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MARCH 2018

EGYPT AND SOUTH AFRICA UPDATE

AFRICA FUND

Through 2017, we posited that the macroeconomic constraints that held back potential in South Africa and Egypt would ease and create a platform for recovery and growth.

Temi Iyiola (Analyst) takes a deeper look at how both economies are progressing and the outlook for investors.

SOUTH AFRICA: POLITICAL CHANGE DRIVING SUSTAINABLE GROWTH

As we predicted, Cyril Ramaphosa was elected the head of the ANC in December and this month he was sworn-in as the country's new president, replacing the discredited Jacob Zuma. This development appears to have kicked off the classic cycle of positive sentiment leading to improving confidence, investment and economic growth. In the 3 months since we published our last note, the currency strengthened 20% and the cost of insuring South African government debt against default fell by 30%.

Indeed, Ramaphosa has immediately started to wield a positive influence, notably:

1. The first budget under his administration shored up expectations regarding the prospects of the country's finances. It included a downward revision of borrowing together with non-core asset disposals, and revenue increases via VAT, which will lead to debt stabilisation at a minimum. This has led to positive growth revisions by sell-side economists.

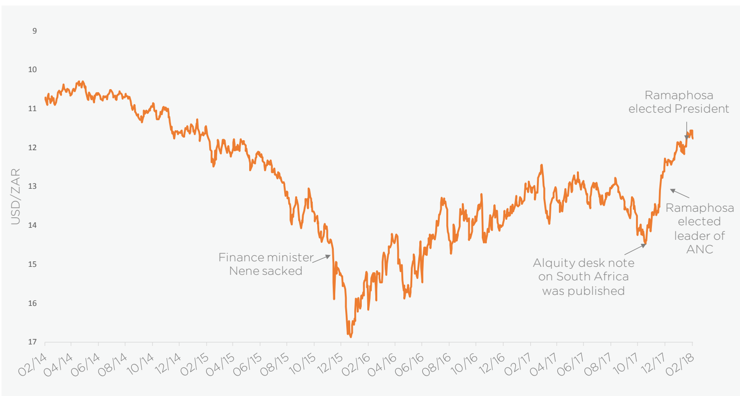
2. Cabinet appointments, which prompted the return of respected candidates to key offices, including Nhlanhla Nene back at the treasury, more than two years after his firing rocked the Rand (see Graph 1), and Pravin Gordon, a former finance minister to manage SOEs, in place of discredited Zuma affiliated ministers.

3. State prosecutors moved against individuals implicated in corruption.

4. The management and governance of sensitive state-owned enterprises were strengthened.

The optimism in South Africa is therefore palpable, the risk of a ratings downgrade has diminished, while inflation risks have begun to dissipate supported by the strong Rand. With this backdrop, monetary policy is expected to become accommodative, boosting growth, unleashing animal spirits and returning the economy to a path of sustainable growth.

Graph 1: The South African currency through the years



Source: Bloomberg

OUR OUTLOOK
FOR EGYPT AND
SOUTH AFRICA

EGYPT: FROM RESTRUCTURING TO GROWTH

An important element in constructing our macroeconomic view, has been to cycle desk based fundamental analysis with focused on the ground research to stress-test our conclusions.

Last month we were again in Egypt to examine our thesis that an IMF backed economic reform program will lead to a V-shaped recovery; an initial period of decline followed by sharp recovery to sustainable economic growth.

We had 20 meetings with different stakeholders including the Central Bank and Ministry of Finance, and sought to understand the impact of the reforms, the economic outlook and whether our belief that the recovery is imminent is in line with developments on the ground.

Our key takeaways are as follows:

• The chronic foreign exchange shortages that dogged the market into 2016 were eliminated through devaluation of the currency and the central bank remains committed to reigning in inflation. To this end, headline inflation declined from its peak of 33% in July 2017 to 17% in January 2018 driven by disciplined monetary policy.

• The majority of announced reforms have been implemented, including the adoption of value-added tax, fuel and electricity subsidy cuts and raising taxes on tobacco. Consequently, the government is on track to achieve a primary surplus in the current fiscal year.

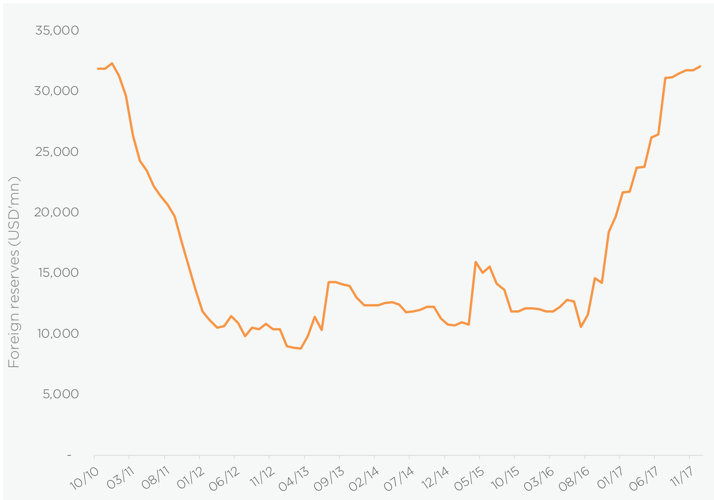
• The final wave of reforms will be structural in nature. In the pipeline is an IPO program to increase private sector participation, an SME law to incentivise and formalise the SME segment and liberalisation of the energy sector.

• Political mismanagement, which came to characterise Egypt over the years, appears to be behind us. The administration of Abdel Fattah el-Sisi understands that the country must live within its means and remains committed to realising the benefits of the reform programme.

• At the micro level, real inflation, which was close to 50% for the average Egyptian consumer, made 2017 a difficult year for consumption and the domestic economy. The best managed companies either resorted to growing exports, rightsizing their products to the new consumption dynamics and/or rationalising their operations.

The decline in volume and footfall has since bottomed out, inflation is falling rapidly, and wages are beginning to catch-up. The pressure on purchasing power is therefore waning.

Graph 2: Egypt - A picture of recovery:



Source: Bloomberg

The government is committed to completing reforms, and all leading indicators are trending into positive territory.

Given the above, we see a positive outlook for the Egyptian economy. The government is committed to completing reforms, and all leading indicators are trending into positive territory. As we predicted, monetary policy became supportive with a 100bps cut last month. Inflation will continue to moderate, the monetary easing cycle will persist, confidence will return together with investments driving consumption and the Egyptian economy will shift from restructuring to growth.

OUR OUTLOOK FOR EGYPT AND SOUTH AFRICA


Temi, our Africa Fund analyst, meeting Oriental Weavers in Cairo

CONCLUDING THOUGHTS:

We see positioning in Egypt and South Africa as similar to that of Brazil 2 years ago, which we were able to effectively monetise in our Latin America fund, having protected much of the downside. Our Alquity Africa fund, with 70% of AUM in Egypt and South Africa, is positioned for cyclical recovery driven by political stability and economic fundamentals, as opposed to the alternatives in other African markets where the growth drivers are more volatile and linked to a less predictable commodity cycle.

At a stock level, the Alquity Africa fund is weighted to companies with sustainable competitive advantage, who provide exposure to domestic sectors in Egypt and South Africa that will benefit from growth over a 3 to 5 year time horizon. We own companies like Bidvest and KAP, industrials who have reinforced their competitive advantages while their competition were constrained, and companies like Edita, Oriental Weavers and MR Price; well managed consumer names who are positioned to grow with consumption.

For more information on the Alquity Africa Fund, please contact:

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All data correct as of March 2018
Sources: Alquity, Bloomberg.

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