IMARA INVESTING IN AFRICA

Asset Management

Communiqué

Monthly

South Africa

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Preamble

Those of our clients and friends who have had the stamina to read my [latterly our] thoughts over many years will know our abhorrence of short-term investment thinking and the incessant babble emanating from most intra-daily media 'investment/market' outputs; for it is not investment but at best speculation and at worst gambling. True investment is what we subscribe to achieve, as hard as it may be – we see ourselves as part owners on behalf of our clients in the enterprises we invest in and are in for the long haul. Great companies with excellent management, good balance sheets, unique offerings and wonderful cash-flows will withstand the vicissitudes of markets.

The following extract from The Business Day of 19 February 2015, is worth a thought provoking read, we thought; enjoy!

""I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grow-ups who behave in the market like children" – Warren Buffett."

Avoid being pushed and pulled by news and opinion has never been harder. Each day, investors are bombarded with more advice, regardless of the outcomes from the last batch delivered the day before. Each week the lights are flashing brighter and the volume is growing louder. Each passing year brings more confusion, not less – more opportunities to be led astray.

But we can fight back. We can arm ourselves with wisdom and historical awareness. We can take control of our media diets and learn to contextularise the things we read and hear. We can categorise the opinions we're inundated with and know when they matter. We can remind ourselves that much of the content being generated in the financial media is what some would call "news-flavoured entertainment" – but that there's nothing wrong with people having biased opinions or participating in the creation of entertainment so long as we, as investors, know better than to reflexively act upon what we're hearing.

There are legitimate commentators in the financial world and there are charlatans. There are people who genuinely want to get things right, and there are those for whom deception is more profitable. Throughout history, names and situations have changed, but the conflicts have not. Everything that has happened will happen again. It's got harder than ever to sort through the calamitous clutter, and yet it's never been more important to do so.

From Clash of the Financial Pundits by Joshua M Brown: *Michael Pireu – email: pireum@streetdogs.co.za*"

SA overview

The search for yield is likely to continue for now

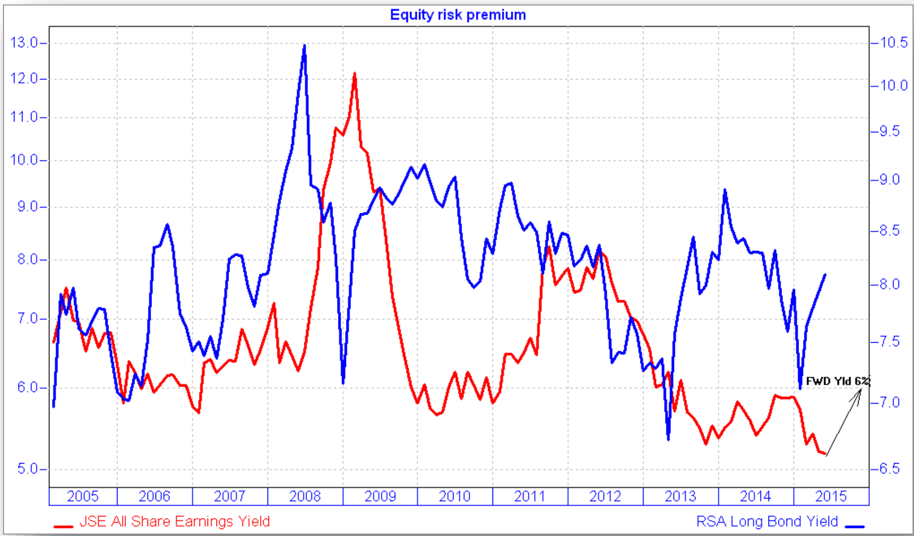
Monetary policy is creating market overshoots on a global basis as investors continue to search for yield. The overshoot is particularly acute in equity markets due to negative real long bond yields in developed markets.

Local bonds and equities remain at record levels owing to continuing strong support from foreign buying because of attractive local yields relative to developed markets. This is unlikely to change anytime soon as there is little pressure for both the FED and the SARB to start hiking rates in the short term. But, interest rate hikes will eventually materialise, albeit gradually, and a correction in asset prices is highly likely nearer to the event.

As can be seen in the chart below, the gap between the earnings yield of the JSE and long bond yields has widened to 2.6% after being as low as 1.4% in the beginning of the year mainly due to a sell-off in local bonds following comments by the FED that asset prices are inflated. The equity risk premium for local equities compares to 3.2% for UK stocks and 2.8% for US stocks making us relatively more expensive. The gap could well narrow (bond yields declining) in the short term if US economic data continues to disappoint and the FED decides to postpone interest rate hikes.

Despite local equities trading at record low yields (record high PE's) it's likely that our market will remain elevated in the short term as foreigners continue searching for yield. Approximately 40% of the JSE and local bond market are owned by foreigners.

Comparing the JSE earnings yield with those of the UK and US markets, the local market appears more expensive that the UK market but slightly less expensive than the US and interestingly is more correlated with the UK market, likely due to the large number of our dual listed mining and industrial counters.



The JSE currently trades on an earnings yield of 5.2% compared to yields of 6.5% and 4.8% respectively for the FT100 and S&P 500. It is worthwhile pointing out though that expected earnings growth for the local market is higher than the UK and the US. So, on a forward basis, valuations do not appear that onerous, particularly if rand weakness sets in again, as far as earnings growth is concerned.

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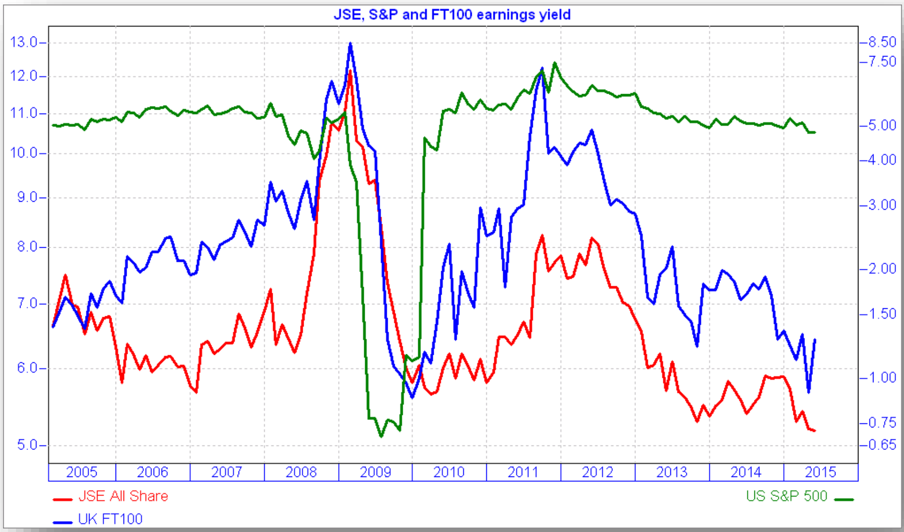


Uncertainty about what is priced in around an interest rate hike by the Fed has caused heightened volatility in equity markets globally and is likely to continue in the near term.

The latest decision by the SARB to leave interest rates unchanged was accompanied by a more hawkish stance on the outlook for inflation and the timing of rising interest rates locally. In its comments, it now seems certain of a FED hike this year and is expecting a potential fallout in markets and the local currency (thus higher inflation) when this happens due to foreign disinvestment flows. It now seems that the SARB is willing to act on the strong assumption of a hike by the FED instead of acting after the event, in order to prevent a sell-off in the currency and markets as well as to thwart a vicious inflationary spiral.

To quote opening remarks from our latest MPC meeting:" *The challenges facing monetary policy have persisted, and, as expected, the downward trend in inflation which was mainly attributable to the impact of lower oil prices has reversed. Headline inflation is expected to breach temporarily the upper end of the target range early next year, and thereafter remains uncomfortably close to the upper end of the target band for most of the forecast period.*

The upside risks have increased, mainly due to further possible electricity price increases. The exchange rate also continues to impart an upside risk to inflation as uncertainty regarding impending US monetary policy continues. Domestic demand, however, remains subdued while electricity constraints continue to weigh on output growth and general consumer and business confidence".

The SARB has revised its inflation forecast upwards to 4.9% (4.8%) and 6.1% (5.9%) in 2015 and 2016 respectively. Growth dynamics in the local economy remain poor with continuing downgrades from both the IMF and local economists which do not support a rise in interest rates but the decision will be driven by the above mentioned exogenous factors. Analysis of the latest GDP figures showed that manufacturing and mining continue to contract which will have an on-going negative impact on unemployment and more importantly could cause more labour and social unrest in due course. We are fearful that this might result in further rating agency downgrades with negative consequences for the rand and current account deficit. There is very little reason not to expect currency weakness in the medium to long term. Thus our strategic positioning in the funds we manage around counters with foreign earnings flows and/or a unique local offering together with increased cash holdings in portfolios.

Our overall assessment of investment markets and equities in particular is that most markets are in high territory and the risk of increased volatility has increased. The FED, in its communication, has been very effective in guiding the markets regarding the timing of interest rate hikes. They continue to state that they will remain data dependent and that a first rate hike does not necessarily mean more will follow or if more rate hikes do follow, they ought to be gradual. Nonetheless, once the decision is announced, we expect markets to have a short term kneejerk downward reaction despite some form of a rate hike being priced in at current levels.

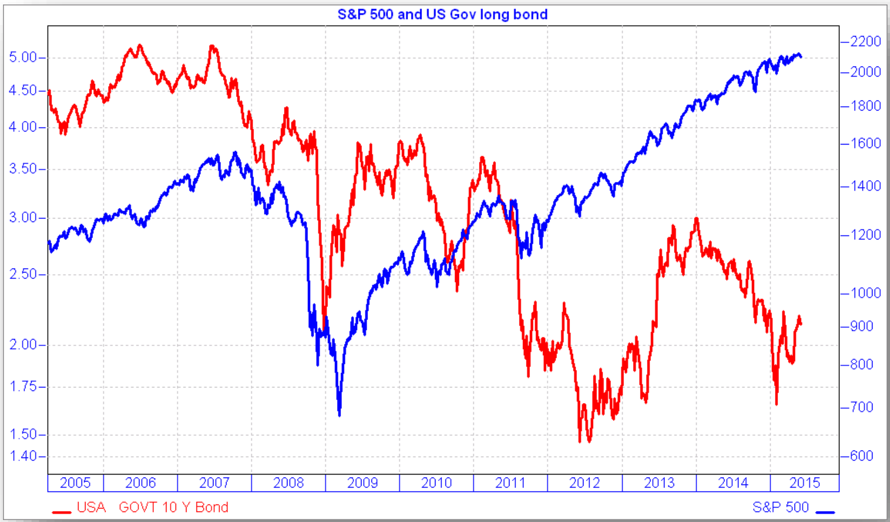
It is worth remembering that any US interest rate increases will be due to a vibrant economy which by definition is good for corporate profits and ultimately shares. What is of vital importance is the initial quantum of the first increase [very small, we believe] and the weaning of the US off ultra-low rates – the Fed must not get ahead of itself! So not all negative but volatile!

News from abroad

Historically, equities were expensive when bonds were cheap and vice versa. Today, this is not the case with both bonds and equities, particularly in the US, being at elevated levels. Risk averse investors who prefer bonds and cash are still earning negative real returns. Higher risk investors are forced into overvalued equities as this is the only asset class still "promising" a measure of yield.

Bonds did, however, become less expensive after Both Janet Yellen and ECB President Mario Draghi voiced their concern over excessive risk taking (equity and bond markets are too high) and the impact that might have on financial stability. Following their comments, US long bond yields jumped 9% during the first two weeks in May but has subsequently retracted by 4% and currently trades on a meagre 2% yield (10yr Government Bond). Equities continue to react positively on "bad" economic news as this is seen to delay any interest rate hike action by the FED. When the FED eventually acts, both asset classes are likely to become cheaper. Equities should rebound after the initial reaction as higher rates mean the economy is growing. In theory, bonds yields should move up (prices decline) along with short term interest rates until near the peak of a rising interest rate cycle. But, as the FED stated, interest rates could rise at a very gradual pace due to low inflationary expectations which may result in bonds and equities continuing to be positively correlated.

The chart below shows the price correlation between bonds and equities and that the positive price correlation started in late 2011 with yields declining (prices up) alongside rising equity prices. Bond yields spiked in 2013 after an announcement by then FED Chairman Ben Bernanke that they might scale back their bond purchase programme (QE). By late 2013, the Fed decided not to taper, sending yields lower. We are therefore at that point again. If Janet Yellen announces a "taper" in the form of a change in interest rates, bond yields will rise alongside lower equity valuations, but maybe not significantly so, if markets aren't surprised, i.e. – meaning a hike in interest rates is "priced in" or was lower than expected. We shall see.



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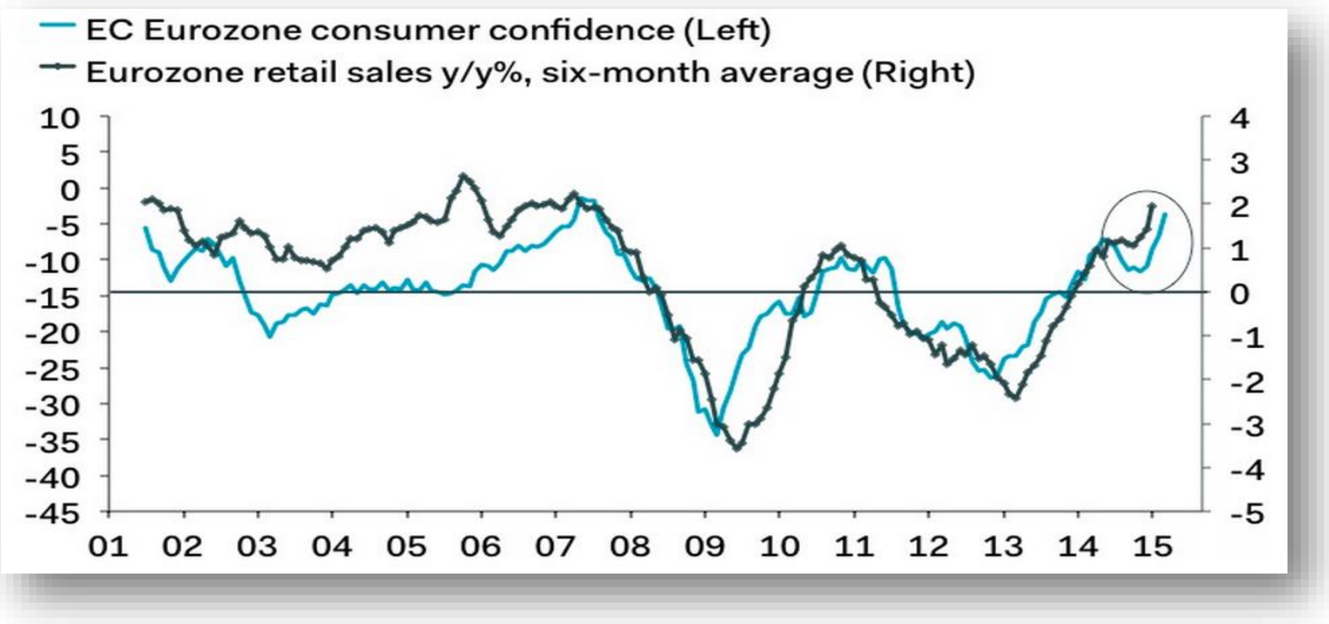
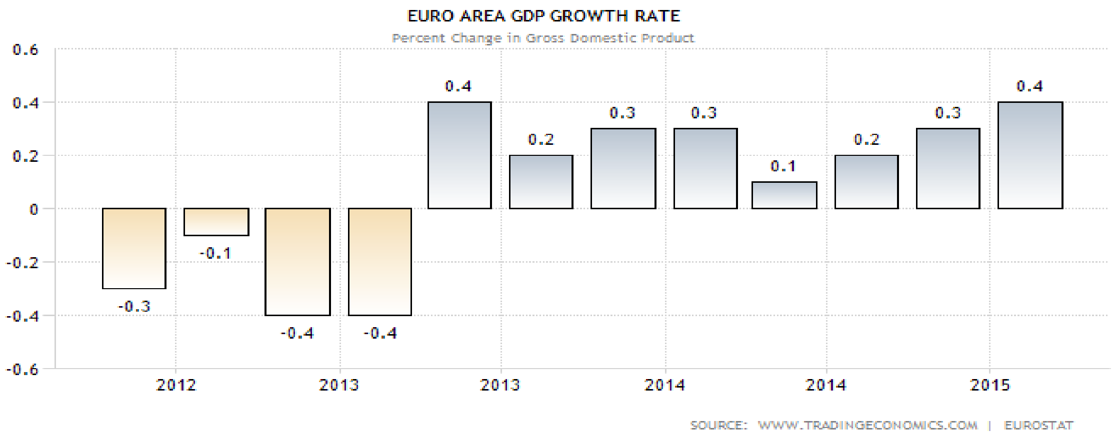
We remain of the opinion that the FED will tread cautiously in order not be forced to cut rates soon after hiking if the economic recovery falters. Economic data remains fairly mixed. Unemployment is looking better but there still is a fair amount of slack in the labour market and wages aren't really going up. Inflation also is not a concern yet and in fact the latest number suggested that they are experiencing slight deflation.

The European economic recovery remains on track. Consumer confidence and retail sales have reached 8 year highs.



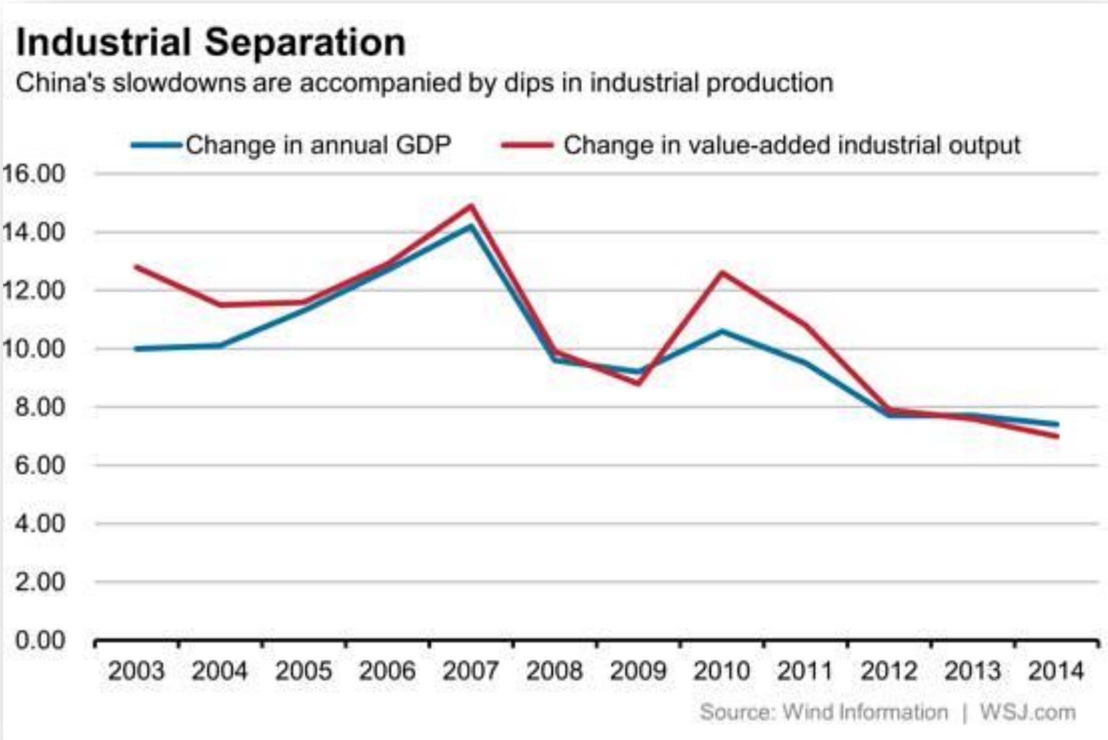
Source: Business Insider



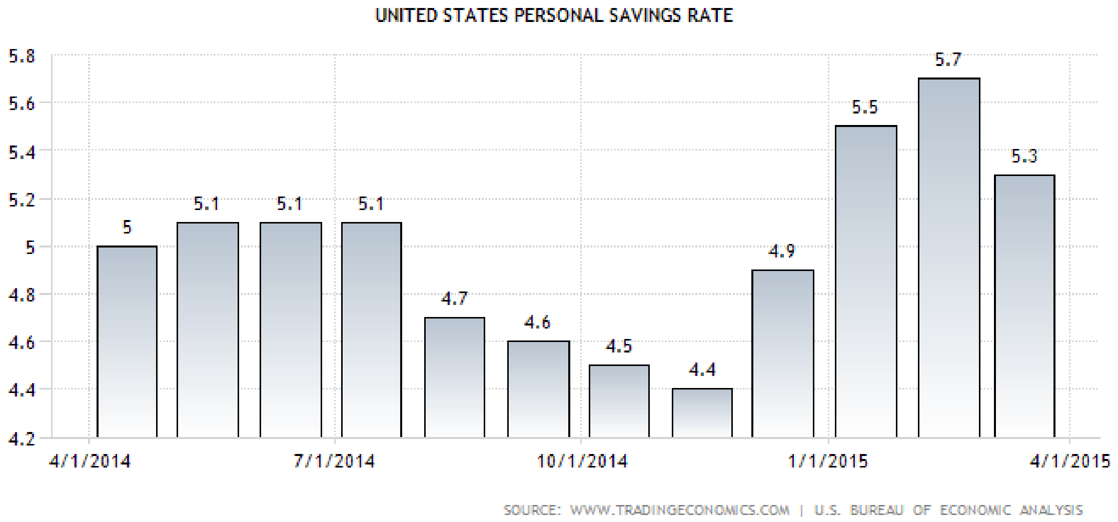
But markets are a bit worried about the situation around the probability of Greece exiting the monetary union. The main issue is whether Greece will be able to fund a 3.5 billion euro bond maturity on 20 July that is held by the ECB. This is a high-risk event. A default might lead to the ECB cutting off Greek banks' access their ELA (Emergency Liquidity Assistance) facility which could result in Greece being forced to exit the union. Our view continues to be that a compromise will be reached once again as the Euro area does not wish to set a precedent "on how to exit".

Markets will likely act negatively on an exit, bond markets in particular. The US government has increased pressure on Greece and its lenders to make compromises to reach a bail-out deal and avoid a Grexit. Recently, US Treasury Secretary Jack Lew issued a warning, to quote; *"The notion that there is no contagion ....I think it's a mistake to think that a failure is no consequences outside of Greece"*.

Emerging markets continue to track economic events in China given its importance to commodity producers. Chinese authorities have dramatically increased efforts to support economic growth. Following interest rate cuts in November last year and again in March this year, the People's Bank of China(PBoC) in April reduced the reserve requirement for banks by 100 basis points with the aim to stimulate growth in bank lending for infrastructure projects and private consumption. Recent data for industrial production, retail sales and fixed investment have all been very disappointing confirming that the economy is slowing down faster than previously expected. More and more economists are predicting that the PBoC will start buying local government bonds soon as to embark on their own form of QE.

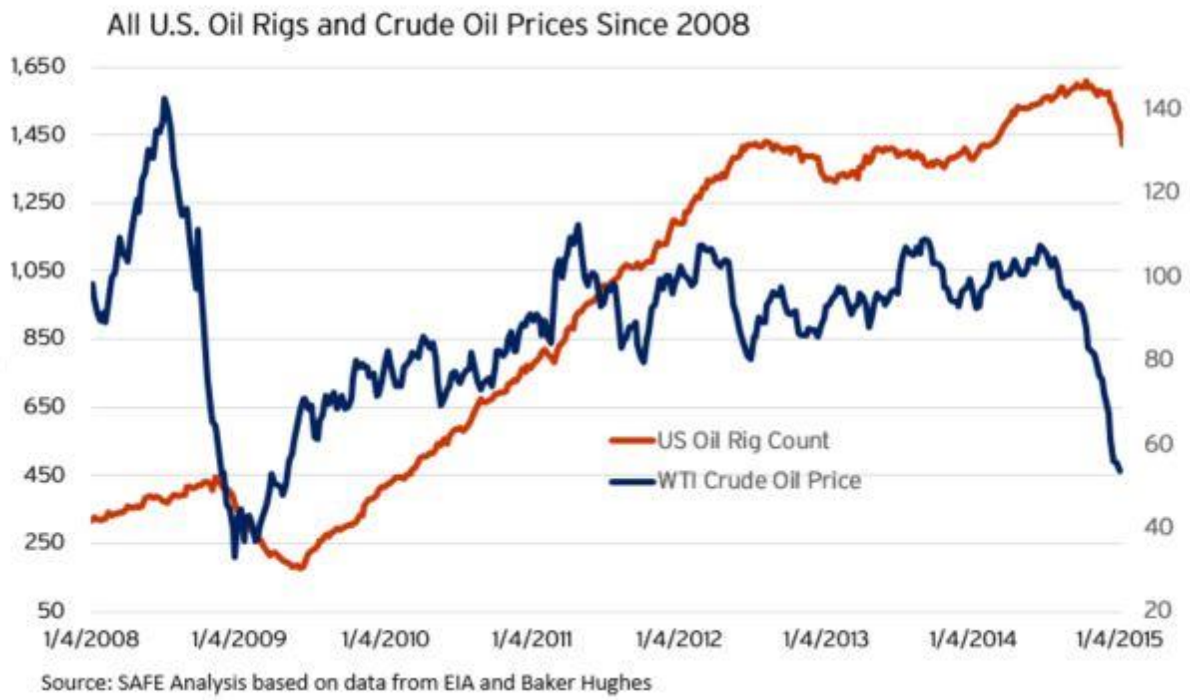


The impact of lower oil prices on global economic growth has been rather muted and is fuelling deflationary pressures. Households have delayed spending in anticipation of higher oil prices and have preferred saving the windfall. The two charts below indicate increased saving as the oil price collapsed.



We anticipate that as the European and US economies continue to improve that sceptic households will eventually start spending again.

Oil production is expected to continue to decline as the rig count number, which measures US and Canadian drilling activity, has dropped by 50% - a possible bottom. Supply and demand is slowly rectifying and is now very sensitive to changes in either sides of the equation. So we are still of the opinion that oil could well trade in the $50-$70 range for some time; still a net benefit to global economies.



In a nutshell

- Monetary policy is creating market overshoots on a global basis as investors continue to search for yield. The overshoot is particularly acute in equity markets due to negative real long bond yields in developed markets;
- With the local equity risk premium at 2.6%, our market appears slightly expensive on a relative basis. UK stocks are trading at 3.2% and US stocks at 2.8%. The gap could well narrow (bond yields declining) in the short term if US economic data continues to disappoint and the FED decides to postpone interest rate hikes;
- The SARB has turned more hawkish on inflation despite slowing economic growth. They are also wary of portfolio outflows and a weaker rand when the FED starts hiking. There is a possibility that they might pre-empt the FED in order to stem the potential portfolio outflows and try and protect the rand to some degree (unlikely to work);
- Markets are at elevated levels but could remain so for still some time but with a higher degree of volatility;
- The big question remains the FED and what they are going to do – how big and when are they going to rise;
- US economic data remains very mixed and they have dipped into deflation which is a risk to the economy;
- We are still of the opinion that oil could well trade in the $50-$70 range for some time; still a net benefit to global economies;
- Europe is now the star performer and most key economic indicators have turned positive and QE has still a way to go;
- Greece: some form of agreement which should support equity and bond markets, is expected around its debt issues;
- China is slowing faster than predicted which is bad for emerging markets but is likely to stimulate fairly aggressively;
- In the event of interest rate action by the FED being followed by a fall equity prices, market weakness should be exploited to increase exposure to equities as rising interest rates should indicate a vibrant economy and bode well for corporate earnings and ultimately shares over the medium to long term;
- Thus our strategic positioning in the funds we manage around counters with foreign earnings flows and/or a unique local offering together with increased cash holdings in portfolios.

Sincerely

Chris Botha **Dave Eliot**

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