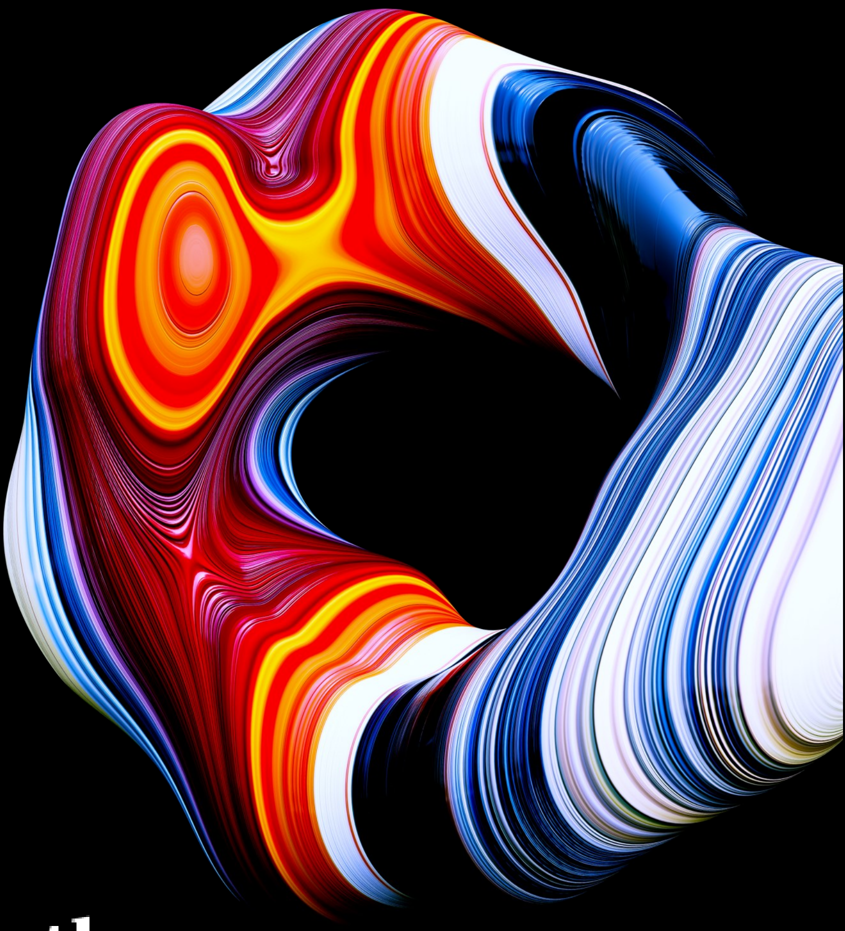
NORTHSTAR

ASSET MANAGEMENT

QUARTER 3 MARKET REPORT



Closer to the truth

THE BIG PICTURE

BREXIT—DOES IT MAKE ECONOMIC SENSE?

By Adrian Clayton (Managing Director & CIO) and Rachel Finlayson (Analyst)

Our lead article covers the 'impending' departure of Britain from the European Union. The vastness of the topic limits us to dealing with only four focal areas – trade, financial services, immigration and the total expected economic impact of Brexit.

History

The United Kingdom joined the European Communities in 1973, later to be renamed the European Union. It is the second largest economy within the Union after Germany, boasting annual GDP of €2.3trn, making it 4.6 times the size of the average EU economy and 210 times the size of the smallest economy, namely that of Malta (€11bn). The UK accounts for a rather

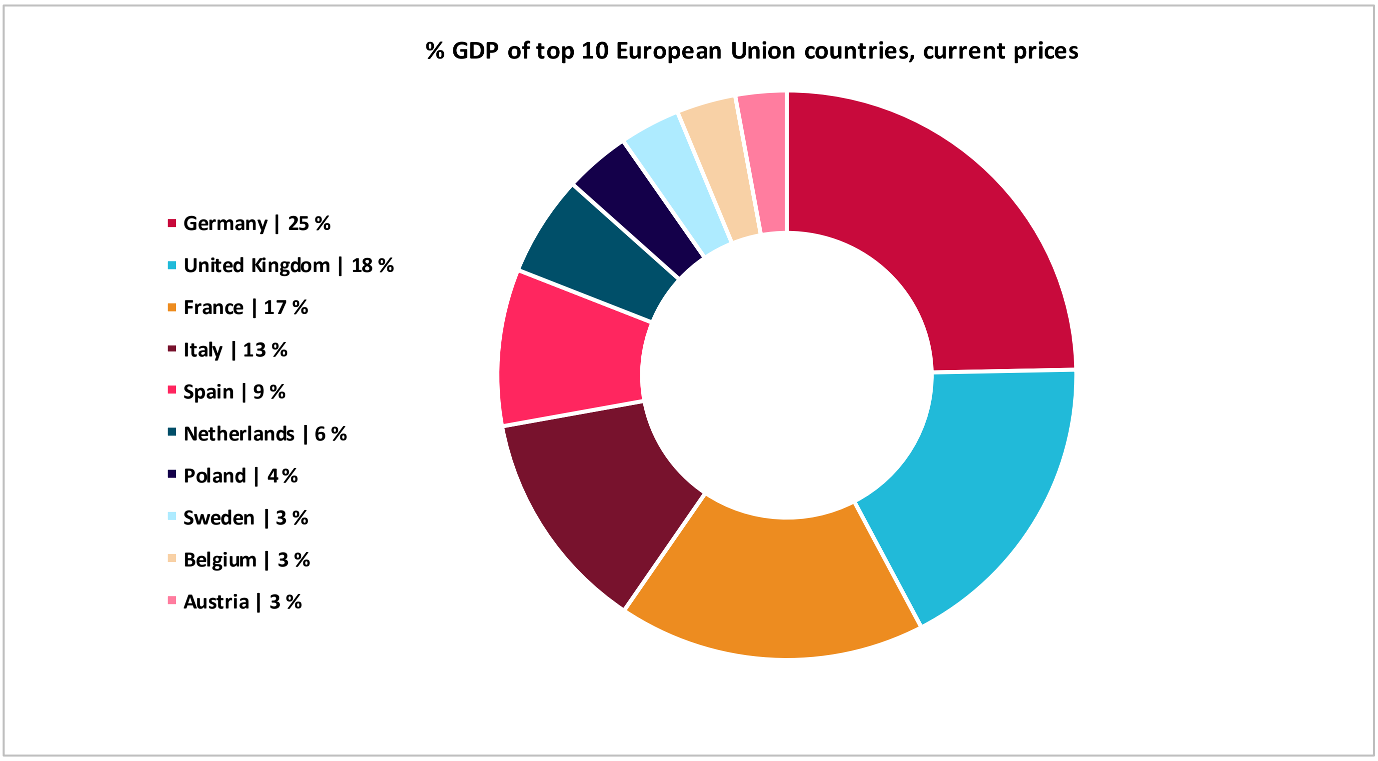


Figure 1. GDP of Top 10 European Union countries. Source: IMF DataMapper & Northstar. September 2019.

significant 15% slug of the entire economic union, consequently, its intended departure should not be underestimated.

Britain has had two referendums on remaining in the EU, in 1975, 67.2% of voters decided to stay and in 2016, 51.9% decided to go! It is the only member country to have held referendums on remaining. We try to unpack the main impact areas of Brexit and how this could affect economic growth.

Trade

Exports of goods and services account for approximately 28% of the UK's economy. Roughly 43% of UK exports head to EU countries, but significantly the UK also exports in excess of 10% of goods and services to other countries which have aligned themselves to the EU's trade agreements. EU and related trade accounts for between 12% and 15% of UK GDP – in 2017, the UK sold goods and services to Europe worth £274bn.

Conversely, Europe's trade with the UK in 2017 was £341bn, implying that the UK was running a trade deficit with Europe. About 8% of the EU's total trade goes to the UK, but excluding EU member countries, the UK accounts for 18% of Europe's total external trade.

Post Brexit, UK companies will need to complete customs declarations and get health checks for animal products being transported into the Union. The European Commission has provided no special waivers for Britain's busy roll-on, roll-off ports which are of the busiest and cheapest methods of transporting goods and services between the EU and UK. Furthermore, the EU has started employing and training customs officials that will deal with trade red tape in the future. It is estimated that 80% of UK small and medium sized firms have no contingency plans in place for Brexit.

Financial services

Financial services accounts for 12% of UK GDP and two million jobs. UK banks lend over a trillion euros to European companies and governments. 87% of US investment banks' EU staff are employed in London and 78% of EU capital markets trading is conducted from London.

This is not by chance. The less stringent labour laws and strict, but non-draconian, legislation around financial services relative to the EU, has made London the perfect spot to access the European Union for global financial institutions. In addition, passporting rights, which allow British based firms to sell their products to the EU and vice versa without the need to obtain a license, get regulatory approval or set up a local subsidiary has led to seamless financial integration of the UK into the EU. It is estimated that 5 500 UK firms and 8 000 European firms operate across waters accessing each other's market, relying on passporting.

Martin Wolf, from the Financial Times, probably best summarises what London faces as a result of Brexit – "It was emerging as the undisputed financial capital of Europe, as well as one of the world's two most important financial centres. After Brexit, it is likely to become an offshore centre, relatively more vulnerable to policy decisions, especially regulatory decisions, made elsewhere, particularly the Eurozone."

Immigration

At the heart of the 'leave' vote was the issue of immigration and the loss of autonomy for the UK to decide on who should be allowed to live within its sovereign borders. Based on the House of Commons' Migration Statistics Paper of 3rd June 2019, in the year ending December 2018:

- 6.1 million British inhabitants were foreign nationals – this represents 9% of the total population.
- 3.6 million EU nationals (excluding the UK) were living in the UK.
- 785 000 UK nationals were living in other EU countries, excluding Ireland.
- Between 1960 and 1990, the number of UK emigrants exceeded the number of immigrants.
- Since 1998, the number of immigrants exceeded emigrants by over 100 000 per year.
- In 2018, 54% of immigrants were subject to immigration control, evidence against the view of uncontrolled flooding of the UK by EU immigrants.

A lack of clarity on the future of EU citizens living in the UK in a post Brexit world exists, but Britain has proposed a settlement scheme that effectively provides those, that have lived in the country for longer than 5 years with permanent residence. Periods shorter than 5 years require an application to enjoy permanent status. The sticking point is that after Brexit, new EU entrants face harsher entry requirements. The UK's Migration Advisory Committee (source Financial Times) has published a paper with the following interesting facts on immigrants:

- 85% of EU migrants create their own employment in the UK or find formal work – they do not try and seek state benefits. This is significantly higher than other migrants.
- There is no evidence that EU migration has reduced wages in the UK, a common complaint by Brexiteers.
- EU migrants pay significantly more in taxes per head to the Exchequer than the average UK citizen – they also contribute far more to the tax base than they utilize in social benefits.
- The evidence that migrants increased the crime rate in the UK is not backed by data. Eastern European men seem to be more responsible for petty crime, whereas British men commit more violent crime and are higher users of drugs.

Expected economic impact of Brexit on the UK and European economies

There is broad agreement amongst mainstream economists that stronger trade, investment and migratory links boost a country's economic output. With the current uncertainty as to the type of British exit that will occur, it makes predictions on the economic impact to the UK and Europe cloudy, but four factors are key to understanding future growth.

Trade barriers - it is difficult to see a post Brexit world with smooth trade between the UK and EU. Prospective trade barriers are probable and these reduce growth.

Foreign direct investment (FDI) – FDI is intimately tied to trade and in 2018, 43% of the UK's FDI originated from the European Union. Reduced trade equates to reduced FDI and reduced growth.

Productivity - a key post Brexit issue is whether highly productive Eastern European skills migrate back home or remain in the UK.

Regulations - the EU is known to have stifling legislation that is regarded as growth inhibiting. Should the UK be in a position post Brexit to dampen this impact, it might offset reduced growth stemming from higher trade barriers, loss of FDI and possible loss of productivity.

Economic life after Brexit

Since the Great Financial Crisis (2008), economic growth has been muted in most parts of the world and stimulating economic activity has required Herculean fiscal and monetary interventions by governments and their central banks. Figure 2, depicting GDP growth in Europe and the UK, highlights this point. It is clear from our analysis that Europe and the UK face new Brexit challenges and that growth will be under renewed pressure.

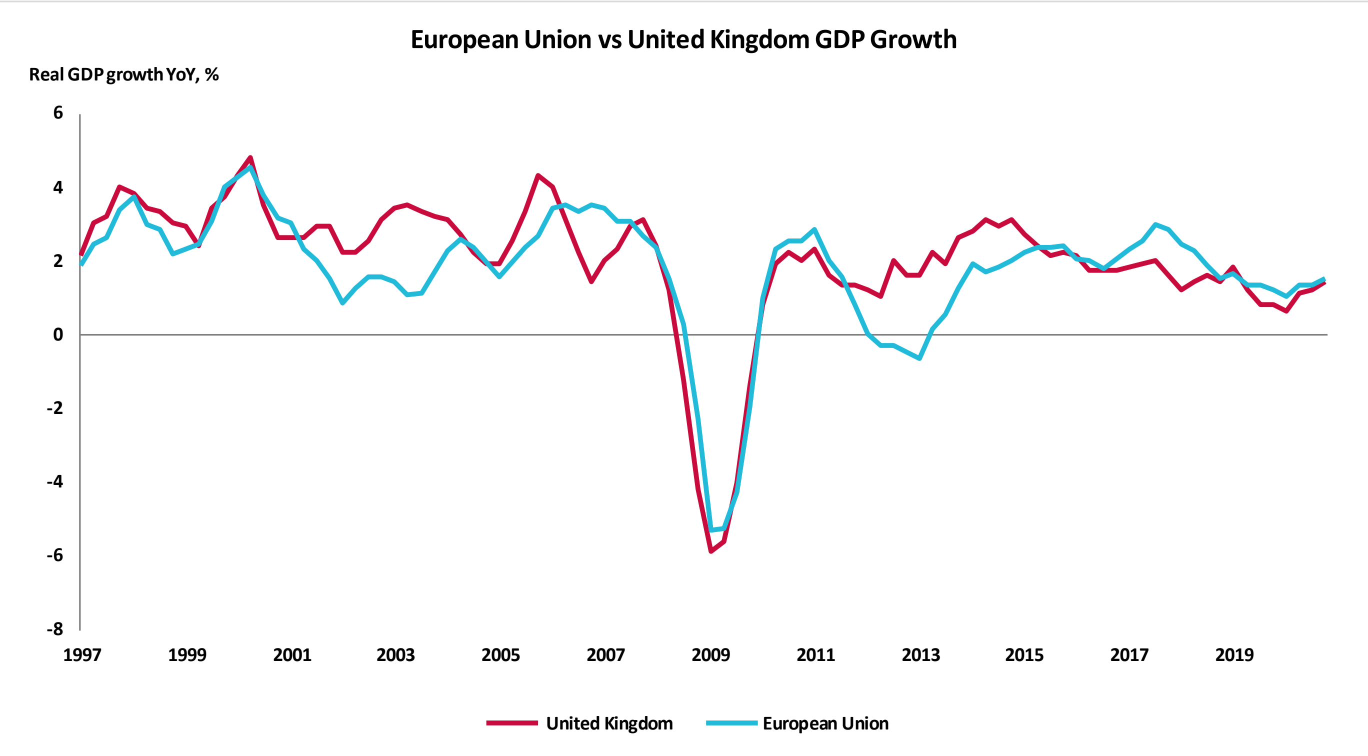


Figure 2. European Union versus United Kingdom GDP growth. Source: Northstar and Bloomberg. September 2019

We are not underestimating the potential for serious systemic risk due to Brexit and will be closely monitoring developments in the months ahead.

FROM THE ANALYSTS

TAKING STOCK OF THE MARKETS – LET THE NUMBERS DO THE TALKING

By Adrian Clayton (Managing Director & CIO)

The Northstar asset allocation framework

Each quarter we conduct an analysis on the relative value within each asset class available to us as investors.

Asset classes include equities, commodities, property, fixed income (government and corporate credit) and cash and this granular, methodical and numeric exercise purposefully removes human intuition – we let the numbers do the talking. The output is an asset valuation matrix that directs us to the highest potential returning investments whilst accounting for risk taken.

The Northstar buy list

Although our asset allocation work is important, we attach greater credence to our bottom-up, fundamental valuation work which we conduct on each security (share, property, bond etc.) before making an investment. Over the years we have built valuation models on the majority of locally listed companies as well as a significant number of offshore stocks. This library of work provides us with a real-time view of what potential upside returns we think our funds offer.

So what are the numbers telling us about potential returns in South Africa from both a bottom-up and top-down perspective?

The Rand

We appreciate that South Africa faces enormous challenges, many of which can fundamentally adjust the value of domestic assets. The modeling work, which we are demonstrating here, does not attempt to capture unforeseen events, it instead makes use of existing real data.

Based on our purchasing power parity (PPP) model, Figure 3, which we use internally, the rand is undervalued. A conservative value for the ZAR is R12.35 to the US$. Whilst pin-pointing an absolute number with respect to the rand's real value is a fool's

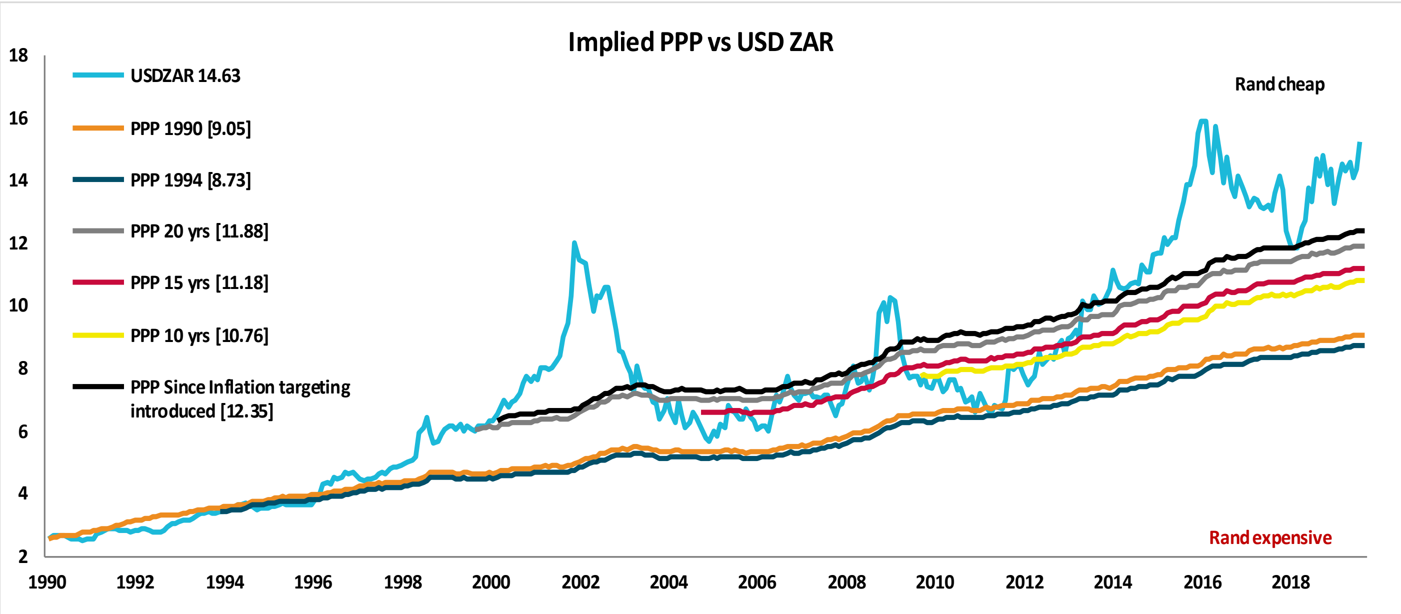


Figure 3. Implied PPP versus USD ZAR. Source: Northstar and Bloomberg. September 2019.

game, we prefer to use the model as a reference for when the currency is showing extreme behavior – the present is such a time.

South African equities – bottom-up

The chart below tracks the discount to intrinsic value of the companies on our domestic 'buy list.' Currently, these shares by our calculation are on average, about 30% undervalued – unfortunately we are unable to say if or when this valuation gap will

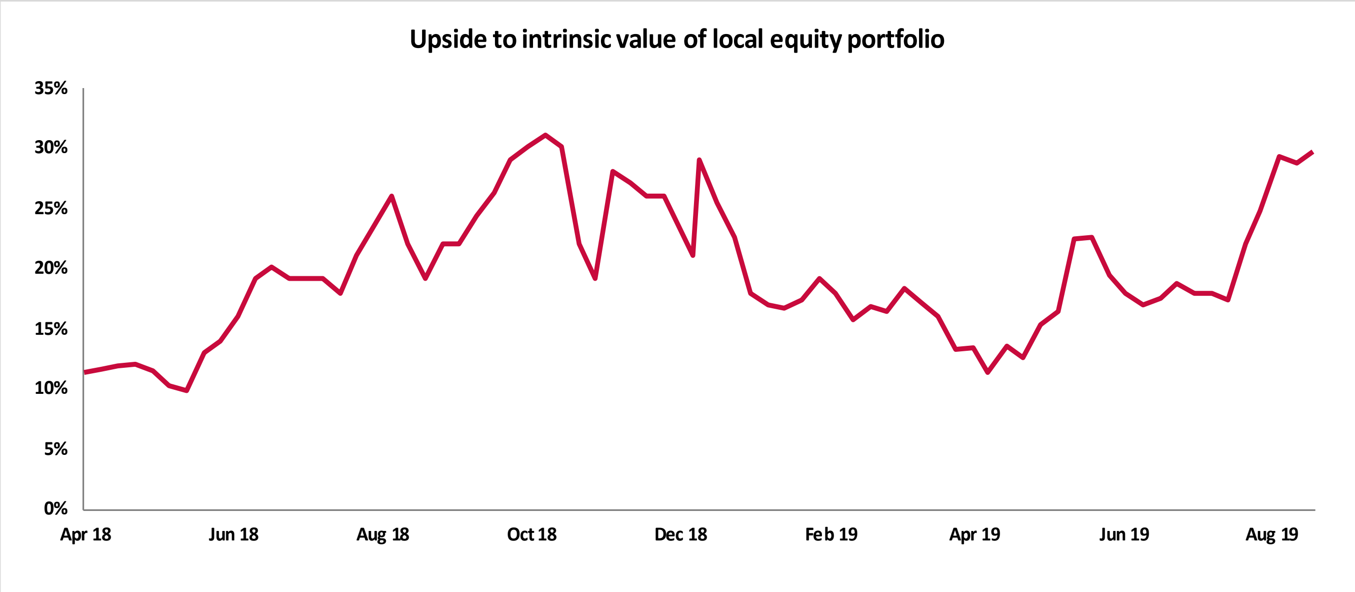


Figure 4. Upside to intrinsic value of local equity portfolio. Source: Bloomberg, Northstar. September 2019.

narrow. Our 'buy list' companies are trading as cheaply as they were in late 2018, the last time we communicated to our clients that an opportunity was emerging on the local market.

South African equities – top-down

Corroborating our bottom-up or fundamental valuation work on local companies is our asset allocation analysis (top-down) quantitative work on equities. In Figure 5 below, our calculation for prospective returns for the JSE Capped Swix index is 15.4% - a rational equity investor should demand a return of approximately inflation plus 7% for equities which we call a hurdle rate. With South African inflation just above 4% at present, the hurdle rate return for equities is 11%. With potential returns from the market significantly higher than that at 15.4%, domestic equities are once again a viable option for our clients.

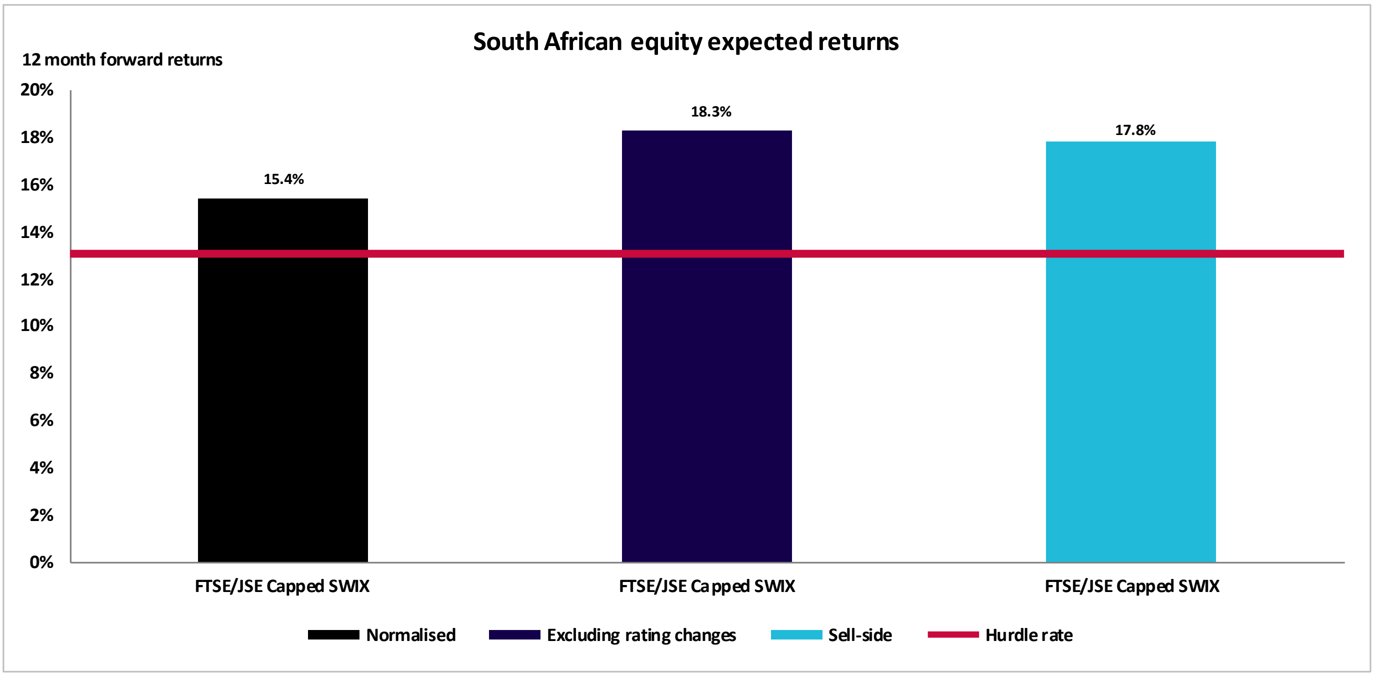


Figure 5. South African equity expected returns. Source: Northstar. September 2019.

Fixed income assets – cash, bonds and property

We use the same approach for cash, bonds and property.

At current low levels of inflation in South Africa of 4%, the 7% yield offered by banks on deposits, is in our view, a very attractive low risk return that substantially outperforms the hurdle rate on cash, which we regard as inflation.

The hurdle rate returns for bonds (Figure 6, indicated in red) does not need to be as high as equities – bond investors take less risk than equity investors and many bonds are shorter-duration investments, implying lower required returns. Elevated yields (cheap prices) in South Africa are a function of concerns of a credit downgrade as well as the fiscus issuing a disproportionately large amount of paper into the market to fund the budget deficit and parastatal bail-outs. Our work shows that potential returns on bonds, for the most part, currently compensate investors well above the hurdle rate required.

Finally, on property, for the past few years, our analysis has been directing us away from property – potential returns remain significantly lower than what a rational investor should demand from this relatively high risk asset class.

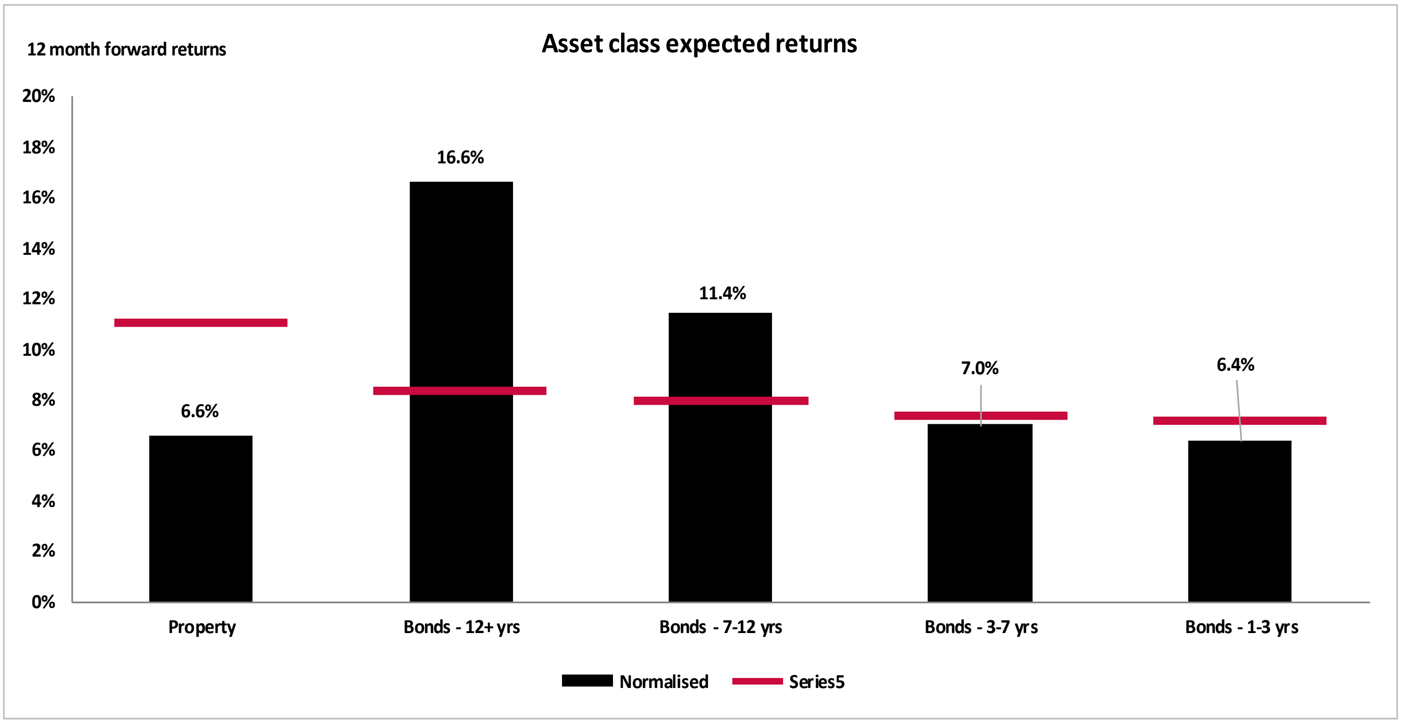


Figure 6. Asset class expected returns. Source: Northstar. September 2019.

The Northstar Sanlam Collective Investments (SCI) Managed Fund

Our 'house-view' balanced fund incorporates all this thinking into one product. Asset allocation adjustments within the fund are based on both our buy list expected returns together with our asset allocation framework outlined above. It is the ideal vehicle for clients that do not want to make asset class calls themselves.

Until recently (July 2019), we have been overweight offshore assets and underweight South African risk assets, the likes of property and equities. Against this, we have been overweight bonds, which have performed superbly. During the last quarter, we have however reduced the fund's total offshore exposure, the reasoning is two-fold, offshore equities are no longer cheap and the rand became undervalued (see above). Simultaneously, the domestic equity weighting of the fund has been increased as South African stocks have begun to offer more value.

Each of these moves is consistent with the framework shown above, an approach we have followed consistently over time and which has been value enhancing to our clients.

CORRIDOR CHATTER

IT'S IN THE MIDDLE, CYRIL

By John Steenhuisen (Political Analyst)

The big question on everybody's mind is how long can the policy contradictions continue to disrupt the reform agenda South Africa so desperately needs? What has become abundantly clear over the course of the last year is that President Ramaphosa has been boxed in completely, not by his political opposition, but by his detractors in his own party. Ramaphosa's reform agenda has been reduced to the proverbial eunuch in the brothel, possessing all of the desire but none of the ability.

The latest welcome reprieve from rating agency, Moody's, has given a small breathing space. It does however contain some very stark warnings for the Ramaphosa administration and it ignores these at its own peril. Moody's has cited continuing policy uncertainty, slow implementation of structural reform and the dogged determination to continue bailing out failing state owned entities rather than deal decisively with the spectre of Eskom.

The brutal truth is that whilst Ramaphosa may be in the driving seat in the Union buildings, he is clearly not in the driving seat in Luthuli House where the faction led by Ace Magushule and Zuma proxies clearly rule the roost. This is perhaps best demonstrated by the bizarre reaction of the governing party to a discussion document recently released by finance minister, Tito Mboweni. On the whole the document provides a sound analysis of the restraints on economic growth and sets out some sensible remedies to them. Instead of welcoming this illumination of an economic path forward out of the darkness of painfully slow growth, crippling public debt and horrific unemployment, the reaction from within the governing ANC has been schizophrenic at best with some senior leaders in the governing alliance completely disowning the minister and the document.

What this points to is the trend that the schisms that exist in the governing party are widening rather than narrowing. This is evidenced on nearly every single major issue facing the country, from the debate on expropriation without compensation, the nationalisation of the Reserve Bank, prescribed assets and the approach to Eskom. Given the dire situation that South Africa finds itself in, with dwindling confidence in the economy and outbreaks of violence across the country, the time for dithering and vacillation has long passed. It's time now for President Ramaphosa to make his move and drive through the bold reforms that are required to pull the country and our economy out of the dive. The continued to and fro in the government is a luxury we simply cannot afford.

The centre of the ANC cannot continue to hold as these stark contradictions are laid bare. To move South Africa forward something has to give, the final showdown between the enemies of growth and the reformists within the governing party is fast approaching. The time for Ramaphosa to strike is now, he must move quickly before he is moved against. The faction of rent seekers surrounding Ace Magashule is determined to isolate Ramaphosa, recapture the state and get their hands on the spoils. If Ramaphosa moves decisively in the direction of growth-oriented policies he will gather up the support of the rational centre of South Africa across the spectrum.

And perhaps that is just what South Africa needs, a break in the stale logjam of our politics. A new majority positioned at the rational centre of politics, with the best from all parties coming together and uniting around a common set of values and a decisive reform agenda that can bring change and set South Africa on a new trajectory of growth and opportunity. This will provide a solid bulwark at the centre of South African politics against the radical tendencies of the rabid left and right parties that threaten to tear our economy apart. It is hard to be hopeful and look for positives in the difficult days South Africa is living through, but maybe, just maybe, this will be the catalyst for a political realignment and readjustment that can offer hope and change to a country so desperate for it.

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