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International

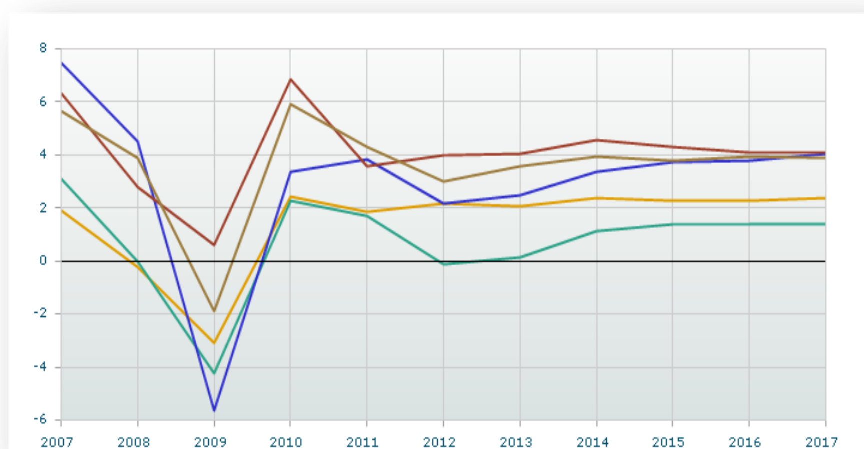
Equities the way to go

The financial crisis has now been with us for just over five years. With the Eurozone crises improving and expectations that the fiscal cliff in the US will be abated, the world economy is finally moving towards a more meaningful recovery, albeit slowly. In the US, we expect that the sequester (spending cuts and tax hikes) will at worst be phased in over a period of time as neither Republicans nor Democrats can afford a slowdown in the relatively fragile recovery. In the event of an immediate implementation of the full measures, we estimate that this could shave off 0.5% of the current growth rate of 2.5%.

Globally, markets have reacted positively along with positive economic news from the US and China and more stability in Europe. Most developed markets reached all-time highs in January gaining on average 5% in January alone but experienced a small correction of about 2% last week, which in our minds is healthy.

Global growth forecasts paint a reasonably bullish picture for equities as can be seen in this chart. Of particular interest is the expected recovery in Europe gaining momentum off a low base.

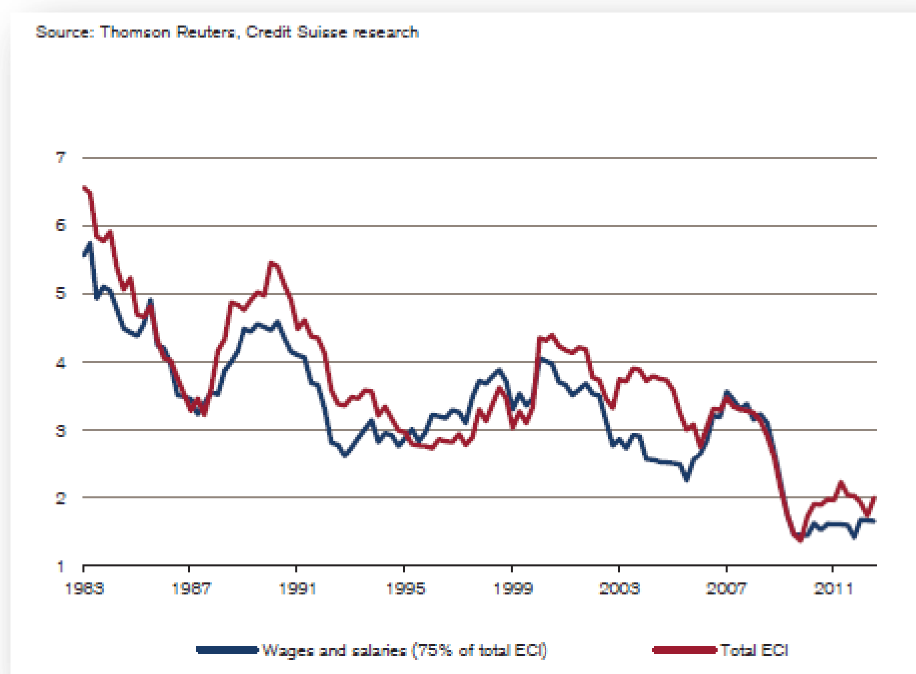
The Economist Global Forecasting Service



Real GDP growth
(Market exchange rates)

North America
Western Europe
Transition economies
Asia & Australasia
Latin America

We anticipate that the recovery in the US will be accompanied by only a moderate increase in inflation. Historically we have found that moving from deflation to mild inflation leads to a re-rating in equities, while moving from deflation to high inflation leads to a de-rating in equity valuations. Recent comments by the US Fed that quantitative easing could be slowed, which caused the sell-off in markets, is in fact positive for markets as this indicates that the economy is in better shape than expected. If higher inflation is accompanied by financial repression (QE), real bond yields could very well stay at current levels or move lower, thereby stabilising government debt and possibly helping to increase employment. Employment and wage growth is the largest economic driver in developed economies, so an improvement in these variables should bode well for company profits and therefore equities going forward.



Growth in the wage component of the Employment Cost Index is close to a 30-year low….

The table below indicates historic PE's for global equity markets. Most markets experienced a rerating during the past twelve months and given long term averages don't appear overly expensive

Global Equity Market P/E ratios

	30 March 2007	26 June 2007	27 Sep 2007	29 Feb 2008	29 May 2008	26 June 2008	28 Nov 2008	26 Feb 2009	27 Oct 2009	23 March 2010	26 Aug 2010	27 Jan 2011	22 Feb 2012	**27 Feb 2013**
US	17.5	19.6	22.7	15.5	16.4	15.9	11.0	11.3	19.8	20.8	15.1	17.5	15.1	**17.2**
Japan	26.5	22.5	19.5	14.9	16.8	16.4	10.8	13.7	30.2	31.4	16.0	15.9	17.1	**15.6**
China												13.2	9.3	**8.1**
UK	13.9	12.0	11.3	10.7	10.6	9.6	8.0	7.5	11.9	12.3	13.6	15.5	10.5	**13.9**
Germany	13.7	15.1	13.5	12.0	13.8	12.7	11.2	9.3	23.6	18.5	14.1	15.5	10.9	**11.7**
Russia												10.1	6.5	**6.0**
Australia	16.2	14.9	15.8	13.3	14.6	13.9	10.7	10.7	17.3	17.3	13.8	15.3	13.2	**18.4**
Hong Kong	15.0	21.8	25.7	20.8	17.5	15.6	8.9	7.4	18.3	16.1	13.4	15.7	10.8	**12.7**
India												22.0	18.3	**17.3**
Singapore	15.3	14.8	13.3	10.3	9.6	8.9	5.1	5.6	18.8	18.4	15.1	13.6	8.3	**12.1**
South Korea	11.9	12.3	13.2	11.5	13.2	13.1	7.8	8.0	19.0	19.4	14.3	16.3	13.4	**16.2**
Brazil												14.3	11.8	**13.9**
South Africa	17.1	16.3	14.6	15.2	15.3	14.3	9.5	8.6	14.1	16.7	16.1	18.6	15.8	**16.1**

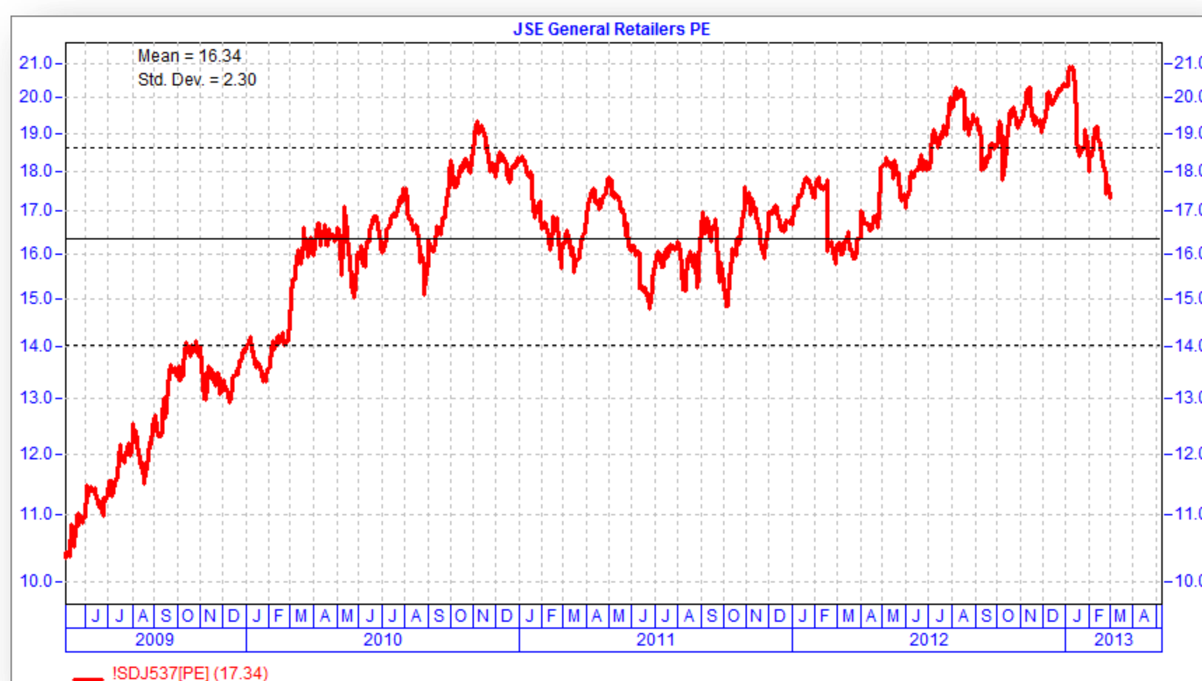
Source: FT 28 FEb2013 P/E's relate to a sample of stocks that cover at least 75% of each markets capitalisation

A further positive factor is that the global economic system is awash with free reserves with banks having huge scope to extend loans and in the process stimulate consumer demand. This together with economic growth that is improving but remaining below potential and low inflation provides good scope for multiple expansions in equities should this trend continue.

South Africa

Will fixed investment drive growth in the future?

Over the last decade, GDP growth in SA was largely driven by consumer expenditure, hence the huge rerating in our retail stocks over the past couple of years. On average, shares rerated by 50% as foreigners bought our stocks to bring them more in line with other emerging market retailers such as Latin American stores.

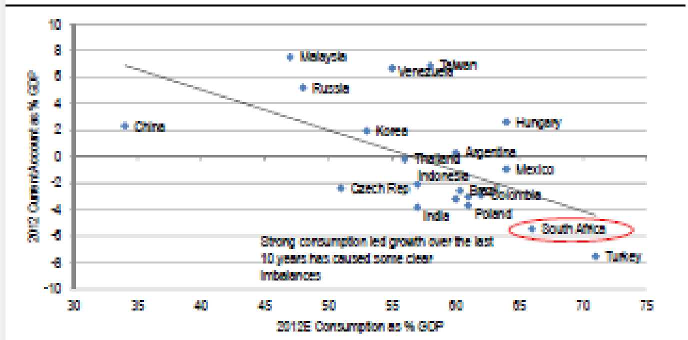


The labour action in Q42012 had a profound impact on retail spend during that period and most of the retailers posted, although still good, disappointing results and profit guidance at the beginning of this year. The outlook also appears somewhat muted; one reason being the high level of unsecured lending that has caused debt levels of consumers to reach uncomfortable highs. However, we still estimate that retailers could grow earnings in the high teens, not the 30% level we have come accustomed to. The 18% de-rating since January 2013 provides a long-term buying opportunity as these shares are now more realistically priced given expected growth levels.

Our retail companies are amongst the best run businesses on a global basis with returns on equity (ROE) of between 30%-40 %(global averages are 25%-30%). Most of our local retailers are also aggressively pursuing Sub Saharan Africa, which is experiencing a bourgeoning consumer market. The key success factors are the logistical capability of our local retailers and the strong brand awareness amongst African consumers. We therefore view the recent de-rating in our retailers as very healthy and believe that at current levels, they have excellent long term growth prospects, hence our previously stated optimism.

We anticipate that Retail consumption as a percentage of GDP will decline as SA companies continue to focus on prospects north of our border; nevertheless it will remain a key driver of GDP.

South Africa vs GEM: Household Consumption % GDP vs Current Account % GDP

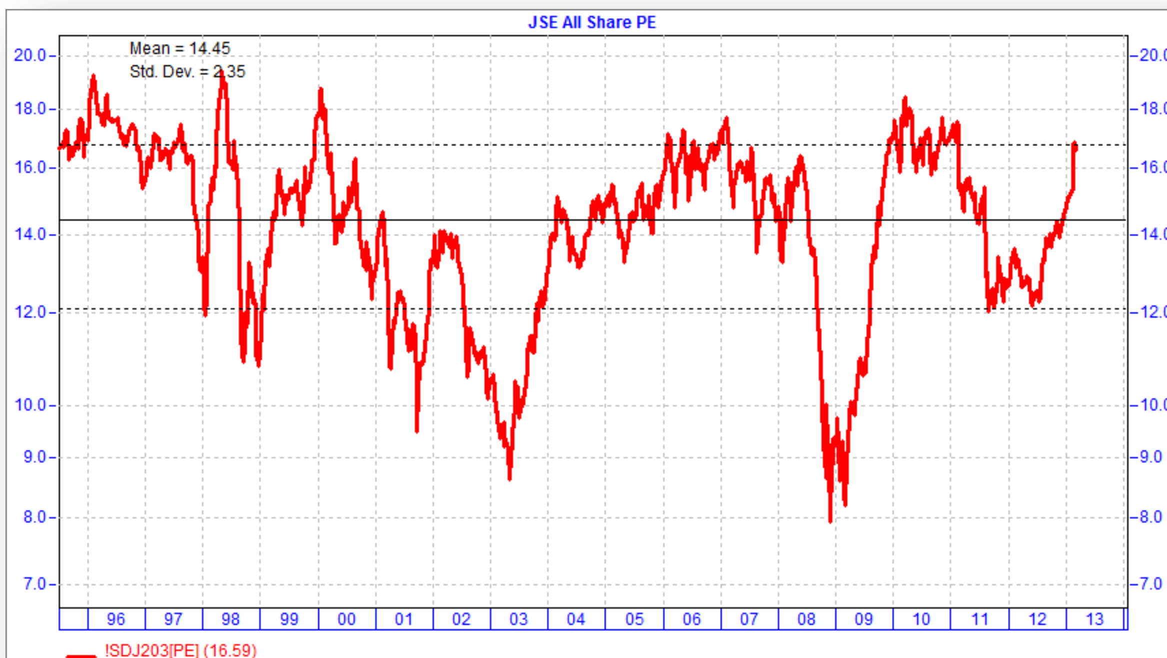


Source: SA Reserve Bank, IFS, IMF, RMB Morgan Stanley

This chart indicates the high contribution of Household consumption to GDP

Following a renewed commitment by Finance Minister Pravin Gordhan in his recent budget speech around the planned R850bn infrastructure expenditure, over the next decade, we believe that this could become the main driver of our GDP growth. Although the planned spend was announced a couple of years back, very little has meterialised due to skills shortages at governmental tender level. We sense that central government is now far more involved in making sure that decisions get implemented. Time will tell, but this spend could have a very positive impact on our construction, manufacturing and retail sectors.

Our market corrected somewhat last week on the back of global market weakness, but has recovered since then with "risk on" sentiment returning after better than expected housing and manufacturing data in the US.



On a long term PE basis, the market seems over stretched in the short term and a correction of about 10% cannot be ruled out. On a forward basis we are trading on approximately 13.6x earnings. The long term trajectory for our market remains very bullish with Africa north of us growing fast and local fixed investment hopefully getting off the ground.

We will be buyers of equity on price weakness, particularly rand hedges, retail, and fixed investment related stocks.

In conclusion

- **We expect the US Fiscal Cliff will be avoided by phasing in the planned spending cuts and tax hikes.**
- **US real interest rates will remain low which will stimulate economic expansion and employment which should lead to higher equity valuations.**
- **We expect that improved growth (particularly in the US), will be accompanied by only a modest rise in inflation.**
- **The Eurozone has stabilised and a recovery in GDP growth is expected in the second half of this year.**
- **Locally, we expect the contribution of retail spending to GDP to taper off over the next couple of years with fixed investment and peripheral sectors making a more meaningful contribution.**
- **Although the expected profitability growth of retail stocks are expected to be lower than recent historical norms, we believe the shares offer good long-term value following the recent sell-off due to the negative impact of last year's labour unrest.**
- **We expect continued investor concerns around our national budget deficit and will remain relatively overweight rand hedge counters in portfolios, as currency weakness is expected over the medium term.**

Sincerely

Chris Botha

Dave Eliot

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