Communiqué

Monthly

South Africa

November 2015

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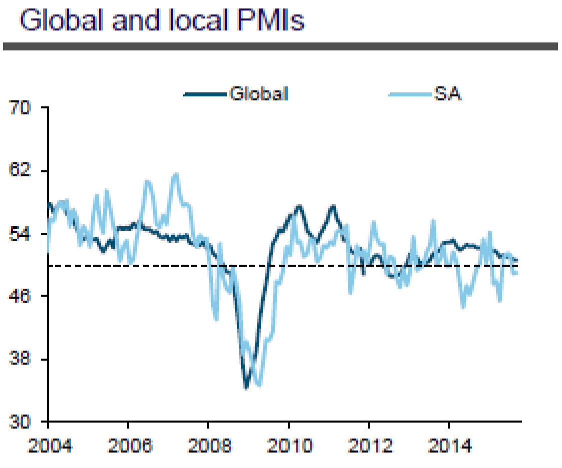
Don't fret the FED

Local

The JSE experienced a good recovery of 7% during the month, mainly due to a big rerating in the resources sector of 18% and a 30% jump in SAB Miller's share price, following an announcement of a take-over bid from number one brewer in the world, AB Inbev.

Emerging markets as a whole staged a recovery as China announced yet another cut in key interest rates and a further reduction in reserve requirements for banks. The risk-on sentiment and future returns in emerging markets will most likely be driven mainly by events in China over the longer term. An interest rate hike in the US could cause volatility around the event but will likely be a short term issue.

The rand has been rather volatile once again, strengthening from R14 rand to the US dollar down to R13 during October and has since weakened by 5% to R13.6 at the time of writing. The recent uproar by university students and the EFF chaos in parliament as well as heightened risk of further rating agency downgrades, were undoubtedly contributing factors to the weaker currency. If the trend persists, pressure will mount for interest rates to be raised locally as a counter to the negative inflationary effects of a weak currency, despite deteriorating GDP growth.

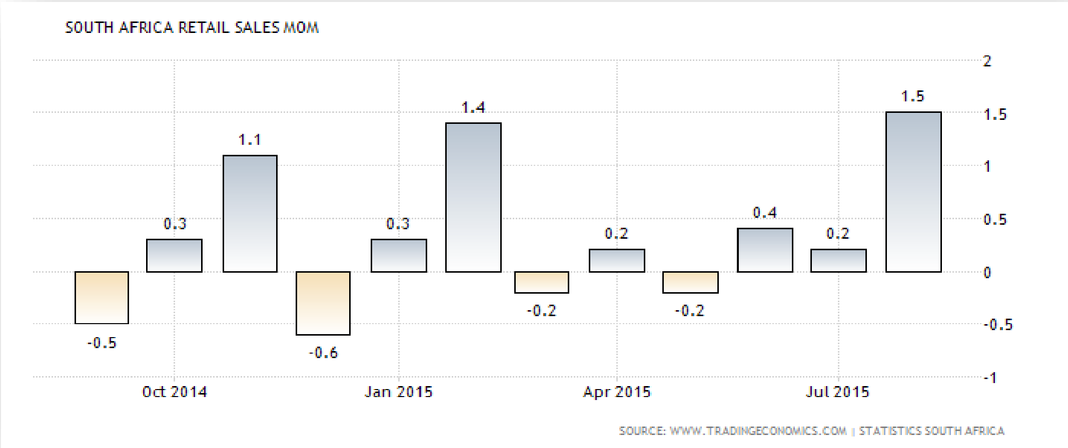


Source: RMB Global Markets

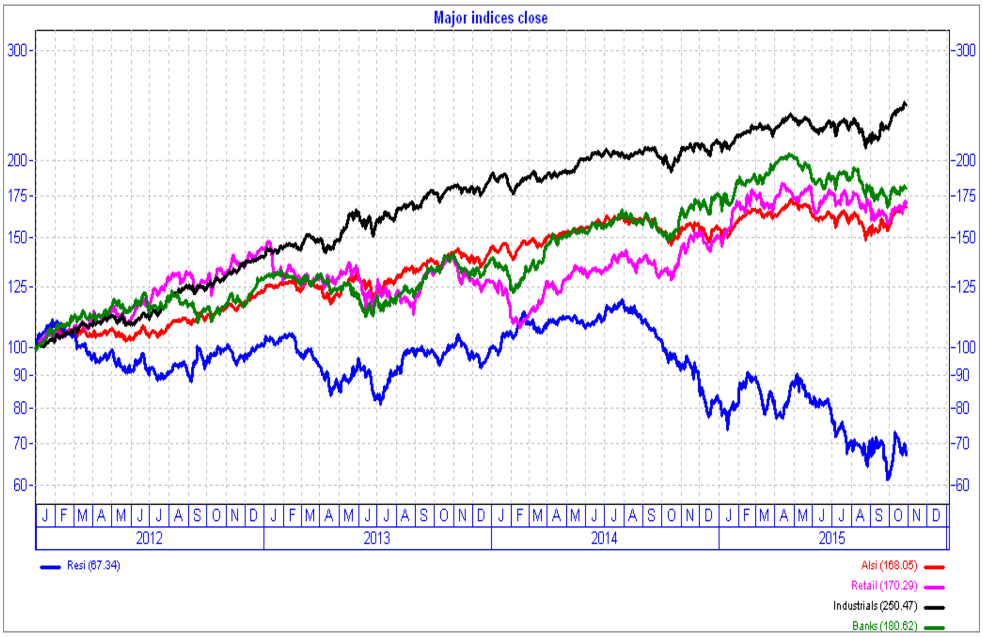
Consensus GDP growth in SA for 2015 now stands at 1.6% which has been a number we have flaunted for some time now. The biggest downgrades are emanating from agriculture (drought), manufacturing and mining as commodity prices continue to decline, although we are seeing some signs of stability in some metal prices; which could be further supported if stimulus continues in China. The subdued backdrop to the SA economy is reflected in our PMI which has been below 50 since June this year.

Despite the downgrades in GDP, private consumption seems to have staged a small rebound after the severe consumer pessimism in the second quarter of this year but we are cautious as to whether the trend will continue, due to deteriorating employment conditions and high consumer indebtedness. A potential interest rate hike in November and expected higher food and fuel prices, thanks to the weakening rand, will not help matters.

Recent results from listed retailers have proved to be on the soft side and were generally somewhat lower than market expectations (albeit still good in general). The outlook comment from management teams was also fairly cautious and muted.



Company results in the main have been quite good with 48% of companies reporting numbers that were ahead of market expectations, particularly in the industrial rand hedge space, which will likely remain the status quo. From a sector perspective, as can be seen in the next chart (black line), industrial counters (mainly rand hedge) continue to outperform with a vibrant pick-up in October following good results. The underperforming sector over a long period of time remains resources (blue line) although we did see a sharp(but short) rebound in prices in October, following stimulus measures in China and a more dovish stance around a FED hike this year. Banks (green) and retailers (pink) - often viewed as proxies for one another, have been flat for the year so far after a long period of outperformance. Retailers, still loved by foreigners, will likely continue to deliver reasonable returns but stock selection will be key (cash and quality counters).

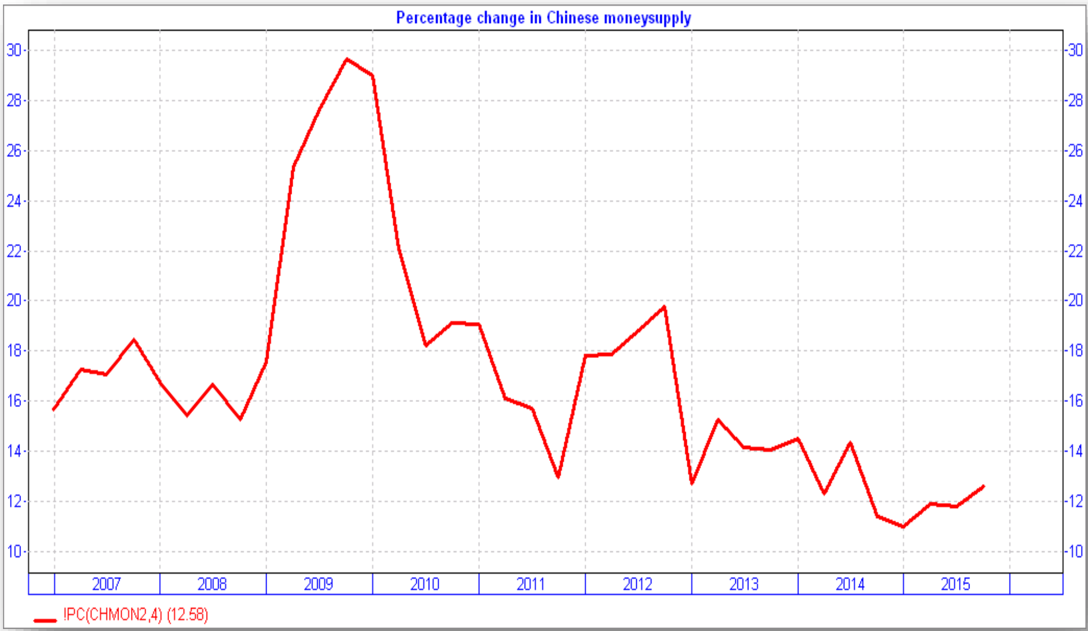


Source: iNet Bridge

Our general outlook for the equity market over the next 12 months remains positive with expected headline earnings growth in the low teens for non-mining counters driven by expansion into foreign markets and rand weakness. Even retail stocks, despite the fairly gloomy economic outlook should provide similar returns.

Although not officially measured, anecdotal evidence suggests that foreigners from countries north of our borders are playing an increasingly important role in terms supporting the local retail trade which could well lead to some positive surprises when companies report their next set of results.

The big question remains what to do about resources. Our sense is that this end of the market seems more stable now with spot prices trying to find a base. However, in the near term things could still be very choppy due to uncertainty around the rate of the Chinese economic slowdown. The Chinese government are well aware of this and have a large pot of ammunition to manage a soft landing. The chart below indicates that money supply in China remains very tight which suggests ample scope to cut interest rates further.

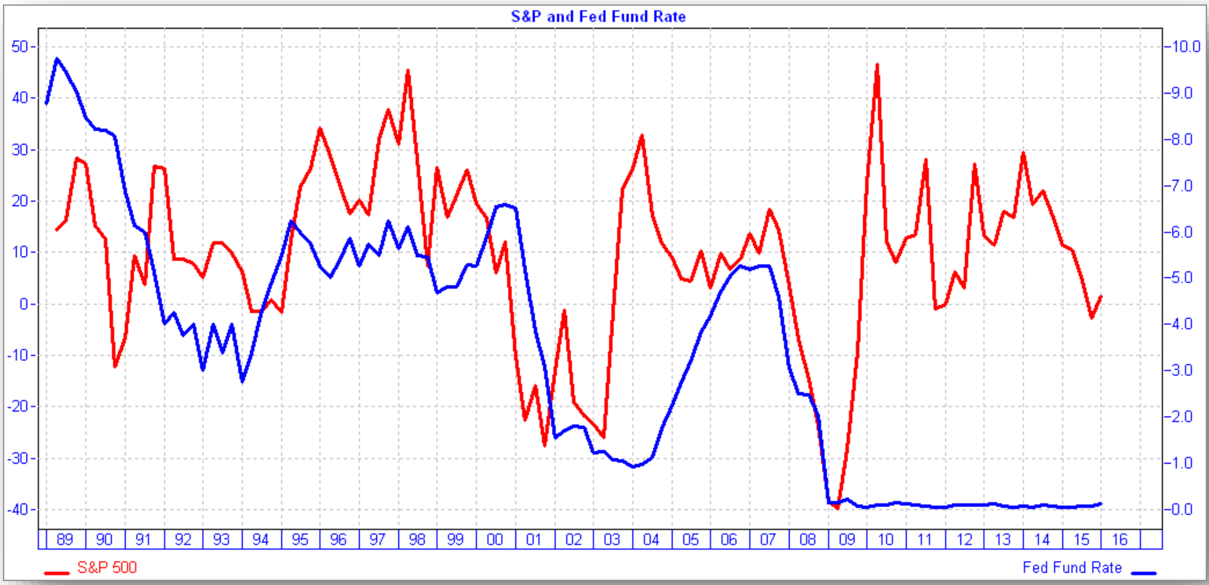


Despite the various and serious economic headwinds we face locally, many listed companies successfully exploit gaps in the local market (like private education and healthcare) caused by poor governance and lack of skills. The trick is not to focus too much on headline news but to focus on quality and innovative companies with a proven track record. Our client portfolios continue to be well diversified across a broad range of sectors including resources, albeit muted.

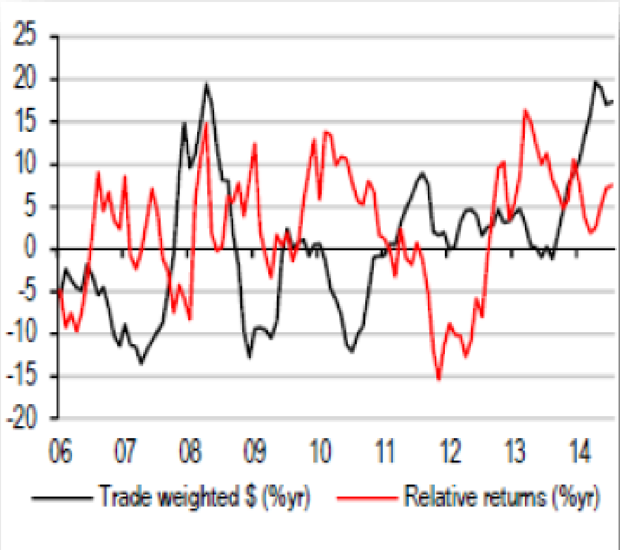
Abroad

We think markets are overly concerned about a FED tightening. The first rate hike could be in December this year but chances are that their decision will be pushed out into early next year. In any event, given no inflationary pressure and volatility in emerging markets, a rate hike will likely be small and probably not be followed by more increases anytime soon.

History suggests that equities can do well even if the FED tightens. A study done by HSBC indicated that the average return for US equities was +6% during the first 12 months after a hike. The chart below indicates the positive correlation between the FED Fund Rate and US equities. Note the sharp increase in equity valuations after the announcement of QE in 2009.



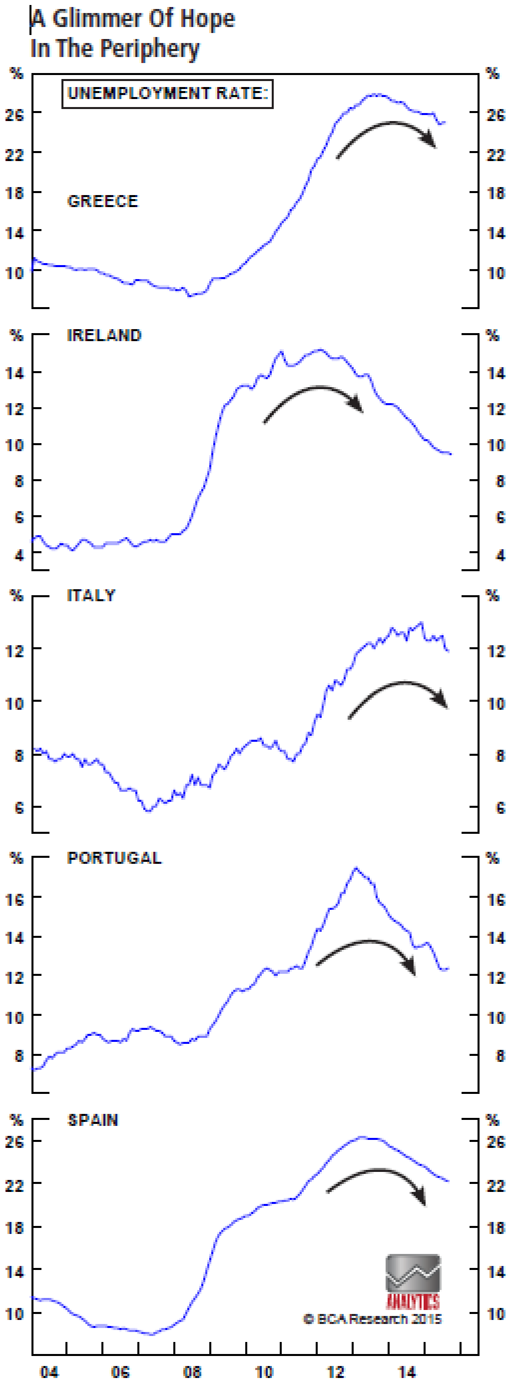
The key driver of the return was earnings growth (higher rates mean a better economy and higher earnings) but multiples typically contracted. The risk this time around, however, is that we are further down the line in the US earnings cycle. US real earnings are above previous peaks and operating margins are above average. Therefore, multiples could contract more aggressively compared to other cycles. A weaker dollar could counteract the impact due to better export earnings from US companies which will likely be the case if the first rate hike is delayed.



Source: MSCI, Thomson Reuters Datastream, HSBC

US exports could support market returns if the USD weakens

Slowing growth in China and falling commodity prices continue to cause low inflation on a global basis. The IMF recently estimated that inflation in developed economies would fall to only 0.3% in 2015 and rise to 1.6% in 2016 compared to the official target of 2%. The risk of deflation is in our view not as serious as say 6 months ago, due to falling unemployment (even in peripheral Europe) and likely wage hikes in the next couple of months in both Europe and the US.

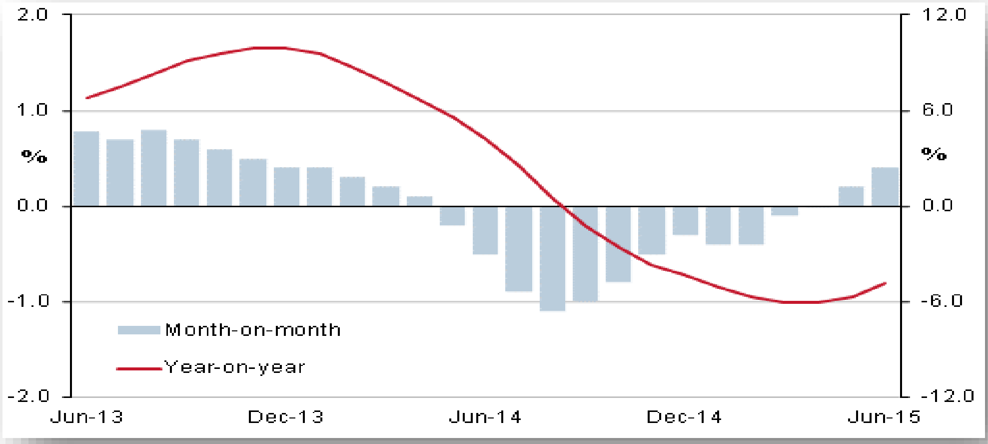


Source: BCA October 23, 2015

Furthermore, falling energy and commodity prices should eventually lead to a decline in energy and mining investment which will likely be offset by increased capital expenditure in other areas of the global economy such as retail as an example, which should support more spending by consumers. Spending in Europe in particular continues to gain momentum as witnessed by increasing demand for credit.

We remain optimistic that China's stimulus efforts will eventually bear fruit. Despite manufacturing data not looking very encouraging, indicated by falling purchasing managers index(PMI) readings, things are not all lost as the service industry PMI readings are moving up and Chinese credit growth and house prices are increasing. House prices in China expanded at the fastest pace in 17 months in June (latest data available)

Chinese House Prices

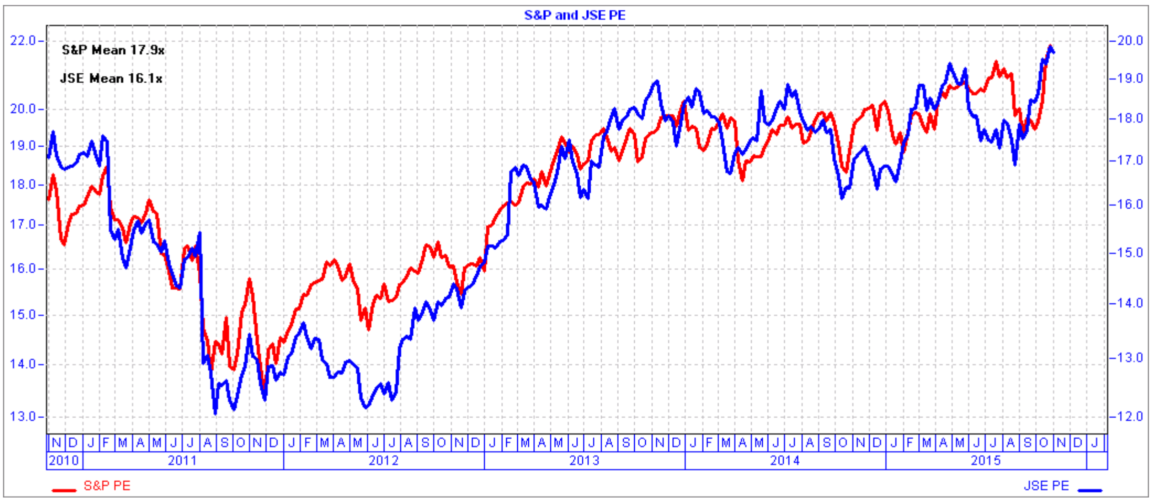


Source: National Bureau of Statistics of China (NBS) and Thomson Reuters.

It's likely that spending will also be directed to the infrastructure, particularly in rural areas. To quote Tim Condon, Head of Asian Research at global banking group ING NV in Singapore, "The efforts that they've put together to stimulate infrastructure investments are beginning to pan out. The worry with data in July and August was that there was a downward spiral and we were in a hard landing. This allays that fear."

China's broadest measure of new credit extension exceeded estimates in September, suggesting the government's efforts to boost lending is beginning to gain traction. Aggregate financing rose to 1.3 trillion yuan ($205 billion), from an originally reported 1.08 trillion yuan in August which exceeded the median estimate of 1.2 trillion yuan.

In general then, we are slightly more optimistic that the global economy is okay with growth in Europe picking up slowly and the US ticking along. China will remain the wild card. S&P profits and local reported profits are doing just fine, given the environment. The US and our market to a lesser extent, still appears somewhat expensive, but fundamental underpinnings should provide some support at these levels.
Currently the JSE trades on 19.8x earnings and the S&P on 21.8x. This compares to their 5-year respective mean PE's of 16.1x and 17.9x.



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Interest rate movements locally and in the US will, however, determine where to from here. Sometimes good news is bad news and bad news is good news looking at the market's reaction after every FED meeting. The market is confused and our view is, although unlikely, that the FED needs to hike soon and get it over with in order to provide better certainty for markets. When this happens, a drop in markets might be a possibility, but then again that might signal a stronger economy and better profits which should cause markets to go up, in due course. Who knows? In the event of a drop it could be used as a buying opportunity!

To conclude

- The JSE recovered 7% during the month mainly due to a big rerating in the resources sector and a 30% jump in SAB Miller's share price following an announcement of a take-over bid from AB Inbev.
- The recent uproar by university students and the EFF chaos in parliament as well has heightened risk of further agency downgrades were contributing factors to a weaker rand. After strengthening from R14 to R13 to the dollar, it weakened again by 5% to R13.6 at the time of writing.
- Consensus GDP growth for 2015, has declined further to 1.6%. The biggest downgrades are emanating from agriculture (drought), manufacturing and mining (falling commodities).
- Local company results in general have been good with 48% of companies reporting numbers that were ahead of market expectations.
- Our general outlook for the equity market over the next 12 months remains positive with expected headline earnings growth in the low teens for non-mining counters.
- Markets are overly concerned with a tightening by the FED. The first rate hike could be in December this year but chances are that their decision will be pushed out into early next year.
- A study done by HSBC indicated that historically, the average return for US equities was +6% during the first 12 months after a hike.
- Slowing growth in China and falling commodity prices continue to cause low inflation on a global basis. The IMF estimates that inflation in developed economies could fall to only 0.3% in 2015.
- We remain optimistic that China's stimulus efforts will eventually bear fruit.
- China's broadest measure of new credit extension exceeded estimates in September, suggesting the government's efforts to boost lending is beginning to gain traction.
- We are slightly more optimistic now that the global economy is okay with growth in Europe picking up slowly and the US ticking along.
- Interest rate movements here and in the US will determine where to from here.

Sincerely

Chris Botha **Dave Eliot**