Swaziland
1th quarter 2017

Investments

CEO's corner

In this edition of our quarterly newsletter we leave the CEO's corner to Ms Azola Zuma. Her intelligence, insight in the financial industry and success has led her to her current position as CEO of Sanlam Investment Management. We look forward to hosting her in Swaziland as our parent company CEO, thereby giving our stakeholders an opportunity to share in her amazing ideas and creativity.

Woman's view on the world of investments – Azola Zuma

"We need investment policies that future-proof our economy"

Azola Zuma

CEO of Sanlam Investment Management

From Ngcuka to running one of the largest asset management businesses in the country. Tell us more about your path into asset management.

I spent the first 11 years of my life in Ngcuka in the Eastern Cape, before my mother moved us to KZN, where I was introduced to the English language as my mother enrolled us in a multi-racial school. After matric I moved to Cape Town to study towards a Business Science degree at the University of Cape Town. Going to university was the best decision of my life.

During my honours year an older friend pointed me towards investment consulting and mentioned the largest company in the space, Alexander Forbes. So, I approached Alexander Forbes with my CV, and soon afterwards their asset consulting team called me to arrange an interview with the chief actuary of the Alexander Forbes group, Mr Neil Lloyd. I guess that intimidating interview prepared me for any intimidating situation I would encounter for the rest of my life. I secured the job and that is where I got introduced to the world of investments and asset management.

Except for a stint in the Netherlands and the UK studying towards an MBA and MA respectively, I've been in the investment industry ever since.

What is the best investment you've ever made?

I invested in a share linked to my employ in my third job. The company listed at R1 in 2007 and by the time I bought the shares in 2008, it was a penny stock (due to the global credit crisis that hit the AltX shares the most – with corrections of up to 60% to 80% in certain instances). By the time I exited the investment in October 2014, it was trading at R1.60 – a more than 100% return over the period. After saving up, I have more capital to play with now, so the real excitement is only starting in terms of how my portfolio of stocks is going to perform for the next five years.

What do you view as the biggest investment opportunity often overlooked by advisers?

I'm a fundamental patriot and a firm believer in the saying 'charity begins at home'. In the case of South Africa, the country has unique problems based on its history and I think the notion of long-term capital being allocated as though we are a normal society is disappointing. We have an acute unemployment problem, an infrastructure crisis (social infrastructure in particular – housing and student accommodation), we have tracks of land lying fallow; yet the world is already experiencing a food security problem. So what remains curious to my own mind is why regulators, allocators of long-term capital and their advisers are not getting together and crafting investment policies that will future-proof this economy.

If I'm to put my conventional lens back on, I think that advisers do not place much emphasis on dividend yield type strategies and allocating money specifically towards them and I think that's a missed opportunity.

newsletter

Swaziland

Developments in the Domestic Economy

Real GDP Developments

The Central Bank of Swaziland in its March 2017 Monetary Policy Statement reported that real GDP growth is expected to shrink by 0.6% in 2016 from a revised estimate of 1.9% in 2015 (previously 1.7%). Decreases are expected mainly in the primary and secondary sectors. The projected deceleration in output is mainly informed by the drastic effects of the drought which had devastating effects on agriculture, agro-processing, power generation and water supply. This is projected to be further compounded by lower SACU inflows for the 2016/17 fiscal years which will compromise government activity in the short to medium term.

Inflation

The Annual consumer inflation declined to 6.8% in February 2017 from 8.2% in January 2017, resulting in an average of 7.5% for the two months. The notable slowdown mainly benefited from a decrease in food and transport inflation. The inflation forecast from the Central Bank of Swaziland (CBS) for the first quarter remains at 7.5%.

Foreign Reserves

Over the quarter, Gross Official Reserves declined by 2.5% to reach E7.5 billion at the end of February 2016. The fall in Reserves was mainly due to payment of Government's external obligations combined with the appreciation of the lilangeni exchange rate against major trading currencies over the review period. At the level, the Reserves could cover an estimated 3.5 months of imports, down from 3.6 months cover as at the end of December 2016. Compared over the year, the Gross Official Reserves declined further to E7.5 billion with an import cover of 3.5 months.

Exchange Rate

The external value of the Lilangeni strengthened against major currencies over the period under review. As at 14th March 2017 compared to December 2016, the Lilangeni strengthened by 5.42% to average E13.29 to the US Dollar, 5.22% to average E16.42 to the pound and 3.44% to average E14.12 to the Euro.

Credit Extension

Year-on-year credit extended to the Private sector increased by 7.4% at the end of January 2017. The increase was moderately lower than the 15.5% recorded in the past review period at the end of November 2016. Growth in credit to the business sector reflected a notable improvement while credit growth for the Household and Other (other financial corporations, local government and parastatals) sectors decelerated.

Review – SA Capital Markets

This quarter saw the ALSI post a return of 3.8%. SA Industrials rebounded strongly (up 6.6%), helped by some of the non-resource sector rand hedge heavyweights. SA Resources also did well (up 2.7%) with good performances coming through from Forestry and Paper (+12.1%) and Platinum (+7.9%). SA Financials took some body blows, down 1.1%, with the Competition Commission's investigation into the conduct of banks in the foreign exchange market and the removal of the finance minister weighing on sentiment.

The rand strengthened somewhat over the quarter too from R13.68/$ to R13.42/$ at the end of March. The 10-year RSA bond yield closed the quarter at 8.84% from 8.92% at the end of December. Generally, emerging market currencies did quite well over the quarter, supported by upbeat commodity prices. Nominal bonds returned 2.5% for the quarter, inflation-linked bonds lost 0.6% and cash returned 1.8%.

Review – SA Economy

The cabinet reshuffle and the sudden recall of the finance minister and his deputy had dire consequences when Standard & Poor's (S&P) downgraded our foreign debt rating to junk at the beginning of April (BB+) with our local currency debt downgraded to one notch above investment grade (BBB-). But within a week of the reshuffle after the end of the quarter, Fitch upped the ante by being the first agency to downgrade our local currency debt to junk.

As a nation, we are now at a point where political ideology will not trump fiscal consolidation and such political self-mutilation could be costly in the long term. Foreign creditors own over a third of our debt and the cost of debt will rise and inhibit our ability to prioritise expenditure towards poverty relief. While the savings industry in SA is large - approximately R9 trillion (with more than half in equities) - foreign investors account for a third of this amount with approximately a third of their investment in government debt.

The downgrade of our local currency sovereign debt could force many foreign funders, who in total own over 35% of our debt, to disinvest as SA debt would drop out of foreign sovereign debt indices and be relegated into the less popular High yield division, leading to capital flight.

Outlook – SA Capital Markets

The outlook for markets is still/again uncertain. The global economic backdrop is one of improvement on the margin, which all else being equal should benefit SA assets and the currency. Relative to this support, the risk of additional downgrades to SA's credit ratings will now cast a new shadow over SA assets. Should a 'sanity prevails' event occur in the near future, the impact of that on SA bonds and the currency could be material. But in the absence thereof, investors will be faced with the impossible question of whether local assets are priced cheaply enough to reward investments in them despite the additional downgrade risk that President Zuma's actions have brought.

After reaching 18-month highs, the rand sold off heavily on the back of the negative news, depreciating by over 10% against the greenback over a number of days. But we witnessed a sharper sell-off in 2015 when we had the unexpected replacement of the finance minister before seeing a 23% strengthening of the currency until the recent fateful events. A number of dual-listed counters sold off in 2016 with the strong recovery in the rand weighing on their performance.

Outlook – SA Economy

A key question is whether the consensus base case for the South African economy will remain intact. Commentators have been looking forward to an improvement in real economic activity in 2017 together with disinflation and a possible interest rate cut late in the year or early next year.

In this regard it should be noted that following the initial sell-off in the currency, the rand/dollar exchange rate vacillated around a level not far from the average for the past year. It has therefore not depreciated far enough as yet to turn into an 'inflationary force' or to alter the base case of lower inflation heading into 2018. Given the current level of the currency, supported by expected lower food price inflation, we expect the annual advance in headline consumer price inflation (CPI) to slow from 6.3% in February 2017 to 5.6% by

end 2017. Thereafter, inflation is expected to average 5.2% in 2018. If this forecast is realised, the possibility of an interest rate cut would return.

If the rand continues to fall, inflation expectations are likely to increase and inflation forecasts would rise. In a scenario where depreciation of the currency matches the previous sharp fall in the rand in late 2015/early 2016, we would expect inflation to remain sticky at 6.5% or a bit higher through the second half of 2018. In addition to eroding real incomes, this would likely prompt the SARB to hike interest rates by, say, up to a further 50bps to100bps, which effectively derails the expected increase in domestic final demand through 2017 and into 2018.

Global Review – Capital Markets

The first quarter of 2017 contained a lot of news (as well as noise) around Donald Trump and how he is faring as a president. Markets continued in a positive manner on the back of his campaign rhetoric regarding tax reforms and deregulation. However, towards the end of the quarter doubts started to form amongst investors - relating to the efficacy which Trump will be able to deliver on his promises. Very little has in fact been implemented to date and the jury is still out. As a result the reflation trade lost momentum towards the end of the quarter, specifically in Europe. Economic data from across the globe has been improving over the quarter; ³soft data´has seen significant improvements whereas the hard data has been lagging and is much more moderate in magnitude. Going into the second quarter investors are eagerly waiting for the hard data to confirm the recovery. While it is widely acknowledged that the economy is showing signs of improvements, risks to the global economy have not disappeared. One of these risks for equity markets going forward is a significant increase in inflation without the accompanying earnings growth. Going forward the French elections could be a massive shock to markets specifically if Le Pen comes to power. However, market participants are ascribing a very low probability to such an event. On the other hand, it seems that the recent perceived market shocks, those events which were perceived as a negative at the time, namely Brexit and the Trump victory, have sent equities to all-time highs while volatility has descended to all-time lows. That being said, the bond markets have not agreed with the rosy picture that equities have painted in the first quarter of 2017, but also advanced over the quarter.

Global Review – Economy

Encouragingly, global economic conditions lifted towards the end of 2016 and remained relatively buoyant in the opening months of 2017. Income growth firmed amidst improving momentum in global industrial production. These developments have been complemented by a lift in global capital goods expenditure while global employment growth is also being sustained.

Also, emerging market (EM) commodity producers benefited from an improvement in their terms of trade as commodity prices, in general, increased in keeping with firmer global industrial production.

The durability and strength of the increase in real economic activity is yet to be tested, including in EM economies where some countries must deal with debt overhangs amidst limited room to ease economic policy. But, on balance, current information, including consumer and business surveys, suggests real gross domestic product (GDP) growth should be firmer in 2017 relative to last year.

US real GDP growth may moderate in the first quarter of 2017, but the country’s labour market remains robust. Elsewhere, in the Euro Area, purchasing manager surveys have been especially buoyant, while industrial production growth in EM Asia has been particularly strong in the opening months of the year, notably in EM Asia excluding China and India.

Global Outlook – Equity Markets

During the quarter global equity markets, as measured by the MSCI World Index rose 6.38%. Since the US elections the index has gained in all of the calendar months. For the calendar months over the quarter the MSCI World returned 2.41%, 2.77% and 1.07% respectively. Most major regions produced positive returns; Asia Pacific ex Japan led the charge, rising 11.76%, while Europe followed with a positive 7.44%, North America and Japan followed with returns of 5.88% and 4.49% respectively. As noted above, risks very much remain and not the least in Europe going forward. That being said the region did avoid perceived market risk events during the quarter. In Europe the risks that were averted were the Dutch elections, where voters remained in the moderate category and did not move more towards the right, while in Germany Angela Merkel has fared respectably in the state elections - removing some fears of a similar shake-up in political stance as in the Netherlands.

Global Outlook – Economy

The annual advance in global inflation has also increased, mainly in the developed markets (DM), while inflation outcomes in EM have been more mixed. To date, higher inflation primarily reflects an increase in energy prices. Nonetheless, given currently available information, the inflation outlook for the year ahead still appears to be relatively benign, although firmer global producer price inflation suggests further increases should be expected in prices at retail level. Long-term inflation risks include potential shifts towards inward-looking economic policies and the loss of momentum in global trade liberalisation.

Meanwhile, against the backdrop of higher, albeit still contained, inflation, central banks in DM are likely to gradually shift towards less accommodative monetary policy stances. In the Euro Area, the Harmonised Index of Consumer Price (HICP) overall inflation increased 2.0% in the year to February 2017 - in line with the inflation objective of the European Central Bank (ECB). This has eased the Bank's deflation concerns. Even so, at the conclusion of its Governing Council meeting on 9 March 2017, the ECB left its key policy rates unchanged, while indicating that it 'continues to expect the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of the net asset purchases'. However, assuming an absence of renewed disinflation, the ECB may, at some point this year, signal its intention to shift towards a less accommodative stance.

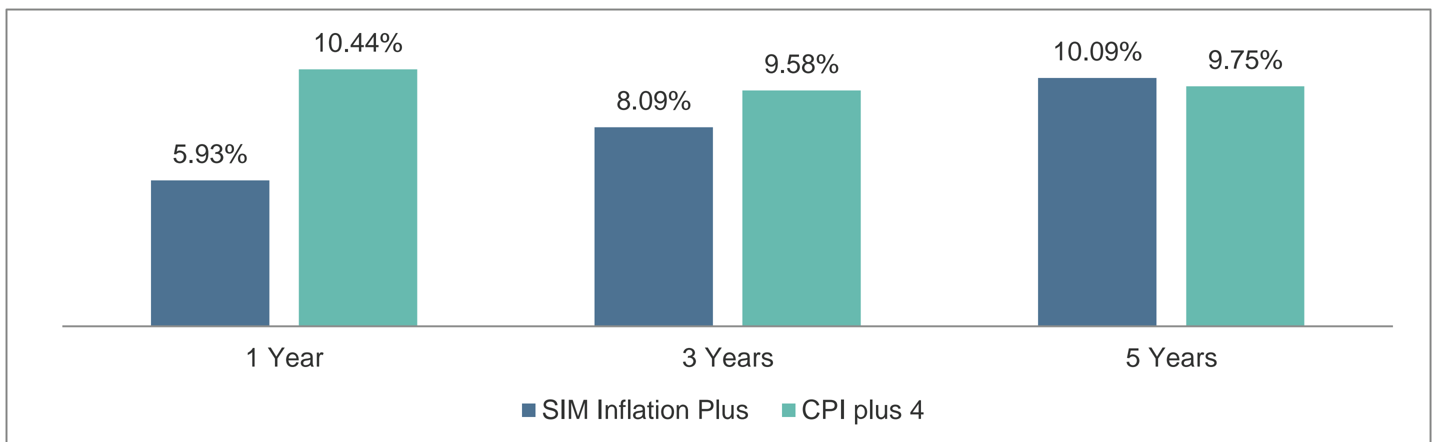
Investment Strategy

Domestic (SA)	Position	Rationale
Local equities	Underweight	We reduced the size of our underweight position, as we believe the SA market has become less overvalued relative to developed equity markets. The SWIX trades on a current price to earnings (PE) ratio of 15. Given earnings forecasts the PE ratio could drop to about 13 in a year's time. On a price to book basis our market has dropped from 2.8 in 2015 to a current level of 2.3.
Local Bonds (SA)	Overweight	We retained our overweight in SA long bonds. The real yield on offer remains attractive relative to that of other developed and emerging markets. Part of the high yield can be ascribed to political risk.
Inflation-linked bonds	Overweight	We retained our overweight position. Ten-year inflation-linked bonds (ILBs) currently offer an attractive real return of 2.15%. SA ILBs provide protection against unexpected inflation and are currently attractive relative to developed market (DM) ILBs.
SA listed Property	Neutral	We believe JSE-listed properties are slightly expensive at a current dividend yield of 6.4%, but retained our neutral position for geographic diversification and its higher yield in a yield-starved environment. Approximately 35% of JSE-listed property companies' earnings are now from outside SA.
International (Global)	**Position**	**Rationale**
Global equities	Underweight	We introduced an underweight in global equities in January as markets have rallied since the US elections. The Graham & Dodd PE ratio for the US has only been higher during the internet bubble of the 90s and the run-up to the US stock market crash of 1929. However, European equities remain cheap and we continue to hold an overweight position in Europe.
Global bonds and Cash	Underweight	We retained our underweight position. At a yield of 2.4% US long bonds offer a positive real return relative to our long-run inflation assumption of 2%, but we are concerned about long-run global inflation and now require an attractive premium above 2%.
Global Property	Overweight	We retained our overweight position via listed REITs. Our portfolio currently consists of nine companies that have properties in the US, UK, Europe and Australasia. The average dividend yield of the portfolio is 5.7%. Rising bond yields do mean the cost of funding would increase over the longer run, but we also expect some earnings growth from these companies.

Fund Performance

SIM Inflation Plus Fund

This is a multi-asset low equity fund which aims to deliver smooth, positive real returns (adjusted for the effects of inflation) targeting CPI +4% over a rolling 3 year period. Equity exposure is limited to 40%. This actively managed fund is a combination of investments in equity, bonds, money market instruments and listed property both locally and abroad. It can invest 25% offshore. This fund uses derivatives to protect capital.



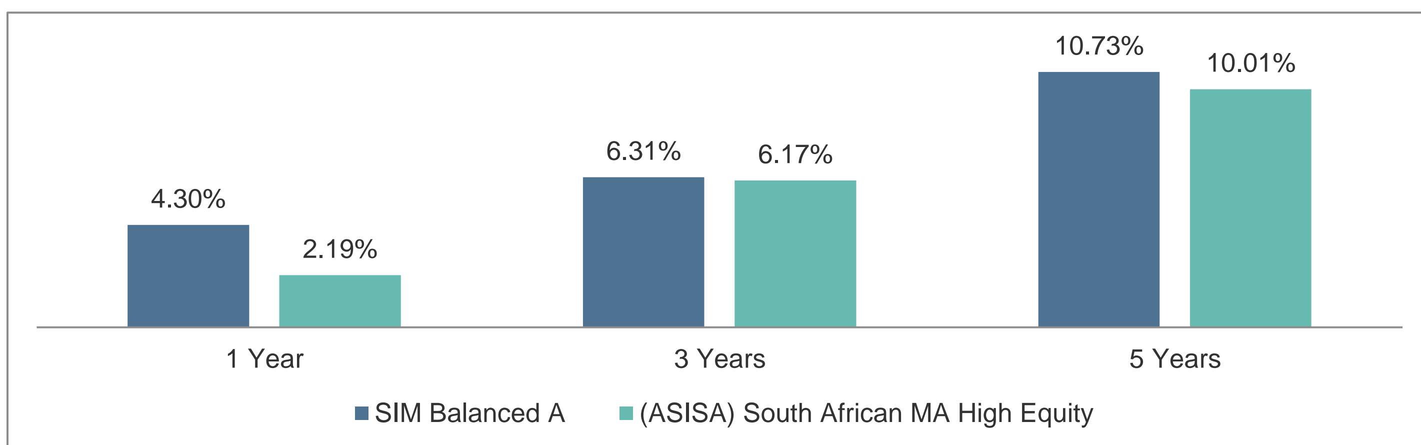
Fund Commentary

The first quarter of 2017 was a good (or bad?) mix of Trumponomics, populism and another bout of local political instability which occurred towards the end of the quarter. A significant cabinet reshuffle occurred on the evening of 30 March, including the removal of finance minister Pravin Gordhan. Global equity markets had a healthy quarter with tailwinds still prevailing from the promises of the Trump presidency, while an uptick in developed market inflation was quite welcoming. After a pronounced sell-off in global fixed-income last quarter, most markets stabilized during the quarter. The Federal Open Market Committee raised US rates in March, as expected, but disappointed with a fairly balanced outlook on rates for the remainder of the year.

We can write a few pages on domestic issues, but we'll stick to a few highlights (or lowlights). Minister Gordhan's budget hit consumers fairly hard and the fiscal space left in future has diminished significantly. During the quarter SA bond yields reached levels last seen prior to 'Nenegate' while the rand reached lows of about R12.30/$, again wiping out much of the idiosyncratic risk premium. Some of these gains were, however, reversed towards the end of the quarter with the news that Gordhan was replaced.

SIM Balanced Fund

This is a medium-risk portfolio that aims to deliver income and capital growth over the medium term. This portfolio is designed to minimise volatility and aims to cultivate as smooth a ride as possible. There is some exposure to risky asset classes (such as equities) necessary to grow capital over the medium to long term. This fund holds a large weighting in JSE shares with a maximum equity exposure of 75%. Capital exposure will also include investments in money market instruments, bonds, listed property and up to 25% in offshore assets. The preservation of real capital is of primary importance in achieving this objective.



Fund Commentary

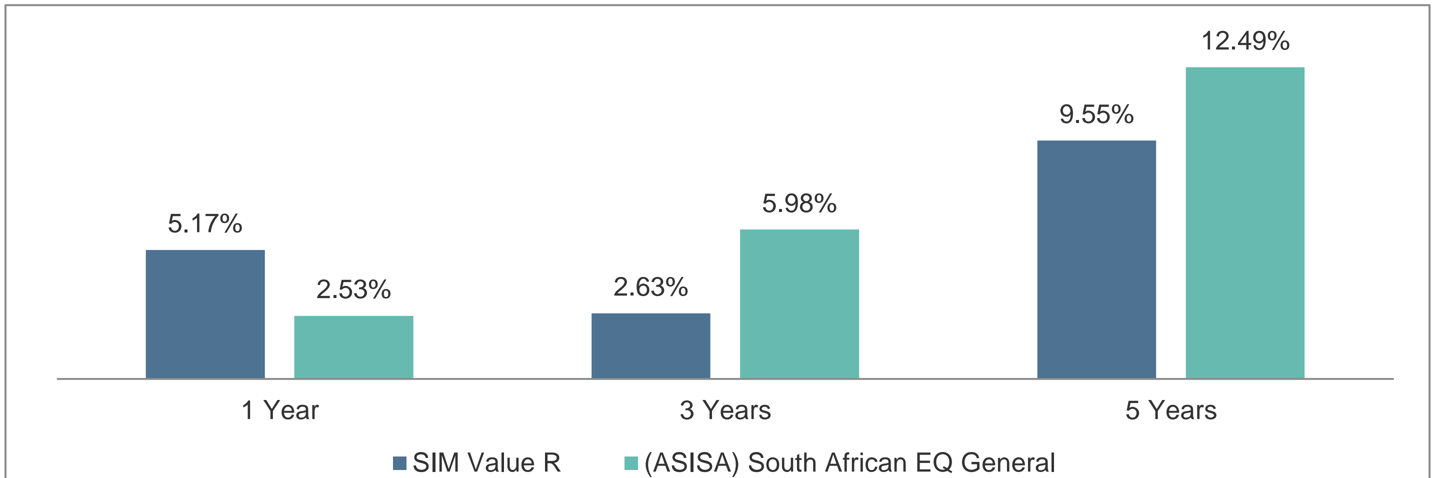
The first quarter of 2017 was quite a challenging one during which to manage a fund, due in large part to political developments. Internationally the Trump administration with it's 'wild card' flavour just took control of the world's largest economy, while Europe saw the practical start of Brexit and the lingering question of whether there is more to follow elsewhere in the punch-drunk European Union. For South Africans, the significance of these events seemed to disappear towards the end of the quarter when local political events, unleashed by our president, rocked our fixed interest and currency markets.

Interestingly enough though, by the end of the quarter most asset classes experienced only very small net movements for the quarter. Local asset classes all showed small net gains varying between 1.5% and 3.5% - including bonds, despite the jump in bond yields towards the end of the quarter. And with the currency having made only a marginal net move for the quarter, foreign assets too showed relatively small moves, with global equities being the best performer of the bunch with a gain of around 5%. Effectively the losses induced by local developments towards the end of the quarter just about took away the gains experienced for the global backdrop, which was one that marginally favoured emerging market assets. From a performance perspective our fund came through the quarter with positive returns, illustrating again the benefit of a diversified multi-asset portfolio.

SIM Value Fund

This is an aggressively managed pure equity fund diversified across all sectors of the JSE. It offers a reasonable level of current income and the potential for long term outperformance. The portfolio aims to deliver capital growth over the long term (greater than 5 years) also substantially outperform the markets. The portfolio is diversified across all major asset classes with significant exposure to equities, and may

include offshore equities. The fund managers only invest in shares which are undervalued and are very aware of downside risks. A maximum of 25% offshore assets may be held. There may be some capital volatility in the short term, although higher returns may be expected from five years or beyond.



Fund Commentary

The local portfolio is up approximately 2% for the quarter. Some of the small and mid-cap stocks, a differentiator for us relative to our peers, have performed well.

Hudaco surprised the market with a positive result highlighting the benefits of improved demand in the mining and manufacturing sector with an improved outlook going forward.

The share price is up 30.8%. The Altron Group is in the process of restructuring. We have supported the activist approach that Value Capital Partners has taken in unlocking value in Altron. It has already started to bear fruit.

The share price is up over 20% this quarter (it has almost doubled over the past 12 months) and we believe our clients will continue to benefit from the value unlock. Northam Platinum, one of our largest holdings, rose by 30.7% over the quarter. What detracted from relative value, however, is the fact that we do not hold Naspers in the portfolio. It is now over 17% of the SWIX Index. Our nemesis continues to rise - the share price was up 10.4% over the quarter. We would prefer to allocate this 17% to other attractive investment opportunities (that are on the ‘easier to analyse’ pile). This, we believe, will be better for our clients over the long term.