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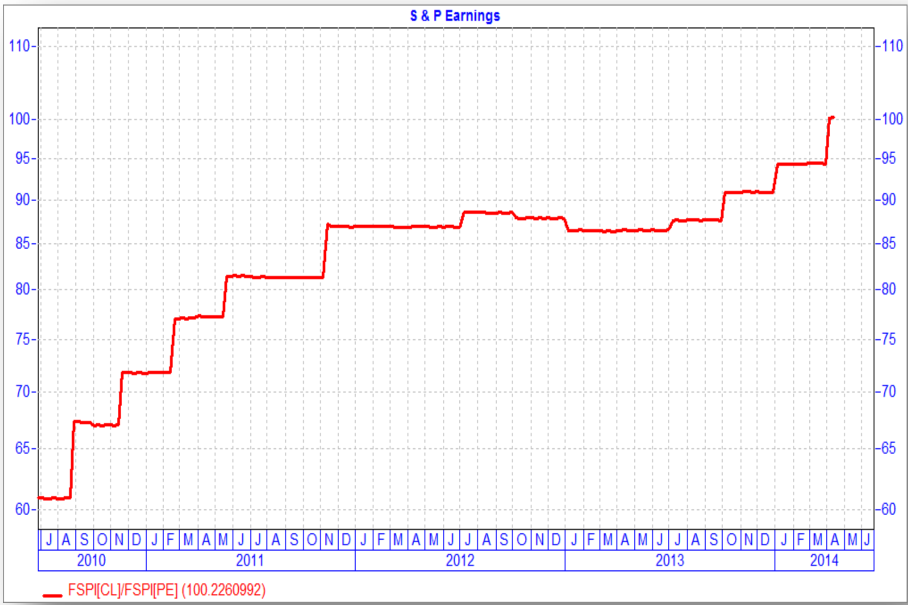
## *Bubble, Bubble toil and trouble*

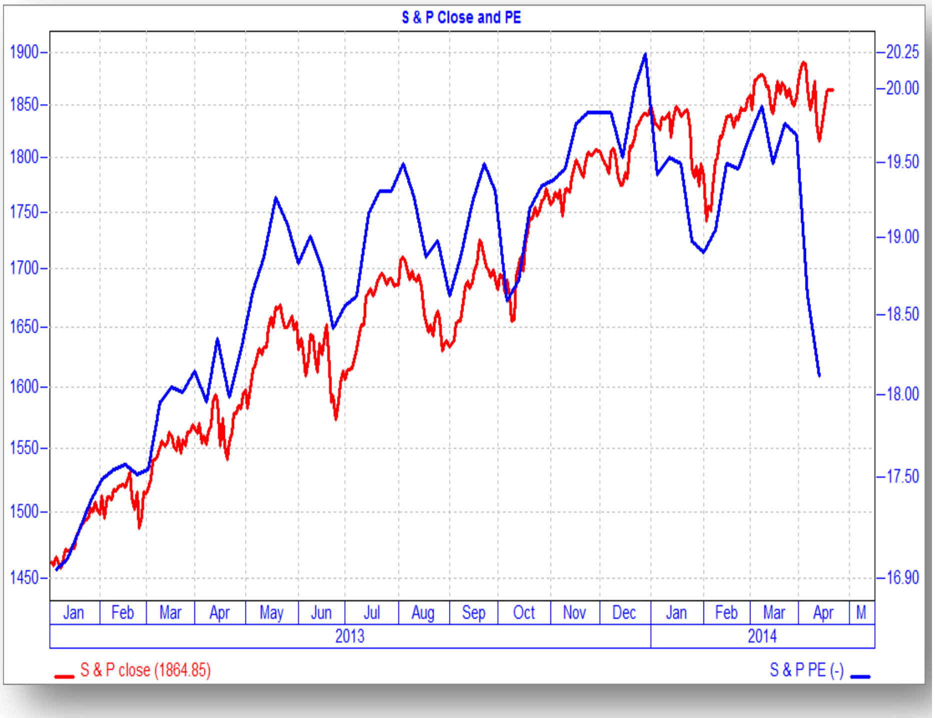
## International

Global equity markets continue to move higher, although with some volatility, supported by reasonably strong earnings growth, particularly in the US. The S & P 500 Composite Index in the US, is up 17% year on year, with a recent average price earnings multiple of 18.1 times; after reaching a high of 20 times in early April 2014.




The decline is mainly due to very supportive earnings growth and continued margin expansion by US corporates driven by sluggish employment data (although improving) and strong momentum in technical innovation. Furthermore, very little evidence of rising inflation is emerging and expectations of interest rates remaining low for some time are further fuelling the rise in equity prices as real yields on income producing assets remain negative in most cases. Slow but positive growth in Europe and continuing growth in China should support US corporate profits. As can be seen in the above chart, US corporate earnings have been steadily increasing since the middle of last year following two years of declining earnings. The trend is likely to be enhanced with a more synchronised global economic recovery.

The big question from an investment point of view is whether the US market is overvalued and if we are entering into an asset bubble scenario. Our view is that we are not and that equity prices will rise further for the reasons mentioned above. However, we expect the ride to be more volatile and that eventually we will enter into bubble territory, but not in the near term. The chart opposite indicates the S & P price earnings ratio and equity prices.




As can be seen in the tables below, forecast economic indicators for the US remain positive with continuing improvement in the job market and GDP growth(stable, no big increase) accompanied by low inflation, in fact, the risk of deflation remains real, especially in Europe, which could have a negative impact on pricing power and corporate earnings.

***Median Forecasts for Selected Variables in the Current and Previous Surveys***

| | Real GDP (%) | | Unemployment Rate (%) | | Payrolls (000s/month) | |
|---|---|---|---|---|---|---|
| | Previous | New | Previous | New | Previous | New |
| | | | | | | *Quarterly Data:* |
| *2014:Q1* | 2.5 | 2.0 | 7.1 | 6.7 | 187.0 | 177.4 |
| *2014:Q2* | 2.9 | 3.0 | 7.0 | 6.6 | 193.5 | 193.5 |
| *2014:Q3* | 2.9 | 2.8 | 6.9 | 6.4 | 201.8 | 195.2 |
| *2014:Q4* | 2.9 | 2.7 | 6.8 | 6.3 | 202.1 | 215.0 |
| *2015:Q1* | N.A. | 3.2 | N.A. | 6.2 | N.A. | 201.0 |
| *Annual Data (projections are based on annual-average levels):* | | | | | | |
| *2014* | 2.6 | 2.8 | 7.0 | 6.5 | 189.9 | 187.7 |
| *2015* | 2.8 | 3.1 | 6.4 | 6.1 | N.A. | 206.9 |
| *2016* | 2.7 | 3.1 | 6.0 | 5.7 | N.A. | N.A. |
| *2017* | N.A. | 2.4 | N.A. | 5.5 | N.A. | N.A. |

*Source: Federal Reserve Bank of Philadelphia*

***Median Short-Run and Long-Run Projections for Inflation (Annualized Percentage Points)***

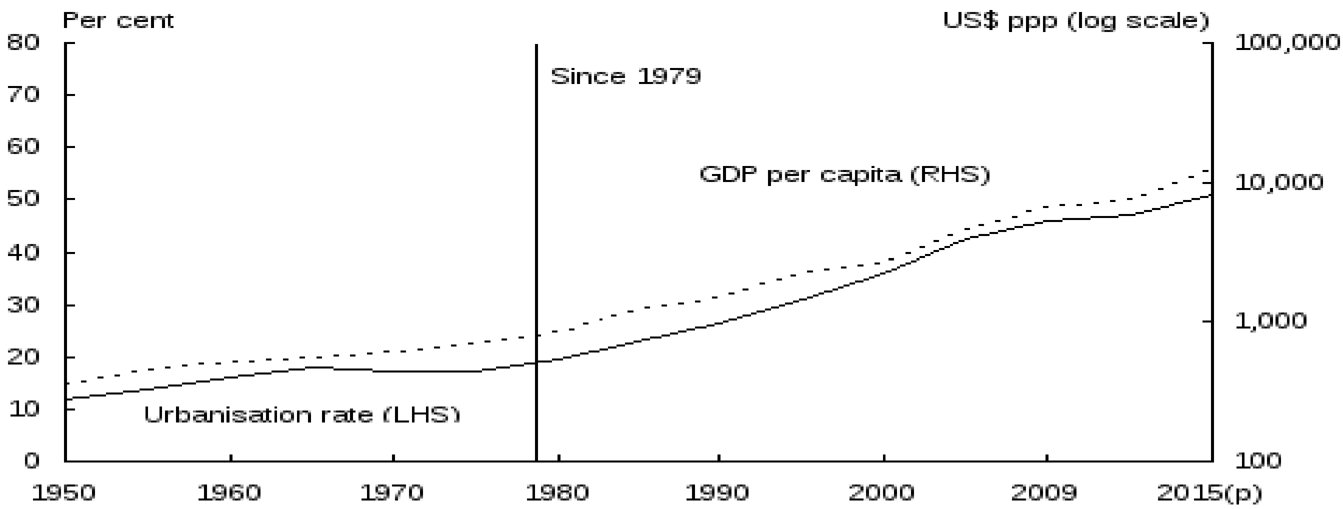
| | Headline CPI | | Core CPI | | Headline PCE | | Core PCE | |
|---|---|---|---|---|---|---|---|---|
| | Previous | Current | Previous | Current | Previous | Current | Previous | Current |
| *Quarterly* | | | | | | | | |
| *2014:Q1* | 1.8 | 1.7 | 1.9 | 1.8 | 1.8 | 1.3 | 1.7 | 1.5 |
| *2014:Q2* | 2.0 | 1.7 | 1.9 | 1.8 | 1.9 | 1.5 | 1.8 | 1.5 |
| *2014:Q3* | 2.0 | 1.9 | 2.0 | 1.9 | 1.9 | 1.7 | 1.7 | 1.6 |
| *2014:Q4* | 2.1 | 2.0 | 2.0 | 1.9 | 1.9 | 1.7 | 1.8 | 1.7 |
| *2015:Q1* | N.A. | 2.0 | N.A. | 2.1 | N.A. | 1.8 | N.A. | 1.8 |
| | | | | | | | | |
| *Q4/Q4 Annual Averages* | | | | | | | | |
| *2014* | 2.0 | 1.8 | 2.0 | 1.9 | 1.9 | 1.6 | 1.7 | 1.6 |
| *2015* | 2.2 | 2.0 | 2.1 | 2.0 | 1.9 | 1.8 | 1.9 | 1.8 |
| *2016* | N.A. | 2.1 | N.A. | 2.1 | N.A. | 2.0 | N.A. | 1.9 |

*Source: Federal Reserve Bank of Philadelphia*

The major swing factor regarding the sustainability of a global synchronised recovery remains China. There is heightened risk that the realignment of their economy from a fixed investment model to a more consumer orientated one could have a negative impact on growth. The latest reported quarterly GDP figure released was that the economy grew by 7.4%, although one basis point better than expected, is still below their 7.5% target.

Chinese Premier Li Keqiang has reiterated that the top priorities for authorities are to maintain job creation and maintain labour market stability and that 7.5% is the minimum growth rate required to obtain this. We therefore don't rule out some form of further fixed investment stimulus in order to accelerate the growth rate if needed. Furthermore, there is a big drive to clean up shanty towns in the larger cities and to accommodate the rising flood of migrants from rural areas. We remain convinced that growth could surprise on the upside and be positive for emerging markets in general.

**Urbanisation and GDP per capita in China**



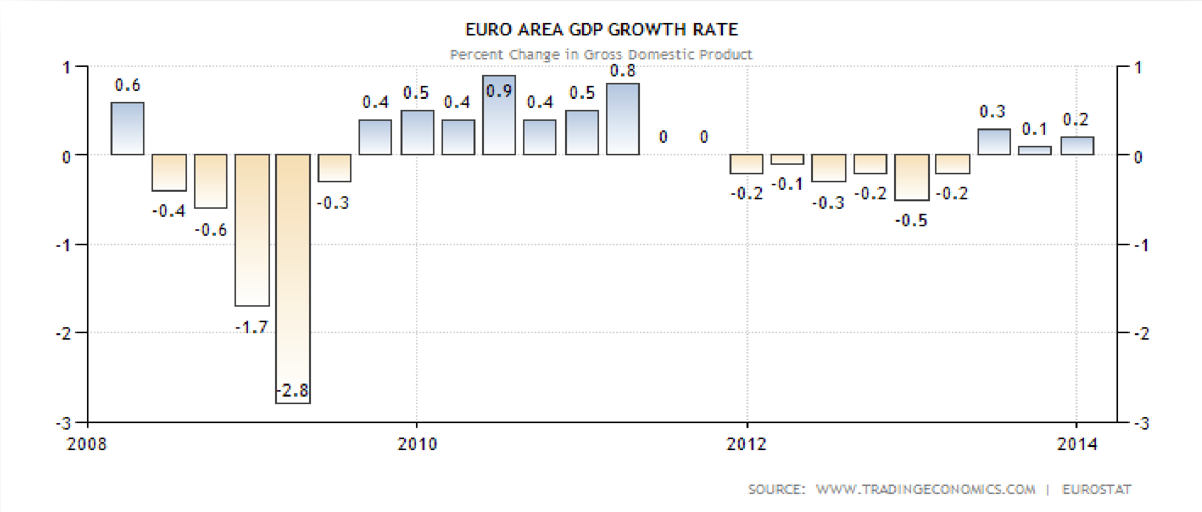

*Source: United Nations, IMF and Australian Treasury.*

In Europe, progress in terms of an economic recovery remains slow and fragile to say the least. As can be seen in the following charts, employment growth remains weak, except in the UK and Germany. More worrisome though is the threat of deflation with most economists expecting inflation to remain below 1% well into 2015. Further stimulus can therefore not be ruled out.

Eurozone Employment Year on Year % change


*Source: Capital IQ*

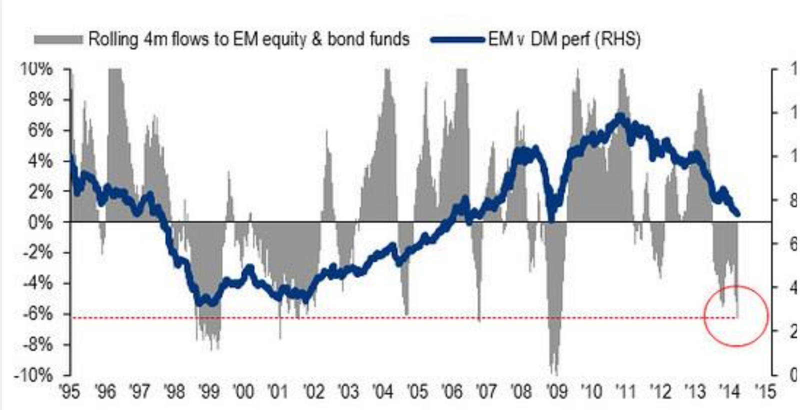
Thus we believe that interest rates both in the US and Europe could remain low for quite some time and continue to be supportive of equities as a preferred asset class.




A more interesting question from our perspective is what about emerging markets as a geographical play, seeing that China could potentially surprise on the upside? Emerging markets and their currencies have staged a strong rebound after a bumpy start to the year because of US tapering fears, expected rate hikes in the US and a stronger dollar. Our view is that the dollar might weaken somewhat in the short term as investors digest the fact that short term interest rates in the US will only possibly start rising in 2015 and that there is no hope for rising rates in the Euro area for a long time as they battle with deflation.

Emerging markets could in the short term attract some international capital into their equity and bond markets- a hunt for yield. However, the longer term picture, see chart alongside, is still showing net outflows since 2013, largely due to the QE tapering announcements and thus rate hike expectations in the developed world. But for reasons mentioned above, we expect a short term rally in emerging markets.

**Inflows into Emerging Market (EM) bonds and equities and EM performance relative to Developed Markets**

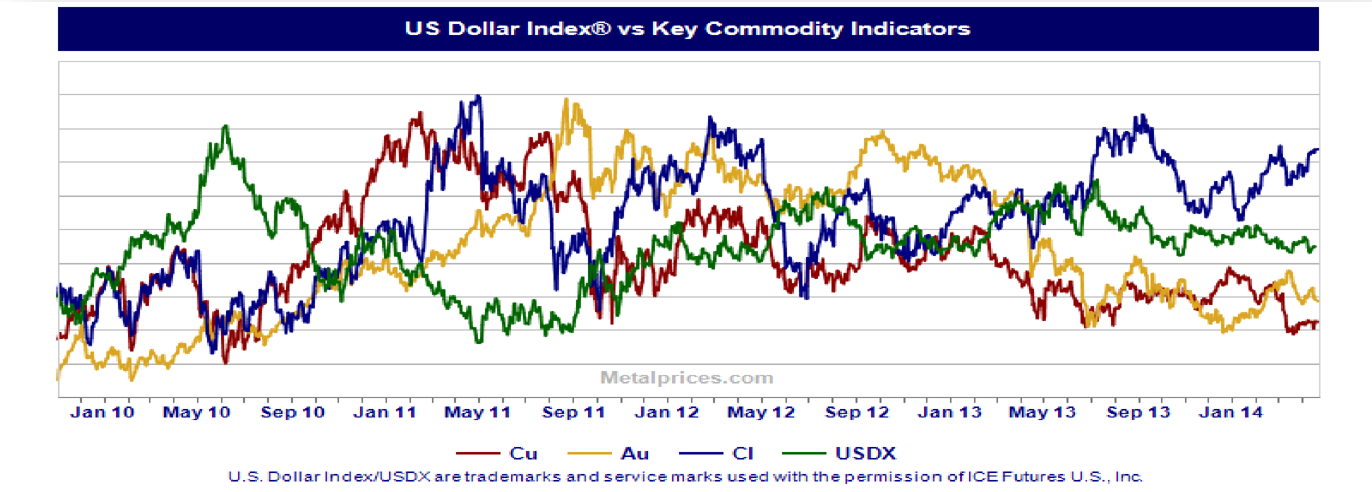



*Source: Market Watch, BofA Merrill Lynch, EPFR Global, Lipper*

International investors are increasingly more savvy in emerging market investing. A distinction is being made in terms of external debt levels and GDP drivers. South Africa is a good case in point, with low foreign debt, adequate foreign reserves and a changing economic model. Services and exposure to the Sub-Saharan consumer is growing at a rapid rate. Services is now the biggest contributor to our GDP (see chart below) and China is now the country's biggest trading partner.

The problem with some emerging markets and commodities (which they produce) is that there remains an apparent oversupply problem particularly in iron ore and other base metals if China does not come to the rescue in terms of growth. However, on the positive side, there is an expectation that some unprofitable high cost and high pollutant iron ore producers and steel mills in China could close which will support spot commodity prices.

The longer term prognosis remains more problematic as the dollar will eventually strengthen as interest rates rise in the US first and then eventually in Europe. The dollar and commodity prices are negatively correlated. See the chart below which indicates the inverse correlation between a Dollar Index (blue line) and prices for copper (red line), crude oil (blue line) and gold (yellow line).

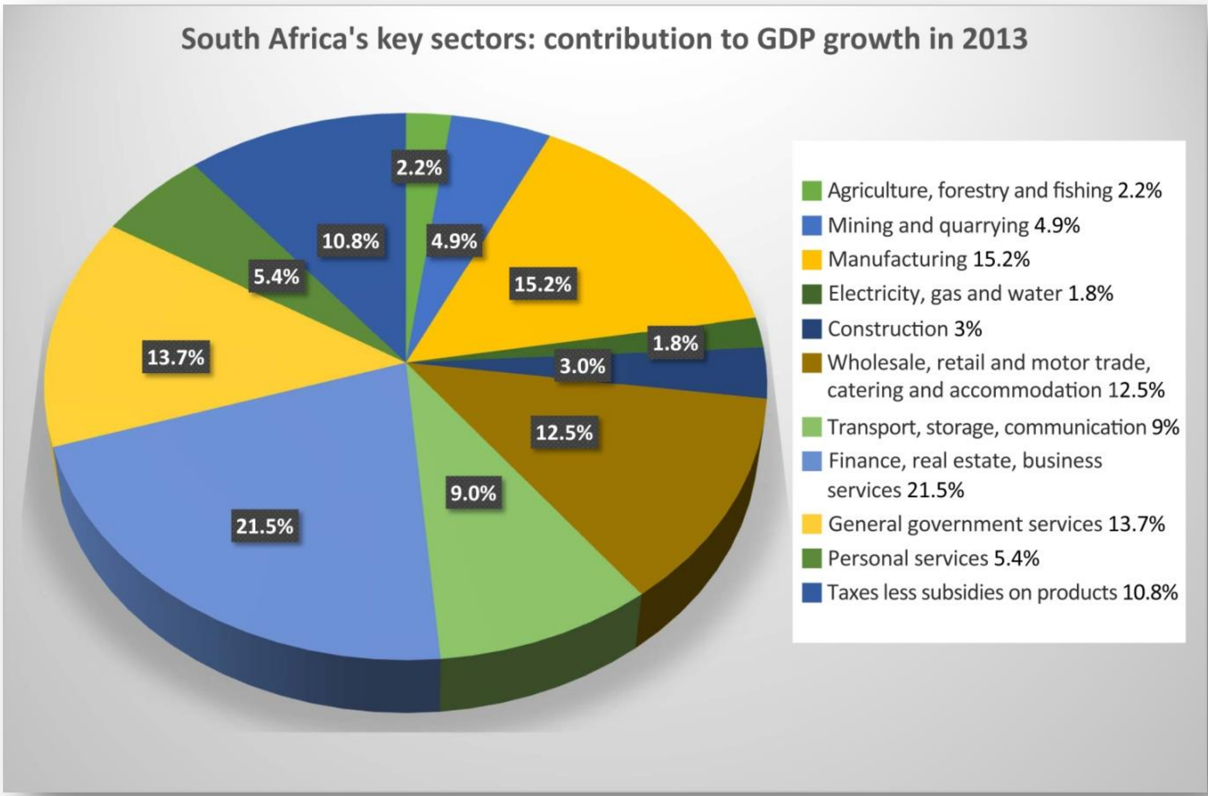



*Source: Metalprices.com*

## South Africa

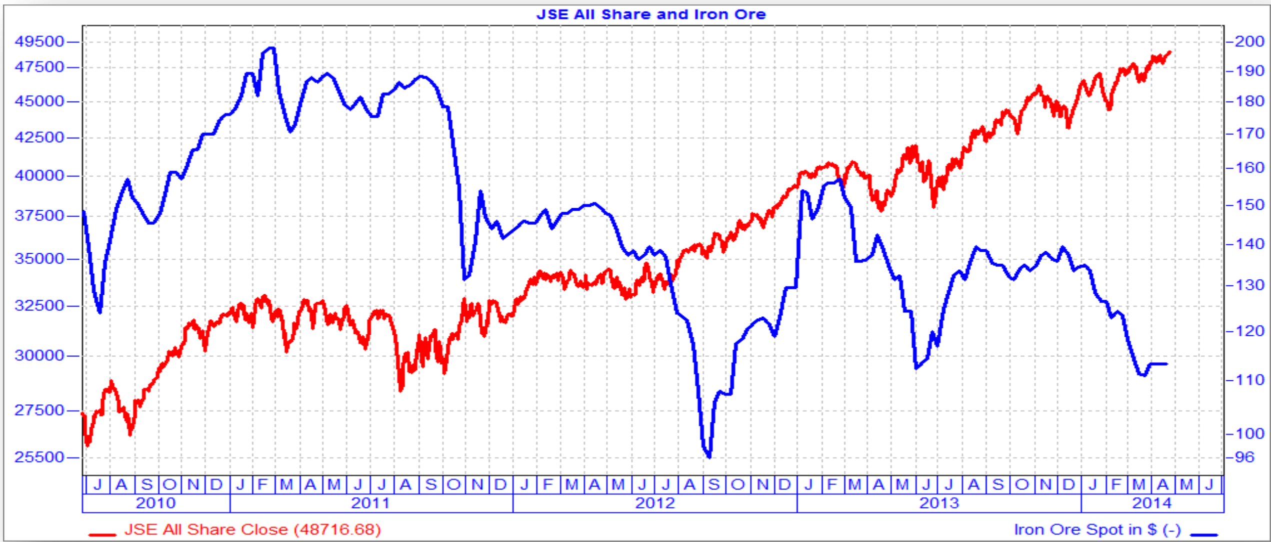
The JSE All Share Index continues to deliver solid returns despite the rand strength relative to the dollar – a function of net foreign buying into our bond and equity markets. The JSE All Share is up 5% year to date and up by 27% year on year. Reported earnings continue to surprise on the high end of company guidance which has caused the market's price earnings multiple to contract to 17x from 18x in the beginning of the year. The forward expected multiple one year out is 14.5x based on 15% earnings growth for the market as a whole which is in line with its long term moving average.

Foreign investment flows into our bonds and equities are likely to continue in the short term due to reasons mentioned above. Headwinds facing commodities might not be that problematic for our market as the SA economy's is steadily changing to a more service orientated one as can be seen in the chart below. Direct mining (hence commodities) is increasingly contributing less to GDP with services contributing the largest portion. However, it's important to note that peripheral activities around mining probably contribute a large portion to the manufacturing cluster. Commodities therefore still play an important part in the economy but is no longer the main driver of GDP and the stock market.

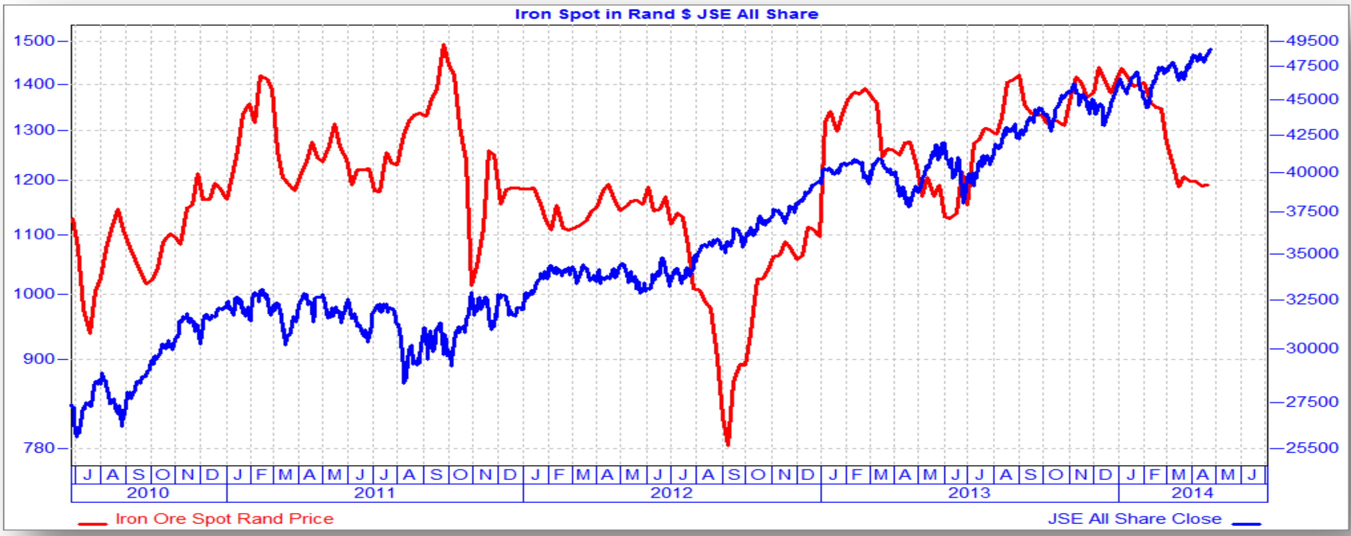



*Source: Media Club SA, Stats SA*

Further evidence that the local equity market is less concerned about commodities can be seen in the following chart which depicts a very low correlation between spot iron ore prices (the most important commodity) in dollar terms and the performance of the JSE All Share Index.



Iron ore in rand terms is more positively correlated with the price performance of the JSE but is still statistically not that significant.




On the local economic front, GDP growth forecasts continue to drift lower with consensus currently standing at 2.6% growth for 2014 and 2.7% for 2015. We remain at 2.5%. It is possible that growth could surprise on the upside if the developed world and China recovers more robustly.

As far as local interest rates go, the big two issues to watch are the rand dollar exchange rate and potential rate hikes in the US, or the expectation thereof. It is more than likely that inflation will breach the upper target band of 6% set by the SARB but we remain of the opinion that the SARB will allow the breach for a short period of time given the poor consumer environment and below trend growth in GDP. Any rate hikes are likely to be modest.

As discussed previously, we are fairly optimistic that emerging markets, including SA, will attract renewed foreign investment flows over the near term following dovish comments by the US Federal Reserve around when they expect interest rates there to normalise (read increase). This should be supportive of a stable rand dollar exchange rate which will have a positive impact on our current account deficit which in turn will support the currency even further.

At JSE sector level the two best performing sectors were banks and retailers which increased by 9% and 12% respectively in March, again providing evidence of large foreign buyers returning to our market on the back of rand strength and more dovish views on US interest rates. Foreign investors remain the largest shareholders of our retail stocks and banks are often viewed as a good proxy for retail stocks.

We are finding it increasingly difficult to find good value opportunities in the current market after the stellar run in equities lately although some stocks in the mid-capitalisation space still looks interesting. Having said that, there also appears no glaring risk for a sizable correction in the market (for now) and expect the market to tread sideways in the short term supported by good earnings numbers. The secular long-term themes (urbanisation and emerging middle class consumer) remain bullish for equities. If, indeed, the market does undergo a correction, we will potentially view that as a buying opportunity.

## In conclusion:

- Equity markets remain buoyant as there is no real evidence of rising inflation in developed markets.
- We expect interest rates to remain low for some time which could cause markets to move higher still.
- Corporate earnings in the US have been steadily increasing since the middle of last year after two years of declining earnings. The trend is likely to continue with a more synchronised global economic recovery.
- The risk of deflation remains real which could have a negative impact on pricing power and corporate earnings in developed markets.
- Emerging markets and their currencies have staged a strong rebound after a bumpy start to the year due to tapering fears, expected rate hikes in the US and a stronger dollar.
- The major swing factor regarding the sustainability of a global synchronised recovery remains China. Chinese Premier Li Keqiang has reiterated that the top priorities for authorities are to maintain job creation and maintain labour market stability and that 7.5% is the minimum growth rate required to obtain this.
- Reported earnings from locally listed companies have surprised on the high end of company guidance which caused the market's P/E multiple to contract to 17x from 18x at the beginning of the year.
- We are optimistic that emerging markets (and SA) will continue to attract foreign investment flows over the near term following dovish comments by the US Federal Reserve around when they expect interest rates to rise.
- Banks and retailers rallied 9% and 12% respectively in March, providing evidence of large foreign buyers returning to our market on the back of rand strength and more dovish views on the US interest rate environment.

**Sincerely**

**Chris Botha** **Dave Eliot**

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