IMARA
Asset Management SA

Communiqué

Monthly

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Markets are pricing in doom and gloom. Why?

Global

The recent decline in both equity prices and bond yields followed steep declines in global growth estimates. Real bond yields are currently trading below 2009 lows reflecting renewed concern of deflation and in some cases investors are now even sighting the risk of a global recession. We don't subscribe to this view.

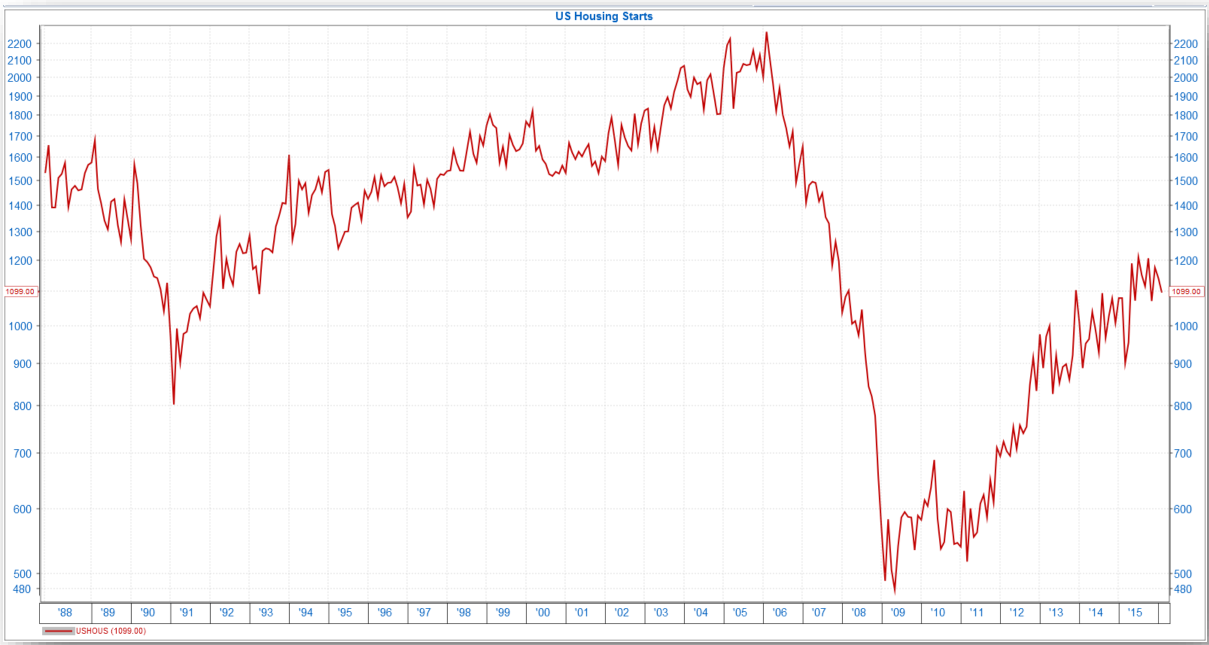
The downgrades are to a large degree being fuelled by oil and commodity prices that are currently at multi-year lows. The bears are interpreting the declining prices as a leading indicator of a severe slowdown in the global economy hence the sell-off in markets. We remain more on the bullish side as the decline in spot commodity prices are due to an oversupply issue rather than a big drop-off in demand. The fall in spot commodity prices were exacerbated by momentum investors and speculators. Following slightly better PMI numbers from China recently, spot commodity prices spiked upwards due to short covering by speculators.

This in turn caused a sharp recovery in resource stocks although they are mostly still in negative territory on a year view.

Due to the financialisation (investors and speculators) of commodities, a large degree of the oversupply can be explained by the so called contango effect. Due to huge investment demand a few years back long dated future contracts were priced higher than spot prices. Higher future prices were an incentive for producers to expand production capacity. Following this massive expansion in capacity a couple of years later, traders and speculators got nervous and started reversing their long positions pushing prices even lower than was fundamentally justified. The inverse could very well happen in due course if investment markets react to supply cuts or positive economic surprises which could push spot prices too high relative to fundamental valuations.

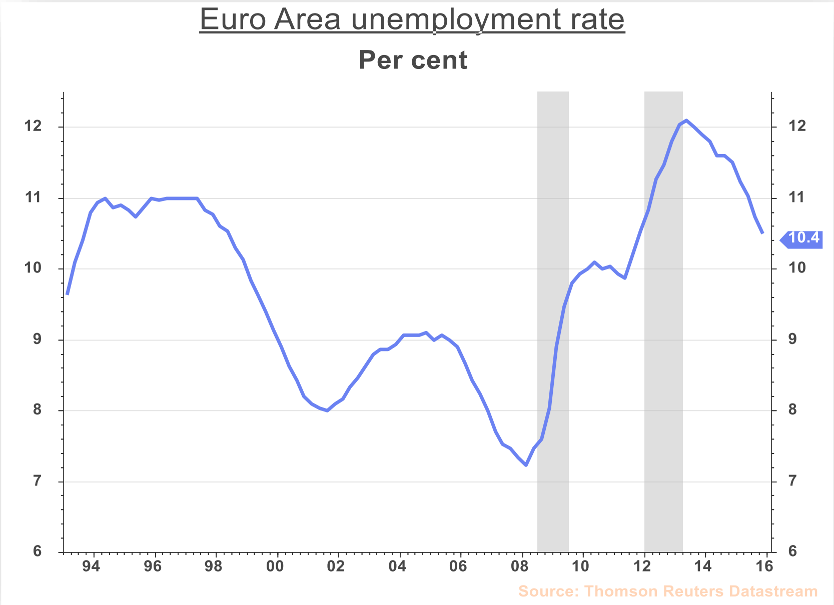
Commodity markets will continue to be a boom and bust story. In the current low spot environment, large cuts in capital expenditure are being announced nearly on a daily basis. Low commodity prices will eventually lead to higher consumer expenditure in both developed and emerging markets which will push spot prices up to a tipping point again as investors realise that a supply shortage might be looming due to cuts in capital expenditure (new capacity) in the previous down cycle (currently). Big capex deferrals should therefore eventually lead to rising spot prices.

The big question is whether equity and commodity markets' prediction of a severe global slowdown will prove to be correct? Our view is that although growth forecasts have in general been lowered, it's not all doom and gloom as US indicators such as housing and wages continue to trend positively. Historically, housing data has been the best predictor of a recession. Building permits and housing starts are close to eight year highs.



Source iNet Bridge

In the Euro area growth remains somewhat sluggish but steady. Fourth quarter 2015 growth came in at 0.3% quarter on quarter annualised (at least it's not negative). Importantly, the unemployment rate continues to trickle lower and consumer expenditure continues to improve. The ECB continues to reiterate that they will stimulate if need be. We expect the low oil price to eventually further support consumer expenditure.



The sell-off in equities over the past two months has not been justified by underlying fundamentals both from a macro economic and company perspective. The sell-off was likely due to bulls and bears being indecisive on what to do next (animal behaviour). Two other factors however might have also contributed to negative sentiment. One is the shift from QE (although some still pending if needed) to negative interest rates by central banks which will likely impact commercial banks' margins. Also there is growing concern what global banks exposures are to commodity producers and whether this could lead to another financial crisis. Banks are not likely to be as geared and overexposed to mining compared to the underlying exposure they had to subprime mortgages before the last financial crises. These are to different assets with different risk characteristics. In the event of an "event" it's likely to be and income statement issue (write-offs/impairments) rather than a balance sheet issue (unlikely they will have equity stakes in miners). Banks balance sheets are in far better condition compared to the subprime years where subprime mortgages (which people couldn't pay back) formed an abnormally large part of their assets.

The second is deterioration in the "wealth effect" amongst consumers. The actions by central banks over the past couple of years by cutting real interest rates have pushed up asset prices that are not fully supported by economic reality (Yet). The risk is that if global growth disappoints, markets could remain on the back foot which could cause consumers to delay spending even more.

Overall though we expect European fundamentals to continue to improve slowly and the US to continue to grow (maybe at a slower pace than expected). Further stimulus from China and Europe should support risky assets in the medium term. Corporate earnings both locally and abroad have in general beat expectations. Markets are offering better value currently and we therefore remain supportive of equities as the preferred asset class in 2016.

Local

We were slightly disappointed by the recent budget announcement by Pravin Gordhan. We were expecting more stringent cuts in government expenditure and more privatisation initiatives. Overall though we think enough was said to delay a sovereign downgrading for the time being but the risk still remains for a downgrade later this year if the planned actions to boost economic growth do not materialise at ground level. Growth estimates have now dipped to below 1% to 0.9%. This will be the main focus area for the international rating agencies.

Local bonds and the currency sold-off during the budget speak reflecting the disappointment by particularly foreign investors. The rand risk premium remains very large and the currency is very oversold but we think structural damage was done during the "Nenegate" saga. A more aggressive budget could have easily pushed the rand to below the R15 to the dollar level but investors were disappointed. The next credit rating is due in June this year.

Source: iNet Bridge

The global environment should be moderately supportive for the rand. Risky assets and emerging markets made moderate gains of late in the wake of firmer commodity prices (or more stability rather). The revision in Eurozone inflation to 0.3% from 0.4% will likely promote further easing by the ECB. This together with a more dovish tone by the FED as well as better news from China should be positive for commodity markets.

A recent positive development prior to the budget has been engagement between business and government mainly on how to prevent agency downgrades. South Africa's captains of industry have identified three priority initiatives that they believe will help set the country back on the road to stronger economic growth and job creation.

The three initiatives are: averting a credit rating downgrade, accelerating growth of small and medium enterprises to create jobs and identifying key investment projects in economic sectors. These quotes from a recent article on Moneyweb:

"We have started working together at a time in SA when we are as close to a perfect storm as we could be," says Cas Coovadia, head of the Banking Association of SA. *"If business and government don't work together and take a long-term view, we will not turn this around".*
"SA is at a critical economic juncture, with slow growth, high unemployment and real risk of a sovereign debt downgrade," adds Stanley Subramoney, lead convener of the business initiative. *"We are committed to working actively and urgently with government and labour to support the steps."*
"SA business is announcing three specific initiatives to help translate the National Development Plan into faster growth, new jobs, and greater economic inclusion," adds Vassi Naidoo, chairman of Nedbank.
The first is the focus on preventing a ratings downgrade and is convened by Nedbank's Mike Brown and Old Mutual's Ralph Mupita.

Local economic data remains worrisome. PPI for January jumped from 4.8% to 7.6% and consumer prices in South Africa went up 6.2 percent year-on-year in January this year accelerating for the fourth straight month in a row and reaching the highest since August of 2014. Figures came in above market expectations, due to higher cost for electricity, food, transport and alcoholic beverages. Recent comments by the SARB remain hawkish with the rise in CPI and will likely result in further rate hikes this year albeit perhaps at a lower and slower pace given the deteriorating global inflation and growth environment. Consensus amongst economist seems to be for a 25bp hike in March this year with a potential pause after that (depending on the rand of course).

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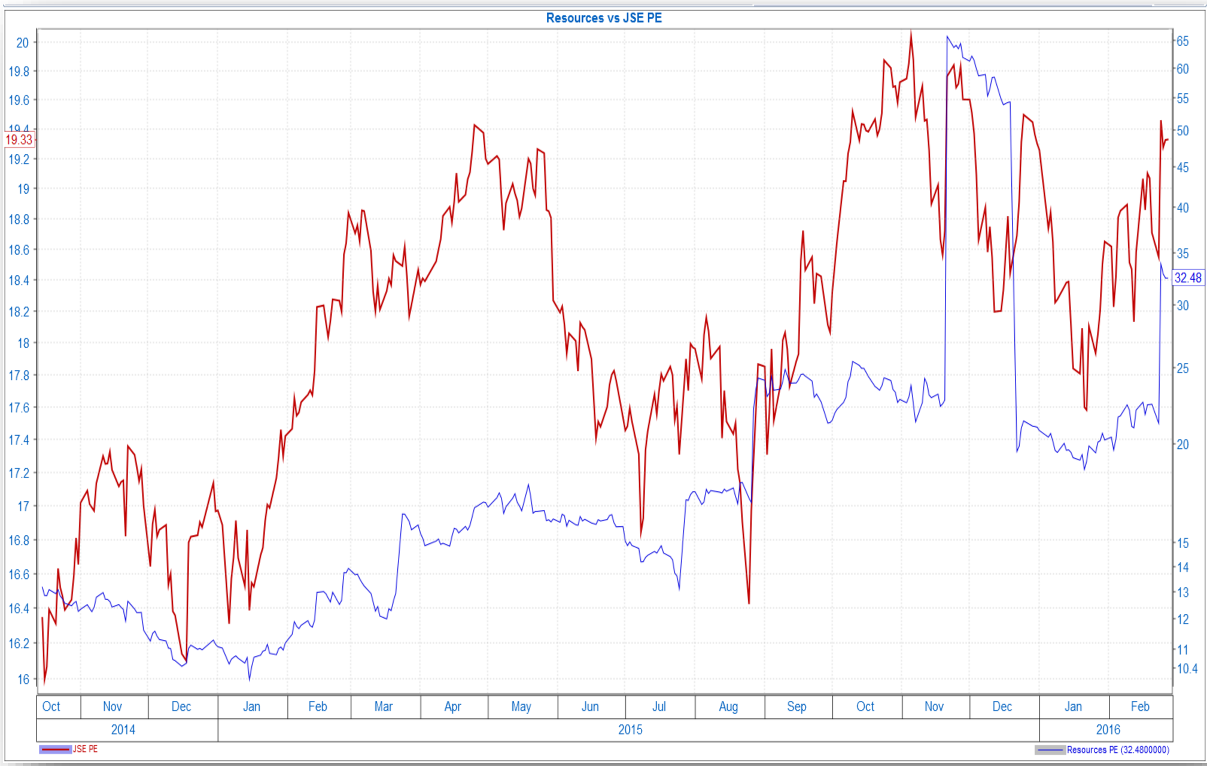
On the local market, the main feature was the strong rally in resource stocks despite no real improvement in supply side fundamentals although there are some early signs that some capacity is slowly being removed from various markets. However, share movements remain very volatile in the commodity space. The chart below indicates the big upward movement in the resources index price earnings ratio which pushed up that of the JSE in unison. The big move in the resources sector was both due to a rerating buy investors as well as poor results from the sector. Investors in this sector are typically forward looking and will anticipate a recovery in earnings 18 months ahead of time. Expect more short term volatility despite the recent rally.



Source: iNet Bridge

We remain surprised how good the current reporting season has been with results in general beating expectations. We were particularly surprised by listed retail stocks that posted double digit growth in most cases. They all sighted a very good festive season but warned that the consumer will be under strain in an environment of rising interest rates and hence focus will be on improving efficiencies and cutting costs in order to protect their margins.

To Conclude

- Real bond yields are currently trading below 2009 lows reflecting renewed concern of deflation and some market players even sighting the risk of a global recession. We don't subscribe to this view.
- Recent weakness in equity markets correlated with lower oil prices as bears interpreted the decline as a leading indicator of a severe slowdown in the global economy.
- large cuts in capital expenditure by commodity players are being announced nearly on a daily basis which should eventually lead to a recovery on spot prices.
- Current low commodity prices will eventually lead to higher consumer expenditure in both developed and emerging markets.
- Although global growth forecasts have in general been lowered, it's not all doom and gloom as US indicators such as housing and wages continue to trend positively. Historically, housing data has been the best predictor of a recession.
- We expect European fundamentals to continue to improve slowly and the US to continue to grow but maybe at a slower pace than expected.
- We were disappointed by the recent budget announcement by Pravin Gordhan. We were expecting more stringent cuts in government expenditure and more privatisation initiatives but it has nevertheless probably safeguarded us form another agency downgrade in the short term.
- Recent comments by the SARB remain hawkish with the worse than expected rise in CPI and will likely result in further rate hikes this year albeit perhaps at a lower and slower pace given the deteriorating global inflation and growth environment.
- The main feature on the JSE was a strong rally in resource stocks despite no real improvement in supply side fundamentals although there are some early signs that some capacity is slowly being removed from the system.
- The reporting season so far has delivered surprisingly good numbers, particularly from retail counters, but most management teams remain very cautious looking ahead.

Sincerely

Chris

Chris Botha

Dave

Dave Eliot

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