INTUITION

(n: immediate insight; receive knowledge by direct perception)

In this special edition:

- Understanding the recent turmoil

SPECIAL EDITION

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HARVARD HOUSE GROUP

MARKETS: UNDERSTANDING THE RECENT TURMOIL

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The February issue of Intuition had already been finalized when markets took a volatile turn for the worse in the last week of January. Hence we thought it might be useful to update clients with recent events in this "Special Edition" of Intuition.

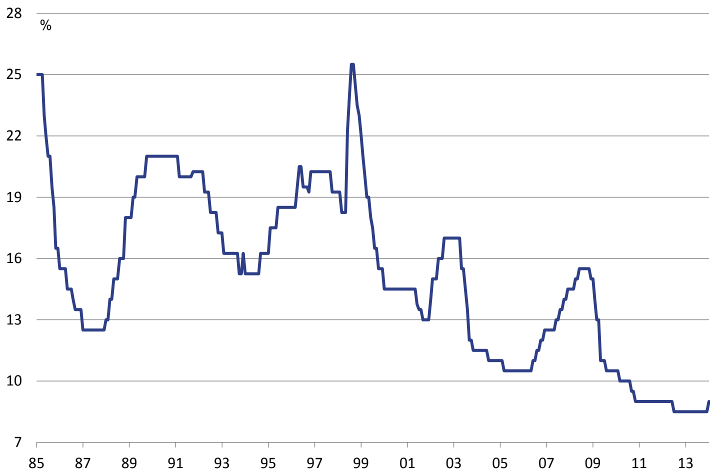
In our seminar late last year, we highlighted that local markets were expensive and in need of a period of consolidation. Yet we also made the case for an improving global economy and consequently, improving profits which would ultimately lead to firmer share prices. Those were our forecasts in late November. However, markets have started the year on an unusually volatile note. What are the reasons behind this volatility, and have they caused us to change our outlook for the year ahead?

The foundation for the current volatility was laid in mid December. After delaying the start of their tapering program, the US Federal Reserve did indeed announce the first slowdown to the rate at which they were printing money – a reduction of $10 billion per month from the level of $85 billion per month. Initially markets fell. But the reason behind the decision was that the US economy was improving. Various data releases towards the end of December (from both the US and Europe) confirmed a far healthier economic outlook. Shares rallied hard. So much so that many markets across the world (the JSE included) finished the year at record highs.

The first week of 2014 started where 2013 finished, but soon the euphoria started to fade. Economic data turned slightly more inconsistent, but turmoil struck Argentina. Its currency has tumbled 19% so far this year in reaction to a huge current account deficit and soaring inflation. Foreigners have been voting with their feet and abandoning the country in droves. Unfortunately Argentina is not the only vulnerable country. Nicknamed the "Fragile 5", Indonesia, Turkey, Russia and South Africa round off this unfortunate group of countries. All have large budget deficits (the government spending more than it collects in taxes) and large current account deficits (meaning that we are reliant on foreign capital to pay our local bills.) Why should this matter now? The US Federal Reserve has shaved a further $10 billion off its quantitative easing program, and the flood of money previously invested in emerging markets is reversing – quickly. Investors are rightly concerned about whether these countries can cope with an outflow of foreign investment.

The net result is that currencies have been exceptionally weak, and last week, central banks took action. Interest rates have been raised across many emerging markets. In particular, Turkey doubled its interest rates overnight – the night before our own Reserve Bank was due to meet to decide on interest rates. Locally, not one economist or investor expected a rate increase - our economy is already on its knees - but that is exactly what happened. Our prime rate of interest was raised by 0.5% - the first time that we have had an interest rate hike since May 2006 and the first change in interest rates since July 2012. That decision was met with disbelief by the market. Immediately, the Rand weakened further, and foreigners sold our shares aggressively.

PRIME INTEREST RATE

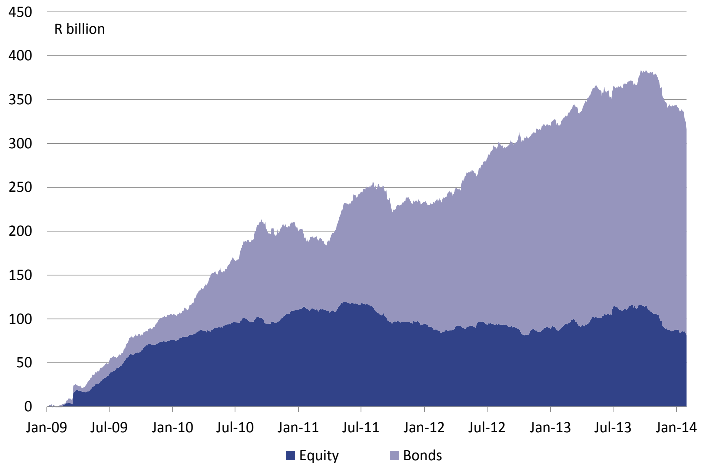


This is the first interest rate hike for seven years. Our concern is that it will not be the last.

What was the Reserve Bank thinking? In short, the Bank was concerned about the impact of the weak currency on inflation. Inflation is rising, and is expected to rise further over the next twelve months. So were they right to react? Unfortunately, and in our opinion, raising interest rates under such a scenario rarely has the desired effect.

Without boring you, the reason why it does not work is as follows: foreigners are invested here to benefit from the higher growth that emerging markets have to offer. Our economy is already weak and higher interest rates will only weaken it further. So foreigners sell aggressively and take their money away. The consequence is that the rand weakens further, fuelling inflation concerns and consequently prompting further increases in interest rates. So unfolds a vicious downward spiral of weak economies, weak exchange rates and high inflation - hardly an enviable position. Since October, when it became clear that the US would slow it QE program, foreigners have withdrawn R65 billion from this country alone. The momentum has gathered pace over recent weeks.

FOREIGN PORTFOLIO INVESTMENTS INTO SA



Foreigners have been selling their local investments and repatriating the funds overseas.

The turmoil has not been limited to emerging markets alone. Broadly speaking, equities across the world have fallen during January, and the currency turmoil is also making its presence felt in developed countries. Many large multinationals have operations across the world. Extreme currency movements are denting the profits earned in emerging markets when translated back into the company's home currency. So some of the world's largest and most reliable companies – stalwarts such as British American Tobacco, Diageo, Unilever (the list goes on and on) – are also finding their own share prices under pressure – thanks to issues far from their shores.

Where does that leave local investors? We remain very comfortable with our view that global economies are set for a solid recovery this year. Despite the slight weakness in January in some areas, on balance the momentum remains solid, as does the fall in unemployment – a critical component that ultimately fuels consumer spending and growth. Better global growth should be beneficial for emerging markets, once the dust has settled.

For local investors, the situation is slightly more complicated. It is useful to cast your eye back to the chart of the Prime Interest Rate. The last time that interest rates were raised to protect the currency was in 2001 / 2002, and before that in 1998. To be clear, we certainly do not expect anything like the reaction that prevailed in 1998. But what is clear from both prior examples is that one interest rate increase is seldom sufficient. More often than not, interest rates will rise several times before the dust settles. Having only expected the first rise towards the end of the year, that is a significant change to our outlook for the year.

During questions at our seminar held last week, we made the comment that the one thing that markets always react to is changing interest rates. Higher rates impact shares in two ways.

1. Higher interest rates slow the economy, which impacts on profits and dividends, and
2. Interest rates are a key variable in the calculation to value shares.

Both of the above are negatively affected when interest rates rise.

Let me summarise the situation so far:

1. Thanks to changing policy in the US, foreigners have been withdrawing their funds from emerging markets.
2. This in turn has caused currency weakness. Particularly hard hit have been the "Fragile 5" – those countries that rely heavily on foreign capital to pay the bills.
3. The Reserve Bank is concerned about the impact of a weaker Rand on future inflation, and has taken action – interest rates have risen by 0.5%.
4. Foreigners have taken fright, which has caused the Rand to weaken further with consequent implications for inflation. The concern is that interest rates will rise further before the dust settles.
5. Rising interest rates are negative for shares, both in terms of growth and valuations.

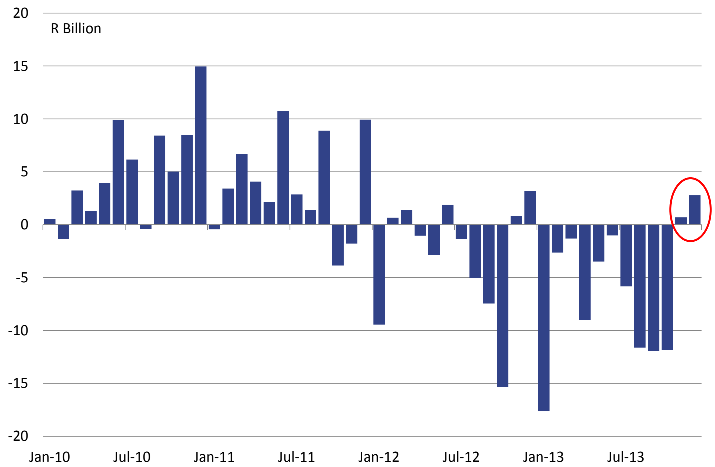
So far, the news does not sound very positive, but the outlook is never as one-sided as it appears. Clients will know that the bulk of our shares have expanded aggressively overseas, and so a weaker Rand is very beneficial for profits. In fact, we expect profits to grow at a rather healthy pace when companies start reporting their results this month and next. Coupled with lower share prices, valuations can return to more normal and attractive levels very quickly.

One area of the market that is affected is the listed property sector. We have spoken before about the correlation between the share prices of listed property shares and bond yields. Bond yields have weakened, and so too have the prices of listed property. But our core argument remains unchanged: changes in share prices do not affect the level of income distributed to shareholders. Capital property Fund is the only fund to have reported results so far. Its distributions were up 8.7% and it is forecasting growth of 9% for the next twelve months. We expect the sector as a whole to deliver growth in income to shareholders of between 7% and 9% in the next few months as reporting season gets underway. That is ahead of inflation. Like shares, falling prices and rising income distributions restore value extremely quickly. Twelve months ago, listed property was, on average, providing an income yield of 6.2%. Today, the average income yield is almost 8%. In our view, that is attractive for those seeking long term income from their portfolios.

The frustrating part of such periods in financial markets is that we often feel like a dingy boat on the ocean – buffeted around by the currents with little ability to make a difference and take control. One area that would improve sentiment and reduce concerns about the Rand is our trade account – our exports and imports. Having highlighted the dismal trade balance in several of our presentations, we note that the country has recorded a trade surplus (exports higher than imports) for the past two consecutive months. A few swallows does not make a summer, but if this trend continues, that will go a long way to improving sentiment on the Rand, and a stronger Rand would reverse much of the turmoil we are currently experiencing.

In summary, we all know that financial markets are volatile. Often our gut tells us that a period of weakness is coming, but we are often surprised by the trigger for such an event. Periods of volatility are never pleasant and it is only natural for anxiety to rise. But such periods are completely natural and part and parcel of long term investing. The next few weeks and months may well see markets gyrate from one

TRADE BALANCE



The Trade Balance has been dismal, but is a weaker currency finally starting to make a difference? It is too early to confirm a reversal, but this statistic is worth watching.

extreme to another – yet in our opinion, the case for a long term investment in equities and property remains as strong as ever. It does appear that inflation is rising, so we remain extremely wary of assets that deliver negative real returns. Furthermore, we see no reason for income from investments (dividends and interest) to decline. To the contrary, we expect income from investments to rise steadily, thanks in part to the translation of foreign profits back into Rands at a substantially weaker exchange rate. Consequently, client incomes are not in jeopardy. If clients do not draw income, then it will be reinvested at far more attractive levels, laying a strong foundation for future growth.

Clients are reminded that we are always available to chat through any specific issues. Please contact your financial consultant or portfolio manager if you have any queries or concerns.

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