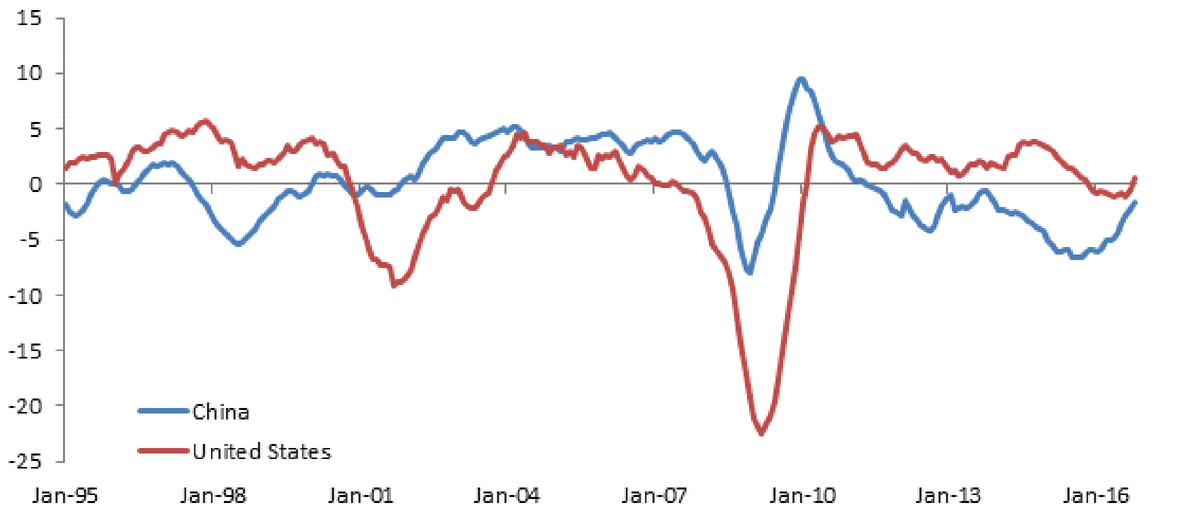
PRESCIENT
INVESTMENT MANAGEMENT

GLOBAL ECONOMIES SHOW STRENGTH IN A GRAND GO-AROUND[1]

Haakon Kavli and Raphael Nkomo of Prescient Investment Management argue that, on their own, the South African and United States recoveries are not yet convincing. But the signal from China is undeniably strong.

Fierce discussions have raged in recent years over the question of whether China's declining growth rates will eventually lead to a soft or hard landing. Chinese economic activity decelerated sharply between 2013 and early 2016 and few economists have entertained the idea that this descent might precede a rebound. However, recent data suggests this may be the case. Our proprietary measure of growth in Chinese economic activity, the Prescient Economic Activity Index, has now returned almost entirely to its long-term average.

Figure 1: Growth in economic activity relative to long term trends. See footnote 2 for details.[2]



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[1] A go-around is aviation speak for an aborted landing, in which a descending aircraft changes course prior to landing and returns to circuit height.

[2] The figures plot the Prescient Economic Activity index for the USA, China and South Africa. A number below zero suggests below average growth in economic activity. A positive number suggests growth is faster than its long run average. (A negative number does not necessarily imply negative growth). The numbers are derived using a statistical method that draws the common trend from a large set of roughly 100 variables including consumer spending, industrial production, employment, transportation, energy consumption, survey data, etc.

That's significant because a re-acceleration in Chinese economic growth will provide a much-needed boost to South African and global economic activity.

It's evident that both South African and US economic activity closely mirror developments in China. By our estimates, the US economy spent most of 2016 at below average growth. However, the most recent data indicates a sudden recovery. Similarly, South African economic activity has decelerated consistently since 2013 but also shows modest signs of turning around in recent months.

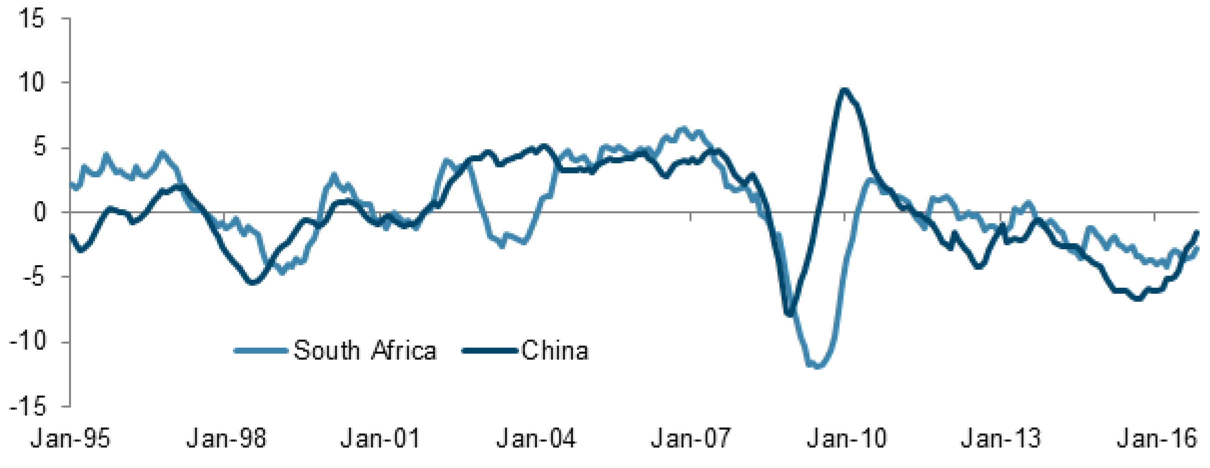
On their own, the South African and US recoveries are not yet convincing. South African GDP growth is close to zero and we need more data before we can confirm that the recession risk has been averted. But the signal from China is undeniably strong and that is important. Historically, most South African contractions have been halted by a pickup in demand for our exports, which are mainly commodities sold to faster growing economies like China. In general, if China grows South Africa benefits.

The relationship is clearly visible in the strong correlation between Chinese and South African economic activity in the graph. This is not a spurious correlation.

According to a database gathered by Massachusetts Institute of Technology, South Africa exports more goods to China than any other economy. Our exports to China consist of 20% iron ore, 15% diamonds, 12% ferroalloys (metals), 7% chromium ore, and a wide range of other chemicals and commodities.

These are all important inputs in industrial production and infrastructure development. As long as South African commodity production is free from political interference and structural constraints, the country is perfectly placed to benefit from a pick-up in global growth.

Figure 2: Growth in economic activity relative to long term trends. See footnote 2 for details.



Significantly, global reflation, the first phase of economic recovery after a period of contraction, is not entirely dependent on China.

After the recent presidential election in the US, we have been told by the President Elect to expect a vast round of infrastructure spending and corporate tax cuts. Historically, such fiscal injections have been effective methods for reinvigorating growth, though it would depend on the ultimate size of the programme.

If Trump successfully implements the promised $1 trillion infrastructure investment program, this will cause a significant spike in demand for the kind of commodities South Africa produces. Trump could therefore become a significant catalyst for SA economic expansion. At the industry level, the beneficiary sectors would include construction materials and engineering, metals and mining, machinery, and certain transportation segments.

While this projected expansive policy poses obvious long-term risks, such as rising debt burdens and potential overheating of the US economy, the medium-term effects are rather positive for South Africa.

The US economy is not in need of such aggressive fiscal stimulus, but South Africa is growing well below potential and would greatly benefit from increased demand. Unfortunately, the South African treasury does not have the fiscal space to implement its own round of stimulus.

As a consequence, the Republican clean sweep in the US elections appears to be pro-growth for equities and bearish for bonds in the short- to medium-term. Our expectation is primarily centred on decreased regulation, favourable tax reform, increased fiscal spending and less congressional gridlock.

If our expectations are met, the above combined effect should drive stronger revenue growth and higher net income margins, which are positive for equities.

Another important pillar of the President Elect’s key deliverables is the proposed cash repatriation incentives of an estimated $2.5 trillion in untaxed US corporate foreign profits. These accumulated untaxed foreign profits are likely to induce US multinationals to return cash to shareholders in the form of buybacks, dividends, mergers and acquisitions or capex expansion. These are all positive developments for equities.

If correct in the above analysis, we expect value and small cap stocks to outperform in South Africa. This is typical of early cycle rallies. This is also motivated by the fact that value and, more recently, small cap stocks have been disproportionately penalised in the recent past and are trading at unusually attractive discounts.

Ends

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About Prescient Limited

- Prescient's subsidiaries include: Prescient Investment Management (SA), Prescient Securities, Prescient Management Company, Prescient Life, Prescient Fund Services, Prescient Fund Services (Ireland) Prescient Wealth Management, Prescient Profile, Prescient Global, Prescient China and EMHPrescient Investment Management.
- Prescient Investment Management was the first institution in Africa to be granted a Qualified Foreign Institutional Investor (QFII) licence by the China Securities Regulatory Commission (CSRC).
- Prescient Investment Management, together with its technical partner Evolution Africa, launched a Clean Energy and Infrastructure Debt Fund, during 2016.
- Prescient Investment Management is a signatory to the United Nations Principles of Responsible Investing (UN PRI) and pledged to the Codes for Responsible Investing in South Africa (CRISA).
- The Prescient Global Income Fund, now known as the Prescient Global Income Provider Fund, was ranked by Morningstar as the 7th top performing fund for 2015.
- More recently, the Prescient Income Provider Fund won the Raging Bull Award for the Best South African Interest-bearing Fund – the top-performing fund on straight performance in the South African interest-bearing short-term and variable-term sub-categories and the South African multi-asset income sub-category over three years to December 31, 2015.
- Morningstar data also confirmed that The Prescient China Balanced Feeder Fund has been the top performing South African domiciled fund for the second year in a row.
- Prescient Investment Management was named Overall Investments/Asset Manager of the Year at the Imbasa Yegolide Awards 2011, Absolute Return Manager of the Year in 2013 and Bond Manager of the Year and Responsible Service Provider of the Year in 2015.
- For any additional information such as fund prices, brochures and application forms, email info@prescient.co.za or visit www.prescient.co.za
- Prescient Investment Management Ltd, is an authorised financial services provider (FSP 612).

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