IMARA
Asset Management SA

Communiqué

Monthly
South Africa

June 2017

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Trump caught up by reality but growth is synchronising

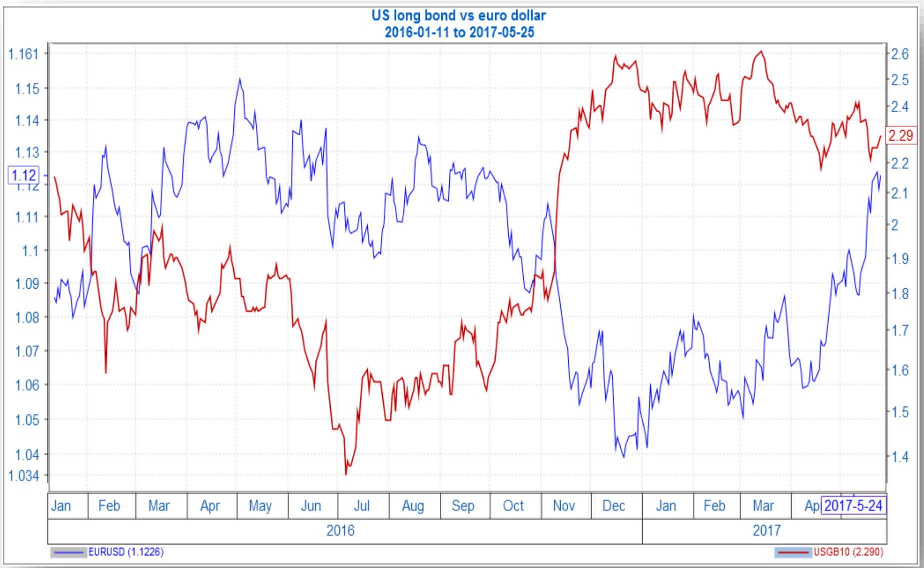
Abroad

The Trump administration's 3% growth target for 2017 will be difficult to achieve due to continued delays in implementing the campaign promises as he is struggling to get things through Congress. Despite the Republicans having a majority in both houses, opinions are divided. Furthermore, Washington has taken a far more moderate approach on global trade compared to Trump's more protectionist agenda. The objective in congress is to not harm global free trade and growth but will support some regional rebalancing.

Despite this, US growth will likely be in the region 2.5% to 2.7% in 2017 accompanied by inflation of approximately 1.9% which remains below the Fed's 2% target. Tension in the job market remains on an upward trajectory accompanied by a slow increase in wages, mainly at the lower end of the market.

Following the publication of the minutes from the previous Fed meeting and recent comments by several members, it is fairly clear that the normalisation of monetary policy will continue. Looking at markets, a further rate hike at the June meeting seems to be factored in. The US 10 year long bond rate at a low 2.3% (**Red**) is reflecting some doubt of any further hikes later in the year. With yields this low, it might provide the Fed with an opportunity to buy back some bonds to reduce the size of its balance sheet which could cause yields to rise aggressively. However, this will cause the dollar (Blue) to strengthen which could derail the growth trajectory. A tricky one then.

US long bond and euro/dollar



Source: Imara/Iress

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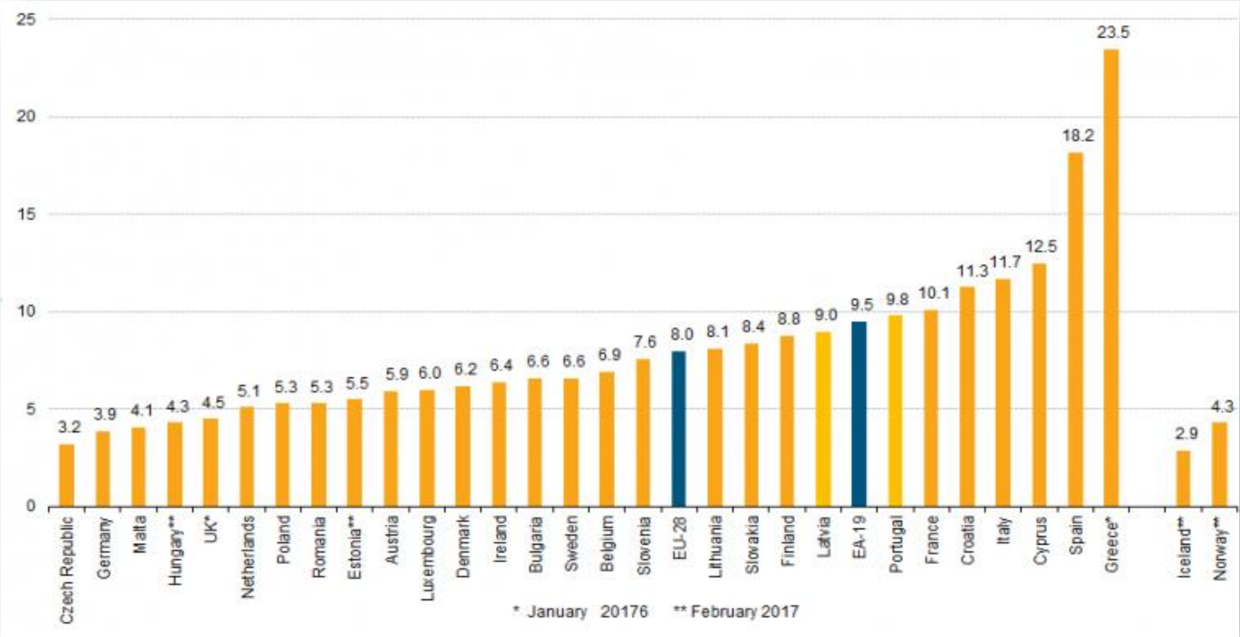
In Europe, PMI activity indices for May confirmed that economies in this region continue to improve with the second quarter PMI of 56.8 at a 6 year high. The main drivers of growth in the region continue to be France and Germany. The current growth trajectory is sustaining the strengthening of the euro against the dollar (see Chart on the previous page - **Blue**) which is bolstering the European Central Bank's capacity to also normalise its monetary policy.

Eurozone PMI's

Source: FT.com

Despite the recovery in the Eurozone, inflation remains very subdued. Furthermore, although the job market is improving, the broad unemployment rate is not back to a sufficiently low level to create pressure on wages. Analysing the last set of minutes of the ECB's monetary policy meeting, it was clear that the ECB is more optimistic about growth in the Eurozone but members remain cautious on the capacity to increase interest rates. They did however indicate that the risk of deflation has diminished materially which we believe paves the way for a less accommodative stance by the ECB and could lead to them gradually reducing asset purchases towards the third quarter of the year.

Eurozone Unemployment rate



Source: Eurostat

Moody's Investor Services downgraded China's sovereign rating for the first time in 30 years but remains two grades above investment status. Main reasons for the downgrade were slowing growth and increasing debt levels. China's credit worthiness is now on par with Japan but still higher than most other emerging markets. Markets shrugged off the downgrade as most of China's debt is internal and held by state owned banks. Foreign denominated debt only accounts for 6% of total debt. Having said that, this does highlight lingering concerns that the country's reliance on credit to support its growth might cause problems down the line in terms of inflationary pressure. Chinese bond yields have been rising steadily as investors demand a higher risk premium for funding the government's liabilities.

Chinese debt to GDP percentage

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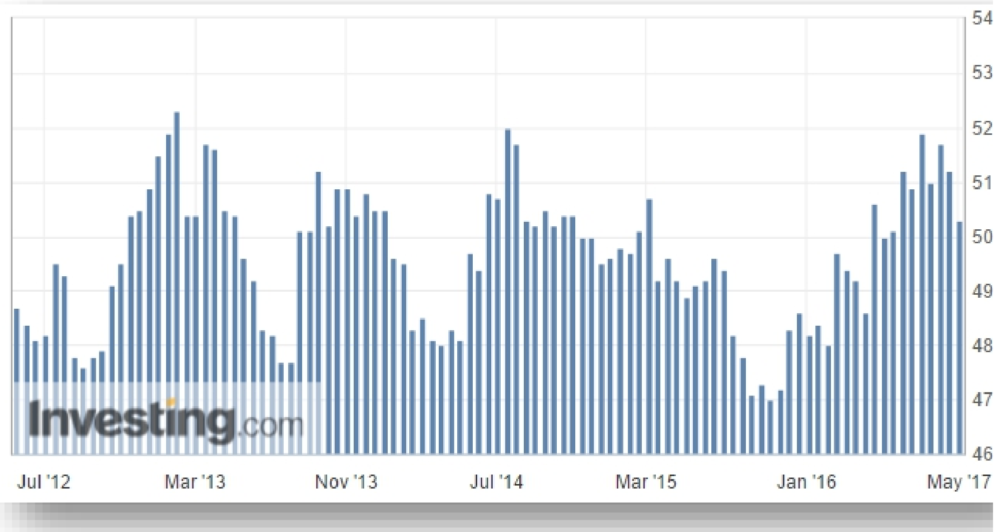
China's manufacturing purchasing managers index recently fell to a 7 month low of 50.3 mainly due to tighter credit. This suggests that growth momentum has probably peaked and could well moderate further in the second half of 2017. It's important to monitor this trend as sign of trouble in China could easily derail the current rally in global equity markets given the country's significant role in global trade. Also, given that they are the largest consumer of commodities, what happens there will have an immediate effect on other emerging markets.

Caixin Manufacturers Purchasing Managers Index (PMI)



Source: Business Insider

Local

The rand and bond markets continue to benefit from firm commodity prices and global risk-on sentiment with continued foreign purchases of emerging market debt. The local currency at R12.95 to the US dollar has breached the important R13 level from a technical perspective. The rand is likely to remain firm in the near term bar any further political surprises or a change in the global growth cycle which plays a major role in spot commodity prices. A headwind might be a possible investment downgrade by ratings agency Moody's which we expect sometime in June.

The SARB's MPC left the repo rate unchanged at 7.0%. However, as at the March meeting, the decision by the MPC to leave interest rates unchanged was not unanimous. Again, one member of the 6 member MPC advocated for a 25bps repo rate cut.

Various economic and financial market indicators have improved since the March MPC meeting as indicated in the table below.

MPC	CPI	CORE CPI	USDZAR	Crude Oil USD	Crude Oil ZAR
24-Jan-17	6.7 (Dec)	5.9 (Dec)	13.47	USD55.44	ZAR741.29
30-Mar-17	6.3 (Feb)	5.2 (Dec)	13.04	USD52.54	ZAR685.27
25-May-17	5.3 (Apr)	4.8 (Apr)	12.89	USD53.96	ZAR695.49

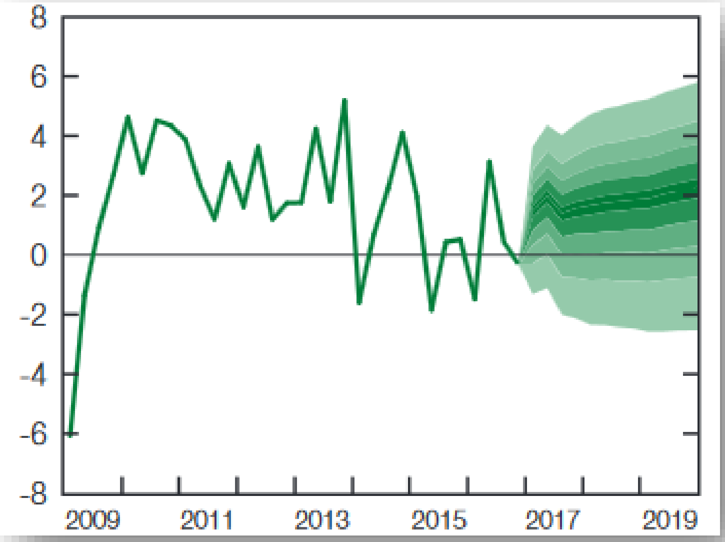
Source: Thebe stockbroking

The SARB has revised its inflation outlook downwards in the near-term given the strength in the rand and lower oil price but did highlight the uncertainty surrounding the future trajectory of the currency and that this is a major risk to the inflation outlook.

According to the MPC "the outlook for the rand, and therefore the risks to the inflation outlook, will be highly sensitive to unfolding domestic political uncertainty, as well as decisions by the credit ratings agencies. The rand could weaken significantly in the event of a worst-case ratings downgrade scenario that could result in South African government bonds falling out of the global bond indices."

But the message overall was that the SARB might be ready to cut interest rates given the improved inflation outlook with above mentioned risks the main headwinds which could cause the SARB to tread water for now until greater clarity on these factors emerge.

SARB projected GDP growth – darkest area the most likely outcome



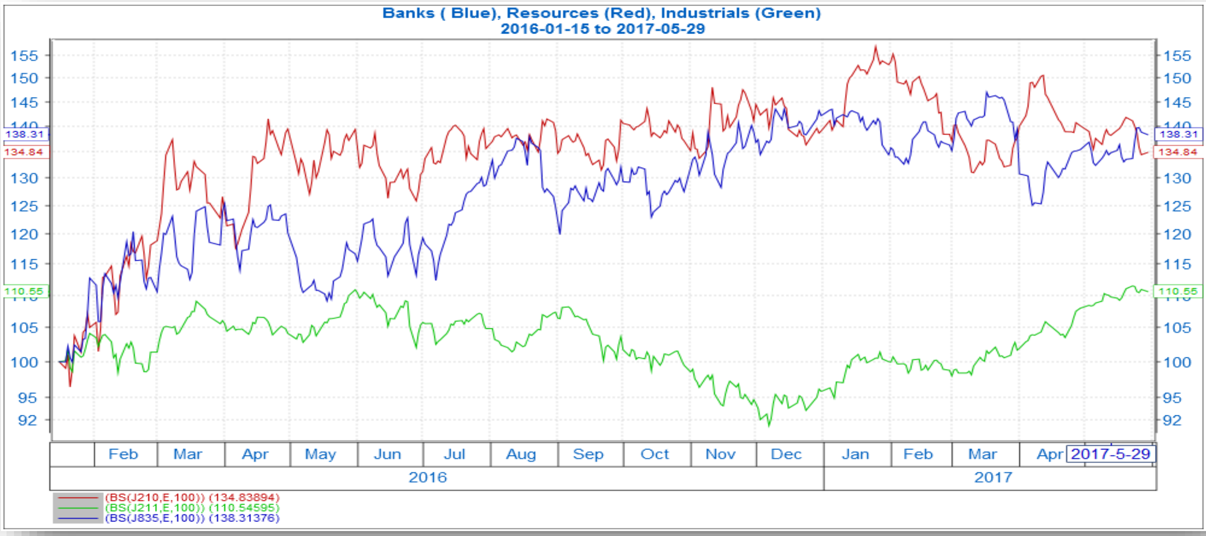
Source: SARB

In the event of the rand not depreciating meaningfully and if greater certainty about the domestic political landscape emerges it's likely that the SARB will be in a position to cut interest rates.

Despite recent strong performances in manufacturing and mining production data as well as retail sales, the SARB lowered its outlook for growth going forward. To quote; "Domestic economic growth prospects have deteriorated, as the impact of the ratings downgrades is expected to weigh on domestic investment and consumer sentiment … However, the trajectory of the growth forecast is still positive. The bank has revised GDP growth downwards for 2017 & 2018 both by 0.2% to 1.0% & 1.5% respectively. 2019, forecast is 0.3% lower at 1.7%"

The JSE is up 6% year to date and we expect merging market inflows to remain a theme for the remainder of the year. The move in the market so far has largely been driven by a 15% return in industrial rand hedge shares. The resources index is down 4% year to date and the banking index flat for the year. We anticipate a return of approximately 12% for the JSE in 2017.

Major indices price movement



Source: Imara/Iress

Portfolios in general remain overweight industrial rand hedges and at weight resource counters relative to the JSE all-share index. Banking shares remain inexpensive but a further ratings downgrade could be a headwind in the short term.

Company News

Reinet NAV at March 2017 is c.2% below our estimate as of that date, with no major unlisted valuation surprises at first look. They have effectively refinanced their GBP300m medium-term collar financing arrangement and increased gearing with a GBP500m facility to 2022. Similar to last time, REI has bought put options over BATS shares (15.5m) to protect the value of the BATS shares pledged as security for the borrowings (plus they've pledged a further 4.5m to collateralise the premium loan as the put premiums are payable over the life of the transaction).

Old Mutual update: New business growth in SA has deteriorated slightly but actions to improve margins are effective. FY 17 earnings growth should be moderate.

Vukile reported FY'17 DPS of 156.75c (7.1% y/y) relative to our expectations of 156.9c (7.2% y/y). This is in line with management guidance of c.7% growth. A number of events occurred during the period including the Sovereign sale and the Gemgrow transaction which was used to strengthen their balance sheet and refocus the business on the retail sector. These events have weighed on our original forecasted FY'18 DPS growth of 5.8%. Management guidance for FY'18 is 7-8% however this is dependent on the successful conclusion of a transaction in Spain which presents both timing and execution risk.

To conclude:

- The Trump administration's 3% growth target for 2017 will be difficult to achieve due to continued delays in implementing the campaign promises
- Despite this, US growth will likely be in the region 2.5% to 2.7% in 2017 accompanied by inflation of approximately 1.9% which remains below the Fed's 2% target
- In Europe, PMI activity indices for May confirmed that economies in this region continue to improve with the second quarter PMI of 56.8 at a 6 year high
- Moody's Investor Services downgraded China's sovereign rating for the first time in 30 years but remains two grades above investment status
- China could easily derail the current rally in global equity markets given the country's significant role in global trade
- The rand and bond markets continue to benefit from firm commodity prices and global risk-on sentiment with continued foreign purchases of emerging market debt
- In the event of the rand not depreciating meaningfully and if greater certainty about the domestic political landscape emerges it's likely that the SARB will be in a position to cut interest rates
- The SARB has revised GDP growth downwards for 2017 & 2018 both by 0.2% to 1.0% & 1.5% respectively. 2019, forecast is 0.3% lower at 1.7%

Sincerely

Chris

Chris Botha