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NFB FINANCIAL SERVICES GROUP

FROM THE CEO's DESK

Later this year, I am privileged to be cycling in a very special, fund raising cycling event. NFB has been a sponsor and supporter of this event for almost ten years. The event is great fun and raises millions of rands each year which support some very special initiatives which help deter criminals (a DNA project), uplift people by giving them skills and a future, and a few more.

The relevance of this paragraph to my editorial, is this year's tour is called the “Wonderland Tour”. Like in Alice in Wonderland, there are mad hatters, magic and loads of confusion!

This reminds me of the markets and this crazy world we live in! Starting with Brexit. I got this sooo wrong. We seldom forecast at NFB, but in this case I certainly called it wrong. What is important to note is how markets reacted. Chaos ensued and amongst other developments, property funds were temporarily 'gated', meaning they closed the funds to redemptions. Currencies went into a spiral, the British Pound leading the charge. The UK and overseas companies with UK listings or exposure got hammered. A few weeks later, and with the exception of property and financials, many of the shares are at, and some above, pre-Brexit levels.

Domestically, the rand has continued its highly volatile track and is trending stronger on the majors, much against the trend forecast by us doom and gloomers! Watch this space. We have a very interesting political and labour negotiation season ahead. The other factor which should always be factored into one's view on investments, in particular equity, property and currency calls, is time and timing. Looking at long term trends is always insightful. Clear conclusions can be drawn from these. They say the trend is your friend.

A while back I was bold enough to break NFB's doctrine on forecasting once more. I suggested that the rand at R17/$ was crazy. As it happens this was an accurate call. At current levels, I am a whole lot less confident to make a call and typical of markets, trusted sources of forward looking exchange rates vary greatly.

The Rand recovery bulls are calling it around R12 'next year'. The bears are seeing R17,50. Given this dispersion, the politic and economic realities and the free lunch offered by diversification, I am trending towards advice supporting increased offshore investment.

I have included two graphs to display these concepts in action. Firstly, a long term graph with the trend clearly displayed. The second, a short term graph with the volatility on show.

I guess the critical point which always needs to be considered before worrying about trends and volatility, is an individual's needs and circumstance.

20 YEAR USD ZAR WITH 3 YEAR MOVING AVERAGE

2 YEAR USD ZAR WITH 3 YEAR MOVING AVERAGE

A further issue concerns the difference between genuine offshore investment, typically achieved through Foreign Investment Allowances, and Asset Swaps and investment into Rand Hedges. The former is the sleep easy option. You genuinely have international monies in your name and which are overseas. The latter two are locally sourced and offer protection from any rand weakness, but are redeemable in rands at some future date. This does not offer real protection. Reverting to my thoughts above, where I referred to the offshore property funds and 'gating', the bad old days where Exchange Control disqualified us from holding offshore assets or the freedom to take funds offshore come to mind! This is not scare mongering, but a point being made which warrants inclusion in our thinking. Had you asked a UK investment professional a week before Brexit if they were worried about liquidity in the property unit trusts, they would have laughed. They aren't today, and what is more, they are defenseless for the medium term to manage prices and risk in client portfolios. I wonder what they are telling folk who are retiring at the end of July and who need cash?

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“...I am trending towards advice supporting increased offshore investment.”

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TOO FLUSH TO FAIL?

Are current central bank supported equities levels artificially inflated and what does this mean looking forward?

One needs to just look at the headlines in the financial news to see an apparent disconnect between global equity markets and the economic fundamentals and valuation metrics which theoretically should ultimately be driving them.

- Longest earnings recession since crisis looms for US shares (4 July 2016 – Financial Times)
- Not too late to reap gains after S&P 500 hits high (11 July 2016 - CNBC)
- Economy stutters as Brexit fallout takes hold (10 July 2016 – The Telegraph)
- The FTSE 100 just entered a bull market (11 July 2016 - Bloomberg)

While anxious investment eyes are focused firmly on the negative tone of catchphrases such as Brexit (Britain's pending EU exit); the Italian job (Italian banking failure contagion); Nenegate (the firing of ex finance minister Nhlanhla Nene) and China's hard landing (stalling Chinese growth figures), certain equity markets are flirting with all-time highs. In addition, global growth projections have been revised downwards four consecutive times by the International Monetary Fund (IMF); corporate earnings across the board continue on a descending trajectory (revisited later in this article) and aforementioned market shocks lead to spikes in volatility and disruptions of hopes of stability. So the question begs asking – how are equity markets continuing to stay afloat in these choppy seas?

The answer lies in the actions of the global central bank heavyweights injecting liquidity into markets at a rate which may well have led to stretched equity market valuations and a potential threat of damaging reversions.

With official policy rates at record lows (in some cases negative), alongside quantitative easing programs, currently active in Japan and Europe and previously in the US, equity markets have been propelled through a series of wild swings with investors continually twisting the metaphorical risk-on/risk off (RoRo) taps.

- Chinese growth data miss implying weaker demand for commodities – risk off.
- Negative US employment data implying the Federal Reserve (Fed) won't raise rates – risk on.
- Initial concerns and confusion over the impact Brexit will have on future of the Eurozone and the UK – risk off.
- Subsequent realization of possible lower UK rates and further Japanese stimulus in the face of above confusion and concern – risk on.

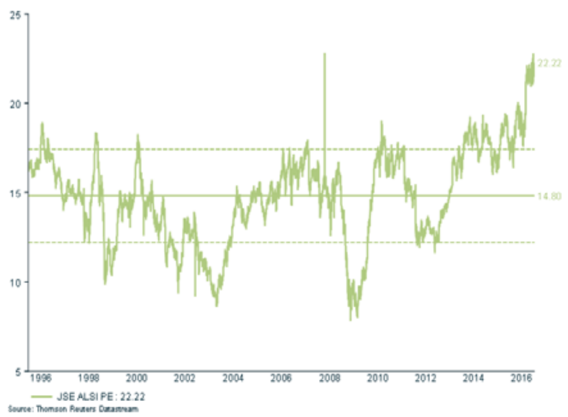
All this volatility and near-constant retreat to safe assets, in particular gold, and US, Japanese and Swiss sovereign debt, in times of uncertainty has led to a compression in yield in these assets into unchartered territory. Globally, there is now approximately ten trillion dollars of negative yielding government bonds in the market, including securities with terms as far out as twenty years in Japan and fifty years in Switzerland. The Swiss now rewards investors with minus 0.012% for the luxury of a half-century debt instrument. While conservative investors scramble for anything resembling a positive yield and the promise of a 'safe asset', the need for capital to be allocated to riskier assets such as equity and property opens up.
In this instance what we have seen is that despite corporate earnings trending downwards, or at the very best flat, equity markets have managed to hold steady and in some cases, including the US, UK and South Africa, offer low-to-mid single digit returns over the past year. This all despite grey swan* events spiking volatility and leading to large scale short term sell-offs, with the likes of Nenegate and Brexit being prime examples. What then emerges from such a situation is the abnormal notion of a bull market profit recession.

The table below shows what the effect has been on the price-to-earnings (P/E) ratio of these indices.

Index	Index Return 1 Year	Earnings Growth	Resultant P/E Ratio Growth
S&P 500	4%	1%	4%
JSE ALSI	2%	-20%	28%

What becomes clear then is that certain P/E ratios are beginning to get out of line with historical norms. The JSE All Share Index now trades at a P/E of over 22, well above one standard deviation of the long term average of 14.8. These levels are unprecedented in terms of our twenty-year data set and thus offer cause for concern. The three ways of normalizing a P/E ratio are 1) a retraction in prices or 2) earnings growth or 3) a combination of both, and with somewhat pedestrian growth in the price of the index it's fair to say the majority of this surge in the ratio has been on the back of a drop in earnings – a drop in excess of 20% that is.

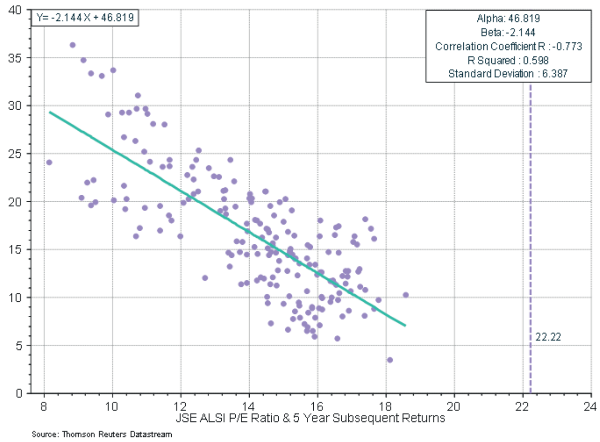
JSE ALL SHARE INDEX (ALSI) PRICE-TO-EARNINGS RATIO



(Source NFB Asset Management)

In order to find empirical evidence to perhaps provide some solace or to confirm such concerns, we ran a model to test if there was a significant relationship between the starting P/E level and the subsequent five-year total return of that index, which we did for a number of global markets. What we found was a moderately strong relationship between a high P/E ratio and lower subsequent five year returns for the JSE ALSI.

JSE ALSI PRICE-TO-EARNINGS RATIO AND SUBSEQUENT FIVE YEAR TOTAL RETURN



(Source: NFB Asset Management)

At the current level of 22.22 (marked by means of the dashed, vertical line), which has never been captured by the model, one would expect that returns are more likely than not to be muted in the coming years. If we assume that inflation is likely to average around 6% per annum over the next five years, then the above chart implies negative real returns from South African equities, i.e. that those who invest now are likely to go backwards in inflation-adjusted terms over the next five years.

Note that the rather alarming message in the earlier paragraph is only for South African equities in general. There may be certain sectors of the market (either in terms of market capitalisation (i.e. size of company) or in terms of industry sector (financials versus industrials for example) that may perform very well in the economic environment we set out in this article. This is where the benefits of active management shine through.

Marry the high valuations of South African securities supported by a developed world awash with cheap money through a series of expansionary monetary policy programs globally, with an already low and decreasing global, and to a worse effect South African, growth environment, placing further pressure on already weak earnings and you have a situation where something simply has to give. The normalization of the P/E realized through a turnaround in earnings in the current macro-economic state of play is difficult to fathom, which leaves weakness or a simply flat movement (assuming earnings growth) in the price of the index.

This is not to say that this situation is imminent, as central bankers continue to find new and exciting methods to keep economies and asset prices afloat, all the while investors search for yield, be it in near or sub-zero bonds or riskier equities. However, should a point be reached where the taps are turned off, these unrealistic debt-fuelled valuations may well need re-evaluation.

Perhaps the most suitable sensationalist news headline we love to live off of late which speaks testament to the above goes as follows – Don't fight the central banker gang that might hand us Dow 20,000 (Market Watch.)

**Grey swan – a termed coined by renowned author Nassim Taleb which means a volatile event likely to have a sizable impact on a security or market which, unlike an unforeseen black swan event, can be anticipated through superior analysis and macro-economic foresight.* ■

> *"…should a point be reached where the taps are turned off, these unrealistic debt-fuelled valuations may well need re-evaluation."*

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FROM THE CEO's DESK

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Switching our attention to the local market, we are, as NFB has matured, been asked more and more about safe, tax free or tax efficient sources of income. We have a number of potential solutions, ranging from dividend focused share portfolios, to use of new retirement annuities, to shield taxable drawings from other retirement assets, to simply investing in a unit trust which focuses on earning mainly dividends, guaranteeing capital and doing so whilst offering 24-hour liquidity.

With a world which appears to be entering into an extended phase of low interest rates, we are also applying our minds to securing more sustainable (5 year) guaranteed income solutions. These fit nicely into the range of investments in client's portfolios, both in providing tax efficient income, but also reducing your tax rate applicable on other investments. Space limits me from expanding on this, but please engage with your advisor should this be of interest to you or your trustees.

For clients who like to keep things super simple, NFB also offers immediate access (24hr) call accounts at quite superior rates.

In conclusion, what makes life interesting is the unconventional. Mad hatters and magic are all about. Our job together with you, our clients and associates, is to define our respective needs, explore all obvious and sometimes less obvious solutions, and implement plans built to be robust yet flexible, in order to meet our respective needs in a sustainable way.

'Noise' is a constant, but with your support, NFB has become a substantial player in the South African wealth and advisory markets, capable of developing cost efficient and tax friendly solutions using both in-house and institutional propositions to meet the local and offshore requirements of an amazingly diverse client base.

In a few weeks' time, South Africa goes to the polls. If you can, this important event needs all eligible folk to spend a part of what is a special public holiday making your mark. The time has come for all South Africans to take responsibility for the road we travel as a nation. ■

> *"Our job, together with you, our clients and associates, is to define our respective needs, explore all obvious and sometimes less obvious solutions and implement plans built to be robust yet flexible, in order to meet our respective needs in a sustainable way."*

SENSIBLE INSURANCE

You are probably aware that if you crash your car while driving under the influence of alcohol or other drugs, your insurance company has the right to repudiate your claim, leaving you liable not only for the damage to your vehicle, but also for any other damage caused by the accident.

What you may not know, and what the new Ombudsman for Short-term Insurance, Deanne Wood, points out in a media release, is that your insurer **does not** have to prove beyond reasonable doubt that you were driving under the influence, for it to repudiate your claim. It simply has to come to that conclusion “on a balance of probabilities” - a much lighter burden of proof.

The outcomes of criminal and civil cases are determined by different criteria. “In criminal cases, in order to secure a conviction of, for example drunk driving or driving under the influence, the State is required (as we heard repeatedly during Oscar's trial) to demonstrate **beyond a reasonable doubt** that a driver was indeed driving in such a state. There must be no question as to a person's guilt.

“In civil cases (such as a claim under an insurance policy), the insurer need only show that the insured was, **on a balance of probabilities**, driving under the influence”. This means your insurer does not have to rely on the results of a blood or breath test to confirm that you were over the legal limit at the time of the accident; all that is required is sufficient circumstantial evidence.

Deanne Wood explains that examples of circumstantial evidence on which insurers often rely are statements by police or emergency service personnel at the scene of the accident; doctors or nurses who attended to a driver who was admitted to hospital; eyewitnesses who were able to observe the driver's state; witnesses who can account for the driver's whereabouts prior to the collision and who can attest to whether he or she consumed alcohol, and video footage from restaurants or bars.

In some cases a driver may try to avoid the consequences of getting caught 'drunk driving' by unlawfully leaving the scene of the accident. The Ombudsman advises against this course of action.

If you are in an accident in which a person or an animal is killed or injured, or any property (including another vehicle) is damaged, the National Road Traffic Act requires that:

- You stop your vehicle and report the accident to the police;
- You ascertain whether a third party sustained any injuries, and if so, render whatever assistance you can;
- You ascertain the nature and extent of any damage sustained;
- Where reasonable grounds exist for a person to ask for your name, address and other personal details, you provide such information;
- If no report is lodged at the scene of the accident, you report the accident to the police within 24 hours of the accident (unless you are prevented by injury from doing so) and produce your driver's licence and further details; and
- Except on the instructions of a medical practitioner, you not consume any alcohol or drugs until you have reported the accident to the police and, if so ordered by a traffic officer, you have been examined by a medical practitioner.

Your failure to comply with **any one** of these provisions entitles your insurer to reject your claim and if you complain about it to the Ombudsman's office, your complaint is likely to be rejected.

Always ensure that your policy premiums are up to date in order to ensure that your policy is in force when you may need to claim. In addition to this, it is wise to strictly adhere to the admonition not to drink and drive or leave the scene of the accident as this will jeopardise the chances of a successful claim.

Should you have any queries with regards your short term insurance, please do not hesitate to contact an NFB Private Wealth Manager at one of our NFB offices in Johannesburg, East London, Port Elizabeth, Stellenbosch or Cape Town.

> *“Your insurer does not have to prove beyond reasonable doubt that you were driving under the influence to repudiate your claim.”*

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