Market and Economic Update

Investment Weekly

Adviceworx

25 April 2016

MARKET AND ECONOMICS

RAND RIDES WAVE OF GLOBAL RISK APPETITE

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The rand rally continued last week. From the beginning of the year to the end of last week, the rand gained 9% against the US dollar. However, it weakened sharply in the first three weeks of January from R15.55 to R16.93 and then gained 15% since 20 January 2016.

GLOBAL FACTORS DOMINATE

Why the sudden turnaround? It is no coincidence that the rand hit rock bottom on the same day as the oil price. The oil price bottomed around $28 per barrel on 20 January and is now above $40. Other commodities also bottomed at the same time. The Thomson Reuters CCI, an equally weighted broad index of commodity prices, gained 14% since 20 January and is positive year-to-date (after five years of relentless declines). Global equities had a horrendous start to the year, but also improved from late January onwards.

In other words, the rebound in commodity prices and improvement in global investor sentiment towards emerging markets are behind the rand rally and not any changes in local, political or economic reality. The latter actually add volatility to the exchange rate, but the trend is still determined by global factors.

CHINA STABILISING

One of the reasons why sentiment towards emerging markets has improved is that fears over a hard landing for China have eased for now. China's economy shows signs of growth stabilising, at least in the short term. While the gross domestic product (GDP) growth rate continues to decline, the economy still expanded by 6.7% compared to the previous year. On a more forward-looking basis, both the services and manufacturing purchasing managers' indices have moved into positive territory (above 50 index points). The real estate sector – at the heart of the growth slowdown – shows improved activity in residential sales and new construction. Retail sales have also accelerated slightly, while investment in infrastructure picked up.

The latest International Monetary Fund (IMF) global forecasts indicate that China was also the only major economy to see its growth outlook upgraded from the previous predictions. However, the expected growth rate of 6.5% this year and 6.2% next year still represents a slowdown. The IMF also warned that the improvement in China's growth outlook could come at the cost of longer-term problems, as it increased the flow of credit to struggling industries, worsening the nation's problems of overcapacity and rising debt and the dominance of state-owned enterprises in the economy. The choice between slower growth or a more balanced and sustainable economy has been a difficult one for China's leaders. The growth wobble of the past year appears to have put reforms on the back-burner with Beijing choosing to stimulate the 'old economy' sectors.

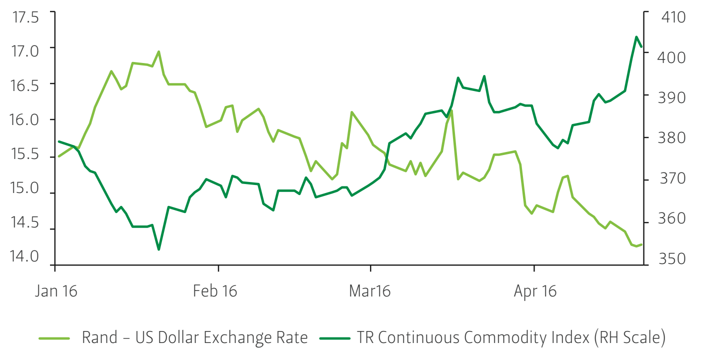
Relative to the very lofty expectations of the previous decade, emerging market growth was disappointingly low (of the much vaunted BRICS, Brazil and Russia find themselves mired in recession). However, emerging markets are still likely to grow much faster than developed markets.

Since the start of the year, the MSCI Emerging Markets Index has outperformed the MSCI World (developed market) Index by 5% in US dollar terms. Since global risk appetite recovered (on 20 January), it outperformed by 10%.

NOTHING IS A ONE-WAY BET

The other reason why emerging markets rallied is simply that they became too cheap, in local currency terms, but especially in dollar terms. Emerging markets equities have underperformed developed markets for the past five years. At the beginning of the year, the forward price earnings ratio on the MSCI Emerging Markets Index was at the largest discount to the MSCI World Index since 2005. Emerging markets currencies have been hammered (the rand in particular) hard and currency investors can benefit from appreciation as well as decent returns on the underlying assets. As an example, the yield on the 10-year South African rand-denominated government bond was a very attractive 9.5% in January. Long bonds have returned 7% in rand terms since the start of the year, which means US-based investors have seen a 16% gain in US dollars, which is not bad at all. Moreover, a stronger rand tends to imply lower inflation and stronger bonds, potentially a virtuous cycle for foreign investors. For local investors, this once again highlights the importance of diversification and not letting emotions impact your investment decisions. Towards the end of last year it was very tempting to assume the rand would continue weakening and to abandon local assets. It is too early to say if the rebound in commodity prices and emerging markets sentiment will be sustained, but the volatility of the rand – and its sensitivity to global risk appetite – means it is never a one-way bet.

CHART 1: THE RAND AND COMMODITY PRICES



Source: Datastream

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INFLATION DECLINES, BUT RAND HOLDS THE KEY FOR INTEREST RATES

Consumer inflation declined to 6.3% year-on-year in March from 7% in February as expected. Between February and March, the consumer price index increased 0.8%.

Petrol inflation declined sharply from 20% year-on-year to 3.8%. This was due to a 5.7% cut in the petrol price in March, but also because petrol prices increased sharply in March and April last year, creating a more favourable base. Even after the 88 cents per litre increase earlier this month, year-on-year petrol inflation in April should be at -2%. Based on the current average under recovery of 12 cents per litre, petrol inflation should be around -1% in May.

The big worry remains food inflation, which increased from 8.6% year-on-year in February to 9.5% in March. On a month-on-month basis, food prices have increased by 1.6%. Bread and cereal prices increased 13%, reflecting the massive increase in wheat and maize prices earlier in the year. Fruit prices saw big month-on-month and year-on-year increases. Meat and fish prices also accelerated marginally on a year-on-year basis. Vegetable inflation receded somewhat from extremely elevated levels.

Looking ahead, maize prices have pulled back from a record R4 800 per tonne to R4 100 per tonne and wheat prices from R4 900 to R4 500 per tonne. Since South Africa is a net importer of both at the moment, the exchange rate plays a key role, meaning that the recent rand appreciation could keep a lid on food inflation down the line.

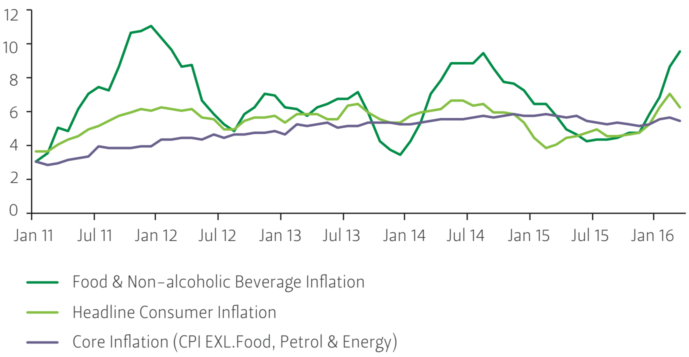
FEES HAVE FALLEN

Education inflation halved from 9% after Government announced earlier this year that there will be no university fee increases. This, together with a decline in alcohol inflation, saw core inflation moderate from 5.4% to 5.7%. Core inflation excludes volatile food, petrol and energy prices, and is a measure of underlying inflationary pressures in the economy.

INTEREST RATE OUTLOOK COULD IMPROVE

The South African Reserve Bank (SARB) remains hawkish and has raised interest rates as it expects a protracted breach of the upper end of its target range, despite the fact that it characterises the economy as being in "a downward phase of the business cycle" (since November 2013). The Reserve Bank is particularly worried that the rand could weaken further and/or that pass-through of the weak exchange rate to inflation could accelerate. The pass-through rate has been surprisingly low over the past five years; indeed about half of what the SARB expects it to be. There are signs of accelerated pass-through with some exchange rate-sensitive items in the core CPI basket posting rising inflation. Clothing and footwear inflation increased to 4.8% year-on-year from 4.5%, while household appliance inflation climbed to 6.1%. Pass-through might still accelerate and the exchange rate itself is clearly still vulnerable to shifts in global sentiment. However, the fact that the rand has made substantial gains from historically weak levels should help relieve upward pressure on interest rates.

CHART 2: SOUTH AFRICA INFLATION



Source: StatsSA

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INDICATORS

BEST – The price of iron ore, one of South Africa's four major export items, shot up to US$70 per tonne.

WORST –Microsoft and Google both announced profits that missed analysts' estimates leading to a fall in the tech-heavy Nasdaq composite index.

Equities – Global

Description	Index	Currency	Index value	Week	Month-to-date	Year-to-date	1 Year
Global	MSCI World	US$	1 686.0	0.84%	2.31%	0.60%	-5.39%
United States	S&P 500	US$	2 092.0	0.43%	1.55%	1.41%	-0.24%
Europe	MSCI Europe	US$	1 506.0	1.21%	2.17%	-2.08%	-11.57%
Britain	FTSE 100	US$	9 088.0	0.91%	2.43%	-2.24%	-13.65%
Germany	DAX	US$	1 062.0	1.72%	2.02%	8.46%	-7.65%
Japan	Nikkei 225	US$	156.4	1.63%	7.87%	7.87%	-6.48%
Emerging Markets	MSCI Emerging Markets	US$	845.0	0.00%	0.96%	6.83%	-18.91%
Brazil	MSCI Brazil	US$	1 373.0	-1.65%	4.02%	34.08%	-19.66%
China	MSCI China	US$	57.8	-0.98%	2.16%	-2.50%	-30.46%
India	MSCI India	US$	451.7	0.54%	1.28%	-0.50%	-11.95%
South Africa	MSCI South Africa	US$	454.0	-0.44%	1.79%	15.23%	-21.72%

Equities – South Africa (TR unless indicated otherwise)

Description	Index	Currency	Index value	Week	Month-to-date	Year-to-date	1 Year
All Share (Capital Only)	All Share (Capital Index)	Rand	52 926.0	0.15%	1.29%	4.17%	-2.24%
All Share	All Share (Total Return)	Rand	7 186.0	0.25%	1.63%	5.34%	0.70%
TOP 40/Large Caps	Top 40	Rand	6 316.0	0.03%	1.17%	2.47%	0.14%
Mid Caps	Mid Cap	Rand	15 372.0	1.26%	3.82%	23.10%	2.85%
Small Companies	Small Cap	Rand	19 785.0	2.13%	5.17%	17.09%	6.29%
Resources	Resource 20	Rand	1 940.5	4.14%	12.91%	26.60%	-19.19%
Industrials	Industrial 25	Rand	12 881.0	-1.59%	-1.54%	-2.26%	3.61%
Financials	Financial 15	Rand	7 937.0	1.48%	-0.09%	4.99%	-8.32%
Listed Property	SA Listed Property	Rand	2 120.0	-0.24%	0.90%	11.11%	4.59%

Fixed Interest – Global

Description	Index	Currency	Index value	Week	Month-to-date	Year-to-date	1 Year
Global Government Bonds	Citi Group WGBI	US$	936.7	0.05%	1.53%	7.60%	6.49%

Fixed Interest – South Africa

Description	Index	Currency	Index value	Week	Month-to-date	Year-to-date	1 Year
All Bond	BESA ALBI	Rand	497.8	-0.36%	1.12%	6.81%	1.24%
Government Bonds	BESA GOVI	Rand	496.6	-0.33%	1.06%	6.55%	1.74%
Corporate Bonds	SB JSE Credit Indices	Rand	167.9	1.62%	-5.33%	-8.58%	-20.09%
Inflation Linked Bonds	BESA CILI	Rand	243.3	1.08%	2.94%	5.20%	6.14%
Cash	STEFI Composite	Rand	338.6	0.15%	0.42%	2.12%	6.68%

Commodities

Description	Index	Currency	Index value	Week	Month-to-date	Year-to-date	1 Year
Brent Crude Oil	Brent Crude ICE	US$	45.1	2.31%	12.85%	25.39%	-27.19%
Gold	Gold Spot	US$	1 232.0	0.41%	-0.08%	16.01%	2.41%
Platinum	Platinum Spot	US$	1 013.0	2.32%	3.58%	16.30%	-11.99%

Currencies

Description	Index	Currency	Index value	Week	Month-to-date	Year-to-date	1 Year
ZAR/Dollar	ZAR/USD	Rand	14.39	1.06%	1.85%	7.95%	-15.62%
ZAR/Pound	ZAR/GBP	Rand	20.51	0.29%	2.83%	12.29%	-11.85%
ZAR/Euro	ZAR/EUR	Rand	16.17	1.29%	3.27%	5.06%	-19.42%
Dollar/Euro	USD/EUR	US$	1.12	0.89%	1.61%	-2.41%	-4.46%
Dollar/Pound	USD/GBP	US$	1.44	-1.75%	-0.01%	2.77%	3.47%
Dollar/Yen	USD/JPY	US$	0.01	2.25%	0.00%	-6.74%	-5.62%

Source: I-Net, figures as at 1 April 2016

THE WEEK AHEAD

SOUTH AFRICA

- Producer inflation
- Money supply and credit extension
- Trade balance

US

- New home sales and home prices
- Durable goods orders
- Consumer confidence
- Federal Reserve interest rate decision
- UK first quarter GDP growth initial estimate
- Personal income and spending

EUROPE

- Eurozone loan growth
- Eurozone economic sentiment index
- Eurozone inflation
- Eurozone unemployment
- Germany Ifo index
- UK first quarter GDP growth

JAPAN

- Leading indicator
- Inflation
- Industrial production
- Retail sales

The Old Mutual Wealth Investment Note is published on a weekly basis to keep our clients and financial planners informed of what is happening in financial markets and the economy and to share our insights. Markets are often very volatile in the short term and similarly, economic data releases or central bank actions may cause concerns for investors. This does not mean that investors should take action based on the most recent events. It is better to be disciplined and remain invested in well-diversified portfolios that are designed to achieve long-term objectives. Our Strategy Funds are actively managed, with asset allocation changes based on valuations and in anticipation of future real returns, and not in response to the most recent market noise. The future is always uncertain and that is why our Strategy Funds are diversified and managed with a long-term focus.