Communiqué

Monthly

South Africa

December 2016

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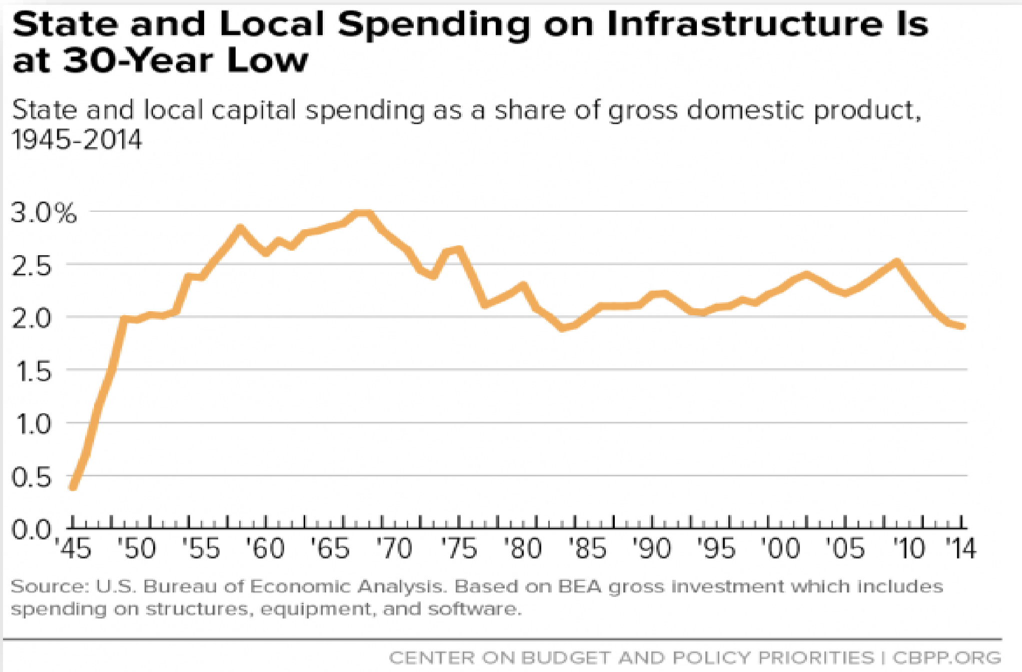
Trumpnomics

Abroad

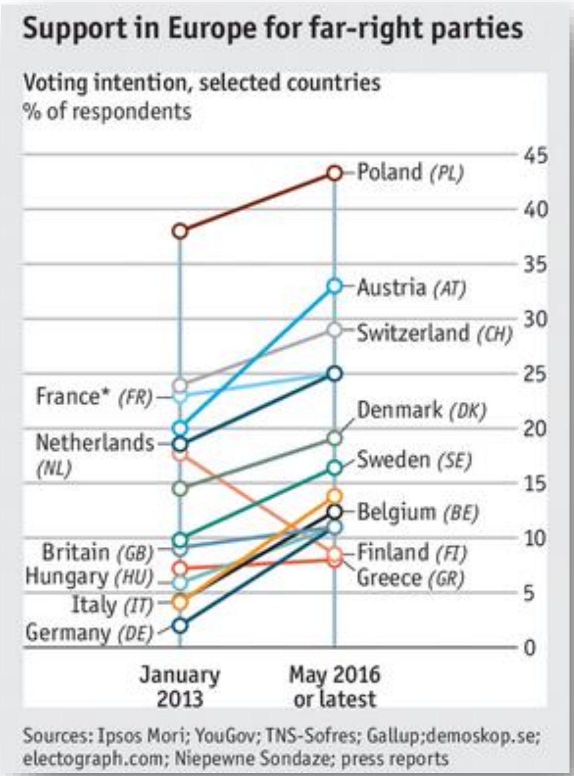
Like Brexit, anti-establishment sentiment defeated the establishment in the US election with protectionism now likely the new world order. The election result was not so much about what Trump believes in but more about what he stands for. To bring to an end the enriching of the elite at the expense of the rest of the people. Trump's acceptance speech showed much more restraint and we expect that he will surprise on the upside in due course.

According to Deutche Bank, anti-trade sentiment is increasing globally, with the fewest free trade agreements in 2016 signed since 1987. Trump's promise of higher fiscal spending on infrastructure and tax cuts should boost the US economy but might not be so easy to achieve due to the conservatism amongst republicans which will more than likely not be in favour to lift the debt ceiling to fund all of this.



Source: Centre on Budget and Policy Priorities

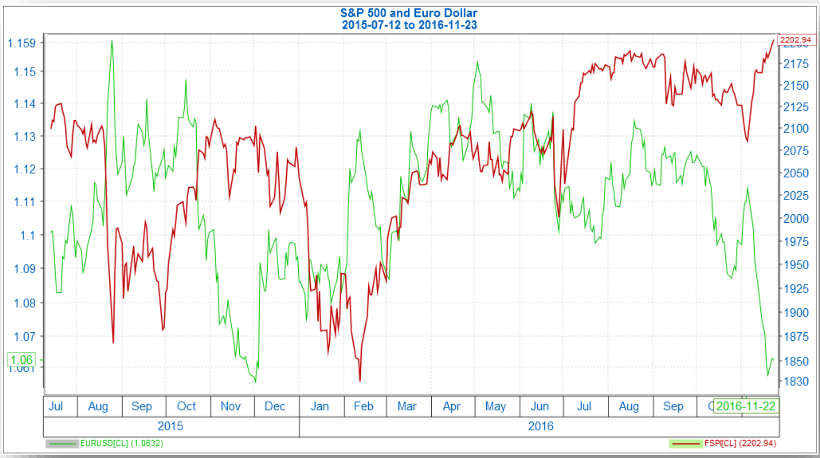
Following Brexit, other European nations will also hold elections and signs are that protectionism in Europe is also on the increase. Anti-trade policies in our view are not a viable option in the long term as this will most likely cause the global economy to grow below potential inflicting pain on the job market and ultimately consumer spending which in turn could lead to an even further increase in populism.



Source: Economist May 2016

The risk/reward trade-off of anti-trade policies becomes worse if one considers that it has not been international trade and sources of cheaper labour that caused the displacement of jobs, but rather the increase in modern technology. Lower skilled workers were impacted the most by technological innovation but will eventually also impact higher skilled jobs as innovation steams ahead. This of course will bolster corporate profit margins at the expense of more job losses which will in the end cause massive political problems along with more social unrest and protectionism. Therefore, education and competitiveness should be the main aim of politicians to ensure a skilled workforce which in turn could lead to new industries being formed ensuring more jobs and more wealth for those countries. This is the Trump promise. So, let's see.

Global markets experienced a correction after the Trump victory but all is forgotten with the US S&P 500 trading at a record high at the moment. The market was fuelled by reflationary expectations due to the promised tax cuts and fiscal spending. This has caused renewed strength in the dollar with a corresponding negative effect on most emerging markets which also have recovered somewhat with the view that increased spending in the US will boost commodity prices. The stronger dollar is likely to remain in the near term as markets are now pricing in a 100% chance for lift-off by the FED at the December meeting. The risk of course is that if the dollar remains strong, this could in fact have a negative impact on company earnings due to the large export base. Furthermore, the strong dollar could cause inflation to rise less than expected, further hampering company earnings. This therefore poses a risk for equity market valuations at these heady levels. From a valuation perspective, emerging market currencies appear exceedingly attractive and if Trumpnomics does work, we could see a sustainable rise in commodity prices and hence those countries exporting them, in other words, emerging markets. The accompanied chart indicates the record high for the S&P (red) and the relative strength of the dollar against the Euro (green) which appears severely overbought.



Source: I-Net

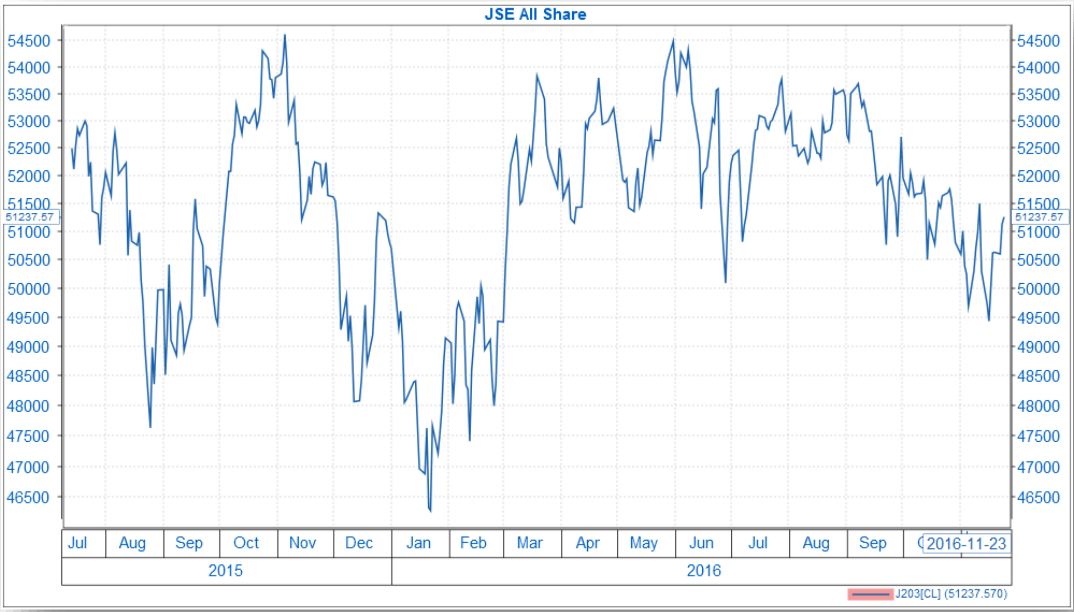
In Europe, ECB President Mario Draghi, in his statement to the European Parliament, indicated that the Eurozone is recovering at a "moderate to steady pace and unemployment is falling", but that the central bank will continue to rely on the current unprecedented level of monetary support to help the Eurozone inflation rate return towards the Bank's target. Draghi also repeated his call for fiscal policies to support the region's economic recovery.

Finally, anti-trade movements might see further stimulus from Beijing as this will have a negative impact on exports. Residential investment is on the decline and the reliance on investment to stimulate growth will likely decline further. China can prolong the debt fuelled stimulus by reducing interest rates further and try to artificially weaken the renminbi. We view the former as the more likely outcome to stimulate domestic demand. It overall should bode well for emerging markets.

Locally

In SA, the political landscape, although still a mess, has stabilised somewhat. The greatest near term risk is undoubtedly the outcome of the decisions by the various rating agencies in December around our sovereign risk ratings. The more important one is the outcome of Standard & Poor's rating as they are considering cutting our status to junk. Moody's and Fitch might move us to the lowest ranking of investment grade but it's the trend that will worry investors.

In assessing the ratings, agencies typically asses economic trends, debt dynamics, judiciary landscape and politics.



Source: I-Net

We are still of the opinion that the combination of recent government and business cooperation and *"sales pitch"* to foreign investors will be enough to avoid a downgrade for now but more needs to be done to ensure faster economic growth to avoid a downgrade later in 2017.

Sentiment towards emerging markets turned negative after the Trump election with stocks declining by 4% following the announcement but has recovered by the same amount as we speak.

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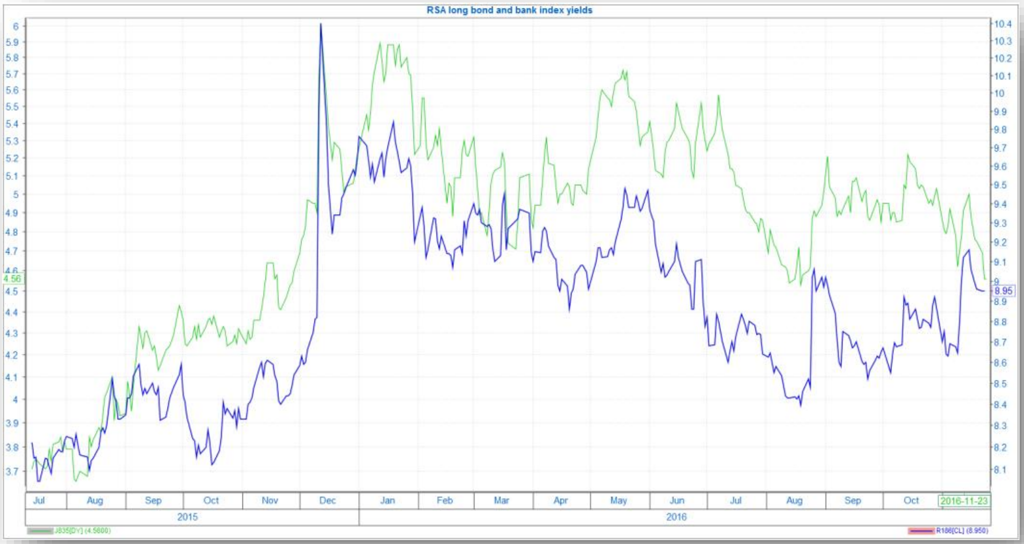
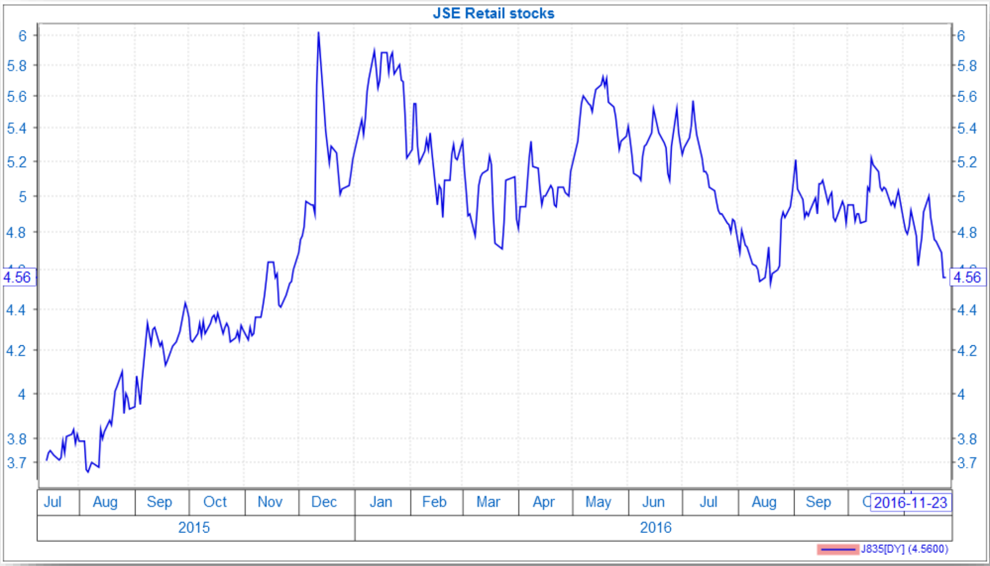


Source: I-Net

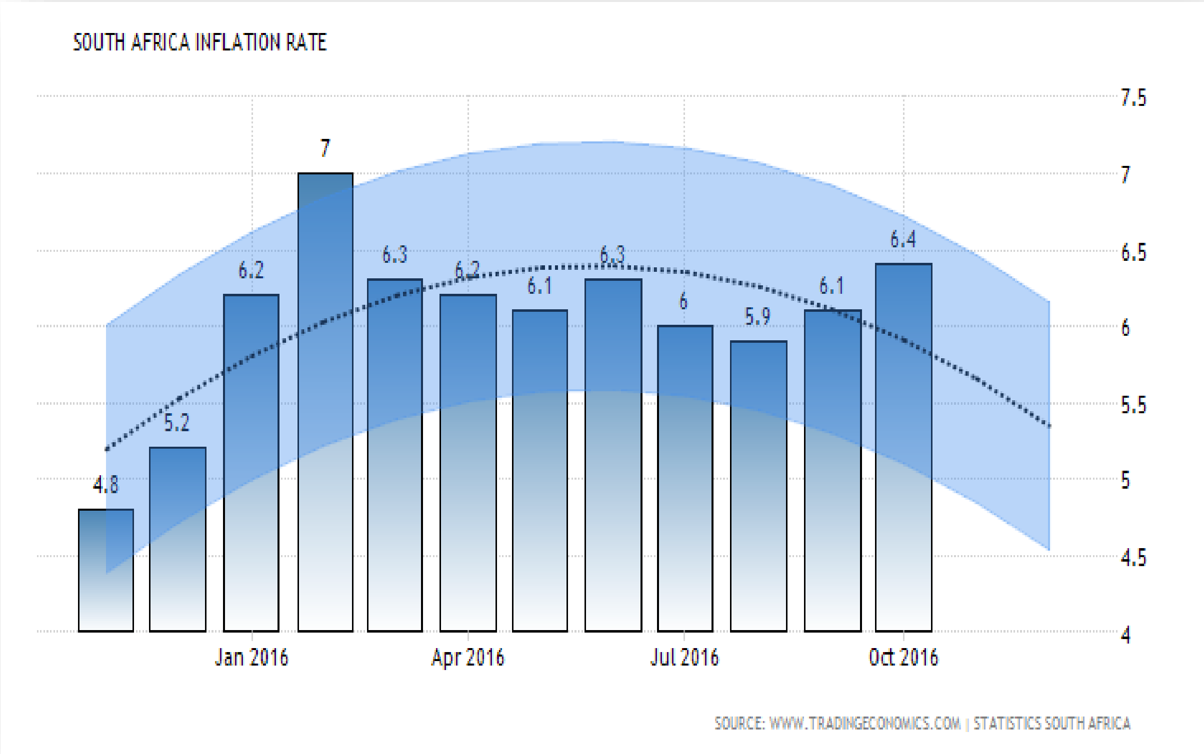
A downgrade will more than likely cause an overreaction by foreign investors despite the view that a downgrade is mostly priced in with long bond yields at around 9% (blue) and banking stocks on dividend yields of around 5% (green).

Given that the JSE mainly consist of rand hedges, if we avert a downgrade we could expect a bout of rand strength, which could in fact trigger some weakness in the market due to the negative impact on earnings in due course. But having said that, this will benefit other sectors like banks and retail stocks. The retail index has been under some pressure of late following poor results from the likes of Mr Price, Woolworths and Truworths which highlighted the severe state of the local consumer.



Source: I-Net

Indications are therefore that an interest rate hike this year is mostly out of the equation supported by a fairly benign inflation trajectory. Current inflation is mainly driven by food inflation due to the historic impact of the 3-year long drought but expectations are that we are entering a normal rainy season which should see inflation stabilising or even reduce a little. Given that the economy is only expected to grow by 0.5% in 2016 there could well be a chance that we could see a rate cut next year some time. This chart indicates that forecast inflation is expected to gradually start decreasing.



As a whole, we remain positive on local equities for the remainder of the year given the expected inflationary trajectory (read interest rates) and a potential positive surprise on the ratings front (which we anticipate).

To conclude:

- Anti-establishment sentiment defeated the establishment in the US election with protectionism now likely the new world order
- Trump's promise of higher fiscal spending on infrastructure and tax cuts should boost the US economy but might not be so easy to achieve due to the conservatism amongst republicans
- Anti-trade policies in our view are not a viable option in the long term as this will most likely cause the global economy to grow below potential inflicting pain on the job market and ultimately consumer spending
- Global markets experienced a correction after the Trump victory but all is forgotten with the US S&P 500 trading at a record high at the moment The market was fuelled by reflationary expectations due to the promised tax cuts and fiscal spending
- From a valuation perspective, emerging market currencies appear exceedingly attractive and if the Trumpnomics does work, we could see a sustainable rise in commodity prices and hence those countries exporting them
- ECB President Mario Draghi, in his statement to the European Parliament, indicated that the Eurozone is recovering at a "moderate to steady pace and unemployment is falling", but that the central bank will continue to rely the current unprecedented level of monetary support
- In SA, the greatest near term risk is undoubtedly the outcome of the decisions by the various rating agencies in December around our sovereign risk ratings

- We are still of the opinion that the combination of recent government and business cooperation and “sales pitch” to foreign investors will be enough to avoid a downgrade for now
- Indications are that an interest rate hike this year is mostly out of the equation supported by a fairly benign inflation trajectory
- Given that the economy is only expected to grow by 0.5% in 2016 there could well be a chance that we could see a rate cut next year some time

Sincerely

Chris

Chris Botha

This is our final communiqué for 2016.

Wishing you and your loved ones a blessed and safe festive season.

STRONG IN NAME. RESOLUTE BY NATURE