Your Quarterly Report

2nd Quarter Market Insights

South Africa
We've reached the half way mark of 2017 and there has been no shortage of market moving events. Domestically, it would be hard to capture all the local news flow in this quarterly commentary, suffice to say that the lack of leadership in South Africa has taken a severe toll on the economy and more importantly on the sentiment of local citizens. Blatant looting and corruption of the country's wealth has been in full view, unabated and unchecked.

In early April, President Zuma axed Minister of Finance, Pravin Gordhan, sending ripples through South Africa's financial system. The move precipitated credit rating agency Fitch to follow in S&P's footsteps and downgrade SA's sovereign credit rating to junk. The downgrade made Fitch the first of the agencies to cut the rating on SA's rand denominated debt (local-currency) to junk status.

At the end of May, the South African Reserve Bank held its repo rate at 7%, despite core inflation being close to the midpoint of its target range. Policymaker hawkishness can be explained by political uncertainty which could weaken the currency and erase the recent improvement in inflation dynamics. South Africa also entered a recession for the first time in eight years, piling pressure on a government facing corruption allegations and credit downgrades. South Africa's economy contracted by 0.7 percent in the first three months of 2017 after shrinking by 0.3 percent in the fourth quarter of last year, lagging market expectations.

On the back of this news on June 9th, Moody's announced that it had downgraded the country's long-term foreign and local currency debt ratings one notch, and gave it a negative outlook.

Sources: S&P Global Ratings, Fitch Ratings and Moody's Investor Service

The table illustrates that South Africa's local-currency rating is one notch away from junk status (it will be junk status if either S&P or Moody's downgrades our local-currency rating by one notch or more), whilst the foreign currency rating is already junk status. Reviews by S&P and Fitch loom in early December and if S&P should downgrade our local-currency by one notch to junk status, then approximately 20% of the R600bn of local-currency bonds owned by foreign investors would be liquidated. This would place huge pressure on our bond market and the rand.

Foreigners look at comparative real yields which is currently close to 3% in South Africa (SA 10-year Bond Yield [R186] – inflation) compared to a real yield of 0.25% in the US and negative yields' in Germany and Japan. Foreigners have been net buyers of SA's bond market (coming in at R48bn as at the end of May). These foreign portfolio holdings and inflows would be at risk due to mandate restrictions, forcing foreigners to exclude non-investment grade bonds from their investment universe.

South African equity markets have felt the full brunt of slowing economics and political turmoil. The JSE has had a torrid time as foreigners have been net-sellers and local market participants have been sitting on the side-lines trying to determine what "bomb-shell" will hit next. Some high-quality businesses are now trading at attractive valuations; financial markets crave certainty and at present there is little in the local market. The rand continues to benefit from a weaker USD and continued bond buying by foreigners – the "blind" search for yield.

Globally
The US-led economic cycle has been long and slow, US economic data has been mixed, although jobs numbers are strong and corporate earnings have surprised to the upside. US investors have been buoyed by corporate earnings, positive election outcomes in the European Union and a weaker US dollar driving US financial markets to new record highs.

As expected, the Federal Reserve (Fed), announced at its 14th June meeting that it would increase the target range for its federal funds rate by 25 basis points, to 1.00%-1.25%. Markets appeared cautious on this stance due to recent weak economic data out of the US.

This is the Fed's fourth short-term rate increase in the current expansion and its third increase in the last six months. Market indicators reflect some doubt about the Fed's forecast, implying about a 40% chance of at least one more hike this year but a low likelihood of three increases in 2018.

President Trump grabbed headlines on numerous occasions over the quarter which included his controversial travel ban, his first state visit to the Middle East and Europe, pulling the US out of the Paris Climate Accord and the firing of FBI Chief James Comey, sparking considerable outrage and causing the dollar to weaken.

In Europe, elections in France proved to be uneventful with the preferred candidate Macron convincingly beating far-right candidate Le Pen. Whilst Theresa May's decision to hold a snap election turned out be an embarrassment with the Conservative Party winning 318 seats but falling 8 seats short of an outright majority. Her gamble to secure an election manifesto of a "strong and stable leadership" she felt necessary to deliver Brexit, clearly backfired.

Tensions on the Korean peninsula continued to mount with more ballistic missile tests, sparking international alarm and straining relations among China, Japan, North Korea, South Korea and the United States.

China had a series of weak economic readings over the quarter suggesting a recent pick-up could be fizzling. The government's efforts to rein in the country's ballooning debt starting to weigh on future trade data. During the quarter, ratings agency Moody's downgraded Chinese government bonds, citing concerns of the level of debt in the economy as well as the lack of progress in financial reforms.

Broad Market Returns over the quarter

Index Returns	Q2 2017		2017 (YTD)	
	U.S. Dollar %	ZAR %	U.S. Dollar %	ZAR %
MSCI World	3,2%	3,4%	9,5%	3,9%
JSE All Share Index	-1,9%	-1,7%	7,00%	1,5%
JPMorgan Global Bond	0,0%	0,1%	0,30%	-5,2%
SA All Bond Index	-0,2%	-0,2%	5,70%	5,7%
SA Listed Prop	-1,9%	-1,6%	4,90%	-0,5%
Global REIT	2,3%	2,5%	1,90%	-3,4%
ZARUSD	4,0%	4,0%	-5,9%	-5,9%

As at 28 June 2017

Conclusion

Key drivers of global growth continued to be centred around a US-led global recovery. US and European corporate earnings continue to be a positive beacon in an otherwise mixed minefield of economic data. The recent outcome of key European elections will go a long way in allaying investor fears of an imminent collapse of the European Union.

China continues to be a region of concern, especially given its ballooning debt and overall lack of transparency. North Korea's advancing missile program, ahead of previous estimates, has put Kim Jong Un's unpredictable regime three to five years away from achieving its ambition of being able to deliver a nuclear weapon to the US. President Trump has made it clear that the US will not accept a nuclear power in North Korea and a threat that can target the United States and target the American population.

The new emerging threat of global cyber-attacks is fast becoming one of the biggest worries for businesses around the world and could cost organisations billions if not managed.

We will continue to monitor these and other risks as they develop but our focus will remain on ensuring that we manage well-constructed portfolios that are not unduly exposed to a single outcome. In our view, now more than ever will the importance of considered portfolio construction be essential.

We appreciate your support and trust in managing your wealth.

The Strategiq Capital Team.