The Equity Tactician: Embracing Brazil and South Africa

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Welcome to our first edition of *'The Equity Tactician'* – the vehicle to express our tactical (short-term – less than a year) investment ideas within the equity space. '*The Equity Tactician'* along with its two sister ships – '*The Equity Strategist'* (that takes a strategic view – 3 to 5 years) and '*The Equity Thematician'* (takes a long-term view – 10 years) – will constitute our fleet of Investment strategy notes specialising in equities.

Setting up the rules of the game

- Unless otherwise stated, all trades are in USD.
- In all our recommendations, we anchor to the MSCI indices to maintain consistency in the frame work and also because of their wider acceptance.
- The primary benchmark for this exercise is MSCI All Country World Index (ACWI) – the broadest equity universe. However, we would like to restrict our ideas only to liquid markets within this space.
- We highlight explicit risks associated with the proposed investment(s) and readers could also obtain some market intelligence from our '*Know Your Trade*' data tables in this report.
- As always, if you would like to know if a particular tactical idea suits your risk-appetite and investment objectives, please reach out to your Relationship Manager/Investment Advisor at ADCB.

Embracing Brazil and South Africa

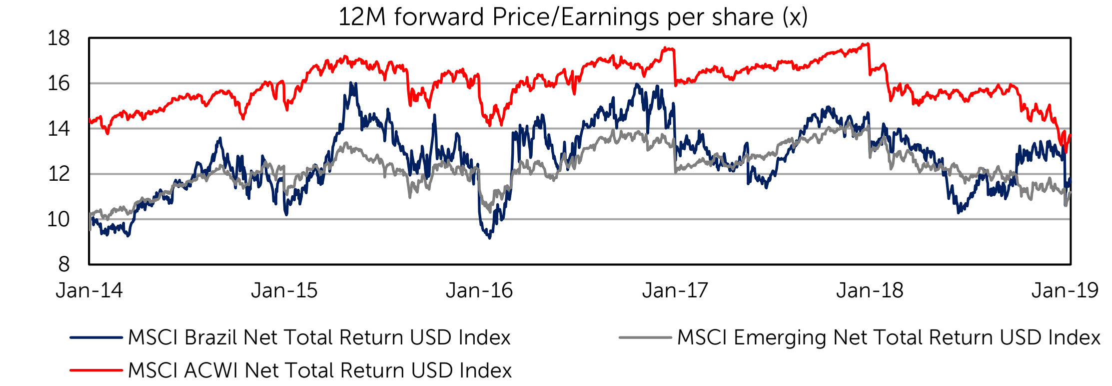
Readers of our *Quarterly Investment View, January 2019* would remember our underweight stance on Emerging Markets (EM) led by China. In that note we also mentioned about our selective preference for India, Brazil and South Africa within EM space (see page 15 of *Quarterly Investment View, January 2019)*. Our overweight stance on India is strategic and we retain this (see page 14 of *Quarterly Investment View, January 2019)*. However, our preference for Brazil and South Africa is more tactical and in this note we expand on these two markets.

For both Brazil and South Africa, the earnings growth expectations for 2019 are strong – c21% for each compared with 9% for MSCI EM and c8% for MSCI ACWI. We also see scope for valuations to expand in both these markets on the back of reform implementation. This puts both these markets on a strong footing when the global equity market is constrained by the late cycle phenomena of slower growth, higher volatility and limited scope for valuation rerating. In both Brazil and South Africa, USD investors can also benefit from rising domestic currency. The common risks include a runaway appreciation in the USD and a Chinese hard landing – we don't expect both. For South Africa any disappointment for ANC in national elections could be an impediment for the equity market there; however recent polls do not hint at this.

Tactical overweight: Brazilian equities

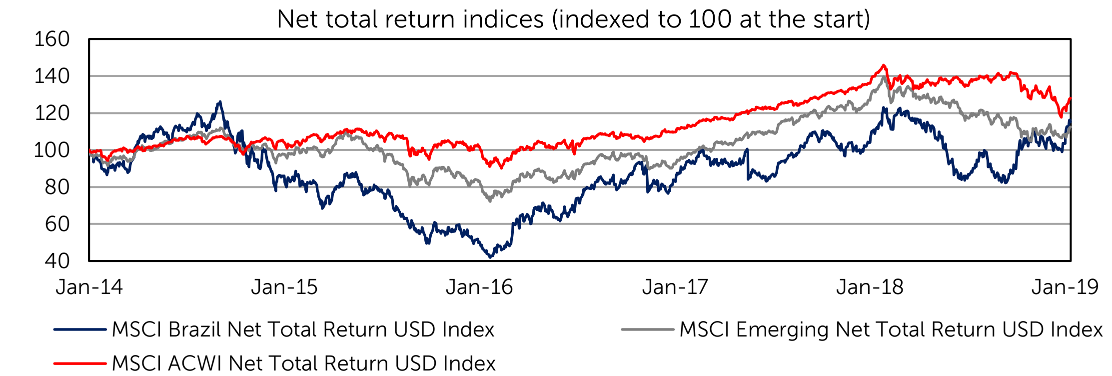
- Brazilian equities are strongly geared to economic rebound. IMF expects Brazilian economic growth to accelerate from 1.4% in 2018 to 2.4% in 2019.
- Contained inflation should help put a floor on the cost of equity for the market. We have started to see this already – Brazil's consumer prices slowed in December, leaving annual headline inflation below the central bank's target band for the second consecutive year.
- Yes the equity markets has performed strongly over the past few months but we still believe this has further to go. Especially as foreign investors who fled the market in 2018 return.
- Valuations are not expensive (see chart below) and the scope for a rerating comes from the implementation of structural reforms – pension reforms, fiscal consolidation and privatisation. Worth noting that the COPOM monetary policy committee has stated that the domestic risks to reform have fallen.
- Consensus expects the earnings growth for the market to be c21% this year; we expect this strength – especially in relation to other EMs and DMs – to materialise through the year.
- Valuations might have further optionality with any potential surprises on earnings. Of course, we acknowledge that the estimates currently are already high.
- Further strength in BRL against USD should help USD investors in the market. Even if the USD remains stable at the current levels that should support Brazilian equity performance.
- *Risks to our tactical overweight Brazil trade include an unforeseen rapid appreciation in USD and Chinese hard landing. Further, investors should bear in mind, the higher volatility in Brazilian equities – when compared to those in the developed world (see Know Your Trade statistics on the following page).*

Brazilian equities are cheap compared with Global equities and in line with EM which are cheap



Source: MSCI, Bloomberg Consensus, ADCB calculations

Strong cyclical upswing should help Brazilian equities outperform looking ahead



Source: MSCI, Bloomberg, ADCB calculations

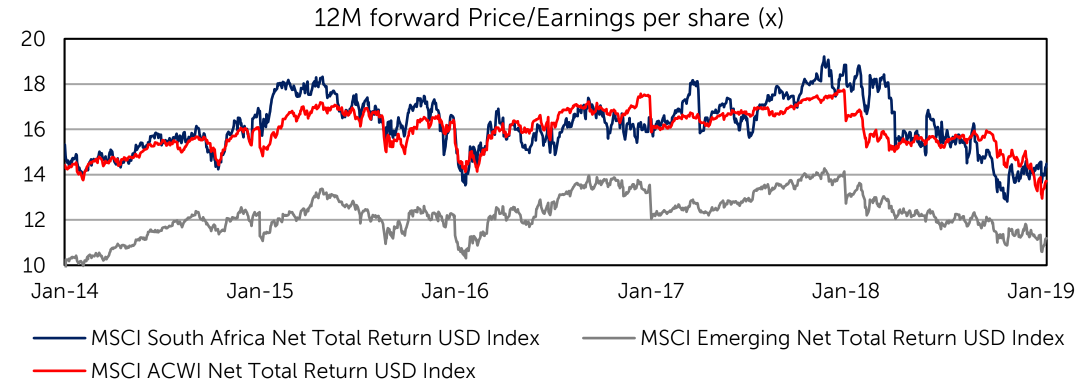
Know Your Trade> Risk, return, valuations and earnings: Brazil, EM and ACWI	MSCI Brazil Net Total Return USD Index	MSCI Emerging Net Total Return USD Index	MSCI ACWI Net Total Return USD Index
1 month total return (%)	14.2	4.1	0.7
3 month total return (%)	13.9	5.3	-2.9
6 month total return (%)	31.1	-5.0	-6.6
12 month total return (%)	3.7	-14.3	-8.9
YTD total return (%)	11.4	3.7	3.9
3 year annualised total return (%)	36.3	14.1	10.4
5 year annualised total return (%)	3.9	3.1	5.2
10 year annualised total return (%)	NA	8.0	9.5
30 day volatility	29.1	16.2	19.1
90 day volatility	33.5	17.9	16.0
180 day volatility	32.9	16.0	12.6
360 day volatility	28.3	14.3	11.3
162 week volatility	30.4	16.4	12.3
Correlation (52 week)	0.4	0.8	1.0
Beta (52 week)	0.8	0.9	1.0
12M forward Price/Earnings per share (x)	11.6	11.2	13.7
12M forward Price/Book value per share (x)	1.8	1.4	1.9
12M forward Dividend yield (%)	3.9	3.2	2.9
12M forward Price/Sales per share (x)	1.5	1.1	1.4
12M forward Price/Cash flow per share (x)	7.2	7.0	9.2
12M forward earnings growth (%)	20.7	8.9	7.6

Source: MSCI, Bloomberg Consensus, ADCB calculations | Data as at close of 11 January 2019

Tactical overweight: South African equities

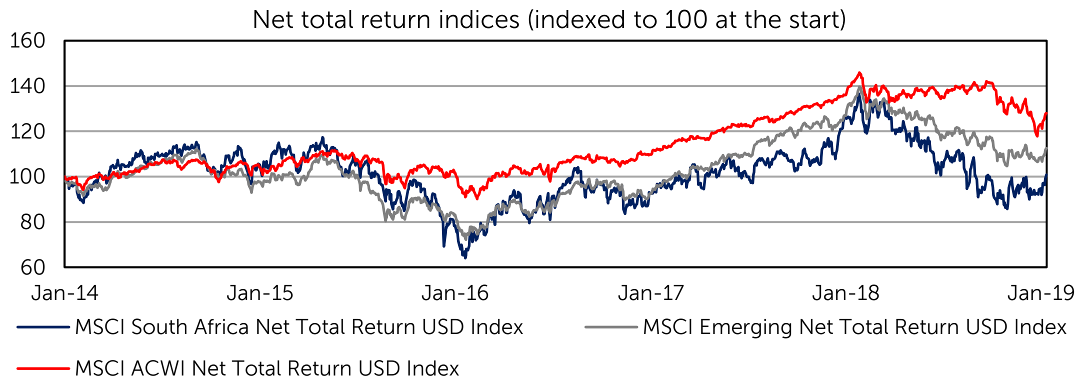
- The macro picture looks favourable especially with a recovery in economic growth. IMF estimates are for the GDP growth to accelerate to 1.4% this year from 0.8% in 2018 after slowing significantly from 1.3% in 2017.
- Economic, business and equity market cycles are supported by lower UST yields, a stable USD, well behaved oil prices and potential ZAR strength.
- South African equity valuations have corrected quite sizably during 2018 – leaving scope for reversal now (see chart below). In this context any economic reforms are likely to trigger rerating in the market.
- Recent polls suggest a dominant position for The African National Congress (ANC) in the South African general elections this year (Poll: ANC set to dominate national elections, Bloomberg News, 6 January 2019) – this should help Cyril Ramaphosa to implement some of the structural reforms.
- Earnings growth, coming for a depressed base, is expected to be strong. Bloomberg consensus estimates are for the earnings of MSCI South Africa to grow by 21% this year – compared with 9% for MSCI EM and c8% for MSCI ACWI.
- *Risks to our tactical overweight South Africa trade include a rapid appreciation in USD, Chinese hard landing and disappointment for ANC in national elections – none of these are likely in our view. Further, investors should bear in mind, higher volatility in South African equities – when compared to that in DM (see Know Your Trade statistics on the following page).*

South African equity valuations have corrected quite sizably during 2018 – leaving scope for reversal now



Source: MSCI, Bloomberg Consensus, ADCB calculations

South Africa has underperformed over the last five years – but this year could be different



Source: MSCI, Bloomberg, ADCB calculations

Know Your Trade> Risk, return, valuations and earnings: South Africa, EM and ACWI

	MSCI South Africa Net Total Return USD Index	MSCI Emerging Net Total Return USD Index	MSCI ACWI Net Total Return USD Index
1 month total return (%)	9.5	4.1	0.7
3 month total return (%)	14.8	5.3	-2.9
6 month total return (%)	-7.3	-5.0	-6.6
12 month total return (%)	-18.2	-14.3	-8.9
YTD total return (%)	6.5	3.7	3.9
3 year annualised total return (%)	14.1	14.1	10.4
5 year annualised total return (%)	0.9	3.1	5.2
10 year annualised total return (%)	NA	8.0	9.5
30 day volatility	33.5	16.2	19.1
90 day volatility	35.1	17.9	16.0
180 day volatility	35.7	16.0	12.6
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162 week volatility	29.6	16.4	12.3
Correlation (52 week)	0.6	0.8	1.0
Beta (52 week)	1.1	0.9	1.0
12M forward Price/Earnings per share (x)	14.5	11.2	13.7
12M forward Price/Book value per share (x)	2.0	1.4	1.9
12M forward Dividend yield (%)	3.4	3.2	2.9
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12M forward earnings growth (%)	20.8	8.9	7.6

Source: MSCI, Bloomberg Consensus, ADCB calculations | Data as at close of 11 January 2019

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTTNews
4. Reuters
5. Gulfbase
6. Zawya

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