overberg
asset management

OAM Local Income Portfolio[1]

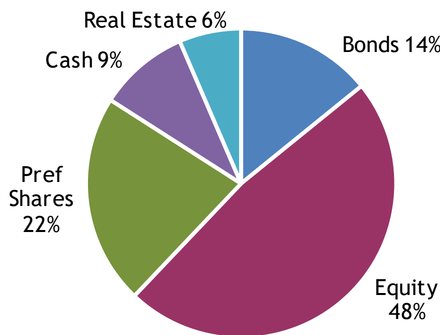
Technical Details

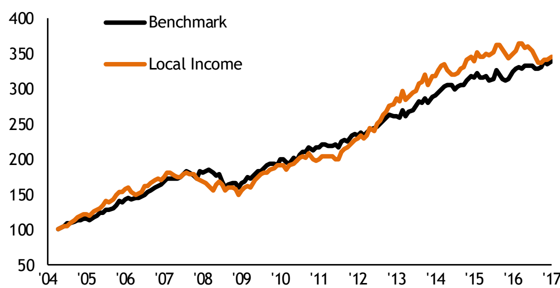
- Base currency: **South African Rands**
- Benchmark: **JSE All Share (30%) and ALBI 1-3 yr (70%)**
- Asset Allocation: **Flexible mix of equities, bonds and cash**

Investment Objective

- conservative growth
- consistent annual returns
- low volatility

ASSET ALLOCATION





(As calculated by Overberg Apr 2017)

1) Individual portfolio representing Local Income investment style

March 2017

	Income %	Benchmark %
Annualised Total Return	10.22	10.07
2004 (July - December)	18.33	14.20
2005	25.71	23.16
2006	14.50	21.94
2007	4.40	12.27
2008	-10.60	-9.99
2009	16.80	18.00
2010	11.73	11.90
2011	4.79	4.78
2012	22.86	14.38
2013	19.66	10.43
2014	3.67	6.98
2015	7.64	3.09
2016	-5.18	5.04
2017 YTD	2.30	2.68

Return over 3, 5 and 7yrs	2.79	8.50	8.78

*Since March 2005: All performance figures include income and are net of fees and expenses

Growth 2017	Income %	Benchmark %
January	1.05	2.30
February	-0.18	-0.81
March	1.42	1.19
April		
May		
June		
July		
August		
September		
October		
November		
December		

	%
Annualised Income Yield	4.80

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Disclosure: There is a risk associated with investing in our financial products. The value of the investments and income may rise as well as fall, and there is a risk that the client may suffer financial losses. Returns are dependent on the performance of the underlying assets and other variable market factors. Past performance are not indicative of future performances.

Market Review

South African equity markets recorded positive gains during the first quarter (Q1) showing the first green shoots of the long-awaited recovery. The All Share index gained by +2.77%. The rand firmed in line with other emerging market currencies from R/$13.70 to 13.40 a gain of +2.19%. After last year's strong gains the Resources 10 index moved sideways although still eked a small +0.66% increase. The Industrial 25 index rallied +6.33% helped by strong moves in dual listed stocks such as Naspers and British American Tobacco as well as increased confidence in domestic industrial porduction. However, weak credit growth held back the Financial 15 index with a loss of -3.28%. Bonds fared well as inflationary pressures eased and expectations increased that the Reserve Bank would start cutting the benchmark repo rate before year-end. The All Bond 1-3 year total return index rosae +2.6% over the quarter. The dollar gold price recovered from its -12.5% loss in Q4 2016 with a substantial +10.7% surge in Q1.

Unfortunately the clock has been set back by President Zuma's ill-fated cabinet reshuffle and removal of Finance Minister Pravin Gordhan and his deputy Mcebisi Jonas on 30th March. The steadily improving outlook for the economy based on rising business confidence and consumer confidence will undoubtedly unwind over coming months as the full effect of the credit rating downgrades are felt. The consequences of the credit rating downgrade will be higher borrowing costs for all South African persons, a weaker exchange rate, higher inflation, lower investor confidence and slower economic growth.

Standard & Poor's Global (S&P) was the first to downgrade South Africa's long-term foreign currency credit rating to sub-investment grade or so-called "junk" status. Fitch Ratings followed by ascribing junk status to local currency as well as foreign currency debt, being the first and so far, only agency to do so. Fitch reported that the Treasury's ability to withstand spending demands from state-owned companies and government departments could weaken and that the nuclear programme is now likely to proceed relatively quickly. With 90% of South Africa's debt raised in local currency the local currency credit rating is clearly the most important to the country's fiscus. South Africa's local currency bonds will be jettisoned from the World Global Bond Index if more than one rating agency downgrades the local currency rating to junk status. The chances are high: Moody's rating agency has put South Africa on review for a downgrade and S&P has South Africa on "negative watch". While Moody's is still two notches above junk status there are precedents for a two-notch downgrade, as occurred in Brazil in February 2016. Being dropped from international bond indices would result in forced bond selling by foreign institutions of around $10 billion.

GDP growth has been on a declining trend since 2011. In 2016, South Africa succumbed to the perfect storm with year-on-year growth of just 0.3%. GDP growth was negatively affected by accelerating inflation, rising interest rates, declining consumer spending, slowing mining and manufacturing demand, the impact of political uncertainty on business confidence and one of the worst droughts in living memory. However, and notwithstanding the credit rating downgrade GDP growth will rebound in 2017 and 2018, potentially by more than currently projected. GDP growth of 1.5% is likely in 2017 as the negative conditions which beset the economy in 2016 begin to reverse. A recovery in global economic growth is boosting South African export demand with firming international commodity prices and rising global trade promoting the manufacturing and mining sectors. Agricultural production will rebound strongly as weather patterns normalize. The US Department of Agriculture forecasts South Africa's maize output will increase in 2017 by 65% year-on-year more than reversing the 27% decline in late 2015 and early 2016.

Admittedly taken prior to the Zuma reshuffle, forward-looking economic indicators, which measure expected conditions in 3-6 months' time, are showing a strongly positive trend. The South African Reserve Bank (SARB) leading indicator has increased to its highest since the fourth quarter 2014. The Bureau of Economic Research manufacturing purchasing managers' index (PMI) increased from 50.9 in January to 52.5 in February, its strongest since June 2016

and above the expansionary 50-level for a second straight month. The South African Chamber of Commerce and Industry's (SACCI) business sentiment index jumped from 93.8 in December to 97.7 in January, its highest since October 2015.

Meanwhile market expectations for an interest rate cut are likely to rise as consumer price inflation (CPI) returns to within the Reserve Bank's (SARB) inflation target. The SARB has hiked the benchmark repo rate by an aggregate 200 basis points since it initiated its rate tightening cycle in January 2014 but for the past year has left rates on hold. At its policy meeting in September last year the Reserve Bank said it may be approaching the end of its hiking cycle. Food price inflation is expected to reverse course in 2017, falling sharply in line with increased agricultural production, in turn bringing down CPI, which is expected to average 5.5% over 2017. This is well within the SARB's target range of 3-6%, which despite recent rand turbulence should embolden the central bank to cut interest rates. Interest rate cuts will boost consumer and business confidence, household expenditure and investment spending. At its policy setting meeting on 30th March, although before the President's cabinet reshuffle, the SARB noted that inflation appears to have turned the corner. While the start of monetary easing may be delayed the SARB is nonetheless likely to announce the first interest rate cut before year-end.

Despite government's efforts to undermine the country's improving growth prospects the economic outlook is improving. Dr. Monfort Mlachila, the IMF's senior representative in South Africa, highlighted the importance of neighbouring African countries to South Africa's economic outlook, stating that this fact is sometimes overlooked. The neighbouring region accounts for 30% of South Africa's total exports and an even greater proportion of manufacturing exports, making it the country's largest export destination. After slumping in 2015 and 2016 due to weak commodity prices and drought conditions, which affected agricultural output and hydroelectric power generation, economic growth in Sub-Saharan Africa is expected to pick-up sharply in 2017. International commodity prices are rising, current account deficits are narrowing, and the normalization of weather patterns is boosting agricultural output and hydroelectricity generation. Currencies are stabilizing and inflation is falling allowing central banks to ease monetary policy. The rebound in Sub-Saharan Africa is good news for South Africa's economy. The economic cycle in Sub-Saharan Africa is enjoying a solid recovery. Following growth of just 0.7% in 2016 GDP is expected to expand in 2017 by 3.5% accelerating to 4.0% in 2018.

How will successive Fed rate hikes affect the rand and South African bond and equity prices? Like most cycles this Fed hiking cycle coincides with an acceleration in global economic growth, firming in commodity prices and increasing demand for emerging market exports. In the last Fed tightening cycle between June 2004 and June 2006 emerging market equities increased sharply. Emerging market equities have outperformed developed market equities in three of the past four Fed tightening cycles. The same trend is likely to be repeated in 2017, with early signs that emerging market company earnings have stabilized and are beginning to accelerate after recording 15-year lows last year (relative to developed markets). During the last Fed tightening cycle between June 2004 and June 2006, the rand depreciated by 17% versus the US dollar from R/$6.14 to 7.18. However, the ten-year bond yield firmed from over 9% to under 8% while the All Share Index more than doubled from 10,109 to 21,238. The Fed tightening cycle is likely to be positive for the JSE.

The rand's volatility is largely explained by local political uncertainty. However, commodity prices and global financial conditions are equally important drivers of rand volatility according to a paper prepared by the IMF, which investigated the drivers of rand volatility in the period since the 2008/09 global financial crisis. Though the rand will dip on the likely news that the Treasury is breaching the budget parameters stipulated in the 2017/18 State Budget the brightening outlook for commodity markets and global financial markets may limit the rand's downside. After a gloomy 2016 the consensus outlook for South Africa's economy has become overly pessimistic. Despite rising political risk the cyclical economic rebound in 2017, although less strong than it might have been in the absence of Zuma's cabinet reshuffle, will still take many by surprise fuelled by a recovery in agriculture, manufacturing and mining, falling interest rates and increased business and household spending.