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MARKET INSIGHT
Summer 2017

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2017 has a silver lining!

The two major events in 2016 were Brexit and the election of the property mogul and former reality television host, Mr Trump, as President of the United States. The outcomes of both the referendum and election surprised most and observers quickly moved to identify the common threads between these and other events.

Both Brexit and the Trump election victory point to the elevation of national interests over globalisation. It is about jobs, opportunities and economic growth in the home countries rather than global trade and stability (globalisation).

Economic integration, for instance in the European Union, trade agreements and the interests of multinational corporate entities often embody globalisation. Globalisation may have continued uninterrupted had it not been for instability in the Middle East. ISIL stepped into the power vacuum caused by the overthrow of the Iraqi regime by the American-led alliance more than a decade ago. Regional instability resulted in a human wave of refugees that rolled over Europe and affected the US. Countries such as France, Germany and Turkey often experienced terror campaigns aimed at its citizens.

Political change is likely to continue in 2017. Elections are scheduled in The Netherlands (March 2017), France (April/May) and Germany (August/October 2017). It is feasible that nationalist political parties could gain support in these elections.

As governments pursue policies pandering to these agendas, economic growth across the world may diverge. We expect some countries to experience strong economic growth and other countries to experience mediocre economic conditions.

GDP % change Y-o-Y	USD bn	Q3/16	2017	2020
United States	18 037	1.7%	2.5%	2.6%
Euro Area	11 540	1.7%	1.6%	1.9%
China	11 008	6.7%	6.5%	5.8%
Japan	4 123	1.1%	1.1%	1.7%
United Kingdom	2 858	2.2%	1.2%	1.8%
India	2 095	7.3%	7.1%	5.7%
Brazil	1 815	-2.9%	0.5%	1.9%
Russia	1 775	-0.4%	0.6%	2.2%
South Africa	313	0.7%	1.2%	2.6%
Source: OECD and www.tradingeconomics.com				

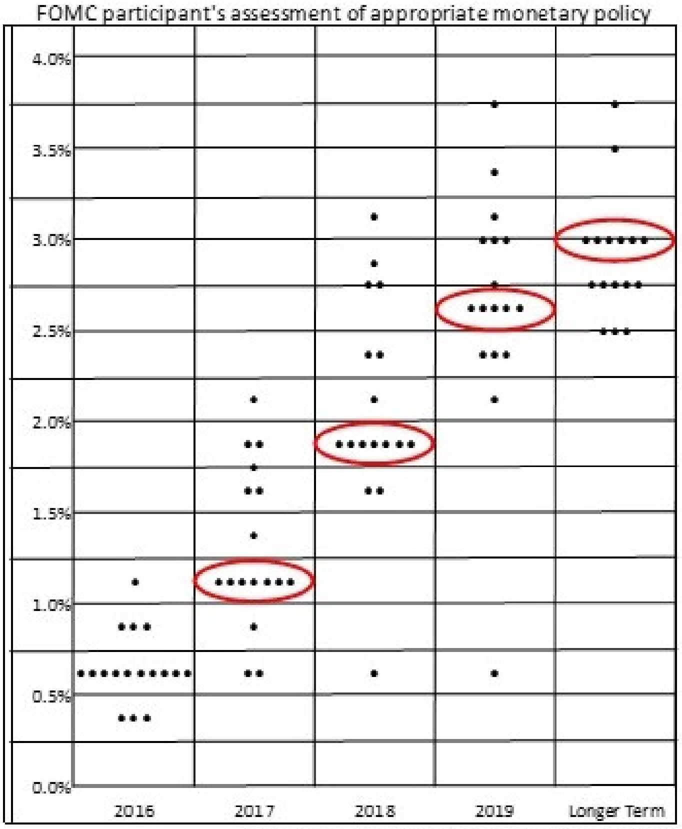
The obvious winner is the United States, where promises of favourable tax reforms, accelerated spending on infrastructure and protectionist trade policies on which President Trump was elected, are likely to lead to stronger economic growth. In this event, a strong US Dollar that maintains parity with the Euro would not surprise us. Despite expectations of interest rate increases by the Federal Reserve in 2017, the forecasts for US GDP growth is 2.5% (1.5% in 2016) and 3.0% in 2018, based on significant infrastructure investment growth. An assertive stance on trade agreements and some sabre rattling towards China (who could be labelled a currency manipulator) remain the wildcards that could affect the US Dollar in 2017.

We expect challenging conditions in the United Kingdom while it negotiates its possible withdrawal from the European Union. Economists present a sobering picture about the likely impact of Brexit. The OECD forecast GDP growth in the UK for 2017 at 1.2% (down from 2.2% in 2016) and 1.0% in 2018. The forecasts shows both private consumption expenditure and private fixed investment spending declining.

In Europe, China, India and Japan we expect economic growth rates at similar levels to 2016.

In 2016 the prices of gold (+8.5%) and platinum (+1.3%) increased marginally only when compared to increases in the prices of oil (+52.4%) and iron ore (+81.0%). The oil price could be sustained at present or even marginally higher levels as oil producers agree on targets to cut back production, but the ever-present threat of alternative sources of production could hinder a significant increase.

Commodity prices usually increase sharply, for a sustained period during an economic upswing. Some of the increases experienced in 2016 could continue into 2017, as older and unprofitable capacity is closed down.



Federal Open Market Committee's Explanation of Economic Projections

Globally, interest rates are set to increase in 2017, with the Federal Open Market Committee participant's expecting two to three interest rate increases and a further three increases in 2018 (each dot on the graph represents the forecast of the fed funds rate for each year by a voting member of the FOMC). Assets priced of US interest rates will be adjusted accordingly.

Positive expectations from share markets in developed countries could see emerging markets losing ground as an attractive investment returns could be earned in developed environments. Emerging market debt could find support as returns in the interest-bearing markets of developed markets are expected to be low or negative.

In South Africa, we expect improved economic conditions in 2017 when compared to 2016:

- We expect robust growth from the mining sector in 2017, mainly because of stronger demand expected from China and consolidation of global supply. The draft changes to the mining charter relating to BEE partnerships could cause some uncertainty around the sector.
- Agricultural conditions are set to improve. Solid rainfall in 2016/7 has improved conditions, but it is not sufficient yet to raise dam levels to normal seasonal levels. Even if it continues to rain, the growth from the agricultural sector may only normalise in 2018.
- We anticipate improved conditions in the manufacturing sector for 2017. Electricity supply is stable and increasing business confidence and global factors could combine to allow South Africa to manufacture more competitively.
- Private consumption expenditure is likely to remain under pressure in 2017, largely because of continued high unemployment and high levels of personal debt.

The repurchase rate is still in a rising phase. We expect economic growth in South Africa to improve, but marginally only. The extent to which the SARB's Monetary Policy Committee can continue to increase interest rate to maintain the purchasing power of the Rand is uncertain.

We should emphasize that our expectations are not determined by merely extrapolating past returns, but determined by building economic development and investment scenarios. These scenarios are accompanied by identifying risk themes, which should any of it manifest, initiates a review of our outlook.

We acknowledge that cycles in financial markets do not run according to calendar years and events that we anticipate may play out in shorter or longer periods than expected.

The basis for our outlook is that the Rand is undervalued when using a purchasing power parity to assess it. Should the economy improve and stable conditions prevail otherwise, one would look for continued stability in the Rand.

Significant risks for this outlook are:

- unexciting economic prospects;
- sentiment caused by political developments; and that could push the exchange rate to a weaker level;
- and rising fuel prices (imported inflation) should the oil price increase and the Rand weaken.

We rank expectations for 2017 for the asset classes considered by retirement funds as follows:

2010	2011	2012	2013	2014	2015	2016	2017E
Mid CAP 30.3%	Gl IB R 28.8%	FINI 38.1%	Gl Eqt R 57.0%	FINI 27.3%	GL Eqt R 34.6%	RESI 34.2%	ALBI
PROP 29.6%	Gl Eqt R 15.8%	INDI 36.5%	Sm CAP 26.3%	PROP 25.1%	Gl IB R 30.8%	Mid CAP 26.9%	Sm CAP
Sm CAP 24.7%	PROP 8.9%	PROP 35.9%	TOPI40 22.8%	Sm CAP 20.6%	PROP 10.8%	Sm CAP +20.9%	Mid CAP
INDI 24.0%	ALBI 8.8%	Mid CAP 29.5%	INDI 21.5%	Mid CAP 19.6%	STeFi 6.5%	INDI 19.3%	RESI
ALSH 19.0%	FINI 7.4%	Sm CAP 29.0%	ALSH 21.4%	GL Eqt R 16.7%	ALSH 5.1%	ALBI 15.5%	INDI
TOPI40 17.2%	STeFi 5.7%	ALSH 26.7%	Gl IB R 20.0%	GL IB R 11.3%	TOPI40 4.2%	PROP 10.2%	PROP
FINI 16.6%	Mid CAP 4.7%	TOPI40 26.1%	FINI 19.1%	ALSH 10.9%	FINI 3.9%	FINI 7.4%	FINI
ALBI 15.0%	ALSH 2.6%	Gl Eqt R 21.8%	Mid CAP 13.0%	ALBI 10.2%	ALBI -3.9%	STeFi 7.4%	STeFi
RESI 12.3%	TOPI40 2.2%	ALBI 16.0%	PROP 8.4%	TOPI40 9.2%	Sm CAP -3.9%	ALSH 2.6%	ALSH
STeFi 6.9%	Sm CAP 1.1%	Gl IB R 8.6%	STeFi 5.2%	INDI 7.0%	Mid CAP -7.5%	TOPI40 -1.6%	TOPI40
Gl Eqt R 0.5%	INDI -3.4%	STeFi 5.5%	RESI 1.4%	STeFi 5.9%	INDI -10.1%	GL Eqt R -4.2%	GL Eqt R
Gl IB R -5.6%	RESI -6.5%	RESI 3.1%	ALBI 0.6%	RESI -14.7%	RESI -37.0%	GL IB R -9.6%	GL IB R

Should South Africa maintain its sovereign debt credit rating, we expect domestic bonds to perform positively considering the positive steps announced by the Minister of Finance in the 2016 National Budget speech to control public spending and reign in wasteful government expenditure. This would imply a narrowing of South Africa's sovereign credit spread.

We remain concerned about the outlook for the top 40 South African shares. Resource prices could contribute positively, but share prices could respond less positively in a stable Rand environment. Shares depending on domestic trade and operations are likely to do a bit better despite trying conditions. Rand hedge shares are likely to provide strained returns, but could contribute positively if the Rand weakens.

Starting with an expected risk-free return of 8% for the money market, we expect bonds, listed property and shares outside the TOPI40 to provide investment returns higher than the money market. A stable Rand scenario should see the TOPI40, global equity and global bonds contribute less than the domestic money market.

Considering our outlook, what would the ideal investment manager look like? Should investment managers use SECTOR, SIZE and STYLE bets to outperform in 2017? In our view, emphasis on bonds and for shares on value investment style, small/mid cap shares and resources exposure could provide some excitement in 2017.

The best performing large sector for the quarter to 31 December 2016 was the Industrial sector as it increased by 5.3% for the quarter and 21.5% for the year. The Basic Materials sector performed best for the year (+34.2%), but worst for the quarter (-1.2%). The Financial sector achieved 2.9% for the quarter and 5.4% for the year. Bonds in the 12+ year category performed best for the year (+17.5%), but worst for the quarter (-0.04%).

For the period ended 31 December 2016, the financial markets performance is as follows:

To December 2016	3 months	1 year	3 years	5 years
FTSE/JSE All Share Index	-2.1%	2.6%	6.5%	16.8%
Listed property	1.3%	10.2%	16.9%	24.4%
BEASA All Bond Index	0.4%	15.5%	7.4%	8.5%
STeFi Composite	1.9%	7.4%	7.0%	6.9%
MSCI World (ZAR)	1.8%	-4.2%	14.6%	23.4%
Barclays Global Agg. Bonds (ZAR)	-7.3%	-9.6%	9.6%	11.4%
Rand/Dollar (+ stronger)	0.2%	12.9%	-8.1%	-8.2%

The investment return for the ASISA Multi Asset Class peer group funds are as follows.

Average investment return to December 2016				
Peer group	3 months	1 year	3 years	5 years
Guaranteed	1.3%	6.9%	10.7%	11.3%
ASISA MA Low Equity	-0.2%	3.7%	6.5%	9.0%
ASISA MA Medium Equity	-1.3%	1.6%	5.9%	10.0%
ASISA MA High Equity	-1.2%	1.9%	5.5%	10.9%

Investors were not rewarded for assuming more risk, in both the quarter and the year to December 2016.

Guaranteed and conservative portfolios outperformed moderate and aggressive portfolios.

The investment returns generated by large investment managers on global balanced funds to December 2016, reflect the difficult and uncertain conditions that prevail in financial markets presently.

The top and bottom quartiles of the global balanced large investment managers are:

	Top and bottom quartiles of global balanced funds to December 2016			
	3 months	1 year	3 years	5 years
Top quartile	Investec	Allan Gray	Investec	Investec
	Oasis	Sanlam	Allan Gray	Prudential
	ABSA	Prudential	Prudential	Allan Gray
Bottom quartile	Stanlib	Coronation	Foord	Momentum
	Momentum	Foord	Oasis	ABSA
	Coronation	Stanlib	Stanlib	Oasis

The composition of the top large managers for the quarter differs significant from the top managers over longer periods. Both Oasis and ABSA usually maintain approaches that are more conservative and prevailed in the difficult markets experienced in October and November.

Investment managers who depend on bottom-up valuation principles such as Allan Gray, Sanlam and Prudential still dominated in 2016. Coronation makes a surprise appearance at the bottom of the large managers for the quarter ended December 2016 and find itself in the bottom quartile for 2016.

Finally, trustees sometimes ask a question about how to kick-start economic growth in the short-term. We believe the following 10 steps could be considered:

1. Implement the **National Development Plan**
2. Create **policy certainty** by giving clear signals to stakeholders
3. A more flexible approach to **fast-track job creation**
4. Focus on **5.9 million unemployed people**
5. Work to achieve **price stability and employment**
6. **Infrastructure projects** – water, sewerage, electricity, communications, harbours, rail, roads
7. Reduce **size of public sector** and wage bill
8. **Service delivery** efficiency - especially to the poor
9. Promote **civil cohesion**, one cannot run a country through the court system
10. Leadership (government, business and labour) must promote **THE VISION** to civil society, to accept sacrifices now in exchange for greater rewards later.

Marcus Rautenbach
Principal Investment Consultant

Cape Town	Tel: +27 (0) 21 912 3300	Simeka House, The Vineyards Office Estate, 99 Jip De Jager Drive, Bellville, 7530
Durban	Tel: +27 (0) 31 566 2302	1st Floor, Northwing, 2 Cranbrook Crescent, Douglas Saunders Drive, La Lucia Ridge, 4051
Pretoria	Tel: +27 (0) 12 369 8800	3rd Floor, Podium at Menlyn, 43 Ingersol Road, Cnr Lois and Atterbury Road, Menlyn, 0181
Sandton	Tel: +27 (0) 11 263 4300	Building 2 Alice Lane, 11 Alice Lane, Sandton, 2196

www.simekaconsult.co.za | info@simekaconsult.co.za

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