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MARKET INSIGHT

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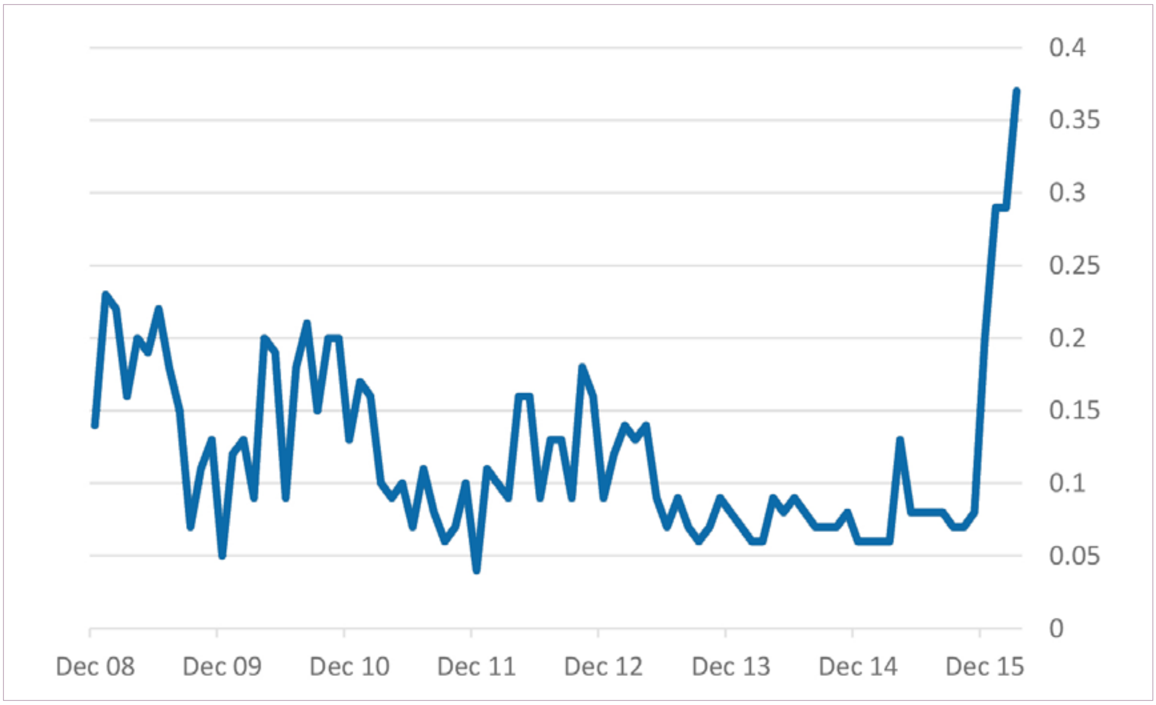
The probability of a sovereign rating downgrade currently dominates economic discourse in South Africa. While one cannot ignore the impact of such an event, economic developments are not about sovereign ratings only. A number of key economic variables are likely to be important for financial markets going forward.

One of the main drivers of our economic outlook presently is the interest rate policy of the Federal Reserve Bank of New York. The Federal Reserve has indicated that interest rates in the United States will gradually increase in future. Whether further interest rate increases in the US materialise over the next year or not, mere speculation may result in volatility in emerging markets.

Crucially, the Federal Reserve has indicated that interest rate increases depend on factors that include:

- the stabilisation of foreign economies and financial markets (trading partners);
- an appropriate level for the US Dollar as strong US Dollar would depress inflation and exports, and hurt US manufacturing;
- stabilisation of commodity prices globally;
- the US housing sector which is required to contribute to national output; and
- sustained higher US core inflation.

US Fed Fund Rate (%)



Source:INet

Increased interest rates in the US could result in further Dollar strength against other currencies such as the Euro and Yen, but also against the South African Rand. A strong Dollar is not ideal for the US as it reduces the competitiveness of US exports and manufacturing, which in turn may have an effect on GDP growth in the US.

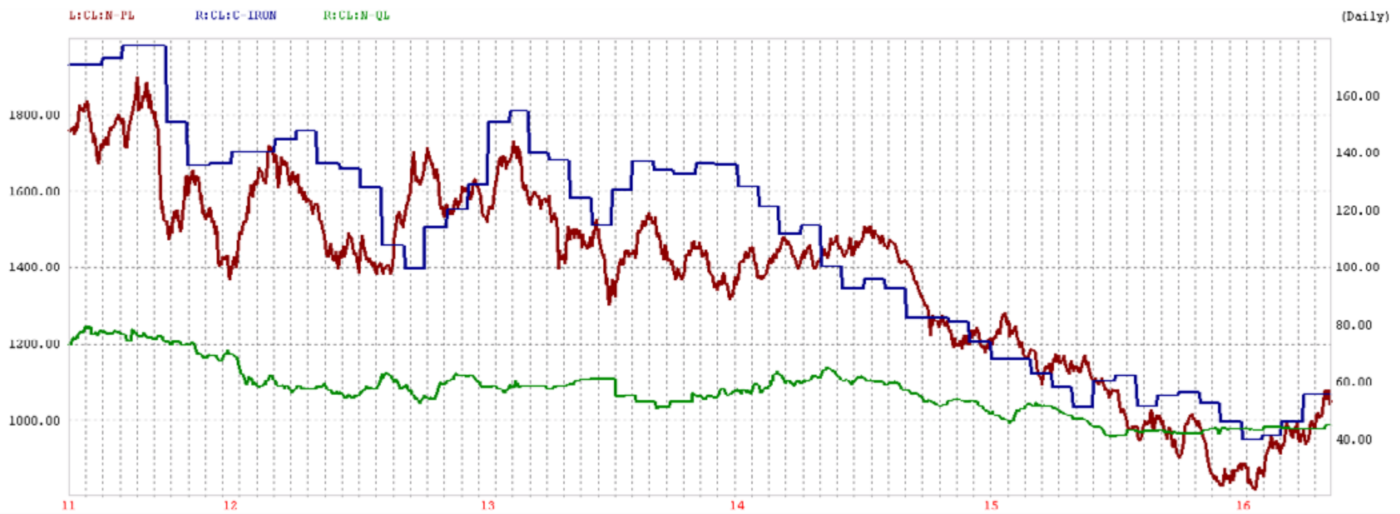
Euro/US Dollar

Source:TimBukOne

The outlook for commodities in the next year remains important for South Africa as demand for our major exports has been soft through to the end of 2015. South Africa's largest export items include platinum, iron ore and coal and our trade account (a deficit of -R50.6 billion in 2015) will remain under pressure until demand for these commodities improve on a sustained basis.

Oil accounts for approximately 25% of South Africa's imports. The depressed oil price in 2015 prevented the deficit on the trade account from being larger. Should the oil price increase in 2016 and 2017, it will affect the deficit on the trade account negatively.

Platinum ($/oz., red, left axis), Iron ore ($/tonne, blue, right axis) and Coal ($/tonne, green, right axis)



Source:TimBukOne

The above-mentioned factors are material to South Africa, but our influence on these variables is limited.

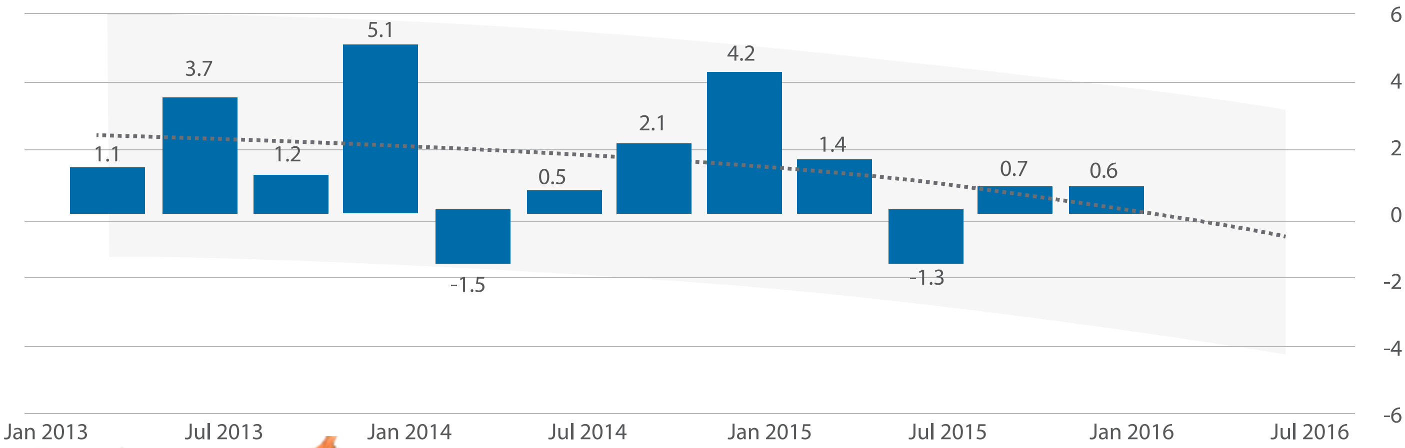
When considering factors that are determined internally by South Africa, government's stated intention to reduce the national budget deficit significantly over the next three years is positive. This depends largely on the freezing of civil service appointments, positions and promotions. Many are sceptic about the chances for success considering government's record to contain the burgeoning civil service.

The severe drought experienced in South Africa in 2016 requires the import of maize and wheat to meet domestic demand. These imports add to the pressure to the trade account. The drought has resulted in higher food prices already and food inflation (+25% on some items) is likely to increase further once the price of protein (particularly red meat) follows suit.

The risk of higher fuel prices has reduced as major oil producing countries refuse to cut back their production. Nevertheless, increases to fuel prices remain a risk and combined with food inflation, South Africa's inflation rate could remain higher for longer. Higher inflation, in turn, may necessitate more increases to South Africa's repurchase rate.

The annual assessments by rating agencies Moody's and Standard and Poor's in 2016 are more important than usual. South Africa runs the risk of its sovereign rating being reduced to non-investment grade ("junk status"). The imminent downgrade results largely from poor economic growth prospects, with GDP growth for 2016 expected at 0.7% and 1.4% for 2017.

South Africa GDP growth rate



Source: www.tradingeconomics.com: Statistics South Africa

A sovereign rating below the current investment grade will lead to outflows from both our share and bond markets. Many investors worldwide only have exposure to South African financial markets because of our financial markets being included in global indices. If South Africa is reduced to non-investment grade status, our financial markets will be excluded from global indices and some global investors will withdraw capital.

The Rand is likely to remain vulnerable in 2016 and perhaps 2017 considering the risk of capital withdrawal, higher interest rates in the US and a continued weak demand for commodities.

The performance of financial markets reflects the uncertainty caused by economic expectations. South African shares (FTSE/JSE All Share Index) struggled as is evident from the 3.9% for the quarter to March 2016 (3.2% for the 12-month period). Bonds (BEASSA All Bond Index) fared a little better with an investment return of 6.6% for the quarter to March 2016 (-0.6% for the 12-month period). Money market returns improved to 1.7% for the quarter to March 2016 (6.6% for the 12-month period), reflecting the five interest rate increases since 2014. The performance of listed property slowed from the heady levels that prevailed earlier as the average return of property collective investment scheme vehicles was 5.0% for the quarter to March 2016 (4.0% for the 12-month period).

As the exchange rate of the Rand strengthened by 5.5% in the quarter to March 2016 (weakened by -17.2% for the 12-month period), the performance on global shares in Rand was -5.4% for the quarter to March 2016 (17.3% for the 12-month period). In Rand, global bonds produced 0.4% for the quarter to March 2016 (26.3% for the 12-month period).

The investment return achieved by the risk-profiled peer groups are shown in the table that follows.

Average index-based investment return of risk profile peer groups to March 2016

Peer group	3 months	1 year	3 years	5 years
Guaranteed	1.8%	11.2%	14.8%	13.0%
Conservative	3.3%	6.3%	12.5%	14.9%
Moderate	3.0%	7.6%	15.0%	17.7%
Aggressive	3.1%	6.7%	16.4%	19.3%

The investment returns generated by investment managers to March 2016, are unconvincing in comparison with previous periods, mainly because of modest returns that prevailed in financial markets. The top and bottom quartiles of the global balanced peer group are reflected below:

Top and Bottom Quartiles of Global Balanced Funds to March 2016

Top Quartile	3 months	1 year	3 years	5 years
	Allan Gray	Allan Gray	Investec	Foord
	Sanlam	Foord	Allan Gray	Investec
	Prudential	Investec	Coronation	Coronation

Bottom Quartile	3 months	1 year	3 years	5 years
	OMIG	Oasis	OMIG	Sanlam
	MMI	ABSA	Stanlib	MMI
	ABSA	OMIG	ABSA	OMIG

The top quartile of global balanced funds is dominated by value-cognisant investment managers (most notably Allan Gray), as the pervasive Rand weakness abated in Q1 of 2016.

This is evident especially over the short-term. Reminiscent of the past, the bottom quartile is largely populated by investment managers who form part of insurance or bank groups, such as OMIG, MMI (previously Momentum) and ABSA.

We are not convinced that the financial risk for emerging financial markets, particularly South Africa, has declined to the extent that we can endorse a large-scale shift to value-cognisant managers yet. Many risk factors could still affect financial markets (e.g. sovereign credit rating downgrade) and 2016 could still produce mediocre investment returns.

The time to switch back into domestic value cognisant managers is looming and retirement funds should take steps to prepare for the eventuality.

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