Portfolio Manager Quarterly Comment

Market overview

The quarter was dominated by an unfolding **emerging market crisis** as the detention of American pastor Andrew Brunson led to US sanctions against Turkey, which then precipitated a currency crisis and a flight to safety to the greenback and US treasuries. BRATS – Brazil, Russia, Argentina, Turkey and South Africa – came under pressure as fundamentals were put under the spotlight. Emerging market currencies had the worst two-day sell-off since Trump's election with the Rand losing 10% intraday against the US Dollar on a 'manic Monday' mid-August. Turkish corporates have accumulated almost a quarter of the country's GDP in foreign debt but while these are matched by foreign assets, a sudden weakening of the Lira can potentially lead to a liquidity squeeze on the servicing of the debt, which would adversely impact the Turkish banks who are providers of half of this debt. By mid-September, the Turkish central bank hiked rates by over 6% to 22% in defiance of what its president intended in order to prop up the Lira, which fell 24% against the greenback over the quarter.

Argentina hiked short-term rates by 15% to 60% in order to try to control a bulging trade deficit and inflation running at 30% with the Peso crashing by 29% in the process. A number of emerging currencies were also engulfed in the sell-off with, for instance, the Indonesian Rupiah dropping to three-year lows. With the trade war accelerating, Asian stocks experienced 10 consecutive days of losses – the longest losing streak since 2002.

But some of the turmoil was self-inflicted. The Nigerian central bank ordered MTN to repatriate a decade of dividends (US$8 billion) and fined four banks, including Standard Bank, for participating in the transactions. This has been a long-running dispute which was deemed to have been settled in the senate previously.

Investors were undecided whether these were idiosyncratic events or whether **contagion** to the rest of emerging markets could weigh on South Africa's sovereign rating. The **tariff war** between President Trump and China continues with the threat of 10% tariffs on $200 billion of Chinese imports escalating to 25% next year. The Chinese economy is most at risk from the trade war but the government is taking measures to boost infrastructure spend by increasing bank liquidity to maintain credit growth around 11% p.a. and facilitating local government bond financing.

On the European front, the main concern remains Italy, whose budget deficit is projected to spike from 0.8% to 2.4% as political parties try to make good on electoral promises. The UK remains embroiled in a very messy Brexit with the uncertainty having a negative impact on the economy.

South Africa

After a dismal first-quarter growth print of -2.2%, the second quarter GDP print was again negative at -0.7%, plunging the economy into a **technical recession**. Agriculture was the main culprit again in the second quarter, down 29% after a 34% decline in the first quarter, and the bus strike weighed on the transport sector in the second quarter. Domestic demand remains weak, down almost 4%, with some rebound in exports by 14% helping. Companies continue to run down inventories, detracting from GDP.

The economy should drag higher in the second half of the year as we shake off the worst impact of agriculture after good rains and companies re-stock ahead of the Christmas season. We remain on track for 1.3% economic growth in 2018, which would be a sub-par outcome, but the second-half growth numbers should look more decent, up 3% off a low base. Consumer confidence is holding up after reaching record highs at the beginning of the year but **business confidence remains in the doldrums**. Retail price inflation is likely to peak at just over 5% this quarter as we're seeing food inflation rising slowly to over 3% after meat prices (35% of the basket) move from deflation to inflation and electricity prices rise 7% p.a. Durable goods price inflation remains low, below 3%, with many items in deflation. But the **real economy remains weak** with retail sales weak, growing at around 1%. Wage growth slowed from over 8% to 5% this year but the public sector wage agreement will help the second half of the year. Consumers have remained risk averse and this has led to an increase in savings at the expense of consumption. Money supply (with base money growth at less than 3% p.a.) and credit growth remain subdued, which would suggest that economic growth should still remain below par. The overall picture is one of very weak nominal GDP growth.

The **Rand has now weakened** considerably this year, down 12% against the US Dollar, and is one standard deviation away from purchasing power parity (PPP) – although it is often the case that a currency blow-up sees the currency moving over two standard deviations from PPP. This leaves the SA Reserve Bank (SARB) constrained at the moment, unable to raise rates in a weak GDP environment.

What added to, and detracted from, performance

The Top Choice unit trust was down some 68 basis points outperforming the FTSE/JSE Shareholder Weighted Index, which was down 330 basis points.

The main driver of performance was the **exposure to Resources stocks, with the sector up 5%. Impala Platinum** was up 36% after it decided to streamline the loss-making shafts from its Rustenburg area. Given the weaker Rand, the platinum group metals (PGM) basket has improved by 8% quarter-on-quarter and the company should move into a free cash flow positive position following its planned restructuring. Our large position in **Anglo American plc** continues to do well, up 6% this quarter after it delivered solid results. **Sasol** also performed well, up over 10%, with Brent oil up 7% this quarter in Rand terms. The oil price is at four-year highs with supply concerns augmented by the US threatening to boycott Iranian exports.

Our second largest holding, **Old Mutual**, also was up strongly by 14.2% after it unbundled its holding in UK wealth manager Quilter. Old Mutual now has come home with a primary listing on the JSE and will focus on its core South African financial services offering. After the unbundling of most of its stake in Nedbank, the extent of the discount at which the financial services giant trades, compared to its peers, will become even more apparent. On the downside, **Standard Bank**'s Nigerian operation was caught in the cross-fire between MTN and the Central Bank of Nigeria. A fine was imposed on all the banks involved in the repatriation of dividends by MTN over the past decade and the negative sentiment saw Standard Bank pull back by over 6% this quarter.

Naspers, the largest position in the fund, pulled back 12% after a strong second quarter. Despite realising $12 billion from selling down some of their Tencent (China) stake and their stake in Flipkart (India), the stock was hurt by a slowdown in the growth rate of Tencent. The Chinese have instituted a new regulatory process, which has made it more onerous to get approval for new online games. Naspers, however, continues to trade at a considerable discount to its investment in Tencent.

Our strategy

At the end of last year, positive sentiment swept through the JSE as elusive global flows found their way into South African equities, driving up the value of retail and banking stocks. Now a wave of negative sentiment has led to money exiting emerging markets and South Africa has not been spared. The resources position we accumulated over the past few years when the sector was decimated is now bearing fruit. With the current sell-off in some blue-chip stocks, we are able to accumulate positions in stocks that are offering excellent upside to intrinsic value, which should yield outsized returns in the years to come. As contrarian investors, we had remained steadfast in our investment positioning by taking long-term views when investing in stocks and avoiding short-term news.

The fund reflects the best views of SIM's equity unit trust portfolio managers and holds approximately 20 stocks. It is not benchmark-cognisant and owns no offshore stocks. We believe that this portfolio provides the best of both worlds in terms of representing our investment ideas aggressively, while providing adequate diversification. The fund's largest holdings are companies of which valuations are below our estimate of fair value.