

WEATHERING THE STORM

Dave Mohr and Izak Odendaal, Old Mutual Multi-Managers

Last week, everything seemed to be going wrong. It started early on Monday morning with the rand briefly spiking above R15 to the dollar in thin Asian trade as the Turkish crisis deepened. The rest of the week was hardly less volatile, with the local currency closing at R14.80 to the dollar on Friday.

FOLLOWING THE SCRIPT

Turkey's crash follows the script of a standard emerging market (EM) crisis. Turkish banks, companies and, to a lesser extent, the government borrowed heavily in hard currency in recent years. Doing so provides the benefit of lower interest rates, but comes at the cost of massive exchange rate risk. As it happens, some \$16 billion in dollar-denominated debt is due in the next year, and will now have to be repaid at a much weaker exchange rate. The lira, down 90% against the dollar over the last 12 months, might recover somewhat, but is very unlikely to make up the entire loss. This has often been called the 'original sin' of emerging market economies, the fact that they borrow abroad in hard currency due to insufficient domestic credit supply or high interest rates, or simply because foreign investors and banks are eager to lend into a fast-growing economy. Turkey's economy was running hot the last few years, partly due to government stimulus and partly due to a lack of central bank reaction. This in turn contributed to a massive current account deficit.

This was also the opening chapter to the EM crises in the 1980s in Latin America, followed by East Asia and Russia in the 1990s and Argentina in 2001. For a while things go well, but for some reason, investors then get spooked and a self-fulfilling crisis sets in. This then follows the next chapter: the currency is sold off, worsening the debt sustainability, which in turn scares more investors who dump the currency. The final chapter usually involves the imposition of capital controls, a bail-out from the International Monetary Fund (IMF) or a default on the debt.

Eventually, the economy can recover but with a much weaker exchange rate and a far smaller reliance on debt. In the case of Turkey, markets were calmed somewhat after the government announced a \$15 billion injection of Qatari money and a promise to cut back on spending to cool the economy. But it is surely not over yet.

KING DOLLAR

The other element the Turkish crisis has in common with previous crises is the rising dollar. A strengthening dollar tends to cause havoc across emerging markets. The dollar started the year on the back foot, but has rallied from April onwards against developed and emerging currencies alike. There are a million things influencing foreign exchange markets at any given moment, but broadly speaking the current strength of the US economy means US interest rates are expected to rise much faster than in other major economies. The imposition of import tariffs by the US government on a number of its trading partners also supports a strong dollar.

Unlike the Fragile Five episode in 2013 and 2014 and the Chinese devaluation scare of late 2015, there is very little chance that the Federal Reserve will pause on its path of gradually hiking rates. For one thing, Fed Chair Jerome Powell has explicitly in the past said that he did not think the Fed had any control over how the dollar impacts EMs. But the main reason is that the US economy is strong, and inflation is creeping up.

Where this episode has been different is the lack of true contagion to other markets. For instance, the East Asian crisis of 1998 spread from Thailand to the Philippines, then to Hong Kong, Korea, Indonesia and finally, Malaysia, all with the same rapid but unsustainable growth path. Today, Turkey is largely seen as unique in its particular cocktail of risk factors. True, currencies across the emerging markets have declined. The Indian rupee fell to a record low, but is only down 2% since the start of the month, while the rand has lost 11%. The Turkish lira lost 22% in August alone. But there is no question of a run on Indian banks, capital controls in Brazil or South Africa being forced to turn to the IMF (despite media speculation along those lines). South Africa is an emerging market and cannot escape turmoil in our peer group, even if we are not at its epicentre. South Africa has largely avoided the original sin thanks to a large local bond market and healthy banking system.

CHINESE WORRIES

Meanwhile, the other big support for emerging markets, China's economic juggernaut, also appears to be more hindrance than help at the moment. The latest economic activity numbers from China were weaker than expected, but certainly not weak in absolute terms. Retail sales, for instance, grew by 8.8% instead of 9.1% as expected, while fixed investment grew 5.5% instead of 6%. Nonetheless, Beijing seems likely to introduce further modest stimulus measures to support growth against the backdrop of continued trade tensions with the US.

The combination of softening Chinese growth expectations and a stronger US dollar has pummelled commodity prices. Gold showed absolutely no sign of being a safe-haven investment amid the turbulence of the past few days. It fell to an 18-month low of \$1 170 per ounce while platinum fell to a level last seen in 2004. Industrial metals, which are more sensitive to perceptions around global growth, are also under pressure. Copper has lost 17% since June.

Thus while mining production was surprisingly strong in June (rising 2.8% from a year ago), the medium-term outlook for mining is clouded by the weakness in global commodity prices. Fortunately, mining output was also positive in the second quarter and should therefore show a much-needed boost to second quarter GDP growth when the data is released early next month. However, weak commodity prices and negative capital flows mean that South Africa is not benefiting from the strong global economy.



IMPACT OF A WEAK RAND

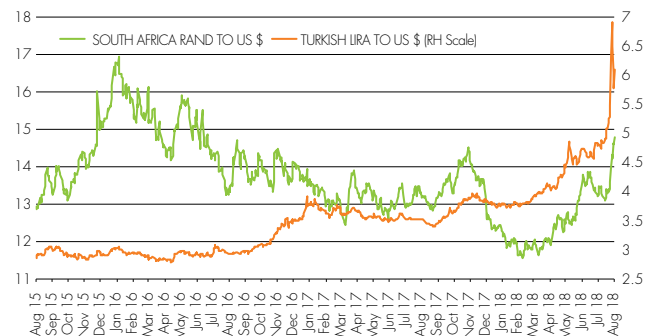
Weaker commodity prices have placed additional pressure on the rand, since South Africa is a commodity exporter (unlike India or Turkey). But it does offset the commodity price weakness to an extent and supports export incomes and tourism. It doesn't necessarily stimulate new demand for exports, since our competitors' currencies might also be weaker, but existing exporters (such as farmers) benefit. Crucially though, South African companies and households have built up substantial foreign assets, the former through acquisitions of subsidiaries abroad, and the latter through pension fund and discretionary investments.

A weaker currency does make imports more expensive, but whether it results in a broad-based rise in consumer inflation depends on whether companies are willing or able to pass on cost increases to their customers. StatsSA's report on retail sales clearly shows a lack of pricing power on the part of retailers: inflation was only 2.4% year-on-year in June overall, and negative for retailers of furniture and appliances (still reflecting some of the rand strength of last year). Retail sales grew slower than expected in the 12 months to June, only 0.7% in real terms, and were marginally negative in the second quarter compared to the first.

Storm clouds also hovered above the local equity market. The JSE was impacted more by Chinese video games than the unfolding Turkish turmoil, but it was still a torrid week. Naspers, the largest stock on the JSE, fell after the Chinese internet giant Tencent, of which it owns slightly less than a third, posted unsatisfactory results. Tencent grew revenue by 30% from a year ago, an astonishing feat for such a large company, but the share price was discounting better numbers. Tencent blamed delays in approval of new video games by Chinese regulators. A number of other JSE-listed companies also reported disappointing earnings results and trading updates, including Goldfields, Tiger Brands, Truworths and Sappi.

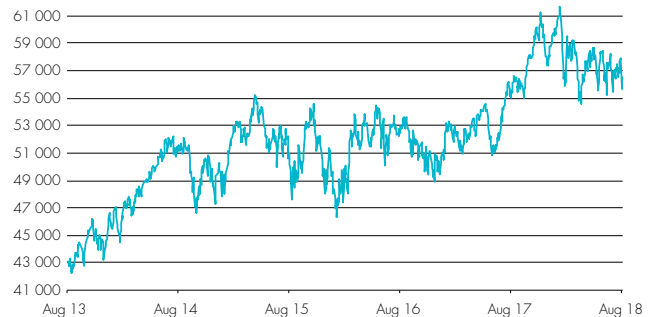
With all the volatility on markets, it is important not to lose sight of the following. Firstly, the rand is not the share price of the country and we do not need to be despondent if it weakens. Rather, it is a barometer of global investor risk appetite, and its ups and downs help to rebalance local economic activity. Secondly, appropriate diversification remains the best defence, rather than batten down the hatches. Finally, storms pass, but in their wake often provide opportunities when currencies, asset classes or securities are oversold.

CHART 1: SOUTH AFRICAN AND TURKISH LIRA AGAINST THE US DOLLAR



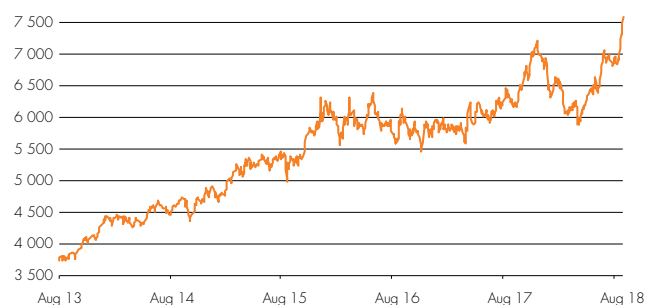
Source: Thomson Reuters Datastream

CHART 2: FTSE/JSE ALL SHARE INDEX



Source: Thomson Reuters Datastream

CHART 3: GLOBAL EQUITIES IN RAND



Source: Thomson Reuters Datastream



INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	2 131.0	-0.42%	-1.02%	1.33%	10.07%
United States	S&P 500	US\$	2 850.0	0.60%	1.21%	6.58%	17.28%
Europe	MSCI Europe	US\$	1 667.0	-1.48%	-5.18%	-7.23%	-1.94%
Britain	FTSE 100	US\$	9 637.0	-1.57%	-5.25%	-7.35%	1.40%
Germany	DAX	US\$	1 331.0	-1.33%	-6.00%	-5.88%	0.53%
Japan	Nikkei 225	US\$	201.5	0.26%	-0.04%	-0.27%	12.40%
Emerging Markets	MSCI Emerging Markets	US\$	1 022.0	-3.77%	-5.98%	-11.74%	-3.86%
Brazil	MSCI Brazil	US\$	1 722.0	-0.63%	-6.41%	-14.88%	-9.98%
China	MSCI China	US\$	77.1	-6.37%	-7.62%	-12.82%	-2.50%
India	MSCI India	US\$	585.9	-2.28%	-1.70%	-4.11%	3.69%
South Africa	MSCI South Africa	US\$	459.0	-6.90%	-13.40%	-24.13%	-12.24%

EQUITIES - SOUTH AFRICA (TR UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	56 648.0	-1.83%	-1.37%	-4.80%	2.23%
All Share	All Share (Total Return)	Rand	8 181.0	-1.73%	-1.27%	-3.18%	5.28%
TOP 40/Large Caps	Top 40	Rand	7 290.0	-1.79%	-1.29%	-2.12%	6.11%
Mid Caps	Mid Cap	Rand	14 864.0	-2.94%	-2.65%	-12.44%	-4.07%
Small Companies	Small Cap	Rand	19 498.0	-0.72%	0.12%	-7.25%	-0.68%
Resources	Resource 20	Rand	2 694.7	-1.09%	0.91%	17.87%	26.63%
Industrials	Industrial 25	Rand	14 126.0	-2.32%	-0.54%	-6.55%	-0.70%
Financials	Financial 15	Rand	9 029.0	-1.20%	-5.50%	-6.98%	9.19%
Listed Property	SA Listed Property	Rand	1 942.4	1.57%	0.74%	-21.17%	-13.90%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US\$	926.7	-0.72%	-1.35%	-2.26%	-1.51%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	609.3	-0.92%	-2.68%	3.68%	6.78%
Government Bonds	BESA GOVI	Rand	604.1	-1.01%	-2.88%	3.03%	6.10%
Corporate Bonds	SB JSE Credit Indices	Rand	115.1	-0.09%	-0.13%	-8.78%	-15.97%
Inflation Linked Bonds	BESA CILI	Rand	251.3	-0.30%	-0.28%	-0.54%	1.33%
Cash	STEFI Composite	Rand	400.3	0.13%	0.32%	4.53%	7.30%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	71.8	-1.64%	-3.01%	7.12%	40.73%
Gold	Gold Spot	US\$	1 186.0	-2.06%	-2.63%	-8.56%	-7.92%
Platinum	Platinum Spot	US\$	784.0	-5.31%	-4.97%	-15.70%	-19.75%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14.65	-3.95%	-9.38%	-15.49%	-9.48%
ZAR/Pound	ZAR/GBP	Rand	18.68	-3.64%	-6.75%	-10.39%	-8.73%
ZAR/Euro	ZAR/EUR	Rand	16.76	-4.17%	-7.39%	-11.33%	-7.27%
Dollar/Euro	USD/EUR	US\$	1.14	0.00%	2.54%	5.35%	2.63%
Dollar/Pound	USD/GBP	US\$	1.28	0.16%	2.75%	5.88%	1.18%
Dollar/Yen	USD/JPY	US\$	0.01	-0.39%	-1.22%	-1.91%	0.56%

Source: HNet, figures as at 17 August 2018



ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Consumer inflation

US

- New and existing home sales
- Minutes of the previous FOMC meeting
- Flash Markit Purchasing Managers' Index
- Durable goods orders
- Jackson Hole Central Banks Symposium

EUROPE

- Eurozone Flash Markit Purchasing Managers' Index
- Minutes of previous ECB monetary policy meeting

JAPAN

- Inflation rate

Whilst every care has been taken in compiling the information in this document, the information is not advice and Old Mutual Multi-Managers and/or its associates, do not give any warranty as to the accuracy or completeness of the information provided and disclaim all liability for any loss or expense, however caused, arising from any use of or reliance upon the information. Please note that there are risks associated with investments in financial products and past performances are not necessarily indicative of future performances.



HELPLINE +27 21 524 4430 | **FACSIMILE** +27 21 441 1199 | **EMAIL** ommmclientquery@ommm.co.za | **INTERNET** www.ommultimanagers.co.za

Old Mutual Multi Managers ("OM m|m") is a business unit of Old Mutual Life Assurance Company (South Africa) Limited ("OMLACSA"), a licenced Financial Services Provider, Reg. No: 1999/004643/06. OM m|m is authorised to provide financial services on the OMLACSA license, FSP 703.