



Richard Cluver Predicts

In our 29th year of service to the investing public of South Africa



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Overwhelming most investment thinking in South Africa today is the assumed great probability that the ratings agencies will downgrade our bonds to junk status when their next reports are due, probably around the middle of this year.

Such a move, it is argued, will force many pension fund administrators to dump SA bonds because their investment mandate precludes them from holding anything with a "junk" label. And, not wishing to be caught in the rush for the door, many have since the Nenegate affair, been selling off all their South African holdings. As a consequence, the Rand collapse has accelerated from a year on year average rate of 15.7 percent which has persisted since the Zuma administration came to power as outlined by my green trend line on the right to a current 155% annualized rate as depicted by the red trend line.



It is accordingly important to consider a lecture just given by Investec Asset Management Economist and Strategist, Nazmeera Moola at the Discovery Financial Planning Summit 2015:

"While undoubtedly serious, the threat of a downgrade to sub-investment grade needs to be seen in context. Firstly, South Africa is on the cusp of losing its investment grade rating with one of the three major ratings agencies – Standard & Poor's – who has rated the country at BBB- with a negative outlook. It has two years in which to decide if it will lower the credit rating to BB+ or if it will remove the negative outlook and keep South Africa at BBB-. So, this rating could remain at BBB- for up to two years.

"Secondly, the potential downgrade to junk status only applies to the sovereign debt issued in foreign currency, which is approximately only 10% of the country's total issued debt. The vast majority of South Africa's debt has been issued in local currency. It is also these rand-denominated bonds that have been included in the World Government Bond Index (WGBI). Therefore, if the country loses its investment grade rating, it will not force widespread selling from rand-denominated South African government debt.

"Though South Africa is not peering over the precipice just yet, all is still far from well with South Africa's finances. In the immediate aftermath of the finance minister shuffle, investors were clearly rattled, judging by the sharp weakening of the rand and the sell-off in bonds. Even now, with an experienced and trusted hand back at the helm of the Treasury, the rand is still significantly weaker than it traded at the beginning of December, and bond yields are still 80 basis points higher than before President Zuma's announcement.

This is partially due to a deterioration in the global economic environment. But we believe it is mainly the result of a loss of trust in the Treasury and South African Reserve Bank. This trust has been built up with investors over the last 20 years.

"This meant that, despite global developments, emerging market issues and indeed our own challenges (such as Eskom concerns, disappointing growth etc.) South Africa was still viewed

as the 'least ugly girl at the ball'. I.e., investors would be cognisant of risks pertaining to emerging markets and South Africa, but were reassured by the belief that the country has strong structural institutions in the Treasury and SARB, which would largely do the right thing. By his announcements in December, President Zuma managed to undo this trust in one quick move. It will take a long time to rebuild it. Prior to the president's announcement the R186 was trading at 880 basis points, whereas it is now in the region of 930-960 basis points.

"Despite the worrying situation, all is not lost for South Africa's finances. Since his re-appointment, finance minister Pravin Gordhan repeatedly has reiterated his commitment to retaining South Africa's investment grade rating. The first step will be the presentation of a plausible 2016 National Budget to parliament later this month. To buy time with the rating agencies, Minister Gordhan needs to produce a far smaller budget deficit for the fiscal year that starts 1 April 2016 than the 3.3% of GDP the Treasury announced in the October 2015 Medium-Term Budget Policy Statement.

"The Treasury is facing lower revenues than they have previously forecast. To produce a lower deficit, he will have to raise taxes and cut expenditure. In an already weak economy, this will not be easy to achieve. Furthermore, with municipal elections looming, there will be the temptation to distribute some largesse. Unfortunately the cupboards are bare, and there is only room for symbolic largesse.

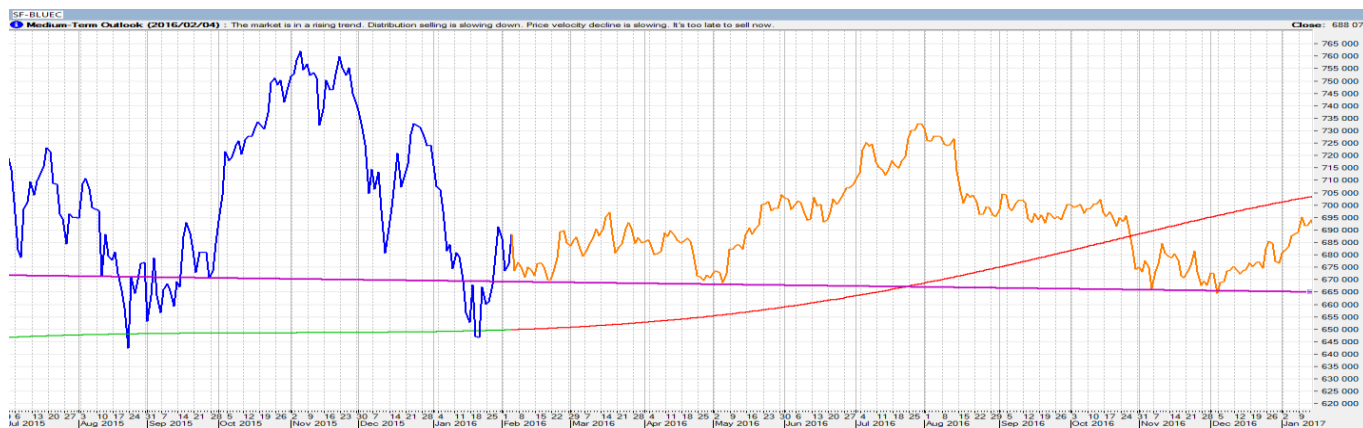
"Gordhan will also have to provide continued assurance that South Africa will not incur any major long-term liabilities that are not funded. In light of recent events, there also has to be an awareness that there is zero room for populist spending such as the student fee debacle of last year.

"With all this in mind, the minister's ability to produce a great budget is limited, but ideally we should see a reasonable budget. This will buy time with the rating agencies. The key is to combine it with tangible progress on structural reforms that will boost the growth outlook. These measures should include the resolution of the visa issue, some headway on labour and education reforms, doing away with undue bureaucracy in small business and the award of independent coal power provider contracts to the private sector. If the South African government can implement structural reforms, these should go a long way towards easing the pressure on our sovereign bond ratings."

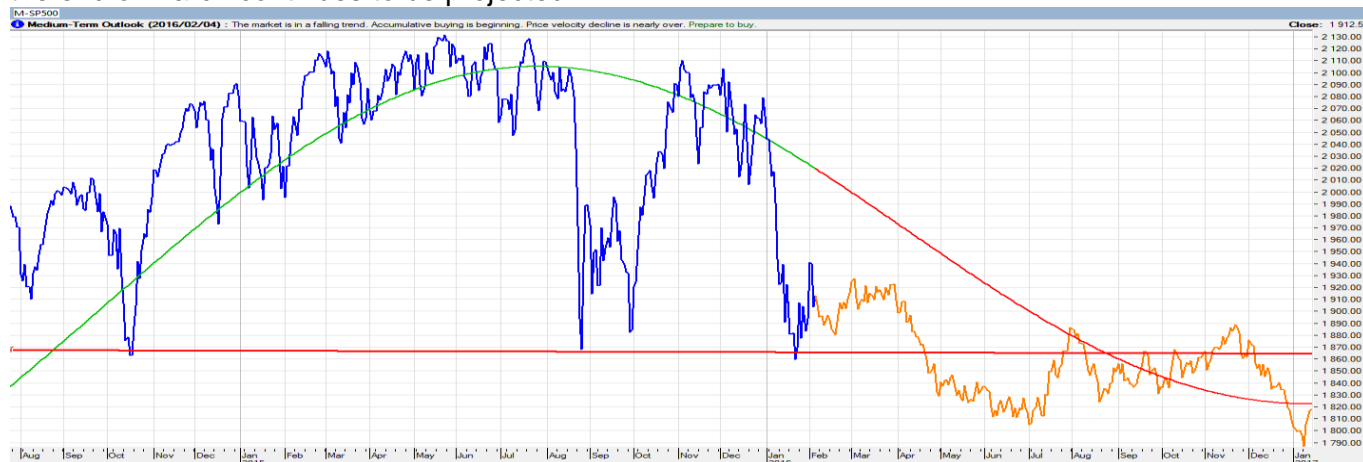
In other words, a lot of the panic is unwarranted. Probably our greatest fear then is fear itself. So to return to the theme that I have been adhering to for the last few weeks "How far can the market fall and how long will the bear market last?" Last week I offered a ShareFinder projection that suggested that the JSE Top 40 Index was about to top out and retreat, which is exactly what happened. However, a curious thing happened yesterday when in response to international trends, the index reversed upwards again. But, suggests ShareFinder, this is likely to have been another false dawn event which (although it could last a few days more) is likely to see the market headed downwards again until early May as outlined in the graph below:



Similarly, analysis of the ShareFinder Blue Chip Index (below) indicated a much happier trend for the ShareFinder Blue Chip index which has now formed a solid support line to which it is likely to retreat over the next fortnight and thereafter begin a solid recovery trend once Pravin Gordhan's Budget is behind us:



Globally, represented by New York's SP500 Index below, I noted last week that a support line had just been breached and I told you that ShareFinder was projecting a two-month recovery ahead of a continuation of the bear market at least until July. Exactly that happened and a bull phase lasting until the end of March continues to be projected.



Both in this column and in Prospects I have illustrated why London-listed shares appear for now to offer the best growth prospects. Here, ShareFinder continues to predict a fresh bear trend beginning around February 25 and lasting until the first week of May when a new bull phase is scheduled to begin.



So I continue to stress that your best investment option for 2016 is to move as much capital as you can afford to a London account and prepare to start buying at the start of May. In ALL future issues of Prospects we will as this past month, list the top ten buys in growth and income growth categories in

London, the New York Stock Exchange and the Nasdaq in the US and the Australian All Ordinaries exchange.

The next month:

New York's SP500: I correctly predicted a continuation of the down-trend with the next recovery likely to begin next Monday erratically through to the end of February.

London's Footsie: I failed to predict this week's sharp decline which is likely to continue until Monday followed by an erratic and volatile recovery until mid March.

JSE Industrial Index: I correctly expected the decline to continue in a whip-saw trend. Now I see a recovery well into March.

Top 40 Index: I correctly predicted a decline but it was over sooner than I expected. Now I see an up-trend until the 17th.

The ShareFinder Blue Chip Index: I correctly predicted a brief recovery which is probably now over with declines now likely until the third week of February.

Golds: I wrongly predicted declines but I believe they have merely been delayed and now I see an erratic decline until mid-March.

The Rand: I correctly predicted a recovery followed by modest declines which I expect to continue for most of February.

The Predicts accuracy rate on a running average basis over the past 576 weeks has been 83.55%. For the past 12 months it has been 91.96%.

Richard Cluver