ANGLORAND INVESTMENT INSIGHTS

JANUARY 2017

THE OUTLOOK FOR THE JSE IN 2017

Compiled by Desmond Esakov and David Smyth (CFA)

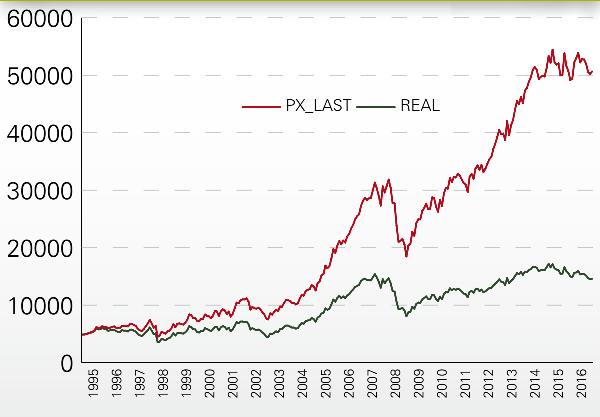
ANGLORAND FINANCIAL SERVICES GROUP

© Anglorand Securities Limited

The Outlook for the JSE in 2017

It is our custom to provide an outlook for the equity market in South Africa at the beginning of every year. As with the previous investigations, we have applied a number of alternative indicators to try determine the current intrinsic value of SA equities. The applied value indicators are objective and we do not let our subjective perceptions and feelings influence our judgement. It is also worth mentioning that the value approach is a longer term one as equity markets can remain in an extreme state of disequilibrium for substantial periods, sometimes for many years. Nevertheless, we firmly believe that over the long run, equity markets gravitate towards their fundamental (intrinsic) value which is driven by a number of economic and firm specific variables.

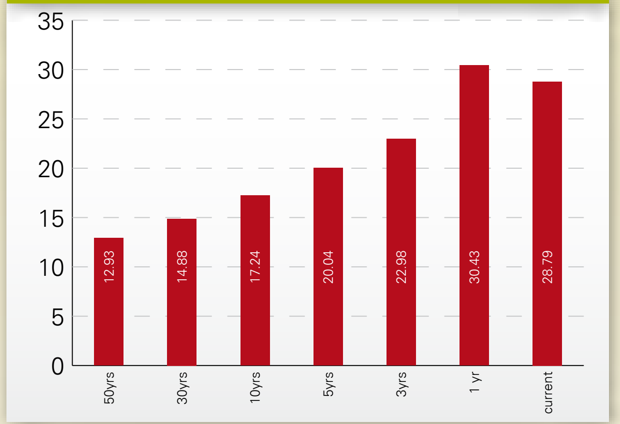
FIGURE 1: JSE ALL SHARE PRICE INDEX



Source: Bloomberg

According to figure 1, the JSE is at near record levels in nominal terms although in real terms (the latter is devised by deflating the nominal terms with the SA head line CPI) the index is down roughly 15% from an all-time high reached in 2015 and is still below levels attained prior to the financial crisis in 2009. The relatively depressed level of the JSE in real terms suggests that the index is relatively cheap as equities over time should outperform inflation.

FIGURE 2: JSE AVERAGE PE RATIO OVER VARIOUS TIME FRAMES

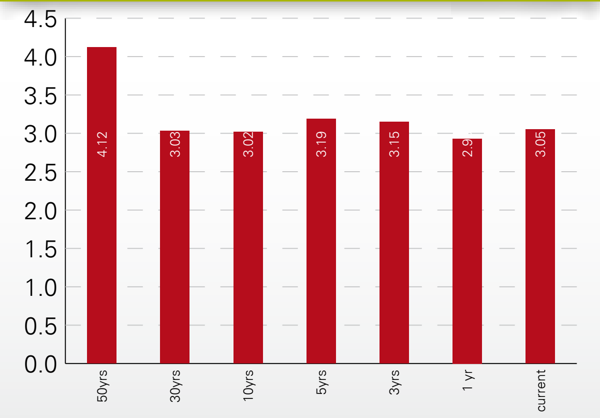


The first indicator we have analysed is the average PE of the JSE over various time frames. Over extended periods markets generally gravitate towards an average or mean historical earnings. If markets traded in excess of average earnings for extended periods, this would likely attract competition to the higher return environment, which would then ultimately serve to reduce prices and hence profit margins resulting in a trend back to the historical average.

Figure 2 shows that the current PE of 28 for the JSE ALSI is well above the average of 17x over the last 10 years, and 15x over the last 30 years and 13x over the last 50 years. This indicator seems to suggest that the JSE is expensive. However, the current PE includes the earnings of a number of large resource companies such as BHP Billiton whose earnings are currently depressed due to the collapse in commodity prices but with the recent recovery in commodity prices, earnings of these companies should recover which in turn should result in a decline in the PE multiple. In fact according to Bloomberg estimates the JSE forward PE multiple is around 15.5, largely in line with the long term average which would suggest that South African equities are fairly valued.

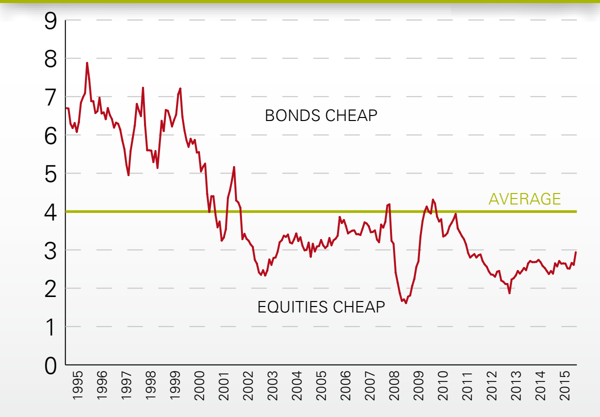
© Anglorand Securities Limited

FIGURE 3: JSE AVERAGE DIVIDEND YIELD OVER VARIOUS TIME FRAMES



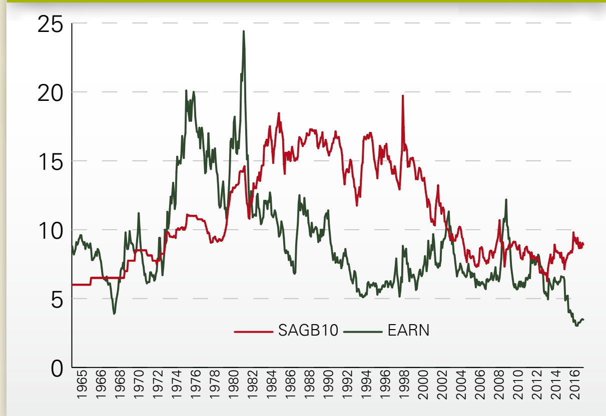
Although on an earnings basis the JSE appears to be richly value, the current dividend yield of 3.1% is largely in line with the average of 3% over the last 10 and 30 years, suggesting from this perspective the market is fairly valued. Taking a longer time frame of 50 years however, the market appears to be expensive with the divdend yield over half a century averaging 4.2%.

FIGURE 4: THE RATIO BETWEEN RSA LONG BOND YIELD AND JSE DIVIDEND YIELD



We have also analysed the ratio between the yield on long-term government bonds (10 year) and the ALSI dividend yield. This method, which is often used by investment strategists, suggests that the higher the ratio between the long-term bond yield and the dividend yield, the more overvalued equities are relative to bonds and vice versa. After reaching a record low valuation relative to bonds in 2009, equities rebounded sharply, appreciating by close to 200% since the depths of the financial crisis in 2009. This price appreciation has seen the relative value of equities to bonds diminish, although the ratio still remains below the long term average of around 4, suggesting that on a relative basis equities are still cheap.

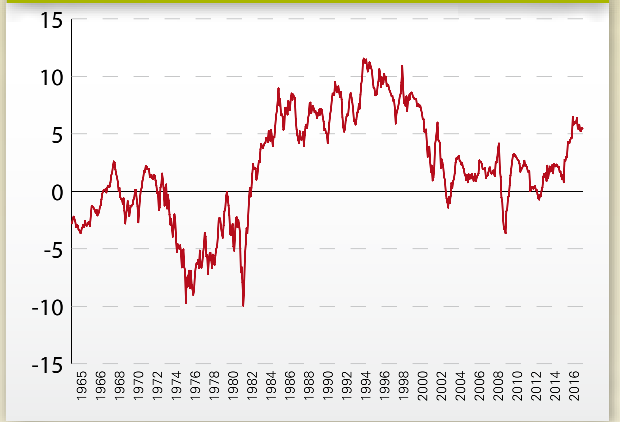
FIGURE 5: THE RATIO BETWEEN RSA LONG BOND YIELD AND JSE EARNINGS YIELD (EY)



A similar indicator is to compare the Earnings Yield (EY) of the JSE to the yield on long term government bonds. Generally speaking, if government bond yields are higher than the earnings yield of the market, then on a relative basis government bonds offer better value. At the present point in time, it can be seen that with the current bond yield at just below 8.9% and the JSE EY at 3.5%, bonds appear to be offering significantly better relative value, with the spread widening substantially over the last twelve months as revealed in Figure 6. It must be noted that the earnings yield we have used is based on historical earnings of the JSE but as we highlighted earlier earnings of the overall market are projected to improve significantly largely due to the sharp rebound in commodity prices. Using the consensus earnings forecast of Bloomberg we calculate the forward earnings yield to be approximately 6.5%. Although this valuation is significantly more appealing on a relative basis bonds still look to be more attractively valued.

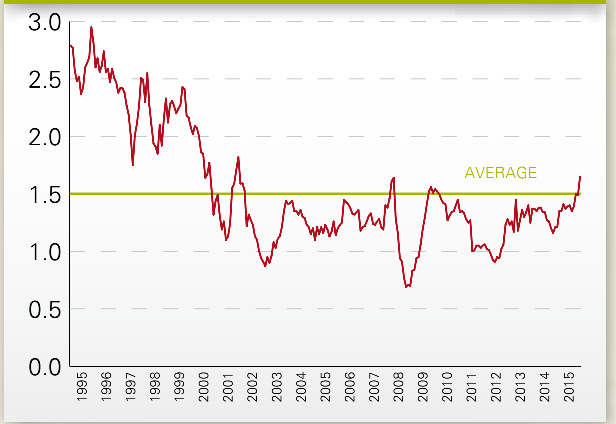
© Anglorand Securities Limited

FIGURES 6: WIDENING SPREAD SUGGESTS EQUITIES RICHLY VALUE RELATIVE TO BONDS



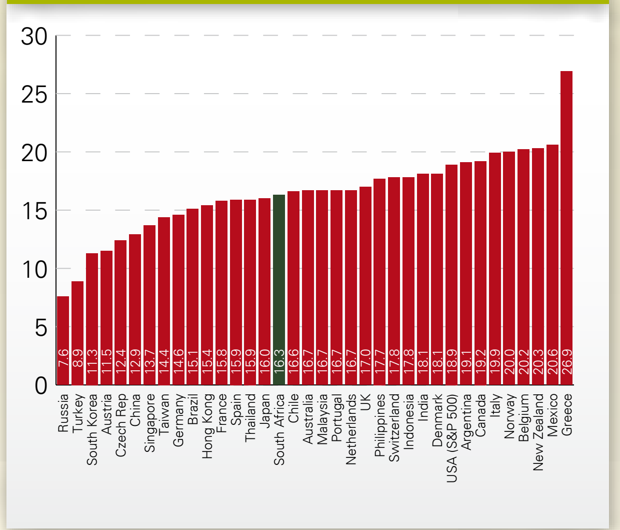
We however continue to stress that despite bonds seemingly more attractively priced than equities, we continue to avoid long term SA government debt, especially given our continuing negative outlook for the currency due to the country's weak external position and the deteriorating fiscal positon.

FIGURES 7: JSE VALUE BY THE US FED MODEL



The US Federal Reserve Bank suggests a simple macro model to estimate over/undervalued situations for equity markets. The so called Fed model suggests that a fair value forward PE ratio for a market should be a function of the long-term bond rate. More specifically, the fair value PE for the JSE should be defined as the inverse of the RSA 10 year bond rate. Thus, with the current yield of the RSA 10 years bond rate at 8.9%, the forward fair value PE for the JSE according to the Fed Model is 100/8.9 = 11.2. The forward PE multiple is 15x, suggesting that equities are overvalued.

FIGURE 8: COUNTRY PE RATIOS AS OF END 2016.



© Anglorand Securities Limited

FIGURE 9: COUNTRY DY RATIOS AS OF END 2016.

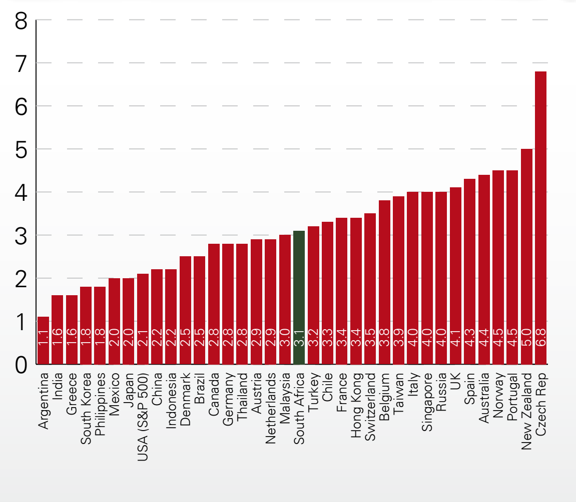
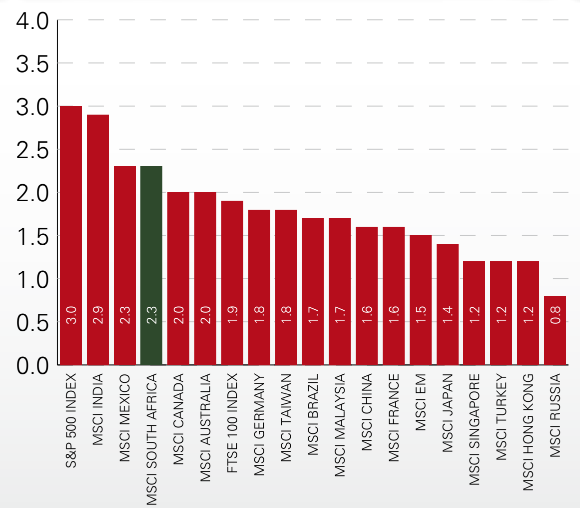


FIGURE 10: COUNTRY PRICE TO BOOK RATIOS



With the globalisation of world investment markets, we believe it is also worth comparing the PE ratios and dividend yields with international peers. Figure 8 and 9 both show the PE ratio and the dividend yield of the JSE in comparison with many other world equity markets.

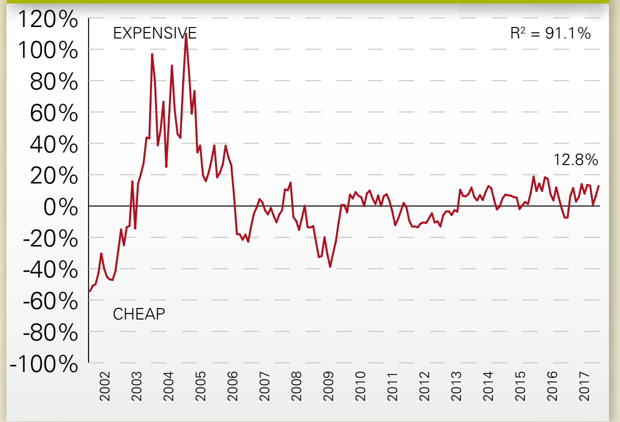
According to figures 8 and 9, the JSE is the 16th and 18th cheapest market respectively among 36 investigated countries. Again this international comparison suggests that South African equities are fairly valued.

Although Figures 8 and 9 suggest that compared to other international markets, South African equities are probably fairly valued, when looking at the price to book ratios of various countries the JSE looks expensive with the overall market trading in excess of twice its book value. However, this NAV valuation is somewhat misleading, as the MSCI South Africa ratio which we have used, excludes major dual listed shares such as Anglo American and BHP Billiton, both of which are trading at low book values. When these major dual listed are added back, the book valuation in fact declines to around 1.98, largely in line with most of its peers.

Even when this lower price to book ratio is taken into account, we feel on a risk reward basis a number of countries offer more compelling value than the JSE. For example a number of Asian countries have better growth prospects than SA while valuations are more attractive. Markets such as Singapore and Hong Kong are therefore likely to generate superior long term returns while at the same time also offer a higher margin of safety than local equities. Other global markets we continue to favour include Japan, which appears to be attractively valued while progressive economic policy changes made under President Abe should continue to provide a fillip for company earnings and returns. For investors with a higher risk appetite, Russian equities look to be offering exceptional value, although one must remain cognisant of the political risk.

© Anglorand Securities Limited

FIGURE 11: REGRESSION VALUATION MODEL



Finally, we have also devised a regression model to determine the intrinsic value of the JSE by using a series of explanatory factors that we believe should account for movements of the JSE. The combined effect of the explanatory variables is defined as the simulated or predicted line. The simulated line is then compared to the actual values of the corresponding share price index. We have used overall earnings, the USD/ZAR exchange rate and the copper price as the explanatory variables and using an ordinary least squares model, our results suggests that these three variables can explain over 90% of the markets movement. Our regression model seems to suggest the JSE is overvalued. According to our model the JSE should be trading at 49,000 compared to the value of 47,000 as of the end of December 2016. Again this model only takes historical earnings into account. When we plug in projected consensus earnings the JSE appears to be fairly valued.

DISCUSSION AND SUMMARY

Based on a number of indicators and models we have analysed, the domestic market appears to be fairly valued. We do however feel that the valuation of the overall market is somewhat misleading due to the fact that earnings are likely to increase due to the sharp rebound in commodity prices. In addition index heavyweights such as Naspers and Richemont which together account for in excess of 25% of the market weighting, both trade at lofty PE multiples in excess of 30x. In contrast SA banks, for example, which are in general high quality businesses but constitute a relatively small weighting of the overall market are trading at earnings multiples of 11.7x , a significant discount to the PE of the overall market even when taking forward earnings into account. Given the situation we have described, we remain firmly of the view that investors need to remain highly stock selective. Overall, we also remain firmly of the view that in the long run a well-diversified portfolio of carefully selected stocks will provide returns in excess of the local inflation rate resulting in an increase of real wealth for investors.

DISCLAIMER *This report and its content are confidential, privileged and only for the information of the intended recipient. Please destroy this document if you have received it in error. The Author of this report (AR) make no representations or warranties in respect of this report or its content and will not be liable for any loss or damage of any nature arising from this report, the content thereof, your reliance thereon its unauthorised use or any electronic viruses associated therewith. This report is proprietary to the AR and you may not copy or distribute the report without the prior written consent of the AR. The author of this report currently holds some of these shares on behalf of client or in a private capacity.*