Douglas Investments
Investment Environment

November 2019

International

As the US goes into Thanksgiving weekend, most market indices such as the S&P500 and Dow Jones are hitting record highs. There is some logic in this as the Fed's Beige Book (which is a collection of economic stats across the US) confirms things are pretty well balanced with economic growth being supported by the low interest rate environment. Even the Q3 2019 GDP has been revised to an annualized growth of 2.1%, which is ahead of market expectations. Indications from the labour market also support this, with jobless claims declining by 15,000 to 213,000 at the week ended 23 November. This means most US citizens that want to work, are employed.

However, as markets hit new highs valuations become more stretched and Investors have to question if this is driven by current circumstances as indicated above or should the market not be looking forward. The graph below might contextualize why Douglas Investments thinks valuation are stretched. It's a 10 year S&P500 graph comparing earnings growth, shown as dark blue, compared to share price growth shown in light blue. When the dark blue earnings growth, is above and steeper than the light blue price growth, P/E's will be contracting and earning are growing faster than price, meaning stocks are getting cheaper, which is a healthy situation. The opposite is also true and it is interesting to see the crossover in the middle of the 10 year period where price increases have outrun earnings increases since 2015 effectively causing P/E's (valuations) to expand (stretch). This is apart from December 2018 where we had a proper price correction only to see a dramatic rebound. The rebound was caused by the FED (Powell) reversing on interest rate policy (in December 2018 he talked of 3 interest rate increases in 2019) and show a complete reversal interest rate policy by "promising" they would remain benign and probably come back, which was in fact the case mid-2019.

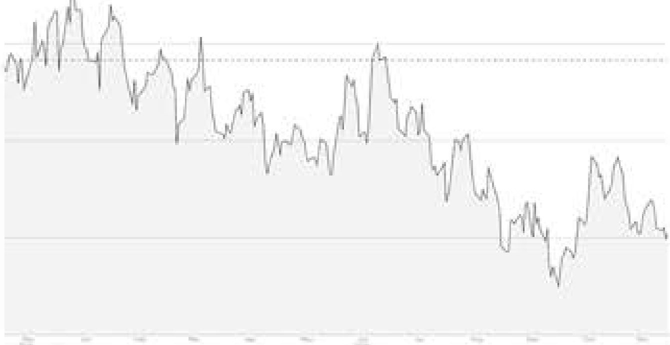
So in 2019 the market rebounded strongly to the extent that price growth strongly outpaced earnings growth. This has the effect of P/E's expanding and stocks are becoming more and more expensive. The prices were/are being driven by the lower interest rates and investors taking a risk on approach because there is no yield available on cash or near cash investments.

But, if the situation persists (and it cannot go on forever), either stock prices have to come back or earnings need to resume the historic strong growth and to adjust valuations. The oxymoron in this is, the very reason for the soft interest rate environment, is the FED is concerned that US economic growth is slowing and this is hardly the time to expect earnings growth to be strong!

What could disrupt this thesis? One could surmise that a complete settlement of trade tensions and a reversion to the original status quo allowing or causing some strong economic growth. Will that happen? We doubt it, unless Trump does an about turn which seems to be beyond his character.

One should not ignore European equities as they might be the key beneficiary of a cessation of the trade wars. One also has the benefit of buying the Euro at around EUR/USD 1.10 which, as shown in the graph, is pretty much a 2 year low – the Euro is cheap when spending USD. Concerns around Europe remain Brexit and that the economy is supported by significant monetary interventions, being ongoing quantitative easing and non-existent interest rates. We continue to watch Europe as a possible diversification, however if we are correct about US equities one needs to remember all markets are synchronised.

EUR/USD Spot Exchange Rate — Source: Bloomberg

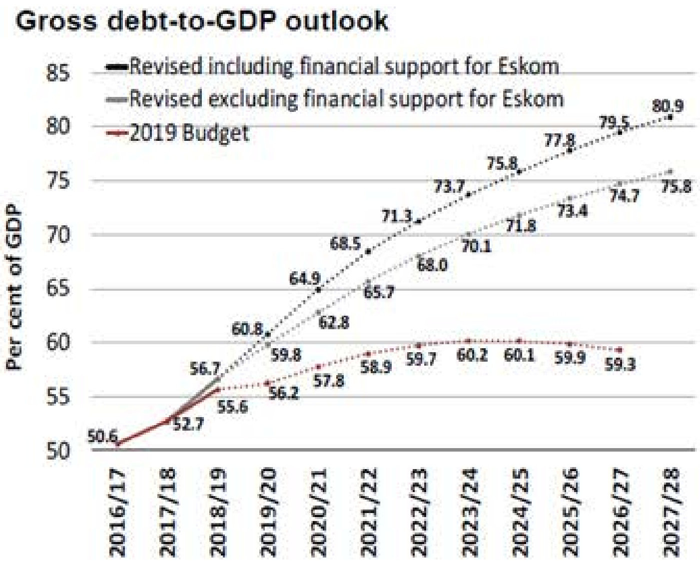


Block 8, Bryanston Gate, Cnr Curzon & Main Road, Bryanston, 2191
P O Box 67306, Bryanston, 2021
www.douglasinvestments.co.za
tel: +27 11 463
fax: +27 87 237 0797
FSP no: 26359
Douglas Investments

South Africa

South Africa remains a very difficult market to call and we continue to believe that if Investors can expatriate funds to invest in developed markets, the opportunity should be taken as the risks of both the SA economy and the R/$ are very high. As our favourite economist, Kevin Lings, commented after the Medium Term Budget Statement (MTBS), when Moody's placed SA on a negative watch, it should be understood that rating agencies will only change the actual rating after a period of being placed on watch. It is therefore almost certain that SA will be downgraded post the February 2020 fiscal budget, and our very own central bank has indicated that junk status could cause "a sell off of between $5 million and $8 billion of its bonds" which in turn means an expatriation of these funds. Let's use the middle number of $7.5 billion at the current R/$ 14.80 = R111 billion of outflows. The current exchange rate is being used, but it is unlikely to hold should there be such a significant outflow.

So what can South Africa do to avoid this crisis? Lings believes some dramatic action in relation to State Owned Enterprises (SOE's) needs to be demonstrated before February. In particular, Eskom and SAA need meaningful changes to actually be implemented, indicating the extensive debt situation is addressed. This effectively gives the government 2 months - as we are prone to enjoy the festive season. It is also worth noting that the Rand will get some support from the relatively high interest rates available in South Africa and this might be the reason why the Reserve Bank is reluctant to drop rates notwithstanding lower inflation and weak economic growth. The tough question is where does this all end, and unfortunately there is a very real risk that SA could fall into a debt trap. The graph below was released by National Treasury after the MTBS.



Against this background the JSE has shown some growth (ALSI +5% 2019 YTD), albeit very pedestrian in recent years, but if this is converted at an ever weakening exchange rate it will amount to nothing in hard currency terms. This is the reason that Douglas Investments encourages Investors to expatriate funds to participate in international equity markets in hard currency.

As we move into the festive season, we should take some comfort that the US market has performed exceptionally, particularly considering the challenges we faced this time last year! We do however remain concerned about SA investments but this should not detract from the fantastic lifestyle we can enjoy over the holidays.

Please note that our offices will be closed from 22 December, and will reopen on 6 January.

Thank you for your support over the past year - wishing you a happy holiday season and all the best for 2020!