cadiz
ASSET MANAGEMENT

Quarterly review

INTERNATIONAL COMMENTARY

Global political tension is elevated

Risky assets dislike uncertainty. There is little doubt that the recent pronouncements by President Trump on restricting imports from China have moved his sphere of influence and disruption beyond the borders of the US. Investor confidence has been further eroded by the fact that China will not roll-over as most other nations have done when the US imposed sanctions (as happened with Japanese motor vehicles in the early 1980s).

This 'tit-for-tat' trade war could not have come at a worse time as equity markets were at all-time highs and there was elevated buying by latecomers. Initial research indicates that, save for the businesses directly affected, the impact on overall growth and corporate earnings is likely to be minimal. It is hoped that common sense will prevail and that the final packages will be a lot smaller and less invasive than those proposed.

The macro picture continues to improve

Here is a brief recap of the latest data that supports this view:

- US economic growth was revised up in the fourth quarter of 2017 to 2.9%, which generally exceeded expectations. Stronger personal consumption was the main driver. Strong US demand was also reflected in the current account deficit, which widened by $128 billion in the fourth quarter as US consumers imported more foreign goods. This last factor, together with a large budget deficit (estimated at some $600 billion for 2017), should keep the US dollar under pressure. As expected, the Federal funds rate was raised in March by another 0.25% to 1.75%.
- China reported GDP expansion of 6.9% for 2017. The Chinese central bank is expected to carefully manage liquidity conditions, as ongoing regulatory tightening and the shadow banking clean-up apply pressure on the country's money and credit markets. GDP is expected to slow modestly to 6.6% in 2018.
- The European macro backdrop remains subdued, except for Germany. While the European Central Bank (ECB) announced its quantitative easing (QE) plans for 2018 late last year, there are creeping doubts about whether it will meet its stated inflation and growth targets.

Equities took a breather after a particularly strong 2017

Table 1: International market returns

International (US$)	Quarter	12 Months
MSCI World	-1.2%	14.2%
MSCI Emerging	1.5%	25.4%
MSCI SA	-4.0%	25.6%
JP Morgan Global Bonds	2.1%	5.3%
US Cash	1.6%	1.2%

Sources: Deutsche Bank, I-NET

The quarter started out looking as though 2018 was going to be a repeat of 2017. January saw massive inflows of about $100 billion into equities, which was an all-time monthly high. Global equity market capitalisation stood at $87 trillion. Then equities corrected by nearly 9% between 26 January and 9 February. Although there was a brief surge after this, equity markets ended the quarter almost at the lows.

There were numerous reasons for the pullback:

- Momentum was just too frothy after the longest bull run on record and a strong 2017, so the early surge in January was unsustainable.
- A pick-up of 2.9% in the US average hourly earnings report triggered fears that inflationary pressures were picking up faster than anticipated.
- Bond yields backed up, especially the benchmark US 10-year rate, which approached the key 3% level. A breach of this level is seen as negative for equity markets.

- Newly installed US Federal Reserve Chair Jerome Powell commented that growth and inflation were tracking on target, aided by a more supportive global backdrop and stimulative local fiscal policy. This had the market briefly assigning odds on four rate hikes of 0.25% each in 2018. We don't expect more than three hikes this year.
- President Trump's announcement of a tariff structure on imported Chinese goods was subsequently followed by a reciprocal Chinese announcement of tariffs on imported US goods.
- Trump further eroded confidence by attacking Amazon's business practices, which led to falls in other US software companies like Facebook, Apple and Alphabet. These declines were the dominant detractors from global equity market performance in the last month of the quarter.

With equities on the back foot, other assets outperformed in the first quarter

Commodities (+2%) was the best-performing asset class for the quarter, with oil up by over 4%. This brings the annual returns from oil to close to 28%, driven by rising global economic growth and a greater adherence to production quotas by OPEC. Against this, the industrial commodity complex had a weak quarter (-7%), with the benchmark copper price down by a similar amount. Somewhat surprisingly, the gold price limped up by a marginal 1%, despite all the political uncertainty.

Second in the performance league was the fixed interest market (+2%). Within this there was a clear preference for quality. Global government bonds achieved the best return of close to 3%, whereas emerging market sovereign bonds lagged at -1%. In this context, we must applaud the performance of South African bonds, as explained in the next section.

We still favour equities over bonds and cash for 2018

While the recent quarter's performance is a shot across our bow, we stand by our view. A global resynchronisation of growth and the accompanying reduction of QE does raise risks, but we believe that earnings growth will provide a sufficient offset. The fiscal boost of lower corporate taxes in the US, should translate into substantial once-off US earnings growth. Initial earnings estimates for the first quarter of 2018 have been set at 17% year-on-year! That said, the market is forward-looking and will start to discount the effect of higher rates, slower economic and earnings growth in 2019. Stockpicking will therefore be the key to outperformance.

LOCAL COMMENTARY

Trying to mend the macro with a whole lot of good news

The key macro features of the quarter were the presentation of Finance Minister Gigaba's Budget (who was replaced by Nhlanhla Nene a few days later), a revision of 2017 GDP data, Moody's assessment of South Africa's debt risk, and an interest rate cut.

On balance, the Budget met consensus expectations with a prudent amount of fiscal austerity

The main elements of the Budget were the following:

- A 1% VAT increase to 15%, although zero-rated items will remain so
- An increase in social grants of 5%-6%
- An excise duty increase of some 6%-10%
- An increase in estate duty and donations tax from 20% to 25% on amounts above R30 million
- A fuel levy increase of 22c/l
- Free higher education to absorb R57 billion over the next three years
- A carbon tax, set to be implemented on 1 January 2019

Its delivery and the replacement of the finance minister at the end of February also ended the bull run of both local bonds and the rand, which started in mid-November 2017.

Moody's maintained South Africa's sovereign debt rating above investment grade

The surprise was the revised outlook statement from negative to stable, based on the proposed strengthening of institutions, improved growth prospects, and fiscal consolidation. This should be supportive of investor flows. It also provides some room for the new government leadership to begin its vital institutional reform process.

Economic growth was higher than expected

The rollout of good news continued into March when Statistics SA announced that economic growth in the fourth quarter of 2017 was materially higher than expected, at 3.1% quarter-on-quarter, seasonally adjusted and annualised (SAAR). This led to an overall growth rate of 1.3% for 2017. But this was not all; at the flick of a pen, following retrospective data revisions, the statistics no longer reflected a technical recession in the first two quarters of 2017!

There was an interest rate cut based on a more benign inflation outlook

The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) added to the feeling of goodwill by cutting the repo rate by 0.25% to 6.50%. While it came down to a casting vote decision, this was supported by a more benign inflation outlook. The SARB lowered its inflation forecasts, which are now comfortably inside the 3%-6% target range. The overall view was that the MPC may require a further retreat in inflation expectations or a stronger rand before it will entertain the idea of another cut. Our house view is that there might be another opportunity for the SARB to cut the repo rate later this year.

Table 2: South African financial market returns

Asset class (ZAR)	Quarter	12 Months
All Share	-6.0%	9.5%
All Bond	8.1%	16.3%
Listed Property	-19.6%	-7.1%
Cash	1.6%	7.4%
Tier-1 (ZAR)	**Quarter**	**12 Months**
Resources	-3.8%	10.6%
Financials	-3.6%	17.5%
Industrials	-8.0%	5.7%
Size (ZAR)	**Quarter**	**12 Months**
Large Cap	-6.3%	11.0%
Mid Cap	-3.6%	2.3%
Small Cap	-1.3%	-2.8%
Bond market (ZAR)	**Quarter**	**12 Months**
All Bond	8.1%	16.3%
1-3 years	2.6%	9.6%
3-7 years	3.8%	11.8%
7-12 years	6.2%	14.9%
12+ years	10.0%	18.2%
Rand	**Quarter**	**12 Months**
vs US$	4.4%	13.2%
vs Euro	1.9%	-1.9%
vs Sterling	0.4%	0.0%

Source: Deutsche Bank

A strong rand, corporate governance breaches and a rotation dominated

The local market produced a mixed bag of returns for the quarter, as shown in Table 2:

- Bonds headed the performance league, reflecting investor optimism about the political changes and macroeconomic announcements after the ANC elective conference in December. Interestingly, it was the long end of the bond market that rallied the most, suggesting a higher risk appetite. For most of 2017, the 3- to 12-year area provided the bulk of the support.

Both local bonds and the rand/dollar exchange rate were ranked in the top four of their global peer group categories. The FTSE/JSE All Share Index (ALSI) return of -6.0% in the quarter is the worst quarterly performance in the past eight years.

- Industrial shares were the worst performer, returning -8.0%. Naspers (18% of the ALSI and 33% of the industrial sector) fell by 16% in the quarter. Several issues drove it lower, including a 12% sell-off in Tencent's share price (which had in turn been hit by the global sell-off in tech shares), a growing number of shareholders querying its dual-class share structure and remuneration policies, and the announcement that it would be selling 190 million of its Tencent shares to raise $9.5 billion to further grow its classifieds, food delivery and fintech businesses.
- Resources lost 3.8%. The standout feature was that the winners of 2017 became the losers for the year to date, with Exxaro (-27%), Kumba (-21%) and Assore (-16%) all materially down.
- Financials fell by 3.6%, but due to a quirk of the index, this sector also includes property companies. By stripping these property shares out, a different picture emerges. Santam was up by 24%, driven by better-than-expected results. Standard Bank added another 12% after having risen by 29% in 2017.
- Listed property shares had a particularly difficult quarter, falling by nearly 20%. Most of the fall was driven by a handful of shares: Fortress-B (-70%), Resilient (-65%), Greenbay (-61%) and NEPI Rockcastle (-44%). At the heart of the fall is Resilient, which has holdings in the other entities. The company has been aggressively acquiring investments over the past few years and questions have arisen over its accounting policies.
- There can be little doubt that after African Bank, investors have become a lot more sensitive to governance issues. This will have intensified after Steinhoff, Resilient and EOH. This is a good thing, because failures in governance can be hugely costly to ordinary shareholders who are typically at the back of the queue when it comes to salvaging anything from the ashes of a collapsed company.

Where to from here?

The strong rand is undoubtedly a plus for consumers. While we cannot discount further upside, it has dragged up the valuations of those shares that are strong rand beneficiaries, such as the banks and retailers. Without a materially positive change in South Africa's growth trajectory, we believe these valuations aren't justified. We have also used the strength in the rand to take our offshore weighting – where possible – to the maximum 30% that is now allowed. We believe that there is better value in certain offshore markets. In the meanwhile, an aged bull market and the lifting of quantitative easing does promise greater volatility. Stay diversified. ■