Communiqué

Monthly

South Africa

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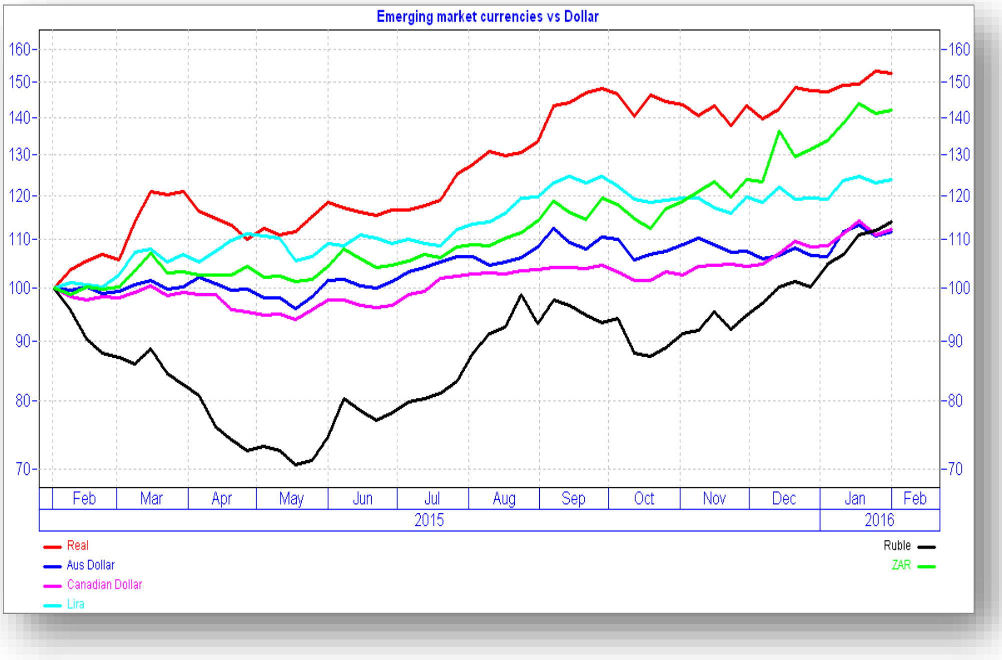
Imara Asset Management South Africa
257 Oxford Road, Illovo. Johannesburg
+27 11 550 6181

Fundamentals versus Perception

Local

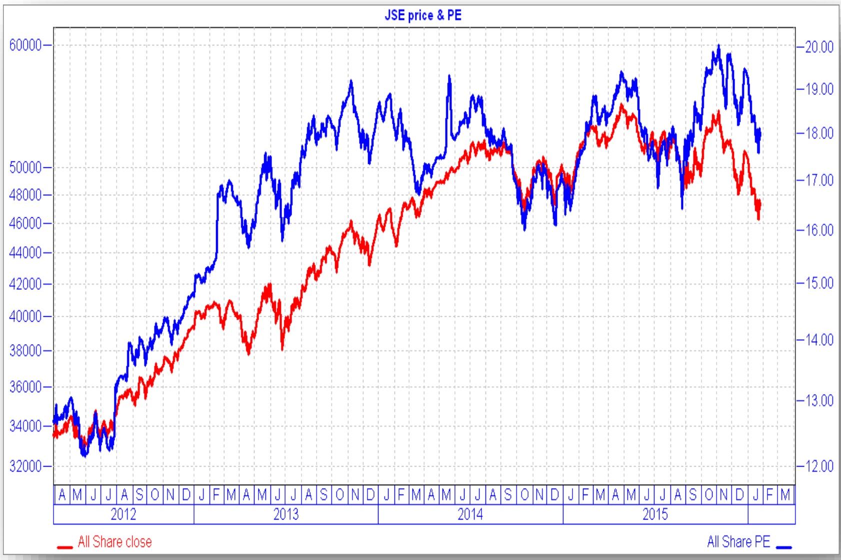
The big event for us was President Zuma's surprise sacking of fairly highly regarded finance minister Nhlanhla Nene and replacing him with a totally unknown minister with dubious qualifications. Our sense is that this was due to Nene opposing a restructuring of a SAA airbus purchase deal and the planned nuclear programme, which SA can ill afford. Both the share and currency markets reactions were severe; the decision was reversed 3 days later with Zuma replacing Nene with a previous highly regarded finance minister Pravin Gordhan, which saw markets retrace some of their losses.



Source: iNet Bridge

Following the announcement, the ZAR weakened 10% against the dollar reaching an all-time low of 15.90 in mid-December. The currency staged a 6% retracement after the "fix" by reappointing Gordhan but has subsequently continued to weaken along with a falling oil price and continuing negative sentiment around emerging markets in general, also on the back of Chinese growth concerns.

On a fundamental basis, the ZAR is at least 30% undervalued but the February budget and risks of further agency downgrades, are likely to keep the currency on the back foot. The chart on page 1 highlights the rand weakness alongside most other emerging market currencies.



Source: iNet Bridge

The local stock market declined following the "announcement" and is down 7% year to date despite some surprisingly good company profit announcements particularly in the retail space. The overall market's price earnings ratio has declined from 20 times to 18 and is trading on a forward ratio of 15.5x. Better value indeed, which will further be supported by rand translated earnings (70% All Share earnings are rand hedge).

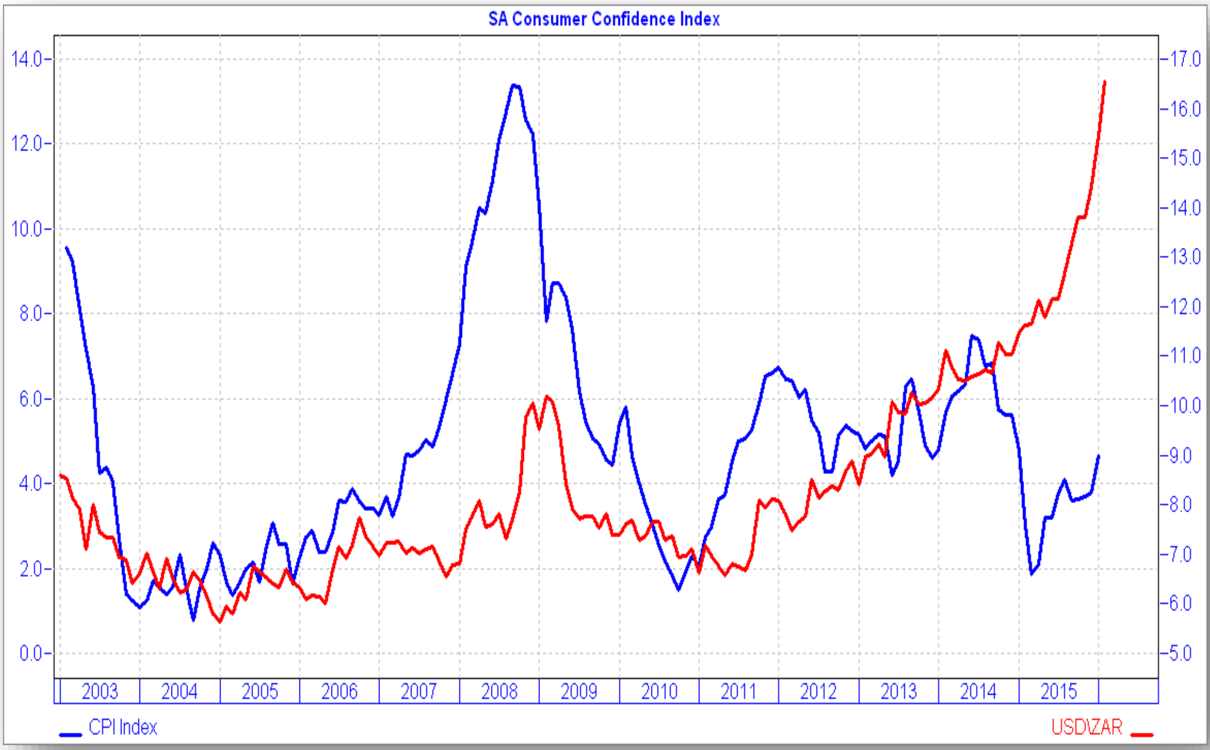
Following the weakness in global stock markets, the table below indicates that markets in general are offering better value than a year ago.

	26 Feb 2009	27 Oct 2009	23 March 2010	26 Aug 2010	27 Jan 2011	22 Feb 2012	27 Feb 2013	28 Aug 2013	29 Jan 2014	24 Oct 2014	29 July 2015	4 Oct 2015	**1 Jan 2016**
US	11.3	19.8	20.8	15.1	17.5	15.1	17.2	17.9	18.6	19.5	21.3	19.9	**18.7**
Japan	13.7	30.2	31.4	16.0	15.9	17.1	15.6	16. 2	16.2	15.1	18.2	15.0	**14.7**
China					13.2	9.3	8.1	7.2	6.6	6.4	17.8	6.4	**5.3**
UK	7.5	11.9	12.3	13.6	15.5	10.5	13.9	14.9	14.1	15.0	17.1	16.2	**15.6**
Germany	9.3	23.6	18.5	14.1	15.5	10.9	11.7	13.2	15.7	14.9	16.9	14.3	**15.6**
Russia					10.1	6.5	6.0	5.7	5.6	5.3	8.8	8.1	**8.8**
Australia	10.7	17.3	17.3	13.8	15.3	13.2	18.4	18.9	17.9	15.6	17.3	16.5	**16.3**
Hong Kong	7.4	18.3	16.1	13.4	15.7	10.8	12.7	10.8	11.5	11.8	12.9	11.0	**9.8**
India					22.0	18.3	17.3	12.9	14.6	18.0	20.7	20.0	**18.3**
Singapore	5.6	18.8	18.4	15.1	13.6	8.3	12.1	12.3	12.3	13.0	13.5	11.0	**11.1**
South Korea	8.0	19.0	19.4	14.3	16.3	13.4	16.2	14.8	15.8	15.1	12.8	12.5	**10.1**
Brazil					14.3	11.8	13.9	14.8	12.8	12.7	14.2	12.7	**10.0**
South Africa	8.6	14.1	16.7	16.1	18.6	15.8	16.1	16.5	17.0	16.9	17.9	16.8	**15.0**

We remain positive on longer term company fundamentals. However, uncertainties around China and a perception that the low oil price is indicating heightened risk of a global recession, will likely cause further volatility. A fillip for global markets could be more stimuli by central banks and a more dovish stance by the FED regarding future rate hikes, already evidenced. Stimulus form the ECB is more than likely given the fragile recovery in Europe with little inflationary pressures.

The SA economic front remains problematic. Growth is likely to be less than 1% this year but inflation will likely increase due to the on-going drought (higher food inflation), electricity price increases and the weak currency. The SARB will most likely continue to gradually hike interest rates in order to try and reduce inflation and stabilise the rand; already seen, of late.

The following chart indicates the high correlation of inflation and the ZAR. Given the severe weakening of the rand, inflation normally picks up sharply, unless the rand stages a sharp recovery, this trend should continue soon.



Source: iNet Bridge

The local consumer is likely to remain under pressure given high inflation (and food prices), a weak rand and shrinking job market. The lower end of the consumer market will see the greatest initial impact which could lead to greater social unrest and labour disruptions. The weak rand should in theory, make expansion in local manufacturing capacity a viable option to deploy excess capital but politics, labour issues and uncertainty around electricity supply will probably force local companies to continue to expand their businesses offshore.

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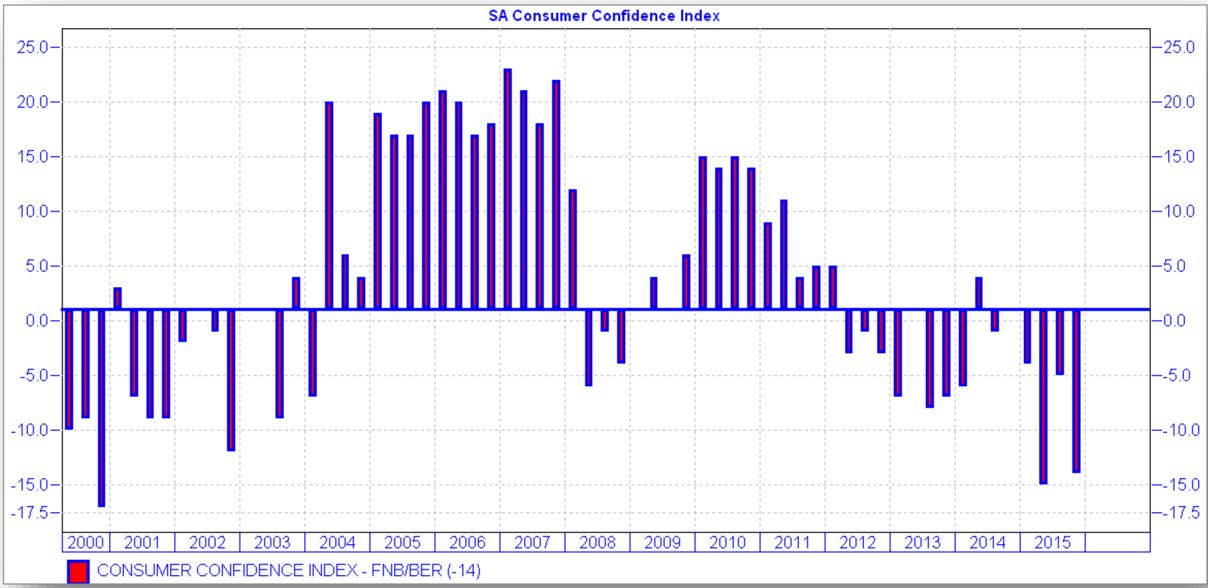
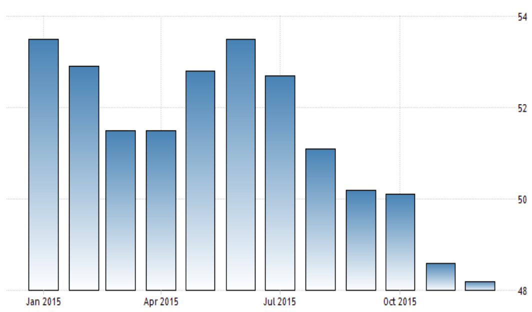


Source: iNet Bridge

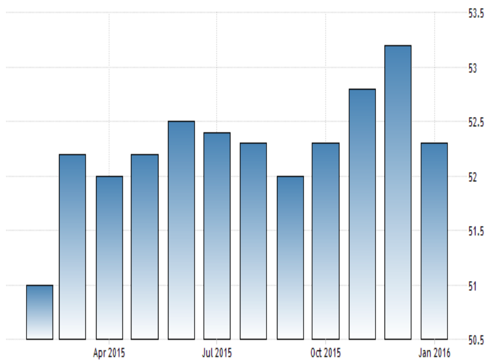
Abroad

Fears have re-emerged regarding the “R” word [recession]. Global manufacturing data is indicating that activity has slowed due to slower emerging market growth, plummeting oil prices (impacting energy sector) and a strong dollar. But in Europe, there are early signs emerging that the windfall from the lower oil price is beginning to be reflected in consumer expenditure. If consumers continue to spend their windfall and labour markets remain resilient (particularly the US) manufacturing weakness might not necessarily mean that we are in the grips off a potential global recession.

US Manufacturing PMI



Euro Area Manufacturing PMI



Source: Tradingeconomics

The above charts are somewhat cause for concern but in the broader table below, one can see that most emerging markets appear to be increasing manufacturing activity albeit more likely from translation gains rather than actual activity due to weak exchange rates.

US and European manufacturing in particular, is a function of slowing emerging market growth which as a group makeup 30% of global GDP. The US furthermore might be suffering from a severe “weather effect” (it’s happened last year) due to extreme storms since the beginning of the year which could well result in a pick-up in manufacturing as weather conditions improve in due course. The adverse weather conditions could provide a short term lift in the oil price after being sold down heavily the past couple of years as fears of deflation have re-emerged. However, given that sanctions against Iran (4th largest producer of oil) have been lifted and they are in dire need of foreign exchange reserves, the medium term prognoses for oil remains bearish due to an ever increasing supply glut.

Manufacturing PMI

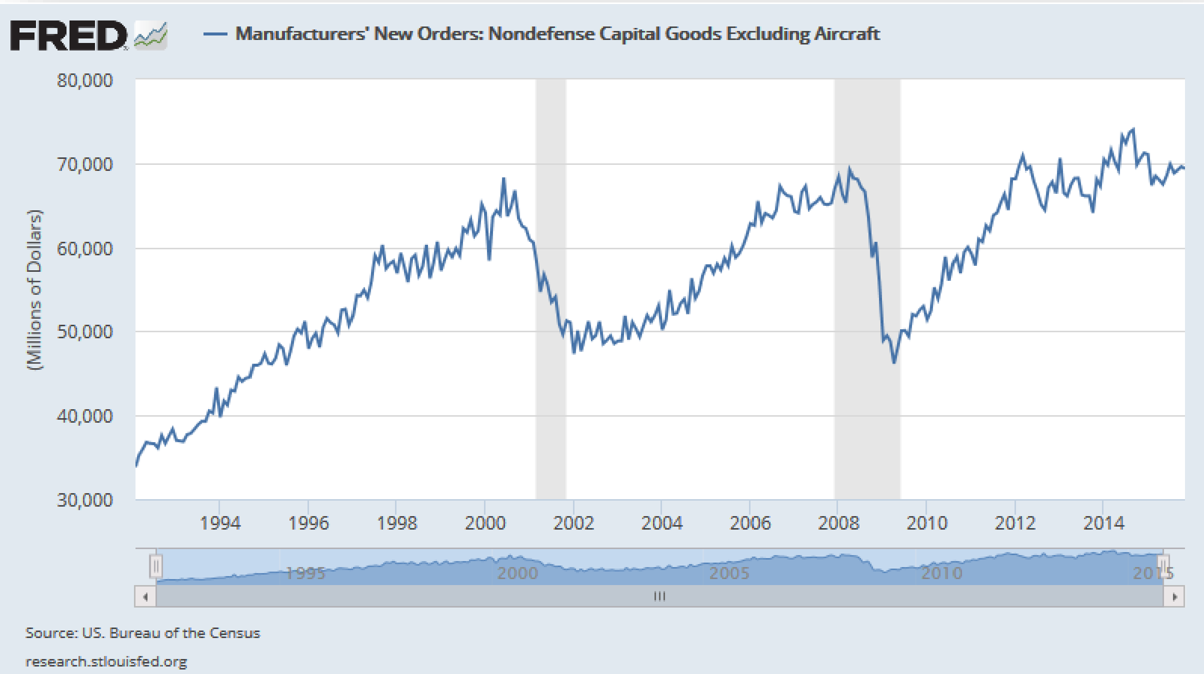
WORLD	Last			Previous	Highest	Lowest	
Australia	51.90	Dec/15	▼	52.50	62.13	30.86	Monthly
Austria	50.60	Dec/15	▼	51.40	54.30	46.90	Monthly
Brazil	45.60	Dec/15	▲	43.80	53.20	43.80	Monthly
Canada	47.50	Dec/15	▼	48.60	56.30	47.50	Monthly
China	48.20	Dec/15	▼	48.60	52.30	47.20	Monthly
Czech Republic	55.60	Dec/15	▲	54.20	57.50	46.00	Monthly
Denmark	56.56	Dec/15	▼	61.46	70.56	24.79	Monthly
Egypt	48.20	Dec/15	▲	45.00	52.50	37.10	Monthly
Euro Area	52.30	Jan/16	▼	53.20	59.00	33.50	Monthly
France	50.00	Jan/16	▼	51.40	57.50	42.70	Monthly
Germany	52.10	Jan/16	▼	53.20	62.70	32.00	Monthly
Norway	46.80	Dec/15	▼	47.50	64.60	34.80	Monthly
Poland	52.10	Dec/15		52.10	55.90	46.90	Monthly
Russia	48.70	Dec/15	▼	50.10	53.20	47.60	Monthly
Saudi Arabia	54.40	Dec/15	▼	56.30	61.80	54.40	Monthly
Singapore	49.50	Dec/15	▲	49.20	51.90	48.30	Monthly
South Africa	45.50	Dec/15	▲	43.30	64.20	34.20	Monthly
South Korea	50.70	Dec/15	▲	49.10	52.60	45.70	Monthly
Spain	53.00	Dec/15	▼	53.10	55.80	41.10	Monthly
Sweden	56.00	Dec/15	▲	54.90	71.40	32.70	Monthly
Switzerland	52.10	Dec/15	▲	49.70	66.90	32.60	Monthly
Taiwan	51.70	Dec/15	▲	49.50	56.10	45.60	Monthly
Turkey	52.20	Dec/15	▲	50.90	55.00	48.00	Monthly
United Arab Emirates	53.30	Dec/15	▼	54.50	61.20	51.70	Monthly
United Kingdom	51.90	Dec/15	▼	52.50	61.50	34.40	Monthly
United States	52.70	Jan/16	▲	51.20	57.90	51.00	Monthly
Vietnam	51.30	Dec/15	▲	49.40	54.80	43.60	Monthly
Greece	50.20	Dec/15	▲	48.10	51.30	30.20	Monthly
Hong Kong	46.40	Dec/15	▼	46.60	53.30	44.40	Monthly
Hungary	49.10	Dec/15	▼	55.80	58.30	37.63	Monthly
India	49.10	Dec/15	▼	50.30	55.00	48.50	Monthly
Indonesia	47.80	Dec/15	▲	46.90	58.50	46.40	Monthly
Ireland	54.20	Dec/15	▲	53.30	57.50	48.00	Monthly
Israel	50.70	Dec/15	▼	52.50	64.70	27.80	Monthly
Italy	55.60	Dec/15	▲	54.90	55.60	48.00	Monthly
Japan	52.40	Jan/16	▼	52.60	56.20	29.60	Monthly
Kenya	55.50	Dec/15	▲	51.70	56.20	51.70	Monthly
Lebanon	47.90	Dec/15	▲	46.90	49.50	44.70	Monthly
Malaysia	48.00	Dec/15	▼	48.10	49.50	47.00	Monthly
Mexico	52.40	Dec/15	▼	53.00	57.10	49.70	Monthly
Netherlands	53.50	Dec/15	▲	53.40	57.00	48.00	Monthly
New Zealand	56.70	Dec/15	▲	54.90	62.77	36.08	Monthly

Source: Tradineconomics

The weak global economic growth numbers towards the end of 2015 has given rise to fears of recession and looming full-blown financial crises. When investors panic investment fundamentals get thrown out of the window. Sentiment has imploded not because of deteriorating economic fundamentals or a policy 'mistake' by the FED, but rather fears of the fragility of the global economic expansion – not being helped by a slowing China – which by the way they are in entitled to do, as they shift towards a more service orientated economic model. Recession fears are more than likely overblown and we do not forecast a global crisis!

The near term risks will remain focused around Chinese data and the oil market. In any event data out of China towards the end of last year clearly indicated that the economy is stabilising and is still growing at a solid pace. More stimulus from China is highly probable and also in the Eurozone, where the ECB recently hauled out their big bazooka announcing higher than expected further QE measures. Draghi said a programme of quantitative easing worth €60bn a month would start in March and last until at least next September or when inflation returned to near its 2% target. To quote David Keeble, global head of interest rates at Credit Agricole in New York: ""This is open-ended QE; and fundamentally the key message that Draghi will want the markets to take away from today. He took out the bazooka. It is a big and credible programme".

The outlook for the US economy remains more upbeat than what is discounted in financial markets. Granted, the energy and related sectors will be negatively impacted by the current oil price, but it's important to remember that 60% of US GDP is driven by consumer expenditure, here again, the windfall from falling energy prices should be positive in due course. Business and consumer confidence are at near cyclical highs and new orders for capital goods continue to show signs of improvement (albeit slowly).



Source: Federal Reserve Economic Data – St Louis

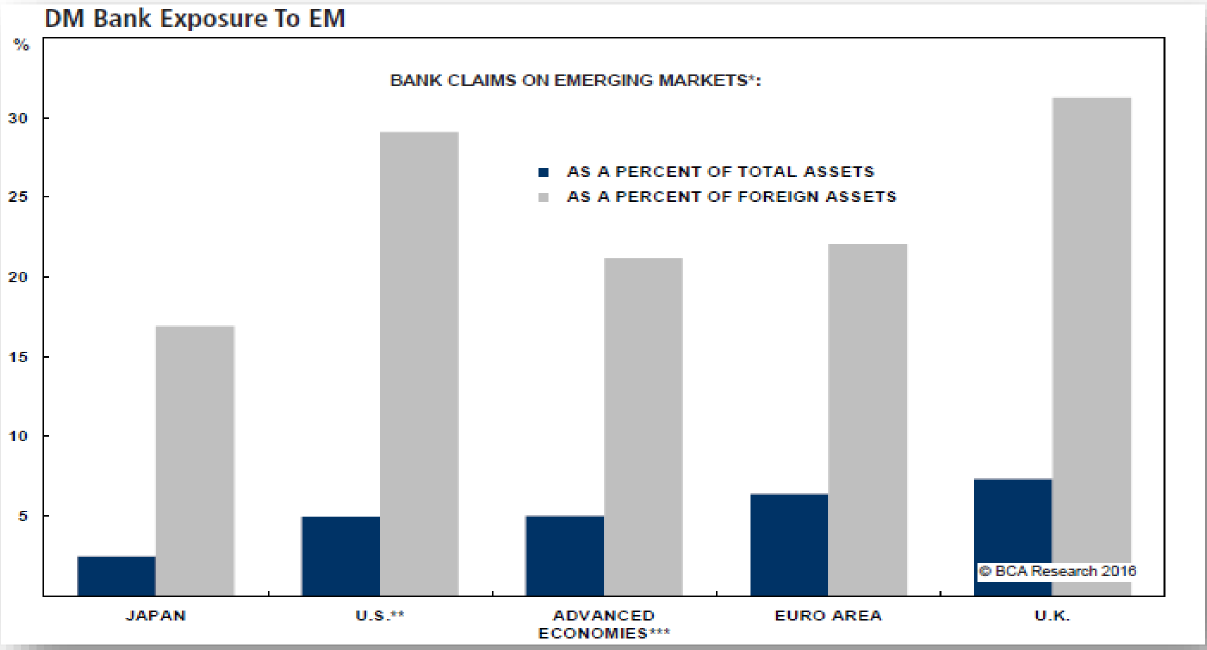
The US labour market continues to steadily improve with unemployment currently at the FED's target but price stability (inflation) is still way off their 2% target (currently 0.7%).

Source: Tradingeconomics

The overall picture of the US landscape is therefore a steadily improving labour market with little inflation. The strong dollar and week oil price is a headwind for the economy in terms of the risk that inflation could turn into deflation and the negative impact oil will have on the energy sector.

The recovery in general can be summed up as more fragile than previously expected and the likelihood remains that the FED may not hike rates for some time. Some commentators argue that given current headwinds the FED might have made a policy mistake and run the risk that they might have to reverse their decision at some point. Current data suggests that it is premature to call the last decision a policy mistake but there is little pressure to hike any further in our view, for quite some time.

One major theme for 2016 will be the outlook for emerging markets following the severe sell-off both in currencies and stock markets in the wake of plummeting commodity prices and the implications of this for developed markets. The possibility of adverse spill overs from the emerging market fallout is probably the number one risk for developed markets through trade channels, commodity prices and potential risks in the global financial system. The latter however is probably not that big a risk as emerging market foreign denominated debt is actually quite low compared to previous episodes of global financial stress. Developed market banks' exposure to emerging market debt currently represents only 5% of their assets with more than adequate bad debt provisions according to research from the Bank Credit Analyst.



Source: Bank Credit Analyst January 22 2016

The IMF estimates that a one percentage point decline in emerging market growth usually reduces growth in developed markets by about 25 basis points which mainly affects Europe and Japan.

According to the IMF, lower commodity prices could in fact lessen the impact of weaker emerging market growth as they account for half of global energy consumption and 70% of metals consumption despite most of these countries also being exporters of commodities.

In the long run, lower oil and commodity prices should be net positive for global growth and will lower inflationary pressures which will likely cause interest rates in developed markets to remain low for a long time. Emerging markets however could enter a raising rate cycle due to weak currencies and higher inflation. Stock market returns in most emerging markets will be heavily influenced by what happens in China. If the Chinese economy surprises on the upside, a sharp rally in both emerging market stock prices as well as spot commodity prices might ensue.

To conclude, the main themes for 2016 will be:

- Low oil and commodity prices and the impact that will have on global inflation.
- Due to the above, the heightened risk of deflation in developed markets.
- Interest rates in developed markets remaining near zero for far longer than expected or even being cut further to negative nominal rates forcing savers to start investing – corporates, governments and private individuals.
- The strong dollar and the impact it will have on the US economy.
- Will US growth disappoint and what will the impact thereof be on the US stock market?
- How long will the capital flight out of emerging markets last?
- Can Chinese growth save the above exodus from emerging markets by surprising on the upside?
- Locally, the upcoming annual budget will be a key event. Following the appointment of Pravin Gordhan as finance minister, it's widely expected that a prudent budget with strong fiscal discipline will be announced which could be supportive of the rand and local investment markets?

In summary

- Despite the quick “fix” by president Zuma, the rand subsequently continued to weaken after the re-appointment of Pravin Gordhan along with the falling oil price and continuing negative sentiment around emerging markets due to Chinese growth concerns.
- Local stocks declined following the above announcement and are down 7% year to date despite some surprisingly good company profit announcements, particularly in the retail space.
- A fillip for global markets could be more stimuli by central banks and a more dovish stance by the FED regarding future rate hikes, already seen.
- Local GDP growth is likely to be less than 1% this year but inflation will increase due the on-going drought (higher food inflation), electricity price increases and the weak currency. The SARB will most likely continue to gradually hike interest rates in order to try and reduce the increase in inflation and stabilise the rand also already evidenced.
- Fears of a global recession have re-emerged. Global manufacturing data is indicating that activity has slowed due to slower emerging market growth, plummeting oil prices and a strong dollar.
- If consumers spend their windfall from the lower oil price and labour markets remain resilient (particularly the US), manufacturing weakness might not necessarily mean that we are in the grips off a potential global recession.
- The main event risk remains negative surprises around Chinese GDP growth. However, recent data out of China indicated that the economy is stabilising and is still growing at a solid pace. More stimulus from China is highly probable and also in the Eurozone where the ECB recently announced further QE measures.
- The outlook for the US economy remains more upbeat than what is discounted by financial markets.
- The US labour market continues to steadily improve with unemployment currently at the FED’s target rate but price stability (inflation) is still way off their 2% target (currently 0.7%).
- The recovery in the US can be summed up as more fragile than previously expected due to the low oil price and strong dollar which could increase the likelihood of the FED not increasing rates for some time.

Sincerely

Chris

Chris Botha

Dave

Dave Eliot