Melville Douglas

Dynamic Strategy Fund

Quarterly Commentary

The quarter was a strong one for equity. The JSE more than recovered from the June quarter's rout which followed the cabinet "reshuffle". Over the quarter, the portfolio's equity slightly underperformed the market, mainly because it was underweight basic materials (though the holdings did very well) and Naspers, and had some poor performers in IT and healthcare.

The year has been remarkably good to investors. That is thanks to the favourable global backdrop: strong economic growth, accommodative central banks, sustained recovery in corporate earnings and continued low interest rates. South Africa has had astonishing challenges, mainly political, but because markets had already adjusted for the deterioration last year, returns have been satisfactory, even if they have not kept up with other emerging markets, which have been the star performers so far this year. The economy should be performing much better in this global environment, and even though Q2 GDP growth rebounded from recession, it was narrowly based (agricultural recovery mainly) and the transmission from strong global demand to domestic demand is not working because household and business confidence have been badly undermined.

Globally, the central bank debate has moved on from "whatever it takes" determination to create growth, to worrying about the emergence of inflation and the need for a gradual change in policy to avoid disruptive changes later. This means the world will be different in 2018, and there may be higher volatility as the impact of central bank action becomes less certain.

At home, South Africa's governance challenges have become all too clear, among them the financial weakness of state-owned enterprises, which now threatens the sovereign credit rating. The latest bailout of the national airline is obviously damaging, but in the short run it is the only answer, given the threat that default would pose. The presentation of the Medium Term Budget in October will be important for what it reveals regarding government's commitment to fiscal stability and plans to return floundering state-owned entities to financial viability, but the challenges are substantial: tax revenues are under severe pressure. Late in the year there are the challenges of the ANC's elective conference and scheduled reviews from credit rating agencies.

The fact that the domestic economy should by now be responding very healthily to the strong global environment, but remains stuck, is purely down to the impact of politics on interest rates and confidence. The Reserve Bank is forced to keep real interest rates high to maintain stability. Household and corporate finances are in a healthy state and the banking system could easily fund a cyclical upswing, but demand will stay weak until confidence returns, which requires a sensible political outcome. The rest of the year and 2018 may prove somewhat more volatile than 2017 so far. Valuation and diversification are paramount.

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