CLUCASGRAY

ASSET MANAGEMENT

ClucasGray Quarterly Commentary

September 2017

Let's go
We can't
Why not?
We're Waiting for Godot

The excerpt from Samuel Beckett's highly acclaimed play, "Waiting for Godot", in some way captures the national mood as we build up to the end of 2017. Much lies in store, most notably the ever present risk of further rating agency downgrades and the ANC conference scheduled for December where a new party leader will be elected.

Whilst there is an argument to be made that consumer and business confidence has fallen in the wake of political developments, we find it disappointing that the knock on impact of the unsettling political backdrop has caused independent institutions like the Reserve Bank to adopt a conservative approach to interest rates – they acknowledge that inflation is subdued and likely to remain so for their forecast period, they concede domestic demand is extremely weak as evidenced by benign credit growth, and confidence amongst consumers and business is low. Yet they have refrained from using further monetary policy to provide stimulus to the consumer economy, preferring to adopt the "wait and see" approach seemingly prevalent amongst consumers and businesses – "waiting for Godot".

We have no unique foresight into how events will unfold. We reiterate our comments from previous quarterly commentaries that the South African economy has for generations operated within an uncertain political framework; we are appalled along with many fellow South Africans at the extent of perceived state capture being revealed of late, and the apparent lack of consequences for those implicated; but we stress that our role as custodians of our clients' savings is to objectively assess the facts, ignore the emotion and invest accordingly.

Investment Environment

Notwithstanding the South African landscape referred to above, we feel it is important to remember that we operate in an increasingly integrated global economy, which is experiencing a pleasing recovery in activity. Glencore, in their recent results presentation, mentioned that this is the "most synchronized global economic growth environment in the last six years", which is bourne out by the below chart, showing an improvement in the Purchasing Managers Index across all major regions.

		2015						2016												2017					
		Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
	Global	50.8	50.5	50.4	51.0	51.0	50.7	50.9	50.0	50.7	50.2	50.1	50.4	51.0	50.7	51.0	51.9	52.0	52.7	52.7	53.0	53.0	52.7	52.6	52.6
	Developed	52.1	51.9	51.7	52.6	52.3	52.0	52.1	50.8	50.9	50.5	50.3	51.1	51.4	51.2	51.5	52.6	52.9	53.7	54.2	54.1	53.9	54.1	54.1	53.9
	Emerging	49.1	48.6	48.4	49.0	49.2	49.0	49.4	48.9	50.2	49.6	49.5	49.3	50.3	50.1	50.3	51.0	50.8	51.1	50.8	51.3	51.6	50.8	50.5	50.8
Eurozone	Eurozone	52.4	52.3	52.0	52.3	52.8	53.2	52.3	51.2	51.6	51.7	51.5	52.8	52.0	51.7	52.6	53.5	53.7	54.9	55.2	55.4	56.2	56.7	57.0	57.4
	France	49.6	48.3	50.6	50.6	50.6	51.4	50.0	50.2	49.6	48.0	48.4	48.3	48.6	48.3	49.7	51.8	51.7	53.5	53.6	52.2	53.3	55.1	53.8	54.8
	Germany	51.8	53.3	52.3	52.1	52.9	53.2	52.3	50.5	50.7	51.8	52.1	54.5	53.8	53.6	54.3	55.0	54.3	55.6	56.4	56.8	58.3	58.2	59.5	59.6
	Italy	55.3	53.8	52.7	54.1	54.9	55.6	53.2	52.2	53.5	53.9	52.4	53.5	51.2	49.8	51.0	50.9	52.2	53.2	53.0	55.0	55.7	56.2	55.1	55.2
	Spain	53.6	53.2	51.7	51.3	53.1	53.0	55.4	54.1	53.4	53.5	51.8	52.2	51.0	51.0	52.3	53.3	54.5	55.3	55.6	54.8	53.9	54.5	55.4	54.7
Developed	Switzerland	50.0	51.3	48.0	49.6	49.0	49.9	50.2	51.1	53.0	53.1	55.3	51.5	51.5	51.6	54.4	55.2	55.9	56.2	54.6	57.8	58.6	57.4	55.6	60.1
	UK	52.3	51.8	51.5	54.5	52.5	51.2	52.5	50.9	51.1	49.5	50.4	53.1	48.3	53.5	55.3	54.2	53.5	55.9	55.6	54.6	54.0	57.0	56.3	54.3
	US	53.8	53.0	53.1	54.1	52.8	51.2	52.4	51.3	51.5	50.8	50.7	51.3	52.9	52.0	51.5	53.4	54.1	54.3	55.0	54.2	53.3	52.8	52.7	52.1
	Japan	51.2	51.7	51.0	52.4	52.6	52.6	52.3	50.1	49.1	48.2	47.7	48.1	49.3	49.5	50.4	51.4	51.3	52.4	52.7	53.3	52.4	52.7	53.1	52.4
Emerging	Brazil	47.2	45.8	47.0	44.1	43.8	45.6	47.4	44.5	46.0	42.6	41.6	43.2	46.0	45.7	46.0	46.3	46.2	45.2	44.0	46.9	49.6	50.1	52.0	51.5
	Russia	48.3	47.9	49.1	50.2	50.1	48.7	49.8	49.3	48.3	48.0	49.6	51.5	49.5	50.8	51.1	52.4	53.6	53.7	54.7	52.5	52.4	50.8	52.4	50.3
	India	52.7	52.3	51.2	50.7	50.3	49.1	51.1	51.1	52.4	50.5	50.7	51.7	51.8	52.6	52.1	54.4	52.3	49.6	50.4	50.7	52.5	52.5	51.6	50.9
	China	47.8	47.3	47.2	48.3	48.6	48.2	48.4	48.0	49.7	49.4	49.2	48.6	50.6	50.0	50.1	51.2	50.9	51.9	51.0	51.7	51.2	50.3	49.6	50.4
	Korea	47.6	47.9	49.2	49.1	49.1	50.7	49.5	48.7	49.5	50.0	50.1	50.5	50.1	48.6	47.6	48.0	48.0	49.4	49.0	49.2	48.4	49.4	49.2	50.1
	Taiwan	47.1	46.1	46.9	47.8	49.5	51.7	50.6	49.4	51.1	49.7	48.5	50.5	51.0	51.8	52.2	52.7	54.7	56.2	55.6	54.5	56.2	54.4	53.1	56.2

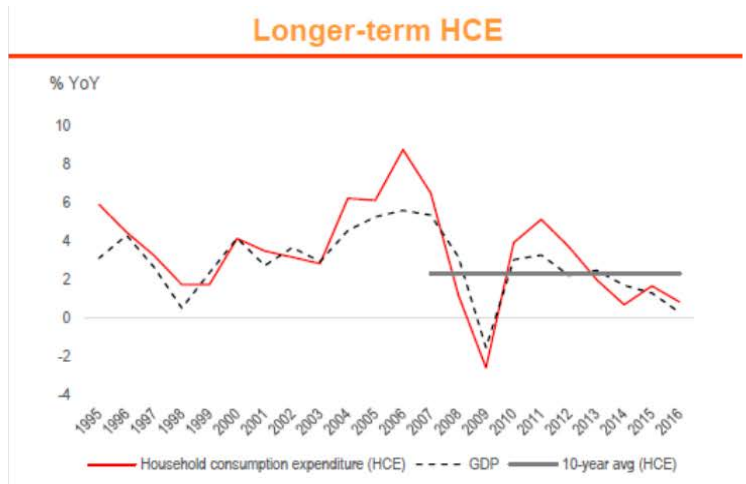
Lowest relative to 50 PMI — 50 — Highest relative to 50 PMI

Source: Investec

After a prolonged period of depressed global growth, benign inflation and extremely accommodative monetary policy, the global economy has entered a reflationary cycle. An environment of improving growth and steadily rising inflation has historically been supportive of stronger company earnings growth, increasing commodity prices and a rise in global bond yields. This is a very different environment to the one investors have grown accustomed to over the last few years, with consequences for both asset allocation and stock selection decisions.

The constructive global economy also has a bearing on how local economic events unfold over the next while. South Africa, along with other emerging markets, has tended to be a beneficiary of improving global growth – with the link between growth and commodity prices, and the importance of commodities in the South African economy, this is intuitive.

As highlighted in the below chart, this is the first time since the 1998 emerging market crisis that South Africa's growth rate has decoupled from global growth, and has in fact slipped below the aggregate of the Developed Economies. The adjacent chart shows how domestic household consumption expenditure has been declining steadily for the last number of years.



Source: Macquarie

We don't have all the answers as to why this may be the case, and whilst tempting to lay the blame on ill-judged cabinet reshuffles, evidence of state capture and the ongoing political noise, we believe there is a stronger argument to be made that this is merely part of an economic cycle. The South African consumer has endured a structurally weaker currency over the last 6 years, with the resultant impact on inflation and interest rates being well documented. We believe that relief is in sight – food inflation is starting to fall noticeably, overall inflation appears contained and we have entered a period of falling rates. We believe that the major headwinds to the consumer economy over the last 5 years are in the process of subsiding – the chart below shows that in periods when inflation and interest rates have fallen in the last 20 years, real compensation has risen, providing support to the consumer economy.

Figure 7: Rallies in real compensation coincided with a decline in inflation and the short rate

Source: Investec Securities research, DataStream and I-Net

Equity Markets

At ClucasGray we place a significant amount of emphasis on our fundamental research and investment process – we believe effective and objective investment decision making requires the ability to anchor to a consistent application of a process.

When one is invested in good businesses which continue to grow real earnings (per share) and trade at reasonable valuation multiples, we believe that patience will in due course be rewarded. Indeed the current environment for South African oriented companies is certainly one in which investors' patience has been truly tested. We all aspire to own quality companies at attractive valuations, but this is not always possible – what is the benefit of investing in a quality company if the price is wrong? Philosophically we feel that all investing has to take account of valuations, and hence our team spends significant amount of time debating appropriate valuation multiples for individual companies and sectors.

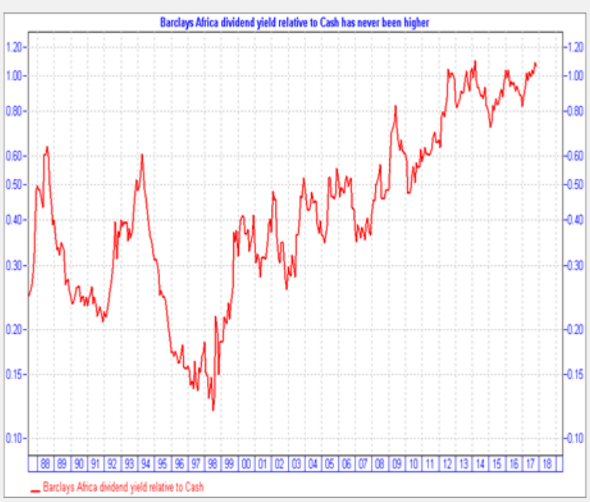
We have identified a number of what we deem to be good companies, which due to a confluence of events are currently trading at extremely attractive valuations. The nature of the investment industry is that certain opportunities typically present themselves in periods of stress, and whilst inflection points are obvious in hindsight, at the time things are often less clear. It is common consensus now that markets were very cheap in 2003 and 2009 – each period was characterized by specific and valid concerns at the time: 2003 there was global fear of deflation; in 2009, amidst the global banking crisis, solvency concerns about large multinational financial institutions pushed the global financial system to the brink of systemic meltdown.

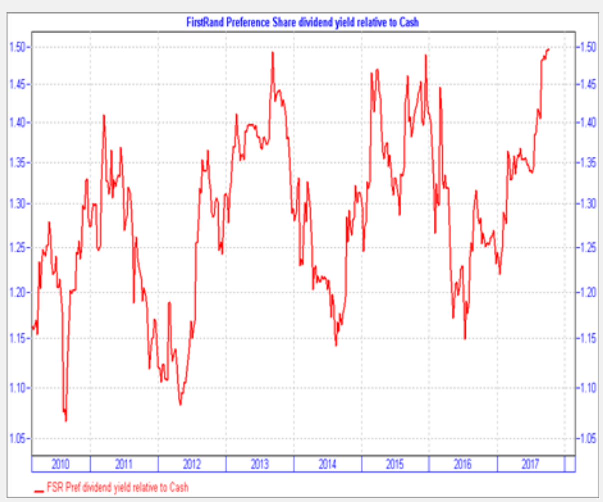
What makes the current opportunity set interesting is that the overall market continues to hit record highs and traditional valuation metrics on many major Indices look stretched. Yet, the domestic environment referred to earlier has resulted in many companies trading at valuation multiples not experienced in many years. Whilst there is an element of the unknown as to how the political developments unfold, we believe there is an equally compelling argument to be made that we are nearing the end of a protracted consumer down cycle, and conditions start to improve off a subdued base.

The polarized nature of the current market – relatively expensive quality global industrials and extremely cheap domestic companies makes the current environment compelling for active managers. As part of our process we look for companies that have the ability to grow earnings and (or) the prospect for a re-rating – investors are increasingly being spoilt for choice. We continue to incrementally add to positions in companies where we believe patience could be handsomely rewarded.

As managers, we are continually invited to reflect on which assets can provide us with the best chance of delivering on our investment objective of inflation beating returns over sustained periods of time.

In the charts below we compare dividend yields available in banks and preference shares to cash yields. As can be seen, in the case of Barclays Africa, the dividend yield relative to cash is the highest in the last 30 years. Likewise FirstRand's preference share dividend yield is 50% higher than current cash yields.

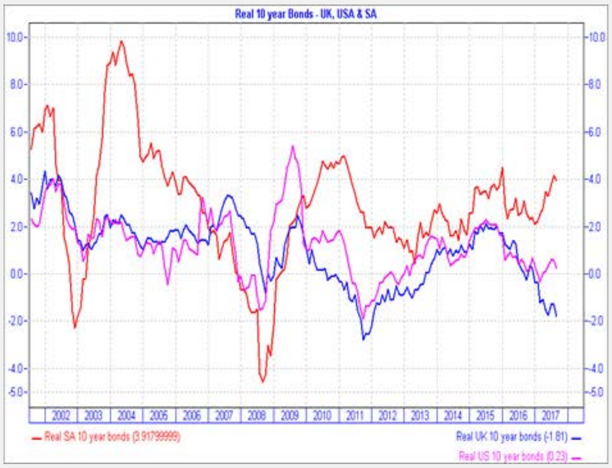


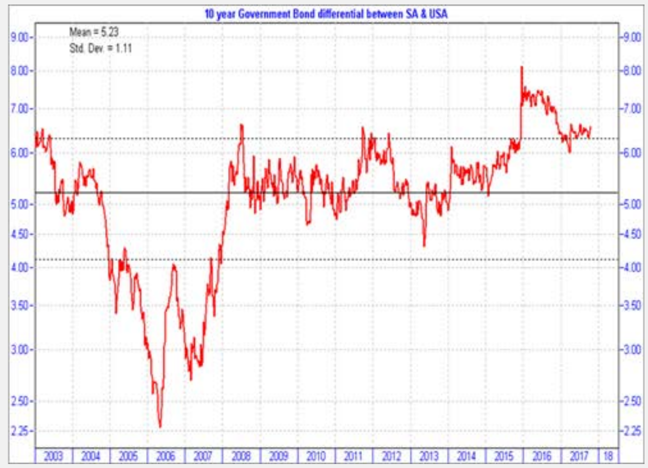


Source: Iress

These 2 charts illustrate the types of opportunities that can are currently available to local investors. We believe that investors will be well served by taking advantage of these and other similar opportunities.

Allied to this, real yields available in short duration income assets continue to look attractive. As illustrated by the left hand chart below, the South African real 10 year bond is materially higher than developed market real bonds. This gap is likely to increase as domestic inflation moderates and global economies reflate. This could well prove supportive of South African yields, particularly given the nominal yield gap between SA and US Government bonds remains elevated, as shown in the right hand chart.





Source: Iress

Globally things are different, and our analysis and assessment of prospective returns from most global asset classes looks less appealing. Granted, there have been opportunities we have been able to exploit around currency movements, regional growth dynamics and select valuation anomalies, but broadly speaking we expect most global asset classes to deliver low nominal returns, in Dollars especially outside of equities. To generate Real Rand returns could require further currency weakness, which may not be consistent with where we are in the global economic cycle.

We continue to believe that by adopting a disciplined approach to both asset allocation and security selection we can continue to deliver attractive real returns for investors over sustained periods.