Quarter in Review

The first quarter of 2018 has been unexpected to say the least. Close to 90% of market forecasters overseas (and probably in SA) saw the market having a positive first quarter. Nonetheless, it has provided a reminder that it is critical to understand exactly what future expectations are already priced into markets, specific stocks and economic outcomes. Furthermore, when everyone is of the same view, it pays to question consensus (or at least take some money off the table).That being said, we are pleased with the performance of our two funds during the first quarter. **Effectus PFP Multi Strategy Prescient RIHF** delivered a return of **10.11%** against the **Top40's** return of **-7.12%** (an **outperformance** of **17.23%**). **Effectus Equity Fund** (model portfolio) generated a return of -**3.51%**, well ahead of the **SWIX40's** return of **-7.91%** during the first quarter of 2018. It was a challenging quarter, with only banks and general retailers showing positive year to date gains but we are of the view that the corrective action in the markets provides opportunities. The forthcoming quarter will likely be one where there is again significant dispersion between sectors and increasingly stocks as well.

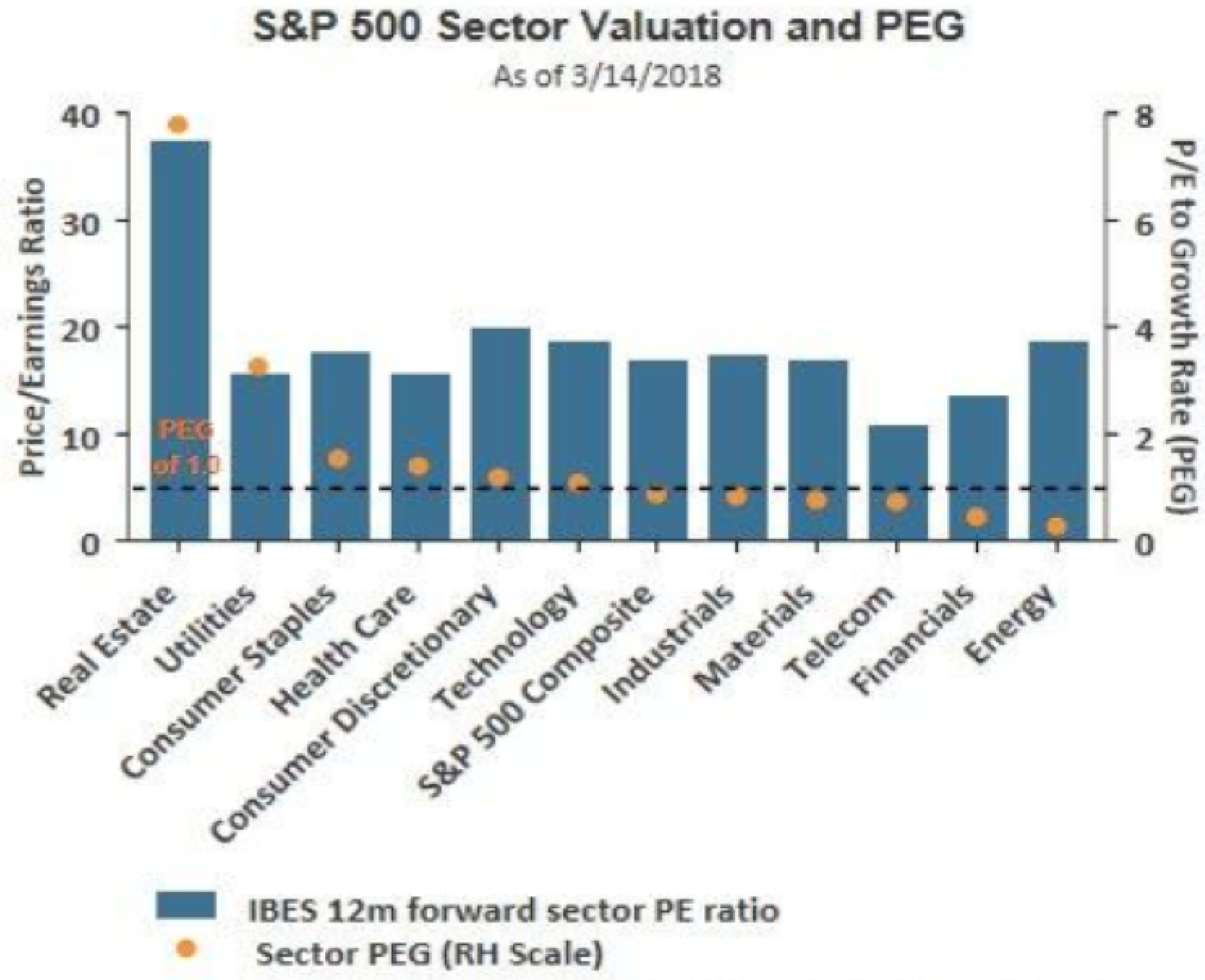
Looking Ahead

While we remain optimistic in the medium term we need to recognise that in the shorter term there are a number of global factors converging to create a destabilising effect and the corrective price action and high levels of volatility may not be over in the short term. These factors emerge as the themes of protectionism, populism, geopolitcs, rising rates and inflation, the regulation of tech and the ongoing unwind of global liquidity prevail. This confluence of factors is disruptive in relation to the globally co-ordinated efforts of the past few years to get the global economy into a stage of collective growth.

Global Trade Data

Global trade data has softened over the past few months. Of the 30 countries which Markit reports a manufacturing PMI for, 21 declined month over month. It is important to keep in mind that 90% (27) of the PMI's are above 50, only 12 of 30 Manufacturing PMI's are down versus a year ago and the average reading for all 30 countries is above 53. Even as PMIs are moving lower, the global economy is still relatively healthy, with a PMI above 50 implying expansion. Given the continuous expectations of positive data, a normalisation of the market and expectations is to be expected coming off multi-year highs for many global growth indicators.

Markets are relatively more attractive than they were 12 months ago. The chart below shows five sectors in the S&P 500 Index are trading with PEG ratios below 1.0, even the S&P 500 Index itself has a PEG less than 1.0. In July of last year, only one sector had a PEG ratio less than 1.0 and that was the Energy sector. The S&P forward PE multiple is at the lowest since Brexit. As we head into first quarter earnings, we expect the underlying economic strength to show through.



Global Trade Data

As for **China and India**, which we follow closely (and have discussed in previous letters), the powerful long term trends of growth and infrastructure investment, coupled with clear leadership remain in-tact and only a global growth scare would put this to the test.

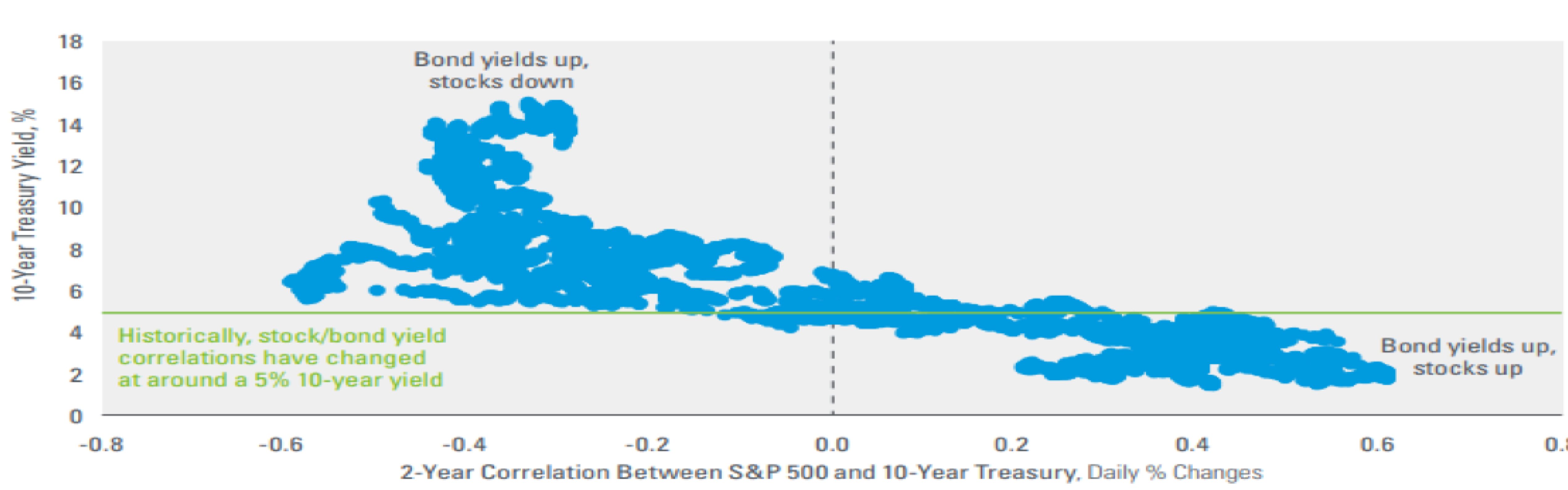
Trade Wars

We are of the opinion that the trade wars are not going to continue to escalate. Our **base case** is that neither Trump nor China actually wants to pursue this path and will find a compromise solution. The loud rhetoric is a negotiating tactic of Trump and a desire to force China's hand into amending some of their trade practices, providing US companies with better access to China's markets. Given that China has long been aware of the need for reform yet has been deliberately slow to act, we expect them to compromise enough to placate the US and give Trump his moral and political victory while at the same time opening up the economy in a positive move for markets overall. The duration of the dispute however could still extend for some period of time, and headlines will prolong the heightened volatility of global markets and increasing growth risks in the near term. We have long had a firm belief in China's strategic leadership and while the 'trade-war' outcome may appease the US, in reality it is unlikely to be detrimental to China or their economic growth prospects.

Interest Rates & Inflation

One of the outlier risks we see in global markets is an upside surprise in inflation as labour markets continue to tighten which may lead to Central Banks raising rates more aggressively than is currently forecast and changing the outlook for growth. However, the question as to whether stocks and rates can both move higher at the same time is not in itself a reason to be bearish the equity market outlook. Rising rates, economic growth and inflation can be a positive equity market combination. We have noted in previous newsletters but believe it is worth pointing out again that stocks and bond yields tend to move together when the 10-year treasury yield is below 5%, as illustrated in the chart below. The obvious caveat to this is a sharp rise in rates rather than a gradual pace in line with the steady economic and earnings growth profile. With regard to inflation, historically when inflation is below 3% the average PE of the S&P 500 is over 18 times while the recent pullback has brought it to around 16.6 times. So in an orderly and gradual **rising rate, rising inflation and earnings growth** environment we do not foresee major equity market risk. However, an inflationary surprise and consequently a rates shock would indeed pose significant risk to equity markets and the economic growth cycle.

2 **STOCK AND BOND YIELDS TEND TO GO UP TOGETHER AT LOW INTEREST RATE LEVELS**



Source: LPL Research, Bloomberg, FactSet 02/16/18

Correlations are based on 2-year periods, daily data. Data back to 1968.

Correlation ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

Volatility

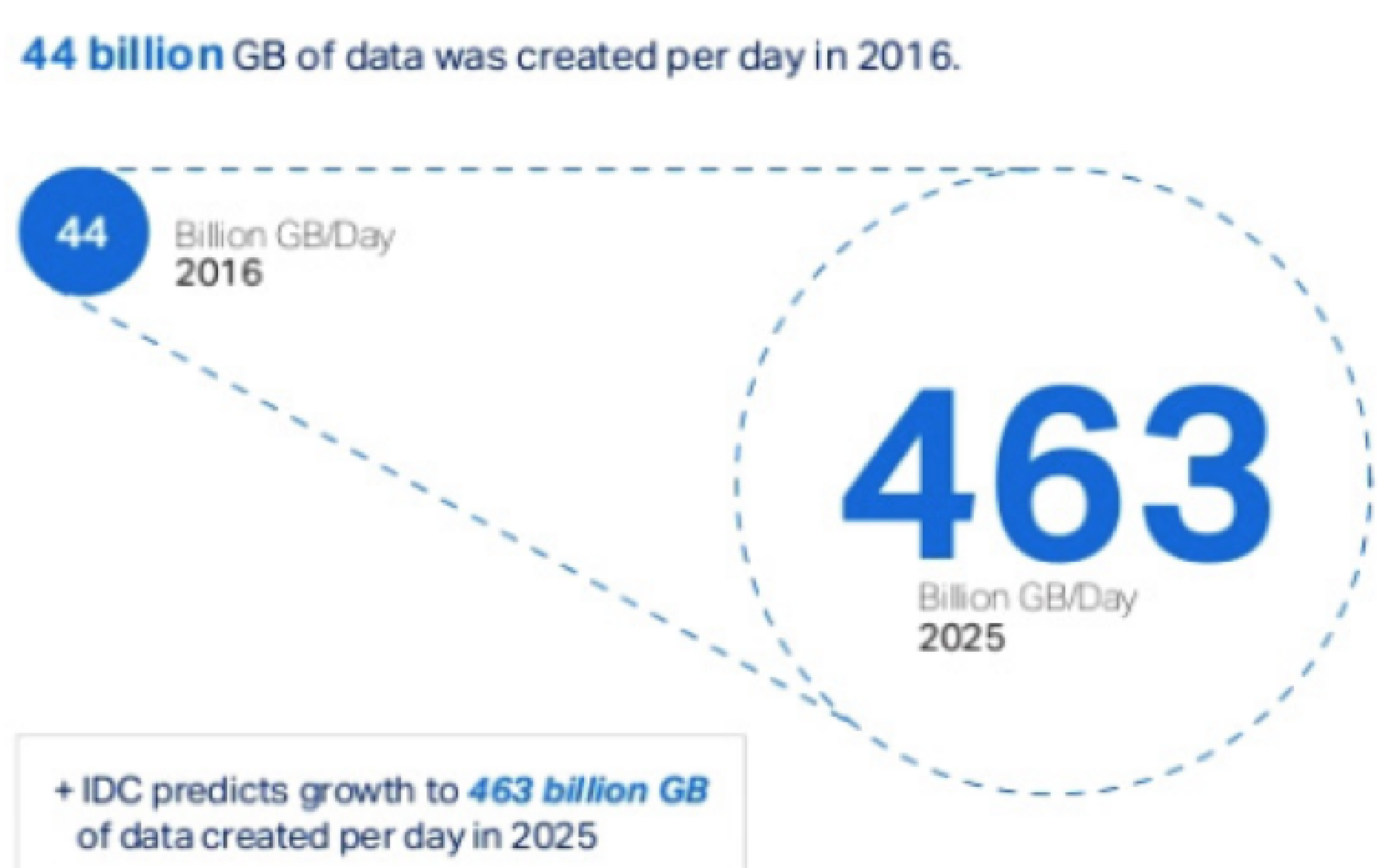
With regard to the **elevated levels of volatility,** we do not see this as a risk in and of itself. Volatility has been abnormally low since the GFC and even more so over the past 2 years, suppressed by the global flood of liquidity and other stimulus measures. Liquidity in itself has a volatility dampening effect and as we are well into the unwind of quantitative easing, with the US leading the way as rates are being normalised and the massive Fed balance sheet is being unwound which is effectively withdrawing liquidity from the market. It is a question of when rather than if the ECB (and eventually Japan) follows the US in the unwind of their QE programs. This reduced liquidity has inevitably led to a normalisation of market volatility which appears heightened in relation to the extreme lows of the past 18 months but is in fact not out of line with long term averages.

Technology

We have felt for some time that the risk of regulation for some of the bigger companies like Facebook and Google is growing and despite the fact that their valuations are moving into reasonable territory we are cautious on such names. Having said that we believe the **secular growth story** attached to the global digital revolution is firmly intact and will be relatively stable and earnings in some sub-sectors will be defensive in the event of a global slowdown. On this basis we remain bullish on technology as a whole and in particular some fundamental themes that underpin this evolution, particularly Artificial Intelligence (AI), Data Storage and Analytics.

AI will be the underpin to almost all the technology we see around us. There is not a single large cap tech company that is not aggressively pursuing AI capabilities (Google alone has made 12 related acquisitions since 2012). Cloud-computing, search, voice assistance etc all rely on AI to drive growth. Once of our top picks in this sector is Xilinx, which provides programmable chips which are vital for AI and for cloud computing. For example, Amazon's cloud is powered by Xilinx and Baidu is also using the very same chips to power machine learning. Xilinx provides the 'picks and shovels' to the mining industry.

Another sector we believe has many years of structural tailwinds to come is Data and the demand for storing and accessing the Data. This trend will continue to accelerate exponentially in the years and decades to come. According to a study by IBM, 90% of the data on the internet has been created since 2016. The demand for storing and accessing data is an opportunity for a semiconductor company like Marvell Technology which provides the newer solid state storage drives (SSD) that are superior to traditional hard disk drives. It has a new CEO who has narrowed the focus on storage, networking and connectivity and is a partial turnaround story.



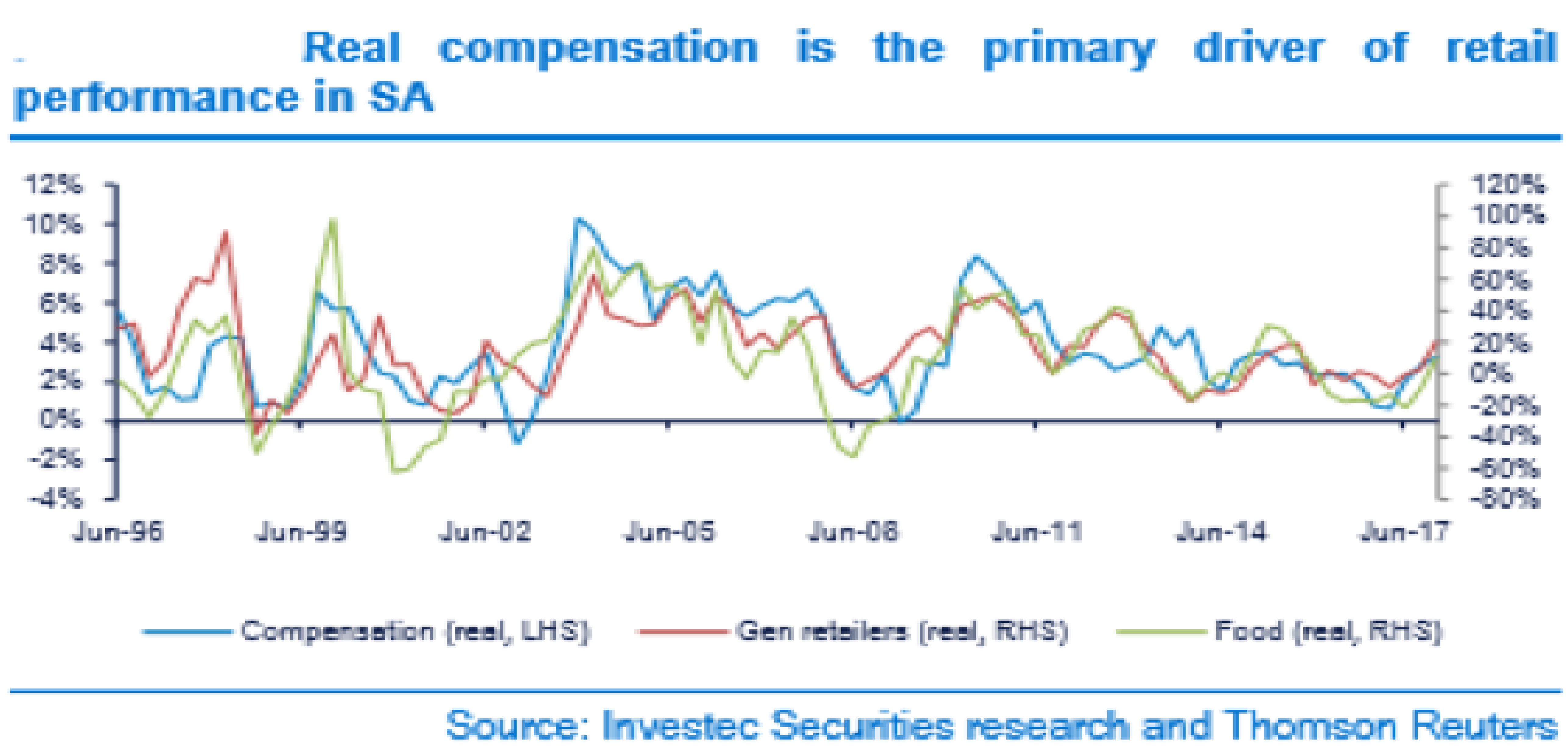
Source: MicroFocus https://www.slideshare.net/Micro-Focus/growth-of-internet-data-2017

South Africa

We continue to believe in the potential of the SA recovery and the self-help story around South African exposed companies has a long way to go. In the short term some of these shares ran ahead of the improved fundamentals and are enduring a healthy correction, but in the medium term the opportunity remains. After many years of stagnant growth, the SA Inc basket of companies is fairly lean, well capitalised and operationally geared for an uptick in the SA economy.

The change in leadership brings with it many opportunities as there are a large number of political, economic and structural changes that can be made to enhance the growth prospects in SA, independent of the global landscape. While some of these changes are very complicated and difficult to expect in the near term, there are also a number of high-impact easy wins such as fixing SOE leadership, resolving the mining charter and rooting out corruption that can fuel a turnaround in consumer and business confidence as well as the economy. The outlook for SA GDP is being upgraded towards 1.4% for 2018 and we think the risk still remains to the upside making SA a relatively attractive investment destination. An on-going improvement in consumer and business confidence is a key metric that we see driving this upside.

In line with our view on SA exposed companies above we remain bullish on the outlook for B**anks, Diversified Financials and Industrials** (automotive, logistics etc) and expect the market to be buying the dips on these counters. The local bourse will be further supported by ongoing foreign capital inflows. In addition, the Re**tail sector**(especially credit) stands to benefit significantly if our bullish SA view plays out. The relatively benign inflation outlook and steady Rand and improving employment outlook is supportive of the retail sector. Total compensation in SA is up 8% yoy and inflation is below 5%. This equates to real wage growth of around 3% (in particular the lower LSM) and we see potential for another rate cut this year. Another lagged beneficiary of these trends is expected to be the gaming and leisure sector.



Should global markets and trade dispute noise begin to settle down we expect the **ZAR** to once again have a strengthening bias into the second half of the year while in the near term it may continue to consolidate in line with emerging market currencies.

We have become less bearish on the more **defensive sectors** such as Rand Hedge Global Industrials as valuations have moved towards more attractive levels, while we remain neutral on Healthcare and Pharma at current levels as valuations begin to look more interesting. However the high-yield, bond like equities are unlikely to perform in a rising rate environment.

We retain our long held positive outlook for **Resources** both from a global growth and demand perspective plus the unique South African opportunity which the new Government represents. Tied into this we see the global mining sector moving into the capex expansion cycle and favour the industrial and mining equipment providers. In addition, new orders for capital goods from manufacturers in the US are already up 8% yoy - an environment in which commodity prices rally and US breakeven inflation rates pick up.

A quick word on Steinhoff, Viceroy, Capitec, Resilient and all things related. We strongly believe that one positive consequence of the many painful and volatile months for some companies and investors is that the improved level of financial scrutiny and the standard of analyst's interrogation has dramatically improved in any stocks that are potentially in the cross-hairs of another Viceroy-type of fallout. In the long run a higher standard of demand by investors in relation to corporate governance, disclosure of related party transactions and acquisition-related earnings and cash flows, amongst others, can only be good for the market as a whole.

Conclusion

We believe it is too early to call the end of the bull market globally and indeed we are in the early stages of one locally. Overall we see the recent market selloff both globally and locally as an opportunity, taking a 6-12 month view. Our essentially bullish outlook will change if there is a macro event that challenges the outlook for global growth or materially increases the risk of recession in the next 12-18 months. We retain our preference for exposure to commodities, late cyclical plays and technology.