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NEWSLETTER

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ECONOMIC COMMENTARY - By Francois Stofberg

Economic Update – The Road Ahead

Since our representatives in parliament, who act on our behalf, voted that we (they) still have confidence in our president, Jacob Zuma, I thought it would be good to give you a run on our expectations for the road ahead. Please bear with us, forecasts are based on assumptions and expectations, it's not an exact science and it's quite tough to remain completely objective. At best, we use our experience, and a lot of information and data, to make educated guesses.

We don't expect much from local markets over the short term (12 – 18 months). Most likely we'll see more side-ways movement, or even some "correction" if Naspers blows off some steam. Over the last couple of years, markets have been pressed ever-lower by a very hostile economy. Political instability, and the lack of responsible government leadership that go with it, have contributed most to this downward slump, and continue to be the greatest threat to a prospering South Africa.

In the medium term (18 – 24 months) however, we believe local markets will have another big upward swing. This will most likely be driven by pockets of attractiveness, due to low valuations and the depressed nature of our currency. Marginal improvements in political stability (like a change in ANC-leadership and a lot of talk about "making South Africa great again"), positive emerging market sentiment, and a search for higher yields, will also help. During these initial periods, we continue to favour local equities over bonds, over cash.

From this point, much will depend on the environment created by South African politics. Companies are already doing what they should be doing: creating wealth, employing people, and paying taxes (in that order of importance). Preventing companies from creating wealth, disincentivizes them from creating more jobs. Everything should therefore be done to allow companies to prosper in South Africa (in most instances they should simply be left alone without any government intervention). Without structural changes in our political sphere, South Africa will remain on this trajectory of 0.8% to 1.5% economic growth, and markets will do little to surprise us during the next 3 to 5-year period. The most notable issue that must be addressed, is the accountability of politicians. This includes addressing the lack of leadership, inability to successfully implement objectives, and their general wastefulness of state finances.

Following from this, the rand will most likely strengthen over the medium term (18 – 24 months), compared to current levels of R13.50. The rand can easily trade within a R11.90 to R12.70 band during this period. However, because of inflation differentials, the rand should continue its long-term depreciating trend after the brief stint of improvement. Our research has shown that over the long term, the rand depreciates annually by 5.5% to 7.5%. Because of a stable currency, and monetary policy that has helped to stabilise prices in general, we believe the South African Reserve Bank will most likely decrease interest rates in the next year, with between 0.5% and 1.0%. The exact decrease will depend on the rate at which prices continue to contract during the period. After this, interest rates will most likely remain unchanged for another year, as we do not expect any major changes in aggregate demand, or structural changes to aggregate supply. After 2 years, barring any substantial economic or political shocks, interest rates will only be used marginally to keep prices stable.

Concerning international markets, we continue to favour European and Japanese markets over US markets; a view that will persist until the US markets have blown off some steam. This is supported by our view that the US economy, and specifically monetary policy in the US, has run divergent for too long. This generalised view does not exclude companies within the US that remain attractive. We doubt we'll see any major shifts in US equity markets in the short term, currently we only expect some form of gradual correction. Furthermore, we are cautiously observing the hiking cycle in the US and worry that in another counter-theoretical stint, the hiking cycle will lead to higher inflation. Cheap money is drying up and companies will soon enough have to start competing for scarce skills and capital, which might trigger an inflationary-cycle. On the other hand, over the same period European stocks have been kept down. Growth has, however, returned in France (and even Japan!), the Greeks seem to be off the hook (no one seems to worry about debt anymore), and Mario Draghi continues to mention that the European Central Bank will do everything to protect the EU (a decision that will help to stabilise the financial industry in Italy). For this reason, we believe EU stocks will do relatively better in the short term. After that, it's anyone's game.

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