quarterly Commentary as at 31 December 2017

MelvilleDouglas
A Member of Standard Bank Group

Melville Douglas

High Alpha Fund

Quarterly Commentary

The quarter was another strong one for equity. The JSE was up over 7%, boosted at the end by strong performance from financials and other sectors sensitive to domestic SA demand. The portfolio's equity outperformed the market in the quarter, helped by its overweight position in financials but also by some specific retail exposure that were up very strongly. The underweight holding in Naspers continued to be a negative factor on a relative basis, and the fund's IT holdings did poorly. Consumer services, financials, industrials and real estate returned 15%, 19%, 20% and 16% respectively over the quarter. Relative performance was helped by the lack of any exposure to Steinhoff or its related companies. The Steinhoff collapse started with the company delaying the release of its 2017 financials, and then announcing "accounting irregularities" and firing the chief executive. The company has significant liquidity problems and it will be some time before the full story is revealed. It may turn out to be one of the largest corporate failures in SA history. We did not own it because we could not assess too many risks, and because the wider group has a poor governance history in respects we think are particularly important. The rand strengthened over 10% against the US dollar in the quarter, undermining the return from the rand hedges and the tactical position in global equity holdings which did well in dollar terms.

2017 produced high returns for equity investors, both globally and in SA. High returns globally were supported by strong earnings growth, but were also the result of much higher ratings: as the year progressed investors became more convinced that low interest rates were here to stay. 2018 may prove less straightforward globally. Strengthening economic growth and the US's additional fiscal push at a moment of low unemployment may prove to be a combination that tests the limits of the "new normal": the Fed may be forced into more aggressive action sooner than it thinks. In SA, nothing was straightforward at all: because of the politics, markets lurched from one cabinet reshuffle to the next rating downgrade threat and back again, and then had to endure the Steinhoff disaster. In the end, the ANC elective conference outcome (in which Cyril Ramaphosa was elected ANC president and who is therefore the country's president-in-waiting) was taken very kindly by markets even though it was ambiguous as to how much decision-making power rests in the new president's hands. The rand strengthened sharply and the long bond yield fell. Greater policy clarity, specifically on the issue of fiscal sustainability (which president Zuma has done his best to undermine) will emerge over the nest quarter. This will be key for the outcome of the next rating review, due from Moody's in March. A more stable political environment will also boost consumer and business confidence; if so, the Reserve Bank has plenty of scope to support a recovery by reducing interest rates. Some SA assets are no longer cheap, but the domestic economy has lagged the world badly, and it now has an opportunity to correct that. The political situation is not fixed, and the global uncertainties will rise as 2018 advances. Investors need to be wary of prices, diligent regarding valuation and be sure that diversification is adequate.