Market Commentary – Quarter Ended September 2018

Market Review

US equity markets significantly outperformed those of other major regions during the third quarter of 2018 as US economic growth and earnings data remained very strong. Japanese equities also performed well while European equity gains were modest. Collectively the equities of emerging markets declined.

Index	3 Mth Total Return in USD (%)	3 Mth Total Return in EUR (%)	3 Mth Total Return in GBP (%)
MSCI World	5.0	5.5	6.3
S&P 500 (US)	7.7	8.3	9.1
FTSE Europe ex UK	1.8	2.4	3.1
FTSE All Share(UK)	-2.0	-1.5	-0.8
TOPIX (Japan)	3.2	3.8	4.5
MSCI Emerging Markets	-1.1	-0.6	0.1
MSCI Asia ex Japan	-1.6	-1.1	-0.4

International trade issues continued to dominate headlines this quarter. Although new rounds of tariffs heightened fears of further escalation in the trade dispute between the US and China, progress was made elsewhere. A new trade agreement between the US, Mexico and Canada defused the risk of a trade war on the North American continent. A truce agreed between the US and EU, whereby new tariffs would not be implemented while trade talks were ongoing, also allayed concerns.

Trump confirmed that the US would be imposing tariffs on about $200bn of Chinese exports and threatened to increase this by the start of 2019 should the two countries fail to agree a deal. China retaliated with tariffs on about $60bn of US goods. Trump then threatened to raise tariffs on another $267bn of Chinese imports.

The new United States-Mexico-Canada Agreement (USMCA) will replace the North American Free Trade Agreement (NAFTA). An initial agreement between the United States and Mexico was reached before finalisation with Canada on 30 September 2018. The agreement will take effect after being passed into law and signed by each country. USMCA will, inter alia, give the US more access to Canada's $19 billion dairy market, incentivise more domestic production of cars and trucks, increase environmental and labour regulations, and introduce updated intellectual property protections.

The US and Europe issued a joint statement in July which outlined their intention to work together towards zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods. US import tariffs on steel and aluminium imposed in March will however remain.

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The US

The S&P 500 Index rose by 7.7% in US dollars.

US second quarter Gross Domestic Product (GDP) increased at an annual rate of 4.2%, supported by a strong labour market. The unemployment rate remained at 3.9% in August, close to its 18-year low. In September, US consumer confidence hit its highest level since 2000. Wage growth rose to the highest level since 2009, supporting retail sales growth of over 7% year-on-year.

As had widely been expected, the US Federal Reserve (Fed) increased its target rate by 0.25% to 2.25% during the quarter. The Federal Open Market Committee dropped its long-standing description of monetary policy as “accommodative” and reaffirmed its outlook for further gradual increases in 2019.

Europe

Eurozone

The FTSE Europe ex UK index rose by 2.4% in euros and by 1.8% in US dollars. Returns were tempered by investors’ worries about slowing economic growth and the negative impact of global trade skirmishes on Europe’s international trade-dependent economy.

Eurozone economic growth slowed to 2.1% in the second quarter, gradually decelerating from 2.4% in the first quarter and 2.7% at the end of 2018. Unemployment fell to 8.1% in August, the lowest rate since late 2008. European Central Bank president Mario Draghi said that slower-than-expected economic growth appears to be a temporary setback due to uncertainty over the global trade environment, adding that the central bank remains on schedule to phase out its bond-buying stimulus program by the end of December.

UK

The FTSE All Share index fell by 0.8% in sterling and by 2.0% in US dollars amid fears of a “no deal” Brexit.

UK economic growth recovered from the slowdown seen in the first quarter and, as widely expected, the Bank of England raised interest rates by 0.25% to 0.75% at its August meeting by unanimous vote. In September the central bank reiterated that future increases would be at a gradual pace and to a limited extent. Unemployment remained at 4% in July and the number of job vacancies hit a record high.

Japan

The Topix index rose by 5.9% in yen and by 3.2% in US dollars following a surge towards the end of the period as investors looked past global trade tensions and focused on the strength of the US economy, the top destination for Japanese exports. The re-election of Prime Minister Shinzo Abe to a three-year term as leader of the ruling Liberal Democratic Party signalled continuity in economic policy.

Second quarter annualized GDP growth was revised sharply higher to 3% from 1.9%. Unemployment fell to 2.4% in August while the number of jobs available to applicants remained at its highest level since 1974. The Bank of Japan maintained interest rates at their most recent meeting reiterating that they would remain extremely low for an extended period.

Emerging Markets

The MSCI Emerging Markets Index fell by 1.5% in US dollars.

China: The MSCI China IMI Index fell by 7.6% in US dollars. Chinese stocks slid for the second quarter running and the yuan weakened by 4% against the dollar. Uncertainties over China's trade dispute with the US and the country's slowing pace of economic growth hurt investor sentiment.

Russia: The MSCI Russia IMI Index rose by 5.6% in US dollars, benefitting from crude oil price strength. Interest rates were raised by 0.25% to 7.5%.

Brazil: The MSCI Brazil IMI Index rose by 5.1% in US dollars on good corporate earnings reports and ahead of October's presidential election.

India: The MSCI India IMI Index fell by 4.3% in US dollars. The rupee weakened by 5% and traded near record lows against the US dollar. Interest rates were raised by 0.25% to 6.5%.

South Africa

South Africa's economy slipped into recession for the second time since 2009, as negative GDP growth of 0.7% (quarter-on-quarter) surprised investors on the downside. Persistent decline in the mining and manufacturing sectors and a temporary drop in agricultural produce were the most significant factors in the result.

Refreshingly, President Cyril Ramaphosa's response was swift as he announced six measures to boost growth in the near to long-term. While limited attention was paid to the reform of state-owned enterprises (SOE's) and the land debate (likely for political reasons), Mr. Ramaphosa addressed a few key economic bottlenecks such as the onerous visa regulations and delays on the approval of additional network capacity. Furthermore, he pledged to lower the cost of doing business, reprioritise government spending, propel the private sector through a R400bn infrastructure fund and to provide greater policy certainty for investors via a revised mining charter.

On the latter and after a lengthy spell of engagement with varying stakeholders, Minister of Mineral Resources Gwede Mantashe laid out a revised mining charter with clearer requirements for companies operating in this sector. In particular, concerns around carried interest and the "once empowered, always empowered" principle have been allayed. Investec described the charter as a sensible compromise between all stakeholders, which would bode well for the future of an industry in turmoil.

In what was a close vote, the Reserve Bank again left interest rates unchanged as inflation came in below expectations at 4.9% (year-on-year).

The Rand and the JSE: The Rand worsened its year-to-date losses in the third quarter by depreciating 3.1% against the dollar, 1.7% against sterling and 2.4% against the euro. The JSE similarly struggled as foreign selling continued due to a combination of disappointing GDP growth and further pressure on emerging markets in general. While resource shares remained resilient, the All Share Index decreased by 2.5% on the back of an 8.4% decrease in the Industrial index.

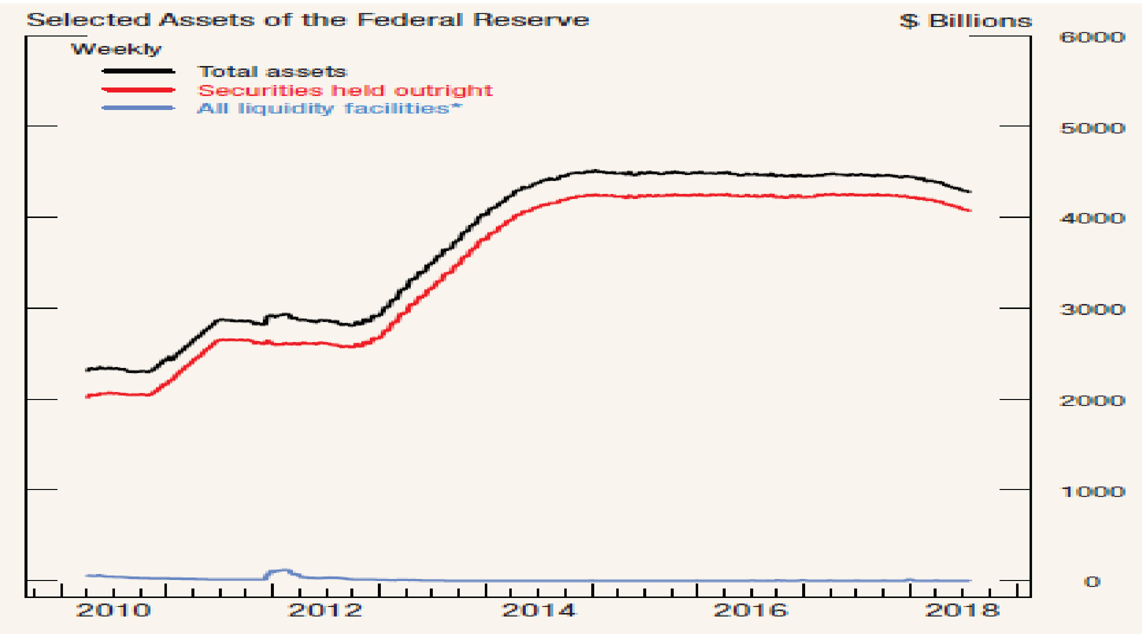
INVESTMENT ENVIRONMENT AND OUTLOOK: *Trump targets China and the Fed*

In our previous report we highlighted what in our opinion were the two most important risks to the immediate outlook for economies and markets. These were the escalation of Donald Trump-led US import tariff increases ("trade wars") and US Federal Open Market Committee (FOMC) -led increases in the federal funds target overnight interest rate.

While the former has generally produced improved agreements with several major trading partners, Trump remains committed to his trade dispute with China, arguing that the USA is winning the trade wars as evidenced by the fact that USA growth has been accelerating, while Chinese growth has been slowing. While China continues to cling *inter alia* to outmoded and outdated concessions granted by the World Trade Organisation (WTO) to infant economies, e.g. the sharing of intellectual property, we believe that Chinese capitulation is inevitable but the timing thereof impossible to predict.

The latter has more recently gained attention following sharp corrections in global equity prices amidst concerns that the US Fed may pick up the pace of its interest rate hikes. Quoting Donald Trump: "I really disagree with what the Fed is doing. I think the Fed is making a mistake. They're so tight. I think the Fed has gone crazy." So is he right? "Crazy" might be too strong a word but there is no doubt that since Q1 2018 the Fed has been tightening monetary policy by selling securities such as Treasury Bills (TB's) which takes liquidity out of the financial system (chart 1). One could even make a case that monetary policy has been tightening since quantitative easing (QE) ended in 2014. As the Chinese proverb says, "When there is no gain the loss is obvious!". In any event by their own admission the Fed is no longer accommodative.

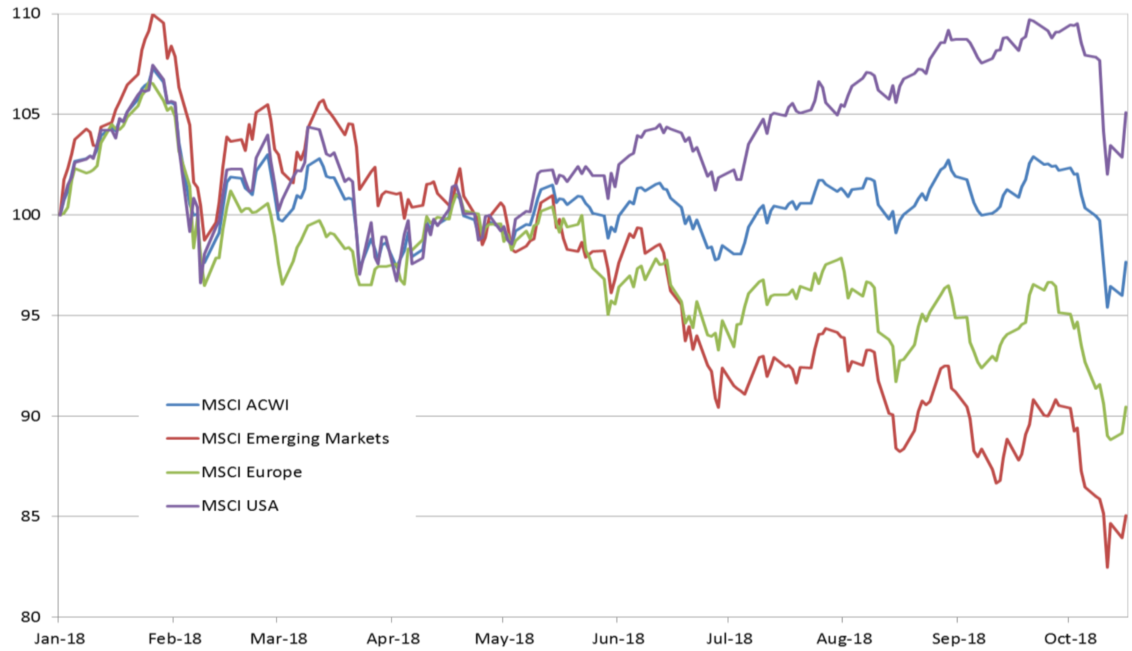
<u>Chart 1: Assets of the the US Federal Reserve (August 2018 report)</u>



On balance we feel that the Fed will act responsibly and only raise target rates reactively to good economic data. The NY Fed's model to which we referred last quarter still shows the probability of a US recession to be low and for the time being we are prepared to give this robust indicator the benefit of the doubt. Perhaps Christine Lagarde (MD of the IMF) summed it up best when she said "I wouldn't associate (Fed chairman) Jay Powell with craziness. He comes across - and members of his board - as extremely serious, solid and certainly keen to base their decisions on actual information." Accordingly we remain of the view that US yield curve inversion (when the US 3m TB rate increases over and above the US 10 year bond rate) should be our red flag of choice in calling an end to the US equity bull market.

Since the commencement of trade wars at the end of Q1 2018 there has been significant divergence between US, European and emerging market shares (see chart 2) with the US the big winner while emerging markets have suffered most. These extreme divergences are creating opportunities for exploitation in terms of tactical asset allocation.

Chart 2: Selected global equity market indices (1 January 2018 =100)



SOUTH AFRICA: *Still suffering from emerging market headwinds*

The South African economy and Rand is behaving very similarly to other commodity exporters which are in turn being affected by the actual and perceived economic slowdown in China. This has been exacerbated by further rises in oil prices owing to both global growth and geopolitical factors. While Rand weakness has mitigated declines in certain JSE-listed international shares, it has been insufficient to offset the underperformance of those with large emerging market exposures e.g. AB-InBev and British American Tobacco. SA banks and retailers have unsurprisingly also experienced headwinds.

STRATEGY: *Exploiting extreme divergences between developed and emerging markets*

We expect emerging markets and currencies to remain under relative pressure until such time as there is more clarity as to the outcome of US - China trade wars and the future stance of the US Fed. Believing that the US holds most of the economic cards, it is most likely eventually to prevail in achieving a much fairer global trade order. This implies average global tariffs eventually ending up lower than where they were in 2017 which of course would improve the outlook for the global economy. While it may be hard to envisage peace breaking out from the current wars, wonderful contrarian opportunities occasionally arise for investors with longer term time horizons and this may well be one of them.

Such opportunities are also to be found on the JSE, including certain dual-listed international blue-chip shares, and those of companies exposed to the domestic economy. These will be similarly exploited.

INDICES BY SECTOR

		Sector	2017 29-Sep	29-Dec	2018 29-Mar	29-Jun	28-Sep	3 Months % Chg	*6 months* % Chg	*9 months* % Chg	*12 months* % Chg
J857	1	Life Assurance	37029	43992	43545	38786	43304	11.6%	-0.6%	-1.6%	16.9%
J177	2	Mining	25982	27351	25386	29982	31068	3.6%	22.4%	13.6%	19.6%
J580	3	Financial	41264	47450	44820	42072	42449	0.9%	-5.3%	-10.5%	2.9%
J235	4	Construction	21	22	24	22	22	0.0%	-8.3%	0.0%	4.8%
J835	5	Banks	7570	9619	9808	9085	8952	-1.5%	-8.7%	-6.9%	18.3%
J537	6	General Retailers	6 556	8017	8575	6930	6810	-1.7%	-20.6%	-15.1%	3.9%
J203	7	**All Share Index**	**55 580**	**59505**	**54865**	**57160**	**55790**	-2.4%	1.7%	-6.2%	0.4%
J200	8	**Top 40**	**49 376**	**52533**	**48795**	**50980**	**49587**	-2.7%	1.6%	-5.6%	0.4%
J272	9	General Industrials	176	203	202	180	174	-3.3%	-13.9%	-14.3%	-1.1%
J273	10	Electronics	12 894	12186	12865	13498	12933	-4.2%	0.5%	6.1%	0.3%
J150	11	Gold Mining	1 325	1304	1105	1060	996	-6.0%	-9.9%	-23.6%	-24.8%
J211	12	Industrial 25	75 729	79085	71103	75342	68994	-8.4%	-3.0%	-12.8%	-8.9%
J357	13	Food Producers	9142	10807	9785	8948	7852	-12.2%	-19.8%	-27.3%	-14.1%
J353	14	Beverages	211	231	220	231	177	-23.4%	-19.5%	-23.4%	-16.1%

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