IMARA
Asset Management SA

Communiqué

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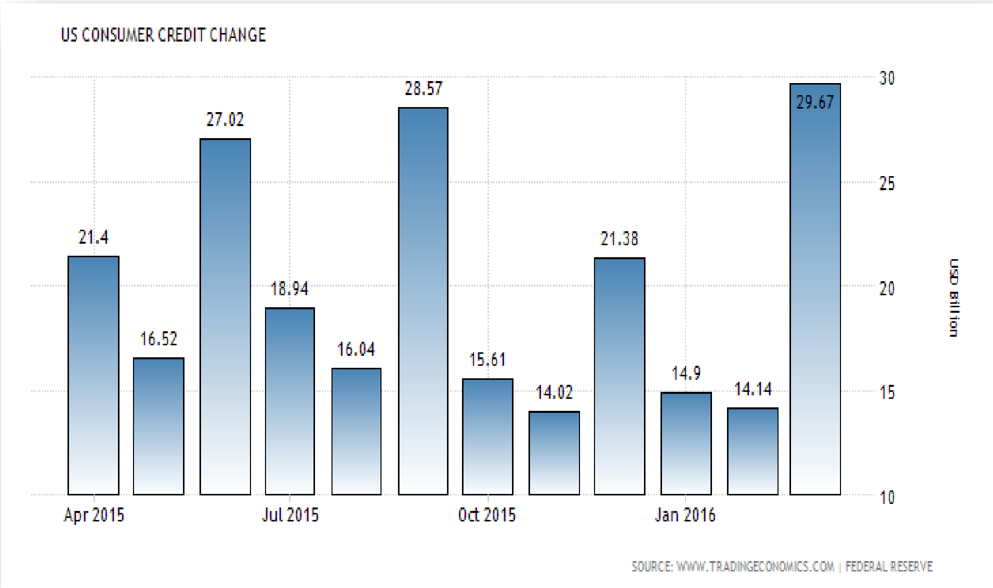
Imara Asset Management South Africa
257 Oxford Road, Illovo. Johannesburg
+27 11 550 6181

Are central bankers out of bullets?

Abroad

For many decades now, the effectiveness of monetary policy has been underpinned by the willingness of both lenders and borrowers to embrace credit which was an important factor that underpinned economic growth. This also caused asset prices to rise, particularly risky assets. After the financial crises however, borrowers all but disappeared with excess supply of savings being accompanied with no demand for new investment. Central bankers' efforts to boost demand by pushing real interest rates to negative territory have not been successful as households continue to deleverage due expectations of lower inflation.



The problem with debt aversion is more pronounced in developed countries, particularly in the Euro area. The rate of credit growth in Europe has stabilised at a level far lower than what the central bankers were hoping for. The US on the other hand has experienced a sudden recovery in credit demand but this is likely due to seasonal factors with the median trend actually still declining.

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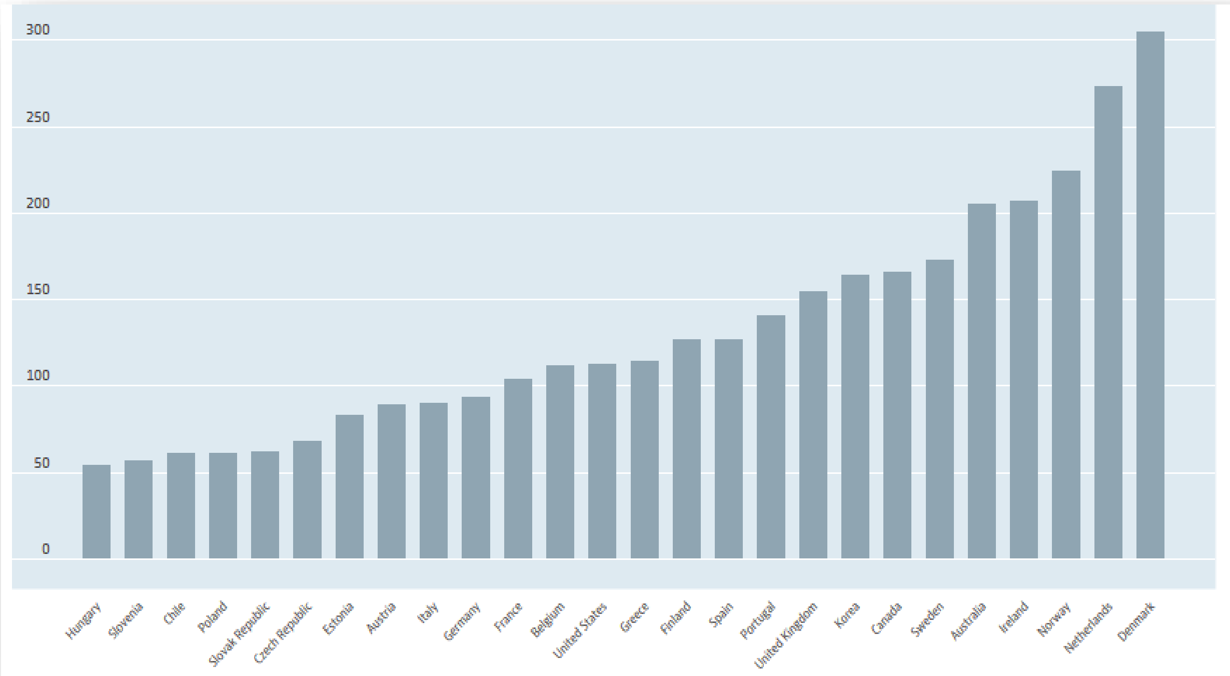
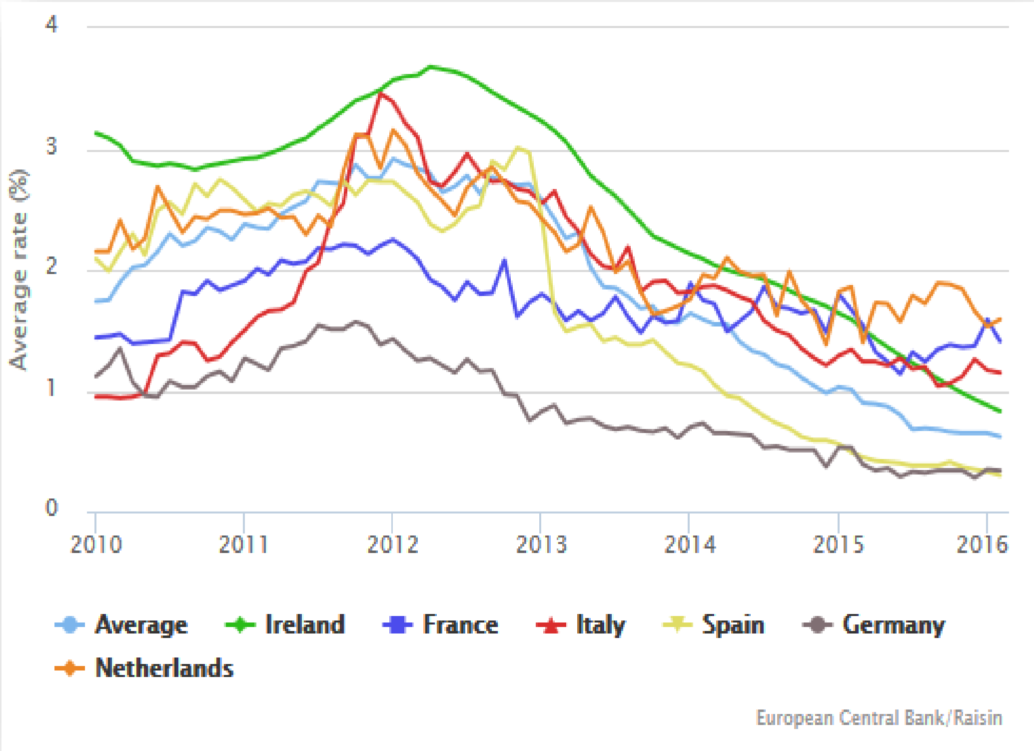
The issue around deleveraging can clearly be seen in the next chart which indicates that household debt relative to disposable income remain extreme in most countries. The key issue is whether the financial crises was a watershed event that caused a structural shift in consumer attitudes toward debt, hence the sharp increase in the savings rate.



Source: OECD data

The question however is that with interest rates this low, how long will the current rate of savings last given negative real returns?

Interest rates in Europe on 1 year fixed term deposits



So what can we do to boost demand and increase inflationary expectations? The likely answer is the use of "Helicopter Money". This term essentially means that central banks might actively print money to monetize government deficits or to transfer cash directly to households, either through the fiscus or through consumption vouchers. This increase in consumption could well result in more employment and production mobilising resources that would otherwise be idle. The question is will consumers rather save this extra money? Evidence from historic cuts in taxes suggest that at least 20% of this windfall will be spent. More importantly though is that helicopter money will likely result in higher inflationary expectations which should lead to less saving and hopefully more spending. If consumers believe that enough money will be printed to lift inflation to the relevant target levels, real rates will fall and spending will increase. The idea of all of this is to alter the behaviour of people. The difference between QE and helicopter money is that the latter results in a permanent increase in bank reserves and the former only in a temporary increase in reserves as central banks could in the process of buying assets announce that the assets will never be unwound or paid back. This increase base of money could well be viewed by people as inflationary which will hopefully cause less saving.

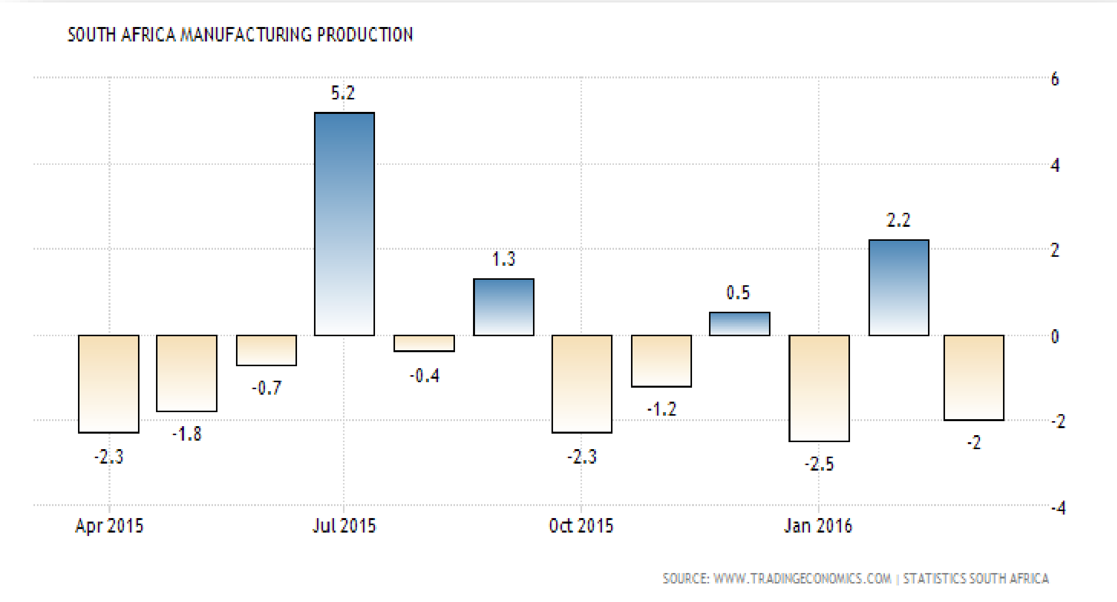
Economic growth in the US remains steady and Europe continues to recover at a decent pace given the weaker Euro and low oil price but deflation remains a risk there.
Global markets remain somewhat volatile but we still think equities will be the best asset class to invest in over the medium term. We expect markets to remain choppy given the following headwinds:

- The next Fed rate hike is approaching, which will impact the U.S. dollar, oil prices and risk assets in general.
- The June UK referendum on staying/exiting the European Union could be a make or break for the UK and euro area economies. UK markets and the currency have already been held back by this threat, but considerable downside or upside is probable ahead.
- The tight link between the U.S. dollar and oil prices is showing signs of fraying, which would be important for equity and high-yield bonds

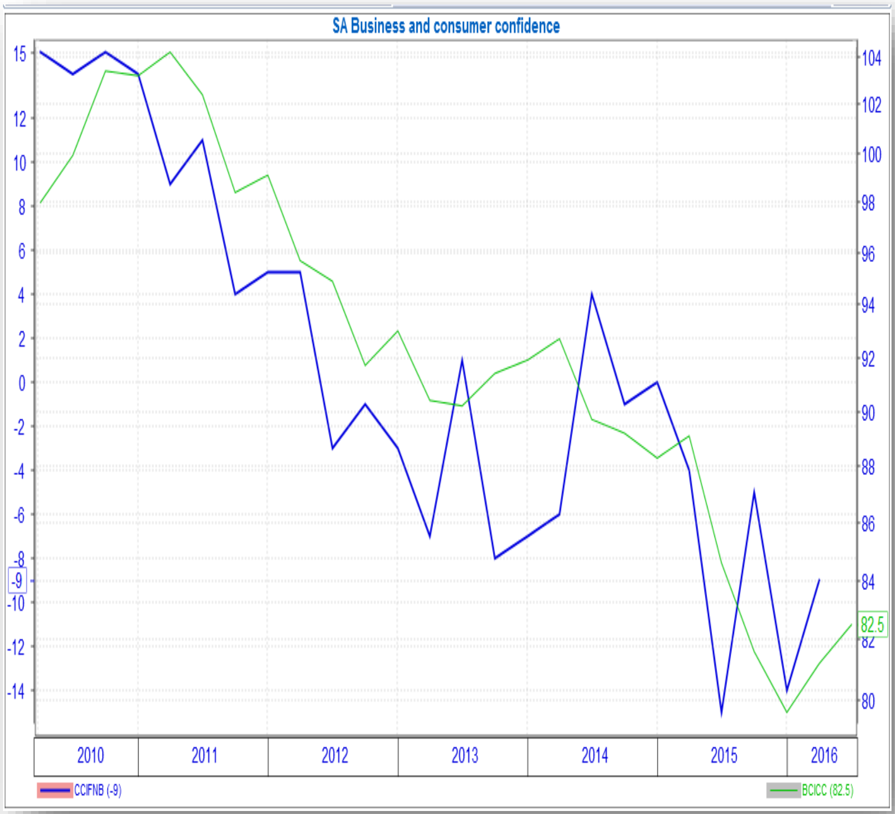
Some US Federal Reserve members continue to justify a rate hike in June (we don't think so). The president of the Saint Louis Fed, James Bullard, reiterated recently his intention to vote in favour of a rate hike in June. He believes that the Brexit issue would not constitute a challenge for the Fed's strategy, justifying this by the idea that the impact in the short term would be negligible given that negotiations in the case of an exit would be spread over two years. Also, the president of the Philadelphia Fed, Patrick Harker, declared that additional monetary tightening in June was "appropriate", indicating that the job market was "extraordinarily dynamic", which should lead to an acceleration in wage increases and inflationary pressure. At the same time, this pressure will be reinforced by energy prices which have stabilised. He also said that he still forecast two or three rate hikes in 2016, considering that the level of inflation will reach its target in the medium term.

Local

The local economy continues to deteriorate and high-frequency data from the first months of 2016 paint a bleak picture going forward. Manufacturing output remains on a downward trajectory despite a weakening currency. Moreover, news from the labour market remains negative as we enter wage negotiation season. The rand has remained volatile in recent weeks and the partial recovery experienced in April proved to be short-lived. The currency depreciated sharply in the first weeks of May amid a weak economic outlook, concerns about a possible credit downgrade as well as heightened political uncertainly. Minister Pravin Gordhan's fight to protect the Treasury and stave off state capture will be a key feature in the near term which could cause continued volatility in the rand exchange rate and also influence the country's sovereign rating by international rating agencies.



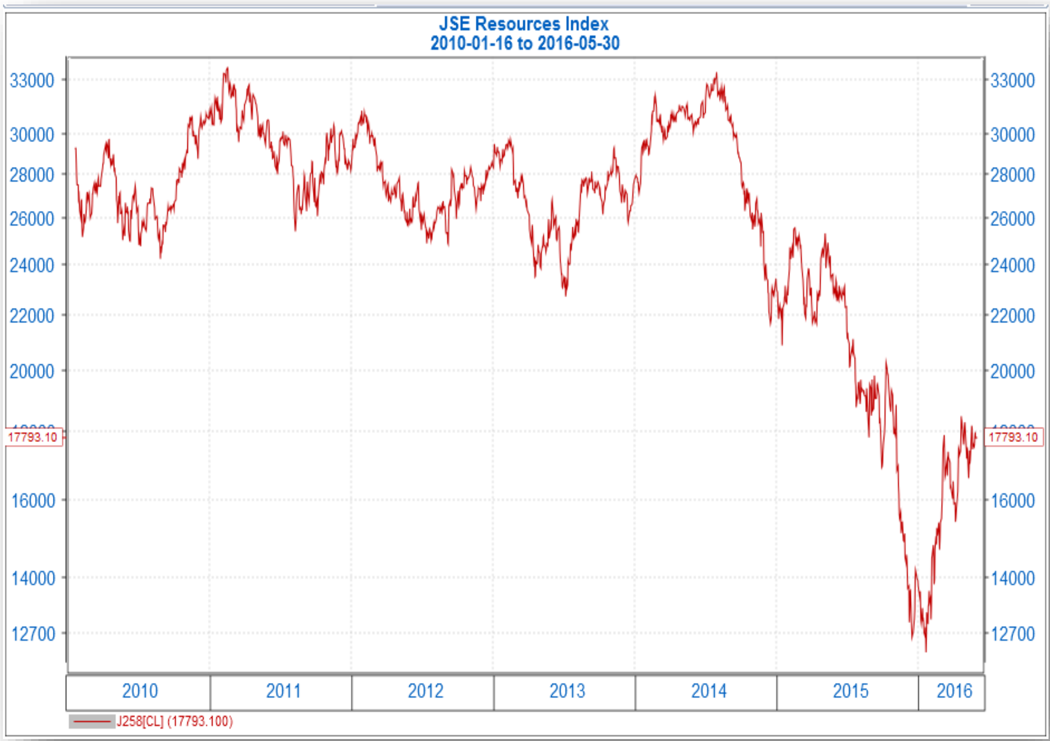
The economy is forecast to grow by 0.9 per cent in 2016, with a gradual improvement to 2.0 per cent in 2017. Weaker global growth prospects and slower growth in key emerging markets will however be a key driver of these growth assumptions. Lower oil prices over the short term should boost global growth, trade and consumption. South Africa's terms of trade will benefit from the decline in the oil price. Real exchange rate depreciation and low inflation should support the competitiveness of local firms. Low investor confidence will remain a concern in the near term which could lead to heightened volatility in our equity and bond markets. The medium-term strategic framework announced by government together with the long awaited infrastructure investment will hopefully lead to a higher growth trajectory in due course.



Source: iNet Bridge

We remain somewhat surprised at the very good reported earnings from locally listed retail companies. Our guess is that the informal economy is much larger than people think and also that there is a lot of foreign buy from consumer's north of our borders. Furthermore, the chart below indicates that both business confidence (Green line) and consumer confidence (Blue line) have turned positive since the beginning of the year which we also find surprising. One reason might be that we are possibly nearing the end of our rising interest rate cycle. Hiking cycles have historically lasted about 29 months and we are currently in month 27. We expect one more interest rate hike of 25bp this year and then probably none after that.

In terms of sector performance on the JSE, we remain sceptical of the sustainability of the extremely strong recovery in resource stocks since the beginning of the year as this is not supported by an improvement in the mismatch between supply and demand and is most likely due to short covering by traders. The index is up 45% year to date but is still 46% below its high of 33000 reached in 2011.



Source: iNet Bridge

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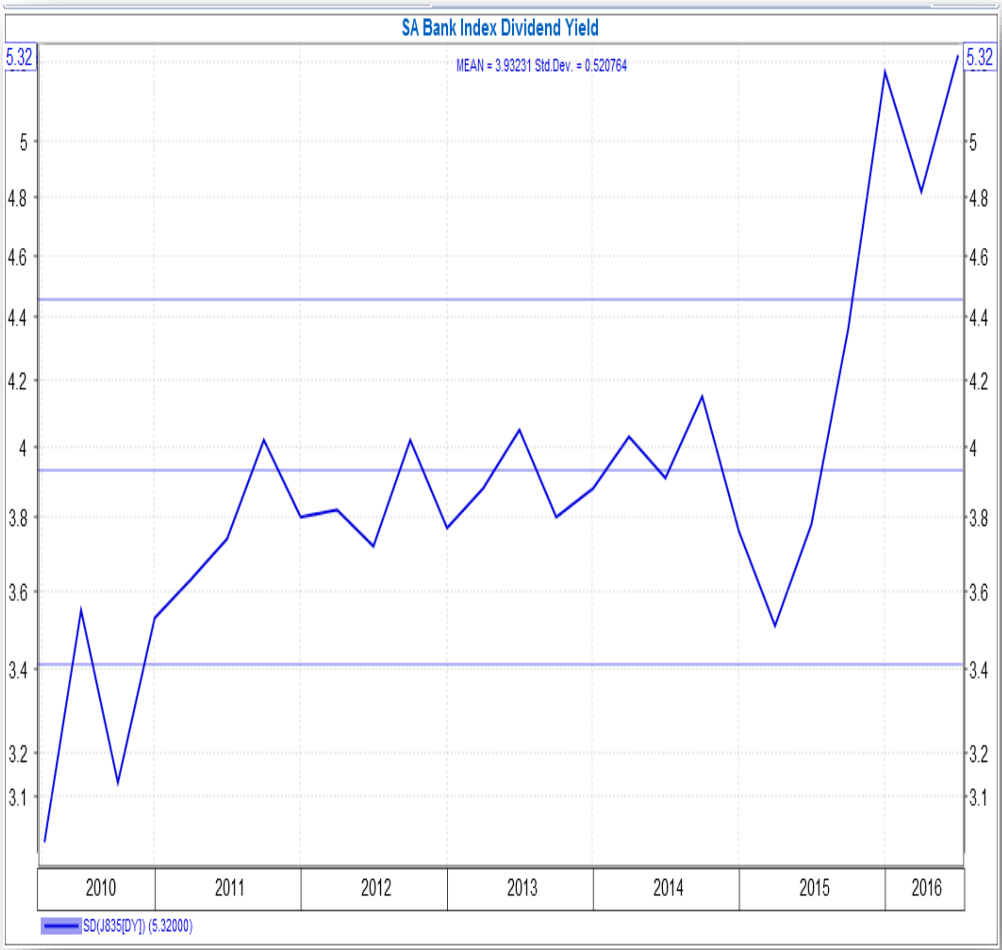

Source: iNet Bridge

One sector that stands out as offering very good value is the banking index which currently trades on a very attractive dividend yield of 5.3% with some banks trading on yields of between 7% and 8%. The main risk in terms of bank ratings hinges on whether we are going to be downgraded by the international rating agencies to junk status. A sovereign downgrade invariably leads to a down grade in banks due to their cost of funding. This could also lead to more interest rate hikes to stem the likely fall in our currency. A large portion of local banks and retailers are owned by foreign investors, so one can expect a severe correction in these sectors once a downgrade is announced. However, at current valuations, it's likely that some of the risk of a downgrade is already priced in. In the event of a correction in these sectors following an announcement, we will more than likely view that as a good buying opportunity.

To conclude:

- Central bankers' efforts to boost demand by pushing real interest rates to negative territory have not been successful as households continue to deleverage due expectations of lower inflation
- The rate of credit growth in Europe has stabilised at a level far lower than what the central bankers were hoping for.
- The key issue is whether the financial crises was a watershed event that caused a structural shift in consumer attitudes toward debt, hence the sharp increase in the savings rate.
- So what can we do to boost demand and increase inflationary expectations? The likely answer is the use of "Helicopter Money" whereby central banks actively print money to monetize government deficits or to transfer cash directly to households, either through the fiscus or through consumption vouchers.
- The local economy continues to deteriorate and high-frequency data from the first months of 2016 paint a bleak picture going forward.
- Minister Pravin Gordhan's fight to protect the Treasury and stave off state capture will be a key feature in the near term which could cause continued volatility in the rand exchange rate and also influence the country's sovereign rating by international rating agencies.
- One sector that stands out as offering very good value is the banking index which currently trades on a very attractive dividend yield of 5.3% with some banks trading on yields of between 7% and 8% but the action by rating agencies will be the main drivers going forward.

Sincerely

Chris

<u>**Chris Botha**</u>

STRONG IN NAME. RESOLUTE BY NATURE

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