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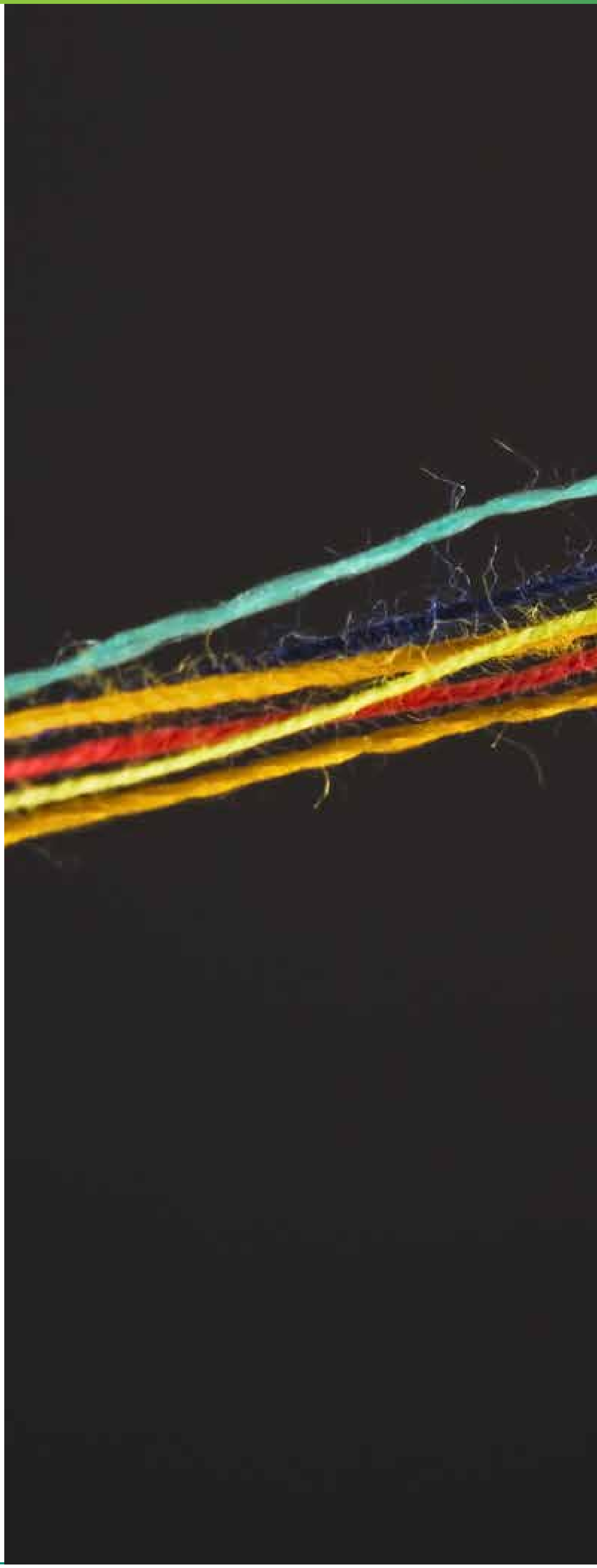

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SA ON THE **SLOW MEND**

JOHANN **ELS** | CHIEF ECONOMIST

ABOUT **THE AUTHOR**

As Chief Economist, Johann is responsible for all local and global macroeconomic research. Specific focus areas include the rand, inflation, interest rates and fiscal matters.

After experiencing increasingly volatile markets during the latter months of 2018 – mostly on the back of recession fear, worries about a full-scale trade war, the Chinese economic slowdown and uncertainty around the US interest rate cycle – some measure of calm returned late in December and into January 2019. This was thanks to the prospect of some trade agreement between the US and China as talks got under way, more Chinese policy measures to stimulate their economy, and the increasing likelihood that the US Federal Reserve Board (Fed) will pause their interest rate hiking cycle.

KEY TAKEOUTS

- STRONG LABOUR MARKET AND RESTRAINED FED EASE US RECESSION FEARS
- CHINA TAKES STEPS TO REVIVE GROWTH
- RECENT DATA BRINGS HOPE THAT SA ECONOMY IS IMPROVING
- SA RATES TO REMAIN ON HOLD IN 2019

US-CHINA TRADE TALKS GET SERIOUS

Following agreement between Presidents Trump and Xi at the G20 meetings in Argentina in December that a US/China trade deal will be pursued, a first round of talks has taken place. There seems to be a real willingness to get a deal done as realisation of the potential damage of a trade war to the global economy seems to have focused the minds. Also, in the wake of slowing Chinese data, the Chinese authorities have continued with policy measures to stabilise the economy, including another cut in the reserve requirement ratio (RRR) rate – the ratio of bank reserves that must be held at the central bank, the People's Bank of China (PBoC). Reducing this rate essentially injects more money into the economy. Further policy stimulation is set to come from more RRR cuts, VAT rate cuts and increased government spending by expanding the fiscal deficit – through a combination of tax cuts and increased spending, as well as frontloading municipal infrastructure spending.

FED TAKES A PATIENT APPROACH

Another factor that eased some of the extreme fears was the increased sense that the US Fed might not raise interest rates at the same pace as they did during 2018 (that is, four hikes of 25 basis points each). The Fed's monetary policy committee, the Federal Open Market Committee (FOMC), communicated a somewhat more dovish message after their December meeting. Not only was

the number of possible rate increases for 2019 reduced in the so-called "dot plot" (essentially the forecast of the FOMC members), but Fed chairman Jerome Powell has since stated that they can afford to be patient in an environment where inflation remains muted. He even indicated that the Fed might be willing to rethink the pace of balance sheet adjustment.

The minutes of the December FOMC meeting also highlighted this willingness to be patient – especially in an environment where global risks could potentially influence the US economy. While a patient Fed will be a positive in terms of reducing recession fears, the latest US employment data also restored some calm, highlighting that the economy is still robust and the labour market strong.

I remain of the opinion that recession risk remains low and that growth rotation from the US to elsewhere should mean better balanced and more synchronised growth – albeit at a slower pace. With the end of the US rate hiking cycle in sight, I expect a weaker US dollar during 2019 – around US$1.25 to US$1.30 per euro by end of 2019, from a level of US$1.15/€ at the time of writing, is not far-fetched at all. This will be a good environment for emerging markets in general and South Africa in particular.

GREEN SHOOTS IN SA ECONOMY

While South Africa's economy remains stuck in a low confidence and weak growth environment with lots of risks, the data over the very short term seems to have improved a bit. The global improvement highlighted above has certainly helped – impacting the rand and petrol prices and thus the inflation outlook substantially.

The latest growth data points to a positive GDP number in the fourth quarter of 2018. While a full data set is not yet available, preliminary numbers show that mining and manufacturing production should be up nicely from the third quarter (Q3) average. Mining production for October was up 18% on an annualised basis from Q3 and manufacturing production for October and November was up 4% on the same basis. While electricity production for October and November was up close to 3% on this basis, the load shedding impact will likely shave a large portion off this number in December. In addition, the latest leading indicator, as calculated by the South African Reserve Bank (SARB), also ticked higher after a number of months of decline.

LOWER CPI TO KEEP RATES IN CHECK

Following several months of large petrol price increases during 2018, the fall in international oil prices and the more stable rand exchange rate led to significant petrol price declines in December and January. Underlying inflationary pressures have been weak – as evidenced by the core inflation rate (4.4% in November 2018), inflation excluding administered prices (3.8% in November) and the retail sales price deflator (2.3% in October 2018). As explained before, in a weak growth environment, businesses find it difficult to pass on price increases to consumers, hence the very weak pass-through of rand weakness into final consumer prices. Following the 5.2% headline inflation rate in November last year, the large petrol price declines will likely see headline inflation falling to 4.5% in December and 4.2% in January 2019. I maintain my below-consensus forecast of a 4.8% CPI inflation average for 2019.

While I still believe, as explained last month, that the Reserve Bank did not need to hike interest rates in November 2018 (given the weak growth environment and prospects for continued low inflation), I expect rates to remain on hold throughout 2019, for the same reasons. Both the market consensus and the Reserve Bank's forecast for inflation are too high and will need to be revised lower. While I expect some growth improvement, the bulk of this will likely only occur after the elections, that is, during the second half of the year. The potential impact of stronger growth on pricing ability and thus inflation is therefore likely only to manifest during 2020.

My expectations for a better balanced global growth outlook, a slower US Fed and weaker US dollar, combined with a post-election confidence improvement in South Africa, should lead to a stronger rand exchange rate during 2019. This will aid confidence and the inflation trajectory.

A better global environment, including an improved environment for emerging economies, should help SA through a stronger rand exchange rate. Some growth and balance of payments benefits should also follow. Despite risks around growth, a cyclical uptick should continue during 2019, aided by improved post-election confidence. Growth should improve from below 1% in 2018 to around 2% in 2019. Low inflation should lead to unchanged interest rates this year. ■

FISCAL CONSOLIDATION MILLSTONE **STILL WEIGHS ON THE SA ECONOMY, AND BONDS**

FUTUREGROWTH INTEREST RATE TEAM

DAPHNE **BOTHA**
Portfolio Manager and Head of Risk Management

RHANDZO **MUKANSI**
Portfolio Manager

YUNUS **JANUARY**
Interest Rate Market Analyst

WIKUS **FURSTENBERG**
Portfolio Manager and Head of Interest Rate Process

REFILWE **RAKALE**
Research Analyst

Following a temporary reprieve in November, the fourth quarter of 2018 turned out to be an extension of most of the year in terms of market volatility and weakness. Emerging markets had to face the consequences of compromised international trade and its potentially negative impact on global economic growth, the continued shift away from global quantitative easing, a 40% drop in crude oil prices since October and rising political risk, specifically the emergence of populist leaders in Latin America's two biggest economies. As a result, investor caution manifested itself in foreign investors selling emerging market bonds.

KEY TAKEOUTS

- SARB FOCUSED ON CONTAINING INFLATION, DESPITE WEAK GROWTH
- INVESTORS AFFIRM SARB AND BUY LONG BONDS
- NOMINAL BONDS GENERATED SOLID RETURNS IN 2018, DESPITE VOLATILITY

Considering our own significant structural economic hurdles, South African financial markets got dragged down in this maelstrom of global risk aversion. This was evidenced by foreign net sales of local currency denominated bonds totalling R71 billion in 2018. In addition to offshore developments, the foreign selling was also in response to a disappointing, but realistic Medium-Term Budget Policy Statement delivered in October 2018. The Finance Minister acknowledged that much-needed fiscal consolidation was, once again, being pushed out, causing longer-dated bond yields to rise sharply. The yield on the benchmark R186 (maturity 2026) spiked to 9.32%, the weakest point since November 2017.

MORE ATTRACTIVE YIELDS LURE LONG BOND INVESTORS

The fiscal disappointment was offset by a hawkish central bank. In November, the South African Reserve Bank (SARB)'s Monetary Policy Committee raised the repo rate by 25 basis points (bps) to 6.75%, the first rate increase since February 2016. This decision, mostly driven by concerns about high inflation expectations, had a direct impact on both the level of bond yields and the shape of the nominal yield curve. Short-dated bond yields increased marginally in response to the repo rate increase. At the back end, local investors expressed their approval of the SARB's intention to contain inflation despite weak economic growth by buying long-dated nominal bonds at the higher, more attractively priced yields. This, coupled with a stronger rand, caused the yield on the R186 to decrease by around 30bps from its weakest intra-quarterly point of 9.32%. Consequently, the yield on the benchmark R186 (maturity 2026) moved lower to 8.88% on 31 December, 9bps lower than the September close of 8.99%.

The more recent economic data releases did little to change our assessment of our broad investment theme: a benign inflation outlook amidst sustained weak economic activity. The underlying inflation trend at both producer and consumer levels remained fairly subdued and is reflective of a rather strong disinflationary environment. On a negative note, the release of the latest external trade account data showed another significant current account deficit of -3.5%, calling into question Government's ability to sustainably shrink the size of the negative current account balance.

INFLATION-LINKED BONDS UNDERPERFORM

Inflation-linked bond yields receded marginally in the second half of November. Even so, market weakness in the first half of the month gave rise to a steepening of the real yield curve slope. The yield of the benchmark R197 (maturity 2023) initially increased to 3.05%, its weakest level since April 2010, before pulling back to close the fourth quarter of 2018 at 2.92%, only marginally higher than the September close of 2.90%. Despite this, the bearish steepening of the yield curve caused the JSE ASSA Government Inflation-linked Index (IGOV) to render a poor return of 0.43% during the quarter, underperforming both nominal bonds and cash by a significant margin.

Despite significant intra-quarter nominal bond market volatility, the JSE ASSA All Bond Index managed to deliver a return of 2.8% over the three-month period ending December 2018. Cash performance, as measured by the STeFI total return index, rendered a return of 1.8% during the quarter. The return profiles of the three interest-bearing asset classes for the 2018 calendar year follow the same pattern as the past quarter's return. The inflation-linked bond index (0.3%) underperformed both nominal bonds (7.7%) and cash (7.3%) by a significant margin.

At a global level, the shift from quantitative easing to quantitative tightening remains the main trend for now. However, the risk to a sustained global economic recovery should not be ignored and this may cause a slowing of this tightening monetary policy trend over the next year. This tightening trend also implies that global bond

yields, more specifically the US Treasury market, may have already peaked for now and could hover in a tight, slightly lower range in the near term.

Locally, our main concern with regard to the bond market remains the strong link between lacklustre economic growth and fiscal consolidation – or more specifically, Government's rising debt burden as a consequence of a lack of fiscal consolidation, which continues to threaten the country's sovereign risk profile as well as placing pressure on domestic funding costs. By way of example, the chart shows Eskom's significant share of Government's contingent liability. The realisation of this liability onto the central government's balance sheet will have a notable impact on Government's debt service cost and thus fiscal consolidation efforts.

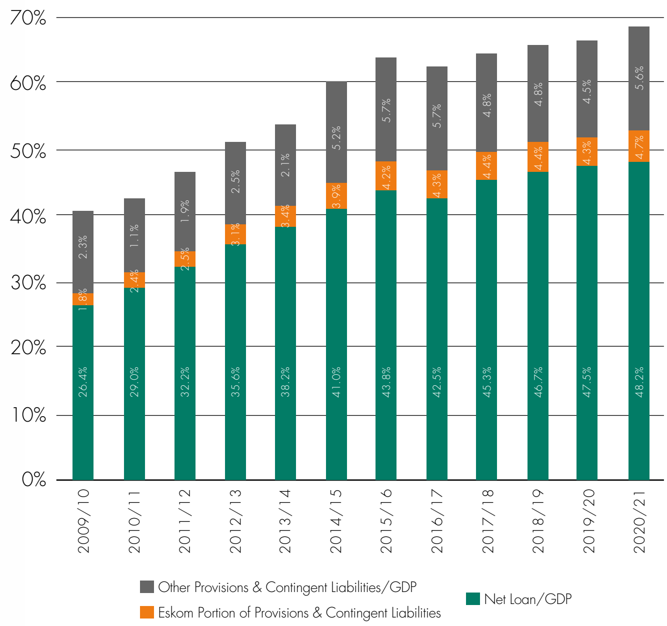
The risk of a failed economic recovery has not dissipated, and despite the strong third quarter rebound in gross domestic product (GDP) growth of 2.2%, the underlying economy remains structurally weak. This makes us question the quality of tax revenue collections, which, in turn, keep the risk of a budget deficit overrun at elevated levels.

SARB KEEPS A KEEN EYE ON INFLATION

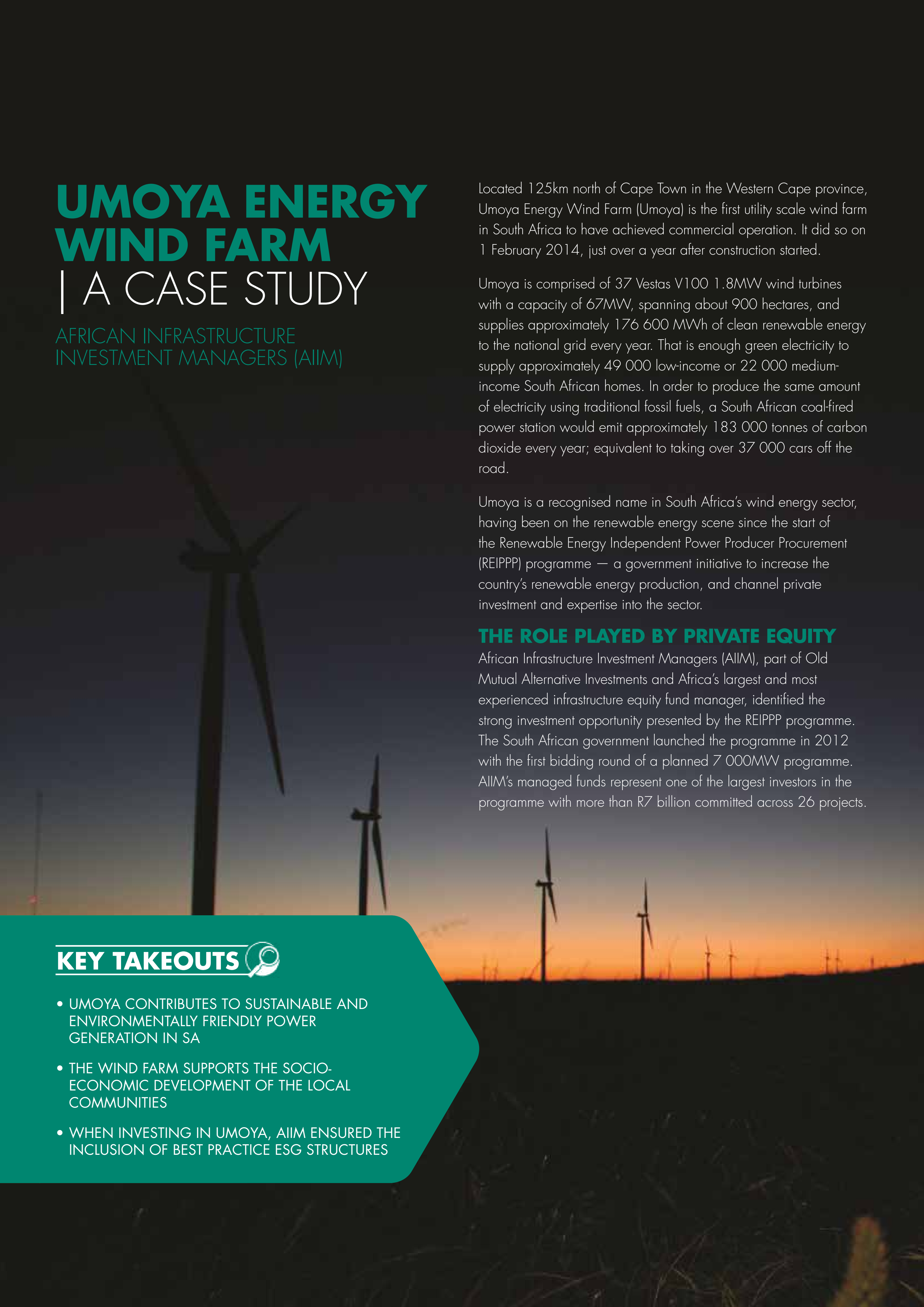
On the monetary policy front, we maintain our view that, following the recent repo rate increase in November, the SARB will remain hostage to the opposite forces of a lacklustre economic growth outlook and limited upside risks to inflation in light of the strong disinflationary environment. For now, this suggests to us a stable policy path combined with a central bank that will keep warning of their response to the threat of higher inflation outcomes. The underlying domestic disinflationary trend and the risk to the global growth outlook should not be ignored. On balance, the risk to the stable repo rate outlook is still skewed to the upside, mostly due to stubbornly high inflation expectations.

While the observable investment theme and related real-time developments mostly have negative consequences for the local bond market, it is important to note that the current market valuation is largely reflective of this. Cheaper market valuations following the sell-off during the second quarter afforded us an opportunity to cautiously increase risk by selectively buying nominal bonds. We shall continue to look for opportunities to increase bond market exposure, but only into bouts of weakness, considering the level of uncertainty discussed above. ■

THE SOUTH AFRICAN GOVERNMENT'S NET LOAN POSITION, OTHER PROVISIONS AND CONTINGENT LIABILITIES (PERCENTAGE OF GDP)



Sources: National Treasury, Futuregrowth



UMOYA ENERGY WIND FARM | A CASE STUDY

AFRICAN INFRASTRUCTURE INVESTMENT MANAGERS (AIIM)

Located 125km north of Cape Town in the Western Cape province, Umoya Energy Wind Farm (Umoya) is the first utility scale wind farm in South Africa to have achieved commercial operation. It did so on 1 February 2014, just over a year after construction started.

Umoya is comprised of 37 Vestas V100 1.8MW wind turbines with a capacity of 67MW, spanning about 900 hectares, and supplies approximately 176 600 MWh of clean renewable energy to the national grid every year. That is enough green electricity to supply approximately 49 000 low-income or 22 000 medium-income South African homes. In order to produce the same amount of electricity using traditional fossil fuels, a South African coal-fired power station would emit approximately 183 000 tonnes of carbon dioxide every year; equivalent to taking over 37 000 cars off the road.

Umoya is a recognised name in South Africa's wind energy sector, having been on the renewable energy scene since the start of the Renewable Energy Independent Power Producer Procurement (REIPPP) programme — a government initiative to increase the country's renewable energy production, and channel private investment and expertise into the sector.

THE ROLE PLAYED BY PRIVATE EQUITY

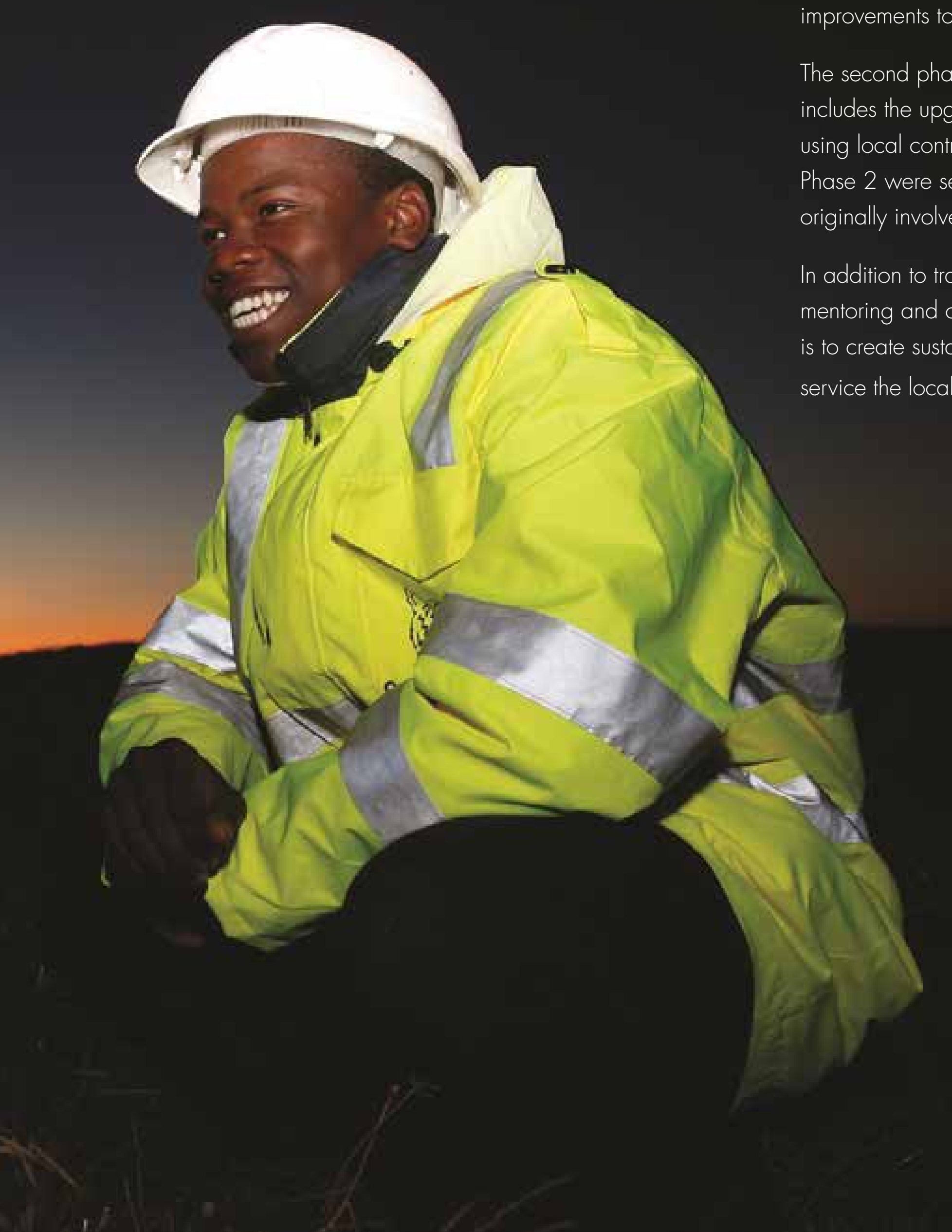
African Infrastructure Investment Managers (AIIM), part of Old Mutual Alternative Investments and Africa's largest and most experienced infrastructure equity fund manager, identified the strong investment opportunity presented by the REIPPP programme. The South African government launched the programme in 2012 with the first bidding round of a planned 7 000MW programme. AIIM's managed funds represent one of the largest investors in the programme with more than R7 billion committed across 26 projects.

KEY TAKEOUTS

- UMOYA CONTRIBUTES TO SUSTAINABLE AND ENVIRONMENTALLY FRIENDLY POWER GENERATION IN SA
- THE WIND FARM SUPPORTS THE SOCIO-ECONOMIC DEVELOPMENT OF THE LOCAL COMMUNITIES
- WHEN INVESTING IN UMOYA, AIIM ENSURED THE INCLUSION OF BEST PRACTICE ESG STRUCTURES

Having been an active investor in the infrastructure sector since 2000, the AIIM funds entered the Umoya project at an early stage of the development, managing the project to financial close. The Umoya site was strategically positioned with close proximity to a major distribution line and to large commercial energy users, which simplified construction and connection requirements. The site also benefited from strong wind resources, measured over an extended period of 24 months.

Investing in Umoya meant that AIIM would be working with a strong partner in Vestas, one of the largest wind turbine suppliers in the world. Following investment, AIIM recruited internationally experienced personnel to manage the development of the project for its funds and, post financial close, to manage the construction, operations and financing of the project. AIIM also provided oversight of the construction process through its board representation, with Umoya achieving commercial operation on schedule and within budget.



AIIM oversaw the establishment of the project company with the inclusion of best practice environmental, social and governance (ESG) structures with the development of a Social and Environmental Management System (SEMS) in compliance with the internationally recognised Equator Principles and IFC Performance Standards.

A FORCE FOR GOOD

Beyond its contribution to sustainable and environmentally friendly power generation, Umoya is focused on supporting the socio-economic development of the local communities within which it operates. It achieves this through capacity building, skills transfer and funding of beneficiary programmes that address local skills gaps, such as the Hopefield Home Improvement Project.

This project was designed to improve the energy efficiency of low-cost homes as well as the lives of their residents. During Phase 1 of this project, which took place over a period of two years (2014 – 2016), 19 previously unemployed residents of Hopefield were trained in plumbing, electrics or carpentry and employed to make improvements to more than 600 homes in Hopefield.

The second phase of the project, which started in January 2017, includes the upgrade of 351 more homes over a three-year period, using local contractors. The three contractors identified for Phase 2 were selected from the pool of 19 artisans who were originally involved in Phase 1.

In addition to training, the programme also includes business mentoring and coaching. Umoya's ultimate objective for the project is to create sustainable contracting businesses that are able to service the local community for years to come. ■

SA COMPANIES IGNORE VOTES AGAINST EXECUTIVE REMUNERATION AT THEIR PERIL

ROBERT **LEWENSON** | HEAD OF ESG ENGAGEMENT

ABOUT **THE AUTHOR**

Robert is responsible for proxy voting and engagement, representing Old Mutual Investment Group on various industry bodies and championing responsible investment for the Old Mutual group. He has 10 years of work experience in the legal profession and asset management industry.

Salaries across the pay band, from CEO through to blue-collar workers, are increasingly under the spotlight. If the interests of shareholders are to be properly aligned with those of company management in terms of setting and implementing company strategy effectively, then we must rein in the issue of unchecked executive remuneration or face the prospect of poor or misaligned implementation of company strategy. Inaction by shareholders in this area will exacerbate the income inequality that continues to blight South Africa.

KEY TAKEOUTS

- SA FACES GROSS INCOME INEQUALITY
- KING IV MARKS FAIR AND RESPONSIBLE REMUNERATION AS A KEY INDICATOR OF ETHICAL LEADERSHIP
- SOLVING INAPPROPRIATE PAY PRACTICES REQUIRES COLLABORATION BETWEEN COMPANIES AND INVESTORS
- ASSET MANAGERS MUST ENGAGE COMPANIES TO ADDRESS UNCHECKED EXECUTIVE REMUNERATION

A SHAREHOLDER-INCLUSIVE APPROACH

The King IV Report has set out the requirement that should a company have more than 25% of shareholders vote against its remuneration policy, then the company is required to engage with dissenting shareholders. At the very least, such steps should include an engagement process to ascertain the reasons for the dissenting votes, appropriately address legitimate and reasonable objections and concerns raised (which may include amending the remuneration policy), or clarify remuneration governance and/or processes.

The challenge is that the shareholder vote itself is non-binding, and as a consequence, many companies falsely assume that paying, lip service to King IV, requirements is enough. By continuing to do so, the risk for participants in the financial ecosystem is that alignment between investors, asset managers and investee companies is eroded.

As a shareholder, Old Mutual Investment Group is highly active when it comes to holding management teams accountable for executive remuneration. Our published letter to the CEOs of the top 100 South African companies in August 2018 reiterated our expectations for companies to practise ethical leadership, lead on transformation and to integrate environmental, social and governance (ESG) considerations into company strategy. Fair and responsible remuneration, as required by King IV, is an important indication of ethical leadership at board level. We take the matter very seriously in line with our responsible ownership activities.

MIND THE PAY GAP

Solving inappropriate pay practices requires collaboration between companies and investors to create the right alignment that works for all stakeholders in financial markets. We believe in engaging regularly with company management on operational and company-specific issues, as well as on issues related to governance performance, such as executive remuneration. Where we believe it to be in the best interests of our clients, and where we have exhausted our engagement with management, we will seek out opportunities to collaborate with co-investors as a means to drive change regarding the company's pay practices. Where such collaborative efforts are undertaken, we will ensure that conflicts of interest and issues relating to "acting in concert" are appropriately addressed.

In a recent report on remuneration by a well-regarded remuneration consultant, we were acknowledged as having one of the highest number of votes against company remuneration at 37% of our total proxy votes by number during the reporting period. A major step forward would be to adopt our request that all votes on remuneration become binding and that a simple majority against a remuneration proposal should force a rethink.

In isolation, voting against remuneration is still not enough to bring about meaningful change, and more must be done. It is critical that we focus on developing common practices that address legitimate and reasonable objections and concerns raised by investors regarding executive remuneration practices.

COMMITTED TO ROBUST ENGAGEMENT

The obligation is on both the company and material asset managers (with 3-5% holdings) to engage regarding their concerns prior to the annual general meeting (AGM). Should a company still receive a 25% vote against their remuneration then a private meeting (online or otherwise) between the company and material shareholders should take place as soon as possible to close out remaining concerns, including a timeline to rectify issues. If a company refuses to institute this process, collaborative engagement between material shareholders should be initiated with possible media exposure, should it be deemed necessary. The company then runs the reputational and governance risk of a large vote against members of the Remuneration Committee at the next AGM.

We cannot ignore the importance of ensuring that South African companies engage in fair and responsible remuneration practices and, as an asset manager committed to serving our clients' best interests, we will continue to drive positive change both at an investee company level and collectively across the industry. ■

MARKET INDICATORS AS AT 31 DECEMBER 2018

	DY %	P/E Ratio	1 Month %*	12 Months %*
FTSE/JSE All Share Index			4.3	-8.5
FTSE/JSE Resources Index			12.3	15.5
FTSE/JSE Industrial Index			2.4	-17.5
FTSE/JSE Financial Index			0.6	-8.8
FTSE/JSE SA Quoted Property Index			-1.1	-25.3
ALBI BEASSA Bond Index			0.6	7.7
STeFI Money Market Index			0.6	7.2
MSCI World Index (R)			-4.1	6.7
MSCI World Index ($)			-7.6	-8.2

*Total return index percentage change

Economic Indicators		Latest Data	Previous Year
Exchange Rates			
Rand/US$	December-18	14.35	12.38
Rand/UK Pound	December-18	18.32	16.74
Rand/Euro	December-18	16.47	14.86
Rand/Aus$	December-18	10.13	9.68
Commodity Prices			
Gold Price ($)	December-18	1280.9	1296.7
Gold Price (R)	December-18	18450.4	16019.3
Oil Price ($)	December-18	54.4	66.5
Interest Rates			
Prime Overdraft	December-18	10.3%	10.3%
3-Month NCD Rate	December-18	7.1%	7.2%
R186 Long-bond Yield	December-18	8.9%	8.6%
Inflation			
CPI (y-o-y)	November-18	5.2%	4.6%
Real Economy			
GDP Growth (y-o-y)	September-18	0.6%	1.3%
HCE Growth (y-o-y)	September-18	1.2%	2.3%
Household Consumption Expenditure (HCE) Growth (y-o-y)	September-18	-0.6%	0.9%
Gross Fixed Capital Formation (GFCF) Growth (y-o-y)	October-18	2.0%	1.1%
Manufacturing Production (y-o-y) (seasonally adjusted)			
Balance of Payments			
Trade Balance (cumulative 12-month)	November-18	$3.5	$13.1
Current Account (% of GDP)	September-18	-3.5%	-2.1%
Forex Reserves (incl. gold)	November-18	$697.3	$684.8

Sources: JSE, Iris, I-Net

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