Quarterly Performance Review and Outlook

ECM

Local and International

Review of the last Quarter

For the quarter ending 30 June 2017, the Effectus Multi Strategy Opportunities Fund generated a return of 0.25% whilst the JSE All Share Index delivered a return of -0.85% (an outperformance of 1.1%). The Effectus Equity Fund (model portfolio) delivered an outperformance of 1.02% against its benchmark. We are satisfied with this performance given the level of volatility and uncertainty that was present in the JSE over the last quarter. The Funds performed well in the Resources and Technology sectors whilst the SA Industrials and Financials were a drag on our performance as we overestimated the potential for the South African economy to turn around.

Outlook for the South African Economy

The outlook for SA domestic earnings remains muted as the SA economy entered recession in Q1. Consensus real GDP growth forecasts now range between 0.4% - 0.8% in 2017 and 1% - 1.8% for 2018. The downside risks to growth have been underestimated for the past 2 years as the turning point in the SA economy continuously gets pushed out further. The factors supporting this growth outlook include potential rate cuts, supportive commodity prices and global PMIs with which SA GDP has previously had a high correlation, however these are being countered by the ongoing socio-political landscape. It is a concern for us that SA is no longer reflecting the correlation to global growth that is has in the past. This indicates not only political, but structural issues as well. The challenges in the socio-political environment have led to low business and individual confidence levels, the impact of which is low levels of capital commitment and spending, amongst other things. Consequently, we have lowered our optimism around the SA economic cycle versus our stance at the start of the year as we see the recovery playing out over a longer time horizon than we initially expected, feeding through into our view on the various sectors. From a rate cut perspective, we still see 2 cuts of 25bps before year end as our base case, assuming the ZAR/USD remains below the R14 level.

Banks and Financials

Banks are buoyed by high, supportive dividend yields (circa 5.5% for the index), an undemanding forward earnings multiple below 10x, and are well capitalised and geared for growth, however the limited prospects of an improving credit environment and the long-term threat of alternate providers (in the form of fintech disruptors and the likes of Capitec) keeps us mostly on the sidelines with a mildly positive bias. We remain cautious on the insurance space as we see factors such as pressure on investment income and policy lapse rates keeping earnings under pressure.

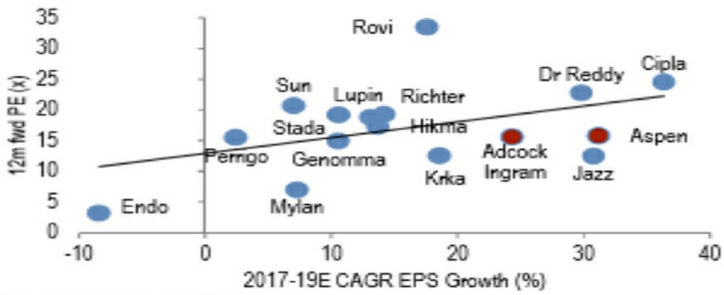
SA Industrials

The industrial and corporate focused SA space also looks fairly attractive at a glance with decent dividend yields, however the opportunity for corporate SA to grow their margins with GDP growth below 1% is limited. As such we also have a neutral outlook on the sector preferring to look for stock specific opportunities. This is a space highly correlated with SA GDP and should see a cyclical upswing if economic fundamentals in SA improve, much as we are seeing globally. Once signs of green shoots appear in SA, this is a sector we would look to for outperformance.

Pharmaceuticals

The structurally positive long-term environment for pharma remains intact and we see opportunity in the SA Pharma sector as quality management moves through a consolidation phase and into a new potential growth phase. The sector itself screens as undervalued relative to its peer group given the growth prospects (see graph below). We particularly like the blend of self-help opportunities coupled with long term tailwinds.

Figure 5: Global pharma: 12m fwd PE vs. eps growth



Source: Bloomberg, J.P. Morgan

Retail

We remain cautious on the retail sector holistically, particularly discretionary retail as this sector remains in a challenging environment. The retail environment remains extremely tough with an under-pressure consumer and fierce international competition (H&M is growing revenue at over 60% versus other retailers who are struggling for above inflation revenue growth). As long as the overall size of the market is constrained by low GDP growth, we feel that the apparent attractiveness of discretionary retailers reflects a potential value trap. We also expect a fair amount of price discounting to continue, keeping a lid on potential margin improvements. Adding to the above, a key defensive tool of the SA retailer has been the extensive national footprint and the difficulty of foreign competitors to grow floor space. The demise of Stuttafords, ongoing rationalisation of Edcon, and tough retail environment leading to store closures, will improve the ability of new foreign entrants to ramp up their footprint adding further pressure to margins and revenue.

The food retail space is likely to see ongoing margin pressure driven by falling inflation and a struggling consumer, leaving us bearish on the space.

We have been and are still more upbeat on the outlook for food producers relative to the retailers as the falling input costs feed through into margin expansion in H2 of 2017. However, the slower than expected economic recovery in SA has offset a large part of this benefit through lower than expected volumes, leading us to be less bullish than previously.

The one bright spot on the food retail sector has been Bidcorp, a stock we have long held. While it has run hard in the short term, it remains a top pick longer term with the ongoing and successful migration to higher margin business by management, coupled with a broad geographic footprint and excellent cash generation.

Technology and Telecommunications

Technology and indeed the local market is dominated by Naspers and one cannot ignore its importance. As the rump assets continue to underperform and in fact trade at a negative value, the key value driver of Naspers has been its 33% stake in Tencent. Tencent may appear expensive at face value but with a FY19 PE of around 24x and average earnings growth between 25 and 30%, this multiple unwinds rapidly as earnings will double approximately every 3 years. In addition, with monthly active users (MAUs) of close to 900m, and revenue per user well below Facebook, the opportunities for growth in China remain significant as China is the most advanced market in terms of the pace of mobile innovation. China has 700 million smartphone users, encompassing half of the population, and it has expanded by roughly 50 million new mobile users annually over the past two years. 50% of Tencent's MAUs spend 90 minutes a day on WeChat, with 75 messages sent per user per day. So, while Naspers price does become stretched and face meaningful corrections in the near term, the long term fundamental story remains sound in our opinion.

Currently, the telco sector offers value on two fronts. MTN is at the beginning of what we expect to be a slow but steady recovery cycle, supported by Nigeria exiting its recession and further positive developments as the new senior management changes begin to take hold. We also see Telkom as a good self-help story with management laying the foundations of a good track record over the past 18 months.

Global Industrials

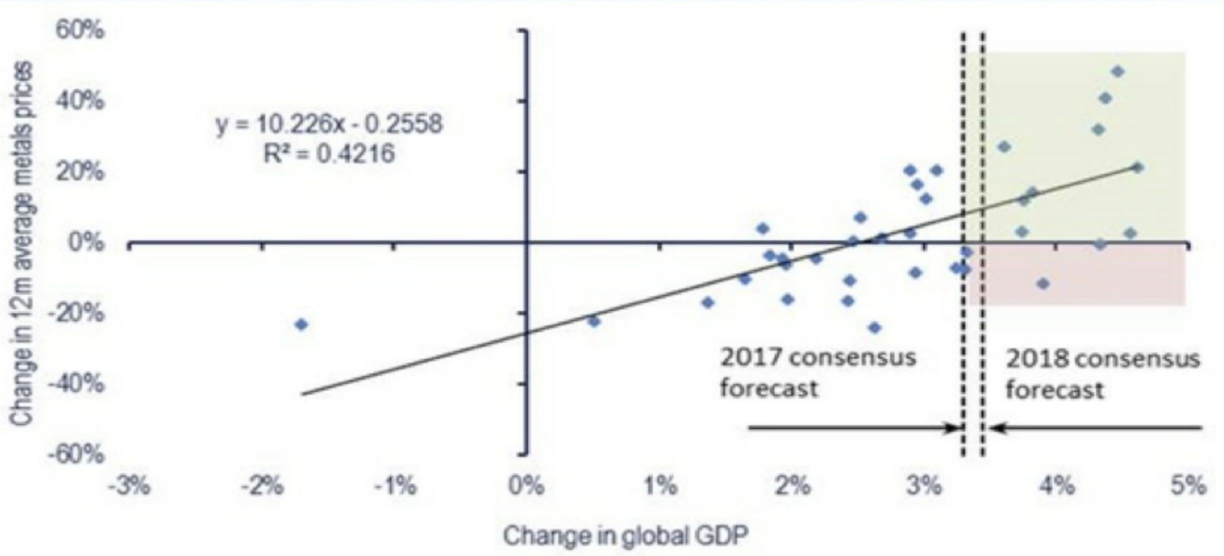
In line with our global outlook below, we remain bullish on foreign earners that have rand hedge qualities and are either tied to a part of the global growth cycle (such as Mondi and Sappi) or have the ability to self-help and grow through the cycle (such as Bidcorp). We have turned neutral with regards to the pure defensives such as Mediclinic and British American Tobacco which are foreign exchange earners/yield plays but vulnerable to sector rotation as global growth gathers steam.

Resources

We have been positive on the resources and mining space but acknowledge the volatility in commodity prices and sector behaviour by expressing shorter term views within the longer-term constructive outlook. With global growth expected to reach 3.5% in 2017 and 3.8% in 2018, coupled with long-term demand drivers of steady and managed Chinese growth, and balanced supply and demand fundamentals, commodity prices are expected to have significant underpin (see graph below). In addition, miners remain at low levels of committed capex and are generating good free cash flow at current levels, leaving room for uplift.

It is a statistical anomaly for commodity prices to decline with global growth in the consensus forecast region.

Figure 2: Global GDP & metals prices 1980- 2016; we expect 3.6% in 17E and 3.9% and 18E



Source: Investec, World Bank, Thomson Reuters

Of note, this expectation of global growth means it is unlikely that commodity prices will fall materially over the rest of the year. As indicated in the above chart, history suggests that when global growth is greater than 3.5%, metals prices are more likely to increase in price (green shaded upper area) than to fall (red shaded lower area).

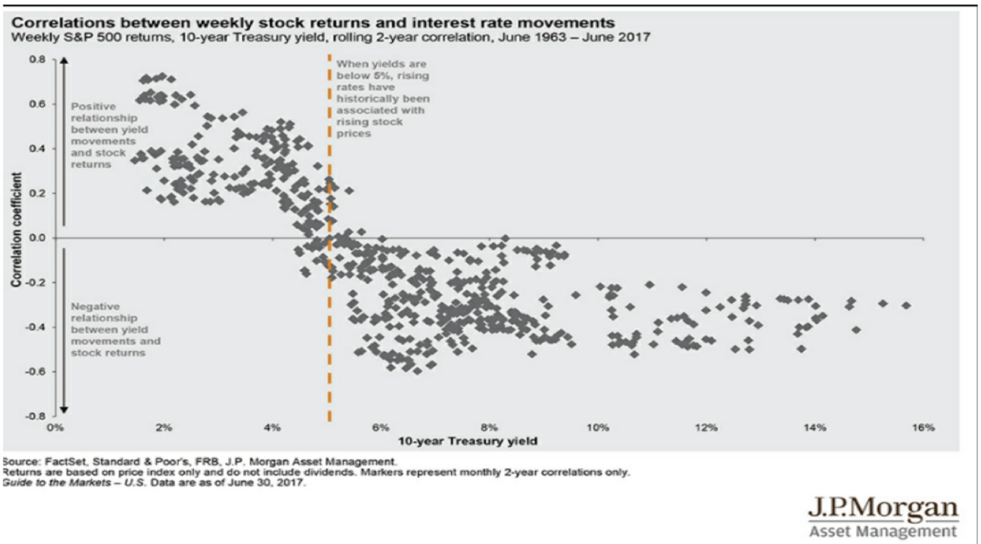
Our outlook for oil and gas in the longer term is not quite as robust as the broader commodity basket. The shale gas supply growth and cost innovation coupled with depressed prices (and thus accelerated non-Opec production) mean an ever-increasing supply of oil despite Opec's efforts. We expect the range of $40 to $55 to be fairly sticky with risks to the downside. With a longer time horizon, the inevitable mass production of electric vehicles will come sooner than expected and add further structural demand pressure and in fact accelerate oil production for the foreseeable future.

Global Outlook

We remain constructive on the outlook for global growth across most regions including EM and see the synchronised upswing gaining traction as most regions are reporting positive GDP growth.

Recently, there has been another noticeable shift in central bank rhetoric as they re-align with their core purpose of maintaining financial market stability and look for ways to cut back on monetary stimulus. Global bond yields are laying the groundwork for a global rising rate environment. While any rapid tightening of monetary conditions could derail the growth cycle we do not believe that is the likely scenario as many central banks are still in accommodative mode and the unwind will likely be very gradual in the face of only modest inflationary pressure and limited wage growth pressure.

In the US, the Federal reserve is continuing slowly on its path towards restoring some normality to the rates curve and unwinding its massive balance sheet. Although the US is nearing full employment, the lack of upward wage pressure means the stimulus will continue at a modest pace. We expect to see cyclical stocks (homebuilders, materials, industrials and financials) as ongoing beneficiaries of the global growth cycle and outperforming the more defensive sectors such as high yields, property and consumer staples and sector correlations will likely remain low. Rising rates is currently not a concern for equity market returns as historically stocks have performed well in a rising rates and growth environment – the threshold of when rates start to dampen equity market returns is a US 10-year treasury yield of greater than 5% (currently the yield is 2.38% - please refer to the chart below).



The European recovery continues at a steady if not spectacular pace as reflected most notably in the services and manufacturing PMIs in France and Germany. We expect the gradual unwind of stimulus and rising bond yields to favour the leading banks in particular.

The UK is however moving into the dangerous territory of low growth, flat wages and rising inflation and stands as a good example of the cost of uncertainty to an economy. Should the BoE move towards a rising rate cycle more quickly than expected this could worsen the outlook further. The full Brexit impact is still to be felt and is expected to unfold over several years. As such we are cautious to bearish on SA listed UK - centric stocks, specifically property and retail counters.

China remains on track for growth at 6.5% or better this year, especially with elections in the latter part of the year we expect the government will go out of their way to manage currency and GDP volatility and consequently provide support to the commodity complex (even if it means keeping underperforming assets in business). The issue of the shadow banking system as always remains in the background and we keep an eye on its developments.

The Indian economy continues its growth trajectory of close to 7% with ongoing government support and commitment to infrastructure, tax and monetary reform and jobs growth a key driver. Along with China this remains a key leader in the global growth trajectory and importantly a net beneficiary of lower oil prices.

Conclusion

Whilst we recognise that the forthcoming quarter has historically been a volatile and poor performing quarter from a seasonal perspective, we firmly believe that there are pockets of opportunity that can be exploited in order to generate alpha. Hence we remain cautiously optimistic regarding the potential returns that can be generated for investors by focusing on the right sectors and stocks as the global monetary policy and SA political landscapes evolve.