SA Equities 2018 roundup and outlook for the year ahead

January 2019 – ALUWANI Capital Partners
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Asset class returns: 31 December 2018 in Rand on a per annum basis

	2017-12-31	2015-12-31	2013-12-31	2008-12-31
	12 Month	3 Year p.a	5 Year p.a	10 Year p.a
Equity	-8.5%	4.2%	5.8%	12.7%
Gold	14.1%	3.8%	8.0%	8.5%
Platinum	-0.8%	-5.5%	-4.3%	3.0%
Property	-25.3%	-1.2%	5.7%	12.1%
Bonds	7.7%	10.8%	7.7%	7.7%
Inflation Linked Bonds	0.1%	2.9%	4.6%	7.4%
Cash	7.3%	7.4%	6.9%	6.7%
DM Equity	6.5%	3.9%	12.2%	15.2%
EM Equity	-0.5%	6.9%	8.8%	13.2%
Global Bonds	14.9%	0.0%	8.1%	6.9%
Global Cash	16.1%	-2.6%	6.6%	9.0%
Africa Equity	1.5%	-2.2%	1.2%	n/a
Africa Fixed Income	7.5%	5.5%	13.0%	17.8%
CPI +5	10.2%	10.5%	10.4%	10.3%

Asset class returns in perspective

Much has been said, to the point of near despair about broader investment returns for the year 2018. It is most useful to have a broader perspective when reviewing financial asset class returns, to this end long run history and a comparison to the broader universe of investible financial assets is most informative, as opposed to just a 12 months performance review.

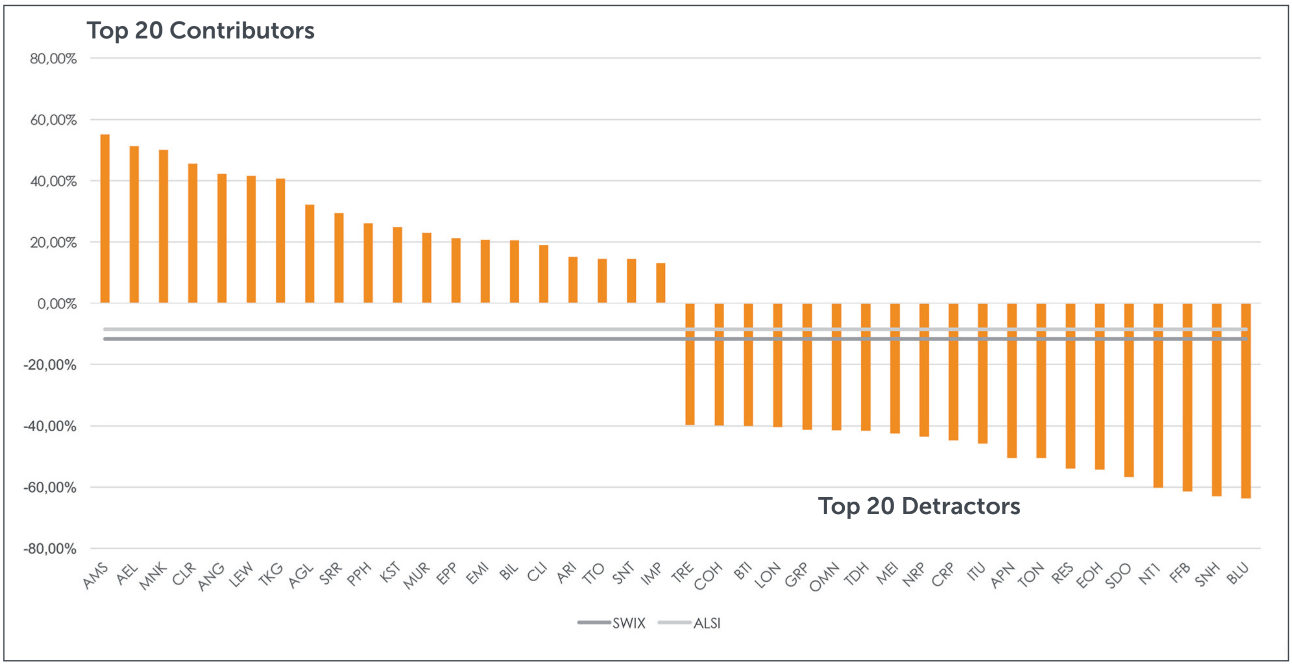
The table above lists our investible universe of asset classes as allowed by the various mandates we manage for and on behalf of our clients. A few hard facts and observations:

- Indeed the past 12 months to end December 2018 were terrible for investors, especially domestic and emerging market equities and domestic property (the riskiest asset classes).
- Over the last 5 years, on a per annum basis, very few asset classes have managed to generate a return above inflation + 5% (10,4%) this being an approximation of a minimum required return for investing in riskier assets like equities.

This means, over the past 5 years, an equities investor has not been sufficiently rewarded (5.8%p.a JSE All Share return vs 10.4%) for the risk of investing in equities, other than Global Equities, most specifically developed market equities which in addition were buffeted by the weakening USD/ZAR exchange rate, and African Fixed Income, all other asset classes have returned sub-par returns over this time horizon.

For domestic equities in particular, the return profile appears to be deteriorating, i.e. from 5 years to 3 and the past 12 months, even against our other Emerging Market basket. The same could be said for domestic listed property sector, with domestic bonds, cash and African Fixed Income the most consistent.

JSE All Share: 1 Year stock return distribution
Key takeaway: Equities are considered a long term game, requiring a lot more patience



Source: ALUWANI Capital Partners

Over a 12 month period to end Dec 2018, the domestic equity market individual stock performance showed a lot of breath with the best and worst performing stocks returning +55% (AngloPlats [AMS] | AECI [AEL] | Anglo Gold [ANG]) and -63% (Blue Telecom [BLU] | Steinhoff [SNH]) respectively, making it fertile ground for astute stock pickers. Despite dismal overall headlines JSE perfomance, there is always opportunity for stock picking.

However, the picture changes drastically when looked at over the very long term, over the past 10 years, equities (domestic + global) have been head and shoulders outperformers compared to all other bar African Fixed Income. Global equities and African Fixed Income returns have been buffeted by the weakness in the ZAR/USD over these respective timeframes.

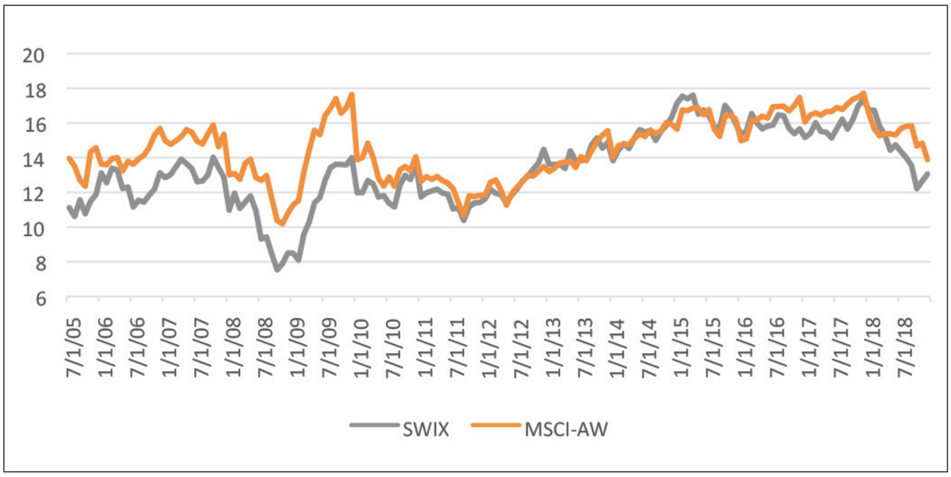
It is easy to despair and chase the latest winners, after all 5 years is long-term enough, however it is important to have some appreciation of the environment that led to such dismal returns over this time horizon. 2018 was the worst year for global equities since the global financial crisis of 2008. The 2008 global financial crisis was an impactful significant development both for the actual economies and financial markets across the globe, warranting an unorthodox response from the authorities in the form of quantitative easing. Briefly and very simplistically, quantitative easing was meant to make financial conditions easier for businesses in the real economy in the form of artificially low interest rate to stimulate growth and employment, spearheaded by the US Federal Bank. The unintended consequence though was that most of that 'cheap' money found its way into financial markets, equities being the main beneficiary as investors were seeking high yielding growth assets. Anything artificial is not sustainable and so the era of low interest rates had to come to an end at some point, and the Fed started that process in earnest just over a year ago of normalising interest rates on the back of sustained economic growth in the US, with equities set to be casualties after being initially beneficiaries of that cheap money.

The 2nd thematic that played well against domestic equities in particular in 2018 (in fact the same can be said of the past 5 years) was the lack of economic growth, a key underpin for corporate earnings. As a reminder, equities returns are a function of corporate earnings growth (which can be lumpy and susceptible to disappointments, unlike fixed income instruments whose yield is smoothed through to maturity), dividends and a rating in the form of a multiple, ie Price/ Earnings ratio (multiple investors are willing to pay for that expected earnings growth). 2018 was a particularly bad year for growth, at some point SA did go into a technical recession with conditions remaining tough for both business and the consumer (eg VAT + interest rate hikes and record petrol price).

Deconstructing the JSE returns for 2018, shows that the main drag on performance was valuations: the 12 month forward consensus PE for JSE All Share Index started the year at 16x and ended the year at 12.7x, leaving total returns for the index deep in negative territory despite earnings growth over 2018 of 8.5% and a 3% contribution from dividends. The good news is that there was earnings growth of 8.5% despite a fairly anaemic GDP performance, the lack of confidence (largely on the back of domestic socio-political factors like land reform policy, SOE challenges, etc) undermined the rating multiple investors placed on those earnings, ie P/E thus all compounding into negative returns. Clearly, a challenging global backdrop as detailed above was not supportive.

Valuations – as illustrated below, SA index multiples are starting 2019 at close to 6 year lows and not far off aggregate Global Equities multiple. Looking back, we note that SA multiples were lower than they are now over the GFC and slightly lower in around 2011 and 2012 when there were also significant concerns over the global growth backdrop. For existing domestic equity investors, our view is to stay the cause and rather see the past 12 month returns as a pull back in valuations that has created a buying opportunity.

12 Month Forward Consensus PEs: SA (including and excluding Naspers) vs MSCI EM



Source: ALUWANI Capital Partners, Bloomberg

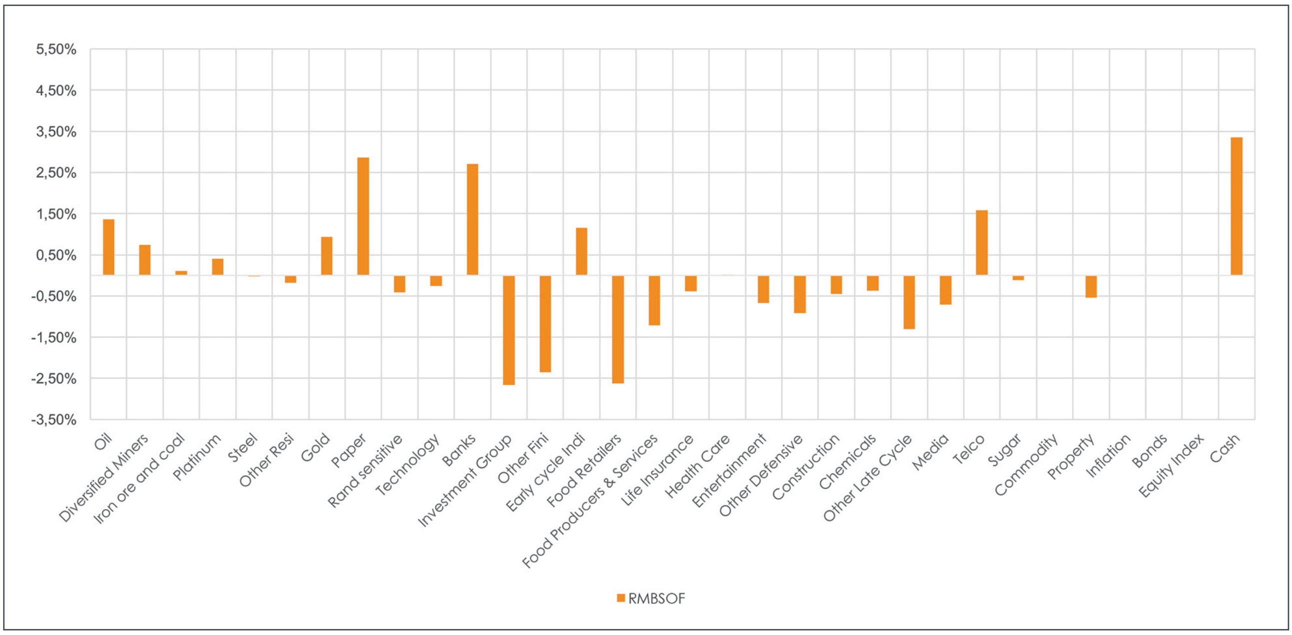
Macro outlook

Our base case for South Africa in 2019 is a slow (but somewhat rocky) road to recovery (1.3% GDP growth for 2019), but with a narrative that stacks trend up better towards H2 2019. SOE finances are a definite concern for the fiscal outlook, however Minister Mboweni has made it clear that additional fiscal resources are constrained and the onus is on newly appointed SOE management to accelerate the necessary reforms. We are cautiously optimistic that SA average inflation will remain at the mid-point of the SARB's inflation target range at average of 4.7% for 2019. Our optimism for a benign inflation outlook is premised on lack of consumer demand led + producer push inflation pressures. The upside risks to our inflation outlook remains the extent to which Eskom is able to secure the 15% p.a for the next 3years price hikes, oil price and food inflation. Our base case is that our MPC retain interest rates at current level, with an off chance low probability of a 25basis point pre-emptive hike.

At best we see the ZAR/USD at R13.40 by year end, with the global growth momentum favouring better relative growth from the rest of the work vs the US. A weaker US$ is good for commodity prices and commodity producing currencies like the ZAR: constraining the returns outlook for the large offshore element of the JSE All Share index, yet supportive of domestic corporate earnings.

Within domestic equity sector preferences – the forecast macro backdrop implies a better relative environment for sectors/stocks that are (i) skewed towards staple expenditures, and (ii) where competitive pressures are lower allowing for easier pass through of input costs. In this context, the relative merits of SA banks and food retailers stack up well. On the flip side, we see lack of pricing power and margin compression as a problem for SA telcos, healthcare, property and retail apparel. Within the offshore earners/exporters, our preferences are settled on diversified miners and PGMs given the underpin from Chinese government spend on infrastructure and tighter vehicle emissions standards.

Equity Portfolios Sector Active Weights - Average Sector Weights across Equity Sector



Source: ALUWANI Capital Partners

OIL: we prefer Sasol for its strong free cash flow generation capability once the Lake Charles project is fully ramped up operating at full capacity.

Diversified Miners: Valuation still compelling at prevailing spot prices. Our exposure is through Anglo American and Billiton.

Platinum: vehicle emissions regulation creating sustained structural demand for rhodium, our best pick is Anglo Platinum.

Gold: consider it more like portfolio insurance (what if we are wrong). Our exposure is through low cost producer defensive play with low operational+ balance sheet risk: AngloGold.

Paper: prefer Mondi over Sappi, but have exposure to both on valuation considerations.

Rand Hedges: underweight overall the sector: less exposure in Richmont on China growth concerns and valuation, a bit more exposure on BTI (than Richmont) better relative valuation however pending (nicotine content / minor exposure to new age cigarettes) regulation still weighs negatively on the share.

Banks: Our best liked high conviction sector call based on most attractive (relative to other sectors) valuations. On the financials side, we see banks continue to outperform life companies and property. Our domestic banks are well capitalised with very low impairments as evidenced by low credit loss ratios which is almost unprecedented for this time in the credit cycle. This means that they are best positioned to take advantage of an economic recovery matched by improving credit demand. We prefer FirstRand and Standard Bank, whilst we admire Capitec's disruptive innovative spirits, in our view it is expensive with heroic growth assumptions required to justify the current share price.

Life Companies: Life companies do well in an expanding economic growth environment coupled with a vibrant financial market, as life policy sales (their mainstay engine for growth) are often a 'grudge / feel good purchase' which is often a hard-sell in a constrained consumer environment the we currently have, in addition a significant portion of their book and embedded value is invested in financial markets that require positive returns as a catalyst for share price appreciation. In the South African life company landscape, bar Discovery the other players appear less innovative hobbled down by legacy challenges they don't seem able to overcome year in year out. We have exposure to Old Mutual initially on the back of the managed separation thesis which proved beneficial to shareholders given the share price performance of the past year, looking forward they need a credible bankable growth story.

Retail: In the retail space, we see defensive/high quality names outperforming counters with a higher risk profile: we expect investors to take an increasingly cautious view on company debt levels, dividend policies and balance sheet strength/quality (risk of investment/goodwill impairments), a continuation of the stance we saw in 2018 when companies that disappointed were sold-off down hard. We see Food/FMCG counters outperforming discretionary retailers, supported by an acceleration in food inflation and low real GDP growth. In our view, value/discount retailers will continue outperforming premium and credit-based retailers helped by down-trading in a relatively tough consumer environment. We prefer the likes of Mr Price, Foschini and Woolworths.

Media: We continue to like Naspers, despite underperforming in 2018. We are of the view that the long term growth story through their subsidiary TenCent continues to hold and is being unreasonably discounted by the market. We like management's renewed focus of monetising non-performing and ex-growth businesses, eg upcoming spin-off of MultiChoice.

Telco's: our exposure is through Telkom, we think the full value of the property portfolio is not fully reflected in the valuation, as for the other players Vodacom + MTN we are of the view that regulation in major operating jurisdictions remains a headwind.

Our portfolio exposures reflect our preference for companies with bankable self-help stories that will continue to attract investor capital where earnings growth is underpinned by structural/company specific drivers, irrespective of the macro environment.

Risks to our view

We believe, just like the prior years, global and domestic socio-political news will continue to dominate sentiment and impact financial market returns: The ongoing 'trade war' between the two largest economies in the world (US and China) / Brexit will be another destabilising factor to the extent that details of a 'divorce' remain unsettled. Domestically, even though national elections by themselves have become none-events as our democracy matures, voter apathy is a risk that could be reflected in coalition pacts, that do date at a provincial government level have proven to be a distraction impacting service delivery. Land reform policies in principle should positively impact the broader population in the form of inclusivity into the mainstream, however, implementation thereof if not immaculately executed could wipe out some of the expected benefits.

Asset Class preferences on a risk-adjusted basis in order of most preferred: domestic cash, bonds equities and property, whilst retaining a neutral weighting to offshore allocation, within the offsure allocation we prefer emerging market equities over developed market equities and fixed income.