Quarter in Review

The first half of 2018 proved to be a tale of two quarters. The global and SA growth optimism that drove markets higher in the first quarter reversed sharply in Q2 led predominantly by emerging markets. As such, much of the gains from our accurate Q1 positioning were given back in Q2 as the tailwinds both in SA and globally reversed sharply, leaving many markets in or close to bear market territory on a USD basis. On the whole it was a difficult and challenging 6 months for us but we believe in our process and look forward to the next six months. Looking back at the last 12 months, we still managed to deliver outperformance in both our long only and hedge funds.

There were some bright spots, notably the US economy and US equities continued mostly as expected with growth in US earnings and GDP sustained and inflation remained muted, even in the face of a tightening labour market. We have held the view that consistent with the past, gradually rising rates in the US would not lead to an equity sell-off and this has proved to be the case thus far. As expected, technology earnings proved to be relatively defensive due to the numerous structural tailwinds mentioned before. The Indian economy which we follow closely also performed well delivering strong GDP growth of close to 7% despite the rising oil price.

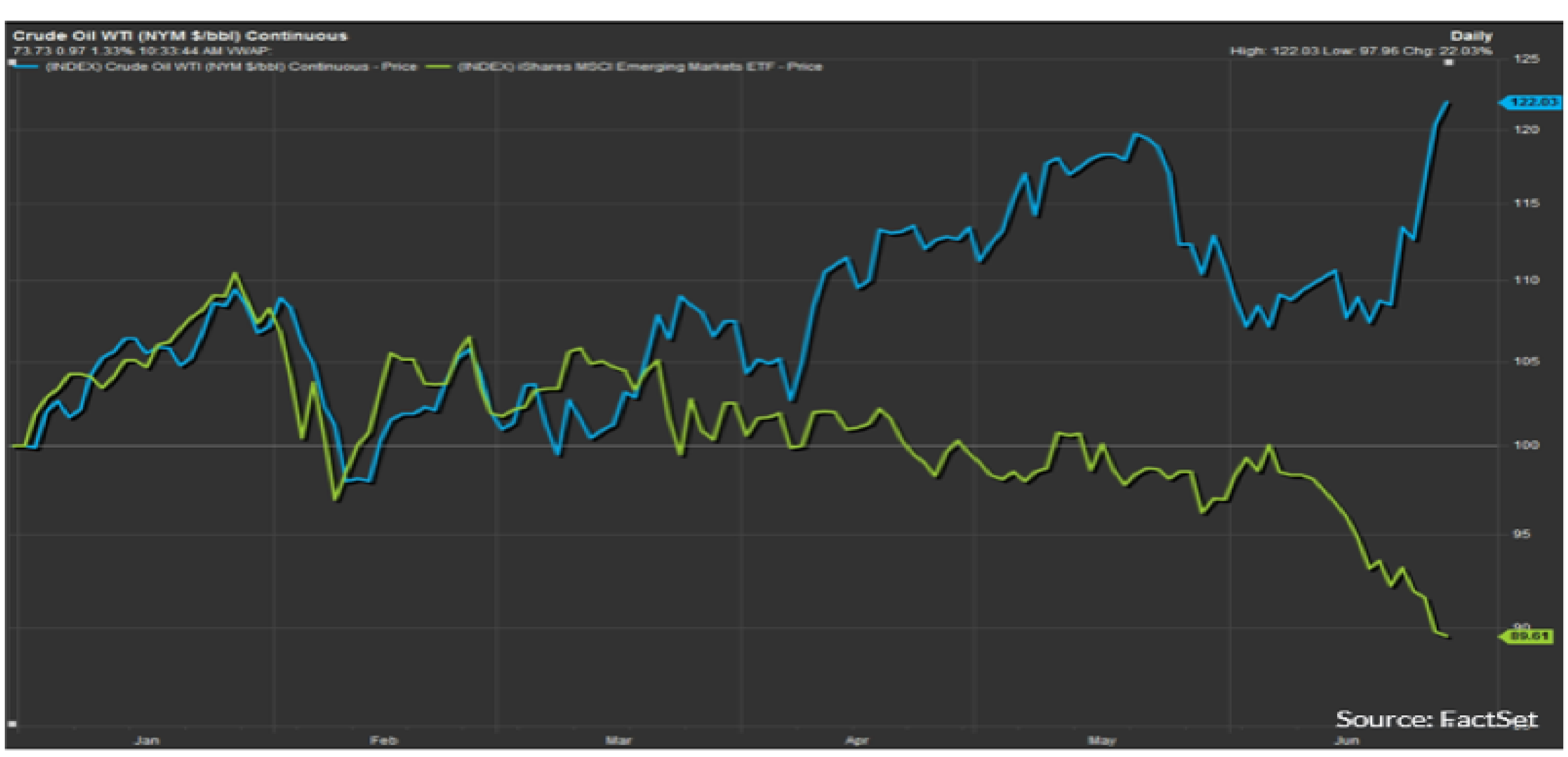
Our view that global growth would remain largely in tact and that this would continue to benefit commodities has been partially accurate with regards to particular commodities such as iron ore and oil, yet the whole commodity basket has peaked and diverged materially from share price performances.

The global growth story has come under pressure led by a softening in many economies such as Europe and parts of Asia and South America. However, there are numerous bright spots such as the US, India and China.

Emerging Market Fallout

The sharp and sustained sell-off in emerging markets was unexpected in our outlook. The MSCI EM index fell around 18% from its high this year and the Top40 fell 24.6% in USD (and close to 12% in ZAR).

The rampant USD coupled with rising oil prices has proved one of the major factors affecting emerging markets. (Below is a chart of the MSCI Emerging market ETF versus the oil price).



Certain idiosyncratic factors in countries such as Turkey, Brazil and Argentina had a larger impact on broader EM sentiment than such events in the past.

The strengthening USD supported by strong US GDP and earnings has resulted in major global equity inflows into the US at the cost of outflows in emerging markets.

South Africa

The real challenge for us came around our call on the **South African macro outlook**. Our primary thesis was that the new political regime would lend itself to a powerful self-help story. It has been and still is our view that actions such as implementing proper controls and governance in key SOEs, concluding the mining charter, taking a firm stand on corruption, policy certainty etc. will have a knock-on effect into the economy. Add to this an improvement in business and consumer confidence, and generally strong global commodities and the expected outcome was and still is for a meaningful improvement in the SA economy and ongoing rand strength. We still have a firm view that most SA cyclicals are now highly operationally efficient and lean after years of operating in an extremely tough environment, which provides them with significant gearing to an improvement in the SA macro landscape.

Our positioning on this basis included overweight positions in banks, insurers, SA industrials and SA credit and food retail sectors to benefit from this upside gearing. As it happened, the lag time between the regime change and concrete on the ground changes has taken far longer than expected to materialise. The mining charter has been delayed, action on corruption has been limited and we have seen rising VAT and taxes, with clear policy framework slow to materialise. The initial rally in metrics such as the lead indicators, business and consumer confidence which supported our view failed to translate into further improvement and they have since receded. External factors such as a significant fuel price increase on the back of strong oil prices and a weak rand meant that our thesis has not yet played out. As an illustration of the sharp turnaround, the bank index fell 23% from high to low, and general retailers fell 28% from the years peak to the low. These moves have been exaggerated by the non-discriminate selling of emerging markets.

Looking Forward

Global Growth

Global growth is not yet dead. As at the end of June, global capex spend is up 4% yoy for all listed firms and is also up 4% for mining firms in particular. US new orders for capital goods are currently up 6.5% yoy. Increases in capital goods orders are associated with both higher IP growth and increases in commodity prices.

Figure 8: Global steel production at a record high

Source: Investec Securities research and Thomson Reuters

Figure 9: Global container traffic at a record high too...

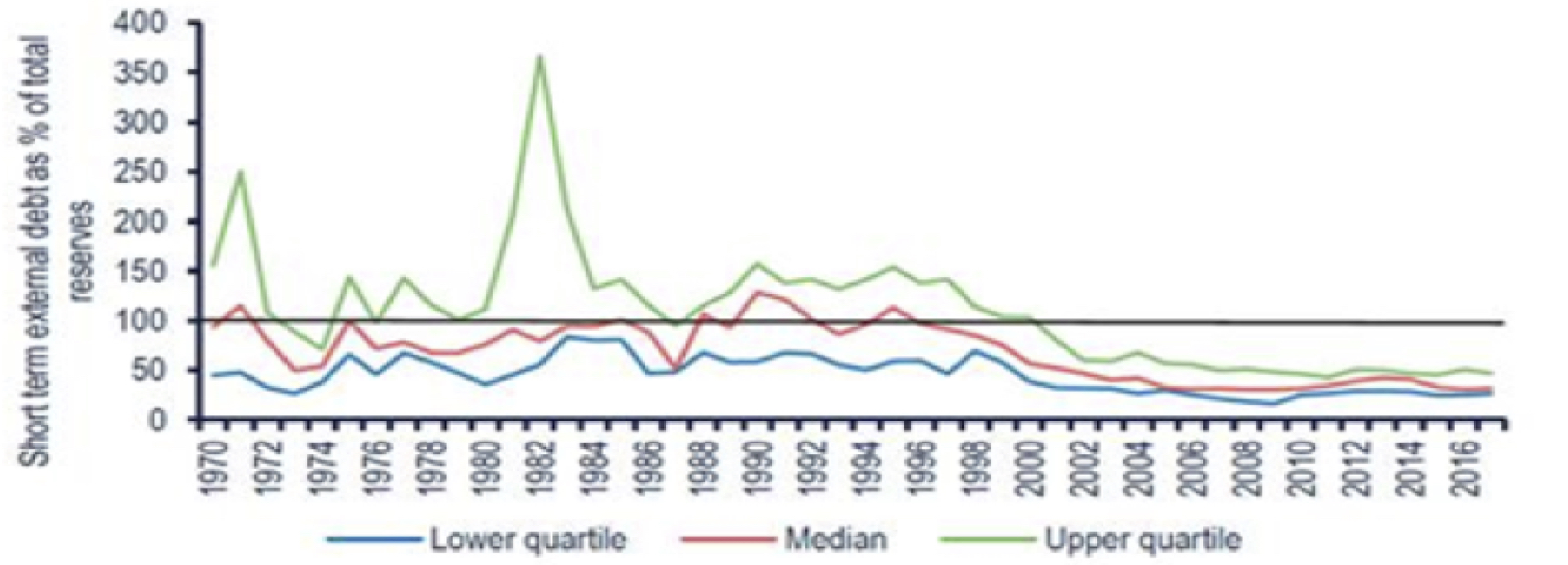
Source: Investec Securities research and Bloomberg

EM as a whole

We believe that the nature of the selloff in EM presents opportunity and that the risk of another EM crisis at this stage is low. EM as a whole is still in good health.

A recent study by the US Fed based on gearing and interest cover, determined that in order for EM corporates to become as risky as East Asian debt prior to 1998, borrowing costs would need to rise 100bps, EM currencies depreciate by 20% and earnings would need to fall 20% simultaneously. Debt profiles have changed - the percentage of short term liabilities to reserves in EM is around the 50% level from close to 100% in 1998. Currently EMs trade at a 20% discount to DMs (Investec).

Figure 13: EM short-term external debt to reserves much healthier post 1998



Source: Investec Securities research and World Bank

South Africa

We believe the significant pullback in many of the sectors (and companies) regardless of quality, with exposure to the SA economy, presents opportunity for those with a longer term outlook. The median P/E of the ALSI is close to 2014 lows with a dividend yield above 4%.

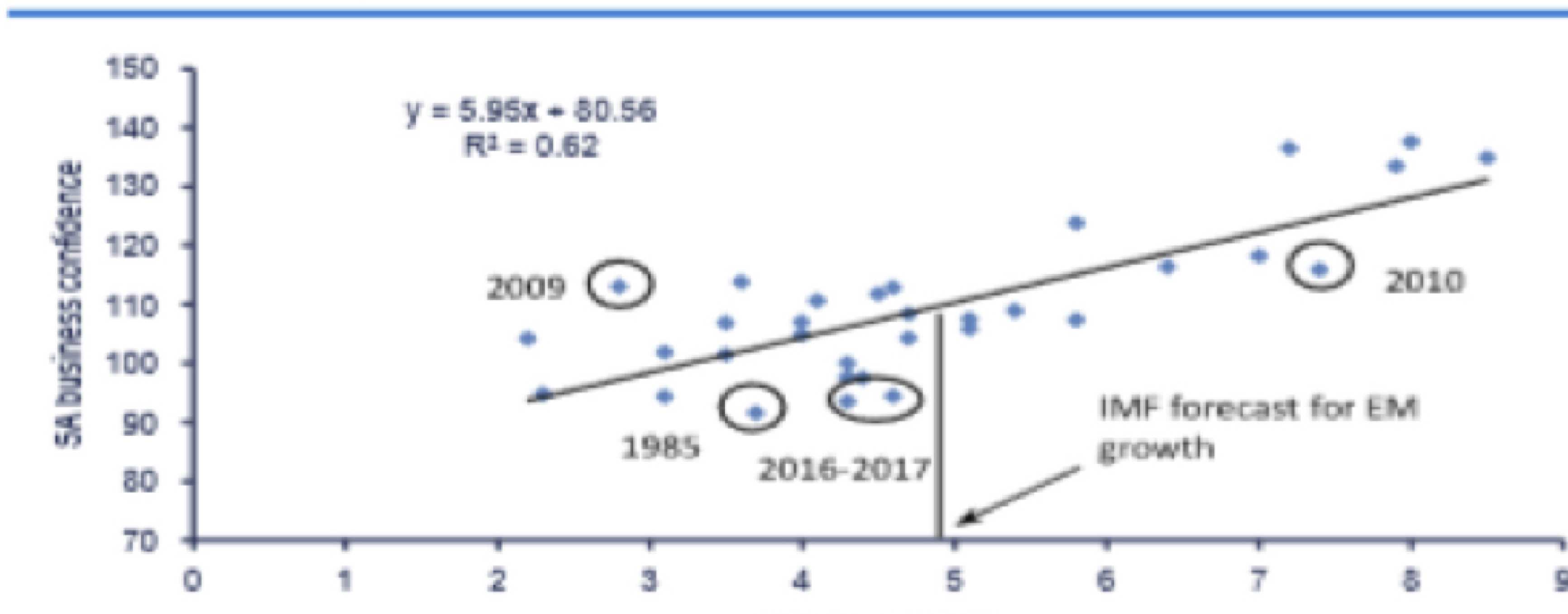
Figure 56: 43% of ALSI constituents have a DY above 4% - nearly the highest since 2009

Source: Investec Securities research and I-Net

While we (along with consensus) have toned down our outlook for a SA GDP recovery, we are still of the opinion that an upward earnings trajectory for SA cyclical companies is the most likely outcome. It should be noted that South Africa's Q1 GDP has shown a downward bias for past 5 years by over 2% and could surprise to the upside. It's clear the extent of the recovery and the lead time between political change and economic change is going to be a lot **slower to materialise and likely to be more muted.**

In addition, the global growth picture has become a little more uncertain and policy implementation in SA is being dragged out longer than expected. We remain positive about the number of 'self-help' opportunities South Africa has which combined with reasonable global growth will create opportunity. SA business confidence is well below the levels expected based on forecast EM GDP growth and should improve off these extremely low levels.

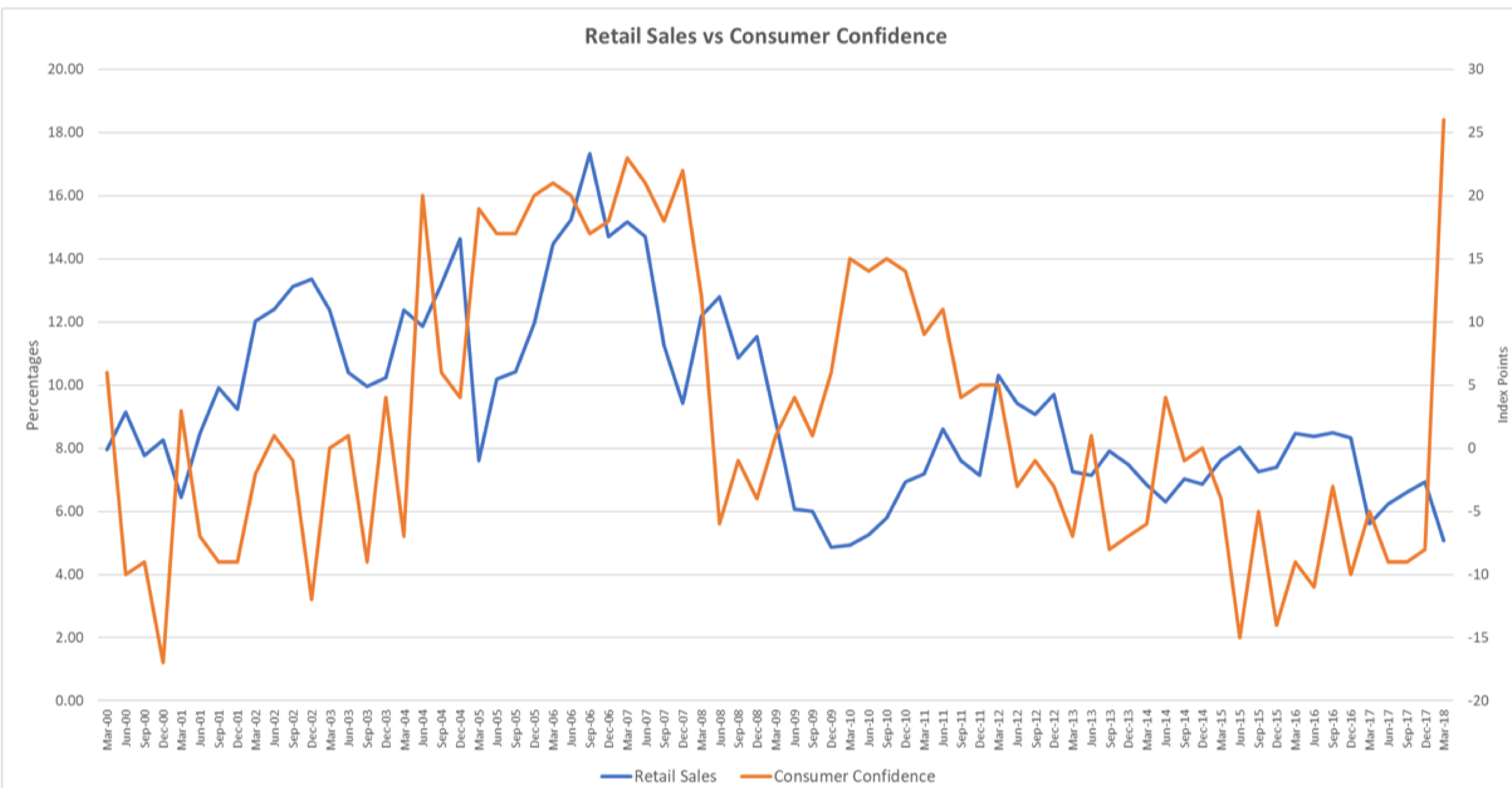
Figure 36: SA business confidence should pick up as global growth remains strong...



Source: Investec Securities research and I-Net

There is a clear correlation between consumer confidence and retail sales, with confidence being a leading indicator, with an average lead time of 7 quarters. For every index point that the consumer confidence moves, retail sales move an average of 0.25% of that move, supporting our constructive outlook for cyclical plays over the next 9-15 months. Additional factors supporting the outlook for consumer spending include the above market salary increases by government, food price deflation and real wage growth (mostly in the lower LSM bands).

Should there be an improvement in the outlook from the increasingly low expectations, earnings have the potential to surprise on the upside. A number of retailers are trading at the bottom end of the forward earnings multiple range over the last 5 years, and hence present attractive entry levels on a 12-month view.



For example: Food Producers and General Retailers Indices 1 year forward P/E trading near the 6-year lows

There is significant potential benefits to be unlocked by having a businessman at the helm rather than a politician, if the President can get it right.

Trade-wars, China and the US

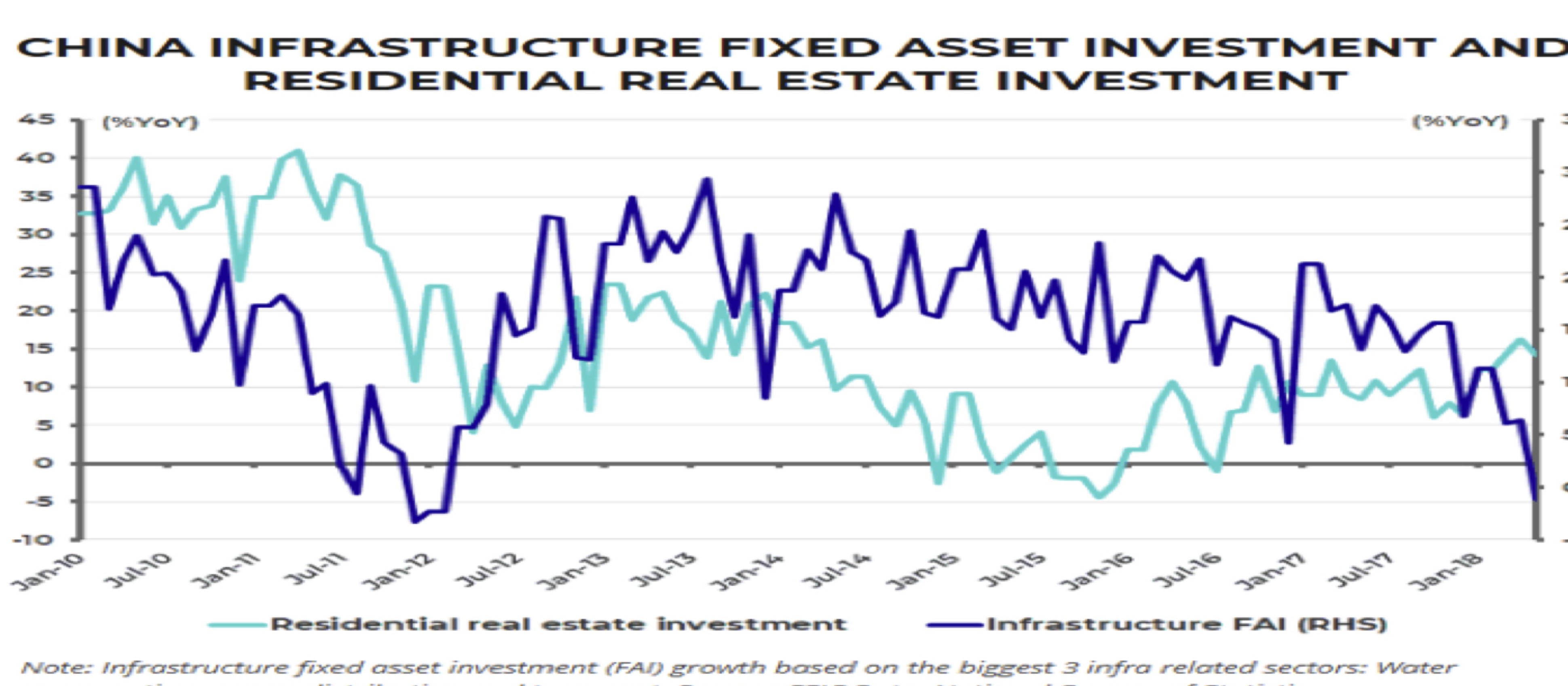
We believe the biggest risk posed by trade wars is less about the financial impact of the tariffs and far more that a meaningful and sustained escalation will have a significant impact on global business and investor confidence which in turn will feed through into a lowering of global growth. In terms of the absolute amounts, they are not significant enough in of themselves to have a material impact on global growth. Nothing slows business and consumer spend like concern about an uncertain future. It remains to be seen if Trump's tactic of alienating both friend and foe will be successful, but we still have a base case scenario of a negotiated outcome which is ultimately going to be in everyone's interest to achieve since the US is a net global consumer.

China - its not all about the trade wars

China is deleveraging, and the economy is changing with the steady transformation into a service-oriented economy continuing unabated, and for this reason the trade-war effect on China is not as large as it would appear. China's Net exports account for only 2% of China's GDP, down from a peak of 9% in 2007 and consumption accounts for the majority of China's economic growth (80% in Q1 2018) and more than half of its GDP. For several years now, consumption and services have had a larger share of China's GDP than manufacturing and construction, a trend expected to continue as the government reaffirms its drive to transition the country. Last year, Chinese exports to the U.S. accounted for only 19% of total Chinese exports. Although the SSE50 Index has lost around 13% YTD, almost half of the stocks in this index have no overseas revenue and the selloff began well before the trade war escalated highlighting that issues other than trade wars are in play.

Deleveraging and rotation

Xi Jinping's focus on retooling the economy has included meaningful deleveraging (shadow banking is a key focus of authorities) which has played a role in reduced exports and slower industrial output. The key here is whether Chinese authorities can continue to manage this necessary deleveraging without inflicting too much damage on the real economy. The knock-on ramifications for commodities and global growth is something we are watching very carefully. One example of the sharp decline in infrastructure investment growth so far this year is that fixed asset investment rose by only 5% YoY in the first 5 months of 2018 vs an equivalent 16.7% YoY in 2017. This has been compensated for by the resilience in residential property which rose by 14.2% YoY in January - May, up from 10% YoY during the same period last year. The commodity index on the other hand has felt the brunt of these changes falling over 10% from its highs.



United States

There are many conflicting bull and bear arguments around the US that to a large extent offset one another. This can best be summarised in a table and discussed below.

Positive	Negative
Tax cuts	Trade wars
Share buy backs	Yield curve inversion
Company earnings	Valuations
Fair valuations	Rising rates
Moderate inflation	

With regard to the trade war, it is fortunately coupled with massive fiscal stimulus which should at least serve to offset the negative effects if not outweigh them. Our view is that the positive stimulus effects will be outsized compared to the tariff effects. Failing a full-blown trade-war we expect US economic growth will remain intact and accelerate into H2 as tax stimulus takes full effect.

Interest rates and inflation in the US

We do not see an inflationary shock as a significant risk factor at this stage given the stubbornly slow wage growth in the US and the ongoing rapid rate of technological productivity and innovation increases. We once again confirm our view that a gradually rising interest rate cycle is not in of itself negative for equities when coupled with growth.

Its not all about yield curve inversion

The 2/10 year UST yield curve inversion is a much debated topic. It is certainly worth keeping in mind as to the future outlook for the economy but is not a sell indicator in its own right and needs context with a number of other indicators. As highlighted below, the stock market typically does not crash immediately upon inversion/recession warning. An average of 21 months pass after the yield curve flattens and a recession is declared.

AN INVERTED YIELD CURVE ISN'T TROUBLE IMMEDIATELY

2–10 Year Yield Curve Inverts	Recession Starts	Months From Inversion to Recession	S&P 500 Price Return From Inversion to Recession
08/18/78	02/01/80	17.7	9.9%
09/12/80	08/01/81	10.8	4.3%
12/13/88	08/01/90	19.9	28.5%
05/26/98	04/01/01	34.7	6.1%
01/31/06	01/01/08	23.3	14.7%
	Average	21.3	12.7%
	Median	19.9	9.9%

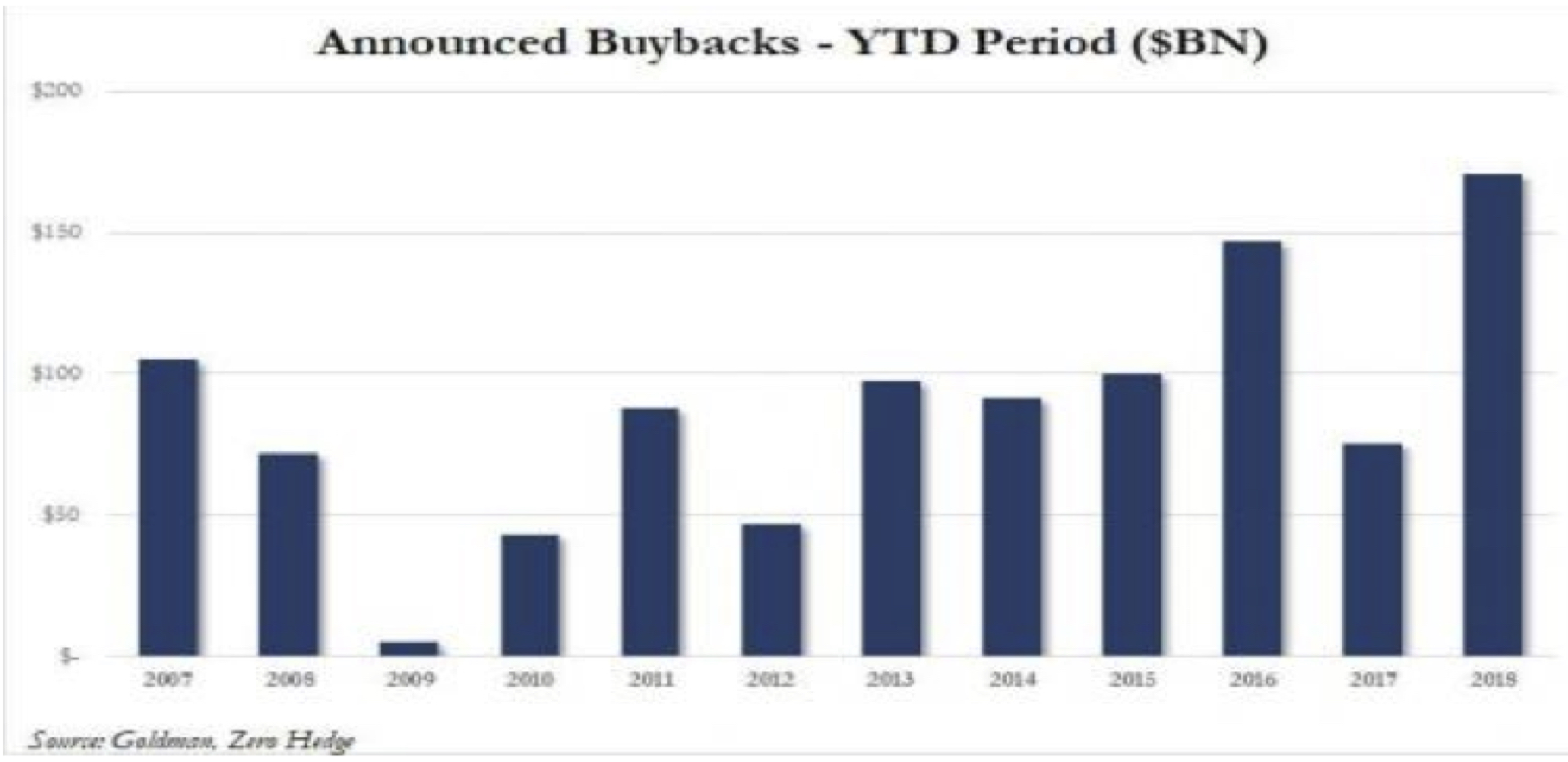
Source: LPL Research, FactSet, NBER, 07/05/18

Don't forget earnings

Over the long term, it is earnings growth that drives share prices. Earnings growth in the US has been stellar and remains a tailwind, however we are wary of the very high expectations heading into 2019. Experience shows that in the shorter term, whether earnings or data are 'better or worse' than expectations matters more than the absolute number. We are cautious of the high base that has been set. In contrast, the EM baseline earnings and growth expectations are being reset lower. Equities in the US are neither over or under priced at this stage. The one year forward S&P multiple is in line with the long term average at just over 16.

Cash flush corporate America

The massive tax savings boost has added to the already massive cash pile of US corporates. In response, they have been repatriating billions of dollars from overseas and using those repatriated dollars and tax savings to buy back significant amounts of own stock, another major positive for US markets. American corporations have been the largest buyers of shares in the U.S. since 2009. According to the Federal Reserve, American corporations have bought back $3.3 trillion worth of stocks since 2009, making them the largest buyers of US shares over this period. While this has been a massive tailwind, we watch carefully for signs of reversal.



What worries us the most

·The risk that China gets it wrong. China has a phenomenal track record of managing risks in the economy. However the excess credit, the property boom and shadow banking coupled with structural economic changes pose massive challenges. This will have a serious knock on effect in the global economy.

·The trade-war blows up into a genuine trade war that goes beyond a handful of tariffs and is a protracted drawn out affair.

·President Ramaphosa does not have the political firepower to do what needs to be done to kickstart the SA economy leaving us at risk of prolonged stagnation.

·A sudden and sharp rise in global interest rates, although we see low probability of this.

In conclusion

History has proved many times over that times of extremes and maximum pessimism or optimism brings with it significant opportunity. The global issues at play are significant and cannot be ignored. There is no doubt the SA market is testing some key levels to the downside and it is prudent to be more tactical and defensive in positioning at this stage. The volatile first half of the year has left us a lot more cautious in our approach, yet we see opportunity off these low bases.

Barring key events such a global growth shock, full blown trade wars or significant political roadblocks, some of our key perspectives if a moderately favourable outcome transpires can be summarised as follows:

·We have a constructive outlook on SA Cyclicals over the medium term.

·We are constructive on selected emerging markets and India in particular.

·We believe the earnings momentum of innovative tech leaders can be maintained and will look for attractive entry points into the space.

·We have turned more cautious on miners in the short term but believe that underlying commodities such as copper have been sold off too far.

·Precious metals at this stage remain un-investable for us.

We believe in our process and look forward to the opportunities that will prevail over the second half of the year.