IMARA
Asset Management SA

Communiqué

Monthly
South Africa

April 2017

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Maybe markets were expecting too much?

Abroad

The US Federal reserve hiked interest rates by 25 basis points as expected. The surprise however was the more dovish tone during the media briefing with analysts. They are now broadly anticipating only up to three further hikes this year. This compares to up to seven hikes expected previously over the next two years.

Donald Trump's more expansionist fiscal policy certainly was a factor in their decision to hike.

The challenge for the FED is not to be late when (and if) this occurs as inflation might increase more rapidly than expected. Recent activity indicators continue to point to acceleration in economic growth. This was recently confirmed by the Beige Book which showed that tensions in the labour market are on the increase with non-farm unit labour costs rising.

US labour costs are on the increase

This waive of optimism has fuelled a rally in equity markets and the dollar prior to the recent FED announcement.

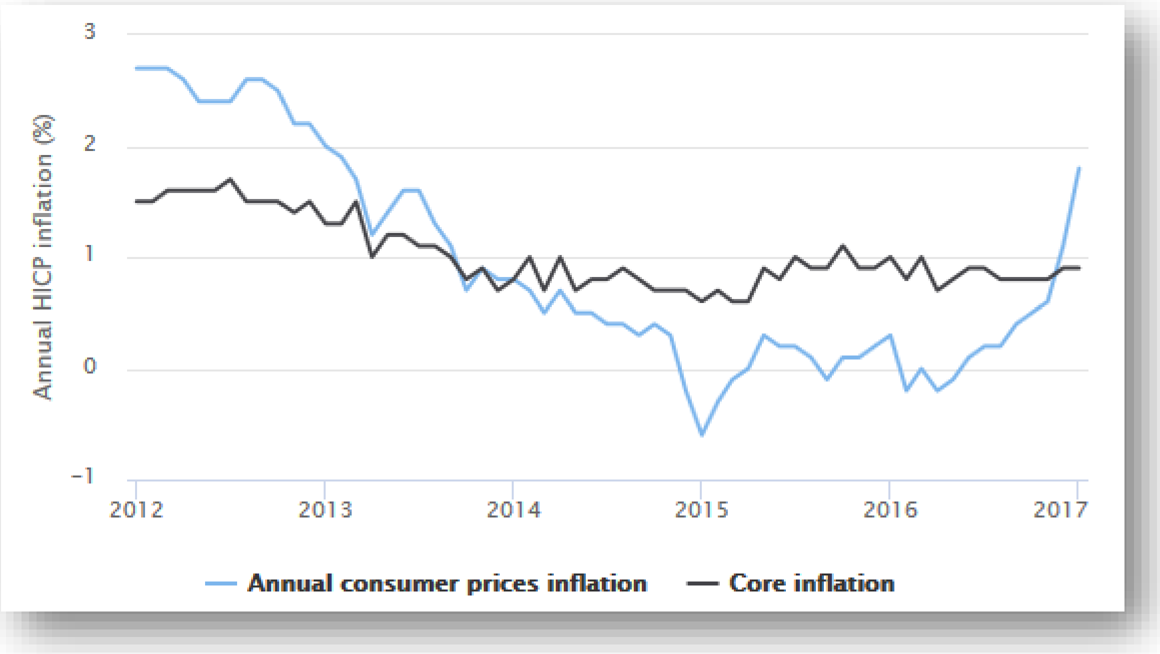
Following the more dovish outlook, equities and the dollar retraced somewhat as markets (and us) now anticipate that the new administration's growth plans might not be that easy to execute. Maybe markets were expecting too much. A case in point is Obamacare. Mr Trump has escalated pressure on Congress to accelerate negotiations to reform the current proposals but he is not winning the battle. This early "test" is illustrating the likely problems he may encounter in both the Senate and the House as he tries to implement his economic and fiscal policies as promised in his campaign. The promised tax cuts for households and companies cannot be implemented before the proposed cost cuts in Obamacare actually have been established. A delay in cutting taxes, especially for the middleclass, could make it difficult for the US economy to pick up steam. The FED knows this, hence their more cautious stance.

The fed will likely review its approach as and when talks in Washington produce some results which could be the catalyst for a change in pace of future hikes.

The recent "Europhile" victory for incumbent Mark Rutte was a relief for markets given tensions around the future of the union but we still need to digest the future impact of Brexit.

The ECB is sticking to its course but is beginning to tweak its message. During their last press briefing, Mario Draghi reiterated that benchmark rates would only be raised long after asset purchases ceased which is in contrast to what financial markets are anticipating. The need for the ECB being forced to lower rates again has diminished as the previous phrase "…..use all of the means at its disposal" to reach their targets has been absent during recent communications. The challenge the bank is facing is rising inflation (at last), which in our view is a good thing, as this is showing a steadily improving economic outlook. Eurozone inflation shot up in January but core inflation remains subdued.

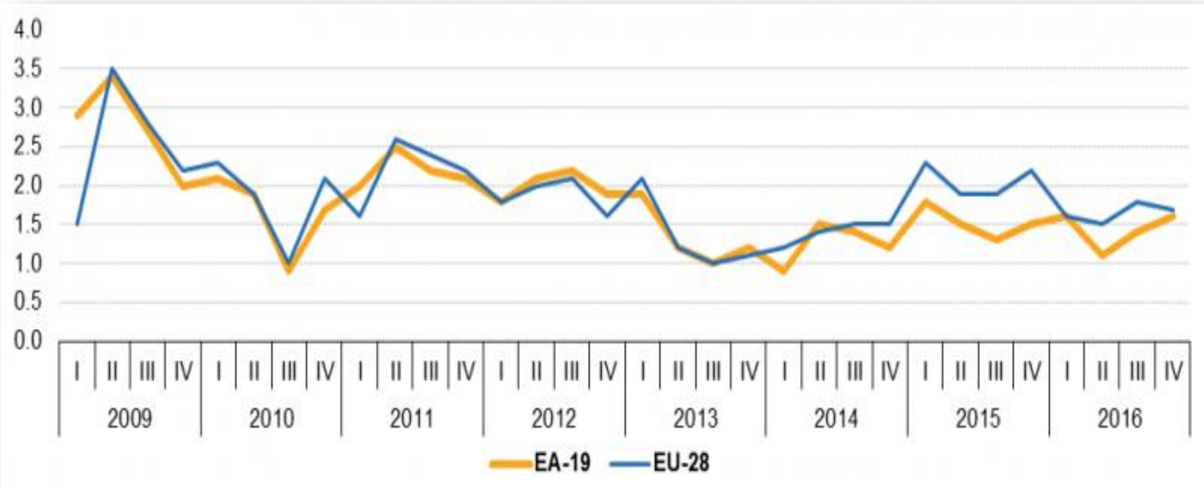
Eurozone Inflation – core not rising yet



Source: The Telegraph Business

A lack of tension in the job market does however indicate that a self-sufficient recovery in momentum is not there yet which will probably prevent the ECB from 'normalising' rates any time soon.

Total nominal hourly labour costs in Europe – no pressure yet



Source: Eurostat

The UK economy is showing signs of stress with slowing retail sales and high levels of household debt. The Bank of England should therefore maintain an accommodative monetary policy which will likely cause sterling to weaken further.

There are also inflationary pressures in the UK with the February number 2.3% higher than the BoE's target. The bank's ability to raise interest rates to curb inflation and stabilise the pound will be hampered by the slowing growth and political uncertainties particularly in the near term if there is a Scottish independence referendum.

Pound vs. Dollar – could start weakening again

Source: iNet Bridge/Imara

Overall then, we expect the stimulus packages from the Trump administration to take longer to implement but they will come in due course and that interest rate hikes in the US will therefore be more subdued. The Eurozone continues to gradually recover along with rising inflation (although slowly) but the ECB will likely only start to taper their asset purchases in 2018 and should remain accommodative for some time still.

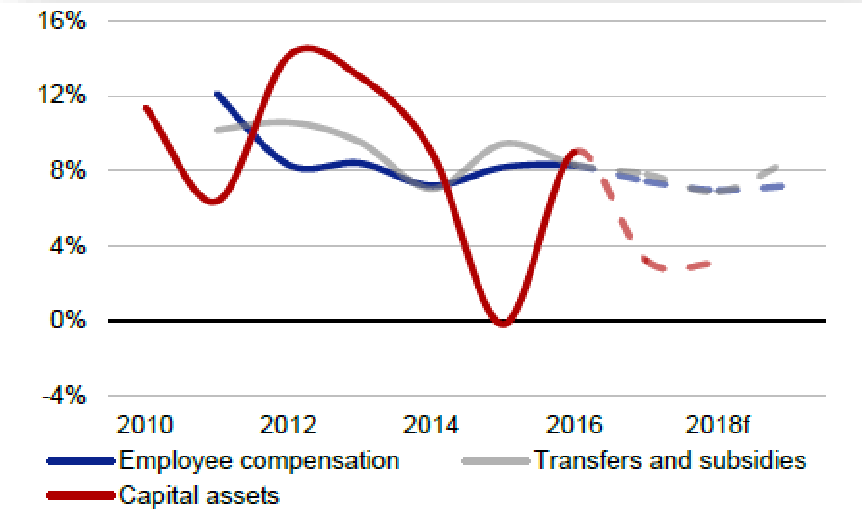
In the near term, we expect markets to remain a bit volatile as confusion regarding the timing of the Trump policies has set in as well as heightened political uncertainty in the Euro area.

Local

The rand and local bond market has continued to benefit from global emerging market flows following the more dovish FED comments and the potential delay in Trump's plans.

The recent budget was a testimony that Treasury will focus on debt sustainability and fiscal consolidation which has also supported the rand and bond market. Of concern is that a larger proportion of government spending has been allocated to areas that will not increase tax revenue sufficiently (read employee costs and subsidies) and spending on capital formation is in fact expected to decline – crucial for job creation. Failure to meet Treasury's growth forecast and revenue collection targets could have severe consequences for our sovereign debt rating.

Government expenditure allocation



Source: SA National Treasury, Avior Capital Markets

Credit rating agency S&P has reiterated that our sovereign rating hinges on three main factors. Firstly, headline economic growth accompanied by higher tax income. Secondly, the robustness of our main institutions (read SARB and Treasury) and thirdly, that contingent liabilities of State Owned Enterprises stay in check.

Despite the allocation of expenditure, we have witnessed steady increases in GDP growth forecasts (we expect 1.7% for 2017) for the year and the strong rand is helping inflation to decline. This could eventually lead to interest rate cuts this year, but rand investors will keep a hawkish eye on developments around our embattled finance minister. Any change there could cause substantial currency weakness accompanied by investment outflows from financial markets.

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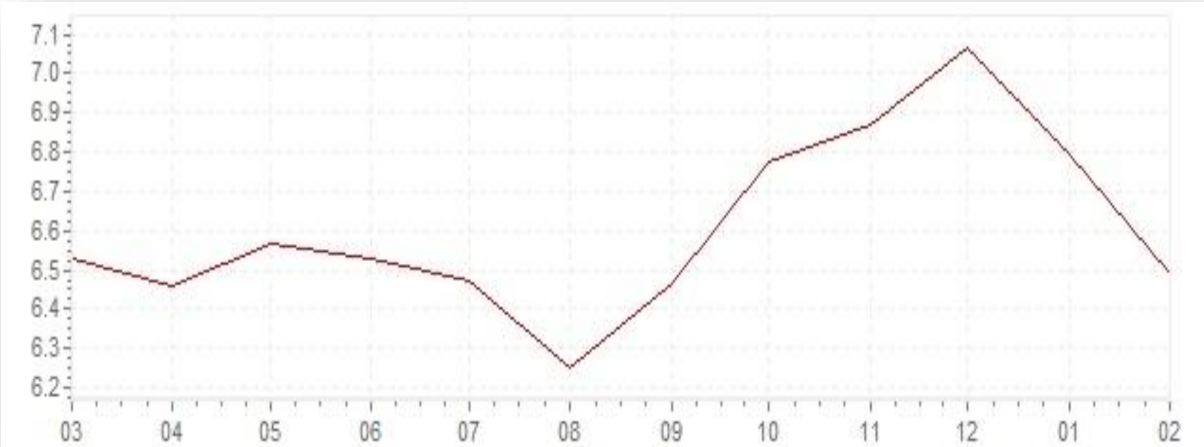
Current CPI in SA – last 12 months



Source: Inflation.eu

On balance, political developments in SA seem to improving with the re-emergence of factions within the ruling party. Local investors have mostly remained on the side-lines as there are mounting fears of a cabinet reshuffle which might impact Gordhan. It is expected that the finance minister will remain in place as removing him will more than likely cause a split in the ANC which could lead to the anti-Zuma camp forming a coalition government with someone else.

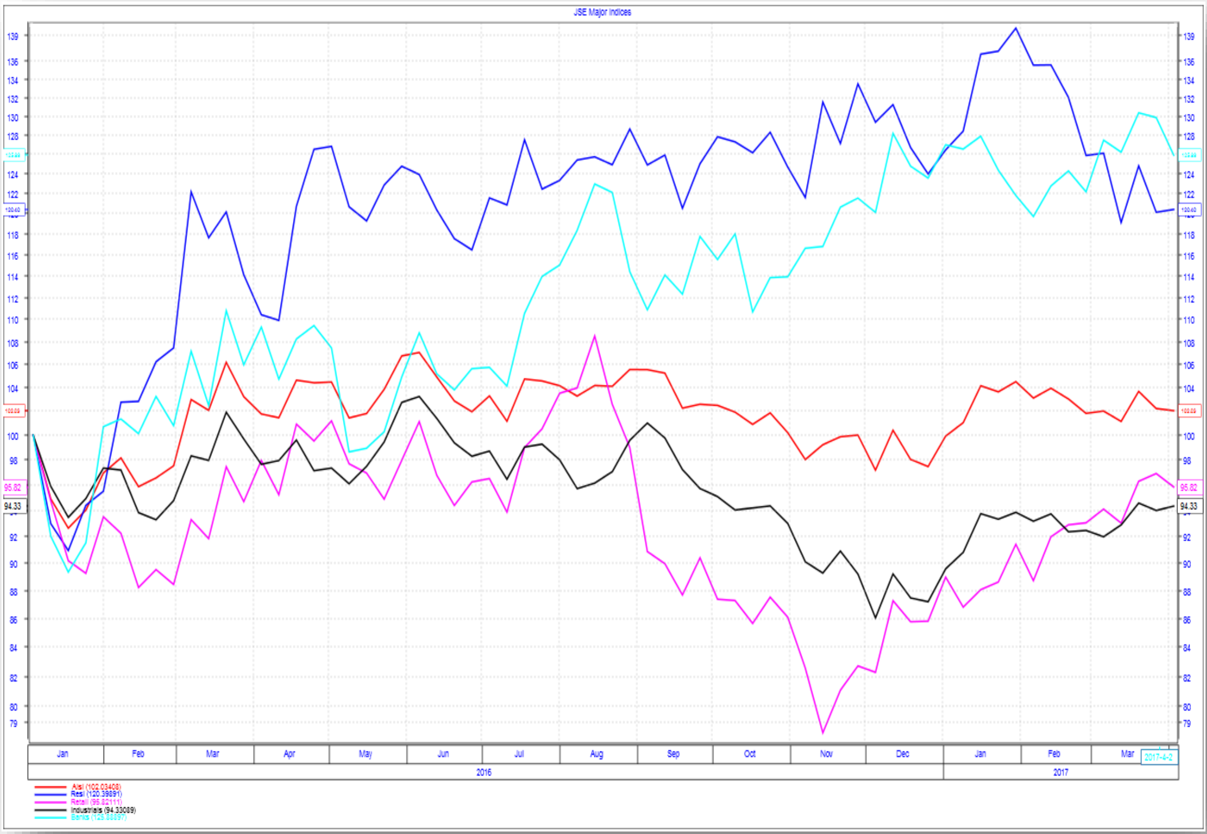
From an investor point of view, all the action has been in local bonds this year so far with yields falling from 8.8% to 8.3% (+6% return) before weakening by 5% in one day following the announcement that the Presidency has recalled the Treasury, business and labour from a foreign road show to investors with no apparent reason (at the time of writing). We await more clarity around that issue.

SA long bond (R186) – Anticipating a "Gordhangate"?

Source: iNet Bridge/Imara

On the equity front, as can be seen below, the all share (red) is more or less flat year to date. The star performers this year so far have been industrials (black) and retail stocks (purple) with returns of 5% and 8% respectively after delivering poor returns last year. Banking stocks (Blue) also are where they were at the beginning of the year. After a stellar year last year, resource counters (dark blue) have declined by 5% in the first quarter of 2017 plagued by the strong rand and mounting doubts that the fundamental reasons behind the reflation trade, or Trump trade, might take longer to materialise – a view we have had for a while now.

JSE major indices performance – resources losing steam



Source: iNet Bridge/Imara

Given lower trending inflation dynamics, stronger rand (for now) and upgrades to economic growth for 2017, we remain optimistic on both SA and emerging markets for the remainder of the year driven by a recovery in both consumer expenditure as well as lending environment. A cut (or cuts) in local interest rates should further buoy our financial markets. The main event risks (which could be severe) to this view are falling commodity prices (unlikely due to reflation globally), Trump unable to employ his plans and the big one for us a "Gordhangate".

To conclude:

- The US Federal reserve hiked interest rates by 25 basis points as expected
- The surprise however was the more dovish tone during the media briefing with analysts
- Recent activity indicators in the US continue to point to acceleration in economic growth
- Following the more dovish outlook, equities and the dollar retraced somewhat as markets (and us) now anticipate that the new administration's growth plans might not be that easy to execute
- The recent "Europhile" victory for incumbent Mark Rutte was a relief for markets given tensions around the future of the union but we still need to digest the future impact of Brexit
- The ECB is sticking to its course but is beginning to tweak its message
- as the previous phrase "…..use all of the means at its disposal" to reach their targets has been absent during recent communications
- The rand and local bond market has continued to benefit from global emerging market flows following the more dovish FED comments and the potential delay in Trump's plans
- We have witnessed steady increases in GDP growth forecasts for the year and the strong rand is helping inflation to decline. Interest rate cuts are a distinct possibility
- The main risk to our positive view on equities for the year is the replacement of Pravin Gordhan

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Please be advised that Imara Asset Management is moving to new offices at the end of March.

Our new physical address is:

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Our telephone, postal address and e-mail contact details remain unchanged

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Sincerely

Chris Botha

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