Northstar Market Report – December 2015

Company research – the only viable path to sustainable returns:

"Economics has never been a science – and it is even less now than a few years ago" - Paul A Samuelson, Nobel Prize in Economic Sciences laureate.

Our quarterly reports are normally filled with our investment cases on companies and we use these as a window for our clients to see what we do each and every day at Northstar. We are in the business of detailed company research and understand the research route is the path less travelled in markets - this is so because it is hard, requires dedication and discipline and it focuses on the long-term. It is also the only way of ensuring sustainable investment returns!

In truth, there are probably better ways of making a 'quick buck' (and losing a fortune). Stock trading and economic forecasting are two that come to mind, but the above quote by Paul A Samuelson eloquently captures why we avoid our productive time being focused on economic prognostication.

Stock research to which we can relate and focused financial modeling creates realistic potential scenarios that, given time, stand a very good chance of being proven correct. That said, there are inflection points when social, political and economic macro factors are tectonic, heavily impacting the very inputs that we and other research firms use in financial analysis. Such a time is right now! With this in mind, this report is initiated with an apology to our readers and clients who are stock purists, as we are going off-piste and dedicating our first quarterly report of 2016 to a few topics that are dominating discussions from book clubs to boardrooms.

Themes covered:

In this quarterly report, two key themes are discussed. We delve into the South African Rand (ZAR), with a particular focus on its weakness and then try to unpack the underlying causes of its fragility and touch on what the rand's 'real' level would be in an environment where politics plays less of a role. We start with a discussion on our credit rating, how far we are from junk status, what junk means for different global institutional investors and what capital flow implications there are if SA is downgraded to junk.

How credit worthy is South Africa and what are the implications of 'junk status'?

The size of South Africa's Government debt:

The South African Government has outstanding debt owing via the bonds it has issued over the years of R1.3trn. South Africa's proportion of government debt to GDP (gross domestic product) has been steadily increasing, bottoming out in 2008 at about 23% and climbing to its current level of 47%. To contextualize this, Japan has Government debt exceeding 200% of GDP, Greece exceeds 150% but Australia is under 40% and our northern neighbour, Botswana, is below 15%. In truth, the absolute number is only one consideration - equally important is the rate of change in debt over time and the actions being taken by a government to combat debt escalating. It is evident that our debt is growing rapidly and is a focal point for rating agencies.

How much of South Africa's Government debt is owned by foreigners?

Foreigners own approximately 35% of all SA Government debt. In 2006, this figure was 8.6% so clearly non-residents have a massive vested interest in South Africa and have believed that our Government would service and repay its debt. However, this faith looks to be waning for rating agencies and there are implications in that certain institutional offshore investors are mandated to abide by credit ratings and will be forced to redeem investments in South Africa, should our credit rating be downgraded from 'lower medium grade' to 'non-investment grade speculative'.

What is South Africa's current credit rating?

At this point in time, the three rating agencies have South Africa on the following long-term credit ratings:

Agency	Rating	Rating description	Outlook	Proximity to non-investment
Moody's	Baa2	Lower medium grade	Negative	2 notches
S&P	BBB-	Lower medium grade	Negative	1 notch
Fitch	BBB-	Lower medium grade	Stable	1 notch

To contextualize these ratings, Moody's needs to drop two notches to Ba1, whereas S&P needs to drop one notch to take South Africa's rating to non-investment grade speculative status.

What are the implications of a rating change?

Should our credit rating fall to sub-investment grade, this does not necessitate that all foreign owners of our Government debt need exit the South African bond market. Research undertaken by the Barclays Emerging Market Economics team estimates that approximately R75bn of capital flows will exit South African Government bonds if South Africa falls out of what is known as the WGBI – the World Government Bond Index. South Africa entered the WGBI in 2012. It is important to appreciate the nuances of the rules with regards to remaining in the WGBI. SA will remain investment grade if either Moody's or S&P decide to maintain our rating as lower medium grade.

The importance of this point is that Moody's has to downgrade South Africa by two notches before we become non-investment grade.

It is further worth noting that much of the foreign money in SA bonds has probably originated from investment professionals tracking emerging market bond indices – such as the Barclays' Emerging Market Local Currency Government Bond Index (EMLGBI) and the JP Morgan Global Diversified Index (EMBI) which are both ambivalent to credit ratings. Thus in these cases, a downgrade to junk will not default these managers to liquidate their South African investments. However, even professional investors can be emotional and negative sentiment might well compel selling – traditionally, credit downgrades have resulted in capital leaving the South African market with concomitant bouts of rand weakness.

In a worse-case scenario, potential outflows from foreigners (assuming they sell all their exposure to South African Government bonds) would amount to R450bn. As far as we are aware, this is not a base-case view of any analyst/economist and it is certainly not our base view either. If it did transpire, the cataclysmic consequences for the South African economy are almost too dreadful to imagine.

The South African rand – where to from here?

Before South Africa was reintroduced into the global financial system in 1980, it took 75c (ZAR) to buy $1!

On the 1st of January 1990, which is where we start our analysis, the rand/dollar exchange was R2.55 and as we write this report, the currency is darting around R16.70 against the US dollar.

In light of this, we thought it would be worthwhile covering a number of issues as far as the rand is concerned. These include:

- To simply calculate the rate of weakness over 25 years.

- To note that periods of weakness and strength occur and to acknowledge that the rand, like any asset, is not a one-way bet in the medium term, irrespective of our sentiments towards it.

- To assess the glide slope (rate of change) of the currency during periods of depreciation versus appreciation – is there anything meaningful in this?

- To identify any duration differences between bouts of appreciation versus deprecation.

- To break-down the underlying reason for the rand's weakness over time and to distinguish how much of its weakness is due to SA factors versus global factors.

- To value the rand on a Purchasing Power Parity basis versus its current level.

***The rand's journey over time*:**

The rand has depreciated by 551% since 1990 against the US$, which represents an annualized depreciation of 7.76%. Please see the below graph labelled *The Rand's Journey*.

Five periods of performance seem to exist within this larger cycle of weakness, these are:

Jan 1990 to Dec 2001 (12 years)

R2.55 to R11.96 13.7% annualized depreciation

Dec 2001 to Dec 2004 (3 years)

R11.96 to R5.67 22% annualized appreciation

Dec 2004 to Jan 2009 (4 years)

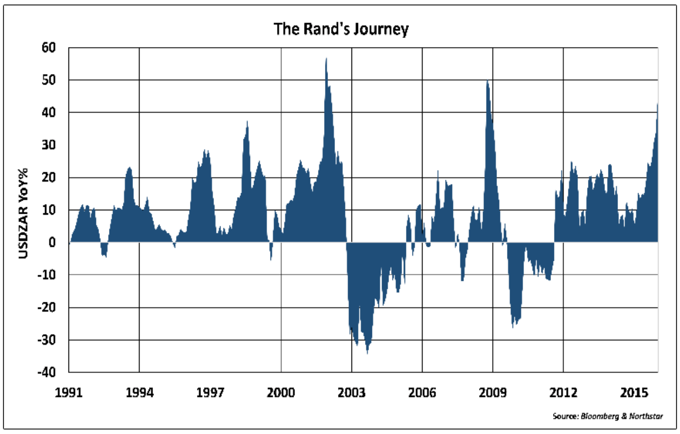
R5.67 to R10.20 15.5% annualized depreciation

Jan 2009 to April 2011 (2 years)

R10.20 to 6.57 17.8% annualized appreciation

April 2011 to Jan 2016 (5 years)

R6.57 to 16.60 21.7% annualized depreciation



Observations with regards to the behaviour of the rand:

Our observations regarding the rand are rudimentary and only when more data is available in the years ahead, will we be able to provide concrete insights with regards to the dynamics that prevail. In its simplest form however, we deduce the following when looking at the numbers above:

1. The rand has devalued against major global currencies over 25 years. Using the dollar as a natural proxy, the depreciation has been 7.76% annualized, which is substantially higher than the inflation differential between SA and the US. Our inflation differential against the US for the full period under review has been 4.56%.

In theory, a currency should weaken by the inflation differential between two countries, but clearly the rand is weakening by more than 3% above this differential annually. Later in our report, we try and unpack the reasons for this.

2. We have had three periods of depreciation and two periods of appreciation. The periods of depreciation have lasted longer than the periods of appreciation, with the latest dose of depreciation being the longest.

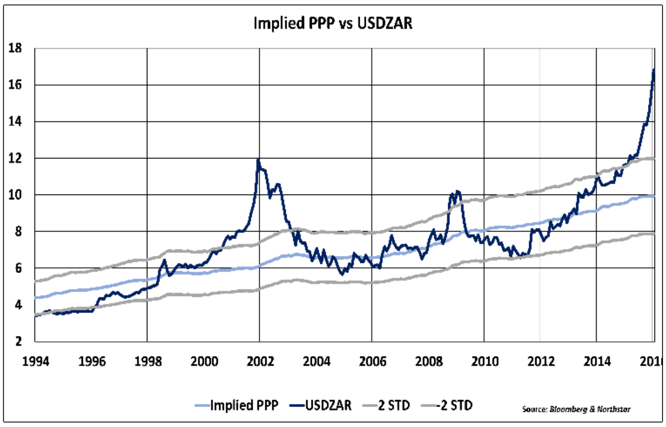
3. The rate of decline during periods of depreciation is lower than the rate of appreciation during periods of optimism – when the currency appreciates, it gives the impression of a snap-back!

4. What seems clear, is that *ceteris paribus* (all things remaining equal), the rand usually strengthens after bouts of extreme weakness. We use the term *ceteris paribus* because currently, there is a valid argument that the SA Government under Zuma may lead South Africa into the economic wilderness. Under this scenario, historical comparisons and assessing values using normal, economic data could prove invalid – in other words, everything is not remaining equal!

The rand based on Purchasing Power Parity:

The below graph provides us with an indication of what the rand should trade at based on the principle of PPP or purchasing power parity.

Purchasing power parity is an economic theory that states that residents in all countries should be able to buy goods and services at the same price, taking their currency into account. So for example, if a bicycle costs R10 000 in South Africa, then that same bicycle should cost $598 in America if the exchange rate is R16.70 to a US$. If this is not the case, through trading, bikes will be exported from the USA to SA or vice versa until the prices equalize and in so doing through arbitrage, a fair exchange rate is achieved. In truth, obstacles to this theory, such as transport costs and trade duties, ensure that PPP is not a perfect science, but it does provide indicative exchange rate valuations.



With this in mind, we present our chart of the USD versus the South African rand according to the principle of purchasing power parity. The rand/dollar exchange rate is the dark blue line on the diagram and the light blue line represents where the rand should trade at against the dollar based on PPP. We have also included bands of standard deviation from the mean – these lines (both in grey) represent major deviations from the PPP 'fair value' level for the local currency. From this chart, what becomes evident is:

1. The rand goes through periods of extreme over and undervaluation.

2. The rand gyrates actively around its true value, with sharp gains and losses.

3. Periods of extreme overvaluation are often followed by periods of extreme undervaluation.

4. The currency traded near its PPP level between 2003 and 2009, which coincided with a booming commodity cycle.

5. In 2001/2002 the rand was extremely undervalued – this happened to be at a time when many South Africans externalized capital.

6. In 2009 the rand was again extremely undervalued – this coincided with the global financial crisis when all 'risky' asset classes were avoided by investors.

7. The rand has never been as undervalued as it is currently based on PPP alone. We state one caveat; this could also imply that South African inflation is about to sky-rocket.

8. Periods of extreme overvaluation include the early 1990's (SA was in its honeymoon phase), 2004/2005 as the commodity cycle began and 2011, which represents a time when China was stimulating economic growth by driving its industrial production and thus, importing heaps of commodities.

What are the main factors that have led to rand weakness?

We found some excellent research from the RMB Global Markets Research team (John Cairns – Currency strategist) on the main factors for the rand's weakness and decided to check the results ourselves by undertaking precisely the same exercise – trying to break-down the components of the rand's performance and isolate each of these.

The rand has depreciated since 2011 by approximately 120% and there are three underlying reasons for this weakness. Firstly, commodity and emerging markets falling out of favour; secondly, the US dollar has been powering ahead against all currencies and thirdly, South Africa has had specific internal factors, which are socio-political and economic, that have led to the rand's sell-off. The attached graph shows clearly the degree to which domestic factors (grey shading) have played the largest role in the sell-off.

Dollar strength:

The dollar index allows us to assess the performance of the dollar against all currencies. The dollar has appreciated by about 28% against global currencies since 2011 and, consequently, we can ascribe about 28% of the rand's weakness, to the dollar.

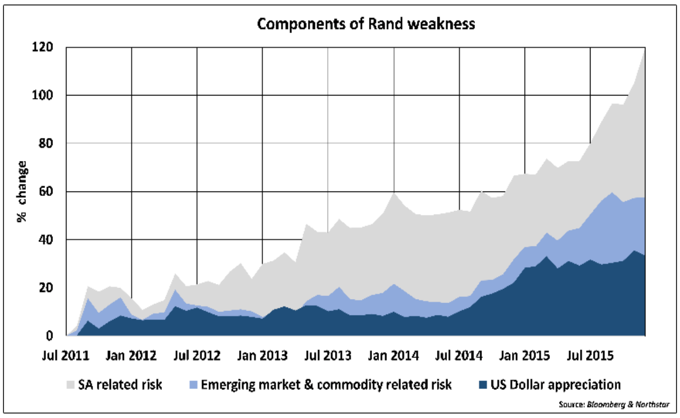
Commodity weakness:

We can then look at a basket of emerging market/commodity currencies (Australia, New Zealand, Turkey, Hungary, Brazil and Mexico), with the knowledge that these currencies tend to move collectively against the dollar. This movement represents the 'commodity risk' which can be ascribed to commodity weakness in the last few years – this has accounted for approximately 30% of the weakness in the rand.

SA Specific:

By adding the commodity weakness and dollar strength (30% and 28%), we can quickly calculate that the balance or residue of the weakness is due to SA-specific economic, social and political factors. This accounts for 42% of the weakness.

By our calculations, if we could extract the political/social/economic risk out of the rand, the currency would presently be trading closer to R10.50 to the US dollar.



Conclusion:

We have tried to cover tricky and emotional topics within a very logical and unemotional framework. South Africa faces real challenges and domestic policy will have a big bearing on whether we are downgraded to 'junk status' by global rating agencies. If this occurs, it has short-term implications for the rand (weakness), but more importantly, the cost of raising debt for Government will escalate further, which will have a stifling effect on South Africa's economic growth over the years ahead.

As far as the domestic currency is concerned, the rand is stupendously cheap at current levels and, in a 'normal world', should be attractive to foreign as well as South Africans investors. If commodity prices rally and/or the dollar weakens, it should be unsurprising to witness an appreciable strengthening in the currency. However, unless South Africa creates a stable economic platform that appeases investors and rating agencies alike and, in so doing, reduces the current high risk premium attached to South African assets, we are unlikely to see the rand appreciate steadily towards its real 'fair value' in the years ahead.

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