FUNDAMENTALS

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ASSET MANAGERS NEED **FULL FLEXIBILITY TO NAVIGATE CURRENT INVESTMENT ENVIRONMENT**

HYWEL **GEORGE** | DIRECTOR OF INVESTMENTS

ABOUT **THE AUTHOR**

Hywel is responsible for the investment performance delivered by Old Mutual Investment Group's listed asset management cluster. He has worked at leading global institutional and private client asset management companies across the globe. His experience spans 25 years in asset management in Europe and the Middle East.

The global asset management landscape continues to evolve at a faster pace than ever before. And while one should avoid reacting to the unrelenting news flow or "noise" in the markets, there are certain macroeconomic events that do call for fleet of foot, with recent events in South Africa being a case in point.

The seemingly relentless pace of political and economic events unfolding in the country currently means that asset managers are required to be significantly more nimble in their decision-making and investment approach. As the risk of a multiple sovereign debt downgrade becomes more likely, the ability of fund managers to act swiftly is even more pertinent.

Against this backdrop, it is crucial that asset managers should be able to adapt in order to navigate financial markets successfully and deliver to client expectations. A multi-boutique structure, allowing for more flexibility than a larger asset manager, enables a fund manager to do this.

In the case of Old Mutual Investment Group's structure, we organise our fund managers into small, focused teams of boutique asset managers, entirely focused on their clients' outcome. The fund managers invest a significant portion of their personal income in the portfolio they manage and benefit from short lines of decision-making within their small, focused teams. This means that they are completely aligned with the client outcome in terms of their own wealth provision.

This lean organisational structure of sensibly sized teams, as well as an appropriate amount of assets under management, also allows for increased focus – something that goes hand in hand with the differentiated and disciplined investment processes employed by boutique funds. It is these unique processes that drive investment autonomy and enable our boutique fund managers to make investment decisions based on independent, original research. In this sense, our boutiques are entirely distinct entities and can take their own view of the market – a level of independence that keeps talented fund managers fully focused on delivering to clients' expectations.

Indeed, if you take our particular structure, which is a pure boutique model, in the sense that the fund managers themselves have direct equity ownership in their own boutique, we are only aware of two other players globally – namely Affiliated Managers Group (AMG) and Legg Mason, both of whom are in the United States – who go as far as we do in terms of the alignment of our fund managers with the end client outcome.

The alignment mechanism is strongest when it comes to delivering performance, client service and business success. This is because the fund managers benefit directly through profit participation in their own boutiques and also through the equity they own in that boutique.

South Africa is a highly competitive environment in terms of asset management, and to succeed asset managers need all the right tools. Given the current economic backdrop and uncertain market outlook, the multi-boutique model offers a remarkable competitive edge through the facilitation of the kind of increased flexibility necessary to navigate this environment. The success of the model is reinforced by investment performance, in that we've been able to demonstrate consistent value added over the 10 years since the launch of the boutique structure.

In short, our investment model aligns us completely to the client, as we do not prosper unless they do. We are, ultimately, as invested as they are.

KEY TAKEOUTS:

- ASSET MANAGERS NEED TO BE MORE NIMBLE IN CURRENT ENVIRONMENT
- A MULTI-BOUTIQUE STRUCTURE ENABLES DECISIVENESS AND INCREASED FLEXIBILITY
- LEAN STRUCTURES AND SENSIBLY SIZED TEAMS ALLOW FOR INCREASED FOCUS
- DIRECT EQUITY OWNERSHIP ALIGNS FUND MANAGERS WITH END-CLIENT OUTCOMES

US DOLLAR SLIDE CONTINUES **AMID POLITICAL GRIDLOCK AND DOVISH FED**

TINYIKO **NGWENYA** | OLD MUTUAL INVESTMENT GROUP: ECONOMIST

ABOUT **THE AUTHOR**

Tinyiko is our young, up-and-coming and dynamic economist, working alongside Johann Els and Rian le Roux. It is her fresh take on everything to do with economics that adds original insight to our macroeconomic analysis.

KEY TAKEOUTS:

- GLOBAL MONETARY SUPPORT EXPECTED TO TAPER
- US DOLLAR SUFFERS AS TAX REFORM HOPES FADE
- WEAK US DOLLAR GOOD FOR EMERGING MARKETS

While the global economy ended the second quarter on a solid footing, supporting investor sentiment, a stream of more hawkish comments by a number of central banks served as a reminder that the extended period of broad-based and extreme monetary support is coming to an end.

Another global feature has been the relentless weakening of the US dollar, despite the US Federal Reserve (Fed) leading the global policy normalisation cycle. A soft US dollar is, of course, a boon to emerging markets as it tends to support commodity prices and reduce pressure on emerging market currencies. As a result, capital flows into developing countries have remained buoyant in recent months. The key factors undermining the US dollar are the political gridlock in Washington (raising concerns over the timing and size of the long-awaited stimulatory tax reform), reduced concern over a more aggressive Fed (as US inflation remains tame amid a tight labour market), and the European Central Bank (ECB) indicating that it, too, is considering tapering asset purchases perhaps from early next year.

TRUMP PROMISES FAIL TO MATERIALISE

It's no secret that US President Donald Trump has had a disappointing start to his presidential term, with the failure of the latest Obamacare repeal raising doubts as to whether the administration will, in fact, be able to implement much of its promised policies, particularly on the fiscal policy front. The US dollar surge late last year was mainly on the back of the perceived positive impact that proposed fiscal stimulus would have on both growth and company earnings, as analysts made upward revisions to their US growth forecasts. Consequently, as optimism over tax reform faded, the US dollar came under pressure.

INFLATION AND RETAIL SALES DISAPPOINT

The US dollar was also negatively affected by growing doubt over whether the Fed will raise interest rates again this year. A combination of the Fed's plan to start slowing asset purchases later in the year and subdued macroeconomic data are driving the softening interest rate view. With the closely watched core PCE (personal consumption expenditure) deflator measure (inflation excluding food and energy) at only 1.4%, weak US inflation implies that the Fed is not achieving its 2% inflation target. In addition, annualised GDP growth during the first half of 2017 was just less than 2%, indicating that the economy is not overheating – warranting a less aggressive Fed. With the unemployment rate at a historically low 4.4%, it appears that the labour market is the only strong signal at present keeping the Fed on course to hike rates one more time this year – even though labour market strength has not convincingly translated into a pick-up in wage growth and consumer demand. Retail sales have been flat since the start of the year and vehicle sales have been trending weaker in recent months. If the market is right about the Fed's likely course of action, then the key case for a strong US dollar (i.e. rising interest rates) is considerably weakened.

EUROPE RECOVERY SPELLS AN END TO QE

Growing expectations that the ECB will soon announce plans to begin paring back monetary stimulus in January 2018 has also played a role in explaining the US dollar's recent weakness. The underlying improvement in the Eurozone economy is clearly reflected in the June unemployment rate falling to an eight-year low of 9.1%. While the Eurozone remains on a recovery path, inflation is pretty subdued, with the core CPI hovering around 1.2% for July and well below the ECB's 2% target. Still, the firming and spreading Eurozone recovery is paving the way for the ECB to follow the US Fed in starting to roll back monetary stimulus through a slowdown in the pace of asset purchases.

We ended last month's review with the conclusion that a better Europe and a less aggressive US Fed would bode well for emerging markets through a softer US dollar – a view that we have held for some time now. While this view is clearly playing out, market focus is shifting to the inevitable tightening in global liquidity conditions – as first the US Fed and then the ECB starts to wind down asset purchases in coming months. While this indeed holds risks to relatively elevated asset prices, we do not think it portends a premature end to the global equity bull market, largely because global growth is firming, which will support corporate profitability.

Inflation and GDP data sourced from FactSet

RECESSION IS LIKELY OVER, **BUT NO REVIVAL IN SIGHT**

JOHANN **ELS** | HEAD OF ECONOMIC RESEARCH

ABOUT **THE AUTHOR**

Johann was recently appointed Head of Economic Research and is responsible for all local and global macroeconomic research. Specific focus areas include the rand, inflation, interest rates and fiscal matters.

KEY TAKEOUTS:

- GOVERNMENT RELEASES GROWTH RESCUE PLAN
- SARB CUTS RATES AND LOWERS FORECASTS
- WE EXPECT SECOND QUARTER GDP GROWTH TO REBOUND

The widely anticipated ANC National Policy Conference took place in early July. Even though the National Development Plan (NDP) was affirmed as the governing party's growth policy guide, very little was actually decided at the conference. However, it is probably positive that relatively moderate views prevailed and that there did not seem to be a lot of appetite for radical policy changes.

ALL THE NEW ACTION PLAN NEEDS IS ACTION

Mid-July saw Finance Minister Malusi Gigaba release Government's Inclusive Growth Action Plan, with the key focus areas addressing:

1. Weak growth and the impact on the fiscal framework;
2. Rising government debt;
3. The state of the state-owned companies and risks to contingent liabilities; and
4. Policy uncertainty and low confidence levels.

While the plan's focus areas are on target, it is difficult to be overly optimistic on implementation – as this is where previous plans also fell short. Nevertheless, it seems that Minister Gigaba and his Treasury colleagues are agreeing on the big issues and risks for the SA economy – and have convinced the ANC to support this plan.

In a further positive development, the Minister of Mineral Resources had to suspend the implementation of the new Mining Charter after severe criticism from the Chamber of Mines, the ANC and the National Union of Mineworkers, among others.

SURPRISE AS SARB SPRINGS INTO ACTION

Moving on to an area we have highlighted a few times over the past several months: the need for lower interest rates. Ever since May 2016, we have warned that inflation will fall sharply during the course of 2017. We said that this trend, combined with a weak economy and a more stable currency, as well as a lower current account deficit (thanks to a much more supportive global economy), should provide the South African Reserve Bank (SARB) with the opportunity to cut interest rates during the second half of 2017. The need for lower rates became ever more pronounced when the economy dipped into recession during the first quarter of this year, inflation slowed more rapidly than even we expected (we now expect a rate of around 4.6% for July) and even the current account deficit surprised on the positive side. As the Reserve Bank governor continued with very hawkish comments in the lead-up to the July policy meeting, we noted that the SARB was running the risk of making a policy error.

However, they then surprised the market with a rate cut after markedly lowering their inflation and growth forecasts. Even though the usual political, policy and credit ratings risks remain, we expect another three 25 basis point rate cuts in this cycle – another one later this year, with a further two cuts forecast for the first half of 2018.

RECESSION IS OVER

I probably don't need to remind you that the economy was in a recession during the last quarter of 2016 and the first quarter of this year. At the time of the release of the first quarter GDP data, we noted that the widespread nature of the weakness (with only the mining and agricultural sectors recording positive growth) was totally unexpected and that perhaps the economy would rebound after likely seasonal distortions. The high frequency data that is available for the second quarter allows us to start building a forecast of better, and quite likely, positive GDP growth. Examples of some of the available data from StatsSA are mining production at +2.6%, manufacturing production +6.2%, electricity production +12.1%, retail sales +7.7% and freight transport +8.4% (all numbers quoted are quarter-on-quarter annualised growth rates). Of these sectors, retail sales, manufacturing production and electricity production all recorded negative growth during the first quarter. With some June data still outstanding, we expect total second quarter GDP growth to come in around +2.4% annualised, up from the -0.3% recorded in the first quarter.

Although this means an end to the recession, growth is clearly still weak and a mild interest rate cycle will, at best, help lift confidence a bit. Political and policy reform remains key to lift confidence and growth.

LOW GROWTH **A BLOW TO FISCAL CONSOLIDATION**

WIKUS **FURSTENBERG** | PORTFOLIO MANAGER AT FUTUREGROWTH

ABOUT **THE AUTHOR**

Wikus manages a range of institutional and retail fixed income portfolios, which include income, core bond and flexible interest rate funds. He also heads up the Interest Rate team at Futuregrowth Asset Management.

KEY TAKEOUTS:

- TAX SHORTFALL AND OVERSPENDING RAISE BUDGET DEFICIT
- GROWTH AND FISCAL OUTLOOK NEGATIVE FOR CREDIT RATINGS
- FOREIGNERS ARE OVERLOOKING SA WOES

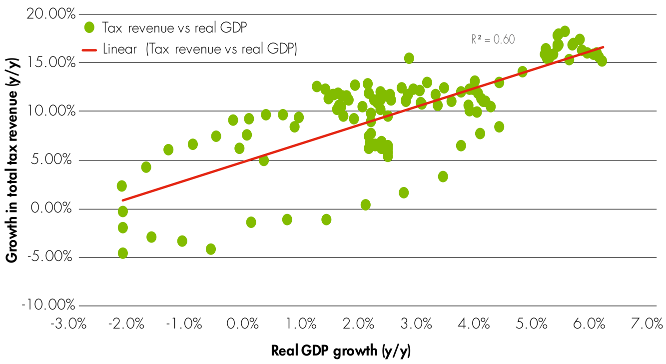
Following the sharp upward correction in yields during the last week of June – when markets were spooked by the European Central Bank president's remark implying that the bank may be nearing the end of exceptionally loose monetary policy – developed global bond markets stabilised. During July, nothing of material interest came the way of market participants to cause another major shift in expectations.

LONG BONDS UNMOVED BY SURPRISE RATE CUT

Locally, the South African Reserve Bank (SARB) surprised most analysts, including us at Futuregrowth, with the 25 basis point (bp) repo rate reduction. In our view, the local bond market responded appropriately – as short- and medium-dated bonds moved in tandem with the cut, while long-dated bond yields ended July at similar levels to the previous month's close. During July, the yield of the benchmark 10-year RSA government bond traded in a fairly wide range of 8.50% and 8.93% before closing the month at 8.61%, or 17bps lower than the June close. In contrast, the long-dated R2048 (maturity 2048) closed the month at 9.86%, a mere one basis point below the previous month's close. The back end of the bond market is not sold on the rate cut and also remains concerned about the fiscal outlook – a view we share. The latest monthly government finance data confirmed these concerns, as the combination of a growing tax revenue shortfall and an expenditure overrun caused a larger than expected budget deficit for the first three months of the 2017/18 fiscal year.

Low real GDP growth will negatively impact tax revenue collections, in turn putting plans for fiscal consolidation at risk. This may force Government to sell more bonds in order to finance the shortfall.

TAX REVENUE COLLECTION AND REAL GDP (MARCH 2006 - MARCH 2017)



Sources: Bloomberg, Futuregrowth

BUYERS ARE BACK. NO WAIT, THEY NEVER LEFT

Despite the larger deficit, the higher nominal yield offered by the local bond market, new-found global bond market stability and the repo rate cut enticed foreign bond investors to turn net buyers of rand-denominated government nominal bonds, to the tune of almost R10 billion in July. This more than reversed the net selling in June and lifted net nominal purchases for the first seven months of the year to R52 billion, or nearly 50% of the total outstanding rand-denominated debt issued by the South African government. This is a very significant holding considering that it is 5% higher than the combined holding of the South African banking, long-term insurance and pension fund industries. It also clearly illustrates that the average foreign bond investor does not share the same concerns we have in respect of persistent low growth and its negative implications for fiscal consolidation and South Africa's sovereign credit rating profile.

Although the rate of inflation at both consumer and producer levels continued to decelerate, the inflation-linked bond market managed to consolidate its long losing streak that started in April last year. The yield of the benchmark R197 (maturity 2023) actually declined 8bps to close July at a yield of 2.47%.

As a result of the above developments, the JSE All Bond Index (ALBI) rendered a total return of 1.5% for the month of July. This is significantly better than cash (0.6%) and the JSE Inflation-linked Government Bond Index (IGOV), which only managed a mere 0.1%. The ALBI is leading the pack for the first seven months of this year, with a very respectable 5.6%, especially considering the number of supposedly bond bearish events over this period. An investment in cash would have rendered a return of 4.0% over the year to date. The global reach for yield has, once again, saved the day.

FUTUREGROWTH VIEW

The modest global economic recovery sets the scene for limited inflationary pressure and a steady monetary tightening cycle for the few economies that are in a position to normalise policy. Our view remains that global bond markets, in general, are not appropriately priced, leaving room for rising yields.

Locally, the downward trend to inflation is entrenched, supported mostly by significantly lower food price increases, with weak consumer demand also playing a role. While the SARB has surprised many with the timing of the recent cut, we still believe that a strong easing cycle should not be pursued. The external trade imbalance, albeit improving, is still too big to allow for a significantly lower real repo rate.

Our main concern remains the strong link between the local low economic growth backdrop and tax revenue collection. Persistent sub-trend economic growth and macro policy uncertainty have negative implications for fiscal consolidation and eventually sovereign credit ratings.

Negative ratings momentum in the medium to longer term, caused mainly by sustained sub-trend economic growth and uncertainty about the fiscal outlook, does not match the continued aggressive accumulation of local currency bonds by foreign investors. This mismatch presents a potential lethal mix for the local bond market. Considering this, we shall continue to approach the market with extreme caution.

Unless otherwise indicated, performance figures in the article are sourced from Futuregrowth and I-Net Bridge (Pty) Ltd

SA'S POTENTIAL AS **A TOP EMERGING MARKET BUY YET TO RIPEN**

FEROZ **BASA** | JOINT BOUTIQUE HEAD

ABOUT **THE AUTHOR**

Feroz is the joint boutique head of the Global Emerging Markets boutique. His passion for investments has seen him managing local and global portfolios for over 10 years. He is currently jointly responsible for managing this investment boutique and the Old Mutual Global Emerging Market Fund.

In the first quarter of 2017, the average GDP growth experienced by emerging markets was around 4%, while South African GDP growth came in at a dismal -0.7% as the country entered into a technical recession. For a foreign investor looking into emerging markets, South Africa isn't a very attractive prospect at this point. However, pockets of market value are likely to emerge.

When it comes to South Africa's macro economy, the worst isn't over yet, but the deteriorating economy is expected to yield more market opportunities – as the local equity market is still not looking very cheap compared with other emerging markets.

In managing the Old Mutual Global Emerging Market Fund, we remain considerably underweight to South African stocks. In terms of pure South African companies, we only hold ABSA and Netcare, which make up about a 4% weighting in the Fund (compared with the roughly 8% South Africa constitutes within the MSCI Emerging Markets Index).

We've been fundamentally vindicated for this underweight position in SA stocks, considering that the MSCI Emerging Markets Index has delivered 9.7% in rand terms for the 12 months to the end of June 2017, while the JSE Shareholder Weighted All Share Index (SWIX) was up only 0.4%.

Despite this underperformance, the South African market is now trading on a forward price earnings multiple of 15.3 times versus the MSCI Emerging Markets Index on 12.8 times (as at August 2017). The emerging markets composite as a whole is still cheaper than the local market.

This implies that while the negative sentiment around South Africa is slowly starting to feed into companies, none of these companies have de-rated to a level that would position South Africa as a screaming buy right now. However, despite the local market having been fairly resilient recently compared with other emerging markets, a continued decline of performance should create better buying opportunities.

GOOD GOVERNANCE PROTECTS SA COMPANIES

South Africa, in the emerging market context, has excellent, world-class companies with good corporate governance standards and first-world financial systems, which allow money to flow into and out of the country. While this has largely protected us from any major corporate decline, the market does appear to be turning and is beginning to underperform. This underperformance is what will trigger value in South Africa from an emerging markets perspective.

Unless something politically significant were to happen that drives up confidence and strengthens the rand, there is more pain to come. Our fear is that the worst is not over yet, with heightened political instability and the potential for another downgrade. However, if the trend of underperformance continues, over time, we expect to see increasingly more pockets of opportunity unfold in South Africa.

Figures sourced from FactSet and Bloomberg

GLOBAL OUTLOOK **IMPROVING, SA STALLS**

PETER **BROOKE** | BOUTIQUE HEAD

ABOUT **THE AUTHOR**

Peter is Head of MacroSolutions, our multi asset-class boutique. He is also fund manager for Profile Edge28 Portfolio, Old Mutual Maximum Return Fund of Funds and Old Mutual Flexible Fund.

KEY TAKEOUTS:

- LONG-TERM RETURNS EXPECTATIONS LARGELY UNCHANGED
- SYNCHRONISED GLOBAL GROWTH TO LIFT EARNINGS
- SA FACES ANOTHER YEAR OF SUB-TREND GROWTH

Every six months we review our longer-term themes and valuations to ensure we don't get caught up in the day-to-day noise of the markets. This is in line with our belief that the ability to outperform lies in taking a longer-term perspective. This review has left expected returns broadly unchanged, while South Africa's longer-term growth outlook has deteriorated.

GLOBAL GROWTH ON THE UP

Our global themes remain unchanged and are continuing to come through – namely, reflation with synchronised global growth leading to strong earnings and strong equity markets. We expect this growth to continue as there are limited signs of overheating and global inflation remains well behaved. The risk to this view is a Chinese hard landing and policy errors from central banks.

SA STAGNATES

South Africa has disappointed relative to our expectations. The two big positive drivers that we were expecting occurred: good rains across most of the region brought an end to the crippling drought and sharply lower local inflation led to higher real incomes. The unexpected ingredient was the dent to confidence inflicted by the firing of then Finance Minister Pravin Gordhan in March this year. This means that although SA's GDP will improve in 2017, it will still be below 1% – resulting in a tough environment for corporate profits.

As expected, the South African Reserve Bank (SARB) has cut interest rates, providing some relief, and we forecast a further 50 basis point decline in rates during 2018. It is clear that the SARB is keeping a close eye on politics while setting interest rates – meaning rates have been higher for longer, which has exacerbated the stagnation of the economy.

Looking forward, political uncertainty will keep investment on the sidelines and mean another year of sub-trend growth. This makes the ruling party's December policy conference a critical crossroads, with potential binary outcomes. We expect the ANC to muddle through, but have used a bar-bell strategy to build our portfolios to manage the risk of unknowable outcomes.

Due to good news internationally and disappointing SA news, we maintain our preference for offshore equity over SA equity. With global interest rates expected to rise and monetary stimulus programmes expected to be wound down, we still find global cash and bonds unattractive. Within SA, we still get good real returns on fixed income assets and lower cash yields should push some investors off the side-lines where they sit with high cash holdings. We think that locally listed property will deliver a decent real return.

Within the different asset classes, our return expectations are as follows:

SOUTH AFRICA

SA EQUITIES

We have reduced our expected real return to 4.5% a year over the next five years, down from 5%. This is due to lower trend growth and a hostile profit environment impacting long-term earnings growth expectations. However, local shares have gone nowhere, which means pockets of value are appearing and we are opportunistically taking advantage of specific weakness and better valuations.

SA PROPERTY

This sector also faces headwinds from a tough economy, but long-term leases and escalations mean that dividends are secure. The locally orientated companies should also benefit from a falling cost of capital (on the back of interest rate cuts). With SA-focused funds yielding 8%, our models show a good real return from property of 5.5% a year.

SA BONDS

Bonds have performed well and, due to our high political risk, offer some of the best real yields in the world. Lower inflation and lower rates are good news from bonds, but we are becoming more cautious over the longer term and have revised our view from being slightly positive to sellers.

SA CASH

Cash has been a tough hurdle to beat, delivering good returns over the past three years. We think rates are too high and, as the economy is on its knees, the SARB will cut rates. This will reduce the available return from cash.

INTERNATIONAL

GLOBAL EQUITY

Strong earnings growth has been good for global equity and we expect continued synchronised growth. However, a lot of the good news is already in the price and it will be more difficult to deliver returns going forward as the bull market matures. This feeds into our long-held theme of a low return world. Our outlook for this asset class over the next five years remains unchanged, and we maintain that global equity offers the best option for real returns.

GLOBAL BONDS

Global bonds are still expensive and the pressure from reducing monetary policy liquidity in the market leaves us bearish.

GLOBAL CASH

Artificially low real returns will normalise. While it is still too early, global cash will start looking more attractive as interest rates rise.

LONG-TERM ASSET ALLOCATION VIEW (JUNE 2017)

	Real Return (p.a.)	View	Comment
SA		**–**	**Good carry and the rand is cheap**
Equity	4.5%	Neutral	Key risk is earnings delivery as economy battles
Property	5.5%	+	Local plays offering good yield
Bonds	3.0%	–	Longer-term risk via credit ratings
Cash	1.5%	Neutral	Local rates have peaked
Global*		**+**	**Offshore diversification attractive**
Equity	5.0%	+	Best option for real returns
Bonds	-1.0%	–	Record low yields = low returns
Cash	-1.0%	–	Cash is trash

* The international return expectations above are in US dollar terms; any rand depreciation will add to returns in rands.

Note: These are long-term real returns expected over the next five years, as at the end of June 2017.

RETAIL THERAPY. **WHAT THE NEXT DECADE HOLDS FOR SA CLOTHING RETAIL**

MERYL **PICK** | EQUITY ANALYST

ABOUT **THE AUTHOR**

Meryl is part of the Old Mutual Equities boutique. Her diverse role includes being responsible for the clothing retail sector as well as packaging manufacturers, heavy equipment distributors and logistics companies. Meryl is also the fund manager of the Old Mutual Gold Fund.

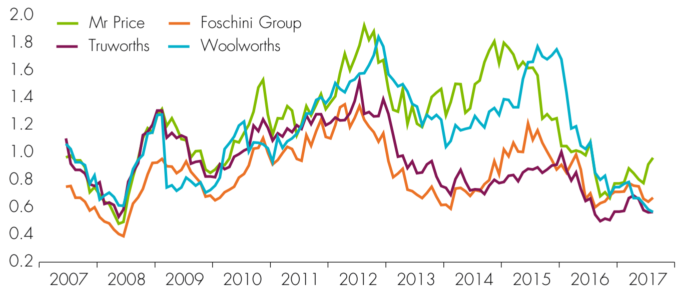
KEY TAKEOUTS:

- IS THE RETAIL SALE A BARGAIN?
- SOUTH AFRICANS ARE GETTING RICHER MORE SLOWLY
- UP TO 50% OF RETAIL SALES ARE ON CREDIT
- GLOBAL RETAILERS ARE CHANGING THE LANDSCAPE

I love a good bargain, but there is always the risk of buying something because it's cheap and not because it adds any value to my life. Today, I'll be discussing a clothing sale of a different kind and unpacking the longer-term value in making a purchase.

In recent months, the price earnings (P/E) multiples of apparel retail stocks relative to the FTSE/JSE Shareholder Weighted All Share Index (SWIX) have tumbled to levels that look temptingly cheap compared with their 10-year history.

COMPANY PEs RELATIVE TO FTSE/JSE SHAREHOLDER WEIGHTED ALL SHARE INDEX



Source: FactSet

ARE RETAIL STOCKS TRULY CHEAP AND A GOOD BUY?

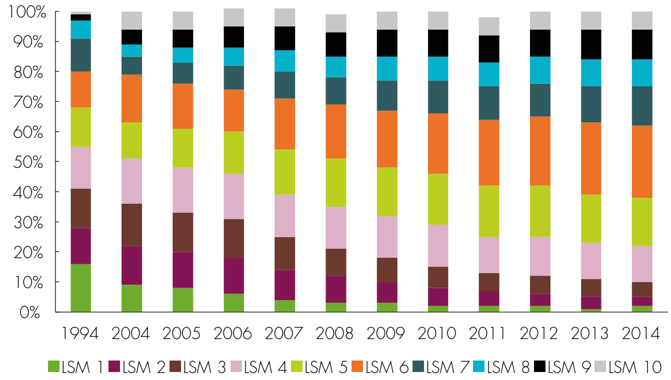
Before jumping to any conclusions, a key question needs to be answered: Will the next 10 years of retail look as good as the past 10 years?

I don't think they will. Here are four things that I expect to be different in the coming decade for South African apparel retailers:

1. South Africans are becoming richer at a slower pace

In the mid-1990s, as South Africans marked the birth of a new democracy, there were also economic reasons to celebrate. South African living standards were improving as a result of growing employment and the roll-out of social grants. The Living Standards Measure (LSM) is a marketing research tool commonly used by retailers as an indication of South Africans' income levels and spending power. The target market for listed national retailers is LSM 6-10. In 1994, 30% of the population was categorised as LSM 6-10. Ten years later, this segment had doubled to represent 60% of South Africans. All retailers were lifted by this rising tide. However, this tide is now receding as the pace of growth in employment and social grant payouts wanes, making growth in the retail sector going forward more of a challenge.

IMPROVING LIVING STANDARDS OF SOUTH AFRICANS (1994 – 2014)

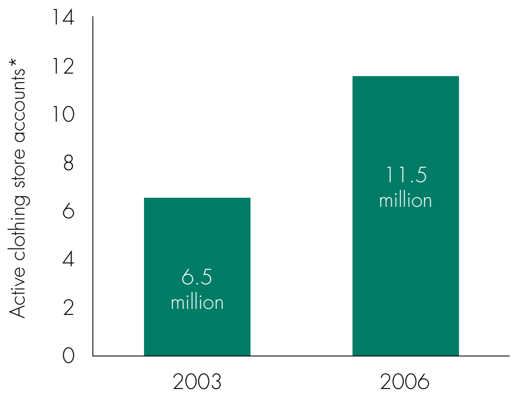


Sources: Renaissance Capital, South African Advertising Research Foundation

2. Store credit will grow at a pedestrian pace

When I graduated and started my first job in 2005, I had no credit card or overdraft facility. However, I opened store credit accounts with Truworths and Foschini. Both clothing accounts came with the option to pay off debt over six months at no interest cost. This was a common thing for not only a young graduate to do, but an increasing number of South Africans. Between 2003 and 2016, driven by growing income levels, the number of store accounts held with national retailers nearly doubled in thirteen years!

EXPLOSIVE GROWTH IN CLOTHING ACCOUNTS



*includes Truworths, TFG, Woolies, Edcon & Mr Price

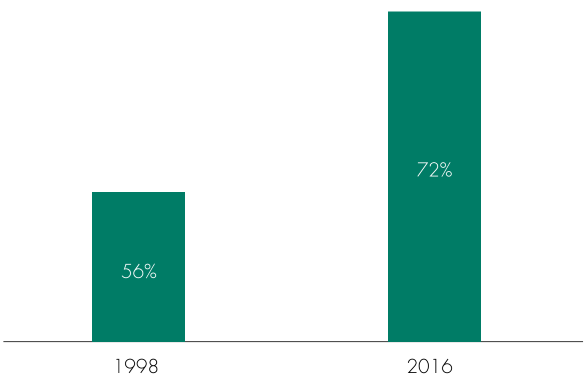
Sources: Deutsche Bank, company reports

The 11.5 million store accounts in 2016 includes the decline in the number of accounts over the previous three years. New credit regulations make it more difficult to open an account, while credit cards and personal loans have also become more accessible, with income thresholds as low as R4 000 a month. At the same time, most store accounts now carry interest charges similar to credit card rates. Some banks also offer close on three years to pay credit card balances, whereas store accounts have to be paid back within 12 months – making the monthly instalments much higher. All the while, as the economy slows, the pool of creditworthy customers has stopped growing. This presents a tougher environment for the likes of Truworths, The Foschini Group and Edcon, with between 30% and 50% of sales being made on credit.

3. **Saturated market offers less "flag-planting" opportunities**
   National retailers have opened, on average, four new stores every month over the past 10 years. Over the past 20 years, national apparel chains have consolidated the retail sector, squeezing out independent retailers by launching new brands or acquiring independent ones. For instance, in 2014 Truworths bought Naartjie and Earth Child. The Foschini Group, on the other hand, has bought Markham, Fabiani and Sportscene, and launched DonnaClaire, Exact and The Fix. Once brands sit within a national chain, their countrywide roll-out is swift… but this trend is running out of steam. In 1998, national retailers held 56% of the SA market share, in 2016 they held 72%. The opportunities for consolidation are dwindling.

GROWTH OPPORTUNITIES DRY UP IN A SATURATED MARKET

NATIONAL RETAILERS' MARKET SHARE OF TOTAL CLOTHING SALES*



*excludes Pick n Pay Clothing & Stuttafords

Sources: SARB, company reports

4. **Global entrants will make retail more competitive (point: margins may come down)**
   Over Christmas 2011, Sandton City customers could shop at Zara for the first time, with Inditex having opened its first South African store in November. The Spanish retailer now has eight stores countrywide. In the same year, Australian retailer Cotton On opened its doors on our shores. Today, Cotton On has upwards of 180 stores in South Africa. The most recent entrant, Swedish retail giant H&M, has opened 10 stores in under two years and is by no means content with that number. Up to this point, South Africa has been dominated by local retailers. Global retailers are changing the local retail landscape by bringing faster access to fashion trends, world-class stores and cutting-edge online platforms often at the same price points or cheaper than the local retailers. Competition is heating up as standards for local retailers rise.

SO WHAT DO WE HANG OUR HAT ON?

The next decade of apparel retail is not going to look the same as the past 10 or 20 years. The post-Apartheid consumer tide has receded. The store credit explosion is over. Global players are raising consumers' expectations of retailers.

Clothing retailers enjoyed a golden decade, but history is unlikely to repeat itself. Only those with the most innovative customer strategies and razor-sharp operations management will thrive this time around. At Old Mutual Equities, relentless research underpins our every investment decision. A disciplined and structured approach to fundamental analysis is essential in identifying and exploiting market inefficiencies – and ultimately extracting alpha. We invest extensively in systems to support our comprehensive research – tracking the long-term history of each share to determine its response under different scenarios. Based on this research we continue to take a "wait and see" approach to the SA retail sector, while holding a position in The Foschini Group, which we believe is well placed to navigate the changing retail landscape.

ECONOMICS **CHOSE ME**

TINYIKO **NGWENYA**

WHAT MADE YOU CHOOSE YOUR CURRENT CAREER?

It's not so much about a certain person who guided me but rather a lightbulb moment that occurred to me in 2014 when I rotated to Futuregrowth Asset Management during my CA(SA) articles. I was sitting in a fixed interest meeting and was fascinated by the conversations around the "China rebalancing" and the US Fed raising rates and what that meant for our bond investments.

It just made sense to me and, more importantly, was intellectually stimulating. I would then go back in the evenings and read up on the various topics to better contribute in the meetings the next day and worked closely with the team, absorbing as much knowledge from them as I could.

Economics chose me and I've never been more grateful to have been given the opportunity by MacroSolutions to work in the Economic Research Unit (ERU) and get paid to do something that I am very passionate about.

WHICH ECONOMIC INDICATOR ARE YOU MOST WORRIED ABOUT CURRENTLY AND WHY?

Growth. At our 2017 forecast of 0.8%, we're not growing enough to integrate young people into our economy. In order to stay profitable, companies have all implemented a hiring freeze, which means that postgraduates, the very skilled individuals that we speak of, are not finding jobs.

WHAT WAS YOUR FIRST JOB?

I joined Old Mutual in January 2013 when I began my Chartered Accountant training.

WHAT DO YOU CONSIDER TO BE THE MOST VALUABLE RECOGNITION YOU HAVE RECEIVED FOR YOUR SKILLS DURING YOUR CAREER?

What makes me smile every day, and gives me assurance, is having someone reply to an email to simply say: "Thank you, that was extremely helpful and/or insightful."

A) It means they actually took the time to go through the work that you put a lot of effort into delivering, and

B) It's small feedback to show you that you are incrementally moving in the right direction.

What I equally value is when a colleague pulls me aside and tells me how I could've done something better. Recognition is great, but it is constructive criticism that truly develops you.

WHO HAS HAD A BIG INFLUENCE IN YOUR LIFE?

I tell him all the time, but Conway Williams, the Head of Listed Credit at Futuregrowth, is the reason I am the person I am today. Before joining Futuregrowth I had the toughest job rotation, so much so that I was ready to pack up and move to another institution. It broke me.

When Conway took me on as his "trainee", he listened. He entertained my curiosity and was unapologetically brutal in his feedback. He also doesn't take life too seriously, which I admire. But when it's crunch time, it's crunch time. I worked my hardest at that time because someone took an interest in me and I can never thank him enough for pushing me to my limit.

WHAT IS YOUR FAVOURITE NON-ECONOMIC PASTIME?

Spending time with my family and friends and just listening to them talk.

MARKET INDICATORS

AS AT 31 JULY 2017

	DY %	P/E Ratio	1 Month %*	12 Months %*
FTSE/JSE All Share Index	2.7	20.5	7.0	7.6
FTSE/JSE Resources Index	2.5	15.6	13.3	10.7
FTSE/JSE Industrial Index	2.8	15.9	5.7	7.9
FTSE/JSE Financial Index	4.5	13.7	5.0	4.8
FTSE/JSE SA Quoted Property Index	6.0	16.8	3.7	3.3
ALBI BEASSA Bond Index			1.5	7.2
STeFI Money Market Index			0.6	7.6
MSCI World Index (R)			3.1	11.1
MSCI World Index ($)			2.4	16.8

*Total return index percentage change

Economic Indicators		Latest Data	Previous Year
Exchange Rates			
Rand/US$	July-17	13.17	13.84
Rand/UK Pound	July-17	17.38	18.28
Rand/Euro	July-17	15.57	15.50
Rand/Aus$	July-17	10.54	10.54
Commodity Prices			
Gold Price ($)	July-17	1269.5	1350.7
Gold Price (R)	July-17	16661.9	18797.1
Oil Price ($)	July-17	52.7	43.3
Interest Rates			
Prime Overdraft	July-17	10.3%	10.5%
3-Month NCD Rate	July-17	7.1%	7.3%
R186 Long-bond Yield	July-17	8.6%	8.6%
Inflation			
CPI (y-o-y)	June-17	5.1%	6.3%
Real Economy			
GDP Growth (y-o-y)	March-17	0.6%	-0.6%
HCE Growth (y-o-y) (Household Consumption Expenditure)	March-17	0.8%	0.6%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	March-17	-0.9%	-3.1%
Manufacturing Production (y-o-y) (seasonally adjusted)	May-17	2.2%	1.6%
Balance of Payments			
Trade Balance (cumulative 12-month)	June-17	$10.7	$12.5
Current Account (% of GDP)	March-17	-2.1%	-5.0%
Forex Reserves (incl. gold)	June-17	$618.4	$683.8

Sources: JSE, Iris, I-Net

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