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INVESTMENT REVIEW

OCTOBER 2017

BRIDGE FUND MANAGERS

"Unlike some politicians, I can admit to a mistake."
Nelson Mandela

ECONOMIC OUTLOOK

Although the US Federal Reserve (the Fed) voted to keep rates unchanged at their November policy meeting, economists continue to forecast one further interest rate hike in 2017. According to the statement published after the meeting, Fed officials believe the slowdown in jobs growth following Hurricanes Harvey and Irma will be short-lived and that momentum in the US economy continues to build. Consumer inflation is now approaching the Fed's target and the US economy expanded by a better-than-expected 3% in the third quarter (chart 1). President Donald Trump appointed Jerome Powell as the next chair of the Fed. Powell is currently a Fed governor and therefore no change in policy is expected once current chair, Janet Yellen, ends her term in February next year.

In Europe, the European Central Bank (ECB) announced that it would halve the level of bond purchases from €60 billion to €30 billion a month. ECB President, Mario Draghi, also confirmed that interest rates needed to remain low to sustain a return of inflation towards levels that are below, but close to, 2%. Geopolitical risk shifted to Spain after the central government rejected a referendum vote for independence in Catalonia and then dismissed the regional government. Eight Catalan ministers have been arrested and a European arrest warrant has been issued for Catalan president, Carles Puigdemont, who has fled to Belgium.

Index	October %	12m %	YTD %
Dow Jones	4.4	32.1	20.6
S&P 500	2.3	23.6	16.9
FTSE 100	1.6	7.7	4.9
EURO STOXX 50	2.3	23.3	14.3
Nikkei 225	8.1	26.3	12.3
Hang Seng	2.5	23.2	28.4
Australia	4.0	10.6	4.5

Source: I-Net Bridge

In South Africa, Finance Minister Malusi Gigaba delivered his maiden Medium-Term Budget Policy Statement (MTBPS) and in so doing, gave an honest assessment of the significant fiscal challenges facing South Africa. A significant shortfall in tax revenue without a commensurate cut in spending or increase in taxes has resulted in a deterioration of all South Africa's fiscal metrics. The magnitude of the deterioration has increased the chance of further sovereign rating downgrades, as both S&P and Moody's are set to review South Africa's credit rating at the end of November. Moody's has already expressed its disappointment with the MTBPS.

Of particular concern to the ratings agencies is the lack of any plan to reduce the budget deficit over the forecast horizon. According to the statement, the budget deficit is forecast to balloon to 4.3% of GDP in 2017/18 (chart 2) and that the country's debt to GDP ratio will continue rising to 60% by 2020/21. The Treasury department also cut the country's growth forecasts to 0.7% in 2017, 1.1% in 2018 and 1.5% in 2019, significantly lower than the previous forecasts announced in February. The MTBPS also forecast a breach of the expenditure ceiling totalling R3.9 billion, which is the result of large appropriations for SAA and the SA Post Office.

MARKET OUTLOOK

A strong earnings season, particularly in the technology sector, propelled global equity markets to record-high levels. Amazon's share price surged almost 15% in October (chart 3), propelling the S&P 500 and Nasdaq Composite indices to record closing levels by the end of the month. According to FactSet, with more than half of the S&P 500 constituents having reported, the blended earnings growth rate for the third quarter is 4.7%. Excluding insurers, which have incurred significant losses following this year's hurricane season, the blended earnings growth rate increases to 7.4%. More than three-quarters of the companies that have reported beat analysts' earnings per share estimates, while two-thirds beat analysts' revenue estimates.

While Treasury yields in the US rose on the back of better-than-expected economic growth, government bond yields in Europe fell after the ECB's more dovish outlook and continued commitment to maintaining interest rates at historically low levels. The prospect of higher official interest rates in the US and lower in-store retail sales continue to weigh on the prices of global listed property companies. During October, the GPR 250 REIT index declined by 1.2% in US dollars and in so doing, bucked the trend in global equity markets. Although the index is up in 2017 (+3.4%) it has lagged the performance of equities.

Index	October %	12m %	YTD %
All Share	6.3	20.1	19.6
Resources	7.1	23.1	20.4
Financials	2.5	10.5	6.6
Industrials	7.6	23.6	25.9
Property	2.0	11.1	10.3
Bond	-2.3	5.0	5.3
Cash	0.6	7.6	6.3

Source: I-Net Bridge

South Africa's equity market rallied strongly in October as the rand weakened (chart 4) and Napers' share price surged 18% (chart 5). The Resources sector also delivered strong returns for investors as commodities prices rose in response to signs of stronger global economic growth. Companies with a domestic focus remain unloved and were sold off following the MTBPS. This trend is unlikely to be reversed in November as the market awaits the outcome of the rating agencies' reviews in November and the ANC elective conference in December. Current valuations suggest the market expects negative outcomes in both November and December.

The MTBPS painted a bleak picture for the South African bond market. New issuance by government is expected to increase substantially over the next 3 years and the prospect of a sovereign rating downgrade to "junk" is now far more likely. The yield on government's benchmark R186 bond jumped 55 basis points to 9.10% (chart 6). South Africa's listed property sector, which now has a more substantial rand-hedge element, gained 2.0% during the month. The domestic listed property companies followed their equity counterparts lower and in many cases now offer initial income yields well in excess of the R186 bond yield.

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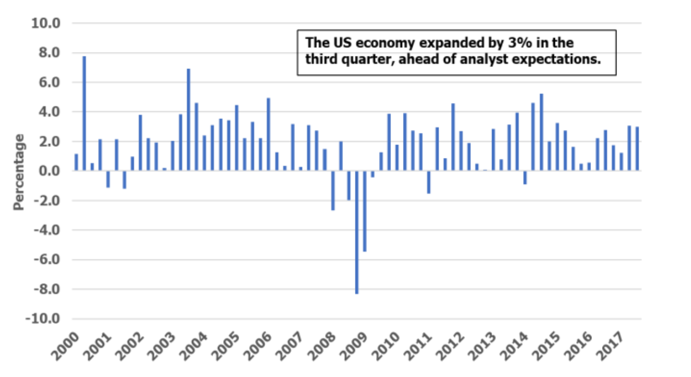
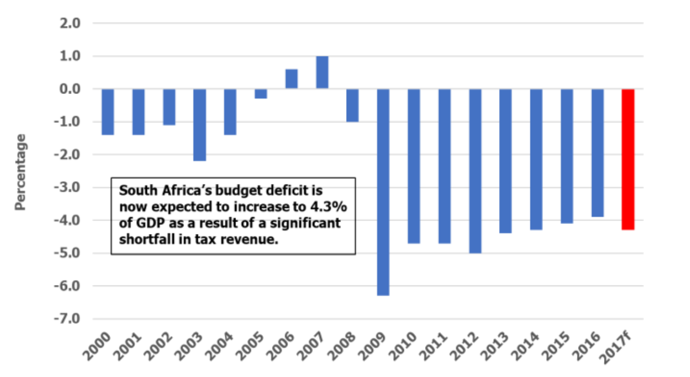
CHARTS

Chart 1: US GDP Growth (%)



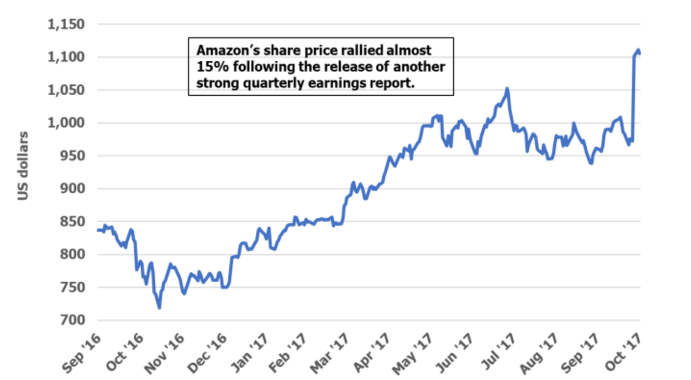
Source: I-Net Bridge

Chart 2: SA Budget Deficit as % of GDP (%)



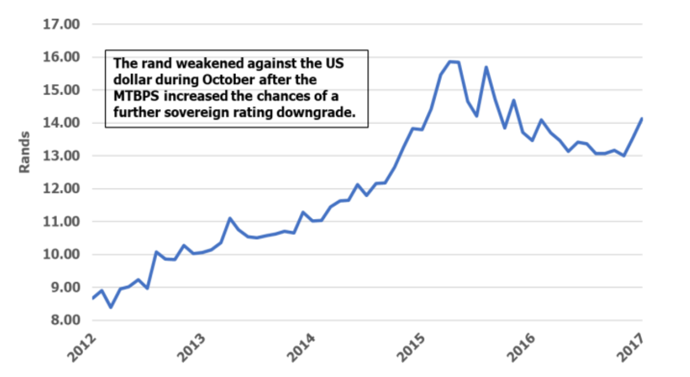
Source: Trading Economics

Chart 3: Amazon Share Price (US$)



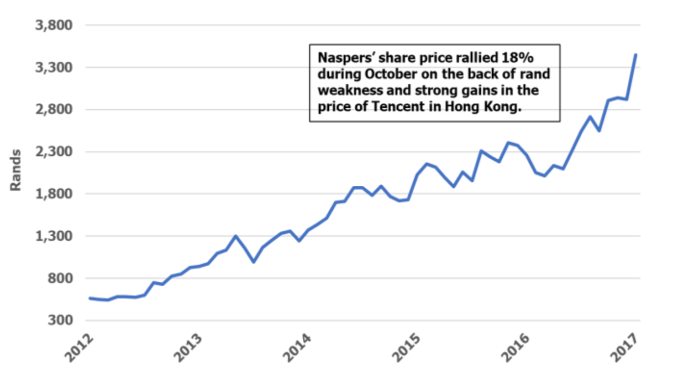
Source: FactSet

Chart 4: ZAR/USD Exchange Rate (Rands)



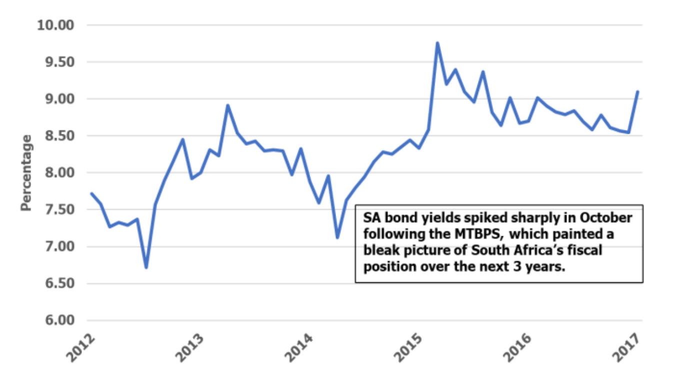
Source: I-Net Bridge

Chart 5: Naspers Ltd Share Price (Rands)



Source: I-Net Bridge

Chart 6: R186 Government Bond Yield (%)



Source: I-Net Bridge

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