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PRIVATE WEALTH
Newsletter - July 2017 7/25/2017

## Interest Rates

The Reserve bank announced last week that REPO Rate will be reduced by 0,25% - this is effectively the interest rate that the Reserve Bank charges when it lends money to other banks and this then has a knock-on effect on the interest rate that banks charge on loans (and offer on deposits).

Officially the Reserve Bank is tasked with trying to keep inflation within a band (3-6%) so as inflation rises so the interest rate is increased to try to reduce demand in the economy (less demand for credit as it is more expensive).

The latest move is as a response to the recent decline in inflation - official CPI is now within the target band at 5,01% while at the same time the local economy is really struggling (SA is officially in a recession after two successive quarters of negative growth).

The actual magnitude of this rate decrease is not likely to have a significant impact in itself except to possibly improve consumer sentiment. It hopefully signals that we have moved into a "rate-cutting" cycle although realistically there is not much scope for any significant cuts in the future.

If rates are cut too much then this is likely to reduce the attractiveness of SA Bonds for foreigners who are currently investing based on the higher interest rates they can earn in SA (vs Europe/US especially). This risk is heightened by the fact that any further downgrade of SA WILL trigger the forced selling of a SA bonds by foreigners.

## Currency Revisited

The Rand has proved to be surprisingly resilient over the past year or so following the dramatic collapse at the end of 2015.

We all love to attribute the movement of the currency to the most recent political drama (and there have been many), but the reality is that this only drives the very short-term ups and downs seen day-to-day. Over a longer period, the Rand is highly correlated to changes in commodity prices.

Over the past 18 months there has been an overall improvement in commodity prices (iron ore, coal etc) and as SA is a large producer of these goods so there is an increased demand for "Rands" as the prices rise.

At the same time, the weak local economy has also seen a reduced demand for imported goods and this has reduced the trade deficit.

As I have made it clear before, I cannot see the future and knowing where the Rand will be trading requires a crystal ball. I do however think that the Rand at current levels has an uneven probability distribution for possible outcomes.

Offshore exposure is important for diversification but at the same time it is also important to be aware that offshore exposure can introduce volatility as it is not only the asset prices but also the currency which impacts the Rand value.

## Sequence of Returns

Fund fact-sheets for various unit trusts all have one common flaw. They all present lovely graphs which show what would have happened if you had invested in the fund at the inception and simply left your money invested for a period. Unfortunately, in the real world there are a number of different scenarios most of which don't involve simply investing a lump sum and leaving it there.

Pre-retirement investors would typically be investing on a monthly basis whereas post-retirement investors would be drawing an income by selling units each month. This would be all well and good if there was no variability of returns, but in the real world there will be good years and bad years no matter how well diversified a portfolio.

This "sequence of returns" can make a big difference to the ultimate outcome. It is possibly easiest to illustrate by way of example. In this example I will show a 10-year hypothetical return sequence but with 2 different scenarios simply reversing the order of the returns.

| Year | Scenario 1 | Scenario 2 |
|---|---|---|
| 1 | 6% | 18% |
| 2 | 5% | 13% |
| 3 | 1% | 17% |
| 4 | 9% | 12% |
| 5 | 9% | 10% |
| 6 | 10% | 9% |
| 7 | 12% | 9% |
| 8 | 17% | 1% |
| 9 | 13% | 5% |
| 10 | 18% | 6% |

The simple "arithmetic" average return for both scenarios is 10% per year, but the actual outcomes are as follows for different "investors"

**<u>Lump Sum Investment of R100,000</u>**

There is no difference and for both scenarios you would have R256,700 at the end of year 10 – an annualized return of 9,89%

**<u>Regular Investment of R10,000 at the start of each year</u>**

Scenario 1: R194,164 at the end of year 10
Scenario 2: R156,404 at the end of year 10

**<u>Regular withdrawal of R10,000 each year</u>**

Scenario 1: R62,536 left over at the end of year 10
Scenario 2: R100,299 left over at the end of year 10

In the case of the regular investment, it is "better" to achieve the good returns once you have built up the capital whereas for someone drawing an income it is better to get the good returns early on.

Nobody can control the sequence of the returns, but there are ways, especially for investors drawing an income, in which the risk of a poor sequence can be mitigated. Remember though that ultimately the exposure to "risk" assets is necessary to ensure inflation beating returns over time.


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# Market Flash

30 June 2017

### Asset Class Performance (ZAR)

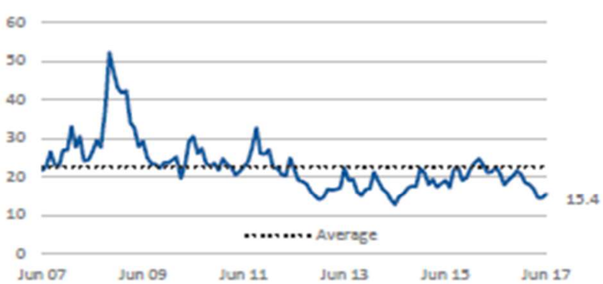

| Asset Class | Index | YTD | 1 Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| Local Equity | FTSE/JSE All Share | 3.4 | 1.7 | 3.4 | 12.2 | 9.3 |
| Local Property | FTSE/JSE SA Listed Property | 2.3 | 2.8 | 13.2 | 13.8 | 14.3 |
| Local Bonds | Beassa ALBI | 4.0 | 7.9 | 7.1 | 6.6 | 8.3 |
| Local Cash | STeFI Call Deposit | 3.4 | 7.0 | 6.3 | 5.8 | 6.7 |
| Global Equity | MSCI All Country World | 6.0 | 5.7 | 12.8 | 22.4 | 10.6 |
| Global Property | MSCI ACWI/Real Estate | 4.5 | -7.6 | 12.0 | 17.9 | 7.7 |
| Global Bonds | JPM GBI Global Traded | -0.3 | -14.5 | 6.7 | 9.9 | 10.5 |
| Global Cash | ICE LIBOR 1 Month | -3.8 | -9.9 | 7.6 | 10.2 | 7.3 |

### ZAR vs Euro

Over the last 20 years the Rand has weakened on average by 5.67% per annum against the Euro. YTD the Rand lost around 3.4% against the Euro, mainly due to SA economic and political instability. R 100,000 invested in July 1997 in euro's, would have given you € 20,200. Today, that would be worth R 302,000.


### SA Stock Market Volatility – SAVI

Volatility is the price change an index experiences over time. Stable price means low volatility and vice versa. Volatility tends to decline as stock markets rise and increase as stock markets fall. Some investors prefer lower volatility, though it often results in lower returns. As illustrated below, SA stock market volatility has been relatively low over the last few years, indicating that our market is currently on the expensive side.




### SA Market Review

During the first week of June we saw a drop in the 2017-Q1 GDP of 0.7%, putting SA in a technical recession. Negative market sentiment was exacerbated by the release of a controversial mining charter and a public protector report that appears to have called for changes in the SARB mandate.

These factors all contributed to the SA equity market (ALSI) falling by 3.5% in June, reducing its overall YTD performance to 3.4%. The largest detractors during June came from the Industrial sector (-4.2%), which posted its worst monthly performance since August 2015. The downturn was led by Consumer Services, with Travel and Leisure down by 6.9% and Media by 6.3%. In addition, Healthcare (-4.9%) and Construction (-5%) also weighed on the market. SA resources also struggled (-3.1%), with the worst performance coming from Gold Mining (-9.5)%.

Bonds and cash, with YTD total returns of 4.0% and 3.4% respectively, have fared relatively better, or in line, with the SA equity market YTD.

### Global Market Review

Global stock markets delivered robust gains in Q2-2017 driven by:

- Stronger earnings growth
- Improved global economic data
- Diminished political uncertainty in Europe

Global stock market returns for the Q2-2017 were:

- MSCI World Ex US + 5.0%
- MSCI Emerging Markets + 6.3%
- US S&P 500 + 3.1%

US stock indices rose to new highs during the quarter with Healthcare stocks leading the way. Meanwhile, the US Federal Reserve raised its benchmark rate with 25 basis points in June, to 1.25%. We also saw oil prices having a volatile quarter on concerns about higher than anticipated global supply.

Finally, global bond prices moved higher during the quarter, boosted by stronger demand and possible waning concerns about inflation.



Sources : Data has been sourced from Morningstar, and reflects market data as at 30 June 2017.