From the global economy to the optimum SA portfolio - Why SA economy plays on the JSE deserve their improved ratings

The global economy is still the main determinant of performance on the JSE. In this note, we break the JSE into three main categories, interest rate plays, commodity plays and rand hedges, and look at how these are likely to perform according to certain global and SA market conditions.

Asset Allocation depends firstly on the outlook for the global economy

In recommending the right mix of equity, bonds, property and cash for a South African portfolio, the first and most important step is to form a view on the state of the global economy over the next 12 months. This view then can be translated very directly into a view on global equity and bond markets and commodity prices. The JSE, if the past is anything to go by, can be confidently predicted to continue to follow emerging equity markets very closely. The issue then for the asset allocator is to decide on the extent of equity exposure and which part of the equity markets will best serve their purpose, given the outlook on the global economy.

The rand is a global risk on currency and inflation and interest rates in SA will take cues from the direction of the rand.

The rand is very likely to take its cue from global markets. The more (less) favourable the economic outlook, the greater (weaker) the global appetite for risk, the stronger (weaker) will be the foreign exchange value of rand. Where the rand goes, the SA inflation rate will follow. Long term bond values will tend to move in the opposite direction to that of the actual and expected inflation rates.

If the domestic economy is judged to be operating well below its potential and this is expected to persist, the Reserve Bank will hesitate to raise interest rates even as inflation picks up.

This reluctance to raise short term interest rates in 2011 represented something of a welcome break with past practice and proved helpful to the performance of the SA economy plays last year. Adjusting interest rates lower as inflation recedes may also be restrained in the future for fear of the presumed danger of excessive reliance on foreign capital inflows as the economy picks up momentum.

Rand strength is good for the SA economy – especially when accompanied by higher commodity prices (in US dollars)

It is very clear that rand strength encourages domestic spending and rand weakness slows it down. The stimulus provided for consumers from more attractive prices for imported goods in the stores and for goods and services with high import content can be reinforced by lower interest rates. A strong rand therefore is likely to boost the earnings of companies dependent on the SA economy, the so called SA economy plays that benefit from strength in final sales and lower costs of imported goods. Their top lines improve and the bottom line benefits additionally from wider operating profit margins. Banks too benefit from a stronger economy that demands more bank credit and leads to fewer bad loans. A weaker rand will have the opposite effects. Clearly, if rand strength is predicted then SA economy plays should offer very good returns and should be avoided if the rand is expected to weaken.

The implications of SA specific risk for the rand on asset allocation

Were the rand to be expected to weaken for SA specific reasons, this would decidedly favour rand leverage stocks over SA economy plays for the SA portfolio, especially if the global economy performs well and commodity prices remain elevated in US dollar terms. Rand leverages are companies, most obviously resource companies, with US dollar revenues and mostly rand costs. Other things being equal, especially with USD prices of metals and commodities unaffected, rand weakness helps to improve the operating margins of those companies.

There is no escaping the damage caused by a rand that weakens in response to less favourable global conditions

Yet even the purest of rand hedges or rand leverages cannot escape damage to their share prices, when the rand and global equity and commodity markets fall away because the outlook for the global economy has deteriorated. A weaker rand may limit the damage to their share prices expressed in rands, but is unlikely to mean higher rand share prices.

We have discovered that, in the absence of rand weakness for SA specific, rather than global reasons, there are very few rand hedges: stocks whose rand values improve with rand weakness or decline in rand value when the rand strengthens. Gold shares might however be an exception in this regard as the gold price in US dollars and (even more so) in the weaker rand can improve the rand and US dollar values of gold shares in very uncertain times.

If the rand remains stable or strengthens should we prefer SA economy plays or Resource companies? A basis for decision making.

Clearly if the rand is expected to come under pressure because of anxieties about the outlook for the global economy, a risk off portfolio (less weight in equities) and more in safe havens, would be recommended. An improving outlook for the global economy calls for a more risk on approach. If so, which shares should be recommended for SA investors?

To provide guidelines for portfolio construction designed to be highly consistent with a top down view on the global economy, it is helpful to categorise the large companies listed on the JSE into three categories. The first group will be comprised of those whose share prices are sensitive to SA interest rates, ie companies largely dependent on the SA economy, for example banks and retailers (*Interest Rate Plays*). A second group of those will be comprised of companies who are much more sensitive to commodity prices, typically resource companies (*Commodity Price Plays*). Then there is a further third category of JSE counters that are not particularly sensitive to either interest rates or commodity prices (*Hedges*). We show the results of this analysis in Table 1 below:

Table 1. Constituents of each index

Interest Rate Plays	Commodity Price Plays	Hedges
ABL	ACL	ANG
ASA	AGL	APN
BVT	AMS	CSO
DSY	ARI	GFI
FSR	BIL	LBH
GRT	IMP	NTC
INL	KIO	OML
INP	LON	SAB
IPL	SOL	
MDC		
MMI		
MPC		
MSM		
MTN		
NED		
NPN		

PIK		
RMH		
SBK		
SHF		
SHP		
SLM		
TFG		
TRU		
WHL		

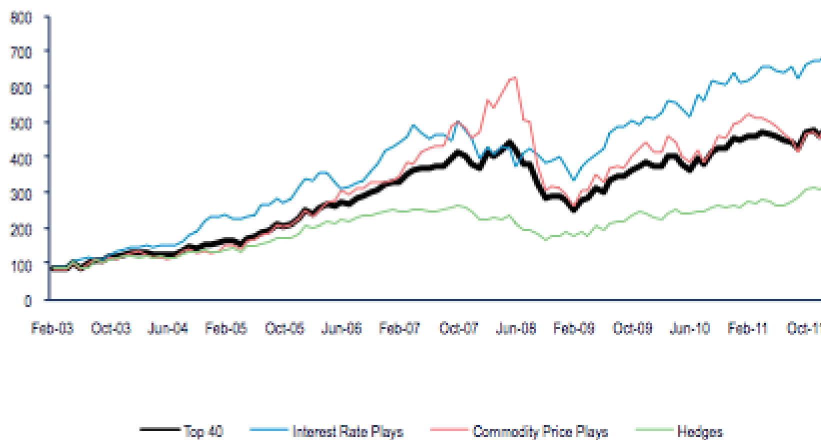
Source: Investec Securities

It should be noted that the interest rate sensitive stocks include most of the obvious candidates: the banks and the retailers. The only surprise inclusion is Naspers (NPN) that appears as SA interest rate sensitive, despite its exposure to offshore economies through its internet linked subsidiaries. The commodity price sensitive mining and resource stocks, including the large diversified mining companies Anglo American (AGL) and BHP Billiton, are predictably sensitive to commodity prices. The large gold mining companies, Gold Fields (GFI) and Anglo Gold Ashanti (ANG), reveal themselves unsurprisingly as hedges - sensitive to neither interest rates nor commodity prices. The other hedges include companies that are much more dependent on offshore economies than the SA economy, for example SABMiller (SAB), Aspen (APN) and also Old Mutual (OML).

Measuring performance of the groups

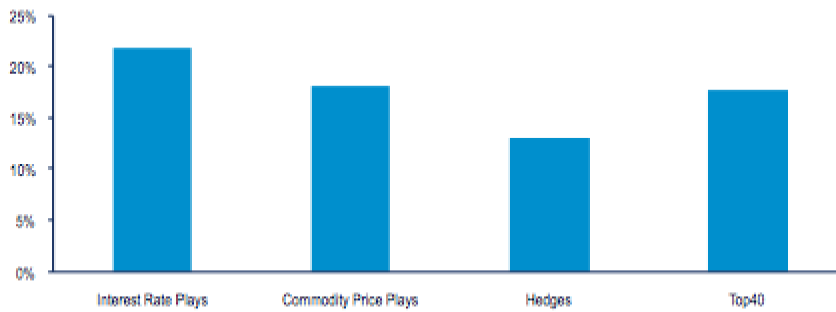
Investec Securities has created indices of these groupings and measured their stock market performance since 2003. As may be seen below, the Interest Rate Plays have been the distinct outperformers and the Hedges the distinctly underperforming sector of the JSE since 2003. The Hedge Index has been dragged down by the gold shares and Old Mutual.

Figure 2. Total returns for each index. Feb 2003=100



Source: Investec Securities

Figure 3. Annual average total return for each index Feb 2003 – Jan 2012



Source: Investec Securities

The Interest rate plays have become more favourably regarded by the share market. Is this justified?

It follows that if we expect interest rates to move up or down, we would add to or avoid the SA plays. If we were to predict SA specific rand weakness or strength, we would much prefer more or less exposure to the commodity plays and or hedges. If we were less optimistic about the outlook for metal and commodity prices, while sanguine about the global economy, a bias in favour of the hedges would be called for.

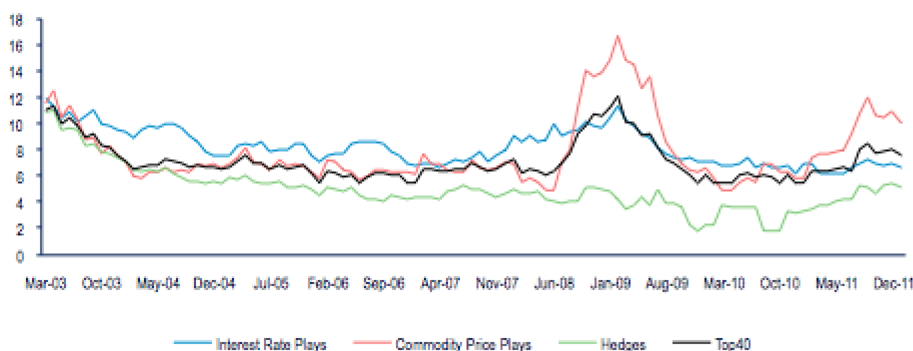
Optimism about both commodity prices and interest rates, implying a stronger rand, would be good for both the commodity and the rand plays. The issue of which stocks to prefer in circumstances favourable to both groups, interest rate or commodity price plays would then have to be influenced in our recommended weights for interest rate or commodity plays by the current valuations of the two groups of companies. Depending then on how relatively demanding or undemanding such current valuations may appear one might recommend more or less of the SA plays or commodity plays.

We show below that the SA interest rate plays have become more demandingly valued relative to the commodity price plays. Part of the superior performance of the interest rate plays over the past 10 years has come from a re-rating of the interest rate plays compared to the commodity price plays. Investors have come to pay more for the group of interest rate plays relative to their earnings while the multiple attached to commodity price earnings has remained largely unchanged over the years.

As may be seen, the interest rate plays now enjoy a higher rating (lower earnings yield implying faster and or more stable earnings growth to come) and that this yield has declined.

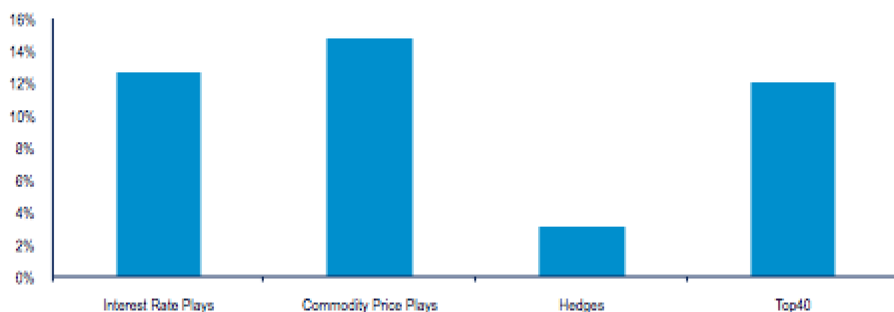
This rerating of the interest rate plays and relative de-rating of the commodity price plays has occurred despite the fact that the group of commodity price plays included in our Index of them have delivered on average faster growth in earnings than the interest rate plays over the period 2003-2011. As may be seen, the earnings yield of the Commodity Play Index increased markedly during the Global Financial Crisis, receded thereafter and are currently somewhat elevated and significantly higher than that of the interest plays- indicating a relative de-rating.

Figure 4. EYs over time – Commodity price plays back to starting level



Source: Investec Securities

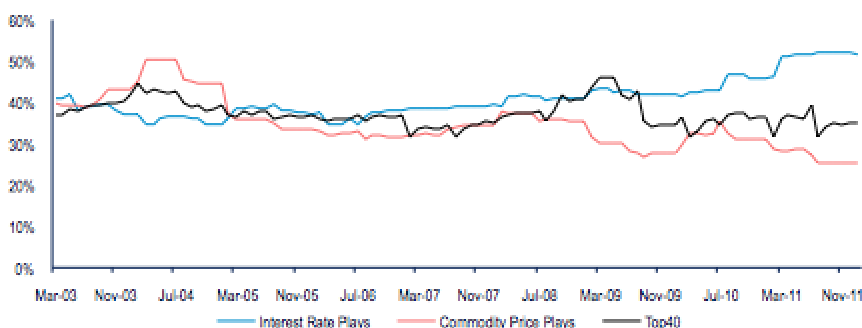
Figure 5. Annual earnings growth Feb 03 - Jan 12



Source: Investec Securities

It should be noted in favour of an improved rating for the Interest Rate Plays that they have tended to pay out more in dividends over the years (increased the ratio of dividends to reported earnings), while the commodity plays have trended in the opposite direction as we show below.

Figure 6. Pay-out ratio

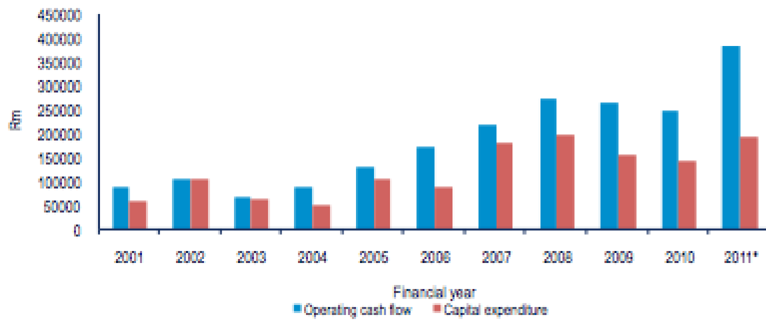


Source: Investec Securities

The commodity plays have remained cyclical rather than growth stocks

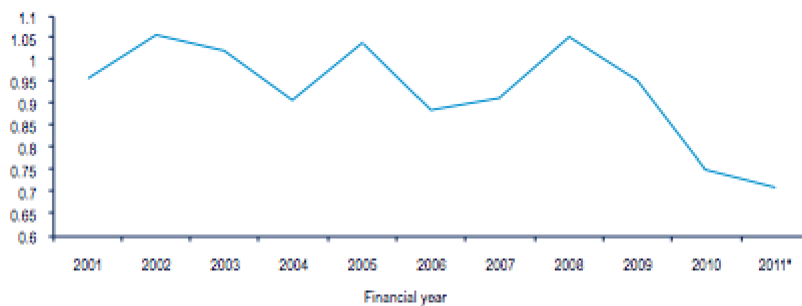
The improving cash flows of the commodity plays have been used to reduce debt rather than pay dividends or increase production capacity as we show below. The commodity plays as a group have generated cash flows well in excess of their investment programmes. The pace of these investments in plant, equipment and acquisitions, having increased over the period 2003- 2006, has stabilised or trended lower since 2007. The managers of these companies therefore have adopted what might be described as a defensive rather than a growth posture, perhaps responding to the turmoil in debt markets that have made rolling over bond issues seem a hazardous process. This cautious approach may be the reason why they have remained regarded as cyclical rather than growth companies.

Figure 7. Commodity Price Plays' investment in additional capacity – well exceeded by operating cash flows



Source: Investec Securities

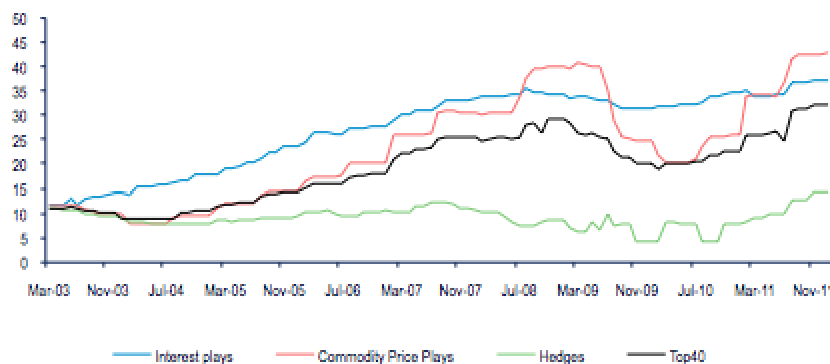
Figure 8. Debt to equity ratio of Commodity Price Plays



Growth and predictability of earnings and dividends can justify a re-rating

The SA interest plays have been able to offer shareholders not only growth in earnings and dividends, they have also been able to deliver growing dividends in a more predictable way. Their earnings cycle has become significantly less variable over recent years while the earnings delivered by the commodity plays have remained highly volatile. The interest rate plays survived the recession of 2008-09 with far less damage to their earnings and dividend flows, than did the commodity plays. Clearly, shareholders are prepared to pay more for predictable dividend flows- based on predictable earnings and a higher ratio of dividends to earnings. The decision of the Reserve Bank to keep interest rates on hold in 2011 was particularly helpful to the performance of the interest rate plays in 2011.

Figure 9. Historical earnings per R100 invested in Feb 03



Source: Investec Securities

We therefore are of the view that the improved rating of the SA interest rate plays is justified on their fundamental merits. The cyclical nature of the commodity plays has restrained their rating and the strong and consistent growth in the earnings and dividends of the SA interest rate plays has improved their ratings. Therefore we suggest that there is no current valuation argument to prefer commodity plays over the interest rate plays in the event of rand strength.

Why the SA interest plays may still be preferred in a favourable environment for equities

The case for both would have to be based on a prediction that equity valuations in the months to come will generally benefit from more risk tolerance and that the rand will benefit from such strength. From the perspective of the rand investor, rand strength may take some of the gloss off resource earnings and so add to the case for the interest rate plays. Rand strength will help hold down inflation and interest rates to the advantage of the interest rate plays. Our own inclination is to place a higher probability on less global risk aversion to come and rand strength rather than rand weakness. Our sense is that given an optimistic view of the global economy, a slight preference for interest rate plays would be in order.