Communiqué

Monthly

South Africa

November 2016

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Taper tantrum

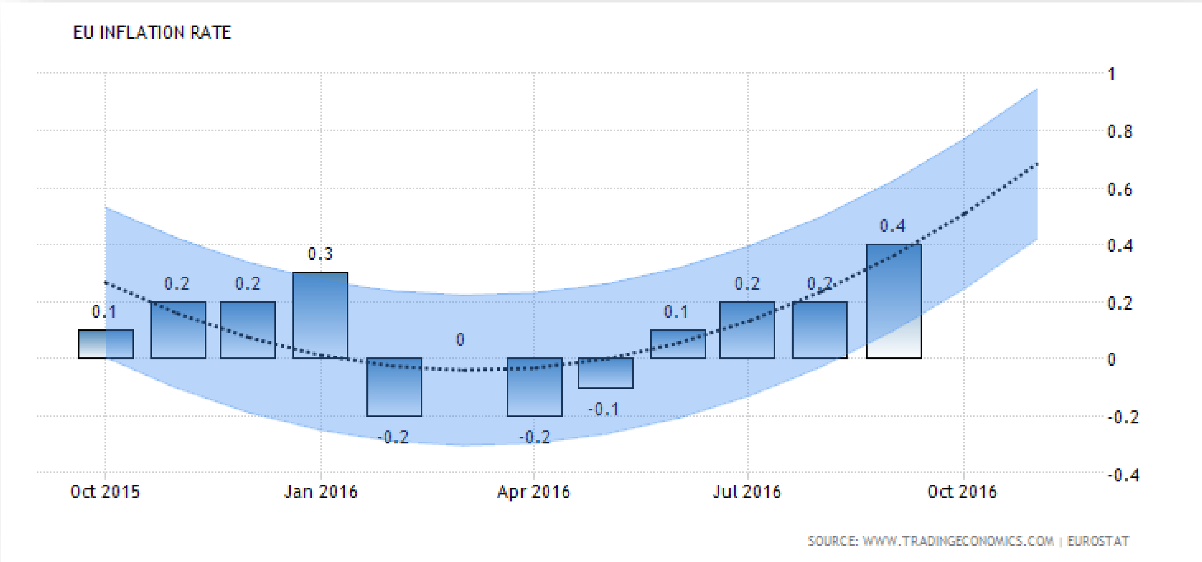
Global

During his last press conference, Mario Draghi dismissed press reports that the ECB is planning to taper QE. But tapering remains a possibility in 2017, probably only towards the end of the year, but very likely. This will have a negative impact on bond yields which will be indicative of rising inflation, which is a good thing, as this will show that global growth has recovered nicely.

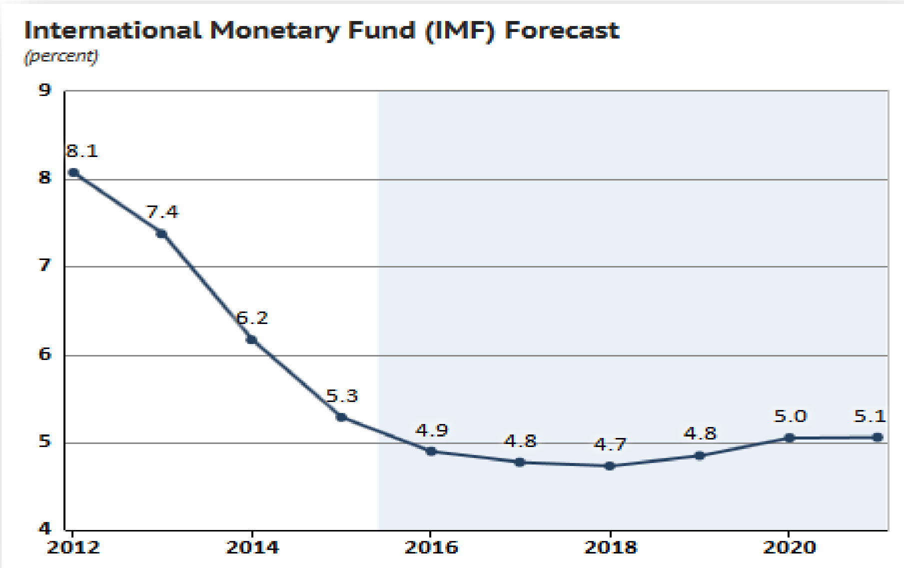
The ideal space of economic growth with little inflation cannot last forever. Commodity prices have stabilised (See Chart) which have arrested on-going concerns that deflation might re-emerge (particularly in Europe). There are also signs that spare capacity in most major economies are in retreat.

Source: INet Bridge

In Europe, a weakening Euro has improved the region's competitiveness and growth in credit extension continues to steadily improve. Most economists expect growth to reach 1.5% in the next couple of years which should eventually cause core inflation to reach the ECB's target of 2% in due course (but not too soon). This will make it difficult for the ECB to continue with QE indefinitely. The chart below clearly indicates that inflation in Europe is in a rising phase and that the threat of deflation has largely diminished.



Most economists remain fairly positive on US growth. Consensus for 2017 currently stands at 2.2% GDP growth. Low borrowing costs have caused a strong rebound in credit demand. Credit growth has now turned inflationary with the latest published growth rate at 8% on an annual basis. Unemployment has also shown a marked recovery. The chart below indicates the historic and forecast unemployment rate for the US by the IMF.

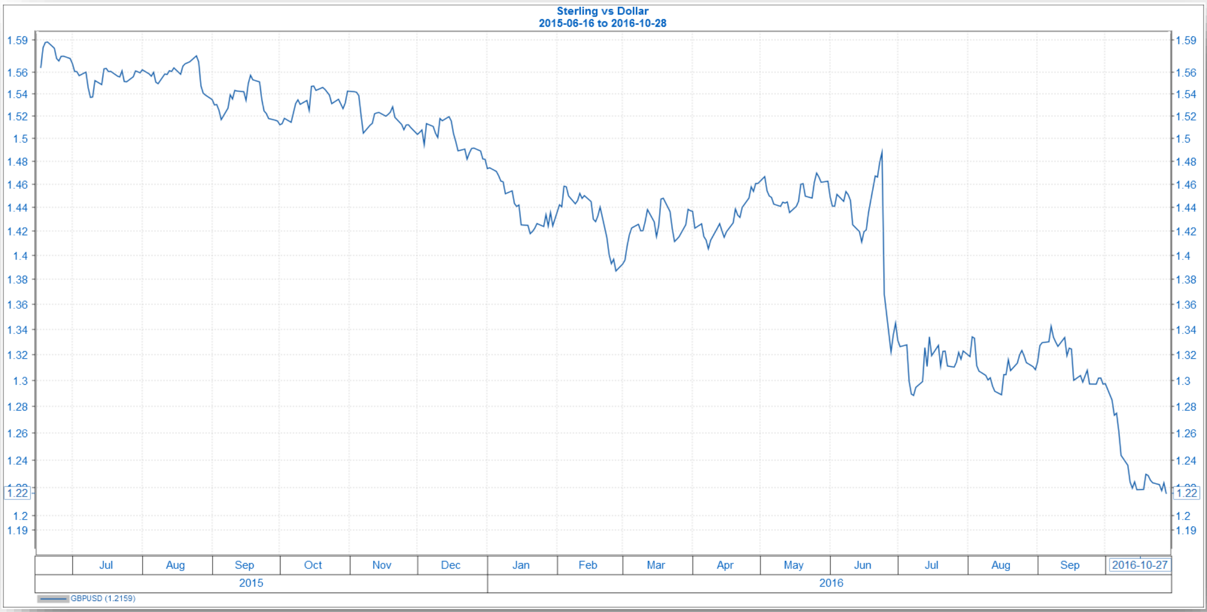


Source: KNOEMA

Productivity growth however has not kept pace with the growth in GDP. This in itself is also inflationary. We are not suggesting that the economy is overheating just yet but there are heightened risks that the FED might fall behind the curve – i.e. at this pace of expansion (if sustained) they need to start raising interest rates fairly soon.

Given current signs that inflation in developed markets is rising and bond yields at record lows, it's fairly obvious that bonds are not pricing in any upward moves in interest rates which could (and should) lead to a sharp sell-off (negative returns) in bonds at some point in time. This will likely cause multi-asset managers to rotate even more money into equities. Equity valuations (expensive at current levels) will be supported by rising earnings as inflation typically bodes well for profits due to enhancements in operating margins and profits.

Recent dollar strength is a reflection of expectations that interest rates in the US will go up. Interestingly, the strength of the dollar is mainly relative to developed market currencies, especially against sterling following the Brexit announcement. Sterling has weakened by 20% against the dollar.



Source: INet Bridge

Emerging market currencies have in fact strengthened somewhat against the greenback due to much higher interest rates and attractive yields in emerging markets. We expect emerging markets to continue to outperform in the near term but this will however depend on the stability of commodity markets, which look okay for now as recent economic data out of China showed that growth there continues despite the many sceptics' prediction of a sharp decline in expected growth.

Local

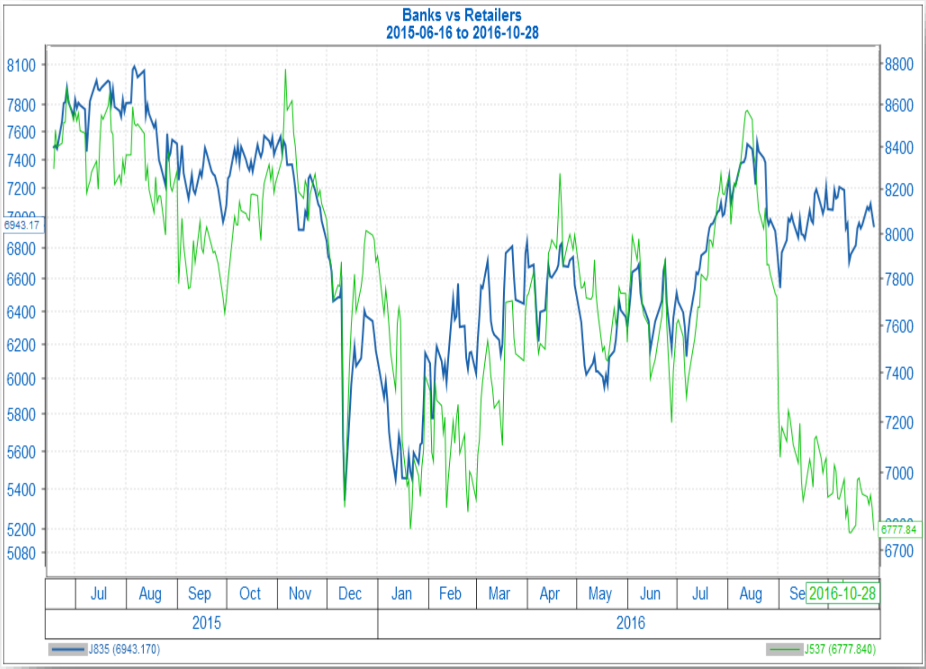
Despite the on-going uncertainty around the fate of Pravin Gordhan, the rand has continued to strengthen against the dollar along with other emerging market currencies. The rand remains among the cheapest currencies on a global basis. Our current account deficit has almost halved since 2013 which will likely provide further support to the currency in the near term. The recent mid-term budget also pleased currency traders which emphasised fiscal and economic stability (although very low growth). Furthermore, high yields on local treasuries will likely continue to attract foreign investors due to record low yields elsewhere. It's likely that the rand will weaken somewhat closer to the time when the FED starts to hike rates in the US. So, short term at least, we expect the rand to remain relatively firm with the main risk being the outcome of the NPA/Gordhan saga.

Source: INet Bridge

Given the stable commodity outlook and the end of our interest rate hiking cycle, implications for the SA real economy are now more positive and we think that we may narrowly escape a downgrade to junk status. This could be a fillip for growth as this will benefit both investor and consumer confidence.

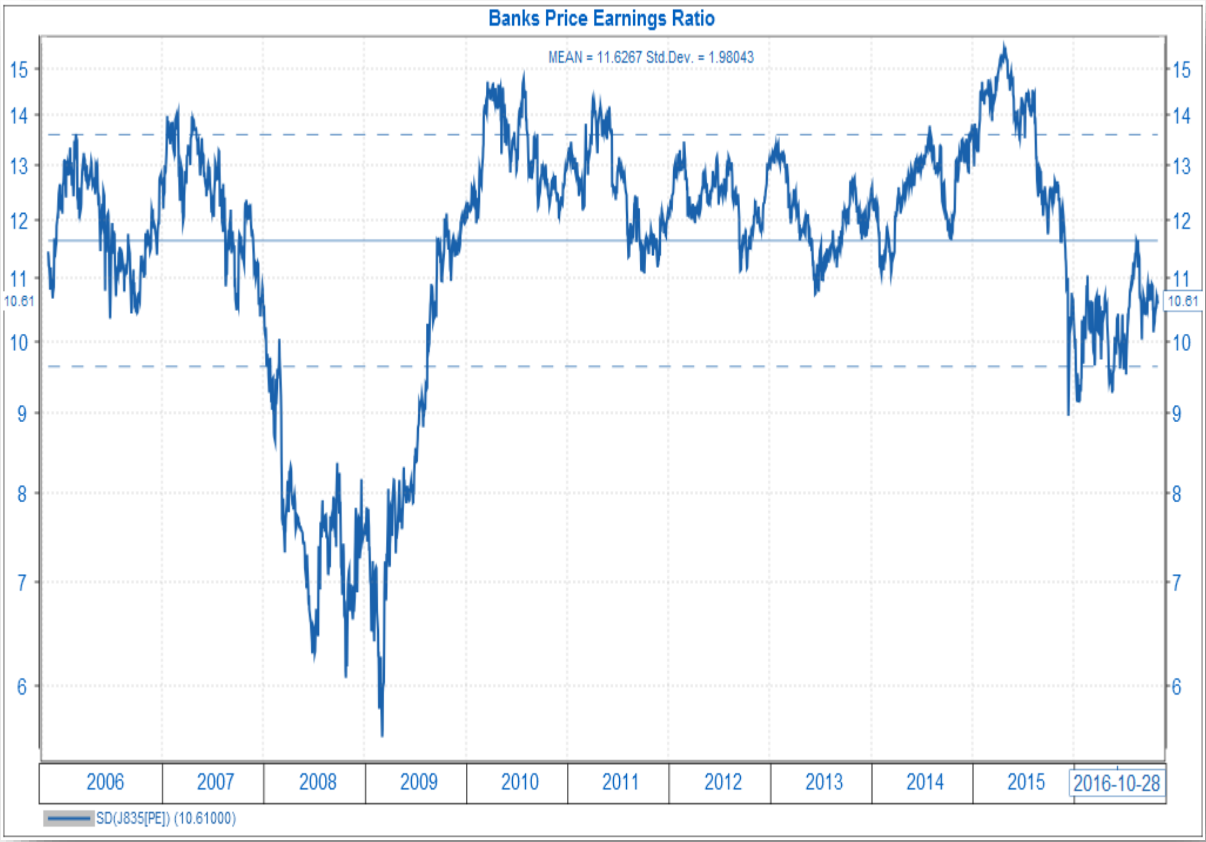
Rating agencies will continue to monitor our growth trajectory in deciding on our sovereign rating. During the mid-term budget, treasury stated that expected growth for 2017 will likely only be 0.5% increasing to 1.7% in 2017.

Following the budget announcement, rating agencies commented that they were pleased with the commitment to fiscal consolidation but raised their concerns about the low economic growth. Poor economic performance remained the main impediment to debt stabilisation they said.



Last month we discussed retail stocks that have shown somewhat disappointing earnings. This month, we thought to touch on banking stocks, often viewed as proxies for retail stocks as they are both sensitive to consumer behaviour. This chart indicates the high correlation between our banks (blue) and retail stocks (green). One can see the big divergence between the two sectors following the disappointing numbers published by some retailers. We think at these levels; retail stocks are offering far better value.

For a while now, banking stocks have steadily been derating on the back of the poor consumer environment, potential ratings downgrade to junk status and concerns around the financial strength of global banks. The latter point is rather questionable given the stability and financial strength of our local banks. SA banks have consistently held more capital than is required by legislation. The current capital adequacy ratio required by legislation is 10%. The current capital adequacy ratio of local banks is 15%. In our view, a sovereign ratings downgrade is mostly priced in and in the event of no downgrade or if a stable outlook is announced, we anticipate a substantial rerating in banking stocks as well as retailers. As highlighted by Moody's, positive economic growth trends will be the key determining factor when the ratings are reviewed which officially occurs in December. The chart below indicates the severe derating in terms of price earnings ratio in 2015 but also the reasonably strong recovery we have witnessed this year so far.



Source: INet Bridge

Overall then, we anticipate equities to continue to outperform bonds due to higher interest rates in the US and less aggressive QE in Europe. We also anticipate that emerging markets will outperform developed markets as the search for yield continues in the near term.

To conclude:

- Tapering of QE in Europe remains a possibility in 2017, probably only towards the end of the year, but very likely given signs of sustainable improvements in the Euro economy.
- A weakening Euro has improved the region's competitiveness and growth in credit extension continues to steadily improve. Most economists expect growth to reach 1.5% in the next couple of years.
- Recent dollar strength is a reflection of expectations that interest rates in the US will go up.
- Given current signs that inflation in developed markets is rising and bond yields at record lows, it's fairly obvious that bonds are not pricing in any upward moves in interest rates which could (and should) lead to a sharp sell-off (negative returns) in bonds at some point in time.
- High yields on local treasuries will likely continue to attract foreign investors due to record low yields elsewhere. It's likely that the rand will weaken somewhat closer to the time when the FED starts to hike rates in the US.
- Following the budget announcement, rating agencies commented that they were pleased with the commitment to fiscal consolidation but raised their concerns about the low economic growth.
- Given the stable commodity outlook and the end of our interest rate hiking cycle, implications for the SA real economy are now more positive and we think that we may narrowly escape a downgrade to junk status.
- Local banking stocks have steadily been derating on the back of the poor consumer environment, potential ratings downgrade to junk status and concerns around the financial strength of global banks. The latter point is somewhat puzzling given that our local banks are better capitalised than foreign banks.
- In the event of no downgrade or if a stable outlook is announced, we anticipate a substantial rerating in banking stocks as well as retailers.

Sincerely

Chris

Chris Botha