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PROSPERITY

IN THIS CLIENT **NEWSLETTER**

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PRIVATE CLIENT SECURITIES

OLDMUTUAL WEALTH

The folly of forecasting has been borne out by the outcome of the Brexit vote and the US presidential election. Macro events have moved from uncertain to unpredictable. No sustained equity market sell-offs occurred after Brexit and the US election, but bond markets have sold off in expectation of higher US inflation. The result of the Italian referendum, the Brexit decision in the UK parliament and the Dutch, French and German elections next year are all events that could have a huge impact on markets yet remain unpredictable, increasing risk in developed markets. In contrast, emerging markets are looking quite stable compared to developed markets and valuations are attractive, but for a strong dollar which may still undermine the performance of earnings from these markets.

The market is expecting the Trump administration to spend up to US$1 trillion repairing and building the US infrastructure, which should boost the commodities, materials and construction-related sectors. This potential move by governments from monetary to fiscal spending policies, gives reason to be optimistic. A normalisation of the interest rate cycle could also happen more quickly if inflation expectations translate into reality through fiscal spending. Other sectors that could benefit from some of Trump's policies include healthcare, industrials and energy with financials also seeing a net interest margin expansion if rates rise more quickly than expected and the sector should also benefit from credit demand driven by investment in infrastructure.

South Africa's business confidence, which is a leading indicator of investments into the local economy, remains at a low level despite a credit downgrade having been avoided for now. SA corporates still sit on massive amounts of cash which has not been deployed and private sector credit growth is still trending lower. However, the SARB's leading indicators and the outlook for agriculture and commodities has certainly improved. Attractive domestic interest rates and a currency confined within a manageable exchange-rate range still present attractive carry-trade opportunities for international investors. However, these portfolio flows are fickle and volatile and not a good basis for long-term investment calls.

So, we are still facing many uncertainties in the markets over the next year. It may useful at this juncture to consider the "70-20-10 rule" as quoted by William Smead. Part one of the rule says that in the next 12 months, the return you can expect on a stock is 70% determined by what the stock market does, 20% is determined by how the industry group does and 10% is based on how undervalued and successful the individual company is. Part two of the rule says that over ten years, 70% of how you did would be determined by the valuation and success of your company, 20% by how the industry did and 10% would be determined by how the stock market did. In other words, investors should keep their eyes on the companies that they invest in and not become slaves to the vagaries of the market in the shorter term. If anything, the sentiments that occasionally weigh on markets will present valuable opportunities to acquire quality stocks at an attractive price.

"The stock market is a device for transferring money from the impatient to the patient" - Warren Buffett

ECONOMIC AND MARKET OVERVIEW

The surprise election of Donald Trump as US president after a long and bitter campaign led to an unexpected market reaction. After the initial shock set in, equity markets rallied strongly, with the S&P500 reaching all-time highs. While Trump said a lot of controversial and contradictory things on the campaign trail, the market has seized on his plans for tax cuts and infrastructure spending.

Unlike the Brexit surprise, there was no flight into safe-haven bonds. Global bond markets, in contrast to equities, accelerated the sell-off that had started in October. The market expects that Trump's pro-growth policies will lead to higher inflation and higher interest rates. It remains to be seen if this will happen in the medium term, but in the short term, a US interest rate increase in December is almost certain. If the US Federal Reserve hikes interest rates by more than is currently priced in over the next year, the result is likely to be a much stronger dollar, which could result in a weaker rand, which in turn puts upward pressure on local inflation and interest rates.

While several currencies slumped against the resurgent US dollar (including the Mexican peso, Japanese yen and Indian rupee), the rand was relatively resilient, ending the month at R14 to the dollar.

South Africa avoided a drop to junk status. Fitch affirmed South Africa's foreign and local currency ratings at BBB-, the lowest investment grade level, but changed the outlook from stable to negative. S&P Global maintained South Africa's foreign currency rating, but cut the local currency rating by a notch. Both are still investment grade, but with a negative outlook. This suggests a ratings downgrade to junk status could still follow in 2017. Like Moody's, Fitch appears comfortable with the fiscal plans laid out in October's Medium-Term Budget. But Fitch emphasised that political infighting in the lead-up to the ruling party's elective conference next year poses risks to governance and policy making that in turn undermines the investment climate in the local economy. It also noted that the Government's debt structure is "highly favourable", with 90% denominated in rand and with an average maturity of 14 years (and therefore limited roll-over risk).

The SA Reserve Bank left interest rates unchanged in November, warning that global (more specifically US) developments pose a risk to the inflation outlook, but for now it appears that interest rates have peaked. The SARB's composite leading economic indicator – which anticipates the direction of economic activity a year or so ahead – increased to the highest level in 14 months. This suggests the worst of the local growth slowdown might be behind us.

LOCAL EQUITIES

SPAR

Spar reported FY 2016 results that were ahead of expectations. Headline numbers were distorted by recent acquisitions, the capital raise and the vesting of the BEE scheme. The group's recent foray into Switzerland, Ireland and South West England contributed 32% to turnover and 18% to profit after tax. The Southern African business, which contributes 73% of Group EBIT, grew wholesale turnover by 9% over the year. Tops (liquor sales) was the best performer, rising 12%, with Build it growing by11.6%. Despite the heightened marketing and promotional activity, gross margins held at 8.2% and other recurring costs were in line with expectations. Benefits from the supply chain were passed onto retailers, as the weak macro environment continued to challenge the industry. The Irish business reported good growth, which was impacted by the Londis and Gilletts acquisitions. Constant currency sales growth in the Irish business was 14.4%, with 3.1% organic growth. Gross margins in the region rose to 10.8% as the group improved distribution efficiencies and had a better product mix. The newly acquired Swiss business made a marginal contribution to profits, reporting a disappointing operating margin of 0.5%. Management pointed out that there were some distortions in the form of IFRS accounting for pension costs and future minority buyout obligations. On an operational level, the result was in line with management's expectations, although it is clear that there is work to be done in making the Swiss business more profitable.

MEDICLINIC INTERNATIONAL

Mediclinic reported a mixed set of results for the first half of 2017. While South Africa and Switzerland reported decent numbers, the Middle East disappointed on the back of regulatory changes, doctor vacancies and integration issues. Revenue for the Middle East was up 112%, with the recent Al Noor acquisition contributing to the vast majority of the growth. Organic growth is estimated to be at low-to-mid single digits. EBITDA margin fell from 21% to 11% mainly due to the introduction of co-payments by a major funder in Abu Dhabi, Thiqa. Volumes from Thiqa declined from 20% to 12.3%, and management remain uncertain of the full impact of the regulatory changes over the short and medium term. South African revenue rose 8% over the year to R7.3bn, largely driven by the 2.6% increase in paid patient days. EBITDA margins declined to 20.7% (21.6% H1 2016) due to higher medical vs. surgical cases and alignment of salary increases across the group. The Swiss business reported solid revenue growth of 4.6% to CHF819m, which can be attributed to the 3.7% growth in inpatient volume. EBITDA margins improved to 18.6% (18.1% H1 2016) on the back of volume growth and cost containment.

VODACOM

Vodacom reported that its revenue grew 5.3 % in the six months ended September, led by an increase of active South African customers and a boost in data revenue. The group increased its subscribers by 1.5 million in South Africa for the period under review, increasing its customer base to 35.7 million in the country. The group's data revenue from its South African operations increased by 19.5% to R9.8 billion.

Data revenue from the company's international markets grew by 15.5% to R2.1bn. The company said data revenue contributed 34.5% of the group's service revenue. During the period, operating profit increased by 5.4% to R10.7bn, while its headline earnings per share remained flat at 440 cents. This was attributed to a tax adjustment in Tanzania and foreign currency impacts. Vodacom spent R5.7bn in capital expenditure to improve its networks in the first half of the year - R4bn of which was spent on its South African networks.

Despite making inroads in its customer base in its home market, Vodacom suffered losses in its international market. Active customers decreased by 11% to 27.9 million, due to disconnections it experienced during the second half of the prior year. However, the company was encouraged by the growth experienced in its M-Pesa operations. M-Pesa revenue grew by 36.8% and there are now 10.9 million customers using M-Pesa in the company's international operations.

LOCAL EQUITIES

NASPERS

Naspers reported solid results for the H1'17 period, largely driven by the strength in the e-commerce businesses and Tencent. Currencies once again had a significant impact on the group's earnings. At constant currencies, group revenue and core HEPS rose 27% and 25% respectively. Development spend increased 38% year-on-year to US$387m, of which US$188m was spent on new initiatives. The e-commerce segment, including Tencent, grew revenues by 30% to US$4.9bn. Operating profits grew 54% on the back of Tencent's performance and smaller losses in many e-commerce businesses. Within e-commerce, the payments division saw strong revenue growth of 71% on increased transactions volume. Etail saw a slowdown in revenue to 3% from 6% in H2'16, partly as a result of weak emerging market currencies and a shift in operating model. The classifieds division saw strong revenue growth on the back of a higher contribution from Avito and an increase in the number of markets where the group is monetising. Notwithstanding total subscriber growth of 7.6% y-o-y, video entertainment reported revenue and operating profit declines of 8% and 43% respectively. Local currency weakness coupled with higher USD content costs played a significant role in the earnings decline. Naspers were not able to pass the full price increases onto consumers, and in some regions the group decreased prices. In aggregate, the group saw consumers trading down to smaller/cheaper bouquets on the back of a weak macro environment. Naspers highlighted that they have seen little impact of consumers moving to streaming video on demand platforms like Netflix.

GLOBAL EQUITIES

FACEBOOK

Facebook reported another set of strong quarterly results as the company's advertising revenue and audience continued to expand well ahead of expectations. Revenue in the third quarter rose by 56% y-o-y to US$7.01 billion. The gains were a record for Facebook, buoyed by mobile video ad sales, including those on Instagram. Mobile ad revenue represented about 84% of total ad sales over the quarter, up from 78% in the same period a year earlier. Facebook's global ad revenue is expected to total $25.9 billion this year, making Facebook the largest ad publisher after Google. The company posted a profit of US$2.4 billion during the quarter, up 166% from a year-earlier.

User growth in the latest quarter was strong. Facebook gained 80 million monthly users in the third quarter and for the first time now has more than 1 billion daily users on mobile. Its mobile ad business brought in $5.7 billion, which was 84% of its total ad revenue versus 78% in the same period last year. More importantly, the ratio of daily users to monthly users — the best way to measure Facebook users' level of engagement with the service — held steady at 66% despite worries that increased competition from the likes of Snapchat is stealing away people's attention. Despite Facebook's strong performance across the board, the company's cautioned that revenue growth rates are expected to decline in the coming quarters and capital expenditure will increase.

STARBUCKS

Starbucks beat analyst expectations and reported US$5.71 billion in fourth quarter revenue - a 16% y-o-y increase in sales. Net earnings for the quarter came in at US$801 million, up 22.8% y-o-y, resulting in earnings of 54 cents per share. The company attributed its top-line growth in part to an extra week in the fourth quarter of fiscal 2016 and incremental revenue from the opening of more than 2 000 stores over the past 12 months. Same-store sales in U.S. stores grew 4%, due in part to a 6% rise in average ticket and a 1% decline in traffic. On a global basis, same-store sales grew 4% during the quarter. China, which saw a 6% increase in comparable store sales, was the strongest geographic segment for the coffee giant.

On a full-year basis, Starbucks recorded US$21.3 billion in revenue, a figure that grew 11.2% over fiscal 2015 revenue, and US$2.8 billion in net earnings, a figure that grew 2.2% year-over-year. Full-year earnings per share grew 4.4% to US$1.90 per share.

Looking ahead to fiscal 2017, Starbucks is projecting "mid-single digit comparable store sales growth" on a full-year global basis, which is in line with the growth rate we have seen over the last few years.

GLOBAL EQUITIES

GILEAD SCIENCES

In its third quarter earnings update, Gilead reported a decline in quarterly net profit to US$3.3 billion from US$4.6 billion a year earlier. Earnings per share, adjusted for once-off items, came in at US$2.75 per share, below an average analyst estimate of US$2.86. The decline in net profit was due to lower sales of its hepatitis C drugs, Harvoni and Sovaldi. Total product sales fell to US$7.4 billion from US$8.2 billion in 3Q15. Sales of Gilead's HIV and other antiviral drugs beat expectations, rising 21% y-o-y to US$3.5 billion. For the full year, Gilead said it expects net product sales of between $29.5 billion and $30.5 billion. Despite an estimated 3.2 million Americans still infected with hepatitis C, Gilead's hepatitis C franchise has continued to experience declining sales as competitors AbbVie and Merck & Co have introduced cheaper alternatives. Health Insurers have also responded by closely monitoring which patients should be treated. Gilead's HIV & oncology franchises appear to be where the group's best opportunities lie.

IMPERIAL BRANDS

Imperial Brands, the world's fourth-largest tobacco company, is accelerating its cost-savings drive and pouring some of the benefits into marketing key brands as it faces the prospect of a greatly enlarged competitor. The maker of Winston, Gauloises and other cigarettes said it plans to spend £750 million over the next three years to make the business more streamlined and efficient. The effort should result in additional savings of £300 million each year by 2020. Imperial also said it would spend £300 million this year on growth opportunities in some of its top markets. The increased investment comes as larger rival, British American Tobacco has proposed a US$47 billion buyout of Reynolds American, which would make it the biggest international tobacco company and could spark further deals in an industry that is shrinking as more people quit smoking.

In its 2016 financial year end results, Imperial reported higher adjusted sales and profit, aided by the acquisition of brands in the United States and a weaker British currency. Net revenue of its tobacco business rose 9.7% to £7.17 billion and adjusted operating profit rose 10.4% to £3.5 billion. Part of the company's simplification strategy involves reducing the number of brands it sells. It is aiming to have around 125 brands or less, down from the current 184. It also expects the weak British pound to benefit earnings by around 14% in the 2017 financial year as the vast majority of its profits come from outside the UK. Imperial also remains committed to raising its dividend by at least 10% per annum.

DISNEY

Disney posted fourth-quarter earnings of $1.10, 10 cents less than the same period a year ago and six cents behind analysts' estimates. Quarterly revenue also lagged slightly behind projections at $13.14 billion. The shortfall was connected, at least in part, to declining performance at ESPN, the all-sports network that has powered Disney earnings for years, but has seen a decline in subscribers over the last three years. Revenue in the corporation's cable networks, which include ESPN, dipped 7% for the quarter to $3.95 billion. Operating income took an even bigger hit, down 13% from the prior year to $1.44 billion. A decrease in subscribers to ESPN meant falloffs in both advertising and affiliate revenues. That came at the same time that programming and productions costs were increasing — partly connected to this summer's Olympic Games in Brazil and to broadcast of the World Cup of Hockey.

Despite the period's shortfall, Disney posted annual earnings that were 11% ahead of those for 2015 — up to $5.72 per share. Disney's film studio continues to perform strongly, churning out four hits this fiscal year that topped US$1 billion at the worldwide box office.

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