DOMESTIC EQUITY

ANCHOR

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At the end of 2Q17, we made the call to downgrade our stance on domestic equities to neutral from overweight, citing rising earnings risks to "SA Inc." in the context of a steadily weakening domestic economy. This proved premature, as the equity market rallied 7% (SWIX) in the face of continued appetite for EMs (the MSCI Emerging Markets Index, for example, delivered a 7% US dollar return).

The performance delivery was pretty broad-based, with Banks up 8% and General Retailers up 5%, but the strongest gains came from Basic Materials, which rose 18%. These have tracked commodity prices higher, resulting in an even better "spot" earnings outlook than previously envisaged. Index heavyweight, Naspers lagged its key value driver, Tencent, during the quarter and delivered only a 1.5% gain.

From a forward valuation perspective, domestic equities by our estimates are at roughly the same levels as at end-2Q17 (see Figure 5.1 below). This is a function of the following:

- A 4% weaker rand against the US dollar – this lifts the earnings base on translation gains for rand-hedge industrial counters.
- A very strong bulk and industrial commodity price environment, lifting the earnings bases of the diversified miners.

It is notable from Figure 5.1 that investors could expect single-digit total returns from the Resources sector, in the absence of higher ratings than current levels. This is because earnings bases are much higher, and hence our year-2 earnings growth assumption is lower. However, these analyses need to be considered with caution: free cash flow yields remain very high in the diversified mining space, and many companies will continue to de-lever rapidly. This could continue to buoy share prices. Furthermore, our earnings figures do not incorporate spot commodity prices – in the case of Anglo, earnings would be 20% higher. Nevertheless, we have moderated our overweight position in the diversified miners on the back of the stellar performance achieved during the past quarter.

Our 12-month total return expectation from domestic equities is 12%. While offering only a 3.5%-4% premium to our expected return from fixed income, we retain our neutral stance on the asset class.

Figure 5.1: Domestic equities - valuation metrics and total return expectations

	12-M FWD P/E	YR +2G	EXIT P/E	DIV %	12M EST. TOTAL RETURN
Resources	13.7	5%	13.0	2.2%	2%
Financials	10.5	10%	10.0	4.9%	10%
Industrials	17.5	14%	17.5	3.1%	17%
SA EQUITY	14.9%	11%	14.7%	3.1%	12%

Source: Anchor Capital

Perception relief rally versus fiscal reality?

Investors in South African equities presently have the complicated task of weighing up the likely impact of two forces, namely, domestic politics and the current fiscal trajectory. For the first time in a while, we feel these could prove to be opposing forces as they pertain to investment markets in the coming months.

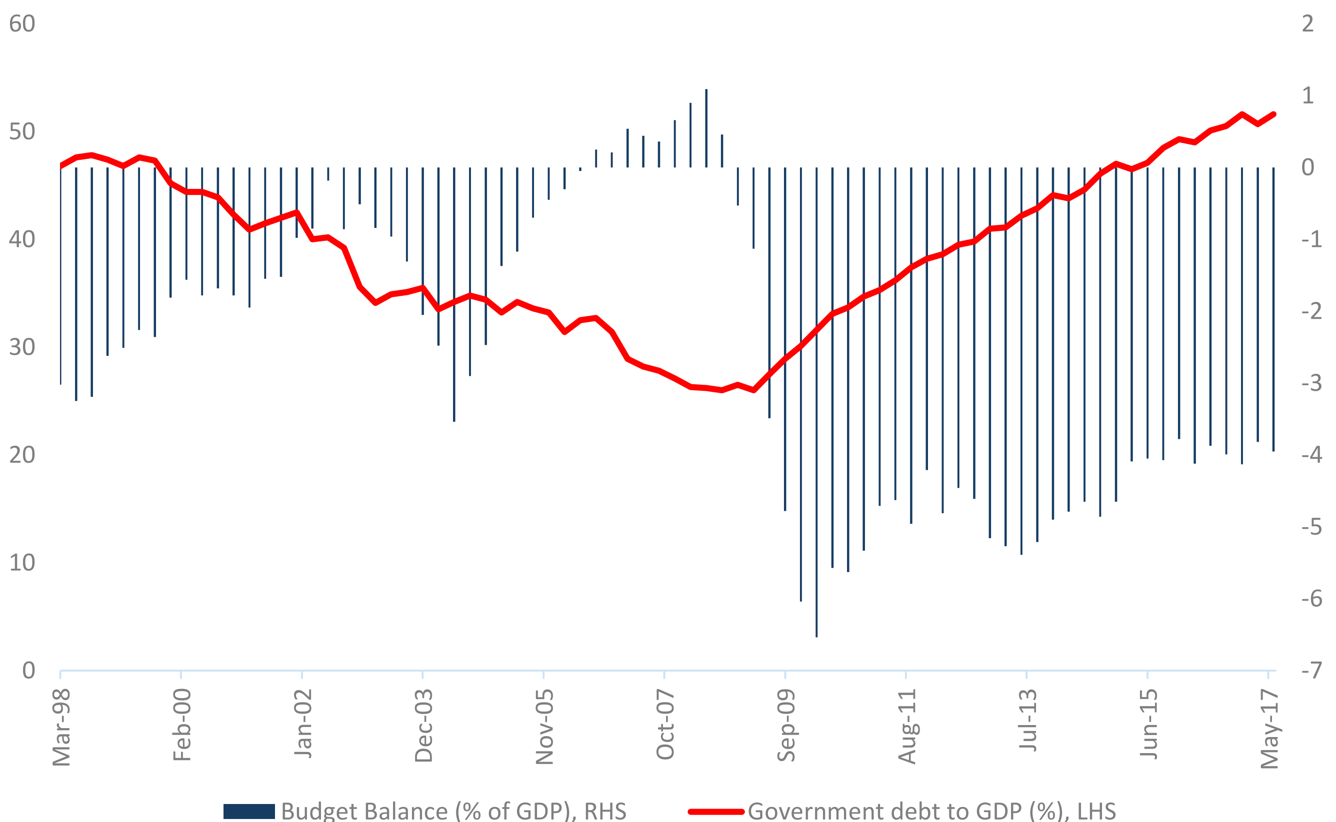
The first aspect of the debate is domestic politics. While the narrative has been overwhelmingly negative for some time, we believe there is an increasing likelihood of an ANC presidential candidate emerging in the December elective conference which could be seen to be more "pro-business" than what investors have had to deal with in the past number of years. The three front-runners appear to be Nkosazana Dlamini Zuma, Cyril Ramaphosa and Zweli Mkhize; we believe either of the latter two would be relatively well-received compared to the former, and we would ascribe roughly equal odds to all three.

Thus, one could say that the likelihood is that South Africa may well achieve a good outcome politically in December. The immediate reaction to a good outcome would likely be a risk-on trade for South African assets, specifically Retailers, Listed Property and Banks. The thinking here is that the vast majority of the current economic malaise is due to very low business and consumer confidence as a consequence of toxic politics, and a return of confidence in and of itself would lift economic activity and release "pent up" demand significantly. Whether or not a market-friendly regime would result in real structural reform down the line is almost a moot point – indeed, we do not hold out much hope in this regard.

We believe the key opposing debate is the fiscal situation in South Africa. For the fiscal year to date through August 2017, National Treasury data indicate that revenue has grown by 3%, while expenditure is tracking 7% higher. If we extrapolate these growth rates for the full year, the likelihood is that Treasury will be facing an approximately R75bn shortfall against budgeted revenue collections, while the deficit would have ballooned to 4.5% of GDP (from a budgeted 3.1%, and 3.4% achieved in FY16/17).

To be clear, South Africa's budget deficit has been worse before (see Figure 5.2 below), but the key difference is that the budget deficit is high and growing at the same time as government debt to GDP is at all-time high levels in post-democracy South Africa. This is what makes the present trajectory so dangerous – debt payments are crowding out room for necessary investment expenditure, making a return to sustainably higher GDP growth rates less likely. This is what ratings agencies will be focusing on.

Figure 5.2: South Africa budget balance as a % of GDP vs government debt to GDP



Source: Bloomberg, SARB

To be sure, the situation is not yet as dire as that of Brazil (10% budget deficit, 70% debt to GDP), but the direction of change is deeply concerning. Absent a significant lift in GDP growth, we are concerned that stickiness in government expenditure coupled with inflexibility on the revenue front (a very narrow taxpayer base relative to population and social-grant recipients) will result in the deficit steadily creeping higher. Furthermore, should tax rates be increased, the likelihood is that this would prove growth negative – especially if it involves a VAT hike (the only real needle-mover to generate more revenue). Ultimately, it is GDP growth which is required to extricate South Africa from this predicament.

Figure 5.3: South Africa's precarious fiscal situation

	2016/17	BUDGETED 2017/18	LIKELY 2017/18	% VS BUDGET	% CH YEAR ON YEAR
Revenue	1,297	1,414	1,336	-6%	3%
Expenditure	- 1,445	- 1,563	- 1,546	-1%	7%
Budget balance	- 148	- 149	- 210	41%	42%
% of GDP	-3.4%	-3.1%	-4.4%		

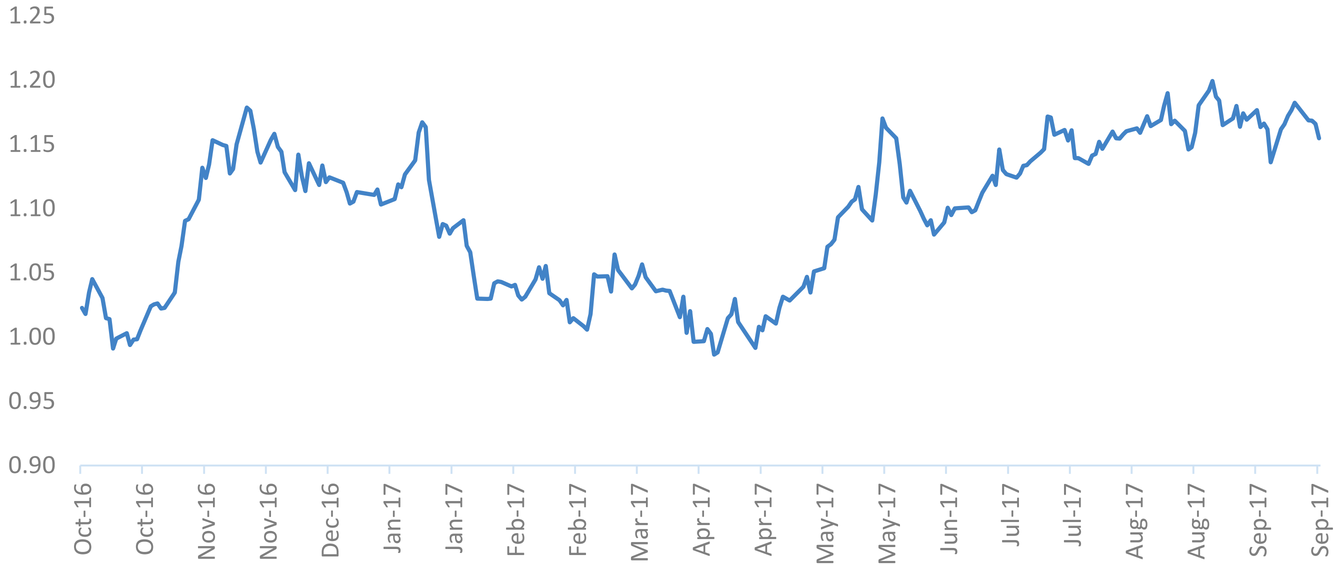
Source: National Treasury data; "likely" column represents Anchor Capital estimates

How does one resolve the fiscal situation? Tax hikes are highly likely in the upcoming budget, but even the most punitive measures in this regard are unlikely to resolve the present situation to anything remotely resembling a satisfactory level. Raising the top marginal income tax rate again to 50% would yield an extra R5bn, while a 1% move in VAT – the only tax type that can really move the needle if adjusted upwards – would yield an extra R22bn. This still yields a gaping hole against the likely shortfall. The expenditure side of the equation would also be a logical point of departure: simply eradicating all forms of corruption would probably yield R50bn-R100bn in savings without impacting service delivery, but this is an unlikely scenario – at least in the short-to medium-term.

We conclude that increasing tax rates will not solve the fiscal problems which South Africa faces: it is only a return of confidence on the part of business and consumers which will achieve this, and via a return of spending, growth and the resultant tax buoyancy which follows. For this, we need a decisively good outcome on the political front in December.

From the perspective of equity positioning, we retain broadly balanced currency positioning in domestic-only CIS mandates relative to the SWIX, while our equity mandates which allow for direct foreign investment are roughly 15% invested offshore. We have commented in the past that Banks were a safer way to play an improving SA environment given strong capital positions and less income statement sensitivity to an economy not growing in real terms. Since end-1Q17, Banks have outperformed General Retailers by 15% with the trend continuing in 3Q17.

Figure 5.4: Banks relative to General Retailers



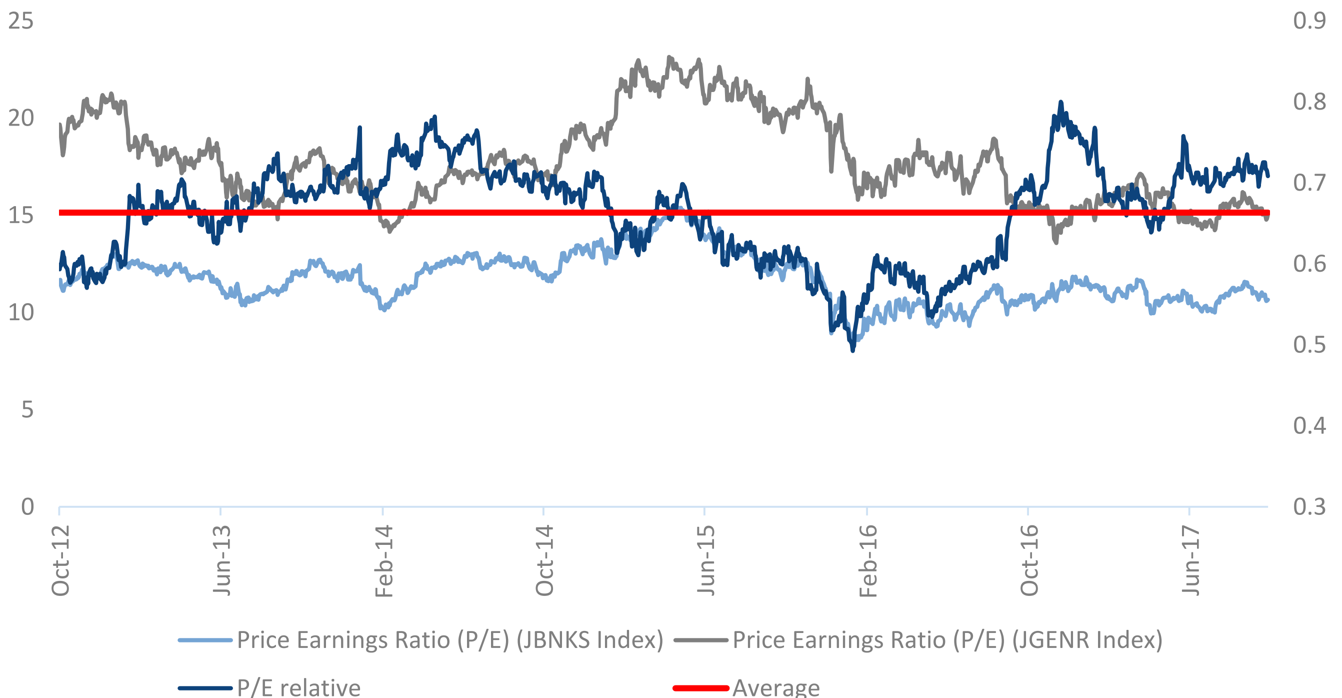
Source: Bloomberg

From a valuation perspective, we regarded Banks as offering better relative value vs General Retailers (they do tend to, however, always trade at a discount) earlier this year.

However, given the persistent recent outperformance we believe this opportunity has largely passed. We have reduced our exposure to Banks in favour of an allocation to discretionary retail (Mr Price, Foschini and more recently a small weighting in Steinhoff Africa Retail), but at a sector level our combined weighting in Banks, Retailers and Food Producers (proxies for South African consumer exposure) remains well below benchmark, highlighting our concerns about South Africa's fiscal position and the potential knock-on effects to consumer demand and growth.

Our main stock-specific overweight positions include Steinhoff, Old Mutual, RMI Holdings, Reinet and Exxaro in the resources sector.

Figure 5.5: Banks P/E relative to General Retailers: no longer undervalued on a relative basis



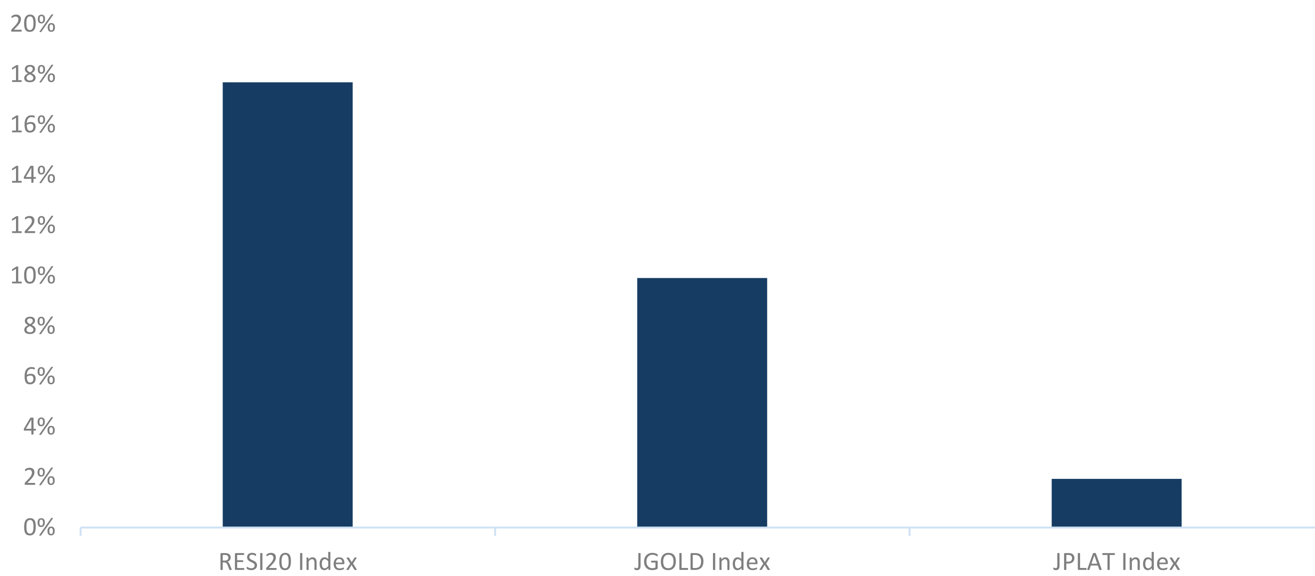
Source: Bloomberg, Anchor Capital

Diversified Miners continue to lead the Resources sector

3Q17 was buoyant for the resources sector on several fronts. Share price performance was strong across the board, driven by generally higher commodity prices. This was particularly true for the Diversified Miners, once again leading the sector (see Figure 5.6). Precious metals miners continued to lag the bulks and base-metal producers.

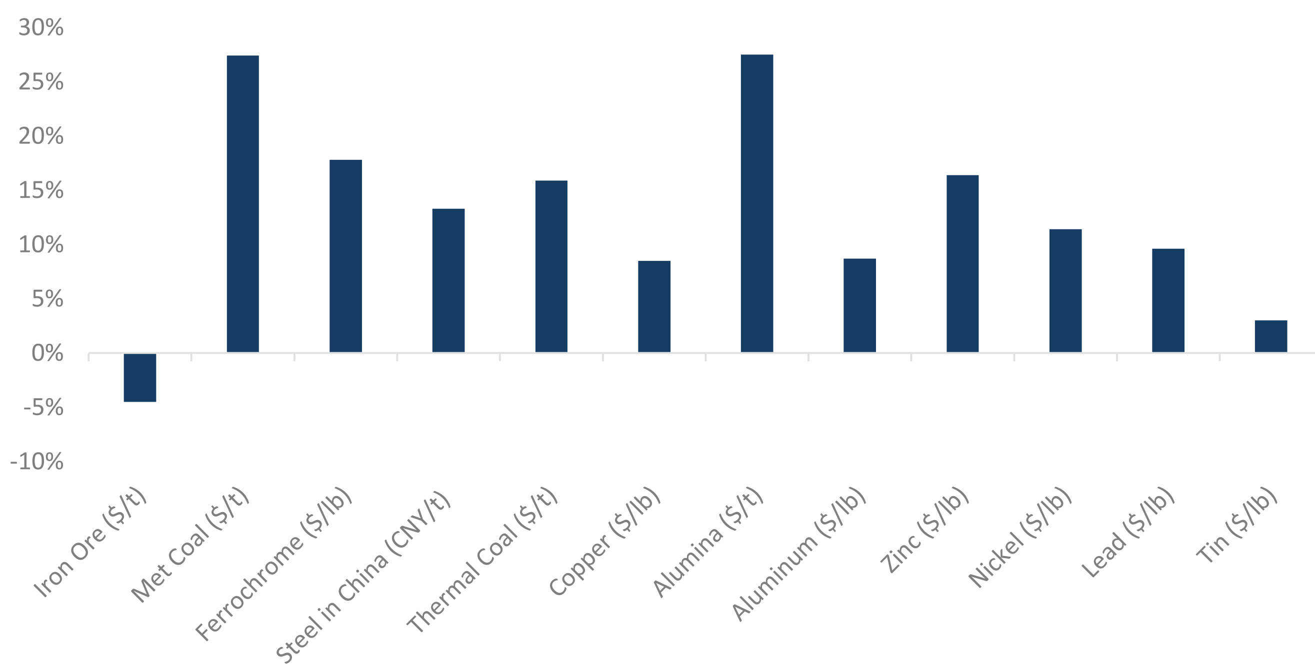
The quarter was also a resumption of the recovery in commodity prices that began in 2016. Most major metals were higher with iron ore the laggard in the bulks and base metals space for the quarter.

Figure 5.6: 3Q17 Resources total return by sub-sector



Source: Bloomberg

Figure 5.7: Bulks and base metal performance



Source: Bloomberg

At face value, this appears ironic given that it was the shares most exposed to iron ore that had the strongest appreciation. This apparent disconnect is explained by the high level at which iron ore began 3Q17. The average iron ore price over the quarter was $72/t, still well above the estimated 90th percentile price of $60/t. While we have not felt that mid-$70/t iron ore prices were sustainable, it has been important to note the level of free cash flow being generated by the diversified miners at these iron ore prices. We estimate that Anglo American, for example, is currently trading at a 17% free cash flow yield. When viewed in comparison to its history, this looks particularly attractive (see Figure 5.8).

Figure 5.8: Anglo American free cash flow yield (2000 – 2017)

Source: Bloomberg

The thesis for the diversified miners is one of enhanced cash returns to shareholders in the short-to medium-term rather than further commodity price appreciation. Considering Anglo American from this perspective is instructive. At Anglo's current level of debt reduction, net debt will reach c. $1.6bn by June 2018 (from $6.2bn at June 2017). The EV/FCFF ratio would unwind from 7.4x as at June 2017 to 6.3x at June 2018 (while also paying 40% of earnings through dividends). This calculation is necessarily an approximation as it requires many implicit assumptions (commodity prices persisting at near current levels, capital expenditure remaining stable, etc.).

Nevertheless, the exercise is informative. Iron ore prices are currently just above $60/t. This price appears more reasonable as it is at the estimated 90th percentile of the cost curve. Furthermore, the four major iron ore producers (Rio Tinto, BHP Billiton, Fortescue Metals Group and Vale) have not grown production significantly as of yet. Whilst forecasting commodity prices is always perilous at best, these factors give us more comfort in iron ore prices at these levels in comparison to the higher levels seen earlier this year.

Platinum holding back the PGM Basket for PGM miners

Platinum shares continued to lag the wider sector. The relative performances of platinum and palladium (the key platinum group metals [PGM]) over the quarter are illustrative of each metal's 2017 performance: platinum continued to lag palladium materially. PGM prices, with the exception of platinum, have moved higher strongly in US dollar terms YTD. Palladium, rhodium, ruthenium and iridium are 37%, 54%, 75% and 44% higher, respectively YTD, to the end of September. The problem for the platinum miners is that platinum is the largest constituent in the PGM basket – approximately 65%, depending on the company.

In September, palladium's price exceeded platinum's for the first time since 2001 (see Figure 5.10). In addition to the fundamental issues of supply and demand, platinum has been plagued by continual negative sentiment. The persistent negative narratives this year have been centered around diesel's decline in Europe and the threat of electric vehicles (EVs).

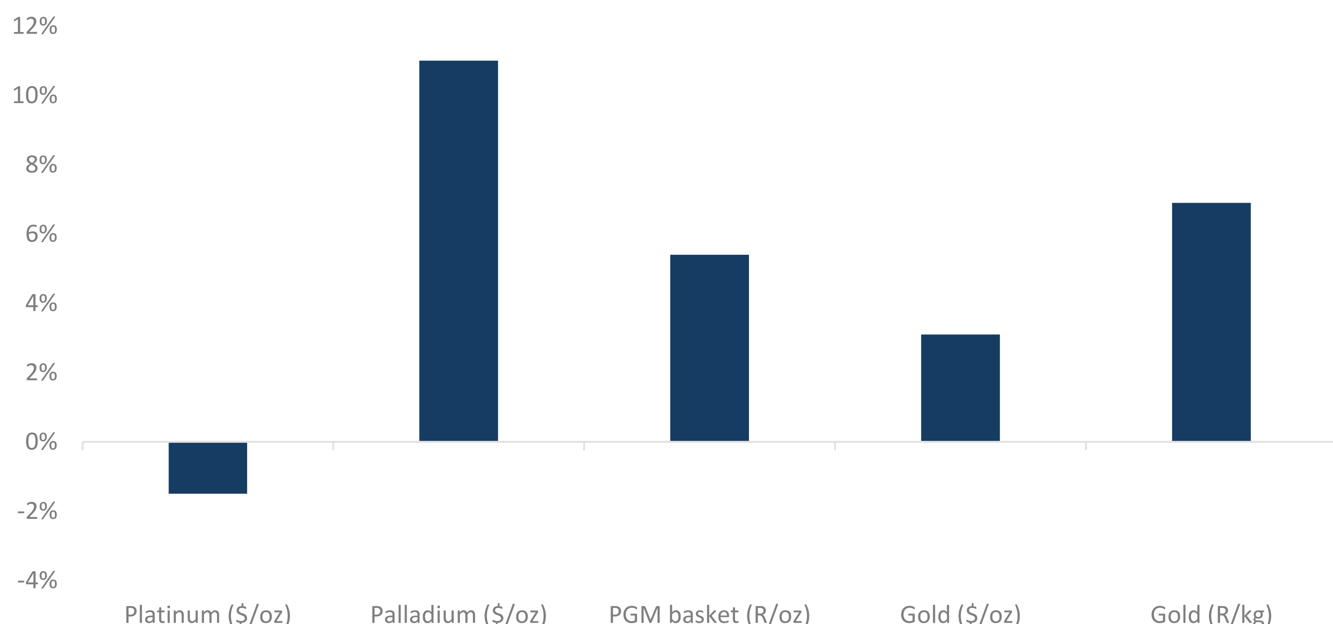
Figure 5.9: Platinum vs. Palladium ($/oz.) (2000 – 2017)

Source: Bloomberg

The platinum price has been much more subdued than other PGM prices, down 2% for the quarter and only 1% higher YTD. It is that lethargic performance of platinum that explains the muted 8% increase in the rand PGM basket YTD, despite the significantly higher moves for PGM metals outside of platinum.

All of the major platinum miners, with the exception of Anglo American Platinum, continue to be free cash flow negative at spot. The industry's current cash burn rate makes the 5% move in the rand PGM basket over the quarter insufficient for profitability and suggests that the Platinum Mining Index's (JPLAT) underperformance vs the RESI-20 Index is not surprising.

Figure 5.10: 3Q17 Precious metal price performance

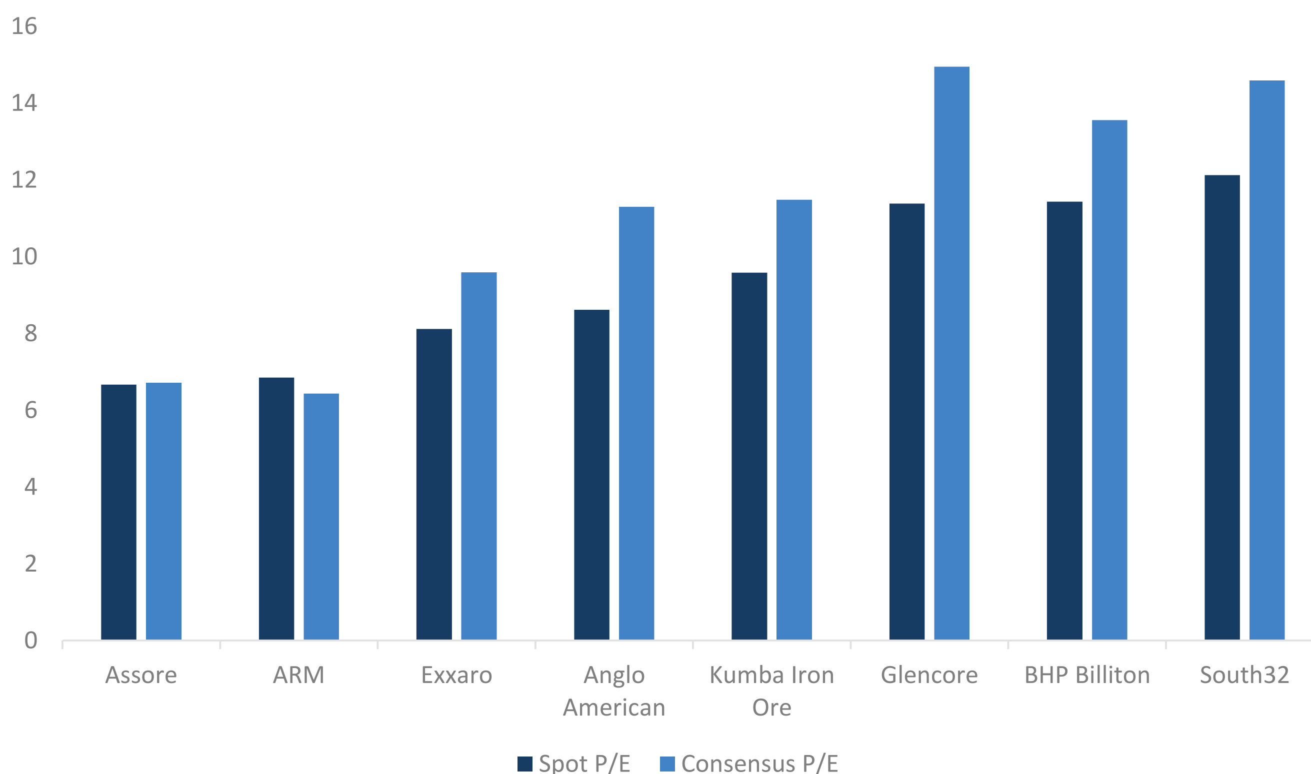


Source: Bloomberg

Whilst we continue to have little to no exposure to platinum in our mandates, we believe the strong moves in PGMs outside of platinum are noteworthy. We view the platinum shares as call options on PGM prices and will continue to monitor the degree of optionality priced into the shares.

The thesis for the diversified miners remains largely unchanged – miners should return material amounts of cash to shareholders given the high levels of free cash flow being generated. The difference between spot and consensus earnings (and thus multiples) is not as large as it has been in the past, which is reflective of the major share-price appreciation across the sector over the quarter. We continue to be overweight the sector through our equity positioning in Anglo American, BHP Billiton and Exxaro.

Figure 5.11: Spot vs. consensus earnings multiples for Diversified Miners



Source: Bloomberg, Anchor Capital

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