Communiqué

Monthly

South Africa

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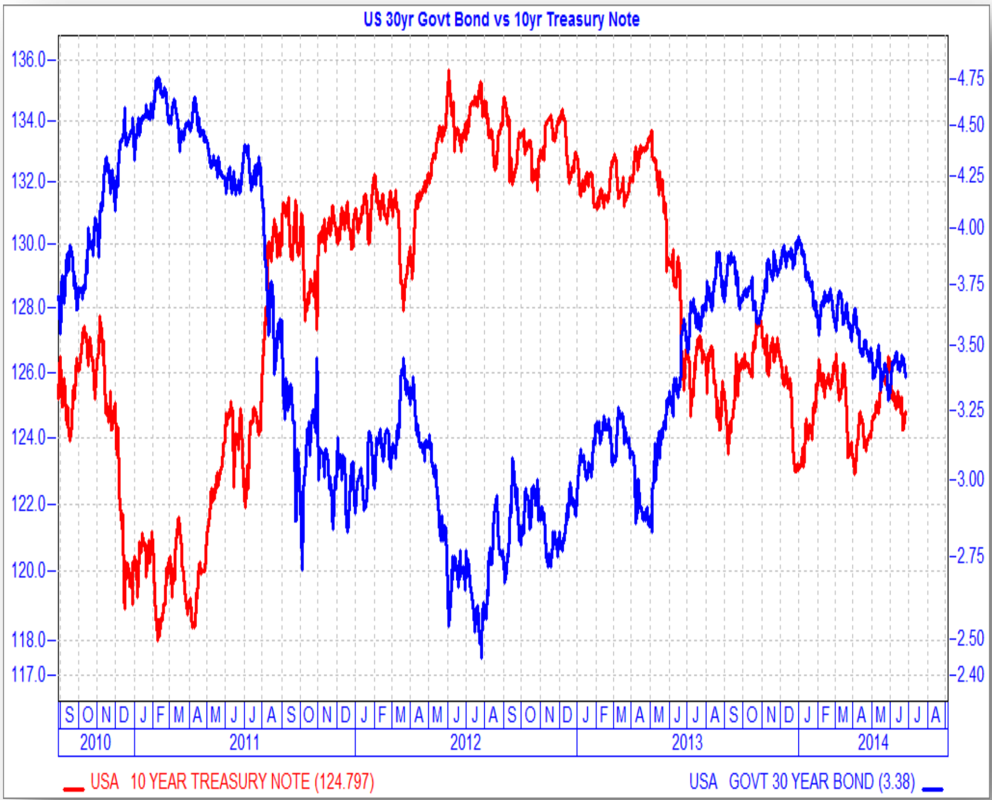
It's about transparency and complacency

International



The biggest consequence of the US Federal Reserve's zero rate policy and heightened policy transparency has been disappearing volatility in asset prices. Bond yields continue to decline and equity prices continue to go up as investors search for yield in an environment of low inflationary expectations and fear of deflation in certain developed markets. Both bonds and equities are pricing in very low inflation, good earnings and job growth as well as an extended period of low to zero interest rates globally. Emerging markets in particular have benefited from increased investment flow due to higher yields and the re-emergence of the "carry trade".

A good indicator of complacency amongst investors is that yield spreads (the gap between Government bonds and Treasury bonds) have narrowed sharply, indicating that investors are not differentiating between assets with different risk characteristics.

Also the VIX index (Chicago Board Options Exchange Market Volatility Index), a popular measure of the implied volatility of the S&P500 index, is trading at near ten year lows whilst the S&P500 is trading at an all-time high as can be seen in the chart below.

Source: Streettalklive.com

The risk of a correction in global markets has therefore increased of late. We think that heightened deflation might not be the trigger for a sell-off, as this is mostly priced in, but that a surprise in higher inflation might cause investors to sell risky assets like bonds and equities. Although the FED continues to utter dovish remarks around the economic recovery not being accompanied by rising inflation, we view that an unexpected rise in inflation in the US to be the main risk for world markets. Jobs data as well as wages in the US continue to improve and the possibility exists that consumption might recover faster than expected, spurring a rise in inflation. In that event, the FED might have to act sooner in hiking interest rates. That event will be particularly onerous for emerging markets due to the large investment flows from developed markets into emerging markets recently.

However, we do not ascribe a high likelihood for this to happen in the near term as core consumer price inflation in the US of 1.4%, although picking up, is well below the FED target of 2%. Generally, economic data from the US is indicating that the recovery is gaining momentum so the next move in interest rates is likely to be up. But when, we just don't know yet, hence our viewpoint that inflation is the key number to keep an eye on. What complicates matters somewhat is that rising inflation, initially, is usually good for company profits as price increases get passed on to the consumer. That is of course before rising interest rates spoil the party.

The picture in Europe is mostly juxtaposed to that of the US. Deflation and potentially dipping back into recession rem ain major risks. Following months of being behind the curve, the ECB (European Central Bank) eventually acted. ECB President Mario Draghi announced a reduction in deposit rates from zero to minus 0.10 percent, making the institution the world's first major central bank to use a negative rate. Policy makers also lowered the benchmark refinancing rate to 0.15 percent from 0.25 percent. Various other measures were also put in place to stimulate lending to smaller privately owned businesses by European banks. Following the announcement, Draghi made it clear in the press conference that if these measures didn't work to boost inflation, the ECB was willing to take further steps, including a possible QE program of asset purchases, "we are not finished yet", he said. In May, the European inflation rate was a low 0.5%, well below the ECB's target of 2%.

In China, first quarter GDP growth slipped to 7.4% from 7.7% in the previous quarter, slightly ahead of analyst forecasts. The weakening growth signals are likely to prompt Beijing to step up measures aimed at supporting growth. The government recently announced a series of "mini-stimulus" measures to offset the slowing growth momentum which will include increased expenditure in railroad infrastructure, water, energy and rebuilding of shantytowns in urban areas. To quote Mr Li Wei, an economist from Standard Chartered, "The economy will rely on investment for some time to come. Without support, economic growth will continue to weaken". Mr Wei added that he expects some monetary-policy support such as a reduction in banks' reserve requirement ratios in the second half of the year to further aid growth.

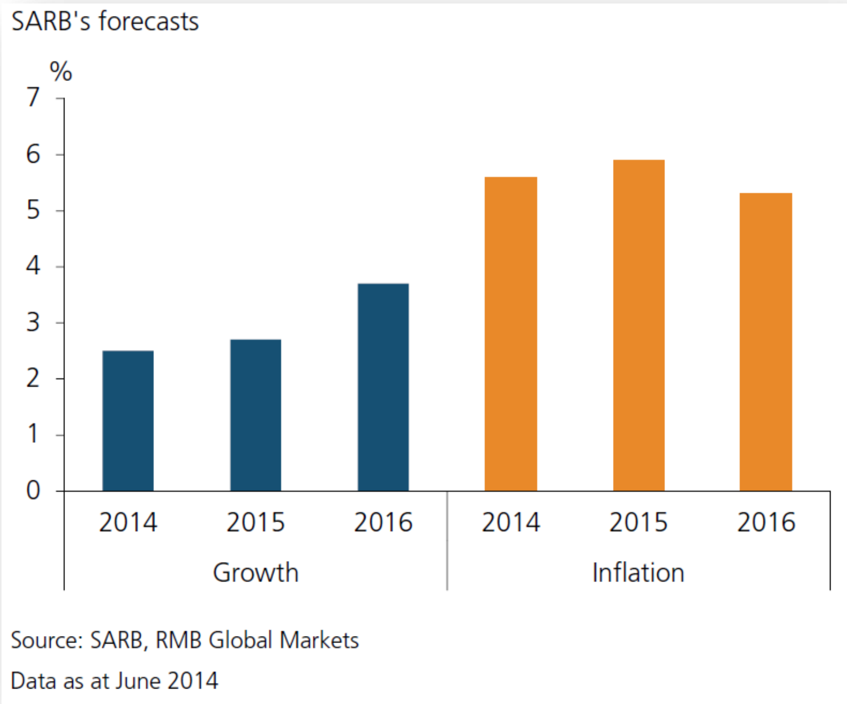
We remain of the opinion that growth will surprise on the upside supported by recent data indicating that manufacturing production is on the increase as can be seen in the latest manufacturing PMI reading. More importantly, as can be seen in the chart below, the PMI readings continue to trend upwards after reaching a low in February this year.

In summary then, the global economic recovery remains more or less on track, albeit slow, mainly driven by Germany, the US and China. However, tail end risks have increased particularly in the rest of Europe, prompting the ECB to cut key interest rates. The sustainability of continued growth in China at around the 7.5% mark and policy actions by the US FED remain the key factors going forward. This is particularly relevant for investment flows into emerging market stock markets.

Global equity markets appear fully valued in the near term but are likely to remain high as inflation globally remains under control and a risk of deflation in Europe. Low volatility in asset prices and complacency amongst investors are of concern in the sense that any bad news on the economic front could trigger a sell-off. But we estimate the risk of a material sell-off rather remote due to excess liquidity in the financial system and the search for yield by investors (bar the FED and China risk).

South Africa

The good news on the labour front that AMCU and the mines have reached an agreement came a little too late. It was interesting to note that an agreement in principle was reached a day before ratings agencies were due to release their latest foreign currency ratings for South Africa, the hope being that a downgrade might be prevented. But the damage was done. GDP growth forecasts have been slashed to 1.9% for 2014 due to the broader negative impact of the labour strikes on the economy. Fitch downgraded our foreign currency long term rating to BBB (one notch above junk status) with a negative outlook from stable previously. S&P downgraded us to BBB- from BBB previously with a stable outlook from negative previously. The downgrades were however expected and had little impact on markets. The rand weakened slightly after the announcements reaching the R10.83 level to the dollar before strengthening again to R10.60 currently. Rating risk will likely remain high due to low economic growth, continuing labour issues and a widening current account deficit which in turn might cause the rand to weaken further. A return to a more positive stance by rating agencies will be very difficult without a substantial narrowing of the current account deficit and a material improvement in the outlook for GDP growth. In fact, a further deterioration in labour relations, which is highly likely, could see growth being downgraded even further. More downgrades are therefore very likely.

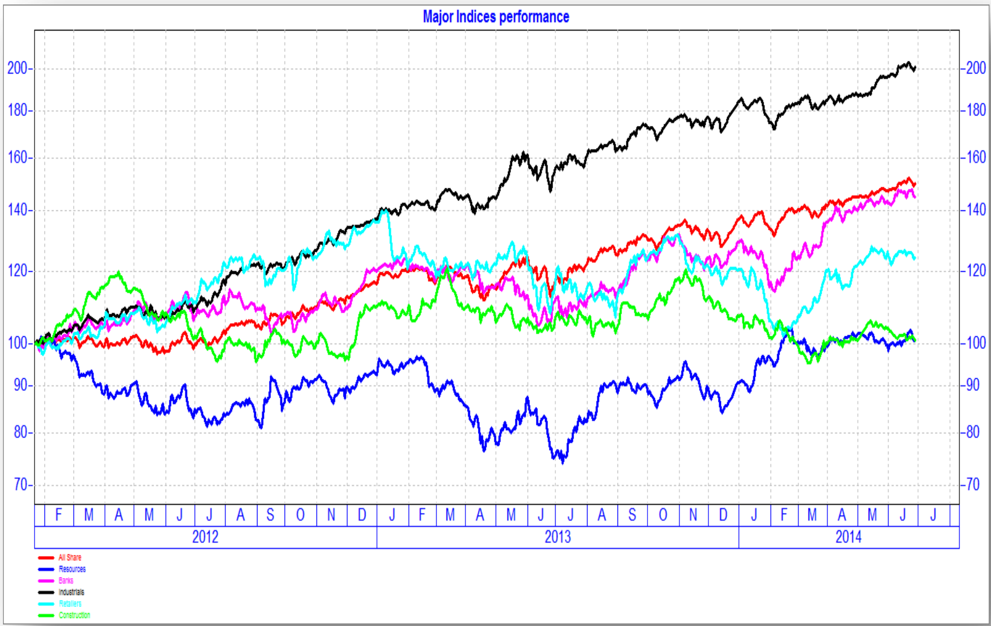


Source: SARB, RMB Global Markets
Data as at June 2014

The local economy continues to suffer from stagflation, meaning high inflation, low growth and rising unemployment. CPI for May came in at 6.6% year on year from 6.1% previously. Again, although way above the 6% target set by the SARB, was expected. The tone of the SARB remains hawkish on the inflation front but given the low growth rate and sluggish consumer expenditure we expect interest rates to remain stable for now. However, if inflation does not start falling soon (the stable rand should help) the SARB runs the risk of falling behind the curve and will have to act eventually but the reaction should be moderate. To quote the SARB: “With domestic growth weak, and world inflation and interest rates low, monetary policy tightening is likely to be moderate. Monetary policy is in a rising interest rate cycle and will align to the speed of global policy normalisation”. The SARB expects inflation to peak at current levels before declining to 5.8% in 2015.

On the investment front, along with other emerging markets, SA has benefited from sizable portfolio inflows following dovish comments by the US Federal Reserve regarding the timing of rising interest rates ("rates to remain low for a long time") and the search for yield by global investors. But we view this as a key risk as discussed previously in the event of inflationary pressures in the US emerging (higher interest rates sooner rather than later) and China disappointing.

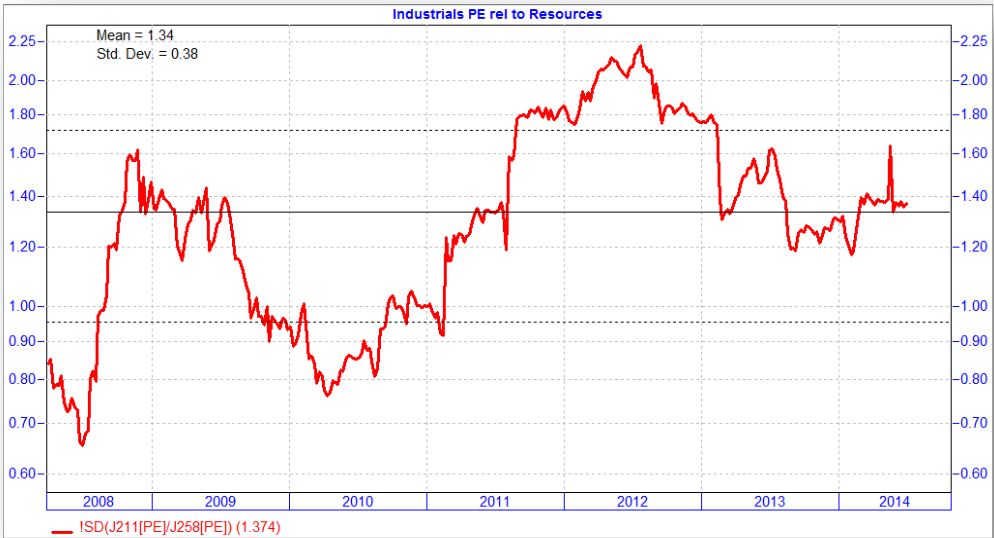
The JSE All Share is up 10% year to date and up 30% over a one year period. As can be seen in the chart below, the star performers year to date have been banking stocks and industrials. Retail stocks had a good start to the year but are starting to underperform. Resources and construction stocks remain in the doldrums.



The market is currently trading on a historic price earnings ratio of 18.1x and on a forward price earnings ratio of 14.9x mainly due to big reratings in industrial rand hedges which are overvalued given earnings expectations. The problem however is that they could remain so for a while given the search for yield by foreigners.

From a valuation perspective, as can be seen in the chart below, industrial counters are trading at nearly a 40 percent premium (22 PE) to resources, which appears excessive but it's important to bear in mind that if one strips out the expensive rand hedges such as Richemont, Naspers and Remgro the ratio reduces to a level more or less on par with the market in general.

Despite our market as a whole appearing somewhat expensive there remain select opportunities to buy quality shares for investors with a long term investment horizon. For reasons mentioned above, foreign buying, no surprise from the FED and sustained growth in China, the probability of a large correction is not material. But risks have increased and any bad news could unsettle the market which will be healthy in our mind and we might use that as a buying opportunity.



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INVESTING IN AFRICA

To conclude

- The biggest consequence of the US Federal Reserve's zero rate policy and heightened policy transparency has been disappearing volatility in asset prices.
- Both bonds and equities are pricing in very low inflation, good earnings and job growth as well as an extended period of low to zero interest rates globally.
- Emerging markets in particular have benefited from increased investment flow due to higher yields and the re-emergence of the "carry trade".
- A good indicator of complacency amongst investors is that yield spreads (the gap between Government bonds and Treasury bonds) have narrowed sharply, indicating that investors are not differentiating between assets with different risk characteristics.
- Given deflation in Europe, the ECB finally acted by dropping deposit rates from zero to minus 0.10 percent. Policy makers also lowered the benchmark refinancing rate to 0.15 percent from 0.25 percent and stated "we are not done yet". Some form of QE can therefore not be ruled out.
- In China, growth appears to be slowing, however, measures such as increased fixed investment spending are being undertaken to accelerate growth. To quote Mr Li Wei, an economist from Standard Chartered, "The economy will rely on investment for some time to come. Without support, economic growth will continue to weaken".
- Locally, the good news on the labour front that AMCU and the mines have reached an agreement came a little too late.
- Both S&P and Fitch downgraded SA's credit rating and risks are mounting for more downgrades in due course as a result of continued labour unrest and poor GDP growth.
- The market is currently trading on a historic price earnings ratio of 18.1x and on a forward price earnings ratio of 14.9x mainly due to big reratings in industrial rand hedges which are overvalued given earnings expectations. The problem however is that they could remain so for a while given the search for yield by foreigners.
- Risks have increased and any bad news could unsettle the market which will be healthy in our mind and we might use that as a buying opportunity.

Sincerely

Chris

<u>Chris Botha</u>

Dave

<u>Dave Eliot</u>

STRONG IN NAME. RESOLUTE BY NATURE