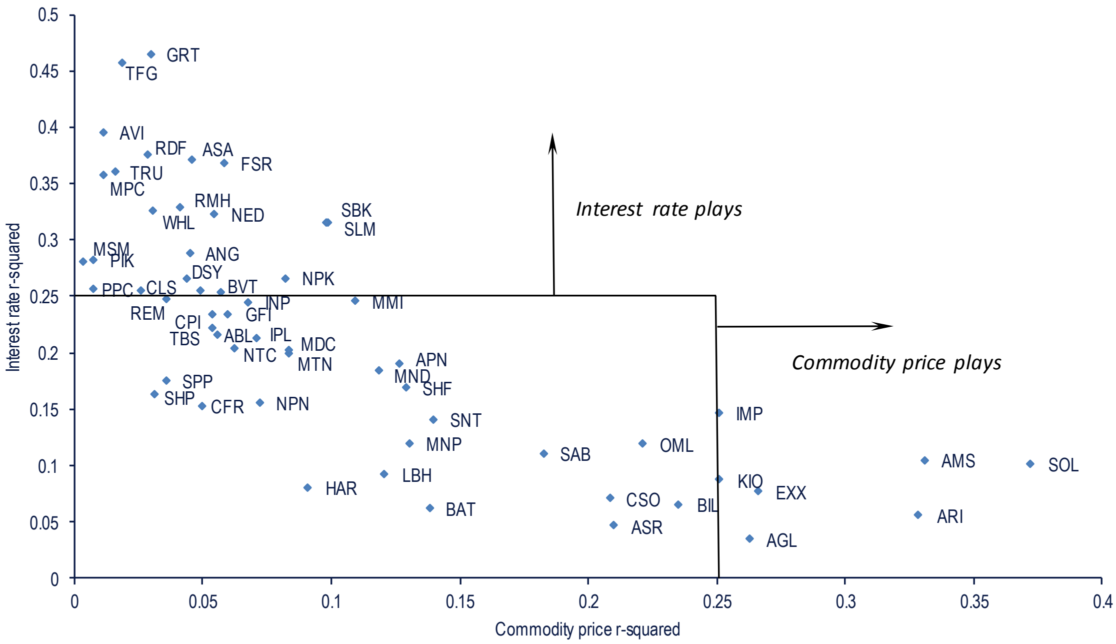
The competition for investor interest that matters on the JSE is that between JSE listed stocks and their Emerging Market peers. Not between SA economy plays and resource counters

How to best categorise the stocks listed on the JSE

We have suggested that the JSE normally divided into Industrials, Financials and Resource counters and sub-sectors is better divided and analysed as *Interest Rate Plays*, (Retailers, Banks and Property Companies etc.) *Commodity Price Plays* (Resource Companies excluding gold mines that are not sensitive to commodity prices- nor even it would appear to the gold price in any consistent way) and those stocks not much affected by either interest rates or commodity prices. These we call *Industrial Hedges.* The Industrial Hedges are companies listed on the JSE that undertake much of their sales and incur most of their costs outside the SA economy. They therefore depend on the state of global economy rather than the SA economy. British American Tobacco (BAT) SAB, Richemont (CFR) are among the most significant of these companies. Naspers (NPN) Aspen (ASP) and MTN have recently joined their ranks. Their global operations have made them much less sensitive to SA interest rates and economic conditions.

The problem with the companies that make up the JSE Industrial Index is that they combine companies with very different characteristics – that is companies that are very sensitive to SA interest rates and economic conditions and other Industrial companies that do not much depend on SA economic developments. In the figure below we group the TOP 40 companies accordingly.

Segregating the South African equity market

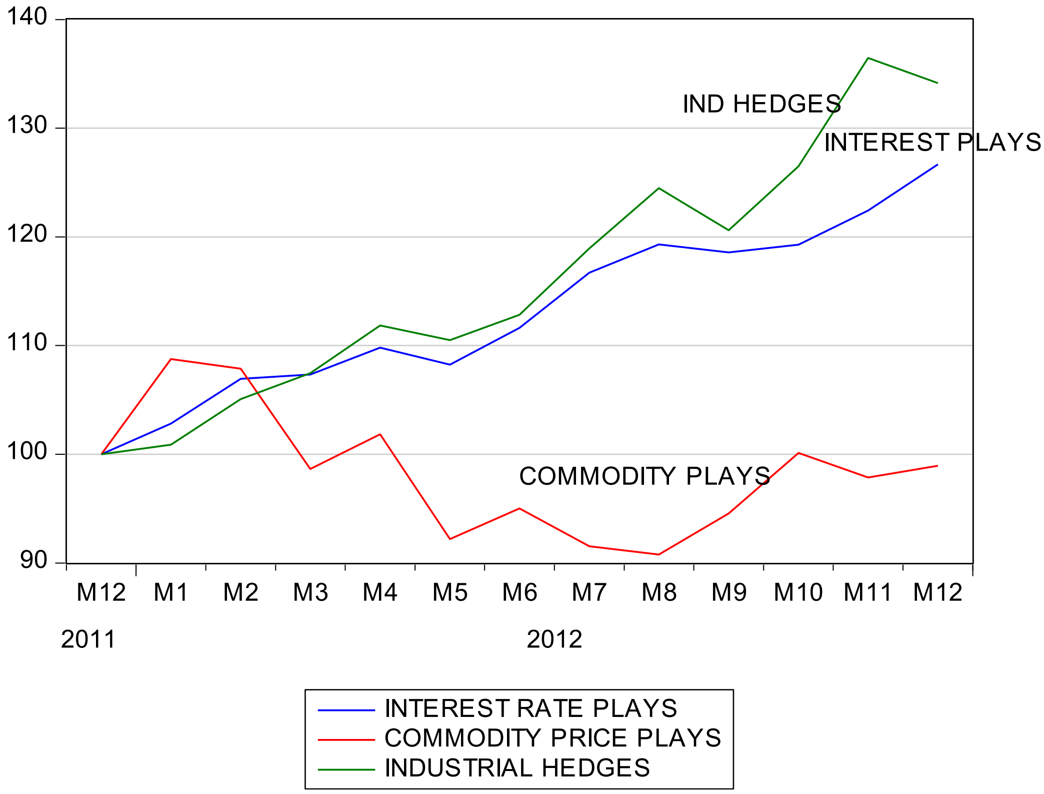


Source: Investec Securities Research and Bloomberg

The interest plays have outperformed consistently

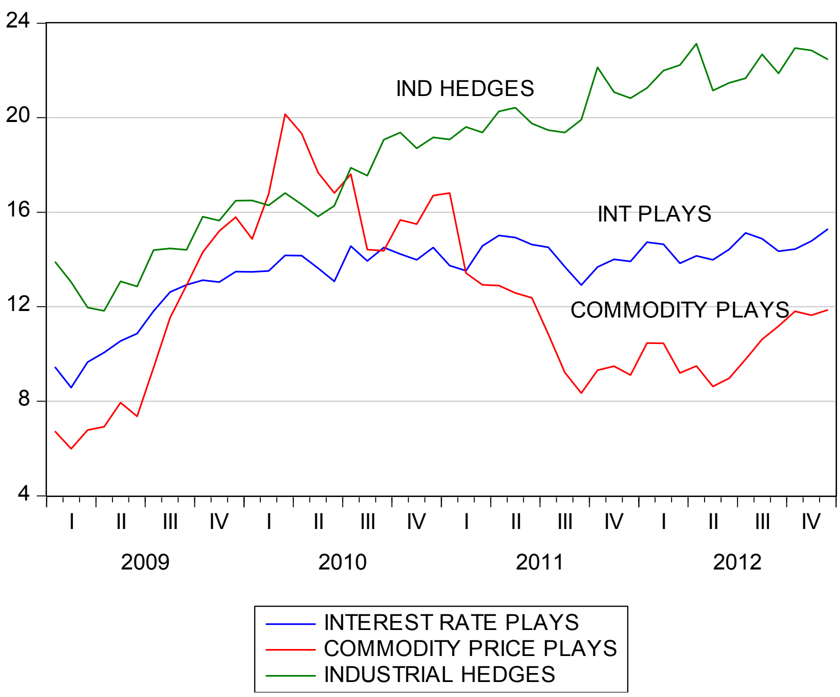
We have created Indices of these groupings going back to 2003. As may be seen below the Interest Rate Sensitive and Industrial Hedges have significantly outperformed the Commodity Price Plays in recent years and again this year. Moreover the price to earnings multiples of the Interest Plays and especially the Industrial Hedges have reached record levels while that of the Commodity Plays have lagged well behind.

JSE Interest Rate Vs Commodity Price vs Industrial Hedges; Valuations (RANDS) January 2012=100



Source; Investec Securities and Investec Wealth and Investment

PRICE/EARNINGS MULTIPLES 2009-2012 ; JSE Interest Rate Vs Commodity Price vs Industrial Hedges;



Source; Investec Securities and Investec Wealth and Investment

Compare like with like- not apples with oranges

This has led many a South African commentator and fund manager for some time now to regard the interest rate sensitive stocks and industrial hedges as very expensive and the commodity price plays as offering value. Such judgments have proved highly fallible as the Industrial Hedges and the SA interest plays have continued to forge ahead while the commodity price plays have continued to underperform.

We would argue, with the help of Chris Holdsworth of Investec Securities, that the comparisons SA fund managers are inclined to make - that is between the relative merits of apparently expensive Industrials and apparently valuable resource companies quoted on the JSE - is the wrong place to look for under or out performance on the JSE. Rather the comparisons to make are those made by global investors who have become increasingly important in determining valuations on the JSE. Global investors compare the relative merits of companies listed on the JSE with their peers, especially emerging market peers, listed on other stock exchanges. In other words comparing interest rate sensitive stocks on the JSE with interest rate sensitive stocks listed on other emerging equity markets or JSE commodity price plays with their peers listed on other exchanges. Not that is to compare the value in the Interest sensitive stocks or the Industrial hedges with the apparent value in resource companies.

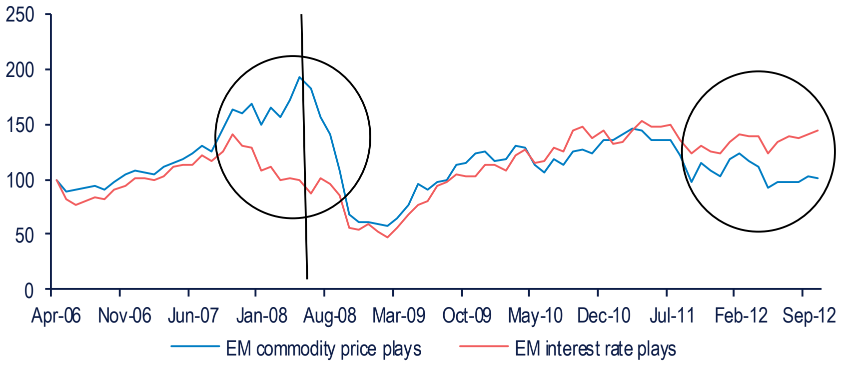
Accordingly Holdsworth undertook the following exercise

- **For each of the countries in the FSTE EM index to recreate the interest rate play/commodity price play segregation.**
- **To aggregate all of the interest rate plays and commodity price plays into an EM interest rate play index and a EM commodity price index.**
- **We use market cap weighted indices below but the results are similar for equally weighted indices.**

The JSE interest rate sensitive stocks as an outperforming emerging market

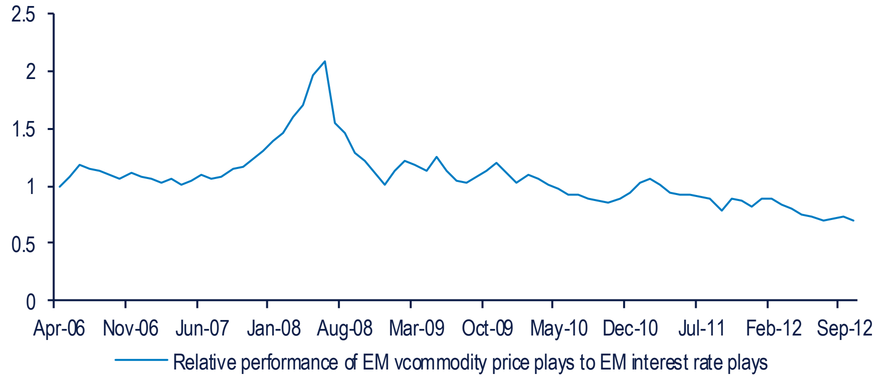
Holdsworth was able to show (see below) that across all emerging markets (not only the JSE) commodity and interest rate plays have mostly performed similarly, with the exception of the period before the global financial crisis when commodity price plays outperformed and more recently when the interest rate sensitive stocks have offered far superior returns. But for the spike in 2008 the commodity price plays have underperformed consistently, as is shown below

EM commodity price plays and interest rate plays haven't often diverged



Source: Investec Securities Research and Bloomberg

EM commodity prices plays have persistently underperformed with the exception of a spike in 2008



Source: Investec Securities Research

Holdsworth was also able to show, going back to 1970, using the conventional JSE Resources Vs Industrial distinction, that relatively high or low price earnings multiples for Resources compared to Industrials provided very poor predictions of subsequent returns- This result held whether subsequent returns were measured over a 12 month or five year period. In other words because resource companies or commodity price plays have underperformed to date does not mean they will perform well or rather better in the months to come. What will matter for relative performance will be subsequent trends in interest rates and commodity prices

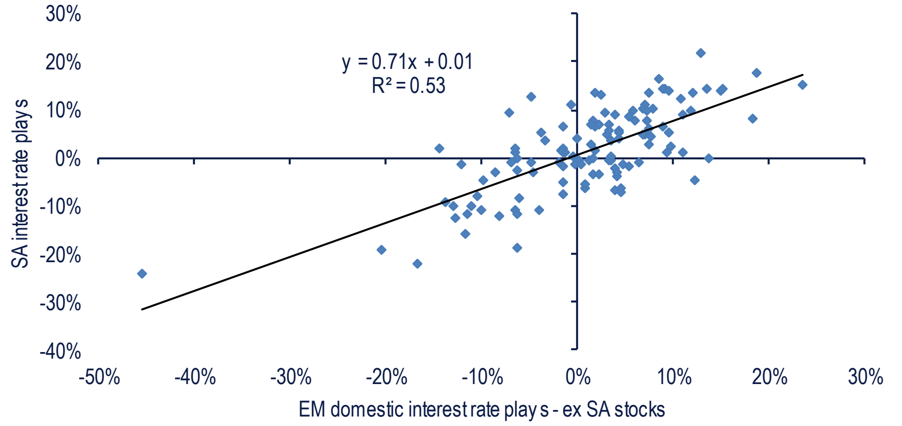
Comparing like with like- interest rate sensitive stocks with other interest rate sensitive counters

The important exercise therefore is not the comparison between interest sensitive stocks and commodity price plays, but to compare SA interest plays with their Emerging Market (EM) peer groupings. By this comparison SA interest plays compare very well indeed and, as Holdsworth shows, fully deserve what has become their premium rating compared to the EM peer group. When comparing the performance of the group of SA interest sensitive stocks to their EM peers Holdsworth found that

- **The monthly correlation of returns all measured in USD is very high (0.73)**
- **Despite low beta, (that is the SA group returns that vary by less than the EM average) the SA interest rate plays have outperformed their EM peers**
- **Outperformance is just over 2.2% p.a. (18.8% vs. 16.4%)**

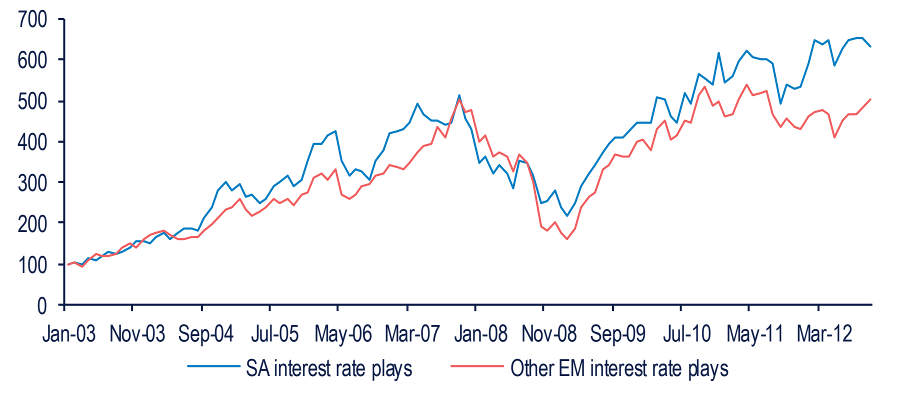
The figures below illustrate these results

SA interest rate plays vs. other EM domestic interest rate plays (USD monthly returns Nov 2002 – Nov 2012)



Source: Investec Securities Research and Bloomberg

Total return indices for SA interest rate plays and other EM interest rate plays



Source: Investec Securities Research and Bloomberg

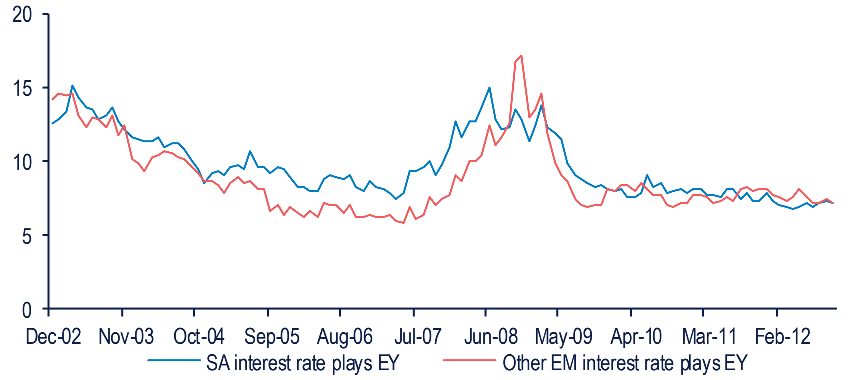
As is shown in the figures below that compare the earnings/price relationship of SA interest rate plays with their EM counterparts the following outcomes are to be observed.

- **The marked rerating of interest rate plays has not been isolated to South Africa. Interest rate plays across all emerging markets have been re-rated- that is enjoyed lower earnings yields and higher price to earnings multiples**

- **The SA interest rate plays currently trade in line and historically have traded in line with their EM peers**

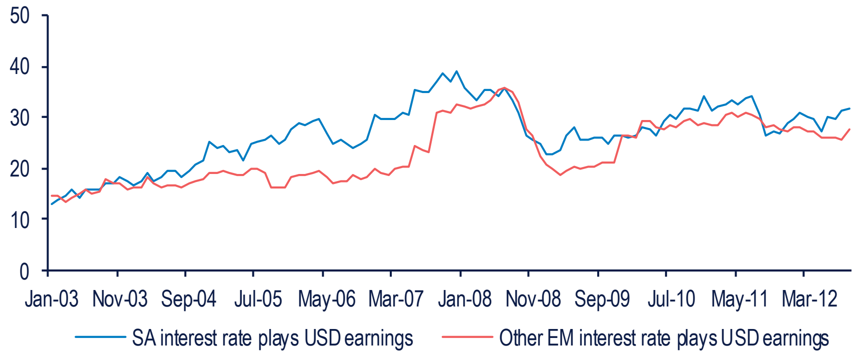
- **SA companies have, however, marginally outperformed on an earnings basis that is have grown their earnings per share in USD at a slightly faster rate than the average EM market.**

Earnings yield for SA interest rate plays in line with that of EM peers



Source: Investec Securities Research and Bloomberg

SA interest rate plays' earnings performance marginally better than EM peers



Source: Investec Securities Research and Bloomberg

The importance of dividends and returns on capital in influencing performance

SA interest rate plays moreover have consistently paid out more of their earnings as dividends as we show below. In a world of low interest rates the ability to pay dividends and to increase them over time is particularly prized.

- **The Dividend Yield of the SA interest rate plays is roughly 1.6 times their EM peers**
- **$100 invested in Dec 02 would have yielded $16 from the SA interest rate plays while only yielding $9 from the EM interest rate plays**
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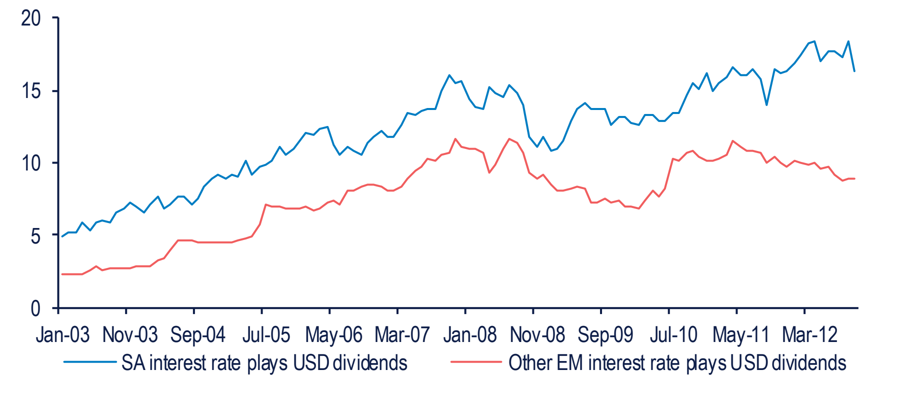
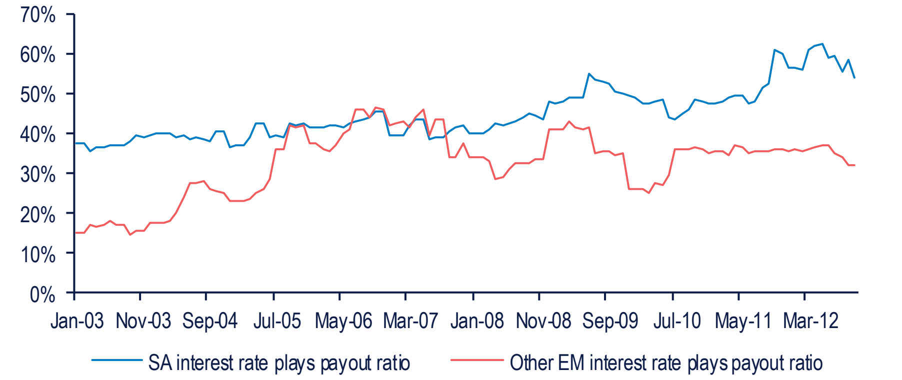
The figures below illustrate how much better the SA interest rate plays have performed on the dividend front -- growing their dividends in USD at a faster rate than their peers and consistently paying out a larger proportion of their USD earnings. A better rating is perfectly understandable given such economic outperformance

SA interest rate plays USD dividend performance well ahead of EM peers



Source: Investec Securities Research and Bloomberg

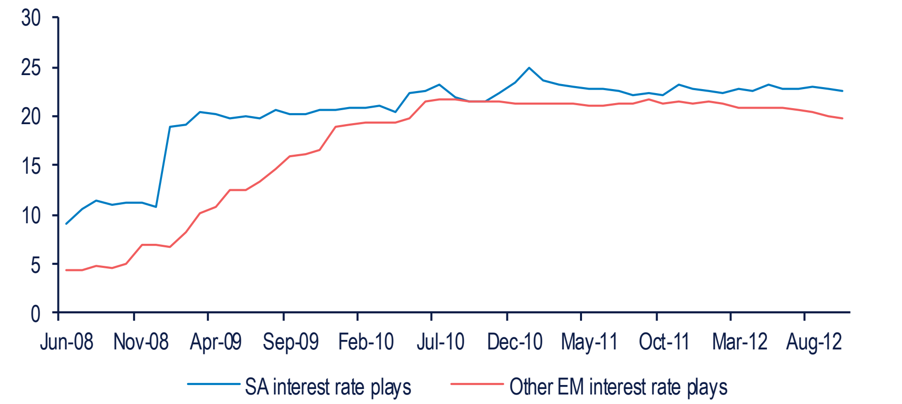
SA interest rate plays consistently pay out more of their earnings as dividends



Source: Investec Securities Research and Bloomberg

In other words SA companies have been able to achieve rapid earnings growth despite high payout ratio. At the heart of this ability to outperform has been the superior returns earned on equity capital employed by the SA interest sensitive cohort, as we show below

SA ROEs persistently higher than that of EM peers



Source: Investec Securities Research and Bloomberg

Future performance will depend on comparative interest rate trends

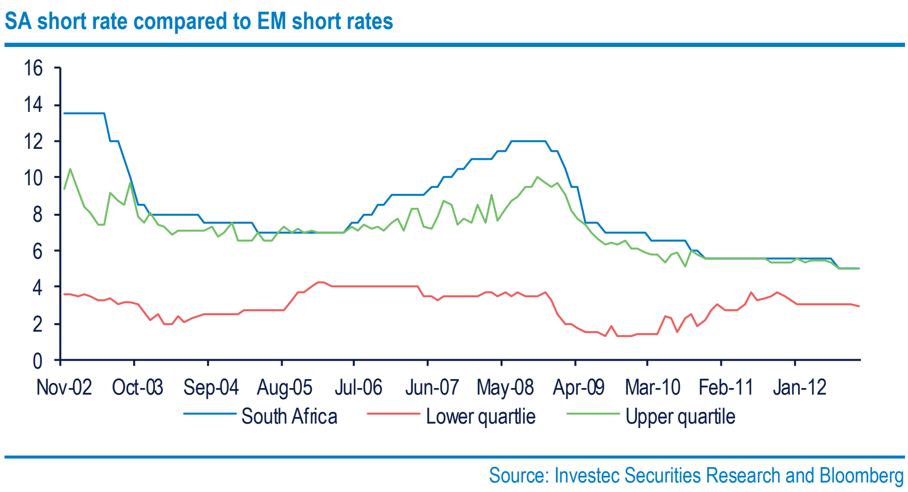
Past performance is not necessarily a guide to future performance. But since we are comparing interest sensitive stocks across the emerging market world a key ingredient in determining future performance will be the (relative) behaviour of interest rates across the EM universe of stocks followed by global fund managers. Will interest rate trends in SA be helpful or harmful to the interest rate sensitive counters on the JSE?

Global investors directly influence interest rates as well as equity prices. When they show an appetite for local currency bonds or the local money market they not only influence yields at the longer end of the market they will also, as is the case when they invest in equities, influence the emerging market currencies and so the outlook for inflation. The stronger the currency, the better the outlook for inflation and so, the lower will trend interest rates at both the long and short end of the market.

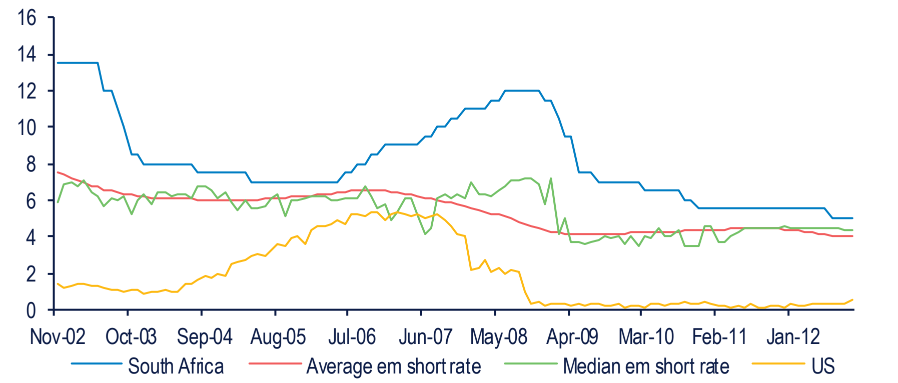
A comparison between SA and other emerging market interest is highly relevant in this regard. The wider the spread between SA and other emerging market interest rates, the more attractive will be RSA interest rates to the foreign investor. In the following series of figures the following trends are highlighted

At the short end of the market it should be noted that

- **EM short rates have converged post March 2010**
- **SA is at the upper end of the range**
- **But the SA spread relative to other EMs has narrowed since 08**



SA short rate in line with emerging market average

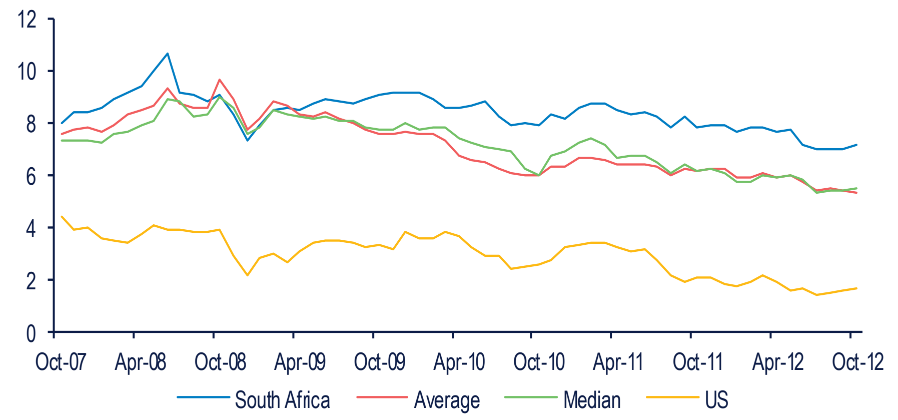


Source: Investec Securities Research and Bloomberg

At the longer end of the yield curve the following facts should be recognised

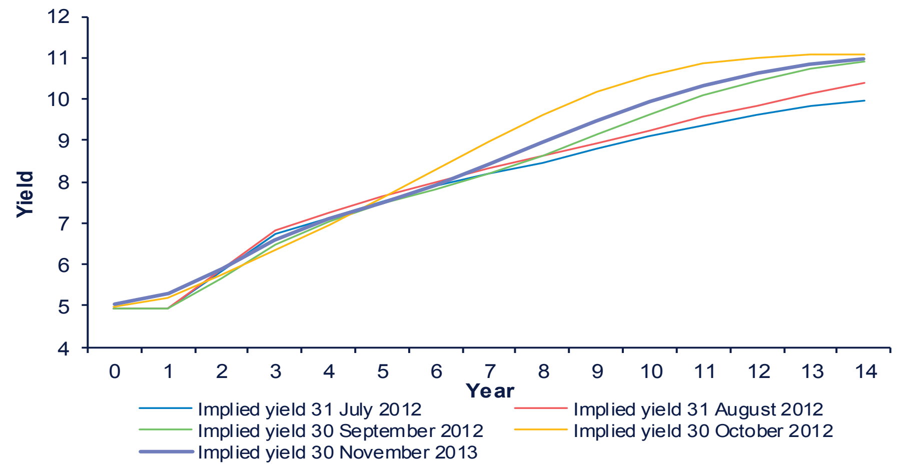
- **While the SA 10yr bond is low by historical standards, the spread against other EMs has actually widened post 08.**
- **The 1 year yield in 9 yrs. time is priced to be 9.5% - 50bps above the average since inflation targeting was adopted and allowing inflation of 6% plus a real yield of 3.5%.**
- **Together this suggests that the long bond yield could still decline even if the short end increases**

SA long bond yield low by historical standards - but relatively high



Source: Investec Securities Research

Implied 1 yr. yield form the zero coupon curve - very steeply sloped



Source: Investec Securities Research and I-Net

Conclusion

The SA interest plays have come through a period of rand weakness and a steeper yield curve very successfully and perhaps surprisingly so over the past year, as has been indicated. Our sense is that these now wider spreads in comparison with other EM fixed interest markets could attract flows of funds from off shore and cause both a degree of rand strength and a flatter yield curve. Very recent trends in the SA bond and currency markets have been helpful in this regard. We show a narrowing the gap between the long and short term interest rates in SA since October 2012. This has been accompanied by a degree of rand strength over the past 10 days

If we are correct in these predictions for interest rates and a flatter yield curve, the outlook for the interest rate sensitive stocks on the JSE remains promising. The key risk to the interest rate plays remains the opposite trend, that is the possibility of rand weakness, more inflation and higher interest rates especially when compared to other emerging markets. We are however confident that in the absence of faster economic growth interest rates at the short end of the market, even given rand weakness will not rise.

We have demonstrated that the performance of the SA interest rate Plays is fully justified by their excellent economic fundamentals. Future good performance will remain dependent on support from lower interest rates- or at least not hampered by higher interest rates.