April 2015

CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

EXCELLENCE
TAKES A LIFETIME
OF PREPARATION

cadiz
ASSET MANAGEMENT

Our investment philosophy and process

As a long-term investment manager, our valuation-based investment philosophy underpins all of our investment decisions and processes.

- We believe that the market is inefficient over the short term due to investor sentiment.
- We believe in mean reversion. This means that both high and low asset prices (relative to their long-term underlying true or intrinsic value) are temporary and will tend to 'normalise' or revert to their long-term intrinsic value. These short-term market inefficiencies create investment opportunities.
- By applying our valuation-based investment philosophy and process consistently over time we find these opportunities both within and across asset classes to deliver long-term investment returns for our clients.

We apply our investment process with patience, diligence and focus

We identify opportunities through bottom-up fundamental analysis

The team analyses the value of an investment using bottom-up fundamental analysis. We compare current prices and valuations (based on an in-depth analysis of the investment) with long-term historical trends, rather than trying to forecast the future.

Long-term macroeconomic themes also play a key role in our process

We combine our bottom-up analysis with a top-down view on the economy. We specifically focus on normalised interest rates and inflation. Interest rates directly influence sustainable economic growth rates and inform the risk-free rate of return. Inflation affects real returns.

We consider and combine opportunities both within and across asset classes

We recognise the need to be expert at identifying and assessing opportunities both within asset classes and at an asset class level. This includes comparing different asset class behaviours and returns and, most importantly, relative to the returns that investors would receive from investing in cash.

We only invest if there is a margin of safety

All investments carry some degree of risk but, even within our high equity products, we only invest if there is an adequate margin of safety built into our valuations. We calculate a current fair market value based on the long-term historical relationships between economic and market variables, and we carefully measure the extent to which investors may be compensated for any inherent risks.

In this edition

ON THE FRONT COVER

THE GREAT WALL OF CHINA - Built nearly 3 000 years ago, this marvel of ancient construction protected the Chinese from invaders and encompasses 21 000km of stonework. The wall stands as a monument to the early dynasties of Asia. A momentous undertaking like this required tremendous perseverance, just one of the skills honed on the journey to excellence.

Introduction

As an investor, it is crucial to understand the views of any investment manager with whom you invest money. By doing this, you are more likely to make sensible long-term investment decisions that can help increase your wealth. Thank you therefore for taking an interest in our views, we appreciate your time and attention.

CAMmunique enables us to share our views

Our quarterly publication provides a consolidated way for us to communicate our latest news, views and insights in one document. By including articles that cover the main pillars of our investment philosophy, we are in effect sharing the insights that frame our thinking.

CAMmunique therefore includes an overview of the last quarter, so that you have easy access to a summary of changes and trends in both local and global markets. This accompanies an economic opinion piece about something topical that is either currently influencing our investment decisions or could do so in future. We then provide you with a piece about equities, one about fixed interest and in our article about 'Where to invest', we do our best to wrap up all our views and make these accessible and applicable to your investment decisions. Because we believe in the value of financial advice, we do always caveat our views with a recommendation to seek professional advice about how our views could be applied to your specific circumstances in a way that will help you achieve your goals.

The heart of our philosophy is about having a structured and disciplined way to find value

We search for value because we believe that the market is inefficient over the short term due to the way asset prices rise or fall in relation to:

- cyclical movements in liquidity (as reflected by interest rates),
- economic activity; and
- investor sentiment.

We therefore think it is prudent to summarise our views about interest rates and liquidity, economic growth trends and where we think investor sentiment may have, en masse, inflated prices to the extent that the value you receive for buying an investment at current prices may be compromised.

Some important insights

Historically, excess liquidity and low interest rates have tended to create asset price bubbles. Over the past six years the search for 'safe' assets against the backdrop of global uncertainty and the massive global liquidity creation has led to global bond prices and the valuation of defensive equities being inflated to the extent that they are overvalued. It is therefore appropriate to ask what is likely to happen when interest rates rise. As Warren Buffet once remarked, '*In economics, interest rates act as gravity behaves in the physical world. At all times, in all markets, in all parts of the world; the tiniest change in rates changes the value of every financial asset*.' It is therefore important to understand that in some instances the future has been 'over' discounted using discount rates that are unsustainably low and current valuations can become unstuck when discount rates start to rise.

The global trends of the last five or six years won't continue indefinitely. The writing is already on the wall for us locally. The massive price appreciation that we have experienced in certain South African listed global industrial equities has led to what we believe are unsustainable valuations.

We believe fortune favours the prepared, so long-term investors like ourselves that position their portfolios appropriately for this event stand to benefit over time.

Francois van Wyk
Chief Investment Officer

Where to invest

With volatility expected, now is not the time to be greedy

by ***Brian Munro***,
Investment Strategist

The low growth, low inflation environment of the past five years should continue. Apart from commodities, all major asset classes are fairly priced or expensive. The range of expected returns for the next year has narrowed substantially, making the risk/return trade-offs for some asset classes less favourable. Volatility is also expected to increase this year. In this environment, it's better to be fearful and focus on protecting capital against downside risk, rather than be greedy. Absolute return funds, which aim to both grow and protect capital, are a good investment choice for this environment.

The low growth, low inflation economic environment should persist

The investment environment of the last five years can be characterised as one of low economic growth, low inflation, extremely low interest rates, and substantial liquidity injections. This has proven to be an excellent environment for long duration assets like equity and property, or inflation-sensitive assets like corporate and government bonds. All these asset classes have richly rewarded investors during the past five years.

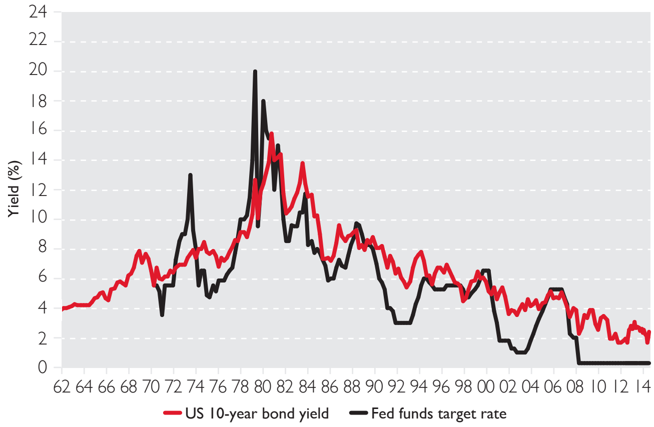
As we look forward to the next year or two, it is a good time to take stock of the 'lay of the land' to determine where the opportunities are and to assess potential risks. To start, we believe that both the local and global economic environment will likely remain one of low growth and low inflation.

- Economic growth will remain low because the world still needs to deal with debt overhangs, weak consumer demand, and governments that are fiscally constrained and burdened with high/mounting debt. Of course, different regions and countries are at different stages of achieving sustainable growth. The clear leader is the US, where economic momentum is slowly gathering pace, as indicated by stronger employment growth.
- Low inflation presides despite the oversupply of unprecedented 'cheap' money globally, as central banks try and stimulate their economies. In fact, many countries are still grappling with deflation (falling prices), either at the consumer level or at the factory gate.

Major asset classes are either fairly priced or expensive

- Global bonds are especially overvalued, being the major beneficiary of fearful investors. From Chart 1 (on the next page), it is clear that US bond yields are at historical lows. Also in Europe, roughly 30% of government bonds are trading with negative yields. This is unprecedented.

Chart 1: US 10-year yield and federal funds target



Source: Bloomberg

- Global equities, on aggregate, are fairly priced on most measures. Within equities, the US market is fair to slightly expensive and has enjoyed a number of tailwinds over the last two to three years. These tailwinds are now fading, while some headwinds are starting to appear, such as the impact of a strong dollar on US exporters. A period of consolidation is likely. European equities on the other hand, do offer value, supported by key drivers such as a lower euro, lower oil price, and lower borrowing costs, coupled with banks being more willing to lend. However, price to earnings (PE) multiples are high, based on the expectation that corporates will deliver earnings growth. There's not much room for disappointment.
- Commodity prices however, remain on their knees, pummelled by the strong US dollar and weak global demand, especially from China. Prospects remain glum.
- Locally, South African equities are expensive and are trading above their long-term mean PE valuations. At the same time, analysts have been revising earnings growth expectations downwards for 2015 and 2016.
- The local property sector has had an excellent run lately, outperforming all other local asset classes over the last year. The sector has benefitted from the investment themes of 'earnings certainty' and 'search for yield'. Even though these themes will likely persist, the property sector is in expensive territory with the dividend yield having fallen below the cash rate.
- Local bonds are perhaps fairly valued, especially relative to US bonds. But South Africa relies heavily on foreign inflows, and foreign investors look at both the currency return as well as how attractive our yields are relative to developed market bonds. A major concern for bond investors over the next year or two is the US Federal Reserve's (US Fed) desire to normalise interest rates from just above zero to above 1%. The Financial Times (FT) summed up International Monetary Fund Chief Christine Lagarde's concerns, 'warning the developing world of the turmoil likely to strike the developing world when the US Federal Reserve begins to raise interest rates'. Largarde pointed out that emerging market (EM) countries received about $4.5 trillion of gross capital inflows between 2009 and 2012, which could easily unwind. If this happens, the rand and other EM currencies could depreciate further.

In addition, the range of returns expected from the major asset classes over the next year has narrowed substantially, making the risk/return trade-offs for some asset classes less favourable.

Coupled with lower returns, we expect market volatility to increase in 2015

The key trigger will likely be the start of the US interest rate normalisation process. The current expectation is that the US Fed will start raising rates in either June or September. However, the focus should not be on when the Fed starts raising rates but rather on protecting your capital against increased volatility in the short term, and positioning our investments for higher interest rates in the medium term.

Volatility will persist across asset classes for some time to come, especially as a large number of central banks have fallen over themselves to weaken their currencies in order to help boost their export sectors and stimulate growth. A case in point is the European Central Bank (ECB). The ECB has set their deposit facility rate to -0.2%, discouraging investors from holding euros and encouraging them to rather invest elsewhere that yields a positive return.

Now is the time to be fearful rather than greedy

With the expectation of increased volatility and asset classes offering less favourable risk/return trade-offs, now is not the time to be greedy. As Warren Buffett said, 'Be fearful when others are greedy and greedy when others are fearful'. With major asset classes either fairly priced or expensive after years of exceptional performance, now is the time to become more fearful and focus on protecting against downside risk.

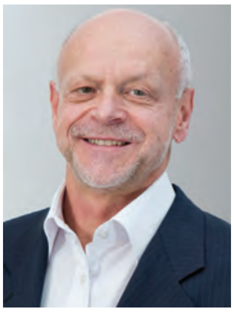
Absolute return funds are best suited in the current environment

Multi-asset class funds, especially absolute return funds (or inflation plus funds) typically have a dual mandate of achieving real capital growth while at the same time protecting capital:

- Ensure no capital loss over any 12-month period – this aims to protect capital. Although this is a key objective, it is not guaranteed.
- Outperform some inflation plus target (typically between +3% to +5%) over a three-year investment horizon – this ensures capital growth in real terms.

Absolute return funds are best suited in the current environment, which requires discernment and caution when assessing investment opportunities and their associated risks. Inflation is the real enemy to maintaining your living standard, and therefore the real enemy to growing your capital (in real terms). However, since we are in a low inflation environment (both globally and locally) you can afford to sacrifice some excessive 'greedy' returns to protect your capital. ■

Quarterly review



by ***Matt Brenzel****,*
Portfolio Manager

INTERNATIONAL

The pause in positive US data that refreshes?

The Bloomberg index that measures economic surprises in the US, the Bloomberg ECO U.S. Surprise Index, has weakened quite sharply since the end of last year. The index is a construct of how well or how poorly reported macro data measure up to expectations. Most of the more recent statistics have underwhelmed, with the possible exception of the employment data – 295 000 jobs were added in February and this brings the total number of newly employed or re-employed to 1.3 million in the past four months. Indeed, more jobs were created in the US in 2014 than at any time since 2009. That said, wage growth remains muted.

In the process, analysts have become distracted by the most recent data and overly negative on prospects for 2015. We expect better data to resume after the first quarter lull. The US economy should still grow by at least 3% in real terms in 2015, supported in large measure by the positive impact of low oil prices on consumer demand. (The IMF estimates that a supply-induced 20% decline in oil prices could boost the level of global real GDP by 0.5-1.3% over a two-year period).

But while lower oil prices have been universally welcomed (except by the producers), the strength of the US dollar has raised concern in some quarters. In their more recent deliberations, Fed officials indicated that the strongest dollar in a decade 'was expected to be a persistent source of restraint' on US exports. Remember that a strong currency is tantamount to monetary tightening. While it is too early to call time-out on dollar strength as the US economy is much better placed than its peers, the currency's momentum could change. For one, it is technically overbought. Secondly, investors are moving substantial equity allocations out of the US into Europe and Japan as those regions show signs of recovery. Thirdly, dollar strength will exacerbate the deficit of the US trade account. Although not yet meaningfully negative, any significant deterioration should erode the currency. From the perspective of the Federal Open Market Committee however, its desire to implement monetary tightening could be delayed into the fourth quarter of this year.

Poor statistics from China demands more

The HSBC Flash Manufacturing PMI weakened to 49.2 in March from the reading of 50.1 in February. This enforces our view that the reform programme and the impact of weak global growth have placed the Chinese economy on a lower growth trajectory and heighten the need for more policy easing. Consensus forecasts two policy rate cuts and three reserve requirement ratio cuts for the rest of 2015.

The Chinese A-share market has largely ignored the economic backdrop. Despite raised margin requirements, new share accounts are running at 1.7 million per week and are approaching the previous highs of 2007. The equity market is up by some 86% year-on-year in local currency terms and 16% in the quarter. A similar trend is evident in Japan where the Nikkei 300 is up 28% year-to-date and 10% in the quarter.

In Europe, the Swiss, the Greeks and the European Central Bank (ECB) dominated headlines

In a move that rocked currency markets in January, the Swiss National Bank abandoned both the label of stodgy central bank as well as the 1.20 CHF/€ floor. In response to significant domestic unhappiness at the amount spent maintaining the peg and faced with the prospect of imminent ECB quantitative easing (QE), the floor was discarded. At the same time, the bank lowered the interest rate on certain deposits by 0.5% to -0.75%. Overnight, the Swiss franc took the lead as the world's strongest currency, rising to 0.85 CHF/€ at one stage. Needless to say, listed exporters with operations domiciled in Switzerland took a pounding.

After a change of guard, the new far-left political leadership in Greece made its anticipated appearance at the ECB, begging bowl in hand, but there will be some way to go before an acceptable resolution is met. Given the elevated levels of the Greek 10-year bonds (11.47% and back to levels last seen in 2013) and the extraordinary lows in the German Bund equivalent (0.2% and well down from the previous high of 2.0% in 2013), it's clear who the market is backing. The ratings agencies agree: Standard & Poor's and Fitch have recently downgraded Greece.

In all fairness, the low in the German Bund can more readily be ascribed to the massive QE bond-buying package announced by ECB President Mario Draghi in January. In summary, the ECB proposes to spend €60 billion per month for 18 months, which started in March 2015. European bond and equity markets, excluding Greece, rallied strongly.

Table 1: International equity market returns

International (US$)	Quarter	12 Months
MSCI World	1.8%	3.3%
MSCI Emerging	1.9%	-2.0%
MSCI SA	2.5%	1.2%

Source: Bank of America Merrill Lynch

Is this a start to a move away from defensives?

The first quarter of 2015 saw a slight move away from the defensive posturing at the end of 2014. Although healthcare led the ranking tables again (+8% year-to-date in dollar terms), retailing (+7%) slotted in at number two. Australian retailers (+24%) and their Mexican (+18%) and Japanese (+17%) counterparts dominated. Utilities (-5%) did a sharp reversal of their leading performance of 2014. As expected, energy (-4%) was again weak as oil prices continued to fall.

LOCAL

The oil dividend – now you see it, now you don't

Finance Minister Nhlanhla Nene delivered his maiden Budget Speech on the 25th of February, to mixed reviews. Tax adjustments were used to compensate for the impact of weaker nominal growth on revenue collections, with personal income tax and taxes related to fuel the main targets to raise revenue. The fuel levy was increased by 30.5c/l, the Road Accident Fund (RAF) levy by 50c/l, and the electricity levy from 3.5c/kWh to 5.5c/kWh. These tax adjustments are expected to raise an additional R17 billion in revenue. Government's consolidated budget framework shows an estimated deficit of 3.9% of GDP for the financial year of 2014/15, and projected deficits of 3.9%, 2.6% and 2.5% respectively for the next three years.

The increase in the rand oil prices and adjustments to the fuel levy, the RAF levy and the electricity levy will adversely impact the near-term inflation trajectory. Increasing maize prices as well as the annual wage negotiation jamboree will add further pressure. While the South African Reserve Bank (SARB) Monetary Policy Committee (MPC) left the repo rate unchanged at 5.75% at their March meeting, the SARB Governor was at pains to point out his concern at the imminent change in the course of inflation. While our base case remains that the MPC will likely leave the repo rate unchanged for the remainder of 2015, and continue its gradual hiking cycle thereafter, recent inflation dynamics indicate earlier rate hikes.

Table 2: South African financial market returns

Asset Class (ZAR)	Quarter	12 Months
All Share	5.8%	12.5%
All Bond	3.0%	12.4%
Listed Property	13.7%	41.4%
Cash	1.5%	6.2%
Tier-1 (ZAR)	**Quarter**	**12 Months**
Resources	-0.2%	-23.0%
Financials	11.2%	33.4%
Industrials	5.6%	22.3%
Size (ZAR)	**Quarter**	**12 Months**
Large Cap	5.7%	10.2%
Mid Cap	7.6%	26.4%
Small Cap	3.2%	18.9%

Source: Deutsche Bank

Property over shares over bonds and cash

Listed property shares continued to enjoy substantial support in the first quarter of the year, as shown in Table 2. Resilient, Redefine and New European Property Investments have been especially strong, regularly swopping leads in the periods under review. Although the euphoria around property has led to a plethora of new listings and rights issues, it still remains a relatively small component of the FTSE/JSE All Share Index (ALSI) at 6% of market capitalisation. With yields at new lows, we wonder how long this strong performance can last.

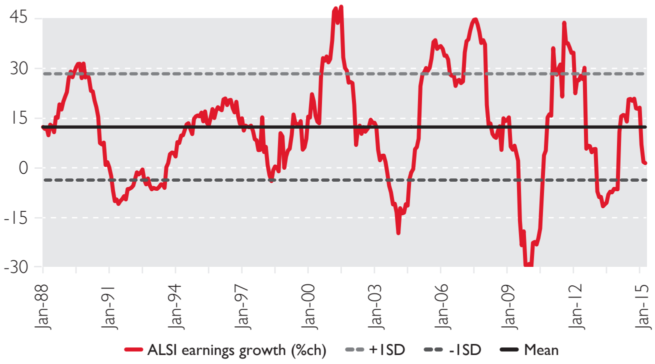
While the large caps staged a rally in the quarter, courtesy of Naspers (+23%), Steinhoff (+28%) and BHP Billiton (+7%), mid and small cap shares outperformed in the year. Financials (+11%) and industrials (+6%) clearly outshone resources (flat) in the quarter. Resource shares were constrained by the performances of Anglos (-15%), Impala (-22%) and Lonmin (-33%). Note that Sasol (-4%) has been reclassified as an industrial share within the chemicals sector.

Where to from here?

There is little doubt that equity markets are living on borrowed time. Share prices are typically driven by falling interest rates and corporate earnings growth. After the great financial crisis of 2008, declining rates provided the initial impetus. Shortly thereafter, corporate earnings stabilised and then were lifted by the benefits of the lower costs of capital and labour, muted inflation and a gradual increase in consumer demand.

While most of the world's central banks have fallen over themselves in the rush to lower rates, the Fed is however aiming at normalising interest rates. The gradual recovery in the macro performances of other countries would lead us to assume that eventually their central banks will also be looking at exiting their expansionary policies. South Africa's own SARB has been decidedly hawkish in its pronouncements on monetary tightening. So the benefit of falling interest rates and their positive impact on the valuation of other asset classes will come to an end. This leaves earnings to do the heavy lifting.

Chart 1: Corporate South Africa's earnings are fading



Sources: I-NET, Cadiz Asset Management

Chart 1 shows the year-on-year percentage change in the earnings of the ALSI since January 1988. The average growth rate in that period is 12% with a standard deviation of 16%.

Following a brief bounce in 2014, earnings growth has slipped again and is flirting with the zero line. Forward earnings have been adjusted downwards on an ongoing basis for the past 18 months. Revisions to the mining sector have obviously provided most of the drag given weak commodity prices, poor demand prospects, labour inflexibility and regular power outages.

But the other sectors have also seen revisions on the back of a consumer hit by grinding price increases, higher taxes and lacklustre growth. Employment growth has only taken place at the employer-of-last-resort, the South African government, and then only to offset those unfortunates laid off elsewhere. While consensus earnings are marginally positive for 2015 and in the mid-teens for 2016, the risks are to the downside.

This leads us to question whether ratings will sustain the market. We would advise against placing too much hope in market ratings to offer protection. Table 3 provides some insight.

- The average duration of the last 10 bull runs has been 51 months. In this regard, the current bull is long in the tooth at 72 months and is the second longest runner in the period under review.
- The returns of the current bull run though are below average, both in absolute and annualised terms. The performance would have been substantially better were it not for the 'oversized' exposure to the miners, which accounted for 60% of the ALSI's market cap in 2008. Notably, the miners (and Sasol) only account for 18% of the ALSI now.
- While the price to earnings ratio (PE) at the beginning of the most recent run was in line with the average of the past, the trailing PE of 18.8 is well in excess of the average. In fact, it ranks third on the list after the 1961-1969 and 1992-1998 periods.
- Consensus earnings growth for this year is pegged at 6% and 14% for 2016. Should these be realised, the forward PE drops to 15.2, which is hardly mouth-watering.

Given the levels of uncertainty and strained equity market valuations, we would not be surprised to see share prices weaken. Brian Munro's article on 'Where to invest' provides sound advice on how to cope with this possibility. ■

Table 3: A history of South Africa's equity bull markets (1961-2015)

Start and end date	Number of months to peak	Absolute return	Trough to peak annualised	PE at trough	PE at peak	PE unwind
April 1961 - April 1969	96	462%	24%	6.0	23.5	
October 1971 - March 1974	29	178%	51%	8.2	13.7	-65%
August 1976 - October 1980	50	387%	46%	4.6	8.3	-67%
June 1982 - August 1987	62	498%	41%	4.1	14.7	-51%
April 1988 - March 1990	23	92%	40%	8.4	10.9	-43%
January 1991 - January 1992	12	41%	41%	8.8	13.2	-19%
October 1992 - April 1998	66	172%	20%	11.6	19.4	-12%
August 1998 - May 2002	45	150%	28%	11.3	13.6	-42%
June 2003 - June 2008	59	281%	31%	9.8	15.3	-28%
February 2009 - February 2015	72	189%	19%	8.2	18.8	-46%
Average	**51**	**245%**	**34%**	**8.1**	**15.1**	**-41%**

Source: I-NET

US interest rate hikes remain on track

by ***Adenaan Hardien**, Economist*

Adenaan Hardien explains why US interest rates are still likely to increase with an overview of the factors that will affect the US Federal Reserve's decision. While the US economy and labour market has strengthened, it is relatively speaking, a fairly insulated and closed economy. Deflation remains a risk globally. Having clarified the reasons why it is more a question of when rather than if US interest rates will increase, he explains the impact on us in South Africa. When US interest rates increase, it is likely to usher in quite an uncomfortable period for South Africa, with rand weakness, inflation fears, and renewed pressure on the South African Reserve Bank to resume its rate hiking cycle.

Dollar strength and a weak oil price remain dominant themes

Dollar strength and a collapse in oil prices were the two main factors that influenced the global economy in the second half of 2014. They continue to dominate the global outlook, despite a potential Greek exit from the Eurozone. The prevailing consensus that the US Federal Reserve will initiate their rate normalisation cycle ahead of other major central banks is driving dollar strength. Concerns about a Greek exit and the continuing confirmation of a strengthening US economic recovery are likely to increase dollar strength. A host of factors, including oversupply and weak demand have driven the weakness in oil prices; but dollar strength has contributed to a broad-based weakening in commodity prices over the second half of 2014.

The consensus view that the US Federal Reserve will start hiking interest rates from mid-2015 is now old. A key question is whether this view is still appropriate given the:

- headwind that a strong dollar presents to the US economy;
- continuing downscaling of global growth expectations; and
- resurgence of deflation fears in major economies.

Hikes are imminent, but the timing is data-dependent

We think we should take the Fed at its word. As such, a June or September lift-off still seems the appropriate bet, with continued US dollar strength as its consequence. This adversely affects South Africa in a number of ways:

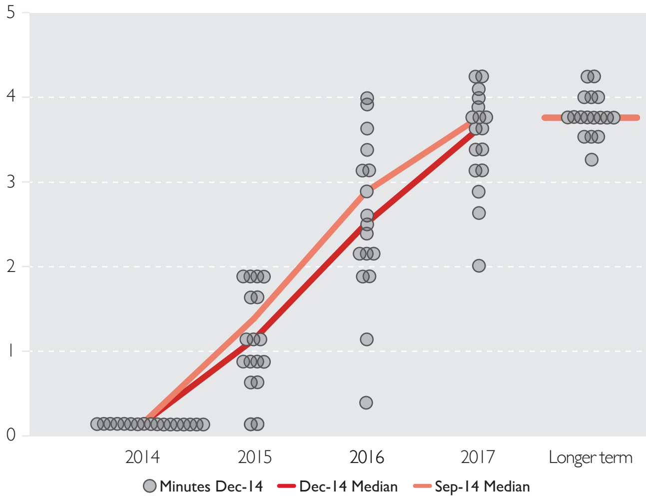
1. The rand is likely to be weaker against the dollar, but this will not necessarily lead to a boost in competitiveness since the currencies of South Africa's major trading partners, like the Eurozone are also weakening.
2. Commodity prices are likely to remain under pressure, which adversely affects commodity producers like South Africa.

3. A weaker rand will adversely affect South Africa's inflation outlook, which puts pressure on the South African Reserve Bank Monetary Policy Committee (SARB MPC) to resume its rate hiking cycle.
4. US rate hikes will adversely affect countries such as South Africa that have benefitted from the so-called carry trade to fund current account deficits.

US Fed forecasts more aggressive tightening

The US Federal Open Market Committee (FOMC) periodically publishes its projections of key variables - including growth, inflation and its Fed funds target rate, with its last set of forecasts published in December (as shown in Chart 1). These showed that 15 out of 17 FOMC members judged that 2015 would be the appropriate year to initiate a rate hiking cycle, while the remaining two thought that 2016 would be more appropriate. The median FOMC member thought that the Fed funds target rate should be hiked from its current range of 0% - 0.125% to 1.125% by the end of 2015, 2.5% by the end of 2016 and 3.625% by the end of 2017. In addition, the median FOMC member forecast that the long-term Fed funds target rate should be 3.75%. The latest Bloomberg consensus shows that forecasters expect the first hike by June, with the Fed funds target rate at 0.9% by the end of the year. Fed fund futures likewise suggest a very subdued hiking cycle, with an increasing probability of the Fed's first hike being delayed to late 2015 or early 2016.

Chart 1: The US Federal Open Market Committee (FOMC) anticipates interest rate increases in 2015

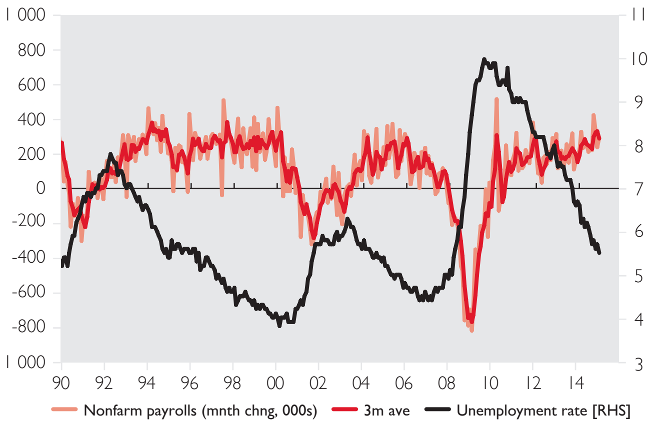


Sources: FOMC and Cadiz Asset Management

US data suggests a robust economic recovery

Data out of the US has been encouraging. More than a million jobs were added over the three months to January 2015, the strongest three-month gain since the third quarter of 2009. In February there was another strong jobs report. As shown in Chart 2, the unemployment rate is at 5.5%, the lowest rate since May 2008, with some who had given up looking for work returning to the job market. Although growth moderated to an annualised 2.2% over the final quarter of 2014, from 5.0% over the preceding quarter, the US still continued to outperform most of its peers.

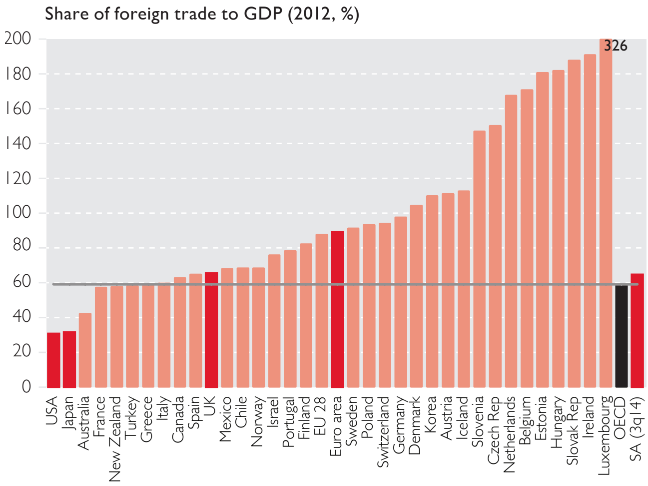
Chart 2: The US labour market is strengthening



Sources: US Bureau of Labour Statistics and Cadiz Asset Management

The outperformance is understandable. The FOMC led its peers in easing rates and using quantitative easing when the global financial crisis started in 2007. This is not surprising because the US housing bubble collapse started the crisis. The US remains a relatively closed economy as shown in Chart 3, and is thus more insulated, with the lowest foreign trade to GDP ratio among peers. In 2012, this ratio stood at 30.4%, compared to 59% for the Organisation for Economic Cooperation and Development (OECD) and 89.1% for the Eurozone. While many governments face an urgent need to cut back on fiscal spending, the US government has been reigning in spending since 2009. Just halting this consolidation trend will boost economic activity. The US remains a net importer of oil, and although the lower oil price will adversely affect its oil industry, the net effect on consumers and the broader economy will still be positive.

Chart 3: The US is a relatively closed economy



Sources: OECD, South African Reserve Bank and Cadiz Asset Management

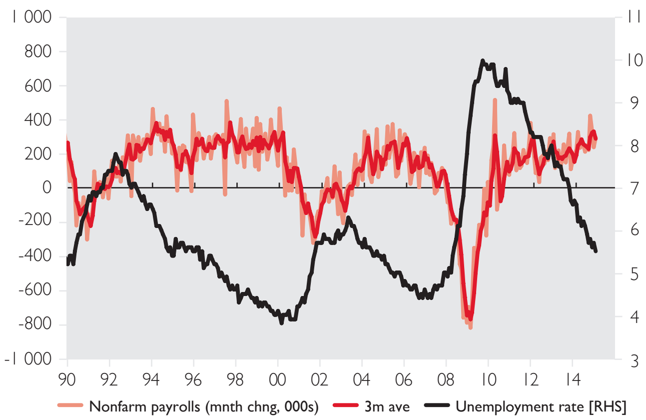
There are reasons to be cautious

The slowdown in the pace of US economic activity over the fourth quarter is a concern. Sectors like housing are lagging and other indicators show a recovery that remains tentative. But perhaps even more worrying to the Fed and most other central banks in advanced economies, is the threat of deflation. In economics, inflation refers to an increase in the general price level of goods and services in an economy, while deflation refers to a decrease in the general price level. The inflation rate is then calculated as the annual rate of change of an index representing the general price level.

Except for very isolated cases, inflation has fallen across countries. Although the broad global decline in inflation has been driven mainly by the collapse in oil prices, large output gaps and continued weak factor and product markets are making the problem worse. Even though US employment reports have shown strong job gains and falling unemployment, wage inflation remains absent. This challenge is more acute in the Eurozone, where 15 out of its 19 member countries are now technically in a deflationary environment.

The Fed has a dual mandate of maximising employment and targeting consumer inflation of 2%. As shown in Chart 4, US Personal Consumption Expenditure (PCE) inflation fell to 0.2% in January, its lowest rate since October 2009. Core PCE inflation – excluding food and energy – declined to 1.3%. FOMC minutes show that although longer-term inflation expectations appear anchored, market-based inflation compensation measures have continued to decline.

Chart 4: US Personal Consumption Expenditure (PCE) deflators show sharp disinflation



Source: Bloomberg News and Cadiz Asset Management

Deflation is the bogyman

Policymakers need to exercise caution when interpreting changes in the inflation rate, given that relative price changes can be confused with absolute price changes, which could lead to a policy error. If oil prices collapse, the inflation rate will decline given that petrol and related goods and services form part of the underlying index. Central bankers would typically recognise that this decrease in the inflation rate represents a change in relative prices rather than a decline in the general price level. But if the shock is significant enough, it can lead to general price level changes. Given the importance of oil in the supply chain of virtually all other goods and services in an economy, such second round effects are more likely.

Deflation is a central banker's worst nightmare. When deflation becomes embedded in consumers' psyches, consumption is delayed, which can lead to a downward growth spiral. The problem is exacerbated as real debt levels increase even if nominal debt levels remain constant. Given wage rigidities in labour markets, deflation may lead to job shedding as workers resist nominal wage cuts. In short, deflation is a recipe for disaster, since it undermines the very processes that ensure the smooth functioning of a modern economy. This is why, despite increasing evidence that the US recovery continues to build momentum, the FOMC continues to stress that hikes will be data dependent.

US interest rate hikes therefore remain a question of when, not if

Recent FOMC statements and minutes confirm that committee members see a moderate economic recovery continuing to gain traction, with the labour market continuing to improve, household spending and fixed investment rising, albeit with housing activity still lagging. Although deflation is a risk, inflation expectations appear anchored. Much of the risk to the economy lies abroad, but the US remains relatively insulated. In short, there is little to suggest that the FOMC needs to rethink their view on the appropriate timing of hikes, other than the fact that other major central banks may want to normalise their own monetary policy more slowly. US interest rate hikes from mid-2015 still seem the safe bet, as does continued dollar strength. This is likely to usher in quite an uncomfortable period for South Africa, with rand weakness, inflation fears, and renewed pressure on the South African Reserve Bank to resume its rate hiking cycle. ■

Why foreigners will buy South African bonds, for now

by ***Jonathan Myerson***,
Head: Fixed Interest

As we have discussed before, the continuous monetary stimulus in the developed world has been benefitting emerging market bonds, including South African bonds. Even though the South African economy is facing many challenges, so are the economies of our peers. When foreign investors consider where they can get the best value, they consider inflation and fiscal outlook as the two key indicators. With South Africa's inflation being low relative to our peers, the real yields of local bonds are attractive. However, with the significant increase in the debt-to-GDP ratio over the last seven years, South Africa's fiscal outlook, and as a result the long-term outlook for local bonds, is not as favourable. Nevertheless, the search for yield should persist and therefore support South African bonds, for now.

Local economic challenges should push up bond yields

The South African economy is facing many challenges, some of which were highlighted in the budget speech delivered by the Minister of Finance at the end of February. Economic growth remains well below pre-crisis levels, the current account and the budget deficits remain wide, South Africa's debt-to-GDP ratio is increasing, and labour wage demands remain high. On balance, these challenges suggest that bond yields should rise.

Finding the bond that offers better value

When investors face the decision of where to invest their money, it's not always a case of which asset offers good value, but rather which asset offers the better value. It is therefore worth 'scanning' the competing universe of bonds and assessing their value relative to South African bonds. All too often we focus on the difficulties that South Africa faces, like poverty, inequality, and political problems, while ignoring the fact that many of our counterparts face difficulties of their own.

Quantitative easing in the developed world makes emerging market bonds more attractive

In a previous CAMmunique, we spelt out the influence of monetary stimulus, in particular quantitative easing (QE) in the developed world on emerging market bonds. Simply put, as part of QE, a central bank buys government bonds, which drives down the yield of their local bonds. As a result, investors look to foreign bond markets for a higher yield. While our focus previously was on the US Federal Reserve's (US Fed) actions, the European Central bank (ECB) has started its own QE programme in March in an effort to revive the struggling Eurozone. It is widely anticipated that the Bank of Japan (BoJ) will follow the same strategy. At the same time, however, the much awaited US Fed 'lift-off' (the beginning of the rate hike cycle in the US) is moving closer, implying that US Treasury yields could rise. As a result, we have a tug of war between forces that should push European and Japanese bond yields lower and those that should pull US Treasury yields higher. Who will prevail? At this stage, we believe that the monetary easing by the ECB and BoJ will succeed and prevent US Treasury yields from moving much higher. In this environment the appetite for higher yielding (emerging market) bonds will remain strong and South Africa bonds could benefit.

But why would foreigners buy South African bonds?

After all, international investors have the choice of other high yielding markets, which are generally emerging markets. To answer this, we look at selected emerging markets (generally those who compete with us) in the J.P. Morgan Emerging Market Bond Index (in local currency). The Index includes 14 countries with credit ratings ranging from BB- to AA-. Given South Africa's credit rating of BBB, we narrow our comparison to countries rated in the BBB rating band. Table 1 shows the selected relevant key market prices and economic indicators.

Table 1: Market prices and economic indicators of South Africa's emerging market peers

	Bond yield*	Policy rate	Inflation	Gov debt (% of GDP)	GDP growth (2014 % y/y)
Brazil	11.67	12.75	7.7	65.8	0.05
Colombia	5.57	4.50	4.4	34.0	4.80
India	7.72	7.50	5.4	60.5	7.50
Turkey	8.79	7.50	7.6	33.6	3.00
South Africa	8.82	5.75	4.4	47.9	1.53
Indonesia	7.51	6.00	6.4	26.2	5.03
Philippines	4.88	4.00	2.5	36.3	6.10
Average	7.85	6.86	5.48	43.47	4.80

Sources: Bloomberg, J.P. Morgan and RMB Morgan Stanley
*This is the bond yield of each country's sub index in the J.P. Morgan Emerging Market Bond Index.

Inflation and fiscal outlook are key indicators when choosing bonds

When deciding whether to buy a South African or other bond, investors will broadly look at two sets of indicators – the inflation and fiscal outlook (which both depend on many other factors). While in both cases it is the long-term prospects that matter, inflation is much more volatile in the short term than the fiscal outlook, which develops over the longer term. Also, the independence of the central bank (certainly in the case of South Africa) allows it to take policy action to ensure that inflation returns to its target relatively fast. Fiscal policy, on the other hand, is laden with political interference and objectives, which means it is a far greater challenge to return the fiscal position to a sustainable path.

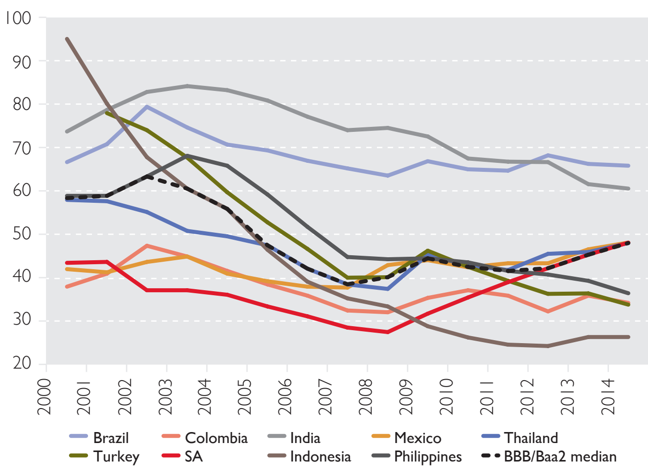
South Africa's real bond yields are attractive compared to our peers

Some foreign investors' focus will be on the near-term relative return prospects from the different bond markets. In other words, if bond yields in one market are relatively high and inflation is low then that's where they will go. Table 1 shows that South Africa's bond yields stack up well against its comparable universe. In fact, South Africa's real bond yield rate (bond yield less inflation) is the highest among its peers. Given the global disinflationary environment, it is reasonable to expect South Africa's inflation to remain relatively subdued for the near future.

Over the long term, the outlook for local bonds is less rosy

Unfortunately, the long-term prospects for domestic bonds appear more problematic. South Africa's debt as a percentage of GDP is marginally above the average of its peers, which does not seem particularly alarming. However, Chart 1 shows the deteriorating trend of key fiscal indicators. Until 2013, South Africa's debt-to-GDP ratio was lower than that of the median BBB rated countries, but it has now moved in line with the median. The rate of deterioration since 2008 is very concerning. Over the last seven years, South Africa's debt-to-GDP ratio increased by an average of 3.5% every year, compared with a median change of 0.1%.

Chart 1: South Africa's government debt as a % of GDP



Source: RMB Morgan Stanley

Poor economic growth is the culprit behind South Africa's deteriorating fiscal position

In 2014, the South African economy grew by 1.5% in real terms, compared with the 4.8% of its peer group. The country's average GDP growth since the financial crisis in 2008 was 2%, while that of the peer group was 4.9%. We don't expect this growth differential to change significantly in the next two years. South Africa's debt-to-GDP ratio is budgeted to rise marginally over the next three years, which is likely to be above the BBB rated countries' median. However, if economic growth does not meet National Treasury's forecast, the debt-to-GDP ratio will move closer to the BB+ rated aggregate.

We believe the search for yield will persist

What does this mean for our portfolio positioning? The recent sell-off in bonds has much more to do with the global environment than South African-specific issues. The timing of the US Fed rate hike has made the market nervous and its behaviour is not surprising. However, we are of the view that, even though some volatility will persist, investors will turn back to seeking yield. This, as discussed above, will be positive for emerging markets as a group and South African bonds specifically. ■

Richemont: Is it time to buy?

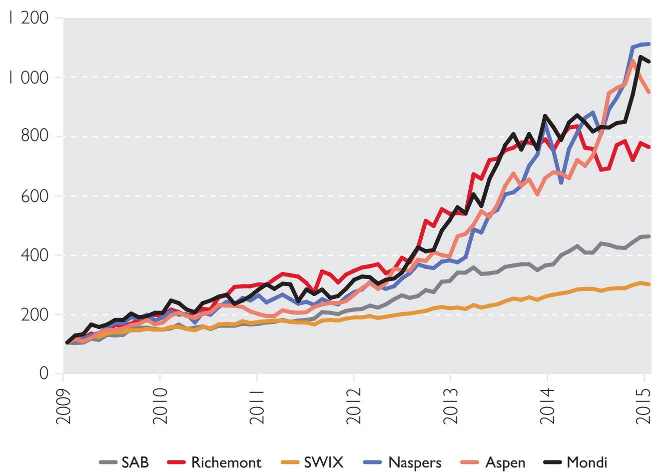
by *Graeme Ronne*
Equity Analyst

Since the 2008 market crash, Richemont has gone up more than seven-fold, materially outperforming the market. We regard Richemont as a quality company, with high barriers to entry, pricing power, a strong balance sheet, good cash generating abilities and a highly competent management team. However, the past five years has been an exceptional growth period, as revenue doubled and earnings tripled. We think this is abnormal in the context of its longer-term history and we are therefore concerned that both earnings and valuation multiples remain well above trend. Investors are prepared to pay a significant valuation premium in return for perceived earnings certainty and growth. In our view, the downside risks are not fully discounted in the current share price and we consequently do not own Richemont on behalf of our clients.

Richemont has been one of the market darlings

Richemont, along with Naspers, Aspen, Mondi and SABMiller, has been one of the market darlings in the current bull market, which is now in its seventh year (as shown in Chart 1). Since the 2008 market crash, the share is up more than seven-fold, materially outperforming the market, which has risen nearly three-fold. We held Richemont in our client portfolios until August 2013, when we sold our entire holding. Since then, the share price has largely been flat, underperforming the market by 24%. Given this relative underperformance, is it time to buy? In our view, it's still too early to buy Richemont, as we have no margin of safety.

Chart 1: Share price performance (2009-2015)*



Source: I-NET Bridge
*Rebased to 100 at the start

A globally-diversified luxury goods player

Richemont is the second largest luxury goods company globally, after LVMH. The group is largely exposed to the hard luxury segments of jewellery and watches, with a strong focus on the high end of the market. Cartier is Richemont's most recognised brand and the dominant profit contributor to the group. Other prestigious brands include Van Cleef & Arpels, IWC, Piaget, Jaeger-LeCoutre and Vacheron Constantin (the world's oldest watch brand). Richemont's largest region is Asia Pacific (ex-Japan). This region accounted for 40% of sales in 2014, and is an important long-term growth market. The group remains geographically well diversified, with a growing presence in the Americas and Middle East. Luxury goods sales are cyclical and closely reflect changes in discretionary consumer spending. Global economic growth and asset prices (stockmarket and housing) are the key drivers of luxury goods demand. This is known as the wealth effect – during boom times people feel richer and spend more while the opposite occurs during recessions.

What makes Richemont a high quality business?

Why do people continue to purchase €25 000 watches when they can simply look at their mobile phones to tell the time? To understand this, we need to understand the psychology of luxury goods. Consumers purchase luxury goods because they convey a sense of status, wealth and exclusivity. Luxury brands have intangible value because of their scarcity factor, which, combined with long histories and heritage, make them highly sought after by many consumers (and very attractive businesses to own). If there is no emotional connection, luxury goods will become commodities. You simply cannot re-create century-old brands and instantly compete in this industry.

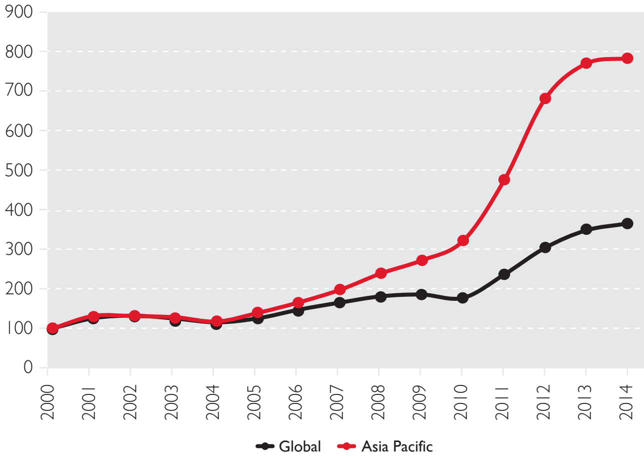
Why is this important? Firstly, as long as luxury goods companies can maintain the intangible brand value of their products, consumers will continue purchasing them, and secondly, barriers to entry will remain high and pricing power reasonably strong. These qualitative features, combined with a strong balance sheet, good cash generation and highly competent management make for an attractive business case.

Richemont's growth prospects are linked to the Asian consumer

Richemont's global sales (as shown in Chart 2) have grown at a compound annual growth rate of 9.0%, while its Asia Pacific sales have grown at 14.7% over the past 15 years. Two things stand out about this impressive performance:

- It took about 10 years for Richemont to double its global sales from €2.5 billion to €5 billion. Over the past four years sales doubled again, to over €10 billion annually off a much larger base and in less than half the time.
- Sales in Asia Pacific (notably Hong Kong and China) exploded from 2010, growing at a compound annual growth rate of 25%, accounting for half of the incremental growth.

Chart 2: Richemont's global and Asia Pacific sales (2000-2014)*



Source: Company data, Cadiz Asset Management

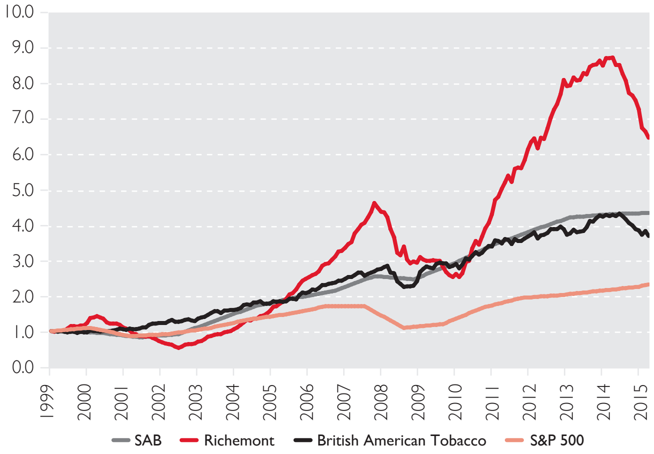
*Rebased to 100 at the start

While the Asia Pacific region remains vitally important to Richemont's long-term growth prospects, we have concerns around the sustainability of growth, given the high revenue base. In particular, growth in Hong Kong and China continues to moderate and perform below the market's expectations. In our view, sales growth is likely to be below trend, as many of the tailwinds turn into headwinds, and the rapid store expansion over the past few years starts to unwind. Excessive credit growth in China and continued weakness in emerging markets remain risks to the medium-term growth outlook in this important region for Richemont.

Earnings are cyclically high and at risk of normalising

Chart 3 compares Richemont's earnings per share (rebased to 100 in 1999) to SABMiller (SAB), British American Tobacco (BAT) and the S&P 500 Index. The past four years have been an exceptional growth period for Richemont (and the entire luxury goods sector) as earnings nearly tripled, materially outperforming SAB, BAT and a broader market of stocks like the S&P 500. Luxury goods companies tend to be very operationally geared due to relatively high fixed costs and high gross margins. This is great when times are good and sales growth strong, but equally painful when the cycle turns, as it always does. Operating margins are now higher than their previous peak levels achieved in 2001 and 2008. It's worth reiterating that over the past four years, operational earnings compounded at an annual growth rate of 30.7% compared to 4.5% per annum over the preceding 10 years. We regard the past four years as abnormal relative to Richemont's long-term history and remain concerned that earnings are cyclically high and are at risk of normalising.

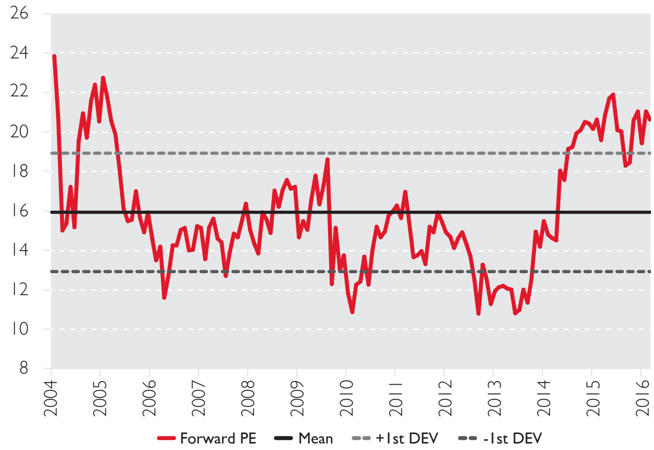
Chart 3: Earnings per share*



Source: Company data, Cadiz Asset Management analysis

*All in US dollars and rebased to 100 at the start

Chart 4: Richemont's one-year forward price to earnings (PE) ratio



Sources: I-NET Bridge, Cadiz Asset Management analysis

Our process focuses on understanding the downside risk of any potential investment

As valuation-based investors, we spend a lot of our time trying to understand whether the downside risk is already discounted in the share price. This gives us a sense of the margin of safety, as our primary objective is to avoid losing money. As such, we are constantly searching for investment opportunities with favourable odds and asymmetric pay-off profiles. We are also conscious that great companies don't come along at a great price very often. There is always a trade-off between quality, valuation and growth. It's important to know where one could be accepting a compromise.

Richemont is trading on a rolling one-year forward price to earnings (PE) ratio of 20.6X (as shown in Chart 4), which is more than one standard deviation above its 10-year average of 15.5X. We would argue that the earnings base is cyclically high and investors are actually paying close to 25X normalised earnings, a 60% premium to the 10-year average.

So there we have it, an investor buying Richemont today is compromising on valuation in return for quality. And for most investors today, 'quality' means earnings certainty and growth, which are both regarded as scarce in the current economic environment. How confident can investors be in Richemont's earnings certainty and growth prospects given that it is at a peak in both its earnings and valuation cycle relative to history? In our view, the downside risks are not fully discounted in the current share price, so we don't own the share on behalf of our clients. ■

Cadiz Unit Trusts' performance

All performance figures in the table below are annualised percentage figures to 31 March 2015.

Unit Trusts	1 Year	3 Years	5 Years	7 Years	Since Inception	Inception Date
No Equity Exposure						
Cadiz Money Market Fund	6.37%	5.88%	6.02%	7.27%	7.70%	01-Mar-06
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index	6.13%	5.59%	5.80%	6.97%	7.39%	
Quartile Rank	1st	1st	1st	1st	1st	
Very Low Net Equity Exposure (up to 20% in listed property and preference shares only)						
Cadiz Absolute Yield Fund	5.89%	7.33%	8.05%	9.20%	9.10%	01-Mar-06
CPI+3%	6.87%	8.20%	8.08%	8.84%	9.07%	
Quartile Rank	3rd	2nd	2nd	1st	1st	
Low Net Equity Exposure (20 - 40%)						
Cadiz Stable Fund	5.28%				6.84%	01-Sep-12
CPI+3%	6.87%				8.21%	
Quartile Rank	4th				4th	
Medium Net Equity Exposure (40 - 75%)						
Cadiz Inflation Plus Fund	3.14%	9.07%	9.86%	10.11%	10.06%	13-Jan-06
CPI+5%	8.85%	10.20%	10.08%	10.83%	11.10%	
Cadiz Managed Flexible Fund	2.93%	10.84%	11.65%	10.31%	10.68%	01-Mar-06
Average of the Domestic - Asset Allocation - Prudential High Equity sector	12.45%	15.08%	12.82%	10.33%	13.18%	
Quartile Rank	4th	4th	3rd	3rd	3rd	
Flexible Net Equity Exposure (50 - 90%)						
Cadiz Equity Ladder Fund	-4.13%	-1.58%	0.81%	5.62%	7.28%	03-Jun-05
CPI+6%	9.83%	11.20%	11.08%	4.42%	11.47%	
High Net Equity Exposure (100%)						
Cadiz Mastermind Fund	-2.09%	8.79%	9.61%	8.94%	10.57%	01-Mar-06
FTSE/JSE SWIX Index	17.73%	21.38%	18.15%	13.81%	15.83%	
Quartile Rank	4th	4th	4th	4th	4th	

Source: Morningstar & Cadiz Asset Management

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