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Communiqué

Monthly
South Africa
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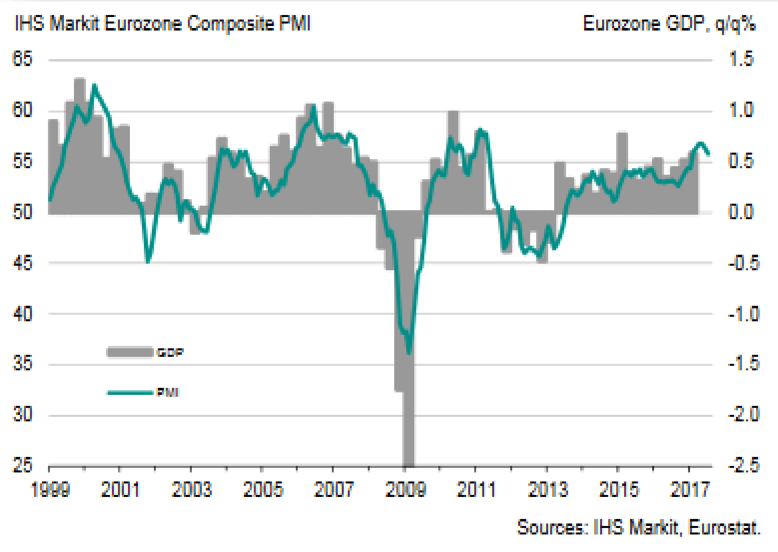
Illovo Edge, 3rd Floor, Cnr Harries & Fricker Roads, Illovo. Johannesburg
+27 11 550 6181

Tapering on the way but may take a while

Abroad

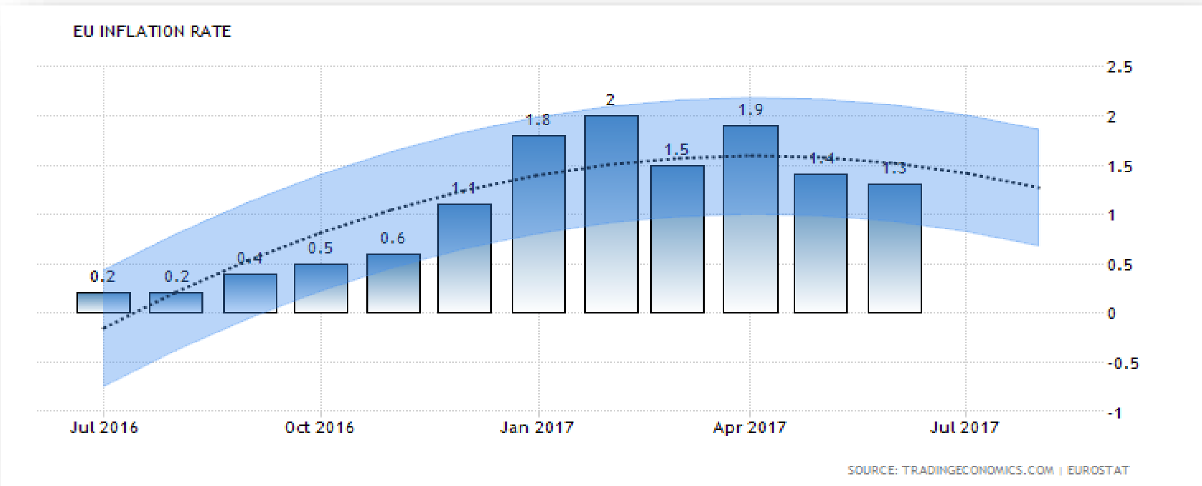
Economists and investors alike remain confident that the European economic recovery remains intact. Leading PMI indicators for July remained strong indicating that growth in the second half of 2017 will continue.

Eurozone PMI and GDP



The positive outlook is supported by a 20 basis points increase in the IMF's forecast for the region to 1.9% for the year. Despite this, we expect that the ECB's discussion to start tapering asset purchases will likely be pushed out to the second half of 2018 as inflationary expectations remain benign.

A risk to the current positive outlook is the stronger euro relative to the dollar due to the inability of the Trump administration to pass reforms.



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The European vigour contrasts with the downward revisions for the US by the IMF which revised growth down to 2.1% for 2017 from 2.3%.

Despite this, Janet Yellen's speech to the US Congress reaffirmed her confidence in the economic expansion but she has turned somewhat more cautious on the timing and trajectory of monetary tightening. What spooked her was the sudden decline in US inflation but the FED is of the view that this was due to certain once-off events and will therefore continue to hike key rates but we are of the opinion that the trend will be slower than what markets are expecting. This of course means more dollar weakness and higher commodity prices which bode well for emerging markets.

To Quote: *"It's premature to reach the judgment that we're not on the path to 2 percent inflation over the next couple of years," Ms. Yellen said. "We're watching this very closely and stand ready to adjust our policy if it appears the inflation undershoots will be persistent."*

Federal Reserve interest rate hopes fade

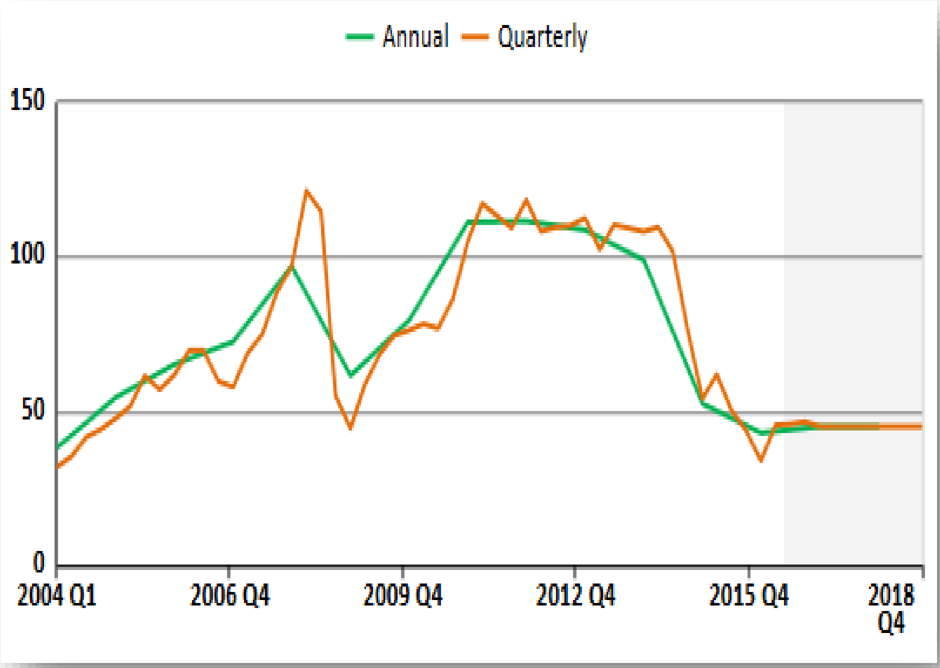
Source: FT.Com

Investors trimmed bets on the Federal Reserve raising interest rates again this year after US inflation undershot forecasts for the fourth month running, triggering lower Treasury yields and a weaker dollar.

The weakening dollar and rising commodity prices are being supported by demand in China.

During the first half of 2017, oil and steel imports rose by 14% and 9% respectively due to high demand from construction activity. The expected increased demand for oil amongst emerging markets could help to absorb excess production from the US but Brent spot could remain vulnerable in the event of OPEC not cutting production.

OECD oil price outlook



In the event of oil remaining lower for longer (our view), global inflation will likely stay low for some time still, which means a very benign interest rate outlook, in other words interest rates will remain low for a while despite a recovery in the global economy. Or at best, that the hiking cycle will be very measured.

Source: OECD

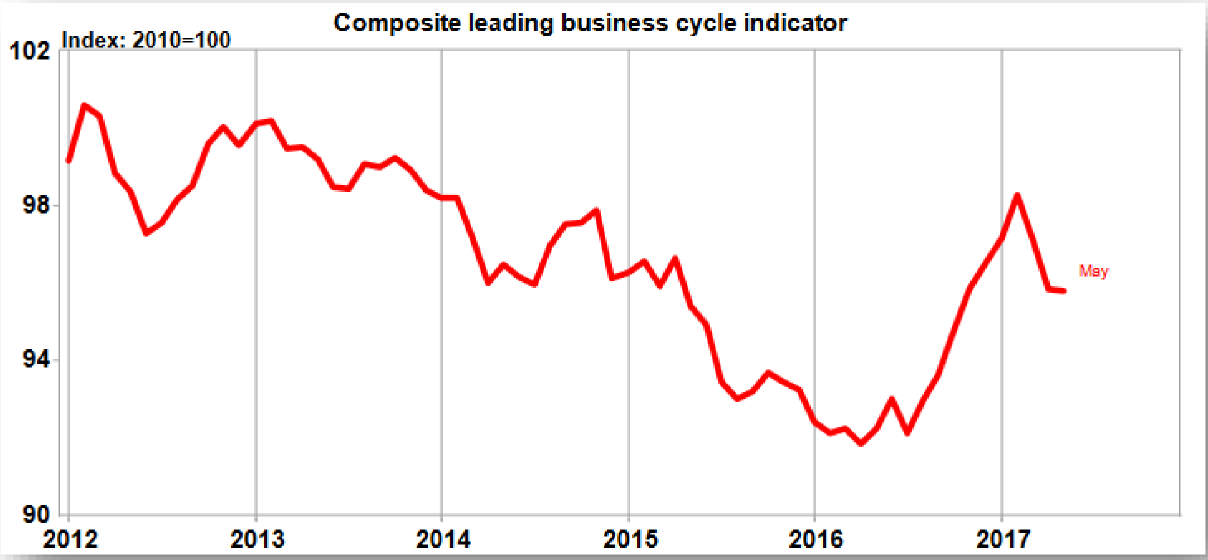
Local

We expect a more uncertain economic environment for the remainder of the year. We expect further declines in inflation which could lead to maybe one more interest rate cut towards the fourth courter of 25bp accompanied by a stable rand due to expected dollar weakness (unless Trump gets his plans passed). It could be that growth locally picks up somewhat towards the fourth courter as lower inflation and lower interest rates start benefitting consumers. Consensus growth however remains at the 0.8%-1% level for 2017 which remains very low.

The SARB has recognised that the business cycle entered a downward phase in December 2013, defined as occurring when the actual pace of aggregate economic activity is slower than the long-term rate of aggregate economic activity.

Clearly economic activity has fallen off materially further in South Africa with the current "technical" recession" prompting the MPC to reverse the end of its last rate hike cycle, with a 25bp cut at its July 2017 meeting.

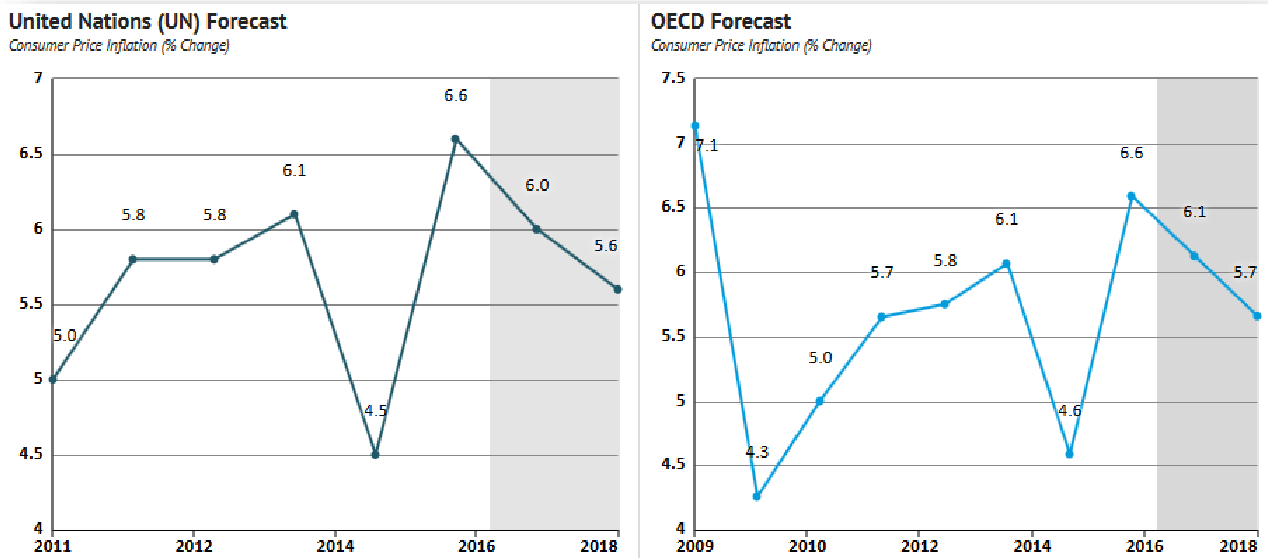
Leading indicator turned down sharply



Source: SARB

While the risk of secular stagnation has faded globally, it has manifested in South Africa. Secular stagnation occurs where low confidence levels translate into low fixed investment growth and employment, dampening incomes and personal expenditure and inflation, leading to stagnant growth outcomes.

UN and OECD expecting inflation to fall further



Source: KNOEMA

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According to the latest Investec Business Cycle Note, the IMF July 2017 World Economic Outlook confirms the view that the global economic recovery is firming, but says “the outlook for South Africa remains difficult, with elevated political uncertainty and weak consumer and business confidence, and the country’s growth forecast was consequently marked down for 2018”.

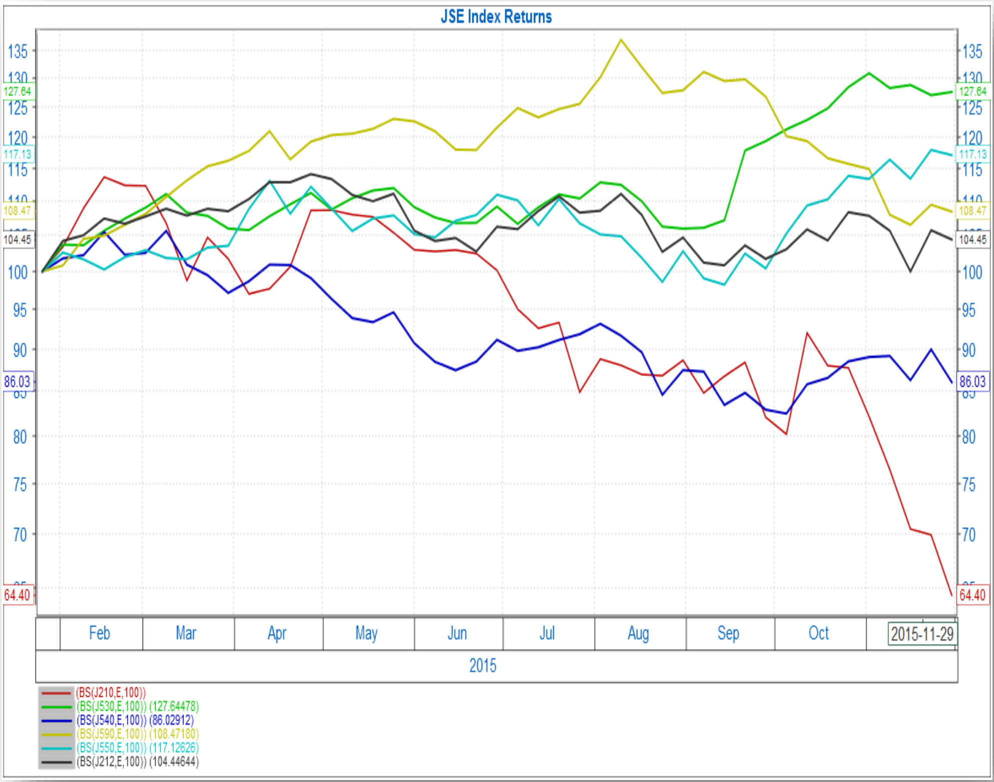
The OECD made recommendations in its recent survey on South Africa on “finding new ways to boost growth and job creation”. Specifically, it recommends “deepening regional integration in the SADC will expand market size and open new opportunities for growth”, and “reducing red tape”.

Additionally, the organisation recommends “more effective public spending will create fiscal space”, “limit annual wage increases in the public sector and redeploy civil servants to priority areas” and to “ensure that state-owned enterprises respect procurement and expenditure rules”.

However, South Africa has not been lacking in good plans, recommendations or policies, but rather in the effective, efficient and timely institution of these plans in a cost effective, business friendly (i.e. one that raises business and consumer confidence) and economic growth supporting manner according to Investec.

Given lower inflation, economic stagnation and a stable (or even strongish rand) where does one invest? The best returns in the equity space will likely be “defensive” SA incorporated stocks such as defensive retailers and undervalued banking stocks. But bear in mind, these sectors have a large foreign shareholder base which can be vulnerable to investor sentiment in the event of any local political shocks. Given the weak (improving later in the year) consumer environment we also prefer retailers that give one exposure to countries north of our border.

In the past, during a similar cycle that we are experiencing currently, returns per economic sector can be seen in the chart below.



Source: Iress

As indicated above during periods of stagnation and low inflation, Consumer Goods (**Green**), Consumer Services (**Light Blue**) and Financials (**Black**) tend to outperform. Resources (mining stocks) tend to perform the worse because of a stable (or stronger) rand dollar rate.

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To conclude:

- Eurozone PMI indicators for July remained strong indicating that growth in the second half of 2017 should continue.
- The European vigour contrasts with the downward revisions for the US by the IMF which revised growth down to 2.1% for 2017 from 2.3%.
- Despite this, Janet Yellen's speech to the US Congress reaffirmed her confidence in the economic expansion but she has turned somewhat more cautious on the timing and trajectory of monetary tightening.
- This of course means more dollar weakness and higher commodity prices which bode well for emerging markets.
- The weakening dollar and rising commodity prices are being supported by demand in China. During the first half of 2017, oil and steel imports rose by 14% and 9% respectively due to high demand from construction activity.
- Locally, we expect further declines in inflation which could lead to maybe one more interest rate cut towards the fourth courter of 25bp accompanied by a stable rand due to expected dollar weakness (unless Trump gets his plans passed).
- Clearly economic activity has fallen off materially further in South Africa with the current "technical" recession" prompting the MPC to reverse the end of its last rate hike cycle, with a 25bp cut at its July 2017 meeting.
- During cycles of economic stagnation, the best returns in the equity space have been in "defensive" SA incorporated stocks such as defensive retailers and undervalued banking stocks.

Sincerely

Chris

Chris Botha