SYGNALS

DECEMBER 2015

KEY INDICATORS

		1 MONTH	3 MONTHS	6 MONTHS	1 YEAR	2 YEARS	3 YEARS	5 YEARS
J203T	J203T FTSE/JSE All Share Index	-1.7%	1.7%	-0.5%	5.1%	8.0%	12.3%	13.0%
J200T	J200T Top 40	-1.1%	2.5%	1.0%	7.5%	8.3%	13.0%	13.2%
J210T	J210T Resources 10	-1.9%	-19.7%	-33.2%	-36.4%	-26.5%	-17.8%	-11.8%
J211T	J211T Industrials 25	-0.1%	7.3%	9.0%	17.9%	17.6%	24.0%	25.0%
J212T	J212T Financials 15	-6.1%	-3.3%	-6.1%	1.1%	13.7%	15.7%	17.9%
J403T	J403T FTSE/JSE SWIX Index	-2.9%	1.3%	-2.9%	3.6%	9.4%	13.0%	14.2%
J303T	J303T FTSE/JSE CAPI Index	-1.7%	1.7%	-0.4%	5.2%	8.1%	12.4%	13.1%
J253T	J253T SA Listed Property Index	-6.1%	-4.7%	1.3%	8.0%	16.9%	14.0%	17.0%
ALBI	JSE All Bond Composite Index	-6.7%	-6.4%	-5.4%	-3.9%	2.9%	2.1%	6.1%
STFIND	STeFI Index	0.5%	1.6%	3.2%	6.5%	6.2%	5.8%	5.8%
	MSCI All Country World Index	-1.8%	5.0%	-4.9%	-2.4%	0.8%	7.7%	6.1%
	Rand/ US Dollar Exchange Rate	7.2%	11.8%	27.0%	35.0%	22.2%	22.6%	18.5%
	Rand/ Euro Exchange Rate	10.4%	8.7%	24.1%	20.0%	7.9%	14.9%	13.7%
	Headline CPI	0.1%	0.3%	1.8%	4.8%	5.3%	5.3%	5.5%
	PPI	0.1%	1.3%	1.9%	4.3%	5.4%	5.5%	6.5%

"Fortunately, many South African institutions, most notably the courts, have not been suborned by Mr. Zuma or his cronies, providing a foundation on which to rebuild an honest and competent government. For that to happen, the ANC must examine itself and the ravages of more than 20 years of continuous power."

The New York Times Editorial, 20 December 2015

MARKET OVERVIEW

December was a conspicuous end to what has been the most difficult year for stock markets since the global financial crisis. Apart from the spectre of the US Federal Reserve increasing interest rates, oil prices fell to below US$37 a barrel, other commodities followed, the ECB and Japan disappointed with insignificant quantitative easing measures after stoking expectations, US high-yield bond funds faced record outflows and, closer to home, credit rating agencies downgraded South Africa, while President Jacob Zuma unilaterally plunged the country into an economic and financial crisis.

The snapshots of 2015 are:

- The S&P 500 lost 0.7% as the strong US dollar punished US corporate earnings.
- Japan's Nikkei Stock Average rose by 9.9% as the central bank's two-year easing campaign weakened the yen.
- The Stoxx Europe 600 index ended the year up 6.4% despite the eurozone flirting with deflation through the year.
- China's Shanghai Composite Index rose by 8.6% even though it lost more than 40% of its value mid-year.
- The MSCI Emerging Markets Index fell by 14.9% in US dollar terms, with emerging markets bearing the brunt of China's slowdown and the sell-off in commodities. Foreign investors have withdrawn a net US$500 billion from emerging markets in 2015, the first annual outflow in decades.
- The MSCI All World Index fell by 0.9% in US dollar terms.
- South Africa's FTSE/JSE All Share Index ended the year up 5.1%, with the rand plunging by 35.0% against the US dollar and the All Bond Index down 3.9%.
- The gold price fell for a third successive year on an upward tilting US interest rate cycle. Gold offers no income, making it less competitive than yield-bearing securities such as US Treasuries. Gold ended the year down 10.4%, its lowest level since February 2010.
- Other commodities had a tough 2015. Copper ended the year 25% lower, iron ore 43%, platinum 26% and silver 12%.
- Oil prices capped a second year as one of the worst-performing commodities, as a global glut of crude continued to weigh on the market. After plunging from more than US$100 a barrel to nearly US$50 a barrel in 2014, the price of US crude fell over 30% in 2015 to below US$37 a barrel. Brent, the global benchmark, fell 35% to $37.28 a barrel.

China continued to slow down in November with the official manufacturing PMI falling to a three-year low of 49.6. Foreign-exchange reserves declined more than expected, exports fell for the fifth consecutive month and industrial profits contracted as industrial overcapacity and China's real-estate market continued to weigh on the economy. Only retail spending, a bright light, continued to hold up well, rising by 11.2% year-on-year in November. A government conference listed a number of economic priorities for 2016 including reducing industrial overcapacity, slashing the stockpile of unsold homes, lowering costs for businesses and mitigating financial risks. The Chinese government is targeting minimum growth of 6.5% for the next five years in order to double per capita income over 2010 levels by 2020, a core political promise. Although more quantitative easing measures are on the horizon, it is unlikely that the economy will show any improvement until the second half of 2016.

The eurozone is holding up better than expected with the Markit manufacturing PMI rising to 52.8 last month. Inflation remained unchanged at 0.1% year-on-year. The ECB announced that it will reduce its negative deposit rate from -0.2% to -0.3% and extend the existing bond buying programme by six months, disappointing the market.

Similarly, the Bank of Japan's announcement of buying bonds with longer maturities and purchasing 300 billion yen annually in exchange-traded funds was seen as too little. Japan's inflation rate came in at 0.1% year-on-year in November, a far cry from the targeted 2%.

The data from the US was more mixed with manufacturing activity and industrial production weaker than expected, but better housing and unemployment data. The ISM manufacturing index fell to 48.6 from 50.1 in October, slipping into contraction territory for the first time since 2012. On a positive note, 211 000 jobs were created in November, while the unemployment rate remained unchanged at 5.0%. 100 000 jobs per month are needed to absorb new entrants into the labour force. Anything above that number creates jobs for the currently unemployed. The labour force participation rate edged up to 62.5% last month. The US dollar continued to strengthen as the divergence of monetary policies between the US and the eurozone, Japan and China led to large inflows of money into US Treasuries.

Although the markets largely focused on the mid-December US Federal Reserve meeting, commodities, in particular oil, US high-yield bond funds and concerns about China contributed to destabilising sentiment.

US high-yield bond funds saw large outflows on concerns about corporate borrowing levels and emerging market debt.

Weak trade data from China, and the People's Bank of China's decision to guide the yuan lower by setting the official yuan/US$ exchange rate at its weakest since 2011, fuelled speculation that the economy may be more fragile than expected.

OPEC, which produces a third of the world's oil, ended its meeting without any agreement to restrain production, while the US agreed to lift a 40-year ban on oil exports. This was an historic move signifying a boom in US oil drilling, with US production up 90% since August 2008. This sent oil prices below US$37 a barrel. US Congress banned oil exports following the 1973 Arab oil embargo which sent domestic gasoline prices skyrocketing. Robust production for the US, Saudi Arabia and Russia, as well as the expectation of Iran's oil coming online, continue to create imbalances. Inventories of crude oil in the US stand at eight-decade highs as producers continue to pump oil at high rates to maximise profits in a low-price environment. Apart from Nigeria and Venezuela, even the wealthy Gulf Arab states are feeling the effects. Saudi Arabia, Kuwait and Bahrain all raised interest rates in a scramble to protect their currencies. Goldman Sachs believes prices could take a drop to as little as US$20 a barrel for supply to adjust to demand.

Commodity prices fell further after Anglo American announced 85 000 additional job cuts and a sweeping restructuring of its business in response to a prolonged commodity-prices slump. Anglo's plans include asset sales, large cost cuts and a suspension of dividend payments. The share price tumbled 10.7% to R72.76, its lowest level in 15 years. Kumba Iron Ore, majority owned by Anglo American, followed by announcing it will cut output by 28%.

The US Fed's eventual increase in its key interest rate from a range of 0% to 0.25% to a range of 0.25% to 0.5% seemed an anti-climax. Most significantly, the move signalled the end of monetary easing cycle. And despite the US Fed indicating that it will move slowly, investors' attention immediately switched to predicting the timing of future increases. The US Fed raised its expectations for growth next year to 2.4% and lowered its projection for unemployment to 4.7%. Inflation is next expected to reach the 2% level in 2018.

2016 is going to be a very tricky year from an investment perspective. Interest rates in the US are expected to continue to increase, bringing more volatility to emerging markets. No recovery is expected from China, a factor which will continue to take its toll on the world economy and commodity prices. No recovery is on the horizon for oil, although expectations of Iran coming online might be premature. South Africa's potential demotion to junk credit status, a crunch review of France in April and the risks posed by Britain's Brexit vote to decide on its European Union membership tops the list of dates to mark on the 2016 credit rating calendar. It will be a year of volatility and uncertainty for the South African markets. In terms of Sygnia's positioning, we will hold the maximum allowable amounts offshore, steer away from corporate bonds, down-weight bond exposure further and look for any opportunities to invest in structures which preserve capital while delivering above cash returns. Our focus is on risk diversification and capital preservation, rather than on maximising growth.

360 DEGREES ROUND THE WORLD

GERMANY: The yield difference between German and US bonds serves as a stark reminder of the diverging paths of two of the world's major central banks. In the wake of the US Fed's decision to increase interest rates, the yield on US two-year notes climbed above 1% for the first time since 2010. German two-year yields, in contrast, have not been above zero since August 2014. The Bundesbank kept its 2016 growth outlook unchanged at 1.8% after the ECB unveiled its December stimulus measures.

UK: According to the Centre for Economics and Business Research, the UK is set to become the best-performing economy in western Europe next year and is likely to overtake Germany and Japan as a global economic leader in the 2030s. Britain is benefitting from the strength of its IT and software industries, as well as its culturally diverse workforce. The UK is currently the fifth largest economy in the world, with a GDP of US$3 trillion this year, behind Germany at US$3.3 trillion, and Japan at US$4.1 trillion.

RUSSIA: Russia's economy contracted by 4.0% in the year to November and the ruble lost over 40% of its value relative to the US dollar as weak oil prices and US and European sanctions continue to take their toll.

SWEDEN: Few places are tilting towards a cashless future as quickly as Sweden, which has become hooked on the convenience of paying by app and plastic. This has alarmed consumer organisations and critics who warn of a rising threat to privacy and increased vulnerability to sophisticated internet crimes.

GREECE: Greece confirmed that it is likely to miss its privatisation target next year. Under the terms of the July bail-out agreement, the Hellenic Republic Asset Development Fund aims to raise €3.7 billion from asset sales in 2016 and €1.3 billion in 2017. Privatisation projects target the sale of airports, ports, railways and land.

SPAIN: The elections in Spain resulted in a hung government as Prime Minister Mariano Rajoy's conservative Popular Party fell short of winning a majority and needs to form a coalition government. During the past four years under Rajoy, Spain's economy emerged from recession and grew by 3% in 2015, but discontent over low wages and unemployment above 20% have spilled over into voting patterns. The political gridlock is expected to drag on into 2016.

JAPAN: The Bank of Japan expects the 2020 Olympic Games in Tokyo to lift GDP by an average 0.2% to 0.3% each year between 2015 and 2018. The unemployment rate is forecast to fall to 2.5% in 2018 from 3.3% in 2015.

MALAYSIA: Malaysia's ringgit fell by 19% against the US dollar in 2015, its biggest annual decline since 1997, as plunging oil prices and a political scandal involving Prime Minister Najib Razak clouded the economic outlook. 22% of Malaysian government's revenue derives from energy-related sources.

BOTSWANA: Botswana's economy officially entered recession, shrinking by 3.7% quarter-on-quarter, and 3.5% year-on-year in the third quarter as diamond and copper production plunged.

BRAZIL: Latin America's biggest economy is forecast to shrink by 2.8% in 2016, after contracting by 3.7% in 2015. Brazil is reeling from the end of the global commodity boom and its own political crisis. The far-reaching probe into an alleged US$2 billion embezzlement scandal at the state oil firm Petróleo Brasileiro SA has implicated top politicians and businessmen, paralysing policy-making and parts of the economy. President Dilma Rousseff faces impeachment for improper budget account and may not survive the year. Brazil's real has fallen by over 30% relative to the US dollar, a fact that will no doubt please foreign tourists planning to attend the 2016 Olympic Games in Rio de Janeiro.

ARGENTINA: Voters in Argentina elected the conservative former Mayor Mauricio Macri as president in November, rejecting a candidate backed by former President Cristina Kirchner, who nationalised industries and imposed currency controls. Macri is Argentina's first non-Peronist president in more than a decade and was elected on promising to end policies of leftist populism and revive the South American country's ailing economy. Macri moved quickly, lifting currency controls, eliminating most agricultural export taxes and announcing new investments in the energy sector. However, going forward, the new government is expected to face strong opposition from Peronists who control both the Congress and powerful labour unions.

VENEZUELA: In oil-rich Venezuela, voters elected an opposition coalition to a majority in Congress, a rebuke of 17 years of "Chavismo," the socialist movement begun by the late Hugo Chávez. The coalition, which takes office in January, said it will focus on fixing the economy mired in triple-digit inflation. However, the existing president, Nicolás Maduro, and his Socialist Party have vowed to stop new policies.

MOZAMBIQUE: Mozambique's central bank raised its benchmark policy rate by 1.5% to 9.75%, its highest level in three years to help curb inflation which surged to 6.3% in November after its currency plunged 36% against the US dollar in 2015.

SOUTH AFRICA

December was a watershed moment for South Africa as the business sector, civil society and the ANC, finally stood up to President Jacob Zuma. The markets welcomed the return of the Minister of Finance, Pravin Gordhan, who promised to focus on fiscal discipline.

The moving chair of the ministry came at a massive cost to the rand and the bond market. The rand lost 7.2% against the US dollar in December, while the BESA All Bond Index was down 6.7% as investors voted with their feet. Equities, and in particular the financial sector, plummeted. The rand ended the month at R15.4/US$, 35.0% down in 12 months, and 10-year bond yields at 9.5%.

The true cost of this foolishness will come next year with higher inflation, interest rates and unemployment, and lower investment and growth.

In fact, money started leaving the country early in December after Moody's changed South Africa's credit rating outlook to negative, while Fitch cut the country's grade by one notch with a stable outlook. Both agencies quoted weak growth and high debt levels as the main factors. All three rating agencies now rank South Africa at their lowest investment grade rating, one notch above junk.

While on the topic of debt, the Cabinet approved the nuclear procurement programme, clearing the way for the Department of Energy to call for proposals to provide South Africa with nuclear power. No cost-benefit analysis has been done, despite several independent studies having found that the cost of new nuclear energy will be greater than energy produced by other technologies. The funding model will form part of the procurement process.

The economic indicators showed continuing weakness with manufacturing activity, as measured by Barclays manufacturing PMI, plummeting to a six-year low of 43.3 in November. Consumer inflation rose to 4.8% year-on-year in November, from 4.6% in October, as did the producer price inflation at 4.3% year-on-year. The current account deficit widened to 4.1% of GDP in the third quarter on the back of weaker exports and more expensive imports.

On the corporate front, the PIC increased its stake in Lonmin from 7% to almost 30% in a clear effort to protect jobs. Lonmin's deeply discounted US$407 million rights issue was undersubscribed. MTN's Nigerian fine was reduced to US$3.9 billion which the company will challenge in a court of law. Naspers successfully raised US$2.5 billion from institutional investors to fund further expansion into e-commerce. And finally SAA's chairwoman Dudu Myeni lost the battle to restructure the airline's Airbus swap deal, which could have threatened the financial stability of the airline.

ODDS AND ENDS

A PR OPPORTUNITY NOT TO BE MISSED?

Celebrating the birth of his daughter, Facebook founder and CEO Mark Zuckerberg announced that he plans to give 99% of his Facebook shares to philanthropic efforts over the course of his life. The shares are currently valued at US$45 billion. Although this is merely a pledge at this point in time, the announcement amplifies the impact of the Giving Pledge, an initiative launched by Bill Gates and Warren Buffett in 2010 that has persuaded 138 billionaires to give away at least half their wealth to charity. In 2006, Buffett was the first billionaire to pledge to donate 99% of his wealth to philanthropy during his lifetime or at his death. He is estimated to have given away more than US$25 billion to date.

YET ANOTHER CLIMATE AGREEMENT

Yet another climate agreement was struck by 190 countries in Paris. The agreement is a collection of voluntary plans submitted by every country to tackle climate change. Most plans focused on shifting to renewable energy sources such as solar, wind and nuclear power and away from carbon-heavy fuels, such as coal and oil. Unfortunately the plans in aggregate do not meet the level of cuts in greenhouse-gas emissions that the agreement itself targets. The conference's goal was to limit global warming to below 2 degrees Celsius above pre-industrial levels. The plans are also not legally enforceable, a condition demanded by the US.

WHAT HAPPENS WHEN YOU WANT TO EXIT ILLIQUID BONDS

Sygnia has been increasingly wary of the illiquidity in the corporate bond market in South Africa. Effectively, the bond market is frozen in that one can buy new corporate bond issues, but one cannot sell. Asset managers disingenuously refer to this as the "primary" and "secondary" markets, with only the "secondary" market being frozen. December brought the dangers of illiquidity into focus when high-yield bond funds in the US posted their largest drop since 2011 in one day. The spread between bid and offer prices stood at 10%, and there were few buyers. One of the largest high-yield bond unit trusts, the US$788 million Third Avenue Focused Credit Fund, halted investors' withdrawals. The fund had US$3.5 billion in assets as recently as July 2014. High-yield bond funds, by definition, need to invest in more risky corporate bond issues and emerging markets debt to generate “higher yield”. As commodity prices have dropped and with looming prospects of higher US interest rates, the appetite for risk has lowered. At the same time the credit quality in speculative-grade debt has been falling, while some companies with high levels of debt have started defaulting on their debt. Interestingly, most commentators now refer to the “high-yield” bond funds as “junk-bond” funds, implying by definition that investors should have known that the two labels are synonymous. Did you?

US INFLATION

Despite increasing interest rates, the US Fed faces a growing dilemma of falling unemployment but no sight of inflation. Low inflation stalls growth in wages and profits, while making debt more difficult to pay off. Since 1992, the US Fed’s policy has been premised on a belief that central banks could control inflation via interest rates. The financial crisis deflated that confidence. Confronted with low inflation and no growth, central banks slashed interest rates and printed money to buy bonds hoping to push down yields and hence encourage households and businesses to borrow. While the world’s major developed economies started to grow, inflation has not. The eurozone faces an annual inflation rate of 0.1% with 1.9% growth in output from a year ago, the UK has minus 0.1% inflation and 2.3% growth over the same period, Japan 0.3% inflation and 1.1% growth and the US 0.2% inflation and 2.2% growth.

A number of explanations are being bandied about. Low oil prices have certainly helped to dampen inflation. Government spending has been cut to control budget deficits. In Japan a theory based on demographics has been gaining popularity. Japan’s aging population seems to have unleashed powerful deflationary forces by lowering expectations of growth, straining the government’s budget and putting a growing proportion of Japanese consumption in the hands of older people who draw on savings rather than younger wage earners.

The real question is, if interest rates cannot be used to manage inflation, what can?

Sygnia would like to take this opportunity to thank all of its clients and investors for their support and trust in 2015. We are deeply committed to managing your savings and to delivering top performance irrespective of market conditions. We wish you all the best for 2016. May the force of change sweeping South Africa be with you.

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