Communiqué

Monthly

South Africa

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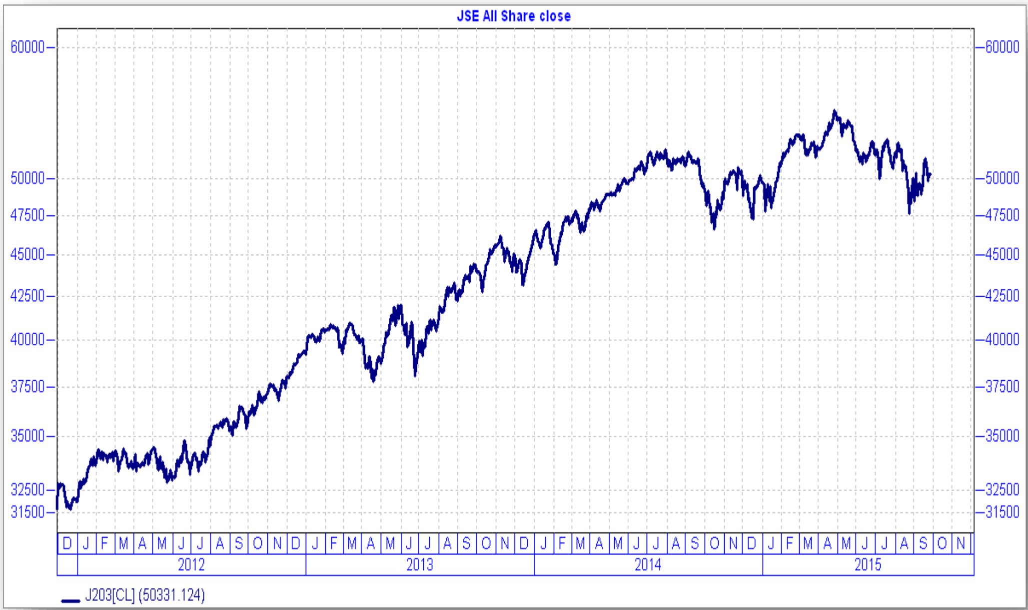
Don't be afraid of quantitative tightening – the market needs it!

Locally

Following no action by the FED to start their interest rate 'hiking' cycle and dovish comments during the media briefing, markets have been rather volatile. Markets were pricing in a 30% probability of the FED increasing rates by 25 basis points, but were not expecting the FED to appear more dovish or to turmoil in the Chinese market as a risk to global growth. The latest comments by the FED (after the meeting) still indicate that they will likely raise rates this year which should provide some short term stability in markets, particularly in emerging markets.

The JSE experienced a 9% correction in August alongside other emerging markets (but fell less than others) mainly as a result of continued weak economic data out of China. Our market declined by a further 2% (after recovering 4% off the low) in September after the FED meeting and has recovered by 3% after the low in August, at the time of writing.



Source: iNet Bridge

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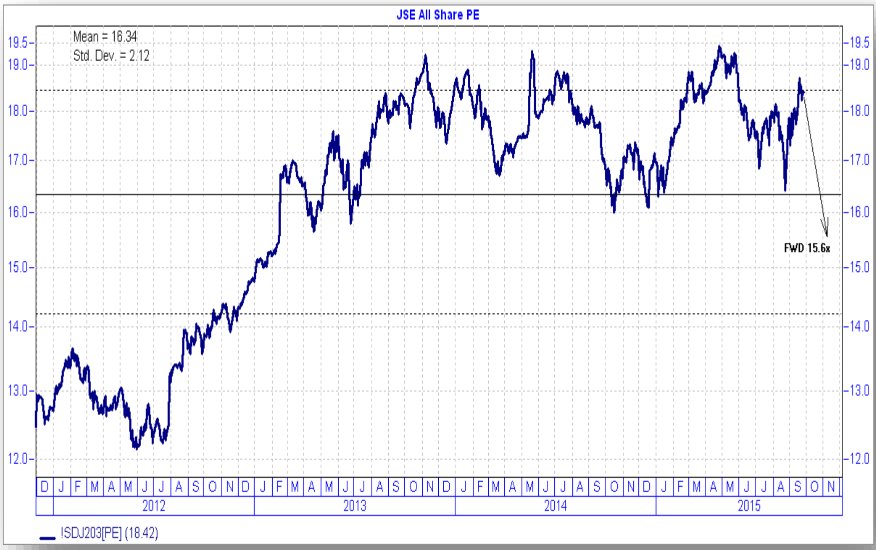
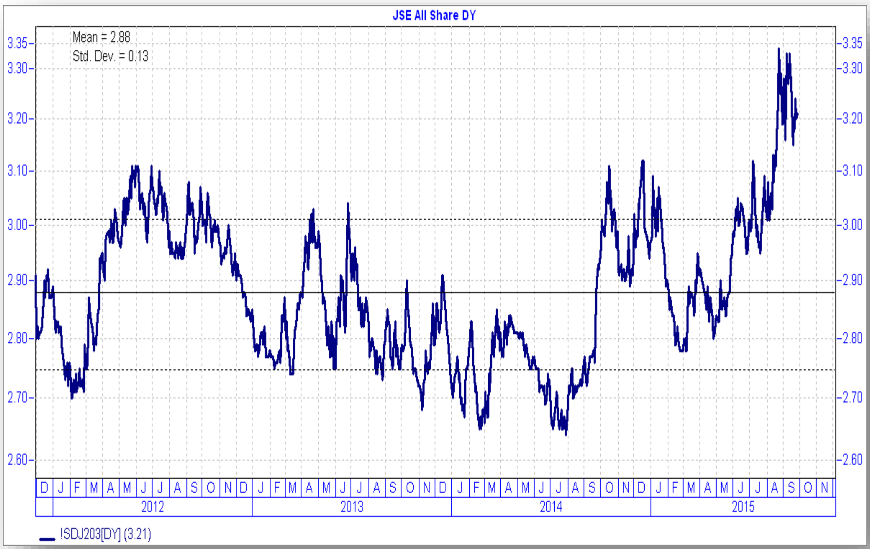
The question is then; is the market offering value at current levels? Let's see what the following charts indicate in the order of price, price earnings ratio and dividend yield over a longish period.



Source: iNet Bridge



Source: iNet Bridge

As can be seen in the first chart, the 50000 level on the All Share remains a key level (currently 50176) with strong support at the 47500 level which is only 5% lower from current levels. Given that the recovery in Europe (second biggest trading partner) and the US (third biggest trading partner) remains intact and the unlikely event of the Chinese economy (biggest trading partner) collapsing, the global backdrop does not suggest the potential for a severe correction in share valuations. Despite local economic headwinds, our investments have historically always been focused on locally listed companies that do business on a global scale (rand hedge) which will benefit from a continued recovery in the world economy and a weaker rand exchange rate. Reported earnings from locally listed companies continue to be very solid which leads us to the price earnings ratio chart.

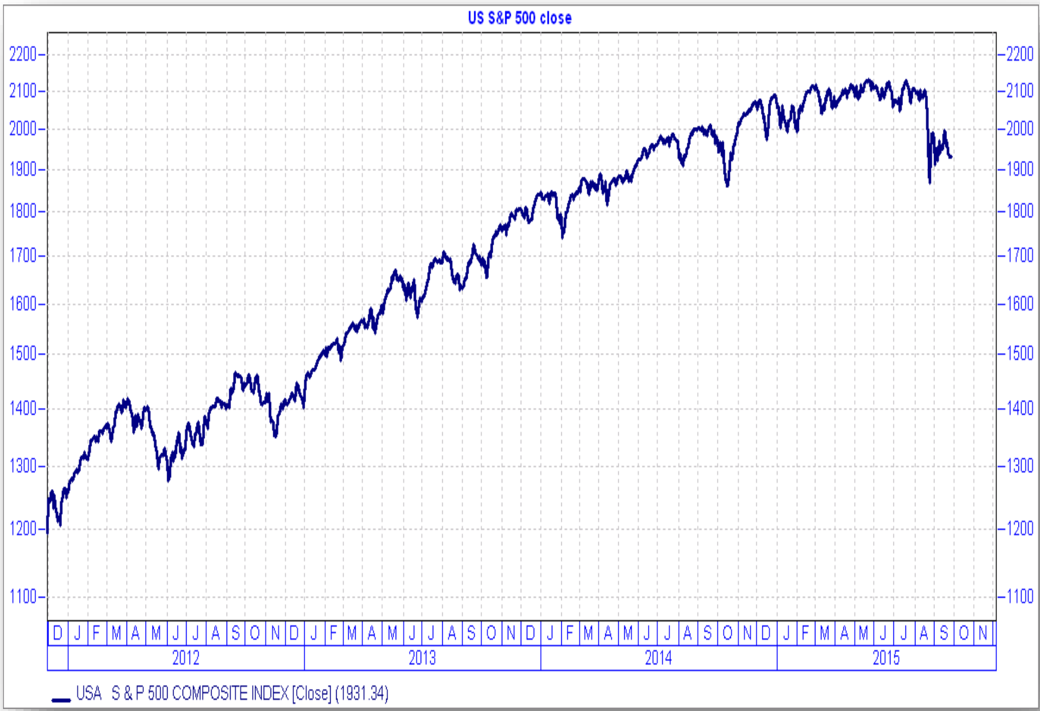
The second chart (price earnings ratio) does indicate that the market remains fully priced on a historical basis trading on a trailing historic PE of 18.5x despite the recent correction. The strong downward move (just over 9% derating) in August was due to the global sell-off in emerging markets despite very good reported earnings from June year-end local financial and duel listed industrial counters. This was counteracted by poor results from mining companies recently and a renewed search for yield by foreign investors causing the PE ratio to rise again(+18.5%) as we write. It's important to note however that on a forward basis the market is trading on 15.6x times which is well below the long term mean PE of 16.3x which is suggesting better value on a medium term basis as earnings growth materialises(likely to be supported by a weakening rand).

In the third chart, the dividend yield on the other hand is suggesting that the market is actually offering value at this point in time trading on a yield of 3.2%(forward 3.7%) compared to the long term mean yield of 2.9%.

Why then the divergent suggestions by the price earnings ratio and dividend yield? The primary reason remains net foreign buying by foreign investors in the search for yield. Therein lays the risk also due to potential foreign selling in the event of resurgence in emerging market fears and capital flight from these markets. The main risk for this will be more disappointments from China and/or if the FED keeps on shifting forward the "inevitable" hike in interest rates (unlikely).

Previously, the main event risk used to be the timing and size of the first rate hike in the US. What appears counterintuitive at the moment, is that markets will likely react positively when the hike is announced (consensus is for December this year) because the uncertainty around the issue will have been removed and that it signals the US economy is doing better than expected. This again should be supportive of market levels in general, reducing the risk of a severe correction. But, as we have warned before, a smooth ride towards the first FED hike is no certainty.

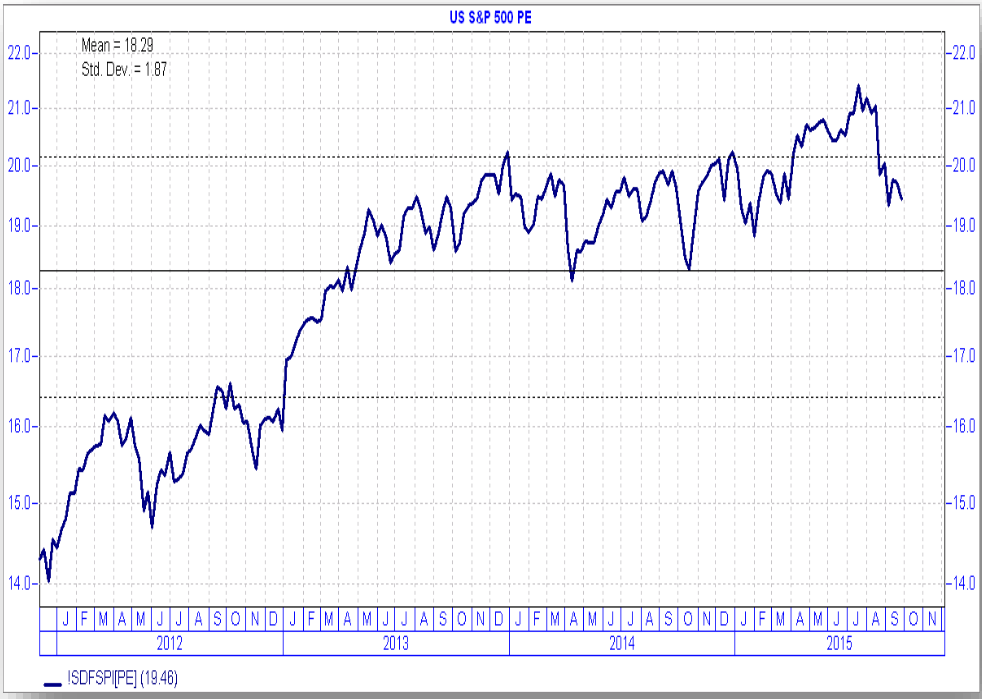
Abroad



Source: iNet Bridge

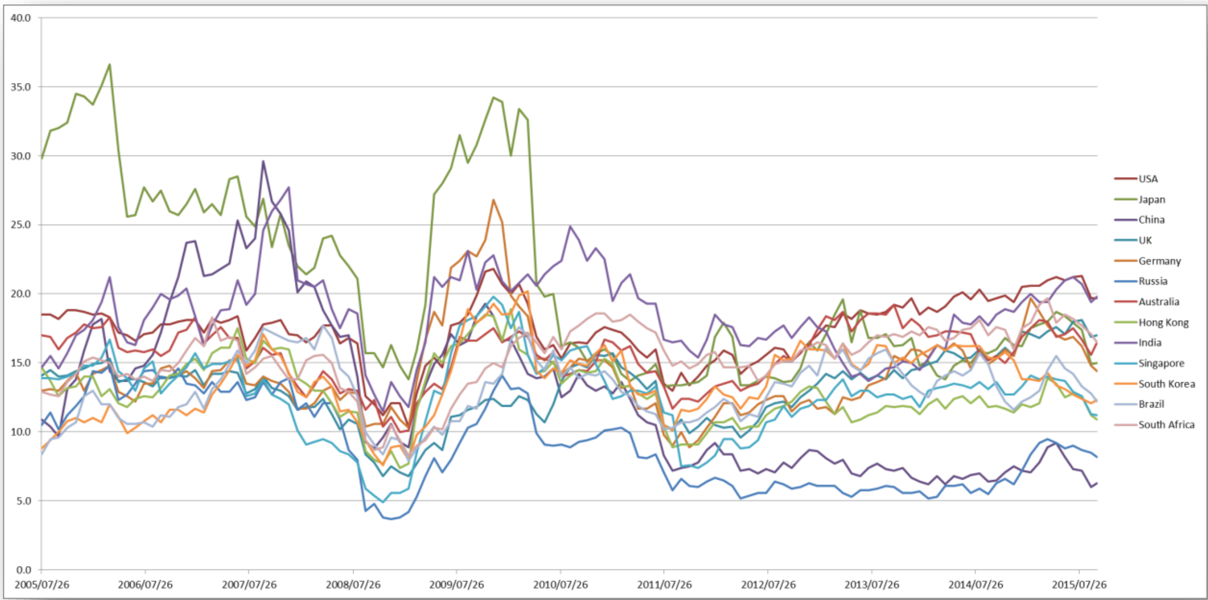
Global markets also need some action by the FED to stabilise matters. The US economy continues to steadily improve with little evidence of inflation. The jobs space is looking better although wage growth remains subdued suggesting that excessive spending and inflation remain a while away. The most likely outcome will be that the FED will do a small hike towards December 2015 to send out the right "signal" to stabilise markets. This could eventually lead to a sustained recovery in the labour market as a stable environment ought to encourage companies to increase investment and employment (if higher rates=improving economy). Return on capital employed should also benefit as the potentially higher rate of investment will be accompanied by lower interest rates (for funding) for potentially a long period of time. The improvement in capital returns amongst listed companies has historically been a positive driver of share price performance.

As can be seen in theses charts, the S&P 500 led the correction in markets during August declining by 2.4% and seems to have also reached a support level of around 1900. It now awaits FED action. The S&P by historical standards does not appear to be that overvalued (although PE's are high – but they always have been) trading on a PE of 19.5x and is trading within a one standard deviation around its long term mean.



Source: iNet Bridge

The chart below depicts various country PE's. Interesting to note that South Africa has held up well compared to other emerging markets and is and has always demanded more of a developed market price earnings ratio.



Source: Momentum SP Reid

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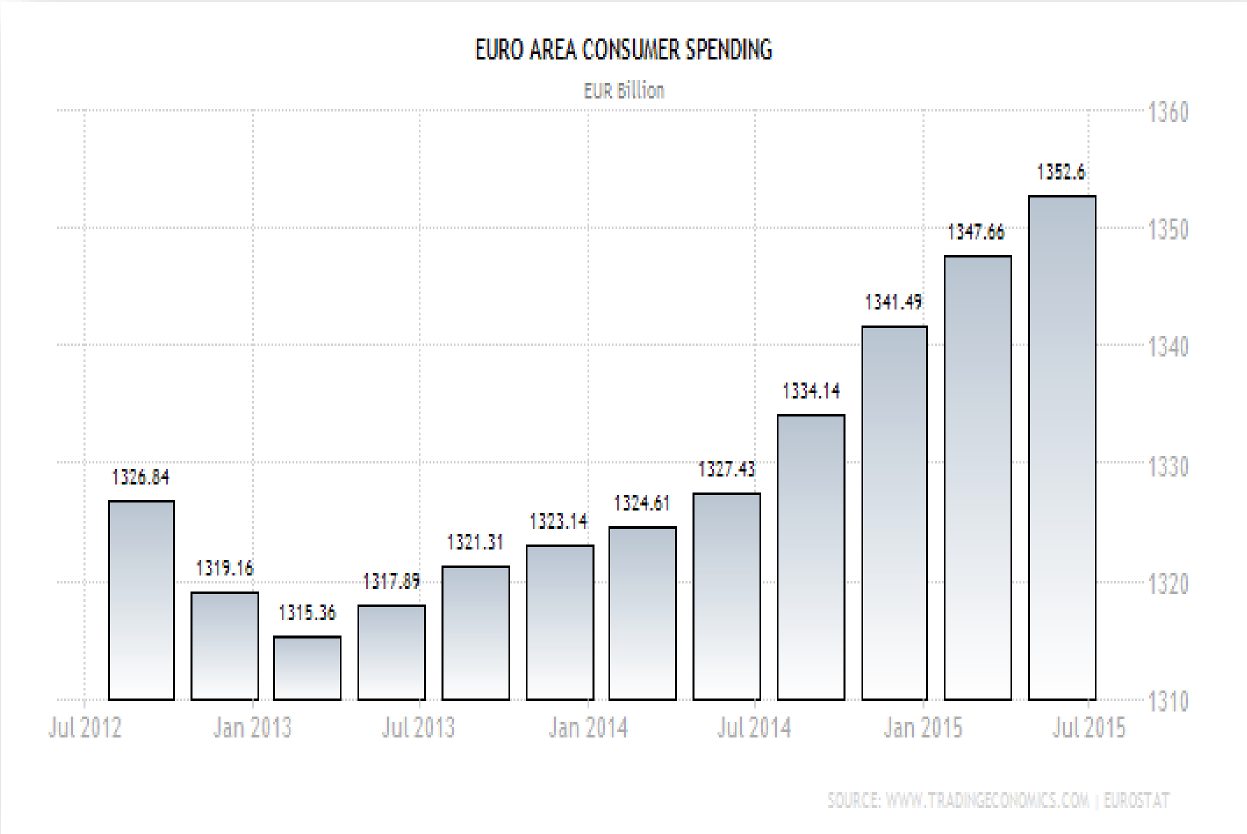
Consumer spending in the Eurozone appears more robust than elsewhere. Again, here also, there is virtually no signs of inflation yet as consumers are spending the windfall from the lower oil price rather than increasing borrowings.



Despite the improvements, the European Central Bank has cut its growth and inflation forecasts (again) for the Eurozone at its latest policy meeting which caused further weakness in the Euro against the dollar. Like the FED, the bank left interest rates unchanged, and said if the climate "darkened" further it would consider increasing its QE programme now if need be and would stimulate the Eurozone economy beyond September 2016 in order to ensure consumer expenditure rises on a sustainable basis.

To quote the ECB's Mario Draghi, "Economic growth in the euro area is likely to continue to be dampened by the necessary balance sheet adjustments in a number of sectors, and the asset purchase programme continues to process smoothly. These purchases have a favourable impact on the cost and availability of credit for firms and households,"

The global economy continues to grow at a below-trend pace and is likely to remain so for the remainder of the year. Efforts by the Chinese to stimulate their economy should lift global growth in due course which will also benefit emerging markets. However, a persistent shortfall in aggregate demand will remain the defining feature in the global landscape which will keep a lid on inflation and likely ensure that monetary policy in major economies remain accommodative for a long time.

Below is the latest Economist poll of forecasters (consisting of all the major global banks). Note the steady increases for growth in the Eurozone and the US into 2016. SA and most other emerging markets continue be revised lower for 2015.

***The Economist* poll of forecasters, September averages** (previous month's, if changed)

	Real GDP, % change Low/high range		Real GDP, % change average		Consumer prices % change		Current account % of GDP	
	2015	2016	2015	2016	2015	2016	2015	2016
Argentina	-3.0/1.5	-1.0/2.6	nil (-0.2)	1.1 (1.5)	– (--)	– (--)	-1.4	-1.5 (-1.2)
Australia	1.8/2.7	1.8/3.3	2.4	2.7 (2.8)	1.7	2.5 (2.6)	-3.2 (-3.1)	-3.0 (-2.9)
Austria	0.4/0.8	0.9/1.9	0.7 (0.6)	1.5	1.0	1.6	1.4 (1.2)	1.4 (1.2)
Belgium	1.1/1.5	1.5/1.9	1.3	1.6	0.4	1.5 (1.6)	1.7 (1.3)	1.9 (1.4)
Brazil	-2.8/-1.1	-1.2/1.3	-1.9 (-1.7)	0.2 (0.6)	8.6 (8.7)	6.1 (6.0)	-4.1	-3.8
Britain	2.2/2.8	1.9/3.0	2.5 (2.6)	2.4	0.2	1.5 (1.6)	-4.8	-4.0 (-4.2)
Canada	0.9/2.0	1.4/2.7	1.4 (1.5)	2.0 (2.1)	1.1	2.0 (2.1)	-2.9 (-2.7)	-2.4 (-2.2)
China	6.6/7.2	6.2/7.4	6.9	6.7	1.5	2.0	3.0	2.7
Denmark	1.5/1.9	1.2/2.2	1.8	1.9	0.7 (0.6)	1.6	6.8 (6.7)	6.8 (6.6)
France	0.9/1.3	0.8/1.8	1.1 (1.2)	1.5	0.2 (0.3)	1.1 (1.2)	-0.7 (-0.9)	-0.6 (-0.8)
Germany	1.4/2.1	1.5/2.7	1.7	2.0	0.4 (0.5)	1.6 (1.7)	7.6 (7.4)	7.2
India	6.8/8.1	6.5/8.4	7.5 (7.6)	7.8	5.3 (5.4)	5.5	-1.2	-1.5
Indonesia	4.4/5.1	4.0/5.7	4.8 (4.9)	5.2 (5.5)	6.4 (6.3)	5.1 (5.3)	-2.4 (-2.6)	-2.8 (-2.9)
Italy	0.5/0.8	0.4/1.7	0.6	1.2	0.2	1.0 (1.1)	2.0 (2.1)	2.0 (2.1)
Japan	0.5/1.4	0.9/2.0	0.8 (0.9)	1.5 (1.6)	0.7	1.0 (1.1)	2.7 (2.6)	2.6 (2.4)
Mexico	2.2/3.2	2.4/3.8	2.5 (2.6)	3.2 (3.3)	2.9 (3.0)	3.5	-2.5 (-2.4)	-2.4
Netherlands	nil/2.2	nil/2.3	1.8 (2.0)	1.7 (1.9)	0.4	1.2 (1.4)	9.2 (9.6)	9.1 (9.5)
Russia	-5.0/-2.5	-1.6/1.6	-3.6	0.3 (0.4)	14.8	6.7	4.9 (5.0)	4.4 (4.5)
South Africa	1.4/2.3	1.3/2.5	1.8 (2.0)	2.3 (2.4)	4.8 (4.9)	6.0	-5.1 (-5.3)	-4.7 (-4.8)
South Korea	2.3/3.3	2.2/3.8	2.6 (2.8)	3.1 (3.3)	0.9 (1.0)	1.8	7.8 (7.6)	7.0 (6.8)
Spain	2.6/3.3	2.2/3.0	3.0 (2.9)	2.6	-0.3	1.0 (1.1)	0.8 (0.7)	0.9 (0.6)
Sweden	2.4/3.0	2.0/3.4	2.7 (2.5)	2.7 (2.8)	0.1 (0.2)	1.3 (1.4)	6.5 (6.1)	6.5 (6.1)
Switzerland	0.3/1.0	0.5/1.8	0.7	1.3	-1.0	-0.1	7.2 (6.7)	7.0
Turkey	2.2/3.3	2.9/3.9	2.8 (2.9)	3.2 (3.3)	7.3 (7.4)	6.8 (6.7)	-4.7 (-4.6)	-4.2 (-5.1)
United States	2.1/2.6	1.9/3.0	2.4	2.6 (2.7)	0.4	2.0 (2.1)	-2.6	-2.6
Euro area	1.3/1.7	1.1/2.2	1.4	1.7	0.2	1.2 (1.3)	2.6 (2.5)	2.4

Sources: Bank of America, Barclays, BNP Paribas, Citigroup, Commerzbank, Credit Suisse, Decision Economics, Deutsche Bank, EIU, Goldman Sachs, HSBC Securities, ING, Itaú BBA, JPMorgan, Morgan Stanley, Nomura, RBS, Royal Bank of Canada, Schroders, Scotia Capital, Société Générale, Standard Chartered, UBS

Source: The Economist September 2015

To conclude

- Volatility has been the name of the game of late. Markets were only pricing in a 30% probability of the FED hiking rates but were not expecting the more dovish comments made during the press briefing that followed.
- The JSE experienced a 9% correction in August alongside other emerging markets (but fell less than others) mainly as a result of continued weak economic data out of China and dovish comments by the FED but has recovered by 3% since then.
- The dividend yield on the JSE is suggesting that the market is offering value at this point trading on a yield of 3.2% (forward 3.7%).
- On a PE basis, the market remains fully priced on a historical basis trading on a historic PE of 18.5x despite the recent correction. The PE ratio has rerated by 8.5% after reaching a low in August. The market's offering better value on a forward basis trading on a PE of 15.6x
- The US economy continues to steadily improve with little evidence of inflation. The jobs space is looking better although wage growth remains subdued suggesting that excessive spending and inflation remain a while away.
- The S&P by historical standards does not appear to be that overvalued (although PE's are high – but they always have been) trading on a PE of 19.5x, not far off its long term mean.
- Consumer spending in the Eurozone appears more robust than elsewhere with no signs of inflation yet as consumers are spending the windfall from the lower oil price rather than increasing debt.
- The ECB remains on guard and will increase QE well into 2016 if need be to ensure the recovery remains on track.
- Markets will likely react positively when the FED hike is announced, maybe later this year, because the uncertainty around the issue will have been removed and that it might signal a better than expected performing economy.

Sincerely

<u>Chris Botha</u> **<u>Dave Eliot</u>**

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