PRUDENTIAL **INSIGHTS**

Hayley Dinler
Quantitative Analyst

MARCH 2018

Thank Goodness For Globalisation

Following almost three years of equity returns going nowhere, 2017 started off with many retail investors believing that we were bound to get poor returns, and thus deciding to avoid equity exposure. It turns out they would have missed out. While many people focused on the barrage of negative sentiment caused by news of Pravin Gordhan's replacement, "state capture", "junk status" and uncertainty within the ANC's leadership, all in the context of very slow economic growth, South African equity returned double-digit figures for the year, well above inflation.

What do we have to thank for these unexpectedly good returns? For a large part it was globalisation, as the strong rallies in equity markets around the world, developed and emerging alike, helped fuel gains in our locally listed shares with global earnings exposure in the second half of the year. "SA Inc." stocks (like retailers, banks and other companies with earnings derived largely from the local economy), meanwhile, got off to a slow start and only came to the party very late in the year. By March, these local stocks were weighed down by poor local factors, and it wasn't until the final quarter, when we escaped a Moody's downgrade and Cyril Ramaphosa was elected to head the ANC, that they experienced a rebound. And then they took off, so that the FTSE/JSE Shareholder-Weighted Index (SWIX) ended with a 21% total return for 2017.

THE COMPONENTS OF EQUITY RETURNS

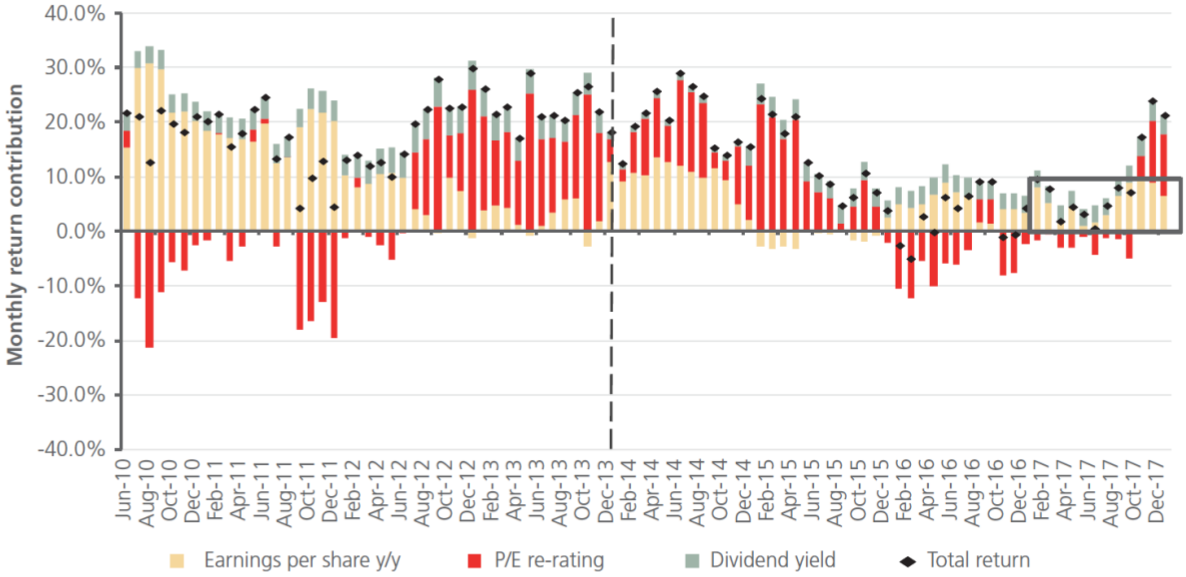
In 2013 I wrote an article looking at the components of return following a similarly fantastic annual equity performance of 20.9%, against a backdrop of subdued economic conditions and poor earnings. As a reminder, when looking at the returns of an equity index or individual stocks, it's important to recognise that total returns comprise three components: dividend yield, earnings growth and changes in ratings as represented by rises and falls in the company's share price/earnings (P/E) ratio.

In his book The Effective Investor, Franco Busetti reduces this relationship into the equation seen at the bottom of this page. Movements in the share price are obviously influenced by individual, subjective judgements regarding the value of a company, while the other elements of earnings and dividend yield are derived from actual data from a company's financial results. An increase in total returns can therefore be driven by a combination of improving earnings, growing dividend yield or a rising P/E ratio (a rise in share price or fall in earnings), also called a re-rating.

TOTAL RETURN = Δ IN P/E + Δ IN EARNINGS + DIVIDEND YIELD

The trend in 2013 was attributable to a P/E re-rating. Graph 1 highlights that 2017 was a different story – one of improving earnings. The yellow bars show how the improvement in company earnings forecasts year-on-year dominates the sources of total return for the SWIX (as depicted in the boxed area of the graph). This came from a combination of globalisation (thanks to the acceleration in global growth and global corporate earnings that came through during the year) and, later, rising equity prices for local companies. For now, we look at globalisation, which underpinned the index for the bulk of the year. Where did these earnings re-ratings come from?

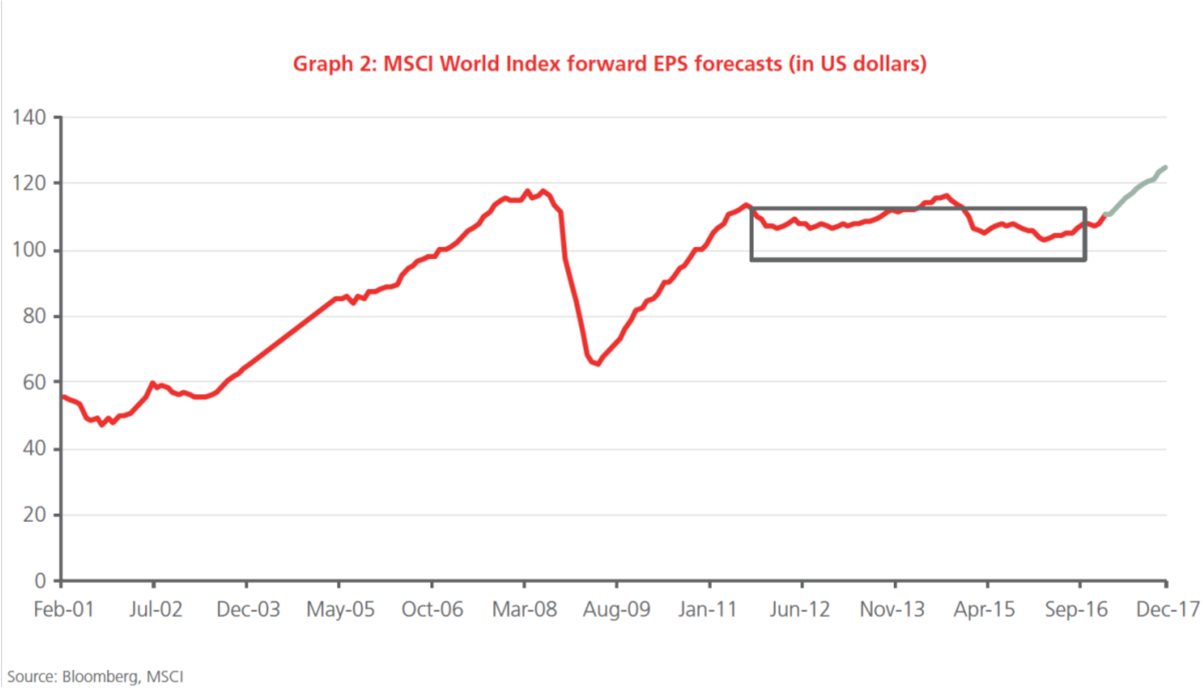
Graph 1: Disaggregating 2017 total SWIX returns:
Dividends, Earnings and Rating



Source: Bloomberg, Prudential Investment Managers

GLOBALISATION UNDERPINS SA EARNINGS

Over the past several years, global earnings estimates were consecutively downgraded as the year progressed. As Graph 2 shows, 2017 was the first year since 2013 with upward earnings-per-share (EPS) re-ratings, with analysts improving their earnings forecasts and accelerating earnings revisions for the year (more earnings upgrades than downgrades). For the first time on record, global equity markets rallied in all 12 months of a year. The MSCI World Index (for developed countries) delivered 21.6% (in US dollar terms) in 2017, the strongest year since 2009.



Although the SWIX is a South African equity index, its earnings exposure profile is not. Currently, 33% of SWIX earnings comes from South African-based revenue – that means that 77% of the index earnings is produced offshore (as compared with 56% in 2010 and under 45% in 2003). South African performance has therefore been highly correlated to developed equity markets due to high offshore earnings.

The big offshore revenue earners in the SWIX (with over 75% of their earnings offshore) include Naspers (which contributed over half of the annual return of the entire SWIX for the year thanks to its hefty 72% return), Anglo American, MTN, British American Tobacco, Richemont and Bid Corp. With these global earners among the top contributors to the index, the diversification benefits have been well achieved, as highlighted in Table 1. In contrast, I cannot neglect to mention that another global group, Steinhoff, was the largest detractor from 2017 returns (and possibly the year's biggest story). It recorded a total return of -93% for the year, almost all in December, detracting 3.11% from the SWIX (with an average weight of 2.8% in the index for the year).

Table 1: Notable company contributions to 2017 returns

	SWIX Weight (%)	Rank of contribution to SWIX return 2017	Total company return 2017
NASPERS	20.57	1	71.80%
ANGLO AMERICAN PLC	2.19	5	34.88%
MTN GROUP LTD	3.87	6	14.52%
BRITISH AMERICAN TOBACCO PLC	4.07	7	11.25%
RICHEMONT	1.74	10	25.73%
BID CORP LTD	1.68	11	24.92%

Source: Prudential Investment Managers

Global commodity prices are also a major driver of the earnings cycle, and the past year was no exception. There is a close correlation between South African earnings in US dollars and the Commodity Price Index given the relatively high weight of resources companies in the SWIX. The accelerating global growth backdrop supported the demand for commodities during the year, which, coupled with supply constraints imposed by the Chinese government, led to higher commodity prices and provided earnings and cash flow support to our general mining companies. We therefore saw the likes of Sasol, Anglo American, Exxaro and BHP Billiton among the top contributors to the SWIX return for the year.

LOCAL COMPANIES ADD LATE GAINS

Looking back at Graph 1, we see that 2017 culminated with the final quarter experiencing a notable turnaround in the contributions to total SWIX returns from the P/E ratio. It illustrates how the P/E ratio (shown by the red bars) had actually detracted from performance in the earlier parts of the year, but then swung to a positive re-rating and contribution in the fourth quarter.

As noted previously, this followed improved confidence in South Africa's outlook on the back of several factors, including: lower inflation and interest rate forecasts; Moody's move to postpone its credit rating downgrade decision in November; and the market-friendly outcome of the ANC elective conference in December. These all led to rallies in the rand and "SA Inc." stocks with significant exposure to South African consumers and interest rates, without a similar rise in their earnings, thus also raising their P/E ratios. These companies primarily comprised the retailers (Mr Price, Foschini, and Tiger Brands) and banks (FirstRand, Standard Bank, Barclays Group Africa).

Thus, in conclusion, while the dominating theme of our 2017 equity market was global earnings growth, we can see that it was in fact a combination of both globalisation and the revitalisation in “SA Inc.” that drove returns for the year and now sets the tone for 2018.