JUNE 2018

# PROSPERITY

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## INTRODUCTION

Clients may be wondering whether the latest global and local developments will weigh on their portfolios. Economic news during the month tended to once again be negative and international emerging markets worries have resurfaced. Nevertheless, market sentiment does wax and wane as we have seen during the course of the first six months of this year and June was no exception.

The tightening in the US has only partly been offset by the continuing accommodative monetary policy of Europe and Japan. Rising trade tensions, the extreme policy mix and hard stance followed by compromise from the US are not helping to ease a growing sense of the possibility that tighter global monetary policy will lead to a credit-driven event. Despite China's growing economic clout, its investible market is still relatively small and vulnerable in the short to medium term. Emerging markets, especially countries that have current account deficits, are already reflecting a reduction in global risk appetite in rising sovereign debt yields and weakening domestic currencies. This includes South Africa. The price of local government bonds has weakened together with the currency. Several overpriced shares, notably domestic-facing companies, have fallen from overpriced levels earlier this year, but these then are also presenting more attractive investment opportunities.

At the halfway mark for 2018 it is useful to remember that when we invest in companies it is more important to consider the future than the past. Shares remain the source of growth in a diversified portfolio, it just depends on the company you keep.

***"If owning stocks is a long-term project for you, following their changes constantly is a very, very bad idea. It is the worst possible thing you can do, because people are so sensitive to short-term losses. If you count your money every day you'll be miserable."*** Daniel Kahneman

## ECONOMIC OVERVIEW

The threat of a global trade war loomed large during the month, with US President Trump threatening further tariff increases against China and the European Union. This comes on top of a range of tariff increases that came into effect during the month, including northern neighbour Canada. All the targeted countries have retaliated with threatened or actual tariff increases of their own. Seen in isolation, the tariff increases are potentially disruptive to global supply chains but the economic damage is probably limited as companies can shift around production. For instance, in response to European tariffs against American motorcycles, Harley-Davidson announced it would increase production outside the US. However, every successive round of tit-for-tat tariff increases risks slowing global growth. Whether Trump's trade tweets are just a negotiating tactic or a permanent feature remains to be seen. The biggest impact is not probably directly on trade volumes, but more the uncertainty it creates for businesses with complex value chains spanning across several countries. Businesses cannot properly plan ahead if there is a risk that key input or selling prices could jump substantially.

But for the time being, global economic growth remains relatively strong. The US Federal Reserve hiked interest rates as expected, describing the US economy as "solid" in its official statement. In the post-meeting press conference, Fed Chair Jerome Powell went a step further and described the economy as doing "very well" and "great."

Meanwhile the European Central Bank downgraded its Eurozone 2018 GDP forecast to 2.1% as well as announcing that interest rates will remain unchanged until at least the summer of 2019, which contributed to a continued strong dollar over the month of June.

Emerging markets (EM) are taking strain with a stronger dollar placing downward pressure on EM currencies and upward pressure on interest rates. The rand, which started the year on the front foot due to positive political developments, succumbed to EM selling pressure in June, falling 8% against the US dollar. It didn't help that new data showed that South Africa's economy contracted by more than expected in the first quarter. The 2.2% decline in GDP was largely due to declines in volatile agricultural, mining and manufacturing sectors and comes off the high base set by the fourth quarter's strong growth number.

The latest current account deficit data was also negative for the rand, showing a greater-than-expected widening in the first quarter, from 2.9% to 4.8% of GDP. The current account balance is the broadest measures of a country's economic engagement with the rest of the world, and in effect shows how much savings we need to 'import' to fund investment in the economy. This largely comes in the form of 'hot money' flows that can quickly leave the country when global investors get spooked.

## MARKET OVERVIEW

South African markets closed in the green for the month of June, aided largely by improved global sentiment on the final trading day. The JSE All Share Index advanced 3.3% on the final day of trade to close at 57 610 points for the month of June (closing up 2.8% for the month).

The world economy continued to expand in the second quarter of 2018, however global markets where under pressure following the threat of a global trade war unfolding. The "triple whammy" threat of global growth slowdown, capital outflows, and an appreciating US dollar resulted in EMs bearing the brunt of the risk-off sentiment. This resulted in the MSCI EM Index closing down 2.5% for the month of June.The MSCI All Country World Index closed in the red for the month of June (down -0.7%), highlighting the broad risk-off sentiment being experienced.

# LOCAL EQUITIES

## NASPERS

Naspers' FY 2018 results were fairly in line with expectations. However, underlying performance encouragingly showed operating leverage within the e-commerce division. Revenues including proportionate contributions from associates and joint ventures rose 38% to US$20.1bn. Excluding acquisitions, disposals and currency movements revenue was up 39%. Core headline earnings for the period grew 72% to US$2.5bn, thanks to continued reduction in development spend (-17% on a consolidated basis), an improvement in trading losses in the Group's e-commerce segment (classifieds excluding LetGo are now profitable) and the strong contribution from Tencent.

Naspers offers us direct exposure to fast-growing online markets in classifieds, food delivery, payments, e-tailing, gaming and advertising. The Group's diversification as a media company is unrivalled, certainly within the EM universe. While many of the Group's platforms remain unprofitable, we believe that there is enough evidence to suggest that in time they will be highly profitable.

Despite the challenges that the Group's pay-TV business has faced over the past few years, the operation remains a cash cow for the Group. The early signs of growth shown by DSTV Now and Showmax, coupled with an improving macro outlook in the rest of sub-Saharan Africa, bode well for the segment's future.

At present, the market is valuing Naspers' rump (the Group's non-listed assets) at approximately a 40% discount to its net asset value versus a historical average of around 25%. This is arguably due to Naspers' large index weighting and the equity outflows from South Africa coupled with the recent underperformance of the unlisted assets. We do not expect these factors to persist indefinitely and so we believe that the Group's discount will narrow in time.

## OLD MUTUAL

On 24 and 25 June 2018, Old Mutual concluded one of the final steps in the managed separation process. This saw the delisting of Old Mutual plc from the London Stock Exchange and the Johannesburg Securities Exchange followed by the listings of Old Mutual Limited and Quilter plc.

Old Mutual plc shareholders received three Old Mutual Limited shares and one Quilter plc share for every three Old Mutual plc shares owned.

Looking ahead, the final step in the managed separation process will see Old Mutual Limited unbundle around 40% of its 60% shareholding in Nedbank to Old Mutual Limited shareholders.

Further information on the split will be provided closer to the date of unbundling, expected for the fourth quarter of 2018.

# GLOBAL EQUITIES

## NIKE

Following on from a good Q3, Nike reported Q4 2018 results that were again ahead of consensus forecasts on both revenue and earnings metrics. Revenue for the period was up 13% to US$9.8bn, up 8% on a constant currency basis. After management guided to an improvement in North American sales in the previous quarter, the region still performed better than expected reporting growth for the first time in a couple of years. Diluted earnings per share for the quarter rose 15% to US$0.69 versus expectations of US$0.64. Going down the income statement, most metrics looked good. Gross margin expanded, the tax rate was lower and the average share count reduced. However, selling and admin expenses increased by 17% to US$3.1bn, offsetting some of the gains from higher gross margins.

Nike is the global leader in sportswear, a position that they have earned through strong product innovation, often being first to market coupled with good operational execution. We believe that these are difficult competencies to mimic on a global scale and give Nike a competitive edge relative to peers.

The Group's fastest-growing regions are outside the US (60% of revenue), a trend that we expect to continue. Nike's market leadership, particularly in China, will be a key growth driver as consumers spend more, particularly within the digital space. On Tmall, China's largest digital platform, Nike is the number one sports brand.

While fully cognisant of the short to medium term North American challenges, we expect the continued focus on direct to consumer sales coupled with the continued product innovation to result in higher sales and margin enhancement over time. The Nike Direct business continues to grow at double digits, increasing its contribution to group profitability.

## STARBUCKS

Starbucks closed 9% down after management revised their sales growth guidance for the remainder of the year and held an investor conference detailing the disappointing outlook and planned strategies to improve performance. Prior to the announcement, the Starbucks share price was flat for the year-to-date and is now down 9% versus the S&P 500, which is up 3.5% over the same period. Below we highlight the key takeaways from management's update and some initial thoughts pending further discussions within the global committee.

Similar to other retailers, same-store sales are a critical metric to monitor for Starbucks. A couple of years ago, the Group was growing this key metric at over 5% per year, which was above peers and often highlighted as evidence of its ability to keep customers coming back into their stores. Last year, management revised the target range of same-store sales to between three to five percent highlighting temporary market dynamics in the key US region as the reason. In the most recent update, management have pointed to same-store sales growth of 1%, which was a huge surprise to the market.

The gradual decline in same-store sales in the US over the period suggests that it's not one particular reason that has led to the slowdown. Perhaps it is a change in customer preferences as highlighted by management, or the Group not executing well on marketing in a saturated market. It could also be negative publicity from the racial incident that happened during the quarter. Either way, management have cited several strategies to re-accelerate growth. They will further focus on their digital initiatives, management changes, the premiumisation of their products, expanding their rewards programme and customising health and wellness options. Critically in our view, they will be slowing licensed stores in favour of corporate-owned, which are more profitable. They will also be closing approximately 150 under-performing stores per year compared to the usual 50 stores and focusing more on underpenetrated areas.

Management also pointed out that same-store sales in China have slowed to 'flat to slightly negative' for the quarter. It highlighted the Chinese government's crackdown on unlicensed delivery companies and weakness in some new beverages as reasons for the weakness. The company plans to have its own licensed delivery arrangement by the end of the year which should see sales improve.

On a positive note (or maybe it is an indication of a fast-maturing company) management announced a US$25bn buyback programme through to 2020 and a 20% increase in the dividend for the year. Assuming the annual dividend grows at 15% over the next three years, this translates to about 25% of the current market cap that will be returned to shareholders.

## ACCENTURE

Accenture delivered better-than expected Q3 2018 results. Excluding the effects of the US tax law changes, earnings per share was US$1.79, up 18% from the prior year and ahead of consensus estimates of US$1.71. Revenue for the period was up 16% to US$10.3bn or 11% in constant currency. New bookings grew by a strong 19.3% to US$11.7bn, with consulting and outsourcing each contributing US$5.9bn and US$5.8bn respectively.

Strong revenue growth saw operating income expand 18% year-on-year to US$1.62bn. Additionally, group operating margins grew 20 basis points over the period.

The Group's underlying sectors performed well. Communications, Media & Technology continues to outpace all other sectors, growing revenue by 18% and operating margin to 18%. Product and Resources both grew revenue above 10% while Financial Services and Health & Public Service grew revenues by 8% and 7% respectively. Regionally, North America increased revenues by 11% to US$4.57bn, while Europe was up 9% and Growth Markets a strong 19% in constant currency.

Within the technology and services that Accenture provides, the majority (55%) is derived from offerings within digitisation, cloud and security solutions. We see these as the most attractive trends within IT services and expect them to support Accenture's growth ahead of the broader IT services sector.

Accenture's business model generates a significant amount of free cash flow. Since listing in 2001, we estimate that the Group has generated around US$40bn in free cash flow and paid out over 90% of this cash to shareholders via dividends and share buybacks. We expect this good capital allocation to continue to drive shareholder returns.

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PRIVATE CLIENT SECURITIES

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