IMARA INVESTING IN AFRICA

Asset Management

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The FED losing patience

International

The US Federal Reserve dropped the word "patience" form its forward guidance on the timing of hiking interest rates in the latest FOMC meeting as expected given continued improvements in headline labour market data.
The committee further stated that it would raise the fed funds rate once it has witnessed "further improvement in the labour market and is reasonably confident that inflation will move back to its 2% objective over the medium term".

Despite continuing improvement in headline jobs data, underlying labour market statistics are suggesting that slack in the labour market is not showing that much of an improvement. Furthermore, the growth in jobs is mostly as a result of improvements in part time jobs. The number of full time workers remains one million below the November 2007 high. More importantly, inflation in the US is not going up and the Fed itself has cut its near-term headline inflation forecasts to average between 0.6% and 0.8% in the fourth quarter of 2015 and is expecting inflation to be 1.3% at the end of the year mostly due to the decline in the oil price. This compares to 1.6% [at year- end] projected in December 2014.

So, despite being "less patient", the risk of a rate hike in June has likely been ditched given lower inflationary expectations. The FED will prefer to hike sooner rather than later, but are fully aware that a premature hike in interest rates could derail the economic recovery. In any event, when rates do start going up, it is likely to be very gradual with an initial hike of between 0.125%-0.25%.

The Fed's median projected fed funds rate for 2016 was lowered to 1.9% from 2.4% previously and 2017 was lowered to 3.1% from 3.6%. The current fed funds rate is 0.25%. The bottom line is that interest rates in the US will go up but the timing thereof has been pushed forward with the earliest hike, in our opinion, possibly in September 2015. However, with little inflationary pressure in the US and the negative impact the strong dollar will have on GDP growth, there is the likelihood that the decision to hike interest rates might be pushed out even further.

The IMF suggests that a 10% appreciation in the real trade weighted dollar has the same
effect as a 100bp hike in interest rates.

The chart below indicates that inflationary forecasts by both J P Morgan and the IMF continue to be revised slightly upwards in most economic regions indicating that the risk of deflation is probably diminishing somewhat but the global economic recovery remains fragile (see IMF GDP forecast).

2015 CPI Inflation Forecasts

		IMF	JPM
	2014A*	Oct-14	Dec 14
Global	2.3	3.9	2.4
US	1.2	2.0	1.2
EuroZone	0.2	1.0	0.9
UK	1.0	1.8	1.4
Japan	2.8	3.0	1.0
Canada	1.9	2.0	1.8
Australia	2.1	2.8	2.4
China	1.5	2.5	1.7
Korea	1.0	3.7	2.0
India	5.1	7.3	6.2
Russia	9.2	6.5	10.2
Brazil	6.5	6.0	6.5
Mexico	4.1	3.5	3.4
DM	1.2	1.9	1.1
EM	3.6	5.4	3.8

* JPMorgan current estimates of actual 2014 CPI Inflation

Source: TCGlobalmacro

Why is deflation bad? The most obvious reason is that corporate profits might suffer due to lower revenue growth and less pricing power as consumers delay spending, particularly on durable and semi durable goods. This will force companies to reduce costs which in turn will have a negative impact on employment exacerbating the reduction in consumer expenditure. However, given continues improvements in headline economic data in the US and Eurozone, we view the threat of deflation not to be a material risk factor.

GDP FORECASTS

Latest IMF projections

The global recovery remains fragile and uneven.
(percent change)

			Projections		Difference from July 2014 WEO update	
	2012	2013	2014	2015	2014	2015
World Ouput	3.4	3.3	3.3	3.8	-0.1	-0.2
Advanced Economies	1.2	1.4	1.8	2.3	0.0	-0.1
United States	2.3	2.2	2.2	3.1	0.5	0.0
Euro Area	-0.7	-0.4	0.8	1.3	-0.3	-0.2
Germany	0.9	0.5	1.4	1.5	-0.5	-0.2
France	0.3	0.3	0.4	1.0	-0.4	-0.5
Italy	-2.4	-1.9	-0.2	0.8	-0.5	-0.3
Spain	-1.6	-1.2	1.3	1.7	0.1	0.1
Japan	1.5	1.5	0.9	0.8	-0.7	-0.2
United Kingdom	0.3	1.7	3.2	2.7	0.0	0.0
Canada	1.7	2.0	2.3	2.4	0.1	0.1
Other Advanced Economies[1]	2.0	2.3	2.9	3.1	0.0	-0.1
Emerging Market and Developing Economies	5.1	4.7	4.4	5.0	-0.1	-0.2
Commonwealth of Independent States	3.4	2.2	0.8	1.6	-0.1	-0.5
Russia	3.4	1.3	0.2	0.5	0.0	-0.5
Excluding Russia	3.6	4.2	2.0	4.0	-0.4	-0.4
Emerging and Developing Asia	6.7	6.6	6.5	6.6	0.1	0.0
China	7.7	7.7	7.4	7.1	0.0	0.0
India[2]	4.7	5.0	5.6	6.4	0.2	0.0
ASEAN-5[3]	6.2	5.2	4.7	5.4	0.1	-0.2
Emerging and Developing Europe	1.4	2.8	2.7	2.9	0.0	0.0
Latin America and the Caribbean	2.9	2.7	1.3	2.2	-0.7	-0.4
Brazil	1.0	2.5	0.3	1.4	-1.0	-0.6
Mexico	4.0	1.1	2.4	3.5	0.0	0.1
Middle East, North Africa, Afghanistan, and Pakistan	4.8	2.5	2.7	3.9	-0.4	-0.9
Sub-Saharan Africa	4.4	5.1	5.1	5.8	-0.4	0.0
South Africa	2.5	1.9	1.4	2.3	-0.3	-0.4

Source: IMF, *World Economic Outlook*, October 2014.
[1]Excludes the G7 (Canada, France, Germany, Italy, Japan, United Kingdom, United States) and euro area countries.
[2]For India, data and forecasts are presented on a fiscal year basis and output growth is based on GDP at market prices.
[3]Indonesia, Malaysia, Philippines, Thailand, and Vietnam.

Importantly for us, Chinese growth projections continue to be revised downwards with a corresponding negative impact on commodity prices, which will by the way, cause global inflation to stay lower for longer.

As can be seen in the chart on the right, China's imports of iron ore (they are the biggest consumer) continues to slow due to lower dependence on fixed investment driven economic growth. The outlook for this commodity remains poor as major producers such as Vale, Rio Tinto and Billiton continue to increase production being very low cost producers and are trying to force high cost producers to shut down in order to eventually improve the supply/demand dynamic.

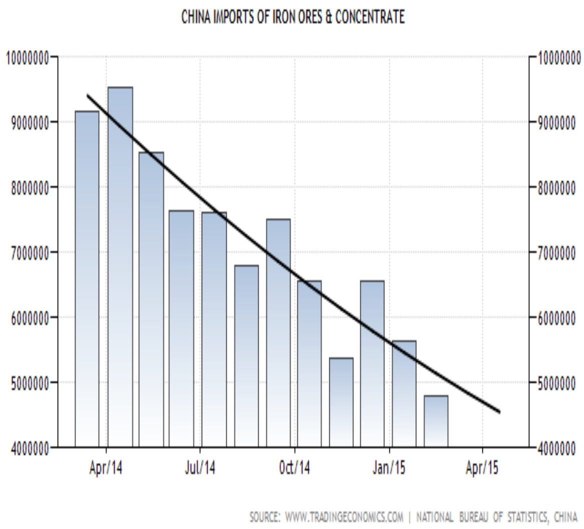
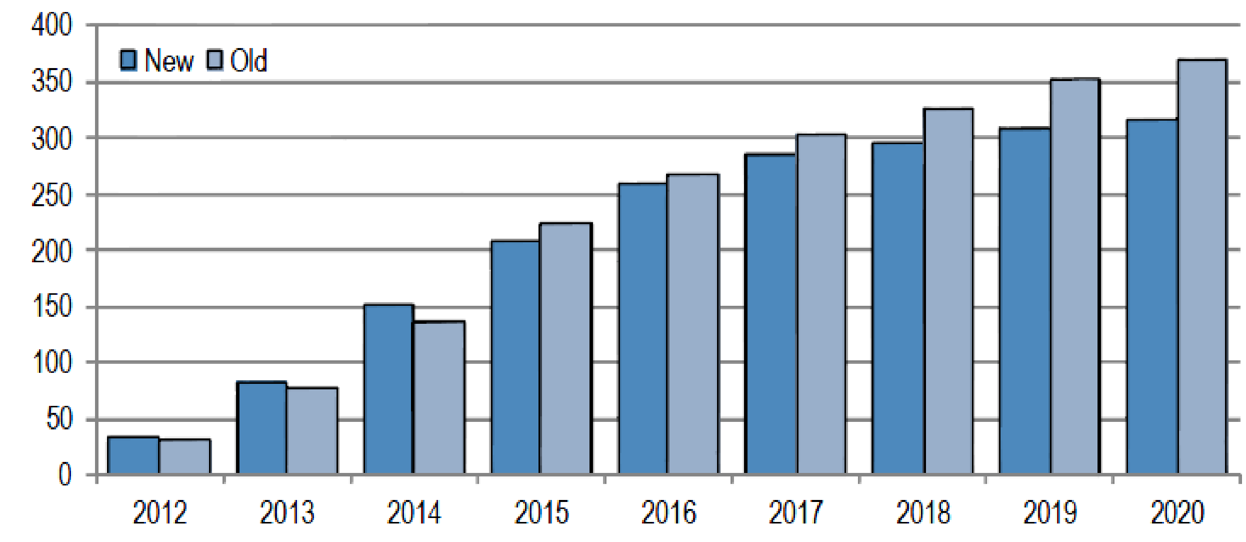


Figure 8: Cumulative incremental iron ore production from the major producers [Mt]



Source: Company data, J.P. Morgan estimates.

In the Eurozone, the economic recovery seems to be gaining momentum at last, - is QE working? According to Mr Peter Dixon, global economist at Commerzbank, “I wouldn't want to give QE too much credence at this stage. The ECB has only been buying for a couple of weeks and QE takes a long time to have any impact - if at all. The outright QE itself has had zero impact; growth was already happening."

The latest Flash Purchasing Managers' Index (PMI) in the Eurozone jumped to a near four year high of 54.1 in March from 53.3 in February. The data was based on surveys of thousands of companies which is a good indicator of increased confidence and economic activity. The survey further indicated first quarter GDP growth of 0.3%, the same as the previous quarter but is at least not declining.

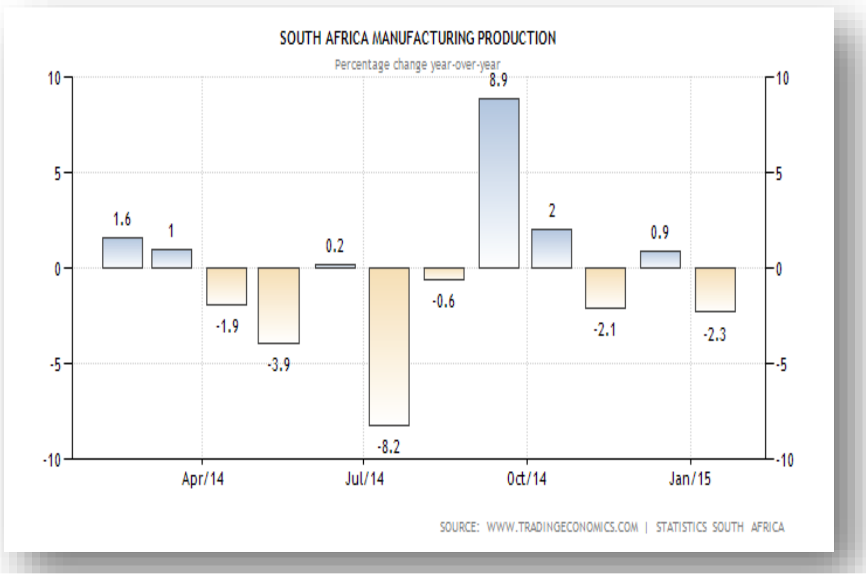
A sub-index measuring euro zone prices jumped to an eight-month high of 49.0. But it has spent three years below the breakeven level of 50, suggesting inflation will not return any time soon. The Euro and European shares rallied after the release of the data. Despite the recent rally in the Euro, we expect the dollar to start strengthening again due to expected increases in interest rates in the US. Again, bad for spot commodity prices as an inverse relationship exists between the dollar and commodity prices.

QE by the ECB could have a positive effect in other markets as any increase in demand there could boost exports in other countries (they are our second largest export destination). Furthermore, half of Europe's sovereign bonds are held offshore, so that could boost the wealth effect in other countries as yields decline (and prices go up). Also, the weakening euro is likely to encourage central banks to remain very accommodative in terms of monetary policy. Denmark, Norway, Sweden and Switzerland have already cut interest rates in response to QE.

The UK economy remains the star performer alongside the US. The UK economy grew by 2.6 %(see chart) in 2014(1.7% in 2013), the fastest pace since 2007. Despite this, given easing elsewhere in Europe, Bank of England Governor, Mark Carney, recently stated that the strength of sterling may convince the monetary policy committee to postpone the first rate hike in the UK. Supporting a possible delay in rising interest rates is that the economy only grew by 0.5% in the final three months of 2014 which was lower than the 0.7% recorded in the previous quarter, mainly driven by a slowdown in construction and mining supply. The services sector is holding up well which is the dominant contributor to GDP making up 79% of total GDP.

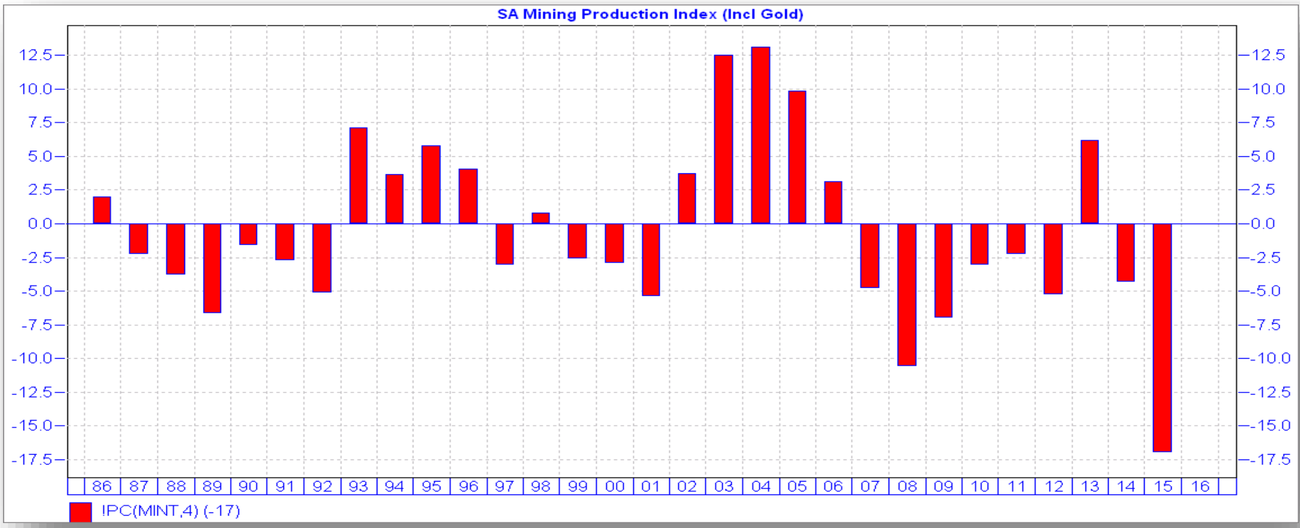
Local News

In contrast to the positive tones from Europe and the US, South Africa is not faring that well. GDP growth forecasts continue to be revised downwards with consensus estimates averaging about 2% for 2015.



A major contributor to the lower growth expectations is expected power supply disruptions from Eskom and excessive pay hike expectations from the public sector. Standard & Poor downgraded Eskom's debt issuances to junk bond status which will make the much needed funding of future capital expenditure more expensive.

Despite the week rand, manufacturing remains in the doldrums (see chart) and mining companies also are not benefiting from the currency due to lower demand and falling commodity prices. South African mining production decreased 2% year on year (see chart) in December 2014, from a revised year-on-year drop of 0.1% (0.4%) in November 2014. The main contributors to the 2% decrease were iron ore and platinum group metals. Power blackouts will make matters worse.



The rand is set to continue to be a structurally weak currency due to lower growth projections, politics, low savings rate and structural economic issues.

The political and legislative environment is making it increasingly difficult for private sector participation and future investment in the economy. A low domestic savings rate limits the pool of investment capital and forces a country to make use of foreign debt to expand fixed investment initiatives. Dependence on foreign capital inflows and the highly liquid nature of the rand on forex markets, will ensure volatility going forward.

It's a telling story that most of the companies listed on the JSE are expanding offshore to grow their business (and our portfolios are positioned accordingly). The retail industry for many years now has been the main contributor to growth mainly due to a fast growing civil service and social grants. History has proven that this model cannot be sustained as inflationary pressure will be the end result. However, the lower oil price could see the spending trend continue in the short term.

On the JSE, the big story during the month was the material de-rating of industrial counters (they were very expensive) relative to resource stocks.

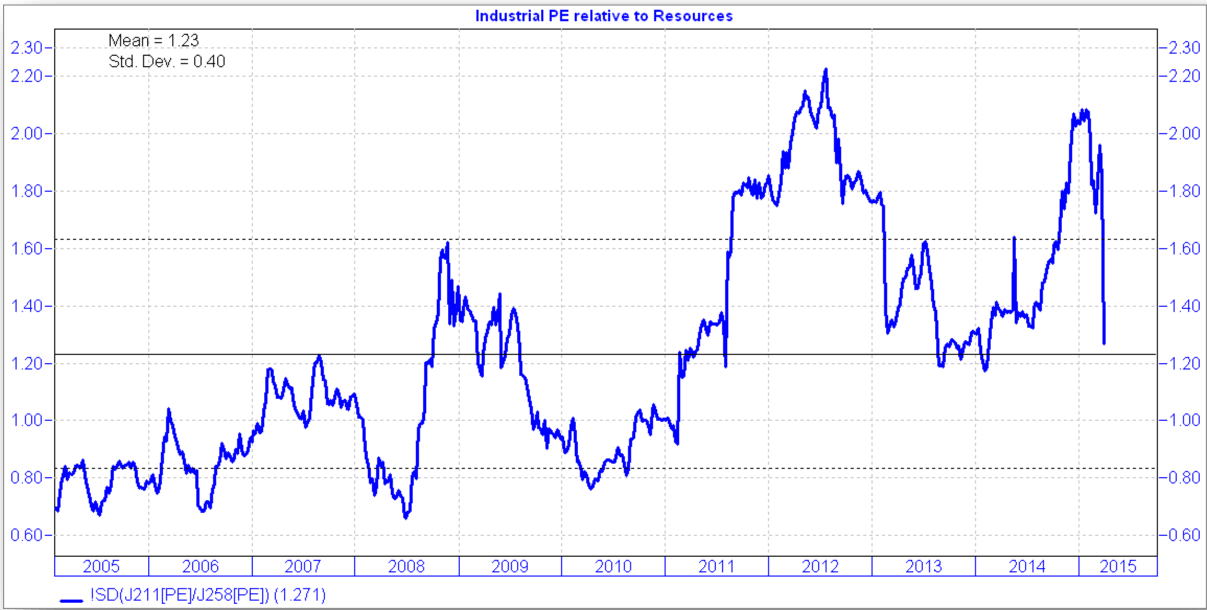
Industrials in terms of their price earnings ratios have year to date, become 37% cheaper compared to resource stocks; (see chart) mainly due to good corporate results. The same thing happened at the beginning of 2013, where the so called sector rotation eventually failed due to a bearish outlook on spot commodity prices and a deteriorating macro-economic backdrop.

Chinese growth has since continued to slow and commodity prices are still declining. These two factors are unlikely to materially improve in the near term. What's new now compared to then is Eskom. Things are actually somewhat worse now. It is therefore likely that the rotation might fail again, despite some resource stocks being fundamentally cheap. Earnings are likely to disappoint. We thus view the correction in "expensive" industrial stocks as a healthy development and earnings therefrom (given their large foreign earnings component) will likely continue to either meet or beat expectations.

The macro variables (low or no commodity and local manufacturing exposure) remain more favourable for industrials and recent weakness might present a good entry point in selected quality stocks.

As a whole, the JSE remains fully valued and heightened volatility around the tightening cycle by the FED (and hence us) *must* be expected.

Although markets in our view are pricing in a rate hike by the FED towards the end of this year, the event, when it actually happens, will probably cause a correction in both bond yields and equity prices. But a recovery could follow soon thereafter, as rising interest rates indicate a growing economy, rising inflation, better corporate margins and profits.



To Conclude

- The FED would like to hike interest rates as soon as possible but can't for now due to low inflationary expectations and labour market slack;
- The expected June rate hike has been shifted to September with expectations of a modest 1/8th of a percentage point or maximum 0.25% hike, we believe;
- The threat of deflation is moderating (even in Europe) but will remain a potential issue for a while as the global economic recovery remains fragile;

- The PMI in the Eurozone jumped to 54.1 in March, the highest in four years. Some suggesting that it's too early for this to be QE at work. Which means growth could surprise on the upside once it eventually kicks in;
- Slower growth in China and increasing production of Iron Ore will weigh on this commodity's price and emerging market commodity plays in general;
- In SA, economic prospects continue to deteriorate not being helped by the woes at Eskom;
- The rand will likely start weakening again after recent strength due to structural economic issues and a low savings rate;
- Sector rotation out of industrials into resource stocks could fail due to poor economic fundamentals and the impact of power shortages on local miners; and China, of course!
- Industrials are offering better value after the recent results season and given more favourable fundamentals will probably continue to outperform over the medium term.
- Investors must expect more volatility in the near term as the FED comes to grips with the timing and size of their inevitable hike in interest rates.

Sincerely

Chris Botha | **Dave Eliot**