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South Africa – cheap currency but expensive equities

The South African equity market is comfortably up in local currency terms over the year-to-date, but has fallen sharply in US dollars. The poor performance of the rand is mainly due to the twin fiscal and current account deficits and has taken the currency into deeply undervalued territory on any sort of PPP analysis; the problem though is that in contrast to some other weak currency countries, most notably India, the performance of exports has been deeply unimpressive. Next year could be somewhat problematic for the economy, especially if the independent central bank, the SARB, decides it has to raise interest rates to head off inflationary pressures. The best hope is probably that the external environment becomes more supportive with stronger growth, including China supporting metals prices, but with weaker oil. We believe that the oil price will weaken along with metals prices as growth in China slows, which would still be mildly supportive for South Africa. The election may generate some noise, but given that the outcome is as close to a foregone conclusion as it is possible to get in a democracy, the real interest will be in the composition of the post-election ANC cabinet, possibly with Cyril Ramaphosa as Deputy President, in which case the government may begin to implement the more market-friendly parts of the National Development Plan.

We still do not have an especially strong view about the equity market going into 2014. The good news is that in contrast to this time last year, relative sector valuations appear to have become somewhat more rational following the underperformance of the Consumer Staples sector (Figure 64). The market though, despite this year's underperformance, still trades at a fairly hefty premium against its history relative to GEM on a price-to-book versus ROE basis. This premium rating reflects the superior governance and capital allocation for South African companies over the GEM average as well as the presence of a sizeable and sophisticated domestic money management industry. We are however somewhat concerned that the improvement in underlying returns as measured by CROCI relative to the rest of GEM has now clearly started to level out (Figure 65), which may reflect the cumulative rise in the costs of doing business in South Africa.

