IMARA
INVESTING
IN AFRICA
Asset Management

Communiqué

Monthly

South Africa

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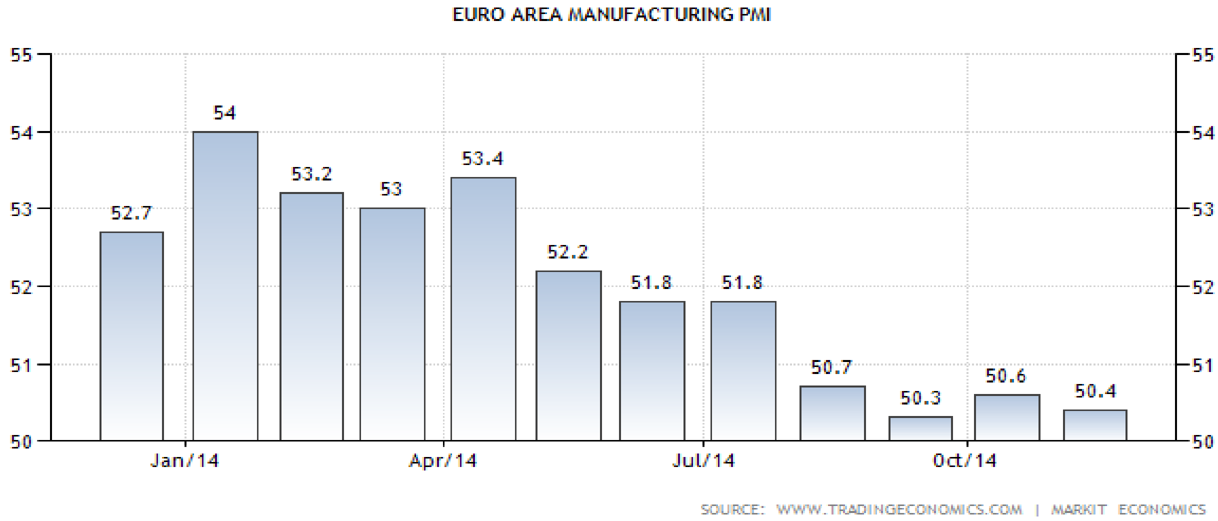
Imara Asset Management South Africa
257 Oxford Road, Illovo. Johannesburg
+27 11 550 6181

Achtung Germany!

International

Despite the pledge by ECB President Mario Draghi to "do whatever it takes" to alleviate the risk of deflation and reduce excess saving in the Euro area, nothing has been done, highlighting a measure of complacency amongst Governmental policy makers. They are fully aware that more monetary stimulus and fiscal stimulus is needed to protect the region from falling back into recession. The main reason for the reluctance is the lack of support from Germany.

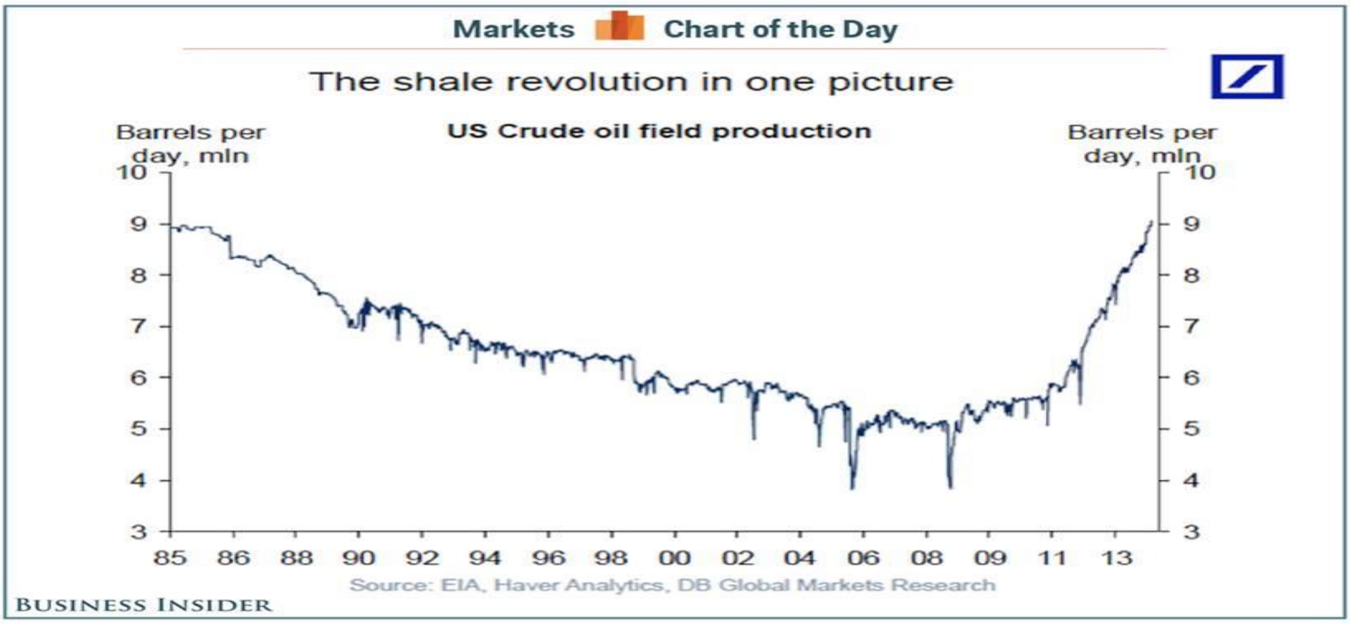
As an export driven economy, the weakening Euro and demise of the peripheral economies has greatly aided the recovery in Germany since the great recession. However, the growth rate of the German economy has slowed down, which might prompt German authorities to become less reluctant to support much needed QE by the ECB. The longer action is delayed, the more drastic the measures are likely to be. The Euro may well still be too strong for the Euro economy. More aggressive QE will more than likely weaken the Euro further, boding well for exports and stem the risk of falling into deflation.



Falling commodity prices due to much needed supply side reforms (too much supply versus demand) and a strengthening dollar are also causing deflationary pressures on a global basis, except in the US. It is likely that the dollar will remain strong due to eventual QE by the ECB and expectations that interest rates will eventually rise in the US as that economy continues apace.

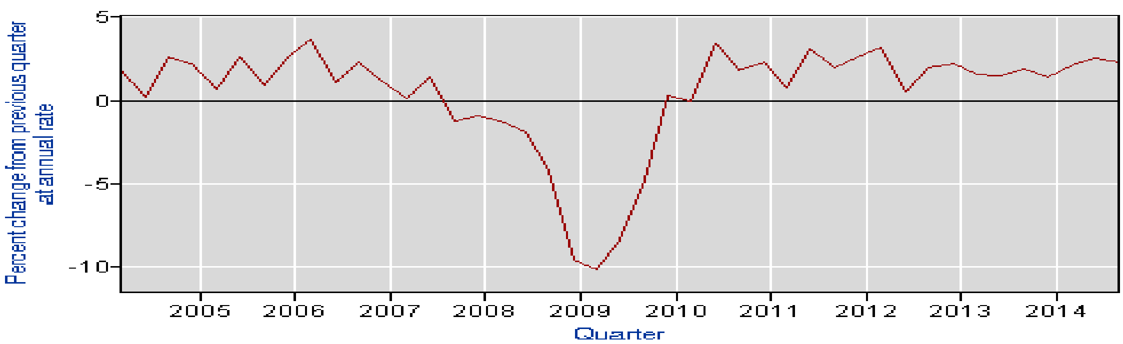
We remain of the opinion that the timing of interest rate increases in the US has shifted forward to say, the first quarter 2016 and that rates will move higher at a very measured pace. Inflationary expectations in the US should remain fairly modest due to the strong dollar, also hampering acceleration in economic growth. The US prefers a weaker dollar due to the plethora of multinational companies conducting business on a global basis. America, therefore, remains in a sweet spot with steady growth and low inflation due to falling commodity prices, particularly oil.

Crude oil prices have dropped by 30% from a high of around $110/b earlier this year. The reason for this has not been weak demand but rather increased supply as OPEC wants to protect their market share due to a big increase in supply from the US. It's likely that oil could fall further. Because of falling oil prices global inflation should remain low for some time while world economies are getting a much need boost leading to better economic growth rates in the coming months.



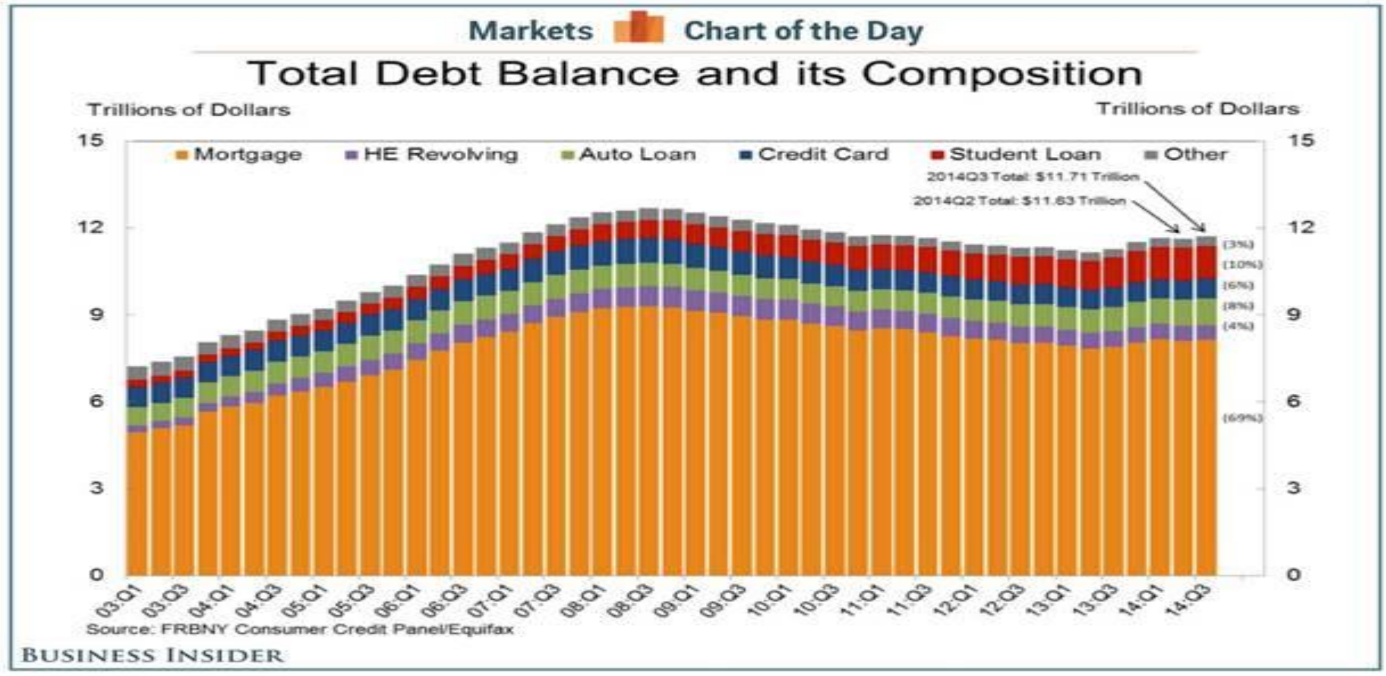
In the US, the job market continues to improve according to headline numbers. However, income gains remain modest. Slack in the labour market appears stubborn, evident in total labour hours data – currently at the same level as in Q3 1999. The growth in jobs has mainly been in part time positions, which typically earn lower wages than permanent jobs.

US Non-Farm Hours worked

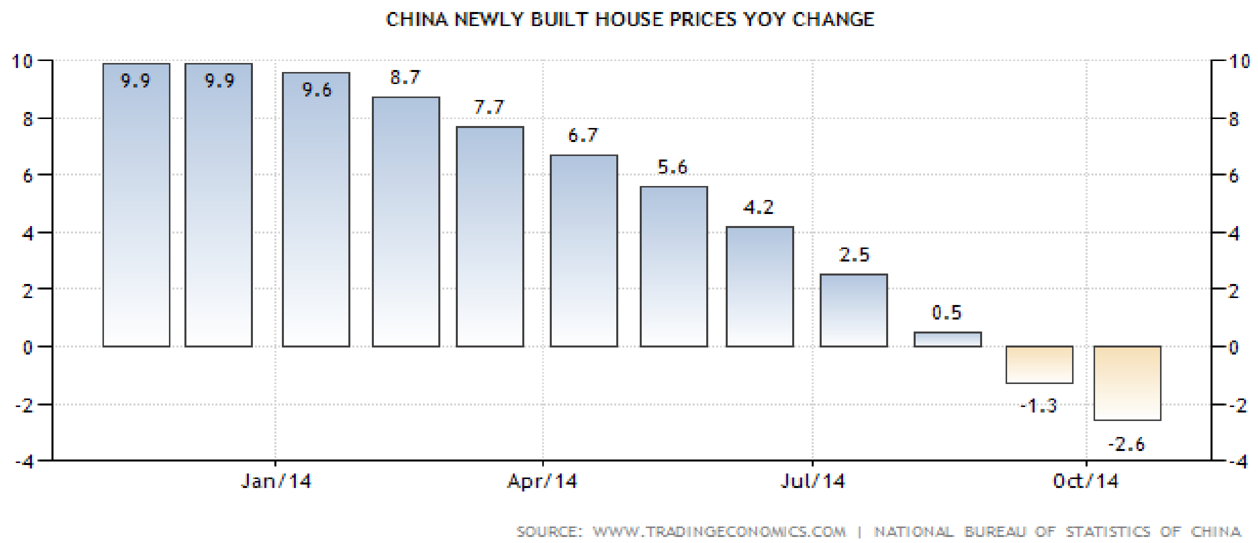


Source: US Department of Labour: Bureau of labour Statistics

Further evidence that the US economy continues to grow can be seen in the chart below. Household debt in the third quarter rose 0.7%, or $78 billion, to $11.71 trillion, up from $11.62 trillion in the second quarter. Mortgage debt rose by $35 billion, or 0.4%, to $8.13 trillion in the third quarter. Student loan debt rose by $8 billion in the third quarter to $1.13 trillion. Auto loan balances rose by $29 billion while the delinquency rate on auto debt fell to 3.1% from 3.3% last quarter. Overall delinquency rates were roughly flat in the third quarter, with 6.3% of all outstanding debt in some stage of delinquency compared to 6.2% in the second quarter.



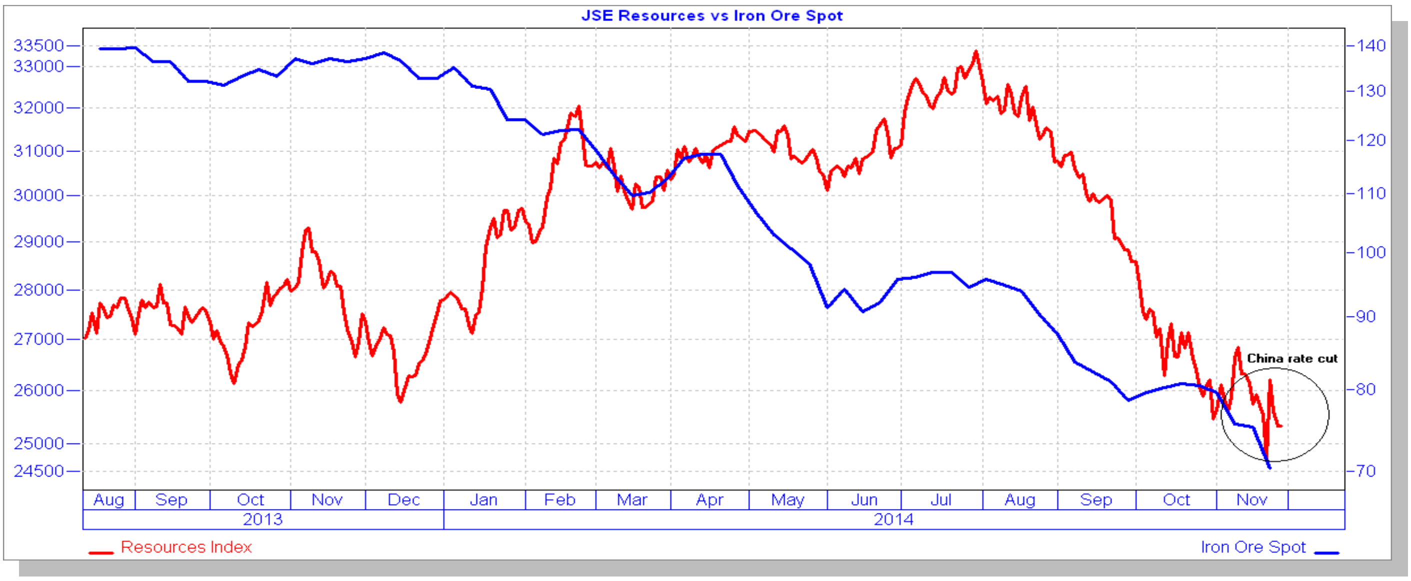
In China, authorities surprised markets by reducing the 12m key lending rate by 40bp to 5.6%. Most economic activity indicators continue to indicate a gradual moderation as the economy is in process of rebalancing from a fixed investment led growth model to a more consumer oriented model. Following the rate cut, emerging markets across the world rallied as this "stimulus" measure was viewed as positive for commodity prices. The main reasoning behind the cut in the key lending rate is to ease financing strains for large corporates rather than increasing appetite for consumer and corporate credit. A fixed investment boom is unlikely as oversupply, particularly in housing, remains problematic. House price inflation has turned sharply negative as can be seen in the chart below. GDP growth in China will continue to moderate but is likely stabilise at the 7.0%-7.3% level as there remains ample scope for further easing by authorities if need be.



In summery then, the global economic backdrop remains one of weak to moderate growth with low inflationary pressure and sizable potential for monetary policy stimulus, particularly in Europe. Japan has reinstituted QE recently as the recovery there has faltered! Market volatility is highly likely because of the uncertain timing of hiking by the Fed, especially in emerging markets.

South Africa

Local equities, particularly resource counters, rallied strongly after the surprise rate cut in China but have retraced somewhat again due to falling iron ore prices on mounting oversupply issues. The global backdrop of moderate growth and low inflation as mentioned above is generally positive for our equities. However, given the importance of China as our largest export partner and falling commodity prices, we expected heightened volatility in our market along with other emerging market commodity producers. Slowing local growth and Eskom woes will further add to negative sentiment from both a local and international perspective, which could lead to further agency downgrades and rand weakness. For that reason we continue to favour industrial rand hedges, albeit that they are for the most part fully priced.

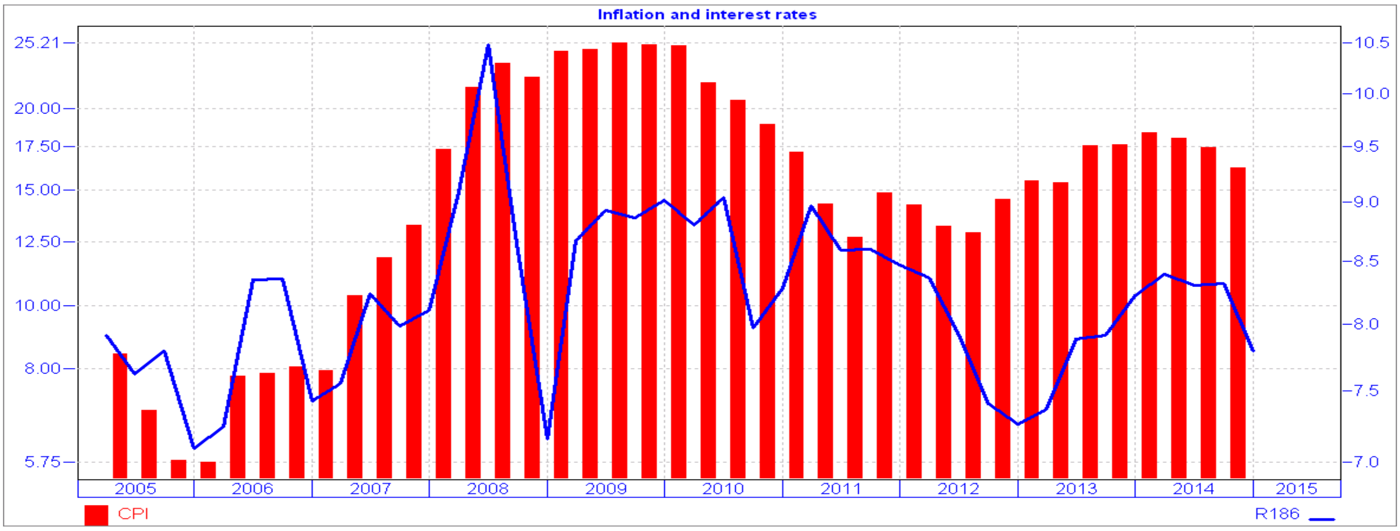


The dominant risk factors facing local equities remain event risks around the FED and ECB. Tighter monetary policy by the FED and SA being forced to realign its policy is the dominant negative risk factor. Much needed QE by the ECB can be viewed as a positive risk factor as Europe is our second largest trading partner.

From a sectorial perspective, resource counters remain inexpensive compared to industrial counters, but weakening commodity prices and Chinese growth concerns are weighing on the index. A weakening rand appears not to be a counter balance at this stage, given the poor supply side dynamics for most commodities. A so called value trap then?

We have increasingly become negative on local stocks exposed to domestic demand, SA Inc. stocks if you will, due to a weakening consumer environment and weak rand which is having a negative impact on company margins – most goods are imported, and it is difficult to pass on price increases to consumers. We are also very concerned about what impact the expected blackouts from Eskom and expected higher personal and other taxes in next year's budget might have on the local economy. Industrial rand hedges are therefore likely to remain buoyant and "expensive". 60% of corporate earnings for listed SA industrials are from offshore, according to research done by J.P Morgan.

On the economic front, pressure to increase local interest rates has diminished substantially due to the falling price of crude. Inflation has peaked and is likely to slow further in coming months. Downward revisions in global growth rates are resulting in lower growth forecasts for the local economy. As can be seen in the chart below, inflation is trending downwards along with our government long dated bonds, which typically have been very accurate predictors of inflation trends.



Moreover, it's interesting to note that a very high correlation exists between SA's PPI and that of China given their trading partner status (see chart below). Chinese PPI remains weak due to slower infrastructure expenditure and declining house prices which is feeding through to lower consumer confidence.

Figure 12: South Africa vs. China PPI inflation

Source: RMB Global Markets Research

Depending on the FED, It is therefore likely that local interest rates could remain at current levels for quite some time or increase at a very modest pace given the inflation outlook.

But all is not lost on the local front, as SA has an array of great well managed companies with good financials. We will continue to invest in such enterprises that have stood the test of time and are likely to continue to deliver good long-term returns for shareholders, albeit not at the same rates of return we have had in recent years. That will have to wait for a local pick up in our economy!

To Conclude

- Markets are still awaiting action from the ECB but there is a measure of complacency amongst policy makers. Monetary as well as fiscal stimulus is needed to protect the region from falling back into recession.
- The longer action is delayed, the more drastic the measures are likely to be. The Euro may well still be too strong for the Euro economy and is likely to weaken further which should bode well for exports and stem deflation.
- Falling commodity prices due to much needed supply side reforms and a strengthening dollar are causing deflationary pressures on a global basis, except in the US.
- We remain of the opinion that the timing of interest rate increases in the US has shifted forward somewhat to say first quarter 2016 and that rates will move higher at a very measured pace.
- Due to the 30% drop in the oil price year to date, world inflation is likely to remain low for some time and could eventually lead to better global economic news.
- In China, authorities surprised markets by reducing the 12m key lending rate by 40bp to 5.6%. GDP growth in China will continue to moderate but is likely to stabilise at the 7.0%-7.3% level.
- Local equities, particularly resource counters, rallied strongly after the surprise rate cut in China but has retraced somewhat again due to a falling iron ore prices (down 47% year to date).
- Given the importance of China as our largest export partner and falling commodity prices, we expected heightened volatility in our local equity market.
- The dominant risk factors for local equities remain event risks around the FED and ECB. Tighter monetary policy by the FED and us being forced to realign our policy is the dominant negative risk factor.
- We have increasingly become negative on local stocks exposed to domestic demand, SA Inc. stocks if you will. We are very concerned about what impact the expected blackouts from Eskom and expected higher personal and other taxes in next year's budget might have on the local economy.
- On the economic front, pressure to increase local interest rates has diminished substantially due to the falling price of crude oil.
- But all is not lost on the local front, as SA has an array of great well managed companies with good financials. We will continue to invest in such enterprises that have stood the test of time and are likely to continue to deliver good long-term returns for shareholders, albeit not at the same rates of return we have had in recent years. That will have to wait for a local pick up in our economy!
- This is our last Communiqué for the year, our next issue will be written at the end of January 2015. ***We wish our clients and other readers well over the festive season with health and happiness in 2015!***

Sincerely

Chris

Dave

Chris Botha

Dave Eliot