Communiqué

Monthly

South Africa

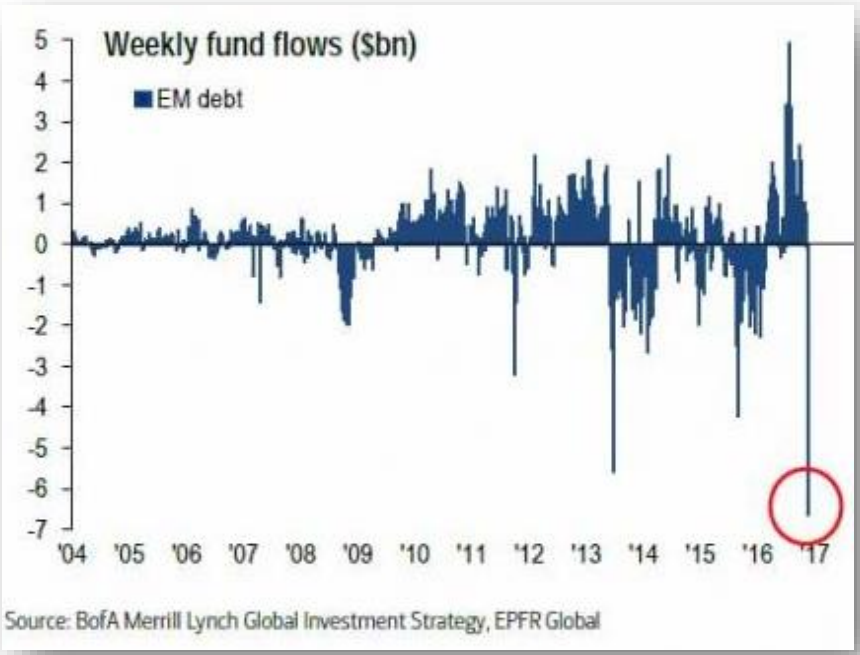
March 2017

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

The re-emergence of emerging markets

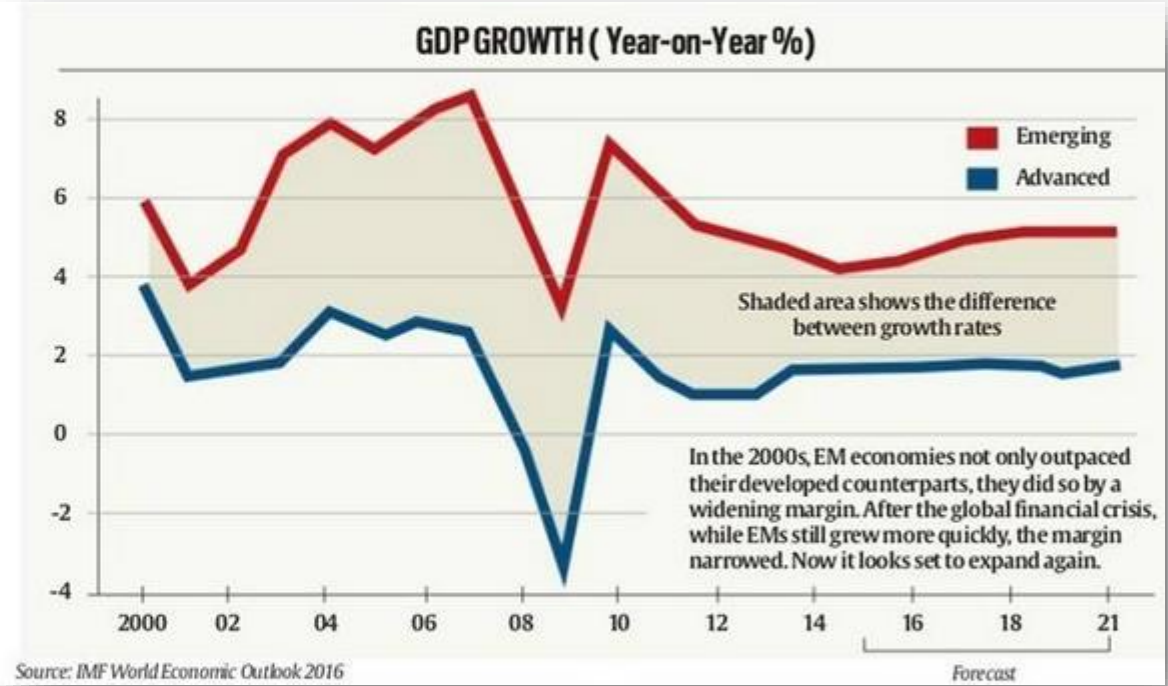
Abroad

The US equity market experienced huge inflows following the election result accompanied by a surging US dollar at the expense of emerging markets. The strong dollar spurred worries about emerging market currencies mainly due to large dollar dominated debt in certain countries.

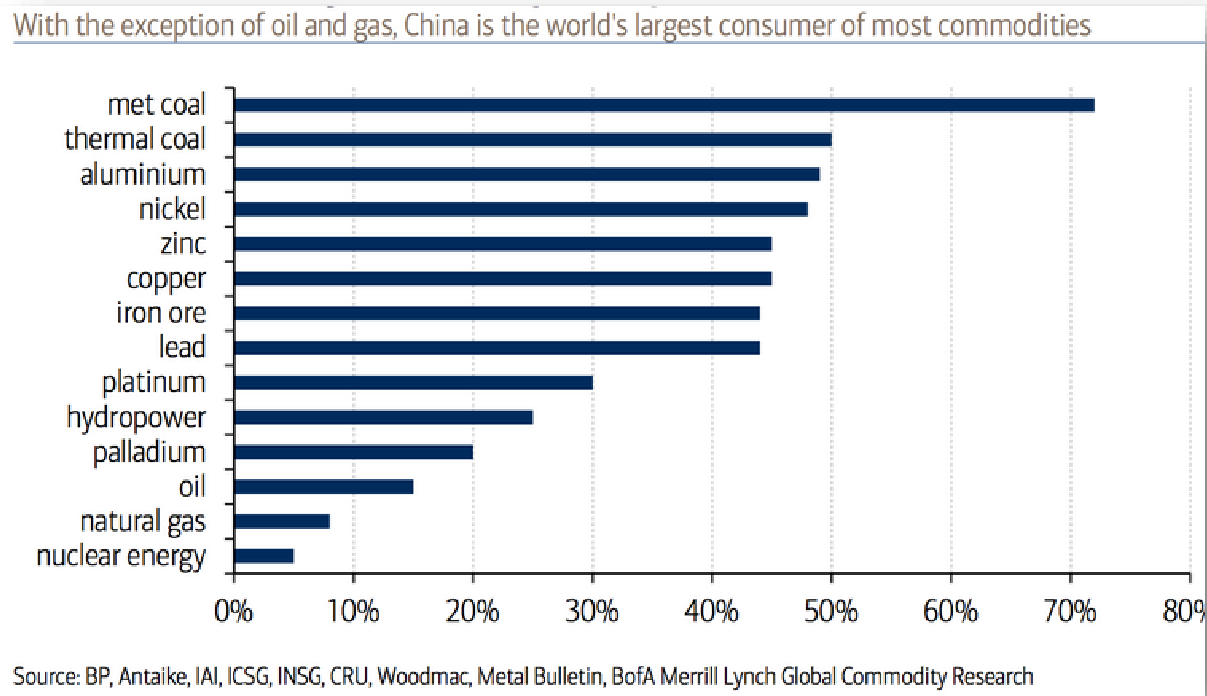


But lately, emerging markets have started to outperform developed markets. The reason is that despite all the promises by the Trump administration of kick starting the US economy, no concrete plans have been presented and hence investment markets have become somewhat impatient.

The dollar has started to weaken which has caused a surge in certain emerging market currencies accompanied by healthy investment inflows. The risk of a new emerging market devaluation crisis has been alleviated. Furthermore, growth estimates in most emerging markets have steadily been revised upwards. According to the Institute of International Finance, emerging market GDP grew by 6.4% in January 2017, the fastest pace since 2011. However, whether this is sustainable is a bit questionable as we do not know if or when the US economy will be impacted by the promised growth initiatives and also how the FED will respond with higher interest rates. But for now, most economists predict that emerging markets will continue to outpace developed markets for some time still.

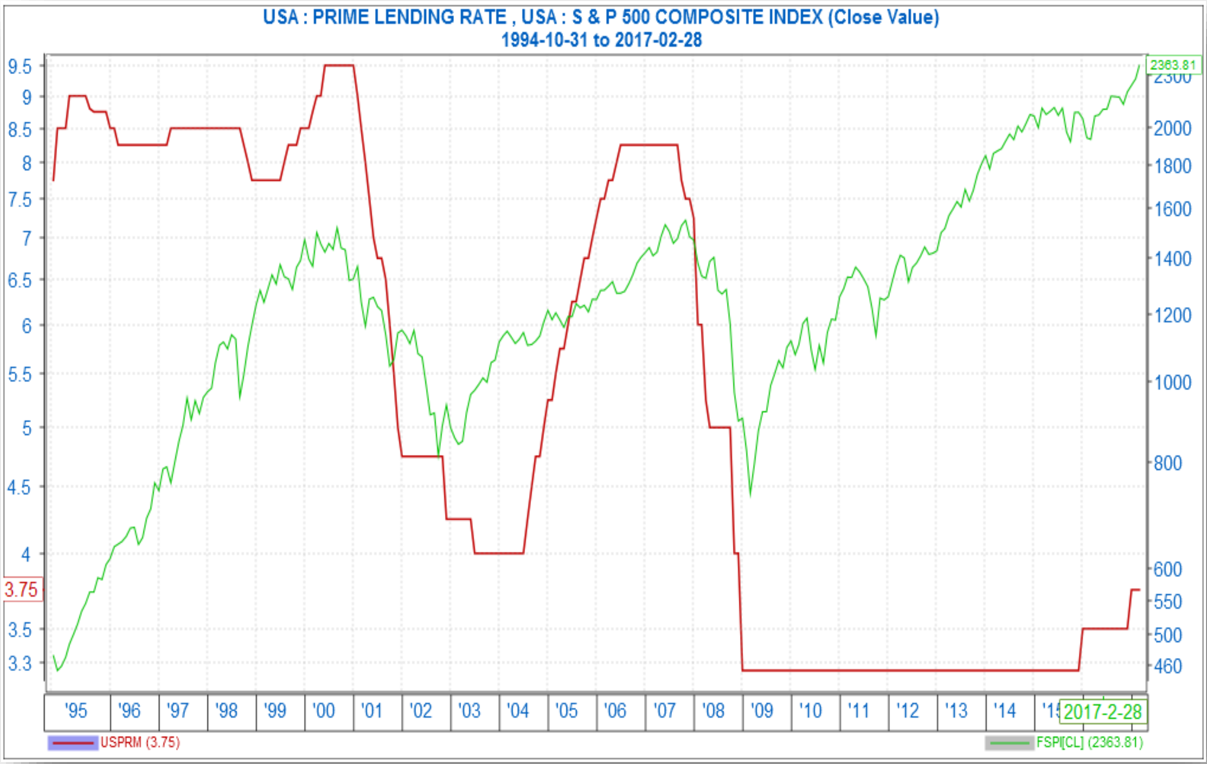


A key reason supporting this argument remains China. Chinese demand has for a very long time been the key driver of emerging market exports. Demand for goods in China has of late been on the increase again. The continuing rise in commodity prices is suggesting that China is spending again.



Higher commodity prices also indicate, or are rather anticipating, higher inflation in due course if and when Mr Trump's "reflation trade" comes through as promised. It's therefore difficult to argue that emerging markets will not benefit from this as the demand for materials will continue to rise.

The reflation scenario accompanied by higher interest rates (in the US) should in theory be a headwind for bond markets and to a lesser extent the ratings of equity markets (mainly developed markets) according to historical behaviour. However, with interest rates at historically low levels, the uptrend in rates might not be providing a meaningful headwind. Over the last 20 years, when interest rates were low, the correlation between stock prices and bond yields has been positive as it suggests that rising inflation and rates will enhance company profits due to margin expansion as they increase their selling prices. When the correlation turns negative, it then suggests that interest rates have risen too much and will likely be a headwind for economic growth and hence company profits. As can be seen in the chart below, rising interest rates (red), indicative of higher inflation in, usually correlates positively with stock market returns and vice versa. Interestingly, one can also see the impact of quantitative easing since the financial crises, with the stock market (green) continuing to rise despite low interest rates (and inflation) since 2009!



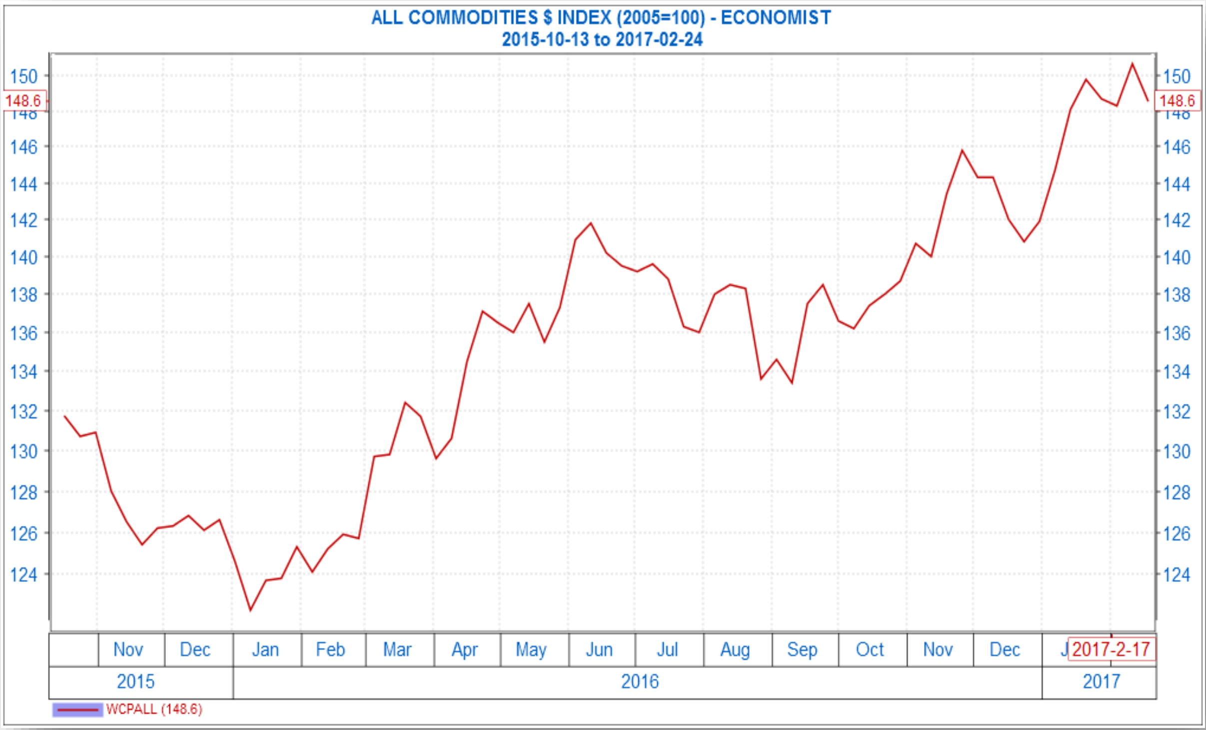
Source: I Net

Overall then, despite equity markets (developed markets) trading at or near all-time highs, the backdrop remains positive with global growth being revised upwards and reflation emerging. Given more attractive valuations in certain emerging markets and the likelihood of commodity prices remaining firm in the near term, we expect emerging markets to continue to attract foreign investment flows.

Local

The stabilisation of most commodity prices (see chart) bodes well for both our economy and investment markets. Despite US bond yields rising sharply over the last couple of months, local bonds have remained fairly firm (lower yields), indicating a reduction in risk premiums as well as an improved inflationary outlook. The strong rand relative to developed economy currencies will further buoy inflationary expectations. Some economists are actually forecasting that the SARB will cut interest rates later in the year. We however are of the opinion that they will likely remain the same.

Economist All Commodities Index – strong recovery



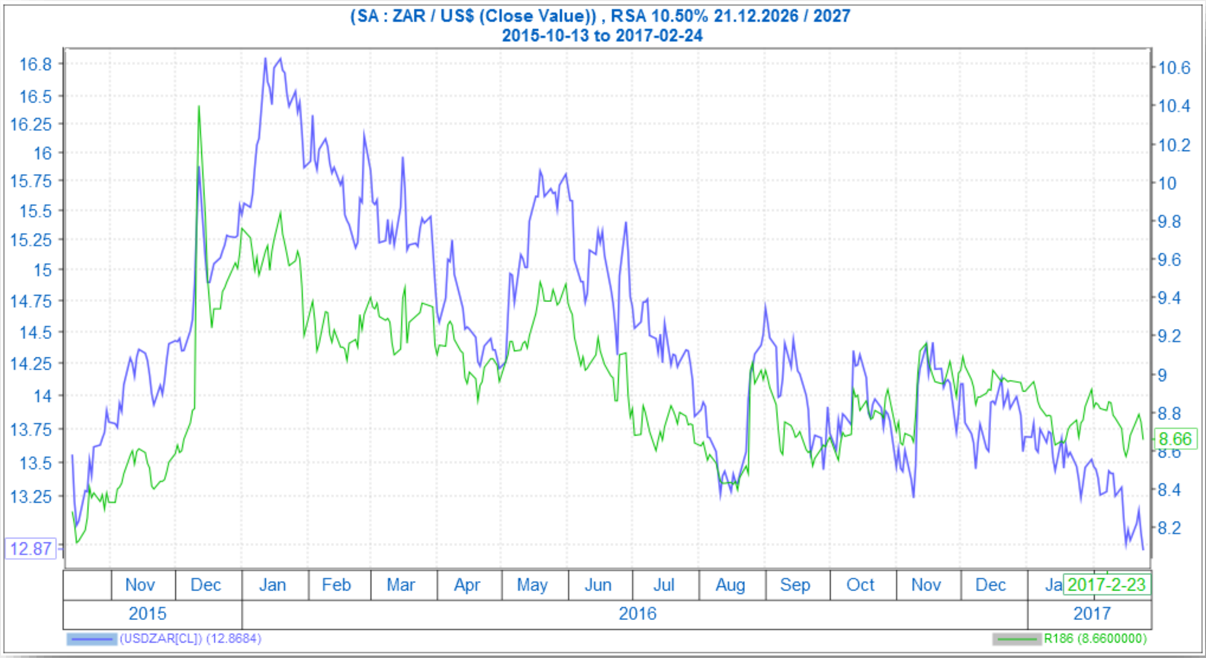
Source: I Net

Given the trend in commodities, a cyclical recovery towards higher GDP growth, although modest, could result in a credit rating downgrade less likely this year. The main risk to this view remains political uncertainly, particularly the issue around the finance minister and potential state capture of the Treasury.

The main feature of late has been the strength of the rand which has been accompanied by falling 10 year bond yields despite higher real interest rates in the US indicating an improved risk perception for SA. The “extra” yield that foreigners require to justify investing in our local bond market can be measured by comparing the real interest rate differential between us and the US. The differential has remained fairly stable since the start of the Trump reflation trade so perceived investment risk has effectively declined. Given more upgrades in local growth estimates and firm commodity prices, the rand is likely to remain firm in the near term. But watch out for politics!

IMARA
Asset Management SA

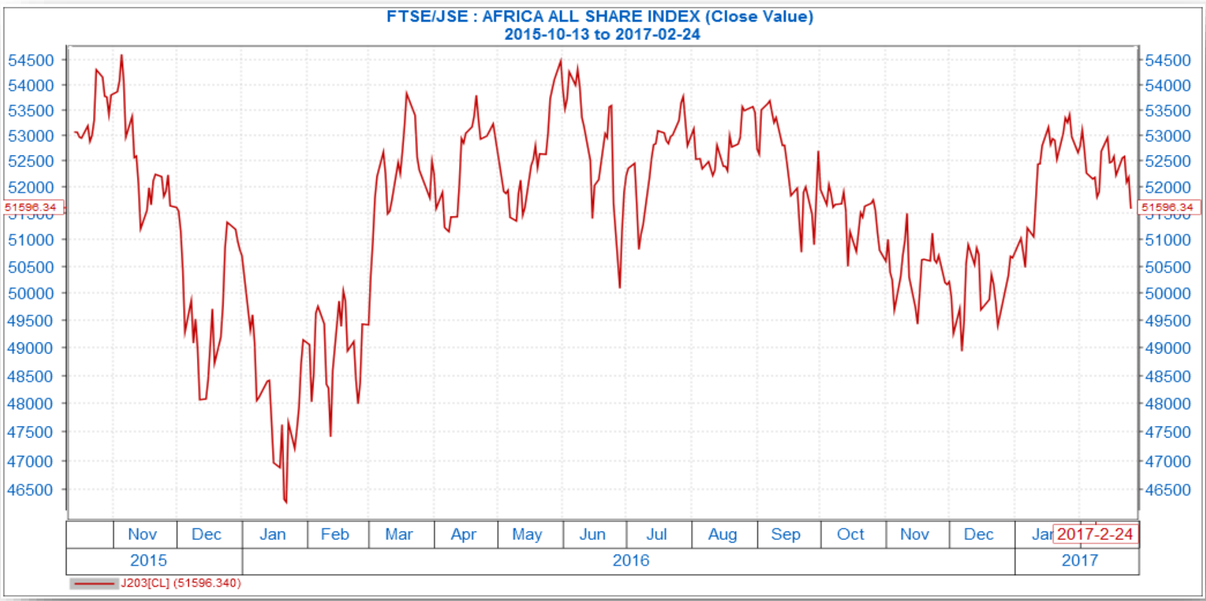
Inflows into bonds and the rand – likely to remain in the near term



Source: I Net

The JSE also experienced some strong investment inflows towards the end of last year and beginning of 2017 but the rally has started to waiver somewhat as markets require more colour around fiscal spending and tax cuts in the US which is needed to support current valuations.

JSE All Share



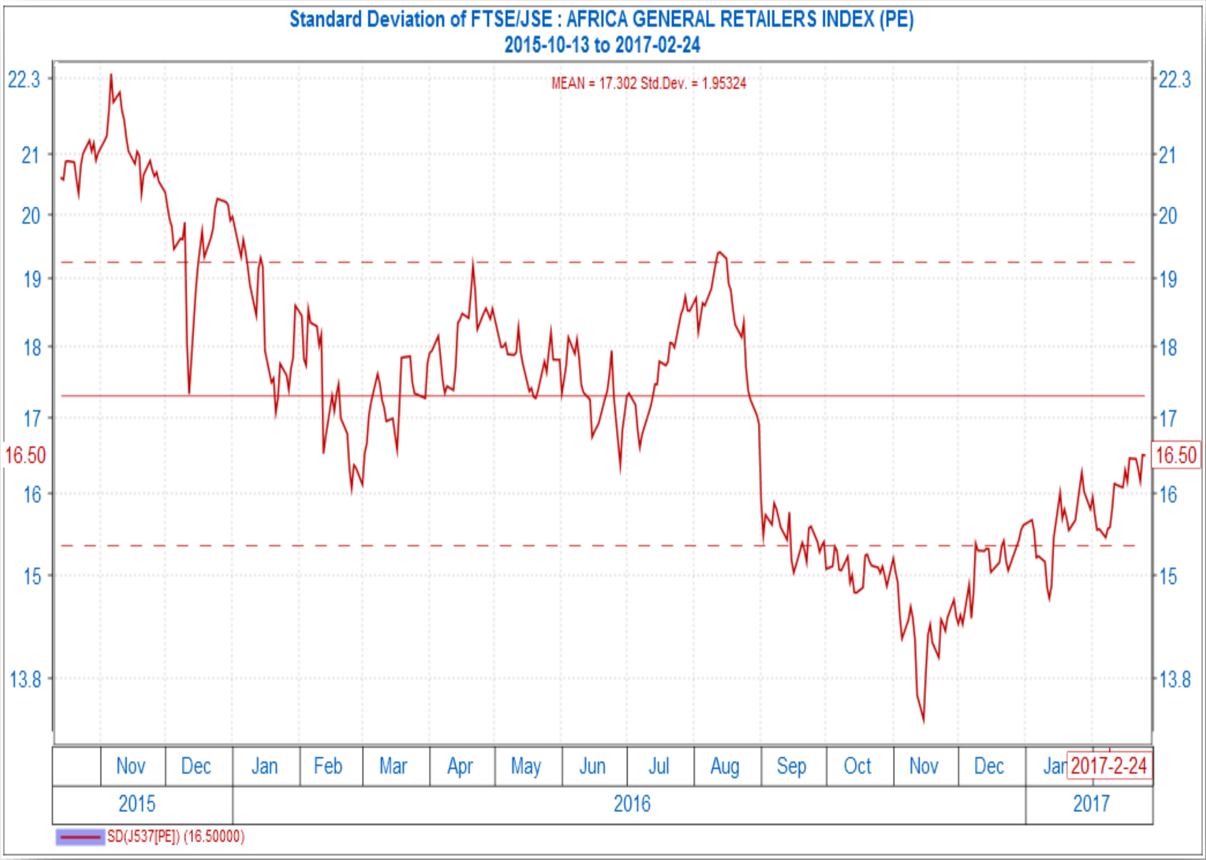
Source: I Net

The JSE Underperformed cash returns in 2016 but is expected to outperform this year given the rise in commodity prices which will eventually lead to better discretionary spending by consumers. Lower risk free yields (long bond yields) will also make stock valuations more compelling due to the lower discount factor in valuation models.

Commodity stocks have performed exceptionally well lately but it's likely that they might take a breather in the near term until more clarity on Trump's plans emerges. But again, China will be the main driving factor.

The strength in the rand will certainly benefit importers such as retailers but also banking stocks given the more benign outlook for inflation and interest rates. Retail stocks in particular seem oversold after reporting uninspiring results towards the end of last year and are now trading on far more legalistic price earnings ratios (see chart)

JSE Retail Index PE



Source: I Net

IMARA
Asset Management SA

To conclude:

- The strong dollar spurred worries about emerging market currencies mainly due to large dollar dominated debt in certain countries but has started to weaken lately.
- The reason is that despite all the promises by the Trump administration of kick starting the US economy, no concrete plans have been presented as yet.
- Growth estimates in most emerging markets have steadily been revised upwards causing strength in their currencies.
- Rising interest rates, indicative of higher inflation, usually correlates positively with stock market returns and vice versa.
- Given more attractive valuations in certain emerging markets and the likelihood of commodity prices remaining firm in the near term, we expect emerging markets to continue to attract foreign investment flows.
- The main feature of late has been the strength of the rand which has been accompanied by falling 10 year bond yields despite higher real interest rates in the US indicating an improved risk perception for SA.
- Commodity stocks have performed exceptionally well lately but it's likely that they might take a breather in the near term until more clarity on Trump's plans emerges.
- The JSE Underperformed cash returns in 2016 but is expected to outperform this year given the rise in commodity prices which will eventually lead to better discretionary spending by consumers.
- Banks and retail stocks will likely outperform in due course due to a benign outlook for inflation and interest rates.

Sincerely

Chris

Chris Botha

STRONG IN NAME. RESOLUTE BY NATURE