ASSET MANAGEMENT House View

This Month's Focus

ADRIAN MEAGER
GM of Asset Management

In This Issue

Offshore investing: A South African perspective.

As South Africans, we have only been allowed to invest offshore for the past 19 years. Pre-democracy, we were limited by rigorous exchange controls as the then National Party government attempted to stem private capital flows out of the country.

Thankfully, in July 1997, exchange controls were relaxed and individuals were allowed to invest R200 000 offshore. This limit has been upped in successive budget speeches to reach the current R10 000 000 per calendar year for individuals of 18 years and older, subject to obtaining a SARS tax clearance certificate.

In addition, individuals of 18 years and older are permitted to transfer up to the limit of R1 000 000 per calendar year without the requirements to obtain a tax clearance certificate.

Individuals younger than 18 years have a travel allowance of R200 000 per calendar year. The significant increase in the individual offshore allowance has coincided with the swift depreciation in the local currency against both the US dollar and British pound.

Notably, offshore investments are a key factor that many investors overlook until the rand takes another steep dive and then invest offshore impulsively rather than while the rand is strengthening, as we are seeing currently.

But why invest offshore?

Key reasons to invest offshore include: diversification of risk, geographic spread, increased investment opportunities and rand hedging.

- **Diversification.** Diversification allows investors an opportunity to spread risk over more than one market with investments in both established (traditionally lower risk) and emerging (traditionally more volatile) markets. A balance of both higher-risk and lower-risk market exposures can provide the growth investors need without taking on excessive risks. Investment planning should involve spreading the risks, whether across currencies, investment vehicles, or markets.
- **Geographic spread.** Geographic spread is investing in different countries at different stages of their growth cycles. Diversifying across several economies is regarded as a way of smoothing-out returns. The South African stock market constitutes around 2% of the world stock market capitalisation, with emerging markets being about 8%, thus it is prudent to invest in larger and more mature markets and not only in emerging markets.
- **Increased investment opportunities.** The offshore investment arena provides increased opportunities, since investors can invest in various countries, products and industries. These opportunities range from foreign currency bank deposits, foreign government and corporate bonds, to shares listed on different stock markets.
- **Rand-hedging.** Inflation has changed investors' attitude towards investments, with the need to continuously generate inflation-beating returns. Diversifying globally could increase inflation-beating returns. When exchange controls were relaxed in 1997, the rate of exchange was R4.60 to the US dollar. Today's valuation represents a 180%

depreciation of the rand against the US Dollar over the following 19 years. The long-term trend line indicates that the rand will continue to devalue against the major developed currencies, thereby creating additional inflation protection.

Yet investors do not always fully understand the different ways to incorporate offshore assets into their portfolios. Below are three ways to incorporate offshore investments in your portfolio.

- **Asset Swaps.** Most asset managers, life insurance companies and stockbrokers are allowed to invest a portion of their assets offshore. Should they not utilise the full allowance of their capacity it is often sold, or allocated to investors. Your funds are physically invested offshore in a vehicle of your choice, in your chosen currency, but the institution would need to repatriate your funds back to South Africa when you want to redeem funds. The funds form part of the balance sheet of the institution you enter the asset swap arrangement with.
- **Feeder Funds.** This is a local unit trust that invests all its assets into an offshore fund or fund-of-funds, with a small portion retained in rand to provide liquidity. The investment is made in rand, is reported in rand and redeemed in rand, while enjoying the gain or loss from both the performance of the fund and the movements in the underlying currency.
- **Foreign capital allowance.** All taxpaying individuals in good standing with SARS over 18 years of age have a single discretionary allowance of R1 million and a foreign investment allowance of R10 million available for investment purposes. The funds are physically invested offshore and may be invested into a broad range of assets, similar to the asset swap, except that the funds do not need to be repatriated, unless you choose to do so.

The three options described above largely achieve the same results, however, there are some important differences, and you should consult with your financial advisor to discuss these and the other important differences. For example:

- Your foreign investment allowance may be retained offshore indefinitely.
- Feeder funds may be taxed on the rand gains or losses when you redeem all, or part, of your investment.
- Asset swaps and foreign investment allowances are generally taxed on the base currency gains or losses.

Offshore investments need to be part of your investment portfolio and should form part of your overall long-term financial plan.

At Warwick, we expect to see the long-term weakening trend of the rand and have positioned our portfolios to take advantage of this trend, while accepting that there may be periods of short-term rand strength in between.

International Market Overview

World markets had a rough October as the MSCI All World Index fell 7.5% for the month and recording the biggest monthly rise in the CBOE Volatility Index (VIX), since March 2018. This was the worst month for equities in almost six years, as more unsettled markets and less monetary stimulus from the central banks to the global economy started to filter through. In addition, the International Monetary Fund (IMF) lowered its growth outlook for both China and the United States as the trade war between the two escalated, and further concerns with respect to US corporate earnings peaking, also impacted on market weakness.

United States of America

The value destruction in world markets was reflected in the US, with the Nasdaq being hit the hardest, ending the month down 9.2%, as its heavyweight constituents were battered (Amazon down around 20%, and Netflix 19%). Both the S&P 500 and Dow Jones were not spared the assault, however, ending October weaker by 6.9% and 5.1% respectively.

On the economic front, even though consumer confidence remains positive, the equity market ignored a strong growth print which indicated that the economy was growing at 3.5% in annualised terms for the third quarter of 2018. Consumer spending remained robust, growing by 4% for the third quarter 2018, the strongest it has been since the fourth quarter 2014 and continues to account for two thirds of the US economic activity. In an indication that inflation was being kept in check, personal consumption expenditure (PCE), grew by 1.6% for the third quarter, less than the anticipated 2.2% increase.

Of concern to world markets is the continued escalation of the trade war between the US and China, with the US increasing the tariff on 25% of all Chinese goods imported into the US, with China

retaliating by imposing a 100% tariff on all goods imported into the country. Analysts believe that that this course of action could possibly lead to global GDP being cut by 0.4%, while growth in the US and China could potentially be weaker by 0.4% and 0.7% respectively.

Europe

European markets, like their US counterparts, were not spared the rout, as all the major indices ended the month deep in the red. President of the European Central Bank (ECB) Mario Draghi, indicated that asset purchases would soon end, even as the GDP print for the third quarter came in at 0.2%, as opposed to the expected 0.4%. Further uncertainty was caused by political anxiety, as Italy was downgraded to a negative outlook, and Germany faces an increase in domestic uncertainty, with waning support in a key regional election for the centrist parties.

UK markets ended the month lower by 5.1%. Brexit continues to hog the limelight with the deadline to leave the EU drawing nearer and the prospect of a deal with the European Union diminishing by the day. Commenting in his budget statement, Chancellor Phillip Hammond pointed out that a 'soft' Brexit deal could possibly lead to a further upgrade in growth and revenue forecasts. On the flip-side, a 'no-deal' Brexit could potentially lead to the announcement of an emergency budget, and the UK's fiscal course being reset.

The last European Council meeting set for 2018 is to take place between 13th and 14th December and is the last date practically possible for the conclusion of a Brexit deal. Essentially the Withdrawal Treaty must be supported by at least 20 of the 27 EU countries, and 65% of their population for it to be concluded.

The DAX 30 ended the month lower by 6.5%, as Angela Merkel indicated her intention not to stand for re-election as party leader but staying on as Chancellor.

In Germany, inflation accelerated to its fastest level since January 2012, despite economic growth slowing, sending mixed signals to the European Central Bank (ECB), as it looks to rein in stimulus in the Eurozone. Consumer prices rose to an annual 2.4% in October as opposed to the 2.2% in September and in line with the expectations of economists. The build-up of price pressures in the largest European economy adds credence to the ECB's plan to cap their bond-buying programme by December, although this is now playing out against the backdrop of a slowdown in economic momentum, not only in Germany, but also the region. This slowing of the economy was reflected by a decrease in unemployment to a seasonally adjusted 11 000 people, marginally less than the 12 000 forecast, while the jobless rate stayed at 5.1%.

The CAC 40 also closed the month lower by 7.3%, even as the French economy continued to accelerate in the third quarter, rebounding from a sluggish first half, largely due to the strongest consumer performance in a year. The increase of 0.4% in GDP was almost twice as fast as the previous period, yet still slightly below the 0.5% forecast by economists. A composite PMI rose to 54.3% in October versus 54.0 in September, as services demand increased while demand for French manufactured goods, most notably in the auto sector, fell to the lowest in four months. This decline in auto manufacturing was reflected in Renault reporting a larger-than-expected drop in third quarter sales, as emerging market turmoil impacted its business.

Asia

The Chinese markets recorded another poor performance for October, with both the Hang Seng and Shanghai Composite ending the month weaker. The Hang Seng, was lower by 10.1% and the Shanghai Composite Index ended down 7.8%. Economic data out of China has indicated that official Chinese manufacturing purchasing managers index (PMI), came in lower, missing expectations with manufacturing growth coming in at 50.2, a weaker than expected level, and at its lowest level since July 2016. The Chinese GDP data printed earlier in the month also pointed to a slowing trend as third quarter number came in at 6.5%, highlighting the impact the trade conflict with the US is having on the economy.

The Nikkei also ended the month in the red, down by 9.1%, even as the Japanese Central Bank maintained its course on monetary policy, while indicating that it will miss its inflation targets for years to come. The Japanese central bank (BoJ), left both its policy interest rates and asset purchase targets unchanged, while indicating that the inflation rate will remain below the 2% level until at least 2021. The BoJ is expected to implement an increase in sales tax from 8% to 10%, but with the expectation that the effects this time would be softer than that in 2014. The BoJ intends keeping its 10-year yield on Japanese government debt at around zero percent as it continues to try and stimulate price growth in the economy by controlling both short and long-term interest rates.

Local Market Overview

Local Equities

Heading into the final stretch of 2018, the JSE All Share Index (ALSI) continued its disappointing performance in September, falling another 5.8% in October. Major market indices were red across the board, with the industrial index once again underperforming, while the listed property index was the best performer for the month. Year-to-date, the ALSI has now declined 9.38%. Here at Cadiz, we do not own the market, but instead invest in quality companies, that have low financial risk, strong management teams, and are attractively priced. The sell-off experienced over the last couple of months has provided us with the opportunity to buy quality companies at lower prices and should contribute positively to future longer-term performance.

In economics, South African retail sales increased 2.5% year-on-year, coming in stronger than expected. Consumer inflation increased 4.9%, slightly ahead of expectations, while producer inflation increased in line with market expectations at 6.2%. The SACCI Business Confidence index ticked up for the month, as the third quarter unemployment rate rose to 27.5%.

RESOURCES - Resources struggled during October, slipping by 4.24%. This has done little, however, to dent its year-to-date performance, with the JSE Resources Index still managing to add 18.83%. The index was weighed down by laggards Sasol and Kumba Iron Ore, which backslid 11.60% and 9.96% respectively. Commodity prices in general took strain, with the Bloomberg Commodity Index falling 2.36% in US dollars. Precious metals fared slightly better, as the platinum price rose by 2.57% and gold by 2.00% in dollars. The increase in these prices helped boost sentiment towards counters like Anglo American Platinum and Harmony Gold, which added 4.31% and 19.61% respectively. In other news, BHP Billiton has announced that it plans to buy back USD5.2bn of its shares, which has been well received by the market, despite the share price easing 4.06% into the red for the month.

INDUSTRIALS - The INDI25's horrid year continued in October as the index slumped another 8.4%, following the c.8% fall in the previous month. Naspers, which makes up over 30% of the index, was the main contributor to the decline as the tech and media giant was the worst performer, falling 15.04%. The Naspers share price continues to take direction from the Tencent share price, which fell 17.3% for the month. Other Rand hedge shares that experienced large downward moves were AB Inbev, Mediclinic, Richemont, Bidcorp and Aspen. On the upside, Clicks was the top performer, boosted by a solid set of results in a very tough economic environment. The pharmacy, health and beauty retailer gained 7.43% followed by Woolworths, Netcare and Mr Price.

FINANCIALS - The FINI15 ended lower for a third consecutive month, declining 4.1% in October. The financial sector in general was very weak, with only one share in the index ending in positive territory. Old Mutual managed to gain 3.44% as the diversified financial services company completed the final step of its managed separation process. During the month, Old Mutual unbundled its majority interest in Nedbank, leaving it with a 19.9% interest in the banking group. On the downside, insurers Discovery and Sanlam ended 7.10% and 6.13% lower. On the banking side, Investec Ltd. and Standard Bank were the worst performers, falling 7.8% and 6.67%, respectively, while Absa was the best performer despite declining 1.82%. We believe the likes of Absa and Standard Bank are looking quite attractive at current levels and have been increasing their weight in certain funds.

LISTED PROPERTY - The local listed property market once again ended the month in negative territory, losing 1.69% over the period. Losses were experienced across the board as prices declined in tandem with a weaker equity market. Counters with an offshore focus manged to temper some of the decline, but still ended in negative territory.

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 is still volatile, but distribution yields are showing some signs of stability.
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 - The rand ended the month at ZAR14.79 against the USD, depreciating by 4.31% over the period. The Medium-Term Budget Policy Statement delivered by the newly-appointed Finance Minister, Tito Mboweni, generally disappointed market pundits, adding volatility to the currency.

Despite South African inflation remaining within the South African Reserve Bank's targeted 3-6%, at 4.90%, external pressures remain.

The trade balance dropped from a positive ZAR8.8bn in August, to negative ZAR3.0bn in September, while manufacturing production slowed from 1.6% to 0.1% in August. The rand wasn't the only emerging market currency taking strain, however, as the MSCI Emerging Markets Currency Index back-slid 1.13% in October. The US dollar has continued to show strength against emerging and developed market currencies, with the Bloomberg Dollar Spot Index gaining 2.30% over the month in USD. The rand depreciated against most major currencies globally, -1.81% against the European euro, -5.00% against the Japanese yen and -2.21% against the British pound.

Local Fixed Income

Market Review

The month of October was characterised by further selling of emerging markets, currency volatility and closer to home, a disappointing Medium -Term Budget Policy Statement delivered by the newly-appointed Minister of Finance, Tito Mboweni.

Global yields were mixed as the 10-year US yield rose another 8 basis points (bp), while its German counterpart declined by 9 bp. The Italian 10-year generic yield rose to end the period at 3.43%

Foreigners remained net sellers of our bonds, with outflows of R9bn recorded for the month of October. Most of the negativity was experienced in the mid and long-end of the curve, with the R186 losing 1.17% and the R2048 down 2.23% for the month. The All Bond Index was down 1.66% for the period.

Inflation linkers had a positive month, supported by the uplift of the June to July CPI prints. Real yields drifted higher on the back of increased auction sizes announced to commence in the month of November.

Event risk continues to rise as the potential for a ratings downgrade looms and a rise in interest rates remains a threat.

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 remain negative while long term-trends indicate a negative bias.
- Local sentiment has been buoyed by an inspired investor conference, but could wane very quickly.

We continue to seek value along the yield curve with careful duration risk positioning of our portfolios.