MARKET MATTERS

20 AUGUST – 24 AUGUST 2018

BORN IN FEAR AND RAISED ON DOUBT

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US President Donald Trump had an eventful week, including the criminal conviction of two close associates and an unfortunate comment on South Africa that caused the rand to briefly wobble. Perhaps most notably for investors, though, was his comment in an interview that he is "not thrilled" by the Federal Reserve's policy of gradually raising interest rates. As a real estate tycoon, he of course prefers low rates and high leverage. The comment, like so many others, breaks with an established precedent of not criticising the independent central bank and puts him in a similar camp as Turkish President Erdogan. Trump also appears to be talking the US dollar down, which is somewhat contradictory as a strong dollar is probably the one thing that will pause rate hikes by putting downward pressure on inflation.

RECORD RUN

What he would be thrilled by is the stock market. Amid much fanfare, the S&P 500 not only regained its previous all-time high, but also surpassed the great 1990s bull market in length (though not in total return), having run 3 455 days without a 20% decline (the conventional definition of a bear market). However, as with most things investment-related, it is useful to look behind the headlines and apply some common sense.

The 1990s bull market commenced after a brief 20% decline following Iraq's invasion of Kuwait. If that is treated as a 'correction' rather than a bear market, the 1990s bull market is in fact much longer, having started in 1987.

After all, a 20% decline as the traditional yardstick for a bear market (and 10% for a correction) is a rather arbitrary cut-off. A 19% loss in value is equally painful and no investor would find comfort in saying "at least it is not a bear market". A more useful definition would include not only the magnitude of the decline, but also how long it takes to recover. After a proper bear market, equity values can take more than a year to regain lost ground.

In the same vein, the current bull market experienced several interruptions, most notably the 19% peak-to-trough decline in 2011. Coming so soon after the 2008 crash, a mixture of concerns over fiscal health in Europe and the US and a stalling economic recovery caused genuine fear among investors. If that event is considered a bear market, again, the 1990s run is longer than the current. The definition of a bear market should probably include a psychological element, when ordinary investors and professionals alike are gripped with angst and panicked selling is rife. This dimension is more difficult to quantify, clearly, but was arguably present in 2011 even if the decline was not quite 20%. The biggest risk of a bear market often is not the loss of value of shares, but whether investors respond to the price declines by crystallising losses and selling out. This is where the real value destruction usually happens.

By the same token, a bull market also has a psychological element, often with a sense of euphoria pervading and a belief that better days lie ahead. In contrast, the notable feature of the post-2009 bull market has been the lack of such exuberance (outside of a few sectors, such as technology). Rather, it has been a case of constantly climbing the wall of worry. More than one commentator termed it an 'unloved' bull market, while several recent articles on the record-breaking run conclude with the question, "Can it last?" Certainly, it was a rally born in fear and raised on doubt as investors were constantly looking over their shoulders as if the great bear market of 2008 was still chasing them. Here is the key lesson: seemingly nobody wanted to invest in the market given the uncertainties, but those who did so anyway were handsomely rewarded. Those who waited for clarity and certainty before investing are probably still waiting. The only way to benefit from a rally – record-breaking or not – is to be invested.

AMERICA FIRST

The rally in the US market has also overshadowed equities in the rest of the world. Chart 1 compares the S&P 500 with the MSCI All Country World Index excluding the US. US equities have simply outperformed, especially this year. This is partly because investors are more excited about US economic growth, which has picked up speed in recent years, and partly because most of the world's leading technology companies are listed there, and prepared to pay more for each dollar worth of earnings. The US market trades at a forward price: earnings (PE) ratio of 16, compared to 12.8 for world markets, excluding the US.

The US market has outperformed the JSE too, when compared in the same currency (Chart 2). Technically speaking (with all the caveats expressed above), the JSE is also still in a bull market with no 20% decline since 2009. But it certainly has not felt like it for the last four years, with the index barely rising (and most of the meagre returns coming from dividends). Between 2009 and 2014, the JSE tracked the S&P 500 in common currency quite closely. The 2009 rally started on the same day as in the US (6 March), testimony to the American market's oversized influence on all global equity markets.

THE JSE'S TROUBLES

So what has gone wrong on the JSE? Gone are the days when the JSE mainly reflected the local economy and the gold price. Gold miners make up less than 2% of the All Share Index today. Instead, if we simplify things, there are four major drivers of the local market today: Chinese internet (Naspers accounting for about a fifth of the All Share), bulk commodities, global consumers (the likes of Richemont and BAT) and SA Inc. which focus on the local economy. More specifically, the latter group largely focuses on the local consumer, since there are very few notable manufacturing companies left on the JSE, while construction is a shadow of its former self. Even thinking local consumer firms is no longer straightforward as most of these companies also have some foreign exposure. A weak rand tends to benefit the first three drivers, and a strong rand the last one. Chart 3 shows a rough characterisation of these four drivers. Without Naspers' bet on Tencent years ago, returns from SA equities would have been much worse.

This year, the diversified mining giants have led the way (and precious metals have slumped). But this is largely a recovery from the 60% slump between mid-2014 and early 2016. After a phenomenal 2017, Naspers has been up and down this year, but the share price is now back to where it was in January. Over the past five years, Naspers has risen fourfold.

The big global consumer companies benefited from a weak rand until early 2016, but the appreciation of the rand since then has been a headwind. There have also been stock-specific issues. Recently, global tobacco companies have struggled, with BAT falling 30% in the first half of the year before recovering somewhat. This last point highlights a drawback of the JSE: it has plenty of global rand-hedge exposure, but it is not widely diversified. For broader and more diversified exposure, you have to turn to global markets.

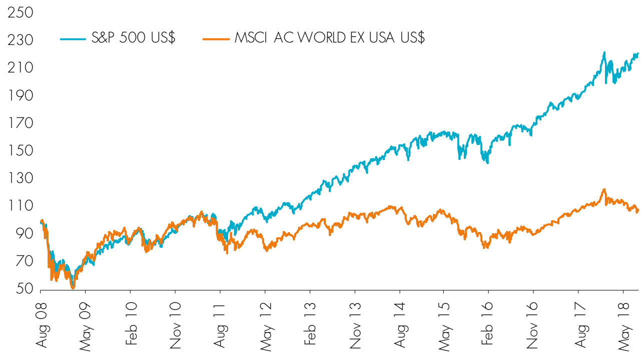
LOW GROWTH, LOW INFLATION

Finally, the SA focused shares rallied with President Ramaphosa's rise to power and the promise of economic reform, but that has now petered out. Growth expectations are fading, policy uncertainty remains high and recent company results and trading updates point to tough conditions on the ground. Shoprite, which reported results last week, is a pertinent example as it is the largest local retailer. Like other tradionally domestically-focused companies, Shoprite has a substantial presence outside South Africa, mostly in other parts of Africa (accounting for about 15% of revenue). But focusing just on the South African supermarkets, year-on-year same-store sales growth was only 2%. This is as a result of fierce competition, weak demand and low inflation. Its average basket of goods was only 0.3% more expensive than a year ago, and the company reported that more than 13 000 individual items on its shelves cost less than a year ago.

Overall consumer inflation, which covers a broader range of items – groceries, petrol, rents, insurance, tariffs and other services – was 5.1% year-on-year in July, according to Stats SA. The increase from 4.6% was largely due to administered prices, notably petrol (up 25%) and water (11%). Core inflation, which excludes volatile food and fuel prices (but includes water), was only 4.3%. Where prices are subject to competition and domestic demand, increases have been muted. Excluding administered prices, inflation was only 3.8%. Clothing and footwear inflation was only 1.8%, recreation only 0.4% and hotels -0.8%. Personal care services (such as hairdressers) saw annual inflation of 0.9%.

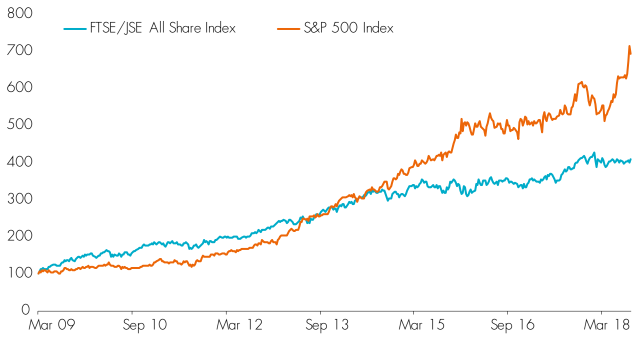
Unfortunately, the Reserve Bank is highly unlikely to cut rates despite low underlying inflation. In fact, the risk of a rate hike within the next year will increase if the rand's recent weakness persists. From an asset allocation point of view, the above points to a preference for local bonds and global equities over local equities. But excluding Naspers, the local market is as cheap as it has been since 2012, with a forward PE of 12. The real return prospects from an appropriately diversified portfolio are therefore reasonable.

CHART 1: THE US VS THE REST, INDEXED TO 100



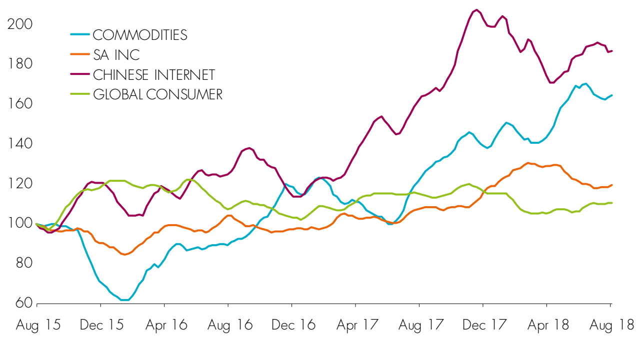
Source: Thomson Reuters Datastream

CHART 2: S&P 500 AND THE FTSE/JSE ALL SHARE, BOTH IN RAND, INDEXED TO 100



Source: Thomson Reuters Datastream

CHART 3: THE BROAD THEMES DRIVING THE JSE



Source: Thomson Reuters Datastream

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 149.0	0.51%	-0.19%	2.19%	10.77%
United States	S&P 500	US$	2 875.0	0.88%	2.10%	7.52%	17.88%
Europe	MSCI Europe	US$	1 702.0	2.04%	-3.19%	-5.29%	0.18%
Britain	FTSE 100	US$	9 736.0	1.03%	-4.28%	-6.39%	2.70%
Germany	DAX	US$	1 375.0	3.31%	-2.90%	-2.77%	3.23%
Japan	Nikkei 225	US$	203.1	0.79%	0.75%	0.52%	15.33%
Emerging Markets	MSCI Emerging Markets	US$	1 048.0	2.44%	-3.59%	-9.50%	-3.14%
Brazil	MSCI Brazil	US$	1 613.0	-3.99%	-12.34%	-20.27%	-19.87%
China	MSCI China	US$	80.1	3.14%	-4.05%	-9.45%	-1.07%
India	MSCI India	US$	600.3	1.63%	0.72%	-1.76%	6.81%
South Africa	MSCI South Africa	US$	493.0	8.59%	-6.98%	-18.51%	-7.68%

EQUITIES - SOUTH AFRICA (TR UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	58 798.0	3.80%	2.38%	-1.19%	3.90%
All Share	All Share (Total Return)	Rand	8 494.0	3.83%	2.51%	0.52%	6.95%
TOP 40/Large Caps	Top 40	Rand	7 600.0	4.25%	2.91%	2.04%	8.23%
Mid Caps	Mid Cap	Rand	15 302.0	2.95%	0.22%	-9.86%	-3.95%
Small Companies	Small Cap	Rand	19 580.0	0.42%	0.54%	-6.86%	-1.83%
Resources	Resource 20	Rand	2 716.8	0.82%	1.74%	18.84%	25.08%
Industrials	Industrial 25	Rand	14 948.0	5.82%	5.25%	-1.11%	2.40%
Financials	Financial 15	Rand	9 384.0	3.93%	-1.78%	-3.33%	11.46%
Listed Property	SA Listed Property	Rand	1 959.2	0.87%	1.62%	-20.49%	-12.42%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	937.1	1.12%	-0.24%	-1.16%	-1.29%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	616.5	1.18%	-1.53%	4.90%	8.41%
Government Bonds	BESA GOVI	Rand	611.6	1.25%	-1.68%	4.31%	7.81%
Corporate Bonds	SB JSE Credit Indices	Rand	115.3	0.20%	0.07%	-8.60%	-15.67%
Inflation Linked Bonds	BESA CILI	Rand	251.1	-0.08%	-0.35%	-0.61%	1.18%
Cash	STEFI Composite	Rand	400.8	0.13%	0.46%	4.67%	7.29%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	75.7	5.41%	2.23%	12.91%	45.48%
Gold	Gold Spot	US$	1 206.0	1.69%	-0.99%	-7.02%	-6.22%
Platinum	Platinum Spot	US$	788.0	0.51%	-4.48%	-15.27%	-19.67%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14.24	2.91%	-6.75%	-13.04%	-7.28%
ZAR/Pound	ZAR/GBP	Rand	18.32	1.97%	-4.91%	-8.62%	-7.81%
ZAR/Euro	ZAR/EUR	Rand	16.57	1.12%	-6.36%	-10.34%	-6.06%
Dollar/Euro	USD/EUR	US$	1.16	-1.72%	0.78%	3.53%	1.72%
Dollar/Pound	USD/GBP	US$	1.28	-0.77%	1.95%	5.07%	-0.38%
Dollar/Yen	USD/JPY	US$	0.01	0.69%	-0.53%	-1.24%	1.26%

Source: I-Net, figures as at 24 August 2018

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ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Credit growth
- Producer inflation
- Trade balance

US

- House price index
- Pending home sales
- Second estimate of Q2 GDP
- Personal income and spending
- Personal consumption inflation

EUROPE

- Eurozone loan growth
- Eurozone economic sentiment indices
- Eurozone inflation and unemployment

CHINA

- Industrial profits
- Official manufacturing purchasing managers' index

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