DOUGLAS INVESTMENTS
INVESTMENT ENVIRONMENT

AUGUST 2019

INTERNATIONAL

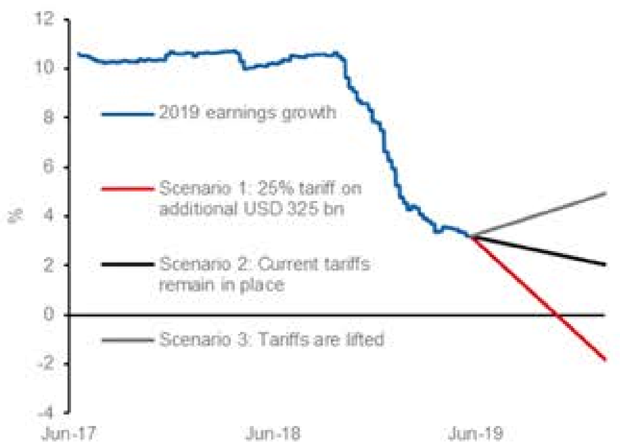
While equity performances have remained positive for the year to date, the month of August exhibited the tussle between the positive effect of monetary stimulus vs the negative effect of anticipated economic slowdown. The S&P500 graph shows the sideways movement during August but a resumption of upward movement into September. It is likely that this volatility will continue well into 2020.

There is a wide anticipation that the global growth cycle is mature and GDP growth is decelerating albeit that economic growth - and therefore earnings growth - are still positive.

S&P 500 INDEX

SOURCE: BLOOMBERG

Unfortunately, the ongoing trade tariff spat between the US and China continues to threaten a further slowdown in earnings. The graph below (courtesy of HSBC) illustrates the slowdown in earnings growth in line with economic expectations and the potential consequent effect of tariffs in various scenarios. To support current equity prices and maintain earnings, at worst the current tariffs should remain in place, but an implementation of a 25% tariff, as currently threatened by the US, could snuff out all earnings growth (see the red line of the graph).



The real question is: "Will Trump continue to push tariffs or will a desire to be re-elected persuade him to end the trade war?" If he were to take the latter action, Trump would be solving a global crisis of his own making! However, it would be better for economies and equities.

Outside the US, other factors subdue economic growth: enter Boris Johnson and his Brexit plans. This not only affects the UK but also Europe and the various trading partners, all of which are in poor economic circumstances. As has been said many times before, markets hate uncertainty!

The counter to this negative economic sentiment has been the coordinated effect of central banks, and in particular the U turn of the Fed, on interest rates.

A return to near zero interest rates has a very positive effect on equity pricing in that the cost of risk-free capital approaches zero, and on the flip side investors are persuaded to take a "risk on" approach (i.e. hold equities) to achieve some returns. The equity investors' dilemma is whether or not low interest rates can support current equity pricing which is often judged by a price earnings ratio. What is interesting is if one looks across the various US sectors – while price earnings ratios have ticked up marginally in line with underlying improving economics over the past years, this has not been significant and an argument can be made that US equities are not unduly expensive.

US Price / Earnings ratios, by sector

Source: Refinitiv, HSBC Private Banking as at 16 June 2019. Past performance is not a reliable indicator of future performance.

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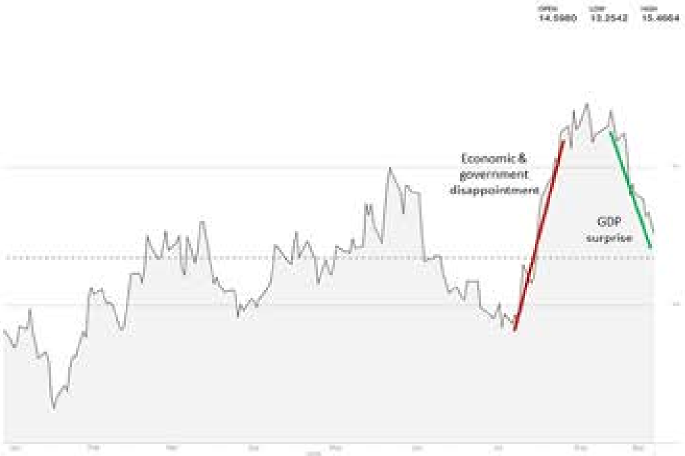
In conclusion a sizeable equity exposure is appropriate but this should be balance with interest earning investments which are largely only available in USD assuming a hard currency choice is required. Some cash (an anchor in any portfolio) can now be deployed into medium term fixed interest investments which is a new opportunity courtesy of the Fed's U turn.

South Africa

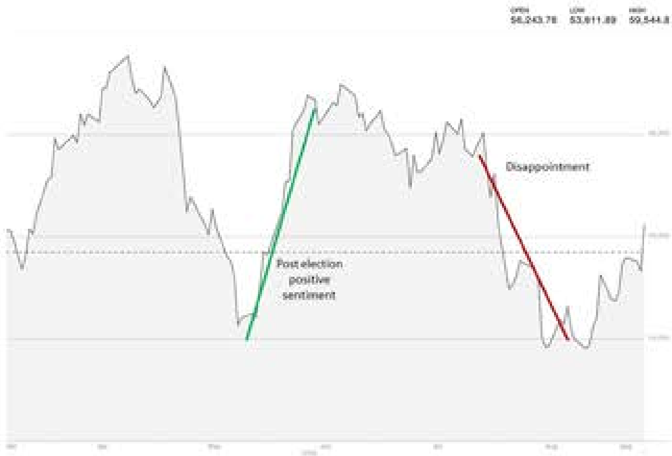
Notwithstanding the weak economy (2019 GDP <0.6%) and SOE debt spiraling out of control, to the surprise of forecasters 2Q2019 GDP increased at an annualized rate of 3.1% This was totally unexpected and has potentially delayed the threat of rating agency downgrades. This has been reflected in the marginal improvement in the ZAR/USD as shown in the graph below.

USD/ZAR Spot Exchange Rate



Source: Bloomberg

JSE All Share Index



Source: Bloomberg

While the ZAR has reflected this positive news, equity investors remain skeptical and a snap shot of the ALSI Index (All Share Index of South African stocks) shows not only the volatility, which shows uncertainty, but also the sideways movement since the May elections.

Maybe the skepticism can be justified on the basis that the political climate remains extremely uncertain, but more importantly appears to be totally ineffective. Government have a couple of critical events coming up in the next couple of months. They are going to have to demonstrate that Eskom can be restructured in the Medium Term Budget Policy Statement to be delivered by Minister Mboweni on 23 October; Minister Patel has to announce Trade and Industry plans to revive the manufacturing and textile industries; the Reserve Bank should drop interest rates significantly on 19 September as core inflation is around 4.5% and to fall in line with other major central banks. South Africa needs to do anything it can to improve confidence (Business Confidence is at a 34-year low), economic growth and employment. Government have to change investors belief that it is ineffective in actioning plans and has no positive intent for the economy. It could be said that South Africa is subject to a random outcome based on a bad set of economic circumstances. If the socio-economic climate is overlaid it is very difficult to talk SA up.