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IN THIS CLIENT **NEWSLETTER**

- Economic and market overview
- Local equities
- Global equities

MARCH 2019

WEALTH
PRIVATE CLIENT SECURITIES

Investment markets have again posted broad gains in March, making this one of the best quarters over the last decade. Some of this performance can be attributed to a recovery from an oversold position late last year, but there were also positive developments on the China/US trade negotiations and a now dovish Fed means that interest rates will remain lower for much longer than anticipated only a few months ago.

In our earlier newsletters we did point to an expected slowdown in earnings due to the high base of comparatives from last year. We still believe that this will manifest as the year progresses and that it may cause equity valuations to come under pressure. However, we also believe that an imminent US recession is unlikely and that accommodative monetary policies from the US, Europe and China will support equity valuations. Sporadic weakness in equity markets could therefore be viewed as good buying opportunities. Such an opportunity was seen very briefly in March as the three-month/10-year US yield curve inverted and gave a "signal" pointing to recession. This spooked markets. However, no single measure can be relied upon to predict the direction of the economy or the market. Despite the yield curve inversion there were many more positive economic indicators and markets duly responded and ended the month in positive territory.

Investors will be well-served to remain invested in companies with defensive and high-quality earnings. Our local and global equity portfolios comprise a good balance between companies with high-quality, defensive earnings and companies offering very significant growth opportunities. Global equities – in developed markets and emerging markets (other than South Africa) – present more than 99% of the investible universe. Sensible diversification requires that adequate exposure is taken to these opportunities beyond the borders of South Africa. Simply said: *"Don't put all your eggs in one (very small) basket."*

ECONOMIC OVERVIEW

March saw Eskom implementing severe rolling black-outs. While the impact on economic activity will only be apparent in a few weeks when the official data becomes available, the knock to investor sentiment was immediate. At present, business confidence is already very weak. The RMB/BER Business Confidence Index, a leading indicator of fixed investment spending, declined from 31 to 28 index points during the first quarter of this year. Various negative factors, including load shedding, strikes and political uncertainty ahead of the May general elections (including noise around land reform and the nationalisation of the SARB), have all weighed on business confidence. But perhaps the biggest factor is simply that businesses are not seeing much demand for their products and services, yet still face rising input costs.

Although the economy posted positive growth in the fourth quarter, with real GDP rising by 1.4% year-on-year, it remains anaemic. Growth in 2018 was 0.8%, but it was a year of two halves, with annualised growth of -1.6% in the first two quarters and 2% in the latter part of the year. While growth should improve in 2019 (it should almost double from a low base if the consensus expectation of 1.5% is met), getting to 2% real growth will be a major achievement. However, if load shedding persists, even 1.5% will seem out of reach.

At the SARB's recent Monetary Policy Committee (MPC) meeting, the repo rate was left unchanged at 6.75%. The committee's views are based on an inflation forecast that was largely unchanged, with an average of 4.8% expected this year and 5.3% next year. Meanwhile, the MPC has once again trimmed its economic growth forecast and views growth risks to the downside. It cut its growth outlook for 2019 to 1.3% (from 1.7%) and for 2020 to 1.8% (from 2%). The Reserve Bank seems more or less comfortable with its inflation forecast, and noted the continued decline in surveyed inflation expectations. However, the SARB is concerned that it is still overestimating economic growth and its leading economic indicator has been declining. The MPC maintains that its rate stance is 'accommodative', but it is hard to agree with this characterisation given that real interest rates are almost 3% and households face a squeeze.

One thing the MPC can worry about less is that US interest rates have stopped rising for now. The US Federal Reserve confirmed its dovish pivot, voting to keep its policy target rate unchanged at 2.25% to 2.5%. The market has been searching for clues on the future path of interest rates since the Fed halted on its hiking cycle at its January monetary policy meeting. Chairman Jerome Powell was at pains to emphasise that his colleagues would follow a patient approach, focusing on incoming data, rather than following a predetermined plan. The so-called dot-plot, a summary of individual Fed officials' own views, suggests no further hikes this year, with only one more pencilled in for 2020. The Fed will also stop the shrinking of its balance sheet by September, ending up with a portfolio of US$3.5 trillion bonds, much more than initially expected. The bond market reacted by driving long-bond yields down close to short yields.

MARKET OVERVIEW

Global markets ended the first quarter of 2019 with solid returns. The US in particular had the best end to a first quarter since 2009. The Dow Jones and S&P 500 Index gained just over 11% and 13% respectively during the quarter. In the Eurozone, German manufacturing activity was the worst in five years as German PMI data missed expectations. In Britain there seems to be no end in sight to the Brexit chaos which could result in a no deal Brexit on 12 April 2019.

Back on home soil, ratings agency Moody's was due to announce its outlook on the SA economy but they decided not to publish anything. Moody's next announcement date on the SA economy is due at the end of November 2019, which is well after the May election date. The JSE followed global markets and also had a strong end to the first quarter, its best since 2007. However, the momentum slowed in March as the ALSI gained less than 1% for the month as news of Turkey's economic woes impacted emerging markets.

On the commodity front, Brent Crude ended March 3% higher as US sanctions on exports from Iran and Venezuela and supply curbs by Opec and other big producers are being felt. As at the end of this quarter, Brent Crude is up 25%. With the rand and other emerging market currencies under pressure, motorists should prepare for a substantial increase in the petrol price. The outcome of the general elections in May will also bring some clarity to current economic uncertainty, which is tangible in the local market.

LOCAL EQUITIES

AdvTech

South Africa's largest private education provider, AdvTech, posted a resilient result in a weak operating environment. The group failed to meet its stated enrolment target of 92 475 students for the year, managing to grow enrolments by 11% to 70 456. Yet, despite weaker-than-expected enrolments, the group grew operating profit by 14% to R763m.

Amid a growth slowdown in South Africa, the group continues to grow through acquisitions and has expanded aggressively into the rest of Africa. Pursuing acquisitive growth is capital intensive, which has led to a 12% year-on-year decrease in the dividend declared for 2018 to 30 cents per share.

AdvTech has built a highly profitable business with an exemplary record of growing both the top and bottom line. The attraction of a business operating in this sector is that education costs typically increase on average 8% per year, well above consumer inflation. Additionally, there is a significant gap in the supply of education in South Africa. Where the state fails, that gap will grow. Even if the state does not fail, the room for growth is still material for private businesses, at both a school level and tertiary level. We feel that AdvTech has the potential to fill that gap through remote learning, acquisitions and organic growth of their existing businesses.

AVI

Branded consumer goods company AVI Limited reported disappointing interim results. Diluted earnings per share for the period were down 6% over the year to 304cps. Revenue for the period was R7.3bn, up 0.2% compared to the previous year. This was the first time since 2006 that AVI's earnings have declined, a clear indication of the pressure that consumers are currently facing. Management highlighted the difficulty in the trading environment, which is leading to volume weakness and competitor discounting in some categories. Despite the difficult trading environment, cash generation remained healthy, with cash generated from operations increasing by 0.9% to R1.6bn on a comparable basis. The group maintained their dividend cover and declared an interim dividend of 165cps, a decrease of 6% from the prior period.

We believe that AVI's strong brand portfolio will continue to outperform peers over time. Evidence of the group's solid brands can be seen in their ability to pass on some price increases to somewhat offset unfavourable exchange rates or falling volumes. We see this as a key differentiator in the current difficult trading environment.

BidCorp

Aided by moderate economic growth across most developed markets, food services group, BidCorp, reported interim results that were broadly in line with expectations. Earnings for the period were up 9.2% to R7 per share, with Eastern Europe delivering a standout performance. Revenue for the period rose 9.1% to R66.4bn despite persistently low food inflation across most regions. The group's trading margin remained unchanged at 4.9% as an improved product mix was offset by higher operating costs in some regions.

In keeping with management's strategy of augmenting organic growth with bolt-on acquisitions, the group acquired several related businesses totalling R338m during the period. Previously discontinued operations, largely made up of the UK contract distribution business, reported a trading loss of R75.6m, similar to the amount in the prior year. Management did not provide additional guidance with respect to when they expect to finalise the disposals.

Bidvest

Despite a tough operating and economic environment, South African diversified industrials company Bidvest reported a resilient set of interim results. The group's diversified portfolio and quality service businesses have ensured a 9.6% increase in headline earnings per share to 629 cents for the half-year to 31 December 2018. Group revenue remained flat at R40 billion with gross margin increasing 1.2% to 29.3%. Trading profit was up 6.3% to R3.3 billion as the Services, Freight and Office and Print divisions delivered standout performances. An interim dividend of 282 cents per share was declared, which represents a 10.6% year-on-year increase.

Management continued with their acquisitive strategy to supplement organic growth, with related bolt-on acquisitions. These acquisitions were mostly in the Services and Office and Print divisions. Notable acquisitions include Aquazania for R390 million and the further acquisition of Bidvest Namibia. These deals should result in meaningful growth and more bolt-on deals can be expected going forward.

FirstRand

In spite of a weak domestic and uncertain UK operating environment, FirstRand Group was able to deliver satisfactory interim results. Group diluted normalised EPS grew 7% to R2.37 per share, driven by strong growth from FNB (62% of earnings), momentum in RMB's Africa operations and the full period inclusion of Aldermore. The Group increased its dividend by 7% to R1.39 per share.

We expect the group's retail and commercial segment, FNB, to continue to maintain market share, particularly in the premium segment where it has proven itself to be innovative and adept at cross-selling. Having led the SA-banking industry in terms of digital adoption, FNB has done well to create customer stickiness through the integration of holistic banking solutions supported by the eBucks loyalty programme and behavioural analytics. We expect their digital platform to drive volumes and provide opportunities for cross-sell and up-sell, growing the profitability of the existing customer base.

Nedbank

Nedbank (now unbundled from Old Mutual) posted a robust annual result, largely supported by its pan-African alliance with Ecobank. Overall group headline earnings grew by 14.5% to R13.49bn as Ecobank returned to profitability. Excluding Ecobank, Nedbank grew headline earnings modestly to R13.1bn (+2.8%). During 2018, Nedbank's total assets exceeded R1 trillion and the group ended the year as the top performing South African bank, returning 12.6% to shareholders. The group's return on equity improved to 17.9% (+1.5%) and the dividend was increased by 10.1% to R14.15 per share.

Nedbank spent a further R77m during the year in relation to its managed separation from Old Mutual, which was completed in October. Following the unbundling, Nedbank acquired 7m shares for R2bn from shareholders in an odd-lot offer. Old Mutual maintains a 19.9% interest in Nedbank and the two companies will continue to collaborate to maximise synergies.

Old Mutual

Financial services group Old Mutual reported its maiden annual results post the unbundling of the majority of its non-African operations. Results for the period were mixed. On the negative side, a change in the functional currency in Zimbabwe and the decline in equity markets in the fourth quarter of 2018 reduced reported profit, net asset value and Funds Under Management (FUM). Results from operations were down 4% to R9.9bn. On the positive side, net client cash flow (NCCF) rose sharply from R5.6bn to R10.7bn, while adjusted headline earnings before the Zimbabwe currency impact was up 1% to R13.1bn, broadly in line with analyst expectations.

The group declared a final dividend of 72cps, bringing the annual dividend to 117cps, in line with its policy of paying out about 50% of adjusted earnings. Further to this, management announced a R2bn share buyback programme for 2019 that is expected to be accretive to shareholder value.

RMI

Financial services holding company, RMI's performance reflected the weak local investment and asset management industry and was unable to grow earnings in the tough environment. Group normalised earnings was down 8% to R2.1bn, largely attributed to a weaker performance by OUTsurance and Discovery as well as greater losses from the group's investments into new ventures. Positively, MMI has shown signs of a turnaround in performance and has reinstated dividends. RMI remains committed to its dividend policy, declaring an interim dividend of 45 cents per share, up 15% on the comparable period.

RMI's aim is to add value by being an active enabler of leadership and innovation in financial services. It acquires meaningful interests with significant influence in industry-changing businesses that can deliver superior earnings, dividends and capital growth over the long term. The group's portfolio strikes a balance between growth and return. Discovery is a pioneering market leader with uniquely-positioned businesses in the healthcare, long and short-term insurance, wellness and financial services industries. Hastings is one of the fastest-growing providers of UK general insurance and has considerable scope to continue growing their market share. OUTsurance provides short and long-term insurance products in South Africa and short-term insurance products in Australia, New Zealand and Namibia. We believe this diversity will continue to stand the group in good stead.

Quilter

Wealth management group Quilter Plc reported its maiden annual results post the unbundling from Old Mutual. Results for the period were good despite the negative market performance during the year and the Brexit impasse. Adjusted operating profit for the period was up 11% to £233m while earnings per share were up 15% to 12.3p. Reflecting the weak markets during the fourth quarter, assets under management and administration (AuMA) were down 4% at year end to £109.3bn. However, average AuMA for the year was £114.7bn, £5.4bn ahead of the year-end value. Further to this, the group reported solid net client cash flow (NCCF) of £4.7bn, 5% of opening AuMA and in line with management's medium-term target.

The group declared a final dividend of 3.3cps, which is in line with its previously stated dividend policy. Management stated that while the current dividend policy is somewhat conservative, they believe that a well-capitalised balance sheet will stand the group in good stead in the event of increased uncertainty. It further allows the group to reach its growth potential both organically and through bolt-on acquisitions.

GLOBAL EQUITIES

Accenture

Global consulting firm Accenture reported a positive result ahead of both analyst and management earnings forecasts. Revenue growth across the group's divisions was driven by strong demand for digital, security and cloud services, which formed 65% of the group's new bookings in the second quarter. Accenture continues to benefit from the large digital transformation programmes being undertaken by corporates and the group will continue to invest in expanding their capabilities across these offerings.

Despite increased acquisitions (US$1.5bn planned for 2H 2019), the group remains committed to returning cash to shareholders. To this end, Accenture's interim dividend was increased by 10% to US$1.46 per share and the group repurchased 11.6m shares during 1H 2019 to the value of US$1.8bn.

British American Tobacco

British American Tobacco posted annual results that were broadly in line with market expectations. It is important to note that these results were impacted by the acquisition of Reynolds International, which distorts meaningful comparisons with previous years. On a like-for-like basis (assuming Reynolds International was owned from 1 January 2017), revenue in constant currency was up 3.5% to £25.76 billion. This was driven by a price increase of 6% and solid growth in Tobacco Heating Products (THP). Earnings per share was up 5.2% (like-for-like) and 11.8% on a constant currency basis, which was slightly ahead of analysts' expectations. The board declared an interim dividend of 203 pence per share, payable in four equal quarterly instalments of 50.75p per ordinary share in May 2019, August 2019, November 2019 and February 2020. This represents an increase of 4% on 2017.

Continental

German mobility technology company, Continental AG, reported weak results in the face of continued poor global vehicle market dynamics. Earnings per share fell by 2.9% to €14.49, largely due to restructuring costs. While the previously announced company restructure and cost cutting programmes are taking effect, the Group was not immune from the broad market performance. Lacklustre vehicle volumes together with currency headwinds and high capital expenditure led to earnings declining from the prior year.

Although the global backdrop for vehicle demand remains uncertain, Continental expects to outgrow the market owing to sustained demand for their better-than-market quality core products. Additionally, the group is pushing ahead with the partial listing of their Powertrain division, expected to take place in mid-2019.

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