Plexus Wealth Watch – Fourth Quarter 2018

Global equities ended the year sharply lower. US markets fell after a public disagreement between President Trump and Fed Chair Powell failed to stop a final rate hike (higher interest rates act as brakes on an economy). The US economy is in good shape but there are some indications that it is approaching the end of the strong expansion cycle. Europe had a challenging year with Brexit reaching fever pitch. Emerging markets were also negative as China underperformed due to uncertainty re the trade war with the US and a slowing domestic economy. During 2018, fund flows left emerging markets in droves and SA was not spared.

As can be seen from the table below, while many of us felt the pain in 2018 in South Africa, and it was tempting to blame this on local factors (partly true), most developed markets also experiencing double digit declines:

Main Country Index	Year to date return
Australia	-18.54%
Brazil	-7.12%
Canada	-19.26%
China	-21.22%
France	-15.70%
Germany	-23.68%
Hong Kong	-11.01%
India	-7.40%
Italy	-19.45%
Japan	-14.52%
Malaysia	-12.48%
Mexico	-16.82%
Norway	-10.86%
Russia	-4.82%
Singapore	-15.46%
South Africa	-29.28%
South Korea	-22.26%
Spain	-18.05%
Sweden	-18.17%
Switzerland	-13.04%
Taiwan	-13.12%
UK	-18.87%
US	-7.32%

At times like these we need to think carefully. What is your primary reason for being invested and what is the intended timeframe? What are your objectives, and have they changed? If they have not, then the best decision is usually to do nothing, which can be difficult when, as humans, we are wired to take action in the face of a challenge. We must stay mindful of the behavioural biases that humans experience in the face of uncertainty.

We have seen an unprecedented 26% total return decline in the SA Listed Property Index (SAPY) over the last year. The sector's worst performance in more than 20 years. The last time the SAPY suffered a negative return was during the subprime crisis in 2008, when the sector lost about 4.47%.

There have been only three other periods since 1995 when property stocks delivered a negative return: 1996, 1998 and 2008. But these declines were not nearly as severe as that of this year, which ranged from a 1% drop to a 16% fall.

There have been a number of factors that have contributed to the weakness in the sector. These include ongoing political and economic uncertainty, the land expropriation issue and the lower-than-expected earnings growth that was declared by many property companies.

The downward revisions of growth expectations have continued during the recent reporting period due to the recessionary economic climate, which has curtailed consumer spending and business expansion and led to higher vacancies and lower rental renewals. The call for all once-off income (eg. Exchange rate gains, consulting fees) to be excluded from distributions has forced an even greater downwards rebase of earnings than would have otherwise been the case.

A potential future threat to the income stream of retail focused REITs is if the Edcon group (which includes Edgars, Jet and CNA) was to fail. Currently a 41% reduction in rentals is being negotiated and we hope that this will help avert a disastrous failure of the company. We have seen a further pull back in predominantly the retail REITs in December following the announcement of the proposed rental reduction as if this does materialise it is likely to knock 2-4% off the forecasted growth in distributions for retail focused REITs for 2019.

Considering how many concerns now weigh on investor confidence it is difficult to predict when appetite for property stocks is likely to recover. While this might not be overnight, investors should keep in mind that listed property is a separate asset class providing much-needed diversification. Property income is underpinned by lease agreements with tenants in these property assets. Rentals are contracted and most escalate at a predetermined rate annually, around 6.5% to 8% in the current domestic market. The income-generating ability of listed property is still far more predictable than most equity stocks, and therefore we believe there is certainly a place for listed property in a balanced portfolio.

We expect listed property to deliver a total return, made up of share price movement plus distributions, of roughly 13% to 14% per year over the long term.

To end the newsletter and the year off we would like to remind investors of the small steps in the right direction that president Cyril Ramaphosa has taken over the last year amongst which are the cleaning out of the Tom Moyane faction of SARS, the appointment of the new head of the NPA, who appears to be truly independent, and in a tough balancing act, he has fired 10 ministers, most of whom were central to allegations of state capture. He has also appointed new boards at SABC, Eskom, Transnet and Denel albeit that the effectiveness of these is yet to be proven.

The recent endorsement by the Managing Director of the International Monetary Fund, Christine Lagardehead, of Cyril Ramaphosa as being the right man to steer the country to economic prosperity, with the help of the private sector, is encouraging. The South African economy officially exited the recession after reporting 2.2% GDP growth for the third quarter of 2018. A survey of economists by Bloomberg forecast growth of 0.7% total growth in 2018 and 1.5% in 2019. All things are cyclical and it appears as if the tide is turning economically and politically in South Africa.

Kind Regards

Eric, Connie, James, Don, Amanda and the team at Plexus Wealth