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Asset Management

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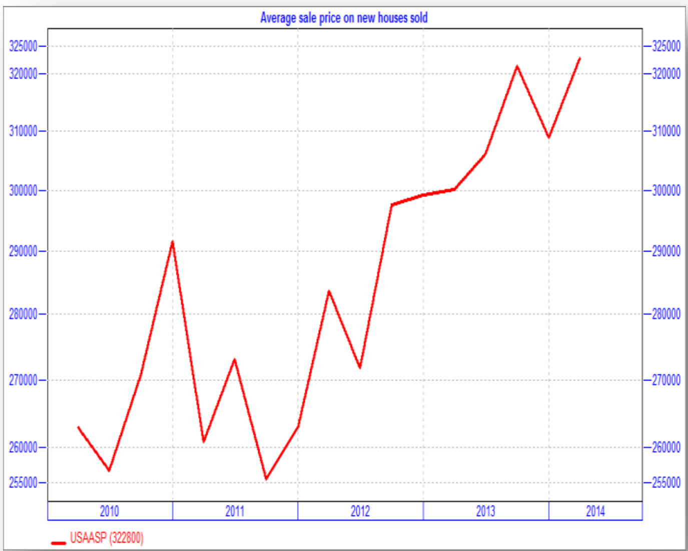
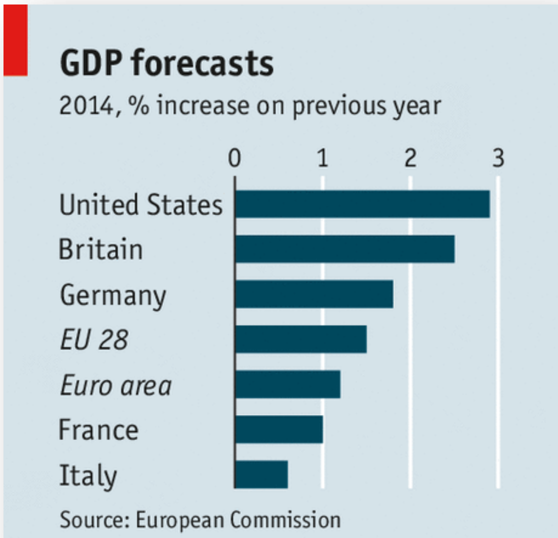
Disinflationary recovery

International

The major theme of a synchronised economic recovery in developed markets remains very much in play. Economic growth in the US in particular seems to be gaining momentum as household balance sheets continue to improve due to rising house prices and a buoyant equity market. Over the past year, house prices have increased by 10% and the equity market by 15%. Consumer confidence and spending have also showed a marked improvement. This stronger economic activity is allowing the Fed to continue reducing purchases of government bonds and it is expected that tapering will gain momentum, but that interest rates should remain low for quite some time, as the recovery is accompanied by very little evidence of rising inflation.





Source: The Economist March 1st 2014

In the Eurozone, the economic growth outlook has stabilised with continuing signs of a slow recovery accompanied by no inflation, in fact, we remain concerned that deflation could still be a risk factor and expect central bankers in this region to remain accommodative in terms of stimulus if need be. Recent manufacturing data in the region surprised on the upside and consumer confidence seems to be improving.

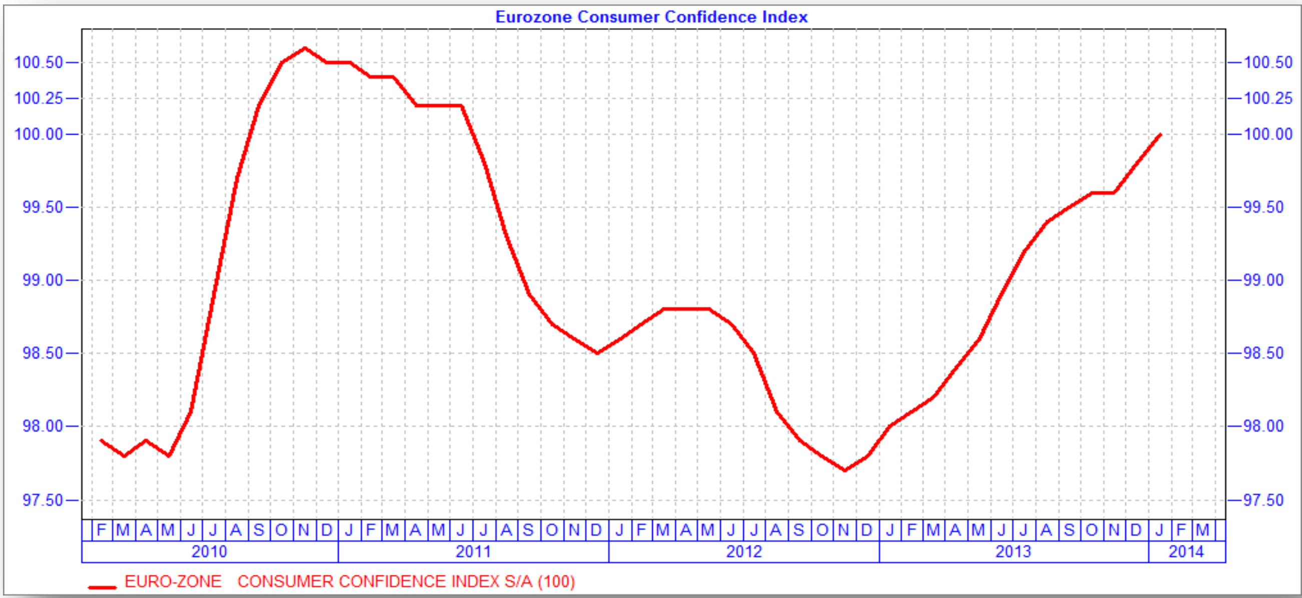
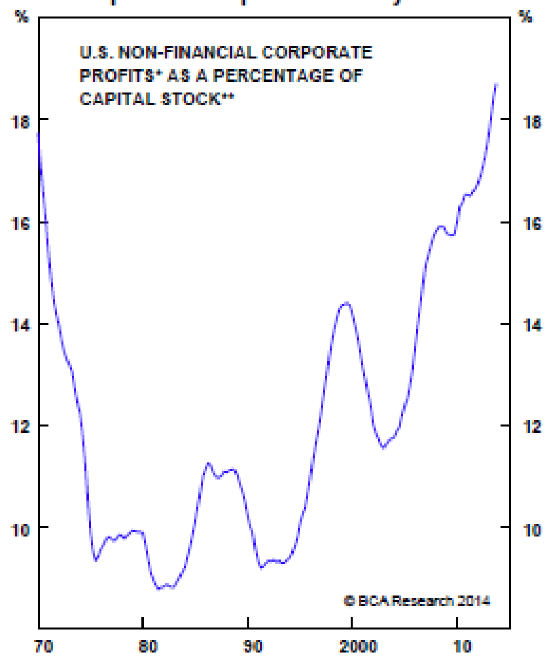


CHART 4
A Steep Rise In Capital Efficiency



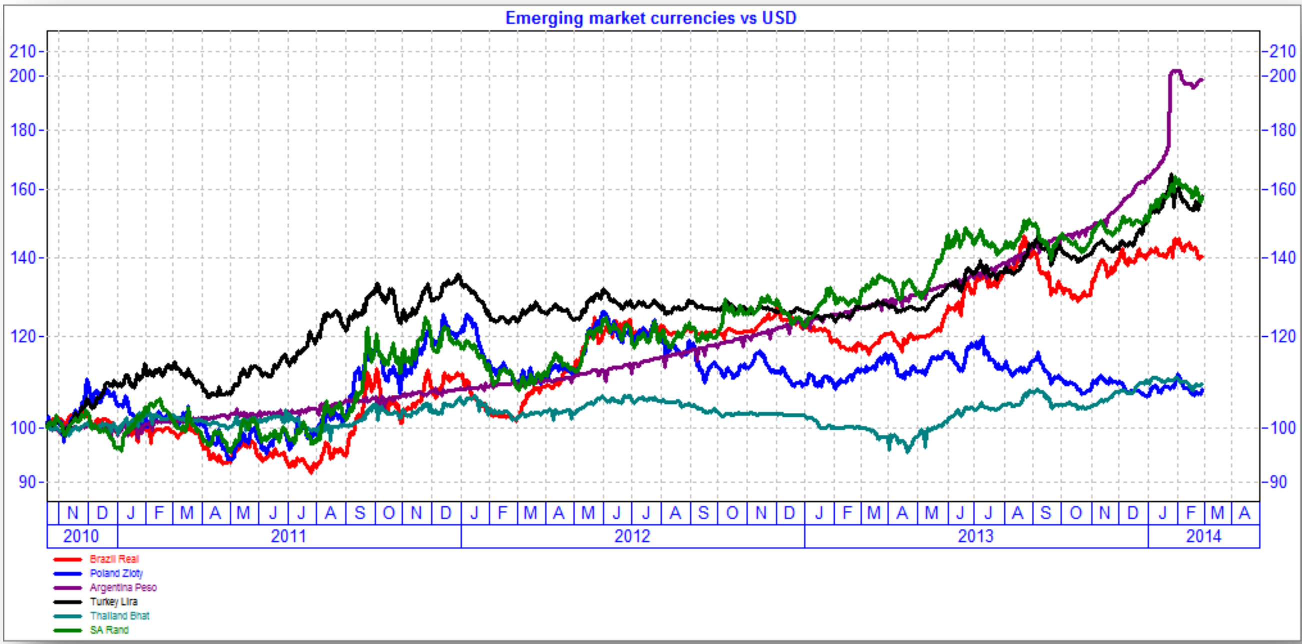
* SHOWN AFTER TAXES. SOURCE: BEA. SHOWN AS A 5-YEAR MOVING AVERAGE.
** SHOWN FOR BUSINESS EQUIPMENT AND SOFTWARE ASSETS.

Source: BCA Research Note 14 February 2014

Despite all these positive factors, saving rates globally remain at elevated levels accompanied by very little direct investment, hence the disinflationary recovery. This is leading to a steady erosion of pricing power in the corporate sector but operating margins and profits are at record levels in the US. This has mainly been achieved by not increasing payroll expenses hence the sticky unemployment level of just over 6% which further supports our argument for low interest rates in the US for some time still. Another reason for the lack of investment might also be increasing technological innovation and therefore higher productivity rates which is likely to support the current high operating margins, which should lead to upgrades in earnings expectations in due course.

Despite high valuations, we expect improving profits to support stock market ratings with the main risks remaining a faltering global economic recovery and a potential emerging market crisis.

As expected and mentioned in previous Communiqués, the actions by the FED and rising yields in the US have caused large outflows of investments in emerging markets; witnessed in material currency devaluations and rising interest rates across the board in an attempt to protect currencies. It can be seen in this chart that there is a particularly high correlation between South Africa, Brazil and Turkey.



Emerging markets need to restructure their economies in order to be less dependent on foreign funding of their trade deficits. These markets have performed very well over the last couple of years in terms of both economic growth (lead by private consumption) and stock market performance. A growing middle class and strong consumer expenditure have generally caused heightened inflation and in some cases resulted in people living beyond their means. It can therefore be argued that interest rates were and are (in some cases) still too high.

When the foreign funding dried up, rates had to go up to curb inflation and currency weakness. This leads to the question whether we are destined for an emerging market crisis in terms of countries not being able to service foreign debt obligations due to a collapse in their currency valuations and a looming banking crisis as seen in the late 1990's. The short answer is not likely. Most emerging market countries have very little foreign debt compared to the previous crises period and although most are running current account deficits, a weakening currency is in fact positive as exports will increase and imports decrease due to rising interest rates and slowing consumer expenditure.

We therefore view the recent sell-off in emerging market assets as probably a once-off, but the major risk remains a material slowdown in the Chinese economy which may cause a further negative ripple effect in emerging market currencies and assets. We however do not foresee this as China needs to grow by at least 7% in order to maintain labour market stability. We expect authorities to provide stimulus if needed to maintain the current growth path.

Despite emerging markets being out of favour at present, we reiterate that urbanisation and growth of the emerging middle class will remain important drivers of global growth in future, aided by young populations and faster economic activity than in developed markets, which are suffering from aging populations and declining population growth (mainly Europe). The chart below indicates the expected growth in the middle class as a percentage of global population per region.

Table 1

The middle class: size and distribution

(millions of people, global share)

	2009		2020		2030	
North America	338	18%	333	10%	322	7%
Europe	664	36%	703	22%	680	14%
Central and South America	181	10%	251	8%	313	6%
Asia-Pacific	525	28%	1,740	54%	3,228	66%
Sub-Saharan Africa	32	2%	57	2%	107	2%
Middle East and North Africa	105	6%	165	5%	234	5%
World	1,845	100%	3,249	100%	4,884	100%

Source: IEMS; Kharas and Gertz, 2010.

Source: Ernst & Young : Hitting the sweet spot

South Africa

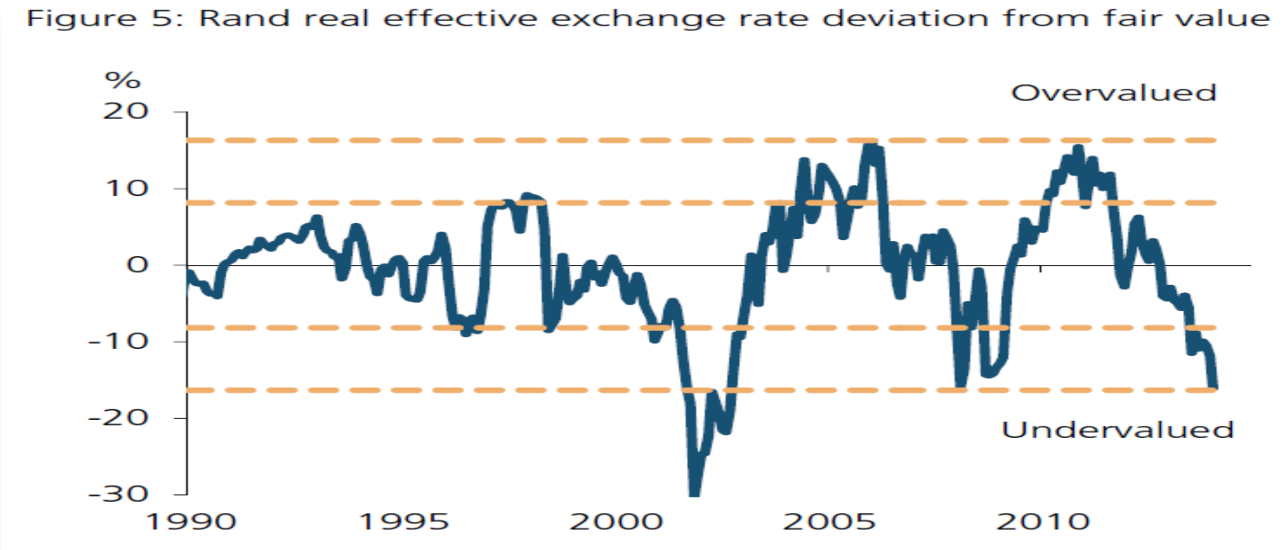
First things first, Pravin Gordhan's budget speech was really a non-event as far as markets were concerned, focusing on the usual themes of job creation, increasing the pace of economic growth and tax relief for the poor. Looming, sizable infrastructure spend was again mentioned (now for many years) but the implementation thereof ,in our view, is still questionable.

After weakening alongside other emerging market currencies (Turkish Lira in particular) the Rand staged somewhat of a comeback after reaching an all-time low of R11.40/US$ and was trading at R10.79 at the time of writing. The sell-off initially had a negative impact on our equity market but share prices have regained all the losses incurred at end January with the JSE All Share staging a 4.5% recovery in February reaching another all-time high towards the latter part of the month.

Current valuations are heady but we expect a fairly robust upcoming reporting (helped by the weaker rand) season which will help multiples to contract to more reasonable levels. We caution however that volatility will be the order of the day for this year as global markets come to terms with Fed policy and resultant uncertainty around emerging markets. We are likely to use market weakness as a buying opportunity to add to high quality stocks as medium to long term underlying fundamentals remain sound.

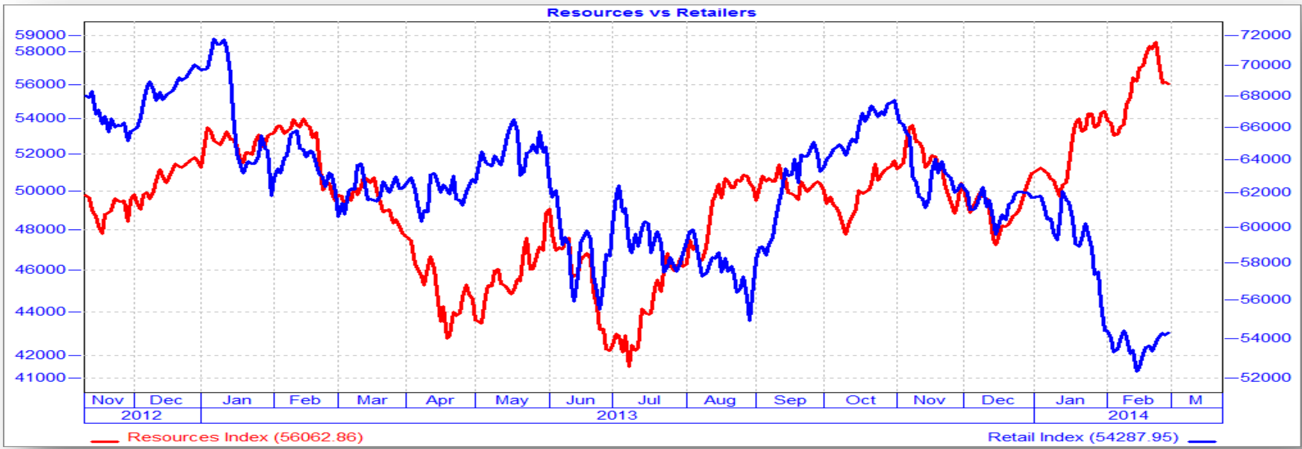
On the economic front, retail sales slightly surprised on the upside, rising by 3.5% year on year in December 2013, up 1.2% quarter on quarter from 0.6% in the previous quarter. Given the recent hike in interest rates and the likelihood of more to come, we don't think this trend will be sustainable, or is actually necessary! The latest rate hike does not imply an aggressive change in the local interest rate cycle as the reasoning behind the move was a pre-emptive measure to stabilise the currency and inflationary expectations.

Consumer price inflation increased by 5.8% in January from 5.4% in December, mainly due to the 39c/l increase in fuel and food prices. With the currency stabilising around current levels and relatively weak expected GDP growth (consensus +2.8% in 2014), it is unlikely that inflation will surprise on the upside alleviating pressure to aggressively hiking interest rates. But the Rand will remain the swing factor. A severe weakening could see the SARB act in a more aggressive manner. The problem area for the Rand remains our current account deficit, which buys us a membership pass into the Fragile 5 Club (India, Brazil, Indonesia, Turkey and South Africa). However, it is highly likely that the deficit will decrease as the weak Rand stimulates export receipts. The global economic recovery should also support our exports both in terms of value and volumes and given the precarious state of SA consumers, imports are likely to level off somewhat.



Source: RMB Global Markets Research 6th February 2014

Investment wise, the two major trends have been weakness in retails shares and strength in resource counters (the weakening Rand at play). Retail shares were impacted by large foreign selling as investors exited emerging markets and also the perception that we are entering a rising local interest rate cycle.



We remain of the opinion that the global backdrop remains supportive of sector rotation into resource counters but that the index appears overbought on a short term view. Industrial counters also appear expensive, particularly Rand hedges. However, given the weaker currency, it is unlikely that these counters will experience a severe pullback as earnings in Rand terms ought to be stellar.

In conclusion:

- The major theme of a synchronised economic recovery in developed markets remains very much in play.
- Stronger economic activity in the US is allowing the Fed to continue reducing purchases of government bonds and it is expected that tapering will gain momentum.
- We expect that interest rates in developed economies will remain low for quite some time as the recovery is accompanied by very little evidence of rising inflation.
- Deflation, particularly in Europe, remains a risk and we expect the ECB to remain accommodative in terms of stimulus.
- Despite heady valuations, we anticipate improving profits to support stock market valuations with the main risks remaining a faltering global economic recovery and a potential emerging market crisis.
- Although emerging markets are out of favour at present, we need to reiterate that urbanisation and growth of the middle class will remain important drivers of global growth in future, aided by young populations and faster economic growth than in developed markets.
- Locally, the budget speech was really a non-event as far as the market was concerned, focusing on the usual themes of job creation, increasing the pace of economic growth and tax relief for the poor.
- After weakening alongside other emerging market currencies(Turkish Lira in particular) the Rand has staged somewhat of a comeback from its low of R11.40/ US$, when investors exited emerging markets due to fears of widening current account deficits and political turmoil. .
- It is likely that our current account deficit will decrease as the weak Rand stimulates exports. The global economic recovery will also support our exports both in terms of value and volumes. Given the worsening financial state of local consumers, imports are likely to level off.
- Two major trends have been weakness in retail shares and strength in resource counters. Retail shares were impacted by large foreign selling as investors exited emerging markets and also the perception that we are entering a rising local interest rate cycle.
- We remain of the opinion that the global backdrop remains supportive of sector rotation into resource counters but that the index appears overbought on a short term view.

Sincerely

Chris Botha

Dave Eliot