INTUITION

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

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JANUARY 2015 VOLUME 12 ISSUE 1

HARVARD HOUSE GROUP

Empowering knowledge and insight exclusively from the Harvard House Group of companies

INTUITION
Market Insight from the Harvard House Group

2014: ENDING ON A VOLATILE NOTE

Michael Porter

Another year is fast drawing to a close. There seems to be a general consensus amongst clients and colleagues that it has been a busy year – most are looking forward to a few quiet weeks over the holiday period. We tend to have short memories, but looking back over2014, it has indeed been a busy and eventful year – especially for financial markets.

The year started on a weak note but that was expected given that markets globally closed at record highs on the 31st December 2013. However, growth concerns soon came to the fore and markets sold off sharply in late January. The Reserve Bank added fuel to the fire by increasing interest rates for the first time since May 2008. But the correction did not last for long. Better US data on unemployment set the tone for a rally that lasted five months and saw the JSE rise by 17%, despite various "speedbumps" along the way.

Whilst one feels that the full ramifications are yet to manifest themselves, one of the more important events of the year was the unrest in Ukraine. It did not take Russia long to annex the Crimean Peninsula and to back rebels in the east of the country. The global reaction has been to place ever tighter sanctions on Russia over the course of the year. This in turn has had a detrimental impact on European growth and the outlook for the broader European economy – and was certainly a contributory factor to the sharp correction in equity markets in September.

"The other major event for the global economy has been the dramatic shift in power in the oil industry."

The other major event for the global economy has been the dramatic shift in power in the oil industry. Under normal circumstances, export restrictions against Russia (a major oil exporter) coupled with a destabilising insurgency across the Middle East would have sent oil prices soaring, with negative consequences for global growth. However, the emergence of the US as a major oil producer (it will be the largest global producer this year, surpassing Saudi Arabia) has seen supply soar whilst demand is under pressure from weak Asian economies. Consequently, oil prices have plummeted. This should be beneficial for the global economy in 2015, but it is weighing heavily on markets in the final weeks of 2014.

2015 is likely to bring more volatility in the first half.

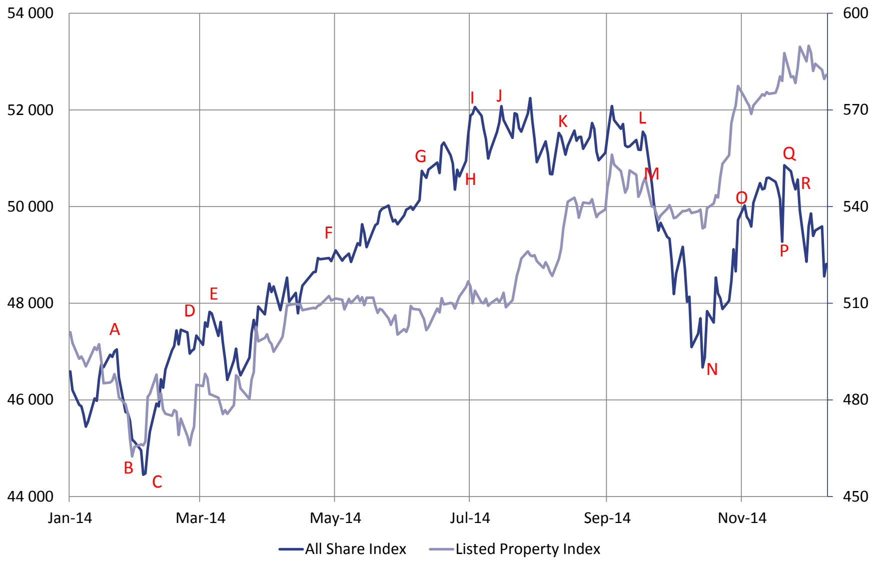
In between, we have had to contend with numerous issues. From a local perspective, the country has suffered one of its worst ever years for industrial action (platinum and steel sectors), we are facing pressure on our finances, and Eskom is in crisis (see next article.) As a consequence, the Rand has oscillated wildly and looks likely to end the year on a weak note given the unfolding power crisis and its impact on economic growth.

Over the past month we have been hosting various seminars on the outlook for 2015. Our near term expectation is that volatility is likely to rise over the next few months, and that does indeed seem to be unfolding. A quick glance at the chart highlights the extreme movements in the JSE recently. We expect this trend to continue into the new year ahead of possible changes to US interest rates. If nothing else, 2015 promises to be another eventful year. We look forward to keeping you updated every step of the way.

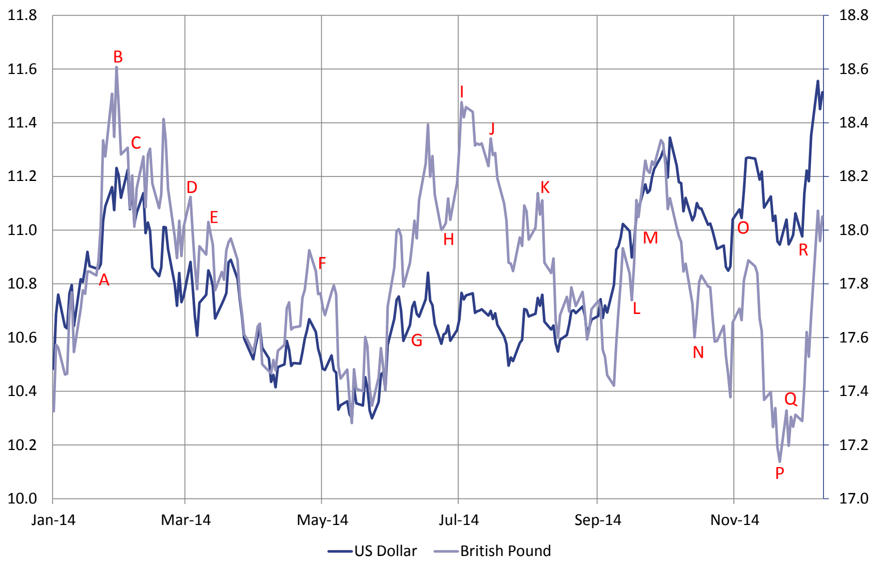
Annual Returns for 2014*	Local Currency	US Dollars
JSE All Share Index	3.9%	-5.9%
US S&P 500 Index	8.3%	8.3%
UK FTSE 100 Index	-6.6%	-11.4%
German Dax Index	0.5%	-9.1%
Japanese Nikkei Index	5.6%	-6.3%

** Returns until 12 December 2014*

JSE INDICES



THE RAND



A. Chinese and US economic data disappointed, prompting a sharp decline in markets. US shares fell to five-week lows. Incidentally, this was also the day that platinum miners embarked on a strike for higher wages.
B. South Africa raised interest rates by 0.5%.
C. A sharp fall in the US unemployment rate sent shares soaring, and sparked a global rally that saw the JSE gain 17% over the next five months.
D. Unrest in the Ukraine led to the annexation of the Crimean Peninsula by the Russian Federation.
E. Weak Chinese data and load-shedding from Eskom called a brief halt to the equity rally.
F. The US and Europe imposed sanctions against Russia.
G. Fitch downgraded South Africa's sovereign outlook.
H. The platinum strike finally drew to an end.
I. NUMSA embarked on an indefinite strike in the steel and metal industries.
J. South Africa raised interest rates by another 0.25%. The outlook for further increases was moderated, which ignited a rally in listed property shares. The next day, Ukraine rebels shot down a Malaysian airliner, which prompted tighter sanctions against Russia.
K. African Bank is put into curatorship.
L. Concerns about global growth, uncertainty over the Scottish Referendum and falling commodity prices sent equities falling worldwide. Weak data (China, US) and a fear that Europe was slipping back into recession in part due to Russian sanctions all weighed on sentiment. The JSE fell almost 10% in three weeks.
M. South Africa left interest rates unchanged, which laid the foundation for a further rally in listed property shares.
N. Better economic data from the US turned markets around. The US ended their QE3 program a week later.
O. A coal silo at Eskom's Majuba Power Station collapsed, which forced Eskom to embark on another round of load-shedding.
P. China unexpectedly cut its interest rates. Markets rallied.
Q. Eskom declared a national power emergency.
R. OPEC decided to keep oil output unchanged. Oil prices fell to their lowest levels in five years.

ELECTRICITY: WHAT CRISIS?

Michael Porter

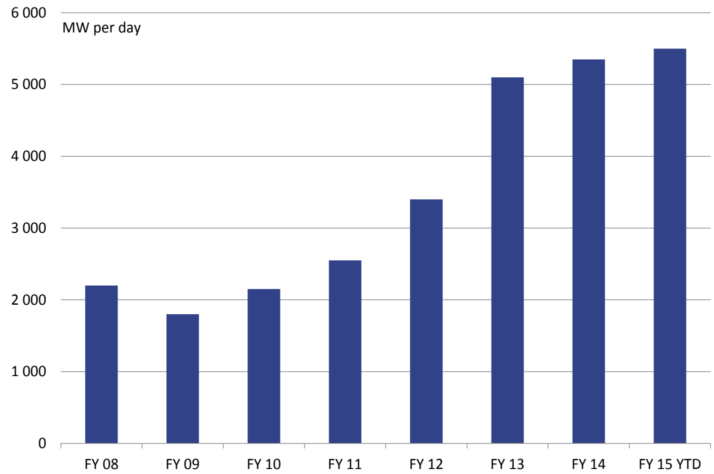
In June 2013 we wrote an article about the dire state of our electricity industry and wondered then whether the lights would stay on during the winter of 2013. At that time, Eskom was confident that Medupi – the new power station being built in Lephalale – would contribute its first power to the National Grid by December 2013. It is a year later and Eskom is only now starting to synchronise the first unit to the grid. Once synchronized, it will still be another six months before the unit will deliver consistent and reliable power to the system.

As we all know, the consequence of the endless delays in commissioning the new power stations has been load-shedding, and the rate of load-shedding has escalated in recent weeks. Not since early 2008 has load shedding been so pervasive and consistent. The first question is why? What has triggered the current crisis? In short, Eskom put the blame on the following factors:

1. Running their existing power plants too hard in an effort to keep the lights on, and in so doing, delaying critical maintenance.
2. Deterioration of quality of maintenance wrk.
3. 64% of Eskom's current baseload power stations are past their midlife, implying that more maintenance is required to keep them operating efficiently.
4. Extreme weather conditions.
5. Disruptions of fuel supplies to the power stations.

While these factors are undoubtedly valid, they raise a host of other issues. The lack of maintenance together with the steadily ageing profile of our fleet of power stations should be ringing alarm bells for anyone who thinks that load shedding is just a short term phenomenon. In our opinion, a critical point to note is Eskom's own admission that only 75% of our power station fleet is available at any point in time to generate electricity. This is down from 85% five years ago. The chart below shows the amount of power not available due to breakdowns and mechanical failures. Eskom points to the fact that the trend is slowing, but there is no talk of reversing it. In our opinion, the clear message from this chart is that the lack of maintenance is coming back to haunt Eskom. In an effort to keep the lights on, Eskom has either delayed, or simply ignored, the urgent maintenance that ought to have been done on a regular basis. As a result, power stations are failing and the level of absolute power that we can produce is dwindling. It should be rising. No wonder that load shedding is underway again.

POWER LOST TO BREAKDOWNS



Thanks to poor maintenance, power stations are breaking down, placing further strain on the balance of the system.

Unfortunately, Eskom finds itself in a vicious downward spiral. Demand for electricity is not really falling, but its ability to supply is severely constrained. There is a small amount of new power coming from various renewable projects, but these are small in relation to our total requirements and are not sufficient to alleviate the near term pressures. Hence Eskom is forced to run its existing power stations harder than ever, which further delays critical maintenance. The end result is additional breakdowns and loss of supply. This point is best illustrated by Eskom's two open-cycle gas turbine stations in the Western Cape. These plants, fueled by diesel, are designed to run for a maximum of 3 hours per day, to provide power over peak evening periods. At present, Eskom is being forced to run these plants for 17 hours a day. The implications are twofold. Firstly, they cannot maintain that level of performance indefinitely before they suffer breakdowns. Secondly, Eskom's diesel bill is soaring. Together, these power stations burned 140 million litres of diesel in November alone. That is proving to be prohibitively expensive. Eskom's diesel bill has soared, which is putting pressure on its overall finances, as well as putting pressure on the country's imports and the Rand. As the saying goes, "it never rains but it pours…"

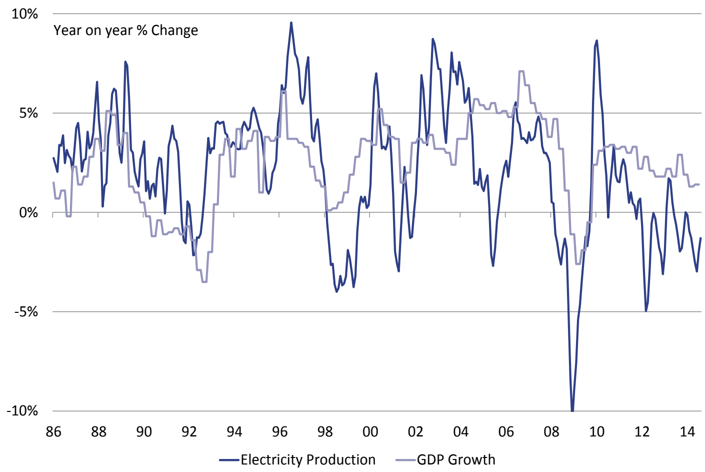
Ankerlig Power Station in the Western Cape. Eskom is being forced to run this station for 17 hours a day – well above its design capacity of 3 hours a day.

It is probably going to take another two or three years before there is a meaningful increase in power generation from the new power stations of Medupi, Kusile and Ingula. Until these new projects start to make a meaningful contribution, Eskom will have its back against the wall. Maintenance is likely to be reactionary rather than proactive and the state of the existing fleet is likely to deteriorate further. However, it is not clear that the situation will improve, even once these new stations are up and running. At that point, we assume that Eskom will be forced to take some of the older plants off the grid for expensive and protracted maintenance and upgrades. That implies that we could easily have a constrained power system for the next five years. Whilst we, as consumers, might groan at the inconvenience of periodical load shedding, the impact on the country as a whole is far more important.

Modern economies run on electricity. Without electricity, economies cannot grow or function. It really is as simple as that. The chart below highlights the close correlation between GDP growth (the light blue line) and electricity production since 1985. As one would expect, the correlation is tight. Since March 2012, we have experienced declines in the level of electricity produced. The rate of growth has been negative. It is no coincidence, in our opinion, that this has coincided with the weakest level of GDP growth for fifteen years. Apart from the strikes, our economy is hamstrung by the fact that there is no surplus power. Developers and businesses do not get approval for new projects unless they can demonstrate a high degree of power self-sufficiency.

Based on our comments above, we are concerned about the outlook for GDP growth over the next few years. Our country is facing pressures from every angle – not least of all the ratings agencies who are continually assessing our economy and the government's ability to raise taxes and repay debt. A lack of GDP growth only accentuates those pressures. Foreigners have sold over R10 billion of our bonds in the last week alone (mid December) due to concerns that South Africa might indeed be downgraded after all. This highlights the broad-based impact of the Crisis – it is not just cold dinners and dark rooms.

GDP GROWTH & ELECTRICITY PRODUCTION



The amount of electricity that we produce is declining, which bodes ill for GDP growth in the years ahead.

What can we, as investors, do to mitigate the impact of this situation? Firstly, we believe that corporate South Africa has long been aware of the looming slump. We have mentioned on numerous occasions how rapidly companies are expanding offshore in search of new opportunities. Hence our leading companies are becoming less and less reliant on our own economy – a welcome trend under present circumstances. Furthermore, we have had a deliberate strategy for some time now of reducing reliance on local companies in favour of those with broader global operations. Given high local valuations and the prospect of a weak economy for a few years yet, we see no reason to alter this strategy.

We live in hope that Eskom will deliver some good news over the course of 2015. But at a recent press conference to update the country on load shedding, Eskom's CEO started his presentation with the following comment: "There is no crisis at Eskom. I think the way Eskom gets reported on creates the perception of a crisis." As every addict knows, you can only start to address a problem once you acknowledge that a problem actually does exist. Disappointingly, we don't appear to have yet reached that point.

THE DAILY NEWS

Nigel Porter

There is never a shortage of bad news. The reason for this is quite simply that bad news sells, in whatever form it is published, whether on TV, newspapers or magazines. Everyone would like to hear good news, but editors rarely publish good news because it is not eye catching and does not increase circulation.

The following quote from "The Week" magazine is significant: "The situation in Iraq and Syria gets worse by the week. Events in the Ukraine prompted one Dutch editor to talk about the summer of hate. In West Africa the worst ever outbreak of Ebola has killed more than 10 000 people and is proving difficult to bring under control. The editor of "Today Programme" admitted that there has been a fall in listening patrons, especially among younger people, and blame this on a surfeit of depressing stories, such as the beheading of captives by Isis".

South Africans would very easily add a long list of woes which greet us every day. The current battle cry is that "Zuma must go, and sooner rather than later". Eskom is clearly a contender for booby prize of the year. We all know about the poor or non-existent delivery of service in all spheres of Government. We also know that the Rand is weak against other currencies, and those who have to buy foreign currency find it a painful exercise.

So why do we bother to mention this topic at all? The main reason is that there is a lot of good news out there and we need to keep a balanced view of events in order to be able to make rational decisions in respect of investments. We think that this is pertinent because an increasing number of clients are debating in their own minds whether South Africa will become another Zimbabwe, with wholesale confiscation of land without compensation, and with hyper-inflation destroying the currency with the consequent total collapse of the economy.

We advise clients that we remain optimistic at Harvard House. The glass is three quarters full rather than half empty and we need to read between the lines and continually look for the positive news. It may come as a surprise to some clients that we think this way, but having analysed companies, we have to be confident that the companies will perform well, so that we in turn can deliver performance to our clients. We have stated so many times that countries are quite different from companies and if the board of directors of a company forecast that there will be an increase in earnings as a result of their management of a company, then why should we not also be optimistic?

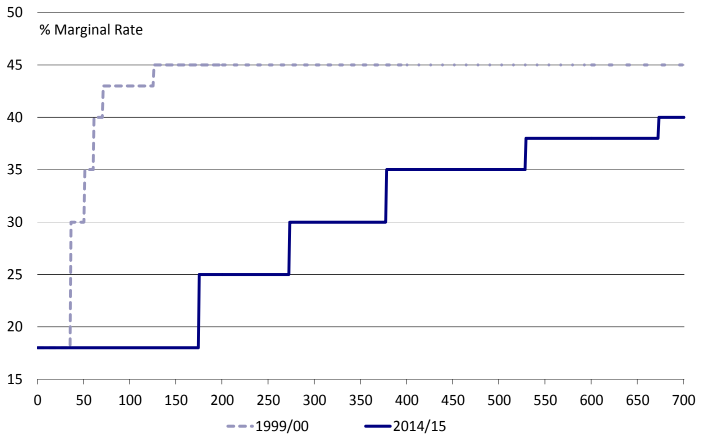
Just think about the following items of good news which will ring bells with many clients, but which are often forgotten because the daily publication of bad news tends to push the good news into the back ground.

1. The JSE all share index hit a low point of 18 465 in February 2009. It has been rising for six years and is still trading close to its peak of 52 060, on 4 July 2014.
2. Interest rates are close to 35 year lows. The Reserve Bank did raise rates by 0.5% on 29 January 2014, and then by 0.25% on 16 July 2014, but current rates are at manageable levels. Does anyone remember that interest rates were locked in a range of 12% - 25% for nearly 25 years. Most of us paid interest on our mortgage bonds of 18% - 22%, and that interest was not deductible for tax purposes. That really was an intolerable burden for parents with children to educate.
3. The price of oil has dropped to $ 64 per barrel. That is the lowest price for five years. The current price has caused Sasol and BHP Billiton to fall in price, but focus on the good news. Oil is the engine of the world economy, and if the key ingredient is at its cheapest

price for five years, then economies around the world will benefit, and have a greater opportunity for growth.

4. We think that the rate of taxation on individuals might rise in the 2015 budget (February 2015). Does anyone remember when the top rate of tax on personal taxation was 72%? A top marginal rate of tax of 40% is not avaricious by historical standards.

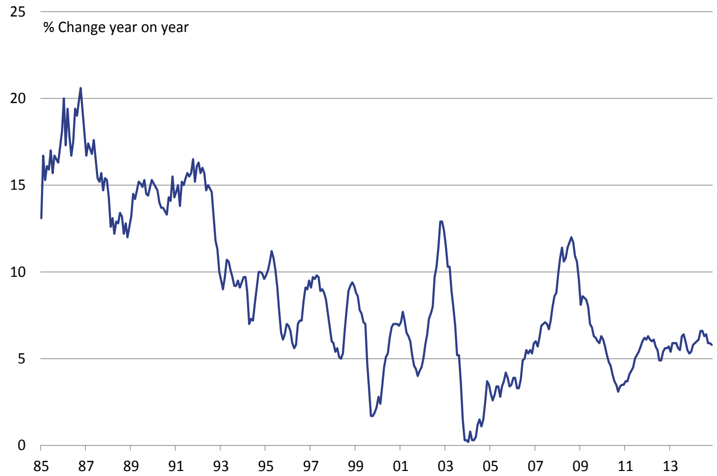
MARGINAL TAX RATES



Back in 1999 the top marginal rate was 45% and it was reached at an annual ncome of R127,000

5. Prior to 1997, no South African resident could take money offshore for investment purposes. Yes, under the National Party, we lived with outrageous restrictions. Now each individual person may invest R4 million offshore. A family of four adults can invest R16 million offshore. Furthermore each one of us may take R1 million offshore each year for travel, education, gifts and other social purposes. That is really good news.
6. We all worry about inflation, and rightly so. We need to counter the reduction in the purchasing power of money by investing in assets which grow their value in excess of the rate of inflation. Our current rate of inflation is 5.8%. Does anyone remember 1980 when interest rates hit 20% in USA because of rampant inflation? We routinely suffered rates of inflation from 13% - 20%. There was a time when Porter Purbrick (CA SA) raised salaries by 10% every six months, in order to keep pace with inflation. Accountants learnt the rules of "inflation accounting" whereby assets were revalued every six months, and both the balance sheet and the income statement were adjusted by an "inflationary index". Thank goodness those days are over.

SA CPI INFLATION



Present rates of inflation are well below those that prevailed in the 80s and 90s

7. Inflation is less than 6% p.a. Many quality companies pay a tax free dividend of 4% (after deduction of the 15% withholding tax). An investor only needs to earn capital gains of 2% in order to keep the purchasing power of money intact. That is a simple challenge, and we at Harvard House like to think that we are equal to the challenge.
8. Companies continue to report very satisfactory increases in profits. Our job is to do our homework and invest in companies that can still prosper in difficult times. Just remember that times are always uncertain. That is what the risk / reward ratio is all about. It is ever present in the markets, every trading day. It is the job of directors to manage companies so that they come out on the winning side. Recent winners include Aspen, Bidvest, First Rand, BAT and Woolies. Laggards that have found the going tough include mining stocks such as Anglos and Platinum stocks, and construction stocks such as Aveng and Murray & Roberts.

There is good news all around us. Does the bad news dominate your life? Every person reacts in a different way, but our optimism is a key building block in the management of portfolios that produce satisfactory returns for our clients.

Anyone for a drink? Our glasses are three quarters full – Cheers!

INSIGHT

Market Updates from the Harvard House Group

INSIGHT SEMINARS: KZN MIDLANDS & JOHANNESBURG

Harvard House has been blessed with both a steady inflow of new clients over recent years, as well as enjoying the loyalty of long-standing clients. We are extremely grateful for both trends. Our January presentation will take a step back from the “noise” of financial markets to reiterate and reaffirm our investment philosophy and approach to investments. Why do we do the things that we do?.

Please RSVP to Annalie Robins on 033 3302164 or annalier@hhgroup.co.za. Please note that we will host two seminars in Natal – one morning session and one evening session in order to alleviate congestion and make the events more accessible. Please take note of the morning venue, the Amber Valley auditorium.

	Natal Midlands - Morning	Natal Midlands - Evening	Johannesburg - Evening
Topic:	Understanding the Harvard House Approach		
Date:	27th of January 2015	27th of January 2015	n/a
Venue:	Amber Valley Auditorium Amber Valley	Fernhill Hotel Midmar / Tweedie Road (almost opp entrance to Midmar)	
Time:	10am for 10.30am	5.30pm for 6pm	

CONTACT DETAILS

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