Communiqué

Monthly

South Africa

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

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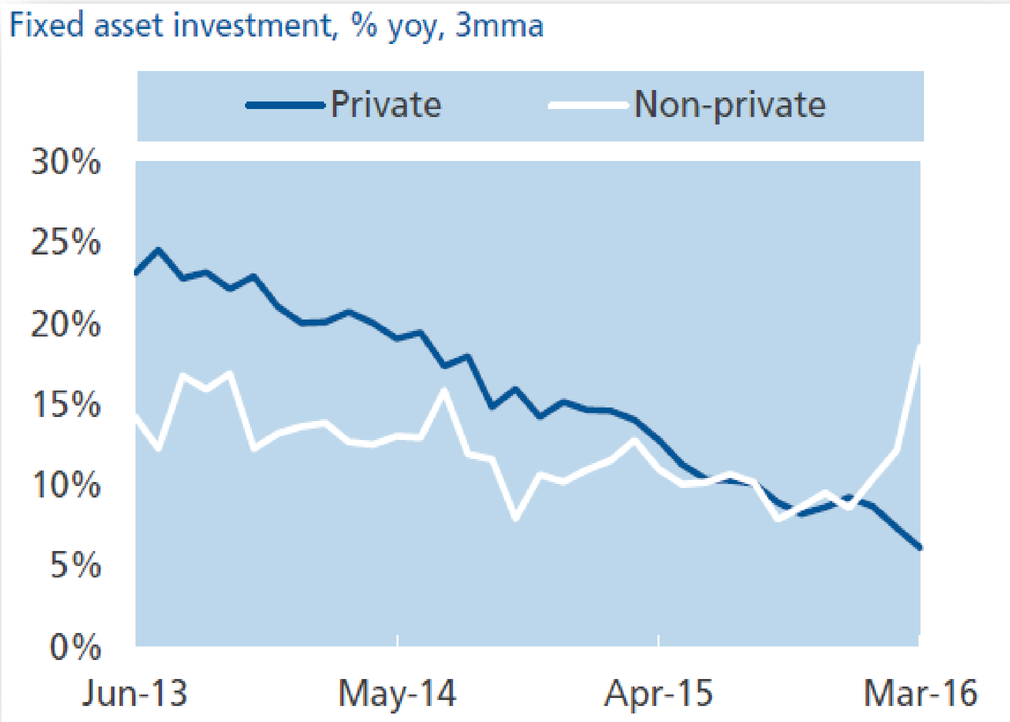
Abroad

The current rally in emerging markets is being underpinned by a strengthening Japanese yen, macro stabilisation and pro-growth policies in China as well as a more dovish Fed.



Source: Lombard Street Research: April 2016

Investor sentiment has improved markedly on the back of strong economic data from China. Chinese exports increased by 20% year on year in March and GDP expanded by 7.1% in the first quarter on an annualised basis. This compares to growth of 5, 5% in the fourth quarter of 2015. The numbers might however be skewed by the Chinese New Year but nonetheless appear promising. Growth was largely driven by consumer expenditure and more fixed investment by state authorities (see chart above). Monetary policy will likely remain very accommodative which should underpin private consumption for some time still.

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Credit growth in China is also on the increase as many companies have resorted to bank loans and the bond markets to fund investment as industrial profits remain under pressure. Mortgage lending also is picking up due to the loosening of home loan restrictions. The question is however how long China can create debt at the current pace to generate growth?

The strong yen and weak dollar have caused a respite in global commodities and emerging market currencies. This is likely to continue for at least the next two quarters or so with a corresponding positive momentum in emerging market equities.

Source: iNet Bridge

Global markets were buoyed by more dovish statements by the Fed following the March meeting. The FOMC noted; "global economic and financial developments continue to pose risks". Recent economic data and downward revisions in estimates now imply only two rate hikes in 2016 compared to four hikes expected at the end of last year. Having said that, core inflation looks set to meet or even come in slightly above the Fed's target so it is probable that the dovish stance could make way for a more hawkish one in due course. Given that zero or negative rates in the rest of the world is likely to persist for some time, even small increases in rate expectations in the US could have a profound impact on the dollar causing the currency to strengthen against emerging market currencies in particular with a resurgence of risk-off sentiment. This will have a negative impact on commodities and emerging market stocks and bonds.

Further current support for emerging markets can be found in the rebound in the oil price with a growing number of analysts commenting that a cyclical bottom has been reached. We are not so sure about that given no agreement being reached recently by the major producers to cut or freeze production volume.

Despite some weakish economic data in Europe, we expect euro area growth to be strong enough to steadily continue to decrease the unemployment rate (currently 10.3%). The region will likely continue to benefit from the relatively weak euro and low commodity prices (although they have picked up) and further easing in bank lending criteria which should keep default risk at bay.

The ECB and BOJ (Bank of Japan) are likely to continue to dig in their monetary toolkits in order to stimulate some form of inflation and economic growth. So far, asset purchases and negative interest rates have done little to address the above. Expect more aggressive packages in due course.

The benefits of lower commodity prices have yet to be felt. One possible reason is that as spot prices collapsed, capital expenditure in additional future capacity has been reduced sharply with a corresponding drag on downstream activities and economic growth. Easing fears of a hard landing in China could well lead to the recent rise in commodities to last a bit longer but will probably be derailed when the US dollar starts strengthening again if and when the Fed turns hawkish again.

Rising supply due to new mines and expansion of existing ones, particularly in copper and iron ore will remain a headwind over the medium term for commodities. This also applies to the oil market, which all means that a material increase in inflation is a long way away.

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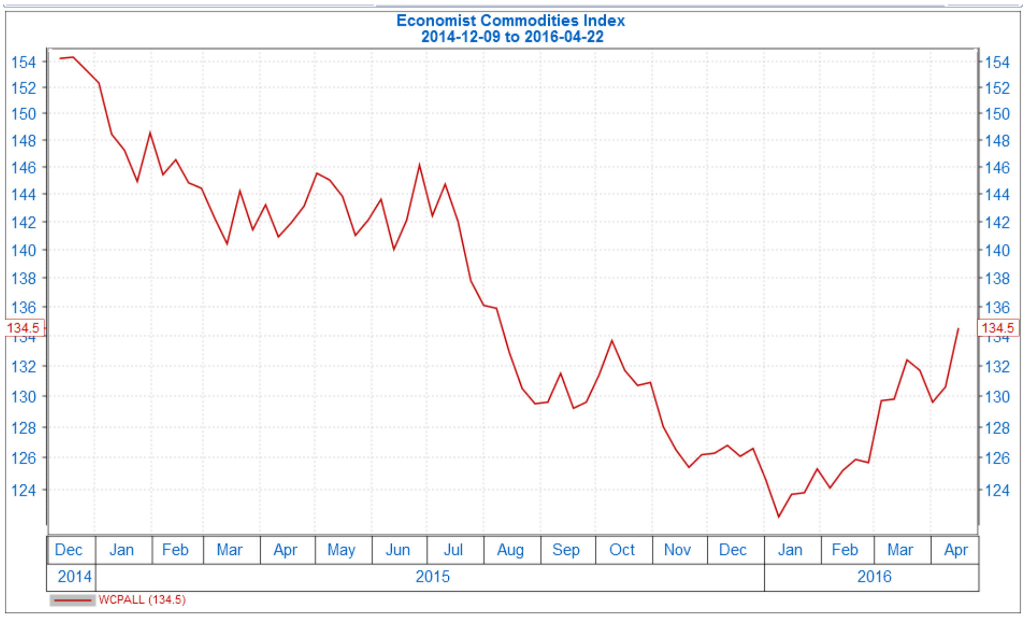
According the World Bank, the anticipated oil price recovery is forecast to be smaller than the rebounds that followed sharp drops in 2008, 1998, and 1986. Downside risks remains. To quote John Baffes, Senior Economist and lead author of the Commodities Markets Outlook; "Low prices for oil and commodities are likely to be with us for some time. While we see some prospect for commodity prices to rise slightly over the next two years, significant downside risks remain."



Source: iNet Bridge

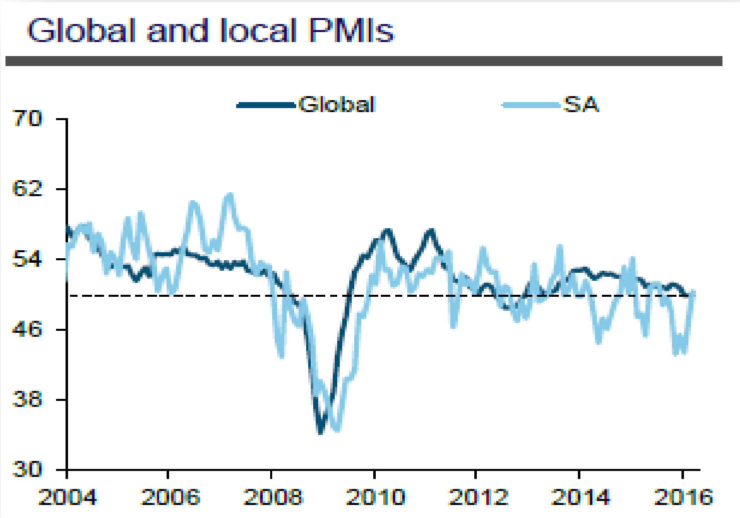
In fact, the World Bank expects all main commodity price indices to fall in 2016 due to persistent over supply, and in the case of industrial commodities, slowing demand in emerging market economies. Of the 46 commodities the bank monitors, they expect 37 of these to be lower by year end.

Moreover, according to Ayhan Kose, Director of the World Bank's Development Prospects Group; "Low commodity prices are a double-edged sword, where consumers in importing countries stand to benefit while producers in net exporting countries suffer. It takes time for the benefits of lower commodity prices to be transformed into stronger economic growth among importers, but commodity exporters are feeling the pain right away."

Overall we expect the global economy to limp along led by the US and China and more stimulus in Japan and Europe. The recent run in commodities and stock prices probably still has some legs for the next two quarters or so but it becomes difficult to forecast beyond that given the supply problem. Further supply cuts and better than expected growth in China are the main candidates for a longer term sustained turnaround in prices. But commodities fell to far the last couple of years and we can comfortably say that a cyclical bottom was reached towards the end of last year.

In South Africa

Despite continuing social-political problems some good news emerged recently with the local purchasing manufacturing index (PMI) jumping above the 50 mark and the rand recovering by the strongest pace in four years. Bond purchasing by foreign investors also remain strong with current ownership standing at 33%, the highest level since October last year.



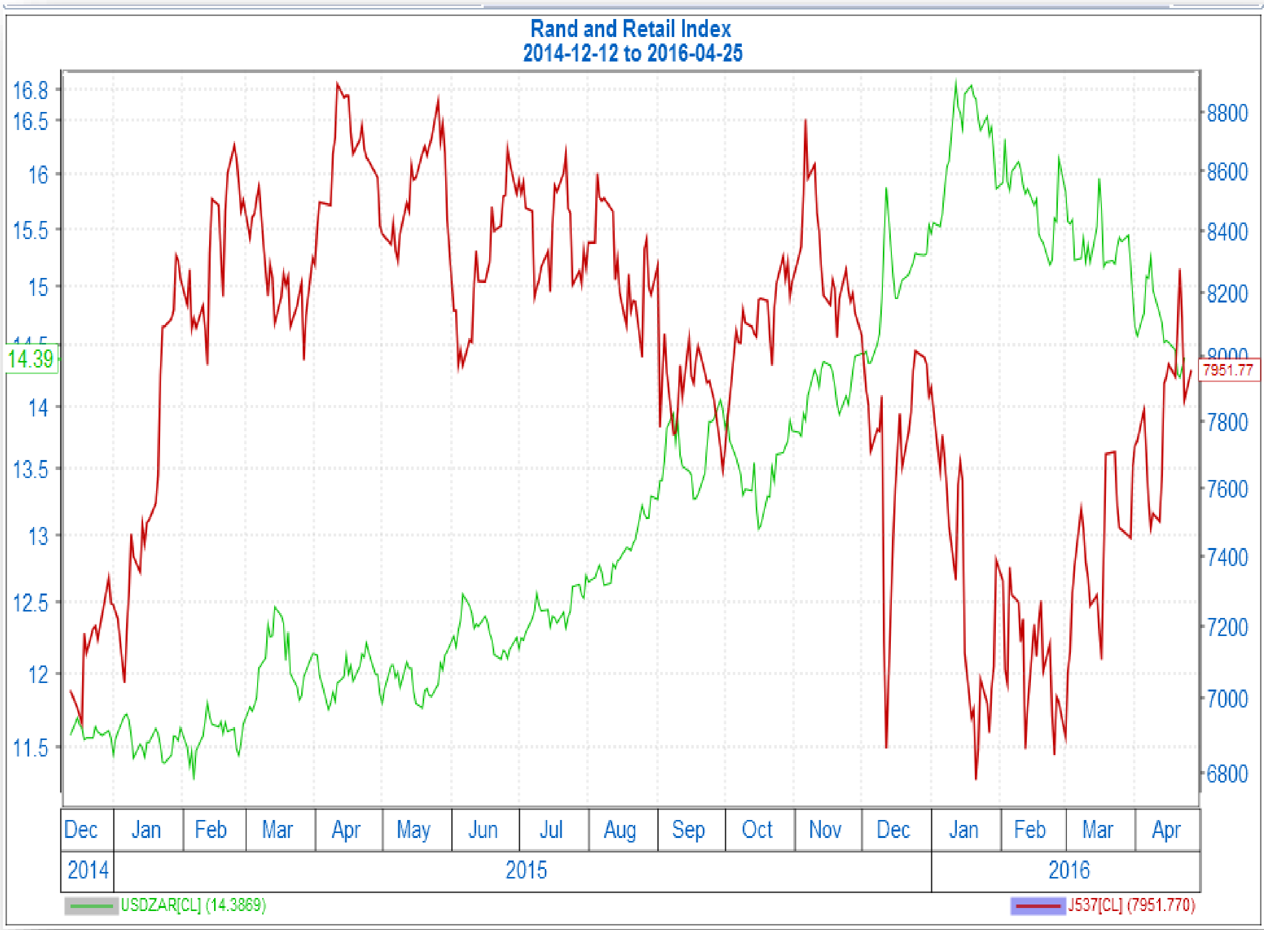
Source: RMB Global Markets: April 2016

Recent comments by the SARB remain on the hawkish side. To quote; "Tolerating additional inflation in the short run could require larger interest rate adjustments later, with proportionally grater cost to the economy. Higher inflation would also have its own economic costs, by damaging competitiveness, eroding living standards and weakening confidence."

The risk of agency downgrades is something the SARB will be watching carefully and they will likely let inflation rise a bit above the upper target band of 6% as more rate hikes will hurt economic growth even further. GDP growth carries the largest weighting in rating agencies assessment of sovereign risk. Research done by RMB has shown that countries that get downgraded suffer a severe slowdown in economic growth and in some cases actually force authorities to cut rates soon after the event.

The rand and local investment markets benefitted from a renewed risk-on sentiment globally due to dollar weakness following dovish comments by the Fed and further strengthening of spot commodity prices. We continue to remain cautious on resource stocks as we do not think the oversupply in bulk commodities are being curtailed at a fast enough pace to reflect underlying fundamentals.
We still expect the Fed to hike this year which could well be the trigger for renewed weakness in the rand and commodities as the dollar will likely strengthen.

On the JSE, as expected, volatility continues. The market was up 4% in April after falling by 4% in March. Near term tailwinds are higher oil and commodity prices as well as the stronger rand which should benefit retail and banking stocks. The chart below indicates the positive relationship between retail shares (Red) and a stronger rand (Green).



We remain of the opinion that despite the hawkishness from the SARB, we are nearing the end of our local interest rate hiking cycle (maybe one more 25bp hike by mid-year). This could be a headwind for the rand down the line but benefit resource stocks and industrial rand hedges. So, short term fundamentals (and momentum) look fairly sound for equities despite heady valuations in certain stocks (industrial rand hedges). We are also entering the northern hemisphere summer period with markets typically moving sideways up until the 3rd quarter of the year. So in theory, one can expect less volatility but maybe things are really different this time around with local political and economic uncertainty?

To conclude:

- The current rally in emerging markets is being underpinned by a strengthening Japanese yen, pro-growth policies in China as well as a more dovish Fed.
- Credit growth in China is also on the increase as many companies have resorted to bank loans and the bond markets to fund investment as industrial profits remain under pressure.
- Despite some weakish economic data in Europe, we expect euro area growth to be strong enough to steadily continue to decrease the unemployment rate (currently 10.3%).
- The ECB and BOJ (Bank of Japan) are likely to continue to dig in their monetary toolkits in order to stimulate some form of inflation and economic growth.
- The recent run in commodities and stock prices probably still has some legs for the next two quarters or so but it becomes difficult to forecast beyond that given the supply problem.
- The risk of agency downgrades is something the SARB will be watching carefully and they will likely let inflation rise a bit above the upper target band of 6% as more rate hikes will hurt economic growth even further.
- Research has shown that countries that get downgraded suffer a severe slowdown in economic growth and in some cases actually force authorities to cut rates soon after the event.
- The rand and local investment markets benefitted from a renewed risk-on sentiment globally due to dollar weakness following dovish comments by the Fed and further strengthening of spot commodity prices.
- Near term tailwinds for the JSE are higher oil and commodity prices as well as the stronger rand which should benefit retail and banking stocks.

Sincerely

Chris

Chris Botha

Dave

Dave Eliot

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