EFFECTUS
CAPITAL MANAGEMENT

NEWSLETTER

Review of Q1 2019 & Outlook

1 REVIEW OF 2019

The first quarter of 2019 was one of the best since 2009 for the All Share Index. The Top40 delivered a 7.8% return excluding dividends, providing some much needed relief from the relentless selling of the previous 6 months. The closing level at 31 March left the index a mere 7% from the August highs (and 13% off the December lows).

1. 1 Sector Performance

On digging deeper the overall market performance can be misleading in terms of sector performance. There were significant winners, most notable being the precious metals index delivering a staggering 51% (dominated by PGM producers). The biggest loser in this last quarter was the general retailers index down close to 16%.

ECM positioning for the quarter benefited from our overall constructive outlook for emerging market equities and a bias towards resources and technology and a blend of selected quality cyclicals and defensive stocks. We also benefitted greatly once again from avoiding some of the worst performing stocks and sectors.

1.2 Economy

Despite the buoyant market and our positive outlook over the medium term, the first quarter was mostly a series of economic disappointments. Most data points have been flat or declining across consumer spending, PMI's, employment, business confidence and credit expansion to name a few. The relative sector performances in the comments above reflect this to a large degree.

What has become a clear hurdle to growth and investment is the ongoing "sitting on the hands" effect. This has been subduing economic prospects for a long time now and has accelerated as the election nears. Neither corporates nor individuals are willing to make longer term financial or strategic commitments until the level of clarity around the country's future improves. This impact can be seen in major consumer purchasing decisions such as housing and vehicles and actual rather than 'planned' capex as well as low levels of FDI. However, there is a growing potential pipeline of pent up demand that may be unlocked as the uncertainties unwind.

2 OUTLOOK FOR THE COMING QUARTER

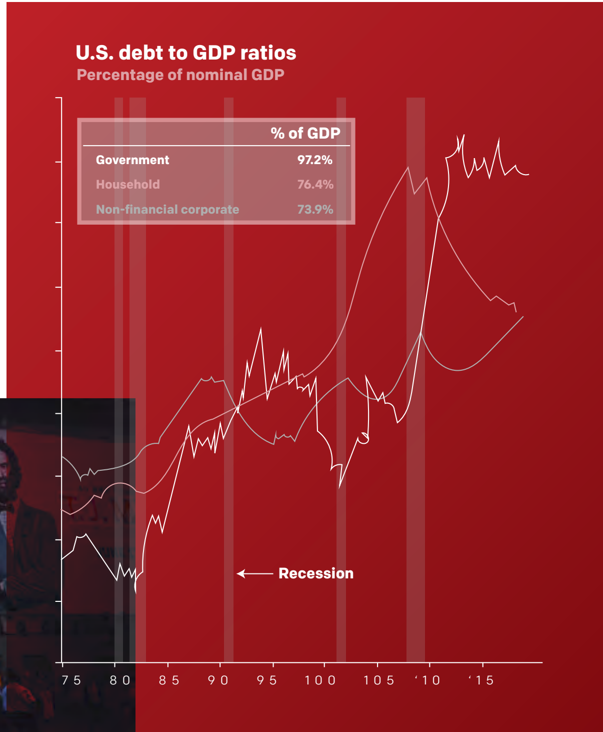
The key question is what is the global growth outlook for the next 12-24 months as certain key economies show signs of weakness? How far out is the US recession? Is Europe about to enter a period of stagflation? The word cloud below provides a clear picture of how 2018 Q4 concerns have faded and morphed into some new ones in Q1 2019.

2.1 US Economy

The US economy remains robust after many years of low but sustained growth. Low unemployment has not resulted in the expected upward pressure on inflation and thus the biggest near-term recession trigger in the form of the FED has reversed its rate hiking stance, paving the way for further expansion, albeit at a slower pace.

Key facts about the current US economy that we believe are important:

The US remains a consumption-based economy at 68% of GDP. The US consumer is in good shape relative to 2008/9; the wealth effect is in full force as household wealth to household debt remains comfortable (see chart below). However, the exponential government debt growth is a longer-term concern that cannot be ignored. Corporate bond yields, a key stress indicator, remain at healthy levels.



2. 1. 1 Trade Wars

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2.1.2 Yield Curve Inversion

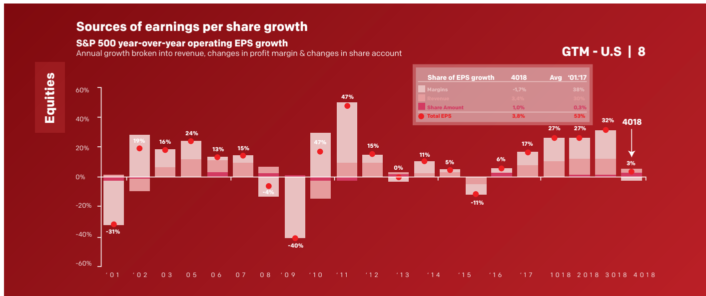
The yield curve inversion is a notable indicator of market concern around the potential for a recession however it is not a guarantee of anything and needs to be looked at in conjunction with other facts and economic data points. While we pay attention to something like this it is not a decision point in and of itself.

2. 1. 3 Corporate Share Buybacks

As to the argument that much of the US stock market performance has been driven by share buybacks since the GFC - we do not necessarily agree. While the massive scale of buybacks will have supported the market on some short-term time frames, as can be seen from the graph below, this has not been the long-term driver of earnings accretion. The health of the US corporate in revenue and margin growth is rather the reason for the corporate ability to buy back shares on such scale.

We are not supportive of share buybacks in certain key circumstances such as the following:

- Better long-term investment opportunities exist
- They are financed by debt
- When they are used to buy shares trading at significant highs
- When they are used to support the share price or manipulate earning



2.2 Europe and Japan

Europe and Japan are both on the verge of a recession with slowing growth and with very little monetary stimulus firepower. Each additional unit of debt is having little to no commensurate GDP impact. The string of slowing economic data out of Europe and the importance of this economic powerhouse to the global economy must not be underestimated. Quantitative Easing did not generate the economic escape velocity required for the region. The charts below reflect how this region is rapidly moving up the list of concerns for global investors, including ECM.

2.3 China

China represents the most carefully managed economy. They have a well-known potential debt crisis which government is working hard to deal with while limiting the GDP impact. We remain of the view that fiscal and monetary stimulus measures being provided will prevent a shock slowdown which could trigger the debt crisis.

2.4 Commodities

We retain with our long held constructive view on the outlook for industrial commodities. This outlook is closely linked to China's fortunes. The Chinese government has a proven track record of successful economic management and infrastructure based stimulus at key moments. Currently, the short to medium term boost being provided by fiscal stimulus allied to the longer term demands of projects like Belt and Road and the growth in consumption by the rising power that is India support the late cycle bull case. The key risk to this outlook is a sustained deterioration in the global growth picture.

Copper specifically remains our top commodity for its key role in traditional industrial growth and its equally key role in new technologies.

2.5 South Africa

By far the dominant feature of the outlook for SA both in the near and long term is the Elections. The outcome itself is not the critical factor as it was with the NEC but rather what does the new government do with some of the promises that have been made. The market will be looking for any signs of genuine clampdown on corruption, policy certainty in areas such as mining and land reform and indications of how much power and influence Mr Ramaphosa really has within the ANC will be key catalysts for the long-term picture.

We watch with concern the declining and persistently low levels of key economic indicators such as retail sales, PMI's and business confidence that do not bode well for further economic growth if the hoped-for changes do not begin to become visible.

On the currency and interest rate front, a 'positive' election outcome should support the prospects for the currency, which allied to the low growth outlook for this year and the next (1.4%, 1.8%) should provide enough fuel for a flat rate path outlook with some potential for a small cut late in the third quarter.

We believe that on a longer term horizon (3-5 years) the market offers significant potential for meaningful real returns. The base is low enough that a scenario where things just become less bad can catalyse improved consumer and investor confidence which in turn will begin to drive economic growth. We believe this effect will become quickly visible at the margin in areas such as housing and property, consumer spending and corporate spending and investment, all of which have been particularly subdued for several years. This coupled with the fact that most of the quality SA Inc corporates trading at the low end of valuations are running very lean, cost efficient operations after several tough years and the potential for decent upside gearing to earnings is very real.

2.6 Elections and Brazil

We looked at the equity market performance in Brazil leading up to the key 28 October 2018 election for potential clues as to what the SA market might do. The Brazilian victor was not previously regarded as market friendly however the preceding 4 months into elections saw a return of over 21 % on the Bovespa followed by a 15% return in the subsequent 3 months. Markets value clarity and certainty above all else. In a similar fashion, the Top40 index has had a strong rally in the months leading up to the election, recording 18% from the lows.

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2.7 South African Sectors

Resources

We remain overall constructive on the space with some preferences such as copper and iron ore over crude oil. The strong free cash flow generation and strict cost control, allied to an a-typically conservative pattern of behaviour around new capex and corporate actions is very encouraging and should remain supportive of the outlook for the miners should commodity prices remain stable.

However, we remain alert to the fact that a global growth shock will see this robust free cash flow quickly unravel.

Financials

As described above we believe the outlook for financials is constructive in a positive election environment. Bank valuations remain towards the lower end of the 10-year range and dividend yields are generous. This is a competitive space however and we believe the players with the strongest IT and client growth strategies will continue to outperform.

Post the very poor investment book performances of the insurers we believe they have the potential for an upside earnings surprise if we see sustained good performance in the stock market added to the excellent Q1 performance.

Retailers

The consumer staples and food producer sectors are also trading on the lower end of their 5-year ranges however these sectors are being hampered by fierce competition and persistently low inflation. We a have a more neutral stance in these sectors, preferring to have relative positioning rather than significant overweight exposure.

Consumer discretionary has the potential to deliver meaningful upside if we see a pickup in consumer spending and a possible reversal of their tightening margins. We believe that some stocks offer a good entry point in the consumer space based on current valuations.

SA Industrials

We prefer to avoid the poorer quality (and cheapest) companies in the space and focus on those with a history of quality management offering good value with growth prospects at this point in the cycle.

3 ECM SPOTLIGHT

At ECM we recognise that trends that are long-term secular and disruptive have the potential to create wealth on massive scale. To be action-able these trends need to be identifiable, sustainable and investable. An easy to identify theme that anyone can see playing out all around us is the rapid technological change in so many different areas of our lives. In this newsletter we will briefly touch on one of those.

Artificial intelligence

Most people know what this is at a high level but perhaps it is not known exactly how it can be used and how it is creating value beyond suggested advertisements and chatbots. AI will touch almost every industry over the coming years and it has begun already.

Using AI requires data for analysis and interpretation. This data requirement opens an entire series of investment opportunities which we will explore in future.

Some key industries already moving rapidly into AI application:

Financial services:

Application in risk management, fraud prevention and investment predictions rank among the top uses currently.

Manufacturing:

AI is being used in smart manufacturing, supply chains, effectiveness assessments.

COMPANIES & COUNTRIES WINNING THE AI RACE

Healthcare:

According to one Accenture study, key clinical healthcare AI can save the US healthcare economy up to $150bn annually by 2026. In clinical diagnosis, AI has the potential to improve outcomes by 30 to 40 percent while reducing the costs of treatment by as much as 50%.

Transportation:

Preventative maintenance savings based on AI data analysis, traffic patterns and automatic safety measures are some of the uses.

Energy and Utilities:

Some applications currently being deployed include automatic plant production adjustments based on usage factors, wind power generation, autonomous vehicles, logistics and delivery.

It is clear the potential for application is massive across any number of industries. What is not as clear is that there is an entire value-chain built around the deployment of AI which offers multiple investment opportunities. For example:

- The data storage solutions such as cloud computing required to support these vast quantities of data.
- The security and integrity of the data stored becomes critical, requiring advanced cyber-security solutions.
- The AI engine runs complex models and computations that rely on advanced processors provided by semi-conductor manufacturers.
- Much of the data is generated or measured by MEMS (microelectromechanical systems), which are miniature machines similar to transistors that have both mechanical and electronic components.
- Development and maintenance of complex AI algorithms relies on cutting edge software solutions and

4 CONCLUSION

While we wary of rapid short-tem repricing of assets, we remain cautiously bullish with respect to the outlook for the quarter and year ahead. We believe the key risk factors that exist globally such as trade wars, Europe and China will continue to grind along at a muted pace without imploding. WIth global interest rates holding lows and even reverting lower in some cases, the supportive environment for equity and bond valuations remains intact.

With a medium to long term view, the risk to reward in holding South African equities at current levels is attractive and warrants meaningful exposure in quality names.

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