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ECONOMIC & MARKET UPDATES

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THE POWER OF INDEPENDENT ADVICE

IN THIS ISSUE

JHB: +27 (0)11 799 8100
PTA: +27 (0)12 347 8240
CPT: +27 (0)21 914 9646

GLOBAL FINANCIAL MARKETS

DEVELOPED MARKET EQUITIES STILL IN FAVOUR

GLOBAL DEVELOPED MARKET EQUITIES HAVE POWERED AHEAD IN USD TERMS OVER THE PAST YEAR AND HAVE OUTPERFORMED EMERGING MARKET EQUITIES. THE COLLECTIVE INVESTMENT PERFORMANCE OF EMERGING MARKET EQUITIES HAS BEEN RELATIVELY FLAT FOR THE PAST 6 YEARS IN USD TERMS.

The talking point most recently, was the rally across emerging markets that kicked off in mid March. This was driven primarily by China, where authorities were looking to provide monetary stimulus to alleviate growth concerns.

Looking across global EM equities, the recent rally has been led by bank stocks and commodity-related equities, which is consistent with the view that Chinese growth prospects should improve.

By the end of April and year to date, however, developed markets resumed their front position, outperforming emerging markets for the respective periods. On balance, developed markets are expected to improve on stronger economic activity, stable low inflation and no interest rate policy changes.

Overall, the positive turn in the global cycle is expected to persist, with room for further acceleration from here. In other words, the room for growth in developed market equities from current levels, albeit not the same extent as seen in the past decade.

The story of developed market equities now outperforming emerging market equities is an interesting one. From 2000 to 2010, the annualised return on the MSCI Emerging Market index was 10.9% annualised in USD versus just 1.3% for developed markets.

Since then this has turned into disappointment as emerging market equities, bonds, and currencies fell sharply in mid-2013, following possible indications of tapering of Quantitative Easing ("QE").

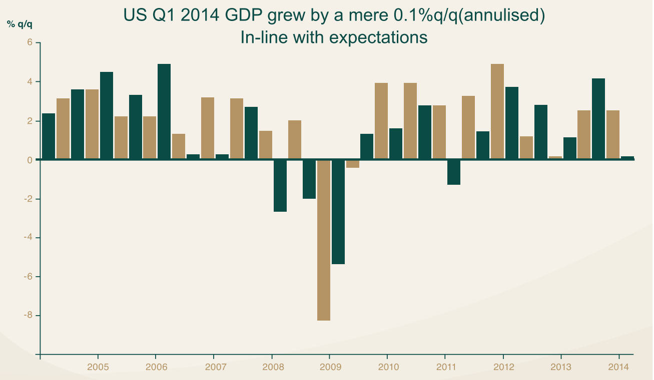
The concerns about emerging markets include slower growth than previous years, over-reliance on excess liquidity arising from the US QE, growing consumer debt, concerns that vital structural reforms had not been undertaken, unease over corporate governance and, for some countries, moves into deficits, possible property bubbles, and street protests and unrest. While many of these concerns are legitimate, EM are in far better shape today than in the 1980s and 1990s.

FOR NOW MARKETS PREFER DEVELOPED MARKET EQUITIES TO EMERGING MARKET EQUITIES AS WE CONTINUE TO SEE STRONGER DATA AND SIGNALS OF CONTINUED RECOVERY IN THESE MARKETS.

Leading indicators of economic activity in the US point to a rebound from the soft patch caused by bad weather in the first quarter.

The GDP data for the US in Q1 2014 has been well below previous quarters, showing a rise of only 0.1%q/q, annualized. The key areas of weakness included a decline in exports, fixed investment and government activity. Consumer spending held up well, especially in the services sector. For 2013 as a whole the US grew by 1.9%, down from 2.8% in 2012. For 2014, we expect growth to improve to around 2.5%.

CHART 1: **US REAL GDP GROWTH**



Source: Kevin Lings, STANLIB

The high-level thinking on the inflation outlook has not changed in any significant way, with the inflation trend running well below its 2.0% target.

There has been little upward pressure on inflation due to weak consumer spending, affected by weather distortions.

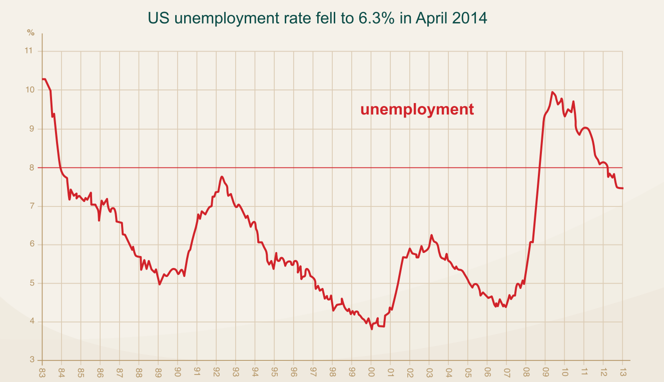
The tapering of QE continues at a consistent pace based on signs of the economic recovery. In December 2013, the Federal Reserve announced that it would commence QE tapering in January 2014 by scaling back their asset purchase programme from $85 billion a month to $75 billion. This was then followed by a further $10 billion reduction to $65 billion at the January 2014 meeting, another $10bn reduction in March and a further $10bn cut at the end of April. It is entirely possible that QE will have been completed by the end of 2014. Then interest rates can start to normalize.

THE OUTLOOK FOR THE REST OF 2014 IS BRIGHTER SUPPORTED BY STRONG EMPLOYMENT REPORTS AND ASSOCIATED WAGE AND INCOME GROWTH.

The April labour market report was impressive with non-farm payrolls (the number of jobs added each month) at 288 000 jobs for April. This is an excellent reading and an average of 250 000 jobs added per month is required for US economic growth to breach the 3% mark on a sustainable basis.

For comparison, during 2010 the US economy created an average of 88 000 jobs per month; in 2011, a far more respectable 173 000 a month; and in 2012, job gains averaged 186 000 a month. In 2013 employment rose by an average of 194 000 jobs a month. In the first four months of 2014 employment has risen by an average of 214 000 jobs.

CHART 2: **US UNEMPLOYMENT REPORT**



Source: Kevin Lings, STANLIB

The stronger labour market, a faster pace of hiring and higher corporate profits have increased tax revenue and this has contributed to a smaller government budget deficit (difference between government revenue and expenditure).

The U.S. Treasury Department announced the biggest quarterly pay down of government debt in seven years. This is good news for bond yields – that they won't rise so fast at the end of Quantitative easing.

The US fiscal balance has declined by more than $1 trillion since its peak in February 2010. Funding a deficit of $500 billion is a lot more manageable for the private sector than funding a deficit of $1.5 trillion.

IN EUROPE, EXPECTATIONS OF FURTHER ECB EASING HAVE BEEN KEPT ALIVE BY A STRING OF LOW INFLATION REPORTS. EURO ZONE INFLATION IS RUNNING AT 0.5% - FAR BELOW THE ECB'S MEDIUM-TERM TARGET OF JUST BELOW 2 PERCENT.

ECB President Mario Draghi told German lawmakers that a quantitative-easing program isn't imminent and is relatively unlikely for now. However, the central bank does stand ready to embark on QE if needed. Draghi has said he is considering unprecedented measures to avert the risk of deflation as he guides the euro area through a gradual economic recovery.

Over the past five years, in light of macro-economic uncertainty and reduced bank lending, European corporates have hoarded cash and deleveraged.

A macro recovery should hopefully give firms the confidence to re-prioritise balance sheet efficiency and start spending again. This would provide a positive backdrop for European equities.

IN APRIL, STANDARD & POOR'S CUT RUSSIA'S SOVEREIGN LONG-TERM FOREIGN CURRENCY RATING BY ONE NOTCH TO BBB- THE LOWEST INVESTMENT GRADE RATING, AND MAINTAINED A NEGATIVE OUTLOOK ON THE RATING.

S&P cites large capital outflows and heightened risks to external financing as the reason for the downgrade. The downgrade already reflects that outflows could pick up once more on the risk of further sanctions and a weakening growth outlook. As Russia's military secured the Crimean peninsula, its currency hit a record low and its stock market plunged in the face of U.S. and European warnings of sanctions over the invasion into Ukraine.

The Obama administration took the first steps suspending military cooperation with Russia as well as talks aimed at boosting trade and investment.

In terms of financial market performances, for April 2014 developed equity markets were up 1.1% (MSCI World), outperforming Emerging Markets which were up 0.4% in US$ total return terms. For the past 12 months, developed markets were up 17.2% versus emerging markets being down 1.5%.

KEY MARKET PERFORMANCES

- **The DJ Eurostoxx was 2.1% for April, 4.2% YTD and 27.3% for the past 12 months.**
- **The S&P 500 was 0.7% for April, 2.6% YTD and 20.4% for the past 12 months.**
- **The UK FTSE 100 was 4.4% for April, 3.8% YTD and 18.6% for the past 12 months.**
- **The Nasdaq 100 was -0.3% for April, 0.0% YTD and 25.8% for the past 12 months.**
- **The Nikkei 225 was -2.7% for April, -8.9% YTD and 0.1% for the past 12 months.**
- **The MSCI China was -2.3% for April, -8% YTD and -0.9% for the past 12 months.**
- **The MSCI Turkey was 7.5% for April, 12.7% YTD and -25% for the past 12 months.**
- **Brent Crude Spot is up 2.5% in April.**
- **Gold was down 0.09% in April 2014 and is down 11.31% over the last 12 months.**

LOCAL FINANCIAL MARKETS

IN CONTRAST TO AN IMPROVING GLOBAL ECONOMIC ENVIRONMENT, THE SA ECONOMY HAS BEEN LOSING MOMENTUM.

The current trend in the leading indicator suggests that the SA economy will remain under pressure during the first half of 2014, largely due to domestic circumstances including the impact of strike activity, higher interest rates, falling confidence and a reduced intention to increase employment.

ENCOURAGINGLY, THERE IS A FAIRLY STRONG RELATIONSHIP BETWEEN THE SA LEADING INDICATOR AND THE OECD LEADING INDICATOR.

SA's leading indicator tends to lag the global economic cycle, both into a slowdown/recession as well as into a recovery. The OECD leading indicator has remained positive during the past few months, despite some softening in economic activity in late 2013 and early 2014, which is an encouraging signal for the SA economy going into the second half of 2014 and early 2015. Hopefully, a steady improvement in the global economy (which should lift SA exports, especially given the weaker Rand) coupled with an improvement in infrastructural development have the potential lift SA's growth prospects in 2015.

It is important that South Africa moves past the labour market disruptions and policy uncertainty that are currently afflicting a number of key economic sectors, and finds a way to lift business and consumer confidence.

THE BIG FACTOR FACING THE SA ECONOMY IS INFLATION AND THE EFFECT ON CONSUMER SPENDING AND DEMAND.

Cost pressures have risen. Administered (compulsory) costs have risen. Cost pressures on essential goods and services have increased significantly and these include electricity, petrol, education, and food. In addition, there is clear evidence that consumer income is under pressure.

CONSUMER CONFIDENCE IS ALSO DEPRESSED, AND CURRENTLY WELL BELOW THE LONG-TERM AVERAGE.

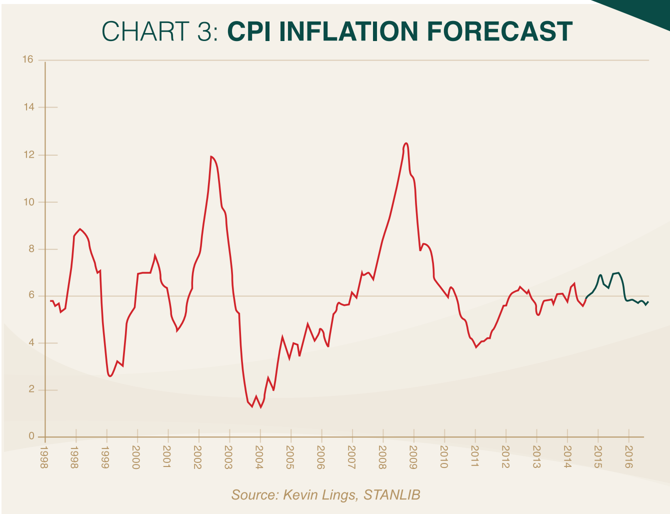
Debt has increased. Many middle to low income earners have become more highly indebted in the past two years and are struggling to meet their repayment obligations, while a rise in strike activity (especially in the mining sector) is eroding spending power in that segment of the labour market.

All of this would suggest that consumer spending is still expected to remain under pressure on a longer-term trend basis. Retail spending rose by only 2.2%y/y in real terms in February. People are still spending on clothing and footwear, as well as building materials and hardware. In contrast, sales of furniture and appliances are experiencing outright recession conditions, while sales of pharmaceutical, medical and cosmetic products have slowed appreciably. The data does not suggest that retail activity is heading towards recession but than consumer activity is restrained.

MARCH WAS A LARGE SURVEY MONTH FOR CONSUMER INFLATION. SOUTH AFRICAN HEADLINE CPI INFLATION ROSE TO 6.0%Y/Y FROM 5.9%Y/Y IN FEBRUARY 2014.

One of the key upside risks to SA consumer inflation in 2014 is food inflation is now up at 7.2%y/y (from 3.5%y/y in December!) and is likely to move somewhat higher over the coming months, depending on further pass-through from Rand weakness.

For 2014, SA inflation is now forecast to average 6.4%, rising significantly above 6% in the second half of the year. For 2013 as a whole, SA CPI inflation averaged 5.8%, up slightly from an average of 5.7% in 2012 and a more subdued 5.0%y/y in 2011 and 4.3% in 2010.



THE RESERVE BANK HAS, OBVIOUSLY, BECOME SIGNIFICANTLY MORE CONCERNED ABOUT THE IMPACT OF THE WEAKER EXCHANGE RATE ON INFLATION, AND IS CLEARLY WILLING TO RAISE INTEREST RATES FURTHER SHOULD INFLATION PRESSURES APPEAR TO BROADEN (HIGHER CORE INFLATION).

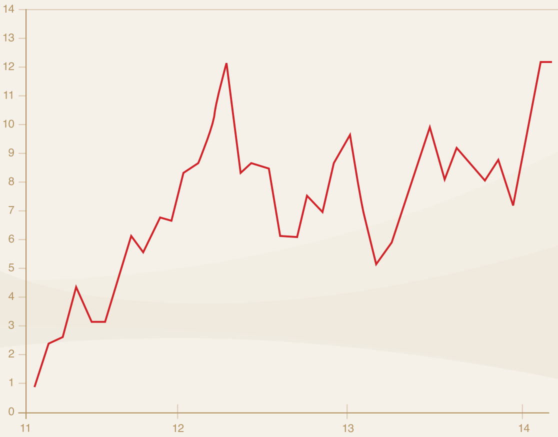
In making the decision on further interest rate changes, the Reserve Bank will take comfort from the fact that the currency had settled, albeit at a weaker level, and that there is negligible growth in private sector credit and money supply. Another two 25bp increases are expected at the next MPC meetings. Each MPC decision is likely to be guided by global interest rate developments as well as the path of the Rand exchange rate at the time of the meeting, coupled with their own assessment of the strength of the economy as well as their forecast of SA consumer inflation.

There has been almost no growth in consumer credit but a surge in corporate credit, with the total private sector credit recorded at 8.8%y/y in March 2014.

The growth in corporate credit continues to move sharply higher and is now up at 12.8%y/y supported by increased demand for trade finance, funding of business activity in the rest of Africa, and some investment expansion. Unsecured credit (in the form of personal loans) has slowed to a mere 4.1%y/y, which is the lowest annual rate of growth since prior to the recession in 2009.

It would appear that banks have systematically tightened lending standards in the unsecured space after experiencing a surge in non-performing loans. Mortgage credit, has been rising at an average of R1.7bn a month but it rose R3.7bn in March. Mortgage credit is only up 2.9%y/y, but appears to be slowly trending higher *(see chart on page 5).*

CHART 4: **SA GROWTH IN CORPORATE CREDIT**



Source: Kevin Lings, STANLIB

Overall, the rate of expansion in total private sector credit remains modest and will not pose any concerns for the Reserve Bank. Hopefully, the composition of credit growth continues to switch in favour of more mortgage activity and fixed-investment finance.

On the production side of the economy, activity remains subdued, with manufact-uring production up a mere 1.4%y/y in February 2014.

It is still not back to pre-crisis levels of activity. For 2010 as a whole, SA manufacturing activity grew by 4.7%y/y, which was obviously a vast improvement on the 13.5%y/y decline recorded in 2009. In 2011, production averaged a more modest rise of 2.8%; in 2012 , a mere 2.3% on a weaker global economy and mining strikes; and in 2013, activity rose by an average of only 1.4%, which is really more stagnation than expansion, with the motor industry heavily disrupted by labour unrest.

The weakness in industrial output reflects a wide range of factors including problems with low productivity, sporadic labour market disruptions, infrastructure bottlenecks, a lack of research and development, and skill shortages.

Fortunately, there is some indication that the weaker Rand is slowly starting to have a beneficial impact on some aspects of production, but this is not widespread enough to boost the entire manufacturing sector. We remain hopeful that SA manufacturing activity will improve somewhat into 2015, supported by the on-going expansion of SA business activity into southern Africa (including increased infrastructural development in Africa), increased infrastructural investment domestically, a pick in residential property building activity and a steady improvement in world economic conditions (exports). In term of financial market performances, the ALSI gained 2.65% in April 2014.

KEY EQUITY MARKET PERFORMANCES

- **The FTSE /JSE Index was 2.65% for April, 7.1% YTD and 58.6% for the past 12 months.**
- **The Top 40 Index was 2.3% for April, 7.0% YTD and 32.5% for the past 12 months.**
- **Mid Cap was 5.1% for April, 7% YTD and 18.1% for the past 12 months.**
- **Small Cap was +2.6% for April, 7.3% YTD and 23.8% for the past 12 months.**
- **The Resource 10 was 3.8% for April, 14.6% YTD and 36.4% for the past 12 months.**
- **The Industrial 25 was 1.3% for April, 2.3% YTD and 32.6% for the past 12 months.**
- **The Financials 15 was 3.8% for April 11.2% YTD and 26.3% for the past 12 months.**
- **Value was 2.9% for April, 7.6% YTD and 26% for the past 12 months.**
- **Growth was 2.5% for April, 6.5% YTD and 31.7% for the past 12 months.**

The All Bond Index gained 0.32% in April 2014 and the Inflation-Linked Bond Index gained 2.45%. Cash returned 0.47%.

Over a 10-year period, the All Share Index returned 20.1%, the All Bond Index returned 9.3%, Cash 7.8%. Property Unit trusts 19.5% and Inflation (headline CPI) returned 5.9%.

The Rand strengthened by 0.2% against the Dollar in April 2014 is down 14.6% over the last 12 months but only down 1.6 year to date. Against the euro, the Rand depreciated by 0.5% in April 2014 is down 18.9% over the last 12 months but only down 1.1 year to date.

Source: Kevin Lings STANLIB, Deutsche Bank, Goldman Sachs.

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All our Financial Planners are CFP® Professionals and members of the Financial Planning Institute of Southern Africa. They are highly qualified to give advice on all investment matters.

MAGNUS HEYSTEK **EMAIL:** magnus@heystek.co.za **TEL:** +27 (0)83 692 8635
Magnus is a director of Brenthurst Wealth Management and is in charge of investment strategies, research and client communication.

BRIAN BUTCHART CFP® **EMAIL:** brian@brenthurstwealth.co.za **TEL:** +27 (0)82 335 5117
BRIAN is head of financial planning at the CAPE TOWN OFFICE and a director of Brenthurst Wealth Management.

JOHAN BURGER CFP® **EMAIL:** johan@brenthurstwealth.co.za **TEL:** +27 (0)82 732 8655
JOHAN is the head of financial planning at the PRETORIA OFFICE and a director of Brenthurst Wealth Management.

RENEE EAGAR CFP®	**EMAIL:** renee@brenthurstwealth.co.za	**TEL:** +27 (0)83 233 9373
SONIA DU PLESSIS CFP®	**EMAIL:** sonia@brenthurstwealth.co.za	**TEL:** +27 (0)83 260 4055
MAGNUS L HEYSTEK CFP®	**EMAIL:** magnus1@brenthurstwealth.co.za	**TEL:** +27 (0)72 071 5567
RICHUS NEL ACCA	**EMAIL:** richus@brenthurstwealth.co.za	**TEL:** +27 (0)78 260 4013
SUZEAN HAUMANN RFP™	**EMAIL:** suzean@brenthurstwealth.co.za	**TEL:** +27 (0)21 914 9646

CLIENT SERVICES & EXCECUTIVE ASSISTANTS:

JHB: +27 (0)11 799 8100 PTA: +27 (0)12 347 8240 CPT: +27 (0)21 914 9646

CHRISTOFF POTGIETER
christoff@brenthurstwealth.co.za

CELESTE PHAKHATI
celeste@brenthurstwealth.co.za

ERNA MARÉ
erna@brenthurstwealth.co.za

NATASCHA DU PLESSIS
natascha@brenthurstwealth.co.za

ANTJE MOUTON
reception@brenthurstwealth.co.za

ESMERIE LOOTS
esmerie@brenthurstwealth.co.za

YOLANDI BURGER
yolandi@brenthurstwealth.co.za

MAGDA KAMFER
magda@brenthurstwealth.co.za

RONELLE STIPP
ronelle@brenthurstwealth.co.za

DIRECTOR & HEAD OF MARKETING: SUE HEYSTEK
sue@brenthurstwealth.co.za

WILLS & ESTATES: ROZANNE HEYSTEK-POTGIETER
rozanne@brenthurstwealth.co.za

TAX & ACCOUNTS: GAVIN BUTCHART
gavinb@brenthurstwealth.co.za

CLIENT COMMUNICATION: MICHELLE BURGER
michelle@brenthurstwealth.co.za

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JOHANNESBURG:

Tel: +27 (0)11 799 8100
Fax: +27 (0)11 799 8101

Unit 2B, Cedar Office Estate, Cedar Road, Fourways, South Africa

PO Box 10150, Fourways East, 2055, Gauteng, South Africa

PRETORIA:

Tel: +27 (0)12 347 8240
Fax: +27 (0)12 347 0601

494A Lois Avenue, Erasmuskloof X3, Pretoria, South Africa

PO Box 32593, Waverley, Pretoria, 0135, South Africa

CAPE TOWN:

Tel: +27 (0)21 914 9646
Fax: +27 (0)21 914 6515

Tyger Waterfront, Waterfront Terraces Block 2, Waterfront Road, Carl Cronje Drive, Bellville, South Africa

Postnet suite 275 P/Bag X22, Tygervalley, 7536, Cape Town, South Africa

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