The Investor©
In our 29th year of service to the South African Investing Public!

Investors face very tough decisions in 2016

by Richard Cluver

As if anything could get worse for South African investors, the Richard Edelman Trust Barometer unveiled in Davos last week has shown that worldwide trust in governments has fallen to its lowest level since the barometer was created 16 years ago. And at the very bottom of the list is South Africa where, according to his findings, only 16 percent of citizens trust their government. Next worst is Brazil where the people are busy impeaching their president. Brazil scored a 21% trust rating.

To create the barometer Mr Edelman's organisation interviews 33 000 people worldwide every October, making it clear that South Africa's "worst in the world" level of mistrust in government happened well before Nenegate sent the Rand into free fall. Edelman is a leading global communications marketing firm that partners with many of the world's largest and emerging businesses and organizations, helping them evolve, promote and protect their brands and reputations.

The Edelman report coincides with the publication by the International Monetary Fund's revised global economic growth figures which predict that South Africa will achieve only 0.7 percent growth in the coming year; half its previous estimate and a tiny fraction of our own Reserve Bank's 3.4 percent estimate.

Writing about the South African economy, The Financial Mail noted in an editorial last week that two events last year pushed the usual scepticism of government into "outright mistrust". They wrote "In road safety terms, President Zuma's firing of Finance Minister Nhlanhla Nene ticked all the boxes: it was reckless, negligent and dangerous. It also provoked serious questions about the president's ability to run the country and his predilection for unwitting sabotage.

"And then there was the abject capitulation by the government to the #FeesMustFall campaign – a collapse that astonished even the most aggressive student leaders. It suggested the government does not have the tactical nous or the old fashioned guts to follow through on tough decisions."

Coupling the Nenegate-inspired collapse of the Rand with the impact of the drought upon critical food supplies makes it clear that even more troubled times lie ahead as the country enters an election year. Economists predict that the price of maize meal is likely to double and they fear shortages due to the inability of our ports to handle

the tonnages that are required to make up our agricultural shortfall. So it is reasonable to expect heightened "service delivery" protest action, strikes and outbreaks of civil unrest which are likely to make us all even more unsettled than we presently are.

Worse, we face the near certainty of a ratings agency downgrade to junk status of our sovereign bonds which will oblige institutional investors to withdraw their money from South Africa as their mandates are linked to the ratings. Such an event will hugely increase the cost of borrowing by the State, pushing up interest rates and further collapsing the share market.

Furthermore, recognising the inevitability of such events, foreign investors are pulling up stakes and fleeing our shores, presenting us with a perfect storm situation. My graph below shows how, during the Zuma years the Rand has been losing value at compound 16 percent a year since January 2011 and how (purple line) that rate has massively escalated to an annual rate of 182.7 percent since mid October.

In the face of such a crisis, the logical advice to investors who want to preserve their capital is to sell out now and move what capital they can to an overseas dispensation. So readers should note the Reserve Bank ruling on such transactions that: "*A tax-payer in good standing and over the age of 18 years, can invest up to R10 million in his/her name outside the Common Monetary Area (CMA-Lesotho, Swaziland and Namibia), per calendar year. A Tax Clearance Certificate (in respect of foreign investments) must be obtained. These funds may not be reinvested into the CMA countries thereby creating a loop structure or be re-introduced as a loan to a CMA resident. (ii) In addition, up to R1 million, within the single discretionary allowance facility, can be transferred abroad, without the requirement to obtain a Tax Clearance Certificate*.

In other words, the average couple can transfer R22-million a year under the present dispensation, although how long this option will remain open in the face of the current crisis is open to doubt. We have accordingly set up a facility with Banyan Private Wealth and Saxo Bank to assist you to both move your money quickly and safely offshore and to invest it on your behalf in an actively-managed offshore portfolio. If you would like further details, please e-mail our associate Kylie Jerg with your contact details. Her e-mail address is Kylie@banyan.co.za. She will contact you and explain how it works.

Illustratively, I offered readers the following sample portfolios which, on the assumption that they continue to deliver the same performance as they have averaged over the past decade, will deliver a total annual return of 278 percent in London and 209 percent in New York while the best the JSE is likely to offer in the next 12 months is 145 percent. Add to the overseas portfolios a minimum of 16 percent for further Rand weakness and it is clear that for the foreseeable future you will get far better returns on an overseas investment than you will locally.

Code	Full Name	Price	Quantity	Cost	Per Share	Value	Risk (%)		% Portfolio	Return(%)
London	**London**					**1000000.00**	**558.47**			**278.17**
AHT.L	ASHTEAD GROUP	1120.00	89.0	100000.00	1123.60	99680.00	17.34		10.0 %	48.47
ANTO.L	ANTOFAGASTA	446.60	223.0	100000.00	448.43	99591.80	6.07		10.0 %	-21.93
EZJ.L	EASYJET	1685.00	59.0	100000.00	1694.92	99415.00	4.36		9.9 %	31.74
SEP.L	STANDARD LIFE EUROPN PRI...	204.50	488.0	100000.00	204.92	99796.00	-10.17		10.0 %	8.39
SGR.L	SHORE CAPITAL GROUP LTD	425.00	235.0	100000.00	425.53	99875.00	518.61		10.0 %	72.08
SMWH.L	WH SMITH PLC	1742.00	57.0	100000.00	1754.39	99294.00	-25.82		9.9 %	28.06
TEF.L	FUNDING FOR HOMES	404.00	247.0	100000.00	404.86	99788.00	21.55		10.0 %	37.10
TPT.L	TOPPS TILES PLC	157.00	636.0	100000.00	157.23	99852.00	66.41		10.0 %	18.51
UTG.L	UNITE GROUP	656.50	152.0	100000.00	657.89	99788.00	-15.30		10.0 %	26.89

Code	Full Name	Price	Quantity	Cost	Per Share	Value	% Gain	Risk (%)	Return(%)
New ...	**New York**					**1000000.00**	**-0.3 %**	**350.73**	**208.89**
ABEV	Ambev S.A.	4.89	20449.0	100000.00	4.89	99995.61	0.0 %	0.00	3.02
AET	Aetna Inc.	103.87	962.0	100000.00	103.95	99922.94	-0.1 %	11.98	28.97
BC	Brunswick Corporation	51.18	1953.0	100000.00	51.20	99954.54	-0.1 %	26.49	24.48
BFR	BBVA Banco Frances S.A.	20.41	4899.0	100000.00	20.41	99988.59	0.0 %	145.48	12.65
CATO	Cato Corporation (The)	38.47	2599.0	100000.00	38.48	99983.53	0.0 %	5.51	6.29
CPA	Copa Holdings, S.A.	48.58	2058.0	100000.00	48.59	99977.64	0.0 %	58.73	5.47
DHR	Danaher Corporation	94.47	1058.0	100000.00	94.52	99949.26	-0.1 %	-29.75	16.31
DIS	Walt Disney Company (The)	111.47	897.0	100000.00	111.48	99988.59	0.0 %	0.61	25.72
LAD	Lithia Motors, Inc.	121.32	824.0	100000.00	121.36	99967.68	0.0 %	71.11	57.04
LUV	Southwest Airlines Company	44.50	2247.0	100000.00	44.50	99991.50	0.0 %	59.57	28.94

Code	Full Name	Price	Quantity	Cost	Per Share	Value	% Gain	Risk (%)
South Africa	**South Africa**					**1000000.00**	**-1.0 %**	**145.31**
AECI	A E C I LIMITED	92.50	1081.0	100000.00	92.51	99992.50	0.0 %	-24.23
AFRIMAT	AFRIMAT LTD	28.24	3541.0	100000.00	28.24	99997.84	0.0 %	36.91
ASPEN	Aspen Pharmacare Hldgs	301.94	331.0	100000.00	302.11	99942.14	-0.1 %	14.18
CAPITEC	CAPITEC	572.00	174.0	100000.00	574.71	99528.00	-0.5 %	-1.49
DRDGOLD	DRDGOLD LTD	2.10	47619.0	100000.00	2.10	99999.90	0.0 %	60.73
MRPRICE	MR PRICE GROUP LIMITED	192.00	520.0	100000.00	192.31	99840.00	-0.2 %	15.12
PERGRIN	PEREGRINE HOLDINGS LTD	30.35	3294.0	100000.00	30.36	99972.90	0.0 %	-7.76
PSG	PSG GROUP LIMITED	239.27	417.0	100000.00	239.81	99775.59	-0.2 %	17.21
RICHEMONT	COMPAGNIE FIN RICHEMONT	107.16	933.0	100000.00	107.18	99980.28	0.0 %	-14.05
SABVEST	SABVEST LIMITED	34.00	2941.0	100000.00	34.00	99994.00	0.0 %	47.69

So the remaining issue as we enter this new year should be whether it is appropriate to sell local shares now? ShareFinder's projections suggest that if you sell now you will arguably get the worst possible prices. My graph projection below suggests that blue chip shares will reach their lowest ebb around February 19 and then begin a steady recovery lasting until at least July during which time the recovery is likely to be of the order of about 8 percent. However, it is likely that, at best, the Rand will continue its 16% long-term average rate of decline which implies that, at best, if you continue holding South African shares your money will remain static in Dollar terms.

So the critical question is what is likely to happen to the Rand in the year ahead, a question that most economists shudder to predict. ShareFinder, however, calculates in the graph below that the Rand could do better than most people expect, predicting that it will reach its strongest level of R23.15 to the British Pound by February 17 after which it will progressively weaken to around R24 to the Pound by June 8. The case for exporting investment capital is thus overwhelming if ShareFinder’s projections prove correct.

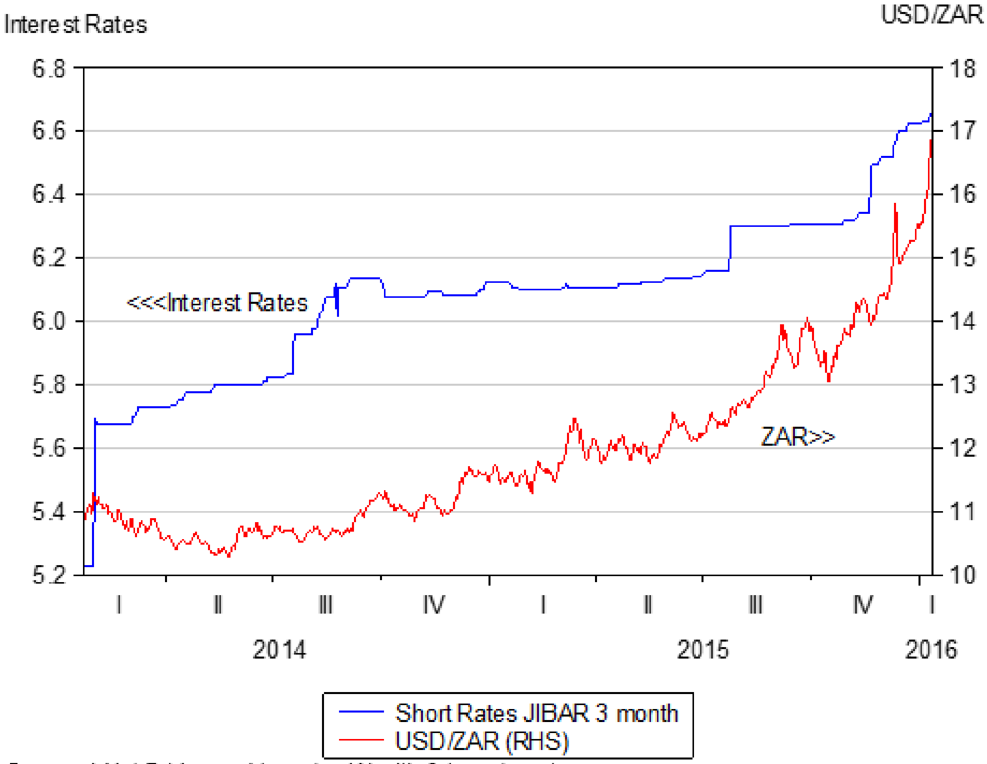
Monetary policy and the MPC: Recognising the facts

By Brian Kantor, chief economist and strategist, Investec Wealth & Investment

The members of the Monetary Policy Committee (MPC) of the Reserve Bank will be even more perturbed about the behaviour of the rand than the rest of us. However they have had (and will have) as little influence over its direction as you or me. The link between short term interest rates that they control and the USD/ZAR exchange rate is shown in the chart below. As may be seen, they began a rate hiking cycle in January 2014 and since then, the higher the rates, the weaker the rand has been. It is very hard to argue that the rand would have been any weaker than it now is had interest rates remained on hold over this period.

There is no good reason to believe that this relationship between interest rates and the rand will be any more predictable in the year ahead than it has been. What is predictable is the impact of interest rates on spending and so GDP growth. Higher interest rates have served to slow the economy down over the past 24 months. Still higher rates will mean even slower growth – without necessarily supporting the rand – and perhaps might even encourage further rand weakness. The slower the growth, the less reason foreign and domestic owners or managers of capital have to invest in South Africa. Growth expected leads the capital flows that determine the value of the rand.

Interest rates and the USD/ZAR exchange rate (daily data 2014-2016)



Source: I-Net Bridge and Investec Wealth & Investment

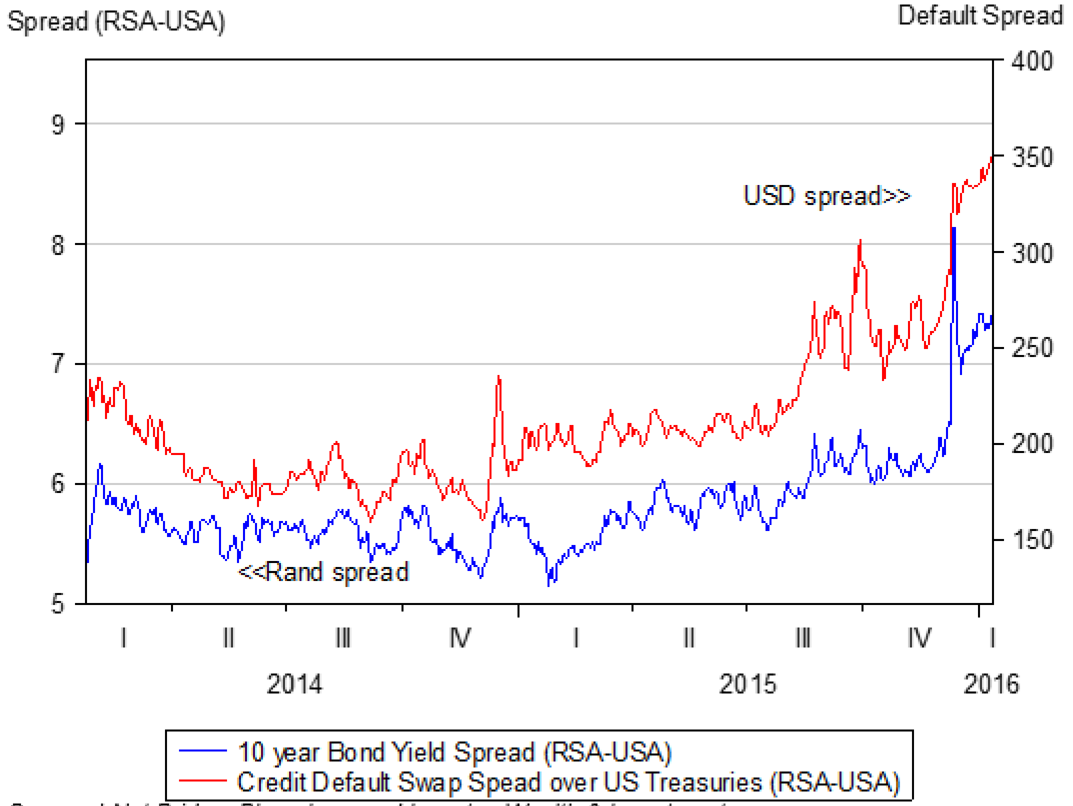
The sooner the members of the MPC fully recognise these facts of SA economic life, the less likely they are to damage the growth prospects of the economy. The exchange value of the rand and so the inflation rate and the expectation of inflation (that take their cue from the exchange rate, for good reasons also incorporated into the Reserve Bank forecasts of inflation) is beyond their influence. Raising interest rates at a time like this because it may support the rand makes no sense at all. The rand may or may not strengthen – for altogether other reasons – especially sentiment about the investment case for emerging markets generally.

More global risk tolerance will mean a stronger rand and vice versa as usual. But the rand has not behaved as usual since President Jacob Zuma intervened so dramatically in SA's fiscal affairs last month. Without such intervention, the rand, given global risk appetites, would have been much closer to 14 to the US dollar than 17. Zuma's actions caused financial markets to raise significantly the doubts it has about SA's ability and willingness to fund its government expenditure without printing money – and so causing inflation.

Hence not only did the rand weaken dramatically, but the expected value of the rand weakened even further. The spread between RSA and US Treasury bond yields, that indicate the compensation for expected rand weakness in the bond market, widened with rand weakness. A weaker rand has resulted in an even weaker rand to come- expected to lose value vs the US dollar at an over 7% p.a rate on average over the next 10 years.

Furthermore the risks of default on SA's dollar denominated debt widened significantly – enough to take SA dollar bond yields into junk territory. SA dollar-denominated interest rates have risen ahead of equivalent junk-rated Russian debt but are still below those on even more vulnerable Brazilian foreign currency denominated debt.

SA risk spreads: 10 Year bond yields and default risk spreads (five year US dollar denominated), daily data 2014-2016



Source: I-Net Bridge, Bloomberg and Investec Wealth & Investment

The newly appointed Minister of Finance, Pravin Gordhan, has committed himself and the country to fiscal sustainability. The market place should believe him, in my judgment. But the market as yet is not giving him the benefit of their doubts. They are going to take a great deal of convincing that SA can live within its means by sticking to the strict limits on government spending that it has set for itself. The role the Reserve Bank can play in this is a limited one. Monetary policy settings will not make much of a difference to perceptions of fiscal policy. They can make a difference to the state of the economy with their interest rate settings. Slower growth makes the task of funding the fiscal deficits even more difficult. They will not be doing Gordhan or you and me any favours hiking interest rates.

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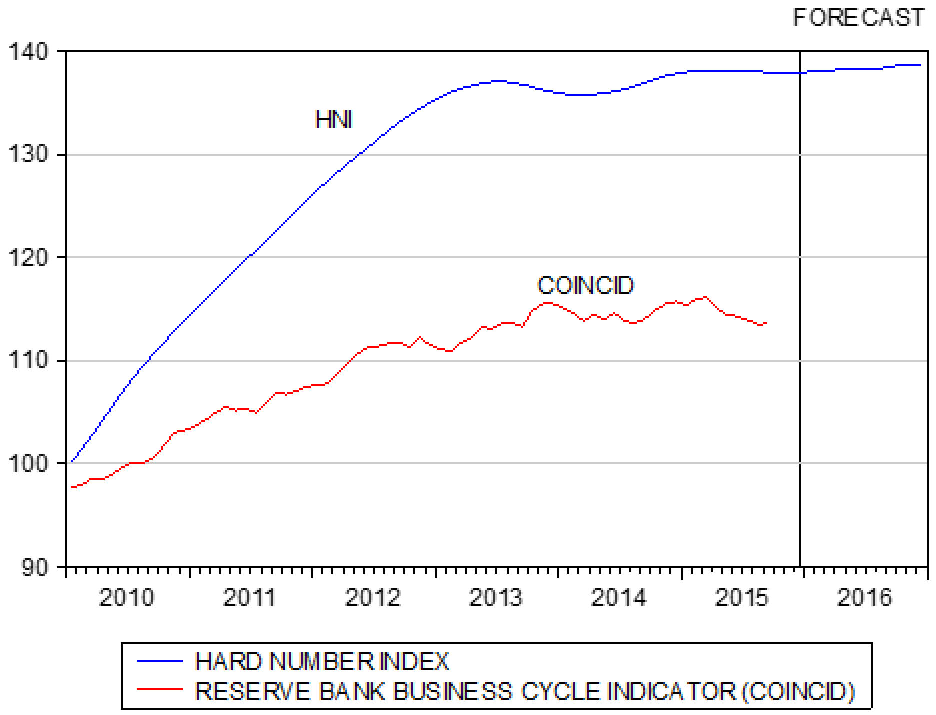
How fares the SA economy? An update to December

By Brian Kantor, chief economist and strategist, Investec Wealth & Investment

With new vehicle sales and the Reserve Bank note issue for December to hand, we can update our Hard Number Indicator (HNI) of the state of the economy at year end. The economy maintained its sedate pace in December. The forecast is for more of the same in the year ahead, that is for slow but not negative growth in 2016. Our HNI serves as a useful leading indicator of the Reserve Bank Business Cycle Indicator updated only to September 2015.

The Hard Number Indicator of the state of the SA economy – to December 2015

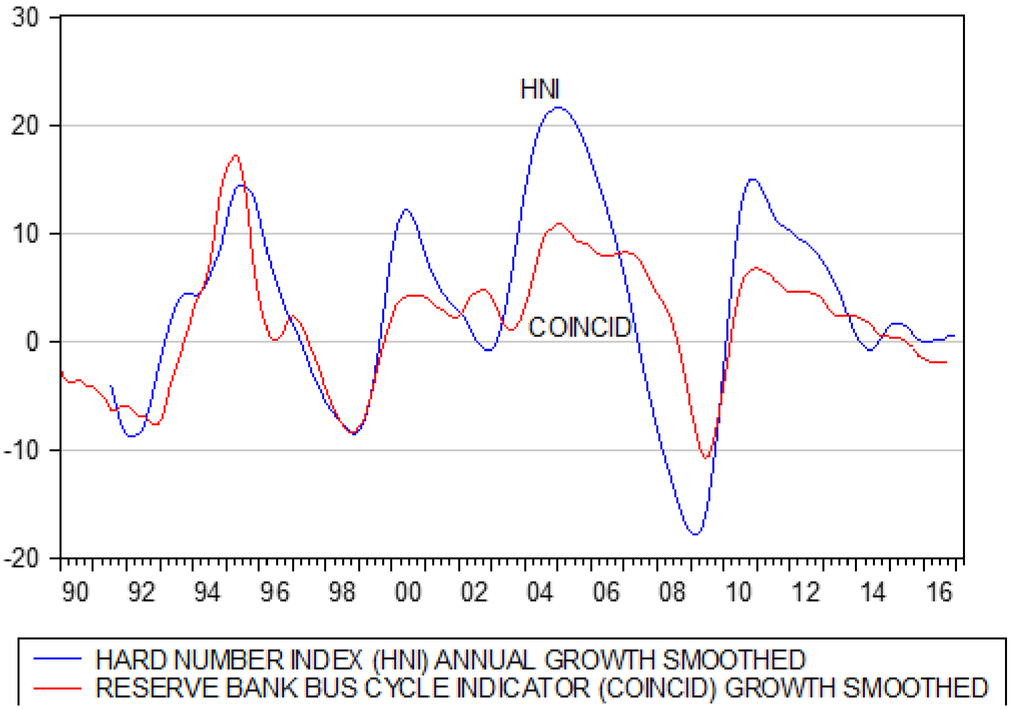


Source: I-Net, Reserve Bank, Naamsa and Investec Wealth & Investment

The HNI and the Reserve Bank coinciding business cycle indicator measure the level of economic activity. When these are converted into rates of change, we show below that the growth rate in the HNI has been declining since 2010 and is currently barely positive and is forecast to remain barely so. It is of some consolation to notice that the weak growth outlook has not deteriorated and is forecast no to do so. The consistent way in which growth in the HNI leads the Reserve Bank cycle helps to confirm its usefulness. It has the advantage of being very up to date and based on hard numbers not sample surveys.

Sales of new vehicles of all sizes in the SA market (that make up half of the HNI) are shown below. While sales are 4% down on a year before, sales volumes, which have averaged over 50 000 units a month, must be regarded as very satisfactory, given the state of the overall economy, especially for the SA manufacturers who also delivered 337 748 units to foreign markets in 2015, 20.5% up on a year before.

The changing pace of economic activity: Growth in HNI and the Reserve Bank Coinciding Indicator (1990-2016)



Source: I-Net, Reserve Bank, Naamsa and Investec Wealth & Investment

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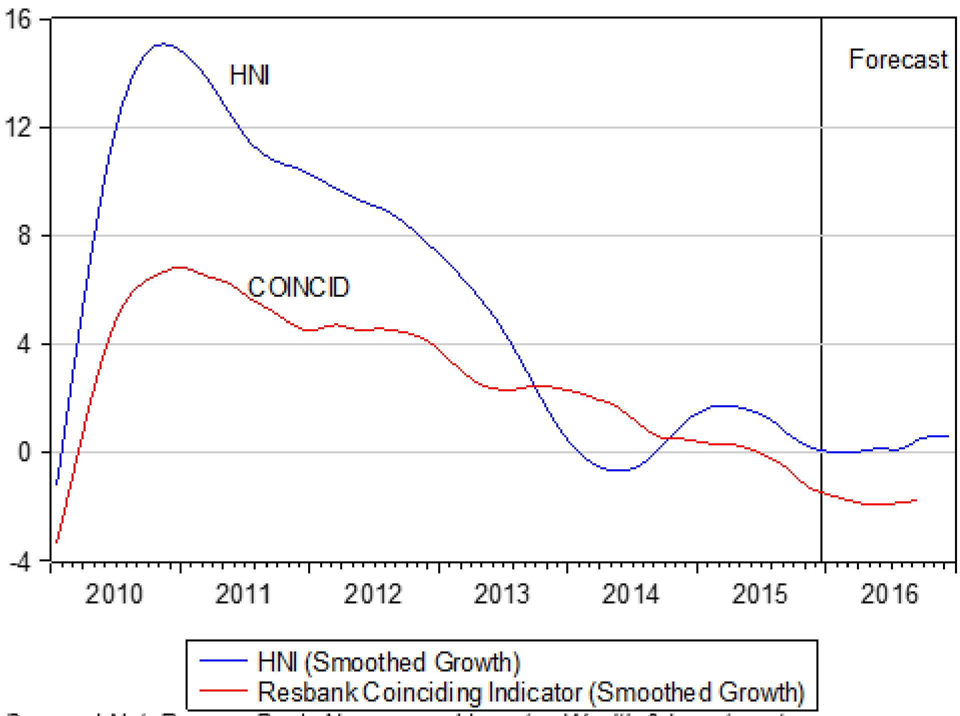

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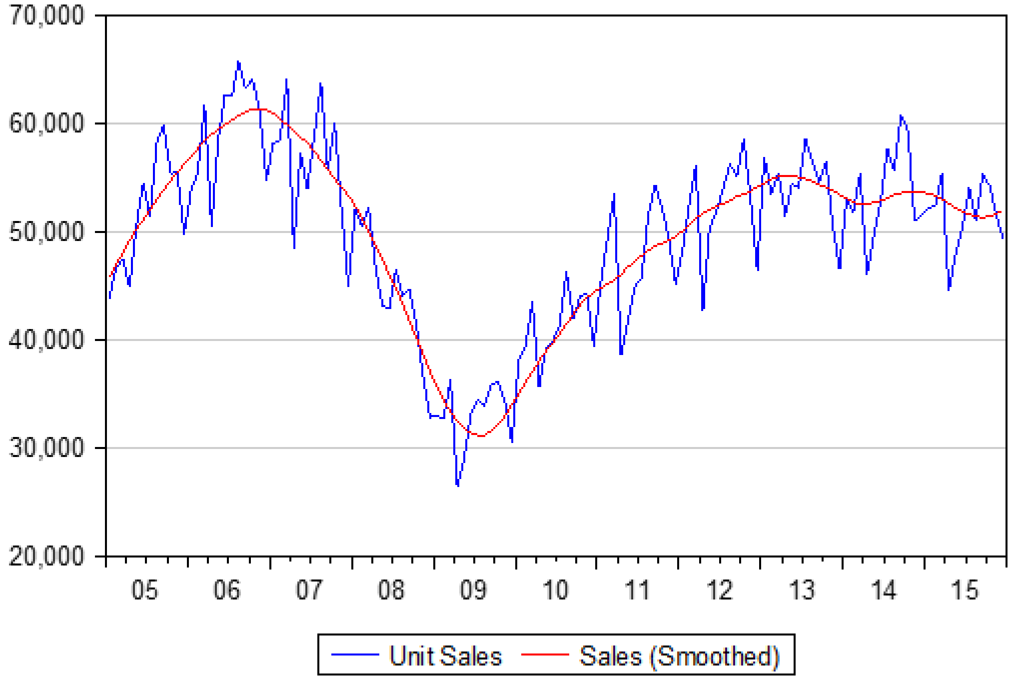
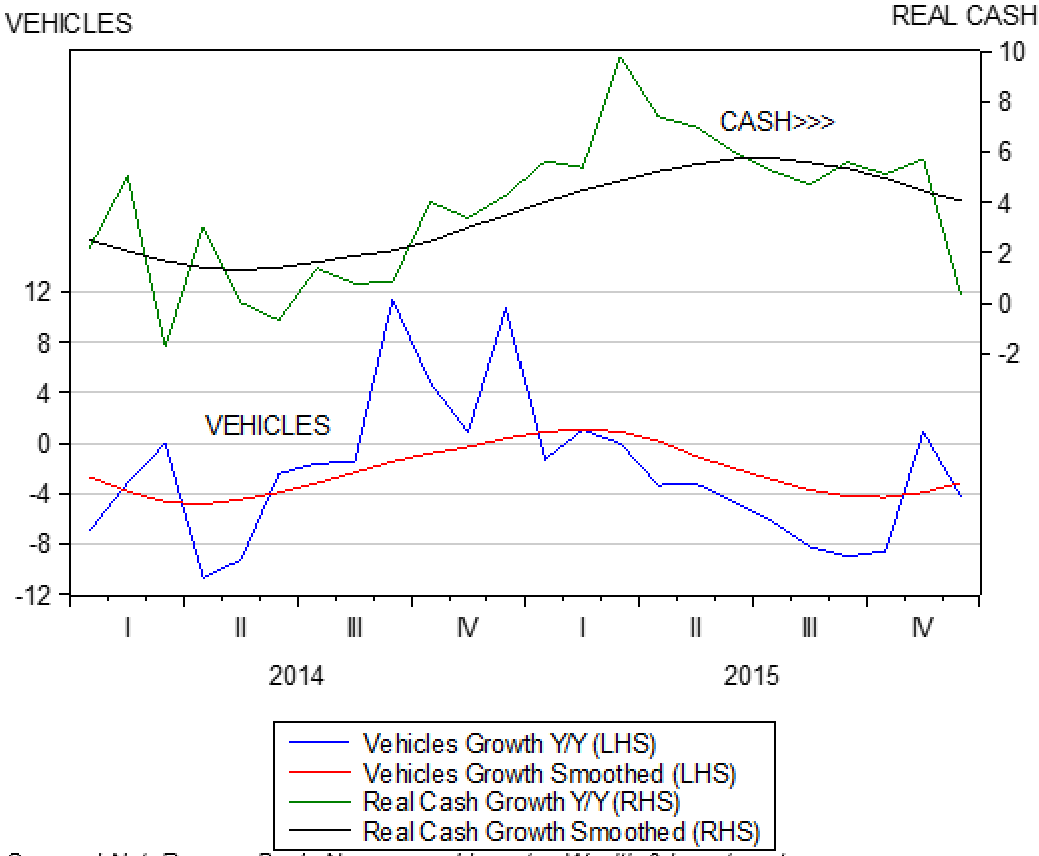
Unit vehicle sales, monthly data



Source: I-Net, Naamsa and Investec Wealth & Investment

The other half of the HNI is made up of the growth in the real supply of and demand for cash. These demands for cash have been growing at a real 4% p.a as we show below. However the cash cycle appears to have peaked earlier in 2015, helped by lower inflation. The demands for cash, to spend on holidays and presents, rise strongly in November and December, though growth slowed this December off a very high base established in December 2014. The growth in demands for cash in SA, despite the heavy and growing use of electronic alternatives to cash, speak eloquently of the important role the informal economy plays in SA – a role however that is not reflected in official estimates of the size of the informal sector, as about 5% only of GDP.

The real cash and vehicle cycles



Source: I-Net, Reserve Bank, Naamsa and Investec Wealth & Investment

The outlook for domestic spending has deteriorated, with the collapse in the exchange value of the rand. Higher rand prices for goods with high import or import replacement content or export potential will further discourage spending by households. That the oil price in dollars has declined by even more than the dollar value of a rand has been a welcome source of relief for households and firms. The inflation outlook has therefore not deteriorated as much as it would ordinarily have done with a rand this heavily damaged.

Hopefully this lesser inflation outlook will help restrain the Reserve Bank from raising interest rates as much as they would otherwise have done. Higher interest rates will do little to help the rand; they have not helped the rand to date that has been driven by global and SA forces well beyond the influence of monetary policy and interest rates. However higher interest rates will be sure to add to the contractionary forces slowing the economy- and undermine further the case for investing in SA. Is it too much to hope for a sanguine Reserve Bank- one that will allow the exchange rate to absorb the economic shocks- and not to add to them? And to happily surprise the market accordingly.

Thought from across the Atlantic

by Tony Sagami

Choppy Seas for Transportation Stocks

"Red sky at night, sailor's delight. Red sky in morning, sailor's warning."—*Old sailor's adage*

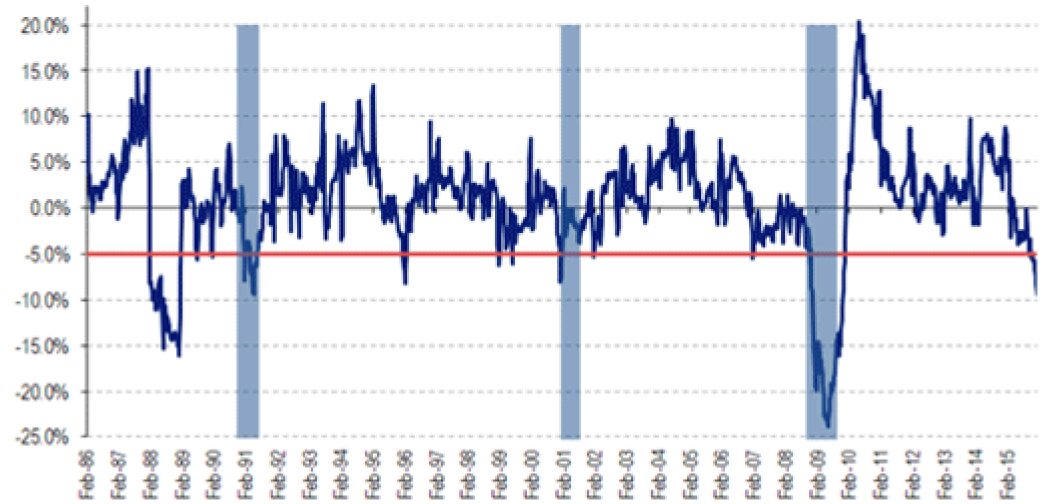
In the old times of sailing ships, sailors paid careful attention to the weather to see if it was safe to set sail. Investors should be watching the economic climate with the same intensity to see if it is safe to invest in transportation stocks.

And let me tell you, the economic climate for transportation stocks is quite ugly.

Red Sky Morning #1: The Bureau of Transportation Statistics (BTS) reported that the total amount of freight volumes fell on a year-over-year basis. The total volume of freight moved by all types of transport—road, rail, pipeline, inland waterways, and as air cargo—dropped by 1.1% in the month of November (most recent statistics available), compared to the same year-ago period.

Red Sky Morning #2: The Association of American Railroads reported that freight volume on US railroads fell by 2.5% in 2015.

Exhibit 1: 4-week moving average of year-over-year change in carload volume highlights the current weakness, not seen since 2009



Source: AAR and BofA Merrill Lynch Global Research estimates

Example: When Union Pacific reported its quarterly results last week, they fell well short of Wall Street expectations. The pinstripe-suit crowd was expecting Union Pacific to deliver $1.42 of profits on $5.54 billion of revenue (a big drop from the $1.61 of profits on $6.15 billion of revenue it made last year), but the company couldn't even deliver on those lowered expectations.

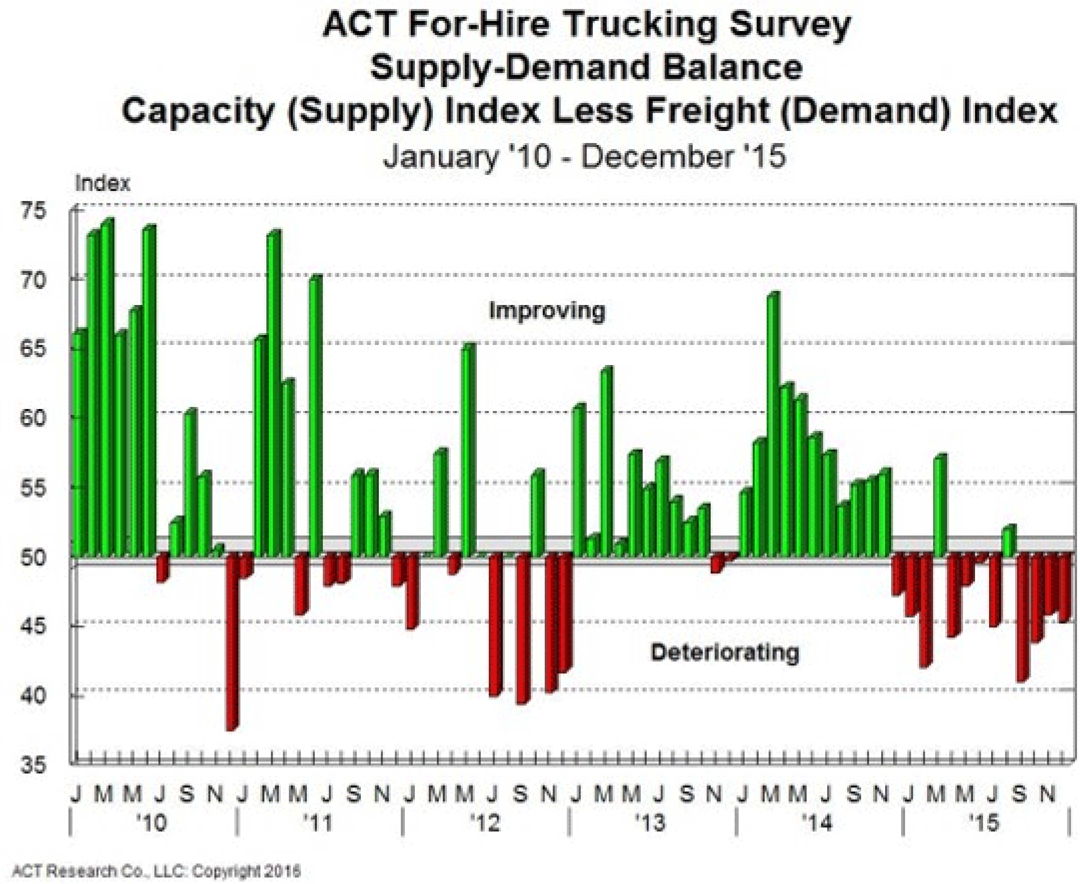
BloombergBusiness News Markets Insights Video

Union Pacific Posts Profit Below Estimate as Cargo Slump Deepens

Union Pacific reported earnings of $1.31 per share—11 cents below expectations—on $5.21 billion of revenue.

The problem? Freight volumes fell 9% as shipments declined in five of the six major freight categories. The one positive category, automotive, was up by a measly 1%… nothing to write home about. This, by the way, is Union Pacific's fourth quarter in a row of declining freight volume.

Red Sky Warning #3: Sales of Class 8 trucks— those with a gross weight over 33,000 pounds, commonly called semi-trucks—have fallen like a rock.



In the month of November (most recent period available), a total of 16,600 Class 8 trucks were sold, well below the 22,000–25,000 expectation, a 59% year-over-year decline and a 36% drop from October.

Red Sky Warning #4: Boeing slashes production of 747-8 by 50%! Boeing was producing one of these jumbo jets every month but announced it will reduce that to just one every two months… a 50% decline!

According to Boeing, the decision to slash production was to “match near-term market demand” for the plane. “Global air passenger traffic growth and airplane demand remain strong, but the air cargo market recovery that began in late 2013 has stalled in recent months and slowed demand for the 747-8 Freighter,” said Ray Conner of Boeing.

Red Sky Warning #5: The transportation woes have spread far beyond US borders. The Baltic Dry Index, which measures the price of moving raw materials by sea, hit a new all-time low.

The Baltic Dry Index dropped to 373 points last week, the first time it has ever been below 400 and a staggering 22% drop in just the first 15 days of 2016.

Conclusion: It doesn't matter which part of the transportation food chain— ships, air, trucks, or rail—you're looking at… they are all in trouble as evidenced by the Dow Jones Transportation Average.

The Dow Jones Transportation Average closed below its August 24 close of 7,595 on December 11 and is already down more than 11% so far in 2016. Worse yet, it is down by almost 30% from its all-time high of 9,310 set on November 28, 2014.

If those old-time sailors are right, all the transportation "red" you see when the stock market opens in the morning is a clear warning of very dangerous investing conditions.

T. Sagami

Tony Sagami