JULY 2017

PROSPERITY

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PRIVATE CLIENT SECURITIES

OLDMUTUAL WEALTH

Looking at developed economies, there is a conundrum of slow demand growth and continued low unemployment on the one hand and still very low inflation expectations on the other hand. This implies that there is currently very little wage growth, despite low unemployment, and no significant input cost pressures from oil and other commodities. It follows that central banks will not be under pressure to raise rates aggressively, if at all, for the rest of this year. This is already reflected in a weakening of the US dollar.

Confidence in the Eurozone, especially in Germany and France, is still improving with the continent continuing to deliver better economic growth and reduced risks of political disruption. With the Eurozone in a structurally positive growth trajectory it supports a pro-growth global macro-economic picture. Unfortunately, the South African economy remains under pressure and is not benefitting from the nascent global recovery.

Markets in the US, Europe and the East delivered positive returns in July with only a few exceptions. Valuations in the US remain demanding even as good earnings are coming out from companies. The technology sector, in particular, appears to be fully valued. The US Food & Drug Administration set out plans to reduce nicotine levels in cigarettes to non-addictive levels by August 2021. This news surprised the market and the share prices of tobacco companies were negatively affected across the board. Our approach to such an event is not to react without allowing time to properly re-evaluate our holdings of affected stocks.

"If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes." – Warren Buffet

ECONOMIC AND MARKET OVERVIEW

Central banks were in the spotlight in July. The combination of robust growth and low inflation is creating some confusion in central banking circles – and in how markets interpret their moves - as one would normally expect stronger growth to push up inflation as the economy runs out of resources (workers, factories and machines). However, the Bank of Japan had to push back the timing of reaching its 2% inflation target for the sixth time to 2019, despite unemployment at a 20-year low of 2.8%.

The US Federal Reserve (Fed), left interest rates unchanged as expected. However, it noted its concern that inflation had declined recently. If inflation remains low – and lower than expected – there is little reason to raise rates further. The Fed also stated its intention to reduce the size of its balance sheet "relatively soon". It will do this by not reinvesting the interest and capital from maturing bonds bought as part of its quantitative easing (QE) programmes between 2008 and 2014. The QE programmes were an unprecedented monetary experiment, and will be unwound. The Fed is therefore likely to pause rate hikes while it begins to trim its balance sheet.

The dampened expectations for US interest rates has placed further downward pressure on the US dollar, which touched a nine-month low on a trade-weighted basis by the end of the month. The inability of Donald Trump's Republican Party to repeal healthcare legislation (Obamacare) is also seen as dollar negative, as it calls into question Trump's ability to implement growth-enhancing reform. While the European Central Bank did not change its policy interest rates or quantitative easing programme at its July meeting, the market increasingly expects it to scale back stimulus soon, based on a robust European economy (despite inflation being very low). Euro member states are reporting strong second quarter growth numbers and economic sentiment indices at ten-year highs are still at levels consistent with continued economic expansion. This has buoyed the euro.

In an unexpected but welcome move, the SA Reserve Bank's Monetary Policy Committee (MPC) cut the repo rate to 6.75% after sharp downward revisions to its growth and inflation forecasts. The MPC sets interest rates to influence the trajectory of future inflation (one to two years out), since rates changes take time to impact the economy. Its updated inflation forecast is thus important. Inflation is expected to average 5.3% this year, down from 5.7%, while forecasts for 2018 and 2019 were also cut. The SARB expects inflation to remain within the target range throughout 2018 and 2019. Core inflation is expected to be below 5% over this period. After the surprise decline in the first quarter, the growth outlook for the year as a whole has been halved to 0.5%. While the SARB expects growth to improve somewhat to 1.2% in 2018 and 1.5% in 2019, these lacklustre growth rates are completely out of sync with global growth and are clearly too low to make any headway in South Africa's social problems.

July was a great month for virtually all asset classes, with the notable exception of the US dollar, which declined by almost 3%, closing. Strong corporate earnings reports from the US drove the major equity indices to new highs several times in July, supported by rising commodity prices and largely positive economic data.

Commodities and equities made up the top of both the local currency and USD performance tables while European equities and government bonds disappointed at the bottom of the table. However, the strong performance of the euro (and USD weakness more generally) lifted most European assets into more positive territory in USD terms. The worst performers were mostly US credit and treasuries, followed by two relatively underperforming agricultural commodities in Corn (+0.1%) and Wheat (-7%). Base metals as well as precious metals recovered from recent lows, with copper up 7% and gold stronger by 4%, closing the month at $1,269. Oil was one of the strongest performers as it led all assets in local currency terms, gaining almost 9% in July. It should be noted that nearly all of the gains came at the tail end of the month following news of Saudi Arabia's pledge to reduce crude exports in August.

Elsewhere, broader emerging market equities saw strong performance in general. An important point to note is the fact that despite the poor performance of broader European assets, European banks actually performed well in the month with gains of 3% in euro terms and over 6% in USD terms as Euro area economic momentum continues to hold strong, backed by rising Eurozone government bond yields. The local All Share Index gained almost 6% and posted its first ever monthly close above 55,000. A move in the rand from 12.90/US$ to 13.18/US$ in the last four days of the month boosted equities but reflected the renewed concern from credit ratings agency Moody's over their concern of political interference in SA's economic policy.

GLOBAL EQUITIES

AMAZON

E-commerce giant and serial disrupter Amazon.com reported second quarter earnings that exceeded expectations on the top line but showed a big profit miss as costs soared. The company reported revenue of US$38 billion, beating the consensus estimate of US$37.2 billion, with adjusted earnings of 40 cents a share. Revenue from Amazon's cloud computing unit, Amazon Web Services, rose 41% to US$4.1 billion, slightly above the consensus estimate of US$4 billion. Amazon's spending cut into profits as spending on fulfilment centres rose 33% from a year ago to just over US$5 billion. Spending on content and technology rose 43% to $5.6 billion. For the third quarter, Amazon is expecting revenue in the range of US$39.3 billion - US$41.8 billion, an increase of between 20% - 28% year-on-year.

Earlier this month, the media reported that Amazon had started a secret lab focused on medical records, telemedicine and health care apps. This follows previous reports that Amazon is looking at entering the pharmacy business.

ROCHE

Roche Holding SA, the world's largest maker of cancer medication, posted stronger-than-expected first half profits despite increasing competition from generic drug makers. Core earnings for the first six months of this year rose 6% year-on-year to 8.23 Swiss francs per share. Overall group sales rose 5% to 26.3 billion Swiss francs (US$27.6 billion), largely in line with expectations. The Pharmaceuticals and Diagnostics Divisions showed strong performance over the period, driven by recently launched medicines Tecentriq, Ocrevus and Alecensa. Looking ahead, Roche expects sales to grow in mid-single digits, at constant exchange rates for the second half of the year with core earnings expected to rise broadly in line with sales.

NESTLÉ

Swiss nutrition, health and wellness giant Nestlé SA, reported a 19% year-on-year increase in net profit to 4.89 billion Swiss francs for the first half of 2017. Earnings per share also increased 19% to 1.58 francs. Total reported sales came in at 43.02 billion francs, down 0.3% from 43.16 billion francs last year. The decline reflected the impact of net divestments of 2.3%, largely related to the creation of the Froneri joint venture, and exchange rate impacts. Organic growth was below expectations at 2.3%, with 1.4% real internal growth and 0.9% pricing. Due to increased restructuring activity, Nestlé's trading operating profit margin decreased 30 basis points to 15%.

Looking ahead, the company expects organic growth to be in the lower half of the 2% – 4% range. Trading operating profit margin in constant currency is expected to be stable as the company is increasing restructuring costs considerably in order to drive future profitability.

GENERAL ELECTRIC

General Electric Co (GE) reported a 12% decline in revenue for the second quarter of 2017, as weakness in its energy connections business offset strength in renewables and power units. Net profit fell by 58% to US$1.34 billion, or 15 cents a share, in the quarter ended June 30, from US$3.3 billion, or 36 cents a share, a year earlier. Revenue fell to US$29.5 billion from $33.5 billion and adjusted earnings fell 45% to 28 cents a share.

GE's closely watched cash flow from operations fell 67% to US$3.6 billion from a year ago, reflecting the loss of contributions from the appliances division, which was sold off. However, cash flow was up from $400 million in the first quarter, and GE said it expects cash flow to increase during the remainder of the year.

HONEYWELL

Honeywell International Inc reported a better-than-expected quarterly profit, as sales in its aerospace unit and the business that caters to the energy industry were not as bad as it had feared. Net income increased to US$1.39 billion (or US$1.80 per share) in the quarter ended June 30, from US$1.32 billion (or US$1.70 per share) a year earlier. The company's revenue rose marginally to US$10.08 billion from US$9.99 billion. Sales in Honeywell's aerospace business fell around 3% to US$3.67 billion in the quarter ended June 30, but the decline was much smaller than the company's forecast of 5% - 7%. The unit, which makes jet engines and provides spare parts, repair, overhaul and maintenance services, benefited from strength in its commercial aviation after-sales business and growth in US defense volumes. Sales in Honeywell's Performance Materials and Technologies (PMT) unit, which makes catalysts and adsorbents used for petroleum refining, dropped about 8% to US$2.24 billion in the quarter. Honeywell had forecast a decline of 10% - 12%. The unit benefited from higher sales of Solstice low global-warming potential refrigerant products.

The US technology and manufacturing company raised the low end of its 2017 earnings per share forecast by 10 cents to $7.00, keeping the high end unchanged at $7.10. It now expects sales of $39.3 billion to $40 billion, up from its previous forecast of $38.6 billion to $39.5 billion.

LOCAL EQUITIES

CAPITAL & COUNTIES PROPERTIES

Capital & Counties Properties (Capco) raised its first-half net rental income as a result of a positive performance at Covent Garden estate, which is located in London. The value of the estate rose 1.5% to £2.4bn in the six months to June on a like-for-like basis, with the estimated rental value (ERV) increasing 2.85% to £98.8m. This follows strong operational progress across the estate, with 43 new leasing transactions signed during the period. Capco's ERV target of £125m by December 2020 remains in place, reflecting the positive growth prospects of the Covent Garden estate. The value of Capco's Earls Court Properties, however, dropped 2.4% to £1.1billion over the period.

The JSE-listed group said the Brexit-induced economic and political uncertainty had affected the valuation of residential-led development land, but had a limited effect on tenants at its Covent Garden estate. Overall, group net rental rose to £32.4m, from £28.6m in the year-earlier period.

BRITISH AMERICAN TOBACCO

British American Tobacco (BAT) reported strong first-half operating profit and sales as the tobacco giant was helped by currency tailwinds. The owner of Dunhill, Lucky Strike and Pall Mall brand cigarettes said net profit during the six months ended June 30 fell 15% to £2.26 billion (US$2.97 billion) as the company felt the impact of last year's sale by Reynolds of the international rights to the Natural American Spirits brand. The US company, which BAT had owned 42% of for years before acquiring it outright, sold the rights to Japan Tobacco Group in January 2016 for US$5 billion. BAT's adjusted operating profit (which strips out restructuring and integration costs and the impairment of trademarks) rose 16%. Revenue rose 16% to £7.72 billion, helped by sterling's weakness, while revenue at constant currency, adjusted for excise on goods purchased from third parties, was up 2.5%. Group cigarette volume was 314 billion, a decline of 5.6% on the same period last year. Last month BAT said it expected profit growth to be weighted to the second half of the year because of the timing of shipments and the way it has allocated marketing spend, investments in next generation products.

The recent announcement of the proposal to introduce further regulations around the nicotine content in cigarettes in the US saw BAT and other tobacco stocks declining. Until there is further clarity around the announcement, we have decided to not react to the news at this stage. We believe that the market has reacted in a kneejerk fashion to what can only be described as negative noise, given that no one fully understands what the ramifications would be if such regulations were put into effect. It is also worth mentioning that this announcement only applies to the US market. Analysts estimate that to implement such regulation would be a fairly long process as people debate and lobby for/against it. Given the above, we feel it is prudent to wait until there is further clarity.

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