SIMEKA CONSULTANTS & ACTUARIES

Investment Notes

January 2015

1 of 2015

What to expect from investment markets for 2015

Gazing into our crystal ball…

The direct impact of global economic events and trends on South Africa is now clearer than ever before. Growth in China, the world economic powerhouse is slowing down. This creates uncertainty for resource producing areas in South Africa, particularly in the coal mining areas, the platinum belt and iron ore producing zones. South Africa has integrated fully into the world economy and the old proverb *that a sneeze in the US markets results in a cold in the South African one* remains true. For this reason, it is necessary to understand the global economic and financial market trends, and their possible impact on South Africa.

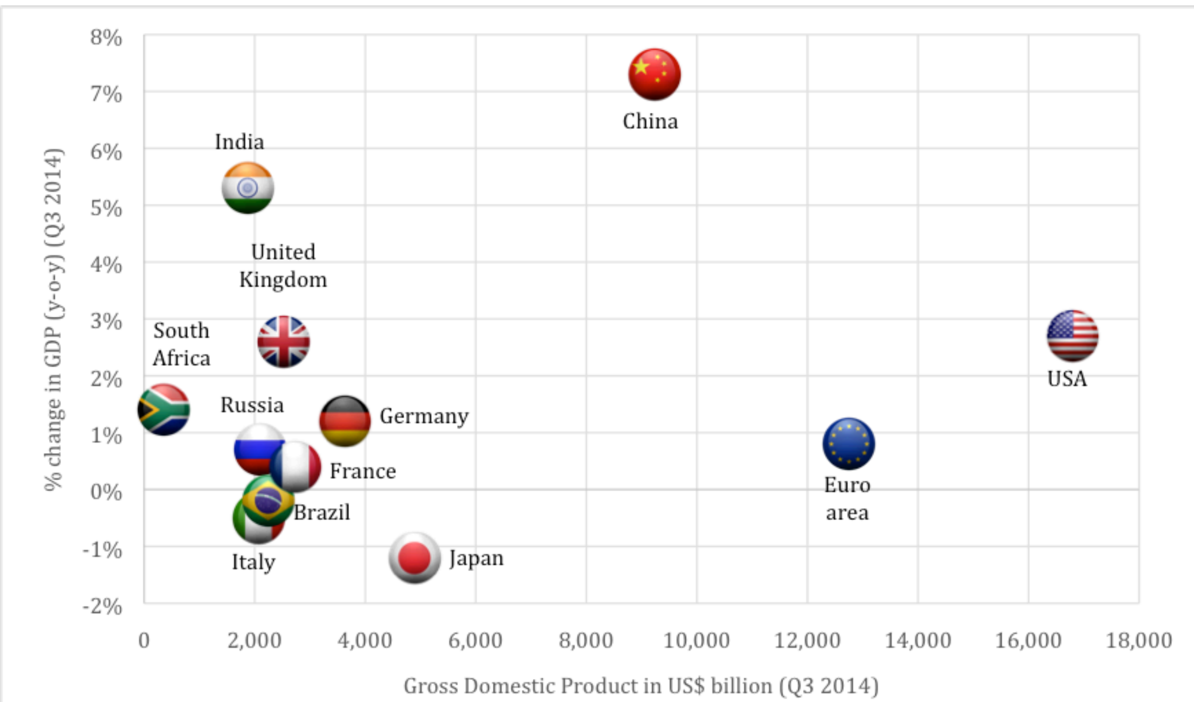
Economic growth worldwide shows some signs of continued, yet cautious recovery. In the **United States**, the **United Kingdom** and India economic growth is improving.

In **China**, economic growth remains high, but since 2012, the Chinese economy has been growing at a slower pace.

In the ‘**Euro area**’, economic growth remains uncertain with the largest three regional economies, **Germany, France** and **Italy** still struggling. **Brazil** and **Russia** appear to be in much the same position.

Since 2013, the promising economic growth in **Japan** has slowed down considerably as Japan experienced negative growth in the second and third quarters of 2014.

Economic Growth



While Europe, Russia, Brazil and Japan are sorting themselves out, global growth will depend largely on the USA and China; the USA will continue to improve however China will continue to grow at an even-slower rate. It is realistic to expect these recent economic trends to continue in this way. As South Africa's major trading partners include China, Germany, Japan, UK and the US, SA will also be affected.

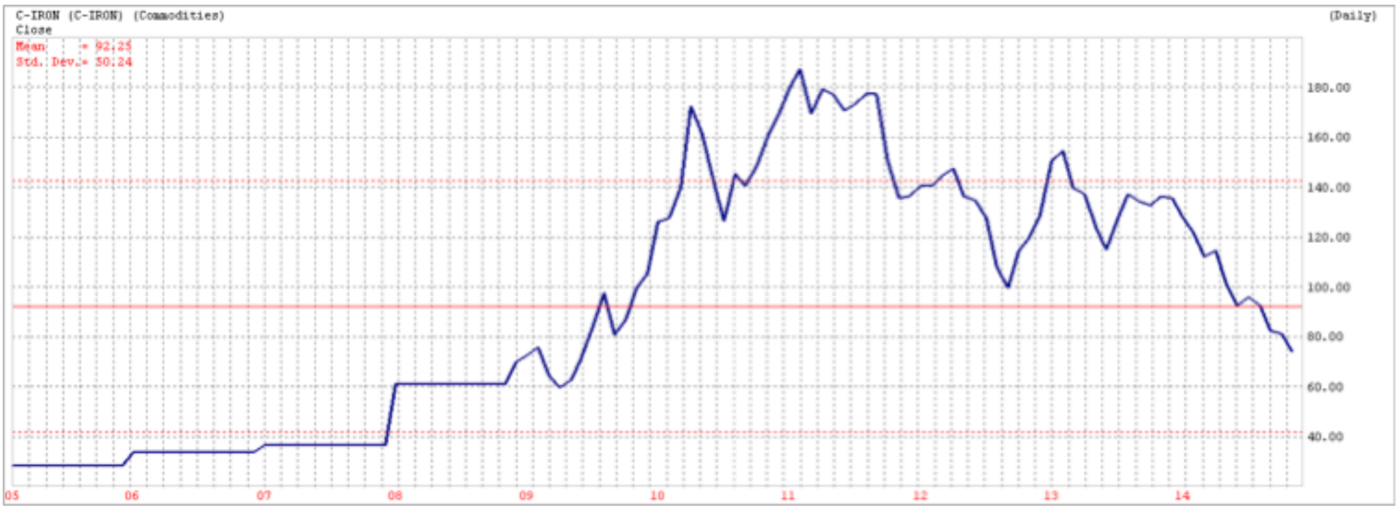
Two important risk factors could affect the world in 2015. The first factor is the sharp drop to the price of oil to below US$50 per barrel. While beneficial for oil importing countries such as South Africa (oil accounts for 24% of all imports), it is likely to have a severe effect in Russia, which depends heavily on revenue from the energy sector. This could create further uncertainty in a part of the world that is already volatile.

Oil - Brent Spot (US$)

Source: Timbuk One

While the drop in the price of oil has been nothing short of extreme, commodities prices generally were softer, reflecting slower economic growth in countries such as China. This is important in South Africa for we export commodities such as coal and iron ore to China.

Iron Ore (US$)



Source: Timbuk One

The same holds true for precious metals gold, silver and platinum.

The US Dollar and Chinese Yuan strengthened against other currencies as a result of the improved competitive economic positions of both the US and China. This is true especially when measured against the Euro, for speculation is rising about a possible 'Grexit' from the Euro. (Greece is the word!) In all probability the devaluation of the Euro may provide some respite in 2015. However, with the US Dollar remaining strong, it could likely affect various currencies from resource producing countries, such as the Russian Ruble and South African Rand.

Money supply has increased sharply around the world since the 2008 events, when authorities used monetary policy measures to stabilise financial systems by increasing liquidity. The economic growth that followed after the increased money supply, did not keep up with the higher level of liquidity. The excess money has not found its way into the real economy to generate further economic growth (e.g. new factories and production facilities and jobs). As a result, excess money floats in the financial system where it remains captured in financial markets – causing asset inflation in particular market segments. This was the case in many share markets since 2008 where the recovery of share prices was impressive given the underlying slow economic recovery.

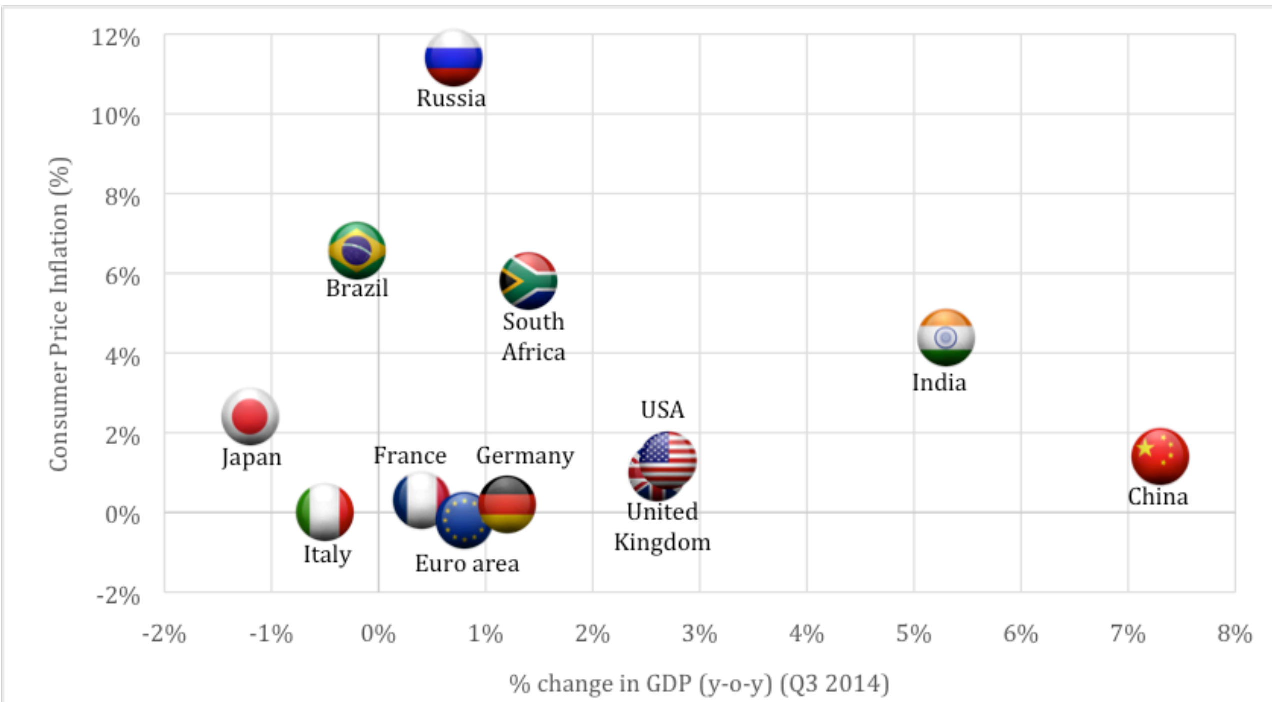
FTSE/JSE All Share Index

Source: Timbuk One

The second risk factor is that the **excess money** captured in a particular market segment (e.g. shares) could leave that market and find its way to another more reasonably priced market (e.g. property, commodities) as market price valuations reach levels that are difficult to justify given the underlying conditions. For this reason it is possible that 2015 may be a year in which higher volatility prevails.

Consumer price inflation globally remains low in developed economies. As inflation often follows economic growth, the prevailing low inflation shows that economies aren't growing to their potential.

Inflation



Countries that have experienced currency devaluation in the recent past – resource producing emerging economies - could see their consumer price inflation increasing as a result of imported inflation. Russia, a net exporter of energy, will in all likelihood experience a strident rise in inflation. Other emerging economies such as Brazil, India and Indonesia are likely to experience higher inflation. In South Africa, the possibility of inflation increasing as a result of the weaker Rand has been offset by the significantly lower oil price.

Investors are therefore more likely to seek value and pay particular attention to the prices paid in 2015 than in the recent past. It is possible that less emphasis would be placed on momentum driving financial markets and that a more conservative outlook will prevail.

South Africa is likely to see continued emphasis on **social spending** in the run-up to the municipal elections in 2016. **Service delivery** will be more important than in the past and our democratic practices livelier. The prevailing electricity constraints will not only have a dampening effect on economic growth but also on the ability to create new jobs. Unemployment remains above 25% and **youth unemployment** exceeds 40% already. It is unsure if the state **education** system can rise to beat the challenge to better equip learners for the job market. Thus the inescapable conclusion is that government will have little alternative but **to raise tax revenue**, most likely of individuals.

This may lead to a more sensitive assessment of risk in South Africa.

We therefore expect that:

- the South African economy would continue to perform below its potential;
- the current account will remain under pressure, although to a lesser extent because of the low oil price;
- pressure on the Rand will not be as pronounced as it has been in the past;
- unemployment will remain a source of concern;
- inflation will slow down; and
- interest rates may not increase as quickly or by as much as anticipated in the past

Our ranking of investment return expectations for 2015 is:

- Global shares
- Domestic property
- Global bonds
- Domestic nominal bonds
- Domestic inflation-linked bonds
- Domestic shares
- Domestic money market

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