FEBRUARY 2016

PROSPERITY

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OLD MUTUAL WEALTH

The five major forces mentioned in our January newsletter are all at play. Low oil and commodity prices coupled with China's slowdown is the main theme, but it is being amplified by weakness in emerging market currencies and widening credit spreads. All this is occurring against the backdrop of low or negative interest rates in the developed world which are symptoms of deflationary pressures. **Global corporate earnings growth will remain under pressure in such an environment.** Locally, our National Budget has been met with scepticism from the market and bonds are pricing in a credit downgrade and interest rate increases. The clock is ticking and South Africa has to pull itself together to avoid a recession.

The last few years has seen a steady upward march in markets globally with asset valuations exceeding historical averages. This upward trend was fuelled by the hunt for yield in a low yield environment where equities provided decent earnings growth and offered total returns well in excess of alternative asset classes. As the saying goes: "a rising tide lifts all ships". However, the uncertainty in markets that started last year has been amplified during the first two months this year. While selected equities still offer handsome prospective returns compared to most alternatives, **it has now become even more important to choose companies carefully** and to position portfolios defensively, but not to miss opportunities to acquire quality assets at attractive valuations or to over-react to negative market sentiment.

ECONOMIC AND MARKET OVERVIEW

Macroeconomic data from the world's major economies still paint a picture of tepid but positive growth, with the global manufacturing sector struggling. However, the benefit of the low oil price is increasingly showing up in data on consumer spending. US personal consumption spending increased by 4.24% in the year to January as steady income and employment growth combined with, low inflation and low debt servicing costs create a favourable environment for consumers.

The Bank of Japan cut its main policy rate to -0.1%, but the market reaction did not go according to script. Instead of weakening, the yen strengthened while equities sold-off. The Bank of Japan joins the European, Swiss, Danish and Swedish central banks in experimenting with negative interest rates in an attempt to lift persistently low inflation rates.

February is Budget month in South Africa. The National Treasury based the Budget on real economic growth assumptions of 0.9% in 2016, 1.7% in 2017 and 2.4% in 2018. The 2017 and 2018 forecasts might still be on the optimistic side, hence the market scepticism. The 2015 deficit is more or less as expected at 3.9% but the projected consolidated budget deficit for 2016/17 is now 3.2% of Growth Domestic Product (GDP), 2.8% for 2017/18, and 2.4% in 2018/19. Treasury expects to run a primary surplus (budget balance before interest payments) this fiscal year for the first time since 2008. This should stabilise the government debt-to-GDP ratio at around 46.2% by 2017/18. The narrower deficit is to be achieved without any major new tax initiatives, another reason for market scepticism. On the tax revenue side, taxpayers will feel relieved. Treasury wants to raise an additional R18 billion in tax this year but is tapping small increases in different sources of revenue, rather than a big-ticket increase (so no hike in VAT, as some expected). The expenditure ceiling, which limits allocations to departments and provinces, has been reduced by R10 billion in 2017/18 and R15 billion in 2018/19, and the increased emphasis on spending discipline is very welcome.

The Budget did not announce any significant measures to enhance South Africa's growth potential and instead reiterated existing programmes and initiatives. What was encouraging was that Government was relooking at its vast portfolio of (generally underperforming) state-owned enterprises with a view of stabilising and rationalising them, while also possibly bringing in private capital and expertise.

Although most markets ended February lower, the losses were not as pronounced as in January. The MSCI World Index declined 0.7% (US$) in February and the MSCI Emerging Markets Index declined 0.2%. In Japan, the Nikkei 225 ended the month 1.8% lower. Losses in the UK and USA were more muted, with the FTSE 100 and S&P 500 declining by 0.9% and 0.1% respectively. Locally, the ALSI gained 0.6% in February. Resources gained 15.6%, while Financials (-1.5%) and Industrials (-2.31%) ended the month lower. During the month, the rand strengthened 0.7% against the US dollar and 0.3% against the euro.

LOCAL EQUITIES

MONDI

Mondi Ltd, a manufacturer of packaging for products from cement to pasta sauce, said full-year earnings increased by 25% due to higher selling prices, volume growth, good cost control and the positive impact of weakening-emerging market currencies against the euro. Underlying operating profit increased to €957 million in 2015 from €767 million a year earlier and sales increased by 7% to €6.8 billion. Mondi, which also supplies wood pulp and paper products, has its roots in printing paper and was spun out of Anglo American Plc in 2007. Currently, more than 75% of its revenue is from packaging and Mondi is seeking to grow further in the industry. The company is working to expand and modernise some of its facilities and has approved a €310 million investment in a new 300 000 ton per year machine at its mill in Ruzomberok, Slovakia. Mondi now has about €450 million of major projects approved and in development and the outlook for the business remains positive.

BRITISH AMERICAN TOBACCO

British American Tobacco is on track to meet its target for high single-digit earnings growth this year as it already has made the bulk of its planned price increases for the year. "We will continue to deliver another year of good, constant-currency earnings per share growth," Finance Director Ben Stevens said recently. He also warned adverse currency shifts would weigh on reported profit in 2016 after exchange rate moves cut last year's margins. Price increases have helped to limit the damage of adverse currency shifts last year. Adjusted profit from operations fell 7.6% to £4.99 billion, in line with the average estimate the company said. Excluding currency fluctuations, profits increased 4%. With sales that are spread across more than 200 markets globally, the company is more vulnerable than most to volatility in currency markets.

NASPERS

Naspers has invested a further US$250 million in Indian online travel venture, Ibibo Group. The investment will be focused on extending Ibibo's leadership position in the Indian hotels category and on additional technology innovations. Naspers believes that the Indian e-commerce market, particularly the online travel segment, offers exciting growth prospects and that with a talented, proven management team and exceptional technology, Ibibo is well positioned to benefit from an increasing number of people using online travel services. Ibibo is the largest online travel company in India, generating more than 2.5 times the transaction volumes of its nearest competitor. During the last three months of 2015, the Group processed more than 6.5 million transactions. According to a report in India's Economic Times, following this latest investment, Naspers will own a 90% stake in Ibibo.

WOOLWORTHS

Woolworths is seeking to carve out a niche for themselves in the high-end food business in Australia, where margins are better and competition is not fierce. This month the company announced its plans to invest in its food range in Australia as it believes that organic produce and other pricier items could appeal to higher earners. Woolworths is seeking to lessen its reliance on South Africa, where it has focused on increasing its free-range meat and organic range as well as foods with fewer preservatives and colorants. Woolworths' food business accounts for 22% of operating profit, with almost all of that from South Africa. If executed well, the Australian food business could become just as material. The retailer's main challenge will be to secure quality food suppliers and Woolworths may start testing food stores in Australia in the next 18 months.

GLOBAL EQUITIES

AB INBEV

AB InBev, the world's largest brewer, has reported revenue growth of 6.3% in 2015, despite profits decreasing by 4%, with total volumes dipping by 0.6%. Going forward, the brewer has said that "premiumising and invigorating" the beer category is one of its key strategic priorities, citing millennial consumers as its target demographic. One area being explored is how technology can enhance distribution, packaging, and other aspects of the consumer's experience. The team has identified a number of initiatives which, while initially small, could eventually become game-changers in the years ahead. For example, digital solutions and craft e-commerce platforms that allow consumers to order beer for quick delivery are being piloted in several countries, including Mexico, Brazil and Canada. Developing its footprint within the "near beer segment" is another way in which AB InBev says it is responding to demand for more choice and excitement within the category. The brewer also re-confirmed its £71 billion takeover of SABMiller and said it was still on track to complete in the second half of 2016. The newly created company is expected to produce about 30% of the world's beer with the two firms predicting cost savings of at least US$1.4 billion a year once the merger is completed.

MICROSOFT

We have recently added Microsoft to our Global Equity Portfolio. Since early 2014, Microsoft has undertaken a strategic metamorphosis and has adjusted its strategy as enterprise workloads continue to shift away from the client/server model to the cloud. The billions of dollars invested in the Azure platform are beginning to bear fruit, and Microsoft's more open approach to delivering software in the cloud will prevent the firm from material technology disruption. Azure is developing into the company's crown jewel, and revenue and workload growth (both doubling) are strong indicators that the firm is delivering on its value proposition to customers. In 2015, Azure produced sales in excess of US$9 billion, as a start-up business. In the enterprise world, Microsoft remains resilient, even as computing moves from the PC server to the cloud device model. Whether it is providing software to run computers, servers, and data centres or providing a cloud platform, Microsoft's size and global scale are key advantages, allowing the firm to undercut competitors' prices while offering complete end-to-end solutions that appeal to customers looking for a one-stop enterprise software provider. The global footprint of Windows Office, as well as Office 365 is unparalleled by any competitor, which is now being reinforced by adding on Azure at a competitive price. Encouragingly, growing cloud adoption has not led to a decline in overall license sales, as was previously feared. Cloud and data centre wins are expected to continue accruing to firms with the size and scale to compete. Microsoft maintains excellent financial health through its maintenance of a solid balance sheet and ability to generate strong, steady cash flow. In the past fiscal year, Microsoft generated more than US$26 billion in free cash flow and had over US$85 billion in cash on its balance sheet. Over the past five years, including all acquisitions and other cash uses, Microsoft has generated more cash than it has spent. With its entrenched customer base and strong proportion of recurring revenue, the company is expected to be able to comfortably service its debt, invest in the business, and return capital to shareholders for the foreseeable future.

CONTINENTAL

Leading technology company Continental has selected a site in Mississippi for the construction of a commercial vehicle tyre plant to drive the future growth of its tyre business in the North American market. Continental has committed to a long-term investment of approximately US$1.4 billion and will employ 2 500 people when the plant reaches full capacity in the next decade. A date for the start of construction has not yet been announced, but the company said it expects to break ground in the next several months in cadence with market demands. The production of commercial vehicle tires is planned to start by end of 2019.

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