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OF INDEPENDENT ADVICE

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RAND RICH BUT DOLLAR POOR

FOREIGNERS WITHDRAW R263 BILLION FROM LOCAL MARKET

By Magnus Heystek - Director and Investment Strategist

CLIENTS of Brenthurst Wealth will be well aware of our long-standing investment strategy of increasing offshore exposure across all our portfolios. Offshore diversification has long been an underlying theme in our investment portfolios, which was accelerated from about 2010 onwards. At the time our investment approach was met with substantial resistance but the events since then, as well as the relative investment performance over the past five years, has vindicated this position and has added considerable wealth to our clients.

It is fair to say, some five years later, that investors who added offshore diversification to their portfolios are today considerably better off than those who did not.

Despite the relative strengthening of the rand versus the US dollar and other major currencies during 2016, we do not see this as a major turning point in the fortunes of the local currency. We see it rather as a temporary reprieve from further currency weakness and will be using this period of relative strength to add to our offshore portfolios on behalf of our clients.

There are substantial headwinds building up which under certain circumstances can again in the near future put severe downward pressure on the rand-exchange rate versus major currencies.

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These include (but are not limited to):

A potential downgrade to SA's international credit rating by the major credit agencies in June 2017.

Sharper-than-expected increases in US interest rates during 2017 and beyond.

A slowdown in the mild upward turn in the global commodity cycle.

Political events, which could include the replacement of Pravin Gordhan as SA's finance minister.

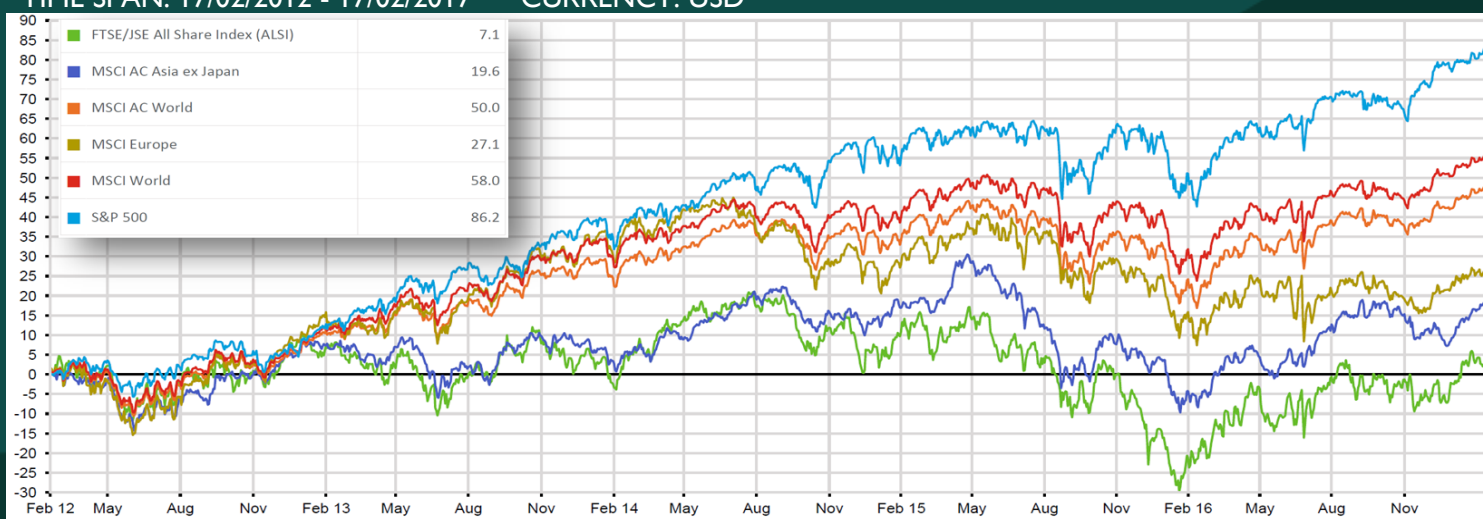
JSE VERSUS THE WORLD (USD)

But first, an analysis of the investment performance of SA-linked investments compared to US-dollar denominated investments over the past five years.

OVER THE PAST FIVE YEARS (GRAPH BELOW) THE AVERAGE INVESTMENT ON THE JOHANNESBURG STOCK EXCHANGE (JSE) HAS PRODUCED VIRTUALLY NO GROWTH WHEN MEASURED IN US DOLLAR.

JSE VERSUS THE WORLD (USD)

TIME SPAN: 17/02/2012 - 17/02/2017 CURRENCY: USD



Even the fact that many SA listed companies earn a substantial portion of their earnings in offshore markets, could not prevent this shocking under-performance of the JSE versus global markets in US dollar terms.

The same comparison, when done in rand terms (GRAPH BELOW), shows an equally shocking under-performance for investors in the local investment market. We find very little reporting about this fact in local media or by the large local SA investment companies.

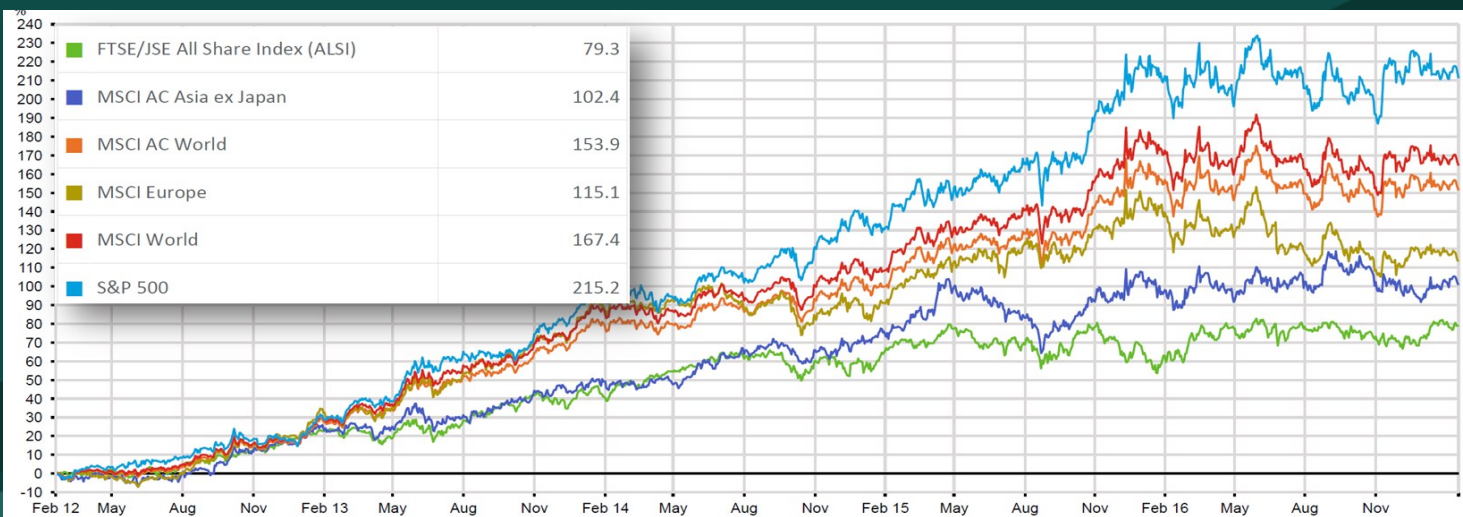
The reasons are obvious: even more money can leave local investment markets (last year R70 billion was invested offshore by private investors) if investors truly understand the full extent of the wealth destruction currently taking place, they will act more forcibly to reduce their exposure to local assets and increase their offshore exposure.

Probably the major reason for the poor performance of the JSE over the past three years has been the consistent selling of local equities by foreign investors.

In January of this year foreign investors were net sellers of a further R24,4 bn. in bonds and SA shares bringing the total rolling annual (12-month) outflows to R163 billion. Even more astounding is the fact that since September 2013 a net amount of R263 billion was sold out of SA equities and bonds. This outflow is unprecedented in modern times and SA, apart from China, is currently the only emerging market country experiencing such an outflow.

JSE VERSUS THE WORLD (RANDS)

TIME SPAN: 17/02/2012 - 17/02/2017 CURRENCY: ZAR



If the outflow of capital is not the result of global themes, then the only conclusion is that this trend has been driven by **LOCAL FACTORS**. International credit agencies have been highlighting the serious structural issues in the SA economy which is leading to such an outflow. The issues are as follows:

1. SA's working age population is not growing faster than its economy, hereby pushing up unemployment to 13-year highs at above 27% of the population.
2. SA's gross domestic product has been declining for several years now, both in rand terms as well as in dollar terms.
3. The economic growth rate has been disappointingly low for several years now, well below trend line and is not expected to have grown by more than 0,5% in 2016.
4. Government finances are in a dire state. Debt (at 50% of GDP) has doubled since the global financial crisis and is now at record levels. State owned enterprises (SOE's) are bleeding the country dry. Regular exposés by SA's media reveal a state of corruption at most SOE's such as Eskom, Transnet, SABC and others.
5. Lack of clear government policies across many sectors of SA industry (mining, tourism, small business) has led to a plunge in confidence and a widespread private sector investment strike. Companies would rather invest in other parts of the world or keep their money in cash than invest more money in SA due to policy uncertainty.
6. Most government interventions are focused on regulation and red tape as opposed to growth enhancements and greater certainty on policies.
7. Protracted political tensions (Zuma vs Gordhan) create policy uncertainty and impede structural reforms.
8. Scenes of riots in SA's parliament are broadcast all over the world, creating the impression of a country in terminal decline, further accelerating investment withdrawals from South Africa.
9. The economy has failed to react to the collapsing currency. Economic activity in export-sensitive parts of the economy normally react positively to a weaker currency. This time around it is not happening to the same extent.
10. Attack on "white monopoly capital". Many local and foreign investors see these continuous threats and attacks on so-called "white monopoly capital" as not only tiresome but also signs of greater attacks in the future, thereby accelerating their intention to withdraw.

RESIDENTIAL PROPERTY VALUES ALSO DECLINING

The lacklustre performance of the local equity market is often counterbalanced by rising residential property prices. This time this has not happened, suggesting that a deeper more structural change in the underlying dynamics is taking place in the property market, one that is not likely to turn around in the short term. The white population in SA, which has been constant for some years now, has started declining in nominal terms, by about 100 000 over the last five years. This is the result of increased emigration, a decrease in the birth rate and an ever-increasing average age.

A buoyant residential property market needs an ever-increasing number of home buying citizens to keep on pushing prices higher. This is not happening and one could expect further declines in the average residential property prices. The exception is the Western Cape where property prices have been supported by the massive numbers of well-to-do buyers from up-north looking for property in a market with a shortage of land and homes.

Add to the fact that SA residential properties on average have dropped by about 40-50% in US dollar terms over the same period, and one can then appreciate the full extent of the increased impoverishment being experienced by middle-class and even well-to-do local citizens without any form of offshore diversification.

The impact of this gradual impoverishment is already being felt in many sectors in South African society and can be seen in the drop in average residential property prices (with the exception of the Western Cape), a decline in new vehicle sales, declining membership of medical aid schemes, golf club membership, foreign travel and generally the sales of imported goods and services. For many South Africans these items have simply become unaffordable and they have been forced to downscale and buy cheaper alternatives.

It is unlikely that these trends will reverse in the near future as the country under the Zuma-administration has been suffering from lacklustre economic growth for more than 7 years now, which is putting increased pressure on government revenue and, very soon, will lead to increases in taxation across a very wide front as government battles to fund the fiscal deficit of R57 billion forecast for the next two years. This will further reduce consumer expenditure and add even more to the already low levels of consumer and business confidence.

Residential property prices have dropped more than 22% in real terms (i.e. after inflation) since the peak in 2007. According to the latest FNB Residential Property Survey average property prices during 2016 only rose by about 5%. Strip out the effect of sharply higher property prices in the Western Cape (up 11% YoY) and average property prices elsewhere in the country are now lower than a year ago.

It is taking longer to sell property now—more than 4 months on average—and in rural areas the formal residential property market has ceased to exist. Many property-owners in small to medium sized towns in many parts of Limpopo, Northwest, Northern Cape and Free State simply cannot sell their properties due to (a) lack of funding from the banks who have quietly withdrawn from these areas and (b) a lack of upwardly mobile young people who prefer moving to larger cities in search of work and career opportunities.

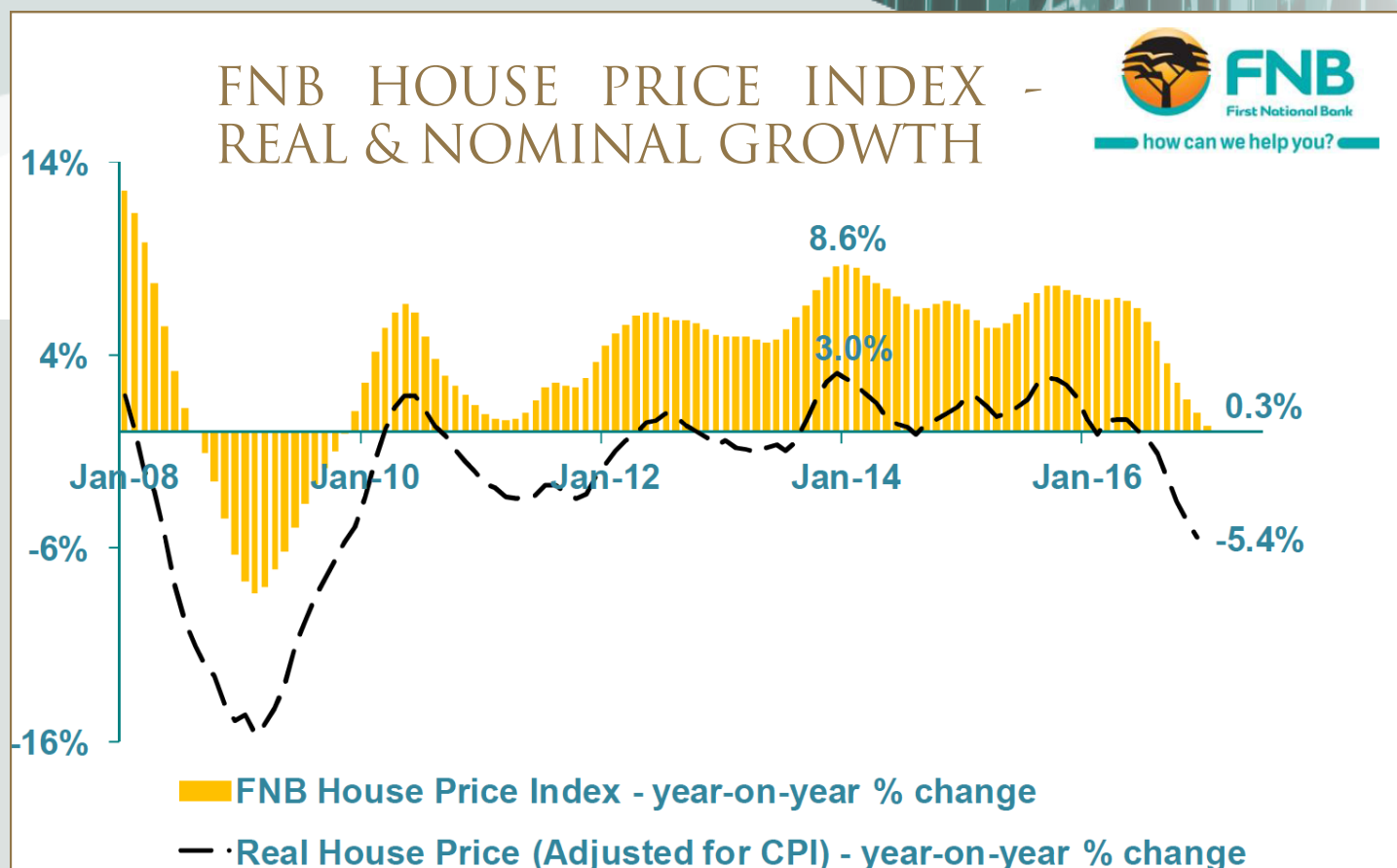
Property prices in the Western Cape, especially in Cape Town, Stellenbosch, Somerset West, Paarl and further afield have been bucking the price trend elsewhere in the country due to the steady stream of well-to-do people either (a) retiring in the Cape or (b) young families heading towards the Cape in search of what is perceived as a better lifestyle and schools.

CONT. RESIDENTIAL PROPERTY VALUES ALSO DECLINING

In discussions with many clients we perhaps pick up trends much earlier than official surveys by the banks and institutions. Many people are actively reducing their investment exposure to residential property in SA, particularly buy-to-let, which has become a millstone around the neck for many investors. With declining property values, rising interest costs and maintenance (as well as a legal system, which supports tenants more than landlords) the BTL as an investment concept is coming under serious scrutiny.

The investment returns on second properties and properties at the coast—which used to be very desirable—are being offloaded at an increasing rate. These properties are being sold at fractions of what they were purchased for or what they were valued at some years ago during the boom times.

Many small and medium sized coastal towns in SA survive mainly on the property taxes that they manage to extract from their mostly absent owners. Many home-owners, faced with rising property taxes, maintenance costs and other costs associated with coastal properties (security/gardening services) are being forced by the current bout of financial austerity – which is unlikely to be a short-term trend – to sell these properties into an already depressed property market. The outcome is unlikely to be good or profitable.



CONCLUSION

The pull-back in the rand from levels around R17 to the USD around the time of the Nenegate-scandal at end 2015 to current levels must be seen against the background sketched above. At the time there was a real chance that the rand could blow-out to around R20/USD. The recent strength of the rand is also driven in part by the surprise victory of Donald Trump in the US presidential elections. So far Trumps policies of reflation and increased expenditure on infrastructure have been good for markets generally, and also the commodity cycle, which benefits the rand.

The surprising strength of the rand has been in large parts counterbalanced by strong offshore investment markets. Investment markets in many parts of the world (US, European, London) have soared to new record highs, a feature which has not happened on the JSE. The JSE overall index, at around 52 000 — a level where it was three years ago — is well down from a peak of 55 188 on 24th April 2015 — almost three years ago.

It remains our view that offshore diversification, even though it introduces a higher degree of volatility and uncertainty, remains the correct investment approach for investors with long term investment horizons (4-7 years and more). We remain eternally vigilant for signs, both politically and economically, of a turnaround in the fortunes of the local market, but as yet we don't see it.

LAUNCH OF BRENTHURST CAUTIOUS FUND OF FUNDS

For investors who cannot tolerate volatility yet need to achieve some growth on their capital, we have created the BRENTHURST CAUTIOUS FUND OF FUNDS PORTFOLIO. This fund comprises several top performing local funds and the objective is to generate growth of between 8-10% with low volatility. As the fund has been registered as a Collective Investment Scheme it does come with added benefit of NO CAPITAL GAINS TAXES when switches are made within the fund.

SPEAK TO ANY ONE OF OUR SIX OFFICES COUNTRYWIDE IF YOU REQUIRE MORE INFORMATION ABOUT THIS NEW AND EXCITING DEVELOPMENT.

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