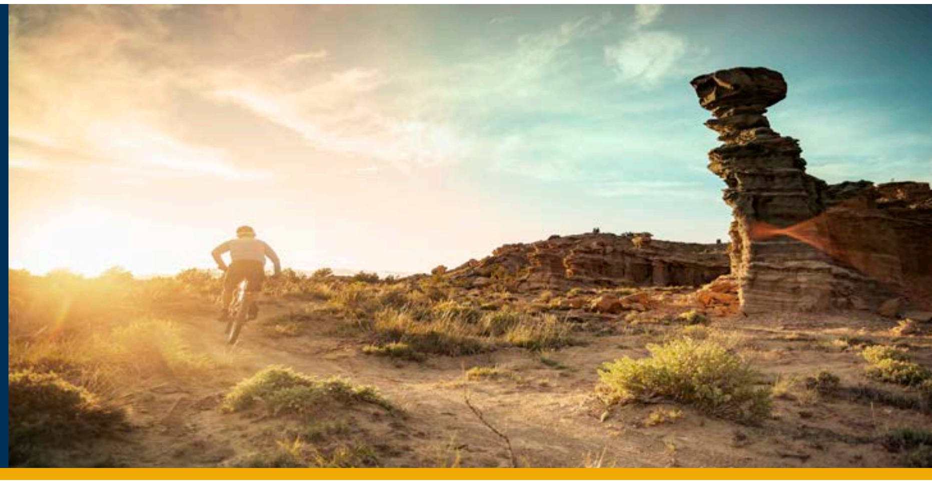
CLUCASGRAY
ASSET MANAGEMENT

ClucasGray Private Client Quarterly Commentary

June 2017



Introduction

There is little doubt that the political and economic landscape has caused some angst amongst many. The leaked emails relating to perceived state capture by prominent individuals provide for captivating headlines, and if even remotely true are extremely disconcerting on so many levels. Cabinet reshuffles referred to in the previous quarter, the radical transformation of the Mining sector proposed in the recently released Mining Charter, the apparent overreach by the new Public Protector in commenting on the Reserve Bank's Constitutional mandate, and the ever present risk of further rating agency downgrades are all very unsettling.

The reality though is that markets do what markets do, and there is no point wishing away the prevailing concerns. If any country should have some perspective on political noise and the bearing thereof on the economy, it should be South Africa, given its extraordinary political history. We believe it is our role as active managers, and custodians of our clients' savings, to navigate our way through the issues of the day.

In previous quarterlies, we have articulated how the ClucasGray investment process is designed to uncover mispriced opportunities, be they companies or asset classes. The best time to invest in businesses is generally when earnings are suppressed, PE multiples are low, and the currencies in which they operate are relatively weak. We find this a useful framework around which to analyse individual companies, broad sectors, and asset classes in general.

Economic backdrop

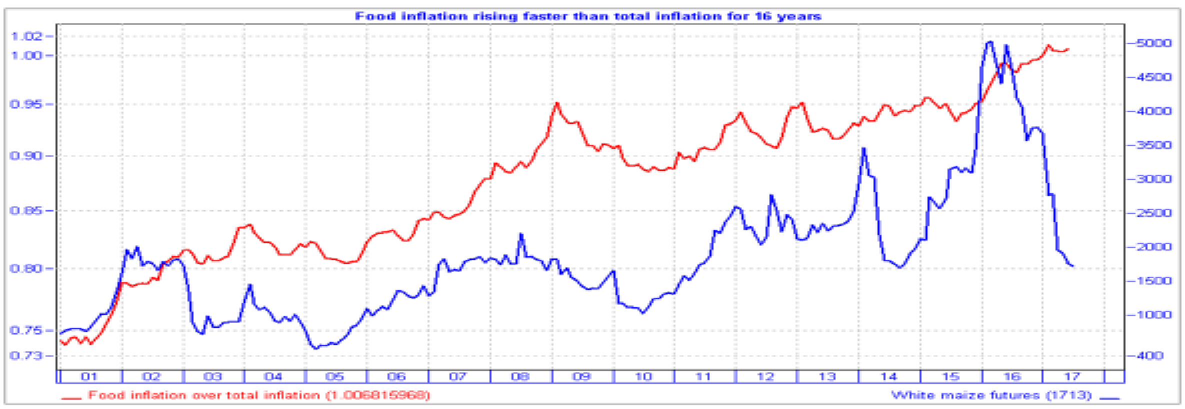
The recent strength of the global economy is expected to continue – we have seen strong evidence of rising economic activity in the US, encouraging signs in the Eurozone, and a steadily improving outlook for emerging market growth. Inflation, long subdued, is moving gradually higher, and although protracted, we believe we are in a normal cyclical upswing globally. The diagram below depicts how we interpret the current state of the global economic cycle – a period of modest reflation where growth recovers. Traditionally this backdrop has been favourable for equities, which rally in anticipation of stronger company earnings, and less favourable for bonds, as yields rise in line with rising inflation. It has typically been good for emerging market growth, emerging market currencies and, dare we say it, commodity prices.

Source: Morgan Stanley

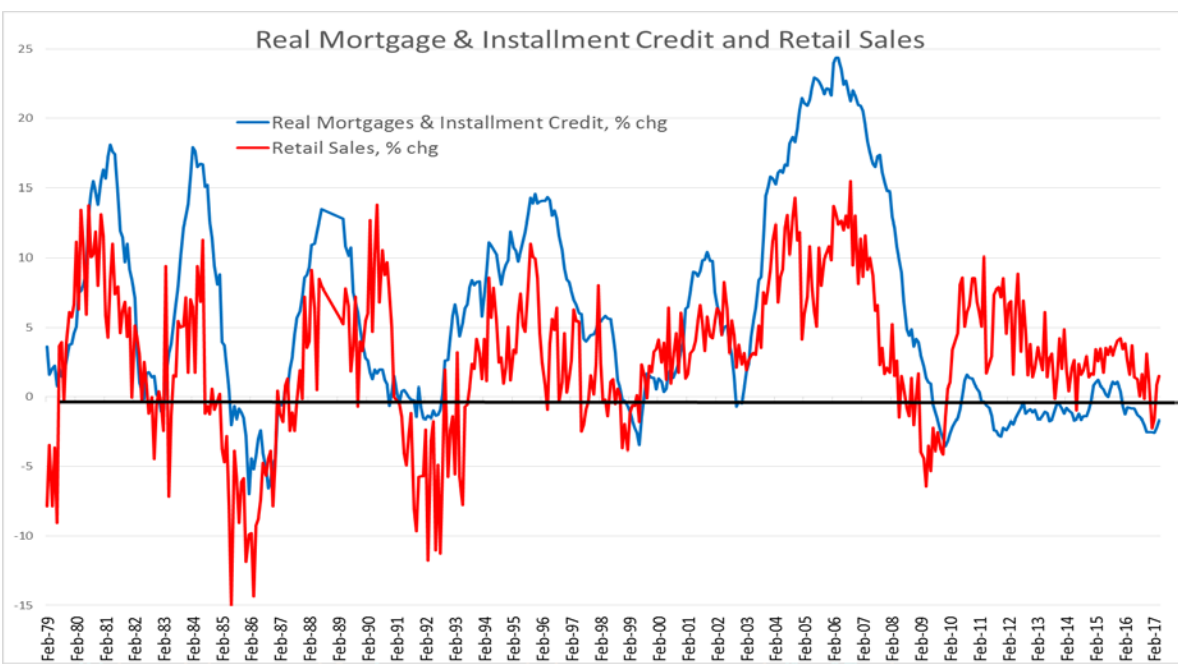
It has been our view that South Africa was to be a beneficiary both of the improving global backdrop, and some domestic factors which we will explore in more detail later. Political developments have, if one believes all one reads, derailed any such development. We believe it is worth revisiting our logic around a cyclical recovery in South Africa, and exploring whether notwithstanding politics, the argument still holds.

The consumer economy in SA has endured many headwinds over the last number of years – the weak Rand, escalating food inflation exacerbated by the drought, rising interest rates and limited employment growth. Given the significance of food in the average consumers monthly expenditure, we find the below chart on the rise of food inflation concerning. It shows how food inflation has outstripped total inflation by a staggering 2% per annum over the last 16 years, which would have a negative impact on discretionary income levels. We have overlaid the price of White Maize onto the graph, as a proxy for the inputs into food inflation, and it is apparent that falling maize prices have historically seen food inflation rise slower than overall inflation – given the decline in maize prices, we expect this cycle to be no different as food inflation is expected to fall sharply.

Food CPI outstripped CPI by 2% per annum over last 16 years – relief in sight



As evidence of the lack of demand growth in the economy, we believe the chart below is instructive. It shows the percentage change in Retail Sales (red line), and a combination of Mortgage & Instalment Sales credit extension (blue line) as an indication for consumer demand.



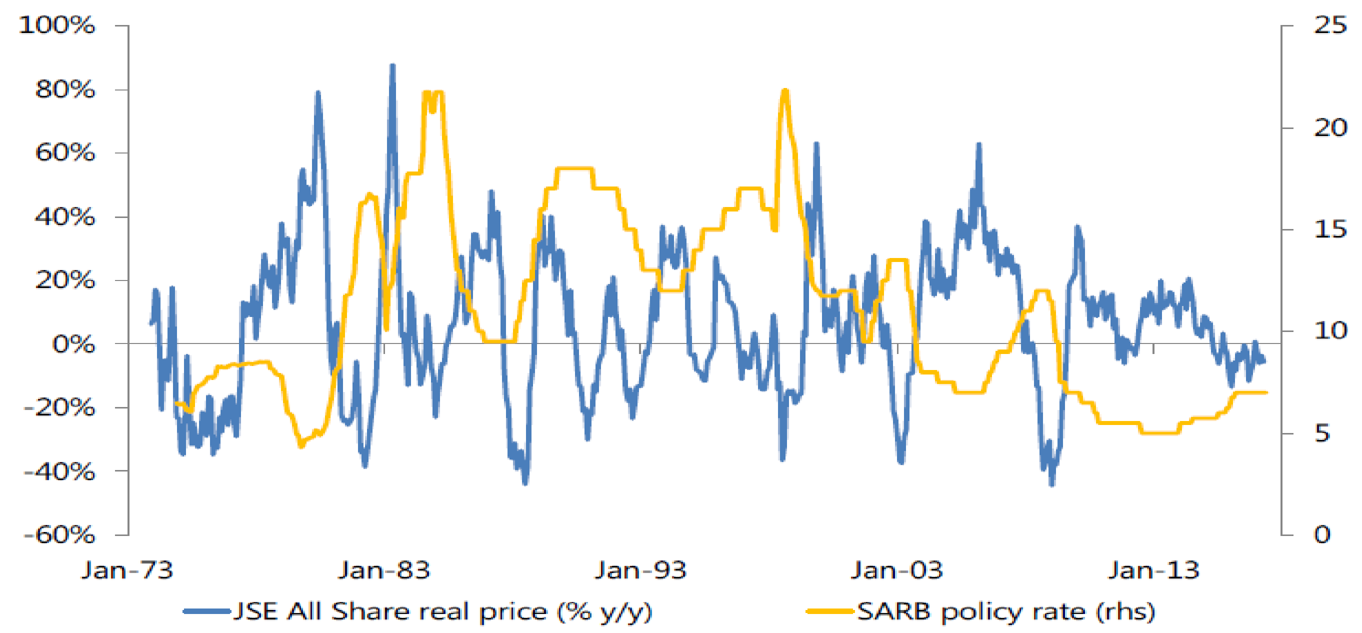
Aggregate credit extension of these 2 major credit categories has been negative in real terms for much of the last 7 years – retail sales have recently dipped into formal recession, but it is evident that consumer stress has been building for some time. These charts date back to 1979, and highlight the cyclicality of the consumer economy – although never pleasant, it is not uncommon for the consumer economy to experience times of stress.

We have for some time been advocating for the SA Reserve Bank (SARB) to adopt a more accommodative monetary policy – inflation is now within the target range, and likely to fall towards the bottom of the range, and credit extension is extremely weak. We believe there are levers for the SARB to pull to assist the economy.

Perhaps one of the more disappointing aspects of recent comments from the Public Protector around the Constitutional mandate of the SARB, is that any action by the SARB runs the risk of being seen to be acceding to external political pressure – the reality is that they have done a remarkable job of curtailing inflation in the recent currency crisis and ensuring credit demand has been contained, to the extent that inflation is in rapid decline. The SA economy requires interest rates to be cut, and we sincerely hope that they start as soon as possible.

The chart below from RMB Morgan Stanley illustrates an interesting feature of the JSE, which is worth revisiting – that there has historically been a good inverse correlation between the performance from the JSE and the direction of interest rates.

Exhibit 10: The SARB policy rate vs JSE real total returns (% y/y)



Source: Thomson Reuters, JSE, RMB Morgan Stanley

The important point to note is that for this thesis to play out is that rate cuts need to provide an environment which is more stimulatory for domestic-facing companies to deliver earnings. And it is earnings which are required to be able to deliver better share price performance from these companies.

Political backdrop and potential implications

South Africans of a particular vintage are familiar with scenario planner Clem Sunter who famously spoke about the choices facing the South African Government in the 1980's. The high road and low road scenarios he sketched became engrained in the dialogue of the day, and his influence on the final negotiated settlement was significant. In many ways, South Africa today finds itself at a cross roads of sorts – we stress this is nothing near the scale of crisis faced in the apartheid era, but nonetheless there are choices to be made by those in power which have ramifications for all.

What would the investment implications be of a potential low road scenario playing out – further rating agency downgrades, exclusion from global bond indices leading to higher yields, currency weakness, a freeze on private sector capital expenditure and a political outcome that is less market friendly? Given the makeup of the JSE with foreign related company earnings making up over 65%, the listed property index with 40% of distribution income from offshore, and the regulatory offshore allowance of 25% within Balanced Funds, it is reasonable to conclude that a large portion of the savings industry is reasonably well placed in the event of a low road scenario.

We see a "muddle through" scenario being an interesting scenario for investors. There is a chance SA does indeed get downgraded, but bond yields and the currency don't react - given our high relative real yields, and a currency that remains weak in real terms, it is not an unrealistic scenario. Coupled with a political climate that is more of the same, interest rate cuts leading to a recovery in the consumer economy, and GDP which slowly recovers off the current recessionary base, there is a reasonable chance that the macro environment is mildly supportive of local company earnings.

Investment Implications

Our investment process is designed to look for companies with the potential to generate real earnings growth, and which trade at attractive multiples. We are constantly looking for mispriced assets where we adopt a fundamental approach to valuing companies and asset classes, but acknowledge that a view on the macro environment in which companies operate is an essential supplement to our investment process.

Under a "muddle through" scenario we believe local investors could well be rewarded in select domestic opportunities. We believe that the political disruptions and slowdown in SA have created an opportunity to invest in good companies at what we deem to be attractive valuations.

Given the potential scenario outlined above, we have deemed it appropriate to maintain, and in many cases increase, the exposure to select opportunities which we see in the domestic market. We continue to be well exposed to financials – banks and select life companies, where we see valuations as attractive relative to the market as we did in the 2008 financial crisis. In addition, other sectors (industrial and consumer-facing) have typically performed well in a falling interest rate environment and we continue to assess these opportunities on an ongoing basis.

We must stress that whilst we believe there is a very good chance that the low road scenario does not pan out, we are mindful of the risks in the event it does. As a result, our portfolio construction includes a number of holdings which would protect the portfolio in such a scenario – companies that have large offshore exposure, but which importantly are attractively valued and should deliver reasonable hard currency returns.

We remain focussed on our overall long term objective, which is to deliver good real returns for our clients.

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.ClucasGray.co.za**

Disclaimer