IMARA
Asset Management SA

Communiqué

Monthly
South Africa
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US Dollar to drive asset returns

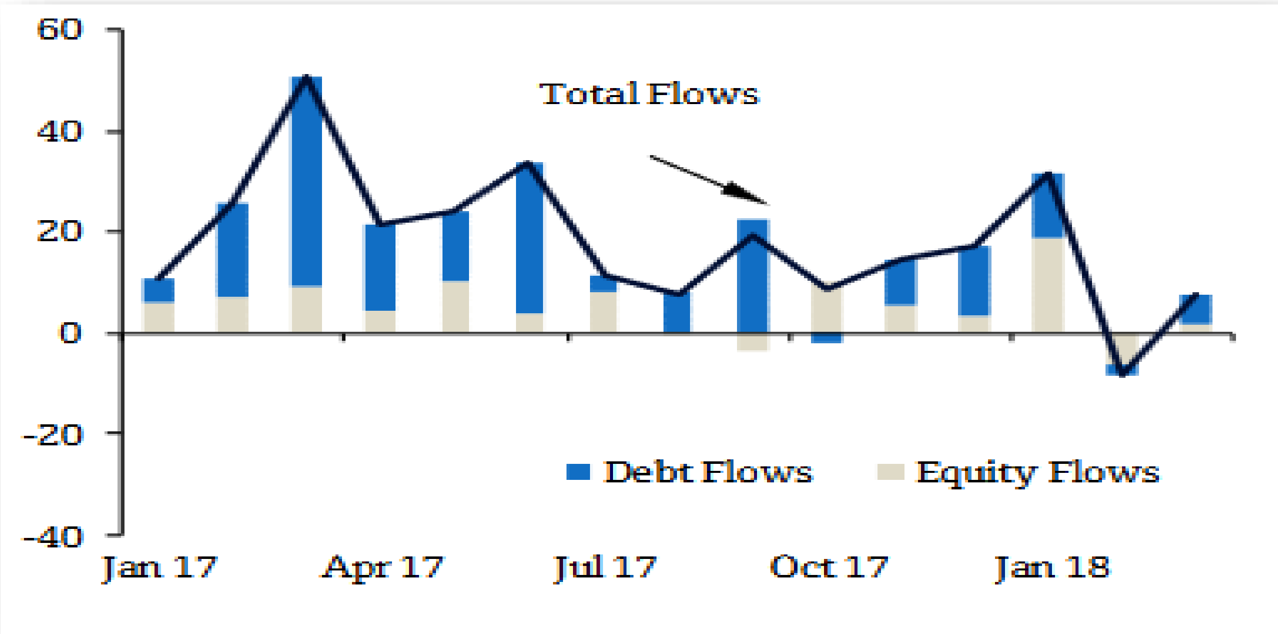
Local

The rand has mostly reacted on global market events of late due to the absence of negative market moving events in South Africa. The rand reached a high of R12.89 against the dollar during the course of the month accompanied by a marked emerging market sell-off by foreign investors.

Foreign investors have been net sellers of local assets to the tune of R43.7bn in May compared to net purchases of R32.3bn from January to April this year. The portfolio flow reversal has been witnessed in most emerging market assets driven by a stronger US dollar and the US 10-year treasury yield breaching the 3% mark indicating that investors are expecting US interest rates to rise further this year. The rise in US treasury yields clearly reflects global risk aversion towards emerging markets.

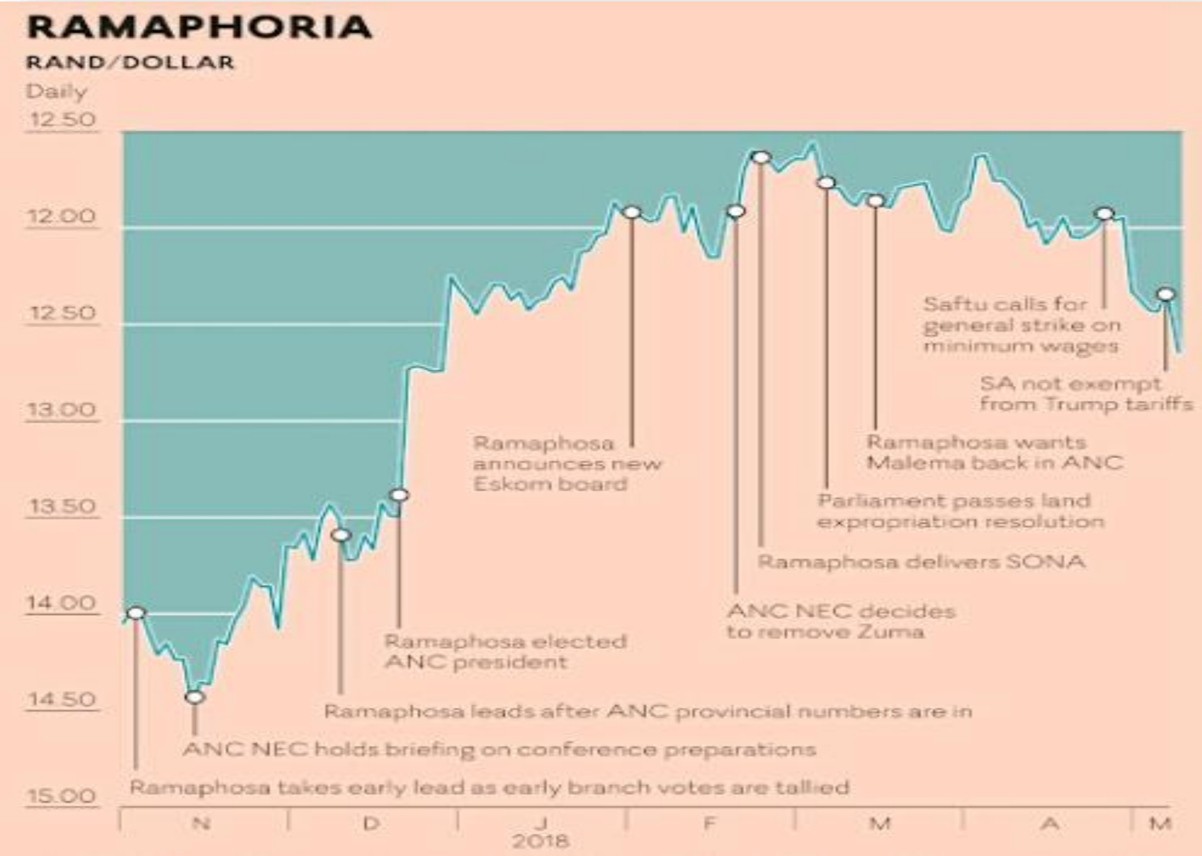
Having said that, South Africa experienced a disproportionally larger outflow due to high liquidity and the waning of the Ramaphosa "effect" earlier in the year.

Emerging markets net capital flows



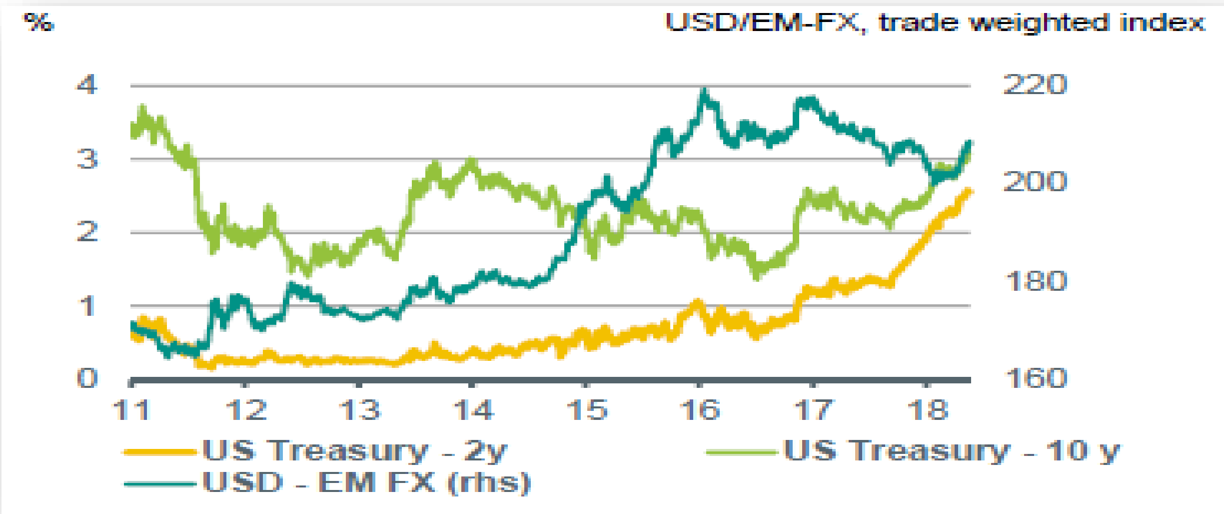
Source: QNB Economics

Ramaphosa effect diminishing



Source: Businesslive

Rising yields and stronger USD drive EM outflows



Source: ABN Amro

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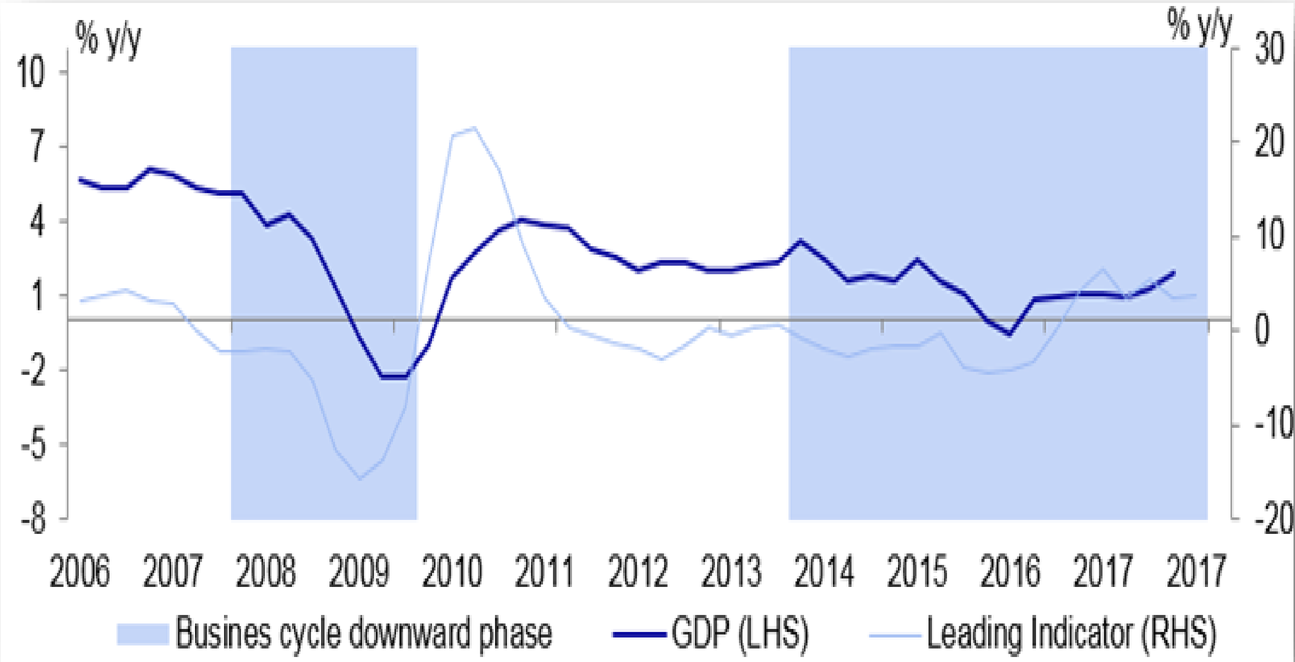
We expect emerging market currencies to remain volatile due to a reflationary environment particularly in developed markets. Higher US interest rates are likely to stimulate further inflows into the US and portfolio outflows from emerging markets due to rising global inflationary pressures in developed markets. In this environment, it is difficult to picture further interest rate cuts for South Africa.

On a more positive note, from a business cycle perspective, March's leading indicator jumped significantly in line with big improvements in consumer and business confidence within the local economy. The leading indicator for the first quarter ending March came in at 107.5 – well up from the fourth quarter in 2017 increasing by 6% overall on an annualised basis.

SA GDP vs. leading indicator



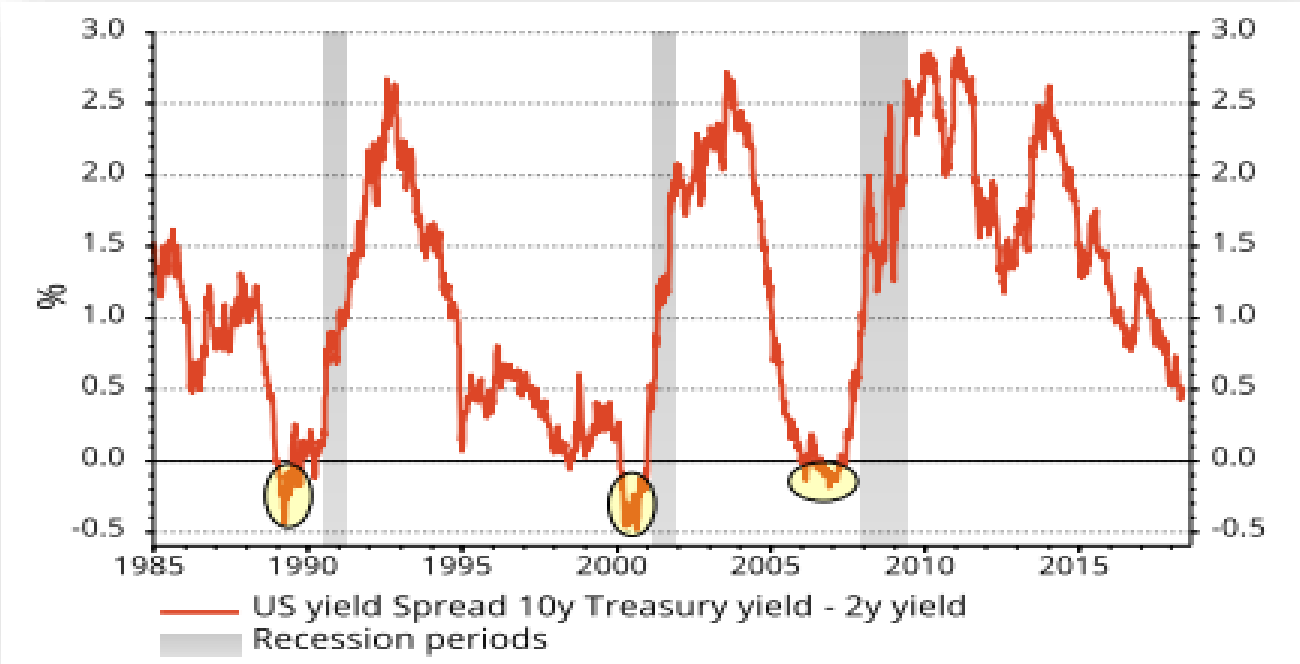
Source: Investec Bank

Looking forward, we expect local economic growth to rise in the second half of the year with a caveat that the improved confidence measures be sustained. A major risk to the sustainability of the above measures is that the methodology for the land expropriation without compensation needs to be resolved.

Abroad

Despite US treasury yields breaching the 3% level, the yield curve (subdued inflationary expectations) has flattened which indicates that markets believe the FED does not need to raise interest rates meaningfully due to rising debt levels and the vulnerability of emerging markets due to a stronger dollar. The decreasing differential between US long term and short-term interest rates (flattening) is expected to persist for some time. It's important to note that if the yield curve becomes inverted (short rates higher than long rates) this will indicate that fears of deflation have increased which could be the early signs of a potential recession in the economy with a typical 1-2-year time lag. We are however not foreseeing this to be a risk in the near term.

Negative US yield curve often a good indicator of a pending recession



Source: RCR Research

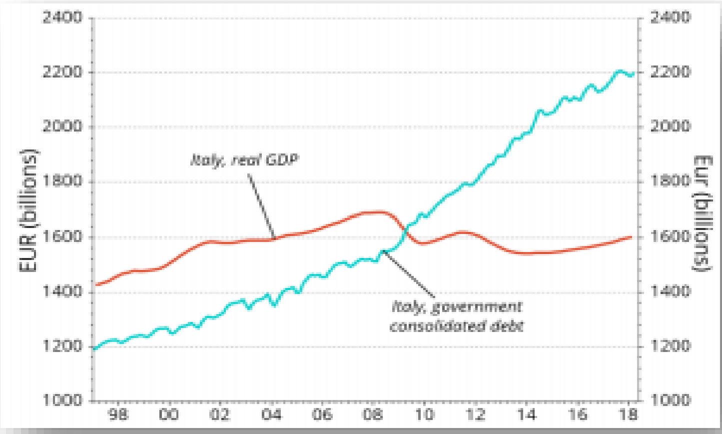
One important reason we thick that the risk of deflation is low, is the rapidly rising oil price due to escalating tensions in the Middle East following the cancellation of the Iran deal by the US. However, higher oil prices have on occasion led to recessions in the past so it's not an insignificant risk. Having said that though, a considerable smaller proportion of western economies' money is spent on oil these days.

It's likely that the FED will take a more dovish stance in the near term due to the flattening of the yield curve which will cause the dollar to weaken. This should benefit company profits which will support the somewhat elevated valuations on the S&P 500. We anticipate that the current trade wrangles between the US and China are unlikely to escalate which will provide further support to markets. Both the US and China have strong cards in the trade battle.

In Europe, economic growth will likely continue to be sufficient for the ECB to terminate its bond-purchasing programme altogether towards the end of this year and start hiking interest rates in the second quarter of 2019. Inflation in the Eurozone remains very low despite heightened economic activity but once full capacity utilisation is achieved (expected by year end) inflation could perhaps rise more rapidly than markets are discounting, particularly in Germany.

However, mounting tensions in the region mainly caused by developments in Italy, could potentially limit the pace of rate increases. This will likely be supportive of German bonds as a "safe haven" and cause the dollar to continue to strengthen.

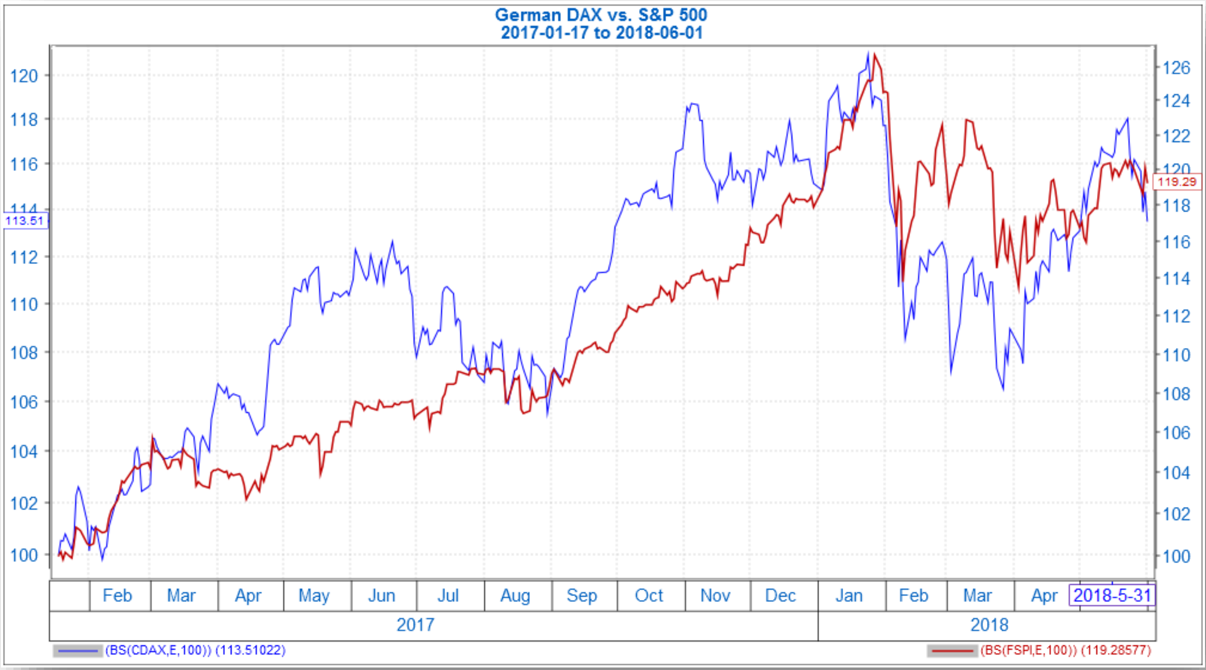
Italian debt – alarm bells ringing



Source: ECR Research

We expect European shares to continue to outperform the US due to the ECB's loose monetary policy and hence weaker euro which will benefit their large export base.

German DAX (Blue) vs. S&P 500 (Red) - German stocks started outperforming in April; strong dollar supported S&P YTD



Source: Iress/Imara

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To Conclude

- The rand reached a high of R12.89 against the dollar during the course of the month accompanied by a marked emerging market sell-off by foreign investors
- The portfolio flow reversal has been witnessed in most emerging market assets driven by a stronger US dollar and the US 10-year treasury yield breaching the 3% mark
- South Africa experienced a disproportionally larger outflow due to high liquidity and the waning of the Ramaphosa "effect" earlier in the year
- March's leading indicator jumped significantly in line with big improvements in consumer and business confidence within the local economy
- we expect local economic growth to rise in the second half of the year with a caveat that the improved confidence measures be sustained
- Despite US treasury yields breaching the 3% level, the yield curve has flattened which indicates that markets believe the FED does not need to raise interest rates meaningfully
- In Europe, economic growth will likely continue to be sufficient for the ECB to terminate its bond-purchasing programme altogether towards the end of this year and start hiking interest rates in the second quarter of 2019
- Mounting tensions in the region mainly caused by developments in Italy, could potentially limit the pace of rate increases in Europe

Sincerely

Chris

Chris Botha