IMARA INVESTING IN AFRICA
Asset Management

Communiqué

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Does current making volatility make sense?

Locally

The short answer is yes. Ever since China devalued the Yuan, market volatility has been on the increase as the move was seen as a desperate attempt to try and prevent their economy from slowing further. One should not forget, however, that the Yuan has been strengthening as the US Dollar has been rising due to its dirty peg to the dollar, therefore a mild devaluation should not have been a shock. That it was, illustrates the extreme nervousness in markets in general.

A weaker currency will aid exports which should boost underlying trend growth of Chinese GDP. This initially caused weakness in other emerging market currencies in Asia but later filtered through to all major commodity producing markets with a corresponding weakness in those currencies. Other emerging market currencies had to weaken in order to make their currencies more competitive relative to the Yuan given the importance of exports in these regions.

Because of China "slowing down" (still likely to grow at about 6%) most commodities started to trend lower (again) along with oil. It was therefore likely that equity prices in emerging markets would have a negative response. Fear of the extent to how important the Chinese economy is to global growth and lower than expected manufacturing data spooked markets further, which caused a sell-off in developed markets and even more selling in emerging markets.

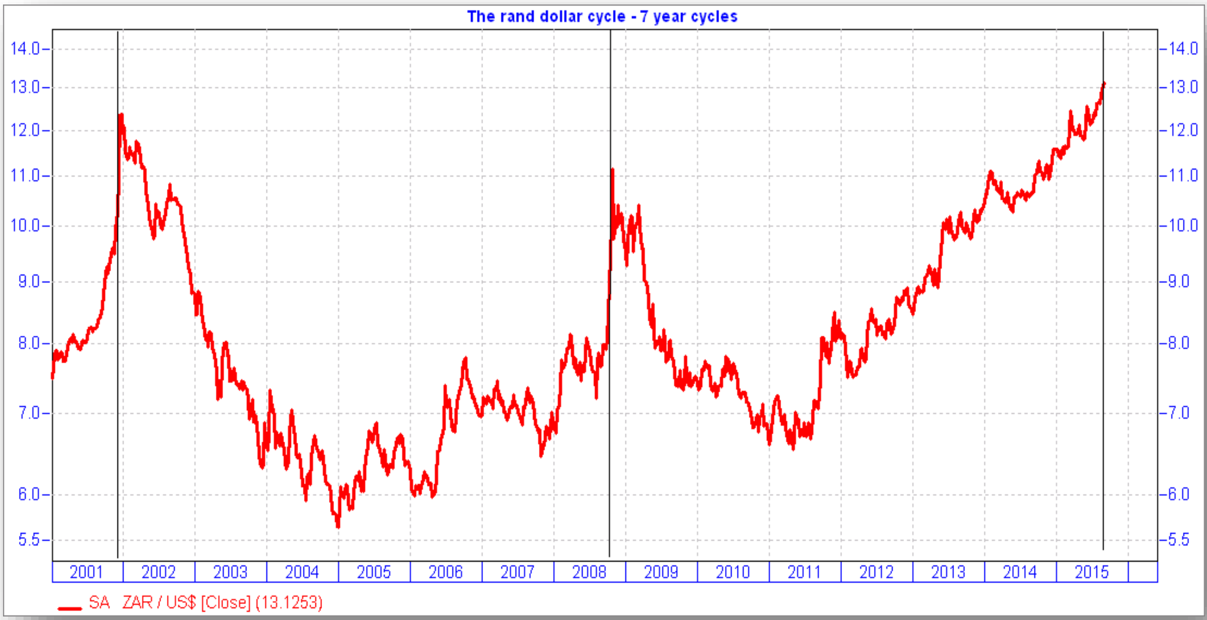
The slump in commodity prices is generally positive for global growth due to lower input costs (margin expansion) but has increased the risk of more deflation (lower selling prices at the factory gate and in retail outlets) due to weak consumer demand.

Data out of Europe continues to suggest that the recovery there remains intact and that the US is ticking along but perhaps slightly below expectations because of a slowing housing market and some deflation creeping in.

Given the market volatility and hardly any inflation in the US, we expect the FED to postpone a hike in interest rates to later this year or early next year. This makes matters rather challenging for the SARB. Poor local economic growth does not justify more rate hikes here but inflation is picking up as our currency weakens. It is possible that the SARB might let inflation temporarily rise above the upper target band due to the low growth environment. Intervention in the currency markets by the bank to try and stabilise the ZAR has historically been unsuccessful and we can see no reason for it to work this time around. We do not have the reserves! The rand is one of the most highly traded emerging market currencies in the world so that exercise might prove to be very costly.

The rand is oversold at current levels from a technical perspective and could well strengthen to around 1250c or so relative to the dollar in the near term, improving the inflation outlook giving the SARB some ammunition to postpone another hike in interest rates.

The following chart indicates what appears to be “7 year cycles” for the rand/ dollar.

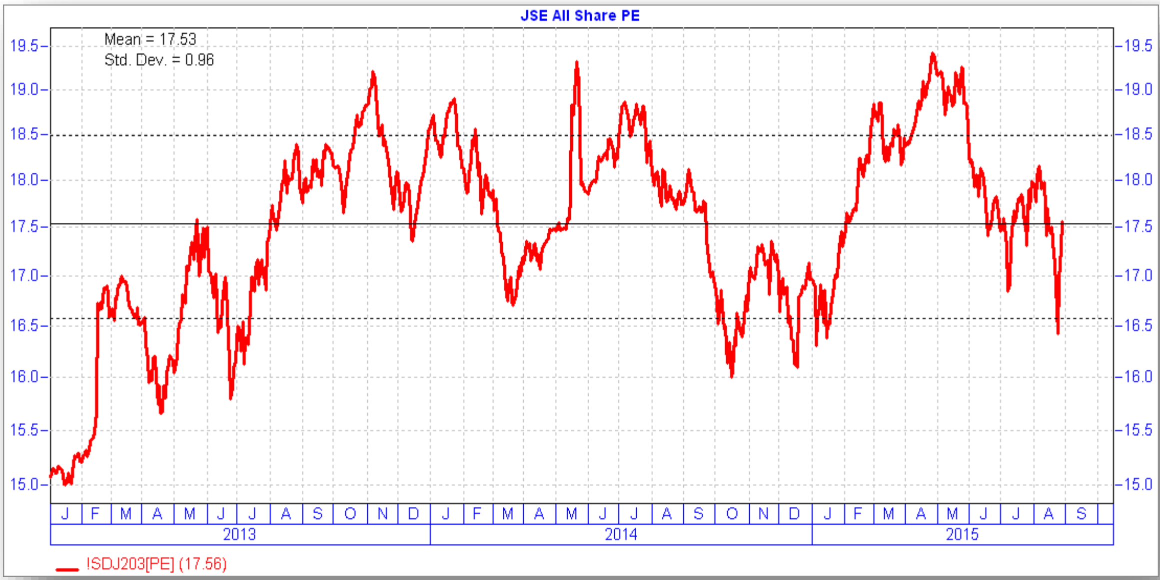


After reaching a high in April this year, the 14% correction in local share prices must be put into perspective. The JSE and US equity markets are still up by 160% and 180% respectively after reaching lows in March 2009.

Our client portfolios have always been (and will be) well diversified across a broad spectrum of economic sectors with a usually large rand hedge component. Furthermore, we don’t “mirror” typical benchmarks (like the JSE) in terms of share weightings and sector exposure which has been very rewarding for clients over the long term. Our Investment process and philosophy has stood the test of time and will remain robust and consistent in the future. We have for some time now warned clients that volatility was likely to increase, and it has. Hence the interest earning cash element in portfolios!

China has a huge amount of “ammunition (cutting interest rates further and reducing bank reserve lending requirements) to ensure a soft landing for their economy. This, together with low commodity prices and little inflation (globally) will likely ensure more stability in markets and better economic prospects over the medium term. Having said that, like we have said for a while now, these gyrations are likely not to be over, but things should slowly start to fall in place for a calmer global economic background and market stability in due course.

As can be seen in the next chart, the JSE is offering far better value at current levels following the 16% contraction in the price earnings (PE) ratio of the market; currently trading at its 3 year mean PE of 17.5 times. The weaker rand should ensure that the PE to winds down fairly quickly as we enter the current reporting season.



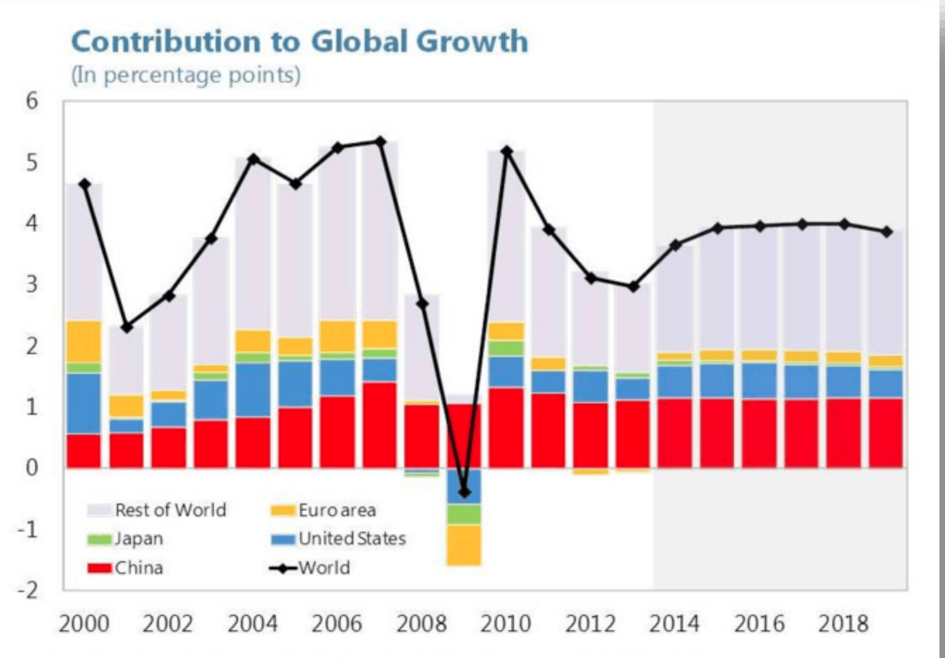
Local economic growth continues to be revised downwards with estimates currently ranging between 1.5% and 1.9% for 2015. Alarmingly, the economy actually contracted by -1.3% in the second quarter this year on an annualised basis. Two consecutive periods of contraction could potentially indicate that we have entered into a recession. The main factors driving the slowdown are power outages by Eskom, weak domestic and foreign demand as well as falling commodity prices. The likelihood of lost production in the gold and coal mining sectors given the current wage disputes could add fuel to the fire.

Along with the dire outlook for growth is the risk of rising inflation; the SARB might still increase interest rates again this year which in our view will be a policy mistake.

Following an IMF staff visit to SA in June this year, they following concluded: "*We project year-on-year inflation to accelerate, breaching the upper end of the target band in 2015: Q4-2016: Q1, easing to 5.5 percent by end 2016. The temporary breach of the South African Reserve Bank's (SARB) inflation target is driven by base effects from higher fuel prices, and electricity tariff increases. As the SARB has noted, monetary policy should generally only address second-round effects of supply-side shocks. The output gap remains negative (1-1.5 percent) and demand pressures subdued. There is significant uncertainty about the timing and pace of Fed tightening, the extent of rand depreciation, and the degree of pass-through. In sum, the SARB could stay on hold unless core inflation or inflation expectations rise, or external financing becomes problematic. The current inflation outlook presents communication challenges and puts a premium on explaining to the broader public the drivers of rising inflation. In that context, the announced publication of the assumptions underlying the SARB's inflation forecast is helpful.*"

Abroad

As China's markets fell and dragged down global equities, the underlying concern is undoubtedly, how much a slowdown in the Chinese economy will affect the rest of the world? Since the 2008 global financial crisis, China has emerged as one of the twin engines of global growth. China has contributed as much to world GDP growth as the US in the past decade and a half. So much so, the IMF projects that China will generate around double what the US contributes to world output until the end of the decade. The US and China are expected to generate as much output as the rest of the world put together (See chart). China currently contributes 13% to global economic growth.



Source: IMF, World Economic Outlook; and IMF staff calculations.

In 1995 China accounted for 2% of global GDP compared to the current 13% contribution.

As China slows from its 10% growth rate achieved in the first three decades of its reform period, beginning in 1979, to a lower 6.5%-7% currently, it is likely to cause global growth to grow at a slower pace. Vulnerable sectors in this slower growth environment will more than likely in the main be commodities and the countries producing them. But urbanisation and a growing middle class should provide some degree of support for a long time.

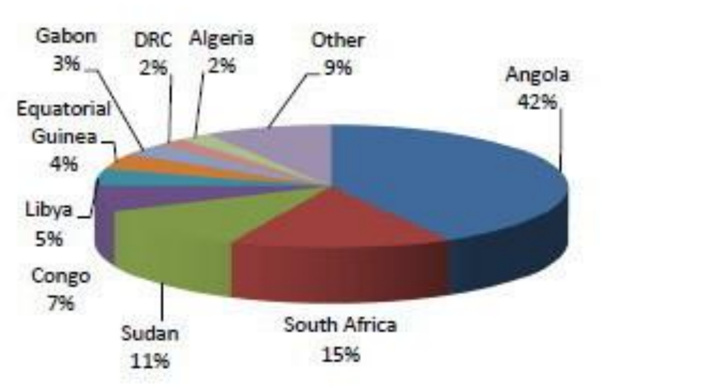
To put the above into perspective, a third of Australia's exports go to China and in Sub-Saharan Africa, one third of all exports go to China. However, the impact will be more concentrated as exports from Angola, DRC, Equatorial Guinea and South Africa account for three quarters of all African exports to China.

Although only 1% of US GDP gets exported to China, there will however be an impact, an example being that Apple sells more iPhones in China than in the US. Europe could also be impacted with many car manufacturers having built assembly plants in China but vehicle penetration remains low per capita which should provide a buffer. The following charts depict China's main export destinations.

The bottom line is that despite a slowdown, growth is unlikely to collapse as there is ample room for manoeuvre by authorities to stimulate GDP. Accelerating growth in Europe and steady growth in the US will act as positives in general terms.

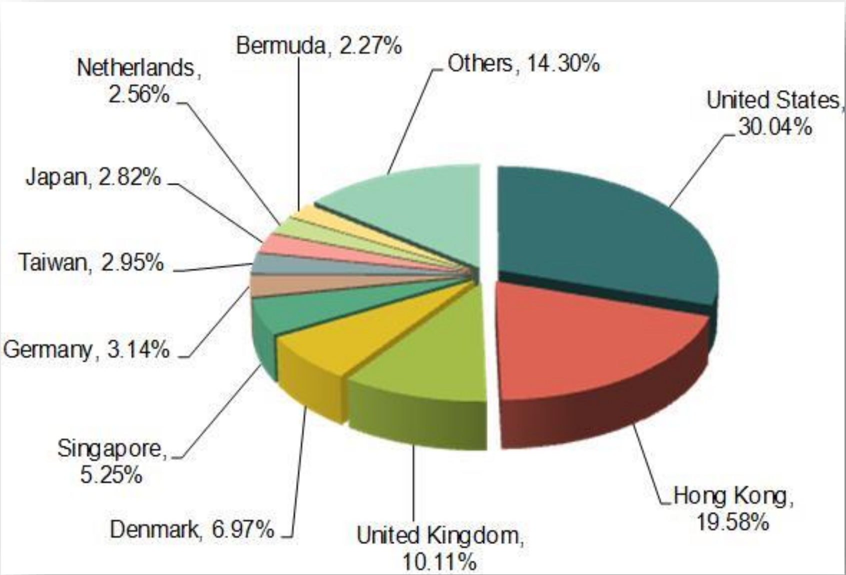
In Europe, business activity rose at its fastest pace in four years in June, boosted by higher spending by consumers and businesses as indicated by the latest Markit composite Eurozone Purchasing Manages' Index (PMI). Combined manufacturing and services activity rose to 54.2, the highest reading since May 2011. This compares to 53.8 in May 2015.

Figure 1: Composition of Africa's total exports to China



Sources: International Trade Centre, Standard Bank Group

China's exports per Region



Source: MadeInChina.com

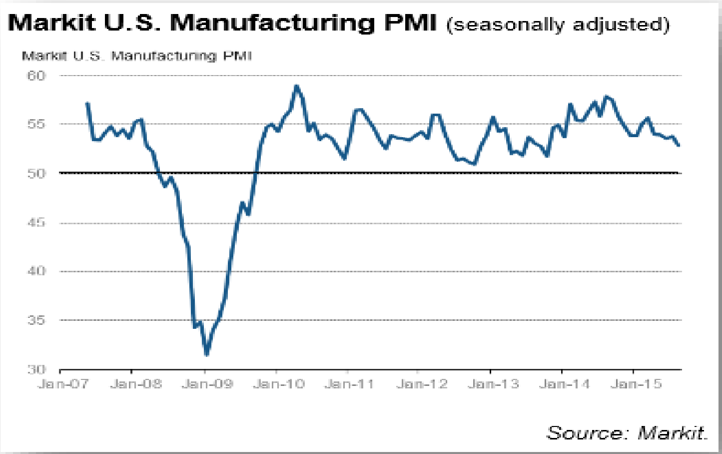
The European Central Bank's (ECB) massive €1 trillion bond-buying programme announced in March appears to be having positive effects particularly in the service sector, with activity running at its fastest rate since mid-2011.

IMARA INVESTING IN AFRICA

Markit said the ECB stimulus programme alongside low inflation boosted spending and investment across the zone as consumers and businesses increased spending in anticipation of rising prices in due course. To quote Markit's chief economist, Chris Williamson: "Despite the escalation of the Greek crisis in the second half of the month, the final PMI for June came in slightly above the 'flash' estimate, suggesting the turmoil has so far had little discernible impact on the real economy".

In the US, growth momentum is again somewhat weaker than expected with the August manufacturing PMI reading at 52.9 compared to 53.8 for July. The main factor weighing on the index was a slowdown in manufacturing output growth. Overall new orders increased, but the rate of growth was lower than in July. Export orders were also lower partly due to competitive issues because of the strong dollar.

To quote Tim Moore, senior economist at Markit; "August's survey highlights a lack of growth momentum and continued weak price pressures across the US manufacturing sector, which adds some fuel to the dovish argument as policymakers weigh up tightening policy in September. With the headline PMI swiftly losing ground after a modest rebound during July, the latest figure now points to the weakest overall pace of manufacturing growth for almost two years. According to survey respondents, the strong dollar continues to put pressure on export sales and competitiveness, while heightened global economic uncertainty appeared to have dampened client spending both at home and abroad. Alongside this, manufacturers of investment goods widely cited growth headwinds from the slump in capital spending across the energy sector. Sluggish manufacturing demand conditions and subdued cost pressures resulted in further restraint in terms of factory gate prices during August. Output charge inflation has broadly flat lined this summer and remains close to its lowest recorded by the survey over the past three years".



We remain of the opinion that interest rates in the US are likely to increase marginally later this year or early 2016. A premature hike may derail the recovery as current economic data appears to be rather fragile. A postponement of this decision will most likely result in more stable equity markets until the actual event.

IMARA INVESTING IN AFRICA

In Conclusion:

- The 14% correction in local share prices must be put into perspective. The JSE and US equity markets are still up by 160% and 180% respectively after reaching lows in March 2009.
- Ever since China devalued the Yuan, market volatility has been on the increase as the move was seen as a desperate attempt to try and prevent their economy from slowing further.
- Because of China "slowing down" (still likely to grow at about 6%) most commodities started to trend lower (again) along with oil. It was, therefore, likely that equity prices in emerging markets would have a negative response.
- China has a huge amount of "ammunition (cutting interest rates further and reducing bank reserve lending requirements) to ensure a soft landing for their economy
- The JSE is offering far better value at current levels following the 16% contraction in the price earnings (PE) ratio of the market. The market is currently trading on its 3 year mean PE of 17.5 times.
- The rand/dollar is oversold at current levels from a technical perspective and could well strengthen to around 1250c in the near term, improving the inflationary outlook, giving the SARB ammunition to postpone another hike in interest rates.
- Local economic growth continues to be revised downwards with estimates currently ranging between 1.5% and 1.9% for 2015. Alarmingly, the economy actually contracted by -1.3% in the second quarter this year on an annualised basis.
- The European Central Bank's (ECB) massive €1 trillion bond-buying programme announced in March, appears to be having positive effects particularly in the service sector, with activity running at its fastest rate since mid-2011.
- In the US, growth momentum is somewhat weaker than expected with the August manufacturing PMI reading at 52.9 compared to 53.8 for July.
- The fragility of the recovery in the US together with heightened market volatility is likely to postpone the first hike in interest rates by the FED to later this year or early 2016.
- Equity markets could well stabilise somewhat until the Fed does increase rates. Once that event has been digested – higher rates due to a strong economy-equity could once again be in favour.

Sincerely

Chris Botha **Dave Eliot**