OVERBERG MARKET REPORT

Tuesday 20th October 2020

IN THIS WEEK'S BOTTOM LINE

Contributed by Gielie Fourie

- The Price Earnings (PE) ratio is a popular starting point when valuing the shares of a company. But then you must trust the integrity of the reported earnings in the audited financial statements. If you have bad data, you cannot make good judgements. Read more in the Bottom Line.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Werner Erasmus

- Retail sales contracted in August by 4.2% year-on-year, better than market expectations for a 6.8% decline, marking the fifth consecutive month of declines in retail activity although at a slower pace. The August reading followed annual contractions of 7.2% and 8.6% in June and July respectively. On a monthly basis, retail trade sales increased by 4% amid further easing of lockdown restrictions. Overall, the trading environment has improved from the levels experienced in the second quarter when large parts of the economy were shut down. However, a return to robust levels of activity is unlikely given that highly constrained consumers, many of whom are facing financial uncertainty, are likely to remain cautious and mindful of their purchases. Meanwhile, wholesale trade sales declined by 0.8% month-on-month in August and were still down by 3.8% year-on-year. Overall, the Temporary Employer/Employee Relief Scheme payments, the government's extended social grants programmes and the low interest rate are mitigating the devastating impact of weak labour market conditions. However, worries about job security and still tough household financial conditions will weigh on consumer confidence and contain spending going forward.

- Mining production fell by 3.3% year-on-year in August, after a downwardly revised 6.5% drop in July. It was the sixth consecutive month of a yearly decline, though at the slowest pace since March. The largest contributor to the decline was gold production, which was down by 14.8% and the largest positive contributor were the platinum group metals (PGMs), which rose by 12.7%. However, year-to-date (i.e. January to August 2019 compared to the same period last year) mining output was still down 15%. More encouragingly, on a month-on-month basis mining production increased by 6.8% in August. This followed month-on-month changes of 20.3% in July and -0.7% in June. Improved demand out of China, one of the key destinations for South African minerals, as well as improved global commodity prices helped to boost the local industry. Looking ahead, the mining sector faces several challenges such as reliable and affordable electricity, capital infrastructure investment, an inflexible labour environment and declining global competitiveness. The rebound seen in global economic activity and demand for mining resources is also in danger of slowing down with large fiscal stimulus measures applied in countries around the world running their course.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Ingrid Breed

- The Composite Leading Business Cycle Indicator: Due Tuesday 20 October 2020. The South African Reserve Bank's composite leading business cycle indicator for August is expected to have continued the trajectory of monthly improvement it has been on since the dip in March, April and May 2020. Despite this improvement it is expected to have remained below the levels we saw before Covid-19. The consensus forecast is that it increased 1.8% month-on-month in August, down from the 2.6% increase in July.

GLOBAL

Contributed by Nick Downing

- The IMF revised upwards its GDP forecasts for 2020. In its World Economic Outlook, global GDP is now expected to contract in 2020 by 4.4%, not as bad as the 4.9% contraction expected in June, and in 2021 growth is projected to be 5.2%. The US is in a far better position than previously forecast with contraction of 4.3% compared with a previous 8%. However, the outlook for other countries has deteriorated. India's contraction forecast for 2020 has deteriorated from 4.5% to 10.3%. South Africa's projected contraction in 2020 has remained unchanged at 8% but disappointingly the rebound in 2021 has been downgraded from 3.5% to 3%. IMF chief economist Gita Gopinath was positive on the outlook, based on improving medical treatments and solid vaccine prospects as well as continued government and central bank support. The IMF urged continued fiscal support despite the fact that governments have so far spent a massive $11.7 trillion, equivalent to 12% of global GDP, in contrast to the 2% of GDP fiscal stimulus allocated after the 2008/09 Global Financial Crisis (GFC). Vitor Gaspar, director of the IMF's Fiscal Affairs Department noted that developed economies would end up with "a higher cyclically-adjusted primary deficit, but that is to a very large extent compensated for by lower interest payments." Economies are expected to grow faster than interest payments. The report noted that banks had entered the pandemic crisis with strong balance sheets, helped by the regulatory overhauls which followed the

GFC, but cautioned that greater regulation should be given to the non-bank financial institutions, which were taking an ever greater part in credit markets. The IMF also recommended regulatory attention to excessive risk taking in the current low interest rate environment, in order to prevent asset bubbles from developing and to mitigate their affect on financial stability.

NORTH AMERICA

Contributed by Nick Downing

- Retail sales were far stronger than expected in September, rising by 1.9% month-on-month up from the 0.6% gain in August and well above the 0.7% consensus forecast. It is the fifth straight monthly increase, with retail sales rising on a year-on-year basis by a solid 5.4%. The so-called core group sales, which exclude the more volatile sectors including food, vehicles, building materials and gasoline, increased by 1.4% on the month up from 0.3% in August and well above the 0.2% consensus forecast. A large part of the retail sales strength is attributed to the delay in back-to-school spending but is nonetheless encouraging as consumer spending comprises two-thirds of US GDP. However, the University of Michigan's October US consumer sentiment index cast some doubt over how long the retail spending spree can continue. While the expectations index increased slightly from 80.4 to 81.2, the current conditions index slipped from 87.8 to 84.9. The reasons given were the resurgence of Covid infections, the absence of additional federal fiscal support and the slowdown in jobs recovery. Reflecting the loss of momentum in the jobs market, initial jobless benefit claims unexpectedly increased in the past week by 53,000 to 898,000. The consensus forecast had been for a further decline to 825,000. Meanwhile, despite the White House lifting its proposed Covid relief package from $1.8 trillion to $1.9 trillion, the Democrat party are still unimpressed, leaving little chance of any further relief before the presidential election on 3rd November.

- With an apparent disconnect between the powerful stock market rally and the dire reality in many sectors of the economy, officials from the Federal Reserve are debating the need for macro-prudential regulations to curb excessive risk taking in a zero-interest rate environment. The debate is focussed on preventing asset bubbles from developing and mitigating their potential fallout on financial stability. The focus would likely be on regulatory initiatives so that the benefits of zero interest rates can continue to trickle down to the real economy. The views expressed mirror the opinions contained in the IMF's World Economic Outlook. Eric Rosengren, president of the Federal Reserve Bank of Boston said that if low interest rates are applied over a prolonged period "you want robust supervisory authority in order to be able to restrict the amount of excessive risk-taking occurring at the same time." Prospects for additional macro prudential regulations are likely to increase in a Biden presidency.

CHINA

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- China's GDP increased in the third quarter (Q3) by 4.9% year-on-year up from 3.2% in Q2 and versus its 6.8% contraction in Q1. In the first 9 months of the year, GDP grew by 0.7% over the same period in 2019, confirming a full recovery to pre-pandemic output levels. The data is impressive. China is the only major economy expected to show economic expansion in 2020. The IMF forecasts aggregate growth of 1.9% in 2020, rising to 8.2% in 2021. Growth in the region of 15% is expected in Q1 2021, boosted by the base effect of depressed conditions in Q1 2020. Industrial output was the growth engine in Q2, but consumer spending appears to be making a comeback and is likely to add to GDP momentum over coming months with a normalisation in demand for in-person services. The unemployment rate reduced further to 5.4% in September compared to 5,6% in August. September's trade data reflect a resurgence in domestic demand. Imports surged by 13.2% on the year compared with a decline of 2.1% in August. The figures were boosted by a 24.8% increase in imports from the US, up from August's 1.8% increase. Exports also fared well, rising by 9.9% on the year as China continued to gain an increasing share of global trade, but in aggregate China's trade surplus fell to $37 billion, its lowest since March, down sharply from $58.9 billion in August and down from $39.1 billion in the same month last year. The rapid recovery in domestic demand is powering China's equity markets. The CSI 300 index has gained 17% this year but is still relatively cheap on a trailing 19x price-earnings multiple compared with a multiple of 40x at the market peak in 2015. Speculation is also far lower, with margin financing at half the 2015 level and retail investors also accounting for half the preceding level of share ownership, signalling continued market stability and decent prospects for further gains.

JAPAN

Contributed by Carel la Cock

- Japan's seasonally adjusted household savings ratio has surged in the second quarter of the year following a sharp rise in the first quarter. The saving ratio calculated as net savings/real disposal income jumped from 7.8% to 23.1%, a level not seen since the mid-1970s. Savings increased by 225.5% quarter on quarter whilst real disposable income rose by 10% driven largely by government support of the economy. Japanese households are reducing private consumer spend which is a headwind to the government's plans of a consumer driven recovery. However, household balance sheets are improving, and this bodes well for future consumer spending once a vaccine is developed and normal social behaviour resumes. New prime minister, Yoshihide Suga, is expected to build on his predecessor's "Abenomics" policies and add further structural reforms in areas such as regional banks, telecoms, and digital transformation. Mr Suga is hoping to unlock the potential in these areas and revive the local economy still struggling from the pandemic and weak global demand for its exports. Exports are down 4.9% year on year and with weak global demand for transport equipment and machinery likely to remain for the foreseeable future, consumer led growth will be a key driver of the economy in the year ahead.

EUROPE

Contributed by Carel la Cock

- Europe will go deeper in the red this year than ever before, adding nearly €1tn of debt as governments open the fiscal taps in support of their respective economies following the devastation caused by the covid-19 pandemic. Member states have submitted their draft spending plans and the aggregate fiscal shortfall of €976bn equates to 8.9% of expected GDP this year according to predictions by the Financial Times. It puts the budget deficit at nearly 10 times the level of last year and it is expected that the deficit will continue growing into 2021. The last peak in aggregate eurozone deficit followed the global financial crisis in 2010 when the deficit rose to 6.6% of GDP. That led to the eurozone sovereign debt crisis with the so-called "Club-Med" member states, Italy, Greece, Spain, Portugal, Ireland, and Cyprus seeing spikes in their bond yields and leading to unpopular reforms following bailouts by the EU and IMF. However, the IMF and World Bank have taken a more sanguine attitude towards higher debt with Carmen Reinhart, chief economist at the World Bank saying: "First you worry about fighting the war, then you figure out how to pay for it". According to forecasts by the IMF, the euro area debt will be 100% of GDP this year, equating to a 15 percentage-point increase from last year, while globally debt levels have increased by 12% of GDP, equalling a whopping $11.7tn. The threat of a resurgence of covid-19 infections and subsequent double dip recession are likely to keep the fiscal taps open until at least 2022.

UNITED KINGDOM

Contributed by Carel la Cock

- Moody's has downgraded the UK's credit rating by one notch to Aa3 with a stable outlook stating that "the UK's economic strength has diminished" and that "growth has been meaningfully weaker than expected and is likely to remain so in the future." Furthermore, the ratings agency thinks Brexit will have a lasting negative impact and will cause "negative long-term structural dynamics" with the likelihood of a no-deal Brexit exacerbating the situation. It also expects the covid-19 pandemic to leave permanent "scarring" that will impact growth and the economy in the years ahead. Government debt has risen during the pandemic and Moody's thinks it has eroded the UK's fiscal strength with no clear plan on how to reduce the debt pile. Lastly, Moody's stated that there has been a "weakening in the UK's institutions and governance" and that "fiscal policy has become less predictable and effective". The UK's opposition parties have strongly criticised the government of prime minister Boris Johnson, laying the blame for a weakening in institutions squarely at his door. The Treasury admitted that public finances have deteriorated but pointed out that things would have been far worse had they not supported the economy and protected jobs, which it regards as its top priority, and is confident in sorting out public indebtedness once the economy has recovered sufficiently.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	- 3.37	55161
JSE Fini 15	- 36.35	9977
JSE Indi 25	+ 7.88	74762
JSE Resi 20	+ 9.89	54129
R/$	- 15.25	16.52
R/€	- 19.31	19.44
R/£	- 13.23	21.39
S&P 500	+ 6.07	3426
Nikkei	- 0.06	23671
Hang Seng	- 12.94	24542
FTSE 100	- 21.98	5884
DAX	- 2.98	12854
CAC 40	- 17.54	4929
MSCI Emerging	+ 1.13	1127
MSCI World	+ 2.51	2417
Gold	+ 25.26	1909
Platinum	- 10.41	870
Brent oil	- 35.10	42.93

BOTTOM LINE

Contributed by Gielie Fourie

- THE PRICE EARNINGS (PE) RATIO: The PE ratio is one of the oldest ratios used to calculate the value of a company. You must rely on the integrity of the reported earnings in the audited financial statements to find the correct earnings figure. If you have bad data, you cannot have good judgements.

- PE, PRICE TO BOOK AND BLENDED MULTIPLIER: Warren Buffett's professor and mentor, Benjamin Graham, used three steps to value a company. (1) He used the PE ratio as a starting point. He preferred the PE to be below 15. (2) Second, Graham calculated the Price to Book (P:B) ratio, which he preferred to be below 1.5. (3) Thirdly, Graham would then multiply the PE by the P:B (15 x 1.5) to arrive at a figure of 22.5. He called this figure the Blended Multiplier (BM). Graham would not invest if the BM was higher than 22.5. Note: The Book Value or Net Asset Value of a company can be found in the Balance Sheet. It is all the assets less all the liabilities.

- CIGAR BUTT INVESTING: Graham was a value investor. He preferred buying beaten-down companies trading far below their Net Asset Values (NAVs). Buffett called it: Cigar Butt Investing. The analogy is picking up a cigar butt on the street. It may still have a few puffs left in it. Not a pleasant smoke, but the "bargain purchase" guaranteed a profit. Buffett followed the Cigar Butt strategy for many years. But there was a major downside to this strategy. It forced Buffett to exit it. The downside was that it took up too much time, physical energy, and resources to turn Cigar Butts around. Today Buffett's approach is totally different. His friend Charlie Munger came up with the strategy that "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price." Paying a fair price means buying at a low PE ratio.

- THE PEG RATIO: Peter Lynch emphasised the importance of annual earnings growth. Lynch realised that the PE ratio ignores the annual growth rate of a company. Two companies, Slow and Fast, may both have a PE of 15, but Slow grows at 10% per year, while Fast grows at 30% per year. To address this, Lynch developed the PEG Ratio – PE divided by the growth rate. Slow will have a PEG ratio of 1.5 (15/10) while Fast will have a PEG ratio 0.5 (15/30). The lower the PEG ratio, the better. Lynch also came up with the concept of GARP – Growth at a Reasonable Price.

- WHAT IS THE CORRECT PE RATIO OF A COMPANY? It is becoming increasingly challenging to find the correct earnings figures of a company. The issue is the number of adjustments to earnings figures. There are so many adjustments that you can calculate many different earnings figures for a single company. Let us look at Bidvest's Headline Earnings per Share (HEPS) for 2020. HEPS from continuing operations was R5.53. Diluted HEPS from continuing operations was R5.52. To complicate things there is also a figure for Normalised HEPS from continuing operations of R10.28 cents. Depending on which figure you use, the PE ratios will differ substantially.

- WHAT IS NORMALISED HEPS? In Bidvest's Financial Statements there is a note on page P14: "Normalised headline earnings per share is a measurement used by the chief operating decisionmakers, the Group executive directors". A Google search confirms this: "Normalised earnings are the most accurate assessment of a company's true financial health and performance". How does that affect Bidvest? At the current share price of R132.00 and Normalised HEPS of R10.28, the PE ratio is just over 12. This is below 15 – it makes Bidvest worth a second look. However, many analysts use the Diluted HEPS of R5.52, giving you a PE ratio of 24, making Bidvest expensive. Benjamin Graham would buy Bidvest at a PE of 12. At a PE of 24 he would walk away.

- THE BLENDED MULTIPLE: The effect on the BM is even more pronounced. The P:B of Bidvest is 1.90. At a of PE of 12, the BM is a modest 22.8. Benjamin Graham would buy. But a PE of 24 multiplied by 1.9 equates to a lofty BM of 45.6. Benjamin Graham would walk away.

- OTHER VALUATION METHODS: In addition to the PE ratio, there are several other valuation methods. We look at three of them. (1) A popular method for holding companies like PSG and Remgro, is Sum of the Parts (SOTP). It has its shortcomings – how do you value unlisted businesses? (2) A second popular method is the Discounted Cash Flow (DCF) technique where you calculate the present value of all future cash flows. Here your result will depend on your choice of discount rates. (3) A third method is to calculate the Liquidation Value of the business – it is the value of all assets should the company go out of business and sell all its assets. Your result will depend on the assumptions that you make. None of these methods are perfect. At best, they can be used to double check that you are on the right track.

- SUMMARY: Great investors, like Graham, Buffett, and Lynch all used the PE ratio. The PE ratio will be corrupted if the earnings figure in the financial statements is corrupted. If the PE is corrupted, the BM and the PEG ratio will also be corrupted. How can you check the earnings figures of a company? One way is to compare the earnings with the Net Cash Flow for the year. If you cannot reconcile the two, something is wrong. If you have bad data, you cannot have good judgements.