IMARA
Asset Management SA

Communiqué

Monthly

South Africa

December 2015

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Can monetary policy do the job?

Local

The 25bp hike in the repo rate was not quite as unexpected as some commentators in the media suggested. The SARB's overriding mandate remains to keep inflation in check, despite a weakening economy. The two main factors driving inflation remain the weak rand and higher food inflation (maize prices are up 60% year to date) due to the current drought conditions which will likely lead to higher food imports next year if the condition persists. Prior to the SARB meeting, the rand weakened by 10% in one month from 13.07 to the dollar to 14.33. But there is a third factor not directly linked to local growth and inflation which is the imminent (although the strong dollar might stall them) interest rate hike by the FED on 16 December this year which poses a risk for emerging markets.

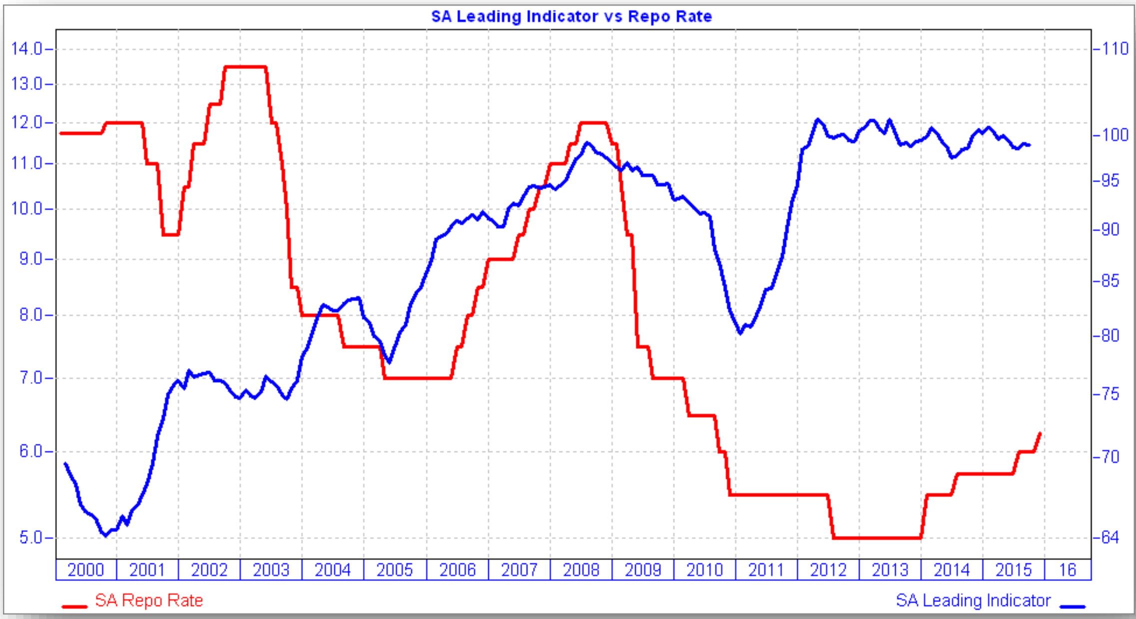
Fears of more rand weakness (higher inflation) and foreign outflows from our bond and equity markets also played an important role in the SARB's decision. They therefore wanted to pre-empt the FED in an attempt to protect the currency and keep potential foreign funding. The rand recovered by only 2% after the announcement and has since weakened further.

Rising interest rates are unlikely to curb inflation, as it is not driven by excessive consumer expenditure but rather exogenous factors (administered prices, Food prices and the rand). The SARB panicked somewhat?

Local growth continues to disappoint. Third quarter GDP came in below consensus estimations at 0.7% quarter on quarter. Yearly growth fell from 1.3% to 1.0% y/y — the lowest since the fourth quarter 2009. Consensus growth estimates for 2015 are around the 1.5% figure. For this to transpire, fourth quarter growth must be in the region of 4.1% - highly unlikely. Estimates are likely be revised downwards to 1.2%-1.3% range!

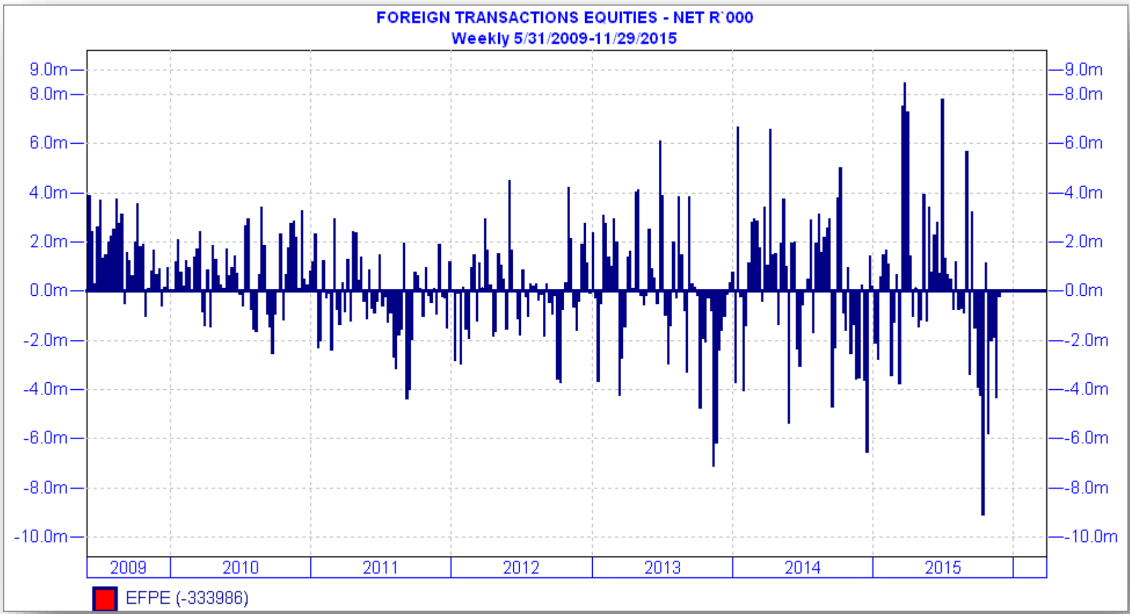
Echoing this weak GDP figure, our leading indicator also continues to disappoint. The latest reading in September dipped by 5.5% year on year which again is the lowest since 2009 and is consistent with annual GDP growth of between 1.0% and 1.5%.

The SARB has hiked rates before when the leading indicator was contracting. But, not at the time when the leading indicator was not expanding on an annual basis.



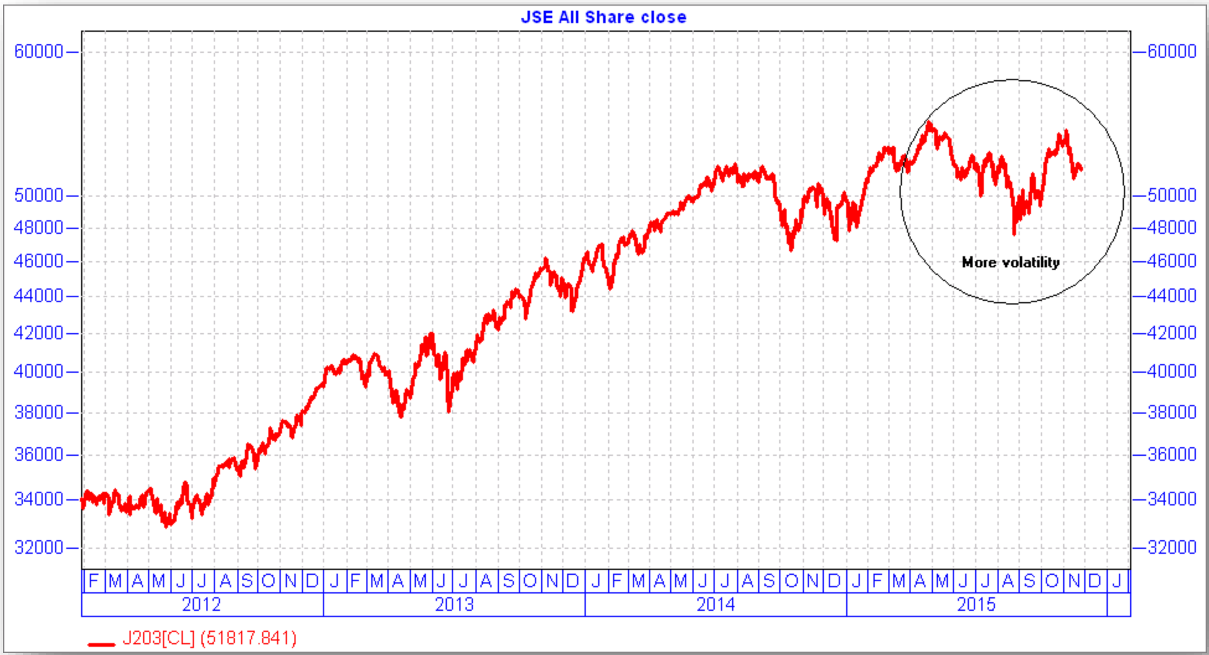
After a 7% upward move in October, the JSE retreated by 3% in November as emerging markets yet again came under pressure due to more hawkish comments by the FED followed by capital flight into developed markets.

Equity markets globally are currently discounting a 25bp hike by the FED in December. Our sense is that when the announcement is made developed markets may strengthen after a knee-jerk mark down, as the uncertainty will have been removed and the economy is strong, is it not?



However, emerging markets might not follow suit as they will be the source of this newfound money flow into developed markets and may be accompanied by further currency weakness. But then again, the current weakness in emerging markets might very well be discounting that to some extent seeing that the JSE has been experiencing net foreign selling for a couple of weeks now (see chart)

Short term volatility can therefore be expected in our market despite sound medium to long term fundamental underpinnings.



Abroad

The US economic expansion is gaining momentum and the Euro area recovery is sufficiently resilient despite the heightened threat of terrorism. The ECB remains on guard to stimulate if need be, to counter the risk of deflation.

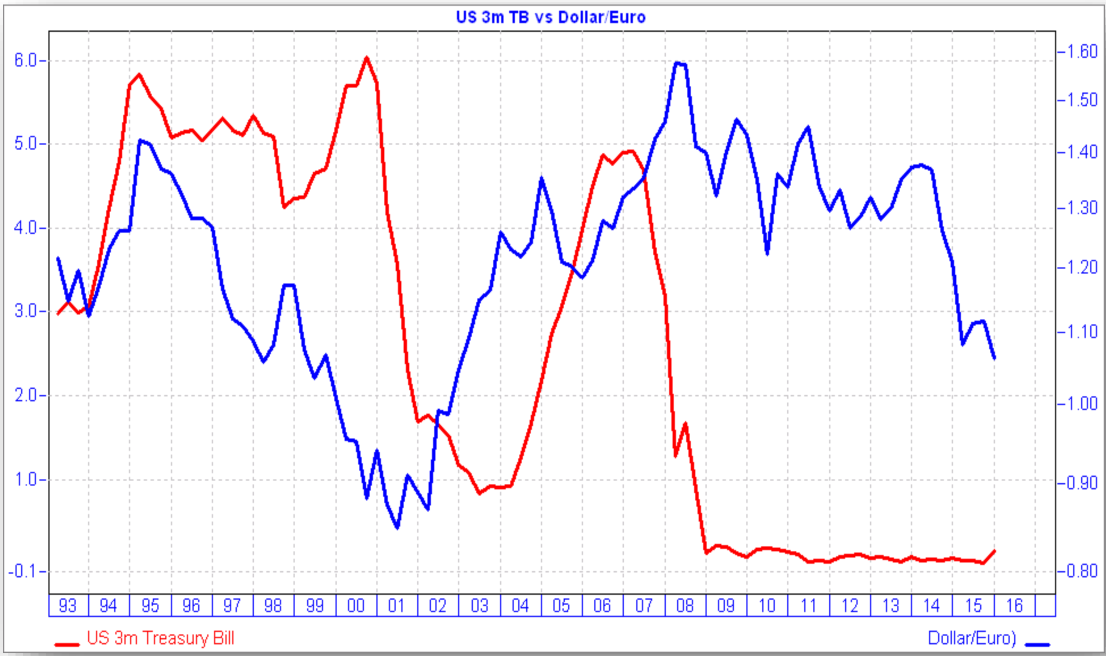
Most investors remain sceptical that Chinese growth is stabilising as witnessed by consistent weakness in commodity prices. The market is awaiting improvements in both the Chinese manufacturing PMI and fixed investment growth which could lead to more stability in commodity prices and in turn be supportive of emerging markets and their currencies.

Despite the significant increase in volatility of late, fundamental underpinnings in Developed markets remain sound given the growth improvements in the US and Europe. In the US, solid job gains should underpin healthy consumer spending which will further be boosted by lower energy costs.

It is difficult to forecast what impact heightened geopolitical tensions might have on investment markets. Markets have historically largely shrugged off the impact of terrorist events since 9/11 in the US, viewing these attacks as mostly once-off events. We expect that markets will eventually react if a series of major attacks unfold.

Short term treasury yields in the US have moved to new highs in anticipation of a FED hike in December. In the chart below one can see that the uptick in the 3 month US Treasury bill was accompanied by dollar strength relative to the euro (moving lower towards parity) and also that the dollar will likely continue to strengthen when interest rates eventually rise.

Headline inflation in the US could start rebounding as the base effect of plunging oil prices a year ago starts to unwind but we don't foresee inflation to be a problem any time soon as oil will likely remain at lowish levels for some time. Any meaningful rise in the spot price will more than likely trigger increased supply from shale oil producers in the US. We estimate that the oil price will probably settle at around $70pb over the medium to long term (currently $46pb) as the global recovery gains momentum. But that may still be a long way off!



The FED will most likely hike very slowly when they do so. Although markets are discounting lift-off in December the strong dollar still poses a headwind [for a first move in 9 years] due to the negative impact on company earnings. Furthermore, the FED's target inflation rate of 2% is way-off current inflation. The bond market in the US is taking a very different view on inflation compared to the FED. Over the next five years, annual inflation is expected to be less than 1.3 percent and over the next ten years' investors are looking 1.6 %!

The Fed is aware of this thinking and stated in their October meeting minutes: "a couple of members expressed concern about the continued decline in market-based measures of inflation compensation." A popular way that markets base their inflationary expectations is to compare yields on Treasury bonds with yields on Treasury Inflation-Protected Securities (TIPS) of the same maturity.

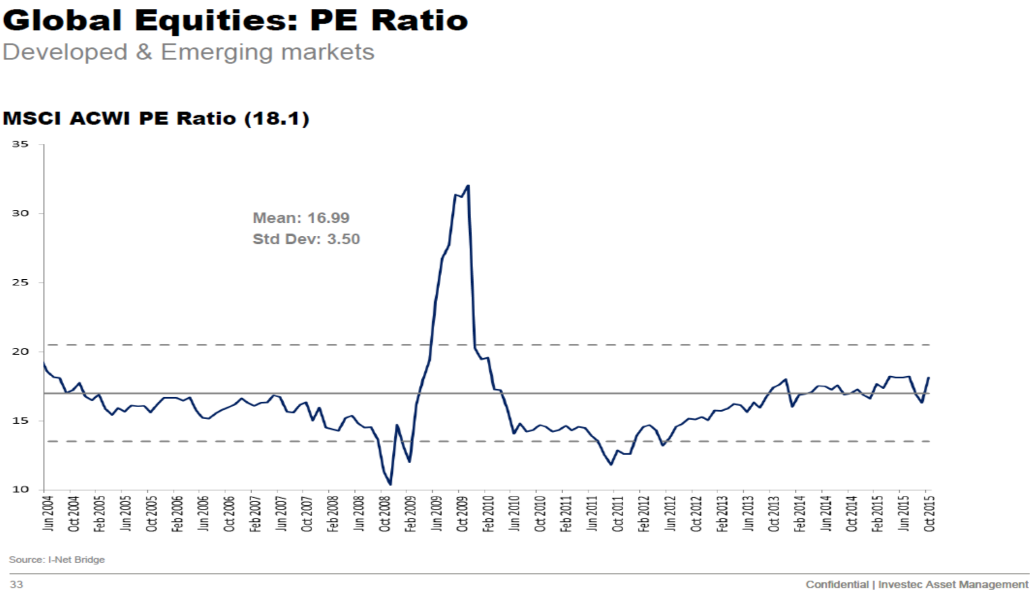
As a TIPS bond pays an investor an amount that varies with CPI (consumer price index) and a Treasury bond is not adjusted for inflation, the Treasury yield minus the TIPS yield should theoretically produce the market's expectations of inflation (see chart below) and is known as the breakeven rate (it's the inflation amount that will make the TIPS investor and the Treasury investor break even with each other).

While the "breakeven rate" reflects expectations regarding the more popular CPI inflation rate, the Fed targets the personal consumption expenditure (PCE) rate.

Source: CNBC

Around this matter, we came across an interesting albeit blunt comment from Bob Andres, Chief Investment Officer of $800 million bond fund Andres Capital Management; "The Fed is never right. Maybe it's that they're using too many models. But I think some of those Fed governors should open up the window, and take a look at the real world. Where is this inflation going to come from? The bond market is more rational than the equity market, and it's certainly more rational than a political Fed and the bond market has been more right over the past five years."

Slowly rising interest rates should over the medium term be bullish for equities as it indicates heightened prospects of inflation (good for company margins and profits) and faster economic expansion. Following the recent sell-off in markets, valuations don't appear onerous as indicated in the chart below. Developed and emerging markets are on average trading at 18 times earnings compare to their long term mean of 17 times.



Source: Investec Asset Management

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For emerging market economies, a stronger dollar and higher interest rates could potentially not be a major headwind if the global economy steadily improves. The trade cycle rather than a stronger dollar will likely be the key driver accompanied by improvements in the Chinese economy (they have ample room to stimulate) and stable commodity prices. The big risk to this view is that if commodity prices continue to fall, it will eventually lead to weaker consumer expenditure and negative economic growth in emerging markets.

We must emphasise that equities tend to outperform in periods of a strong dollar following a hike in interest rates (see last month's chart) for reasons mentioned before (better economic growth prospects).

So, investors need to remain patient and sit through the current volatility as economic indicators continue to improve at a modest pace which will be supportive of equity valuations as faster earnings growth starts to materialise.

To conclude

- *The 25bp hike in the repo rate was not quite unexpected as the SARB's overriding mandate remains to keep inflation in check which is mainly being impacted by the weak rand and higher food inflation. Fears of more rand weakness and foreign outflows from our bond and equity markets also played an important role in their decision.*
- *Local growth continues to disappoint. GDP growth in the third quarter came in below consensus estimations at 0.7% quarter on quarter. Yearly growth fell from 1.3% to 1.0% y/y — the lowest since the fourth quarter 2009.*
- *After a 7% upward move in October, the JSE retreated by 3% in November as emerging markets yet again came under pressure due to more hawkish comments by the FED followed by capital flight into developed markets.*
- *Equity markets globally are currently discounting a 25bp hike by the FED in December.*
- *Despite the significant increase in volatility of late, fundamental underpinnings remain sound given the economic improvements in the US and Europe.*
- *It is difficult to forecast what impact heightened geopolitical tensions may have on investment markets. Markets have historically largely shrugged off the impact of terrorist events viewing these attacks as mostly once-off events.*
- *Following the recent sell-off in markets, valuations appear less onerous with developed and emerging markets on average trading at 18 times earnings compared to their long term mean of 17 times.*
- *Slowly rising interest rates should over the medium term be bullish for equities as it indicates heightened prospects of inflation [must remain controlled] and faster economic expansion.*
- *For emerging market economies, a stronger dollar and higher interest rates could potentially not be a major headwind if the global economy steadily continues to expand.*
- *Now is the time for long term investors to remain patient and absorb the current volatility in markets.*

This will be our final communiqué for the year.

Sincerely

<u>Chris Botha</u>

<u>Dave Eliot</u>