GRANATE ASSET MANAGEMENT

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Monthly Market and economic roundup – February 2018

Key points

- **SA financial markets had another mixed month with bonds significantly outperforming other asset classes**
- **South Africa has probably avoided an immediate Moody's rating downgrade, but the risk of this happening later in the year remains high**
- **A politically induced confidence boost is likely to support growth, albeit to a rate still below potential**

Asset class returns

South African financial markets had another mixed month with the bond market continuing its very strong run (3.9%), recording the best 3 month return since September 2008. Inflation-linked bonds were the 2nd best performing asset class (1.1%). Listed property, on the other hand, had a poor month (-9.9%) recording its worst 3 month return since June 2008.

South African assets performed well in a global context, the local bond market significantly outperforming all other WGBI constituents. Domestic equities (-2%) fared well in a global context, buoyed by a strong rebound in financials, in a month that saw volatility spike and the MSCI global equity index fall by 3.7%.

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

	1 month	3 month	YTD	12 month
Money market	0.54%	1.76%	1.2%	7.48%
Bonds	3.93%	11.85%	5.9%	14.33%
ILB	1.12%	4.66%	-0.2%	0.94%
Property	-9.90%	-15.41%	-18.8%	-6.09%
Equities	-1.97%	-2.20%	-1.9%	17.44%
Rand/USD$	0.42%	16.07%	4.9%	11.25%

Source: *Bloomberg and Granate AM calculations*

Key market events

The Finance minister surprised the market by increasing VAT by 1%, a measure that could be sufficient to ensure that Moody's does not downgrade South Africa's credit rating in the near term. For South Africa to keep its investment grade rating, government must deliver on its budget projections, something that it has not managed to do over the last few years. The market will now look to government's progress in implementing structural economic reforms that will provide the level of economic growth required to return the country to fiscal sustainability. In the near-term risks to the fiscus and credit rating remain the precarious financial state of the SOE's and the public-sector wage increases which have still to be agreed on. Longer term – it's all about economic growth.

Key economic data[2]

Inflation: CPI slowed to 4.4% year-on-year (y/y) to January (December: 4.7%), its lowest rate since March 2015. The inflation slowdown is broad based as evident by the fact that only 2 of the 12 major categories in the index (Education and Miscellaneous goods and services) recorded a y/y increase above the upper end of the inflation target. This is the 1st time this has happened in over 9 years.

Inflation pressures remains subdued suggesting that the downward trend could continue to the end of the 1st quarter. However, the 1% increase in VAT (which becomes effective on the 1st of April) means that inflation is not likely spend any time below 4.5% post the 1st quarter (Q1).

Economic growth: Manufacturing production increased in December by a seasonally adjusted (S/A) m/m rate of 1.1%, which left overall Q4 2017 annualized growth at 6% (Q3: 3.5%). The positive contribution to Q4 2017 GDP growth from manufacturing was negated by mining production, which saw a S/A q/q decline of 6.4% after expanding by 11.4% in Q3 2017.

While retail trade contracted in December, Q4 2017 q/q annualized sales volume grew at 9.3% (Q3: 6.3%) suggesting that overall GDP growth in Q4 2017 decelerated, but remained positive. Looking forward, a politically induced confidence boost is likely to support growth, albeit remaining below potential.

[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

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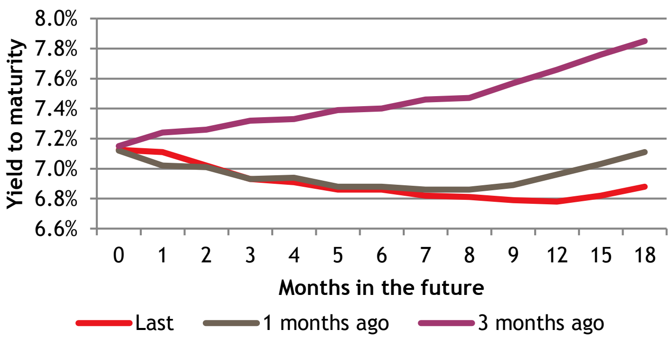
Income Assets Performance and Outlook

Figure 1- Market expectations of path of repo rate

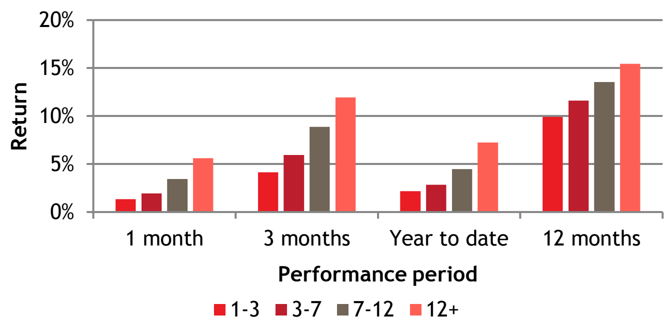


Money market – the Monetary Policy Committee (MPC) of the SARB did not meet during February. The market took its cue from the stronger rand which led to the stronger conviction of rate cuts over the next 12 months.

The market is now pricing a low probability of a rate cut in the March MPC meeting and a 25 basis point rate cut in May.

If South Africa avoids the Moody's downgrade in the next few weeks and the SARB considers the inflationary impact of VAT as transitory, then a March rate cut is on the cards.

Figure 2 - Bond market sector returns

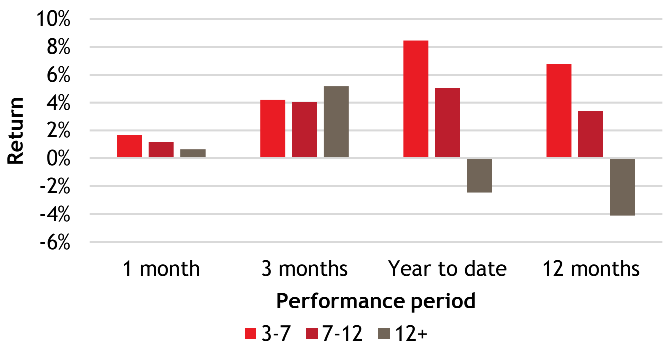


Bond returns - the bond rally continued in February with a significant bull flattening of the yield curve.

The yield on the 1-3 sector of the yield curve declined by 31bp to return 1.1% compared with a yield drop of 47bp on the 12+ sector that returned 5%.

The longer end of the curve remains better value than shorter maturities, but lower yields will require, at a minimum, confirmation that Moody's will not downgrade South Africa's credit rating.

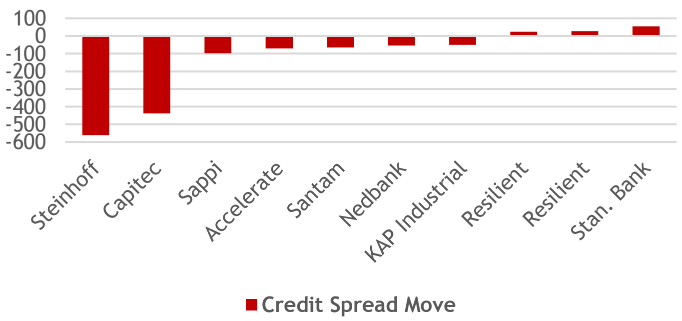
Figure 3 - Inflation-linked bond market sector returns



Inflation-linked bond (ILB) returns – in line with nominal bonds, ILB yields also declined, albeit by significantly less. The ILB curve continued to steepen, the yield on the shorter dated R212 (2022) declined by 35bp compared with that of the longer dated I2050 (2050) that declined by 3bp.

While the valuation gap in the long end of the yield curve has shrank over the last few months, longer dated ILB's remain expensive. Shorter dated ILB's, however, are offering good value as the inflation carry is on an upward trend for the next few months.

Figure 4 - Corporate Bond moves



Corporate Bonds – The biggest credit spread move of the month was again from Steinhoff, on the back of the entity announcing its intention to redeem the local bonds. We also saw spread narrowing from Capitec's subordinated bond, which had previously widened significantly, due to allegations that the bank engaged in reckless lending. Two of the Resilient REIT's bonds widened as investors were spooked by accusations in recent reports about how they run and mark their assets.

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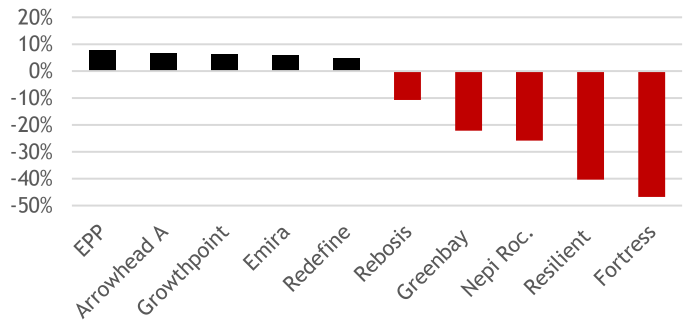
Figure 5 - property stocks: best and worst in February



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

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

The trend of disparity in returns between SA-centric counters and offshore counters continued in February with the SA-centric counters largely outperforming. Resilient's group of companies continued to underperform as they came under scrutiny from reports released by a local hedge fund manager and analysts at an offshore broker which questioned the valuation of the companies and inter-related transactions.

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

Global markets	1 Month	3 Months	YTD	12 Months
MSCI Global Equity (USD)	-4.3%	2.0%	0.7%	15.2%
MSCI Global Equity	-3.7%	0.9%	-0.1%	11.5%
MSCI Emerging Market (USD)	-4.7%	6.6%	3.2%	27.6%
MSCI Emerging Market	-4.0%	4.9%	2.5%	24.0%
S&P 500	-3.7%	3.0%	1.8%	17.1%
Nasdaq *	-1.9%	5.8%	5.4%	24.8%
Bloomberg European 500 *	-3.9%	-1.5%	-2.1%	3.3%
Nikkei 225	-4.4%	-2.7%	-3.1%	17.6%
Global Bonds (Local currency)	-0.0%	-0.9%	-0.8%	0.4%
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)	-6.3%	2.7%	-3.5%	16.0%
Platinum spot (USD/oz)	-1.9%	4.3%	5.7%	-4.0%
Gold spot (USD/oz)	-2.0%	3.4%	1.2%	5.6%
Copper spot (USD/tonne)	-2.6%	2.4%	-4.3%	15.6%

SA equity sectors (%)	1 Month	3 Months	YTD	12 Months
FTSE: All Share	-2.0%	-2.2%	-1.9%	17.4%
FTSE: Top 40-TOPI	-2.3%	-3.4%	-2.1%	19.8%
FTSE: Resource 20	-4.9%	-2.5%	-1.4%	16.7%
FTSE: Industrial 25	-3.5%	-7.8%	-3.3%	18.5%
FTSE: Financial 15	5.1%	12.7%	2.7%	29.1%
Currencies	**1 Month**	**3 Months**	**YTD**	**12 Months**
ZAR per USD	0.5%	16.1%	5.0%	11.3%
ZAR per EUR	2.3%	13.4%	3.3%	-3.5%
ZAR per GBP	3.5%	14.2%	3.0%	0.1%
USD per EUR	1.8%	-2.4%	-1.5%	-13.3%
JPY per USD	2.4%	5.5%	5.6%	5.7%
USD per GBP	3.1%	-1.7%	-1.8%	-10.0%

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

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