2017 Review & 2018 Outlook

Local & International

ECM

Review of 2017

Last year was a challenging year for Fund Managers. Whilst the Top40 generated a return of circa 20% for the year, only a handful of stocks explain this entire return. Naspers comprised 17% of the market return whilst a few other market heavyweights contributed a further 3% of the market's return, implying that the rest of the market delivered no return to investors (excluding dividends). So, whilst it seems that last year was a great year for equity market investors, the reality is that the rally was concentrated in a few stocks and the breath of the rally was extremely poor.

Our Funds performed satisfactorily during 2017. Our long only fund (Effectus Equity Fund) outperformed the market by being overweight resources throughout the year, and by having overweight positions in SA sensitive stocks during the second half of the year (the likes of the banks, retailers and SA industrials). **Effectus Equity Fund delivered a net return of 26.99% for 2017.** The first quarter proved challenging for our Multi Strategy Hedge Fund with the Fund registering a drawdown of 5%. However, the following **nine months were constructive with the Fund gaining 10.5%. The Fund ended 2017 with a netreturn of 5.5%.** Whilst we are not pleased with the performance of the Fund during 2017, we are positive about the turnaround in performance over the last 9 months and we are confident that we will deliver superior risk adjusted returns to our clients in 2018. 2017 in South Africa was characterised by a few key factors. The first half of the year was a rather pedestrian index level performance only to be replaced by a powerful second half, initially dominated by Naspers and then subsequently followed by a powerful rally in the SA Incorporated basket (financials, retailers, SA industrials) as we headed through the NEC conference.

Our approach into an event as binary and as important as the **NEC conference** was to position as neutral as possible with the portfolio carrying minimal risk. This was complimented with some out of the money options on the ZAR and SA Inc. to provide a boost post a favourable outcome. We are very pleased to have **delivered a favourable return through a period as risky as December** (+4.1%) whilst taking minimal risk.

The key to the resilience of global markets despite ongoing calls for a pullback lay in the global economic recovery coupled with an earnings recovery across all major regions.

Led by the **USA,** 2017 was a remarkable year and some facts warrant a brief mention:

·The Dow closed at an all-time high 71 times, the most in history.

·The Unemployment Rate of 4.1% was its lowest since 2000 and Jobless Claims the lowest since 1973.

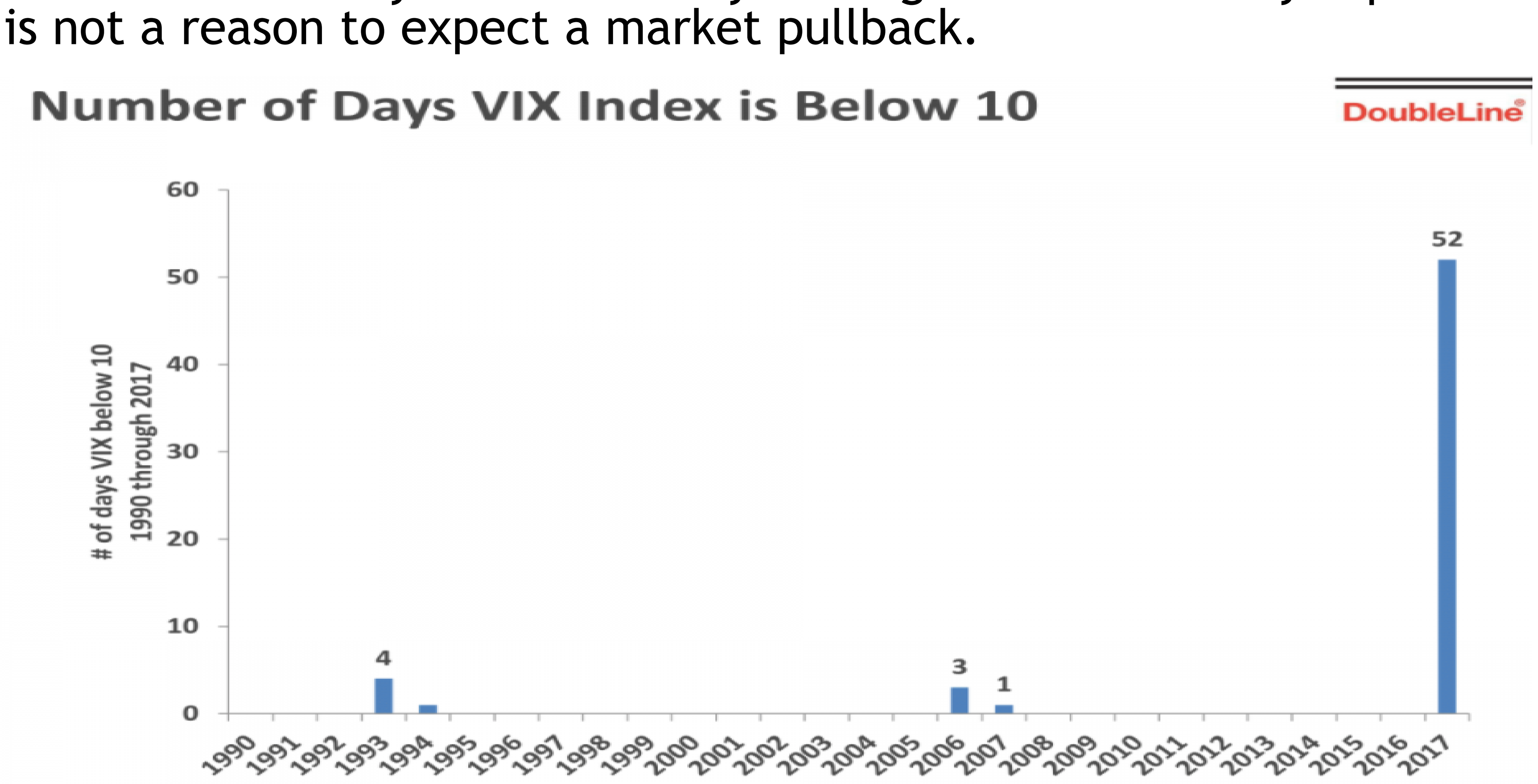
·Non-Farm Payrolls: Up 86 consecutive months, the longest streak in history.

·Both Consumer Confidence and the ISM Manufacturing Index were its highest since 2004.

·The Fed only hiked rates 3 times in 2017, to a year-end range of 1.25 to 1.50%. After subtracting inflation (core CPI of 1.7%), this leaves the real Effective Fed Funds Rate in the negative for 9th year.

·Every major currency in the world finished the year higher against the dollar.

Volatility - contrary to all expectations volatility died in 2017 despite numerous risk factors such as the geopolitical landscape and Trumponomics. The S&P annualized volatility of 3.9% in 2017 was the lowest on record (as was the bond market's 1.5%) and the intraday volatility the lowest on record as well. We expect volatility to make a comeback towards the second half of the year but the key message is low volatility is present due to the favourable equity environment and is not a reason to expect a market pullback.



South Africa - Looking Ahead to 2018

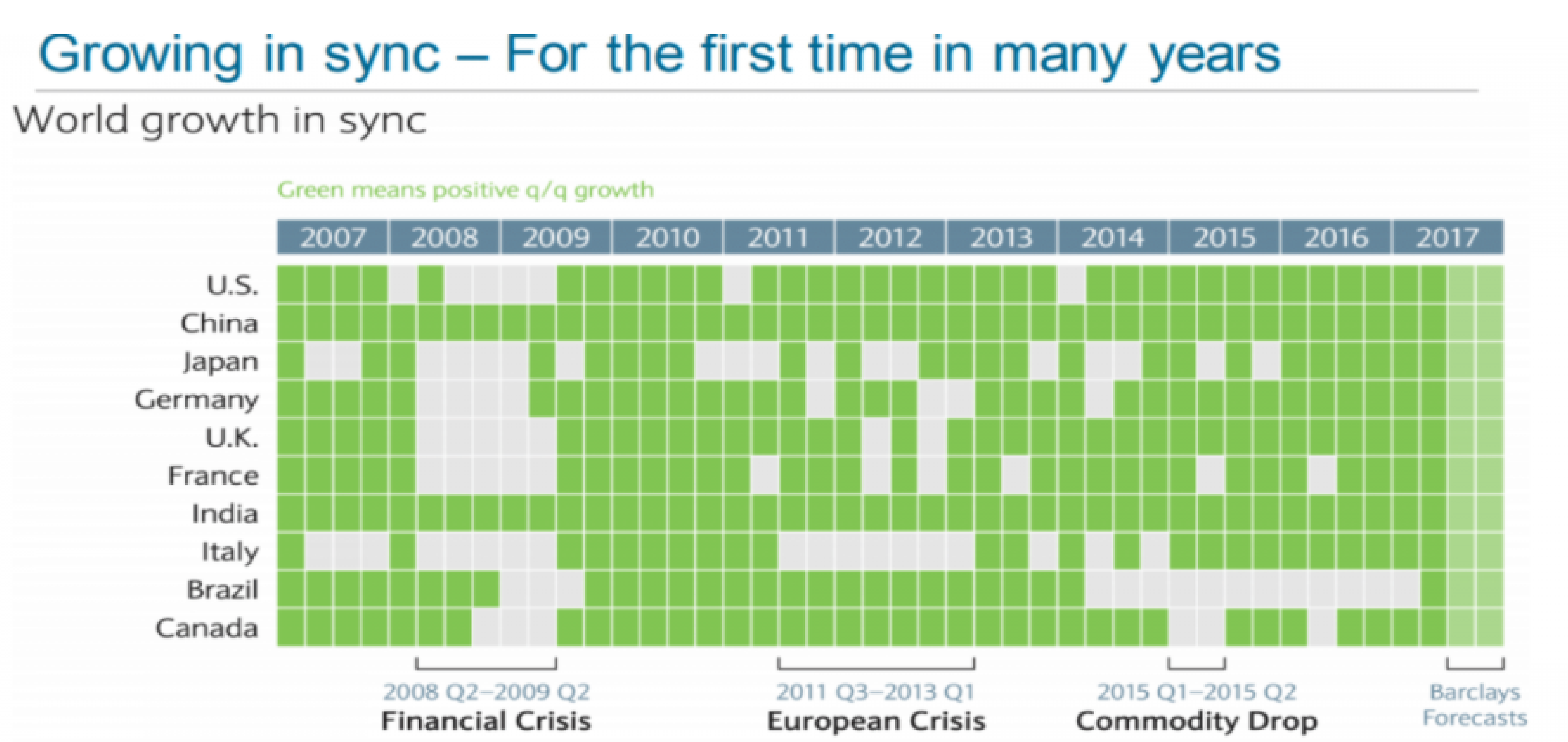
Consistent with our previous view, we are optimistic on the potential for SA to deliver a positive 2018. We expect a few major themes to dominate - the evolving political landscape, foreign investor sentiment (and the commensurate FDI and capital flows) and the global commodity cycle. However, while politics itself may have short term market implications, the key equities driver remains the earnings outlook.

Our **base case** is that improved policy certainty (such as the mining charter) and general investor confidence will have several knock-on effects: 1) the massive corporate cash pile will begin to move off the side-lines and into the economy; 2) consumer confidence will rise and individuals will be less likely to delay major spending decisions such as the purchase of houses and cars and; 3) we will see a return of capital inflows. These factors along with declining inflation aided by a stronger currency and potential rate cuts will also see some spending power recovery by the lower level consumer. We believe this changing momentum will at the margin have a net positive effect even taking the probable tax hikes and even credit downgrades into account and creates a **real risk that SA GDP has an upside surprise** in 2018. While some of this has been priced in over the past month, there is still significant earnings upside potential should we see better than expected growth in SA.

In **retailers,** we continue to favour the cyclical discretionary retailers in line with our outlook on the SA economy. However, we are neutral on the food retail space in the face of potential deflation.We maintain our positive outlook on **SA domestic names,** particularly the cyclical industrials with highly efficient operations and significant gearing to an economic improvement. Other sectors we believe will benefit from the positive SA outlook are the **banking and financial sectors** as economic activity and lending are expected to pick up with rising confidence and growth. **Overall**, we believe the SA market and economy are going to experience a bullish year supported by our bullish outlook on commodities coupled with our bullish outlook on most of SA Inc and an improving political landscape.

Global Outlook

We continue to be bullish on **commodities** with both the shorter and longer term in mind. The favourable macro backdrop remains in place (global growth, ongoing stimulus, tax cuts, the risk of inflation) and the **value relative to stocks** is as cheap as it has been at major historical turning points. Within this picture in mind, we have a bias towards those commodities that are underpinned by the newer economies such as copper, nickel, cobalt and lithium. In addition, as commodities continue to rise this will support **industrial equipment, logistics and service providers.**



USA

In the **US**, fear that 4% unemployment could be the non-inflationary turning point coupled with healthy economic growth fuelled further by tax-cuts and offshore repatriation of USD, will likely mean 3 rate hikes from the US Fed this year. Having said this, the commensurate growth in US corporate earnings should see the equity market weather these hikes well. It is estimated that the **new tax bill will generate a permanent shift of between $10 and $14 in S&P earnings** in addition to the benefits of deregulation. We see **late cycle sectors such as financials and energy** as the biggest beneficiaries of this environment, while **technology earnings** historically perform well in a growing economy. The key to US markets sustaining their positive momentum lies in whether we see a continuation of the strong earnings growth of the past 2 years and the numerous tailwinds in place support this as our **base case** (boosted by regulations and taxes).

India and Technology

In India we retain our positive view on the short and long-term outlook for India. Commitment to structural reform remains in place in what is largely a self-help story for a country roughly 20 years behind China in the urbanization process. We continue to believe in the digital revolution. The transformational changes taking place independent of global growth, such as self-driving cars, electric vehicles (EVs), Internet of Things (IoT), big data and more is a long way from completing the cycle of change. There are many long term opportunities in this space. For instance, the impact of electric vehicles and batteries can be seen in the massive out-performance of related metals such as lithium, cobalt and vanadium. At the forefront of the technology driven disruption is Artificial Intelligence (AI). As more and more data becomes available through the IoT, the impact of AI and deep learning on labour and productivity is projected to be close to $7 trillion and almost $9 trillion on consumers, while the total impact of AI is projected to be close to $15.6 trillion over the next 12 years. The impact will be felt in all areas of the economy including manufacturing, logistics, and services and healthcare, amongst others.

China

China continues to demonstrate admirable control over the its growth and de-leveraging targets while continuing its transition to a more service oriented economy. They are opting for slightly lower, more sustainable growth, a stable currency and a slow economic migration, all of which will remain supportive for commodities and global growth.

Potential Risks to our Outlook

The potential **risk globally**, is that so much positive news is being reported that the data while positive may disappoint relative to **expectations.** If there is a risk in China over the next 12-18 months it could be in the form of an **upside inflation** surprise as urban migration slows, PPI rises and the increased excess capacity begins to take hold. This could come at a time when global inflation is also creeping up. The Chinese central bank is a notable inflation hawk and the makeup of the FED board is more hawkish than before.

Conclusion

Overall, we expect the global trend towards gradual policy tightening along with upward trending inflation and synchronised global growth to remain in place for 2018. The secular bull market is likely to incur some form of meaningful correction during the course of the year - we do not believe this will represent a structural shift, but rather a buying opportunity as the earnings outlook across almost every region is positive. In South Africa, we expect 2018 to be a strong year for the equity market with the Resources and SA Incorporated sectors of the marketing leading the rally. We expect the return profile of the market to have far more breath in 2018 as opposed to 2017 and we believe that there will be plenty of opportunities to generate alpha for our clients.

The team at Effectus wishes you all the best for the year ahead!