IMARA
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Communiqué

Monthly

South Africa

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Is deflation dead?

Abroad

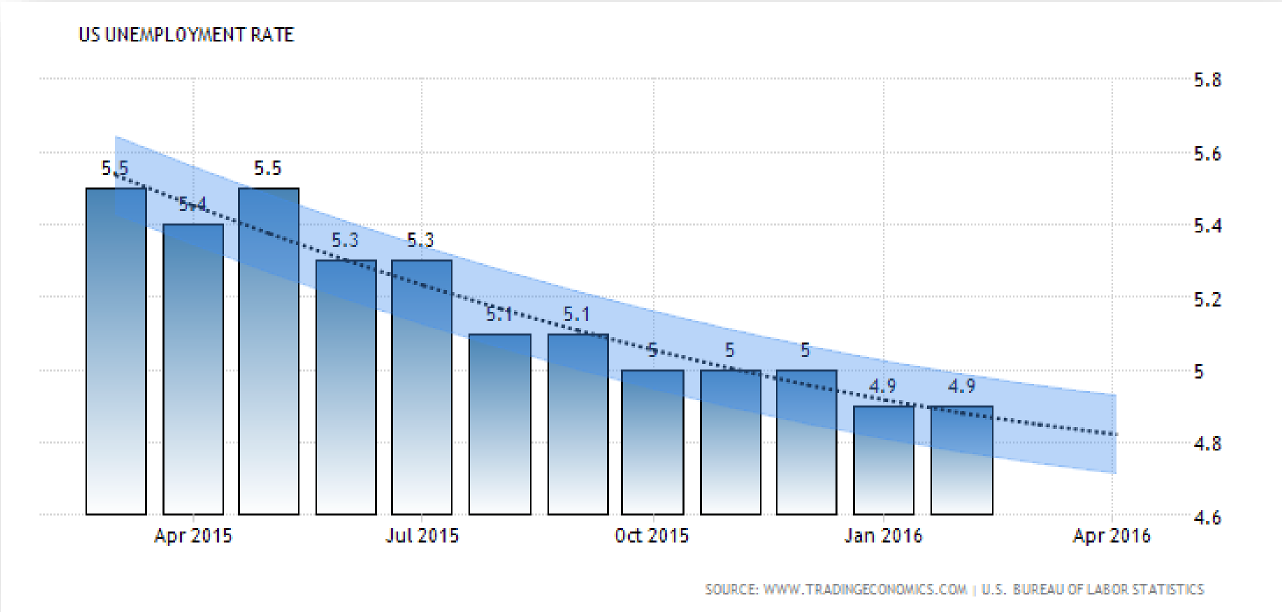
At the beginning of the year investors were in a state of panic with media coverage dominated by the fear of deflation and whether central banks were running out of ammunition to stem the threat of deflation. Following an unexpected rise in US core inflation in February, sentiment has improved somewhat since then and equities have rebounded off their lows. Core CPI is currently increasing at 2.3% year on year compared to 1.6% at the start of the oil crash. A recovery in the oil price and most other commodities has further buoyed sentiment which supported reasonably strong inflows into risky assets and emerging markets of late.

US Core inflation year on year % change

Feb. 29, 2016	2.33%
Jan. 31, 2016	2.21%
Dec. 31, 2015	2.10%
Nov. 30, 2015	2.02%
Oct. 31, 2015	1.91%
Sept. 30, 2015	1.89%
Aug. 31, 2015	1.83%
July 31, 2015	1.80%
June 30, 2015	1.76%
May 31, 2015	1.72%
April 30, 2015	1.81%
March 31, 2015	1.75%
Feb. 28, 2015	1.70%

Source: Ycharts.com

The latest increases in prices appear to be fairly broad based and hopefully there won't be a repetition of 2011 and 2014 when the pick-up in inflation was only temporarily. Furthermore, the rise in inflation has been accompanied by rising unit labour costs and an unemployed rate in line with the Fed's target rate which is set at 5%.

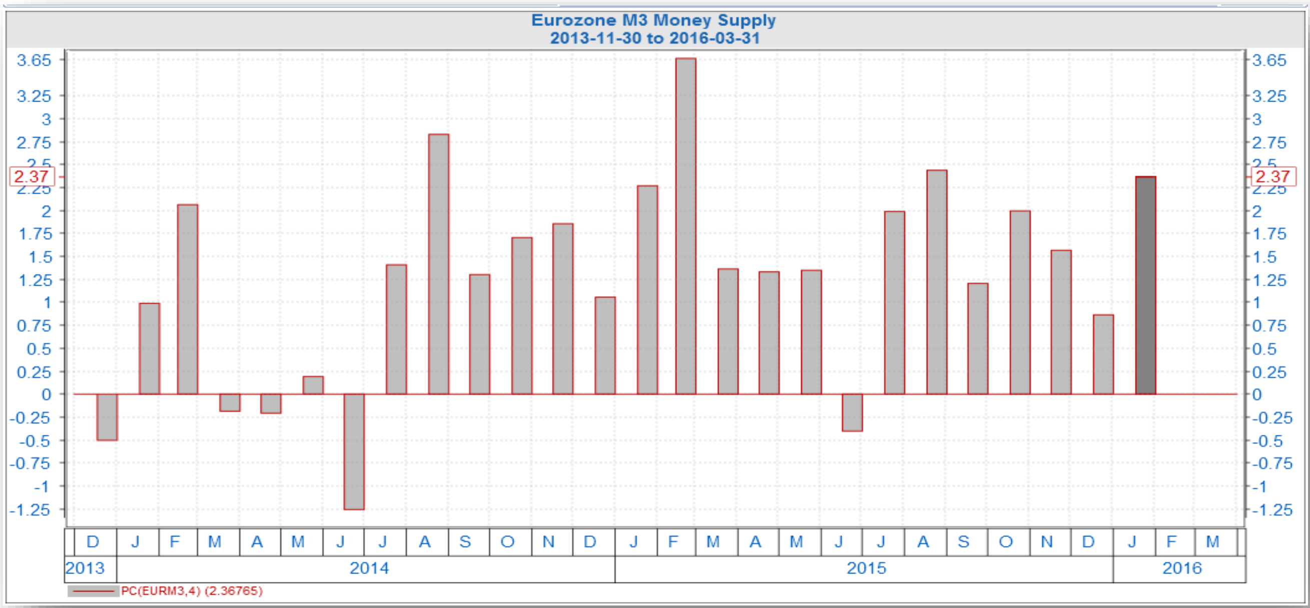


Source: Trading Economics

A weakening dollar (at last) has also eased deflationary pressure accompanied by a rise in commodity prices. The fed's postponement of rate hikes in February and March was borne out of anxiety around the sustainable strength of the US economy. A key risk for the FED is that rising inflation is not accompanied by acceleration in economic activity. Higher inflation alone will likely not be viewed as enough reason to hike rates.

The recent stance by Janet Yellen fuelled appetite for risky assets. She defended the Fed's positioning to gradually increase key interest rates but her statement was less optimistic than previous declarations. Moreover, the Fed members' expectations regarding the timing of rate hikes appear less consensual than before with certain members commenting that the risk of the FED falling behind the curve (should have had more hikes at this stage) has increased as the economy is recovering faster than official data suggests. The FED is therefore leaving its option open in order to manage volatility in financial markets. We remain of the opinion that the US economy will continue to grow steadily but at a pace not conducive for rates to increase at a faster pace than expected. So for now, a dovish stance by an astute FED is likely to remain.

Good news from Europe continues to flow. Most economies in the zone are improving albeit still at a relatively slow pace. The main potential destabilising force remains Brexit in the near term (more on that later). Data in February has suggested that there was a rebound in the granting of corporate loans and M3 money supply showed a sharp increase of 5% on a year on year basis. If the trend persists it will ease pressure on the ECB "to do whatever it takes" to stimulate the economy. The ECB recently announced another TLTRO (Target Long Term Refinancing Operation) programme to arrange cheap financing to banks and corporates to support the credit cycle. Negative deposits rates in the zone will likely encourage banks to convert the resources from the above programme into loans.



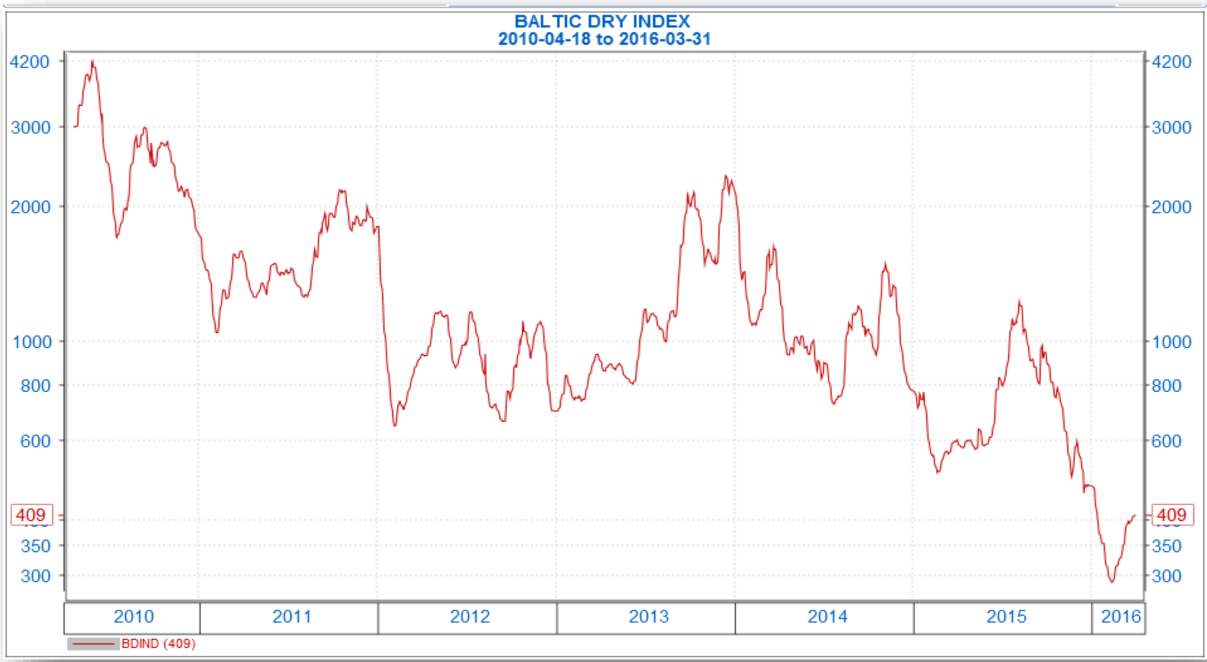
Source: iNet Bridge

On Brexit, we remain of the opinion that Britton will remain in the union despite recent polls indicating that it will be a tight vote. In the event of an exit over a likely two-year exit negotiating process, estimates are that growth in the Euro zone would be 0.5% lower in 2016 and 1.1% lower in 2017 once the full impact on business investment is felt.

Following the financial crises, the concept of globalisation of trade has come under scrutiny particularly amongst nationalist members of the union. Populist politicians have used this uncertainty to attack the free trade assumptions of the globalised elite.

The rise of populist politics and a need to curb income inequality as well as efforts to increase inflation, particularly in the Euro zone, will probably put upward pressure on long term government bonds down the line which could be supportive of regional equities.

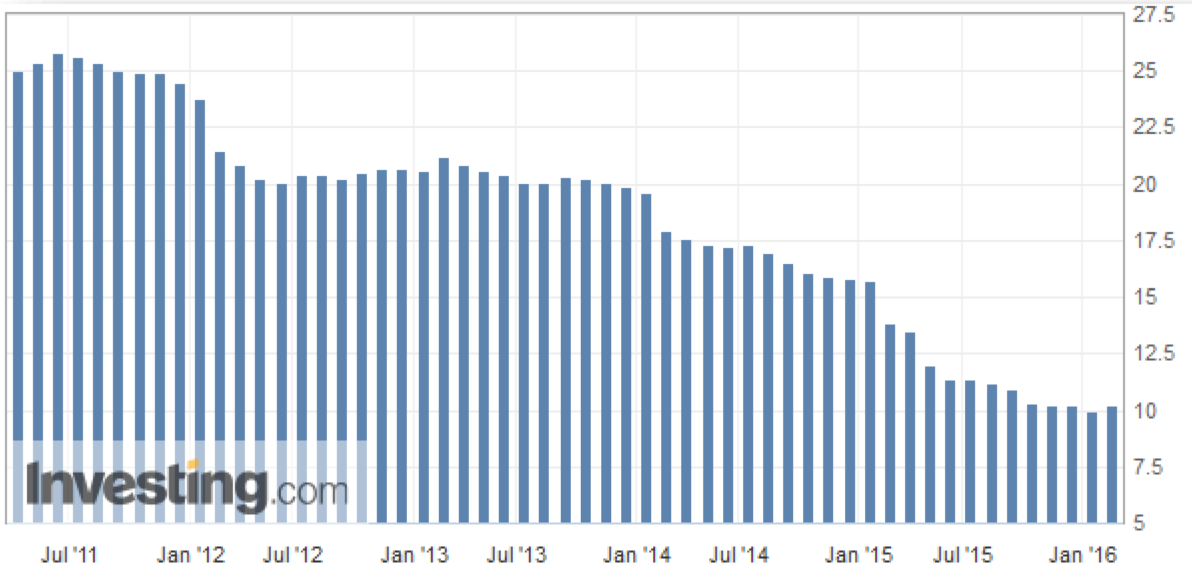
Despite the recent rise in commodity prices, prices are still very low compared to historical norms. Low prices usually have a two stage impact on global growth. Initially low prices prevent further capital investment in the resources sector which typically amounts to 40% of global capital expenditure by listed companies based on research done by the Bank Credit Analyst. Lower prices also have the effect of lowering inflation in developed markets (the situation currently) and lowering growth in emerging markets due to a collapse in export revenue. Cheap commodities and input costs will eventually lead to economic expansion due to a windfall for consumers. This eventually leads to expansion in manufacturing capacity and job growth. In the current environment of stable resource prices and improved sentiment around the prospects for the sector, things appear more positive for the global economy to steadily continue on its current growth trajectory. The Baltic Dry Index is usually an accurate bellwether for conditions in the commodities market and is reflecting the recent recovery in commodity prices. Let's hope it lasts as fundamental reasoning in terms of over supply has not materially changed yet, although there are some signs of manufacturing and production cuts in China, particularly in the steel sector which feeds into bulk commodities like iron ore.



Source: iNet Bridge

As always, discussions around commodities lead to China. The rhetoric amongst policymakers in recent meetings emphasised the difficult choices China is facing. On the one hand, Governor Zhou expressed his concerns over the high level of corporate debt and on the other hand Premier Li is emphasising that the growth target of 6.5% must be met to avoid disappointment. It's likely that the latter will end up as the chosen path given the surge of new credit and stabilisation of fixed investment growth in January this year.

Chinese fixed investment



Source: Investing.com

China's overall debt level has not reached excessive levels yet. However, total non-financial debt will likely grow in the next couple of years as deleveraging in the corporate sector is offset by more borrowing by the state to fund their budget deficit due to an increase in fiscal spending in order to reach their stated growth target. We also expect more government intervention to weaken the yuan which should further support target growth.

Overall then we expect growth in developed markets to continue but could be at a slower pace than economists predict. Weakness in emerging markets will be an important factor for the FED regarding future action on interest rate increases. We remain optimistic that future hikes will be low and slow despite the welcome increase in core inflation. There is a chance that growth in Europe could surprise on the upside but Brexit is a looming short term risk albeit unlikely.

The turnaround in commodity prices, if sustained, could well be a precursor to positive surprises in global growth, including emerging markets. What's important is that sentiment has changed around resources and despite probable volatility in the sector, a major correction back to previous lows appears less and less likely.

Local

The main event at the time of writing was the Constitutional Court ruling around President Zuma and Nkandla which had a profound effect on the rand with the currency instantly breaking the R15 to the dollar level strengthening to R14.72.

The Constitutional Court has found that President Jacob Zuma was in violation of the constitution when he failed to comply with remedial action recommended by the public protector's office and must pay back a portion of the money for the Nkandla upgrade according to a press releases.

Chief Justice Mogoeng Mogoeng said: "The remedial action that was taken against the president has a binding effect. The president should have decided whether or not to comply with the public protector's remedial action or not. If Zuma had objected to Madonsela's recommendation, he should have challenged it through a judicial process. The president failed to uphold and defend the constitution. He said that independent institutions such as the public protector's office was the sharp and mighty sword that stands ready to chop off the head of the abuse of state resources. Parliament, in terms of the constitution, has the discretion to impeach the president if he is in breach of the constitution". National Treasury is to decide on what percentage needs to be paid back by Zuma within 45 days.

The strength in the rand is unlikely to deter the SARB from hiking rates again later in the year due to fears of higher cost inflation because of food (impact of the drought) and electricity price increases. Having said that, according to insiders the recent 25pb hike in the repo rate was a 50/50 split among committee members. Importantly, during the press briefing, they stated that the decision was based on a shift in inflation risk but interestingly the SARB's forecast inflation outlook improved. Given rapidly declining local growth forecasts, this could indicate that the end of the hiking cycle might be closer than previously thought. The previous tightening cycle was 29 months long and the current one 26 months long, so not far to go hopefully. Maybe one more hike in July and that's it.

SARB economic estimates

		2016f	2017f	2018f
CPI (%)	Previous	6.8	7.0	n.a.
	New	6.6	6.4	5.5
Core CPI (%)	Previous	6.0	5.9	n.a.
	New	6.2	5.7	5.2
GDP (%)	Previous	0.9	1.6	n.a.
	New	0.8	1.4	1.8
Current account/GDP (%)	Previous	-5.2	-5.3	n.a.
	New	-4.6	-4.7	-4.9
Trading partner growth (%)	Previous	2.9	3.3	n.a.
	New	2.8	3.2	3.5
Brent crude (US$/bbl)	Previous	41.0	50.0	n.a.
	New	37.0	45.0	50.5
World food prices (%-change)	Previous	-2.8	2.7	n.a.
	New	-3.0	2.0	3
REER (level)	Previous	70.5	70.5	n.a.
	New	71.3	71.3	71.27
Petrol price (%-change)	Previous	7.9	12.4	n.a.
	New	0.0	10.2	9.4
Electricity (%-change)	Previous	12.2	13.0	n.a.
	New	10.1	9.5	10
Potential growth (%)	Previous	1.5	1.6	n.a.
	New	1.5	1.6	1.8

Source: SARB, RMB Global Markets
Data as at March 2016

Source: RMB Global Markets Research: 17 March 2016

The JSE continues to be a bit choppy despite excellent company earnings. It largely is a function of foreign buying and selling, comments by the FED and happenings in China. There has been net foreign buying for most of the current month and will maybe continue following the Zuma judgement. The Market was also buoyed by a stellar performance in resources with the sector up 22% year to date. The all share is up 6% year to date and was up 4% in March.

Source: iNet Bridge

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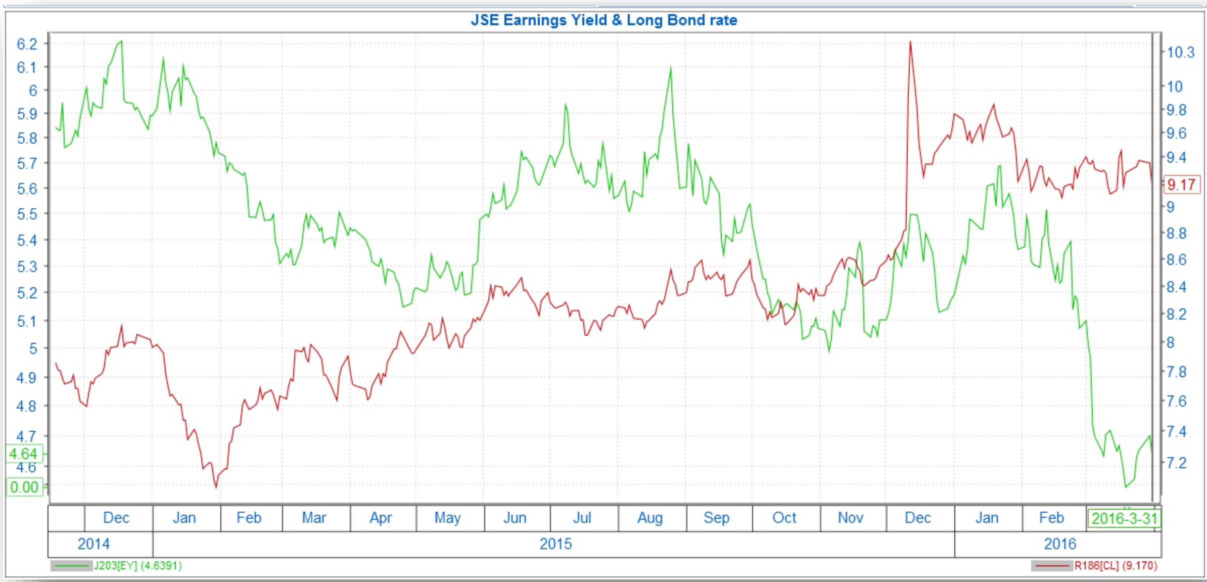
As mentioned above the fundamental problem in the commodity space in terms of the supply/demand dynamic hasn't changed much but sentiment around resources has changed and this is usually a major driver of share prices in advance of an earnings recovery. This does however mean that this component could continue to be volatile in the near term as investors make up their mind that either supply is being cut or that Chines efforts to hit their growth target are paying off. We think the latter will be a positive surprise to markets and will continue to have exposure in the resource space although we are not overweight bay any means. One headwind for commodities might be the oil price. Brent spot rose from a low (for the year so far) of $33pb in February to $41pb in the middle of March but has subsequently retraced back to $39pb. Risks to the downside for oil remain.

The chart below compares the JSE earnings yield (green) with that of the RSA long bond yield (red) which depicts the big rerating the market experienced as price earnings ratios expended mainly due to the run in resource stocks. The yield gap currently stands at 4.5% which is at a level it has not been for some time and makes the market appear expensive. However, it remains a relative easy gap to close for equities given that consensus earnings growth for the markets on a 12m rolling basis is about 12%. On a normalised basis if one excludes resources, the gap drops to approximately 3.1% which is line with long term historical levels.



Source: iNet Bridge

So, in terms of market rating, a lot hinges on the sustainability of the current valuations in resource stocks. Any shocks in this segment of the market remain a risk to the pricing of the JSE all-share index. But remember sentiment has changed and the commodity stocks were extremely undervalued (some still are) and institutional investors are underweight the sector. So hopefully there likely is an underlying buffer if things do go wrong for commodities.

We continue to follow a diversified approach in our client portfolios which has proven to be the correct philosophy given our performance track record.

To conclude:

- Following an unexpected rise in US core inflation in February, sentiment has improved somewhat since then and equities have rebounded off their lows.
- A recovery in the oil price and most other commodities has further buoyed sentiment which supported reasonably strong inflows into risky assets and emerging markets of late.
- A key risk for the FED is that rising inflation is not accompanied by acceleration in economic activity. Higher inflation alone will likely not be viewed as enough reason to hike rates.
- Most economies in the Euro zone are improving albeit still at a relatively slow pace. The main potential destabilising force remains Brexit in the near term which we think is unlikely but it's going to be close.
- The rhetoric amongst policymakers in recent meetings emphasised the difficult choices China is facing. On the one hand, Governor Zhou expressed his concerns over the high level of corporate debt and on the other hand Premier Li is emphasising that the growth target of 6.5% must be met to avoid disappointment which we think will be the chosen path.
- The main event at the time of writing was the Constitutional Court ruling around President Zuma and Nkandla which had a profound effect on the rand with the currency instantly breaking the R15 to the dollar level strengthening to R14.72.
- The strength in the rand is unlikely to deter the SARB from hiking rates again later in the year due to fears of higher cost inflation because of food (impact of the drought) and electricity price increases but we are potentially close to the end of the current cycle.
- The equity risk premium on the JSE currently stands at 4.5% which is at a level which makes equities appear expensive. On a normalised basis if one excludes resources, the gap drops to approximately 3.1% which is line with long term historical levels.
- The sustainability of the current market rating will depend on whether resource stocks can hang on to their recent gains which could well be the case given the change in sentiment amongst investors.

Sincerely

Chris

Chris Botha

Dave

Dave Eliot