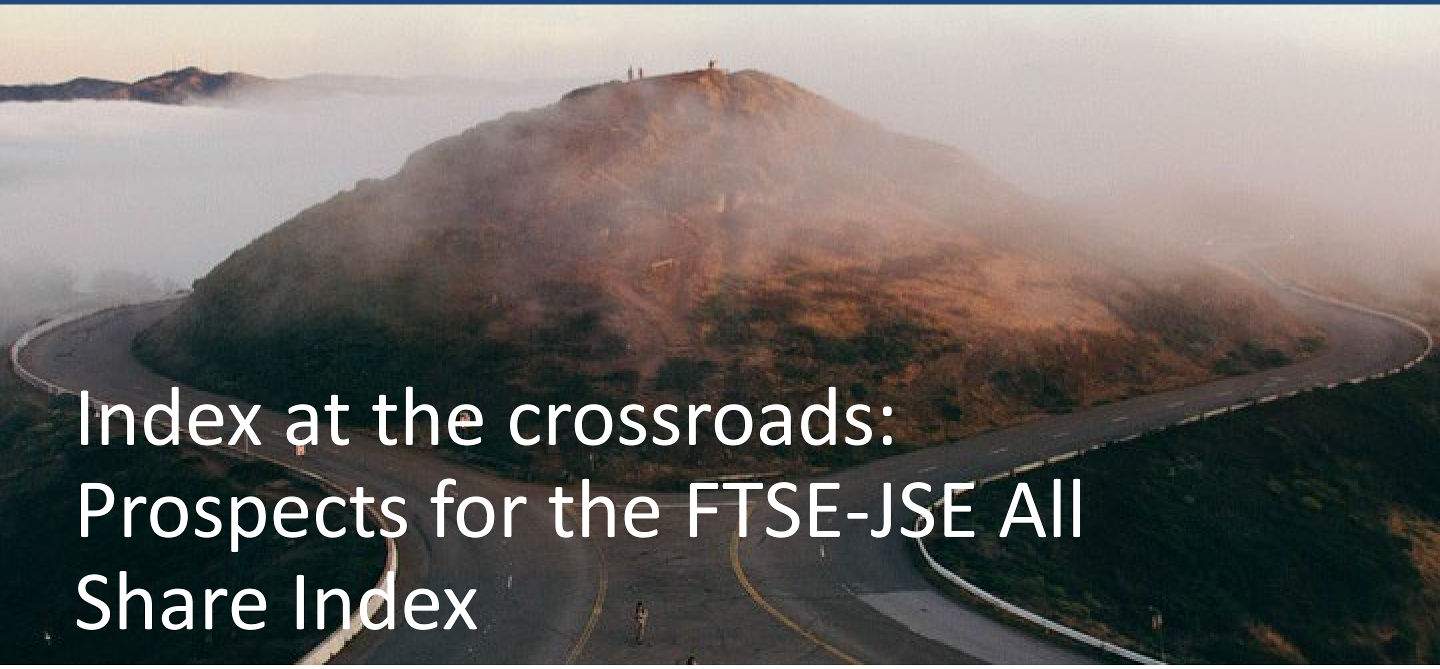

Index at the crossroads: Prospects for the FTSE-JSE All Share Index

Last week this commentary wrote about Emerging Markets (EM) represented by the MSCI EM Index and an Emerging Market currency basket and concluded that after years of underperformance, EM equities were looking cheap relative to their own history and relative to developed market equities. In addition, emerging market currencies looked cheap as measured by standard deviation from its 10 year mean.

This week we delve into the specifics of the Johannesburg All Share Index. At the outset it is important to note that the JSE All Share Index and the commonly used Top 40 Index are not good reflections of the attractiveness of listed South African companies. This is the case as 37% of the All Share Index and 40% of the Top 40 Index comprises just 3 shares which conduct their business globally but happen to be listed in South Africa. These companies are Naspers, Billiton and Richemont - known as the Three Global Titans.

What about the other 166 companies that comprise the remainder of the All Share Index? Once again many of these companies have diversified their businesses to a greater or lesser degree offshore. However, it can be argued for simplicity's sake that any company that earns 60% or more of its revenue from or has 60% of its asset base in South Africa and Africa, is dependent upon the fortunes of the respective countries. Many of these companies are trading in several cases at the same price as 5 years ago. The All Share Index excluding the Three Global Titans is trading at a 20% discount to its 5 year average. This can be a combination of a derating of the sector or company as well as a decline in earnings. In part these go hand in hand as the weaker the prospects for earnings growth, the lower the rating the company attracts – this is a global phenomenon. Of late, many, predominantly South African focused consumer and industrial companies, have reported either interim or final results. Examples include; AVI, Vodacom, KAP, Imperial, Barlows, Motus, Shoprite, Spar, Woolworths, The Foschini Group, Nedcor, FirstRand and Standard Bank. These are, on the whole, all well managed companies participating across various sectors of the South African economy. All have struggled to show meaningful earnings and /or dividend growth, and for the most part their outlook statements talk of continued tough times.

Foreigners have been net sellers of South African equities including dual-listed shares for the past 4 years. The pace has picked up in the past 15 months with R60bn sold in 2018 and R25bn in the first 10 weeks in 2019, even when Emerging Markets are now attracting equity inflows. Conversely, the large South African domestic fund managers have actively added, in the 4th quarter of 2018, to South African equities (3.1%) and bonds (0.9%) while rotating out of offshore holdings (2.4%) and cash (1.4%). This seems to imply that domestic fund managers are expecting a positive outcome from the May elections in terms of policy action and certainty which can improve business and consumer sentiment. Foreign investors seem to be /are taking a different view and are further reducing their already underweight South African positioning. We know that most Emerging Market investors are underweight in South Africa due to its poor longer term growth outlook. The IMF summarized the issues in a report last year stating that bold structural reforms are urgently needed to reignite strong and inclusive growth. These include tackling corruption and strengthening governance, promoting competition in the product markets and including the restructuring of the weak state-owned enterprises.

Continued overleaf

We continue to think that the chances of an equity market and Rand rally post an ANC election victory are reasonable, as current positioning would lend support to an oversold relief or counter rally. However, any meaningful continuation is contingent upon a commitment to continue along the tough reform path that has, to some degree, been outlined in President Ramaphosa's State of the Nation Address. Should the unions' opposition to restructuring be too strong and indicate that the mood for economic reform is too weak amongst the ANC leadership, we then foresee an unravelling of any South African asset rally accompanied by the eventual downgrade by Moody's later in 2019 and the consequences of these disappointments on South African asset prices. South Africa faces another watershed event together with a test of its policy commitment over the next few months.

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