

ASSET MANAGEMENT House View



This Month's Focus

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Local markets disappoint while the US steams ahead.

After coming off a stellar 2017, year to date figures have disappointed, with the FTSE/JSE All Share Index (ALSI) returning -3.84%. Investor confidence remains muted, despite the short-lived "Ramaphoria" which hit South Africa at the end of 2017. Over the last 4 years, the ALSI has returned a paltry c.6% per annum, a far cry from the c.17% seen from the previous 4 years. Market participants have also been rocked by big drops in value from blue chips over the last year, such as Steinhoff, MTN and Aspen.

The stand out performer, despite all the market turmoil, has been resources. The FTSE/JSE Africa Resource Index added 24.09% year to date. A handful of counters has contributed to the sectors overall success, with Anglos, Billiton and Sasol driving most of this performance.

Towards the beginning of the year, we believed that the market may have run

a bit hot in certain sectors, in particular, banking and retail.

Subsequently, the sectors performed poorly, with the FTSE/JSE Africa Banks Index dipping 9.66% and the FTSE/JSE Africa General Retailers Index toppling a staggering 19.13% since the end of February. This sell off has provided buying opportunities and we have started adding ABSA and Standard Bank to our previously underweight financial exposure.

We continue to hold selective quality rand hedge shares that are core holdings in our private client portfolios.

These counters are continually monitored, but we are comfortable holding them at present as we do not see any fundamental changes within these businesses that warrant us to exit our positions.

The South African economy remains under pressure and has recently experienced two consecutive quarters of negative growth, resulting in a technical recession. Economists are now expecting GDP for 2018 to come in between 0.7% - 1%, down from the 2% expected earlier in the year. The rand has steadily declined against major currencies since April and has recently come under immense pressure due to the emerging market selloff in August, which was exacerbated by concerns around land reform policies in South Africa. The rand reached the R15.42/USD mark in September, which is a significant decline from the R11.55/

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USD level seen at the end of February. This currency weakness could result in inflationary pressure down the line and put added pressure on already constrained consumers.

Synchronised global growth has been broadly supportive of equities, primarily in the United States, while Europe is still lagging. The US continues to raise interest rates faster than expected, with at least one more rate hike anticipated in 2018. If an additional hike does in fact take place, it will take the Federal Funds Target Rate to 2.50% for the year. This has led market pundits to re-price interest rate risk, resulting in higher volatility in equities.

Global equity valuations are stretched, with the MSCI World currently at a PE ratio of 15.7X, versus the average over the last 15 years at 14.2X. Despite this, earnings



remain broadly supportive, especially in the US. The US economy remains resilient, and the stronger USD has been supportive of US equities. The MSCI US Index is up 10.63% year to date in USD.

We also doubt the US Federal Reserve (US Fed) will succumb to President

Trump's pressure to keep rates low or to accommodate any effort by the Treasury to intervene in the foreign exchange market with the aim of driving down the value of the dollar. That said, the risk to this view is that the US Fed reacts too slowly to rising inflation. This could cause real rates to

drift lower, with adverse consequences for the dollar. In the rest of the world, central banks continue to be dovish, but we are at a turning point as inflation continues to tick up in the USA, UK and to a lesser extent the EU.

International Market Overview

Most Central Banks worldwide are keeping an accommodative monetary stance, except for the United States, which has raised rates by 25 basis points. Markets have remained largely resilient, despite uncertainty surrounding Brexit and continued friction between the US and China.

United States of America

The United States continues its path of raising rates, adding another 25 basis points to the Federal Funds Target Rate, bringing the total to 2.25%. Rates were raised to curb inflation (as measured by Core Personal Consumption Expenditure), which has risen from 1.6% at the beginning of the year, to 2.0% at the end of September. The medium-term outlook for the US is looking buoyant, as the updated Summary of Economic Projections in the US showed, with GDP expected to beat June estimates for the year. Most US equity markets kept pushing higher over the month, with the S&P 500 Index rising 0.57% and the Dow Jones Industrial Average gaining 1.97%. The NASDAQ Composite Index lagged its peers, shaving 0.70% off the top line. Year-to-date,

the NASDAQ Composite Index has risen an impressive 17.49% in Dollar terms.

Europe

Brexit uncertainty continues to plague Britain as negotiations continued throughout the month. Despite this, the British Pound Sterling has appreciated against both the US Dollar and Euro, gaining 0.55% and 0.51% respectively, and the FTSE 100 Index grew by 1.14% in September in GBP. The Bank of England left their Official Bank Rate unchanged at 0.75%, in line with market expectations, while UK GDP dipped marginally from 1.3% to 1.2% year-on-year in the second quarter of the year. Other European bourses had mixed results, as the German DAX Index fell 0.95%, the French CAC Index gained 1.74% and the Italian FTSE MIB Index grew 2.51%. During the month, the European Central Bank (ECB) left its Main Refinancing rate unchanged at 0.00%, noting that inflation is starting to slowly show signs of recovery and the euro area economy's expansion is ongoing. The ECB has however made mention of slowing down with its asset purchase programme, moving from EUR30bn to EUR15bn, with the goal of ending it entirely in December this year.



Asia

Asian markets were largely positive over the month, regardless of the US trade war which is still fresh in everyone's mind. The Nikkei 225 Index grew by 6.07% in Japanese Yen, reversing its disappointing trend from the beginning of the year until August. The Chinese Shanghai Composite Index added 3.67%, while the Hong Kong Hang Seng Index added a paltry 0.05%. Japanese second quarter GDP was in line with the Bloomberg survey figure of 0.7% (quarter-on-quarter), while August CPI ticked up year-on-year from 0.9% to 1.3%. Chinese inflation has also grown marginally year-on-year in August, reaching a level of 2.3% from its previous figure of 2.1%. Manufacturing PMI in China disappointed slightly in September, slowing to 50.0 from 50.6 in the previous month.

Local Market Overview

Local Equities

The JSE All Share Index (ALSI) ended the third quarter on a very weak note, finishing 4.17% lower for the month of September. All the major indices ended the month lower, except for the resource index, which continues to outperform

for the year. The industrial index was the main drag on performance in September, with some very large moves from some well-known blue chips. On the local economic front, second quarter GDP figures released during September were worse than expected, and the negative growth for two consecutive quarters technically puts the

South African economy in a recession (although many have been feeling the recessionary effects for years!). Both the BER Business Confidence Index, as well as the SACCI Business Confidence Index fell for the quarter and month, respectively. Consumer inflation surprised to the downside, recording an increase of 4.9%, whilst the producer inflation surprised

to the upside at 6.3%. The South African Reserve Bank (SARB) met during the month, and kept interest rates on hold at 6.5% as many had expected. Of the seven committee members that voted, three voted for a rate hike, and this leads us to believe that we could see a rate hike towards the middle of 2019.

The ALSI's decline in September resulted in a -2.17% return for the quarter, as all the gains leading into September were wiped out. It has been a frustrating year for most local investors, and as we head into the final quarter of 2018, the ALSI has delivered negative returns (-3.84%) year-to-date. At Warwick, we are however, not too concerned about what "the market" is doing, and instead we focus on identifying quality companies, that have low financial risk and strong management teams, and are attractively priced. When we find businesses that meet our criteria, we look to accumulate these businesses for the long-term, and let our clients enjoy the very powerful effect of compounding returns over time.

RESOURCES - Resources cooled off slightly in September, only adding 0.38% for the month. This takes the total return to 24.09% year-to-date. A stronger Rand hurt returns during the month, as the exchange rate ended the month at ZAR14.14 per US Dollar. Commodity prices showed some resilience over the month, with the Bloomberg Commodity Index rising by 1.75% in USD. Platinum also enjoyed a good run, rising by 3.57% in USD, helping push counters like Impala Platinum Holdings up over 53%. Gold didn't fare as well, as the price continued to disappoint, closing out the month at USD1190.88 per ounce, a decrease of 0.86%. A new rendition of the Mining Charter was released during the month and has provided some regulatory certainty, but has not seemed to increase the incentive to invest within the industry.

INDUSTRIALS - The INDI25 fell precipitously in September, and is now back at levels last seen in June 2017. The stronger Rand put pressure on many of the large multinationals, with some

large moves resulting in the index falling 8.07% for the month. The most notable move was the 41.88% decline in Aspens' share price, as the Group released results that disappointed investors. The Pharmaceutical company also announced they would be selling their infant formula Nutritional business, with many investors disappointed at the price tag, and concerns around whether this was a forced sale, in order for the Group to reduce the growing amount of debt on its balance sheet. Other large downward moves came from Rand hedge companies such as Mediclinic, Richemont, AB Inbev and Naspers, whilst some of locally focused players, such as Imperial, Bidvest, Clicks and Spar, also came under significant pressure. The INDI25 was the worst performing index during the quarter, dropping 8.25%. For the year-to-date, the INDI25 is now down double digits, having fallen 11.8%. Towards the end of the month, we increased our weight in Mediclinic and MTN in certain models, as we believe these two companies are trading at attractive levels for long term investors. Naspers was trimmed in certain models, in order to fund the purchases.

FINANCIALS - After being down for most of the month, the FINI15 started recovering towards the end of the month. Despite the stronger Rand, the recovery didn't hold, and the FINI15 ended 1.96% in the red. Short-term insurer, Santam, was the top performer, adding 8.5% for the month. Investec Ltd. added 3.49% after the Group announced they would be spinning off their Asset Management division. MMI Holdings was the top performing life insurer, adding 1.22%, whilst Liberty Holdings was the worst performer, falling 3.12%. In the banking sector, Capitec was the only player to finish in the green, adding 2.14% on the back of its interim results. The big four banks all ended in the red, and dragged the overall index lower. Absa and Standard Bank were the worst performers, declining 6.57% and 6.09%, respectively. The FINI15 ended the third quarter in positive territory, adding 4.2%, but is still down 3.8% year-to-date.

LISTED PROPERTY - The local listed property market reversed its gains made during the previous month to end the period in negative territory. The Property Total Return index was down 2.6% dragged lower by some of the large cap stocks such as Growthpoint and Hyprop. Counters with an offshore focus however managed to contain the decline on the back of positive distribution growth.

Property fundamentals remain weak in a low growth environment with very few signs of recovery in the retail sector. The office sector remains a laggard as oversupply increases. The near-term outlook remains volatile but distribution yields are expected to stabilize somewhat for the remainder of the year.

We maintain a diversified mix of property counters in our portfolios. The investment strategy remains focussed in shares that fall within defined quality and liquidity parameters.

LOCAL CURRENCY - Against the United States Dollar, the Rand strengthened by 3.88% over the month. Despite the strong month, the Rand has lost approximately 12% in value against the USD over the course of the year. The United States raised the Federal Funds Target Rate to 2.25% from 2.00%, which had a muted effect on the ZAR/USD exchange rate, while the Bloomberg Dollar Spot Index moved approximately 0.50% against major currencies globally. The Rand wasn't the only emerging market currency which started to strengthen, with the MSCI Emerging Markets Currency Index gaining 0.59% in USD. Against the British Pound Sterling, the Rand has gained 3.24%, against the Euro it has gained 3.75%, and against the Japanese Yen, it has added 6.28%.

Local Fixed Income

Global bond markets were characterised by rising yields with the 10-year US yield rising 20 basis points to 3.06%, the German 10-year generic yield up 14 basis points to end the month at 0.47%, and the French yield also rising 12 basis points to close the month at 0.80%

The local bond market experienced a volatile month as yields were driven by erratic movements in the currency and emerging markets. Initial Rand weakness saw our local yields rise before recovering on the back of the MPC decision not to change the level of interest rates. The All Bond index ultimately ended up 0.25% for the month.

Inflation linked bonds once again had a quiet month with returns from this asset class being relatively flat for the period.

Even though no rate changes are expected in the near term, the risk of a rate hike in the first half of the new year has risen substantially.

Market Review

Our fixed income outlook for the coming month is detailed as follows:

- Economic growth remains low with most economic indicators showing little signs of robust recovery.
- Currency volatility will continue to be fueled by political and international factors.

- Inflationary pressures caused by higher fuel prices and taxation increases remain a threat.
- Liquidity is strong with institutional cash portfolio holdings at high levels.
- Short term technical trends have swung negative while long term trends are neutral for now.
- Local sentiment is negative and remains prone to political risks.

We focus our attention on value in the long end of the yield curve with selective participation in corporate issuance.

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