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PROSPERITY

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OLDMUTUAL WEALTH

Most of the global economy is growing in synchrony and investment markets, both in developed and emerging economies, continue to post gains. Unfortunately, the South African economy is not participating in this upswing in global growth. The local economy remains mired in low growth and low business confidence, as reflected in the budget speech. An economy that runs a budget deficit and continues to borrow to service the deficit is like a household spending more than it earns and borrowing against its assets to make up the shortfall. Eventually, the lender will demand a higher interest rate because of the amount of household debt versus household assets and this higher interest rate causes the deficit to increase even more – a vicious cycle. The only way out is to grow income and cut back on expenses. It is that simple. Many commentators will indicate that developed market countries have much higher debt to GDP levels than South Africa, but those countries either have currencies that are in high demand (reserve and trading currencies such as the dollar and euro) or they have high domestic savings to fund the borrowing (like Japan). South Africa has neither and we remain reliant on foreign investors to fund our deficit.

Against the background of synchronised global growth, our model portfolios remain invested in companies that we believe will grow their earnings significantly over the long term. For local equities this includes companies that have diversified their earnings beyond the borders of South Africa. For global equities this means companies that have meaningful economic moats in growth industries in developed and emerging economies.

"In the search for companies to acquire, we adopt the same attitude one might find appropriate in looking for a spouse: It pays to be active, interested and open-minded, but it does not pay to be in a hurry" – *Warren Buffett*

ECONOMIC OVERVIEW

Facing a R50 billion tax revenue shortfall, Minister Gigaba and the team at National Treasury had only three options in preparing the Medium Term Budget Policy Statement (MTBPS). They could try to squeeze more out of a struggling tax base, cut spending despite increasing demands from various quarters, or borrow more, adding to a rapidly rising debt pile. In the end, the combination chosen favoured the latter. Because of the missing R50 billion, the budget deficit will be 4.3% of GDP for the current fiscal year instead of 3.1% as projected in February. This is a massive jump and was much worse than expected. The deficit will narrow somewhat to 3.9%, but this will not be enough to stabilise Government's debt level over the MTBPS's three-year forecast period. Instead, the ratio of debt to GDP will rise towards 60% by 2021.

By allowing the deficit to widen compared to the previous projected path, the Minister is giving the economy some breathing room. But this comes at a cost. As a result of increasing debt, interest payments will grow by an average of 11% per year over the next three years – the fastest growing item in the budget – reaching more than R200 billion in the 2020 fiscal year. But in the meantime, the risk of further credit ratings downgrades has increased.

Fortunately, the global backdrop is still favourable. Low global yields have made South African bonds attractive despite our fiscal challenges. Prior to the MTBPS, foreigners had been net buyers of R70bn worth of bonds (net selling since the speech has been around R10bn). Central banks are gradually removing stimulus, and as long as the pace is measured and well signalled, developed market bond yields are unlikely to increase rapidly, keeping investor interest in emerging market bonds (including SA) alive. The European Central Bank embarked on the long road to monetary policy normalisation when it announced a reduction in its monthly bond purchases (known as quantitative easing, or QE) to €30bn from January. However, to soften the blow, it will extend the programme until September, while also promising to keep short-term interest rates at current negative levels well past the end of its QE programme.

Global economic growth has picked up materially. US economic growth accelerated to 2.25% in the third quarter and European economic sentiment indices rose to a 17-year high. South Africa has historically followed the global cycle, though it underperformed the global economy over the past two years. Therefore, Treasury's growth forecasts could be too low for once.

MARKET OVERVIEW

Equity markets delivered solid gains through October, starting the fourth quarter of the year in positive territory. Earnings reports from global companies showed positive growth for the third quarter while supportive economic data gave markets a boost and fuelled the momentum that has been building over the last few months. Overall, market volatility is still somewhat suppressed in the US, with the S&P 500 closing within a percentage of the previous close on each of the trading days in the month.

Despite the tumultuous local political and economic landscape, the All Share Index participated in the global rally, adding 6.6% for the month. The trigger for yet another blow to the rand was of course the delivery of the MTBPS. Local bonds re-priced aggressively and the benchmark R186 government bond yield moved from 8.60% to 9.40% very quickly to reflect the higher level of risk to investors associated with SA Inc. Oil prices kept climbing to the highest levels since 2015, which added to local and global inflation pressures, as Brent crude topped US$60 a barrel towards the end of the month. Gold made another attempt to its 2017 highs, but closed under US$1 280 after briefly breaking US$1 300 an ounce.

GLOBAL EQUITIES

ALPHABET

Alphabet reported significantly better-than-expected third quarter earnings. Diluted earnings per share were US$9.6bn, well ahead of the median forecast of US$8.3bn. Revenue growth over the quarter was up 24% to US$27.8bn versus consensus forecasts of US$27.2bn. This was the 31st consecutive quarter of revenue growth above 20%. Geographically, all of the Group's regions performed well. The US, which contributes 46% of group revenue, was up 21%, while EMEA (Europe, Middle East and Africa), APAC (Asia Pacific) and other Americas were up 23%, 31% and 32% respectively. Group operating expenses were well controlled, up 19.8%, resulting in positive operating leverage. The Group's operating margin was up 2% to 28%. At quarter end, the Group had cash and cash equivalents of $100bn, of which about 60% is held outside the US.

Segmentally, Google sites revenues were up 23%, led by mobile search and strong performance from YouTube. Licensing and other revenue (Google Play, Google for Work, hardware) was up 40% while 'other bets' reported revenue of US$302m and a loss of US$812m for Q3. Advertising contributed about 85% of gross revenue. The Group's core search business continues to have a dominant and increasing market share. While growth in desktop search has tapered off, the outlook for mobile is attractive. We believe that in time, there will be better pricing for mobile advertising relative to desktop, resulting in improved group margins. While developments in Android, Google Play, hardware, cloud and other new innovations pale in comparison to the contribution from the traditional business, we believe that over the long-term, they present additional avenues for earnings growth.

MICROSOFT

Microsoft released 1Q18 results that showed double-digit top and bottom line growth. At US$24.5bn, revenue was 12% higher year-on-year as all segments performed better than expected. Earnings per share (0.84c) rose 17% y-o-y, beating the expected 0.72c. LinkedIn surprised with a US$1.1bn in revenue contribution and is expected to contribute to earnings this year. Gross margin increased by 2% to 66% thanks to better sales mix and improving cloud margins. Operating and net income grew 15% and 16% to US$7.7bn and US$6.6bn. Operating expenses grew by 16% to US$8.6bn, with a large component of the increase being attributed to LinkedIn. Cash flow from operations and free cash flow showed strong growth, up 8% and 10% to US$12.4bn and US$10.3bn, respectively.

Microsoft returned US$4.8 billion to shareholders in the form of share repurchases and dividends over the quarter, also announcing an 8% increase in its quarterly dividend to US$0.42 per share. One of the certain trends within the IT sector over the medium to long term is the migration from on-premises to cloud services. In our view, Microsoft is the global leader within this sector with its offerings – Microsoft Azure and Office 365. Additionally, Microsoft is finding innovative ways for artificial intelligence (AI) to enhance existing software suites, critically embedding AI into Office 365 applications to drive efficiencies. LinkedIn, although still relatively small in the portfolio, has the power to draw even more individuals into Microsoft ecosystem as users now number 530 million.

BANK OF AMERICA

Bank of America reported solid 3Q17 results. Key highlights were the strong performance from the consumer banking, wealth and investment management and global banking divisions. Good cost control was once again evident, with the Group reporting the 11th consecutive quarter of positive operating leverage. Net interest income (NII) rose 9% to US$11.2bn, reflecting higher interest rates during the last year. Non-interest income decreased by US$756 million, or 7%, to US$10.7 billion, driven primarily by lower mortgage banking income and lower sales and trading revenue. In aggregate, revenue across the Group's four business lines was up 4% to US$21.8bn. Net income and diluted earnings rose 13% and 17% respectively. For the year-to-date, Bank of America has repurchased US$7.9 billion shares and paid a US$2.8 billion dividend.

Bank of America's management have been able to drive higher operating leverage over the past few years and we believe there remains scope to further cut expenses and improve the Group's efficiency ratio, which will drive earnings higher. Due to the large contribution from consumer banking, Bank of America's balance sheet is highly sensitive to higher interest rates. As US short-term interest rates increase, we expect the bank's net interest income to increase ahead of peers. The Group is well capitalised, which best positions them to navigate the uncertain global environment. Recently, the Group has begun to show strong growth in deposits, taking market share from peers. We expect this to continue on the back of their leading mobile offering, which creates opportunities to deepen customer relationships and benefit from an improving US economy.

GLOBAL EQUITIES

AB INBEV

AB InBev reported a mixed set of 3Q17 earnings. While earnings growth was broadly in line with median forecasts, volumes for the period declined. Revenue for the quarter was up 3.6%, below the year-to-date increase of 4.1%. On a constant geographic basis, revenue per hectolitre grew 4.6% due to management's continued premiumisation drive. Total volumes for the quarter declined by 1.2%. The volume decline was largely due to adverse weather in the US and weak volumes in Brazil. Earnings increased 13.8%, driven predominantly by the 3.5% increase in margin to 38.9%. The Group reported cost savings of $336m during the period following the merger with SABMiller. Management upgraded their synergy guidance by $300m to $3.2bn by October 2020. To date, $1.75bn savings have already been achieved.

As the world's largest beer company, AB InBev benefits from significant economies of scale. The Group converts about 30% of its revenue into free cash flow, more than three times that of its nearest competitor and has the highest margins in its sector. With the SABMiller merger, we expect these favourable metrics to improve over time. The Group has leading market positions in the most important beer regions in the world, earning about 45% of all the profits in the global beer market. In aggregate, almost 60% of revenue is exposed to emerging markets, where there remains much scope for volume growth and premiumisation.

VISA

Visa reported yet another good set of results driven by good cost control and better than expected accretion from the integration of Visa Europe. Earnings per share and revenue for 4Q17 were $0.90 and $4.9bn versus consensus of $0.85 and $4.6bn respectively. Payment volumes increased by 10% year-on-year on a constant currency basis, in line with cross border volume growth. The total number of transactions processed by Visa's network increased 13% over the year, continuing the strong momentum across payment platforms. In absolute terms, Visa processed 43.1bn transactions during the quarter. Visa's three revenue segments, Services (20% up), Data Processing (16% up) and International Transactions (20% up) all posted high double-digit revenue growth aided by the inclusion of Visa Europe. During the period, total cards in issue rose 27% to 3.2bn. Most of the increase was in debit cards (+31% to 2.1bn), which accounted for 65% of the total transactions.

During the 2017 fiscal year, Visa generated adjusted free cash flow of $8.5bn which is the figure they returned to shareholders. Share buy backs for the period were $6.9bn while dividends were $1.6bn. Visa benefits from the megatrend that we are seeing globally as payments move from cash to electronic and card based. The key drivers of this trend are an increase in number of transactions and the size of the transactions. We expect Visa's reported metrics of these drivers to continue to grow at double-digits in both developed and emerging markets.

Visa has invested significantly in its payment network, VisaNet, which has seen the network report high reliability, security and speed - all of which are critical within the electronic payment industry. We believe that the strength of VisaNet coupled with Visa's symbiotic relationship with financial institutions presents a high barrier to entry for new entrants into the electronic payment platforms. Visa's business model allows the Group to earn recurring revenues, maintain high margins and generate high levels of free cash flow in an oligopolistic industry. We believe that these are the quintessential qualities of a great long-term investment.

HONEYWELL

Honeywell reported yet another good set of results, with all the Group's segments performing either in line or ahead of expectations. Revenue for the period was up 3.2% to $10.1bn, slightly ahead of consensus expectations of $10bn. Organic sales growth was up 5%, ahead of the previously guided range of between 2% – 4%. The Group's segment margins rose 120bps resulting in earnings per share growth excluding divestitures of 16% to $1.75 over the year. For the year to date, the Group has reported free cash flow of $1.2bn, up 18%, attaining a 90% conversion rate. Management further raised the mid-point of their full year revenue and earnings per share guidance to $40.1bn and $7.08, respectively.

Honeywell is a well-diversified industrial business that caters to attractive end markets such as home and industrial automation, aerospace and safety. We believe that the end markets that the Group serves provide above average organic growth potential, which will support Honeywell's growth over the coming years. Honeywell's management have been successful at rationalising the Group's portfolio. By divesting from low margin businesses and investing in R&D, the Group has been able to grow margins ahead of peers. We view the recent announcement by management to spin off some of the Group's divisions as a continuation of this winning strategy.

GLOBAL EQUITIES

JOHNSON & JOHNSON

Johnson & Johnson reported solid 3Q17 results. Key takeaways from the results were the strong performance from recent acquisitions, favourable currency tailwinds and good uptake of new drugs. Group revenue for the period was up 10.3% to $19.7bn, ahead of consensus estimates of $19.3bn. Excluding acquisitions, revenue was up 3.8%. Adjusted earnings per share for the period was up 13.1% to $1.90 versus consensus estimates of $1.80. In addition to the revenue and earnings beat, J&J increased their sales and earnings per share guidance for the full year to between $76.1bn - $76.5bn and $7.25 - $7.30, respectively.

Johnson & Johnson is the world's largest healthcare company. This offers exposure to a diverse portfolio of treatments for ailments in immunology, infectious diseases, cardiovascular and oncology, without excessive exposure to a single ailment or patent loss. We believe this diversification will continue to support stable earnings and dividend growth. The Group is highly cash generative and invests about 13% of sales into research and development, which we believe creates a significant moat around the pharmaceutical segment. We believe this is one of the key reasons why the Group has some of the leading drugs in the markets it operates in - a position we believe they will retain.

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