ClucasGray Private Clients Quarterly Commentary

June 2018

"Doubt is not a pleasant condition; but Certainty is an absurd one." Voltaire

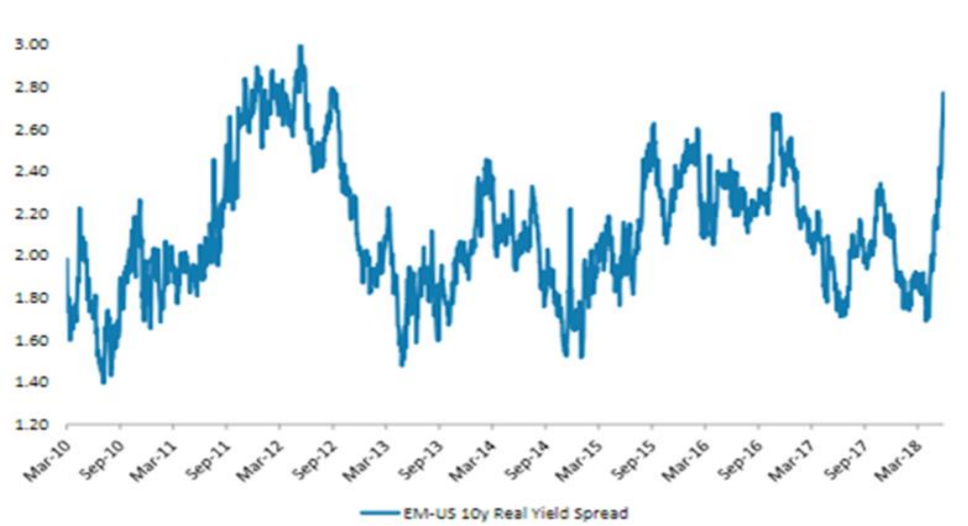
Macro Environment

There has been an anomaly in global markets which doesn't get discussed as much as we think is warranted. Emerging Market crises are typically coincident with periods of slowing global growth, poor corporate earnings, soft demand for commodities and weak emerging market currencies. This is not our interpretation of the current environment, emerging market currency weakness aside.

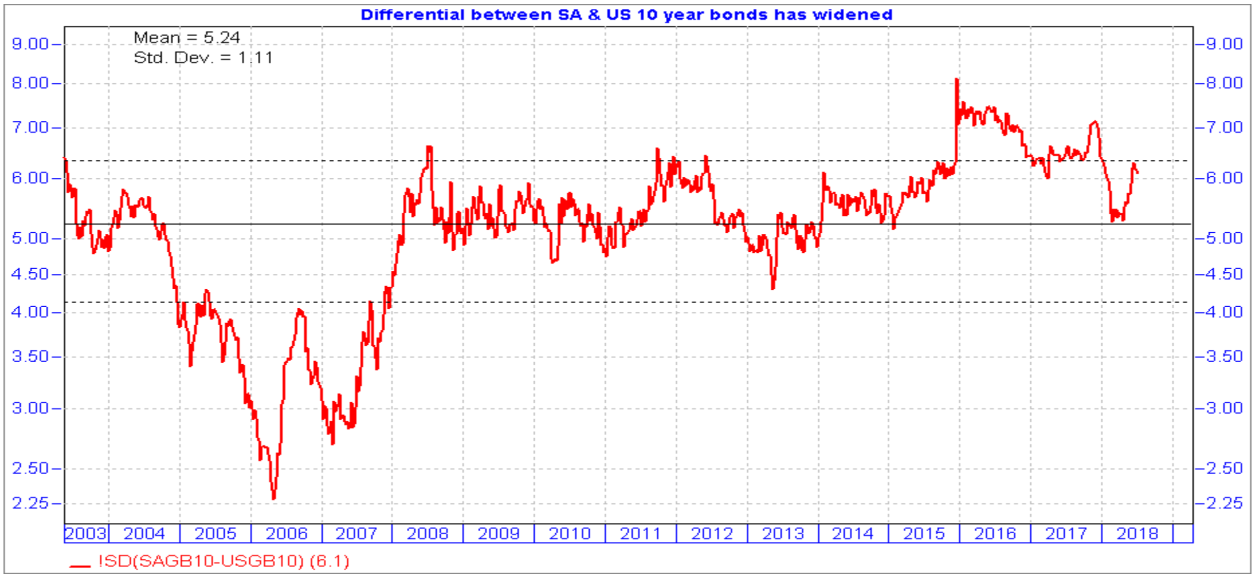
Oil prices have appreciated strongly, principally on the back of strong global demand, and dwindling supply. The US economy continues to show encouraging signs of growth, inflation is steadily rising, with the Federal Reserve gradually increasing interest rates in a desire to normalize interest rate policy. The above factors are symptomatic of an improving global economy - an environment of subdued inflation and commodity prices, and lower interest rates would be indicative of stagnating economic activity, which is a more difficult environment for companies to operate within.

To compound matters for investors, emerging markets have been under severe strain over the last few months, with amongst the most notable casualties being Turkey and Argentina. Each of them has experienced their own unique set of troubles, including elevated levels of foreign currency denominated debt which they are struggling to fund, runaway inflation followed by an aggressive interest rate response. The knock-on impact onto their currencies has been swift and meaningful, with both currencies trading at record lows against the US Dollar.

Memories of contagion amongst emerging markets, coupled with growing fears of a President Trump fuelled trade war which could adversely impact certain economies and industries, has led to a flight of capital back to safe haven currencies like the Dollar, and a commensurate sell off in emerging market currencies, bonds and equities. The charts below highlight the extent of the issue, and the extraordinary pace at which it has played out. The real emerging market bond index spread relative to the US is back to levels last seen in the 2012 and 2015 crises.

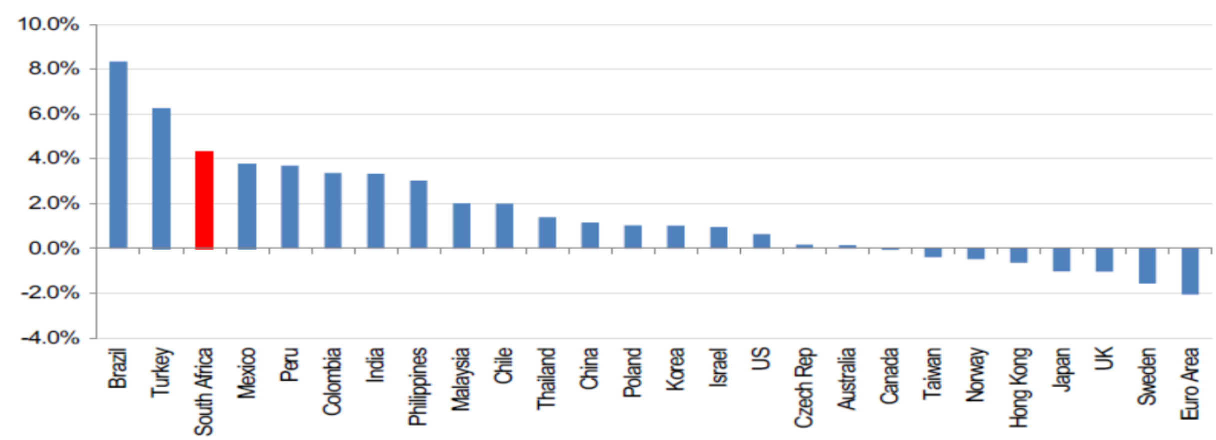


South African bonds, the beneficiary of some euphoria post the appointment of a new president, have not been left unscathed, and retraced noticeably against the US, back to levels seldom seen in the last 15 years.



It is one of the anathemas of South Africa that it is so frequently the recipient of collateral damage when EM crises take hold. Yes, in theory South Africa is deemed an Emerging Market and hence both a beneficiary and victim of global EM capital flows, but in many ways the financial system within which it operates is far from emerging. Notwithstanding the above, as shown in the chart below, South African real bond yields are now the 3rd highest in the investable universe leading to one of 2 conclusions – either SA is on the cusp of a meaningful rise in inflation, or investors have been presented with another opportunity.

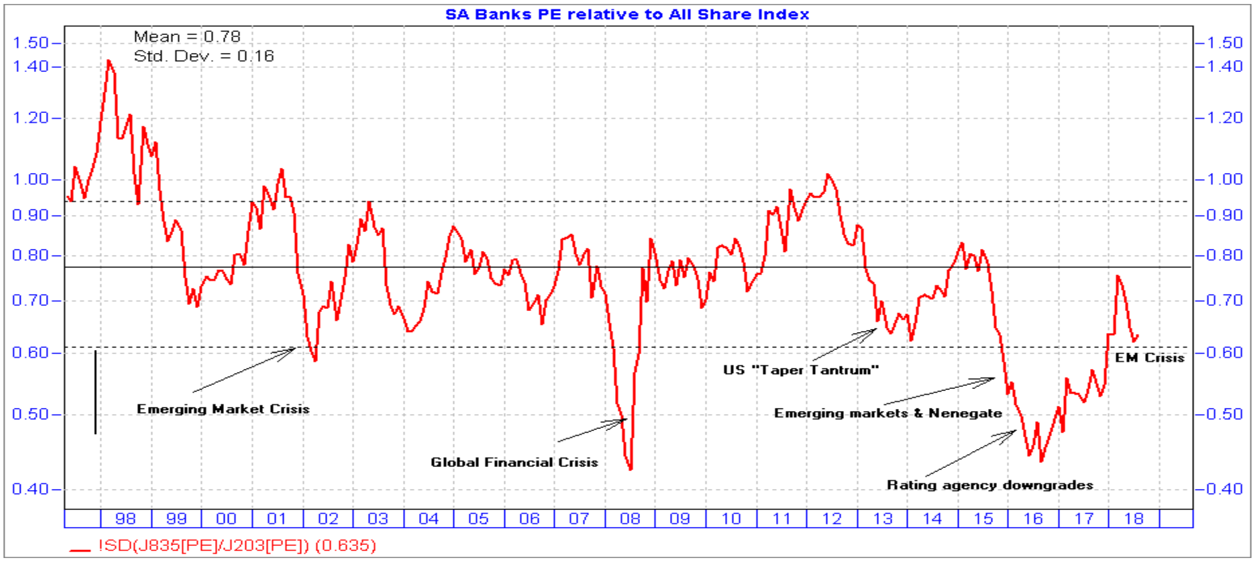
Exhibit 10: 10 year bond yields less 12 month forward consensus inflation expectations suggests that SA has one of the highest real yields across markets



Source: Thomson Reuters, RMB Morgan Stanley research

As a consequence of above events, the Rand weakened by over 15% in the quarter, and as with all previous currency crises, brought with it concerns around rising inflation and potentially higher interest rates. Certainly higher fuel costs, as a consequence of higher Rand oil prices, are a particularly unwelcome development for the consumer economy. We have previously articulated our views on supply side inflation shocks, and the usefulness or lack thereof of using interest rates to fight such inflation, but suffice to say demand in the economy remains subdued, and the last thing the consumer economy needs is a more restrictive monetary policy environment.

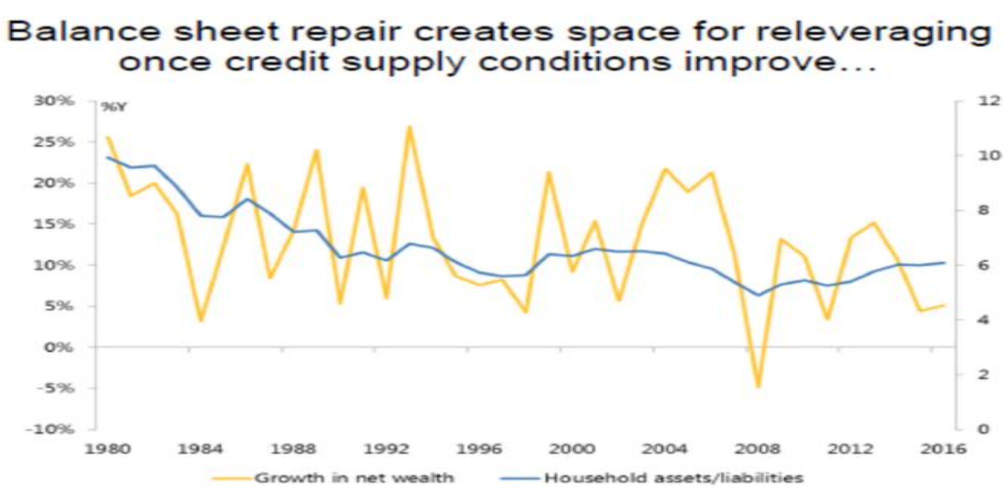
Given that banks are typically highly sensitive to macro events, we thought the below chart would be of interest – it shows the PE relative of the South African banks relative to the overall market over the last 20 years, highlighting the numerous crises that have occurred. Whilst they have recovered off the lows of 2017, it appears to us that many of the above concerns are sufficiently priced in.



We can decry these issues, but markets will always do what markets do. Being flexible in our approach to portfolio construction, these events frequently throw up some mispriced opportunities – this last quarter proved no different, enabling us to make portfolio changes which we think will reward investors in due course.

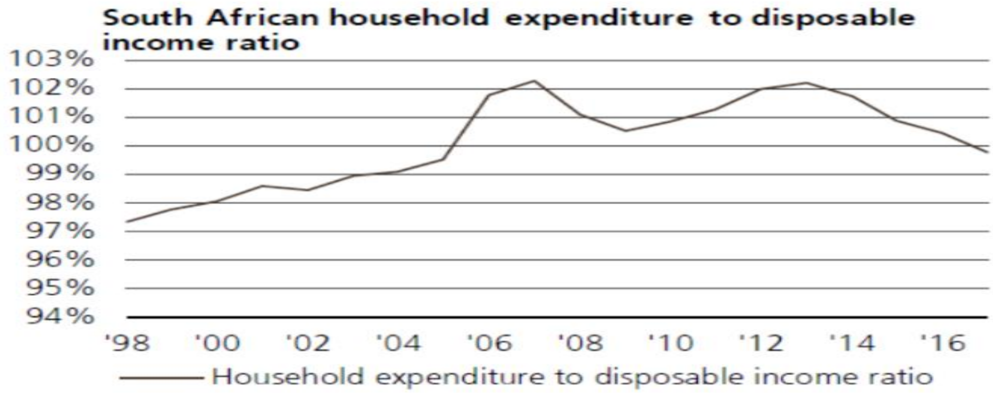
We constantly reassess our central view that the operating environment in South Africa is likely to become more conducive for company earnings growth. Our recent interactions with companies highlight some concerns – improved consumer sentiment is seemingly yet to translate into improving trading. The clean out of allegedly corrupt practices at certain State Owned Enterprises has slowed down their investment spend whilst new management prioritize projects. Demand for credit, whilst steadily rising, remains subdued, extending the prolonged period of negative real credit growth.

We remain encouraged by benign food inflation, which continues to suppress overall inflation as a welcome counter to rising fuel prices. As evidenced by the chart below, consumer balance sheets at an aggregate level, appear to be as strong as they have been at any point in the last 20 years, with household net assets steadily rising as a percentage of liabilities.



RMB Morgan Stanley

Household expenditure is now below disposable income for the first time since 2004 – effectively implying consumers are net savers, and consumer activity has lagged income growth. This “paradox of thrift” has been developing over a number of years, and whilst it does de-risk the economy, a consequence is that it also provides a difficult backdrop for the consumer economy.



RMB Morgan Stanley

We believe the disappointing data is in some ways the result of the deleveraging that has occurred over the last few years. Subdued inflation has typically been a catalyst for improving consumer activity, and whilst the Reserve Bank may no longer be inclined to reduce interest rates following Rand weakness, the lack of demand driven inflation would make a tightening cycle an unnecessary and disappointing development.

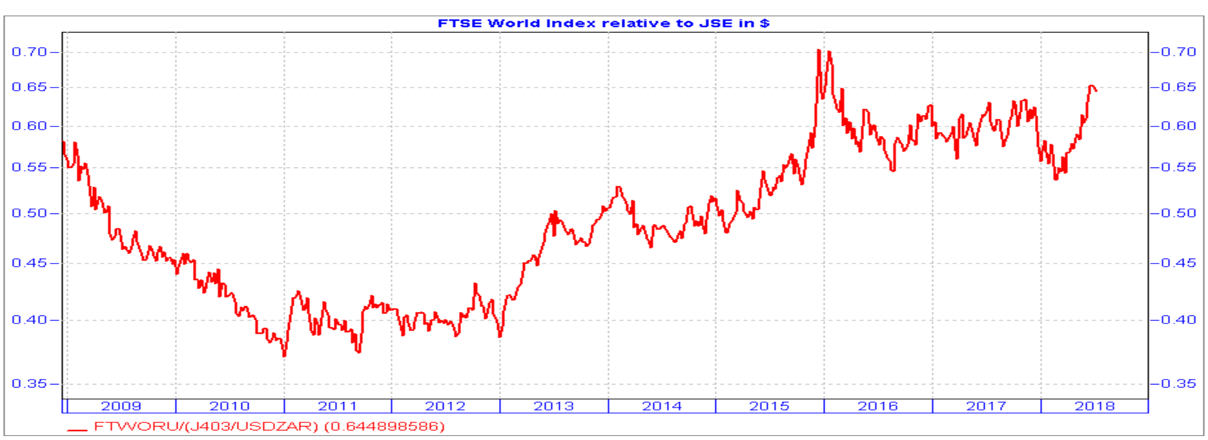
We reiterate the point made by Voltaire in the opening quote – there is clearly some uncertainty surrounding the recovery – we believe diversification across asset classes and sectors that meet our investment criteria is appropriate.

Market Performance (please refer to table in the appendix)

The 2nd quarter saw positive returns for the All Share Index of over 4%, however the returns for the year to date still remain in negative territory. The quarter has also seen divergent performance across key sectors of the market, with Resources up over 20% and Financials down 6%. Domestic property, along with bonds yielded a negative return for the quarter and the domestic property index is now down 21% for the year to date. There are some very stock specific issues at play in the sector, however along with bonds, it is our view that there are some opportunities beginning to emerge to earn attractive real returns.

There were a number of other standout features of the quarter – most notably the Rand depreciation against the Dollar of over 15%, and global oil prices rising strongly (up 17% for the quarter and 22% for the year to date). The consequence of the Rand weakness coupled with the strong commodity prices has provided an extremely beneficial backdrop to key holdings, Sasol and Billiton. These companies returned 25% and 32% respectively for the quarter.

We alluded earlier in the article to the significant stress in broader emerging markets (down 8% for the quarter), but developed market equites have performed well – all in positive territory for the quarter. The chart below shows how dramatic the relative Dollar returns between the FTSE World Index and the JSE has been in the last quarter – all the relative gains made by the JSE since 2015 were given up in a quarter.



South African Equity Market Implications

"The bigger the discount to intrinsic value, the lower the risk; the bigger the discount to intrinsic value, the higher the return." Benjamin Graham

Most readers are well versed in the musings of Buffet and Graham, hence our general reluctance to quote them. However, the above quote feels particularly apt for the South African equity market. Our industry is justifiably focused on risk mitigation strategies and the need for clients to earn acceptable risk adjusted returns. Many of these strategies form an integral part of the ClucasGray Investment Management process. We believe that the ultimate form of risk mitigation is protecting oneself against meaningful capital loss, and the best way to achieve this is to minimize the valuation risk of any investment.

It is our view that an increasing number of South African companies can be described as having:

- Undemanding valuations,
- Strong balance sheets, yet
- Limited prospects for short term growth.

As outlined above, the reality is the broader domestic economy has proved a very difficult one in which to operate, so an overly critical view on a lack of corporate earnings growth does seem unjustified. Companies are always able to grow via acquisitions, but as has been dramatically highlighted in the last few years, this strategy is the corporate equivalent of "kicking the can down the road". When organic growth rates slow, masking these via poor quality acquisitions buys a company time, but won't alter the economic reality for long - numerous South African companies have learnt the painful lesson of an ill-fated acquisitive strategy.

Given the dramatic underperformance of many financial and consumer facing companies, we believe it appropriate to have increased exposure to a select number of these opportunities – indeed many look even more attractive than they did during the height of the 2017 uncertainty.

Our investment process places emphasis on the interplay between earnings growth and a change in valuation. In an environment of slowing organic earnings growth, ratings need to adjust, the extent of which differs between individual companies and sectors. Strong balance sheets are important, more so in periods of slowing earnings, and together with undemanding valuations it implies that companies can still deliver an acceptable return for investors, notwithstanding muted earnings prospects.

Kind Regards

The ClucasGray Team

For more detail on both the ClucasGray Equity and ClucasGray Equilibrium funds and to view our latest fund fact sheets, please see our new website – www.cgam.co.za

CLUCASGRAY INVESTMENT MANAGEMENT

Appendix – Performance to 30 June 2018

ClucasGray							
Data to:	**2018-06-30**						
DOMESTIC MARKET	SPOT	1 Month	Quarter	YTD	1Y	3Y	5Y
JSE All Share TR		2,8	4,5	-1,7	15,0	6,7	11,1
JSE Top 40 TR		3,6	6,2	-0,5	16,7	6,8	11,2
JSE Resi TR		6,4	21,7	18,5	44,6	6,0	3,4
JSE Fini TR		-2,8	-6,6	-7,6	16,8	3,8	12,3
JSE Indi TR		4,9	5,3	-3,9	8,8	6,3	12,8
Property TR		-3,5	-2,2	-21,4	-9,9	0,9	6,7
GLOBAL MARKETS (Local Currency)		Month	Quarter	YTD	1Y	3Y	5Y
MSCI WORLD INDEX TR		0,0	1,7	0,4	11,1	8,5	9,9
S&P 500		0,6	3,4	2,6	14,4	11,9	13,4
Nasdaq		0,9	6,3	8,8	22,3	14,6	17,2
Euro Stoxx 50		-0,2	2,9	-1,0	1,3	2,4	8,3
Nikkei TR		0,6	4,2	-1,0	13,5	5,3	12,3
FTSE 100		-0,2	9,6	1,7	8,7	9,7	8,2
MSCI Emerging		-4,2	-8,0	-6,7	8,2	5,6	5,0
Exchange Rates		Month	Quarter	YTD	1Y	3Y	5Y
ZAR/$		-8,1	-15,9	-10,8	-5,0	-4,1	-6,8
ZAR/£		-7,3	-9,2	-8,4	-6,4	1,8	-3,8
ZAR/€		-8,0	-9,9	-8,0	-7,3	-5,7	-4,5
ZAR/AUS $		-5,8	-11,8	-5,2	-1,3	-2,7	-2,4
ZAR/BRL		-3,9	1,1	5,6	10,5	3,4	4,4
$/£		0,7	5,8	2,3	-1,4	5,6	2,8
$/€		0,1	5,2	2,7	-2,3	-1,6	2,1
$/CHF		0,5	3,7	1,6	3,2	1,9	0,9
COMMODITY PRICES		Month	Quarter	YTD	1Y	3Y	5Y
Oil (Brent)		2,6	16,7	22,3	54,6	3,4	-1,9
Copper (3 month LME)		-3,3	-1,3	-8,6	11,6	4,7	-0,4
Platinum		-5,9	-8,4	-8,3	-8,0	-7,6	-8,5
Iron Ore		-1,8	-1,7	-14,6	-1,9	-0,6	-12,1