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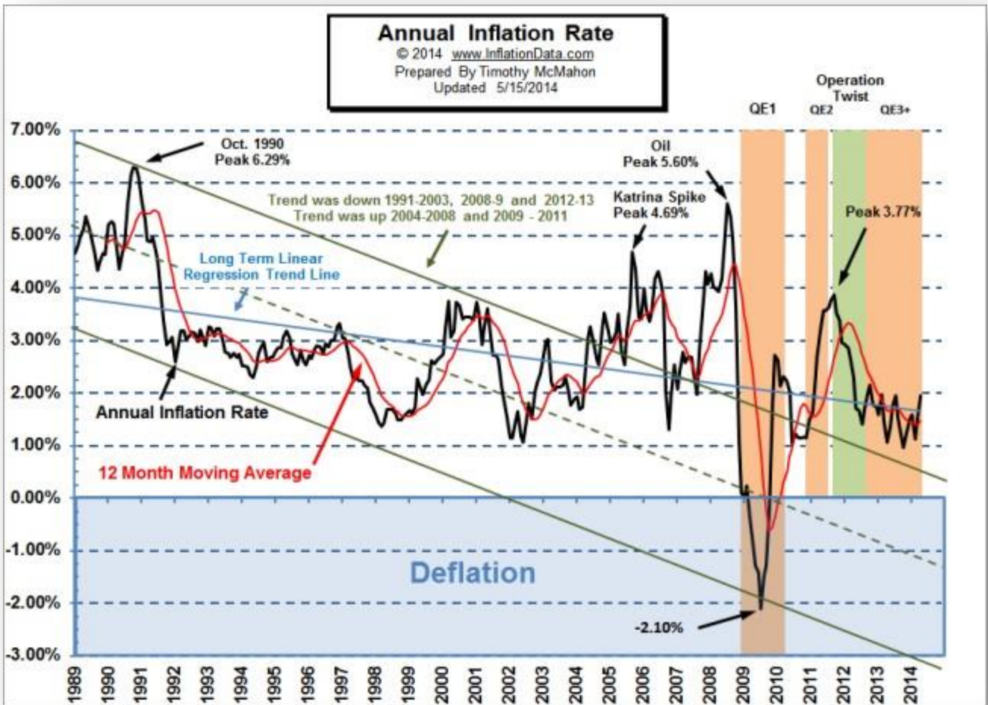
All eyes on the Fed

International

Equity markets continue to deliver positive returns as calm returns to forward interest rate markets in the US. Economic data there continues to provide evidence that the economy is recovering but potentially not as robust as expected previously. Employment is increasing at a modest pace. The main current concern is the apparent deterioration in the housing market as consumers deleverage. Volumes of existing home sales are still trending downwards and the homeowner rate is still declining at 64.8% in April 2014.

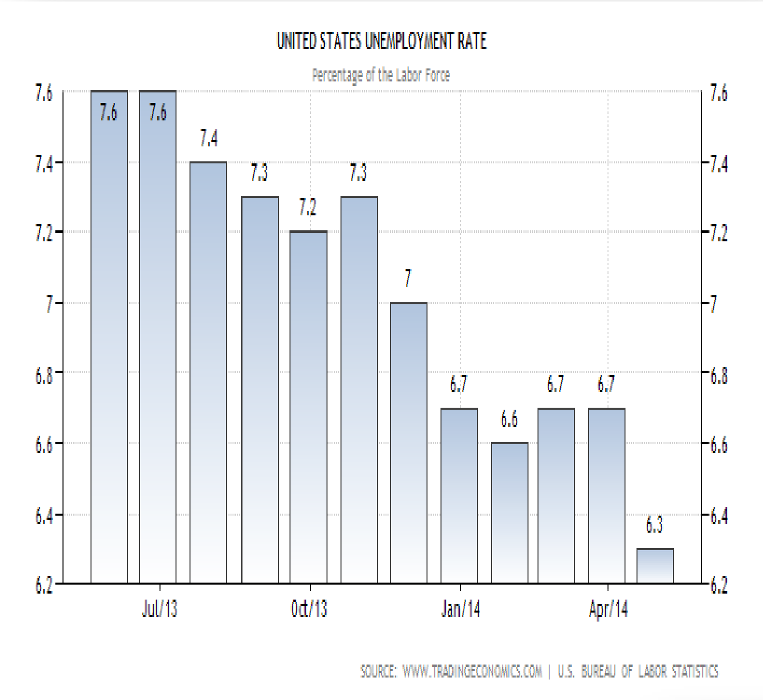


Source: Inflation Data.com

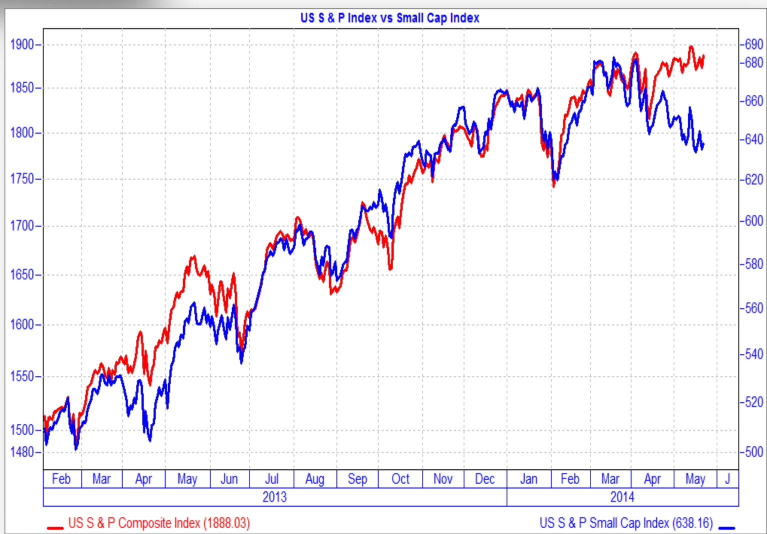
After a protracted period of low inflation and concerns of deflation the April reading of 2%, year on year, reached the Fed's target, after a 1.5% increase in March 2014. The main reason for the increase is likely due to a spike in food prices as a result of droughts in Texas and California. Food constitutes 14% of the inflation basket. However, the latest reading of core inflation, which strips out volatile food and energy, was recorded at 1.8%, below the Fed target. A growing number of economists expect the latest reading not to be sustainable as job growth and employment remains very lacklustre with only a small segment of highly skilled workers being employed.

In April 2014, the jobless rate in the US fell from 6.7 % to 6.3 %, the lowest number since September of 2008, as both unemployed re-entering the labour market and new entrants into the labour market grew. The Fed's target rate is 6% but has stated previously that broad based employment is still not recovering adequately and thus the target might be revised downwards.

It is therefore expected that the Fed will exit QE at a measured pace and comments made by Fed Chair Janet Yellen recently, that interest rates could remain low for a longer period due to the decline in the housing market, confirms that a gingerly approach will be undertaken. Further confirming that the recovery might be at risk of losing momentum was reported retail sales in April 2014; only increasing by 0.1%, mainly due to the severe winter conditions, after a jump of 1.5% in March 2014. It is possible that the downward trend will improve alongside growth in the job market as consumer spending is the main driver of economic growth.



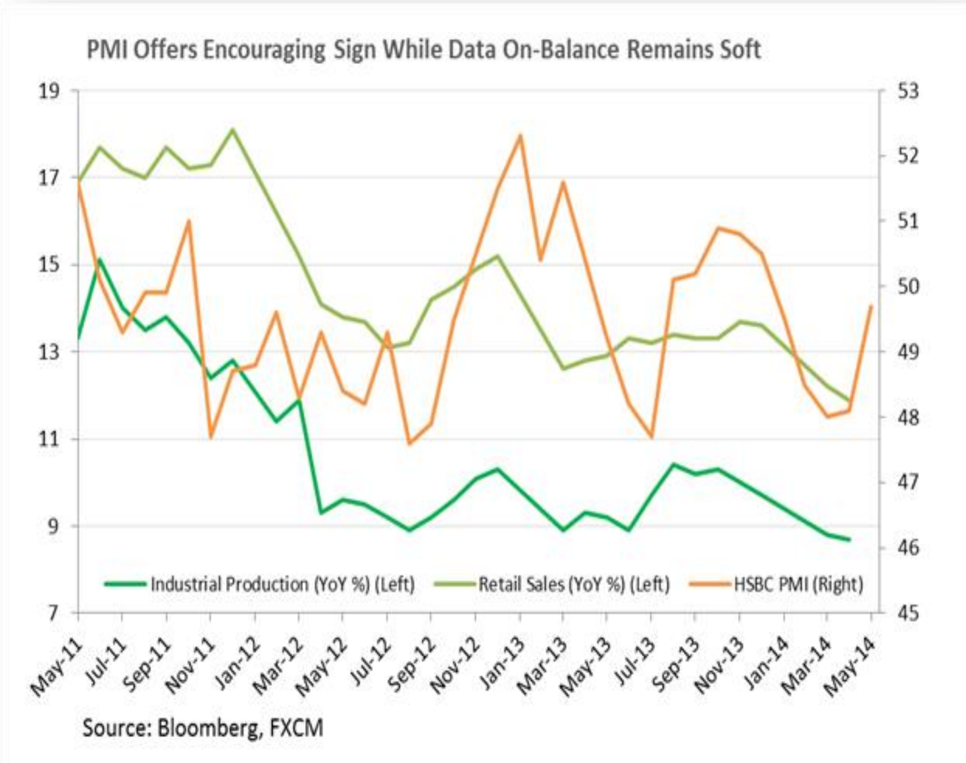
On the equity front, US corporates continue to deliver solid results, generally beating revised estimates. Balance sheets are healthy and operating margins remain at record levels due to low employment growth which should support current equity valuations. US equity markets are currently mainly being held up by selected large capitalisation stocks. The S & P mid and small cap indices are down 2.7% and 6.5% respectively after reaching highs in April 2014. The broader market is therefore may be offering better value and given high investor liquidity levels, a severe correction is not anticipated.



In Europe, deflationary pressures are intensifying. Excluding Germany, wage growth is very low and excess capacity and the strong Euro is hampering the fragile recovery. The general view is that the ECB is behind the curve and should have cut interest rates a while back. Even more concerning is that Europe's largest economy, Germany, which has recovered the most thus far, is also showing signs of losing momentum. The Investor Confidence Survey, which is closely monitored, fell to 33.1 points in May after the April reading of 43.2 representing the biggest fall in two years. The survey consists of analysts and investors expectations of economic growth. The main reason for the drop in confidence is the geopolitical conflict in the Ukraine and fears of slowing growth in China.

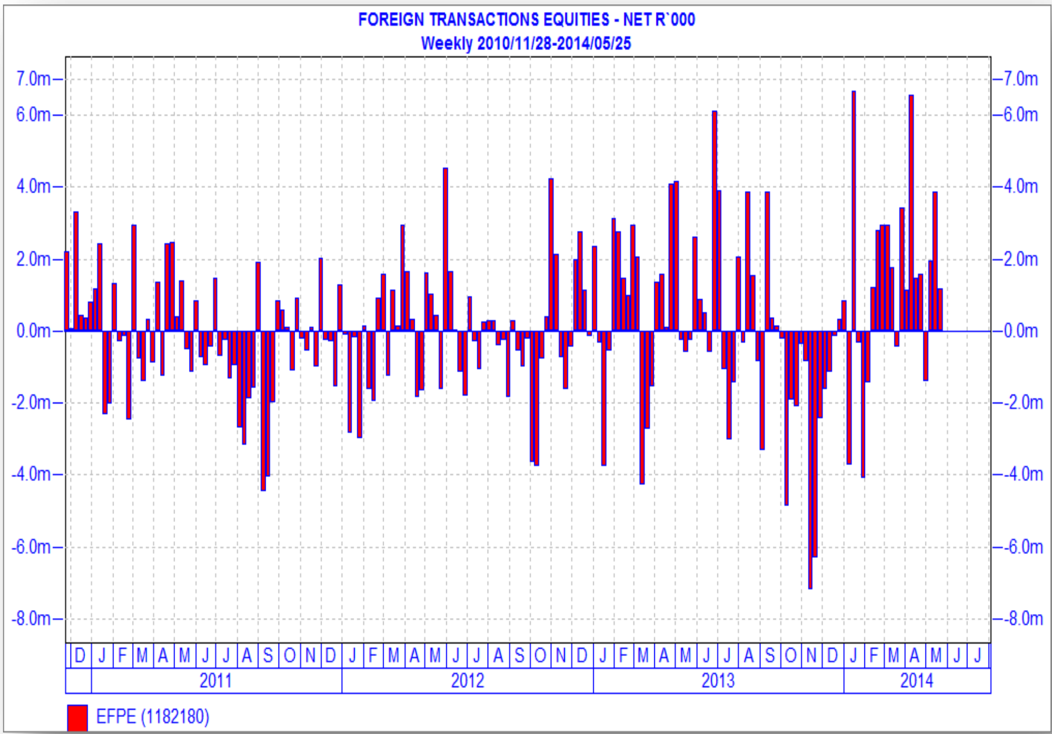
Despite the above survey, it's expected that the German economy will continue to grow in 2014. To quote ZEW (the Survey) president Clemens Fuest: "The decline of the experts' expectations for Germany should be seen against the backdrop of a strong economic development in the first quarter of 2014. Already, there are indications that Germany will not be able to maintain this pace of growth. Nevertheless, one can assume a positive underlying trend for the economic development for the year 2014." Thus it came as no surprise when Mario Draghi of the ECB recently indicated that the Bank could take action to help economic growth and combat potential deflation at the next meeting.

Nervousness regarding the current and future state of the Chinese economy is rampant with data in general indicating that growth is slowing albeit off a high base as they restructure their economy to be less dependent on infrastructure expenditure. We remain of the opinion that growth could surprise on the upside as mention in previous writings due to the "minimum target growth rate of 7%" set by authorities.



Following a spate of disappointing economic releases (although still good) a positive surprise in the form of PMI data for April was released at the time of writing. The manufacturing PMI (Purchasing Managers' Index) for May was encouraging at 49.7 vs. 48.1 in April 2014. This is an important reading as it is edging closer to the expansion threshold of 50 and is the first time the reading has edged up after a series of weak readings the past three months. The main drivers were an uptick in new orders and a ramp-up in production, which could support our argument that economic growth there could surprise on the upside in due course. The chart above indicates the rebound in Chinese manufacturing PMI but that retail sales and industrial production are still trending downwards.

South Africa



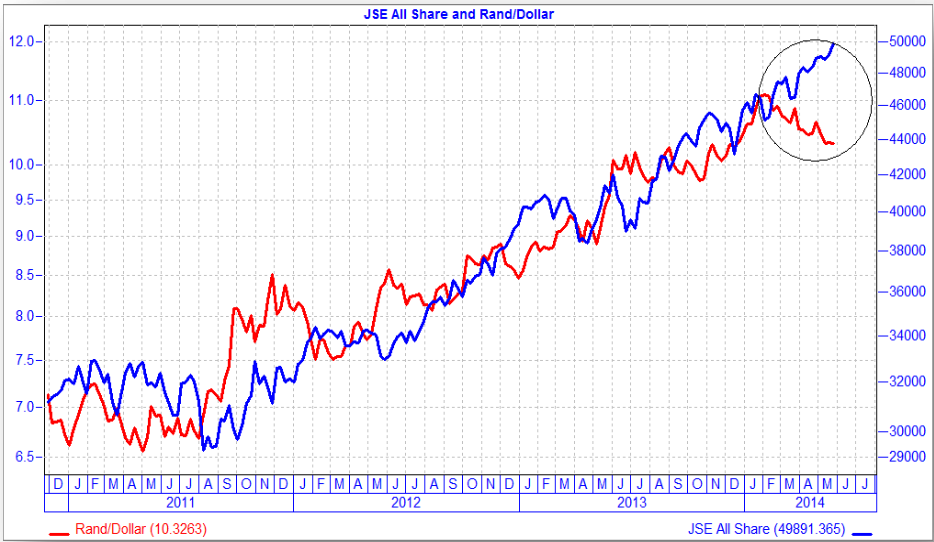
Dovish comments by the Fed regarding the timing of rising interest rates in the US caused renewed inflows into most emerging markets, including SA, the search for yield! Foreign buying of local bank and retail shares pushed our equity market through the 50000 threshold to a new record high. The chart alongside shows net foreign purchases of local equities.

The SARB (South African Reserve Bank) kept the repo rate unchanged but said it would act if inflationary pressures gain momentum. More of a concern is that they revised forecast GDP growth sharply downwards for 2014 to 2.1% from 2.6% previously. The downward revision could very well be due to the ongoing industrial action at our platinum mines which will have an impact on certain peripheral industries thereby broadening the negative impact on the economy. The likelihood exists that expected GDP growth could be revised upwards once the strikes have ended and Chinese growth gains momentum. The latest PMI reading also fell from 50.3 to 47.4 which was accompanied by a decline in manufacturing production to 0.7% year on year in March 2014. A contributing factor without a doubt is the spill-over effect of the continuing strikes on the mines.

Despite the rand staging a recovery to the R10.30 level relative to the dollar, the long term trend of a weakening rand seems to be intact although we do expect the rand to strengthen further in the short term on the back of foreign portfolio inflows. It is likely that the SARB will prefer a weaker currency to aid manufacturing and mining exports. It is therefore likely that local interest rates will remain stable for quite some time as rising interest rates will potentially cause rand strength which will undermine the above objective.

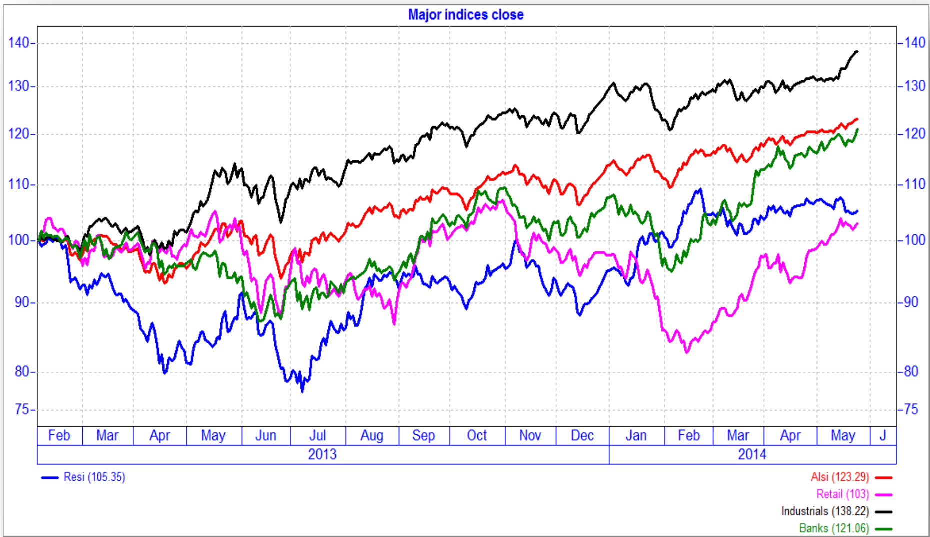
The poor state of local consumers and below trend GDP growth should further aid a low interest rate environment despite CPI breaching the 6% target set by the SARB. Latest CPI data saw inflation reaching 6.1% and most economist expect CPI to peak at around the 6.7% level before retracting under the 6% level later in the year.

We expect the SARB to closely monitor movements by the US Federal Reserve as this will have a major impact on the rand/dollar exchange rate and hence the inflationary impact thereof. Eventual interest rate hikes in the US will likely cause foreign outflows from our bond and equity markets with a commensurate weakening of the rand causing inflationary pressure and hence local interest rates to rise. This could put further pressure on local shares as rising interest rates are initially seen as being bearish for equities. This, together with foreign selling could spark a material correction in local share prices in due course during 2015



On the investment front, as can be seen in the chart local equities continue to forge ahead into record territory driven by foreign buying. The graph also indicates a very high correlation with a weakening rand / dollar due to the large rand hedge component of our equity market. Of some concern however is that the market has continued to go up despite the rand strengthening lately, a clear indication of foreign buying.

Reported earnings remain good and on a forward price earnings multiple of 14.7x the market is not overly expensive. Given the global economic backdrop (Chinese and US growth momentum in particular) and further good earnings growth in local currency terms, there appears no immediate threat of a material correction in share prices. However, a pullback in the near term cannot be ruled out, particularly if global economic data disappoints.



From a sector perspective, Industrials (Black), retailers (Pink) and banking (Green) have been the best performing sectors on the JSE. Resource stocks (Blue), despite the weak rand, have more or less moved sideways, likely due to concerns of slowing growth in China and the nascent economic recovery in the Eurozone. Another contributing factor is some short term oversupply issues in certain base metals which are keeping spot commodity prices down. The long term prognosis for commodities remains positive however with increased demand arising from the growing middle classes and urbanisation in most emerging markets.

In summery then, our local equity market is expensive on a historic basis due to continued foreign buying. Actions and comments by the FED will be key factors to watch as this will determine the direction of the rand and hence inflationary expectations as well as foreign flows into our market. The main short term risk in our view rests with economic growth in the US and China, which we think might surprise on the upside. However, disappointing economic data from these two regions could initiate a sell-off in local assets.

To conclude:

- *The economic recovery in the US remains broadly intact. Job growth is improving but is not at the FED's target rate yet.*
- *The FED has turned more cautious on the timing of potential interest rate hikes as the housing market is showing signs of weakness again. It is unlikely that rates will go up in the short term, maybe late 2015.*
- *Deflationary pressures in Europe have increased and the ECB is set to take action at its next meeting. The outlook for the German economy, the main driver of growth in the region, has also deteriorated.*
- *After a spite of disappointing Chinese economic data, the latest PMI reading came in as a positive surprise and could indicate better than expected economic growth in due course.*
- *Locally, foreign buyers continue to drive up equity prices and the JSE reached yet another all-time high.*
- *Actions by the FED and economic data from the US and China will be the main drivers of local share prices. Negative surprises could cause a market correction.*
- *Despite the above risks, reported earnings remain supportive of current forward valuations.*
- *Actions by the FED will also impact local inflationary expectations and the rand/ dollar exchange rate. A surprise move (rising US interest rates) could further put pressure on our market due to foreign selling of local assets.*
- *The local economy remains in poor shape. The SARB kept rates unchanged but forecast GDP growth was severely downgraded to 2.1% from 2.6% for 2014, which clearly suggest there is no pressure to increase rates bar the above mentioned risks of course.*
- ***All eyes on the FED then!***

Sincerely

Chris Botha

Dave Eliot