overberg asset management

LOCAL PERFORMANCE FACTSHEET

OAM Local Income Portfolio

Technical Details

Dec 2018

- Base currency: **South African Rands**
- Benchmark: **JSE All Share (30%) ALBI 1-3yr (70%)**
- Asset Allocation: **Flexible mix of equities, bonds and cash**
- Individual portfolio representing Local Growth investment style
- All performance figures include income and are net of fees and expenses

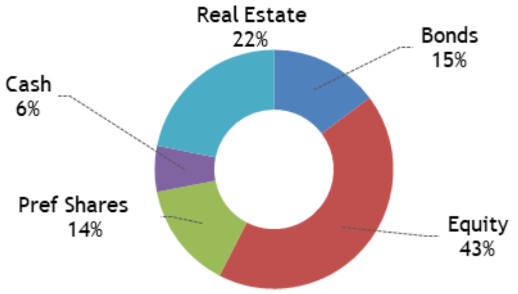
Investment Objective

- Conservative growth
- Consistent annual returns
- Low volatility

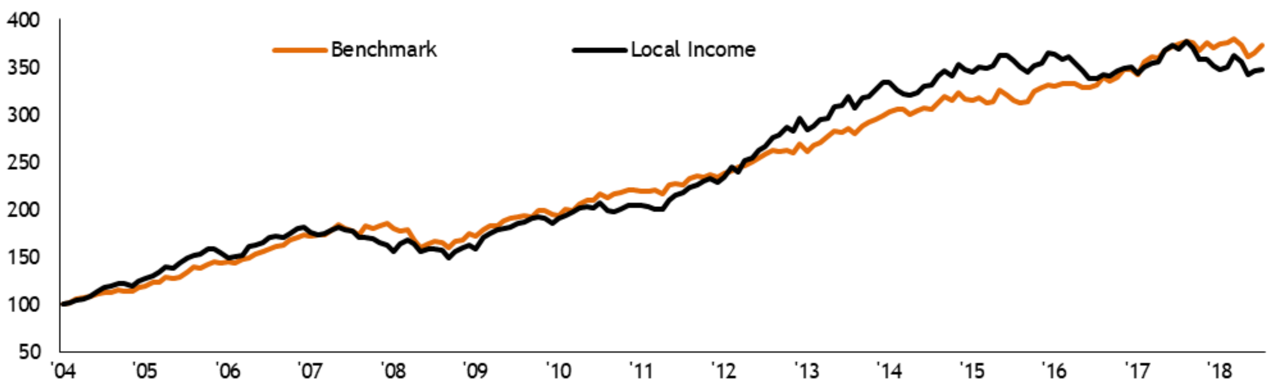
Annualised Growth (%)	OAM	Benchmark
Inception 2004	8.97	9.49
10 years	8.14	8.37
7 years	6.93	7.39
5 years	1.69	5.45
3 years	-0.86	5.74
2018 YTD not annualised	-5.92	-0.54

Annualised Income Yield	4.41%

ASSET ALLOCATION
(see through basis)



Top 5 Holdings	
TRANSNET LIMITED	
DISCOVERY LTD	
NASPERS LTD	
ESKOM 13.5% RS 19/21N170	
RMB HOLDINGS LTD	
Total number of holdings	30



Market Review

2018 was an Annus Horribilis for JSE investors. The JSE All Share Index shed -11.37% in the year cementing the worst five-year period for the JSE in fifty years. Even the stalwart blue-chips of the market, which have traditionally been so reliable in preserving capital, have suffered heavy losses. The JSE is littered with the carcasses of fallen angels. Shares in Mediclinic, Tiger Brands, British American Tobacco and Aspen all fell by more than 40% in the year, MTN by 33%, and Naspers, Richemont and Anheuser-Busch InBev by 17%, 19% and 22%. Around 65% of shares on the JSE dropped by over 20%, meeting the definition of being in a "bear market". In the fourth quarter (Q4) the All Share Index fell -5.33%, the Industrial 25 and Financial 15 indices by -1.18% and -7.25%, respectively, while for the year the latter two suffered losses of -8.35% and -13.18%. The Resources 20 Index was the standout performer, losing -5.0% in Q4 but gaining an enviable +13.10% for the year as a whole. Bonds provided solid ballast to equity portfolios. Despite concerns over South Africa's fiscal slippage, the All-Bond 1-3 Year Total Return Index returned +4.12% in Q4 and +9.12% for the full year. A moderation in US interest rate expectations helped boost the dollar gold price by a solid +7.07% in Q4 reducing its loss for the year to -2.55%. Reduced US rate expectations and a commensurate softening in the dollar helped emerging market currencies in Q4, with the rand appreciating by +4.77% versus the dollar during the quarter although its loss for the year remained in double figures at -10.69%.

As expected the recession ended in Q3. Real GDP grew in Q3 by 2.2% quarter-on-quarter annualised, recovering from the contraction of 0.4% in Q2 and 2.6% in Q1. Among the main contributors, manufacturing, agriculture, domestic trade, transport and communication, and finance, grew in Q3 by 7.5%, 6.5%, 3.2%, 5.7% and 2.3%, respectively. The detractors were mining, construction, and power and water, which shrank by 8.8%, 2.7% and 0.9%. Gross domestic expenditure expanded by 3.2% on the quarter, reversing the 2.9% decline in Q2. The main contributors were a 12.7% increase in inventories, 2.2% increase in government expenditure and 1.6% rise in household expenditure. However, fixed investment shrank by an alarming 5.1%, capping three straight quarters of contraction after declining 0.7% in Q2 and 3.4% in Q1. The Q3 GDP data, while lifting the country out of recession, is little more than a technical recovery from the low base recorded in the first half of the year. A more sustainable improvement will require bold structural reform, investment spending and meaningful jobs growth.

Other economic data and surveys remained soft. The Q3 Labour Force Survey confirms that the unemployment rate increased from 27.2% in Q2 to 27.5% in Q3. In Q3 non-agricultural formal sector employment fell by 65,000 quarter-on-quarter and by 125,000 year-on-year in stark contrast to employment in the informal non-agricultural sector, which increased by 188,000 on the quarter and 327,000 on the year. Despite the net employment growth, the unemployment rate increased due to the labour force expanding by 219,000 on the quarter and 187,000 on the year. Encouragingly, the labour force participation rate improved slightly from 59.1% to 59.5% indicating an increase in the number of people actively seeking employment. Employment growth, traditionally a lagging indicator in the economic cycle, should gather pace as the economy recovers from the recession suffered in the first half of the year. Greater policy certainty and directed policy initiatives, including the recent Jobs Summit and Investment Conference, should encourage employment growth over coming months.

The current account deficit widened slightly from 3.4% to 3.5% of GDP in Q3, due mainly to a decline in the trade surplus. A narrower deficit on the services and income account was offset by a decline in the trade surplus. The trade surplus declined from R38 billion or 0.8% of GDP in Q2 to R14 billion or 0.3% of GDP in Q3. A bright spot however is overall trade activity picked-up with both merchandise exports and imports rising. From Q2 to Q3, export growth increased from 6.6% quarter-on-quarter to 10.6%, while import growth increased from 0.8% to 12.7%, indicative of a general recovery in economic momentum. The current account deficit should subside over coming quarters, with the falling oil price and the strengthening rand helping to keep the import bill in check.

The FNB/BER consumer confidence index fell from its elevated level of +22 in Q2 to +7 in Q3, although it remains well above its long-term average of +2, calculated since 1994. Despite sharp falls in confidence readings, consumers remain optimistic about the business cycle and optimistic that household finances will improve over the next 12 months. The volatility in consumer confidence is attributed to tightening financial conditions, political uncertainty and social instability. These latter factors are likely to affect consumer confidence in the run-up to the national elections, after which confidence should start to stabilise amid reduced political and policy uncertainty.

The RMB/BER business confidence index (BCI) unexpectedly deteriorated in Q3 from 34 to 31, falling further below the neutral 50-level. Following the decline from 40 to 34 in Q2 some recovery had been expected, helped by President Ramaphosa's Jobs Summit and Investment Conference. However, any benefits stemming from these initiatives were outweighed by lingering concerns over land reform, social unrest and strike action. The BCI, at its current level of 31, indicates that around 70% of respondents are unhappy with current business conditions.

More encouragingly, the ABSA/BER manufacturing purchasing managers' index (PMI) rose sharply in November from 42.4 to 49.5, a whisker from the key 50 threshold which separates expansion from contraction. Among the sub-indices, the employment index was the only one to lose ground, from 44.2 to 43.5. By contrast, the business activity index gained from 40.3 to 49.2, the inventories index from 41.4 to 50.2 and the purchasing commitments index from 43.8 to 54.3. The purchasing price index also moved in the right direction from 84.7 to 78.6, indicative of easing inflationary pressures helped by falling oil prices and the strengthening rand. Forward-looking indicators, including the new sales orders index and the index measuring expected business conditions in six months' time, both strengthened, from 39.0 to 50.3 and from 41.7 to 48.6, suggesting improving buoyancy in the manufacturing sector in 2019.

Despite an anemic economy the South African Reserve Bank (SARB) hiked its benchmark repo interest rate by 25 basis points from 6.50% to 6.75%, reversing the March rate cut. The rate hiking decision came despite the SARB lowering its headline consumer price inflation forecast for 2018 and for 2019 from 4.8% to 4.7% and from 5.7% to 5.5%, and its GDP growth forecast for 2018 from 0.7% to 0.6%. Although the rand had strengthened versus the US dollar by around 4% and the dollar oil price had declined by around 20% since the last policy meeting in September, the SARB appeared increasingly concerned about the inflationary impact of potential rand weakness and rising fuel prices. In its policy statement, the SARB cautioned that: "Tighter global financial conditions, financial market volatility and the change in investor sentiment towards emerging markets remain key external risks to the rand." The SARB also cautioned that: "Administered prices, including fuel, electricity and water tariffs, are expected to increase at rates above the upper end of the inflation target range." While acknowledging that the risk to economic growth is titled to the downside the SARB's policy statement highlighted that "current challenges facing the economy are primarily structural in nature and cannot be solved by monetary policy alone."

President Ramaphosa has been working tirelessly at stimulating South Africa's economy. Over October and November Ramaphosa announced a stimulus package aimed at infrastructure spending, chaired a presidential jobs summit pledging to create an additional 275,000 jobs a year and chaired a three-day investment conference attended by 1300 local and foreign business leaders. The mood at the investment conference was positive, reminiscent of the halcyon days under Thabo Mbeki's presidency when South Africa's economy was growing at over 5% per annum. With gradual incremental steps, events over Q4 have boosted Ramaphosa's authority within the deeply fractured ANC. As his authority strengthens, so too will his ability to push through less popular but necessary structural reforms. These reforms will be essential for economic growth to lift sustainably above 5%.

The investment conference came just two days after finance minister Tito Mboweni presented his first Medium Term Budget Policy Statement (MTBPS). Citing weaker than expected GDP growth, Mboweni raised the Treasury's budget deficit and borrowing requirement forecasts, in the process surprising financial markets, which had expected more aggressive fiscal consolidation. Despite some fiscal slippage, the rand and bond yields barely reacted to the mid-term budget, signaling market confidence that credit rating agencies would refrain from further credit rating downgrades. S&P Global Ratings credit rating agency forecasts GDP growth of 0.8% in 2018, rising to above 2% from 2019-2021, offering hope that the country could be awarded a rating upgrade if economic growth strengthened in a “significant and sustained manner.” The MTBPS was positive in key respects. It’s focus on growing the economy rather than maintaining fiscal targets, especially after a recession, will be better for South Africa’s economy and tax collection in the long-run. The re-prioritisation of expenditure towards infrastructure spending will help economic growth. Several references to partnering with the private sector should boost business confidence and private sector investment spending while his refusal to fund wage increases indicates a growing willingness to confront the public-sector unions head-on.

As reflected by weak economic data and subdued consumer and business confidence surveys, economy activity is running well below potential. However, we believe this underwhelming outlook is more than amply reflected in equity market ratings. Equity markets are now offering considerable value with the All Share Index price-earnings multiple currently at 16.7x compared with 21.0x this time last year. If Naspers is excluded the PE multiple falls to 12.5x well below the long-term average of 14.7x. The sizeable discount suggests the equity market is extrapolating current economic weakness into the future. However, current economic weakness is largely a lagged effect from the end of the Zuma era. Recent government initiatives under Ramaphosa and prospects of greater structural economic reforms post the election indicate that the extrapolation of past trends is unreasonable.

Moreover, blame for the worldwide underperformance in emerging market equities is largely attributed to the strengthening dollar and unpredictable US trade policy. Encouragingly, these key market forces may be close to a crucial inflection point. An inflection point in the appreciation in the US dollar and the deterioration in US trade relations should pave the way for a re-rating in emerging market equities. What is good for emerging markets, as an asset class, is also good for the rand and South African equities.

Our clients’ portfolios, while balanced across bonds, preference shares and real estate investment trusts as well as equities, to temper the volatility of equity markets returns, remain tilted towards domestically-focused equities. Domestically focused sectors offer the greatest value and the potential for the strongest re-rating. The key catalysts will likely be global forces comprising a weakening US dollar and a reflation of China’s economy, which both bode well for emerging markets generally. South Africa’s general election should also provide a positive catalyst. Although financial markets may suffer some volatility in the lead-up to the election, a clear mandate for Ramaphosa should usher-in bolder stage-2 reforms from Q2 onwards, providing a solid boost to consumer and investor confidence, household expenditure and investment spending. As well as propelling stronger economic growth and a pick-up in company earnings, the equity market should also enjoy an upward re-rating. Good news has been a long time coming. We are confident that investors will be rewarded for their patience in 2019.