



# OAM Local Real Return Portfolio<sup>1</sup>

October 2016

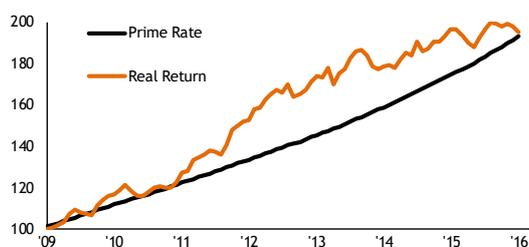
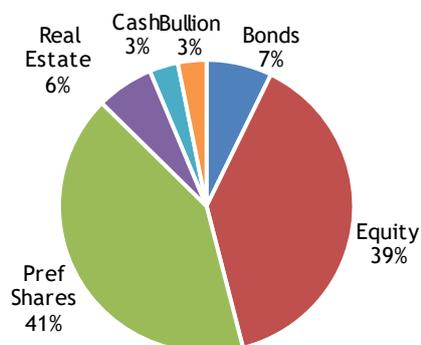
## Technical Details

- Base currency: South African Rands
- Benchmark: Prime Interest Rate
- Asset Allocation: Flexible mix of bonds, listed commercial properties, pref shares and ordinary shares.

## Investment Objective

- conservative growth
- consistent annual real returns
- low volatility

### ASSET ALLOCATION



(As calculated by Overberg Nov 2016)

1) Individual portfolio representing Local Real Return investment

	Real Return %	Benchmark %
<b>Annualised Total Return</b>	10.02	9.85
2010	17.58	11.42
2011	10.14	9.38
2012	19.21	9.11
2013	11.86	8.84
2014	0.26	9.52
2015	8.51	9.83
2016 YTD	1.09	9.01

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

Growth 2016	Real Return %	Benchmark %
January	-1.85	0.81
February	-0.76	0.85
March	2.44	0.87
April	1.84	0.88
May	1.90	0.88
June	-0.24	0.88
July	-0.76	0.88
August	0.51	0.88
September	-0.73	0.88
October	-1.16	0.88
November		
December		
		%
<b>Annualised Income Yield</b>	7.42	



## Market Review

The rand maintained its strengthening trend during the third quarter (Q3), registering a +6.82% appreciation from R/\$14.73 to R/\$13.73. In the year-to-date (YTD) the rand has rallied +11.29% against the US dollar. While good for bonds and the outlook for short-term interest rates, a stronger rand has hampered the All Share index which derives around 70% of its earnings from offshore. The All share index lost -0.51% over Q3 trimming its YTD gains to +2.48%. The Industrial 25 index fared worse due to its heavy exposure to the large dual listed stocks such as British American Tobacco, Naspers and SABMiller, losing -3.85% over the quarter and -4.93% since the start of the year, while the Financial 15 index made respective returns of +0.09% and -3.33%. The standout performer was the Resources 10 index, up +7.12% in Q3 and +27.82% YTD, boosted by China's positive influence on commodity prices and the relative weakness of the US dollar. Bonds performed well in line with the strengthening rand pushing the All Bond index (1-3 year) to a 2.04% gain over Q3 and +8.17% YTD. The dollar gold price eased slightly during Q3 from \$1321.7 to \$1315.9 but maintained a solid +24.03% uplift from its end December 2015 level of \$1060.9.

The economy grew in Q2 by a stronger than expected 3.3% quarter-on-quarter annualised, a relief following the -1.2% contraction in Q1. The improved growth rate is attributed to the very low base that had been established in Q1 and a rebound in mining and manufacturing output. However, capital expenditure by the private sector fell a further -3% continuing the -13% plunge in Q1 and -4% drop in Q4 2015. Business confidence has been undermined by a combination of weak domestic and external demand, infrastructure bottlenecks, rising production costs and uncertainty over government policy. Capital expenditure by public corporations also declined, -2.6% lower in the first half of the year compared to the year-ago level.

Despite the improvement in Q2, the economic outlook remains weak. Monthly data signals a renewed loss in momentum in Q3. Mining production fell in July by -2.4% month-on-month while the year-on-year contraction deepened from -3.0% in June to -5.4%. Manufacturing production unexpectedly fell in July by -1.5% on the month while year-on-year growth slowed sharply from 4.7% in June to just 0.4%. Among the ten manufacturing categories, all but two showed monthly production declines. Unfortunately, the sharp decline in the forward-looking manufacturing purchasing managers' index from 52.5 in June to a sub-50 contractionary reading of 46.3 in July, does not bode well for manufacturing output in Q3. After falling for six consecutive quarters the RMB/BER Business Confidence index increased in Q3 from 32 to 42. Although an improvement the reading indicates that only 4 out of every 10 survey respondents are positive. In addition, the BER confidence index should be viewed with caution as the survey was compiled after the local elections but prior to the recent onset of political uncertainty following the persecution of Finance Minister Pravin Gordhan. Growth in retail sales and new vehicle sales has also declined since the start of Q3.

GDP expanded in the first half of the year by only 0.3% year-on-year, so given the recent loss in momentum it is difficult to subscribe to the SA Reserve Bank's (SARB) 2016 GDP forecast of 0.4%. The SARB has meanwhile raised its GDP forecasts for 2017 and 2018 from 1.1% to 1.2% and from 1.5% to 1.6%. Much is premised on the rand maintaining its stronger levels, which in turn will suppress short-term interest rates and boost business and consumer confidence. However, as stated by the SARB Monetary Policy Committee, the recent resilience of the rand may prove to be "temporary".

With certain caveats on the rand maintaining its current trend, the SARB revised its inflation forecasts. The SARB forecasts headline consumer price inflation (CPI) will peak in Q4 at 6.7% down from a previous 7.1% and will return to the 3-6% target range in Q2 2017 earlier than its previous forecast of Q3 2017. The policy statement projected improved rand levels although cautioned that the rand "remains vulnerable to future changes in the US monetary policy stance, domestic political developments as well as to a risk of a possible ratings downgrade later in the year."



At its policy meeting the SA Reserve Bank (SARB) decided by unanimous vote to keep its benchmark repo interest rate unchanged, for a third consecutive meeting, at 7.0%. SARB governor Lesetja Kganyago adopted decidedly more “dovish” language in his policy statement describing the upside risk to the inflation outlook as having “moderated somewhat”. Kganyago said that provided the currency and inflation forecasts materialize the SARB “may be close to the end of the tightening cycle.” The Forward Rate Agreement curve has flattened since the start of the year indicating that market participants are pricing-in an end to the current interest rate hiking cycle, with the possibility of just one more hike in November or January.

The rand’s direction will be guided by the government’s ability to resolve major concerns around corruption, transparency and accountability, and whether October’s Medium Term Budget Policy Statement is able to demonstrate progress in reducing the budget deficit and reforming state-owned enterprises (SOEs). These factors will have a substantial impact on the outcome of SA’s credit rating updates at the end of the year. Some creditors have already become nervous. Futuregrowth, SA’s largest fixed-income asset manager, has announced that due to concerns over governance, it will not extend new funding to Eskom, Transnet, Sanral, the Land Bank, and the Development Bank of Southern Africa. Moody’s credit rating agency has placed five SOEs on review for a potential downgrade.

Markets will keep a close eye on the upcoming credit rating reviews by Moody’s in November and Fitch and Standard & Poor’s (S&P) in December. Fitch and S&P have SA’s foreign currency rating at one notch above investment grade, while Moody’s rating is two notches above investment grade. The IMF estimates that 20-30% of foreign bond holdings are “ratings sensitive”, which means there could be severe repercussion for the domestic bond market and rand in the event of a credit rating downgrade. According to Judge Dennis Davis, head of the tax advisory committee: “We cannot overstate the disaster that will engulf our fiscal and revenue calculations if we are downgraded.”

The rand’s relative strength is attributed to two key factors, AB InBev’s takeover of SABMiller and the global search for income yield in a global zero interest rate environment. Unfortunately, the first is once-off and the second may have a limited timeframe. AB InBev accumulated around R120 billion in order to pay SABMiller’s South African shareholders, but this has already occurred. Meanwhile, zero interest rate policy by the world’s major central banks has caused yields of many bonds to drop below 0%. In July a record amount, in excess of \$12 trillion worth of bonds, were in negative yield territory. The search for positive yields prompted unprecedented portfolio inflows into high yielding emerging market bonds. However, global bond yields have already started rising, a trend which will tarnish the allure of emerging market bonds. German 10-year bund yields moved back into positive territory on 9th September. The US 10-year Treasury yield has risen steadily from its low of 1.36% in July to over 1.65%. A resumption of the Fed rate hiking cycle will encourage further increases in bond yields. While the Fed refrained from hiking interest rates at its September policy meeting the probability of a rate hike in December or January has risen steadily since the policy meeting.

Although rand hedge stocks have held back portfolio performance over the past quarter we believe the current strategy of meaningful rand hedge exposure in portfolios will be vindicated once the Fed resumes its interest rate tightening cycle. A Fed rate hike will prompt a reversal of global inflows into emerging market bonds. There is also significant country-specific risk attached to the rand, which adds further justification to a meaningful rand hedge exposure. In addition, portfolios have been kept purposefully defensive given that the All Share index is trading on a price earnings multiple of over 23x, well above its 14.9x historic average and the 12.9x emerging market average. Diversification across asset classes is key to capital preservation during the current period of low equity returns. Preference (pref) shares provide excellent diversification to portfolios, currently yielding 8.5-11.5%, net of dividend withholding tax. The Beta (sensitivity of a share’s price to changes in the equity market) of the JSE Pref Share index is just 0.08, which means that, on average, if the JSE All Share index falls by 1%, the Pref Share index will only fall by 0.08%. Real estate investment trusts (REITs) are also appealing, paying income yields as high as 8-10%, with the added prospect of capital appreciation once the SARB completes its interest rate hiking cycle.