In summary

- While we expect growth to remain fairly in line with the government’s 7.6% target, we struggle to see how the economy will unwind, despite the injection of GHS 1.2bn of fresh equity into the banking sector.
- Ghana’s fiscal flexibility remains challenged and thus the country could find itself in a difficult spot in a scenario where a well-flagged bilateral infrastructure agreement with foreign partners do not go through.
- Short term visibility remains hazy as the government continues to grapple with revenue generation in the midst of liquidity challenges within the local financial industry. Investors may thus request for more at the short end of the curve and thus see rise in short term yields. Consequently, we could see further drop in the spread between the long section and short section.
- As we move from clean-up of the banking sector to a similar exercise in other sectors of the financial industry, a lot more risk will crystallize in 2019. We therefore have a less favourable view on credit.
- With a wider deficit projected for 2019, a potential slowdown in portfolio inflows and a weaker reserve position relative to the same period in 2017, we believe the Cedi is likely to weaken against the U.S. Dollar at a sharper rate than it did last year.
- The banking sector crisis will continue to drive equity market sentiment, although we believe the market has overcompensated for this. We opportunistically see good value across multiple sectors in the equity market as price discounting persists.
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Introduction

The key driver of investor sentiment in 2018 was largely linked to changes in the market narrative rather than to decisive shifts in macroeconomic fundamentals. The improving operating environment did little to sustain the optimism from 2017 as investors focused on the headwinds in the financial sector and the potential systemic risk.

External factors such as the Fed rate hikes and geopolitics also stirred up a series of volatility waves which damaged asset class returns as earlier bullish sentiments fizzled into cautionary plays.

How our portfolio performed

Despite the apprehension, our portfolio remained resilient. Our decision to roll down the yield curve to take profit, overweight selected bank deposits, exit overvalued counters and remain neutral on currency helped generate significant alpha in the first half of the year. However, by mid-year, the Fed rate hikes as well as sustained apprehension towards banking stocks forced a change in strategy. We responded by reducing our duration across fixed income and switched from being net sellers to net buyers of equities given the bargains available in the market.

Consequently, we ended the period with an aggregate portfolio return of 18.90% and maintained our zero exposure to the failed banks.

2018: When the bubble burst

So how did we manage to safeguard returns amid the uncertainty within the market?

You will recollect that in our 2018 Investment Outlook – How far can the bull run, we indicated that, while economic growth will remain robust we struggle to see where the investment opportunities lie. This is because, we believed the markets had overcompensated for the positive macro outlook and the bubble was due to burst.

As a result, we anticipated higher yields on the back of quantitative tightening in the developed markets and a wider deficit due to lower than anticipated government revenue. This we envisaged would culminate in the softening of the Cedi. In addition, we indicated that equities were fully valued, and that the market was due for a correction.

While we still await FY2018 deficit figures and the negative return on the Ghana Stock Exchange Composite Index (GSE-CI) was a bit surprising, our key themes largely played out in 2018. The Cedi weakened by 8.4% which was slightly lower than our 9.0% upper limit guidance, while yields picked up to 20% level from 16% in the previous year. The deficit (3.0% of GDP) as at 9M2018 came in lower than expected. However, we maintain our earlier view that the government will miss its 3.7% target (adjusted for rebased series). This is because, while government revenue is front-loaded, expenditure is often back-loaded which results in larger expense figures in the last quarter of the year.

We also anticipated additional bank failures. Our stress test and heat maps of our coverage universe assisted in helping us avoid the challenged banks and kept our portfolio free of any failed financial institution.
In summary, although 2018 was a very difficult year we managed to navigate around the major pitfalls by adhering strictly to our investment philosophy and intelligent investing mantra.

2019: Cloudy with a chance of thunderstorms.
Despite what appears to be the completion of the clean-up exercise in the banking sector, concerns over the impact of a similar exercise in other sectors of the financial industry have kept investors on the fence and left us more cautious in 2019.

We, therefore expect continuous reforms in the financial sector to remain a key driver of investor sentiment in 2019 but unlike 2018, the narrative could weigh heavily on the macro backdrop.

Macros could be stretched
While we expect growth to remain fairly in line with government’s 7.6% target, we struggle to see how the economy will unwind despite the injection of GHS 1.2bn of fresh equity into the banking sector. We believe that the clean-up in the Non-Bank Financial Institution (NBFI) space can lead to additional bailout from the government through issuance of more bonds or special levies. The former could siphon the liquidity from the capital injection and dampen credit growth. The latter will hurt corporate earnings and deepen bearish sentiments on the equity market.

We also envisage lower spending by individuals on the back of destruction of household savings emanating from the liquidity challenges in the NBFI space as well as the asset management industry. We estimate that about half of the GHS 23.6bn in the non-pension asset management space could lead to additional bailout from the government through issuance of more bonds or special levies. The former could siphon the liquidity from the capital injection and dampen credit growth. The latter will hurt corporate earnings and deepen bearish sentiments on the equity market.

Government’s revenue target of GHS 58.9bn for 2019 seems plausible in our opinion. We expect the full impact of the new taxes introduced in mid-2018, increased production from the new hydrocarbon wells as well as favourable global commodity prices to keep the revenue fairly in line with the target. Similarly, we expect total expenditure to remain within target but remain concerned about the GHS 5.3bn foreign financed component of the capital expenditure (CAPEX) contained within the 2019 budget statement.

It appears this expenditure depends on sovereign bilateral arrangements with the country’s foreign partners. Given recent trade war tensions and geopolitics within the Western world, we are concerned about a possible threat to government’s CAPEX plans for 2019. In our opinion, any inability to access foreign funding could jeopardize government’s infrastructure plans and potentially have adverse implications on the estimated 4.2% budget deficit.
Flatter yield curve is imminent

We hold the opinion that the yield curve for 2019 will be less steep than that of 2018 as the government is likely to borrow more at the short end than at the longer end of the curve. This is mainly because the long-term prospect of the economy looks brighter on the back of the pick-up in oil production, a stronger financial system, and expansion of the tax net.

However, short term visibility remains hazy as the government continues to grapple with revenue generation in the midst of liquidity challenges within the local financial industry. Investors may thus request for more at the short end of the curve and thus we may see rise in short term yields.

We believe that yields will drop in the early part of the year before they eventually rise towards the end of 2019. Our argument is premised on the general flight to safety by local pension funds as well as banks. We have observed that banks have maintained 63% of their assets in government securities while the National Pension Regulatory Authority (NPRA) has lifted the cap on Treasury paper from 60% to 70% temporarily to accommodate the safety of pension funds during these uncertain times.

However, we expect the flight to safety of both banks and pension funds to soften as we approach the end of the year. Both sets of investors will have to rebalance their portfolio for regulatory purposes or in the case of banks rebuild their loan book to take advantage of emerging opportunities in the energy sector. Consequently, we see yields dropping in the first half of the year before picking up during the latter stages of the year.

Currency will remain soft

With a wider deficit projected for 2019, a slowdown in portfolio inflows and a weaker reserve position relative to the same period in 2017, we believe the Cedi is likely to weaken against the U.S. Dollar at a sharper rate than it did last year. While we admit that the price outlook for the major export commodities remain positive, we are of the view that production levels will not be enough to neutralize the effect of lower portfolio inflows and a wider deficit. We estimate a depreciation of between 8% and 12%.

As a result, we expect a cross-over of demand from local currency denominated assets to hard currency bonds as investors seek a currency hedge.

Equities offer great bargains, time to cherry pick

Although we hold the view that over the long-term exchange losses from currency weakness negates any returns made through investment in Ghanaian equities, active management and stock picking can yield very favourable results on the GSE.
We are therefore of the opinion that it is time to cherry pick given the attractive valuations on the market. We believe banking stocks, particularly those which met minimum capital through retained earnings have significant upside since they are not exposed to value dilution from the additional equity.

Furthermore, we maintain our view that the market has overcompensated for the banking crisis leaving several banking stocks in oversold territory.

We are also seeing buying opportunities emerging in the consumer and agribusiness sectors as investors buy the rumor and sell the news.

Conclusion: Carry an umbrella

As the headwinds continue to gather and the checklist of concerns in 2019 extends, it is important to note that valuations have fallen sharply to reflect this. In effect, although we maintain our defensive position, we believe the environment in 2019 is ripe for active strategies that focuses on robust bottom-up security selection.

To this effect, we will be net buyers of equities as in our opinion, the market remains awash with bargains. We will do this selectively by consolidating our position in our four selected counters; Enterprise Group, Ecobank Ghana, CAL Bank and MTN Ghana while monitoring opportunities in the agribusiness and fast-moving consumer goods sectors.

For treasuries, hazy short-term visibility, liquidity challenges and portfolio rebalancing from both banks and pension funds is likely to provide us with a less steep curve in a volatile market. Consequently, we do not see much value at the midsection of the yield curve. We, therefore recommend the selling of the belly to buy the wings. This will mitigate portfolio losses if the curve flattens through pickup in short term yields and capture the benefit of flattening yield curve through drop in long-term yields.

Given the current issuers on the market, we prefer to limit our credit exposure to short-term bank deposits primarily for liquidity management.

To summarise, we will remain largely defensive with a strong bias for foreign currency exposure while cautiously and selectively seeking growth opportunities in 2019.

The investment team

ISAAC ADOMAKO BOAMAH, CFA
Chief Investment Officer

DERRICK ASARE MENSAH
Portfolio Manager, Equities

OBED TAWIAH ODENTEH
Portfolio Manager, Fixed Income
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