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PROSPERITY

IN THIS CLIENT **NEWSLETTER**

- Economic and market outlook
- Local and global equities

PRIVATE CLIENT SECURITIES

OLD MUTUAL WEALTH

Lower interest rates and more planned monetary stimulus stole headlines again this month. Around a third of developed country sovereign bonds now have yields that are negative. The most profound example is that of Switzerland where the yield on government bonds of all maturities, up to 50 years, have turned negative meaning that investors are willing to pay the Swiss government for the privilege of lending them money – even for half a century! The remainder of developed country sovereign bonds have yields that are closing in on zero. The price of investing in these "safe" assets has gone up significantly with even ex-US Fed Chairman Alan Greenspan recently warning that bond prices have gone too high.

With the ensuing hunt for assets delivering a positive yield, we continue to see equities performing well. Other high yielding asset classes such as emerging market debt and high yield corporate credit are also doing well. However, we would argue that only equities have the resilience of an asset class that offers long-term real growth. When you look at the enterprises we invest in – these are companies of quality in every meaningful metric. These companies are being managed for the long term, not for short-term gains.

There are concerns about equity valuations having been chased up along with other asset classes in the search for yield. That may be true, but trying to call a top or bottom in the equities market is not possible. What the prudent investor needs to do is diversify appropriately, hold some cash and use any possible market correction as a buying opportunity.

As for concerns about equities being "close to the top", it is insightful to see what has happened in the past. If you were so unfortunate as to have bought stocks only at the three last market tops, you would still have a very respectable total return to show. If you bought on the JSE just before the 1998 emerging market-induced crash, your total return for the index to end July 2016 would be 587%. If you bought just before the 2001 tech bubble burst, you would be up 352% and if you bought before the 2008 financial crises crash, you would be up 59%. There is a trend here and you will find it in most equity markets – the longer your holding period, the better your returns despite even having bought into the market at the worst times. Equities tend to go up over time along with economic activity. It is not smooth sailing, but just give it time.

"The best time to plant a tree was 20 years ago. The second best time is now." – Chinese proverb

ECONOMIC AND MARKET OVERVIEW

Economic growth in the US was below expectations during the second quarter of 2016. Consumer spending picked up, supported by decent jobs growth and higher wages. However, business profits have been under pressure and firms have been reluctant to invest. This is holding back the overall performance of the largest economy in the world. It also had a material impact on expectations for the next interest rate hike in the US.

With interest rates expected to remain low in the US, negative in Europe and Japan and likely to be cut in the UK (in the wake of the Brexit vote), the search for yield is back in full swing. This saw emerging market bonds, equities and currencies gaining substantially in July.

South Africa was no exception, with the rand breaking through R14 per US dollar on the last day of the month. The stronger rand, along with a weaker global oil price, should assist in keeping inflation in check and prevent the South African Reserve Bank from hiking rates, which were left unchanged in July. While the rand has appreciated from the start of the year, it is still weak in absolute terms. This has supported exports and tourism. South Africa posted a trade surplus in the second quarter as precious metal exports rebounded and vehicle exports continue to grow. Lower oil imports are keeping the overall import bill lower. Recent trends in commodity prices support these trends. Manufacturing is also doing better, with the Barclays Purchasing Managers' Index posting a fifth month in positive territory, the best streak of consecutive months above 50 index points in the last three years. In other words, after being hit by a seemingly endless number of shocks in the past five years – including prolonged strikes in key sectors, the global commodity price slump, load-shedding, the worst drought in decades, a collapsing currency and higher interest rates – things appear to finally be looking up for the local economy.

Emerging markets continued their resurgence in July, with the MSCI Emerging Markets Index ending the month 4.7% higher (US$), while the MSCI World Index lagged slightly, 4.2% higher. In the US, the S&P500 ended the month strongly (3.5% in US$). The UK's FTSE 100 ended the month up (3.4% in £) after recovering from the fallout of the Brexit vote. In Asian markets, the Nikkei 225 was 6.4% higher over the month and the Hang Seng was up 5.3% in July. Locally, the ALSI gained 1.2% during July. During the month, Industrials (-0.4%) were lower while Resources (4.3%) and Financials (2.8%) were stronger.

LOCAL EQUITIES

BRITISH AMERICAN TOBACCO

British American Tobacco (BAT) sold just over 332 billion cigarettes during the six months to end June 2016. This represents a 3.4% year-on-year increase despite efforts by various governments to curb smoking. Growth in cigarette volumes translated into a 4.2% rise in interim revenue to £6.67 billion. Net profit, however, declined 2.2% to £2.45 billion. BAT nevertheless raised its interim dividend by 4%. Revenue declines of 6.3% in the Americas and 0.12% in the Eastern Europe, Middle East and Africa regions were compensated for by a 18.2% surge in sales in Western Europe. BAT's Vype brand of e-cigarette has grown to 9% of the UK's cigarette market, 8% in Germany and 5% in France. Vype was launched in five Italian cities, with further expansion planned.

ANGLO AMERICAN PLATINUM

Despite the lower price environment, Anglo American Platinum (Amplats) generated R3.2 billion free cash flow in the six months ended June 30 and cut debt by R2.9 billion. The platinum producer's sales revenue increased by 3% to just under R31billion, its earnings before interest and tax increased by 12% to R1.5 billion, headline earnings totalled R1 billion and headline earnings per share were R3.99. Platinum group metal pricing during the period remained weak, with the average US dollar basket price per platinum ounce sold decreasing by 24% in during the first half of 2016 to US$1632 versus the US$2157 achieved in 2015. The decline in US dollar metal prices was partly offset by a weaker rand, resulting in the rand basket price per platinum ounce ending 3% weaker at R25 100, compared to R25 748 in the first half of last year. Amplats remains focused on cash conservation and disciplined capital allocation. The company is continuing to prepare for the future through market development and modernising through innovation in mining and processing technology. Previous guidance on production remains in place, with platinum production expected to be towards the upper end of 2.4-million ounces. Amplats is forecasting further reduction in net debt at current spot and foreign exchange prices, with earnings remaining highly geared to the rand/US dollar exchange rate.

GLOBAL EQUITIES

STARBUCKS

In releasing its third quarter fiscal 2016 earnings results, Starbucks reported US$5.2 billion in revenue, representing a 7.3% year-on-year increase. Global same store sales rose 4% during the quarter and net income grew 20% to US$754 million. The positive operational gearing in the business is evident from the extent to which net income growth exceeds sales growth. Excluding special items, Starbucks' earnings per share increased 17% to 49 cents per share, in line with analysts' expectations. In terms of regional performance, Starbucks' Americas segment posted a 7% increase in revenue to US$3.6 billion. This was largely driven by additional revenue from 730 net new stores opened over the past 12 months. The company also noted that use of its Starbucks Rewards loyalty program increased 18% year-on-year, with 12.3 million members now in the US. In the China/Asia Pacific region, revenue increased by 18% to US$768.2 million following the addition of 888 new stores over the past twelve months. Starbucks' Europe, Middle East and Africa segment recorded a 7% decline in revenue (to US$273.4 million) due to the conversion of company-owned stores to licensed stores and the unfavourable effects of foreign exchange. Looking ahead, Starbucks slightly lowered its full year comparable store sales growth projection to mid-single-digits and reiterated its full-year earnings per share guidance of US$1.88 - US$1.89.

ROCHE

Roche reported a 6% year-on-year increases in sales (in Swiss Francs) during the first half of 2016. Growth was primarily driven by pharmaceutical sales in the US and strong demand for immunodiagnostic products. The company concentrates its efforts in prescription pharmaceuticals and diagnostics covering Oncology, HIV AIDS, Rheumatoid Arthritis, Diabetes, Cardiovascular and Renal Anaemia. Roche continues to expect sales to increase in the low-to-mid single digits while core earnings is expected to grow at a higher rate than sales. Roche also intends to increase its dividend further in 2016.

VISA

Visa reported a profit of US$412 million during its fiscal third quarter ended June 30, down from US$1.7 billion a year earlier. The decline in profit was due to the inclusion of special items related to the acquisition of Visa Europe. Excluding the exceptional items, net income for the quarter came to US$1.6 billion, which was negatively impacted by the firm US dollar. Revenue rose 3.2% to US$3.63 billion, up 6% on a constant-dollar basis, driven by improved payments volume. Payment volume (the total monetary value of transactions on Visa-branded cards) increased 10% on a constant-dollar basis to US$1.3 trillion. We expect this number to continue to show strong growth as more transactions are settled without the use of cash. Cross-border volume rose 5% on a constant-dollar basis, signifying some resilience on consumer spend despite the challenging global macro environment. Operating expenses, excluding items such as the Visa Europe purchase, fell 7% to US$1.17 billion, reflecting lower personnel and marketing costs. Visa purchased the European operations in June, a deal initially valued at up to €21.2 billion (US$23.4 billion) that was designed to bring its global operations under one roof. The credit-card issuer also added US$5 billion to its stock buyback plan and unveiled a digital payment alliance with PayPal Holdings intended to make it easier for PayPal customers to pay with Visa cards. The deal is expected to increase the number of transactions made on Visa-branded cards.

NEWMONT MINING

Newmont Mining reported strong second quarter earnings results, topping forecasts on production, costs, adjusted earnings per share and cash flow. Second-quarter revenue increased 6.8% to US$2.04 billion, beating the US$1.91 billion average estimate. The strong performance of the company's gold mining operations offset the negative impact of the performance of the copper mining operations. Higher gold prices, higher gold shipments and improved cost performance boosted the company's overall results. Additional production from the recently acquired Cripple Creek & Victor (CC&V) gold mine boosted production volumes, whereas higher volumes and efficiency improvements resulted in improved cost performance for the gold mining operations. Newmont, which has operations in the Americas, the Asia-Pacific region and Africa, has been working to lower costs and increase production after gold fell for three years before the 2016 rally. Newmont expects to add one million ounces to gold production, at all-in sustaining costs of US$700 an ounce or less, over the next two years. Newmont lowered its guidance for capital expenditures slightly to a range of 1.1 billion to 1.3 billion for 2016. The previous top end had been US$1.4 billion. All-in costs are expected to improve to a range of US$870 to US$930 an ounce in 2016, holding relatively steady at US$850 to US$950 in 2017. With gold having traded at an average price of US$1200 an ounce over the last year, the company has a healthy profit margin compared to most of its peers. The company has cut its debt this year by more than US$600 million and remains on track to repay US$800 million to US$1.3 billion of debt between 2016 and 2018, targeting the highest rates and nearest-term maturities first. Newmont left its quarterly dividend unchanged at 2.5 cents a share.

HONEYWELL

In its second quarter 2016 results, Honeywell International reported earnings per share growth of 10% (at US$1.66) from the US$1.51 registered in the 2Q of 2015. Sales growth was more muted registering a 2.2% increase over the prior 2Q number. This is against a tough macro environment which has also hampered other sector participants. Organic growth across Honeywell's three main divisions: Aerospace, Automation and Control Solutions (ACS) and Performance Materials and Technologies (PMT) has shown weakness with management revising guidance downwards. This places a greater emphasis on maintaining/slightly increasing margins to meet targets. Historically, Honeywell management have shown an ability grow margins in tight environments. Notwithstanding, a broad-based macro slowdown resulting in lower than expected revenue (Europe = 25% of sales) will present a challenge to meet full year targets. Honeywell also announced a realignment of its ACS (37% of sales) segment into two new segments: home and building technologies and safety and productivity solutions. This increases the reporting structure from three to four divisions, beginning with 3Q16 results. Consensus expects this split to "unlock" value allowing for two more nimble divisions being better positioned to extract value.

FACEBOOK

Facebook reported strong second quarter results, with revenue up 59% year-on-year (to US$6.436 billion) and net income soaring 186% (to US$2.055 billion) compared with the second quarter of 2015. Revenue from advertising was up 63% year-on-year, with mobile advertising revenue up 76% year-on-year. During the period, mobile ad revenue represented approximately 84% percent of total ad revenue. The fastest growth regions for advertising revenue in the second quarter were the US and Canada and the Asia-Pacific region, which saw growth rates of 69% and 67%, respectively. Monthly and daily active users hit 1.71 billion and 1.13 billion during the quarter, respectively. In addition to the increase in active users, Facebook also disclosed that they continue to see an uptick in the amount of time that users spend on their platforms. Currently, people around the world spend an average of more than 50 minutes a day using Facebook, Instagram and Messenger, and this does not even include WhatsApp. Monthly users on mobile increased 20% year-on-year, and daily users on mobile increased 22% year-on-year. This massive user base has not gone unnoticed by advertisers. Facebook was able to monetise those users, posting US$3.82 average revenue per user, up from US$3.32 last quarter and above the US$3.59 expected by analysts.

MICROSOFT

Microsoft Corporation reported its fourth quarter results, with earnings beating consensus expectations as the company continues to execute well on its shift to cloud-based services from software and reliance on PC sales. The company reported US$22.6 billion in revenues for the quarter ended June 2016 up 2% from a year earlier. Earnings rose 11% to US$0.69 per share ahead of the US$0.58 expected by analysts. The group reported 102% year-on-year growth in Azure, its cloud platform, with revenue up 7% year-on-year to US$6.7 billion. Hardware and software sales fell 4% year-on-year to US$8.9 billion.

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