GRANATE ASSET MANAGEMENT

Part of RMI Investment Managers

Monthly Market and economic roundup – January 2018

Key points

- **SA financial markets had a mixed month with bonds outperforming all other domestic asset classes**
- **Leadership change has buoyed the market, but unlikely to provide sufficient policy traction in time to stave off a Moody's rating downgrade**
- **Lower inflation in the 1st quarter is unlikely to be enough for the SARB to cut the repo rate**

Asset class returns

South African financial markets had a mixed month with the bond market continuing its strong run (1.86%) supported by a further 4% appreciation in the rand against the US$. The strength in the local bond market was despite a 30bp increase in the yield of the 10yr US Treasury and large foreign selling of South African bonds.

While equities were flat (0.1%) the property sector lost 9.9%, its worst month performance since May 2013, as the stronger currency was negative for the offshore counters.

Inflation-linked bonds continue to fair particularly badly as inflation seems to be under control – particularly in the near term.

Table 1 – SA Asset Class Returns – January 2018[1]

	1 month	3 month	YTD	12 month
Money market	0.64%	1.80%	0.64%	7.51%
Bonds	1.86%	6.57%	1.86%	10.79%
ILB	-1.33%	0.26%	-1.33%	-0.09%
Property	-9.91%	-4.31%	-9.91%	3.85%
Equities	0.10%	1.21%	0.10%	16.07%
Rand/USD$	4.48%	19.20%	4.5%	13.70%

Source: *Bloomberg and Granate AM calculations*

Key market events

After an eventful December, 2018 started off on a calm footing. The markets seem to be patient with the change of leadership as there is an appreciation of the complexities within the ANC that Cyril Ramaphosa is facing with the transfer of power. The positive sentiment around leadership change and the steps taken (eg. removal of the Eskom board) have supported markets, but the first real test will be when the budget is delivered (21st of February). After the big negative surprise in the Medium-Term Budget, the market expects detailed and realistic measures from government to improve the poor fiscal outlook. Investors will be looking for short term measures to "plug" the growing budget deficit as well as longer term policies which will move the country onto a higher growth path. Barring this decisive action, we expect Moody's to downgrade South Africa's credit rating.

Key economic data[2]

__Inflation__: CPI rose by 4.7% year-on-year (y/y) to December after increasing by 4.6% in November. The most notable slowdown in the major categories was Recreation and culture (0.4% from 1.5%) followed by Health (5.7% from 6.4%). The most notable increase was Transport (6.4% from 4.4%), its first increase since September, as the price of petrol increased by 4.2% in the month and 14.2% y/y.

Inflation is expected to fall further during the 1st quarter as food prices bottom and the strong rand outstrips the increase in oil prices to push petrol prices lower. Post the 1st quarter, however, barring further strength in the rand, inflation will start rising as base effects and higher taxes (expected in the budget) push prices higher.

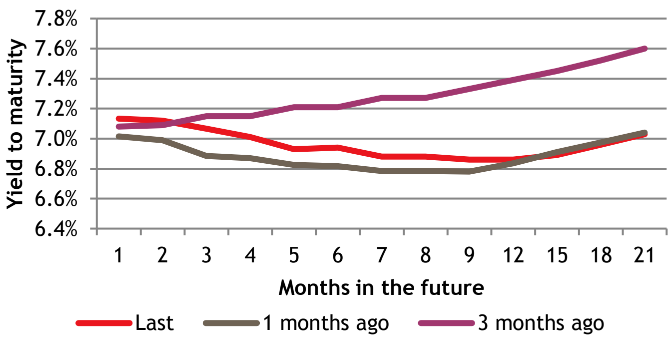
__Economic growth__: Manufacturing production increased in November by a seasonally adjusted (S/A) m/m rate of 0.9% while mining production declined by 0.7%. Their 3 month S/A growth rates were 0.6% and -1.1%, respectively, suggesting that manufacturing positively contributed to GDP growth in the 4th quarter while mining detracted. Retail sales continue to surprise on the upside recording a m/m increase of 4%, in part, a result of the increasing popularity of "Black Friday". Even a significant slowdown in retail sales in December is unlikely to dent the strong contribution to GDP in quarter 4.

[1] Money market - STEFI composite; Bonds- ALBI; ILB - CILI; Property - JSE SA Listed Property index; Equities – JSE All Share Index

[2] Comments on economic data released over the last calendar month

Income Assets Performance and Outlook

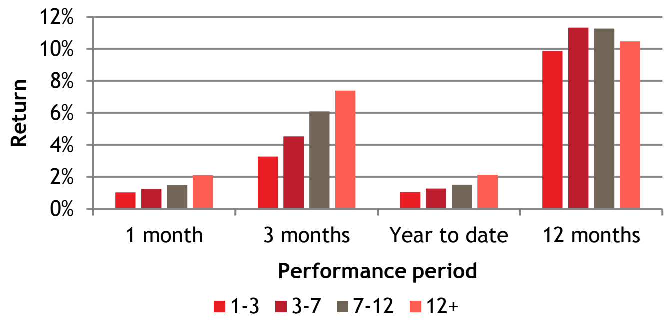
Figure 1- Market expectations of path of repo rate



Money market –the SARB kept the repo rate unchanged at 6.75% in its January meeting in line with market expectations. The overall tone of the MPC statement was more dovish than the December statement (although it did maintain a hawkish bias) as political risk eased past the ANC conference.

The more dovish statement, downward revision to the SARB's inflation forecast and strong rand have combined to lead the market to price a further rate cut by year end.

Figure 2 - Bond market sector returns

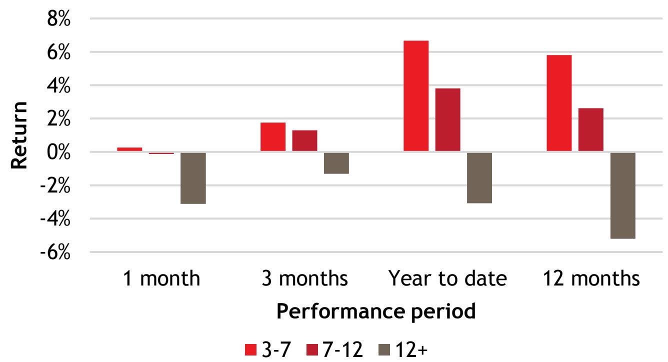


Bond returns - after the very strong rally in December, the bond market settled to return a "normal" monthly rate of 1.86%.

Higher interest and a larger decline in yields of longer dated bonds has resulted in the longer end of the yield curve performing better than shorter maturities.

If there is no further deterioration in the fiscal outlook in the February budget, we expect the yield curve to flatten further.

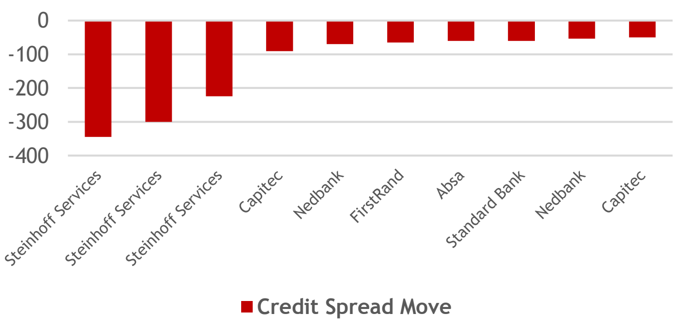
Figure 3 - Inflation-linked bond market sector returns



Inflation-linked bond (ILB) returns - After a strong performance in December, Inflation-linked bonds had a poor January as inflation remains low and the SARB continues to be generally hawkish in its tone.

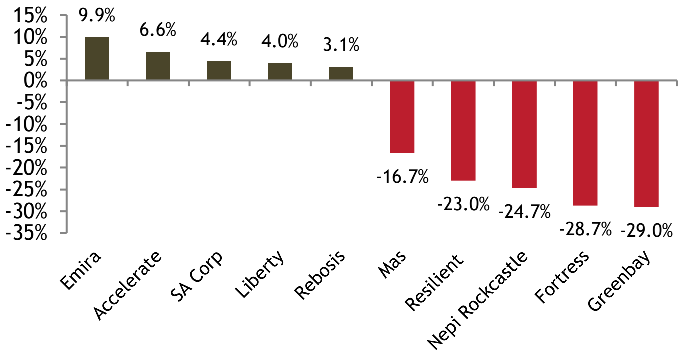
Despite the significant sell-off of the long end of the inflation-linked yield curve, this sector continues to offer poor value. However, a better inflation carry over the next 3 months should provide some support to this asset class.

Figure 4 - Corporate Bond Moves



Corporate Bonds – The biggest spread movers of the month were again from Steinhoff, although in sharp contrast to last month, their bonds were significant outperformers. This was due to Steinhoff Services Limited, the entity responsible for issuing debt locally, announcing that it intends to redeem all R7.6 billion worth of bonds. Spreads in the local banking sector continued to narrow as the demand for high quality credit remained robust, whilst issuance of new credit remains subdued.

Figure 5 - property stocks: best and worst in January



Source for all figures: Bloomberg, JSE and Granate AM calculations

Listed property – The property sector had a poor month (-9.9%) underperforming all other asset classes.

There was however a disparity in returns between SA-centric counters and offshore counters. SA-centric counters outperformed driven in part by the expectation that local property fundamentals would stabilize and potentially improve. Resilient's group of companies was hardest hit by speculation that Viceroy was due to publish a negative report on some of the South African listed counters.

Table 2 - Selected markets returns (to end January 2018)

Global markets	1 Month	3 Months	YTD	12 Months
MSCI Global Equity (USD)	5.2%	8.8%	5.2%	23.5%
MSCI Global Equity	3.7%	6.3%	3.7%	19.1%
MSCI Emerging Market (USD)	8.3%	12.5%	8.3%	38.0%
MSCI Emerging Market	6.7%	8.6%	6.7%	31.2%
S&P 500	5.7%	10.3%	5.7%	26.4%
Nasdaq *	7.4%	10.6%	7.4%	32.0%
Bloomberg European 500 *	1.8%	0.3%	1.8%	10.2%
Nikkei 225	1.5%	5.1%	1.4%	23.6%
Global Bonds (Local currency)	-0.8%	-0.6%	-0.8%	1.3%
EM Bonds (Local currency)	1.1%	0.7%	9.1%	9.1%
Commodity prices (%)	**1 Month**	**3 Months**	**YTD**	**12 Months**
Brent Oil spot (USD/barrel)	3.0%	13.5%	3.0%	25.9%
Platinum spot (USD/oz)	7.7%	9.0%	7.7%	0.7%
Gold spot (USD/oz)	3.2%	5.4%	3.2%	11.1%
Copper spot (USD/tonne)	-1.8%	3.5%	-1.8%	18.1%

SA equity sectors (%)	1 Month	3 Months	YTD	12 Months
FTSE: All Share	0.1%	1.4%	0.1%	16.1%
FTSE: Top 40-TOPI	0.2%	0.5%	0.2%	17.8%
FTSE: Resource 20	3.6%	1.9%	3.6%	9.6%
FTSE: Industrial 25	0.2%	-3.1%	0.2%	20.4%
FTSE: Financial 15	-2.3%	13.8%	-2.3%	22.7%
Currencies	**1 Month**	**3 Months**	**YTD**	**12 Months**
ZAR per USD	4.5%	18.6%	4.5%	13.7%
ZAR per EUR	1.0%	11.4%	1.0%	-1.1%
ZAR per GBP	-0.5%	10.5%	-0.5%	0.9%
USD per EUR	-3.3%	-6.1%	-3.3%	-13.0%
JPY per USD	3.2%	3.7%	3.2%	3.3%
USD per GBP	-4.8%	-6.9%	-4.8%	-11.4%

Source: Bloomberg, JSE, Citibank and Granate AM calculations * Excluding Dividends

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