MARKET INSIGHT

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Autumn 2018

3 tough questions.

Conditions in investment markets in the first quarter of 2018 were starkly different from those in the last two quarters of 2017.

The excitement of bulletproof share prices in 2017 soon gave way to the gloom of share prices that just continued falling. The poor performance of share prices in the first quarter of 2018 was offset by strong performance bonds.

*Table 1: Recent investment returns from large asset classes

Investment returns (Rand)	All Share Index	Capped SWIX Index	Listed Property	STeFI Composite	All Bond Index	MSCI World Index	Barclays Global Bond Aggregate
Q3 2017	8.9%	6.0%	5.7%	1.8%	3.7%	8.9%	5.5%
Q4 2017	7.4%	8.4%	8.3%	1.8%	2.2%	-3.5%	-7.7%
Q1 2018	-6.0%	-5.1%	-19.6%	1.8%	8.1%	-5.6%	-3.2%

The first difficult question is: **What caused the difference between the good investment performance in 2017 and the poor investment performance in the first quarter of 2018?**

The answer is not that straight forward.

Firstly, the exchange rate of the rand weakened against the US dollar from R13.06 on 30 June 2017 to R14.46 in November 2017, a 10% drop in the value of the exchange rate. This fuelled the performance of large rand-hedge shares such as Naspers. Since November 2017, the exchange rate of the rand has strengthened to R11.55 in February 2018, an increase of 25% in the value of the exchange rate. This contributed to the poor performance of large rand-hedge shares such as Naspers.

Secondly, the Federal Reserve Bank (the Fed) in the US raised the federal funds rate three times by 0.25% each in 2017, the last increase in December 2017. A steeper path of hikes is projected for 2019 and 2020 as the economic outlook is improving because of tax cuts in the US. The risk-free rate at which risky assets are discounted also increased and this led to lower asset price valuations. As a result, many investors sold shares, which led to a 10% drop in the S&P 500 Index in the US.

Thirdly, in an attempt to boost economic growth in the US, President Trump took steps to address the trade imbalance that exists between the US and China by introducing tariffs on Chinese imports on products such as steel and aluminium. President Xi Jinping contributed by raising tariffs on certain products imported by Chinese from the US, notably soya beans and aircraft parts. Retaliatory tariff hikes by the US and China could potentially detract from synchronised economic growth through the world, so financial markets reacted poorly.

Higher interest rates and a more protective stance on trade in the US resulted in the US dollar being maintained at fairly stable levels thus far in 2018.

It is unclear to us what the ideal exchange rate of the rand is for South Africa.

Exporting industries (e.g. commodity producers) do well when the rand weakens, but imports become more expensive. South Africa's most notable import remains oil. When the exchange rate of the rand remains relatively strong, exporting industries experience greater difficulty, but imports are cheaper.

Using long-term trends and the inflation differential between South Africa and the US, some economists suggest that the proper value for the exchange rate of the rand is approximately R10.50 per US dollar. Popular measures such as the Big Mac Index and KFC equivalent seem to suggest that the true value of the exchange rate of the rand should be under R10 per US dollar. Our view is that the value of the rand's exchange rate is more likely to be determined by fundamental economic factors than short-term politically sensitive factors.

Fourthly, a factor unique to South Africa, is the impact of governance issues, particularly at Steinhoff International, but also in listed property – notably Resilient, Fortress and NEPI Rockcastle. Steinhoff International plunged by 95%, Resilient by as much as 66%, Fortress by as much as 70% and NEPI Rockcastle by as much as 50%. The property companies share common interests.

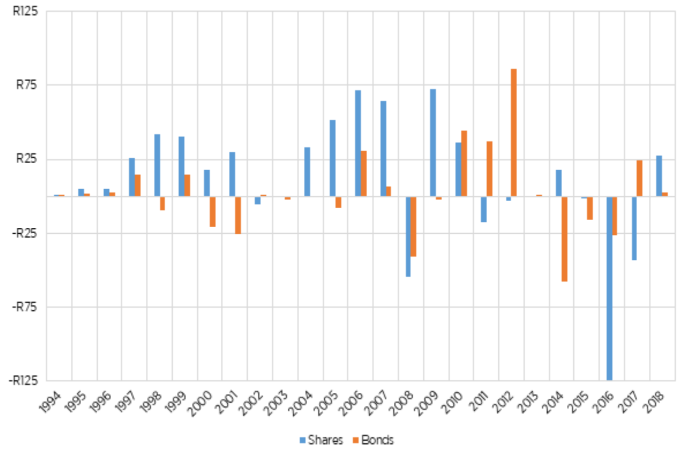
We maintain our view that global investors will likely seek to enhance their investment returns by investing in emerging market shares once the current volatility in share markets decreases. We remain convinced that recent efforts to shore up governance in state-owned enterprises in South Africa will be rewarded by global investors.

We believe that despite strong gains in December 2017, South African share prices have again reached levels that may be attractive to global investors.

During the first quarter of 2018, global investors bought R27 billion in shares listed on the JSE and invested a net R2.5 billion in South African bonds. The total outflow from shares in the three years to 2017 amounted to R170 billion, and R18 billion from South African bonds.

*Graph 1: FTSE/JSE All Share Index in US dollar

*Graph 2: In-/outflows from global investors into/from South African shares and bonds to March 2018



The second question is: **Which of the top ten investment managers of global balanced funds performed well relative to their peers recently?**

The top quartile of the top ten global balanced funds changed significantly recently, with Oasis and Stanlib moving into the top quartile for the quarter to March 2018.

Those who monitor quarterly investment returns may recall that both Oasis and Stanlib often appear in the bottom quartile for individual quarters. It appears that the investment strategies employed by these managers were rewarded in Q1 of 2018 (see table 2), but over the longer term, both the investment managers are still in the bottom quartile of the top ten global balanced funds (see table 3).

Top quartile for the quarter to Jun 2017	Top quartile for the quarter to Sep 2017	Top quartile for the quarter to Dec 2017	Top quartile for the quarter to Mar 2018
Oasis	Investec	Investec	Investec
Investec	OMIG	Allan Gray	Prudential
Stanlib	Pudential	Prudential	Allan Gray

**Table 2: Recent top quartile global balanced fund managers

In Q1 2018, Investec continued to dominate the top quartile. In addition to Investec's solid position, Prudential remains reliable in the top quartile.

For Q1 2018, both Oasis and Stanlib are in the top quartile of the top ten global balanced investment portfolios, but as mentioned earlier, their investment returns still lag over the other measurement periods. Foord continued its slide into the bottom quartile and now occupies a bottom quartile position for the quarter, the year and the three years to March 2018. It appears that Foord invested in several shares that have not performed as expected.

The top and bottom quartiles of large balanced investment portfolios are shown in table 3.

**Table 3: Top and bottom quartiles of global balanced funds to March 2018.

	3 months	1 year	3 years	5 years
Top quartile	Oasis	Investec	Investec	Investec
	Investec	OMIG	Allan Gray	Prudential
	Stanlib	Prudential	Prudential	Allan Gray

	3 months	1 year	3 years	5 years
Bottom quartile	Foord	ABSA	Stanlib	ABSA
	SIM	Oasis	Oasis	Stanlib
	ABSA	Foord	Foord	Oasis

The third and most difficult question we ask of ourselves, is: **How will events unfold in the next 12 months?**

We can see a range of scenarios developing, but broadly, we tend to consider a strong rand and a weak rand scenario.

- In the strong rand scenario, we foresee that investment managers who rely on a bottom-up stock selection process and who include a healthy allocation to domestic bonds will outperform their peers.
- In a weak rand scenario, and depending on the level of interest that we see from global investors, we foresee that investment managers with significant exposure to rand-hedge shares and offshore investments will outperform.

Regardless of which scenario eventually prevails, we expect an improvement in the challenging conditions experienced during the first quarter of 2018.

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*Data for evaluation obtained from IRES INet
**Data for evaluation obtained from Morningstar

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