IMARA INVESTING IN AFRICA
Asset Management

Communiqué

Monthly

South Africa

July 2015

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Let's not be so negative

Local news

It is very easy for South Africans to be overly negative about our country given all the bad news around labour, politics and of course Eskom, amongst other things.

Following our opening remarks in last month's communiqué, regarding our investment philosophy by investing in quality world class companies with a long term view, we thought it appropriate to include a summary of a recent WEF (World Economic Forum) competitive survey on South Africa which was compiled by a colleague of ours Bruce Williamson. As can be seen in the tables below, we rank very favourably from a financial and regulatory perspective but rank poorly, as expected, from a labour, productivity and education perspective. It makes for interesting reading.

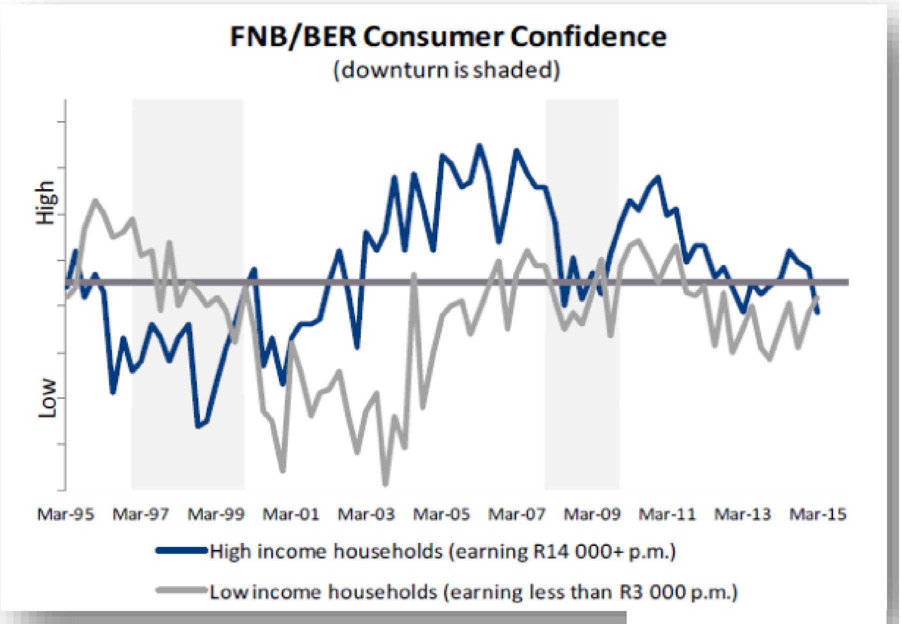
South Africa – WEF Global Competitive Index 2014-2015 (ranked in the top 30% for 40% of the 115 indicators.

Ranking	Indicator	Ranking	Indicator	Ranking	Indicator
1	Strength of auditing and reporting standards	24	Judicial independence	34	Quality of scientific research institutions
1	Regulation of securities exchanges	24	Secondary education enrollment, gross %*	35	Transparency of government policymaking
2	Protection of minority shareholders' interests	24	Quality of management schools	35	Ethical behavior of firms
3	Efficacy of corporate boards	24	Domestic market size index, 1-7 (best)*	35	Contribution of international distribution
3	Financing through local equity market	24	Extent of marketing	35	Capacity for innovation
4	Company spending on R&D	25	Mobile telephone subscriptions/100 pop.*	36	Intensity of local competition
6	Availability of financial services	25	GDP (PPP$ billions)*	37	Quality of roads
6	Soundness of banks	26	Effect of taxation on incentives to invest	37	Venture capital availability
9	Legal framework in challenging regulations	27	Malaria cases/100,000 pop.*	38	Production process sophistication
10	Strength of investor protection, 0-10 (best)*	27	Willingness to delegate authority	38	Local supplier quality
11	Quality of air transport infrastructure	28	Available airline seat km/week, millions*	38	Production process sophistication
14	Effectiveness of anti-monopoly policy	29	Firm-level technology absorption	39	Country capacity to attract talent
15	Legal framework in settling disputes	30	Business costs of terrorism	39	Availability of latest technologies
15	Effect of taxation on incentives to work	30	Business impact of malaria	41	Total tax rate, % profits*
18	Extent of staff training	31	Buyer sophistication	42	Prevalence of foreign ownership
20	Property rights	31	University-industry collaboration in R&D	43	Legal rights index, 0-10 (best)*
21	Reliance on professional management	32	No. procedures to start a business*	44	Quality of railroad infrastructure
21	Affordability of financial services	32	Ease of access to loans	44	Availability of research and training services
22	Intellectual property protection	33	Redundancy costs, weeks of salary*	44	State of cluster development
23	Prevalence of trade barriers	34	Foreign market size index, 1-7 (best)*	45	PCT patents, applications/million pop.*

South Africa – WEF Global Competitive Index 2014-2015 (ranked in the bottom 30% for 22% of the 115 indicators.

Ranking	Indicator	Ranking	Indicator	Ranking	Indicator
46	Quality of port infrastructure	85	Imports as a percentage of GDP*	112	Gov't procurement of advanced tech products
47	Local supplier quantity	89	Wastefulness of government spending	117	Internet access in schools
48	Irregular payments and bribes	89	Fixed broadband Internet subscriptions/100	118	Primary education enrollment, net %*
48	Extent of market dominance	90	Public trust in politicians	119	Gross national savings, % GDP*
50	Country capacity to retain talent	90	Fixed telephone lines/100 pop.*	120	Burden of government regulation
50	FDI and technology transfer	90	No. days to start a business*	126	Int'l Internet bandwidth, kb/s per user*
51	Country credit rating, 0-100 (best)*	92	Exports as a percentage of GDP*	129	Life expectancy, years*
59	Quality of overall infrastructure	93	Tertiary education enrollment, gross %*	133	Business costs of crime and violence
62	Burden of customs procedures	96	Diversion of public funds	133	Quality of primary education
62	Nature of competitive advantage	97	Government budget balance, % GDP*	136	Business impact of tuberculosis
65	Agricultural policy costs	99	Organized crime	136	Business impact of HIV/AIDS
67	Degree of customer orientation	99	Quality of electricity supply	136	Pay and productivity
68	Value chain breadth	102	Reliability of police services	139	Flexibility of wage determination
69	Individuals using Internet, %*	102	Inflation, annual % change*	140	HIV prevalence, % adult pop.*
74	Mobile broadband subscriptions/100 pop.*	102	Availability of scientists and engineers	140	Quality of the education system
76	Trade tariffs, % duty*	104	Favoritism in decisions of government officials	143	Tuberculosis cases/100,000 pop.*
77	General government debt, % GDP*	104	Business impact of rules on FDI	143	Hiring and firing practices
84	Women in labor force, ratio to men*	105	Infant mortality, deaths/1,000 live births*	144	Quality of math and science education
				144	Cooperation in labor-employer relations

Despite our structural problems, the economy will still grow and quality businesses will still make profits and provide returns to shareholders. We as investors need to understand, like our corporates have, that there are always opportunities that can be exploited despite all the obvious headwinds. Take for example the highly successful growth we have witnessed in private education and healthcare companies listed on the JSE as well as the potential for private companies to sell power into the electricity grid in due course ,to name just a few. Moreover, because of our structural issues more and more companies are expanding operations offshore to ensure continued growth. Returns to shareholders will also benefit from a weaker rand exchange rate over time. Our investment philosophy endeavours to capture these opportunities and we have been very successful thus far in exploiting these on behalf of our clients.

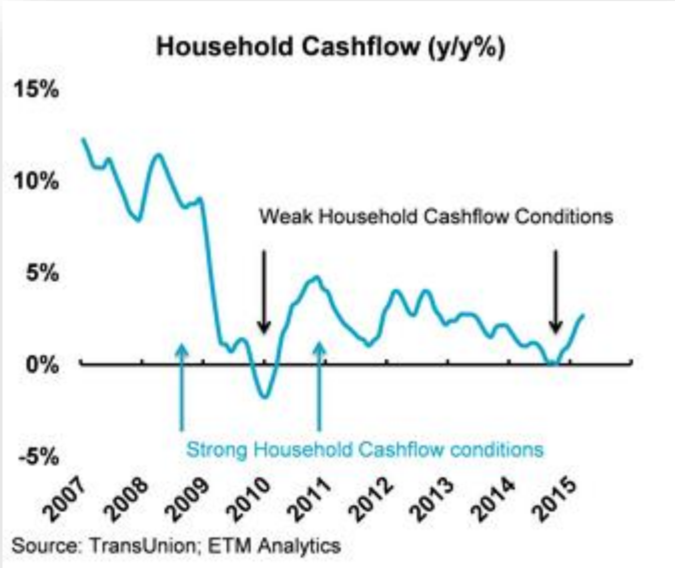


Source: BER

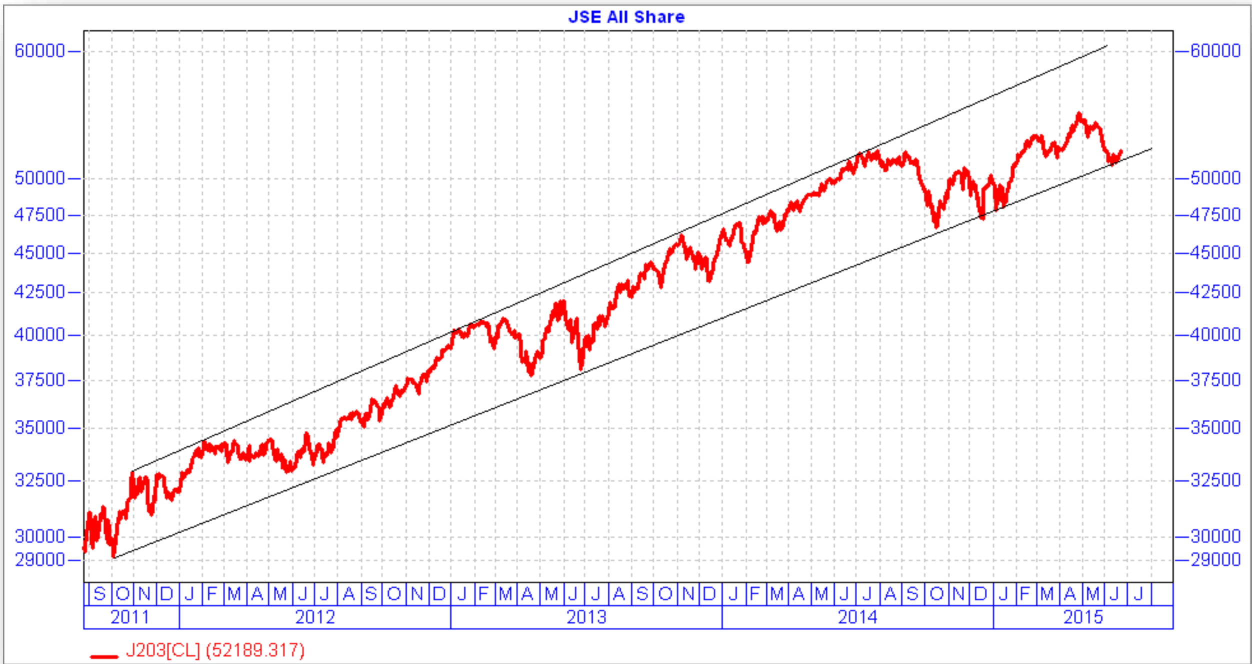
Near term negative factors for the local economy remain heightened inflationary expectations and a hawkish Reserve Bank with most economists now expecting a hike in the repo rate of 25bp in July, despite deteriorating economic growth. Consensus GDP growth for 2015 is 2.1% with inflation expected to average 4.9% in 2015. Forecast risk for inflation is high due to the potential impact the proposed additional Eskom price increase of 12.6% and its negative effects on inflation; exacerbated by a weakening rand. The rand should remain on the back foot due to tightening capital flows into emerging markets when the FED makes its first move around hiking interest rates later this year or very early 2016.

The lower oil price in February and March provided a short term boost to consumer confidence and expenditure but has recently deteriorated again as the higher fuel taxes since the budget have begun to impact.

Appetite for consumer credit is also showing signs of weakness and a looming interest rate hike is most likely to negatively impact consumers spend. Household cash flows (see chart below) have improved somewhat after reaching a low in December last year mainly due to a lower rate of borrowing but is at risk as the cost of existing debt will go up after a move by the SARB.



We cautioned in previous communications that volatility in markets was likely to increase due to expectations around a move by the FED and geopolitical risk particularly around Greece and a potential exit from the euro. This has been the case. The JSE all share has declined by 5% after reaching a high in May this year but is still up 5% (coincidence) year to date and is up 2% year on year. Foreign buying and selling remains fairly volatile with net buying in favour at the time of writing. The accompanying chart indicates the increased volatility and the market appears to still be in an upward long term trajectory and is trading just above its long term support line. Further volatility cannot be ruled out once the SARB and the FED strut their stuff!



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At sector level, resource stocks remain out of favour due to poor macro variables and slowing growth in China despite appearing inexpensive. It's likely that this sentiment will prevail for some time still. Industrial rand hedges appear expensive but the weaker rand (we expect more weakness over the medium term) is supporting valuations on a forward basis which appear more reasonable.
We potentially foresee opportunity in the financial sector due to a likely negative reaction in share prices when interest rates change. Rising interest rates have historically been positive for banking profits as lending margins increase but could eventually cause deterioration in bad debts and slower loan growth.
Given our investment philosophy, client portfolios in general have proven less volatile than the market as a whole.

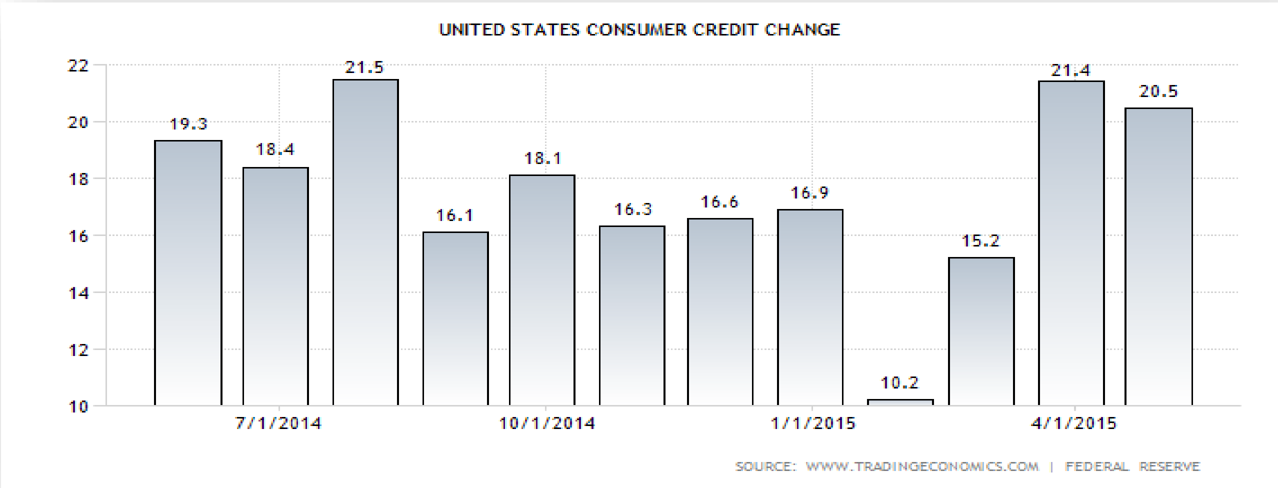
From abroad

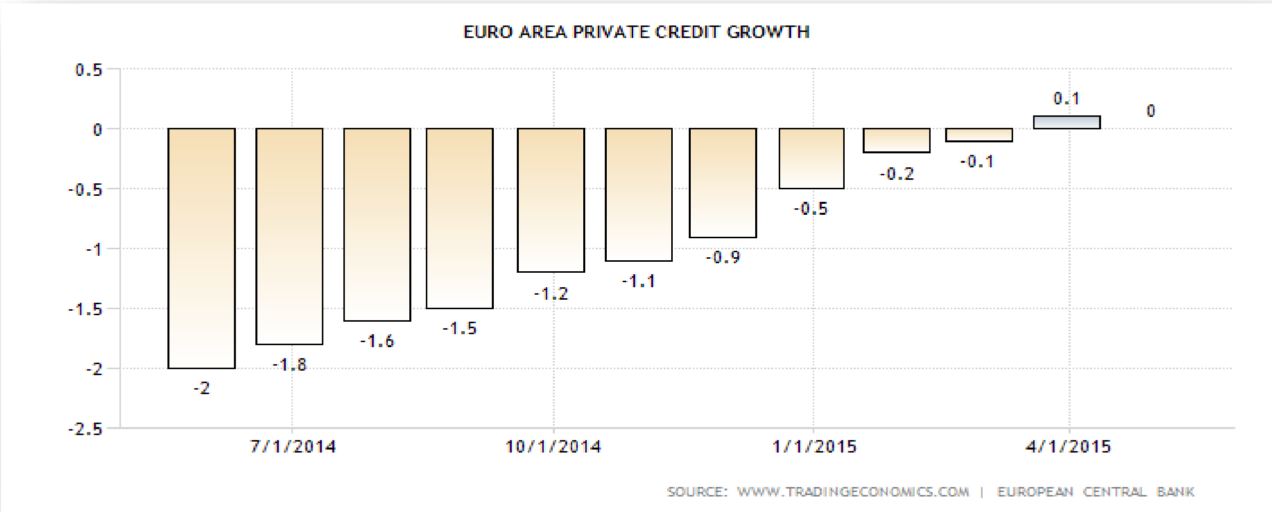
The Greeks and the Germans are still at it. The inability of Greece and its creditors to reach an agreement is growing increasingly tense. The acceleration of meetings at the highest echelon stresses the urgency of the situation. In the last meeting, the latest Greek proposals for a cash-for-reform deal drew cautious welcome from Eurozone finance ministers but emphasised that a detailed study needs to be undertaken. Jeroen Dijsselbloem, chairman of the 19 – nation Eurogroup said the Greek document was comprehensive and "a basis to really restart talks". But German Finance Minister Wolfgang Schaeuble, who has taken a persistent hard line with Greece, was less optimistic stating there was "nothing new" and, "without substantial proposals which can be examined seriously, we can't seriously prepare a euro summit". On a positive note though, Greece confirmed that it was prepared to accept the target of a primary surplus of 1% of GDP this year and 2% next year.

There is growing optimism that progress will be made at the upcoming Eurogroup meeting ahead of the European summit scheduled deadline 30th June. In a worst case scenario whereby Greece exits the Euro, the impact on other economies is likely to be limited as private financial institutions have little exposure to Greek debt. But the markets might think otherwise. By the time you read this it should be old news!!

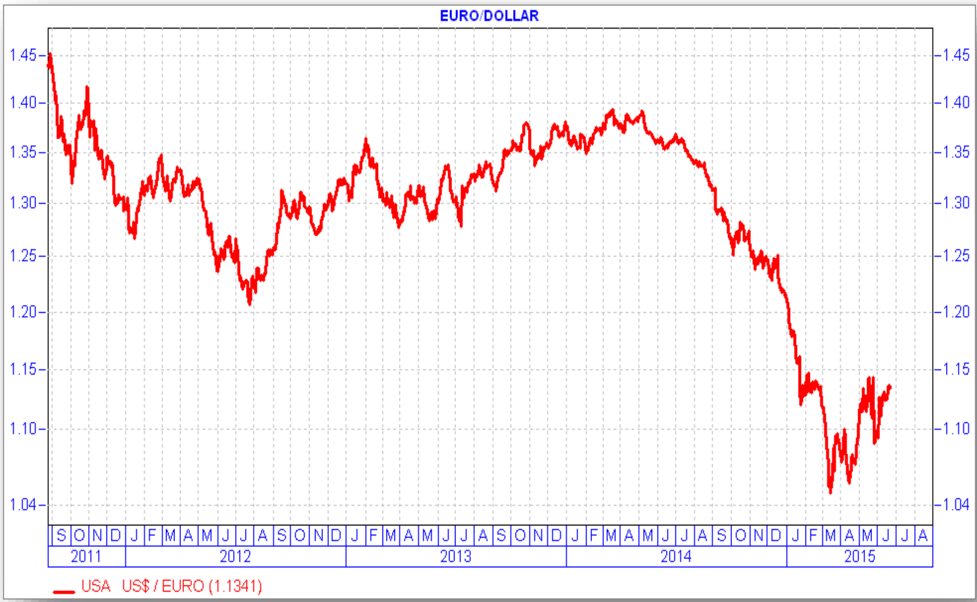
The economic recovery in Europe remains positive. The ECB raised its inflation forecasts from 0% to 0.3% for this year. These factors took sovereign yields and the euro to new highs. Following an interview with ECB President Mario Draghi, the message from the bank remains very clear that they will do what needs to be done to ensure the recovery does not falter. The ECB has not changed its medium-term inflation forecasts (1.8% in 2017) and thinks that asset purchases will be necessary until at least September 2016. This should curb Euro strength as well as sovereign yields for some time and bode well for this big export region. The recovery is being supported by continued strength in the region's manufacturing output (see chart).

As expected[by us], the FED left interest rates unchanged in June but mentioned that it plans to lift benchmark rates before the end of 2015. But they remained cautious and our interpretation was that their confidence in their conviction is waning somewhat given a very mixed economic backdrop with sporadic signs of weakness in certain areas. Despite the FED expecting growth to pick up, they have revised downwards the growth rate for 2015 and believe that the jobless rate will be higher than previously forecast. Forecast growth was reduced to 1.9% for 2015, previously 2.5%. They remain determined to wind down their loose monetary stance but appeared somewhat more cautious. Moreover, unlike Europe, credit growth in the US has stopped accelerating as consumers continue to save rather than spend. Credit growth in Europe is recovering strongly (see charts below).





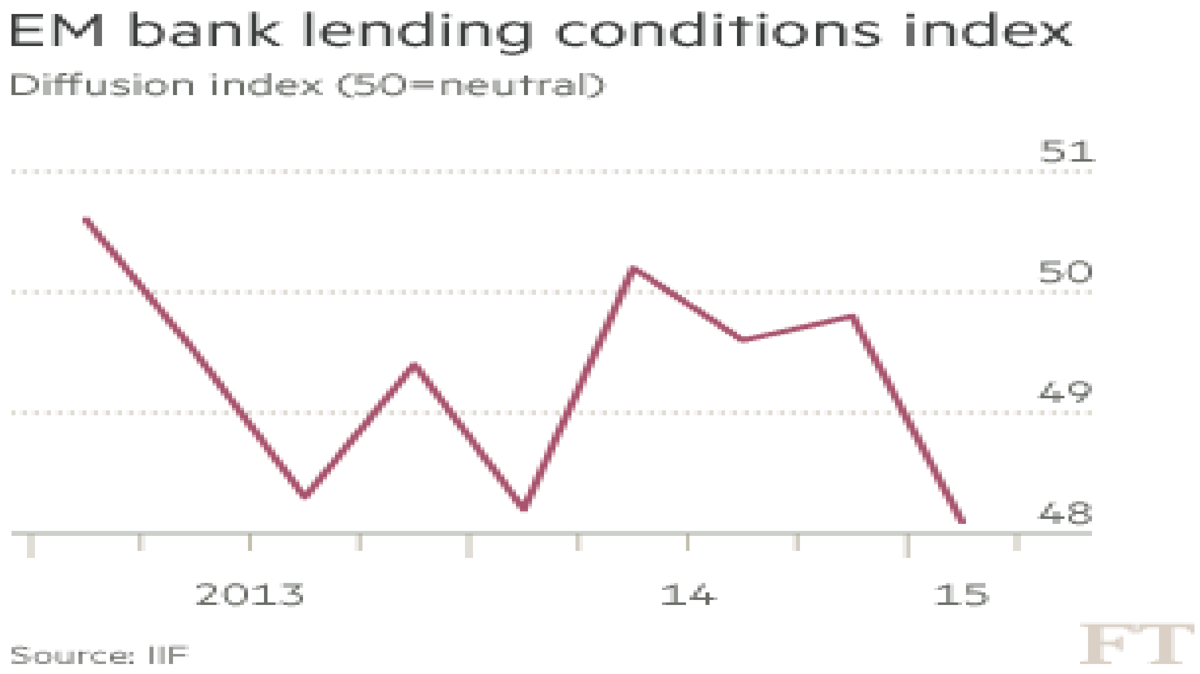
The strong dollar continues to have a negative impact on corporate earnings in the US and the economy. Some 30% of the S&P 500's earnings are non-dollar denominated. Diverging monetary policies on either side of the Atlantic could well lead to Euro/Dollar parity (1:1) in due course likely driven by further strength in the dollar. This could make the FED even more cautious. The chart below reflects the Euro relative to the Dollar – a declining line reflects a stronger Dollar relative to the Euro.

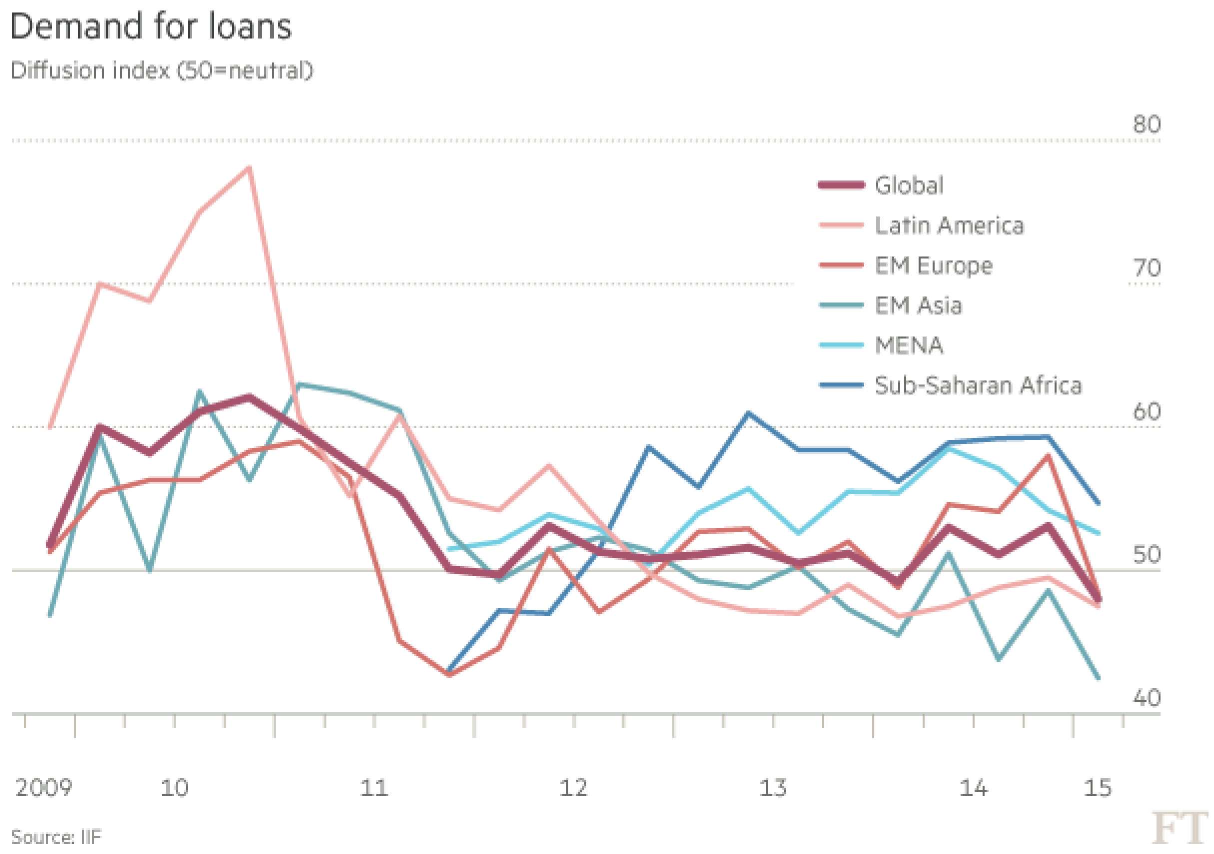


Downside risk to high equity valuations in the US, in particular, will be less of a concern if profit growth was strong. The strong dollar and to a lesser extent continuing closures of shale oil rigs continue to negatively affect profits. Forecast profit growth for 2015, has been revised downwards recently to just 1.4% from 12% expected in October last year for 2015. A move by the FED could well be the trigger to bring valuations more in line with fundamental underpinnings.

The most vulnerable markets remain emerging markets with no respite in falling commodity prices and slowing credit growth at consumer level. Slowing GDP growth, deteriorating balances of payments, high inflation, high levels of foreign debt (not SA), high asset valuations (bonds and equities) and weakening currencies are all ingredients for a perfect storm in the making. With little evidence of economic reform around foreign direct investment, labour and politics, the only mechanism emerging markets have are higher interest rates to try and stem the potential foreign investment outflows from risky assets and to stabilise their currencies. The catalyst here again will probably be the FED. We still believe the SARB could be pre-emptive due to the deteriorating inflation outlook in South Africa and the weakening Rand.

A recent report by the Institute of International Finance shows that bank lending conditions in emerging markets have deteriorated meaningfully in the first quarter of 2015 (see charts below). The report is the result of 14 questions sent to 130 banks operating in emerging markets across the emerging world. At 48.1, the lowest since 2011, it is indicating tightening rather than expansion of credit conditions which will have a negative impact on economic growth. But despite this, rates will probably rise to stabilise currencies and inflation.





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To conclude

- Near term negative factors for the local economy remain heightened inflationary expectations and a hawkish Reserve Bank with most economists now expecting a hike in the repo rate of 25bp in July despite deteriorating economic growth.
- The rand should remain on the back foot due to tightening capital flows into emerging markets when the FED makes its first move around hiking interest rates.
- Volatility in markets is likely to increase due to expectations around a move by the FED and geopolitical risk particularly around Greece and a potential exit from the Euro.
- The economic recovery in Europe remains intact. The ECB raised its inflation forecasts from 0% to 0.3% for this year.
- This should curb Euro strength as well as sovereign yields for some time and bode well for this big export region.
- Despite the FED expecting growth to pick up, they have revised downwards the growth rate for 2015 and believe that the jobless rate will be higher than previously forecast. They remain determent to wind down their loose monetary stance but appear more cautious in doing so.
- The most vulnerable markets remain emerging markets with no respite in falling commodity prices and slowing credit growth at consumer level. Slowing GDP growth, deteriorating balances of payments, high inflation, high levels of foreign debt (not SA), high asset valuations (bonds and equities) and weakening currencies are all ingredients for a perfect storm in the making.
- Despite our structural problems, the economy will still grow and quality businesses will still make profits and provide returns to shareholders. We as investors need to understand, like our corporates have, that there are always opportunities that can be exploited despite all the obvious headwinds.
- Our investment philosophy endeavours to capture these opportunities and we have been very successful thus far in exploiting these on behalf of our clients.
- Please do not be surprised if the cash levels in your portfolio increase to counter the vicissitudes of the share market!

Sincerely

Chris

Chris Botha

Dave

Dave Eliot