

## Time to buy South Africa Inc.

January 2019

Dear Investor,

We wish you and your family a very prosperous 2019.



Source: Google images

After a disastrous 2018, we turn more bullish on a depressed South African economy and on the capital markets. Just as a reminder, 2018 started with a surge in domestic SA stocks and in the Rand as we absorbed the Ramaphosa victory at the ANC elective conference, only to be rudely awakened by a technical recession and falling consumer confidence. We saw a myriad of so-called blue chip stocks lose a large percentage of their capital values – RESILIENT, ASPEN, MTN and BRITISH AMERICAN TOBACCO are but a few of the names.

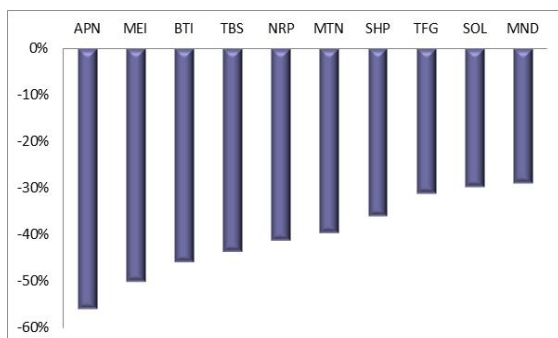


Figure 1 - % fall from 52-week highs

Why are we getting more bullish? We highlight our assumptions as follows

- ❖ The US dollar peaks as the rate of interest rate hikes slow down – after an expansionary period fuelled by quantitative easing, economic conditions are slowing down.

*Our preferred stocks, ETFs and income assets can be discussed with our Portfolio Managers. They will also provide you with information on Afrifocus Personal Wealth and all our investment products.*

**Afrifocus Personal Wealth**

**WealthBuilder**

<https://www.afrifocus.co.za/private-clients/>

**Online CFD Platform**

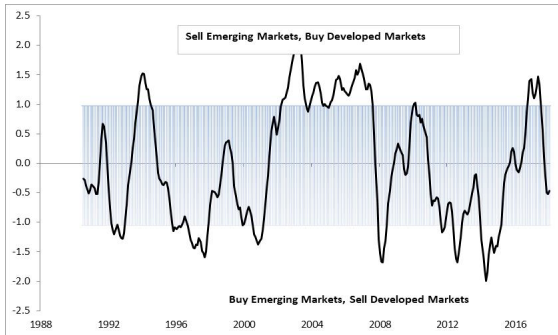
<https://afrifocus.tradedesk.co.za/clients>

The level to watch on the US Dollar Index (DXY) is 95.3.

- ❖ The US-China trade wars are resolved to a certain degree, or the Chinese introduce a stimulus package that reignites an interest in commodities. The latest PMI figures and the import and export volumes suggest a slowdown in that economy.
- ❖ We avoid a further credit-downgrade as the problems associated with predominantly Eskom are resolved. The recent visit by the IMF's Lagarde are encouraging, as well as the unsolicited offer by a US private equity firm to buy 51% of South African Airways.
- ❖ The general elections to be held by mid-2019 are declared free-and-fair, with Ramaphosa given executive authority to overhaul his Cabinet

In this environment we see the following occurring into 2019

- ❖ Emerging markets start outperforming developed markets. The indicator below that combines relative valuation with currency flows favours emerging markets



**Figure 2 - Indicator favours EM**

- ❖ Metal prices rebound from depressed levels and EM growth gets revised upwards. This in turn favours commodity currencies, including the ZAR.
- ❖ The ZAR is currently discounting a further downgrade, as evident from the CDS spreads. As these spreads contract, combined with a weakening of the US\$, the ZAR strengthens, favouring SA Inc. shares.

### Local asset class returns

The assumptions and valuations feed through to the various domestic assets as per the below table.

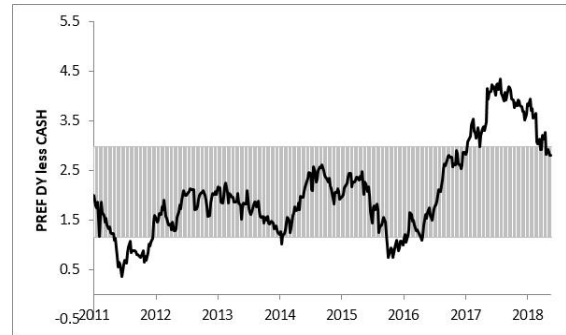
|                      | DY(0) | GROWTH | DY(+12m) | RETURN |
|----------------------|-------|--------|----------|--------|
| JSE PREFERENCE SHARE | 10.1  | 3%     | 9.8      | 15%    |
| CASH                 | 7.3   |        |          | 7%     |
| ALL BOND             | 9.3   |        | 9.3      | 9%     |
| JSE ALSI             | 3.5   | 5%     | 3.4      | 12%    |
| SA PROPERTY          | 9.0   | 6%     | 9.3      | 12%    |

**Figure 3 - Domestic assets forecast returns**

In a typical diversified South African portfolio we would advocate a minimum allocation to cash, preferring preference shares and government bonds for income purposes.

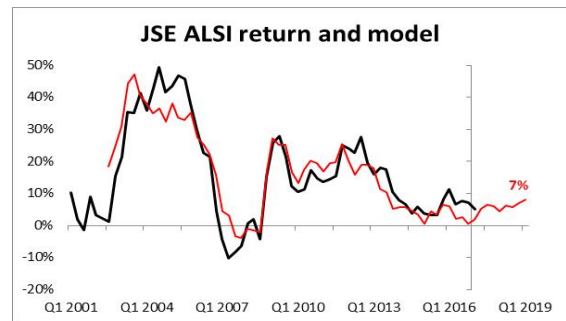
The wildcard here is the forecast yield on the All Bond Index – we believe we are conservative at a target of 9.3%. From a bottom-up approach we can derive a lower target yield – this will further enhance our call to be overweight SA Inc. stocks.

The yields on the preference shares remain attractive, especially on an after-tax basis and when compared to cash. The preference shares of the retail banks have the added benefit of a potential delisting at par under the Basel III regulation.



**Figure 4 - Preference share yield gap to cash**

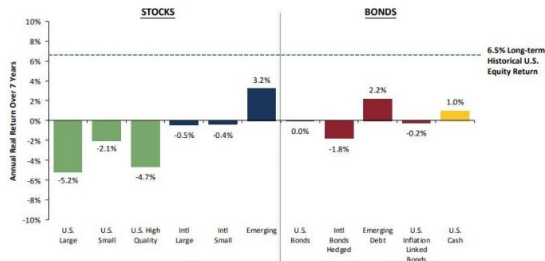
We are however more bearish than the consensus view on the JSE ALSI presented in Table 1, which calls for a total return 28% for market.



**Figure 5 - JSE bottom-up calls for single digit returns**

## Global asset class returns

The projections by GMO presented below calls for emerging equities to be the best performing asset class over the next 7 years.



**Figure 6 – GMO 7-year forecasts**

US equities remain overvalued on all metrics. Investors tend to forget that after the peak in 2000, the S&P500 took 13 years to exceed that peak and start a new rally. We will therefore be underweight US equities on a multi-year view, arguing that there is better value elsewhere.

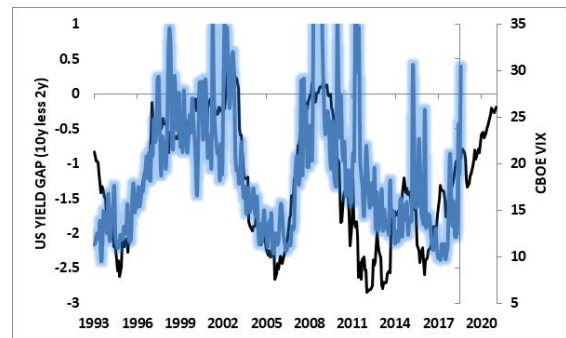
For a very good analysis on the US equity markets read the linked newsletter by Crescat Capital (<https://www.crescat.net/wp-content/uploads/Crescat-Delivers-Strong-2018-Performance-See-Our-2019-Outlook.pdf>)



**Figure 7 - SP500 - at the end of a long bullmarket**

Market commentators like John Hussman are starting to call for large drawdowns in US equities, as the QE programme gets unwound and cheap money disappears.

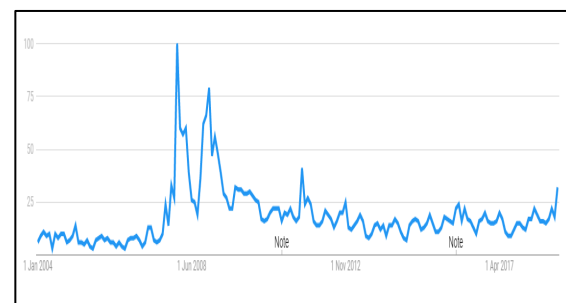
Too much volatility will most likely cause the US FED to pause in its tightening cycle. The yield gap led by 30 months has historically been a good indicator of market volatility. This very simplistic indicator is highlighting continued volatility into June 2021 in US equities.



**Figure 8 - US yield gap pointing to continued volatility**

As a hedge against volatility and tying in with our weaker US dollar theme we recommend an allocation to precious metals in your portfolio – in our fully discretionary WealthBuilder portfolios we currently have an exposure of 8% to gold and platinum shares.

Although too early for an all-fall-down scenario, the chart below highlights Google searches for the term “US recession”. It is on the rise.

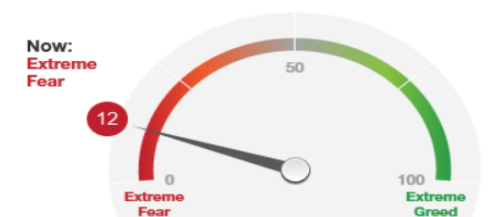


**Figure 9 - Google search for "US recession"**

The CNNBusiness fear and greed index is trading off an extreme – we will expect a relief rally of the S&P500 into 2019Q1. Use the rally to reduce exposure to US equities.

## Fear & Greed Index

What emotion is driving the market now?



**Figure 10 - CNNBusiness Fear and Greed Index**

## JSE listed shares

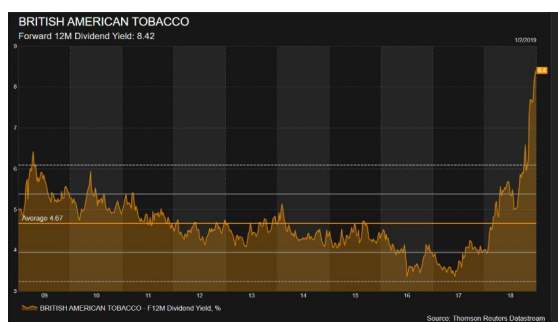
The filter below highlights undervalued, dividend paying shares. The recommendation is as per consensus estimates. There are a number of SA Inc. stocks in the offering, that are yielding more than 4% with inflationary increases in dividend growth over the next two years.

| 31-Dec-18  | NAME                    |      | DY(+1) | 2yCAGR | #PE SD |
|------------|-------------------------|------|--------|--------|--------|
| <b>BTI</b> | BRIT.AMER.TOBACCO (JSE) | BUY  | 8.3%   | 6%     | -2.1   |
| <b>RES</b> | RESILIENT PR.INC.FD.    | BUY  | 10.0%  | 5%     | -1.0   |
| <b>AFE</b> | AECI                    | BUY  | 5.7%   | 9%     | -1.0   |
| <b>HYP</b> | HYPROP INVESTMENTS      | HOLD | 10.2%  | 7%     | -0.8   |
| <b>INP</b> | INVESTEC (JSE)          | BUY  | 5.9%   | 7%     | -0.7   |
| <b>ABG</b> | ABSA GROUP              | BUY  | 7.4%   | 9%     | -0.5   |
| <b>BAW</b> | BARLOWORLD              | BUY  | 4.4%   | 8%     | -0.5   |
| <b>MMI</b> | MMI HOLDINGS            | HOLD | 5.0%   | 103%   | -0.4   |
| <b>LBH</b> | LIBERTY HOLDINGS        | HOLD | 6.6%   | 5%     | -0.4   |
| <b>SOL</b> | SASOL                   | BUY  | 4.6%   | 24%    | -0.3   |
| <b>CML</b> | CORONATION FD.MGRS.     | BUY  | 10.4%  | 7%     | -0.3   |
| <b>WBO</b> | WLSN.BAYLY.HOLMES.OVCON | BUY  | 4.4%   | 15%    | -0.3   |
| <b>GRT</b> | GROWTHPOINT PROPS.      | HOLD | 9.5%   | 5%     | -0.3   |
| <b>NED</b> | NEDBANK GROUP           | HOLD | 5.5%   | 9%     | -0.2   |
| <b>PFG</b> | PIONEER FOOD GROUP      | BUY  | 4.5%   | 5%     | -0.2   |
| <b>OMN</b> | OMNIA                   | HOLD | 6.1%   | 14%    | -0.2   |
| <b>JSE</b> | JSE                     | HOLD | 4.5%   | 8%     | -0.1   |
| <b>VOD</b> | VODACOM GROUP           | BUY  | 6.7%   | 8%     | 0.0    |

**Figure 11 - Undervalued JSE shares**

Companies like AECI (JSE: AFE) and OMNIA (JSE: OMN) could benefit from the recent rains if farmers start planting. The rains should also favour ASTRAL FOODS (JSE: ARL) as the maize price declines with the rainfall.

British American Tobacco has seen a material decline in its share price as a result of an increased debt-burden to from GBP18bn to GBP46bn, coupled with a proposed ban of menthol cigarettes in the USA. If the ban had to be imposed, we believe that the company's revenue could decrease by as much as 20%, and the nett result would be a dividend yield of 5.5%, very different from the 8.4% forecast by analysts. The share is therefore most likely marginally undervalued on a worst case scenario



**Figure 12 - BTI forward dividend yield**

## Preferred ETFs

Our list of preferred ETFs is presented below – it tends to follow our view on asset class returns. Speak to your portfolio manager about these investments for your TFSA.

| Preferred | Not preferred |
|-----------|---------------|
| STXQUA    | SYGUS         |
| STXEMG    | SYG4IR        |
| PREFTRX   |               |
| SYGEU     |               |
| NEWGLD    |               |

Regards

Afrifocus Personal Wealth

Table 1 - Forecast returns for JSE Sectors

| 2-Jan-19    |                               | INDEX | FPE  | FDY   | FORECAST GROWTH |      | TARGET | RETURN |
|-------------|-------------------------------|-------|------|-------|-----------------|------|--------|--------|
|             |                               |       |      |       | EPS             | DPS  |        |        |
| <b>J203</b> | <b>ALSI</b>                   | 52445 | 12.3 | 4.3%  | 30%             | 5%   | 65461  | 28%    |
| <b>J580</b> | <b>FINANCIALS</b>             | 41300 | 11.5 | 5.2%  | 80%             | 5%   | 49906  | 26%    |
| J835        | BANKS                         | 9113  | 10.4 | 5.4%  | 10%             | 10%  | 9874   | 14%    |
| J857        | LIFE INSURERS                 | 42998 | 11.8 | 5.2%  | 8%              | 4%   | 52219  | 27%    |
| J877        | FINANCIAL SERVICES            | 3210  | 13.9 | 3.1%  | n/a             | -3%  | 4430   | 41%    |
| J253        | SA PROPERTY                   | 474   | 10.4 | 10.0% | 28%             | 6%   | 568    | 30%    |
| J000        | FOREIGN PROPERTY              |       |      |       | 1%              | 2%   |        | 42%    |
| <b>J520</b> | <b>INDUSTRIALS</b>            | 44452 | 11.1 | 3.3%  | 12%             | 14%  | 53912  | 25%    |
| J235        | CONSTRUCTION & MATERIALS      | 19    | 9.5  | 4.3%  | 33%             | 66%  | 24     | 36%    |
| J272        | GENERAL INDUSTRIALS           | 174   | 11.6 | 3.1%  | 13%             | 14%  | 200    | 18%    |
| J277        | INDUSTRIAL TRANSPORT          | 136   | 9.9  | 2.7%  | 0%              | -8%  | 204    | 52%    |
| J273        | ELECTRONIC & ELECTRICAL EQUIP | 11979 | 10.7 | 6.4%  | 9%              | 14%  | 11207  | 0%     |
| J275        | INDUSTRIAL ENGINEERING        | 4155  | 35.9 | 4.9%  | 96%             | 18%  | 4288   | 8%     |
| J273        | SUPPORT SERVICES              | 11979 | 10.7 | 6.4%  | 9%              | 14%  | 11207  | 0%     |
| <b>J530</b> | <b>CONSUMER GOODS</b>         | 50547 | 11.0 | 5.4%  | 11%             | 9%   | 63637  | 31%    |
| J357        | FOOD PRODUCERS                | 7412  | 13.3 | 4.6%  | 8%              | 5%   | 8898   | 25%    |
| J353        | BEVERAGES                     | 173   | 14.6 | 3.1%  | 16%             | -6%  | 167    | 0%     |
| J376        | PERSONAL GOODS                | 928   | 17.0 | 3.4%  | 12%             | 9%   | 1156   | 28%    |
| J378        | TOBACCO                       | 5997  | 8.1  | 8.3%  | 9%              | 6%   | 8963   | 58%    |
| <b>J540</b> | <b>HEALTHCARE</b>             | 4885  | 11.4 | 3.3%  | 34%             | 12%  | 6389   | 34%    |
| J453        | HEALTHCARE EQUIP & SERVICES   | 6364  | 14.8 | 3.8%  | 108%            | 13%  | 7068   | 15%    |
| J457        | PHARMACEUTICALS & BIOTECH     | 13645 | 8.1  | 2.5%  | 7%              | 9%   | 22536  | 68%    |
| <b>J550</b> | <b>CONSUMER SERVICES</b>      | 21917 | 20.5 | 1.3%  | 26%             | 15%  | 29981  | 38%    |
| J537        | GENERAL RETAILERS             | 7070  | 15.0 | 4.4%  | 11%             | 12%  | 7362   | 8%     |
| J533        | FOOD & DRUG RETAILERS         | 11280 | 19.5 | 2.7%  | 12%             | 11%  | 12701  | 15%    |
| J555        | MEDIA                         | 630   | 22.3 | 0.4%  | 36%             | 28%  | 938    | 49%    |
| J575        | TRAVEL & LEISURE              | 4576  | 18.0 | 3.1%  | 14%             | 20%  | 5739   | 29%    |
| <b>J560</b> | <b>TELECOMMUNICATIONS</b>     | 5255  | 12.3 | 5.7%  | 22%             | 9%   | 5994   | 20%    |
| J653        | FIXED LINE TELECOMMUNICATIONS | 1996  | 10.5 | 5.7%  | 3%              | 4%   | 1841   | -2%    |
| J657        | MOBILE TELECOMMUNICATIONS     | 167   | 12.1 | 5.7%  | 22%             | 9%   | 194    | 21%    |
| <b>J590</b> | <b>TECHNOLOGY</b>             | 29466 | 27.2 | 2.3%  | 526%            | 69%  | 38265  | 32%    |
| <b>J510</b> | <b>BASIC MATERIALS</b>        | 28549 | 10.1 | 5.9%  | 12%             | -1%  | 33287  | 22%    |
| J154        | GENERAL MINING                | 9950  | 9.9  | 7.2%  | 5%              | -8%  | 11269  | 20%    |
| J153        | PLATINUM MINING               | 22    | 23.2 | 0.7%  | 119%            | 26%  | 22     | 2%     |
| J150        | GOLD MINING                   | 1368  | 13.4 | 0.9%  | 47%             | 47%  | 1303   | -4%    |
| J135        | CHEMICALS                     | 21374 | 8.4  | 4.6%  | 29%             | 23%  | 27772  | 35%    |
| J173        | FORESTRY & PAPER              | 55724 | 9.8  | 4.0%  | 8%              | 10%  | 72156  | 33%    |
| J175        | INDUSTRIAL METALS             | 14482 | 10.8 | 7.8%  | -6%             | -14% | 12728  | -4%    |