APRIL 2018

PROSPERITY

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OLD MUTUAL WEALTH

It's been another volatile month for equity markets continuing a trend that started late January. However, the current market volatility is not abnormal in a longer-term perspective. What was abnormal was the very long period of very subdued market volatility experienced over the five or so years prior to 2018. In some very important ways market volatility is a good thing: it washes out the misallocation of capital and it presents opportunities for long-term investors to buy assets at a better price. What do we mean by misallocation of capital? When assets prices only go up in a straight line it breeds complacency, even euphoria, and indiscriminate investing – both by companies and individual investors in those companies. Over the last decade this potential misallocation of capital has been coupled with ultra-low interest rates which compounds the problem. When asset prices fluctuate to better represent the underlying risks of the investments, greater discipline is required by all market participants. As mentioned, volatile asset prices also offer opportunities to purchase assets at more attractive prices.

Looking beyond market sentiment, there has been a change in some of the fundamentals underpinning equity prices. Economic news from the US and Europe indicated that these economies may be losing some momentum. Personal consumption expenditure in the US appear to have bottomed and inflation is headed higher. So far this has only had a moderate impact on interest rates with the 10-year Treasury yield briefly exceeding 3% during the past month. The trade dispute between the US and China has also caused concerns about growth expectations. The biggest risk is that these trade tensions cause a rapid slowing of both economies.

Despite these emerging risks, there is still a positive tailwind for equities from earnings growth with the US tax cuts supporting this. We believe this year, and possibly next year, will still be positive for equities unless bond yields rise significantly or the earnings outlook deteriorates. Long-term investment themes such as water and food security for a burgeoning population, shifting lifestyles and preferences, transitioning from fossil energy to sustainable energy and increasing digitalisation across many industries will remain powerful forces of growth. Investors should carefully consider their overall asset allocation and remain appropriately diversified, especially given this cautious outlook.

People tend to act too frequently in the stock market because stocks are so liquid. There is no reason to try hitting sixes all the time! Consistency is what matters most.

ECONOMIC OVERVIEW

The benchmark US ten-year government bond yield briefly rose above 3% for the first time since January 2014 as strong growth and a spike in oil prices feed into expectations for higher inflation and interest rates (bond yields and prices move in opposite directions). US economic indicators released during the month of April confirm that growth is sufficiently solid for the Federal Reserve to continue on its path of gradually increasing interest rates. The US economy expanded by 2.8% in the four quarters to end March, marking the seventh consecutive quarter of growth expansion. The Fed's preferred inflation measure has also finally hit the 2% target, supported by a low base formed by unexpectedly low inflation a year ago. This low base and higher oil prices will probably keep inflation above 2% for the next few months. However, for the Fed to get a fright and substantially speed up the pace of rate hikes, price increases that are even more rapid and sustained are required.

The price of crude oil jumped to a four-year high during the month. The global oil glut has slowly dwindled as the agreement between OPEC and Russia to cut output has been remarkably successful while, at the same time, global demand has picked up. Recent geopolitical tension has resulted in the price jumping in this tightening market. Specifically, concerns have increased that Iran would be squeezed out of world markets if sanctions are re-imposed.

The collapse in oil prices in 2014 and 2015 did not quite result in the expected boost to global growth as the negative impact of reduced investment spending and equity and credit market stress related to oil producers almost offset the positive benefits to consumers. One can expect the impact of higher prices to be similarly mixed, crimping consumer spending and resulting in marginally higher headline inflation, while spurring investment spending.

For South Africa, the impact of the higher oil price is twofold but also greatly depends on the rand-dollar exchange rate (as it happens, the rand weakened by almost 5% in April as the dollar firmed). Firstly, it is likely to increase the total import bill, potentially tipping the trade balance towards deficit. Secondly, it puts upward pressure on inflation. Petrol has a 4.5% direct weight in the CPI basket. The bigger concern is the second round impact of higher petrol prices, when companies pass on input cost increases to consumers. However, they can only do that when the economy is strong enough to not risk losing market share to competitors. Recent evidence clearly shows that local companies would rather absorb input cost increases (electricity, fuel and wages) and limit selling price increases.

Headline inflation, measured by the year-on-year change in the consumer price index, unexpectedly declined to 3.8% in March, the lowest level since February 2011. Core inflation, which excludes volatile food, fuel and energy prices, was 4.1% in March. This is the better indication of underlying price pressures and shows companies' limited ability to pass on input costs. Despite the higher oil price, the overall outlook for inflation is still positive and it is expected to remain well below 6% for the next two years.

Apart from the benefit of low inflation, local consumers are also feeling more positive about the political and economic direction of the country. The FNB/BER Consumer Confidence Index jumped to a record high in the first quarter as households across the race and income spectrum indicated a new sense of optimism over their own financial prospects, the country's economy and the timing of committing to purchases of durable goods. This can be attributed to the political developments that has seen President Ramaphosa sworn in and overseeing a number of much-needed reforms and interventions. While the magnitude of the 34-index point jump is probably an exaggeration that is likely to be partially reversed in coming quarters, the direction of the change is both welcome and expected.

MARKET OVERVIEW

The local equity market rallied off the lows of the year with the JSE All Share Index ending 5% higher for April, although remaining in negative territory year to date. Industrial shares led the charge higher on the back of a weakening rand, as the local currency lost ground against its major counterparts and ended the month around R12.46/dollar, its weakest monthly close this year. European markets produced similar gains as the euro weakened to €1.21 against the US dollar. US markets also performed well as corporate earnings for Quarter 1 looked mostly in line with expectations and backed up the positive sentiment. The biggest loser for April was China, as the benchmark Shanghai Composite Index lost 2.7% with the continuation of imposed trade tariffs from the US weighing heavily on the region. Global interest rates remain high on the agenda with a very close eye on the pace at which the US Federal Reserve increases rates over the remainder of the year. Precious metal prices declined as the dollar rallied with the gold price falling to US$1,300 and silver as low as US$16 in the month. Brent crude continued its gain for the year and traded above US$75/barrel, the highest level since November 2014.

GLOBAL EQUITIES

BANK OF AMERICA

Bank of America reported solid Quarter 1 2018 results. Key takeaways from these results were the strong performance across all segments and good cost control. Net interest income (NII) rose 5% to US$11.6bn, reflecting higher interest rates during the last year as well as loan and deposit growth. Non-interest income increased US$327mn, or 3%, to US$11.5 bn, driven primarily by higher equity markets which resulted in higher asset management fees. In aggregate, revenue across the Group's four business lines was up 4% to US$23.1bn. Net income and diluted earnings per share (EPS) rose 30% and 39% respectively, benefitting from the lower tax rate. EPS for the quarter was US$0.62 versus consensus' estimate of US$0.59.

Bank of America's management was able to drive higher operating leverage over the past few years and we believe that there remains scope to further cut expenses and improve the Group's efficiency ratio, which will drive earnings higher.

Due to the large contribution from consumer banking, Bank of America's balance sheet is highly sensitive to higher interest rates. As US short-term interest rates increase, we expect the bank's net interest income to increase ahead of peers.

Recently, the Group has begun to show strong growth in deposits, taking market share from peers. We expect this to continue on the back of their leading mobile offering, which creates opportunities to deepen customer relationships and benefit from an improving US economy.

JOHNSON & JOHNSON

Johnson & Johnson delivered pleasing Quarter 1 results largely due to the good performance from recent acquisitions and good uptake of new drugs. Favourable currency tailwinds also played their part. Group revenue for the period was up 12.6% to US$20bn, ahead of consensus estimates of US$19.5bn. Excluding acquisitions and currency impact, revenue was up 4.3%. Adjusted earnings per share for the period was up 12.6% to US$2.06 versus consensus estimates of US$2.02. In addition to the revenue and earnings beat, Johnson & Johnson increased their sales and earnings guidance for the full year.

Johnson & Johnson is the world's largest healthcare company. It offers exposure to a diverse portfolio of treatments for ailments in immunology, infectious diseases, cardiovascular and oncology, without excessive exposure to a single ailment or patent loss. We believe this diversification will continue to support stable earnings and dividend growth.

The Group has a leading consumer segment focusing on baby care, beauty, women's health and oral care. We believe that those segments are defensive (high brand loyalty) and there is scope for revenue growth within specific emerging markets.

The Group is highly cash generative and invests about 13% of sales into research and development, which creates a significant moat around the pharmaceutical segment. This is one of the key reasons why it offers some of the leading drugs in the markets within which it operates.

DANAHER

Led by the Diagnostics and Life Science segments, Danaher reported robust Quarter 1 2018 results. Organic growth for the quarter increased by 5.5%, maintaining a similar growth rate from Quarter 4 2017. Revenue, including acquisitions, was up 11.5% to US$4.7bn, benefiting from an additional 5% currency tailwind. As evident from the ongoing momentum the business is enjoying, management raised their full-year 2018 earnings guidance.

Danaher serves a diverse number of end markets and we expect them to offer attractive growth over the coming years. It's one of the larger businesses in a fragmented industry and we believe that the Group will grow both organically and through acquisitions.

The Danaher Business System - a continuous improvement business process – enabled management to acquire businesses and improve returns over time. With about 50% of current revenue coming from businesses acquired in the last five years, we see scope for group margins to improve over the coming years.

Danaher has an enviable track record of generating cash in excess of reported earnings. We expect continued high cash generation coupled with management's good capital allocation to result in continued improvement in group returns on invested capital.

HONEYWELL

Honeywell has built on previous good results with all the Group's segments performing either in-line or ahead of expectations over Quarter 1 2018. Revenue for the period was up 9% to US$10.3bn, slightly ahead of consensus expectations. Organic sales growth increased by 5%, in advance of the previously guided range of between 2% – 4%. The Group's segment margins rose 40bps resulting in earnings per share growth excluding divestitures of 14% to US$1.95 over the year. Management guided to a long-term recurring margin expansion of 30-50bps per annum and also raised the mid-point of their full year revenue and earnings guidance for 2018.

Honeywell is a well-diversified industrial business that caters to attractive end markets such as home and industrial automation, aerospace and safety. These end markets provide above average organic growth potential, which will support Honeywell's growth over the coming years.

Honeywell's management has been successful at rationalising the Group's portfolio. By divesting from low margin businesses and investing in research and development, the Group was able to grow margins ahead of its peers. We view the recent announcement by management to spin off some of the Group's divisions as a continuation of this winning strategy.

The Group is highly cash generative. This allows management to either buy back shares or carry out acquisitions, which should enhance earnings in the current low growth environment. Management repurchased US$950m in Honeywell shares over the quarter.

GLOBAL EQUITIES

ALPHABET

A number of positive once-offs helped Alphabet report what appeared to be a satisfactory Quarter 1 2018 result. Net income for the quarter was US$9.4bn, 74% ahead of the previous year's profit of US$5.4bn. Revenue growth in Quarter 1 was up 23% to US$31.1bn versus consensus' forecast of US$30.3bn. Although revenue slightly decelerated from the 24% growth in Quarter 4 2017, this was the 33rd straight quarter of greater than 20% revenue growth. Diluted earnings per share were up 73% to US$13.33, partially boosted by the decline in the Group's effective tax rate that fell from 20% to 11% during the quarter and a change in how the company accounts for equity security investments. Apart from the once-off impacts, the key drivers for earnings growth were a 59% year-on-year rise in paid clicks while the cost per click continued to decline, falling 19% due to the continued shift from desktop to mobile searches.

Despite the strong growth in internet advertising over a number of years, online advertising still contributes less than 40% of total advertising spend. Google is well positioned to benefit from the continued secular trend from traditional to online advertising.

The Group's core search business continues to have a dominant and increasing market share. While growth in desktop search has tapered off, the outlook for mobile is attractive. Better pricing for mobile advertising relative to desktop will result in improved group margins.

While developments in Android, Google Play, hardware, cloud services and other new innovations pale in comparison to the contribution from the traditional business, we believe that they present additional avenues for earnings growth over the long term.

FACEBOOK

Facebook reported Quarter 1 earnings that were ahead of expectations. Revenue for the period was up 49% from the previous year to US$12.0bn, ahead of consensus' estimate of US$11.4bn. Diluted earnings per share for the quarter were US$1.69, up 63% from the previous year and well ahead of the median forecast of US$1.35. Growth was driven by a 50% increase in advertising revenue and good cost control. Operating expenses for the period increased by 39%, below revenue growth, which resulted in group operating margin increasing from 41% to 46%.

Across its multiple platforms (some of which are yet to be fully monetised), Facebook has more than 2 billion engaged users. The Group has a large amount of data on these users, which is enormously valuable for targeted advertising and content viewing preferences. We expect Facebook to continue to increase its average revenue per user over the long term, which will drive profitability.

The Group is highly cash generative and reports EBITDA margins above 60%. While margins are likely to decline in the short term due to increased investment, we see this as being positive over the long term. Increased security and safety will guard the integrity of the platform and reduce the likelihood of punitive regulation.

VISA INC

Visa beat the street with results that trumped even management's expectations with revenue and EPS growth of 13% and 30% respectively. The strong Quarter 2 performance was driven by increased cross border flows and payments volumes. Earnings per share and revenue for Quarter 2 2018 were US$1.11 and $5.07bn versus consensus of US$1.01 and US$4.78bn respectively. Payment volumes increased by 10% on a constant currency basis over the prior year while cross border volume growth grew 11%. The total number of transactions processed by Visa's network increased 12% over the year equating to 29.3bn transactions over the quarter. The Group returned US$2.5bn to shareholders by means of share repurchases and dividends, equating to a 3.6% annualised yield.

Visa benefits from the megatrend that we are seeing globally as payments move from cash to electronic and card-based. The key drivers of this trend are the increase in number of transactions and size of the transactions. We expect Visa's reported metrics of these drivers to continue to grow at double digits in both developed and emerging markets.

Visa has invested significantly in its payment network, VisaNet, which has seen the network report high reliability, security and speed - all of which are critical within the electronic payment industry. We believe that the strength of VisaNet coupled with Visa's symbiotic relationship with financial institutions presents a high barrier for new entrants into the electronic payment platforms.

Visa's business model allows the Group to earn recurring revenues, maintain high margins and generate high levels of free cash flow in an oligopolistic industry. We believe that these are the quintessential qualities of a great long-term investment.

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