IMARA INVESTING IN AFRICA

Asset Management

Communiqué

Monthly

South Africa

October 2014

Imara Asset Management South Africa
257 Oxford Road, Illovo. Johannesburg
+27 11 550 6181

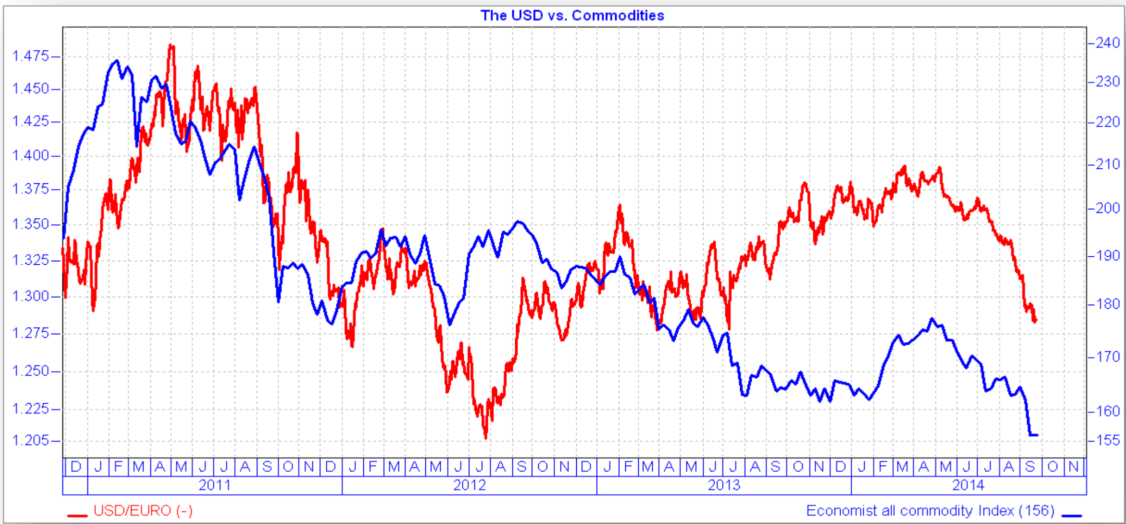
A Tale of two cities

International

The US and the Eurozone are juxtaposed in terms of economic growth and interest rate cycles. The Eurozone in particular remains characterised by too much saving and hardly any spending. It is widely anticipated that some form of outright QE will be needed soon to diminish the risk of deflation. Borrowing cost in the Eurozone is expected to remain low for an extended period of time.

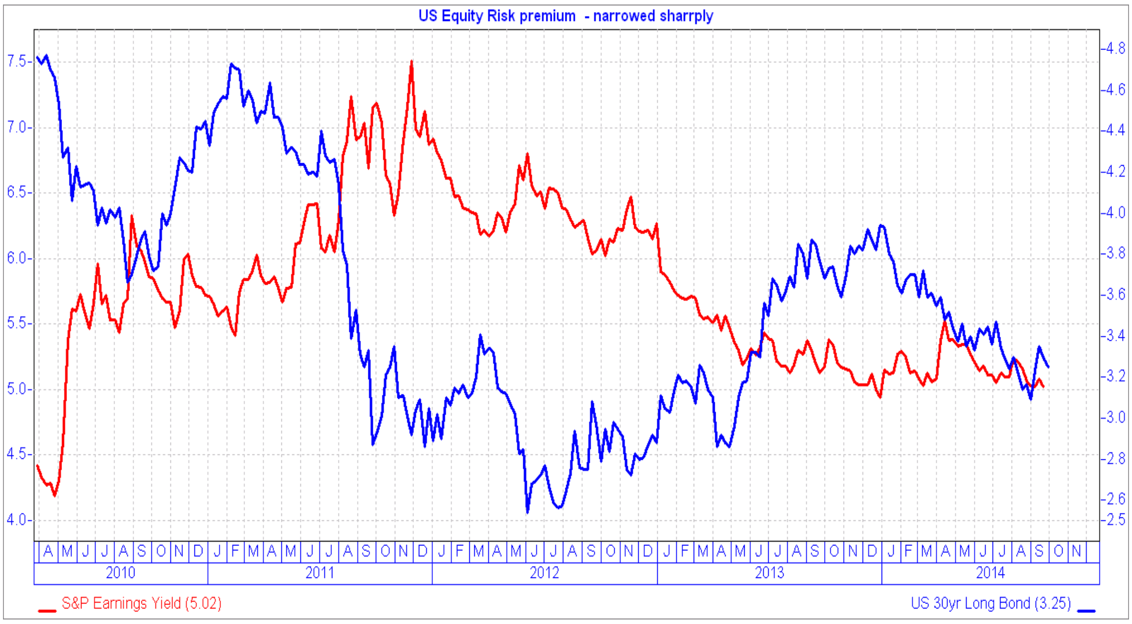
The FED on the other hand is in a different cycle. The US economy grew by 4.2% in the second quarter on an annualized basis but this does not necessarily indicate a sharp increase in economic activity as growth plunged in the first quarter. The strong rebound in growth is largely due to a low base in the previous quarter. Overall growth for the first half of the year came in at a sluggish 1%. The FED will remain data dependant in its decision on the timing of hiking interest rates (expected by mid-2015) and we remain almost certain that it will be implemented cautiously in order not derail the economic recovery. It is therefore likely that the dollar will continue to stay firm relative to other major currencies due to expectations of higher yields in the US.

This will invariably weigh on commodity prices which will be exacerbated by potential slower growth in China. The chart below indicates the negative impact a relatively strong dollar (declining red graph – dollar strength against the



Euro) has on commodities in general (declining blue line).

The impact on emerging markets could potentially be negative in terms of GDP growth. A stronger dollar could also cause an outflow of foreign investors whom in many cases are funding widening current account deficits in emerging markets (including SA). This will force many emerging markets to increase their interest rates to realign with the US in an attempt to retain the funding mechanism of their current account deficits despite poor economic growth. Not something to look forward to!



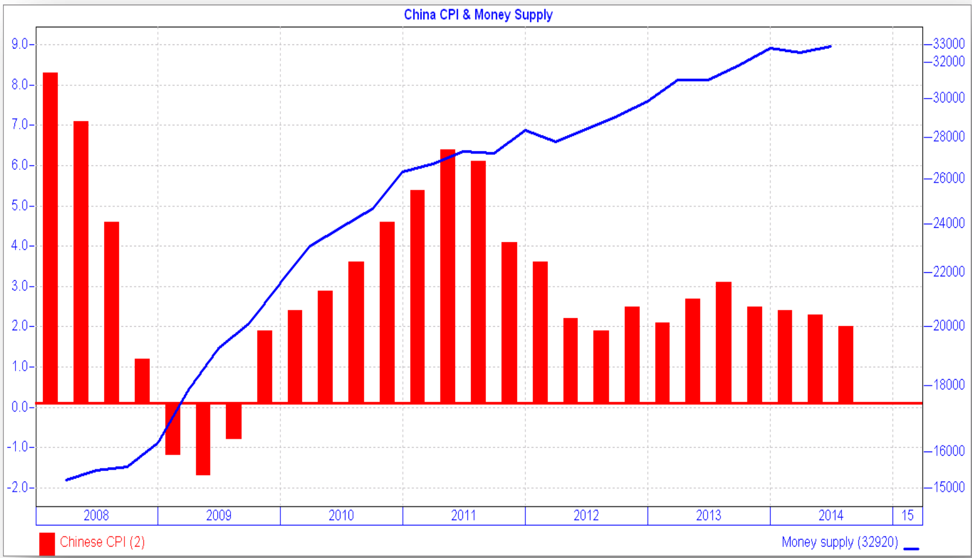
Despite the economic and geopolitical problems, equity and bond markets continue to reach new highs [until very recently] driven by the continuing easy monetary policies with short term interest rates at zero or near Zero.

Earnings optimism in the US in particular is likely to support equity prices for the foreseeable future with the main risk being the timing of interest rate hikes. This is being reflected in decreasing equity risk premia (difference between earnings yield and long bond rate) as can be seen in the chart below for the US.

Faced with deteriorating economic fundamentals in Europe, the ECB recently surprised markets somewhat by further cutting their key policy rates. Following its last monetary meeting, Mario Draghi announced that the deposit rate is now -0.20% and that the benchmark refinancing rate is set at 0.05% and the marginal lending facility was reduced to 0.30%. This, together with other measures, will likely cause a major expansion in the ECB's balance sheet and hopefully in commercial banks as well. The ECB set a target for its balance sheet to expand to EUR3000bn similar to 2012 levels. However, doubt still remains whether this will translate into credit demand (see chart below) in the economy at consumer level, due to continued deleveraging and low consumer confidence. The need for further action by the ECB cannot be ruled out.

In China, markets were somewhat relieved after the manufacturing PMI for September 2014 resumed its positive trend after declining in August 2014 due to a sharp deceleration in industrial production. We

expect the government to remain committed to targeted support measures rather that broad based stimulus to limit the risk of slowing economic growth. Consumer demand and job growth remains steady but the likelihood is



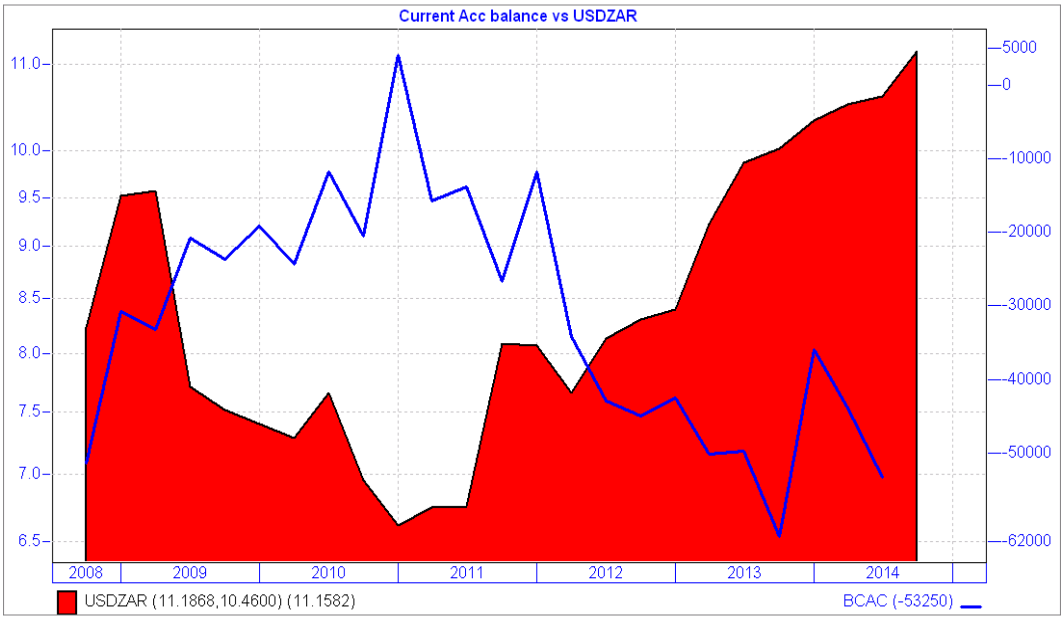
increasing that authorities might use monetary policy to stimulate private consumption as this is their preferred driver of economic growth rather than fixed investment going forward. As can be seen in the chart above, money supply is still on the increase and inflation remains steady which might prompt authorities to cut key lending rates to stimulate consumer expenditure.

Premier Li Keqiang's comments recently accentuated the reform policies rather than broad based stimulus and there is a sense that authorities are willing to accept lower growth than the previously stated 7.5% target level. There was hardly any communication following the weak economic data in August and China could become comfortable with growth in the +7.0%% range as long as the job market improves or at least remains steady. This has already caused heightened volatility in commodity prices and related equities.

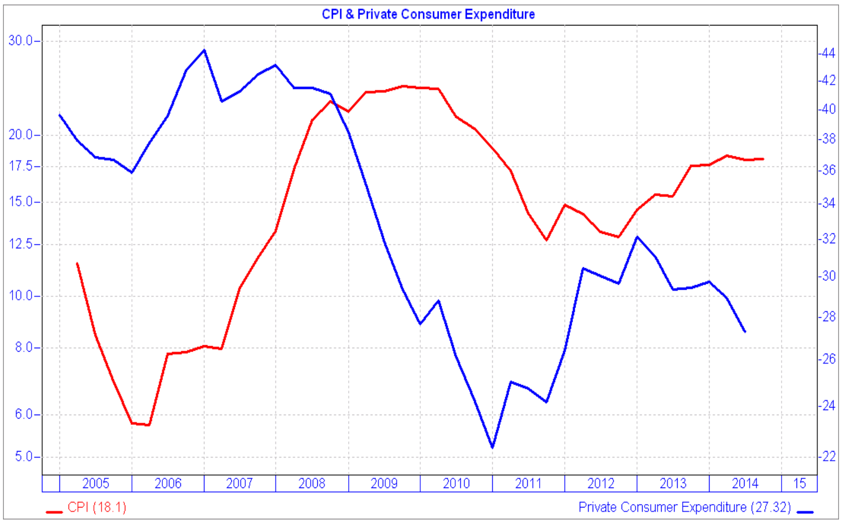
Economic reform in the Chinese economy is needed to ensure more sustainable growth over the long term.

South Africa

A major theme at present is the severe weakening of the rand due to a strong dollar and large current account deficit (mentioned in previous communiqués – see chart below). In the latest MPC meeting, the SARB left the repo rate unchanged but remained cautious on their outlook for inflation. However, their less hawkish stance was before the very recent weakness in the rand. The current weakness in the currency could pose a material threat to inflationary expectations and it is highly likely that interest rates locally will continue to increase[in small steps] in order to alleviate the selling pressure on the



rand; despite poor economic growth and little consumer price inflation.

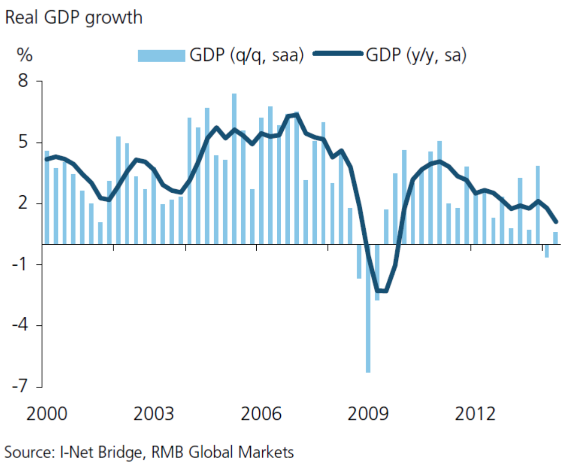


The local economy marginally escaped a recession in the second quarter with a 0.6% increase in GDP after contracting 0.6% in the first quarter. We are looking for around 2% GDP growth this year, consensus has it at 1.9% and investment bank Morgan Stanley dropped its forecast down to 1.3% from 1.8% previously.

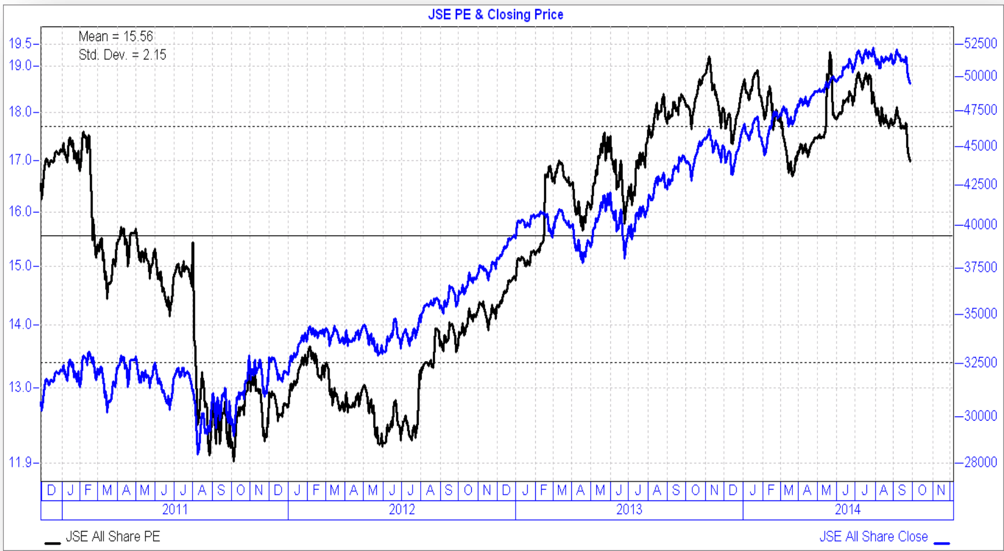
The JSE All share declined by 5% in September with heightened volatility as expected. Foreign selling is likely to put further pressure on our market in the short term as indicated by the weakening rand. The currency impact on earnings however should be positive. The market currently trades on a trailing price earnings ratio of 17x after reaching a high of 19.2x in May this year and is offering far better value at current levels (see chart).

Reported earnings remain very robust and our view remains that our market will largely be driven by expected interest rate movements by the FED and the reaction from the SARB. We remain confident that equities on a 1 year view will outperform interest bearing instruments. Real yields will remain low despite higher interest rates and the risk of capital loss in bonds in

Household consumption expenditure slowed further to 1.5% quarter on quarter in the second quarter 2014. Inflationary pressure is currently mainly driven by administered prices which consumers can do nothing about. The problem however is that a 0.25% or even 0.5% hike in interest rates will in our view not be enough to reduce inflationary pressure by strengthening the rand. Furthermore, as discussed previously, realignment of our rate cycle with that of the US will be a main feature in order to attract foreign funding to finance our current account deficit. Moreover, in theory that is, higher interest should reduce the deficit on the current account as consumers will spend (imports) less. So in many respects raising rates is really all the SARB can do.



Source: RMB Global Markets : 23 Sept 2014



IMARA
INVESTING IN AFRICA

particular has increased due to potential higher interest rates.

To Conclude

- The Eurozone remains characterised by too much saving and hardly any spending. It is widely anticipated that some form of outright QE will be needed to diminish the risk of deflation.
- The FED will remain data dependant in its decision on the timing of hiking interest rates (expected by mid-2015) and we remain almost certain that it will be implemented responsibly as not to derail the economic recovery.
- Emerging markets might be forced to increase their interest rates to realign with the US in an attempt to retain the funding mechanism of their current account deficits despite poor economic growth (particularly SA).
- The ECB recently surprised markets by further cutting their key policy rates. Following its last monetary meeting, Mario Draghi announced that the deposit rate is now -0.20% and that the benchmark refinancing rate is set at 0.05% and the marginal lending facility was reduced to 0.30%.Other measures were announced to try and encourage banks to lend to the consumer/ businesses.
- In China, markets were somewhat relieved after the manufacturing PMI for September 2014 resumed its positive trend after declining in August 2014, due to a sharp deceleration in industrial production.
- Premier Li Keqiang's comments recently accentuated the reform policies rather than broad based stimulus and there is a sense that authorities are willing to accept lower growth than the previously stated 7.5% target level.
- A major theme locally at present is the severe weakening of the rand due to a strong dollar and large current account deficit.
- The current weakness in the currency could pose a material threat to inflationary expectations and it is highly likely that interest rates locally will have to be raised[in small steps] in order to alleviate the selling pressure on the rand.
- Household consumption expenditure slowed further to 1.5% quarter on quarter in the second quarter of this year. Current inflation is mainly driven by administered prices which consumers can do nothing about.
- Consensus amongst economists is for GDP to average 1.9% in 2014 but this number is steadily decreasing with some large investment banks like Morgan Stanley dropping their forecast growth rate down to 1.3% from 1.8% previously.
- The JSE All share has declined by 5% in September with heightened volatility as expected.
- The market currently trades on a trailing price earnings ratio of 17x after reaching a high of 19.2x in May this year and is offering far better value at current levels.

Sincerely

Chris Botha

Dave Eliot