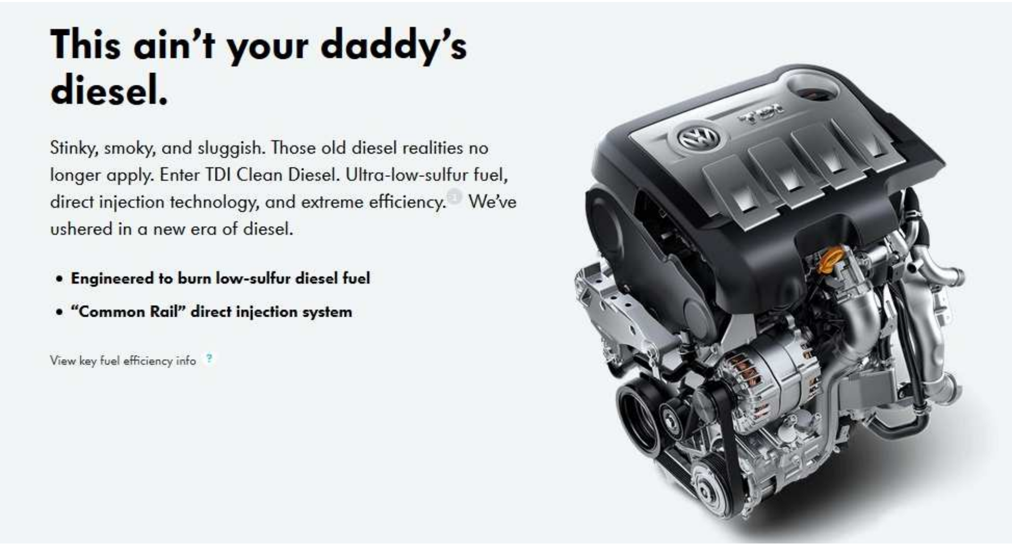
Quarterly Comment for September 2015

"German Re-engineering"

The last quarter has seen a number of significant economic events and market shifts, ranging from the US Fed's decision not to raise interest rates, through to concerns regarding China's growth rates and the resultant emerging market equity woes. The European economy (and all the issues surrounding Greece and their debt) has been overshadowed by the news out of the US and China. However, the very significant issues around Greece remain and the European economy is being forced to face up to two emerging issues that have made front page news around the world: the migrant crisis and the Volkswagen (VW) scandal. The majority of the news flow on these two issues has (quite rightly) focused on the humanitarian issues relating to the migrants and the ethical concerns around VW's actions. However, both issues have the potential to have devastating impacts on the European economy and negatively impact financial markets. This commentary focuses on the economic fallout that VWs travails may lead to.

What happened at VW?

Volkswagen sold approximately 11 million diesel cars globally that had been built with software that hid the extent of their emissions so that they could pass regulators' emissions tests in various countries. This allowed VW to sell the vehicles in those countries – it would not have been allowed to if the actual emissions from the vehicles were apparent in the tests.



The future for VW?

The fallout from this fraud is likely to be massive for the business and this has been reflected in the share price – VW share price has fallen by almost 40% since the news broke.

The impact on the business goes so much further than the costs of recalling and fixing 11 million cars. A question even remains as to whether they will be able to just fix the cars or whether they will need to refund clients. VW's reputation lies in tatters and we will need to wait and see the impact of the scandal on its sales numbers. While facing the distinct possibility of a fall in revenue through lower sales, they are also looking at a material increase in their cost base. This increase is likely to be driven by:

- The costs of the recall and fixing of the vehicles - VW have set aside 6.5 bn Euros to cover these costs
- Significant legal fees to fight lawsuits around the globe (Texas County is suing VW for $100m for worsening pollution levels, rumours of class action suits abound and there is more to come), and the costs if any of those lawsuits are successful in their claims.
- Expected fines from regulators around the globe (which are likely to be material – the initial estimate of fines is $7.4bn from analysts Sanford C.Bernstein Ltd)

We would also expect a potential downgrade in VW's credit rating – this impacts the cost of their borrowings which can also hit future profits.

Apart from all the costs, one should expect that the scandal will take a huge amount of executive focus and time over the coming years, which makes focusing on managing a large business exceedingly more difficult.

One must also not ignore the potential impact on the financing division of the business – basically, VW facilitates loans to customers to buy their cars. There is the potential for higher defaults on the loans if second hand VW car prices fall. The loans are funded by VW borrowing money in the markets, and there are already signs of the cost of funding the loans rising due to the investors' risk perception (which would reduce the margins that VW make in their financing division).

Why does it matter?

Germany's role as the stable financial market underpinning Europe's economy is under threat. VW is the largest company in Germany, employing more than 600,000 employees globally (about 200,000 in Germany) and the supply chain as a result of the business employs countless others. It is also one of Germany's largest exporters (and has a material say in Germany being Europe's leading exporter). Put simply, cars accounted for almost 20 percent of Germany's near $1.5 trillion in exports last year and the motor industry accounts for one in seven jobs. The impact on jobs is already starting with VW placing a freeze on new hires in its loan division and slowing production at one of its biggest engine factories.

Germany is also the largest European economy with many feeling that they have held the Eurozone together through what has been a tumultuous last 7 years. If VW were to go to the wall as a result of the scandal, the impact on Germany would not be insignificant and the flow on effect on Europe and the global economy should not be underestimated, especially if other German car manufacturers are also part of the fraudulent covering up of emission levels. At a time when Europe is having to deal with a migrant crisis and the ongoing potential of Grexit, there are many nervous investors watching how the market reacts.

Asset Class Review

The recent quarter was challenging for the investment markets and will have tested investors resolve. It seems as though market volatility is here to stay for the meantime, so we were fortunate that the returns over the quarter ended up marginally positive for the average balanced fund investor. What is hidden in the numbers though was a depreciating rand, which has the effect of boosting the returns of global asset classes as well as the offshore earnings of locally listed shares. Without this currency boost, returns were largely negative for the quarter.

Returns shown to: 30 September 2015

Sector		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol[1]	10yr Vol[1]
LOCAL MARKET INDICES (In Rands)									
FTSE/JSE All Share Index (ALSI)	ZAR	-2.5%	3.4%	4.8%	15.4%	14.6%	14.8%	10.6%	15.4%
FTSE/JSE SA Listed Property	ZAR	6.2%	13.2%	25.8%	16.9%	18.9%	19.4%	13.1%	17.0%
SA All Bond Index (ALBI)	ZAR	1.6%	2.7%	7.0%	5.3%	7.7%	8.2%	6.9%	7.0%
SA Cash Index (SteFI)	ZAR	1.6%	4.8%	6.4%	5.7%	5.7%	7.3%	0.1%	0.6%
Balanced Benchmark [2]	ZAR	1.0%	6.1%	8.8%	15.2%	14.6%	13.8%	6.4%	6.4%
SA Inflation (1 month lag)	ZAR	1.5%	4.6%	4.6%	5.8%	5.5%	6.1%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	-5.2%	-3.8%	-2.0%	7.9%	6.9%	3.0%	12.8%	16.2%
Emerging Markets Equity (FTSE EM)	USD	-18.7%	-15.5%	-18.4%	-4.3%	-3.2%	5.1%	17.8%	23.8%
Global Bonds (Barclays Global Bond Index)	USD	0.9%	-2.3%	-3.3%	-1.6%	0.8%	3.7%	4.4%	5.6%
Global Cash	USD	0.0%	0.1%	0.1%	0.1%	0.2%	1.7%	0.0%	0.6%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-2.5%	3.4%	4.8%	15.4%	14.6%	14.8%	10.6%	15.4%
Global Equity (MSCI World)	ZAR	3.6%	10.3%	15.0%	26.3%	21.6%	10.9%	11.8%	13.1%
Emerging Markets Equity (FTSE EM)	ZAR	-7.4%	1.0%	-0.1%	13.7%	11.0%	13.6%	11.6%	15.4%
SA All Bond Index (ALBI)	ZAR	1.6%	2.7%	7.0%	5.3%	7.7%	8.2%	6.9%	7.0%
Global Bonds (Barclays Global Bond Index)	ZAR	14.9%	16.8%	18.4%	16.9%	15.6%	12.1%	12.2%	14.5%
COMMODITIES									
Gold (US Dollars)	USD	-4.7%	-6.7%	-7.5%	-14.2%	-2.9%	8.9%	18.4%	19.2%
Gold (Rands)	ZAR	8.6%	11.5%	13.2%	1.9%	11.3%	17.7%	19.0%	21.4%
Currencies (positive return = Rand weakening)									
Rand / Dollar	ZAR	13.9%	19.5%	22.4%	18.8%	14.7%	8.1%	14.1%	16.2%
Rand / GBP Pound	ZAR	9.7%	16.1%	14.3%	16.3%	13.8%	6.4%	12.0%	14.6%
Rand / Euro	ZAR	14.1%	10.3%	8.1%	13.3%	10.1%	7.2%	12.1%	13.7%

The local share market was down 2.5% for the quarter, resulting in a total return of +3.4% for the year so far. This is in line with industry expectations where fund managers have been guiding expectations lower for some time. The fact that most fund managers are underweight local equities will have paid off so far this year as it has been the poorest performing asset class.

The JSE is still trading at an expensive PE of 18.6, and with local earnings looking weaker this remains a vulnerable asset class. Prospects for resource shares still look fairly bleak, particularly with the demand side (China) appearing to weaken. In addition, local large cap industrials – which to date have held up the JSE – have just started to trend negative on earnings, with the early evidence of this being Pick 'n Pay releasing poor results which instantly reflected in the share price – an indication that this was a relative surprise.

On the China point, it's an interesting perspective where China is seen as 'global demand' (for goods, services, resources, etc). You could argue that China is the world's manufacturer, and that global demand is external. The decline in China's growth prospects infer more around global growth being poor than what China itself is experiencing.

Not a pleasant thought and does cause us to question the 'least worst' appeal of global equities as the current asset class of choice.

Of the 10 most negative shares of the quarter, all of them reside within resources. The nightmare continues for these companies, with the new target being Glencore which was down 61% over the quarter. Glencore is both a miner (it owns stakes in various mines) and a trader where it trades commodities around the world. It is under pressure from all angles: a large amount of debt on the balance sheet (via a number of acquisitions) has created a panic amongst investors where sustained low resource prices may mean it heads into default. In addition, the business model of trading global commodities is under threat due to increased transparency in investment markets and buyers going direct to source meaning that this line of revenue could continue to diminish permanently.

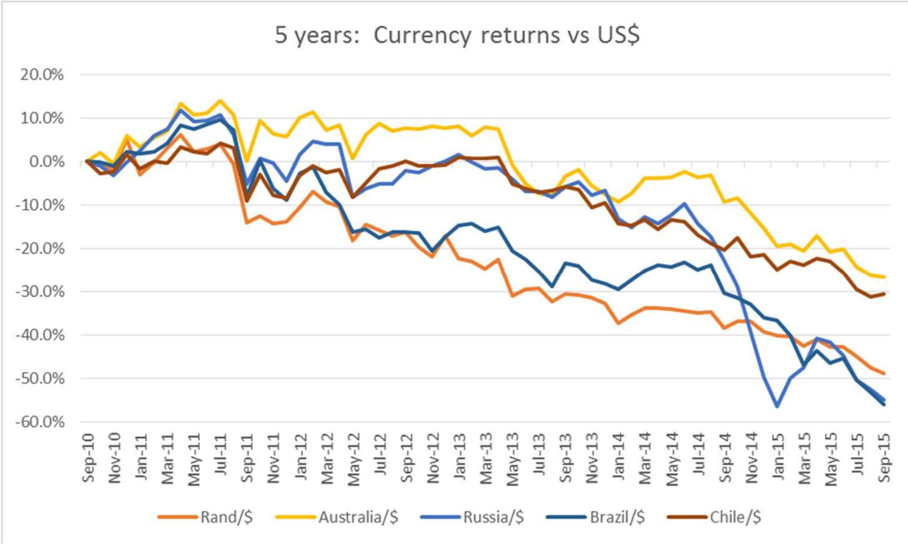
Lonmin - the world's third largest platinum producer - is another which was sold down (-83% over the quarter), effectively the market is pricing in bankruptcy. A few of the value oriented South African fund managers have been buying this share with the view that the platinum sector remains a long term viable investment. These managers are being severely tested in the face of such negative price movements.

On a positive front, SAB Miller was up 24% over the quarter as it looks to be the buyout target of AB Inbev, the world's largest brewer. The combined entity would almost create a global monopoly as the two companies share very little in terms of the markets in which they operate. SAB Miller is widely held across SA portfolios and will have boosted returns.

The key interest rate decision of whether to hike or stay put was put on a hold for another quarter – a stay of execution if you like. The world takes its lead from the US Federal Reserve (the 'Fed'), which decided to leave rates unchanged. This decision was contrary to a fair number of investors, but the fact that markets hardly responded tells us that this was largely priced in. The question now is whether or not the more likely rates increase decision in Q4 is also priced in?

As a result of the continued low interest rate environment, property stocks enjoyed another decent quarter, up 6% (+13%YTD). Property is still yielding lower levels than cash, so the onus on continued distribution growth and low interest rates does place it in a relatively precarious position.

The saviour for most SA investors was the weak rand – always a double edged sword as local returns are boosted, global purchasing power diminishes. Interestingly, the rand is no better or worse than other similar currencies, with all underperforming relative to the US$. It seems unlikely that SA has the macro-economic wherewithal to drive a strong recovery, so rand strength will more likely result from dollar weakness than any real turnaround locally.



In global markets, equities were weak with Developed down 5% (-4% YTD) and Emerging down 18% (-15% YTD) over the quarter in US$ terms – bearing in mind the strong dollar reduces the reported returns of non-US global equities (roughly half the market) and all of emerging market returns. The question for investors is whether or not the substantial discount on emerging market companies relative to developed is reflective of the underlying value. On a bottom up basis, there appear to be more opportunities available in EM markets than we see in developed – based on what fund managers are seeing in their respective markets.