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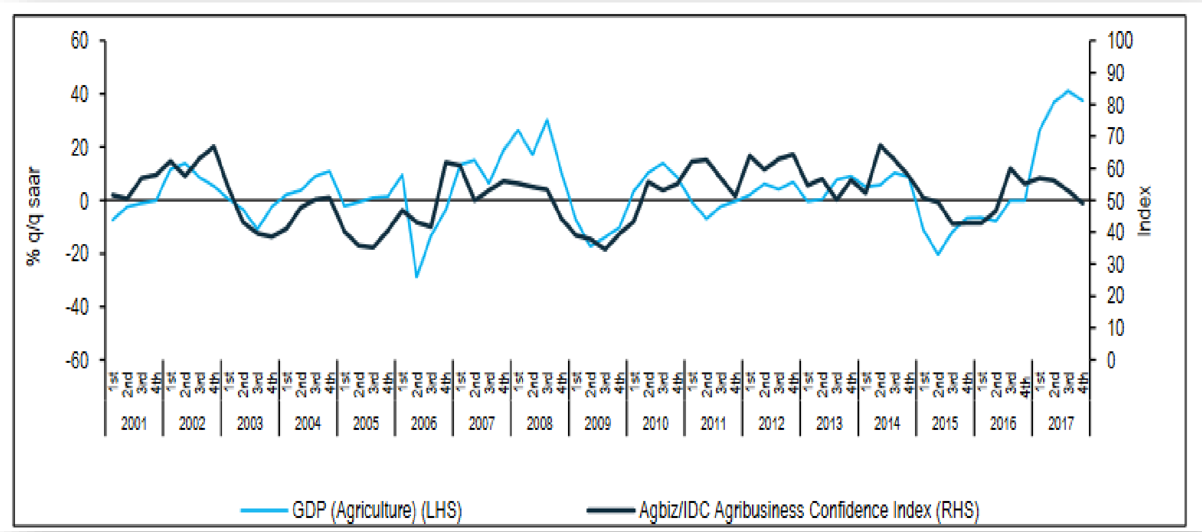
SA growth regime shift

Local

The local economy continued its quarterly expansion with a seasonally adjusted annualised rate of 3.1% vs. 2.3% in the third quarter of 2017. Annual year on year growth for 2017 was recorded at 1.5% year on year, well ahead of consensus of 0.9%. The main contributing sectors of the better than expected number was agriculture due to the recovery following the drought and surprisingly manufacturing. The South African Agriculture economy grew by a staggering 17.7% in 2017.

SA Agriculture GDP vs. Agribusiness Confidence Index



Source: AGBIZ: Agricultural Business Chamber

Following the regime change, as expected, business confidence has risen sharply with the index rising to 45 in the fourth quarter of 2017 and also captures the sharp subsidence in perceived political and policy uncertainty. The SONA and Budget that followed shortly after was also seen to do just enough to stave off the immediate threat of a downgrade by Moody's which subsequently kept the country's rating at investment grade as expected but with a more positive outlook Moody's downgrade.

To quote: *"the recent change in political leadership appears to have halted the gradual erosion of the strength of South Africa's institutions. With changes in governance, a number of key institutions, including the Treasury, the South African Revenue Service (SARS) and key State-Owned Enterprises (SOEs) have embarked on the recovery of their earlier strength."*

SA Business Confidence – highest since "Nenegate"

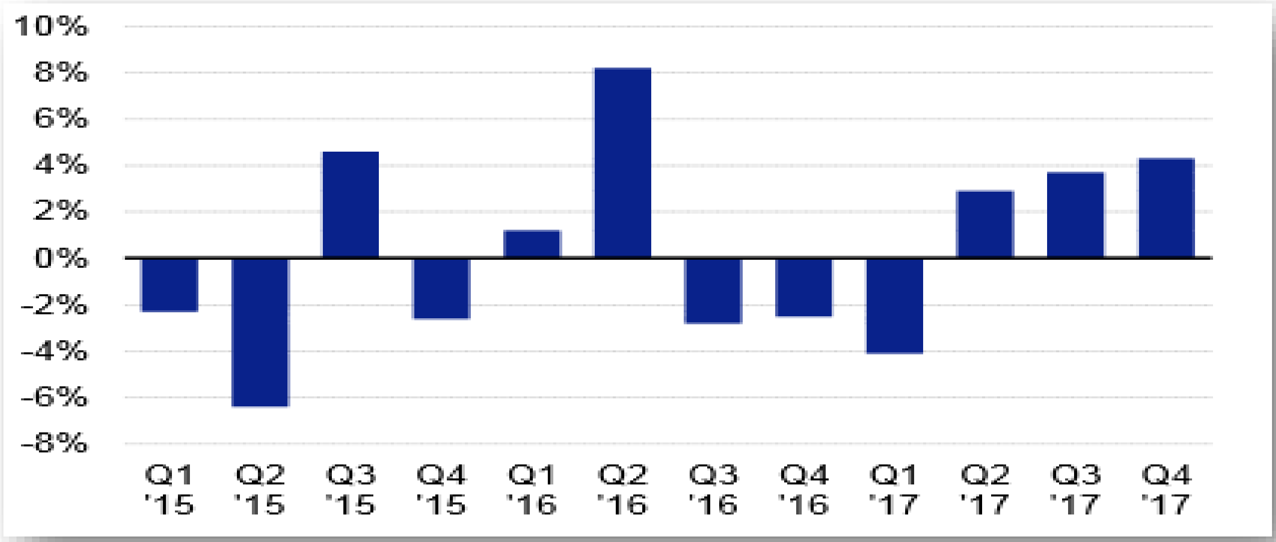
Source: Trading Economics

While the other rating companies will consider the same issues Moody's did when they review South Africa's assessments later this year, Moody's decision won't affect them according to reappointed finance minister Nhlanhla Nene. To quote: *"When they do review us, they will be judging us based on what the situation is then,"* he said. *"If growth begins to take off, if we begin to address structural reforms, then they are also likely to look at us in a positive light."* Standard and Poor is due next on May 25th.

Importantly, Cyril Ramaphosa given his background understands the fact that rising business confidence leads to higher fixed investment and ultimately GDP growth and has therefore announced an Investment Summit in the next couple of months to promote local and foreign investment in SA. Despite the recovery however, confidence is still fragile due to the proposed expropriation of land without compensation and the uncertainty of exactly what will be expropriated.

The combination of a supportive global macro environment, lower inflation and borrowing costs, coupled with the notable change in sentiment will in our view lead to substantial upgrades in local GDP growth forecasts. Economic sectors highly correlated to increased GDP projections include manufacturing, retail and wholesale trade, and finance. Historically, when global growth is strong, the local economy is in a cyclical acceleration. This together with business and consumer confidence having reached an inflection point should bode well for substantial revisions in growth forecasts. We estimate growth of 1.8% year on year in 2018 (0.9% previously) and 3.1% in 2019.

SA manufacturing sector growth – recovery continuing



Source: Avior Capital Markets

We have indicated in previous communications that retailers and financials would likely rerate following the regime change and improved confidence levels which have indeed materialised. The banking index and retail indices increased by 16% and 12% respectively in February following political change largely driven by foreign buyers and view these sectors as fairly valued at current levels.

We expect sectors exposed to the local economy such as manufacturing and agriculture to outperform industrial rand hedge shares on a 12m view. We also favour selected resource counters (despite a strong ZAR) given the favourable global economic backdrop accompanied by a weaker USD due to Trump's potential trade war with China in particular.

We anticipate a total return of 15% for the JSE All Share Index on a 12m view based on local margin expansion and a cyclical recovery in profits of SA Inc. stocks.

Abroad

Signs of US inflation have been subdued throughout this cycle mainly due to the fact that food and energy prices have been in a deflationary spiral. Furthermore, despite the unemployment rate below 5%, wage growth has been more or less stagnant. However, we have witnessed a pick-up in inflation lately due to rising materials, labour and freight costs which are needed to sustain the returns from equity markets.

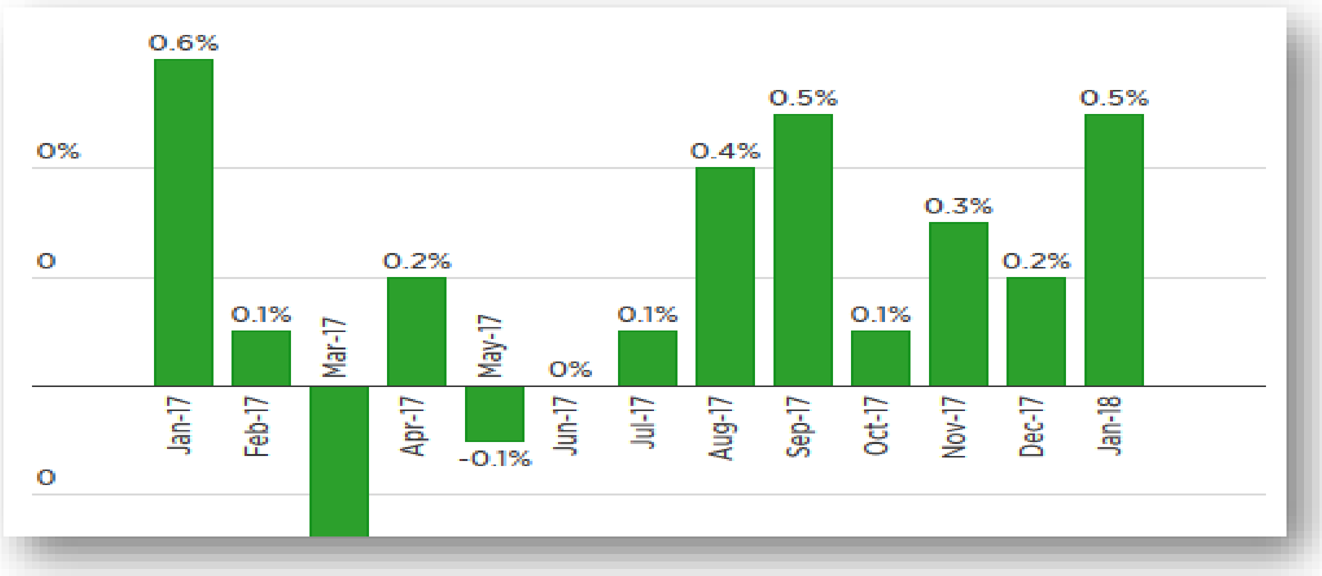
U.S. consumer prices rose considerably more than expected in January, fuelling fears that inflation is about to turn dangerously higher. The Consumer Price Index rose 0.5 percent last month against projections of a 0.3 percent increase, the Labour Department reported. Excluding volatile food and energy prices, the index was up 0.3 percent against estimates of 0.2 percent.

The report indicated that price pressures were broad-based, with rises in gasoline, shelter, clothing, medical care and food.

Markets reacted sharply to the news with the Dow Jones correcting by 10% due to fears that rates in the US might go up more aggressively than expected. Investors began to price in the likelihood that the Federal Reserve will raise interest rates at least three times this year. The worry of the markets is not that inflation is becoming a big problem, it is that the Fed is now forced to play catch up at the same time they are shrinking their balance sheet.

The consensus view on Wall Street has been that the quadrupling of the Fed's balance sheet and prolonged period of very low interest rates have greatly contributed to high equity and bond valuations. Following the correction in markets, equity markets valuations appear more palatable at current levels and we view this as a temporary setback due to earnings projections being revised upwards due to a strong economic recovery in the US which we believe will continue.

US Consumer Price Index

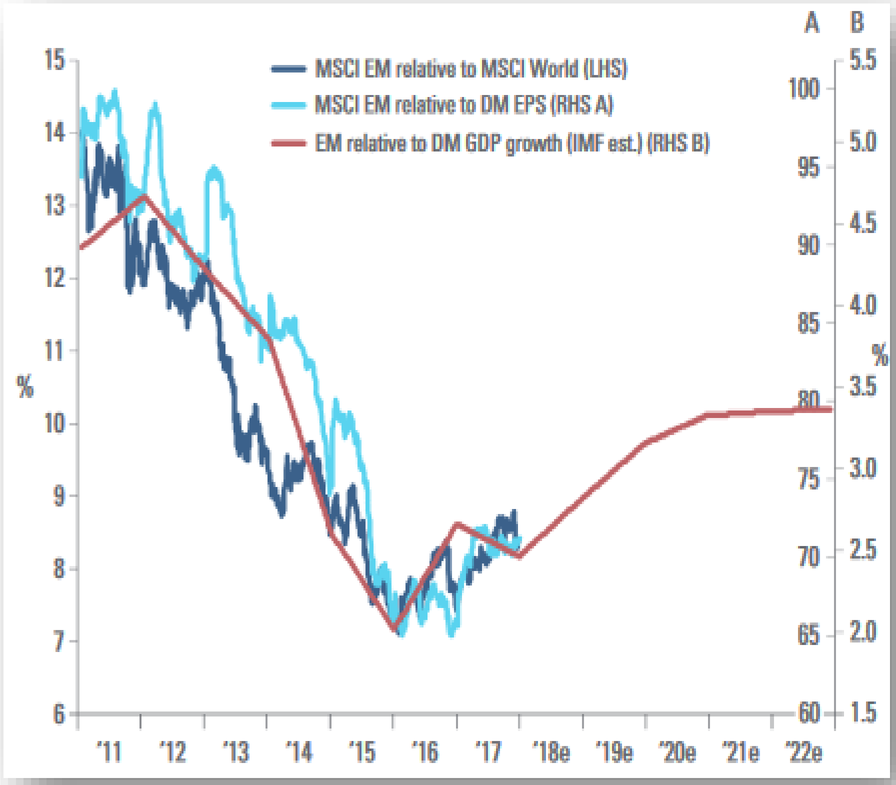


Source: CNBC/US Bureau of Labour Statistics

When it comes to the global economy, the threat of storm clouds always seems to be hovering overhead. But heading into 2018, investors can see blue skies just about everywhere they look. From reduced political tensions in Europe to reform initiatives in emerging markets. Emerging market economies are expected to expand at more than double the pace of developed markets, the widening growth premium is providing an attractive backdrop for both equity and credit investors. The drivers behind EM's growth include both macro and micro factors. According to Goldman Sachs, not only are EM countries in stronger fiscal shape — many countries are running current account surpluses —but investors also have access to deeper and more diversified financial markets.

We maintain the view that China is not heading into a hard landing scenario and will continue to be a key growth driver for global growth. China's drive to deleverage will likely continue and should have a limited negative impact on growth. We expect the process to be gradual and policymakers will adjust accordingly if growth slows too much or if market conditions change.

Emerging Markets GDP growth and equity performance projections



Source: Ashmore Group Equity Outlook January 2018

The primary risk to our positive emerging market view is the ability for developed world central banks to unwind quantitative easing without triggering economic and stock market dislocation. So far, the process has been facilitated by weak inflationary pressure and a supportive global backdrop. Measures to normalise policy are being driven by the desire to replenish policy tools to respond to future economic challenges and are not in response to runaway growth and/or inflationary pressure. The gradual pace of developed world monetary policy normalisation should not prevent still ample global liquidity supporting "risk assets" such as emerging market equity and bond markets.

To Conclude

- Following the regime change, as expected, business confidence has risen sharply with the index rising to 45 in the fourth quarter of 2017 and also captures the sharp subsidence in perceived political and policy uncertainty
- The local economy continued its quarterly expansion with a seasonally adjusted annualised rate of 3.1% vs. 2.3% in the third quarter of 2017
- Moody's subsequently kept the country's rating at investment grade as expected but with a more positive outlook
- The combination of a supportive global macro environment, lower inflation and borrowing costs, coupled with the notable change in sentiment will in our view lead to substantial upgrades in local GDP growth forecasts
- We expect sectors exposed to the local economy such as manufacturing and agriculture to outperform industrial rand hedge shares on a 12m view
- we have witnessed a pick-up in US inflation lately due to rising materials, labour and freight costs which are needed to sustain the returns from equity markets
- Markets reacted sharply to the news with the Dow Jones correcting by 10% due to fears that rates in the US might go up more aggressively than expected
- We maintain the view that China is not heading into a hard landing scenario and will continue to be a key growth driver for global growth
- The primary risk to our positive emerging market view is the ability for developed world central banks to unwind quantitative easing without triggering economic and stock market dislocation

Sincerely

Chris

Chris Botha

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