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WEALTH
PRIVATE CLIENT SECURITIES

The father of index funds, John ("Jack") Bogle died on January 16 at the age of 89. Some of us at Private Client Securities were privileged to hear him speak at an industry conference in 2017 – his mind still as clear as ever and his wisdom shared with passion. Jack Bogle founded the first index fund in 1975 and it was an immediate flop. But perseverance paid off. Today, Vanguard, the investment company Bogle founded, manages over US$5 trillion in assets. Bogle took a complex universe of thousands of stocks and reduced it to a simple, singular entity, the index fund. Through index funds, investing in the stock market became accessible and affordable for ordinary investors.

While many active managers will balk at the prospect of promoting, or even discussing, index funds, we believe it has its place - and not just for the ordinary investor. Our portfolios often include listed index funds, or ETFs, to give us efficient exposure to certain asset classes, sectors or countries where we lack the ability to seek out specific investments or where we believe that broad diversification is the best strategy.

It is interesting to note that prior to founding Vanguard, Jack Bogle headed up Wellington - an active fund manager with a reputation for solid, dependable returns. As the "go-go" era of the sixties came into full swing and high stakes investing took off, Wellington found itself lagging its peers. Under these competitive pressures, the firm abandoned its disciplined and proven investment process and began chasing returns with inadequate regard for the risks. The party came to an end as the stock market bubble burst in 1969. This sobering experience brought Jack Bogle back to basics with the recognition that trying to beat the market, or peers, forever is impossible. This gave birth to his inspiration for the index fund.

At Private Client Securities we are cognisant of our own limitations and the unpredictability of the markets. We seek to deliver outcomes that are reasonable within the specified investment period and risk appetite of the investor. This involves adhering to a disciplined investment process, which also means that we do not take unnecessary risks and that we are patient. Investment markets are not patient. Mix in human emotions and we find that greed and fear too often lead to wealth destruction.

"It's amazing how difficult it is for a man to understand something if he's paid a small fortune not to understand it." – John C. Bogle

ECONOMIC OVERVIEW

After December's market turmoil, global equities bounced back strongly in January. One of the main reasons behind the recent volatility is the market's shifting view of US monetary policy. In December, the fear was that the Federal Reserve's interest rate increases and balance sheet reduction was on "autopilot", and would go too far and choke off the US economy and drain liquidity from markets. Indeed, the Fed hiked rates at its December policy meeting. However, at that meeting the Fed also signalled that it would be more cautious in raising rates, given still-low inflation and signs of strain in interest rate-sensitive areas like housing. At the end of January, this caution became part of its official policy stance, with the post-meeting statement indicating that the Fed would be 'patient' in light of muted inflation pressures and a slowing global economy. The explicit reference to future hikes that had been in the statement since 2015 was removed. A separate statement noted that the Fed would make changes to its balance sheet reduction programme if conditions warranted it. Currently, US$50 billion in bonds that were purchased during its various rounds of quantitative easing (QE) are allowed to mature each month without being replaced, meaning that the Fed's portfolio of assets is steadily shrinking.

The European Central Bank, which also kept rates on hold, faces a bigger challenge. Inflation remains stubbornly low, while economic growth has slowed sharply. The ECB blamed the slowdown on external factors, noting in particular "persistent uncertainty relating to geopolitical factors and the threat of protectionism". Brexit, the Yellow Vest protests in France and Donald Trump's trade wars all fall in this category. There are also some once-off problems, such as the low level of the Rhine River impeding the flow of goods in Europe's main water highway, and new emission standards impeding car production. Germany in particular is heavily dependent on its auto industry. The one party the ECB did not blame was itself. It has halted its quantitative programme, and while its benchmark rate is still zero, it still expects plans to start hiking later this year despite the downshift in its growth outlook, alongside stubbornly low inflation. In other words, it appears to have declared victory prematurely, and might still be forced to retreat from its current path of gradually removing stimulus.

As widely expected, the SA Reserve Bank's Monetary Policy Committee (MPC) left the repo rate unchanged at 6.75%. The Bank cut its inflation forecast to 4.8% in 2019 (down from 5.5%), and to 5.3% in 2020 (down from 5.4%). The change in forecast is largely due to a lower assumed oil price. Consumer inflation declined to 4.5% in December, from 5.2% in November. While this was largely due to a substantial petrol price drop in December, lower food price inflation was also a contributor. Core inflation, which removes the impact of volatile food and fuel prices, was 4.4%, basically in line with the SARB's de facto target of 4.5%.

The low inflation environment was also evident in the post-festive season trading updates of local listed retailers who reported inflation rates of mostly between -1% and 1%. Mr Price was an outlier with 5.8%, and it showed in its weak volume growth. Shoprite reported that some 11 000 items saw price declines last year. In a tough competitive environment, companies are very reluctant to raise prices for fear of losing business. Globally, it seems, the world remains in a low inflation, low interest rate environment.

MARKET OVERVIEW

After a very volatile 2018 that ended in an equally unpredictable December, January began with a bullish tone as global markets shrugged off negative sentiment. If Chinese zodiac signs are anything to go by, then 2019, the Year of the Pig, should bring good fortune as pigs are a symbol of wealth in Chinese culture.

With a few exceptions, global equity markets all closed positive for the month of January, fuelled by the rise in global commodity prices, a less hawkish stance from the Fed, easing tensions between the US and China, and perhaps a likely Brexit deal that will not derail the UK economy. The US dollar gave back some gains against other currencies, even allowing emerging markets to recover at the expense of the greenback. The rand was no exception, strengthening by 7% from R14.34 to R13.34 to the dollar. This move countered the big rise in Brent crude in January, as well as softening other import costs to our economy. Precious metal prices rose and were supportive to the local listed miners on the JSE as gold broke through US$1 300 for the first time since June 2018. Retail and industrial companies however remained under pressure, which weighed on the local market. With this year's local general elections firmly at the top of the agenda, we should expect the usual political noise to gather momentum over the coming months.

LOCAL EQUITIES

Naspers

Media and internet giant Naspers posted strong results for the half-year to September 2018. Trading profit rose by 34% to US$2bn as all classifieds businesses were profitable and ecommerce continues to improve. Acquisitions in the period totalled over US$700 million as Naspers said it continued to invest in existing and new businesses in classifieds, payments and food-delivery verticals.

The payments business is fast approaching profitability, particularly gaining scale in India. While Tencent continues to underpin growth, Naspers is becoming less reliant on Tencent's contribution. This is evidenced by the fact that the group's headline earnings rose 39%, outstripping the 24% growth generated by Tencent.

In the interim period, Naspers announced its intention to list the video-entertainment business on the JSE as MultiChoice Group. The listing is expected to take place later this month. The net result of the listing of MultiChoice Group is that 100% of Naspers revenues and profits will come from online businesses.

Naspers' balance sheet remains strong, with healthy cash flows driven by Tencent's dividend and the proceeds of the Flipkart sale. Management reiterated that they are ready to take advantage of opportunities to acquire good businesses at good prices in the current market and economic climate.

GLOBAL EQUITIES

Nike

Nike is the world's largest athletic footwear and apparel producer/wholesaler/retailer with over US$35 billion in annual sales across all major geographies. Additionally, Nike is doubling-down on an ambitious digital transformation, which aided sales growth of 10% to US$9.4 billion during the most recent quarter. During this period, North America increased sales by 9% and international geographies grew by 20%. Increasingly personalised products provided at scale have allowed Nike to penetrate and remain relevant in the evolving hybrid online/offline market place for retail. Recently, Nike's North American digital business grew sales by more than 30% over the Thanksgiving shopping week while Single's Day in China saw Nike named (once again) the top sports brand on Tmall, with sales up 40% over last year.

Bank of America

Against the backdrop of a fast-growing US economy in 2018, a healthy US consumer, corporate tax cuts and interest rate increases by the Federal Reserve, Bank of America - the US' second largest bank - reported record earnings for the final quarter of 2018 that exceeded analyst expectations. Investors were further buoyed by the bank's improving shareholder pay-out ratio as during the year, Bank of America returned close to US$26 billion to shareholders in the form of share buybacks and dividends. This represents just over 9% of the group's market capitalisation.

Other highlights during the quarter included strong net interest income, which was aided by four interest rate increases throughout 2018. Similar to the last few years, the group managed to control expenses, which led to improved margins and returns. At year-end, the group's efficiency ratio (a measure of its profitability) improved to 58%, down from 65% in the corresponding quarter of 2017. In theory, the optimal efficiency ratio for large banks is 50%.

Johnson & Johnson

Johnson and Johnson, the world's largest healthcare company, reported fourth quarter and full year 2018 results that beat market expectations on both a revenue and earnings basis. Disappointingly, however, the company's fourth quarter results showed slowing growth relative to the full year result. In particular, the Medical Device segment reported negative sales growth over the quarter.

From a more longer-term perspective, there were noteworthy highlights from the results: Johnson and Johnson now generates around 70% of sales from their top market share positioned products; around 25% of sales can be attributed to products launched over the past five years and; the company has grown to include 26 brands/platforms that each generate over US$1bn in sales.

Danaher

Diversified industrial group, Danaher Corporation, reported better-than-expected fourth quarter 2018 results. Pleasingly, organic revenue growth was the key performance driver, rising 5.5% during the quarter and 6.0% over the full year. Acquisitions added a further 2% to revenue, with currency movements detracting from revenue by 2%. Operating margins for the period were down 0.5% to 17.9% as management accelerated investment spending into research and development, sales, and marketing to take advantage of the solid revenue growth during the quarter.

One negative update from the result was that the planned spin-off and listing of the Dental segment has been postponed to the end of 2019 due to the backlog at the Securities Exchange Commission as a result of the just-ended government shutdown. Despite this, the Dental segment continued its recent recovery, reporting its strongest quarterly growth (+2.5%) in over two years.

Facebook

Social media giant, Facebook reported better-than-expected fourth quarter results. Revenue came in at US$16.91 billion, representing a 30.4% year-on-year increase and comfortably beating consensus estimates by 3.19%. At 93%, mobile advertising revenue represented the bulk of total revenue. Earnings per Share (EPS) came in at US$2.38, up 7.7% y-o-y and 8.9% higher than consensus estimates. Total expenses were US$9.1 billion, up over US$1 billion quarter-on-quarter and 62% y-o-y. The significant rise in expenses was driven primarily by continued investment into infrastructure, security and innovation. Increased marketing spend for the promotion of Portal and Oculus Go during the quarter also contributed to the rise in expenses.

Over the quarter, Daily Active Users (DAUs) and Monthly Active Users (MAUs) increased in all regions. Notably, Facebook reported an additional one million DAUs in the US and Canada, regions which were previously experiencing declining to flat growth. Given these numbers and robust Average Revenue Per User (ARPU) growth of 21% y-o-y to US$7.31, it seems that, despite all the negative press, Facebook's platforms remain popular for both users and advertisers.

Microsoft

Strong performance across the Microsoft commercial cloud segment saw the company reporting double-digit revenue growth during the second quarter of 2019. Revenue came in at US$32.5bn and operating income rose by 18% to US$10.3bn.

Over the quarter, Microsoft closed the US$7.5bn acquisition of GitHub, the world's leading open-source software platform. GitHub has more than 31 million developer accounts and recently surpassed 100 million code repositories. More than half the Fortune 50 companies conduct their work in GitHub Enterprise. This acquisition ideally positions Microsoft to penetrate and expand its presence at the top of the software value chain, ensuring that the next generation of coders and programmers integrate Microsoft into the future of software and applications.

Amazon

Amazon.com, the world's largest online retailer, posted revenue growth of 20% for the quarter to US$72.4 bn. CEO Jeff Bezos hailed virtual assistant, Alexa, for the group's stellar performance, highlighting that the Echo Dot was their best selling product. Amazon Web Services (AWS) continues to be the group's growth generator with operating income up 33% for the quarter, a key contributor to the group's 81% increase in operating income, now at US$3.8bn. Prime membership subscriptions reached a new high in 2018 with volumes greater than any preceding period, which contributed to full year 2018 revenues of US$232.9bn (+31%), and saw Amazon more than double its net income to $10.1bn.

While the results were pleasing, they represent the lowest quarterly growth rate posted in 2018 and the slowest sales growth since 2015. A lower Q1 2019 growth outlook and a slowdown in the volume of items sold on Amazon's platforms to 14% in Q4 2018 from 23% a year ago, added to investor concerns regarding a global growth slowdown in 2019 and saw Amazon's share price drop 5% immediately following the release of their results.

CONTACT US

CAPE TOWN

CENTURY CITY

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

STELLENBOSCH

TEL: 021 861 5300
ADDRESS: The Vineyard, Building B, Corner Adam Tas and Devon Valley Road, Stellenbosch, 7600
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

KWAZULU NATAL

UMHLANGA

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

KLOOF

TEL: 031 767 7300
ADDRESS: 75 Old Main Road, Unit 7, Kloof, KwaZulu-Natal
EMAIL: PCS@omwealth.co.za

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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