INVESTMENT REVIEW

FEBRUARY 2017

BRIDGE FUND MANAGERS

"We contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle."
Winston Churchill

ECONOMIC OUTLOOK

It appears increasingly likely that the US Federal Reserve (the Fed) will raise official interest rates at their policy meeting in March. Based on the Federal fund futures rate for March, there is an 88% probability that the Fed will raise interest rates by 25 basis points. The market has responded to recent comments from Fed officials suggesting they are ready to push on with raising interest rates, while at the same time, the Trump administration announced $800 billion worth of infrastructure developments and tax savings, which are likely to boost the US economy and US inflation. The shift from monetary stimulus to fiscal stimulus will need to be managed carefully to ensure the boost to the economy is both meaningful and sustainable and that prices don't start rising too rapidly.

In Europe, there is mounting evidence that the economy is finally showing some signs of life. The depreciation of the euro against the US dollar, negative interest rates and the European Central Bank's (ECB) monthly bond purchase programme are helping to boost the region's manufacturing sector. February's final Markit Eurozone Manufacturing Purchasing Managers Index rose to its highest level since April 2011, with manufacturing production, new orders and employment rising in all countries except Greece. The risks in Europe now appear to be political and not economic, with both France and Germany going to the polls later this year.

Index	February %	12m %	YTD %
Dow Jones	5.2	29.3	5.8
S&P 500	4.0	25.0	5.9
FTSE 100	2.3	19.1	1.7
EURO STOXX 50	2.9	16.1	1.1
Nikkei 225	0.4	19.3	-2.4
Hang Seng	1.6	24.2	7.9
Australia	0.9	15.7	0.1

Source: I-Net Bridge

In South Africa, Finance Minister Pravin Gordhan delivered his budget speech during February. While the market had expected significant tax hikes, the bias towards the high-income groups did come as a surprise. A new top marginal income tax rate of 45% was introduced for amounts above R1.5 million, while the income tax brackets were only adjusted by 1%, creating significant fiscal drag. The dividends withholdings tax (DWT) rate was increased from 15% to 20% with immediate effect. As expected, there were no changes to VAT, company tax rates or capital gains tax. The budget probably did just enough to prevent a ratings downgrade in June.

South African consumer inflation fell to 6.6% in January (chart 1) from December's level of 6.8%. It appears as though December's elevated level will mark the peak in this inflation cycle, with consumer inflation forecast to fall below 6% by the middle of this year. The stronger rand and lower maize prices are the major reasons for the improved inflation outlook in 2017. After the budget increased the tax burden on high income earners and increased the pressure on consumer spending, the South African Reserve Bank may respond to a series of lower inflation prints and cut official interest rates later this year.

MARKET OUTLOOK

US equity markets continue to respond positively to the Trump administration. The Dow Jones Industrial Average gained more than 5% in February and is now up 29.3% over the last 12 months (chart 2). The prospect of more infrastructure spend and lower taxes should boost corporate earnings in the US. According to FactSet, earnings per share growth accelerated to 4.9% for the S&P 500 constituents in the fourth quarter of 2016. Although analysts have been downgrading the earnings growth forecast for the first quarter of 2017, earnings are expected to accelerate during 2017. Equity market valuations in the US will require a sustained period of high single-digit or low double-digit growth in earnings to justify current levels.

The US 10-year Treasury yield declined by 10 basis points despite expectations of higher infrastructure spending and lower taxes in the US. In Europe, bond yields also declined (chart 3) despite the increase in political uncertainty in the region. Global listed property markets were boosted by the lower bond yield environment during February. The GPR 250 REIT index climbed 3.4% during the month, with most geographic regions producing similar returns. While the long-term fundamental outlook for global listed property remains positive, short-term returns will be impacted by movements in global bond yields.

Index	February %	12m %	YTD %
All Share	-3.1	6.3	1.1
Resources	-9.9	19.1	-0.2
Financials	0.2	10.2	-0.4
Industrials	-1.6	0.9	2.3
Property	-0.4	11.0	1.3
Bond	0.7	13.5	2.1
Cash	0.6	7.5	1.2

Source: I-Net Bridge

South Africa's equity market failed to follow global markets higher. A strong rand and lower commodity prices weighed on the Resources sector, which plummeted 9.9% during the month (chart 4) and reversed all of the previous month's gains. The stronger rand also impacted the prices of the large, dual-listed companies that dominate the Industrial sector. The current one year forward p/e multiple on the South African equity market has now fallen below 14x, suggesting it is now reasonably priced. The lower p/e multiple is a function of the vast improvement in the earnings outlook for the Resources sector this year, which relies heavily on a favourable exchange rate and commodity price environment.

South African bond yields were little changed during February. The positive impact usually associated with a stronger rand exchange rate (chart 5) was offset by a modest deterioration in tax revenue and government expenditure estimates following the Finance Minister's budget speech. With no clear direction from the bond market and an increase in the marginal tax rate, South Africa's listed property sector drifted lower during February (chart 6). The current one year forward yield on the sector is now 7.0%, with growth in that income stream forecast at approximately 8% per annum over the next three years.

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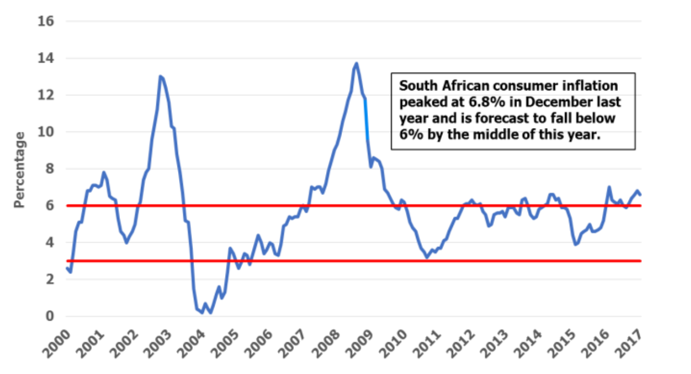
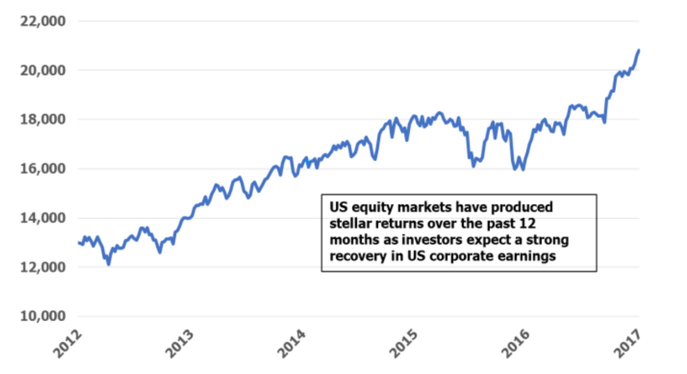
CHARTS

Chart 1: SA Consumer Inflation (%)



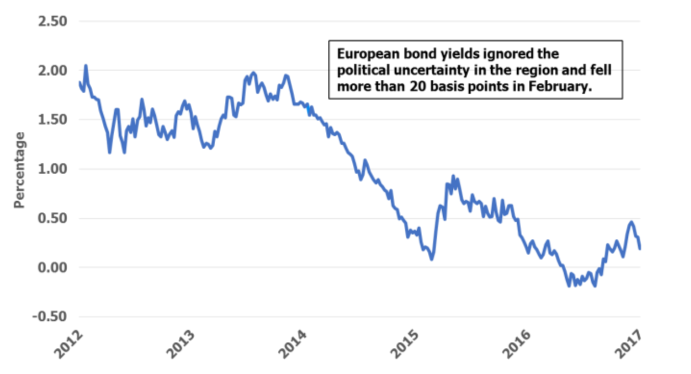
Source: I-Net Bridge

Chart 2: Dow Jones Industrial Average



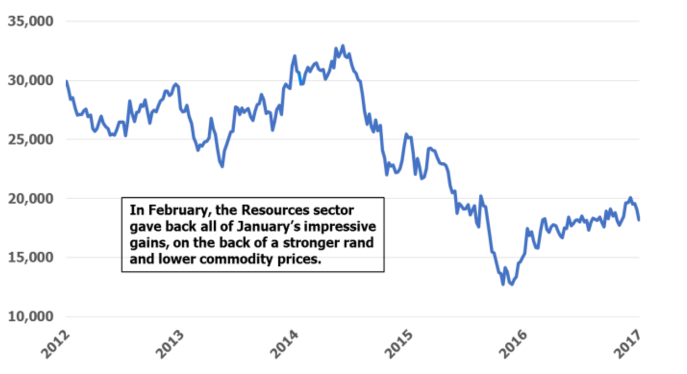
Source: I-Net Bridge

Chart 3: German 10-Year Government Bond Yield (%)



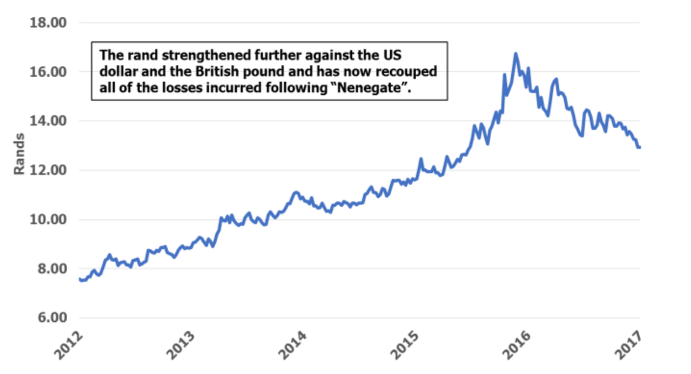
Source: I-Net Bridge

Chart 4: FTSE/JSE Resources Index



Source: I-Net Bridge

Chart 5: USD/ZAR Exchange Rate



Source: I-Net Bridge

Chart 6: FTSE/JSE SA Listed Property Index (TR)

Source: I-Net Bridge

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