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Asset Management

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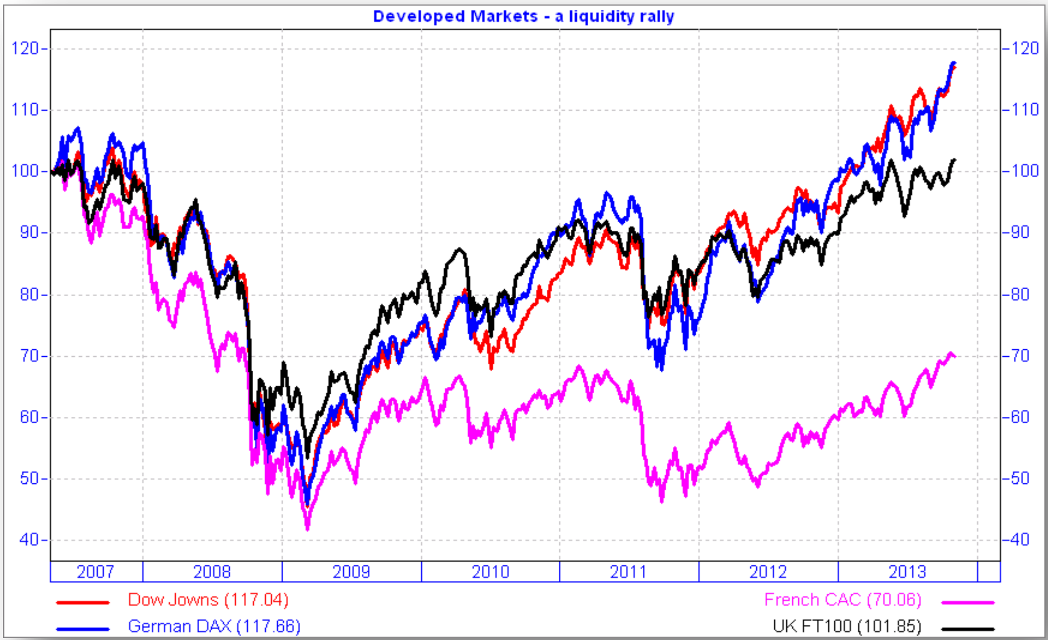
Liquidity remains the key

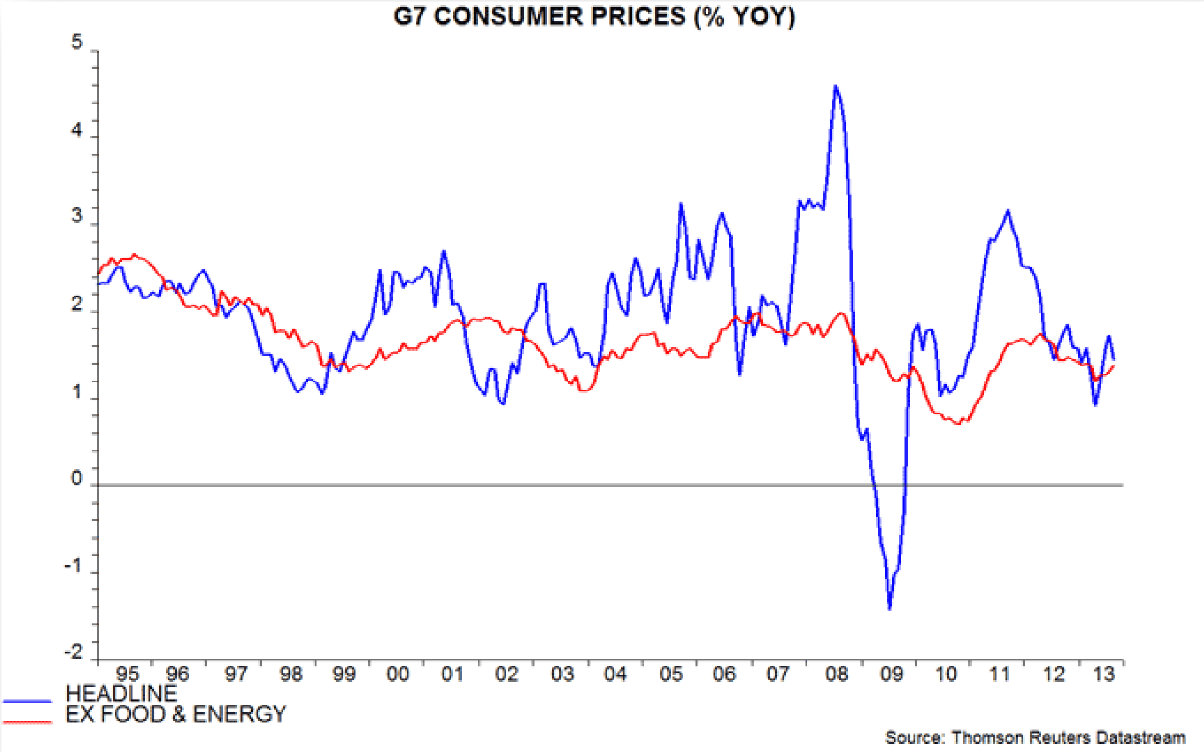
International

Global equity markets continue to outperform most other asset classes with excess liquidity in the financial system the main driver behind the continued multiple expansions. Despite this, the prospect for a meaningful correction in prices and multiple contractions in our view remains somewhat subdued. It is expected that the global economy will continue to improve this year and will accelerate further in 2014.

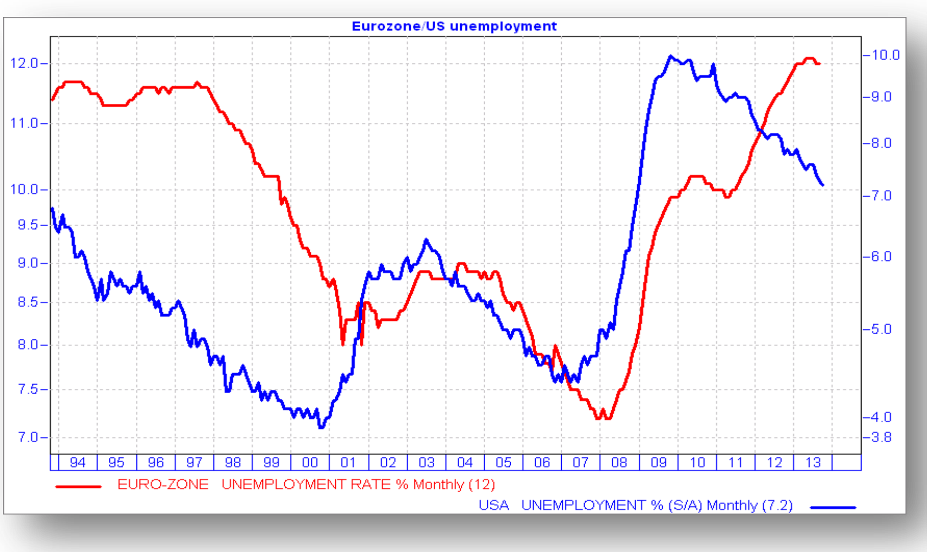


Corporate profits will therefore continue to improve which will support current multiples. We do caution however that markets remain vulnerable to bad news such as tapering of QE or growth expectations not being met.

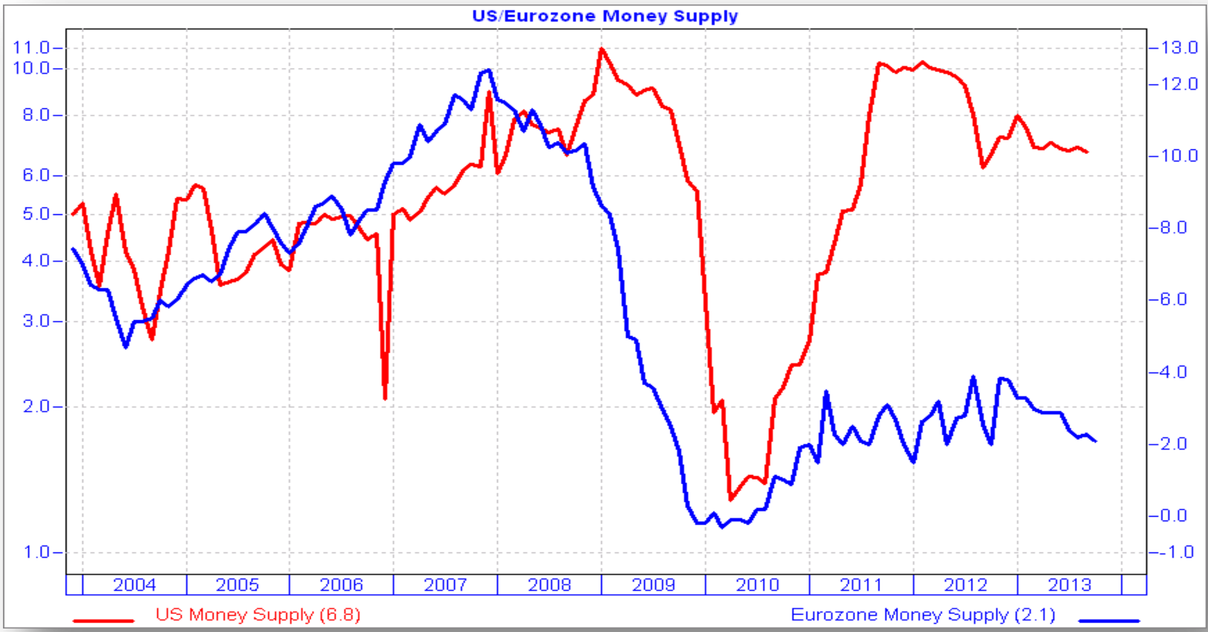
Deflation and not inflation remains the key risk to the global economy with little evidence that all the excess liquidity within the banking system has in fact filtered through to a meaningful increase in final consumption.

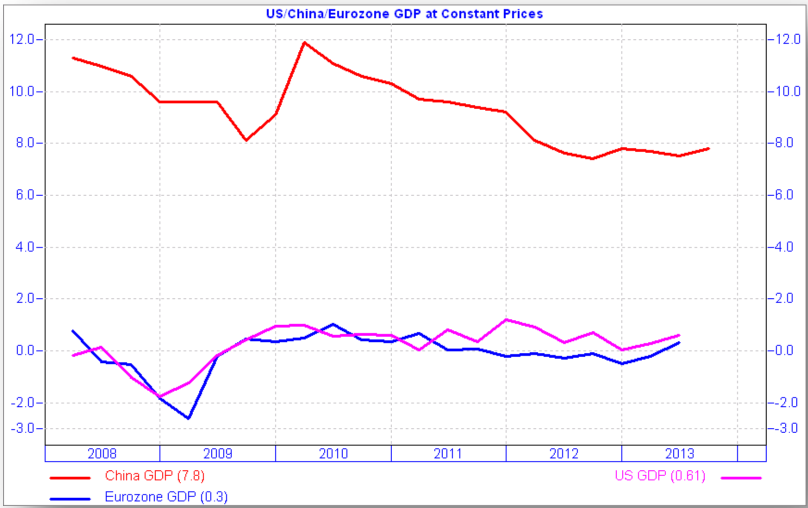


Corporates and individuals remain in a healing phase with little appetite for increased debt (the banks also aren't lending) to fund capital expenditure and private consumption. So, we are growing at a reasonable pace, but not so much as to cause authorities to act on tapering or a change in monetary stance. In the US, job growth, although improving, remains subdued with the unemployment rate remaining above 7% with the last reported reading at 7.2%. Eurozone unemployment has only recently started to stabilise. QE is likely to remain for a while yet and tapering is only likely in our view by mid-2014, only, of course, if US economic growth continues to improve.



Currently, the world economy is still suffering from a positive savings gap – too much saving and not enough consumption. In theory, falling rates should discourage saving (saving rates are negative in real terms) and stimulate demand for credit. This has not happened and money supply and credit extension remains weak on a global basis. Also, if there are expectations for prices to fall further, both corporates and individuals will postpone spending which will exacerbate the liquidity trap.





In terms of global growth, the two star performers remain the US and China. Chinese authorities have responded to a potentially slowing economy by increasing fiscal stimulus and increasing infrastructure investment. Structural supply side reforms continue with the objective to liberalise the economy by making small and private businesses more inclusive in the economy. Thereby assisting in growth and employment which will lead to a more consumer driven economic model.

In the US, the housing market continues to improve fuelling the wealth effect amongst consumers. US corporate profits should further be boosted by exports to growing emerging market countries. Approximately 40% of US profits currently emanate from outside the US, so a continued recovery in Europe and growth in China will support positive GDP expansion.

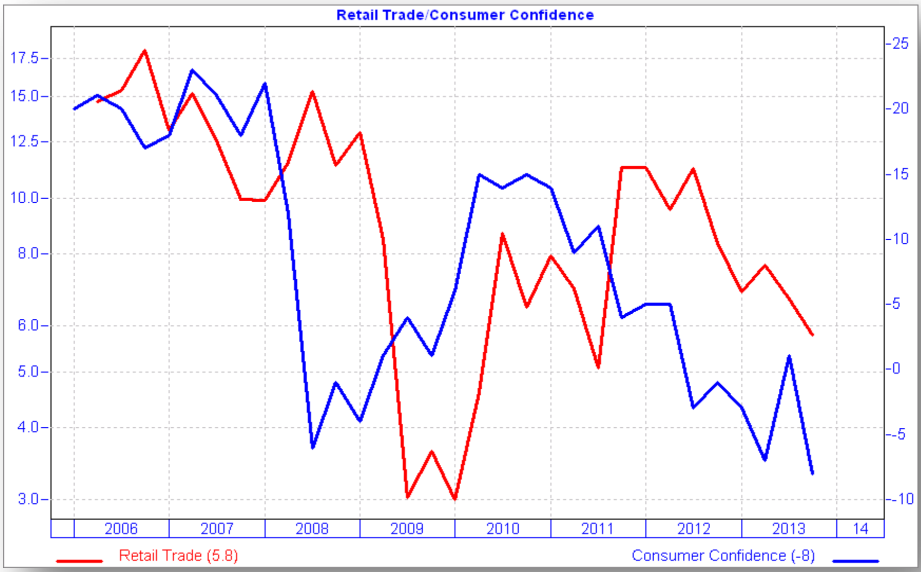
Consensus estimates are that China and the US will growth by 8% and 2.9% respectively in 2014.The Eurozone is expected to continue to recover, albeit at a slow pace.

In summary, although excess liquidity has fuelled the rally in equity markets, fundamental economic underpinnings are positive with prospects going forward also continuing to improve in terms of global growth, albeit at a relatively slow pace.

The low growth, low inflation scenario we think will be a theme for quite a while and interest rates could be stable well into 2014. We don't expect a meaningful correction in equities with the caveat that the global economic recovery remains 'goldilocks' like- not too hot and not too little!

Generally, we feel that equity markets are fairly valued and could go higher in the medium term, driven by continued liquidity flows into financial assets and improving corporate profits. In the short term, we anticipate markets to move sideways, bar any of the abovementioned risks and that multiples could well decline as we move into the next profit reporting season.

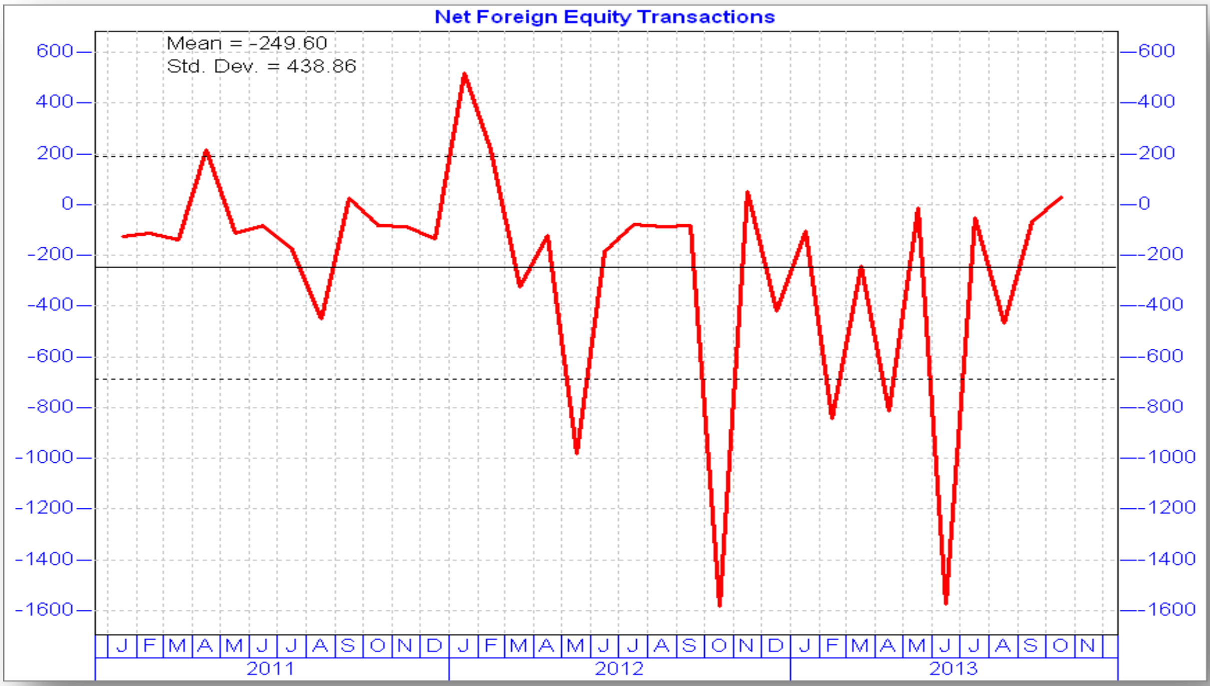
Local



GDP growth prospects have steadily been declining with most economists predicting that growth for the 2013 year will come in at 2% instead of 2.5% predicted previously. Agriculture and mining continues to perform poorly due to weak commodity prices and strike effects. With labour disruptions mostly out of the way and a weakening Rand, we expect manufacturing and commodity exports to improve in due course. Consumer expenditure remains weak due to high indebtedness; however, spending by the middle to upper income groups appears somewhat more robust as mentioned in recent financial result publications by cash retailers in particular.

The outlook from cash retailers regarding the local market remains cautious, but there is widespread optimism around plans to expand further into Sub – Saharan Africa, where forecast GDP growth ranges from 6% to 9%. Exposure to the growing middle class in Africa and their consumption patterns are currently strong themes within our investment portfolios.

Despite the recent labour tensions and weaker currency, foreign investors continued to buy our equities and bonds, pushing the JSE All Share to yet another high recently. The Fed's decision to postpone tapering and an agreement between the US Senate and House of Representatives to raise the debt limit and reopen the government, also provided a fillip to our market with "risk on" sentiment favouring equities. As can be seen in the chart below, net foreign purchases of our local equities continued in October.



South Africa is also seen as the "gateway" into the Sub- Saharan consumer markets and foreign shareholding in our listed retail stocks is now approaching 70% in some cases.

Foreign and domestic ownership of listed retail counters (As at 30 Sept 2013)

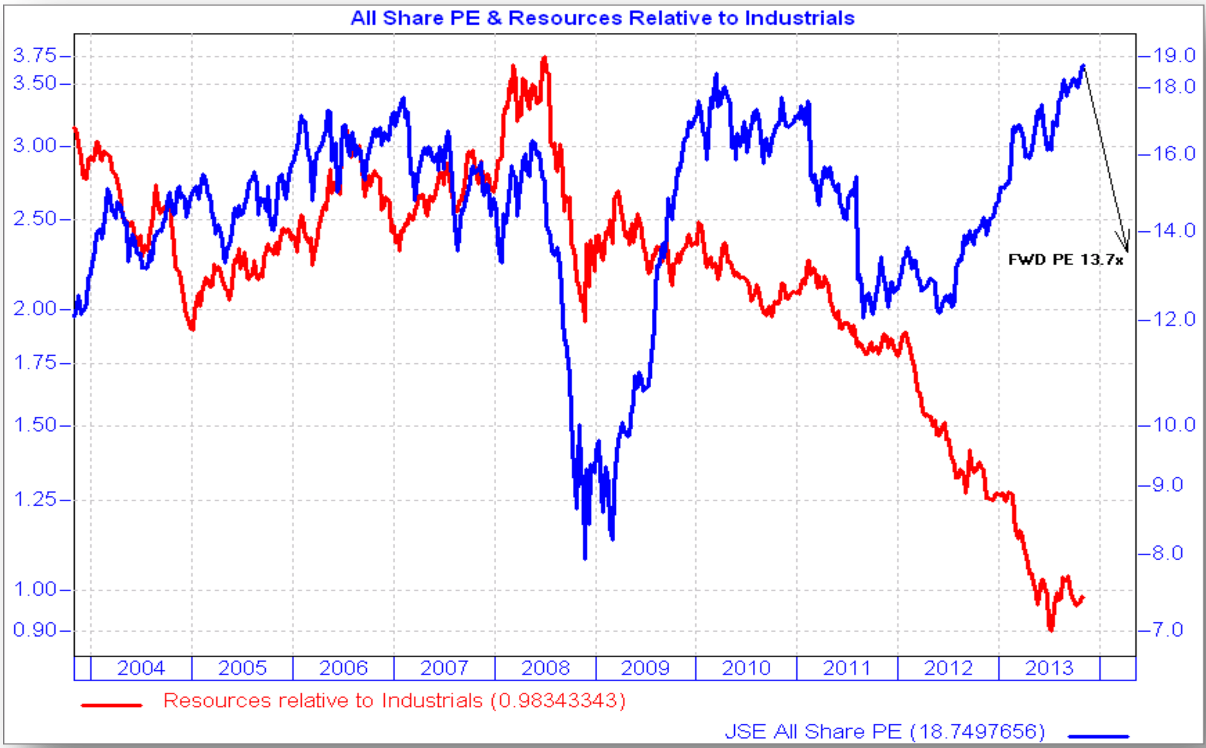
Name	Domestic %	Foreign %
Massmart Holdings	60.54	39.46* (91.92)
Clicks Group	33.34	66.66
Truworths International	35.07	64.93
The Spar Group	38.32	61.68
Shoprite Holdings	43.72	56.28
Mr Price Group	40.02	59.98
The Foschini Group	49.61	50.39
Woolworths Holdings	50.29	49.71
Pick n Pay Stores	74.64	25.36
Pick n Pay Holdings	82.27	17.73

**Excludes 52.46% Wall Mart ownership*

Source: Afrifocus Securities

At sector level, Industrial Rand Hedges remain expensive but should become less so during the next reporting season as earnings upgrades have started to filter through helped by the weak rand. As highlighted in the chart below, resource counters have underperformed industrials since 2008 (red line)but it appears that sector rotation out of industrial counters into more reasonably priced commodity shares is gaining momentum.

If global economic data continues to improve and the rand remains weak one can expect the rotation into resources to gain further momentum. The black arrowed line indicates the 12m forward Price Earnings multiple for the All Share index. At 13.7x forward, the market is not expensive compared to historic standards, however, this will be dependent on the high forecast growth numbers actually materialising. Additional risks include slower global economic growth, China in particular.



Another potential risk to local equities in general, remains the widening current account deficit and the potential impact it might have on the Rand. In the event of a "risk off" scenario, possibly caused by US tapering or lower growth as previously mentioned, foreign selling of local shares and bonds removes our source of the funding of the deficit, which would become a major issue. The lack of funding could cause sharp Rand weakness leading to higher inflation and force the SARB to act earlier on hiking interest rates.

In this type of scenario even traditional Rand hedges will be negatively affected but should be the first to stage a recovery.

As mentioned in previous communiqués, an inverse correlation exists between interest rates and the Price Earnings ratios of equities, which could cause classic sector rotation out of equities into less risky assets such as cash. Although a material risk, we do not ascribe a high probably to this scenario panning out in the short-term.

To conclude:

- Excess liquidity in the global financial system remains the main driver of rising asset prices.
- Improving corporate profits and a postponement of US tapering should underpin current equity multiples.
- Global economic growth continues to improve with very little threat of inflation. In fact, the risk of deflation is still very real; we expect tapering of QE to potentially occur much later than expected.
- However, if either global economic growth slows or tapering occurs earlier than expected, asset prices will be at risk of a correction.
- The unemployment rate in the Eurozone appears to be stabilising with some revival in economic growth, albeit muted, whilst in the US, the unemployment rate has continued to decline, but remains sticky above the 7% level relative to the Fed's target of 6.5%. GDP growth continues at around the 2% level.
- Consumers and corporates remain in a "healing phase" with credit extension and money supply still trending downwards both in Europe and the US.
- China and the US remain the main drivers of the global economic recovery; growth rates for 2014 have been revised upwards for both these economies.
- Global equities appear fairly valued given improving corporate profits and could move higher in the medium term as excess liquidity continues to filter through into financial markets.
- Local GDP growth is now expected to be 2 % in 2013 from a previously expected 2.5%.
- Consumers remain under pressure, especially in the lower LSM market. However, cash and food retailers exposed to the upper LSM segments appear to be doing well with profits also being supported by expansion into Sub-Saharan Africa.
- The postponement of tapering by the FED fuelled foreign purchases of local equities in October with heightened interest in risky assets.
- We remain concerned about the Rand and our current account deficit. Foreign portfolio flows as a funding mechanism of the deficit is a concern. Foreign ownership of local equities remains very large – particularly in the retail segment. Any shake out here will see the Rand weakening further.
- A weaker Rand and relatively strong earnings growth from both industrial and commodity rand hedges, together with stable local interest rates should support current equity multiples on the JSE. The market on a forward Price Earnings ratio of 13.7x does not appear overly expensive compared to historic mean levels, but will be expensive if the estimated earnings numbers do not materialise.

Sincerely

Chris

Chris Botha

Dave

Dave Eliot

IMARA INVESTING IN AFRICA

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