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PROSPERITY

IN THIS CLIENT **NEWSLETTER**

- Economic and market outlook
- Global equities
- Local equities

PRIVATE CLIENT SECURITIES

OLD MUTUAL WEALTH

PROSPERITY

The US Navy SEALs have a saying: "Get comfortable being uncomfortable." During their rigorous training, SEALs go through what is called "surf torture." The process involves everyone linking arms and laying down in the frigid ocean until the body reaches early stages of hypothermia. They do this daily before taking on whatever other tasks are required of them. The point is for them to learn to stay focused on what they need to accomplish, despite how uncomfortable they feel.

In our January newsletter, we indicated that, despite us being cautiously optimistic about 2018, market corrections in excess of 10% can be expected this year. There are no signs of recession anywhere in the developed or developing world. Global growth is synchronised and asset prices are reflecting this. However, nervousness about the US Federal Reserve's pace of rate hiking this year is setting markets on edge. Market pull-backs, such as those we've already seen this year, will occur more frequently in our view. These events will require us to remain focused and on guard against complacency and to "get comfortable being uncomfortable". Of course, such pull-backs in asset prices also represent opportunities to buy into great companies at better prices.

Locally, the Valentine's Day resignation of Jacob Zuma and the apparent seamless transition of power to the business-friendly new president was praised. The positive message in the State of the Nation Address by President Ramaphosa was followed by a budget speech which sought to plug the revenue shortfall through increased taxes. This was followed by a cabinet change which seems to have struck a good balance, for now, between dealing with national imperatives and political appeasement. The 2018 Budget has, to a large extent, spared high-net-worth individuals from threatened "wealth taxes". It was a fine balancing act between introducing an increase in VAT which has been argued to be regressive, in that it mostly impacts the poor, while also taking a larger amount from the more affluent portion of the South African society. What was lacking from the Budget was a clear path to growth and a reduction of unproductive government expenditure. Whether the budget and other recent actions are enough to avoid a downgrade of our sovereign debt status to sub-investment grade will be seen when Moody's make their decision towards the end of March. It's a close call in our opinion.

"… for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle." Winston Churchill

ECONOMIC OVERVIEW

The big focus of global investors this year has been on central banks, especially the US Federal Reserve, and the pace at which they remove the post-financial crisis stimulus measures. The Fed has been hiking interest rates very gradually since late 2015, and the question is whether the pace will pick up. Both the European Central Bank and Bank of Japan are still actively buying bonds (quantitative easing) and maintaining negative interest rates, but they too are likely to step back as inflation slowly rises amid strong economic growth.

Global equities sold off in February because investors were trying to price in the future path of monetary policy against the backdrop of strong global economic growth. This is in contrast to the corrections of late 2015 and early 2016 when deflation fears, falling commodity prices and an economic slowdown dominated.

Locally, markets cheered the resignation of President Zuma and the swearing in of Cyril Ramaphosa as his successor. This has given rise to tremendous optimism, leaving behind the uncertainty and policy contradictions of the past few years. Financial markets have responded positively. With such high expectations, there is much room for disappointment, and certainly the task at hand is huge.

President Ramaphosa has already overseen three key interventions in a short space of time: a credible new board at Eskom, a Budget that attempts to put government finances back on the path to long-term sustainability and a cabinet where the most important positions are filled with capable and respected individuals (notably the return Ministers Nene and Gordhan).

Importantly, the outlook for the local economy was already improving prior to the December ANC conference. The global backdrop of strong growth and mild inflation is very beneficial to South Africa. A strengthening rand over the past two years (despite much political uncertainty) has fed into lower inflation, which in turn has reduced pressure on household finances. Meanwhile, firmer commodity prices have supported a surge in exports. Business confidence should also improve from rock-bottom levels, which should see companies lift investment spending in the local economy.

MARKET OVERVIEW

Volatility returned to markets in a big way in February as markets experienced major swings after a strong first month of the year. The VIX volatility index, which has been trading below 20 since November 2016, spiked to 50 overnight as markets briefly entered correction territory which spooked investors. Most global equity indices dipped off the year highs, but recovered towards the end of February, still ending the month with a negative return. Inflation and interest rate hike fears were partly to blame for jittery markets, and as the US 10 year treasury yield crept closer to 3.0%, the reality of rising funding costs and inflation put a brief end to the pattern of monthly gains we've seen throughout 2017. Commodity prices followed a similar path of price swings, as gold traded in a US$50 range, closing at US$1,317. Brent crude oil dropped as low as US$58 per barrel before ending the month at US$61.60.

On the local front, headlines were dominated by President Ramaphosa taking office, the announcement of a tight fiscal budget and a widely expected cabinet reshuffle. These were largely positive events, and the rand continued its strength in 2018 to reach 11.50/US$, a level last seen in February 2015. This strength in the currency boosted the decline in both producer price and consumer price inflation, which paves the way towards rate cuts by the SA Reserve Bank, the first of such cuts possibly as early as March 2018.

TAXING THE WEALTHY, BUT NO "WEALTH TAXES"

The 2018 Budget has spared high net worth individuals from threatened "wealth taxes" to a large extent. It was a fine balancing act between introducing an increase in VAT which has been argued to be regressive i.e. mostly impacting the poor, while also taking a larger amount from the more affluent portion of SA society. There were no changes to the inclusion rate and annual exclusion amount for Capital Gains Tax for individuals, trusts and companies. No changes were made to Dividends Withholding Tax, the top marginal individual income tax rate and the flat tax rate on trusts. However, there are a number of other notable increases in tax and tax thresholds impacting high income earners and high net worth individuals.

Firstly, there was again no adjustment to the top four tax brackets for individuals. There has been no increase in these income tax brackets for two years which, when inflation is taken into account, means that high income earners are paying more tax. Below inflation adjustments were made to the bottom three brackets for individuals.

Secondly, Donations Tax has been increased from 20% to 25% for donations in excess of R30m made in a tax year and Estate Duty has similarly been increased from 20% to 25% on dutiable estates in excess of R30m. This is significant for high net worth individuals with dutiable estates over R30m as a 25% increase in estate duty is a hard pill to swallow. However, there are estate planning opportunities to assist in minimising the estate duty liability for example, the use of trusts. While trusts have been the subject of much debate regarding their usefulness/ viability after the introduction of section 7C of the Income Tax Act, we still believe that they play an important role in effective estate planning.

The ability to diversify wealth overseas has also been supported by this Budget. While individual offshore allowances remain as they were, institutional offshore allowances have increased by 5%. This is enlightened thinking from Treasury as it gives investors greater freedom and reduces the risk of overexposure to a single market and geography.

Finally, when it comes to spending wealth one would have to pay significantly more in duties and levies on a number of goods, ranging from the basic such as fuel to luxury items. The most notable of these are:

- An increase of 52c/litre for fuel (22c/litre in the general fuel levy; 30c/litre in the Road Accident Fund levy)
- Increases in alcohol and tobacco excise duties of between 6% and 10%
- An increase in ad valorem excise duties for luxury goods from 7% to 9%.

MORE ON TRUSTS

In summary, trusts were spared in this Budget in that no significant changes were made to the taxation of these useful estate planning vehicles. Distributions made by trusts to beneficiaries, the so-called "conduit principle", was not attacked as it has been in the US and UK.

The taxation of trusts remains unchanged in that a trust's taxable income will continue to be taxed at a flat rate of 45% but if income is distributed it will be taxed in the beneficiary's hands. Trusts' capital gains inclusion rate also remains unchanged at 80% but if the gains are distributed to capital beneficiaries they will pay the capital gains tax at the rate for individuals. Because the conduit principle remains intact the benefit of income splitting and the taxation of trust income and gains in the hands of beneficiaries is still a valuable tax-saving tool.

The question is, how do we continue to use trusts as an effective estate planning tool going forward even in the light of the introduction of Section 7C last year? Section 7C effectively made the introduction of funds into trusts problematic. However, there are ways to mitigate against the problem in certain instances. For example, by correctly wording one's last will and testament, one can afford the appropriate discretion to executors to limit the impact of Section 7C on any part of an estate being paid to a trust rather than directly to the heir.

Thorough consideration of the implications of Section 7C of the Income Tax Act becomes even more important when one considers the Budget Speech proposal that the official rate of interest in the Income Tax Act be adjusted. The official rate of interest is the current repurchase rate plus 100 basis points (currently 7.75%). This rate is used in terms of section 7C to calculate the annual donation amount on low interest or interest-free loans to trusts and companies for donations tax purposes. The proposal is for this rate to be increased to a level closer to the prime rate of interest. The annual donations on these types of loans will have to be reviewed to avoid underpayment issues.

LOCAL EQUITIES

ANGLO AMERICAN PLATINUM

Anglo American Platinum delivered results that were above expectations. Revenue grew 6% to R65.5 billion with EBITDA growing 32% to R11.9 billion. This was a strong result showing the company's operational excellence amidst an environment of marginally higher platinum prices. Total PGM production came in ahead of market guidance in spite of the removal of loss-making production from Bokoni, third-party purchase of concentrate from Maseve and unplanned stoppages. Production increased 1% to 5 000 000 oz coupled with production costs that were 2% lower than the previous year, illustrating the success of the company's focus on value rather than volume. Platinum, Palladium and Rhodium make up 49%, 32.6% and 6.3% of total PGM production. EBITDA margin grew by four percentage points to 18.3% while headline earnings increased by 108% to R3.8 billion.

BIDCORP

BidCorp reported H1 2018 results that were largely in line with expectations. Group revenue increased by 7.7% (8.3% in constant currency) to R61.5bn. Group trading profit rose by 8.9% to R3.0bn while gross and trading margins remained fairly flat at 23.6% and 4.9% respectively. Operating expenses were well controlled, rising 3.6% on a comparable basis, despite increasing wage pressures in some of the regions that the Group operates in. Headline earnings per share (HEPS) rose 8.6% during the period to 640c per share. For the full year, consensus expectations are for HEPS of R12.82.

BHP BILLITON

BHP Billiton reported an increase in 1H revenue of 16%, to US$21.7bn with operating profit growth of 11.2%, to US$6.7bn. Attributable profit of US$2bn was 37% lower than last year, however, this figure was impacted by the once-off loss of US$2bn associated with US Tax Reform and, to a lesser extent, the Samarco Dam failure. The company grew underlying EBITDA by 13.5% to US$11.2bn while maintaining a margin of 53% (one percentage point lower (year on year), reflective of the higher commodity price environment over the previous year.

Revenue came in line with expectations. However, higher costs associated with Petroleum, Iron Ore and Coal led to EBITDA disappointing. Full year cost guidance has been maintained leaving BHP Billiton with much containment to manage in H2.

BRITISH AMERICAN TOBACCO

British American Tobacco (BTI) reported full year 2017 results that were in line with estimates. The Group reported earnings per share of 284.4p representing an increase of 14.9% from the prior year and 9.9% on a constant currency basis. Organic revenue for the period was £15.7bn, up 2.9% on a constant currency basis while adjusted organic profit from operations rose 3.7% to £5.9bn. A key highlight during the year was the closing of the Reynolds America acquisition, which management said was performing better than expected from a savings perspective. Including the acquisition, revenue was up 37.6% to £20.3bn and profit rose 39.1% to £6.5bn.

CAPITAL & COUNTIES

Capital and Counties (Capco) reported full year 2017 results that were slightly below expectations. The Group's NAV at the end of the period was down 1.7% to 334 pence per share in line with consensus estimates of 333 pence per share while underlying EPS for the period declined 7.1% to 1.3 pence per share, below consensus' 1.39 pence per share. The Group's total property values at year-end were £3.5bn, a decrease of 0.9% from the previous year. Capco declared a dividend of 1.5 pence per share, a similar number to the previous year.

DISCOVERY

Discovery produced strong results on the back of all business segments moving into profit territory. Core new business grew 16% to R9.3bn, operating profit grew 19% to R4bn and normalised headline earnings grew 30% to R2.8bn. In contrast to previous reporting periods, Emerging Businesses' growth were the stand-out registering a 151% increase in operating profit. Other highlights include Discovery Health growing new business by 10% to R3.3bn, Discovery Invest growing AUM by 22% to R77.8bn and the UK operations showing a healthier performance off increased Vitality engagement and a better mix in the Vitality Life unit. Discovery increased their dividend by 15% to 101cps. The Group remain well capitalised with excess capital reserves at R1.8bn.

GLENCORE

Glencore produced a strong set of FY2017 results propelled by a robust performance from Industrial activities. EBITDA came in slightly ahead of consensus at US$14.8bn, up 44% year on year benefitting largely from higher commodity prices. Net income and EPS grew 320% and 310% to US$5.6bn and 0.41cps, respectively. Higher commodity prices enabled the Company to offset upward trending cost inflation and the effects of a weaker US dollar against producer country currencies.

WOOLWORTHS

Woolworths reported results that were in line with their recent trading update. Group turnover for the first half of the financial year was up 2.5% to R38.8bn, adjusted HEPS declined 8.8% to 223.4cps. The Group's South African operations managed to grow slightly ahead of the previous year, thanks to the food and financial services segments that continue to perform well, while David Jones detracted from the Group's performance. As previously indicated, Woolworths impaired the carrying value of David Jones on their balance sheet by R6.9bn.

GLOBAL EQUITIES

ROCHE

Roche reported FY 2017 results that showed good top line growth across both underlying divisions. Group sales were up 5% to CHF53.2bn with both Pharmaceuticals and Diagnostics growing sales at 5%. As a result core operating profit grew 3% to CHF19bn.

Pharmaceuticals contributed CHF41.2bn to group sales (constitutes 77% of group sales). Growth in this division came largely from recently launched medicines Ocrevus, Tecentriq and Alecensa. However, sales in Tarceva, and Avastin detracted and disappointed. All regions performed well with the United States up 10% and emerging markets growing sales by mid-single digits. European sales, however, declined as a result of lower sales in MabThera/Rituxan amidst competition from biosimilars.

The Diagnostics division contributed CHF12bn to group sales off strong growth from the immunodiagnostics business (up 13%) within the Centralised and Point Care Solutions unit. Although much smaller in sales contribution, the Tissue Diagnostics division also showed strong growth of 11% over the period. Asia-Pacific and Latin America were the strongest regions for this division.

Looking forward, Roche expects sales to grow in the mid-low single digit range while core earnings per share should grow at high single digits. Continued demand for the company's multiple sclerosis and lung cancer drugs should support sales, with the majority emanating from the US and emerging markets growing in relevance. Roche proposed a dividend increase to CHF8.30 per share, the company's 31st consecutive annual dividend increase.

S&P GLOBAL

S&P Global reported solid Q4 2017 results, closing off a great financial year. Revenue for the quarter was up 14% compared to the same period in the previous year. Each of the Group's segments contributed to the growth. Adjusted diluted earnings per share increased 44% for the period to US$1.85 aided by a 2% reduction in diluted shares outstanding, continued productivity improvements and a lower effective tax rate.

The Group's Ratings segment reported a revenue increase of 20% to US$789m, while adjusted operating profit rose 40% to US$439m. The segment's profit margin was reported at 56%. Organic revenue and profit from the Commodities and Market Intelligence segment rose 8% and 13%, respectively, while the Indices segment's revenue and profit gained 12% and 15%, respectively.

WALT DISNEY

Walt Disney reported Q1 2018 results that were broadly in line with market expectations. Revenue for the period rose 4% to US$15.4bn while comparable earnings per share were US$1.89, representing an increase of 22% from the previous year.

The Group's underlying segments showed mixed results with Parks and Resorts once again being the standout performer. Revenue and operating income for this segment rose 13% and 21%, respectively, thanks to the lower base in the prior year due to the impact of Hurricane Matthew. Media Networks was the laggard, reporting flat revenue and a 12% decline to operating income. Part of the decline in this segment's profit was due to ongoing investment into Disney's direct to consumer technology platform, BAMtech. ESPN reported lower advertising revenue, partially offset by affiliate revenue growth and lower programming costs. With traditional media networks continuing to see increased competition from direct to consumer offerings, there is much anticipation for Disney's expanded offering within that segment in the form of BAMtech and ESPN Plus.

CONTACT US

CAPE TOWN

TEL: 021 524 4581
ADDRESS: Old Mutual Wealth, The Estuaries, 2 Oxbow Crescent, Century City, 7441
EMAIL: PCS@omwealth.co.za

JOHANNESBURG

TEL: 011 245 3610
ADDRESS: 1 Mutual Place, 107 Rivonia Road, Sandton, Johannesburg, 2196
EMAIL: PCS@omwealth.co.za

PRETORIA

TEL: 012 369 7220
ADDRESS: 43 Ingersol Road, 3rd Floor, Podium at Menlyn, Lynnwood Glen, 0081
EMAIL: PCS@omwealth.co.za

DURBAN

TEL: 031 581 0699
ADDRESS: 61 Richefond Circle, 2nd Floor Ridgeview Building, Ridgeside Office Park, Umhlanga Ridge, KwaZulu-Natal
EMAIL: PCS@omwealth.co.za

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OLD MUTUAL WEALTH

The Estuaries, 2 Oxbow Crescent, Century City 7441. PO Box 207, Cape Town 8000, South Africa.
Tel +27 (0)21 524 4400 | Fax +27 (0)21 441 1060 | www.omwealth.co.za

Private Client Securities: Cape Town: +27 (0)21 524 4400 | Sandton: +27 (0)11 245 3805 | Pretoria: +27 (0)12 369 7236 | Durban +27 (0)31 581 0600 | PCS@omwealth.co.za