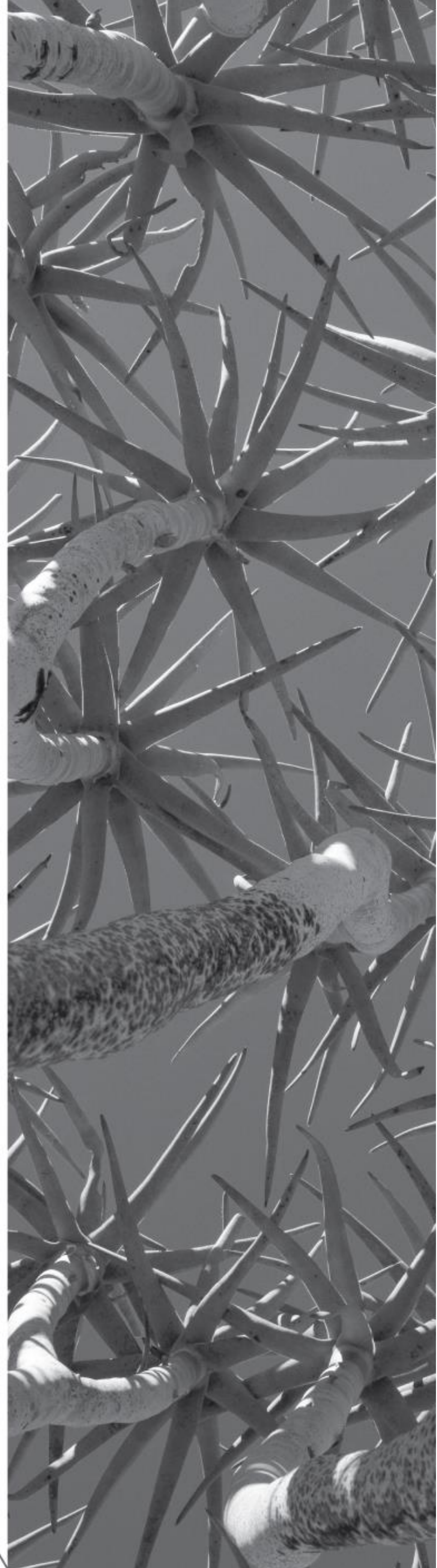
OIL PRICE MELTDOWN

MARKET OVERVIEW

Fourth quarter 2 0 1 4



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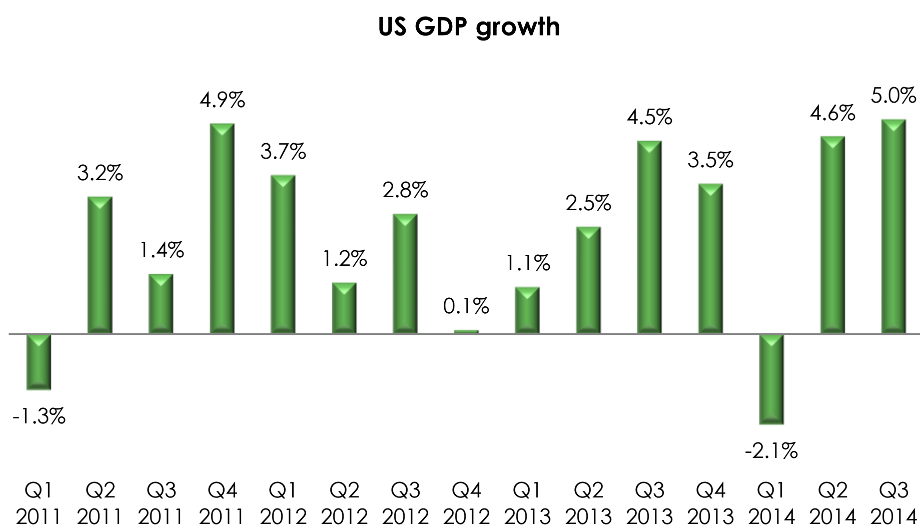
FOURTH QUARTER IN REVIEW

Global

Global growth concerns kept financial market volatility at elevated levels at the end of last year as the post-crisis recovery remained uneven amongst developed market economies. The pace of the precipitous fall in the oil price during the last six months of the year caused a mini-panic, bringing global economic growth into question and destabilising some oil producing economies, most notably Russia. The oil price plunged by nearly 50% during this period, although the majority of the fall took place during the final quarter of the year. Financial markets were mostly concerned about the negative impact of the fall, while the benefit to consumer spending and the contribution to global growth were largely overlooked. The macro-economic environment was characterised by low growth, low inflation and deflationary fears, supporting the argument for accommodative monetary policy.

Actual global economic growth for 2014 was once again lower than anticipated, continuing the pattern of disappointments over the last couple of years. The US was the lone bright spot as growth accelerated towards the end of the year, reigniting concerns over the timing of the first interest rate hike. US GDP growth for the third quarter of the year was revised up to 5% - the strongest quarterly growth rate in over a decade. Job creation accelerated as more jobs were created during 2014 than any year since 1999. About three million Americans found work in 2014 and the strong rise in payrolls pushed the unemployment rate down to 5.6% in December - the lowest since June 2008. The only concern was that wage inflation remained absent.

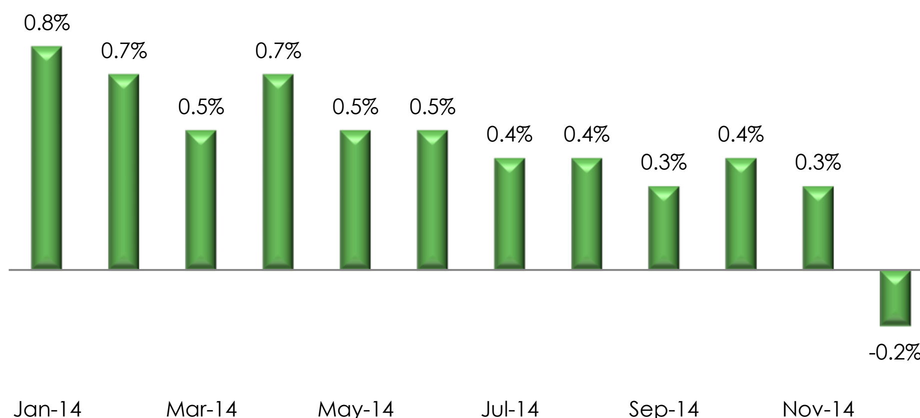


Source: U.S. Bureau of Economic Analysis

Signs of a sustainable US economic recovery shifted attention to the Fed, and when interest rates are likely to start rising following closure of the quantitative easing program in October. The Fed left interest rates unchanged during the year, but changed its guidance slightly at the December meeting by omitting the wording "a considerable period of time" for interest rates to remain at zero. Janet Yellen, the Fed Chairperson, acknowledged a stronger economy but downplayed falling inflation expectations as she was confident that inflation would return to the Fed's targeted level of 2%. Consumer price inflation experienced its biggest monthly decline in six years when the rate fell to 1.3% in November due to the sharp drop in energy costs. It was followed on by an even bigger drop in December to 0.8%.

The US dollar reached an eight-year high due to diverging policy expectations between the US and the other major developed economies. As the US scaled back on ultra-accommodative monetary policy, Japan set forth on even more aggressive stimulus measures and the European Central Bank (ECB) stood ready to engage full-scale quantitative easing to ward off deflationary pressures. In November, ECB President Draghi reinforced the bank's intention to push inflation up towards its target and to expand the bank's balance sheet through asset purchases. The Eurozone officially entered deflation when consumer price inflation dropped to -0.2% in December. Eurozone GDP growth during the third quarter was slightly stronger at 0.2% from 0.1% the previous quarter as household and government expenditure offset a slowdown in investments.

Eurozone CPI

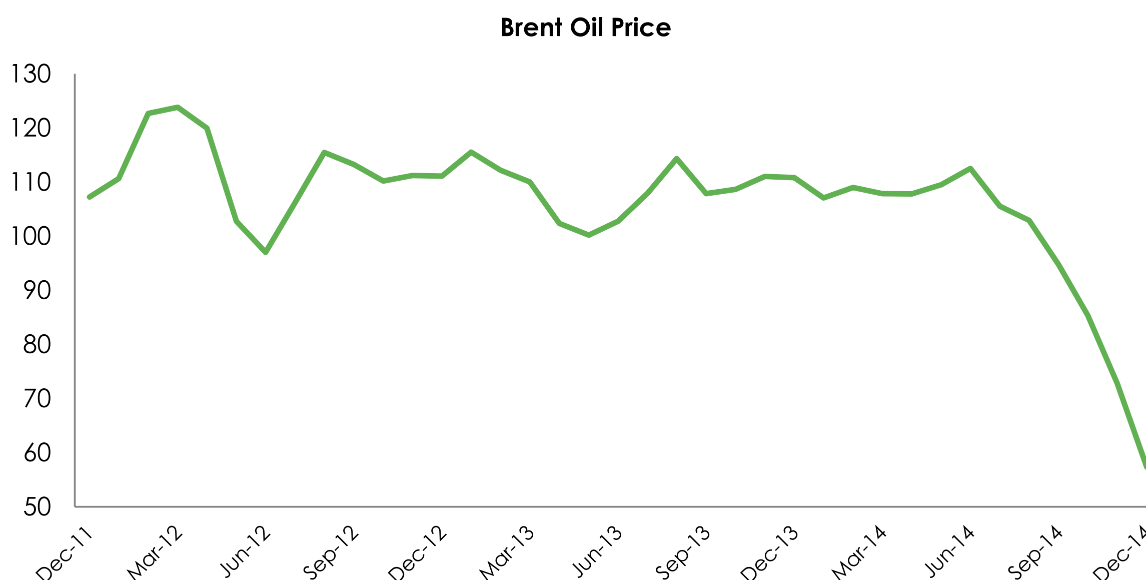


Source: INet

The Japanese economy entered a triple-dip recession during the third quarter when GDP growth fell by 0.5% on a quarterly basis, following a 1.9% decline during the previous quarter. The economy struggled after the sales tax hike in April and the second such hike scheduled for later in 2015 was delayed. Weakness in the economy was broad-based. It prompted Prime Minister Abe to call for an early election and he secured his position through a majority victory that safeguarded his mandate for implementing further aggressive policies to boost economic growth. The absence of supply-side economic reforms remained notable.

Emerging market growth momentum slowed further towards the end of the year and economies dependent on commodity exports struggled. Concerns remained over a slowdown in China, but in a surprise move the People's Bank of China cut its benchmark interest rate in November for the first time since 2012 amidst inflation that lingered near five-year lows. Chinese policymakers reduced funding costs and pushed through reforms to attain a stable, but more sustainable economic growth rate - what China's Premier Xi Jinping termed a "New Normal" economy. Chinese GDP growth of 7.4% year-on-year for the final quarter of the year was better than expected, but narrowly missed the government's growth target and 2014's expansion signaled the worst growth in 24 years. The biggest slowdown came from fixed asset investments.

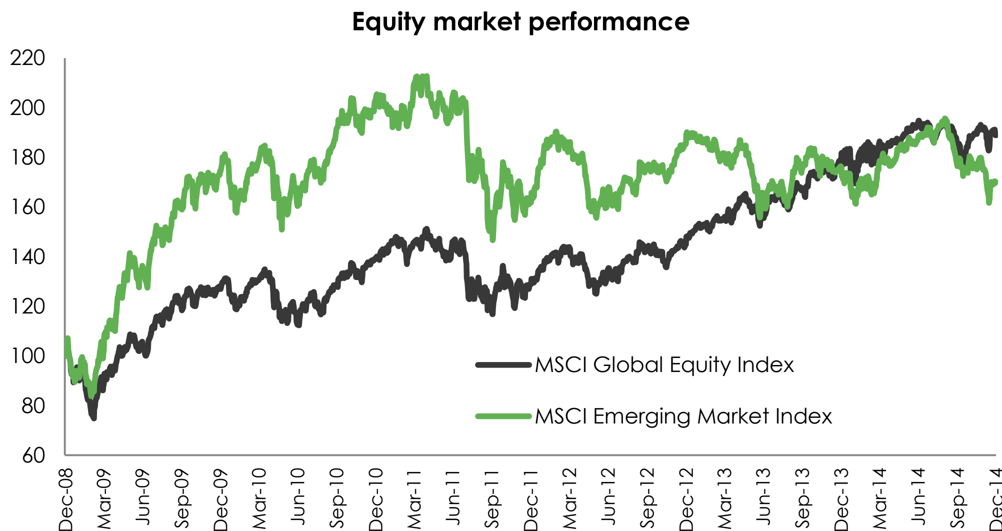
Oil prices tumbled during the second half of the year as OPEC avoided curtailing production in the face of booming US output and poor demand growth. US oil production reached its highest output in history, but even at those levels, the US remained a net oil importer. Brent oil made its high for the year in June before it fell nearly 50% to a four-year low of $55 a barrel in December. It was the longest weekly losing streak for oil since 1986. Much of the oil price decline coincided with the relentless rise in the trade-weighted US dollar. The dollar appreciated by nearly 13% against a basket of currencies in 2014, reflecting the strength of the US economy and widening interest rate differentials amongst the major economies.



Source: Inet

Equity market corrections became more frequent, reflecting uncertainty over the global growth outlook, the sharp fall in the oil price and the potential impact of future Fed interest rate hikes. The MSCI Global Equity Index gained 0.7% during the final quarter of the year to lift its return for 2014 to a disappointing 2.9%. The US equity market was one of the better performing markets and the S&P 500 Index rose by 11.4% during 2014 which was its third consecutive year of double digit returns.

For the quarter, the S&P 500 was up 4.9%. The MSCI Emerging Market Index rally stalled in September and its 4.9% fall during the last three months of the year caused its return to drop to 4.6% for 2014. Dispersion amongst emerging market performance for 2014 was high. Egypt was the best performing with a return of 29% whilst Russia was the worst with a plunge of 46%. It was the collapse in the Russian ruble that led to the sharp sell-off in emerging market currencies and debt during the fourth quarter of the year, which weighed on emerging market equities.



Source: INet

European borrowing costs dropped to record lows as the fixed interest market priced in quantitative easing, deflationary concerns as well as a weak growth environment. German government bonds remained the safe haven of choice and the yield on the 10-year German Bund fell to 0.54%. German bond maturities up to five years were trading at negative yields.

Despite the US Fed's bond buying program coming to an end, US bond yields also edged lower as Treasuries were seen as "high yielding" investments compared to European bonds. The 10-year US Treasury touched its lowest yield for the year in December before closing at 2.17% on 31 December 2014. The JP Morgan World Government Bond Index lost 1.7% during the final quarter of the year and was up 0.4% for 2014. Fixed interest performance was mostly influenced by relative currency returns.

High yield, below investment grade, bonds sold off towards the end of the year as this sector of the fixed interest universe was negatively impacted by large issuance from energy related companies and the subsequent drop in oil prices.

Local

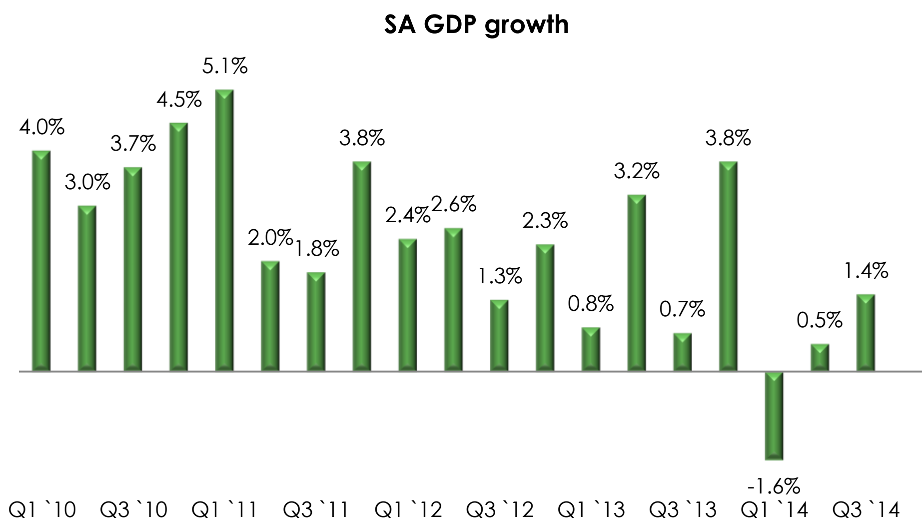
A year and a half ago, emerging markets received a wake-up call when the US "taper tantrum" caused turmoil amongst emerging market currencies. Those that were the most vulnerable to Fed monetary policy normalisation and foreign capital flight were branded the *Fragile Five* and included South Africa, Brazil, India, Indonesia and Turkey. Some, like India and Indonesia, adopted aggressive reforms since then and fundamentally, they have become much stronger economies that can better withstand a potential onslaught of higher global interest rates. In contrast, South African policymakers decided to sit on their hands in the hope that the tide of ultra-low global monetary policy would not recede. There has been a lot of talk about the much-hyped National Development Plan (NDP), but there's little evidence of it in the real economy.

Domestic economic weaknesses grew worse and South Africa experienced its most dire economic performance since 2009. Power shortages once again plagued the country even though Eskom denied the electricity situation was in crisis. The current account deficit remained uncomfortably large at 6% of GDP during the third quarter, despite narrowing from 6.3% in the previous quarter and the economy failed to capitalise on a more competitive exchange rate. It was only newly appointed Finance Minister Nene's credible fiscal consolidation message in his Medium Term Budget Policy Statement that saved South Africa from further sovereign credit rating downgrades that could increase the country's borrowing costs.

In November, Moody's downgraded South Africa's sovereign credit rating by one notch due to persistent structural issues and high debt levels. Fortunately, the negative effects were short-lived. The other two major rating agencies, Fitch and Standard & Poor's, extended the government some time to implement the fiscal consolidation that was promised. However, the economy lacks general policy support and fiscal consolidation will not provide a boost to economic growth. The Medium Term Budget Policy Statement did show conservatism and pragmatism and, while the budget deficit was set to increase slightly to 4.1% of GDP in 2014/15, future deficit consolidation was forecasted to accelerate.

Third quarter economic growth fell short of expectations. GDP growth picked up to 1.4% from 0.5% the previous quarter, but most of the recovery was due to a normalisation in economic activity following strike action in prior months. Manufacturing production was the largest detractor from growth in the third quarter whilst the primary sectors of agriculture, fisheries and forestry were the strongest performers. Manufacturing activity continued to weaken into the final quarter and the October reading indicated that output growth for the sector declined by 1.3% from a year earlier as power outages resulted in a significant slowdown in business activity.

Mining production also struggled into the final quarter and declined 0.4% from a year ago in November. The platinum group metals, gold and copper were the biggest obstacles to growth, keeping their output at pre-strike levels.



Source: Inet

The local economy was also suffered from a household debt overhang and persistently high unemployment. Debt-to-disposable income, although slowly moderating, remained high at just over 78% in the third quarter. This was despite borrowing costs being near record lows and credit to the household sector having slowed to its weakest pace since the start of 2010. The unemployment rate managed only a marginal improvement to 25.4% in the third quarter from 25.5% the previous quarter and remained near its cyclical high of the last 10 years. The International Labour Organisation projected that South Africa will have the 8th highest unemployment rate in the world in 2015.

Reserve Bank Governor, Lesetja Kganyago, left interest rates unchanged at 5.75% in his maiden speech as Governor. His economic growth outlook was revised lower, while the upside risks to inflation were assessed to be more balanced. Lower food and petrol prices helped to offset the effects of a weaker currency. Consumer price inflation moderated to 5.8% in November, and then fell sharply to 5.3% in December.

On a monthly basis, consumer prices declined by 0.2% in December. The uptick in core inflation to 5.8% in November from 5.7% in October was reversed in December, but the growth in core consumer prices remained higher than that of the headline number due to foreign exchange pass-through effects being more notable. Inflation expectations, however, improved.

The rand traded at around R11.00 to the US dollar during October and November, but setbacks in December caused it to depreciate sharply past key technical levels to end the year at R11.45 - 10.6% weaker than at the start of the year. Catalysts of the currency sell-off included strong US November employment numbers, the worse-than-expected third quarter current account deficit, weaker commodity prices as well as concerns over the electricity situation. Overall currency volatility during 2014 was lower than average and the rand traded within a band of 160 cents.

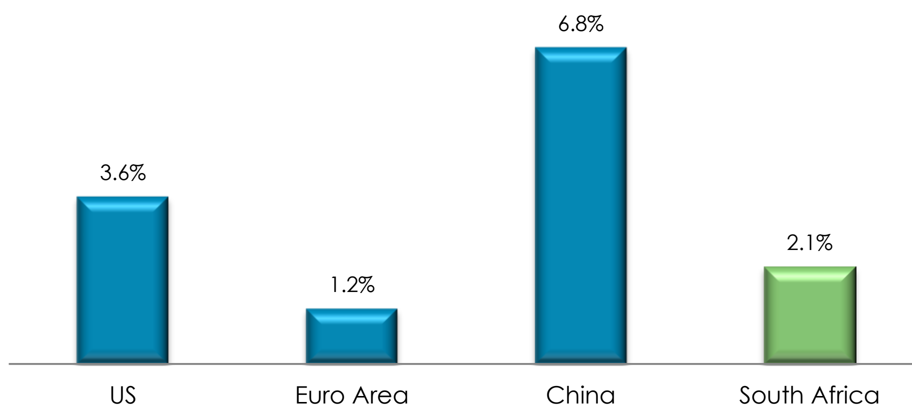
The FTSE/JSE All Share Index gained 1.4% during the final quarter of the year to lift its total return for 2014 to 10.9%. The FTSE/JSE All Share Index peaked in late July. The Index was supported by low interest rates and falling bond yields. The shares that performed the best were the more defensive ones with exposure to either low interest rates or the weaker currency, or both. The resources sector lost 19.8% during the final three months of the year and was down 15% for the year. Financial shares had a strong final quarter and gained 10.4%. For 2014, financial shares yielded a strong return of 27.8%. Industrial shares rose 7.2% during the fourth quarter and were up 17.2% for the year. Foreign investors bought R18.5bn worth of domestic equities in 2014, having been net sellers over the previous three years.

The local bond market ignored the weaker rand and instead found support from lower global bond yields. The All Bond Index gained 4.3% during the final quarter and was up 10.2% for the year, outperforming cash which delivered a return of 5.9% over the same period. In contrast to the equity market, the domestic bond market suffered foreign portfolio outflows of R5.7bn during 2014. Listed property benefitted from lower bond yields, new listings as well as consolidation within the sector to gain 11.1% for the quarter and 26.6% for the year, making it the best performing asset class during 2014.

OUTLOOK

Just as airplanes can experiences turbulence without crashing, so can stock markets. Financial market volatility increased over the last few months from extra-ordinarily low levels and should remain elevated during 2015 as macro-economic inflection points are reached. Specifically, the recent pattern of intra-month volatility looks set to continue. The equity bull market is getting old and is now in its sixth year, but at the same time, bond yields are at record low levels in many countries. The market’s fixation with specific data points has made it overlook the broader picture and investors’ nerves have been unsettled by the pace of the oil price drop. Falling oil and energy prices, however, are a game changer that will boost global GDP. Deflation fears are hence unwarranted and should recede. Global GDP, despite being low, is improving and central banks will remain highly accommodative in the wake of the broad based commodity price declines.

The oil price decline is just what the doctor ordered for the world economy. The benefits that accrue to oil users far exceed the cost to producers in terms of overall economic impact. The International Monetary Fund estimated that the oil price decline could add between 0.3% and 0.7% to world output. In its January 2015 World Economic Outlook, the IMF revised its 2015 world growth outlook lower from 3.8% to 3.5%, mainly due to slower emerging market growth. The diminished growth expectations more than offset the boost from lower oil prices, but in its absence, the revisions could have been much worse. The oil price decline is also undermining central banks' efforts to lift inflation and will prompt further stimulus action from those that have inflation targets as their sole mandate.



Source: IMF World Economic Outlook January 2015

The US was the exception to the IMF's growth downgrades. The US economy seemed to have finally entered a self-reinforcing phase and growth estimates were revised up to 3.6% and 3.3% for 2015 and 2016 respectively. Consumer and business confidence have broken higher and consumer sentiment is now back at pre-crisis levels. Combined with a strong employment recovery this should lead to a step-up in consumer spending. The US is set to once again assume the title of global growth engine. The durable US economic recovery will lead to a pick-up in global exports during 2015.

The US Fed has a mandate of both employment and inflation. With unemployment levels falling back into the Fed's targeted zone, it should start to hike interest rates from zero later this year. But the current low inflation rate will allow patience before doing so. A surprise might come if consumer spending starts to accelerate at a faster pace and push inflation up as a result. This would put the Fed behind the curve and rate increases would increase at a faster rate than what is being priced in. European and Japanese central bank expansion will offset the unwinding of ultra-accommodative monetary policy in the US. These two central banks have made it clear that they will do whatever it takes to beat deflation.

Eurozone growth slowed down towards the end of 2014, but the sharp depreciation in the euro, historically low borrowing costs, the much weaker oil price and diminished fiscal drag from unwinding austerity measures should bolster the region's growth prospects. Don't expect fireworks from the region as growth will remain tepid amidst the debt overhang that lingers, but it should exceed current market expectations.

US equity valuations are somewhat rich, but are consistent with high levels of corporate profitability and are supported by low interest rates. European and Japanese equities are attractively valued compared to their US counterparts and will benefit from continued monetary stimulus and more competitive exchange rates. The earnings expectation bar has also been lowered substantially for these two regions. Future equity returns will rely more on company fundamentals and profitability than on an equity market re-rating. The global earnings cycle is in an uptrend in response to the economic recovery and, despite some of the recent tailwinds dissipating, it should head higher. We do not expect an equity bear market any time soon and believe that equity markets should deliver positive, albeit lower-than-average returns over the next year.

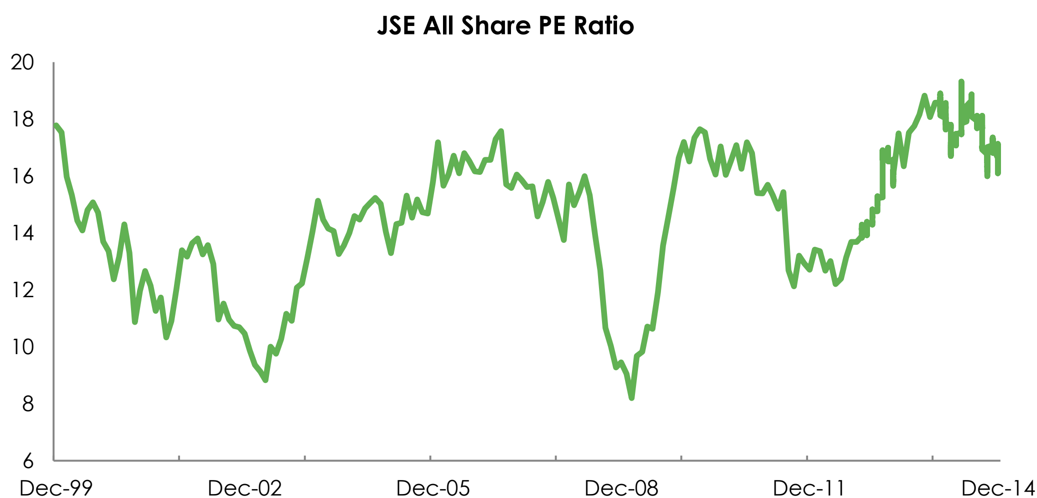
We expect global equities to outperform global bonds. In the near term, global bonds will be supported by central bank buying programs, lower energy prices, deflationary concerns and a savings glut. But longer term, current bond valuations only makes sense if deflationary conditions continue. We view the oil price decline as a once-off and it will work itself out of the system. Due to its positive effect on consumer spending, it might actually cause longer term inflation as demand catches up with supply dynamics. Government bonds will deliver poor returns in response to a gradually strengthening global economy and the start of the US Fed tightening cycle. Given the poor risk/reward trade-off in global bonds, we are underweight this asset class and overweight global equities.

The South African economic outlook remains tainted by structural constraints that will inhibit growth. The unwillingness of policymakers to accelerate reforms, cited by the IMF as one of the reasons it revised its 2015 growth forecast for South Africa to 2.1% from 2.3%, will act as a drag on GDP growth . The domestic economy's near term outlook will largely be determined by the oil price decline and electricity supply as they are contrary to one another in their impact. Electricity constraints are the biggest risk factor for the domestic landscape. Eskom has warned that load shedding can be expected until at least April 2015.In addition, the cash strapped utility will remain under funding pressure to roll out new capacity.

The decrease in the oil price will bring welcome relief to indebted consumers by increasing disposable incomes and reducing inflation. The fall in consumer inflation will allow the Reserve Bank to delay the monetary policy normalisation process. And finally, lower oil prices will take some edge off the wide current account deficit as the oil import component is reduced. Research from Oxford Economics Ltd indicated that South Africa's GDP will be the third biggest benefactor in the

world from the sharp decline in oil prices. The large current account deficit will, however, remain a headache given South Africa's dependence on foreign funding and any reversal of which could cause sharp currency depreciation.

The longer term benefits of the oil price slump will be limited as business investment remains weak. Business confidence levels are depressed and the labour climate is difficult. The weak domestic macro-economic backdrop will make it difficult for local share prices to maintain their high valuation multiples. The FTSE/JSE All Share Index started the New Year on a price-to-earnings multiple of close to 17 which is at the upper end of its historical range. To sustain such a high rating, company earnings growth will have to remain strong and exceed expectations. Despite rand-hedge companies benefitting from a weaker currency, we believe that company earnings and earnings expectations will come under pressure. We are underweight domestic equities.



Source: Inet

The domestic bond yield curve has flattened considerably over the past year as longer dated bond yields declined more than short dated bond yields. This was in response to lower global bond yields, the fall in the oil price and lower domestic economic growth conditions. Longer dated bonds now offer almost no yield pick-up over short dated bonds and we view them as highly overvalued. The threat of a sovereign credit rating downgrade remains a real possibility and Finance Minister Nene's budget will be scrutinised to ensure that fiscal consolidation is indeed possible and that the government is committed to follow through on its promises. The domestic bond market will also be vulnerable to US Fed policy normalisation in the latter part of the year. We remain underweight domestic bonds. In general, macro-economic risks have diminished and should have a reduced impact on financial markets during 2015. Instead, some of the greater risks could be geopolitical risks as social instability is on the increase. This could result in increased levels of financial market volatility that is difficult to predict. For South African investors offshore portfolio diversification is important to take advantage of potential rand weakness that stems from such turmoil and more attractively valued opportunities.

ASSET CLASS RETURNS

	3 Months	6 Months	12 Months
Headlines Indices			
Africa All Share	1.36%	-0.80%	10.88%
Africa Top 40	0.01%	-2.86%	9.17%
Africa Mid Cap	8.82%	10.84%	19.62%
Africa Small Cap	6.56%	8.65%	20.57%
Africa Fledgling	-0.14%	-0.46%	8.71%
Africa Resource 20	-19.81%	-25.13%	-15.01%
Africa Industrial 25	7.17%	6.05%	17.22%
Africa Financial 15	10.37%	9.81%	27.83%
Africa Financial and Industrial 30	7.70%	6.44%	19.17%
Africa Capped All Share	1.46%	-0.66%	11.08%
Africa Shareholder Weighted	3.75%	3.24%	15.42%
All Share Economic Group Indices			
Africa Oil & Gas Index	-28.13%	-30.29%	-13.13%
Africa Basic Materials Index	-15.31%	-21.66%	-13.39%
Africa Industrials Index	4.35%	2.43%	6.99%
Africa Consumer Goods Index	5.20%	0.52%	14.10%
Africa Health Care Index	14.20%	26.35%	35.89%
Africa Consumer Services Index	18.84%	18.39%	29.71%
Africa Telecommunications Index	-5.06%	2.38%	9.72%
Africa Financials Index	10.84%	11.29%	27.28%
Africa Technology Index	8.76%	11.08%	12.68%
All Share Sector Indices			
Africa Chemicals	-5.39%	-7.77%	-1.24%
Africa Electronic & Electrical Equip. Index	-12.47%	-17.87%	-15.29%
Africa Industrial Engineering Index	-4.29%	-6.44%	-13.09%
Africa Automobiles & Parts Index	-2.89%	-14.82%	-17.90%
Africa Beverages Index	-2.89%	0.24%	15.81%
Africa Food Producers Index	15.30%	22.43%	42.97%
Africa Health Care Equip. & Services Index	9.44%	20.79%	30.44%
Africa Pharmaceuticals & Biotech. Index	19.81%	33.03%	42.62%
Africa General Retailers Index	12.96%	14.15%	22.12%
Africa Travel & Leisure Index	10.29%	12.71%	19.40%
Africa Media Index	21.62%	21.29%	38.51%
Africa Support Services Index	1.07%	0.92%	11.97%
Africa Industrial Transportation Index	5.58%	-5.91%	-1.35%
Africa Food & Drug Retailers Index	20.31%	14.72%	12.39%
Africa Fixed Line Telecommunications Index	28.13%	53.17%	150.00%
Africa Banks Index	15.81%	14.45%	32.09%

Africa Non-life Insurance Index	2.12%	11.60%	19.45%
Africa Life Insurance Index	7.04%	5.72%	21.50%
Africa General Financial Index	10.73%	7.19%	26.22%
Africa Software & Computer Services Index	9.63%	13.26%	22.67%
Africa Gold Mining	-9.35%	-20.57%	13.45%
Africa Platinum & Precious Metals	-9.20%	-26.82%	-30.59%
Africa Property Unit Trusts - (PUT)	10.07%	23.93%	31.09%
Africa SA Listed Property - (SAPY)	11.08%	19.10%	26.64%
Bonds, Cash & Inflation			
All Bond Index	4.25%	6.56%	10.15%
Stefi Composite	1.55%	3.07%	5.90%
CPI - New Headline (Previous Month)	0.18%	1.65%	5.80%
Currencies			
Rand Dollar Exchange Rate	1.51%	7.71%	10.63%
Rand Pound Exchange Rate	-1.81%	-1.23%	3.49%
Rand Euro Exchange Rate	-1.76%	-3.83%	-2.98%
Dollar Euro Exchange Rate	-4.21%	-11.64%	-11.96%
Dollar Yen Exchange Rate	-8.79%	-16.16%	-12.63%
Naira Dollar Exchange Rate	13.24%	11.98%	13.94%
Commodity Prices			
Brent Oil (USD/Barrel)	-39.49%	-49.05%	-48.26%
Gold (USD/oz)	-2.12%	-10.85%	-1.85%
Platinum (USD/oz)	-7.11%	-18.70%	-11.88%
Copper ($/Ton)	-5.60%	-8.57%	-14.00%
CRB Index	-17.44%	-25.38%	-17.72%
Global Bonds & Equity			
Global Bonds (R)	-0.19%	3.26%	11.12%
MSCI Global Equity (R)	2.19%	5.63%	13.87%
Global Bonds	-1.68%	-4.13%	0.44%
S&P 500	4.39%	5.03%	11.39%
Nasdaq	5.40%	7.44%	13.40%
MSCI Global Equity	0.66%	-1.94%	2.93%
MSCI Emerging Mkt	-4.88%	-8.99%	-4.63%
FTSE	-0.03%	-1.87%	-2.13%

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