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Melville Douglas

High Alpha Fund

Quarterly Commentary

2018 has proved a disappointment for equity investors. After a strong start, equity markets stumbled and have not recovered to January highs. In fact, the US is the only major market to have delivered a positive dollar return in the first six months. Pressure on emerging markets worsened. During the quarter the JSE was able to deliver a return of 4.5%, led again by resources which were up just under 20%. The outflows from emerging markets were part of a global retreat which affected the JSE and the bond market, and the rand fell almost 14% over the quarter. This brought it back in line with other EM currencies so far this year. As far as the fund is concerned, it delivered a return of 1.4% for the quarter, behind the benchmark which achieved a return of 4.9%. Some of the underperformance was driven by the underweight position in resources. We have an overweight position in financials which had a very difficult quarter. Financials poor performance was generally across the board given the growth and emerging market risk caused by potential trade wars.

The combination of weaker growth outside the US combined with higher US tariffs and threats of retaliation created a painful dislocation for export and commodity economies. The direct impacts of the tariff spat are modest, but the worry is that there is more to follow and confidence and market pricing are already adjusting. Part of the Chinese response to US tariff moves has been to allow the renminbi to depreciate, which adds to the pain for other emerging markets. That has been especially true for economies running current account deficits, which have needed to maintain more restrictive monetary policy (including SA). The slow patch outside the US has been much more extended than economists expected; now they think it will start to lift in the second half of 2018, which will be a key driver for South Africa. SA has been faced not only with external headwinds but the exposure of the costs of cleaning up post-Zuma: a reversion to fiscal stability will take some time, but the right moves are being made, including at state-owned companies. The political difficulties are substantial, most obviously as far as wage negotiations are concerned, but many of the right steps are being taken. Investors are for now more inclined to focus on the risks (Mining Charter, land reform), but equity valuations have changed substantially without a material undermining of the earnings outlook so far. In real terms the rand has weakened to levels that will boost export earnings and activity (weaker levels are associated historically only with global recession or the worst of the Zuma era). Equity ratings have dropped to much more attractive levels and what was an expensive market earlier in the year is producing some interesting valuations. If Europe and Japan can revert to stronger growth, markets will recover and export demand will help SA. The spotlight put on the complications and costs of restoring normality to SOEs and other government institutions has diverted investors' attention, and the US's trade policies have no historical precedent in the modern era and so there are both local and global risks. Our central view is that global growth will recover; political progress and receding inflation threats will at some point enable the Reserve Bank to assist recovery, or at least stand still, whereas markets are pricing for interest rate increases. We thus think that SA can play some catch-up with the rest of the world and a stronger cycle can take hold. Timing is very uncertain, but we have already taken advantage of cheaper valuations to ensure the portfolio will benefit.