IMARA
INVESTING
IN AFRICA
Asset Management

Communiqué

Monthly

South Africa

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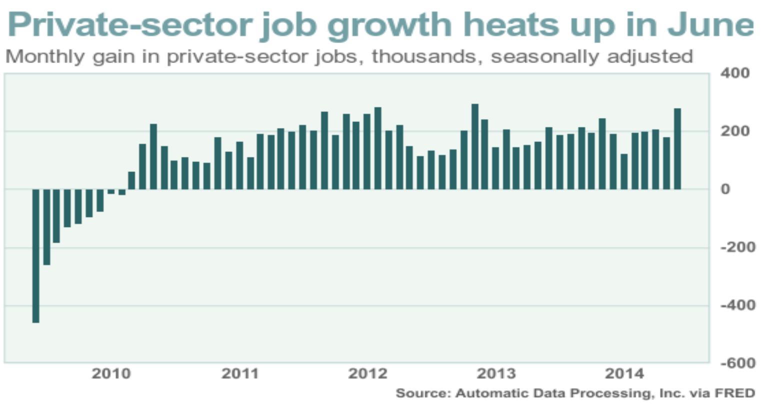
Focus on economic indicators

International

Global equity markets remain resilient and at elevated levels despite heightened geopolitical tensions. Viewing asset prices purely from a valuation perspective can, however, be misleading as stock markets may stay over or undervalued for protracted periods of time due to many external factors. Over the long term share prices are mainly influenced by underlying profit growth, interest rate cycles and inflationary expectations.



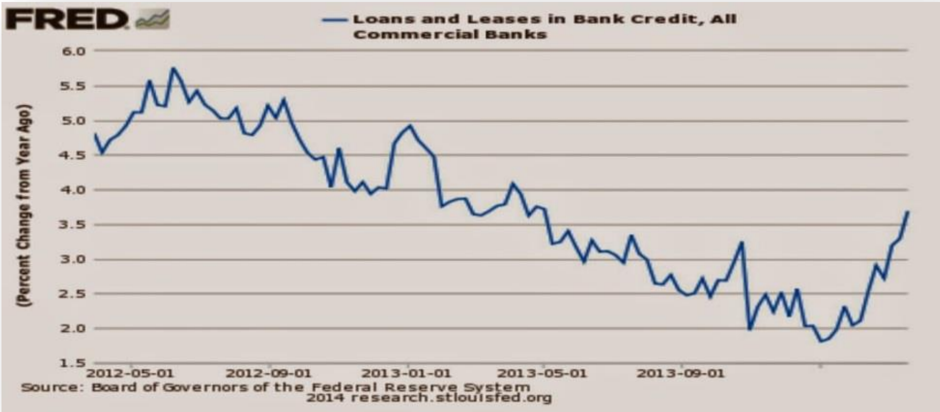
In theory, the value of a share is the sum of expected future profits divided by a risk-free interest rate of similar duration.

Company profits will be impacted by both economic factors and the level of interest rates and of course, management. Rising inflation initially supports company profits due to profit margin expansion (increased prices) and is particularly beneficial in a stable interest rate environment. Rising interest rates will eventually have a negative impact on consumer expenditure and cost of funding for companies, which in turn could cause share prices to decline.

Economic data in the US, in particular, continues to indicate that the recovery remains intact. In fact, the risk of the FED potentially falling behind the curve in terms of the timing of raising interest rates has increased due to the underlying strength of the recovery. In particular, the job market appears to be gathering pace with reported data regularly above expectations. Core inflation is also picking up albeit at a measured pace. The one problematic area could be the housing sector which has shown little evidence of progress.

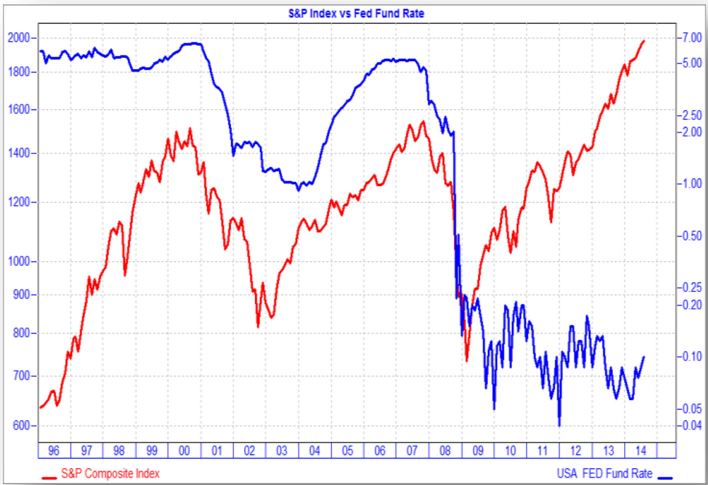
To quote FED chairwoman Janet Yellen, “If the labour market continues to improve more quickly than anticipated by the committee, resulting in faster convergence toward our dual objectives, then increases in the federal funds rate target likely would occur sooner and be more rapid than currently envisioned.

Conversely, if economic performance is disappointing, then the future path of interest rates likely would be more accommodative than currently anticipated". It is therefore likely that at present, markets will mostly react to economic data rather than company specific fundamentals. It is noteworthy to mention that in general reported company results in the US continue to beat estimates. 75% of S&P constituents beat profit expectations during the previous quarter.

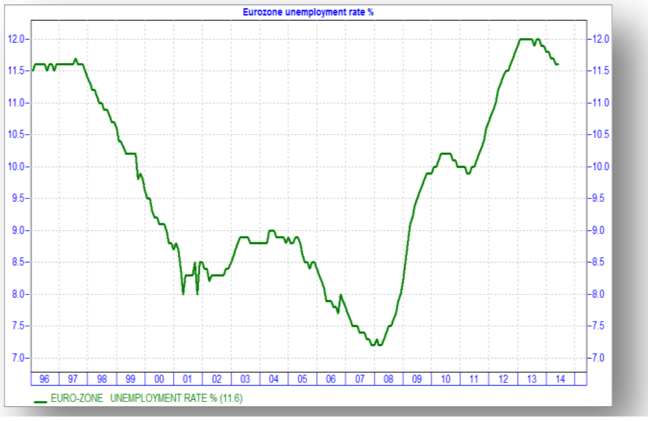


A further sign that the US economic recovery might be gathering pace is acceleration in bank loans to households which should bode well for private consumer expenditure and is likely to ensure that the current pace of economic recovery will be sustained.

Global markets are likely to closely monitor inflation statistics and comments by the FED in coming months. It is interest rate expectations that matter most, not the end of QE, as this is largely discounted. When the expected timing of interest rate hikes become clearer a correction in global stock markets will probably be inevitable. However, it is likely that it will be relatively short lived as rising interest rates typically indicate a healthy, growing economy, which bode well for company profits, provided that inflation remains subdued. A low or deflationary environment accompanied by good economic data has historically always been positive for equity prices. However, as can be seen by the chart, the prospects for a correction are material on the S&P Composite Index in the event of interest rates going up. It also shows the extent of the impact of cheap money (QE) on the level of the S&P index. It was the main driver of the 140% return in equities since the financial crises emerged in 2008.



In Europe things remain much the same. The worst part of the economic crises seems to be over but the pace of economic recovery is struggling to gain momentum and is at risk of faltering. The IMF's viewpoint is that the ECB should ease key lending rates further and embark on a form of QE to stimulate final demand which is being hampered by high unemployment (see chart below – note the sharp increase since the commencement of the financial crises) and no wage increases.



Excessive saving both by corporates and individuals remains problematic and is unlikely to change any time soon given the lack of economic growth. The IMF has downgraded their growth forecast for the Euro region to 1.0% for 2014 from 1.1% previously and has highlighted the risk of deflation in the region.

Along with the US, China remains the glimmer of hope for a sustainable global economic recovery. After focusing on structural reforms in the economy, Beijing has somewhat changed course in that they have reverted back to setting a specific growth target rate for the economy, set at 7.5%. Published GDP growth for the second quarter was 7.5% compared to expected growth of 7.4 %(see chart alongside).

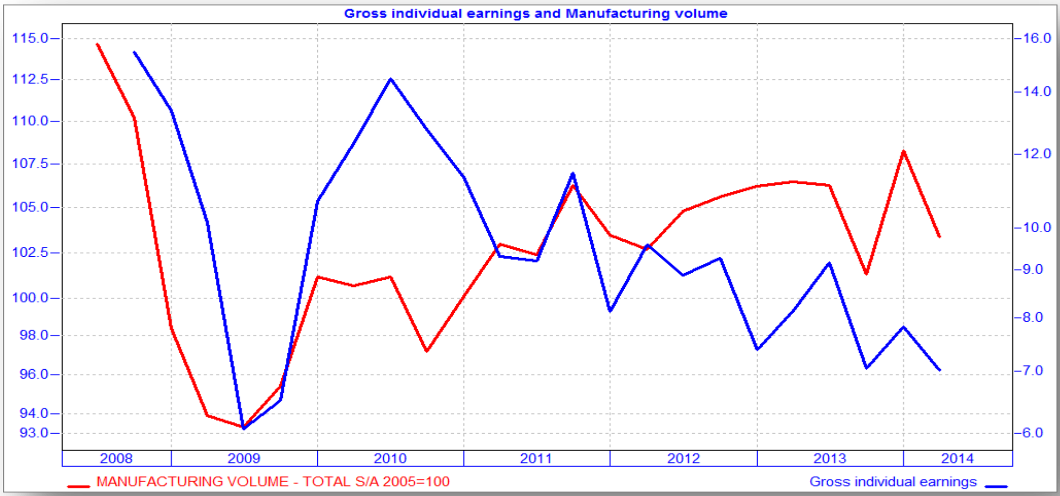
They also have made it clear that they will remain accommodative to ensure the recovery does not lose momentum. Fiscal expenditure surged by 26.1% year on year in June 2014, which is at a two year high. The housing market continues to soften which will impact construction activity, hence the increase expenditure on infrastructure. Furthermore, authorities have adopted a more pragmatic approach in lending activity after indications of stricter supervision in new lending. The number of new loans (see chart) both in the regulated and shadow banking sectors continued to increase in June 2014.

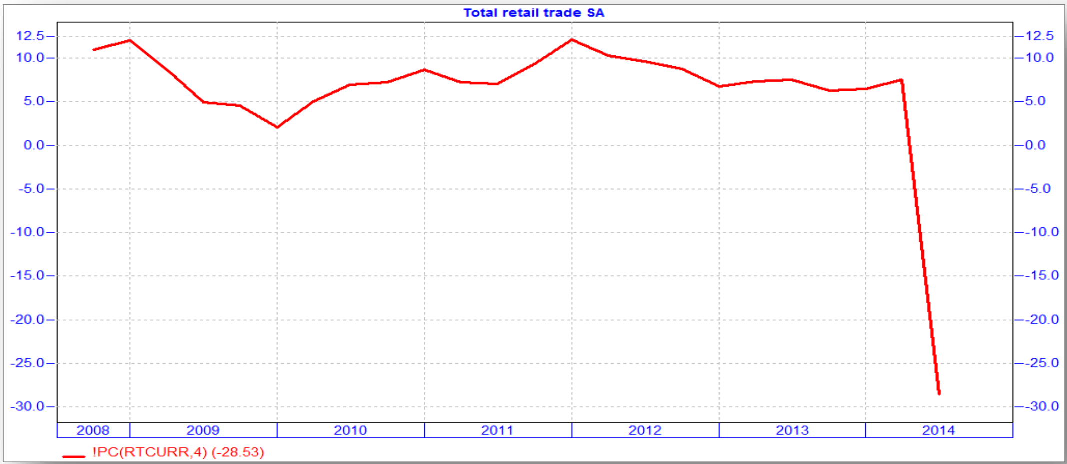
In a nutshell then, the US and China are likely to remain the main drivers of the global economic recovery with Europe still at risk of dipping back into recession. Global equity markets are at heady levels but could remain high as long as there are no surprise movements by the FED with regards to the timing of increasing interest rates in the US. Consensus is that interest rates should remain low for quite some time; however, the likelihood of the FED falling behind the curve has increased as the economy gains momentum.

South Africa

As expected, market volatility has increased lately as investors, both local and foreign, grabble with the timing of a change in the interest rate cycle in the US. The SARB surprised the market somewhat by increasing the repo rate by 25bp recently sighting heightened inflationary expectations despite a slowdown in economic growth and poor consumer environment. Our sense is that this was a pre-emptive move to realign our interest rate cycle with that of the US when rates start rising there. Local inflation (CPI) increased by 0.3% in June 2014 and by 6.6% year on year, slightly lower than expectations [6.7%]. Most economists anticipate that we are now near peak inflation and that with the firmer rand the pressure for further rate hikes is somewhat diminishing.

Investment sentiment remains fairly mixed with participants turning more nervous about the high level of our equity market. A correction [not a crash] is widely expected. However, reported earnings growth remains good supported by the weaker rand; the only real catalyst for a pullback remains future potential actions by the FED and the timing thereof.
The on-going SA labour unrest in general has had little effect on our markets. Foreign sales of our bonds and equities could be a risk factor in the event of prolonged labour unrest. The strikes in both the mining industry and now industrial sectors of the economy have had a profound impact on local production as well as gross earnings of workers which does not bode well for the deteriorating consumer environment(see charts below).





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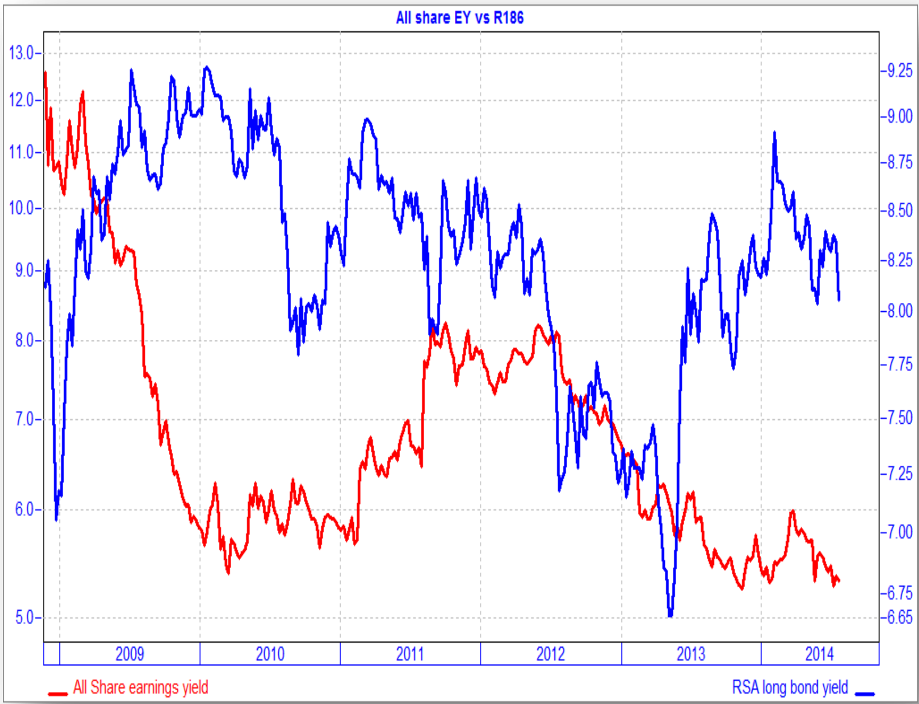
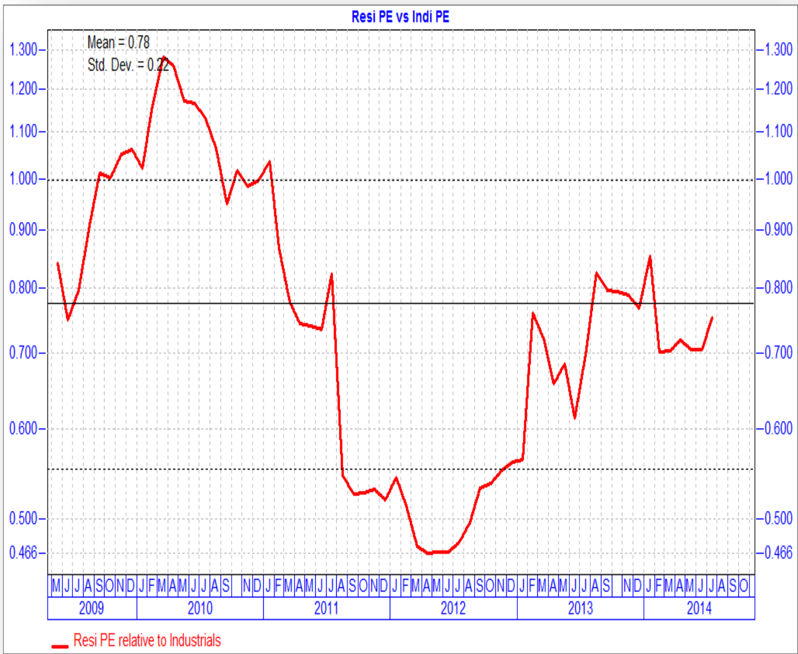
Local equities continue to trade at historically high levels; companies are reporting surprisingly good profits and the main risk to our mind remains the US Federal Reserve's action on interest rates. The equity risk premium (Difference between Equity Earnings Yield and Government Long Bonds) is currently trading at 2.9% which has increased by a fair margin over the last quarter. The gap is unlikely to be narrowed by a drop in long bond rates given the change in our local interest rate cycle (interest rates likely to go up more in due course – according to the SARB) and potential rate hikes in the US in 2015. The earnings yield will increase in the event of a decline in share prices or rising company profits. The risk for the former event to occur has increased due to potential actions by the FED and capital flight out of emerging markets. It is also clear from the chart below that both the bond market and equity market is of the opinion that we are not entering a changing interest rate cycle and has mostly shrugged off the recent repo rate hike and hawkish comments by the SARB around inflation and future interest rate hikes. Therein lies the problem!



At sector level, large industrial rand hedges appear the most overvalued with some value still apparent in the smaller and mid-market capitalisation shares. We are currently investigating further potential investment opportunities in this space.

We are turning more optimistic from a long term perspective on commodity counters given the favourable outlook for the Chinese and US economies. Resource stocks are trading at a 25% discount to industrial counters in terms of price earnings multiple (PE) and are likely to rerate relative to the industrial index in due course.



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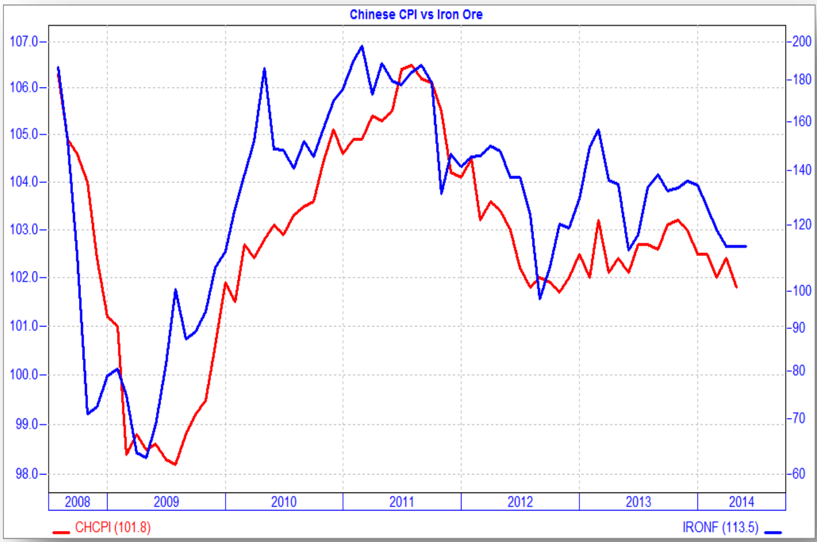
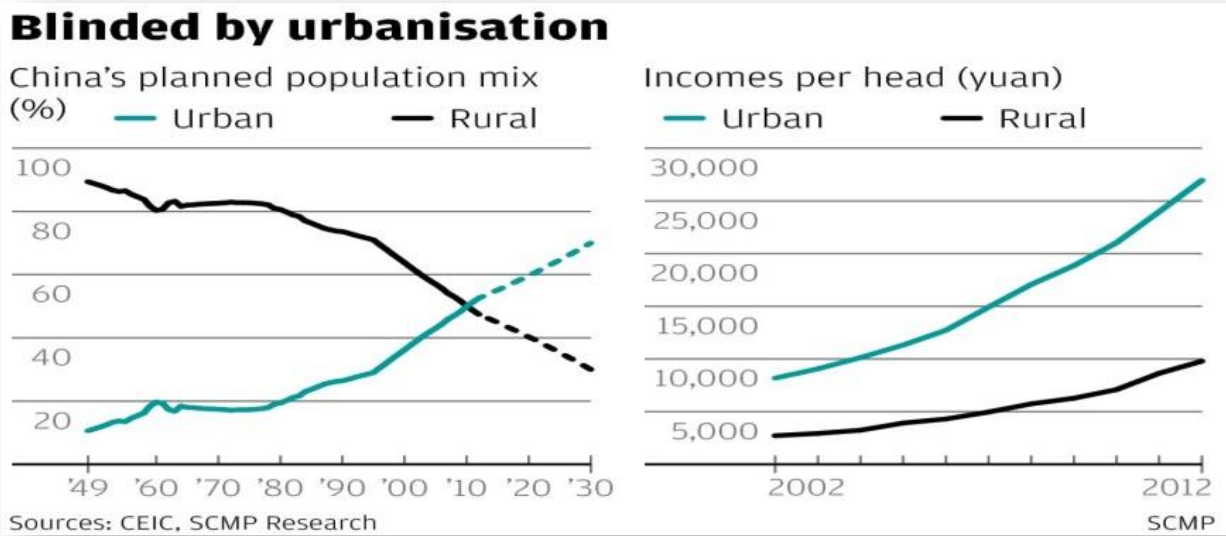


The argument for resource counters can further be supported by the high correlation between the local resources index, iron ore, and inflation in China. They are the largest global consumer of iron ore and thus growth prospects there, have a major impact on commodity prices. Rising consumer inflation suggests accelerating economic growth and consensus estimates are expecting inflation to rise in China.

Rapid urbanisation and growing middle class in China remains a structurally bullish scenario for commodities over the long term. (See chart below).



In summary then, the local equity market as a whole appears overvalued on an historic PE of 18.8X, but valuations are heavily skewed towards large industrial rand hedges. Excluding the handful of highly priced industrials, the normalised multiple drops to about 17X, more or less in line with its long term mean average. So, stock selection remains the key factor. The main catalyst for a correction in local markets will be actions by the US Federal Reserve regarding their interest rate policy.

To Conclude

- Global equity markets remain resilient, but at elevated levels despite heightened geopolitical tensions
- Economic data in the US continues to indicate that the recovery remains intact. The risk of the FED falling behind the curve in terms of the timing of raising interest rates has increased due to the underlying strength of the recovery. The FED continues to be fairly dovish in their communications around interest rates, which are likely to remain low for some time to come.
- It is probable that markets will mostly react to economic data rather than company specific fundamentals
- In Europe, the worst part of the economic crises seems to be over but the pace of economic recovery is struggling to gain momentum and is at risk of faltering. The IMF’s viewpoint is that the ECB should ease key lending rates further and embark on a form of QE to stimulate final demand
- The US and China remain the main drivers of the global economic recovery. Beijing has somewhat changed course in that they have reverted back to setting a specific growth target rate for the economy, [7.5%]. Reported GDP growth for the second quarter was 7.5% compared to expected growth of 7.4 %
- The SARB surprised the market somewhat by increasing the repo rate by 25bp recently, sighting heightened inflationary expectations despite a slowdown in economic growth and poor consumer environment. Our sense is that this was a pre-emptive move to realign our interest rate cycle with that of the US when rates start rising there
- Local inflation (CPI) increased by 0.3% in June 2014 and increased by 6.6% year on year, slightly better than was expected. Most economists anticipate that we are now near or at peak inflation
- Sentiment remains fairly mixed but investors have turned more nervous regarding the level of our local equity market and a correction of some sort is widely expected with actions by the FED potentially the main catalyst
- At sector level, large industrial rand hedges appear the most overvalued with some value still apparent in the smaller and mid-market capitalisation shares.
- We are turning more optimistic from a long term perspective on commodity counters given the favourable outlook for the Chinese and US economies. Resource stocks are trading at a 25% discount to industrial counters in terms of PE and are likely to rerate relative to the industrial index in due course.
- Excluding the handful of highly priced industrials, the normalised multiple on our market drops to about 17x, from 18.8X, more or less in line with its long term average

Sincerely

Chris

Chris Botha

Dave

Dave Eliot