momentum Securities | S P REID

Core Equity Portfolio

September 2016

Investment objective

This is a high conviction portfolio focused on maximising returns to the investors over the medium to long term by investing in JSE listed shares. The returns of this portfolio are based on the ability of the JSE All Share index to deliver returns in excess of inflation and the ability of the portfolio manager to identify undervalued securities within this asset class.

Investment profile

- Investors who have a longer investment term and want the highest possible return on their invested capital
- Value-based investors with high risk tolerance
- Investors who understand that there are investment cycles that cause share prices to fluctuate

Risk profile

- [ ] Low
- [ ] Low-Medium
- [ ] Medium
- [ ] Medium-High
- [x] High

Portfolio information

Inception date	1 June 2015
Investment manager	Momentum SP Reid Securities
Stockbroker/custodian	Momentum SP Reid Securities
Management fee	Max 1% (annual)
Minimum lump sum	R 250 000
Redemption period	5 business days
Benchmark	CPI +4%

Top holdings

Glencore	GLN	8,19%
Remgro	REM	7,75%
Naspers Limited	NPN	7,71%
Reinet/BTI	REI	7,50%
Standard Bank	STD	6,28%

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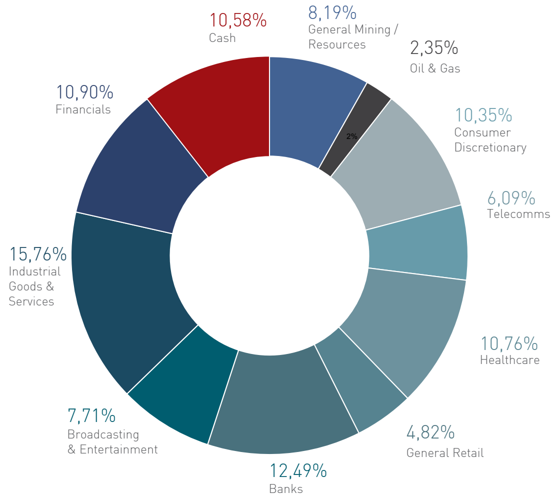
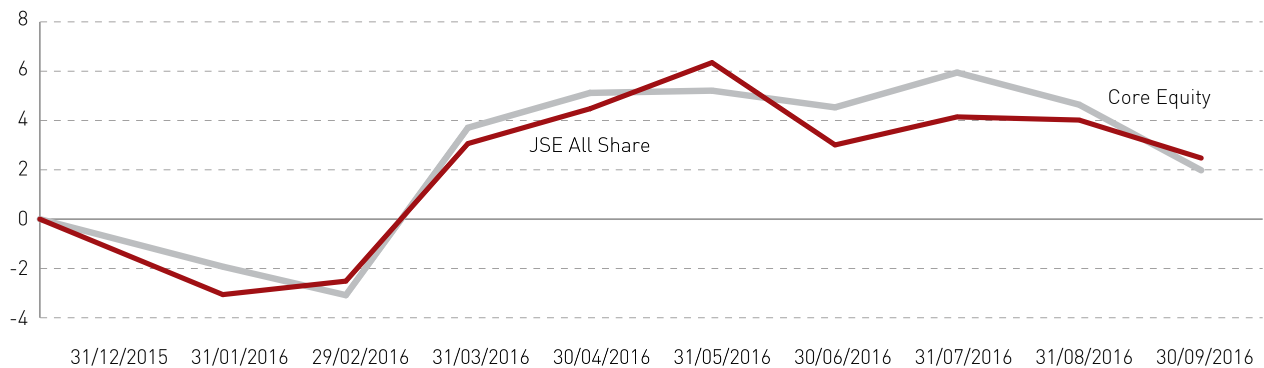
Sector allocation



Performance



Brexit continued to wreak havoc on markets over the third quarter, and Emerging markets started to come into favour as the American electioneering weighed on the US market. Flat interest rates in the US resulted in a weaker Dollar against most other currencies with Rand hedges coming under pressure.

The relative overweight of Rand Hedge counters in our portfolio negatively impacted performance and our portfolio decreased 2.5% over the 3 months and is now up 1.98% for the year. It has lagged the performance of the All Share by 0.50%.

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Economic and market snapshot for September 2016

Global economic developments

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Head of Macro Research and
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United States (US)

Federal Open Market Committee (FOMC) has a more divided outlook on the appropriate time to raise interest rates

Although the US Federal Reserve (Fed) left its policy ate unchanged at between 0.25% and 0.5% at its latest September 2016 FOMC meeting, three of the current ten voting members dissented, preferring a rate hike.

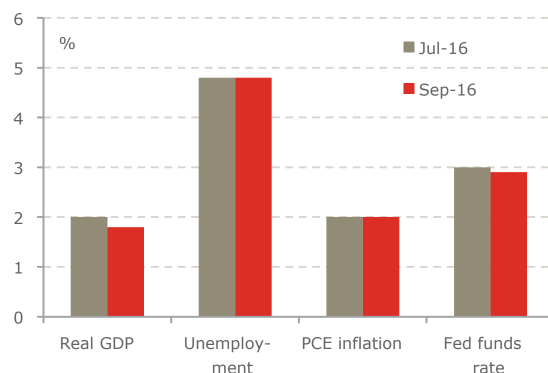
With the FOMC suggesting "that the case for an increase in the federal funds rate has strengthened", the market has maintained a near 50% chance of a rate hike at the December 2016 meeting.

The Committee pointed out that job gains have been solid on average and expect labour market conditions to strengthen somewhat further in upcoming months. In contrast, weaknesses, such as soft fixed investment spend, were noted. Nevertheless, the Committee sees near-term risks to the economic outlook as being "roughly balanced", an improvement from the previous statement in July which merely noted that risks had "diminished".

We believe that the Fed remains committed to a very gradual pace of interest rate tightening given lower trend growth prospects. This was confirmed by the shift in the FOMC's median estimate which indicates two rate hikes next year, down from three in the July 2016 statement. The FOMC has also moderated their outlook on the expected terminal interest rate. The outlook for the Fed funds rate in the longer run has nudged lower from 3.0% in July 2016 to 2.9% in September 2016 (see chart 1), following a deterioration in the Fed's assessment of potential growth (pitched at 1.8%).

In line with the Fed's estimates, we expect around three interest rate increases of 25 basis points each between now and the end of 2017. A gradual rise in inflation (partly encouraged by a tightening labour market forcing median wages higher) is expected to keep the Fed on an interest rate hiking path.

Chart 1: Fed's long-run projections (median estimate)



Source: Federal Reserve, PCE = personal consumption expenditure

Eurozone

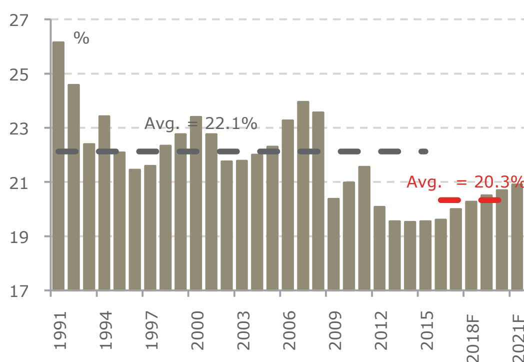
European External Investment Plan unlikely to boost region's growth prospects meaningfully

European Commission head Jean-Claude Juncker proposed to double his European Union (EU) investment plan to €630 billion by 2022. The original plan was launched in 2015, targeting to stimulate the European economy by €350 billion over three years.

The aim of the "Juncker Plan" is to mobilise funding for infrastructure and small-medium enterprise lending. The EU does not make the full contribution, but commits to taking the first losses on risky projects to attract capital from private investors, as well as the European Investment Bank. ABN-AMRO calculates that for every euro of equity capital put into the fund by the EU, private investors were expected to contribute a further 15 euros. However, the current leverage factor is far lower.

There is also little evidence to suggest that the project has yet created a step change in investment. Fixed investment as a share of GDP fell to 19.5% in 2015, significantly lower than the pre-crisis average of 22.1% (see chart 2). The European Commission's Business Climate Indicator decreased to neutral territory (zero) in the August 2016 reading, while corporate loan demand shifted marginally lower in the second quarter of the year.

Chart 2: Fixed investment share of GDP has fallen



Source: IMF, Momentum Investments

Although appetite at the European Central Bank (ECB) appears low for a major policy shift, fragile growth prospects and still muted inflation builds a case for additional stimulus measures.

United Kingdom (UK)

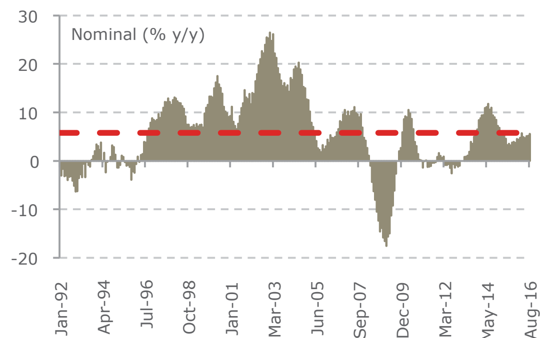
Bank of England (BoE) leaves interest rate unchanged at 0.25%, but hinted at potential cut in November 2016

The BoE noted that recent economic news following Britain's decision to leave the EU (Brexit) had surprised marginally to the upside. Consequently, interest rates and the quantitative easing programme announced at the previous meeting have been left unchanged with all nine members of the Monetary Policy Committee (MPC) voting unanimously.

The MPC specifically pointed to stronger-than-anticipated consumption indicators and a less negative (near-term) outlook on the housing market (see chart 3). In addition, UK asset prices had lifted by more than the MPC expected thanks to the package of stimulus measures announced in August 2016.

Nevertheless, the full impact of Brexit may only be felt further down the line. Surveys highlighting businesses' investment intentions and consumers' willingness to purchase durable goods have weakened, signalling weaker growth ahead. As such, the MPC has left the door open for a further rate cut before year end, suggesting that "if...the outlook at that time is judged to be broadly consistent with the August inflation report projections, a majority of members expect to support a further cut in the Bank rate to its effective lower bound at one of the MPC's forthcoming meetings during the course of the year."

Chart 3: House price growth back at long-term average



Source: Bloomberg, Momentum Investments

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Emerging markets (EM)

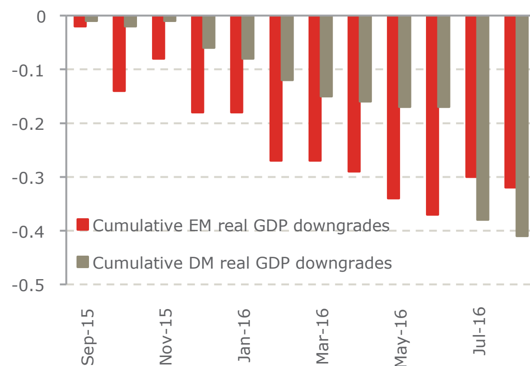
Tentative signs of the growth cycle improving

The growth differential between EM and developed markets (DM) peaked in 2009 at 6.4% and has since narrowed to 2.1% in 2015.

Plunging commodity prices, since peaking in early 2011, partly drove the declining gap between growth outcomes in EM versus DM as net commodity-exporting countries suffered from depreciating currencies, rising inflation, low revenue growth and weak global trade activity.

However, economic prospects for net commodity-exporters appear to be bottoming out in response to firmer currencies since the beginning of the year, coinciding with an 8% uplift in commodity prices over the same time period.

Chart 4: Cumulative GDP growth downgrades



Source: Bloomberg, Momentum Investments, data up to August 2016

Growth in retail sales in the worst-performing regions (Latin America and Emerging Europe) is back in positive territory for the first time in a year. Similarly, the deceleration in growth in exports has slowed from a trough of 29.7% in August 2015 to 13.5% in June 2016.

Cumulative growth downgrades (by the market) to real GDP growth forecasts in DMs accelerated post Brexit, with revisions predominantly concentrated within advanced European economies.

Meanwhile, forecasts remained broadly unchanged for EMs (see chart 4). As such, we expect the differential in GDP growth outcomes between EM and DM to widen in 2017.

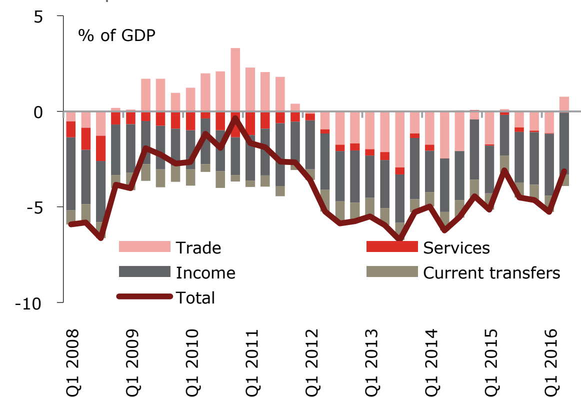
Local economic developments

Current account improves in response to sluggish demand and a weak currency

The rating agencies have previously warned that SA's twin budget and current account deficits are leading to rising public and external debt ratios, while weak economic growth inhibits the country's ability to improve social conditions and overall living standards.

In theory, a weaker currency makes exports more competitive and drives up the cost of imports, which should help to narrow the trade deficit. In SA, however, economic rebalancing has taken some time to materialise despite an earlier depreciation of the rand against a basket of currencies. The SA Reserve Bank's (SARB) second quarter assessment of the current account nevertheless suggests that previous rand weakness seems at last to be yielding some benefits.

Chart 5: Largest trade surplus since final quarter of 2011



Source: Global Insight, Momentum Investments

SA's current account deficit staged a meaningful recovery in the second quarter of the year, narrowing from a revised 5.3% of GDP in the previous quarter to 3.1%, largely owing to a significant swing in the trade account and a reduction in the current transfers paid to the Southern African Customs Union (SACU).

The lower SACU payment was mainly an adjustment for previous import duties paid over to other SACU members based on import forecasts that turned out to be too high, while the lagged effect of the depreciation in the exchange rate benefited SA's trade balance.

According to SARB, the shift in the trade balance from a deficit of R48 billion in the first quarter to a surplus of R33 billion in the second quarter was driven by a 9.1% increase in merchandise exports relative to the first quarter. Vehicle exports to the United Arab Emirates, the UK, Germany and the rest of Africa contributed strongly to manufactured exports, while exports of platinum, iron ore and ferrochrome to China boosted mining exports.

Despite a notable reduction in imports of vehicles and machinery/equipment (thanks to lower infrastructure spending in the public sector), the SARB acknowledged that SA's import penetration ratio (proportion of domestic demand satisfied by imports) remains elevated at 26.2%.

Going forward, we expect weak demand and an undervalued exchanged rate to drive an improvement in the current account deficit. However, the extent of the recovery will likely be capped by the structural drag created by dividend and coupon payments made to foreigners holding SA bonds and equities (captured in the income deficit, see chart 5).

Financial market performance

Global markets

Although facing intra-month volatility, global equities ended the month only 0.6% above where they began. EM equities continued to march ahead of DM equities, increasing over a percent in September 2016, while the MSCI Developed Markets Index gained 0.5%.

The S&P 500 Index recovered in the second half of the month, ending flat, while the Nikkei 225 (-1.9%) and Eurostoxx 50 (-0.6%) suffered losses over the same time period. At its worst point, the Eurostoxx 50 was down nearly 3% mid-month on European banking concerns, triggered by Germany's largest bank (Deutsche Bank) facing a battle to reduce a penalty from US authorities for mis-selling mortgage bonds.

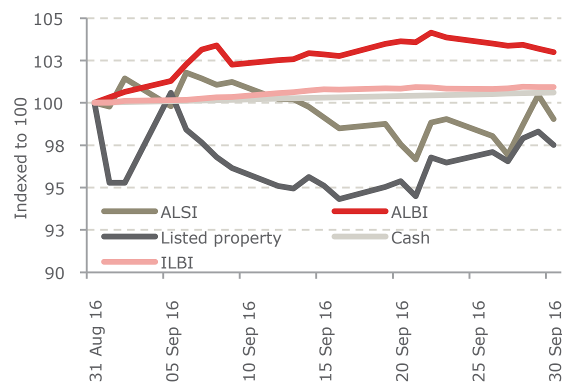
In line with a 3.1% surge in commodity prices in September 2016, the MSCI EM Index rose 1.3%, led by consumer-discretionary and materials stocks.

The MSCI EM Europe, Middle East and Africa (EMEA) Index posted the largest gain (+2.9%) over the month, followed by a 1.3% increase in the MSCI EM Asia Index, while the MSCI EM Latin America Index slipped 0.8%.

Local markets

Despite a slew of positive company announcements during the last few trading days of the month, the FTSE/JSE ALSI ended September 0.9% in the red (see chart 6). The market was dragged lower by rand-sensitive industrials reacting to a strengthening in the local currency. The FTSE/JSE Industrials Index plunged 3.5%, while the FTSE/JSE Resources Index bounced strongly in the latter half of the month, rising nearly 7.5% from its lowest point in the month. Earlier losses across financial shares in the first half of the month reversed. The FTSE/JSE Financials Index ended the month 1.3% higher as European bank-related fears abated towards month end.

Chart 6: Local asset class returns



Source: Bloomberg, Momentum Investments

The FTSE/JSE Mid-cap Index gained close to a percent in September 2016, while the FTSE/JSE Small-caps Index performed slightly better, increasing by 1.2% over the corresponding period.

SA nominal bonds strengthened in a bout of global risk-on trade following the US Fed's decision to leave interest rates unchanged at their September 2016 meeting. SA ten-year government bonds rallied close to 50 basis points by the third week of September, but yields kicked higher in the final week taking their cue from renewed currency weakness.

Listed property edged 1.1% higher over the month, matched by a similar performance in the Inflation-linked bond index (ILBI). SA cash earned 0.6% over the same time period.

Contradicting a poor macro backdrop, the SA rand firmed during the first three weeks of the month as global investors chased higher-yielding assets. The US Fed's and Bank of Japan's decision to maintain their commitment to loose monetary policy provided further support to EM currencies. The part reversal in the currency in the last week of the month could be attributed to profit taking and position squaring, despite the market anticipating a more positive response to the SAB Miller-Inbev merger.

For the month as a whole, the rand benefited from global capital flows and outperformed many of its EM peers, strengthening by 7.1% against the US dollar and 6.3% against the euro.

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