

How do we overcome the 'SA Inc' hangover?

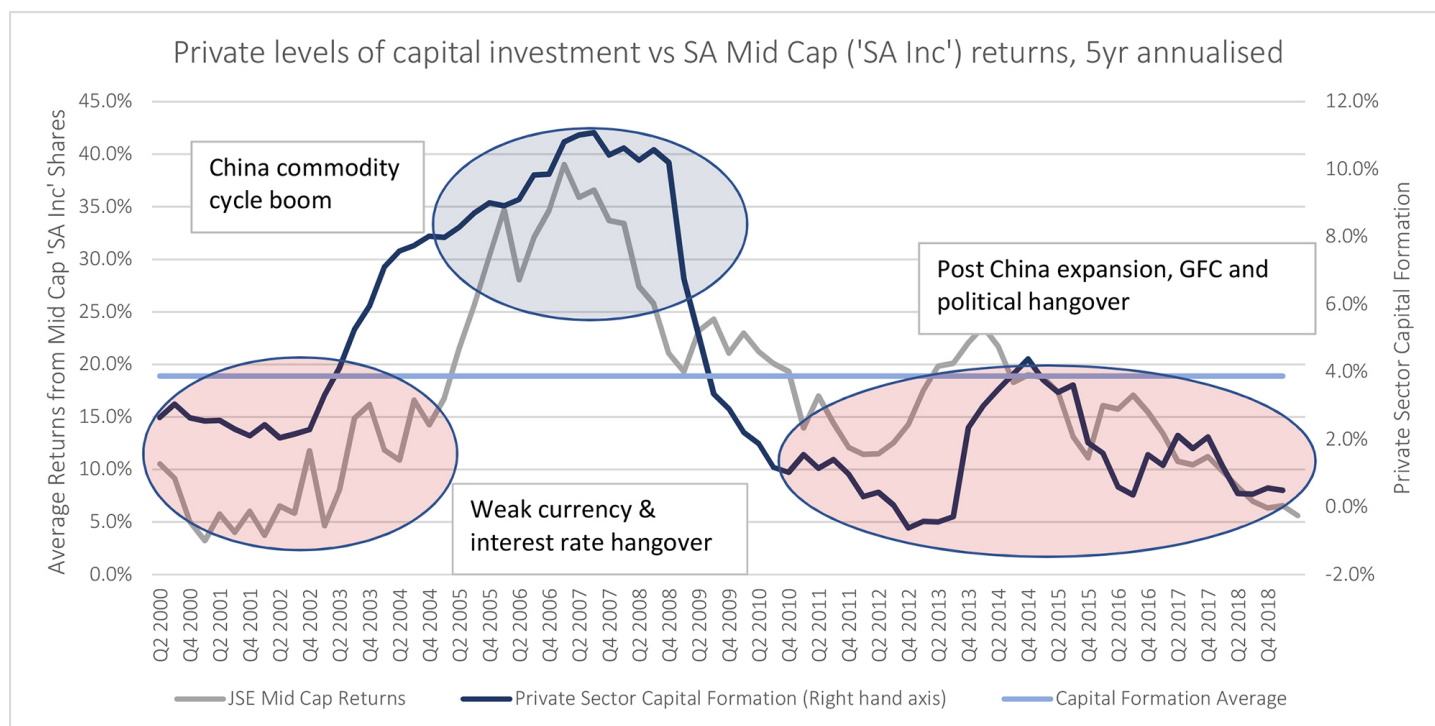
The fortunes of a broad number of counters on the JSE are closely tied to the health of the global economy. For these companies (the likes of Richemont, Naspers and British American Tobacco) they can appear immune from the issues we are having at home.

The balance of our equity market however is directly tied to the local economy – the so called 'SA Inc's' – where their success or failure typically relies on the health of more localised factors such as how much debt the average household is carrying, or general confidence levels and the appetite to spend.

For attractive equity returns from our 'SA Inc' shares, we require a healthy domestic economy – business, government and consumer.

For some time though, our economy has not been healthy and it should be no surprise that SA Inc equity returns have been weak for a protracted period. One of the health checks is to measure how much companies are investing locally for future growth¹. In the chart below, we can show how closely tied our SA Inc equity returns are to the capital investment cycle of private businesses, which we do over rolling 5-year annualised periods.

Since 1960, private companies in SA have grown their net capital investment by around 4% per year net of inflation. Since 2009 we have remained below this level – essentially a decade of underinvestment by private companies in future growth, which is the longest period of underinvestment we can measure. Worryingly, there are no signs yet of corporate SA spending the cash they have been hoarding for future investment.



*Capital investment by private businesses vs equity returns of domestically reliant companies:
1995 - 2019*

While it is quite easy to lay the blame game squarely at the foot of local politics, we are also quite clearly suffering from a protracted Chinese and Global Financial crisis induced hangover. Back in 2000/2001 SA Inc found itself in a similar predicament, where the hangover was brought on by a weak currency, high interest rates and inflation, low consumer confidence and low appetite to invest.

In this period, we also saw the persistent downgrading of the SA Inc shares, to the point where a broad swathe of the market was priced for bankruptcy.

The hangover cure at that point mostly relied on the largest commodity boom we have seen in history, driven by China's growth, which created 10 years of insatiable demand for our commodities. While the SA Inc shares are domestically reliant, they also benefit through the miners (who have a global client base) where they provide a range of support to the mining activities. This commodity super cycle was briefly cut short in 2008 when the property bubble in the US started to unwind through what we now call the 'GFC'². This too contributed to SA's hangover, with companies globally pulling back on their capital investment.

Increased optimism, a strengthening currency, strong economic policy and even drivers like the 2010 World Cup contributed to a period of significant positive sentiment in SA from 2002 which allowed us to get over the 20%+ interest rate hangover of the early 2000's. The net result for our SA Inc's was a five-year purple patch of performance, with average returns of 39% per year.

How does this compare to today? From a valuation perspective the range of SA Inc shares trading at lower valuations is significantly more than any point over the past ten years with 40% of them trading at a PE³ level below 10x earnings which is cheap. Excluding the GFC, we are closing in on the low valuation levels we last saw on the JSE in 2003. It is no surprise that the investment managers who performed well over this period are currently quite excited.

However, we still need to pass the health checks for these attractive valuations to bear fruit through improved earnings making their way through to investor returns:

What can unlock domestic equity returns?

The following items are health checks which have some role in creating the right environment for good equity returns in domestic shares:

Conditions for good future returns	Health Check	Pass/Fail
1. Low starting valuations on shares	We have a wide range of cheap shares compared to history.	Pass
2. High levels of Capital investment by corporate SA	We do not see evidence of this yet.	Fail
3. Low and stable Inflation	Inflation remains low, despite not being driven by domestic growth.	Pass
4. Low and stable or declining interest rates	Rates are high relative to inflation, but cutting these rates exposes our currency to weakness, which causes inflation.	Fail
5. Low levels of consumer debt	Consumers have trimmed debt since 2011, but levels are still high.	Fail
6. Stable and growing global economy	The global economy has had a reasonable period of expansion, we risk missing the party though.	Pass
7. Strong Government balance sheet	Overstretched, underfunded, mismanaged.	Fail

8. Stable and mid-value Currency/rand	The currency currently trades within a reasonable range to accommodate both import and export businesses.	Pass
9. Positive Sentiment	Business confidence remains at very low levels.	Fail
10. New avenues for growth	Aside from a growing middle market to service, nothing stands out.	Fail

So, while the conditions for good prospective returns are partially there, several items need unlocking. There is no doubt SA has made positive steps of late, and there has also been support from the global economy and the commodity cycle. But the key is the incentive for corporate SA to take on a positive mindset once again, but this time without the tailwinds of the Chinese growth story to give us a big foot up (and we certainly don't need any more headwinds like the GFC).

This leaves us with much more of an internal reliance than at any point in our history, and the structural weaknesses in our economy are exposed. From here on out our domestic shares will thrive based on their ability to adapt, innovate, expand and survive. Valuations are looking more appealing, in part because it is unclear how these areas unlock. So, while there is opportunity, the hangover remains.

With this in mind, we selectively consider the exposure clients hold in domestically oriented shares relative to the appeal of lower valuations, but bearing in mind the hurdles to be overcome. It pays to be cautiously optimistic at this point.

¹ We have used Gross Fixed Capital Formation to gauge this, as per Statssa.

² The Global Financial Crisis.

³ PE = Price to Earnings Ratio, a measure of valuation. Lower = cheaper.

data provided by Reuters and Datastream

30 June 2019

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	3.9%	12.2%	4.4%	6.9%	5.9%	13.5%	11.3%	12.2%
FTSE/JSE SA Listed Property	ZAR	4.5%	6.0%	0.8%	-2.3%	5.6%	13.0%	13.7%	13.4%
SA All Bond Index (ALBI)	ZAR	3.7%	7.6%	11.5%	9.8%	8.6%	9.0%	7.7%	6.9%
SA Cash Index (SteFI)	ZAR	1.8%	3.6%	7.3%	7.4%	7.1%	6.5%	0.2%	0.3%
Balanced Benchmark	ZAR	3.4%	10.4%	6.9%	7.2%	7.7%	12.8%	7.5%	7.7%
SA Inflation (1 month lag)	ZAR	1.7%	2.4%	4.5%	4.8%	5.0%	5.2%	1.3%	1.3%
GLOBAL MARKET INDICES									
Global Equity (Datastream World)	USD	4.2%	17.4%	6.9%	12.4%	7.2%	11.3%	11.7%	13.3%
Emerging Markets Equity (Datastream EM)	USD	0.7%	10.8%	1.6%	11.1%	2.9%	6.2%	15.8%	17.5%
Global Bonds (Barclays Global Bond Index)	USD	3.6%	5.4%	5.5%	1.0%	0.8%	2.2%	5.4%	5.6%
Global Cash	USD	0.6%	1.3%	2.6%	1.8%	1.2%	0.8%	0.3%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	3.9%	12.2%	4.4%	6.9%	5.9%	13.5%	11.3%	12.2%
Global Equity (Datastream World)	ZAR	1.9%	15.1%	10.0%	11.0%	13.4%	18.2%	15.6%	14.2%
Emerging Markets Equity (Datastream EM)	ZAR	-1.5%	8.6%	4.5%	9.7%	8.8%	12.8%	13.6%	13.4%
SA All Bond Index (ALBI)	ZAR	3.7%	7.6%	11.5%	9.8%	8.6%	9.0%	7.7%	6.9%
Global Bonds (Citigroup)	ZAR	1.3%	3.3%	8.5%	-0.3%	6.7%	8.6%	14.3%	13.7%
COMMODITIES									
Gold (US Dollars)	USD	9.0%	10.2%	12.9%	2.3%	1.4%	4.2%	13.0%	16.3%
Gold (Rands)	ZAR	6.6%	8.1%	16.1%	1.0%	7.3%	10.6%		
CURRENCIES									
Rand / Dollar	ZAR	2.2%	2.0%	-2.9%	1.3%	-5.8%	-6.2%	15.6%	15.1%
Rand / GBP Pound	ZAR	4.5%	2.0%	0.8%	2.9%	0.3%	-3.5%	16.4%	14.7%
Rand / Euro	ZAR	0.8%	2.3%	-0.3%	0.4%	-2.0%	-4.0%	14.6%	13.4%

Spot Rates		28-Jun-19	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US\$	Rand	14.10	14.10	13.71	10.64	7.72	6.03
Rand/GBP	Rand	17.95	17.95	18.10	18.19	12.72	9.52
Rand/EUR	Rand	16.06	16.06	16.00	14.57	10.83	6.22
RATES							
Libor 6m \$	US\$	2.20	2.20	2.50	0.33	1.11	5.65
Repo Rate	Rand	6.75	6.75	6.50	5.50	7.50	14.92
Prime	Rand	10.25	10.25	10.00	9.00	11.00	18.00
All Bond Index Yield	Rand	9.25	9.25	9.44	8.50	10.28	NA
COMMODITIES							
Gold (\$/oz)	US\$	1,412.30	1,412.30	1,251.13	1,316.93	938.05	261.15
Platinum	US\$	818.00	818.00	851.00	1,480.00	1,186.00	349.00
Oil (Brent Crude) \$	US\$	66.87	66.87	79.44	112.79	67.99	17.48
INFLATION							
SA Inflation	%	4.5	NA	4.6	6.7	6.9	NA

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