IMARA INVESTING IN AFRICA

Asset Management

Communiqué

Monthly

South Africa

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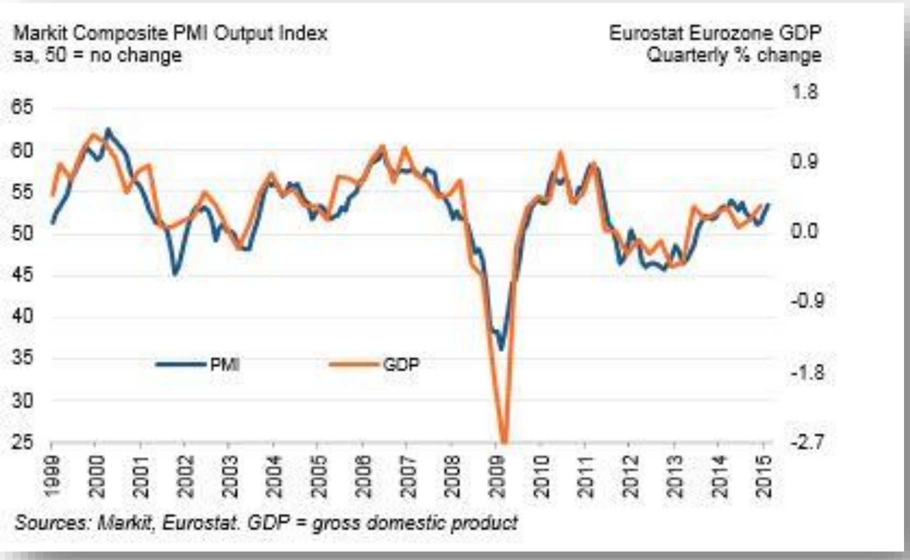
Plato or Plateau

International

In the words of Plato, "a good decision is based on knowledge and not on numbers". The Greek drama continues with no final resolution reached yet between the Troika (European Commission, European Central Bank and International Monetary Fund) and the Greek government regarding the much needed reforms in Greece and the newly debated terms of debt repayments by the country to its creditors.

The standoff is mainly due to stubbornness from the Germans and a more socialist Greece wanting economic austerity to be relaxed, mainly by reducing the trade surplus as a percentage of GDP; which it says will provide more money for the government to spend in order to kick start the economy and create employment.



The Germans on the other hand want a higher surplus in order to ensure that Greece pays back their obligations as agreed upon. Greece has been provided a four month window to stipulate what structural reforms will be undertaken to reduce the risk of a default on their debt and a potential exit out of the Eurozone (Grexit). It is highly likely that a deal will be struck between the Troika and Greece. Greece's demands need to be more realistic and the Germans more accommodating. Supporting some form of Greek leniency is the fact that government spending (austerity) has decreased rapidly over the past 5 years, more than initially requested by the IMF. The likely outcome could be some form of a haircut (reduction in the principle debt); a longer payback period linked to GDP and

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being allowed to run a smaller budget surplus as a percentage of GDP to grow the economy. The Greeks want a surplus of 1.5% compared to the current surplus target of 4.5%. The parties will likely settle in the middle.

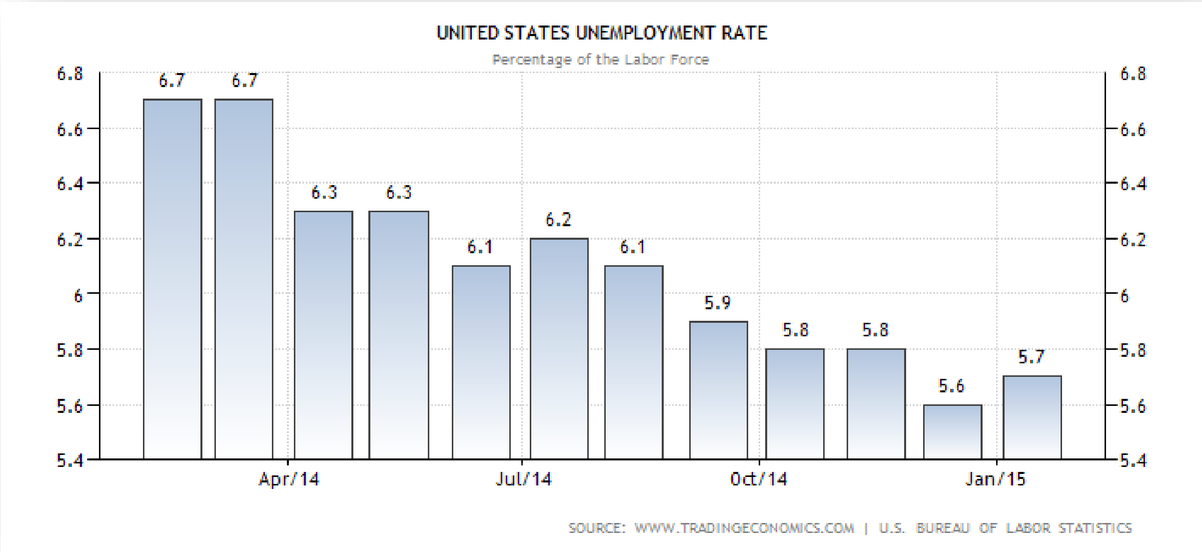
On the European economic front, things in general are looking better, with yet another improvement in the flash PMI(Purchasing Managers Index) reading for February 2015 increasing to 53.5 from 52.6 previously(see chart above) as well as a positive percentage change in the latest quarterly GDP number. Growth in business activity and new orders also hit a seven month high in February. Results from listed consumer discretionary stocks have also in the main beaten expectations; undoubtedly aided by lower energy input costs and a weak euro. Despite these positive improvements, the risk of deflation still remains but has lessened somewhat.

Things are even better in the UK. So good in fact, that the BOE(Bank of England) has turned more hawkish on inflation and have moved forward their targeted inflation level of 2% by one year(two years' time compared to three previously). However, some headwinds are present.

The housing market is showing signs of cooling off. Spending has mostly been driven by a property bubble in the greater London area. The strength of sterling against the Euro is also likely to negatively impact exports and growth in due course. So, the more hawkish stance by the BOE might be short lived as GDP growth may disappoint. With only the FED and BOE in a potential tightening cycle and the rest of the world in an accommodating cycle, we don't expect interest rates in the UK to rise anytime soon.

Source: Nationwide Building Society UK

In the US, headline economic indicators continue to indicate that the economic recovery remains somewhat robust. The job market continues to show signs of improvement and 75% of the S&P 500 listed companies recently reported results that were better than expected. However, further analysis reveals that the recovery might not be as strong as the headline numbers suggest. US unemployment, after reaching a low in December 2014, ticked up again in January 2015 to 5.7%. More importantly, the ISM Non-Manufacturing Employment Index is showing signs of weakness. In the last FOMC meeting by the FED concern was again raised regarding slack in the labour market, so the headline numbers, although good, might not be reflecting the true state of affairs (see charts overleaf)



The other important number the FED watches is inflation. Despite indicating that it will prefer raising rates sooner rather than later as not to fall behind the curve, they also stated that they need to be "reasonably confident" that inflation was nearing their 2% target before any action is undertaken. In fact, inflation dropped sharply in January 2015 to 0.7% from 1.3% in December 2014(see chart below).

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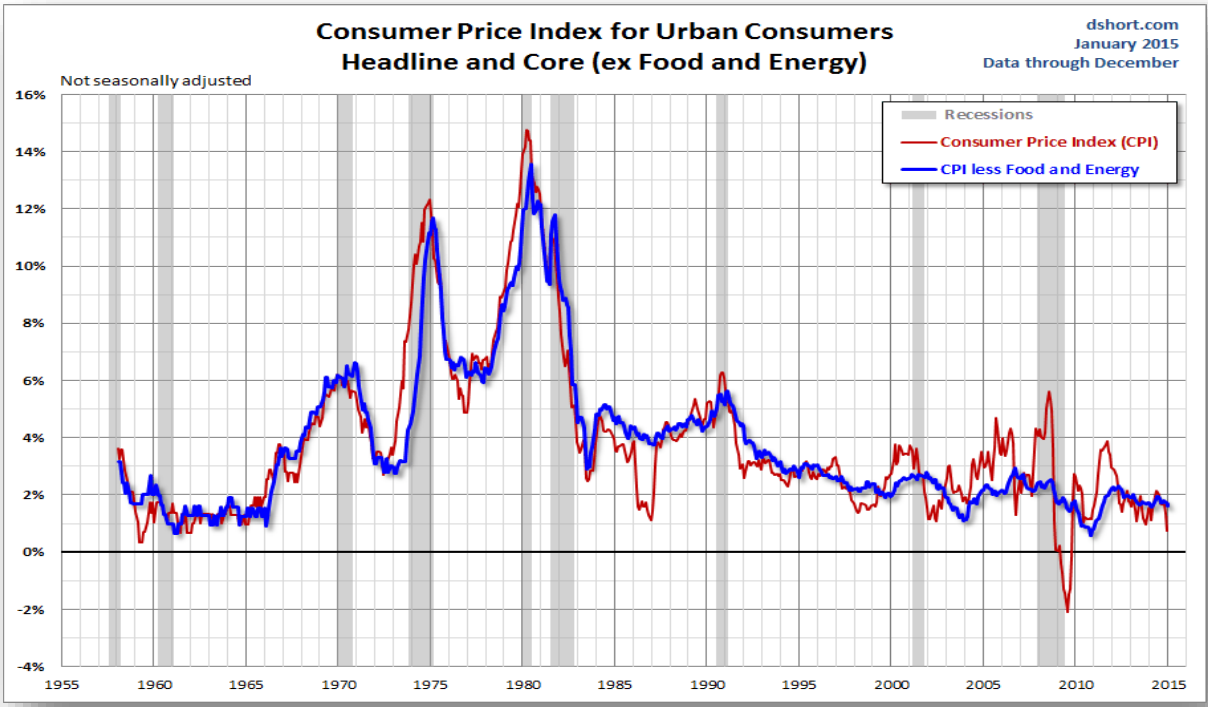


Despite the economy benefitting from lower energy costs, the real reason why growth momentum is at risk of slowing is the strong dollar which is largely negating the positive impact of the lower oil price due to slowing exports.

The main reasons for dollar strength are falling commodity prices, hence emerging market stresses and the expected hike in interest rates by the FED. According to BCA Research INC., markets are pricing in a 76% probability of a rate hike by the FED at the 16-17 June meeting this year compared to an expected 50% chance in January this year.

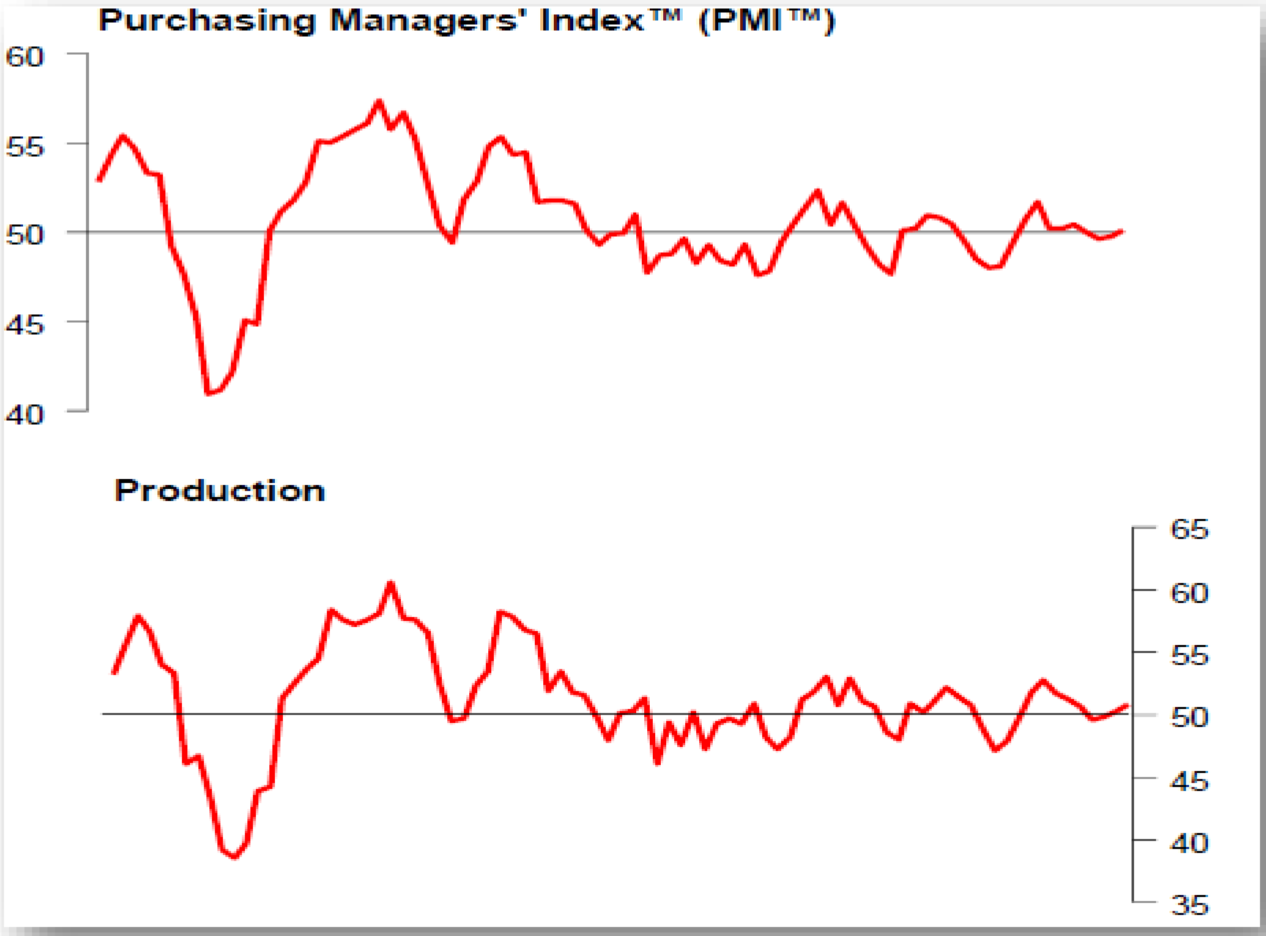
We agree with BCA and think the market has run ahead of itself. Given the impact of the strong dollar, declining core inflation and unconvincing real jobs data, interest rates could remain unchanged for the remainder of the year.

As expectations ebb and flow, there is a possibility that the dollar might weaken somewhat in the not too distant future but the weakness is unlikely to be sustained due to the changing interest rate cycle. But it is in expensive territory!

In China, the pace of growth momentum continues to slow. Factory prices were down 4% year on year in January and CPI inflation has fallen to 0.8% with a corresponding drop in the official Purchasing Managers Index (PMI). The PMI reading dropped from 50.1 in December to 49.8 in January 2015.

Overall, not a big slowdown but activity is cooling off. It is therefore expected that authorities will again drop interest rates to stimulate consumer spending and general economy activity. The Chinese renminbi may be allowed to weaken boding well for exports.

More good news out of Europe should provide a further fillip to the Chinese economy.



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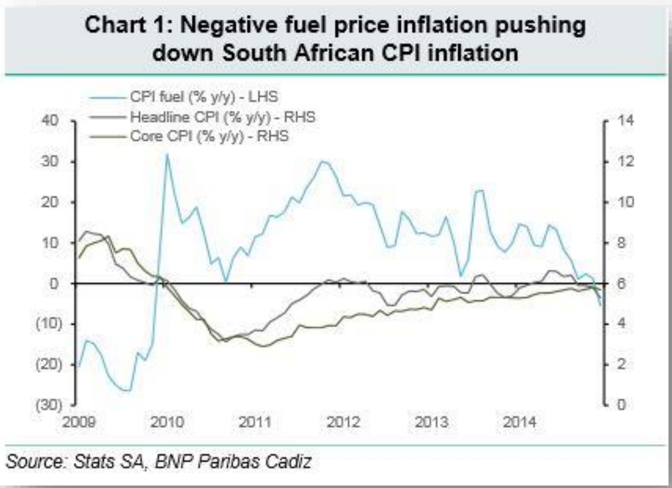

The main event locally was the 2015 budget speech by Minister of Finance Mr Nhlanhla Nene. It was a positive speech in the sense that most analysts (including us) were expecting far more aggressive increases in personal taxes. The top marginal personal income tax rate increased to 41% from 40%. Other taxpayers earning more than R181900 per annum also suffered increases. The big gun, however, was the 80.5c increase in the fuel taxes.

The positive impact of the lower oil price, currently at $60p/b (after reaching a low of $46p/b in January2015), is likely to continue to positively impact consumer expenditure (and confidence – see chart below) as well as CPI. Annual CPI inflation dropped to 4,4% in January 2015 from 5,3% in December 2014, the lowest since April 2011, when CPI stood at 4,2%(see chart above).

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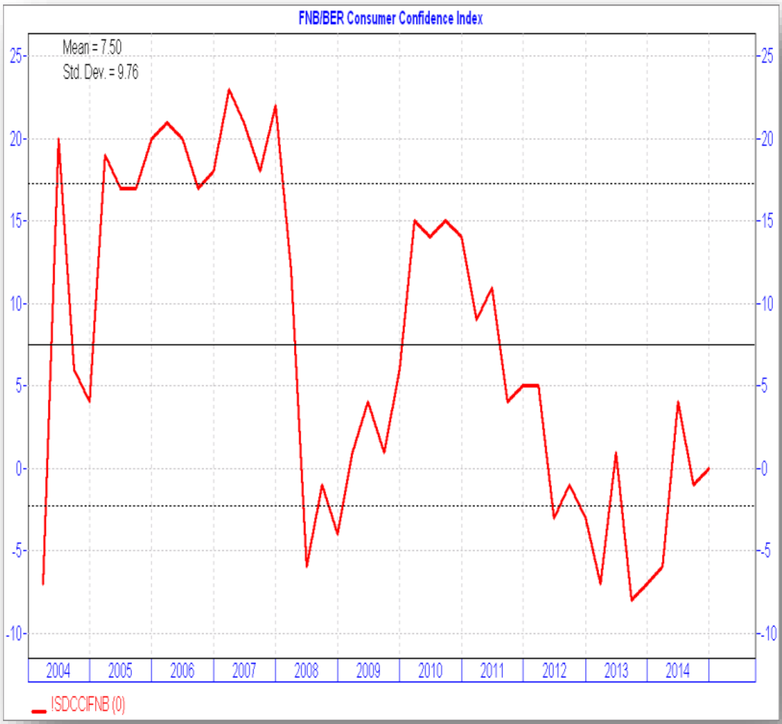
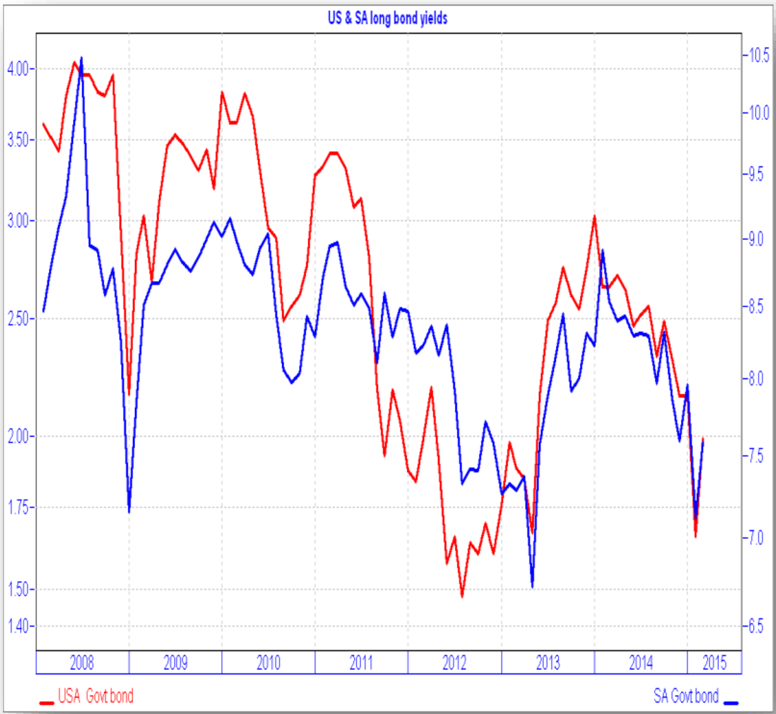
Given a sluggish world economy and continuing rig closures by shale oil producers in the US, we expect oil to be range bound between$40p/b-$70p/b for some time.



Following the last MPC meeting, the SARB's inflation outlook has improved significantly. They expect inflation to average 3.8% in 2015 from 5.3% previously (see previous chart). Projected GDP growth for 2015 was also revised downwards to 2.2% from 2.5% previously (we think that might still be too optimistic and expect growth of around 2% this year).

On interest rates, the SARB voiced concern of the potential consequence of tightening by the FED, meaning they will follow suit despite no economic reason to do so. But as discussed in previous Communiqués, the foreign funding mechanism of the current account deficit will need to remain in place. The chart below, left, clearly indicates the significant correlation of our long dated government bonds with US treasuries.



Recent rand strength, if maintained and the lower oil price should significantly reduce the deficit on the current account which in turn could cause the rand to remain stronger for longer.

The local stock market continues to defy gravity and has reached yet another record high and was up 7% in February at the time of writing (see overleaf).

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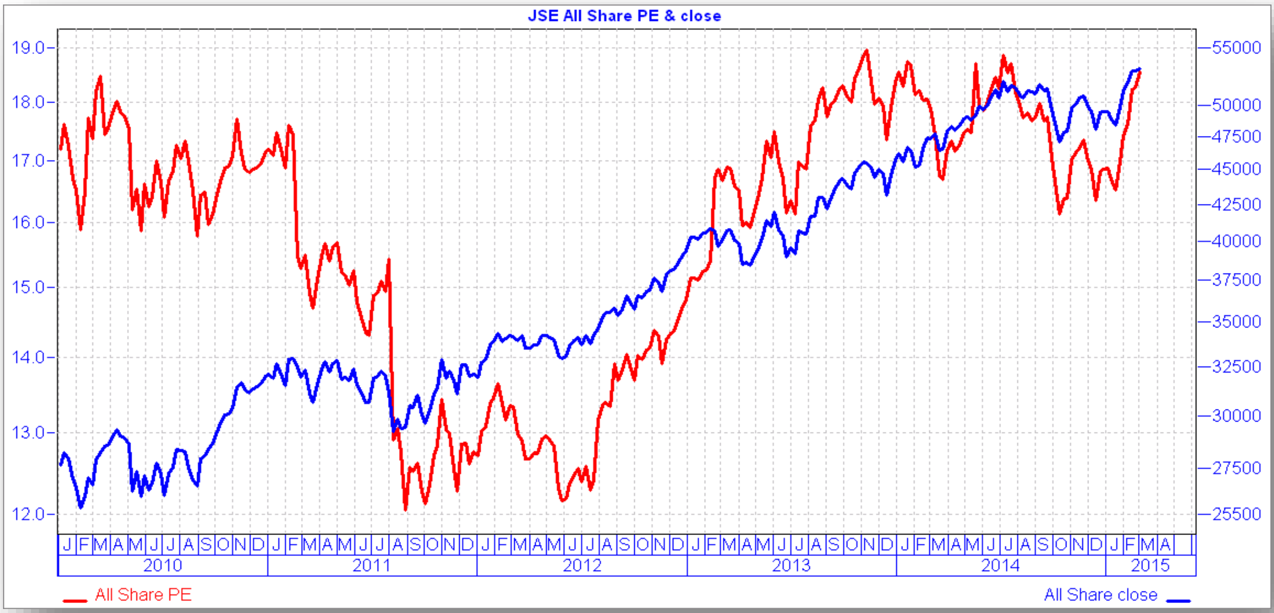

The market in general is expensive, but is likely to remain elevated due to the search for yield and very much a risk-on mentality, especially by foreigners. We still expect a total return of approximately 15% [12%capital+3%dividends] for the year, but wish to emphasise that stock selection has become the key element to manage risk.

Interestingly, reading a recent survey by JP Morgan, most fund managers have gone underweight retailers and industrials and increased their exposure to resources over the last quarter which in our opinion is a bit premature given the still relatively poor economic backdrop in Europe(although improving) and slowing growth in China(the biggest consumer of commodities). Retailers are likely to remain elevated in the near term but watch communication by the FED and SARB, which if more hawkish on inflation and interest rates might cause increased volatility. We continue to favour industrial rand hedges (although fully valued) and selected financial stocks.

To Conclude:

- Greece will likely remain in the European Union and will receive some relief from their debt obligations (but not too much).
- Economic data in the rest of Europe seems promising, indicating that a slow recovery is underway with little or no inflation.
- The Bank of England has turned more hawkish on the timing of hiking interest rates but most commentators think they may be premature, given the slowdown in the property market and the strong pound relative to the Euro which could start hurting exports.
- The US recovery remains intact and headline numbers are indicating that the recovery is gaining momentum. However, further analysis around jobs data and core inflation are suggesting that the recovery might not be strong enough to prompt the FED to hike interest rates in June this

year. It is likely that the rate decision will be pushed out to near the end of the year. In its last communiqué, the FOMC reiterated that they will remain data dependent.

- Chinese economic data remains somewhat volatile but is in general indicating a slowing economy, although certainly not falling off a cliff. We expect further interest rate cuts in China which will likely stimulate growth in due course.
- The benign impact of the lower oil price, currently at $60p/b (after reaching a low of $46p/b in January), is likely to continue to be consumer and inflation positive. The fuel price dropped by 127c/l in January but is likely to go up again due to the rebound in the oil price.
- Annual CPI inflation dropped to 4.4% in January 2015 from 5,3% in December 2014, the lowest since April 2011.
- On interest rates, the SARB voiced concern of the potential consequence of tightening by the FED, meaning they will follow suit despite no economic reason to do so but as discussed before, the foreign mechanism funding of the current account deficit will need to remain in place.
- In general our market is expensive but is likely to remain elevated due to the search for yield and very much a risk-on mentality, especially by foreigners.
- We still expect an overall return of approximately 15% for the year but wish to emphasise that stock selection has become the key element to manage risk. Share price volatility will remain high.

Sincerely

Chris

<u>**Chris Botha**</u>

Dave

<u>**Dave Eliot**</u>

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