CAM PMT
Themes and outlook 2016

January 2016

Capricorn
Asset Management

Intro

Unchartered Territory - Never before have we had a landscape that is dominated by the following, all at the same time:

- ❑ Extreme debt levels almost everywhere. Only manageable because of low rates, i.e. low servicing costs.
- ❑ Such a fast pace of technological change. Disruptors, innovators and humans vs. machines.
- ❑ A geopolitical paradigm shift. After the cold war ended, the US was the leader and policeman of the world. Now we have a multipolar world with a range of nations flexing their muscles.
- ❑ Extremely low interest rates for so long. This went hand in hand with QE, i.e. bloated CB balance sheets. Unknown how this will unwind and what the impact will be.
- ❑ Such a bear market in commodities. Oil may yet pose a threat to political stability in producing countries.

Other structural forces:

- ❑ Peak in Globalisation.
- ❑ Ageing populations and declines in working age populations. Will eventually prove to be threat to fiscal health.
- ❑ Monetary Policy exhaustion. Ineffective. But it pushes up asset prices and devalue currencies. The latter depends on the reactions of other countries.
- ❑ The end of the commodity bull market driven by China slowing.

“Deflation and the hunt for yield”

- **2016:** Real risk of evolving into a global growth recession, that is global growth of the order of 2%. This means that corporate earnings growth everywhere will slow and may have already peaked. **NB:** 3Q15 earnings season will set the tone.

DEFLATION, LOWFLATION, STAGFLATION

EU, Japan, EMs

- **Weak to negative growth and inflation**

USA, NAM

- **Positive growth, low inflation**

RSA, Latam

- **Weak to negative growth, but rising inflation**

1

Global growth drivers:

BCA: "The traditional drivers over the past few decades:

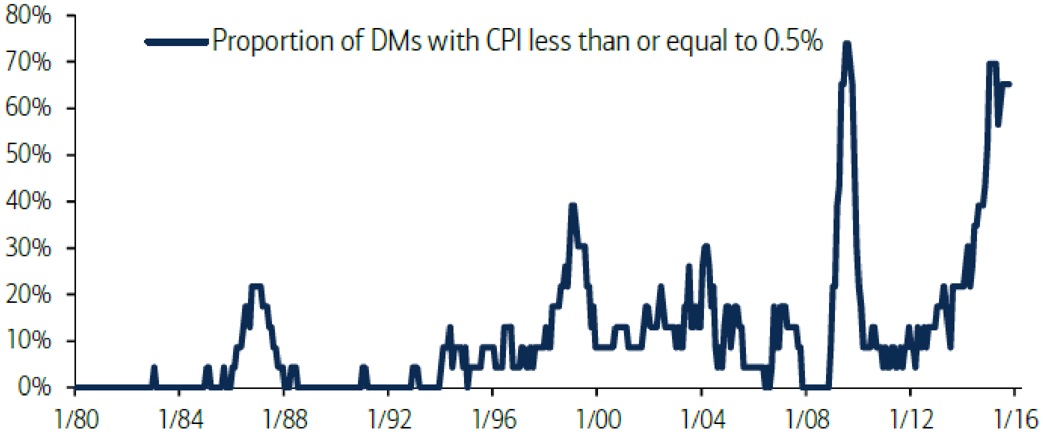
- ❑ A dramatic fall in inflation that had widespread benefits for the economy and financial markets.
- ❑ A rapid expansion of private credit that allowed demand to outpace the growth in incomes.
- ❑ The post-1990 opening up of the global economy – especially in the emerging world – that led to a rapid expansion in trade and investment.
- ❑ The information technology boom that followed the development of the Internet and related innovations.
- ❑ A massive expansion in asset values, triggered by booms in the prices of financial assets and real estate.
- ❑ Broad geopolitical stability underpinned by U.S. dominance."

Some of these will turn into headwinds !!

Deflation, Lowflation, Stagflation…

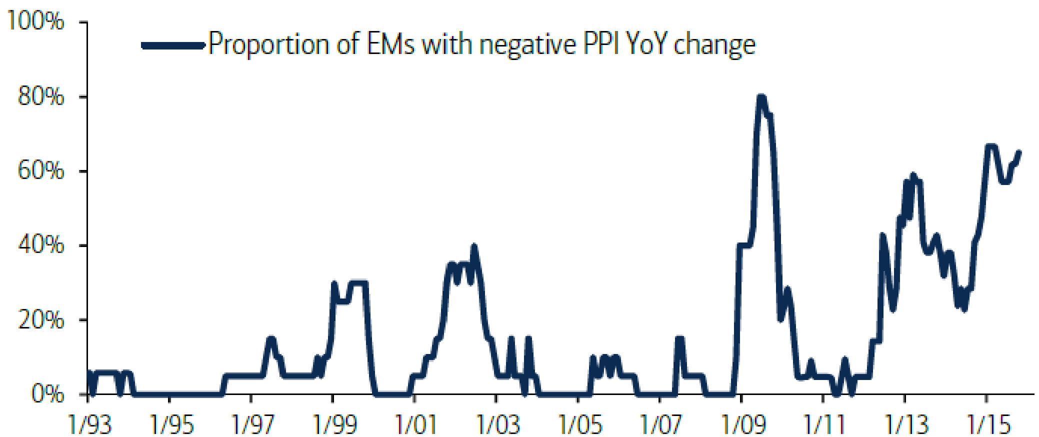
Merrills' growth drivers.

Figure 18: 65% of the world's developed markets have CPI below 0.5%



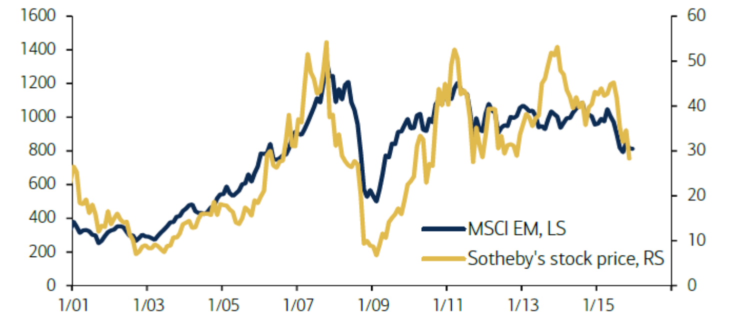
Source: BofA Merrill Lynch Global Research, Datastream

Figure 19: 65% of the world's emerging markets have negative PPI



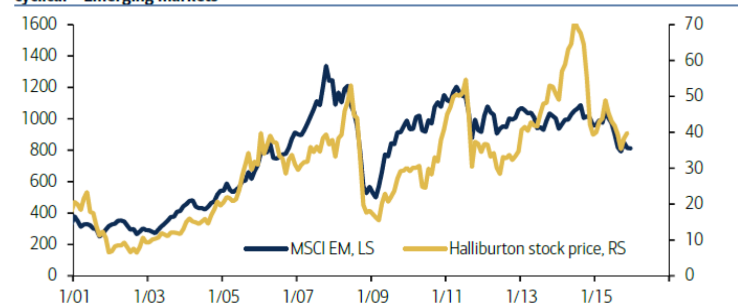
Source: BofA Merrill Lynch Global Research, Datastream

Figure 11: Dr. Sotheby's – the pulse of plutonomists is doddering, and moves with emerging markets



Source: BofA Merrill Lynch Global Research, Bloomberg

Figure 13: Dr. Halliburton - the bellwether of energy capex is sick, moves with that other global cyclical – Emerging markets

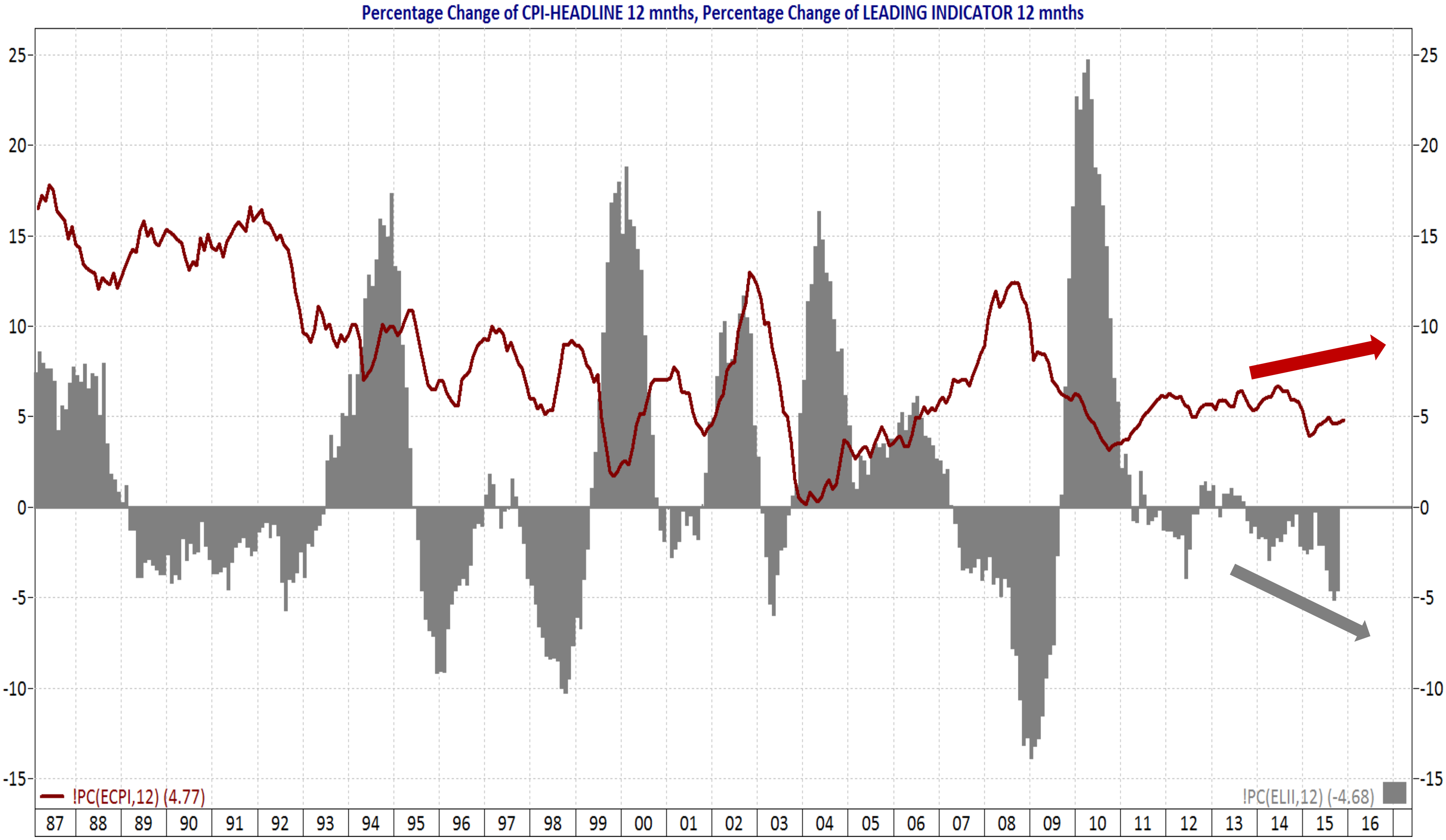


Source: BofA Merrill Lynch Global Research, Bloomberg

Figure 15: Dr. Copper – the "heavy economy's real-time indicator is in free-fall, correlates with China's fixed asset investment growth

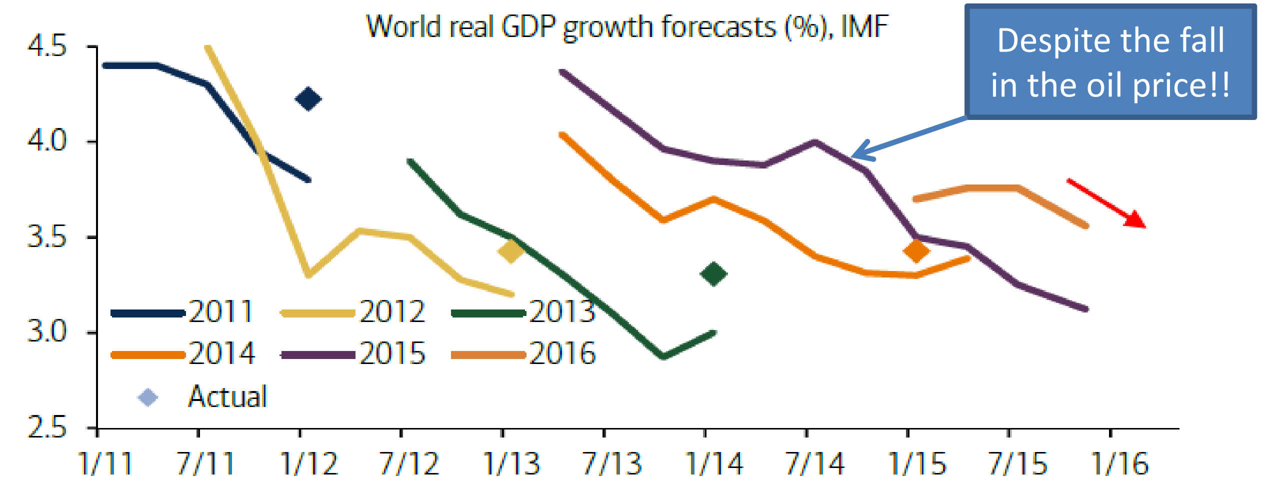
Source: BofA Merrill Lynch Global Research, Bloomberg

Stagflation SA: low and decreasing growth but rising inflation



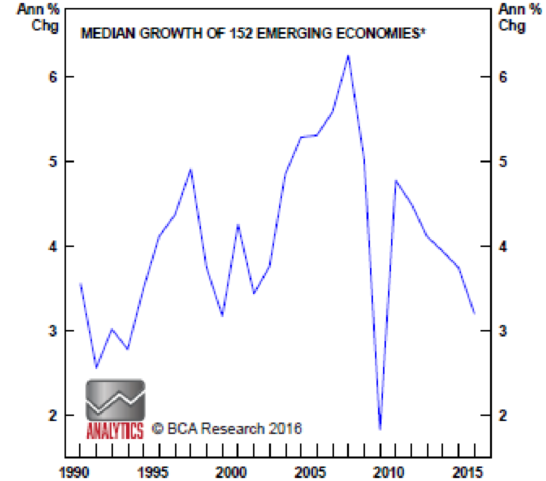
Key Question: Global GDP Growth...

Figure 17: Global real GDP growth forecasts – repeated over-optimism



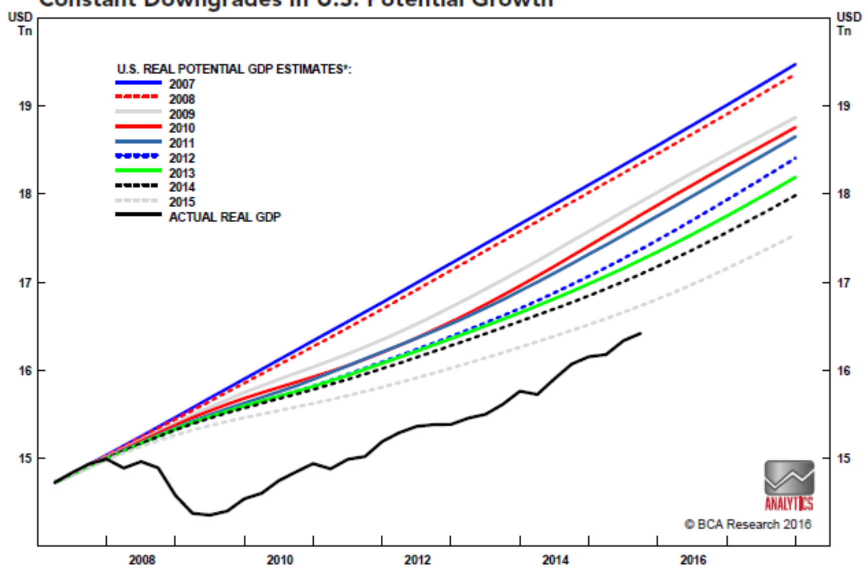
Source: BofA Merrill Lynch Global Research, IMF

A Weak Emerging Economy Performance



* SOURCE: IMF WORLD ECONOMIC OUTLOOK, OCTOBER 2015.

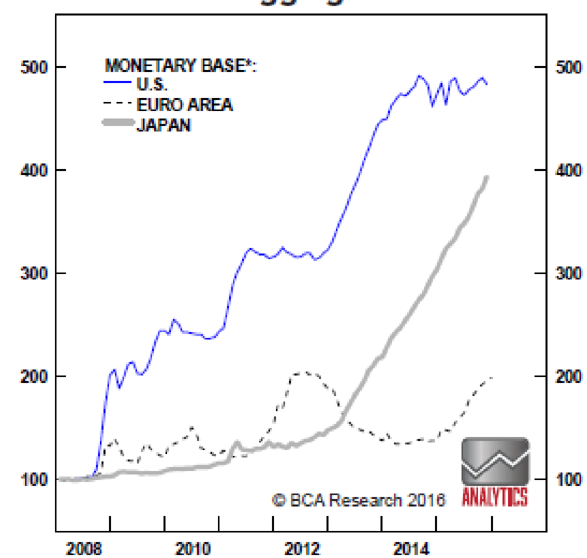
Constant Downgrades In U.S. Potential Growth



SOURCE: THE CONFERENCE BOARD BUDGET OUTLOOK 2007-2016; BEA.

It seems that potential growth rates have slowed everywhere.

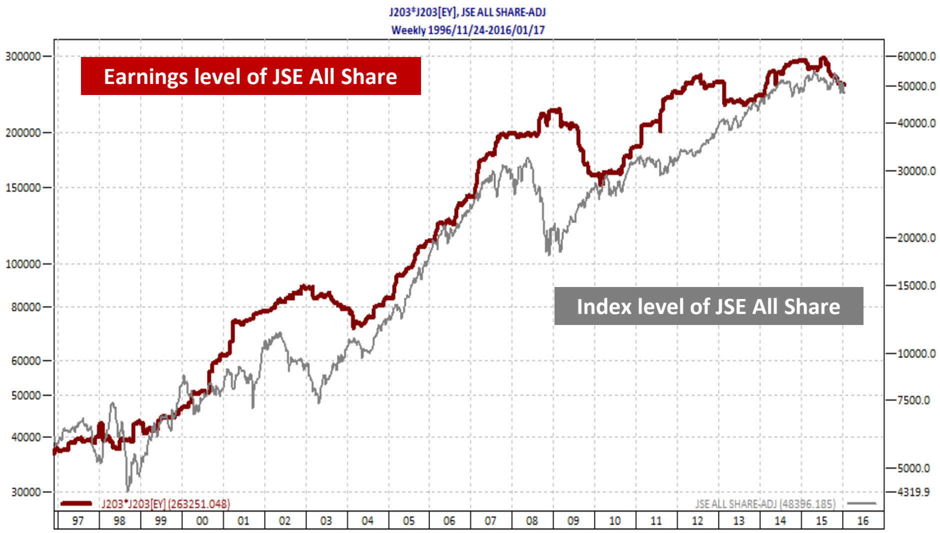
The ECB Is Lagging

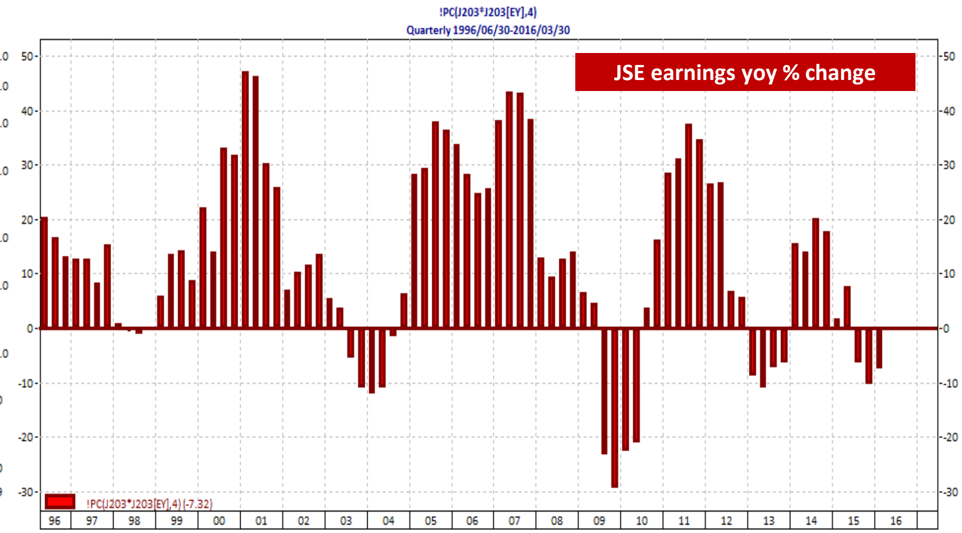


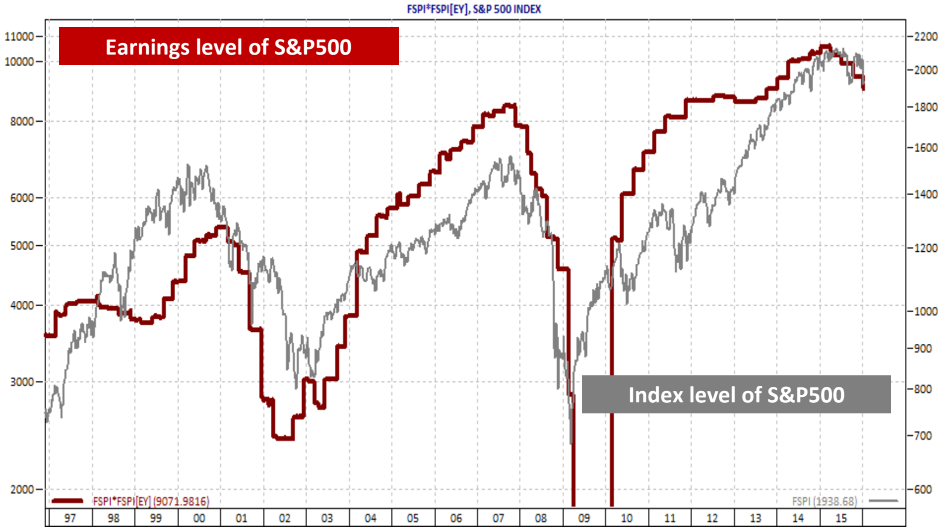
* SERIES SHOWN REBASE TO JAN. 2008 = 100.

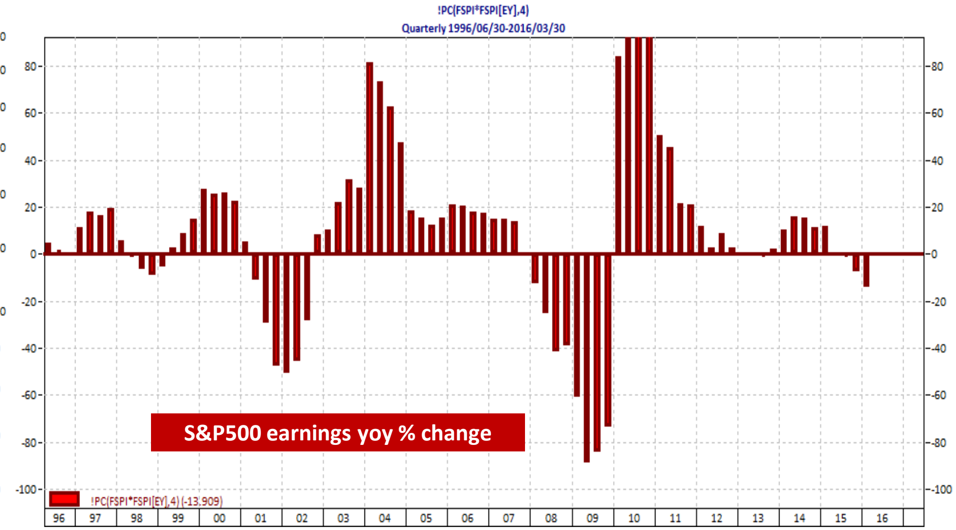
Earnings…

Global corporate profits are falling: the latest YoY growth of global EPS is -5.2% and profits are highly correlated with PMIs; upward momentum in these indicators is desperately needed to prevent Q1 being a quarter of EPS downgrades: consensus forecasts 2016 EPS growth of 7.3% in the US & 7.2% for global profits.









DEATH BY DEBT (or Debt Traps In Various Guises)

Easy money failed to trigger a new credit cycle that would have helped global growth. That is monetary policy was ineffective to turn the cycle decisively.

However, Debt-to-GDP ratios are holding at record levels and rising further.

The only way to deal with it is essentially the following:
- ❑ Grow your way out.
- ❑ Inflate your way out.
- ❑ Default/Restructure.

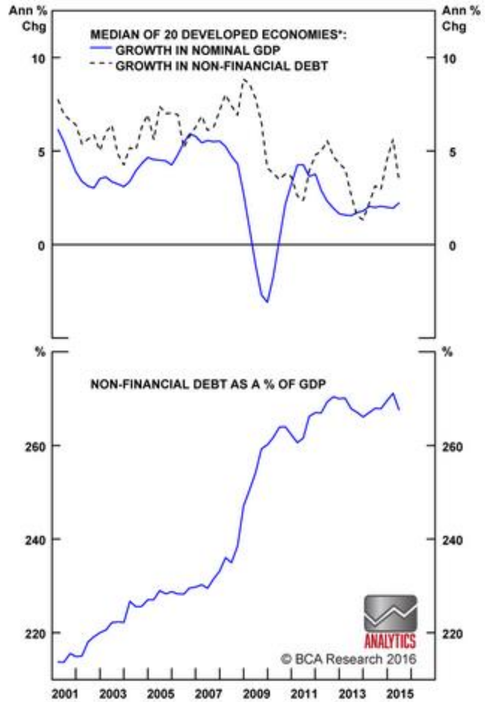
2

Debt.....

- These debt levels are only manageable due to ultra low interest rates.
- This reinforces the 6th theme.

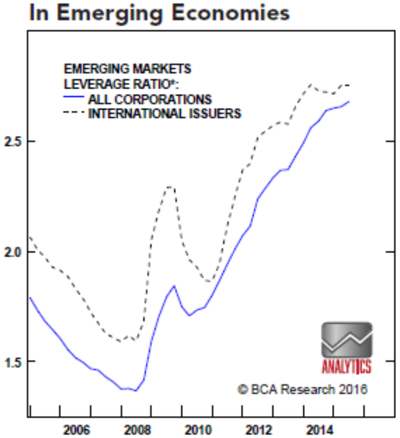
…catapulting EM non-financial debt levels from US$9 trillion from before Lehman to near US$24 trillion currently…
Morgan Stanley

Chart 4
Slow Growth Keeps Debt Burdens High



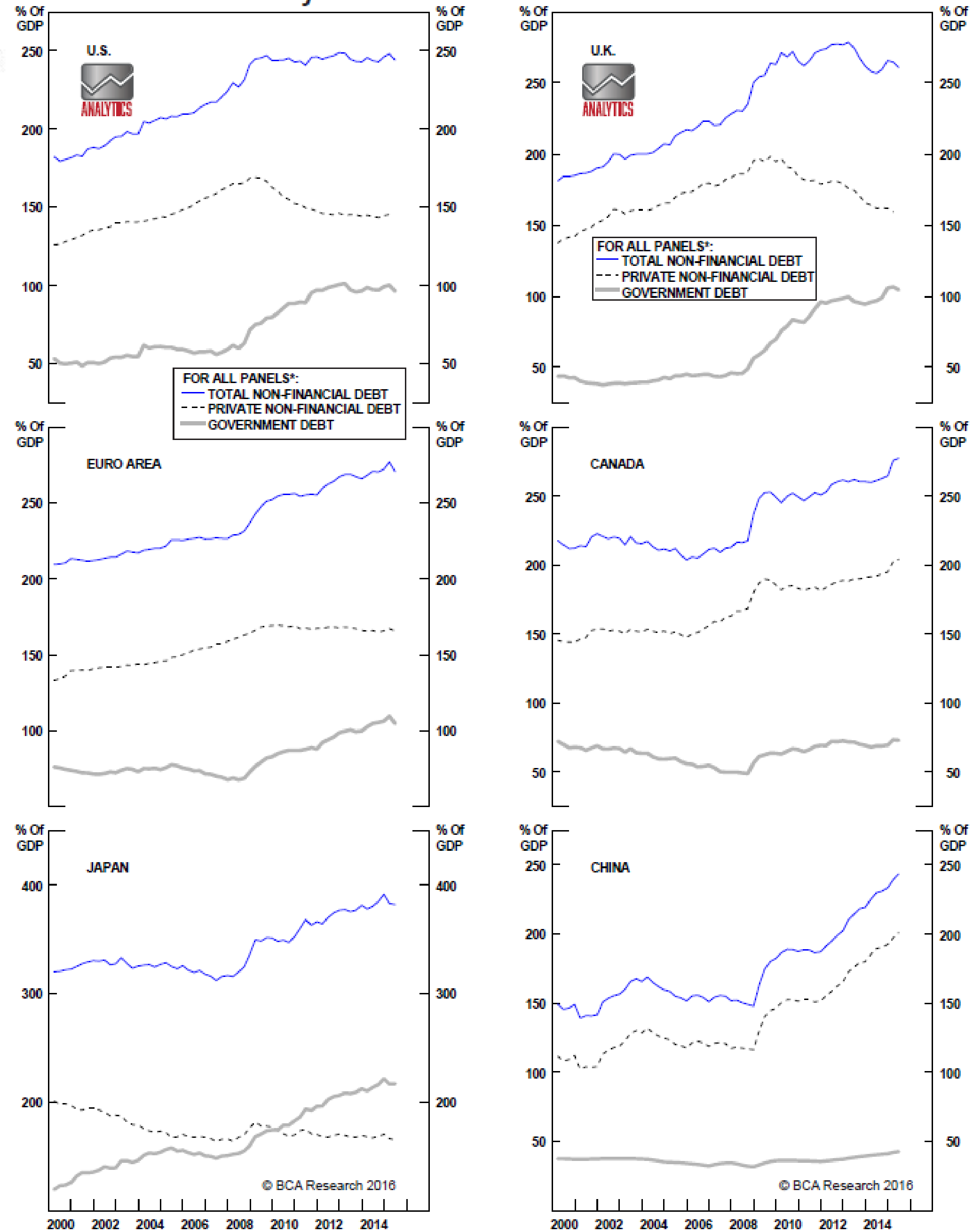
* SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS.

Corporate Leverage Has Soared In Emerging Economies



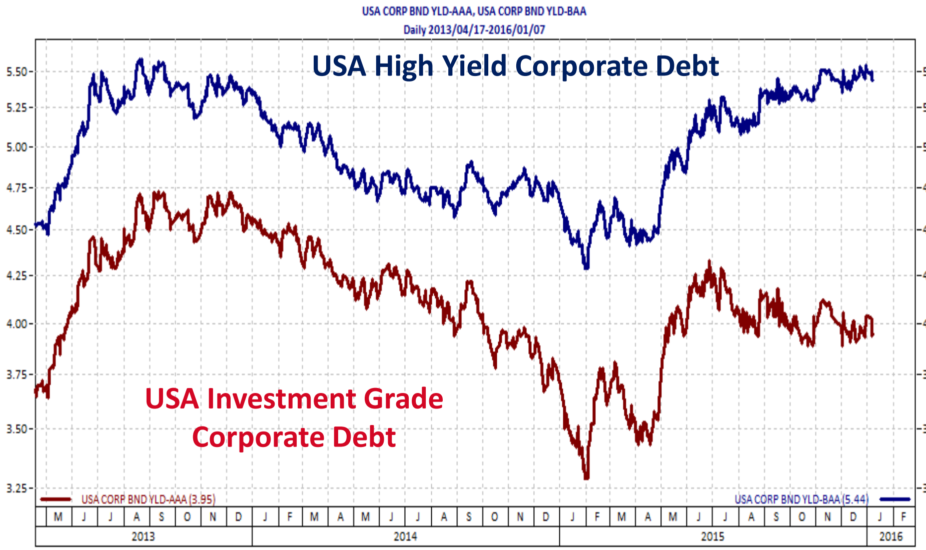
* SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS. LEVERAGE RATIO IS TOTAL DEBT / EBITDA.

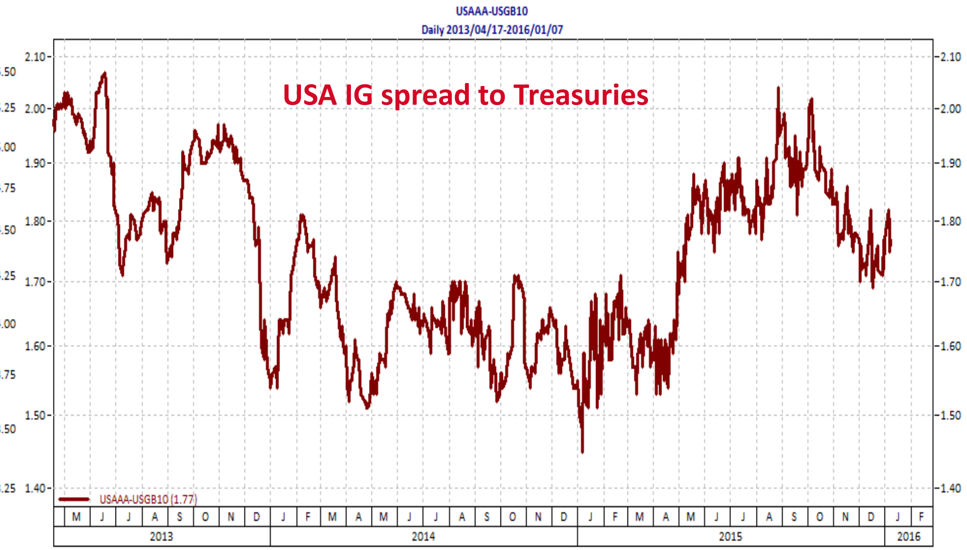
Debt Is Elevated Everywhere

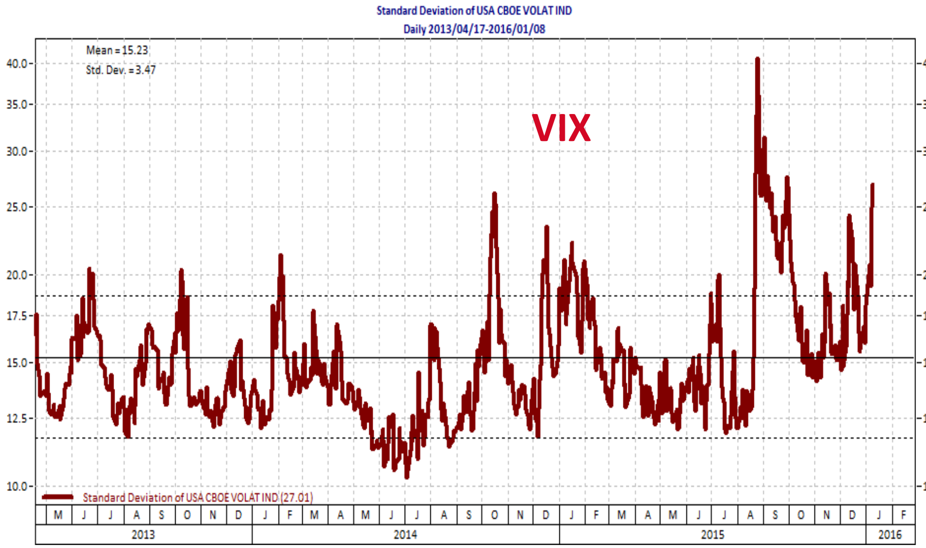


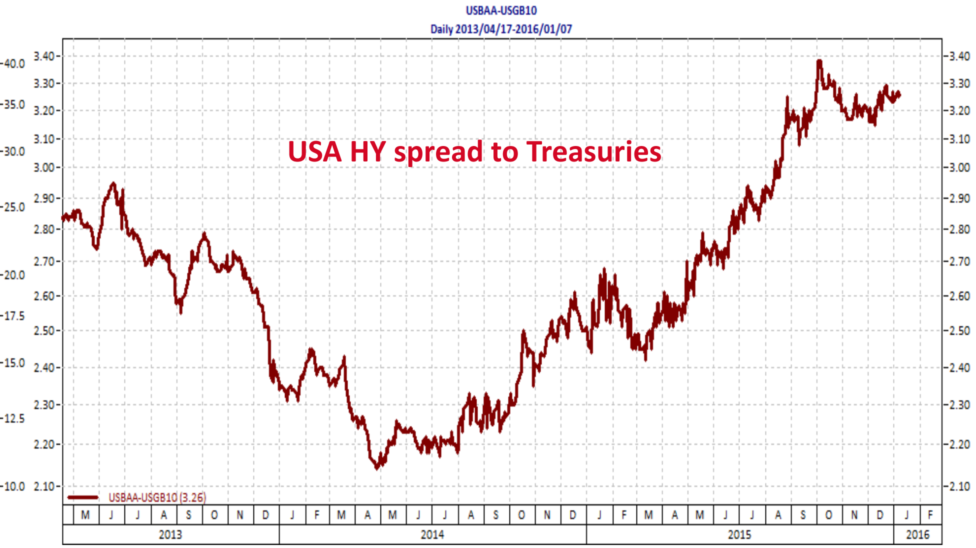
* SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS.

Signs of stress



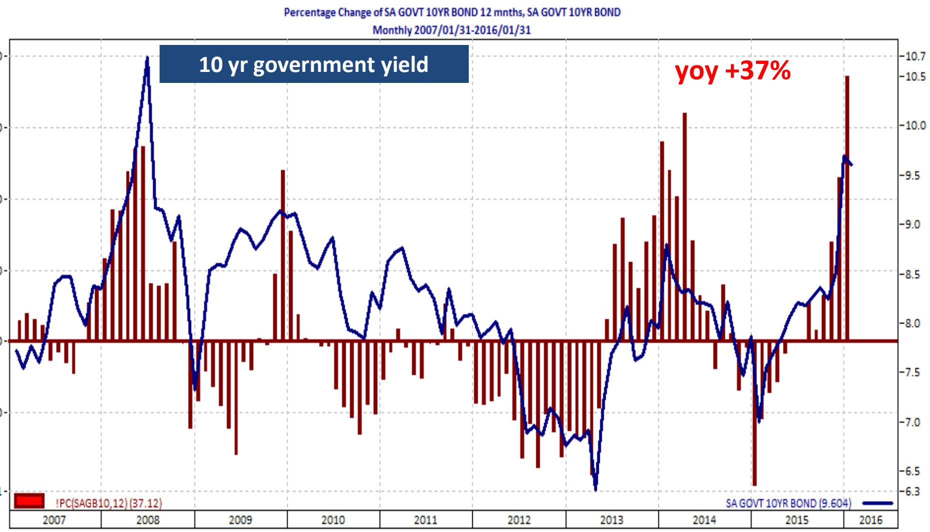


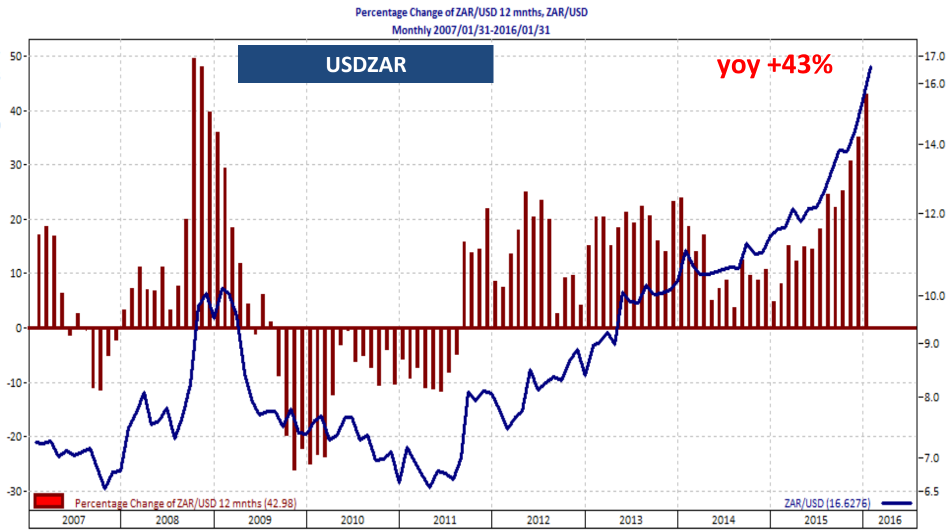


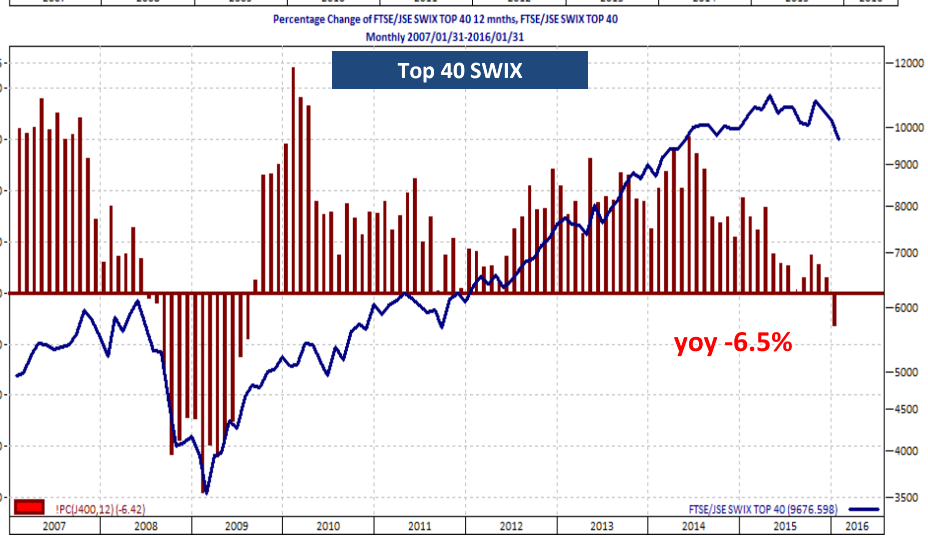


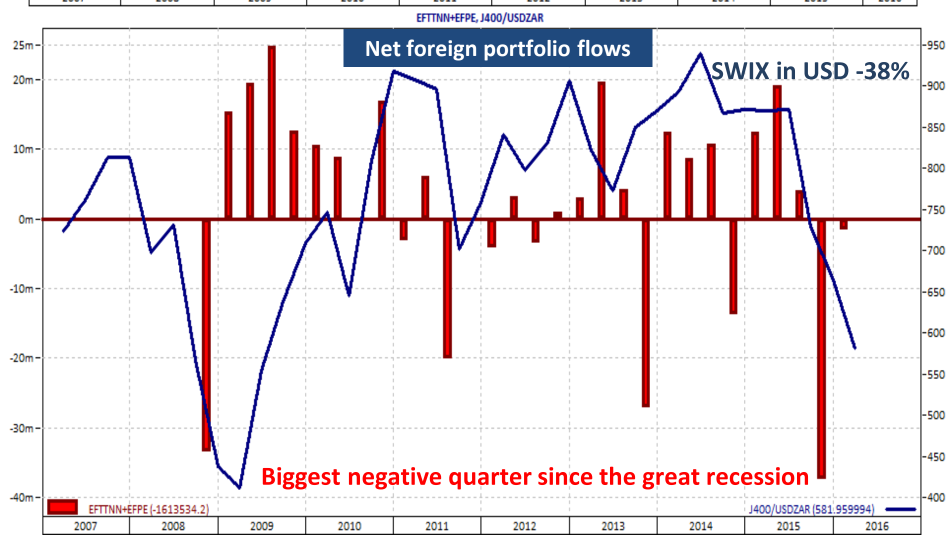
RSA (death by debt) = violent reaction to downgrade risk

“Fallen Angel”









Need to look at the following:

- The likelihood of a downgrade.
- Did the move in the ZAR and bond yields price this in?
- There will be increasing noises and questions re **de-linking of the NAD.**

“Dash for dollars”

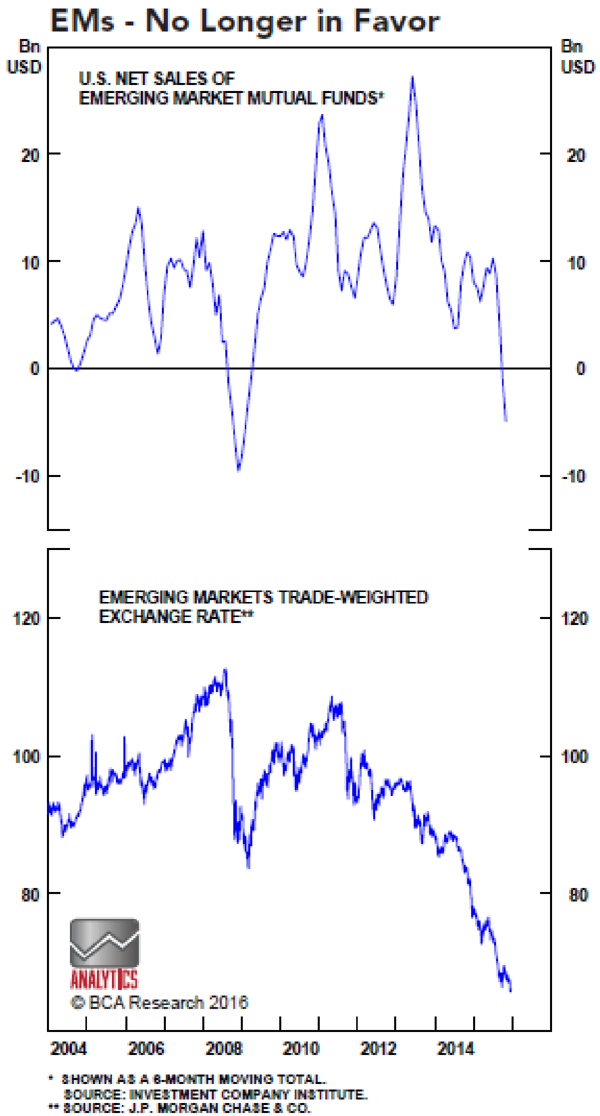
- **2016:** This theme could lose some steam if the Fed continues to postpone. However, the US$ will continue to be the cleanest dirty shirt around.

DOLLAR, DIVERGENCE & DISRUPTIONS

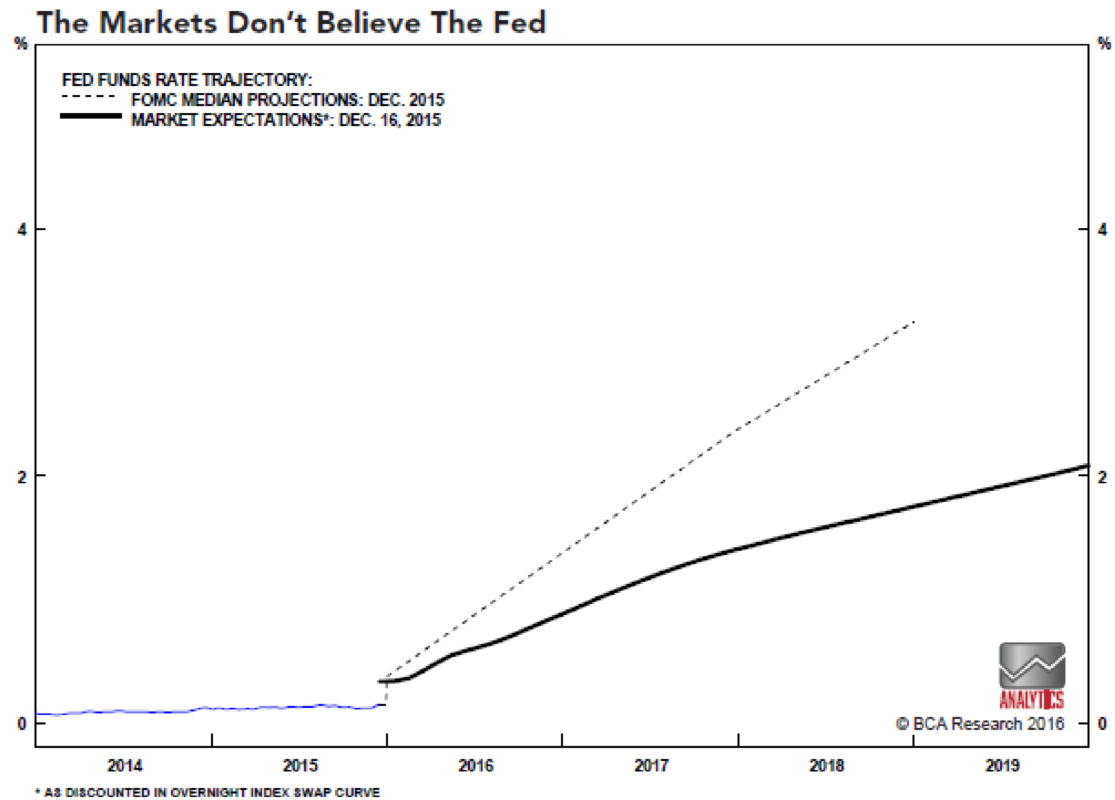
3

Divergence

DM v EM



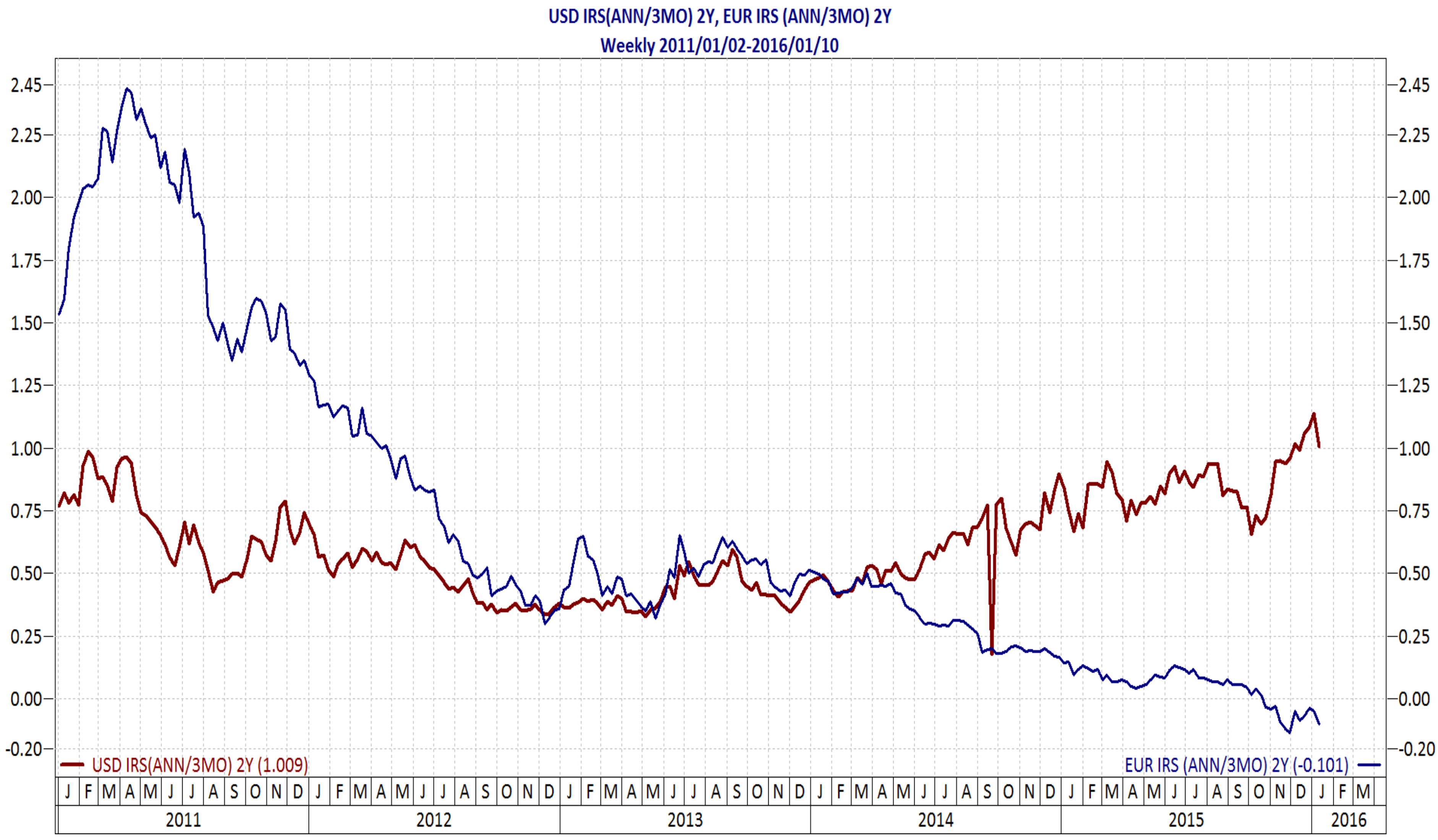
Market v Fed



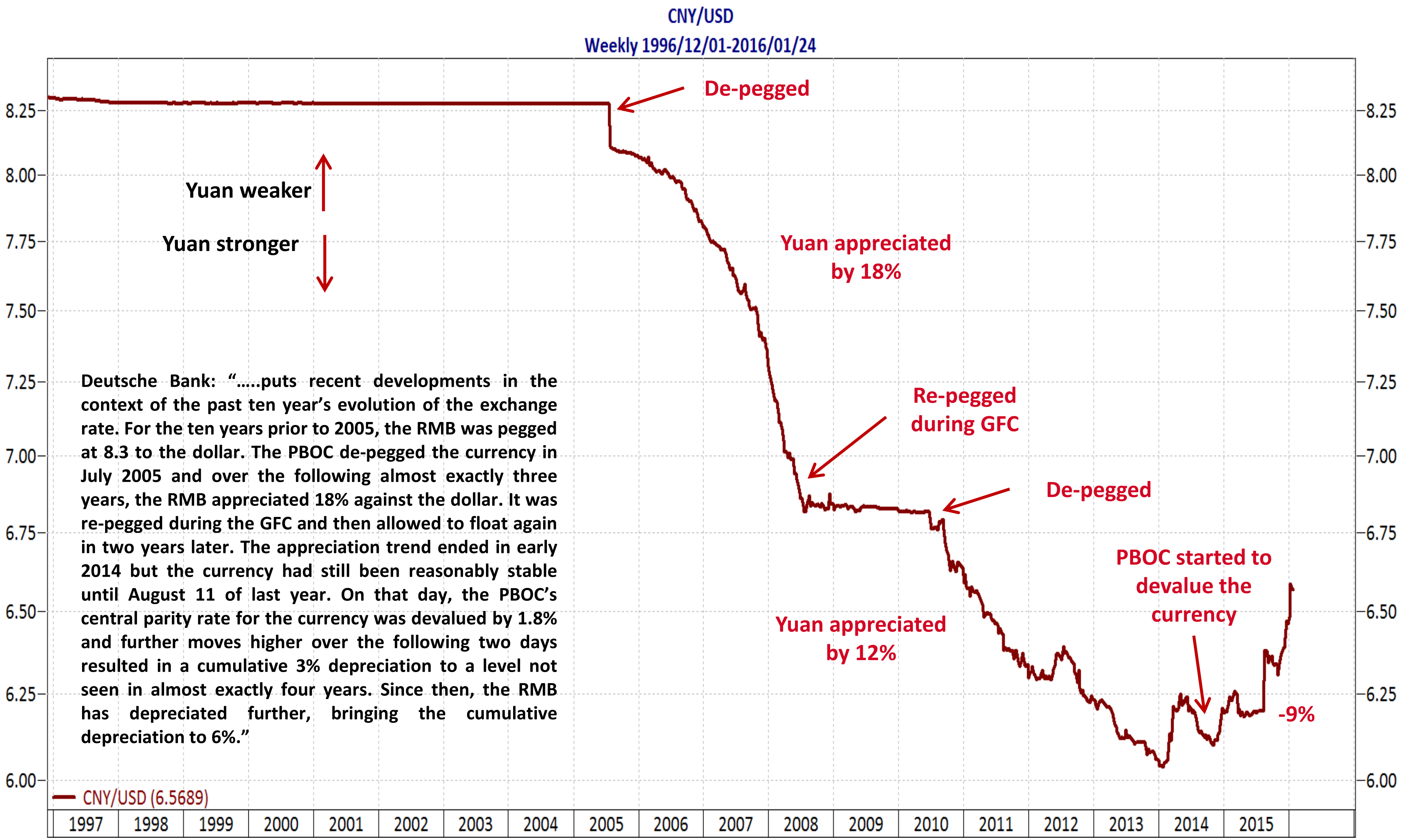
If the Fed is right:

- ❑ Rates will rise much faster than the market expect.
- ❑ The $ will strengthen sharply, hurting profits and exports.
- ❑ Further downward pressure on inflation
- ❑ Market turmoil

US v EU rates

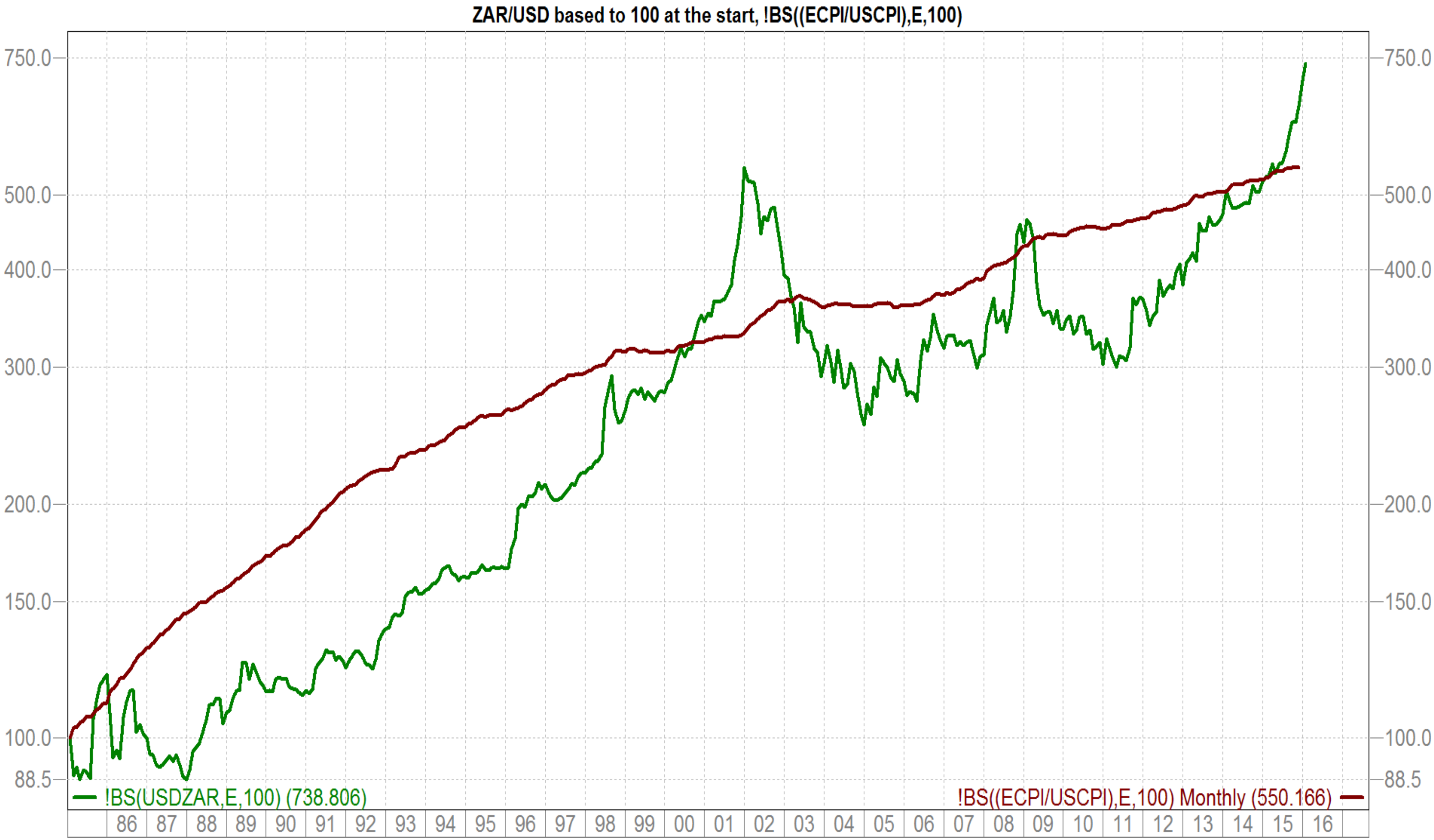

USD IRS(ANN/3MO) 2Y, EUR IRS (ANN/3MO) 2Y
Weekly 2011/01/02-2016/01/10
2.45
2.25
2.00
1.75
1.50
1.25
1.00
0.75
0.50
0.25
0.00
-0.20
USD IRS(ANN/3MO) 2Y (1.009)
EUR IRS (ANN/3MO) 2Y (-0.101)
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M
2011
2012
2013
2014
2015
2016

USDCNY (China Currency)

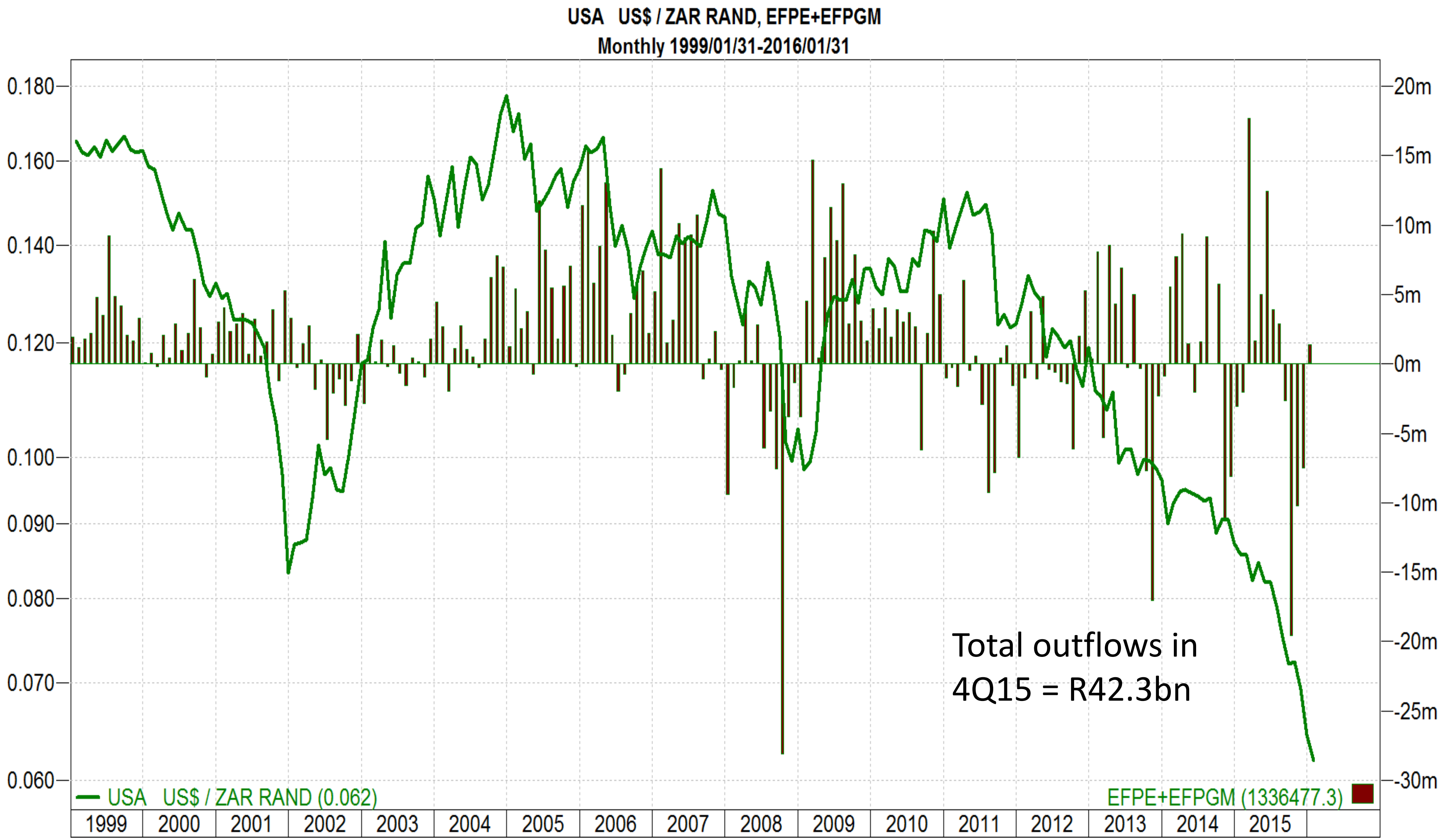


Deutsche Bank: "…..puts recent developments in the context of the past ten year's evolution of the exchange rate. For the ten years prior to 2005, the RMB was pegged at 8.3 to the dollar. The PBOC de-pegged the currency in July 2005 and over the following almost exactly three years, the RMB appreciated 18% against the dollar. It was re-pegged during the GFC and then allowed to float again in two years later. The appreciation trend ended in early 2014 but the currency had still been reasonably stable until August 11 of last year. On that day, the PBOC's central parity rate for the currency was devalued by 1.8% and further moves higher over the following two days resulted in a cumulative 3% depreciation to a level not seen in almost exactly four years. Since then, the RMB has depreciated further, bringing the cumulative depreciation to 6%."

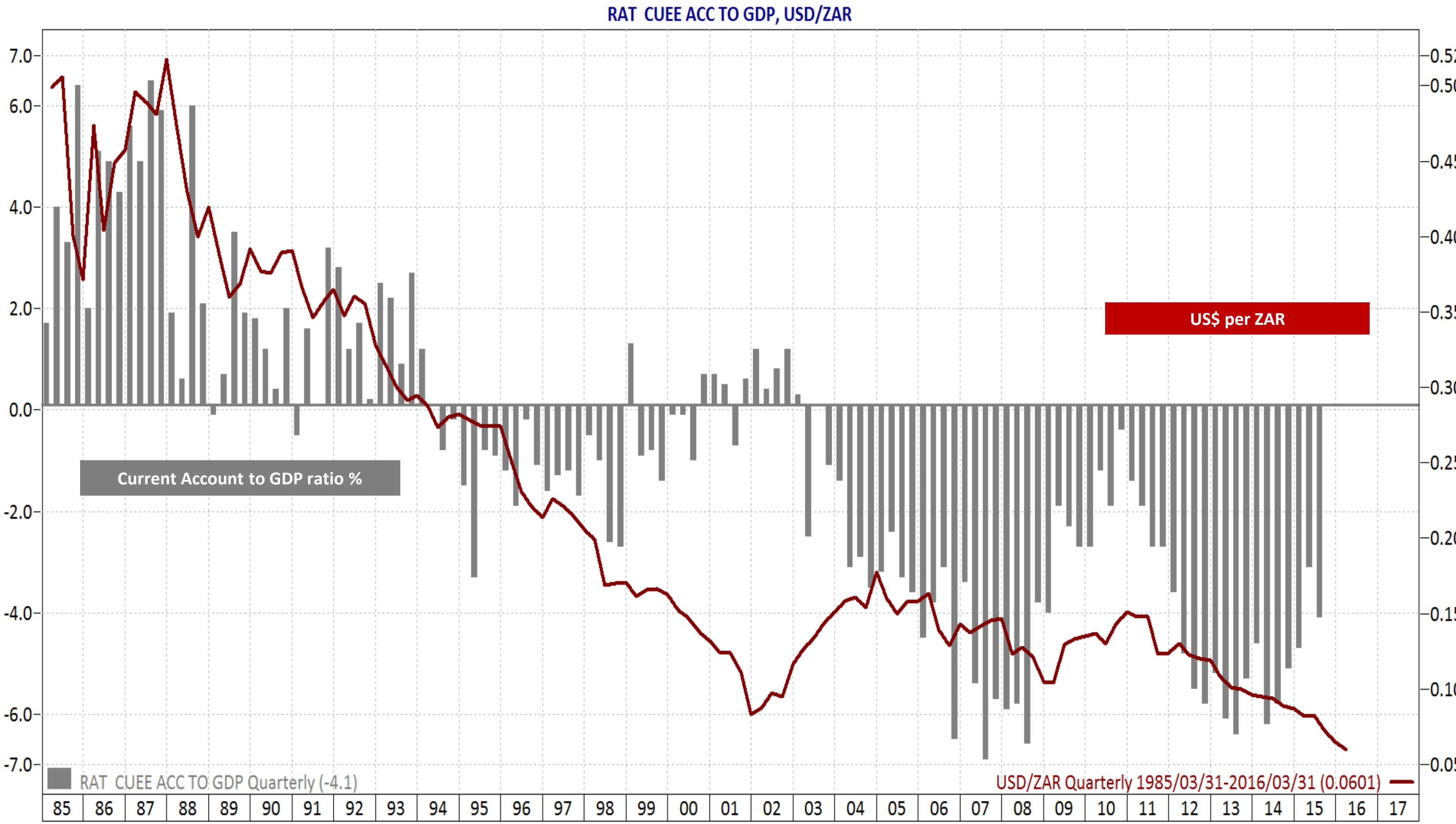
USDZAR, 1985 = 100



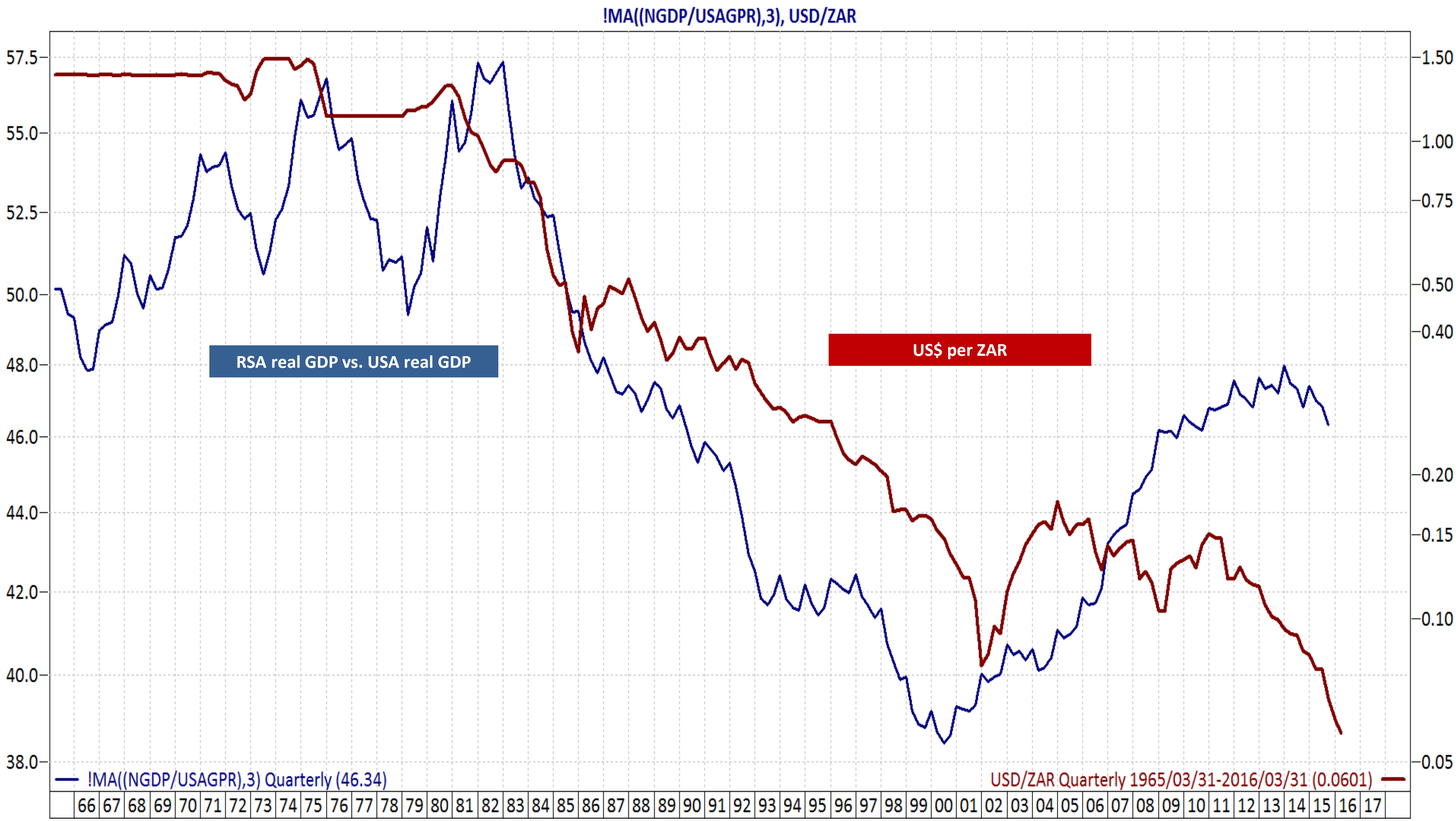
ZAR fx v Flows



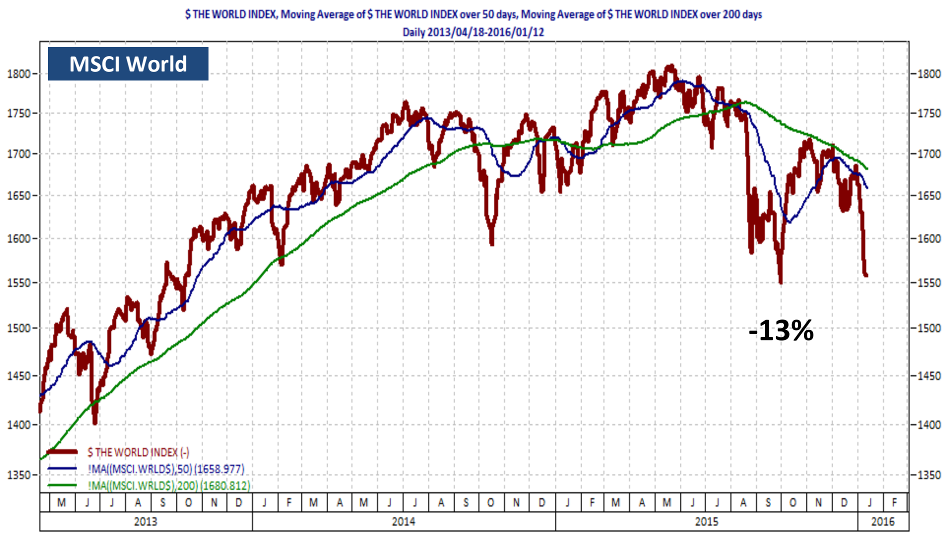
ZAR vs. Current Account

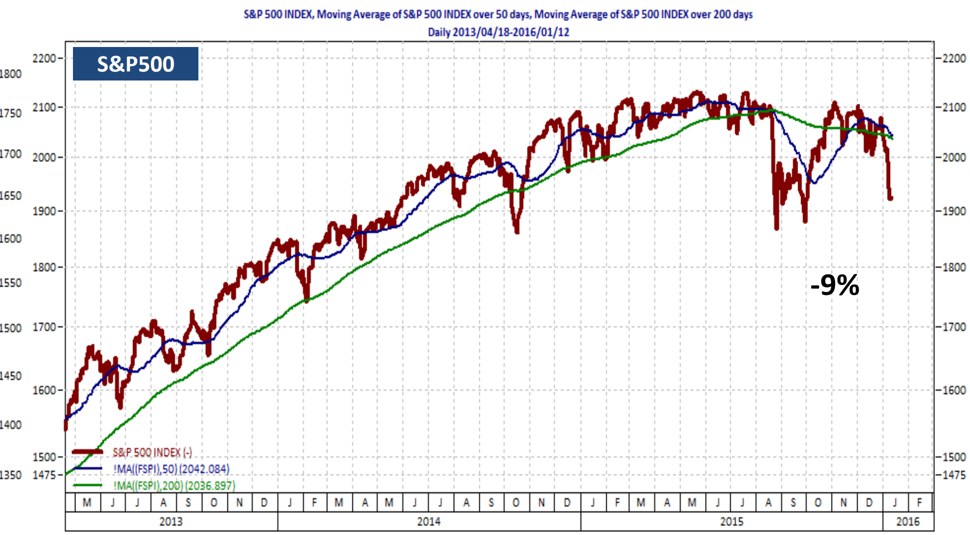


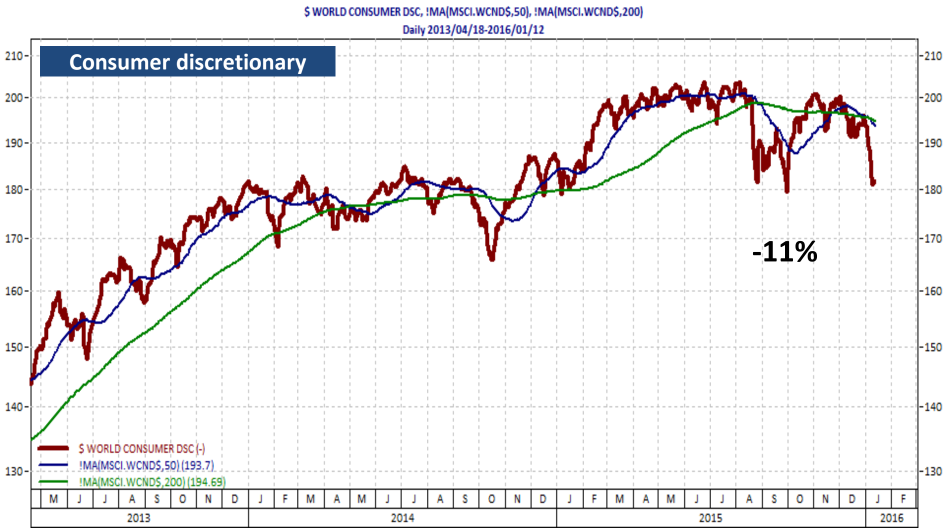
ZAR vs. relative economic performance of SA over USA

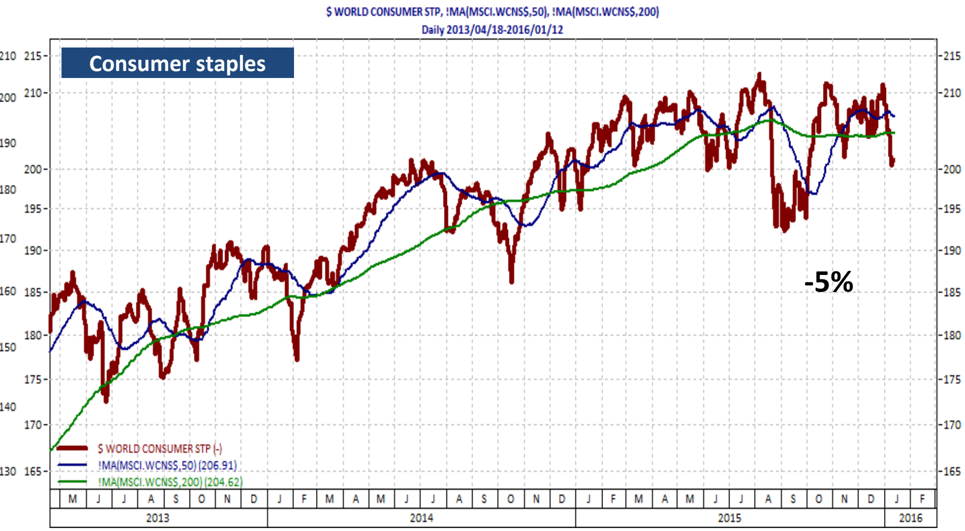


Global sectors

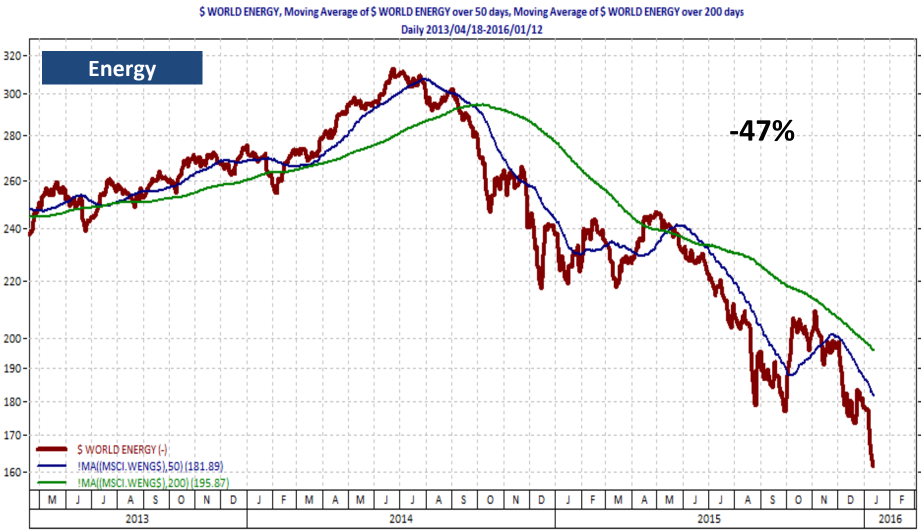


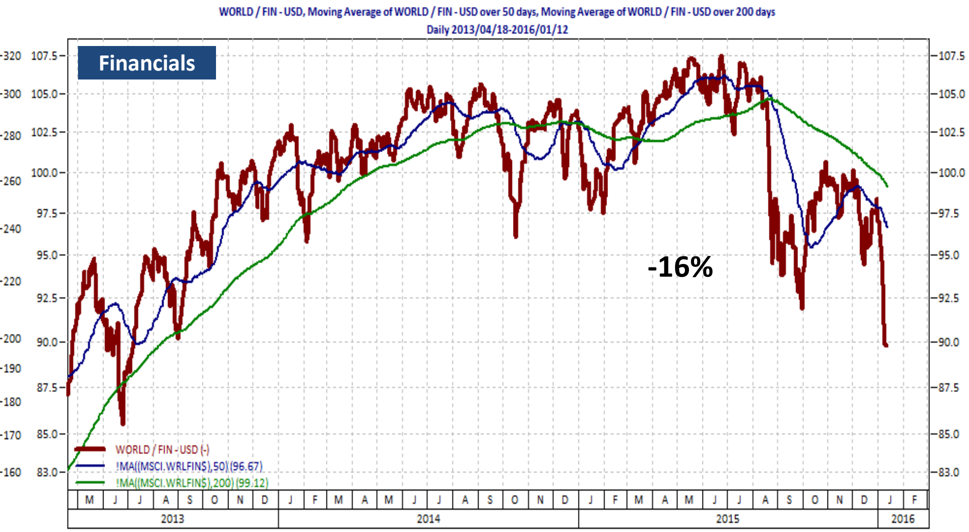


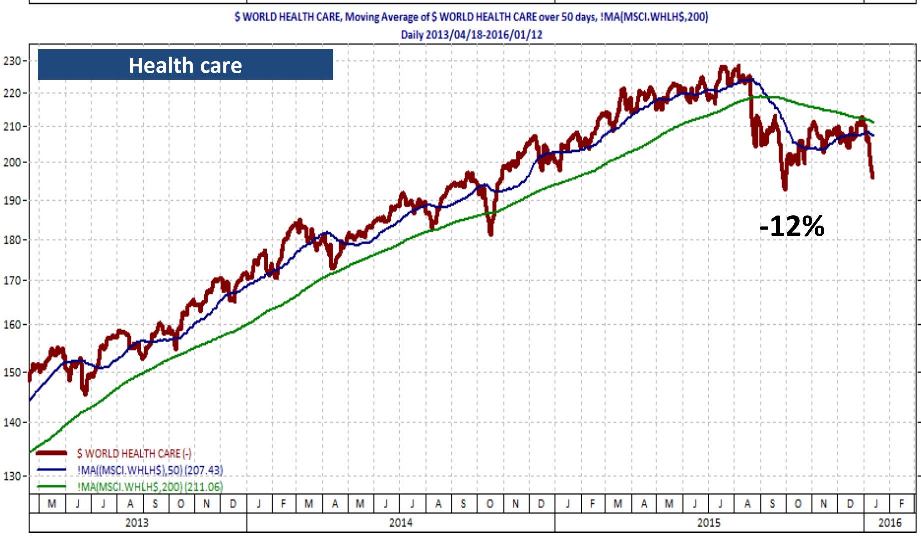


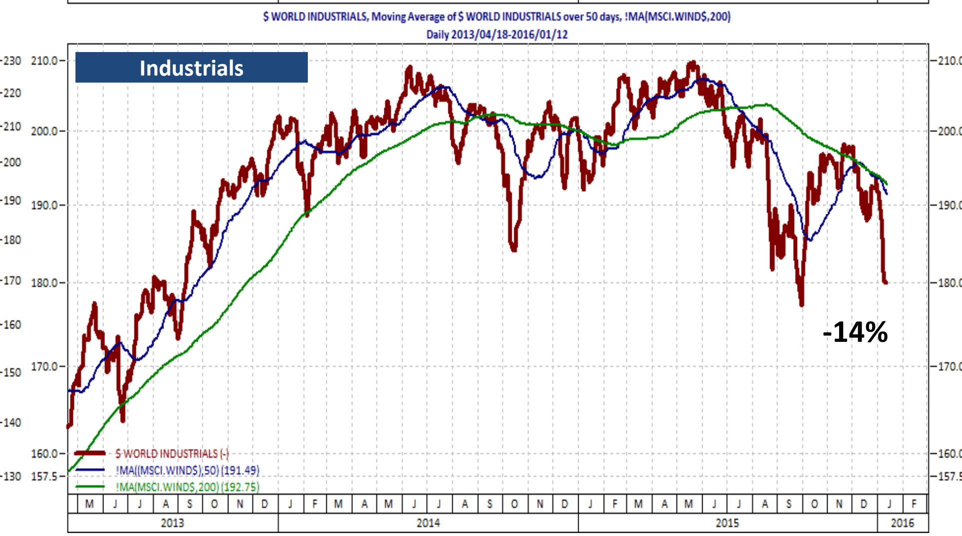


Global sectors

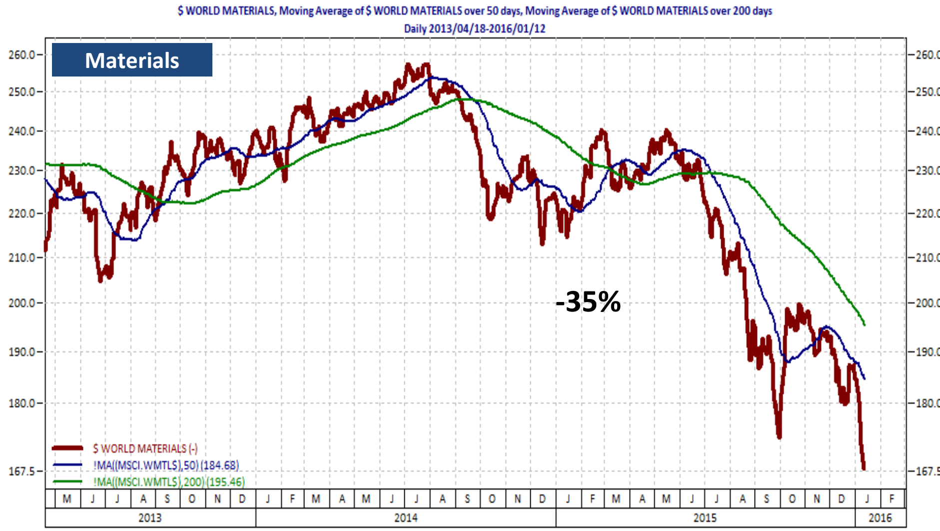


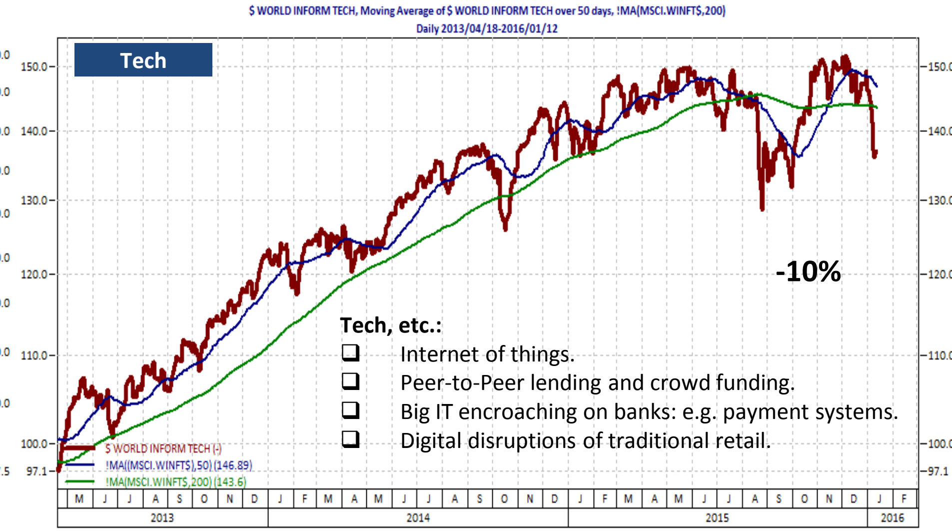


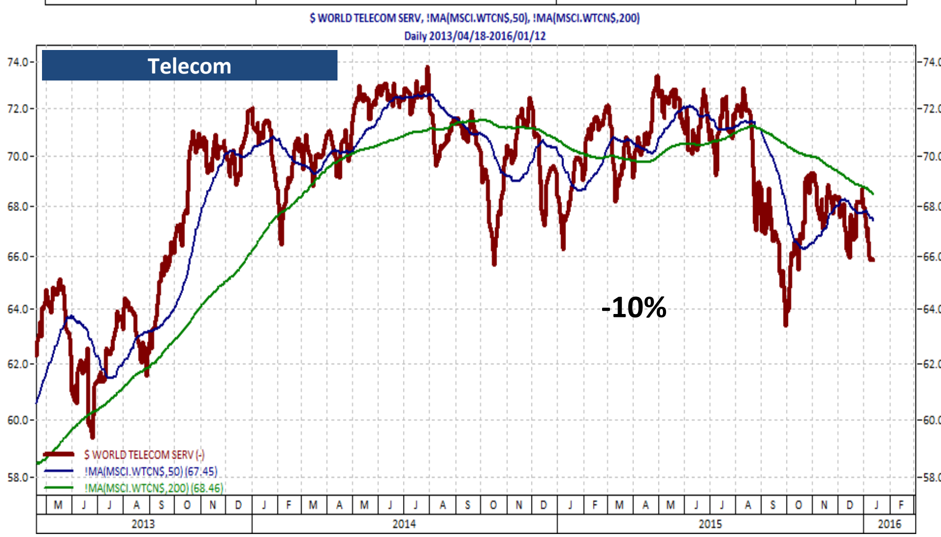


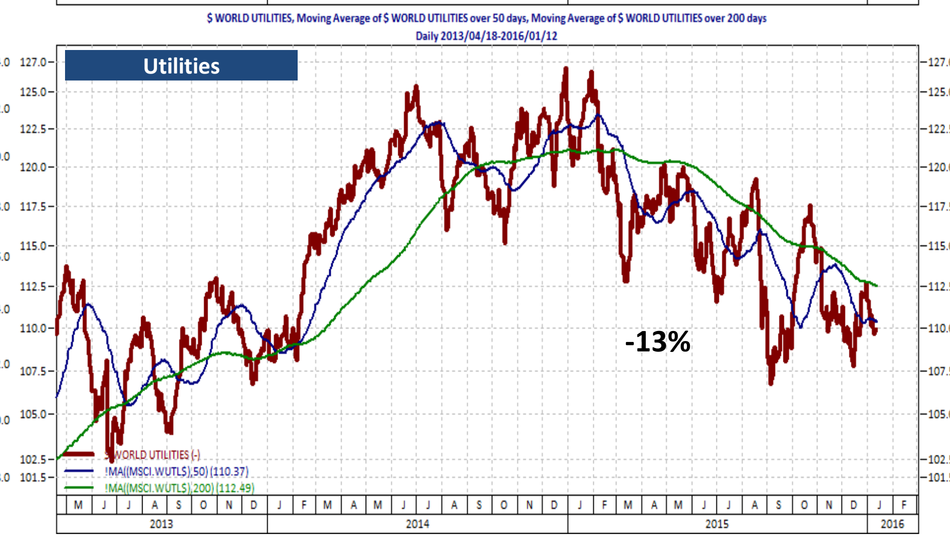


Global sectors









“Oil/energy and commodities”

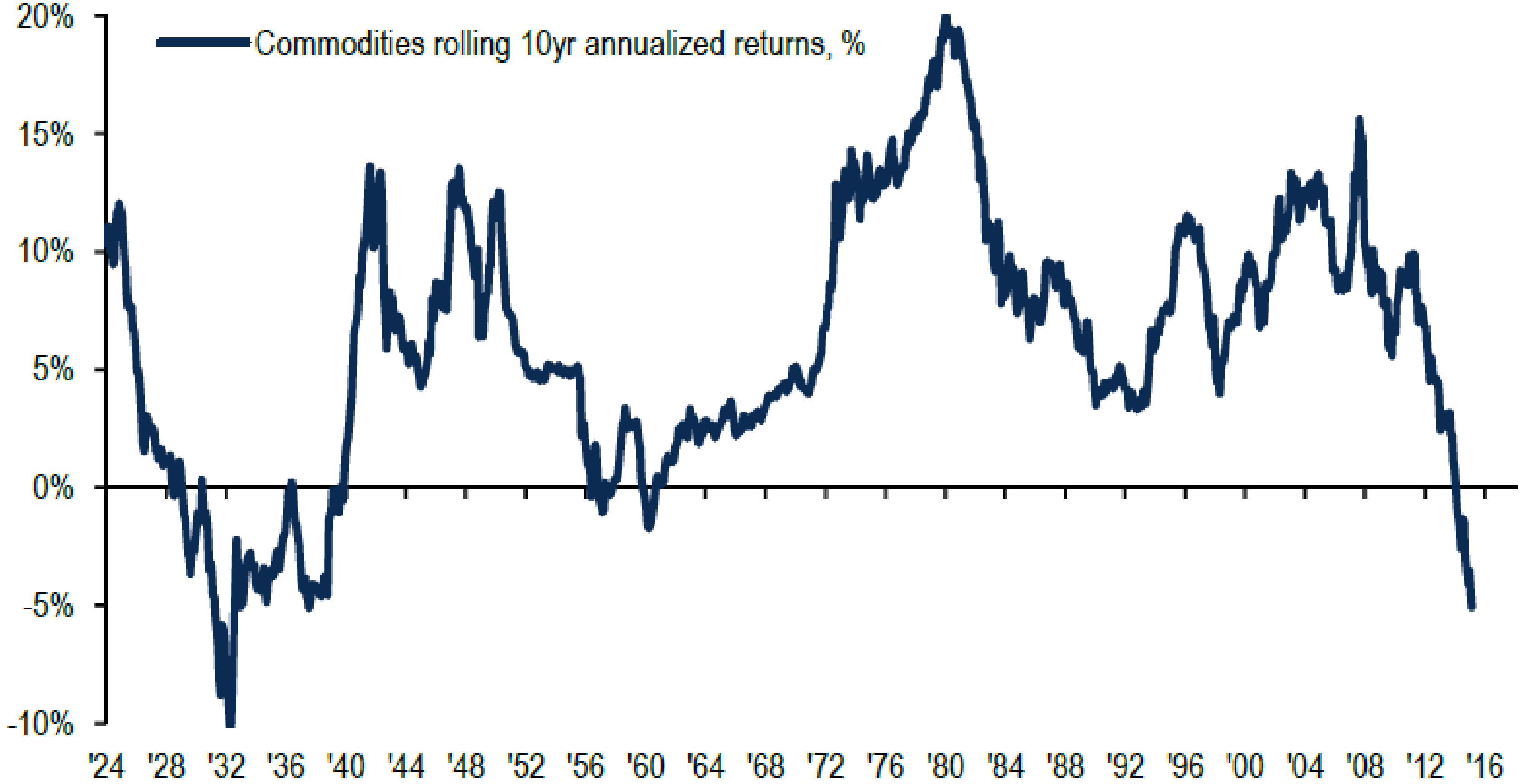
- **2016:** Will continue to assert itself if recession-like conditions develop. The materials sector slump will ripple through other sectors, reinforcing the first theme.

OIL/ENERGY/COMMODITIES/GREEN

4

Title

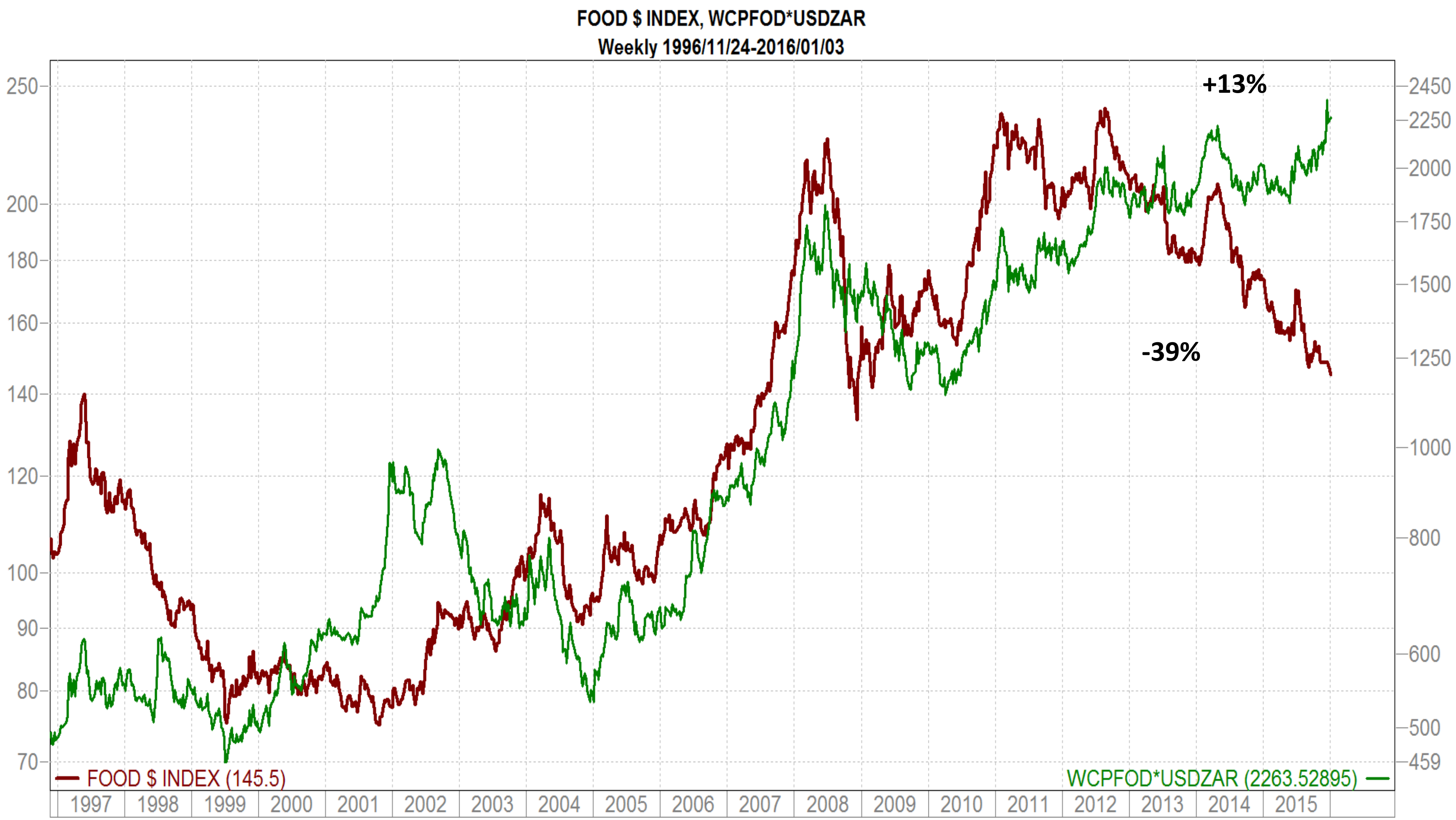
Chart 10: The largest 10-year rolling losses in commodities since the Great Depression



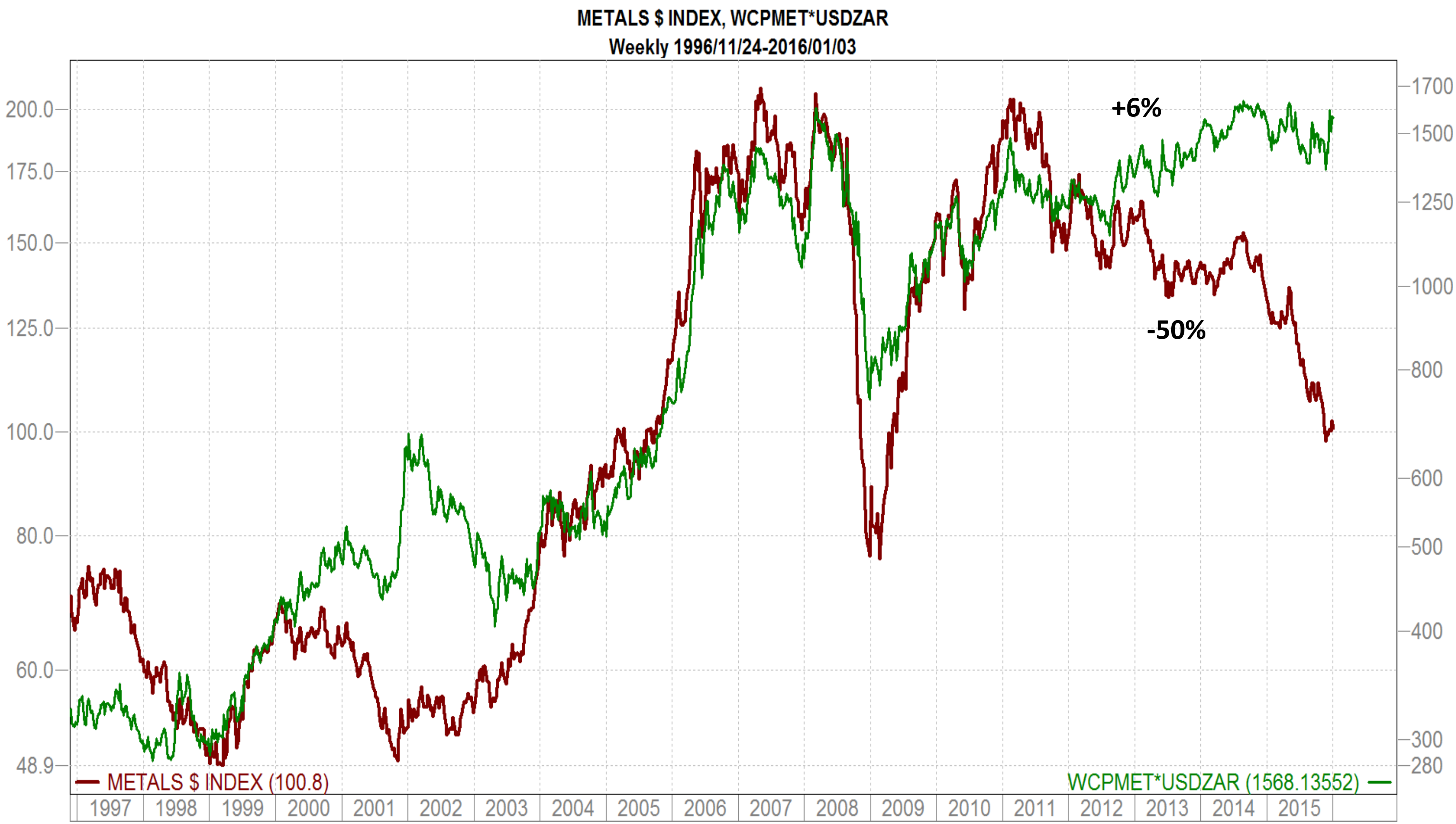
Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

Economist all commodity index

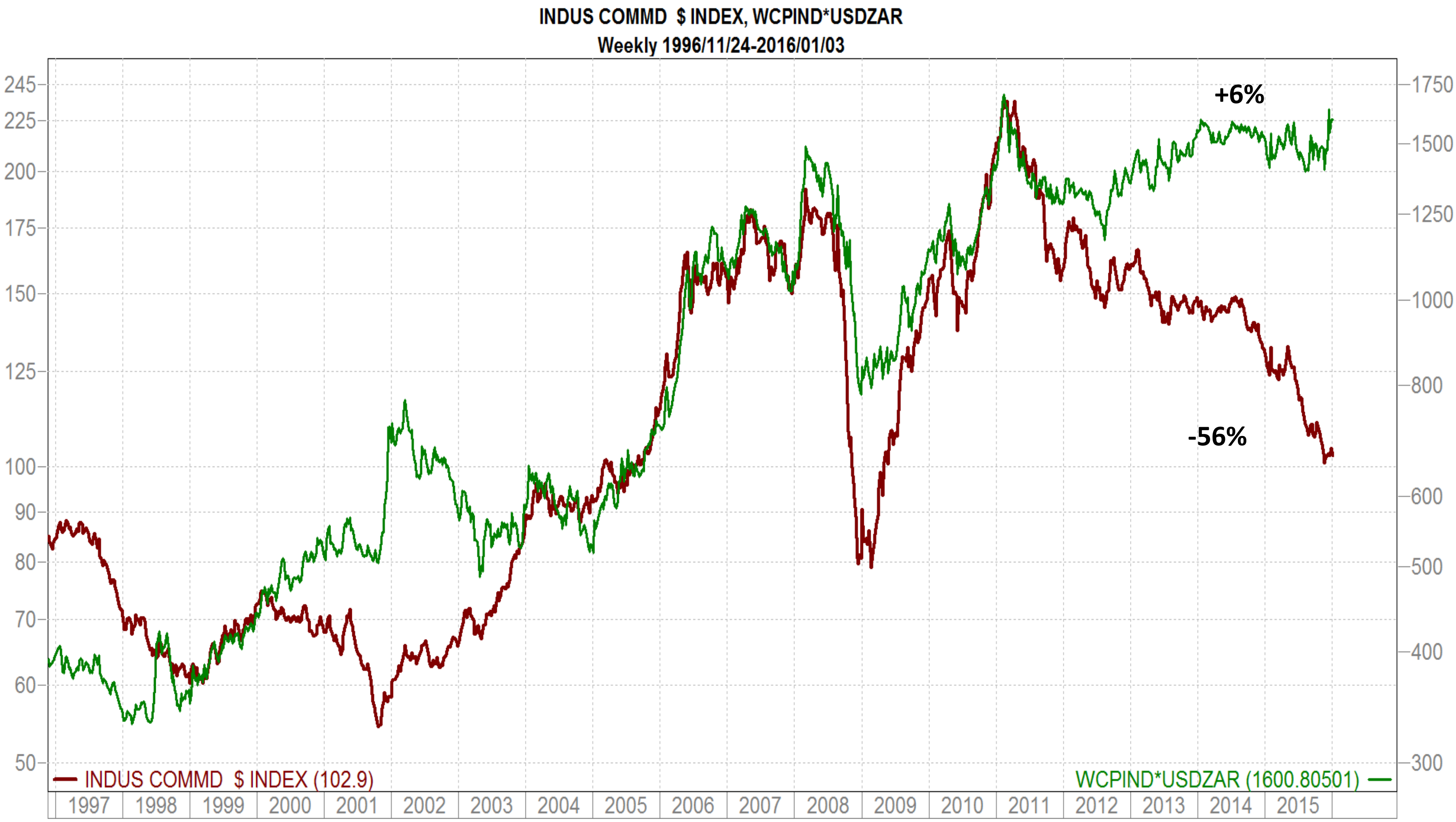
Economist food price index



Economist metals price index



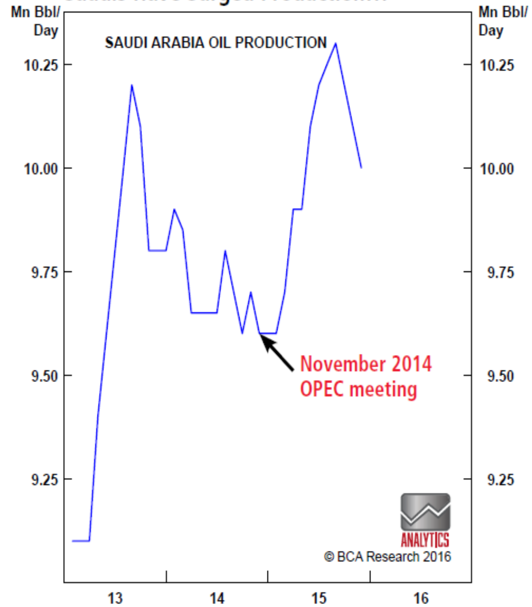
Economist industrial commodities price index



Commodities - Oil

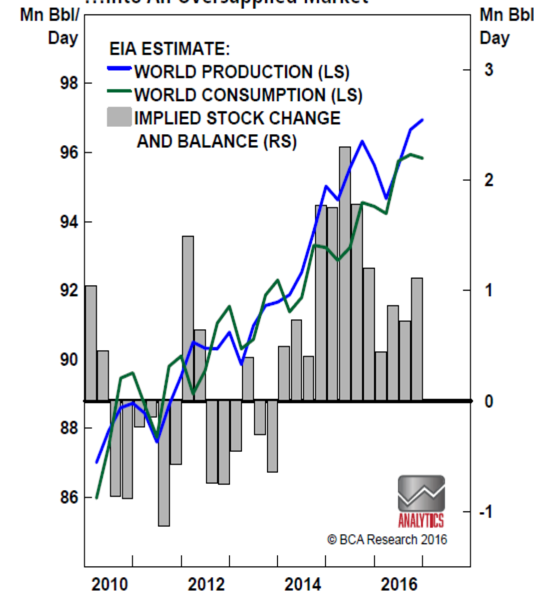
- ❑ Watch for a de-peg of the real
- ❑ Oil may benefit from New China

CHART 1
Saudis Have Surged Production…



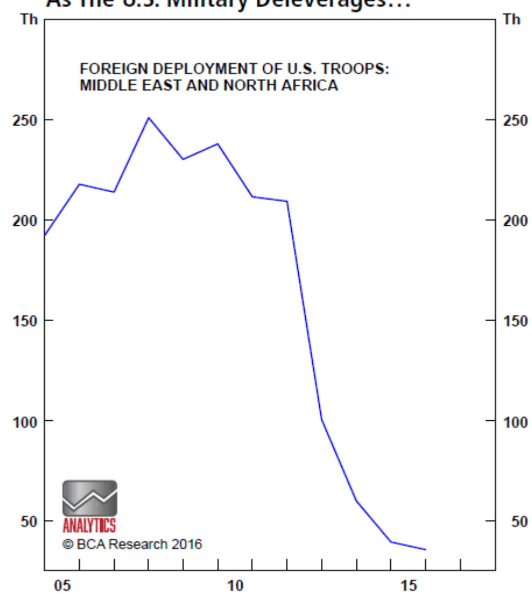
SOURCE: U.S. EIA

CHART 2
…Into An Oversupplied Market



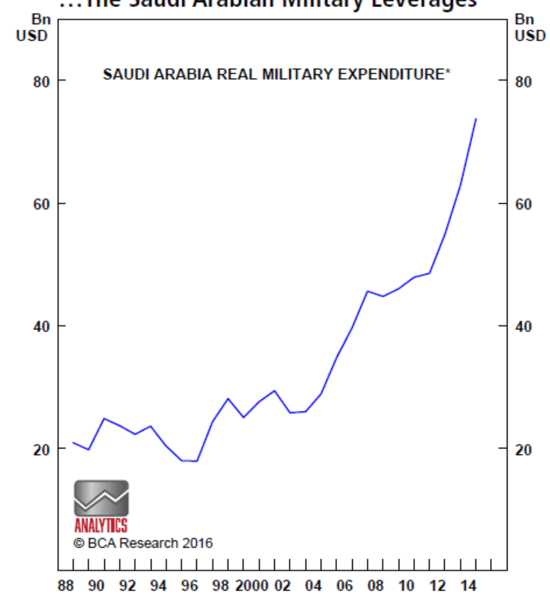
SOURCE: BCA RESEARCH, EIA.

CHART 3
As The U.S. Military Deleverages…



SOURCE: THE HERITAGE FOUNDATION AND DEFENSE MANPOWER DATA CENTER.

CHART 4
…The Saudi Arabian Military Leverages

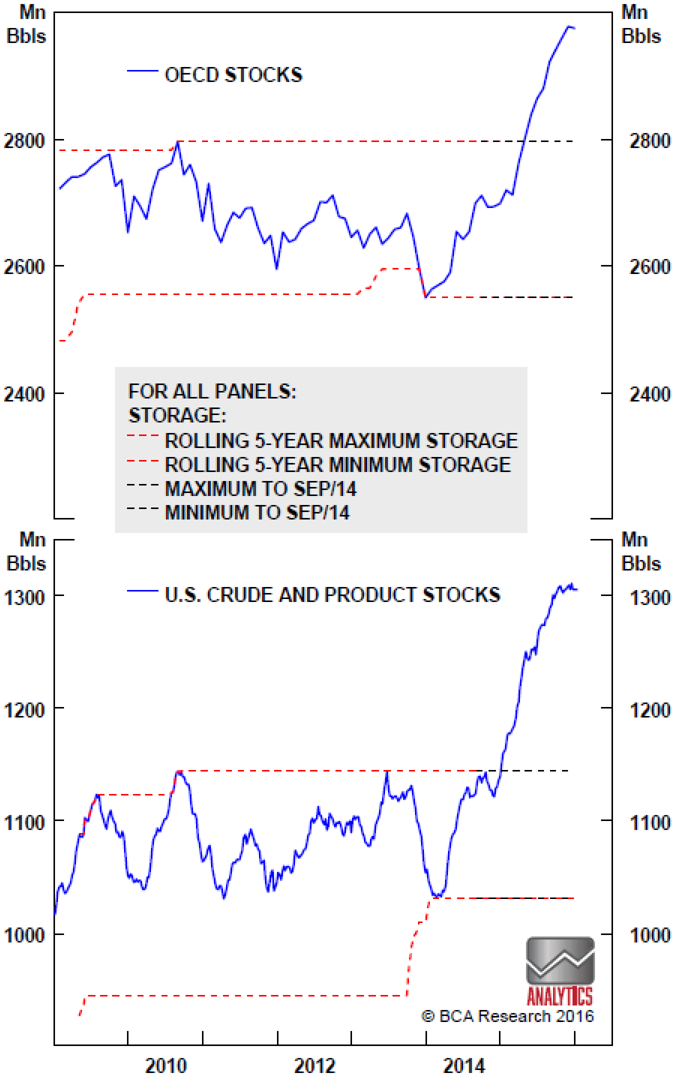


* SHOWN IN CONSTANT 2011 $US.
SOURCE: THE SIPRI MILITARY EXPENDITURE DATABASE.

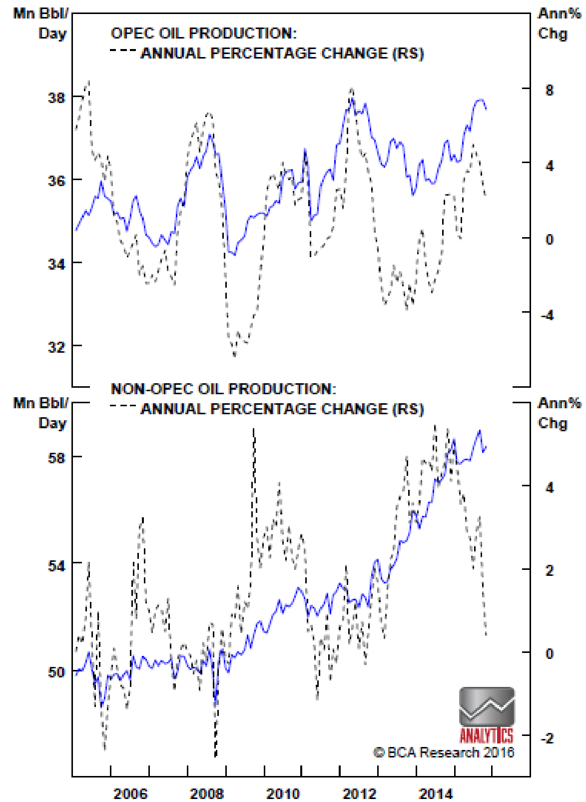
Oil demand and supply “balancing the market” by 2017?

Capricorn Asset Management

Storage Could Yet Be Exhausted, Forcing Oil Prices Lower

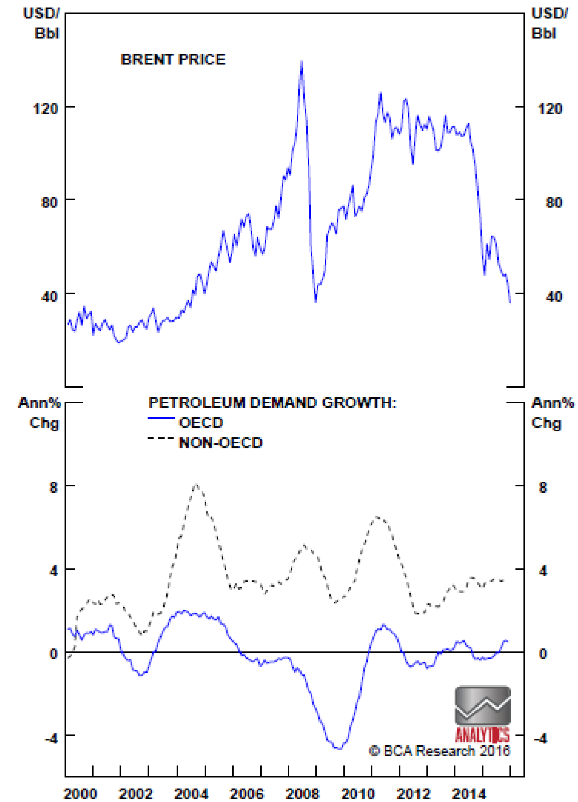


Production Growth Will Slow In 2016



SOURCE: U.S. EIA

Consumption Growth Will Continue, Albeit At A Slower Pace

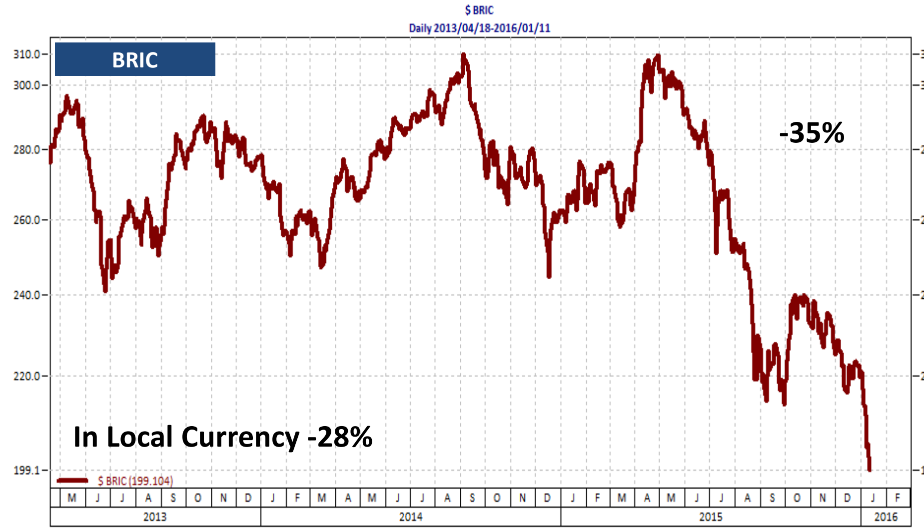


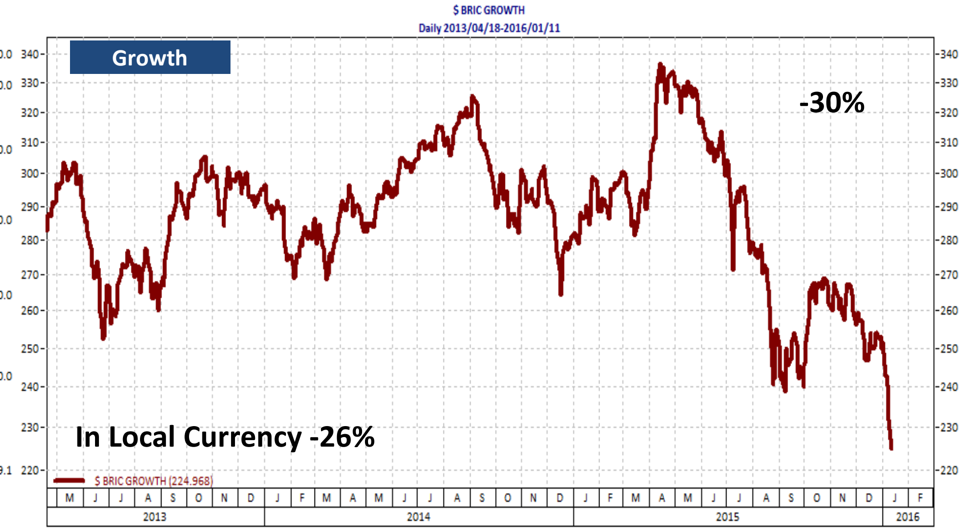
- **2016:** New theme. Used to be that China mainly impacted growth rates and commodity prices. Now they have opened up a new front, namely in markets directly – the equity market and the exchange rate.

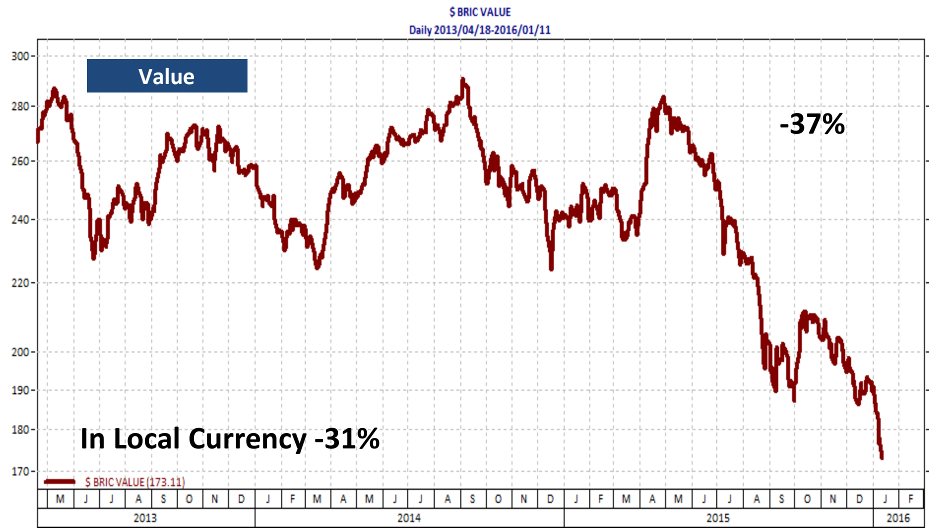
NEW CHINA AND THE DEATH OF THE "BRICs"

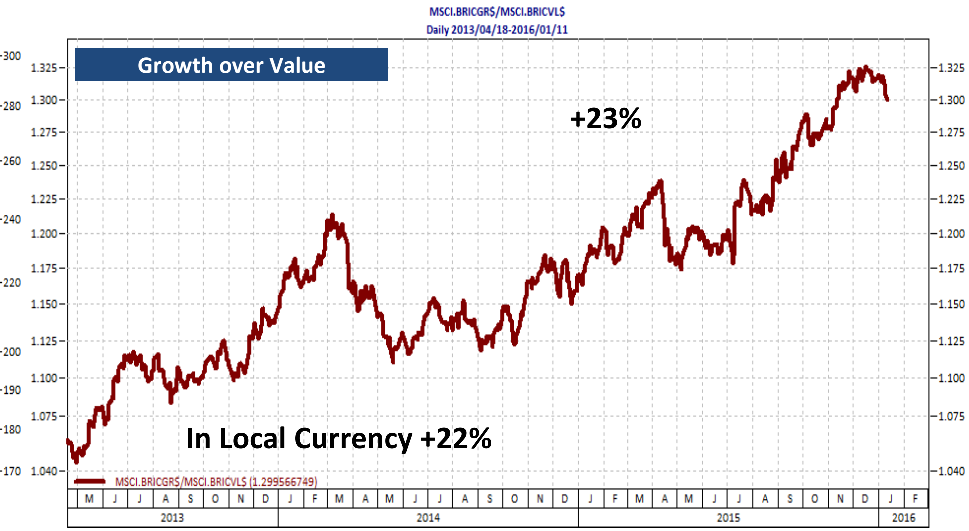
5

BRIC equities (MSCI of BRIC in U$)



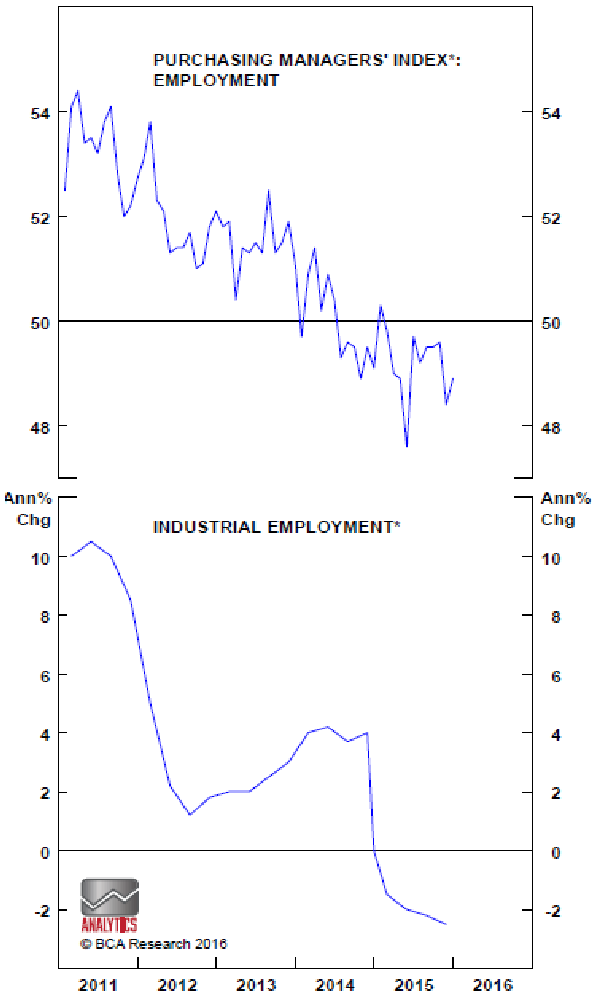






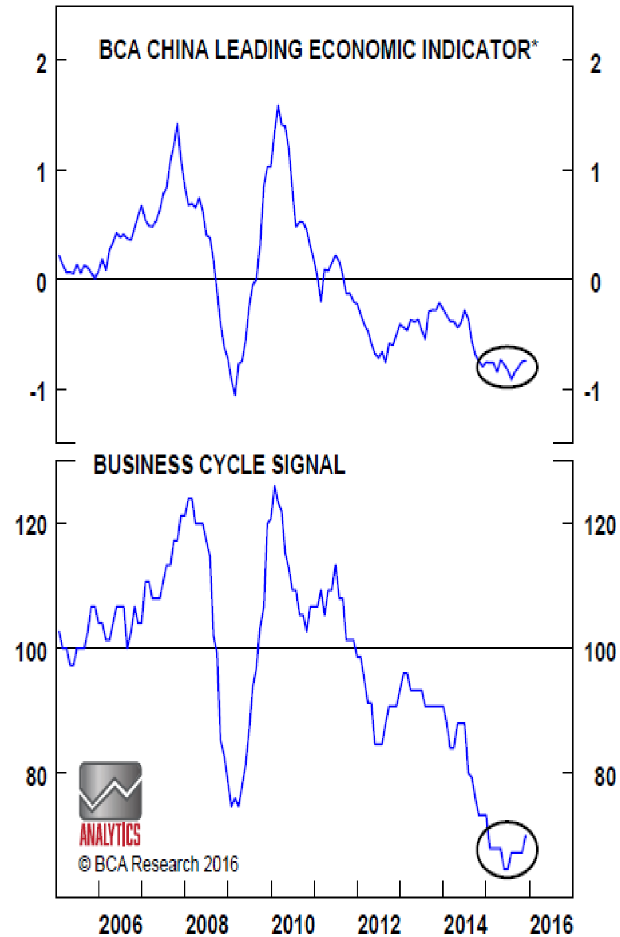
China

Industrial Sector Employment Is Contracting



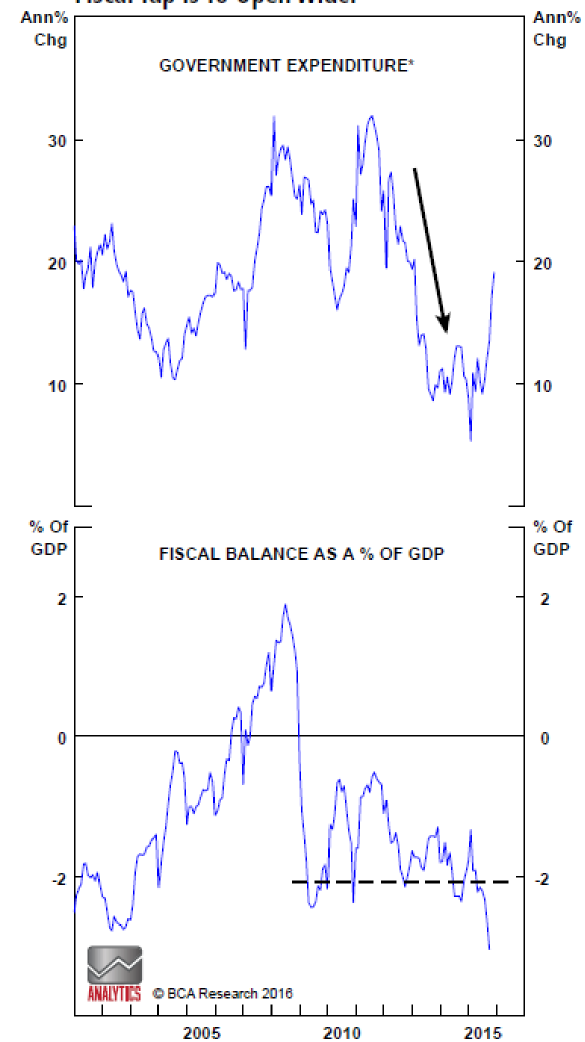
*SOURCE: CHINA NATIONAL BUREAU OF STATISTICS

Tentative Signs Of Bottoming?



*BCA PROPRIETARY INDICATOR

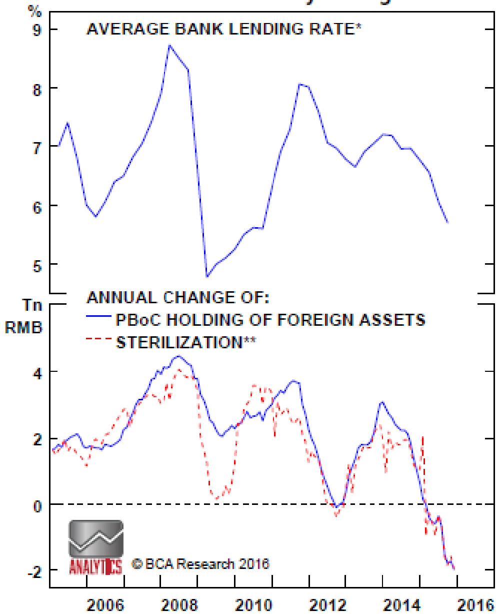
Fiscal Tap Is To Open Wider



*SHOWN AS A 12-MONTH MOVING AVERAGE

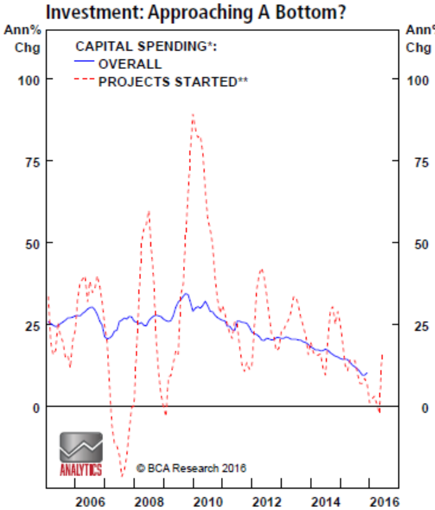
China

Room For More Monetary Easing



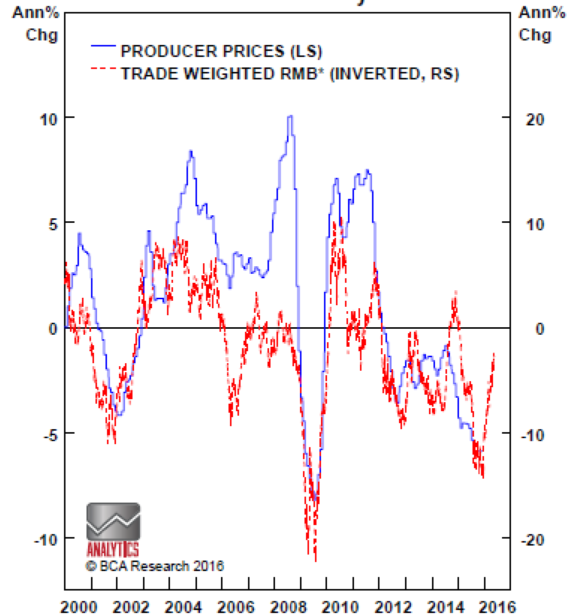
*SOURCE: PBoC
**CENTRAL BANK BONDS, RESERVE DEPOSITS, GOVERNMENT DEPOSITS AND CLAIMS ON COMMERCIAL BANKS

Investment: Approaching A Bottom?



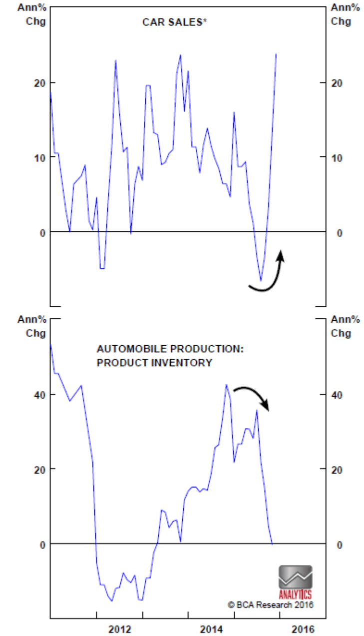
*SHOWN AS 6-MONTH MOVING AVERAGES EXCEPT THE LATEST DATA POINTS
**ADVANCED BY 6 MONTHS

The RMB Is Less Deflationary



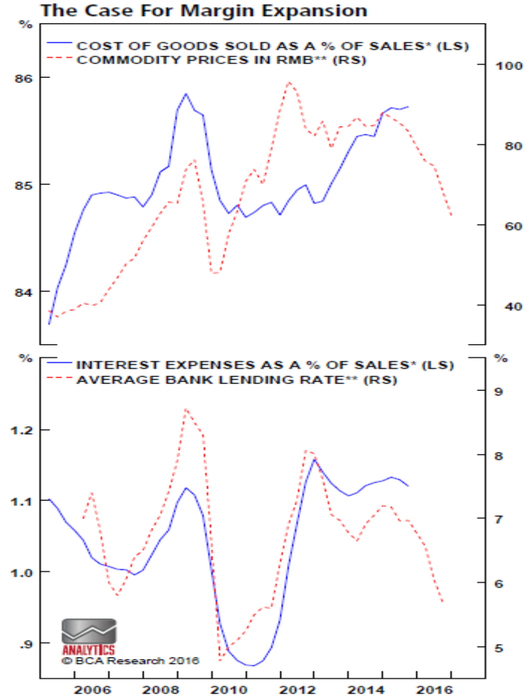
*SOURCE: J.P. MORGAN CHASE & CO.

The Turnaround in The Auto Sector



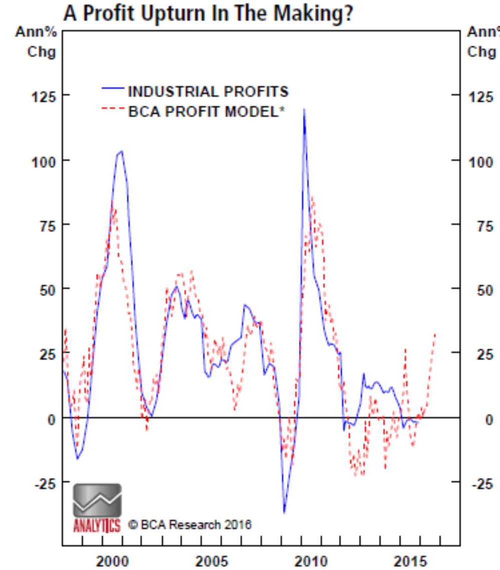
*JANUARY AND FEBRUARY DATA SHOWN SMOOTHED

The Case For Margin Expansion



*SHOWN AS 4-QUARTER MOVING AVERAGES
**ADVANCED BY 4 QUARTERS

A Profit Upturn In The Making?

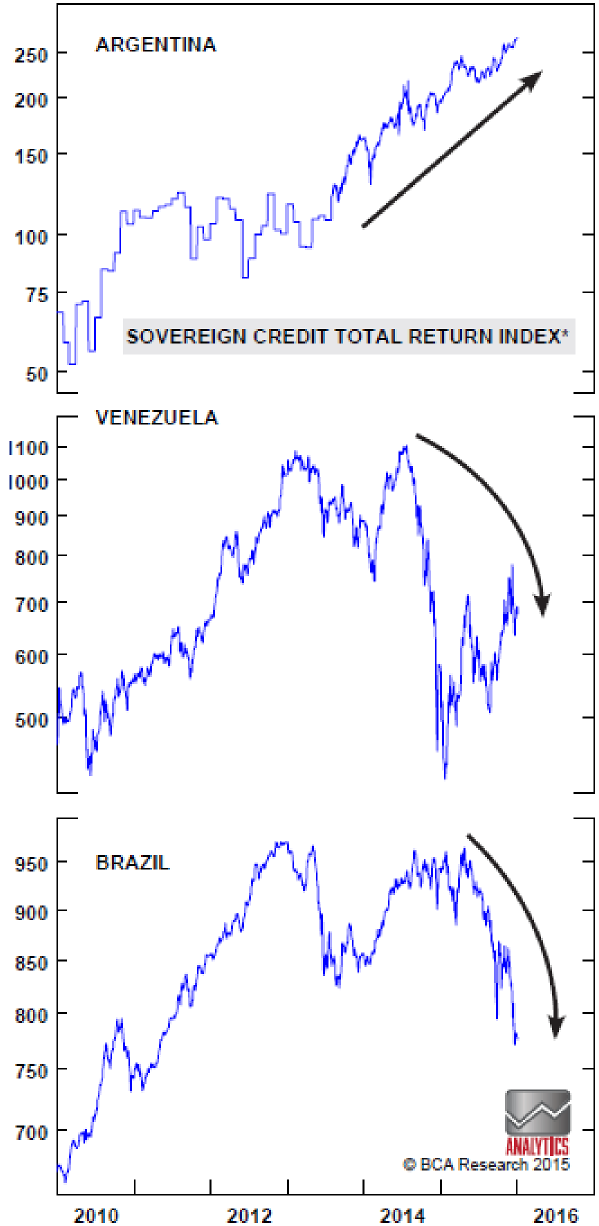


*BCA PROPRIETARY INDICATOR

Latam

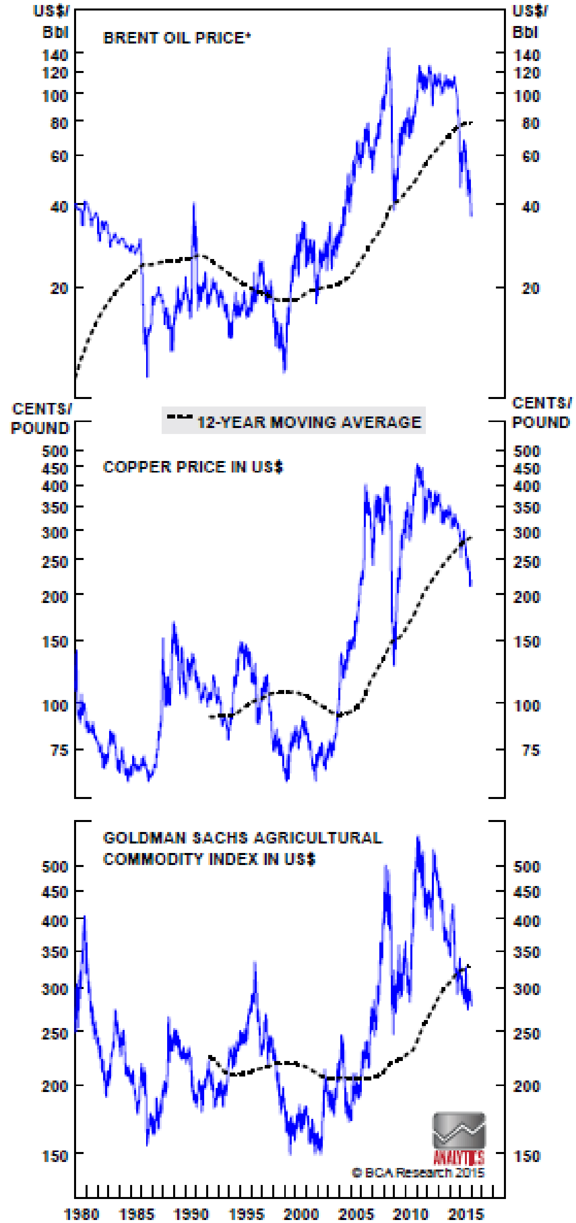
Capricorn Asset Management

Argentinean Sovereign Debt, A Relative Leader



*SOURCE: BARCLAYS

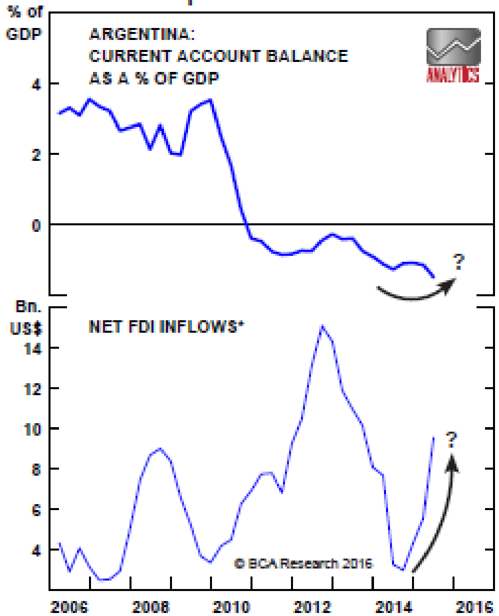
Commodities Structural Bear Market To Persist



*SOURCE: LONDON BRENT CRUDE OIL INDEX.

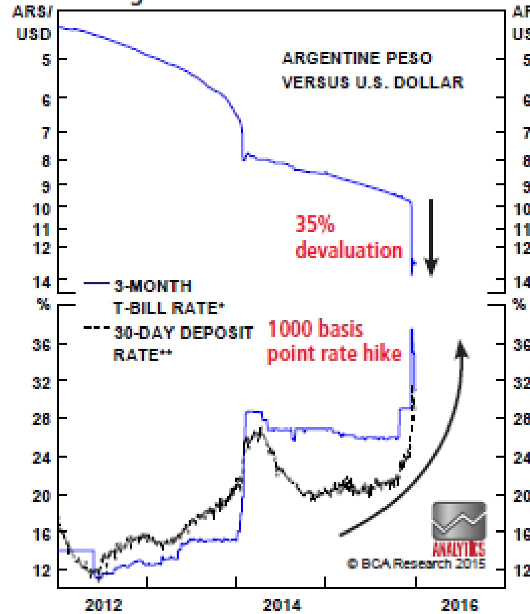
Latam Argentina

Argentina's Macro Fundamentals
Are Set To Improve



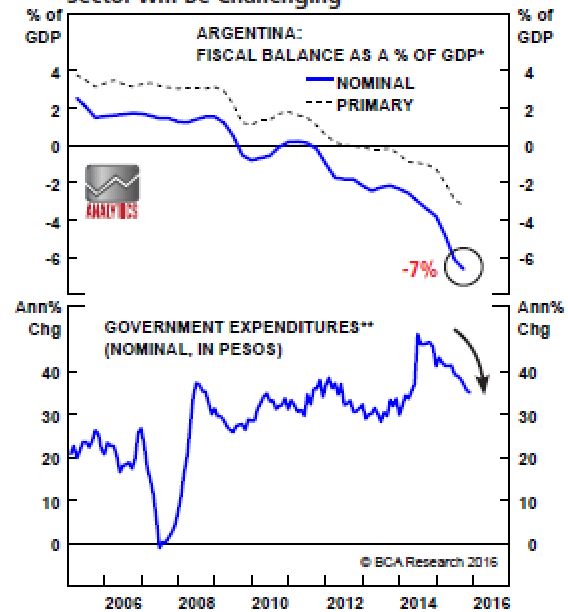
*SHOWN AS A 4-QUARTER MOVING TOTAL

Argentina: Painful Macro Rebalancing
Has Begun



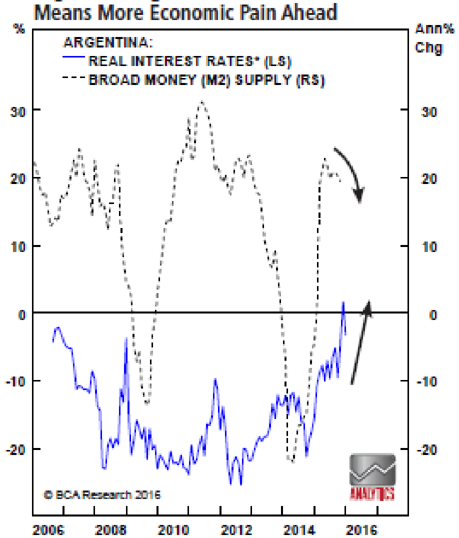
*3-MONTH LEBAC NOTES
KS BALDAR RATE

Argentina: Deflating The Bloated Public
Sector Will Be Challenging



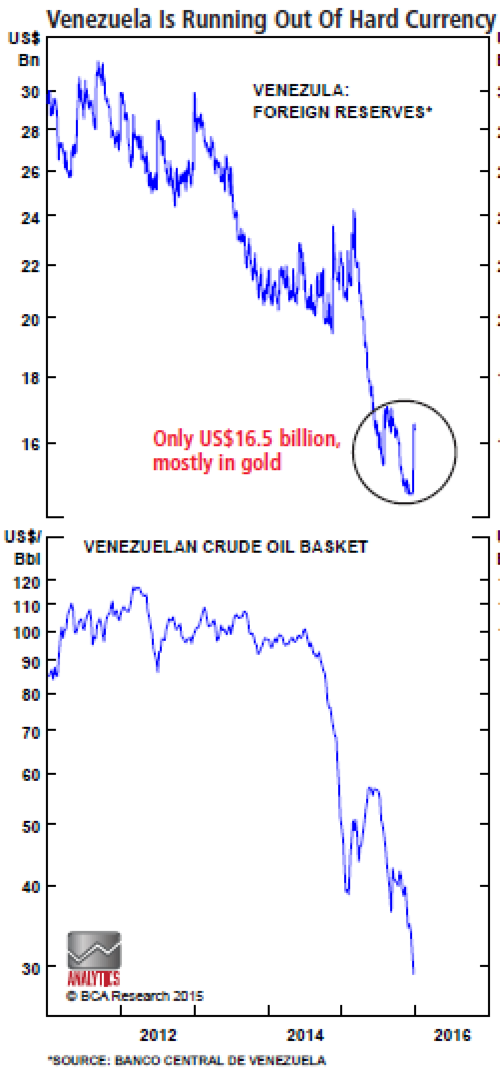
*SHOWN AS A 2-QUARTER MOVING AVERAGE; SOURCE: MECON
**SHOWN AS A 6-MONTH MOVING AVERAGE

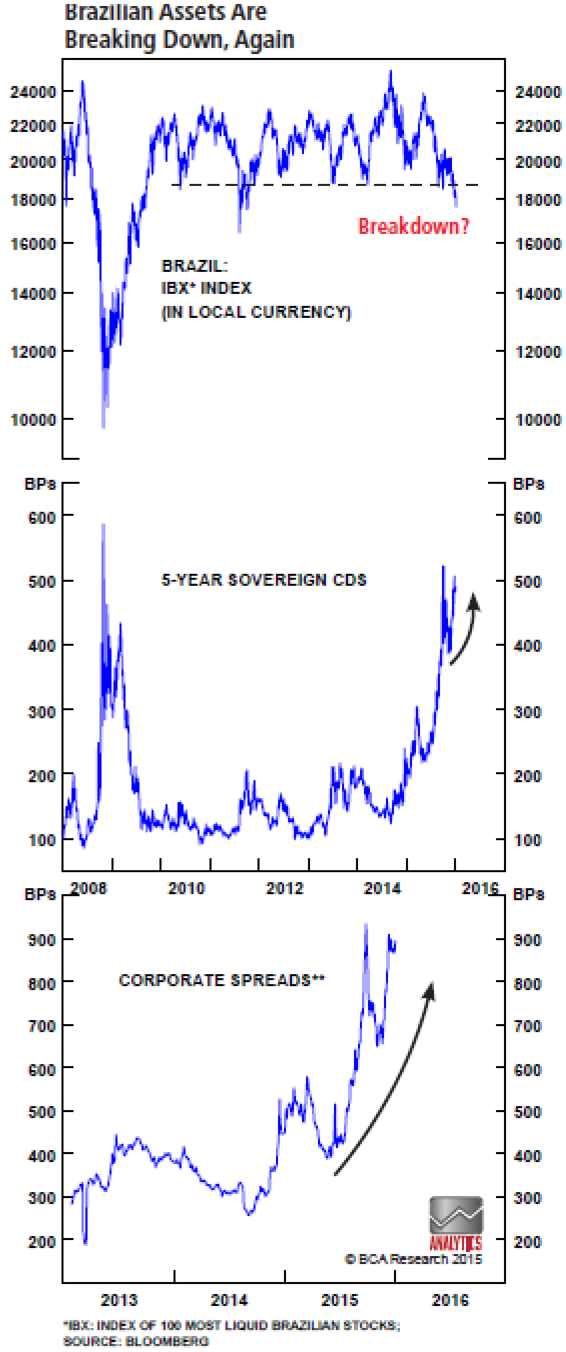
Argentina: Higher Real Interest Rates
Means More Economic Pain Ahead

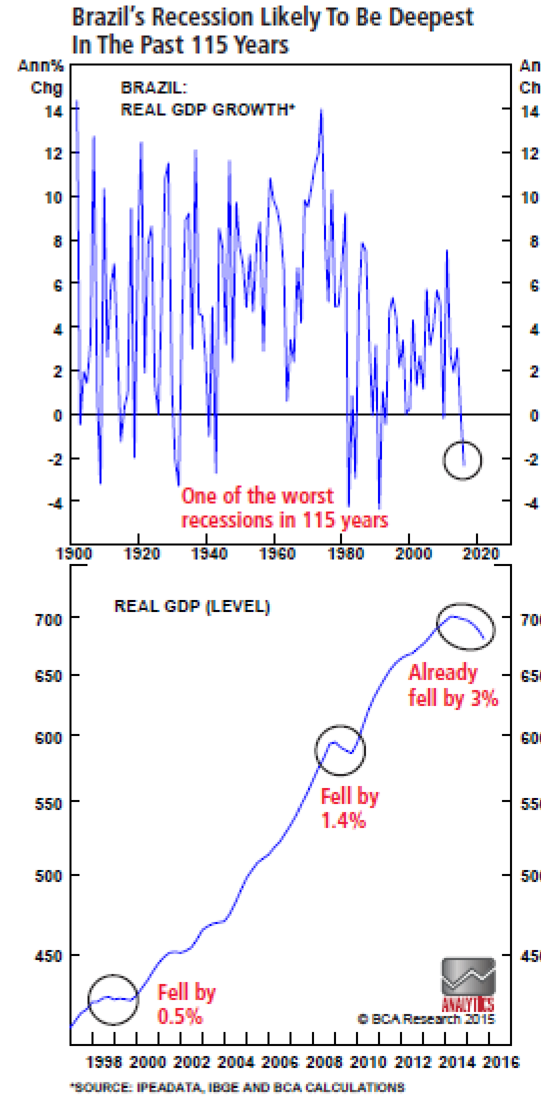


*CALCULATED AS BADLAR INTEREST RATE MINUS 12-MONTH
INFLATION EXPECTATIONS

Latam Venezuela, Brazil



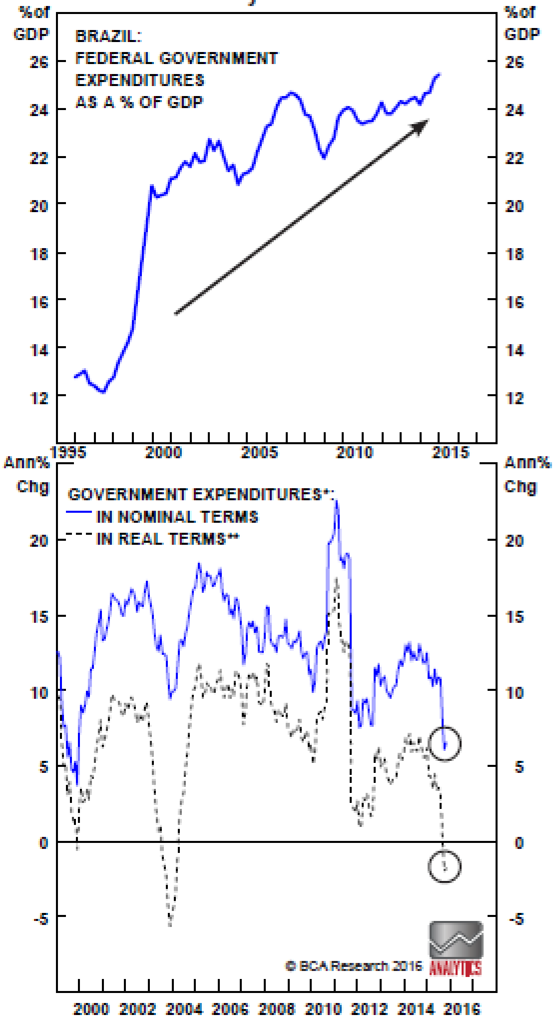




Latam Brazil

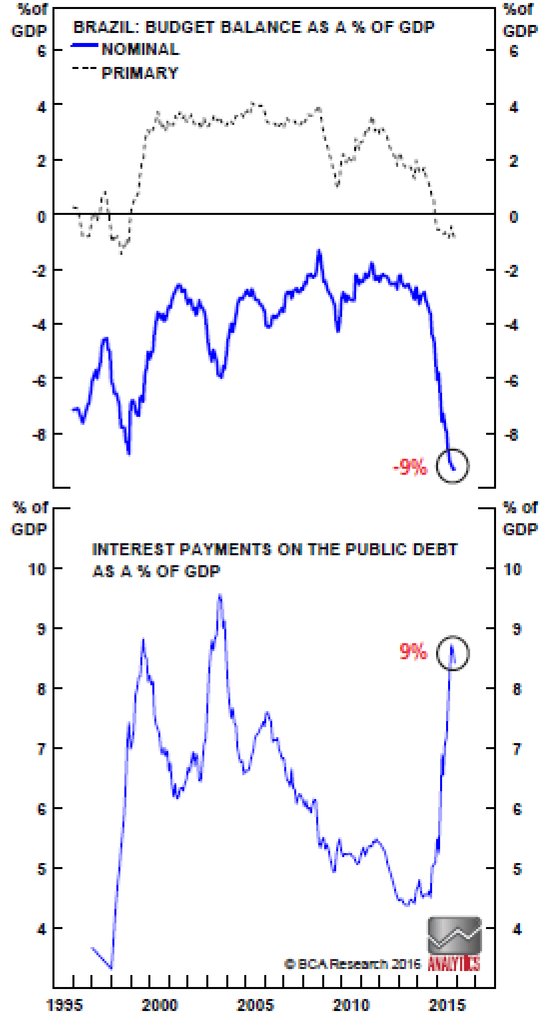
Capricorn Asset Management

Government Spending Is Very Important To Brazil's Economy

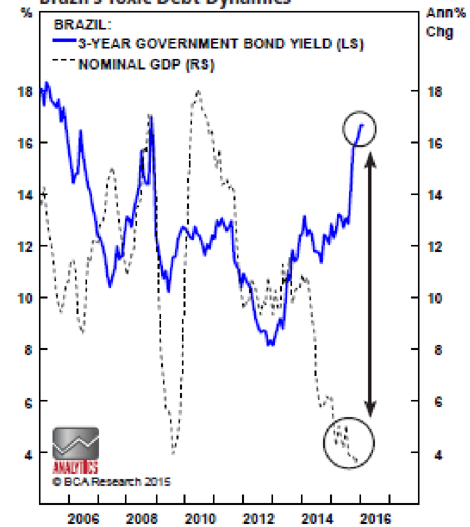


*SHOWN AS A 12-MONTH MOVING AVERAGE
**DEFLATED BY THE HEADLINE CONSUMER PRICE INFLATION (IPCA)

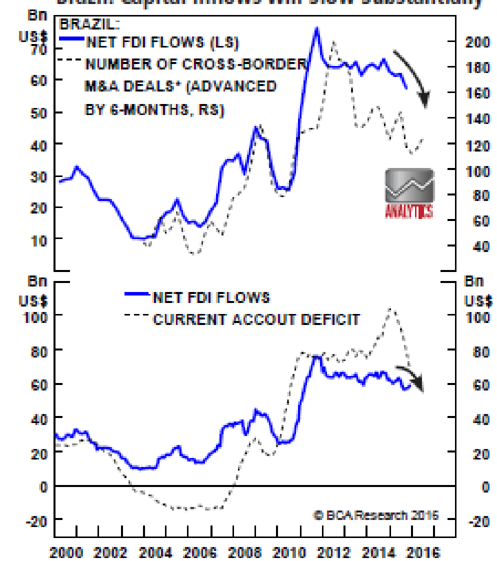
Brazil: Fiscal Deficit Is The Largest In 20 Years



Brazil's Toxic Debt Dynamics



Brazil: Capital Inflows Will Slow Substantially



*SHOWN AS A 2-QUARTER MOVING AVERAGE; SOURCE: BLOOMBERG

"Lower for longer interest rates"

- **2016:** There is a real possibility that policy rates in SA and Namibia will peak mid-2016 and that by mid-2017 we'll start a cutting cycle as the downswing in the economic cycle intensifies.

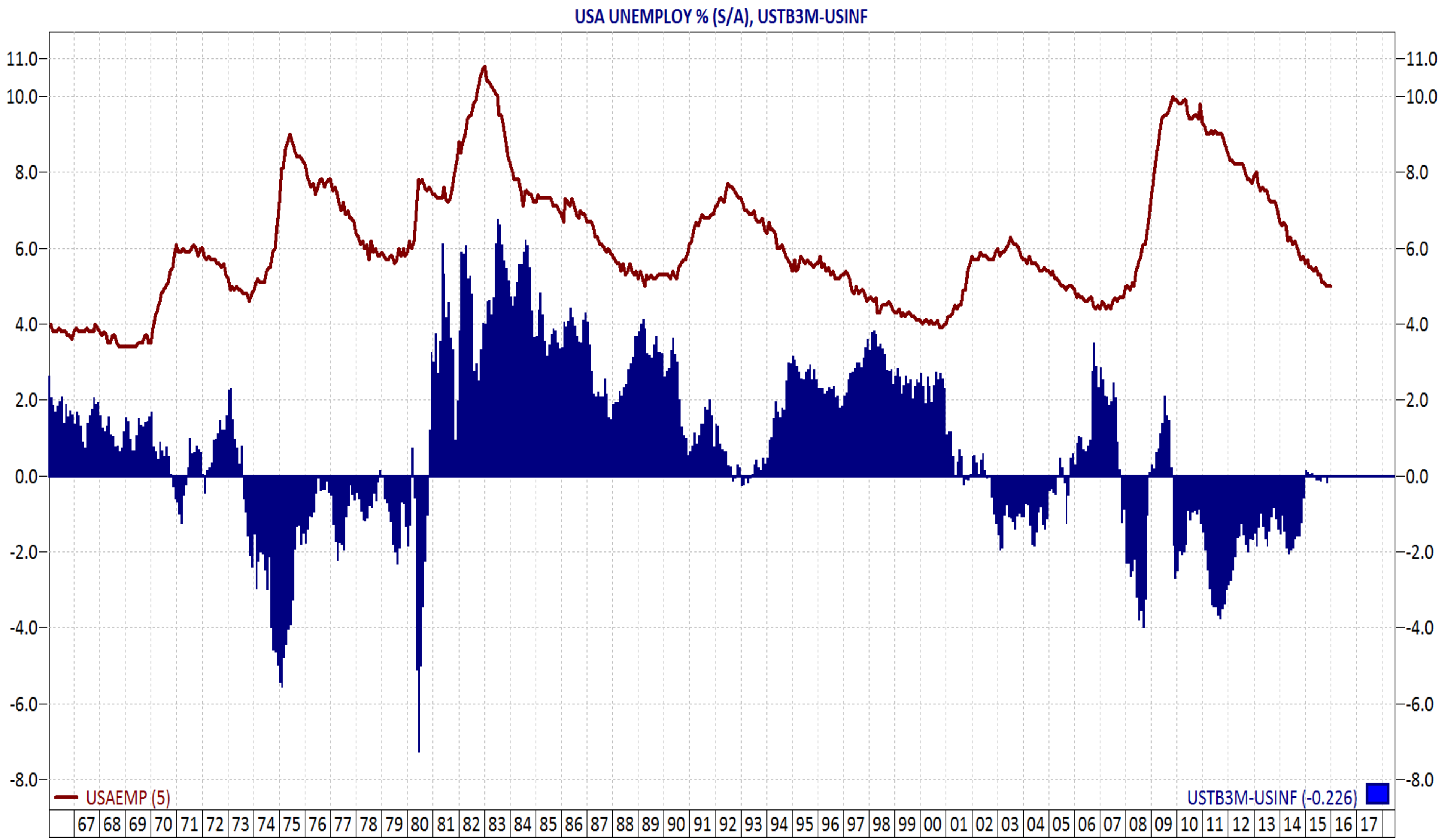
"QE"

- **2016:** QE in some places and unconventional monetary policy settings – such as negative interest rates – could become widespread.

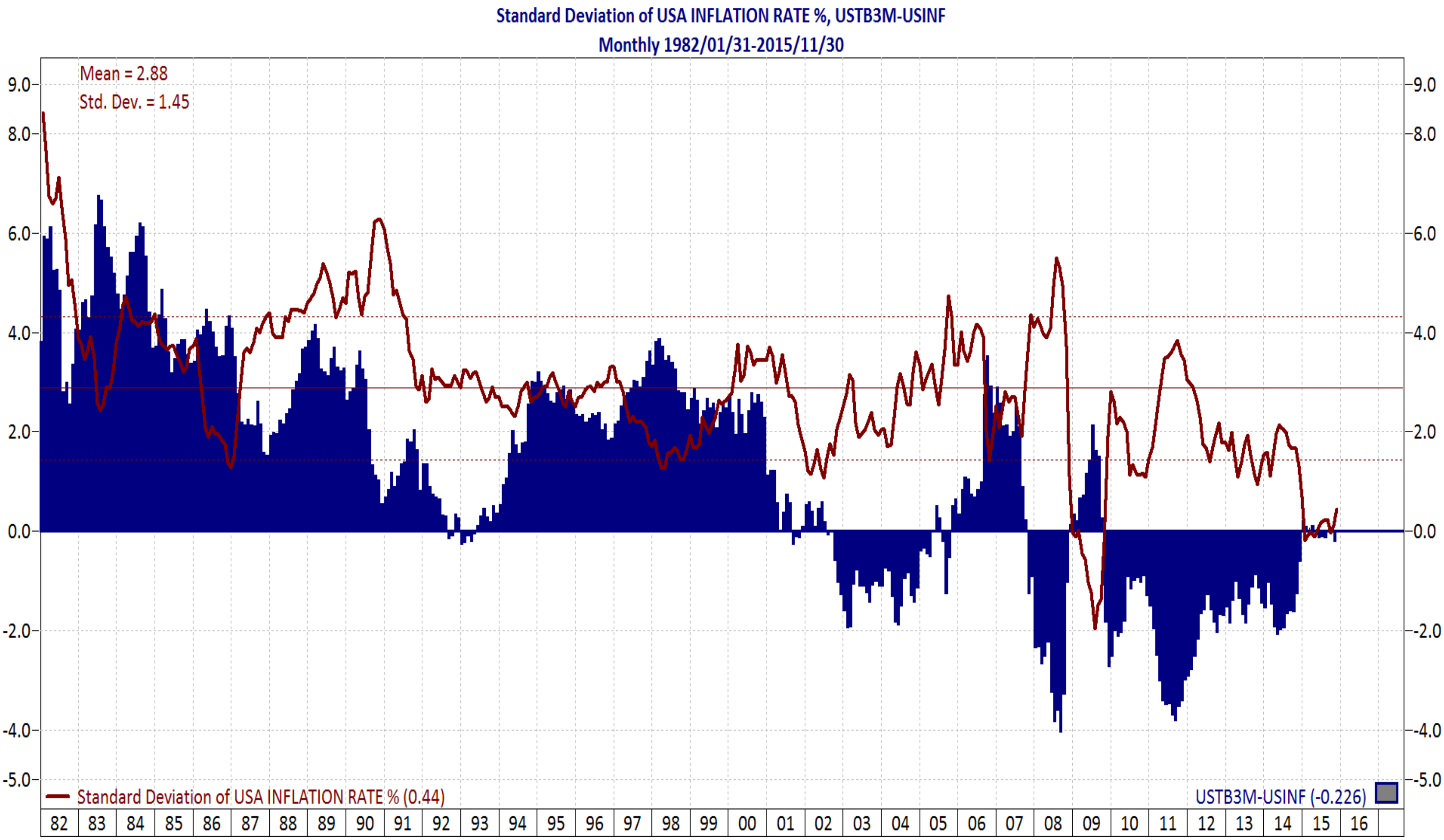
LOW FOR LONGER INTEREST RATES

6

LFL interest rates

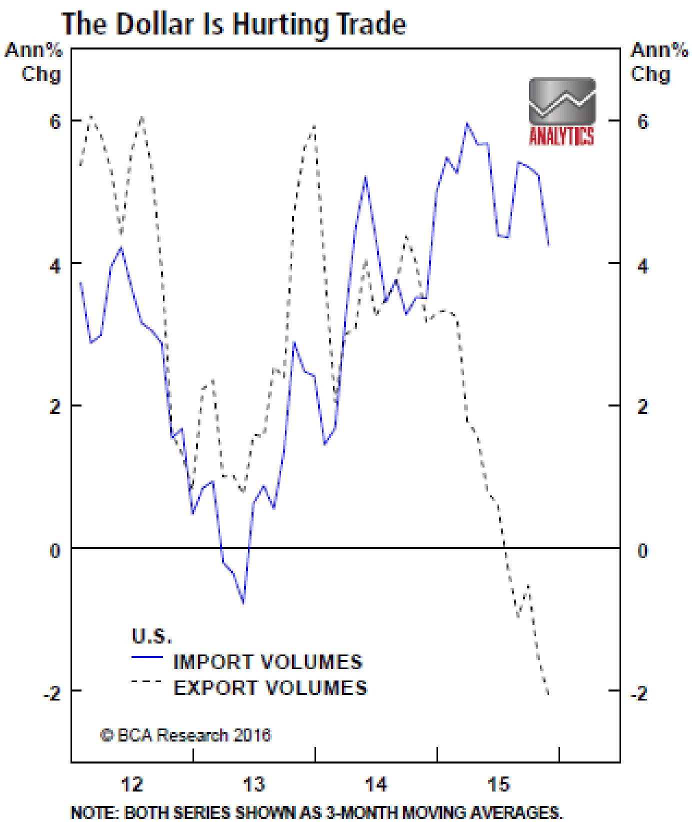


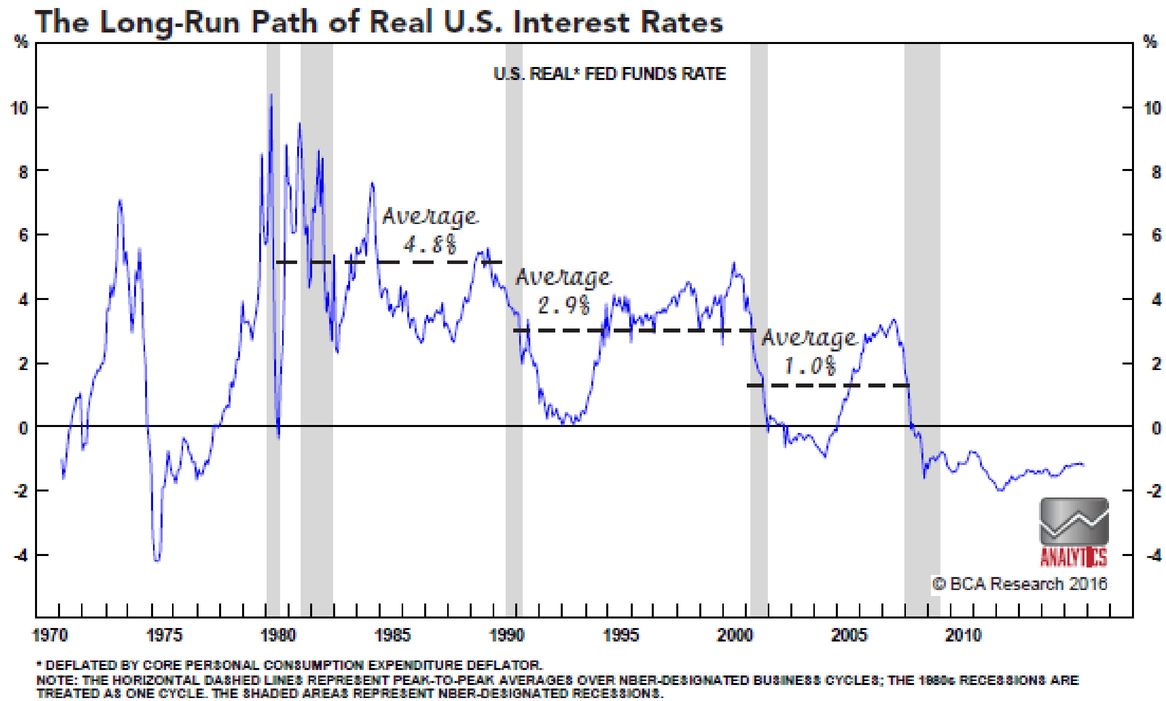
LFL…



Standard Deviation of USA INFLATION RATE %, USTB3M-USINF
Monthly 1982/01/31-2015/11/30
Mean = 2.88
Std. Dev. = 1.45
9.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-5.0
Standard Deviation of USA INFLATION RATE % (0.44)
USTB3M-USINF (-0.226)
82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16

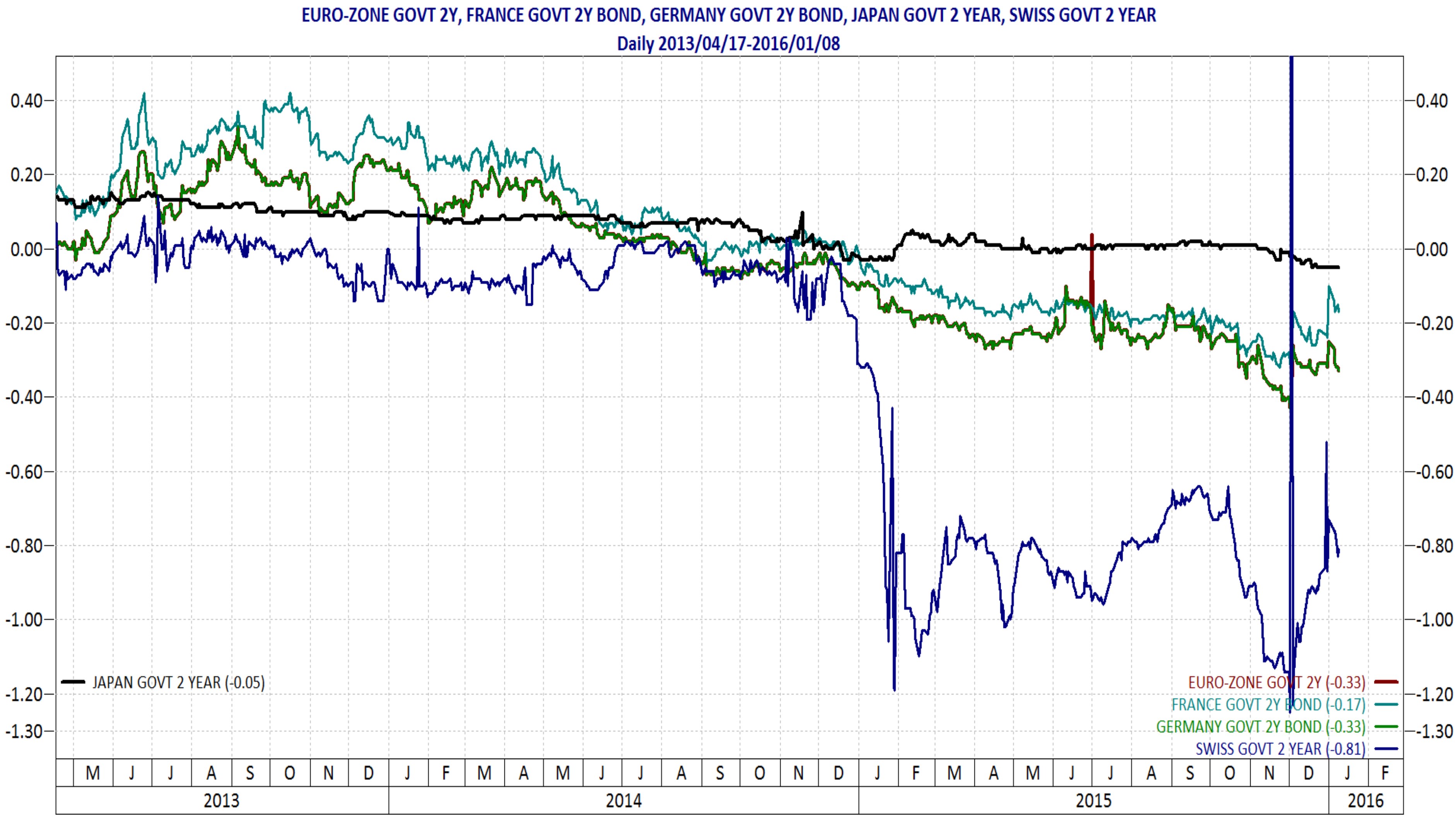
Real rate in US



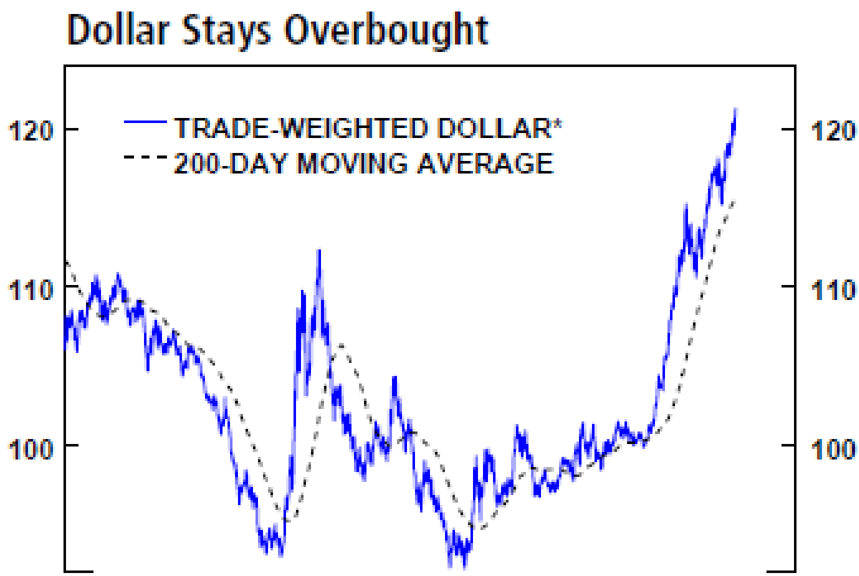


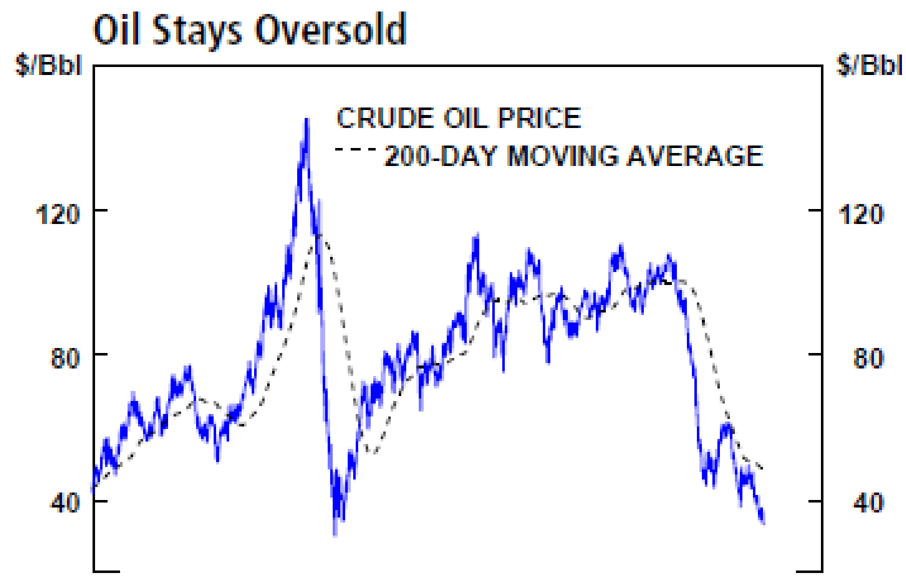
The stronger dollar has clearly had a negative impact on trade, with export volumes down 2.1% in the year to November compared with a 4.2% rise in import volumes (**Chart 7**). The Fed's own econometric model implies that the appreciation in the dollar since May 2014 has tightened financial conditions by the equivalent of 150 basis points in rate hikes. That is about a year-and-a-half worth of rate hikes based on the Fed's dot plot. As we discuss in **Theme #10**, while we do not see much upside for the dollar against the euro or the yen, we do expect the greenback to continuing strengthening against most EM currencies, which could result in an appreciation in the broad trade-weighted dollar of 2%-to-4% this year.

Negative nominal rates



Summary of themes





- Deflation, Lowflation, Stagflation
- Death by debt (or debt traps)
- Divergence
- Oil, energy, commodities, green
- New China
- Low for long interest rates

Themes 1	Description	Investment Implication
 **Deflation Stagflation Lowflation**	▪ Pockets of outright deflation still present. Global growth falls back to around 2%. US at 2%+ and EU at 1%. ▪ US inflation 1.5%+, EU & JAP inflation <1.5% ▪ Stagflation in RSA. Growth barely reaches 1%. With inflation at 6%. Policy conundrum. ▪ Lowflation in Namibia. Namibia to grow by 4%+, driven by specific projects. ▪ China continues to slow down. Exporting disinflation. ▪ Latam in recession. Russia in recession. Oil producing countries struggle.	▪ MM: positive. Domestic rates rising. ▪ BD: negative. Domestic inflation rising. ▪ RE negative: Rising rates, but does show some growth. Favour stocks with some offshore exposure. ▪ In equities look for growth and quality. Growth will remain scarce. We will have high-risk rallies, but it is not sustainable. ▪ EQ: In domestic equities underweight “domestics.”, overweight offshore exposure ▪ OS: 50/50 US (some growth and inflation) and EU (continued QE raising chances of a recovery)
 **Death By Debt**	▪ **(or debt traps in various guises)** ▪ Tremendous debt mountain present in global economy. ▪ A significant increase in interest rates and therefore debt servicing costs will usher in big problems. ▪ Hence, CB’s will not be in a hurry to raise rates.. ▪ This build-up of debt was not growth inducing. ▪ Global aggregate demand is weak, which leads to this. ▪ RSA credit downgrade? Outlook deteriorating. The ANC have looked into the abyss. Hopefully they will step back from the ledge.	▪ Avoid high indebtedness – countries, corporates ▪ The balance sheet will be the key metric this year - “anti-credit” ▪ Possibility of an SA downgrade is a key factor. Yes? Avoid rate sensitives (RE & BD). No? Rate sensitives are attractive. ▪ MM: positive. Will have to hike to protect against a downgrade and a flight of capital. ▪ BD: negative. Downgrade will hit directly on yields. ▪ EQ: low debt positive, high debt negative. ▪ RE: neutral. Type of debt is NB. Fixed vs. Floating ▪ OS: negative. Hit by concerns regarding levels and safety of corporate debt.
 **Dollar Divergence Disruptors**	▪ e.g. Innovators vs. Smoke Stack, Robotics vs Humans, nation vs. nation ▪ Between countries:: USA in a “goldilocks” scenario vs. the rest struggling. Dash for dollars still on, but weaker. ▪ Between policies: USA and UK hiking rates = strong currencies. Europe QE and negative nominal rates. Some EMs to hike: Brazil, RSA, Namibia. ▪ Inter- and Intra- asset classes.	▪ Look for strong balance sheets – countries and corporates. ▪ 50/50 US (dollar will remain strong) and EU (earnings growth probably better). ▪ Geo-political tensions on the rise. Elections. ▪ ZAR very fragile – it is an SA and EM and DM story. Sentiment towards EMs very negative. ▪ In IBA differentiation on credit quality. ▪ In Equity differentiation on balance sheet strength.

Legend:
MM = Money Market
BD = Domestic Bonds
EQ = Domestic Equity
RE = Real Estate
OS = Offshore

Themes 2	Description	Investment Implication
 **Oil Energy Commodities Green**	▪ $40 oil. This may be one area that will benefit from "New China". ▪ The death of peak oil as well as the commodity super cycle. ▪ Commodities continue to struggle. ▪ Energy and Materials sectors in recession. It will ripple out to other sectors, slowing growth, adding to deflation. ▪ The full impact of low oil on producers (countries and companies) is still to unfold.	▪ Avoid energy and materials.. Look for alternative energy. ▪ Differentiate between producers of oil and consumers of oil. ▪ Materials sectors now the key risk for a global recession as well as a down-cycle in earnings on an index level. ▪ Also a key contributor to theme 1.
 **New China and the death of BRICs**	▪ Will China slow or grow? EM debt a major risk. ▪ Able to transition? ▪ More macro-stimulation will in any case be less commodity intensive. ▪ Contribution to global growth rate very NB. ▪ Slower/Negative growth in Brazil, Russia, China and South Africa. India better. ▪ Consumption driven by the aspirational Asian consumer	▪ Still "Naspers over Anglos" theme. Aspirational consumer of the east will drive IT and Media, that is services businesses over commodity businesses. ▪ New China will remain a source of sentiment and volatility swings while the policy makers dither between market forces and their interventionist mind-set. FX, Equity, Rates.
 **Low for longer Interest rates**	▪ US and UK hiking will be very gradual and slow. ▪ EU and Japan will be stuck in ZIRP. ▪ RSA will hike by another 75bp, then will have to start cutting again. ▪ NAM will continue to hike until credit growth slows. ▪ China tilted to more cutting. ▪ EMs would love to cut if they could.	▪ **Hunt for yield is till on.** ▪ Global bond yields to remain anchored in very low territory. ▪ Look for dividend growers. It encapsulates growth and yield. ▪ Rate sensitives (RE & BD) will make a come back.

Legend:
MM = Money Market
BD = Domestic Bonds
EQ = Domestic Equity
RE = Real Estate
OS = Offshore

Simmering issues & Risks

- Government spending v austerity. Only fiscal policy can now bring about a sea change.
- Housing/real estate markets: what is the status? Bubbles building?
- Double-dip or not? How will reversal of stimulus pan out (unwinding QE)? Is dollar liquidity down?
- Currency wars & current account imbalances. Yuan vs. the rest.
- Food prices. Global food prices seem to be falling sharply, but rising in SA.
- When will the ghosts of Greece come back to haunt us?
- Environmental events are on the rise.
- The Middle-East (Iran, Israel/Palestine issues, defence implications)
- Claiming the Antarctic (potential geo-political conflicts)
- Politics: Anti-EU movements, US Elections, RSA local elections
- EU Border controls & immigration – stress on cohesiveness of the EZ