IMARA
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Communiqué

Monthly

South Africa

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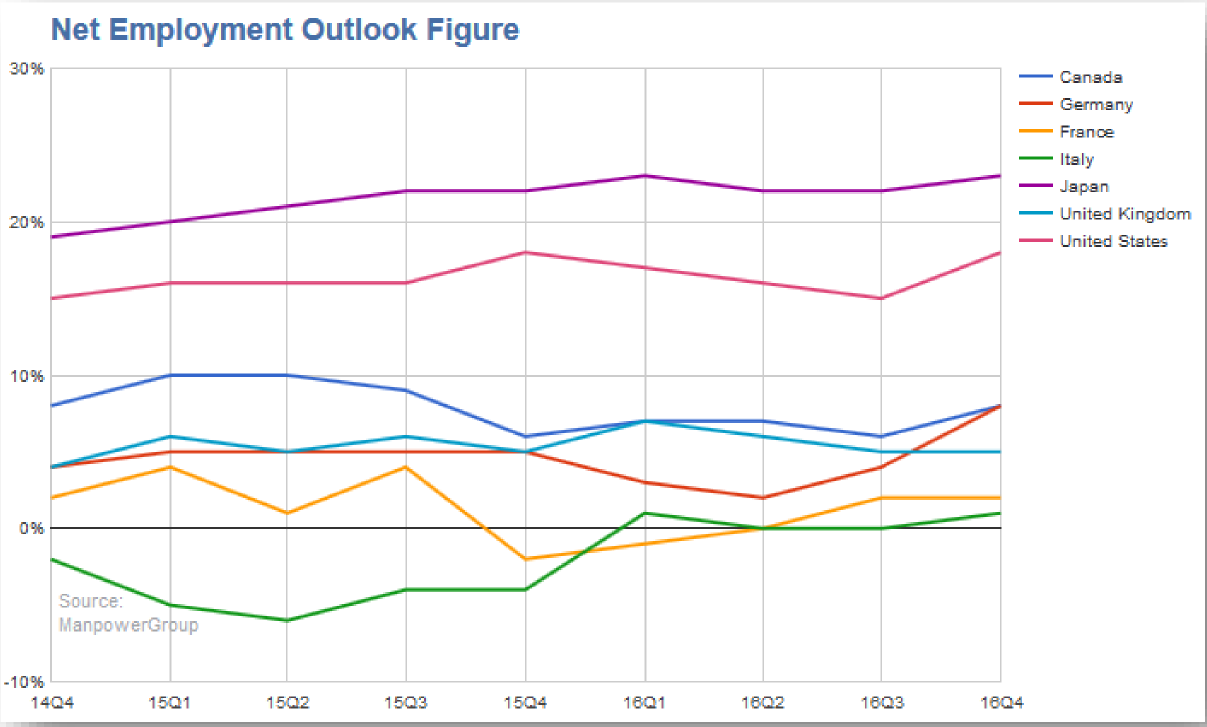
Earnings, not the FED will dictate

Abroad

The US economy continues to grind ahead with relatively good consumer and job growth numbers released recently. Moreover, the latest US Manpower Employment Outlook survey also indicated a sharp recovery and is near a decade high. The conditions for a higher rate of employment and hence higher consumer expenditure are beginning to look more promising which should underpin economic growth over the next 12 months or so.

The FED wants to normalise interest rates in the US, but reiterated that it will be data dependent. A Trump victory in the US elections could well scupper this intention as it is expected that this will cause short term volatility in the dollar and equity markets due to potential policy shifts. A Clinton victory is widely expected to be supportive for equities and the dollar. The make-up of the FED will likely remain unchanged, chaired by Yellen, if Hillary gets elected but will more than likely be changed under a Donald regime. In any event, rising interest rates there will indicate that the economy is doing okay, which will eventually lead to higher corporate earnings and equity prices. Current equity market volatility will therefore likely be a short term phenomenon and should stabilise closer to December as we get closer to the potential hike in rates by the FED. The equity risk premium remains elevated, so there is a fair buffer in terms of valuations in the event of a ***moderate*** rise in interest rates. Earnings, rather than action by the FED, will dictate the trend in stock markets going forward.

Europe economic data continues to improve. The above mentioned Manpower survey (see chart) indicated that also in Europe the big four economies are experiencing further acceleration in employment growth and companies are still planning adding to payrolls. With pent-up demand, more employment, record low borrowing cost and cheap oil, we feel that there might be positive surprises in the global trade environment in the coming months. We therefore anticipate better than expected corporate profits out of Europe in due course.



Along with the relatively high dividend yields on stocks, another potential driver of share prices will be the record low yields on government bonds which in most cases offer negative real returns. Given the continued accommodative policies from central banks globally and a potentially cautious and slow move by the FED, bond yields are likely not to spike up any time soon as there remains little inflationary pressure throughout the world except for some emerging markets where currency woes are causing heightened inflationary pressure. So, bonds will probably remain expensive (low yields) for some time still. US bond yields are at current levels pricing in a permanently deflationary climate, which is not likely and will eventually have to go higher (lower prices). Therefore, the "search for yield" (return) will remain a positive key theme for global equities and emerging markets in particular going forward.

It's important to emphasise that monetary policy by central bankers will remain pro-growth and that they will tread cautiously in deciding to hike rates when and by how much. The main trigger for a more aggressive stance will be a rise in inflationary expectations which does not seem likely anytime soon given cheap oil. Furthermore, the slowly improving consumer environment will continue but at a measured pace given high debt levels.

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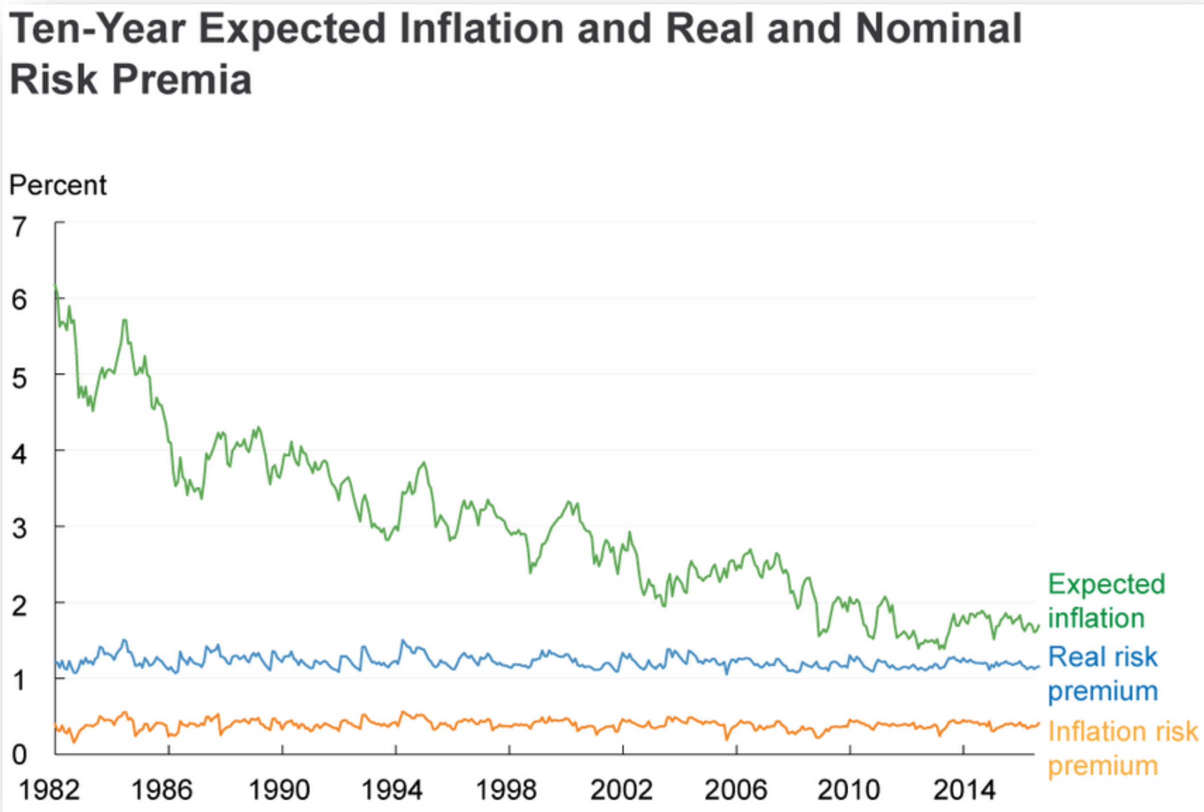
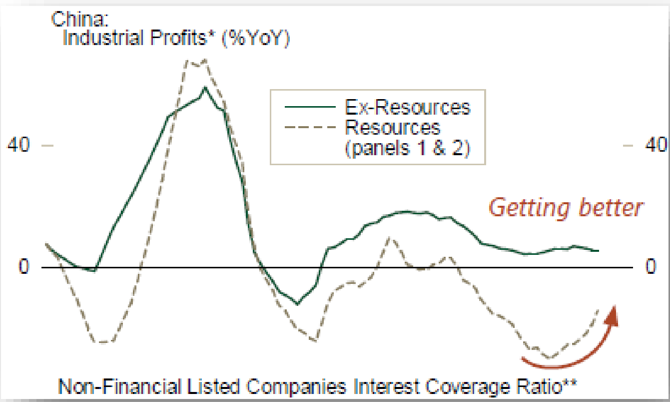


Source: Cleveland Federal Reserve

Recent better than expected economic data out of China, mainly on the housing front, have lessened investor fears of a hard landing in China. The recent reacceleration of real estate demand will likely buffer the broader economic slowdown. We remain optimistic that growth there will stabilise at the 6% level going forward. An important new development for emerging markets in particular is that debt serviceability from mining and metal firms in China is starting to improve and banks have been more aggressive in the disposal of non-performing loans assistant by the central government (as they are mostly state-owned).



Source: Macro Research Board

Debt serviceability improving

So in summary, the global recovery, albeit slow, remains in place largely driven by the US, Euro area and China which should bode well for markets and equities going forward in anticipation of better corporate profits. This is being supported by an increase in global trade. Global bond yields are trading at record lows discounting a deflationary environment which is not sustainable in the medium term which should provide further support for risky assets like equities.

The main short term risk is the outcome of the US elections. A Trump victory will likely cause markets to stumble and the dollar to weaken whereas a Clinton victory will be dollar supportive and good for equity markets.

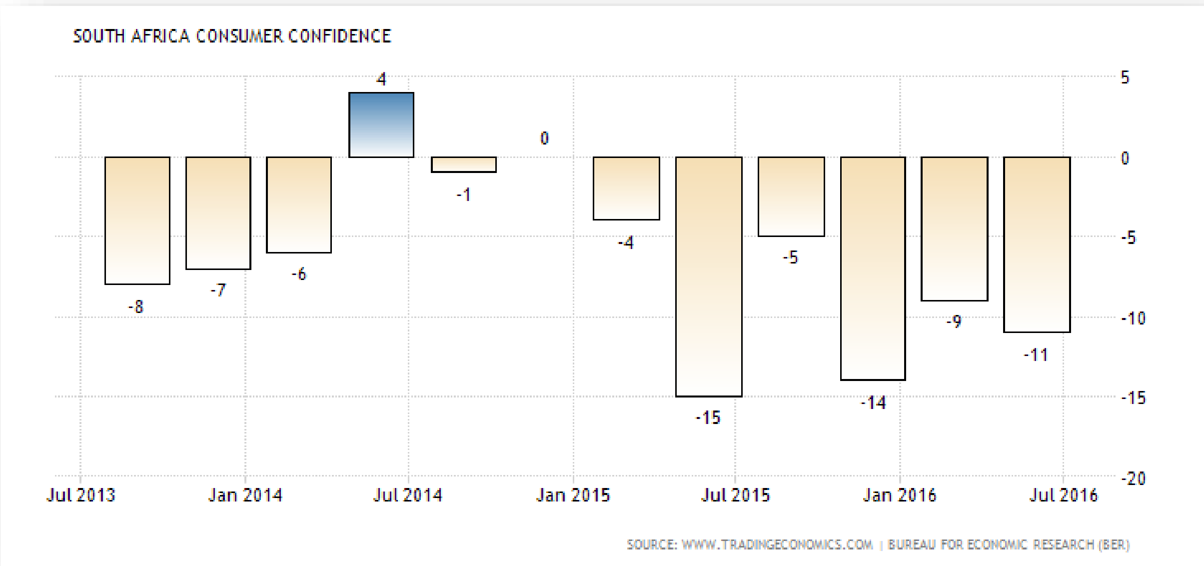
Locally

Business, labour and government have again embarked on an international road show to appease investors and rating agencies in order to prevent a sovereign downgrade in December. It is unlikely that the rating agencies will be convinced that growth locally can pick up meaningfully (their main measure) given structural problems and policy failures. However, we think that as long as there is a concrete plan that is presented we can avert a downgrade.

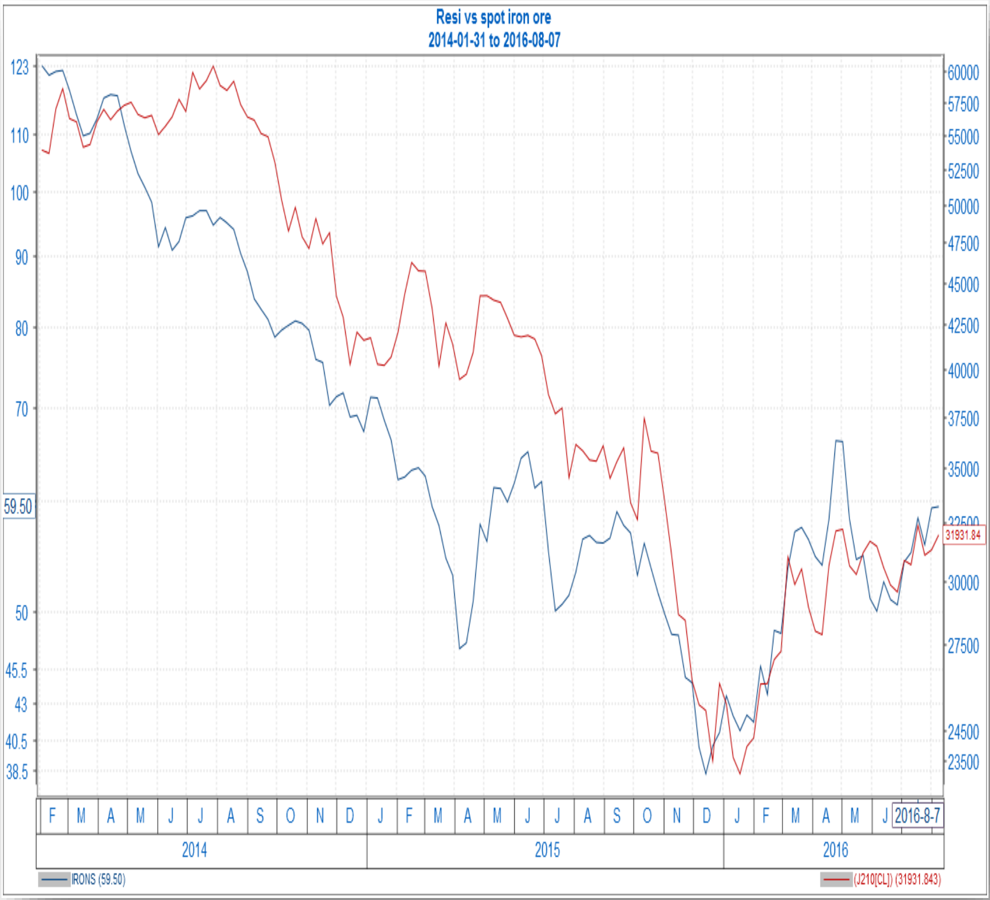
However, one important headwind is our fiscal policy. The recent election results raise the risk that the ANC will embark on a more populist stance. The quickest way for the party to regain voters is to increase fiscal expenditure but there are doubts that spending will occur on capital and investment spend but rather on unproductive expenditure such as more social grants and public wages. Political change at the top will also be a potential game changer – both for our investment markets and the rand if and when it happens.

The global backdrop is improving somewhat with higher commodity prices and a steady improvement in global growth. However, we will likely remain sensitive to global shocks due to our large current account deficit, weak growth and deterioration in government finances. Despite these headwinds however, and bar any external shocks, the global search for yield will likely continue to be supportive of our bond and equity markets.

Private consumption remains weak due to high debt serving costs and no employment growth. Business and consumer confidence remain problematic but could maybe improve if the housing led mini recovery in China proves to be sustainable which will support commodity prices.



Our local bond and equity markets will be driven by 3 key factors going forward. These are action by the FED, commodity prices (read China) and our credit rating. Our markets have been buoyed by foreigners searching for yield, a dovish FED, higher commodity prices and recent rand strength all of which remains intact for now. Recent comments by the SARB, indicating a pause in our hiking cycle (as we expected) will also be rand and bond market supportive in the near term.

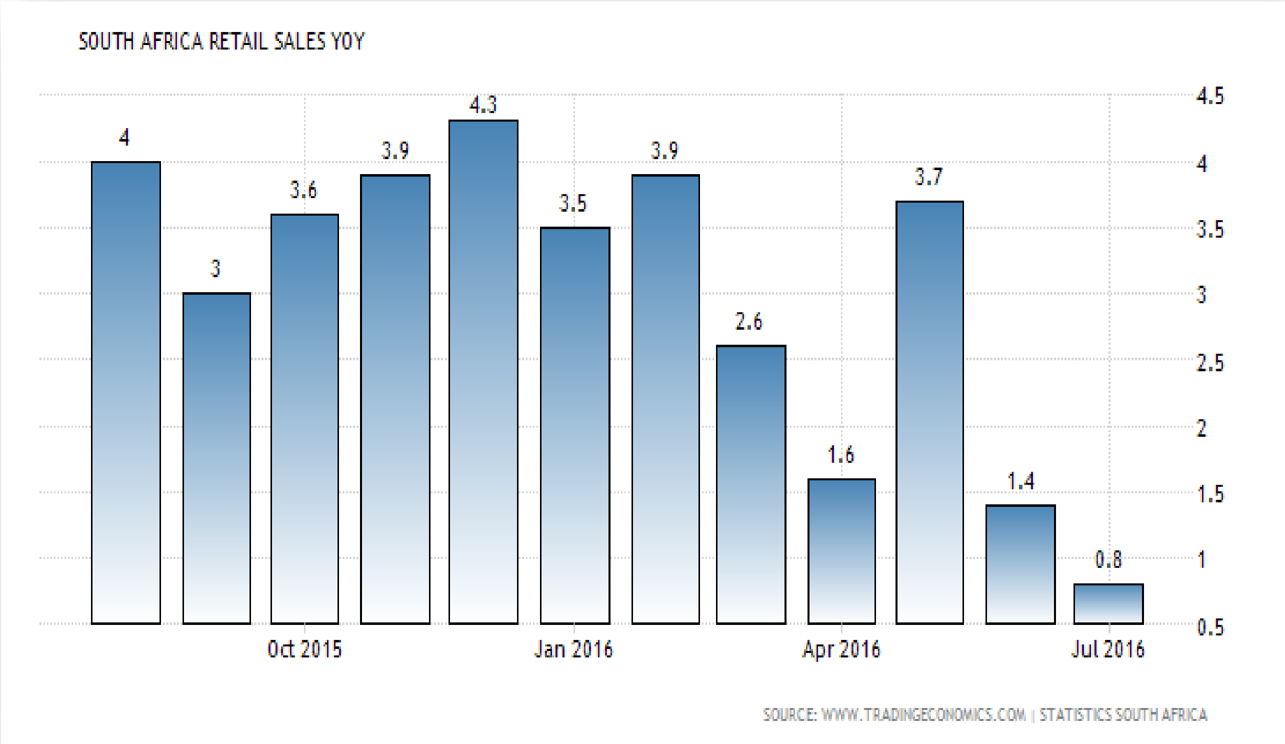


Source: Inet Bridge

We are of the opinion that a downgrade in our sovereign rating is mostly priced into our bond market and banking stocks but banks are on the other hand a direct play on domestic demand which will remain weak over the next couple of months.

From an investment perspective, resource stocks continue to outperform supported by higher commodity prices and the perception that the FED remains fairly dovish. The key risk in the near term will be whether the “recovery” in Chinese growth can be sustained. A worrying factor is the oil price which from both a fundamental and technical viewpoint remains in a bearish trend. OPEC recently announced some cuts in production (only 1m barrels per day) but if history repeats itself it’s unlikely that they will adhere to the policy. On a medium term view, we remain bearish on oil and iron ore and hence we remain cautious regarding the sustainability of the run in resource stocks. The resources index (red line) correlates highly with spot iron ore prices (blue line - see chart above.). Recent comments by the world’s two largest producers Vale and BHP Billiton indicated that they will not cut production to bring the oversupply situation into balance as their cost of production ranges between \$10-\$15 per tonne. This compares to a current spot price of just over \$50 per tonne.

Following a worse than expected 18-week trading update from Mr Price, we have become somewhat concerned about the state of the local retail and consumer environment. The chart below paints a worrying picture which indicates the year on year growth in retail sales.



The guidance was basically for flat earnings siting an unusually warm winter which impacted on their fashion offering. This can happen and may be regarded as a once-off event given management's superb track record. But, they also mentioned that competition was intensifying particularly from foreign retailers and that they were too slow to react by cutting prices in order to move stock. The concern is that the retail landscape may have structurally changed due to intense completion, in other words, the barriers to entry for the industry has deteriorated. We think it was an eye opener for management and the rest of the industry and that things have changed. However, we are likely to give management teams of some of our quality retailers the benefit of the doubt given their good track record. Like our superb global industrial companies that have expanded offshore, we are confident that retail companies can re-invent themselves if needed and indeed take on competitors in their own marketplace, like Woolworths in Australia which is performing above expectations. We will watch developments closely.

To conclude:

- The conditions for a higher rate of employment and hence higher consumer expenditure are beginning to look more promising which should underpin economic growth over the next 12 months or so
- A Trump victory in the US elections could well scupper this intention as it is expected that this will cause short term volatility in the dollar and equity markets due to potential policy shifts. A Clinton victory is widely expected to be supportive for equities and the dollar
- The equity risk premium remains elevated, so there is a fair buffer in terms of valuations in the event of a ***moderate*** rise in interest rates
- The search for yield will remain a positive key theme for global equities and emerging markets in particular going forward.
- The recent reacceleration of real estate demand in China will likely buffer the broader economic slowdown and be supportive of commodity prices
- Locally, it is unlikely that the rating agencies will be convinced that growth locally can pick up meaningfully (their main measure) given structural problems and policy failures. However, we think that as long as there is a concrete plan that is presented we can avert a downgrade
- The global backdrop is improving somewhat with higher commodity prices and a steady improvement in global growth
- On a medium term view, we remain bearish on oil and iron ore and hence we remain cautious regarding the sustainability of the run in resource stocks
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Sincerely

Chris Botha