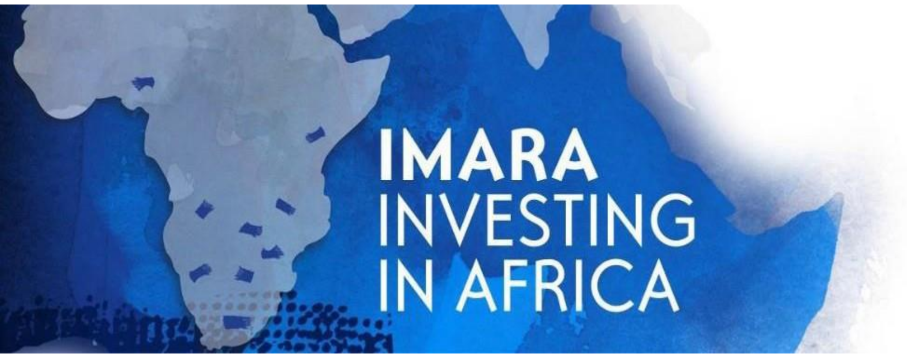

Zimbabwe Investment Notes

Edition Update

Region Zimbabwe

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Interim Update: All Change?

Events over the past days following the military intervention in Zimbabwe have been extraordinary and certainly not predicted. Thankfully there has been no violence; quite the contrary there is jubilation on the streets as the World witnessed last Saturday as tens of thousands of people thronged the streets of Harare, ourselves included. As we write, the President refuses to resign despite being thrown out of his own party and threatened with impeachment. There is no going back though as the country embarks on a new Post Mugabe era. Such a prospect is very exciting. Yet the stock market has been limit down 20% every day since the military intervened. Then again up until a week ago it was up 270% year to date making it the best performing market by far in the World.

It has been rising, not in anticipation of political change, but fear of inflation as a consequence of Government's economic mismanagement that many believed would continue post next year's scheduled elections. A budget deficit of over 10% of GDP could only be financed by money creation as the Reserve Bank created electronic money through the RTGS system. It is the lack of serious economic reform that put the IMF's Lima Agreement on hold with little prospect of any support from the multi-lateral donors going forward. As we have been writing in our last two Strategy Notes, investors have been behaving as though hyperinflation is around the corner despite money growth of 'only' 40%. This has been compounded by foreign investors who have been unable to repatriate their proceeds from the Stock Exchange given the lack of foreign exchange. The only legal mechanism to take their funds out has been to buy Old Mutual shares in Zimbabwe and sell them in South Africa or London. The price of Old Mutual therefore rose to a huge premium pushing the implied exchange rate (OMIR) to over 5.7 to the US dollar (from 1.7 in July) as compared with a black market exchange rate of less than 2 to the US dollar. In our October Strategy Notes we believed that the OMIR had risen too far based at that time on the rate of 3.7 to the US dollar: *"So similar to panic buying of fuel last week, we wonder whether investors are behaving as they did in 2008 by buying equities at any price ignoring any measure of fair value. Of course, if the RBZ continues to create greater quantities of electronic RTGS money in the months ahead then this course of action may prove to be correct. For now we are delighted that our clients have built a comfortable cushion to preserve long term capital whilst the economic and political risks continue to rise. If that cushion should deflate somewhat short term, we will not be concerned as monetary assets remain risky at a time when property is increasingly hard to come by using RTGS money."*

The reason for the market's fall in recent days is entirely understandable if the prospects for a credible economic reform programme, an end to the printing of money and a potential IMF deal – and with it a flood of aid money - have increased following the political changes currently taking place.

In short the substantial cushion that we have built is deflating and is starting to reflect "globally normal" valuations now that the economic and political risks appear to be falling. Time will tell as the weeks progress as to whether these risks have indeed fallen.

We are not panicking about the market's fall at all. Our balanced portfolios were up by 200% odd at the recent peak so even if the market halves we will still end the year with a very respectable profit. Further we are not attempting to be clever by selling our shares now and buying back lower down. Market volumes are far too low to attempt that in practice of course. We are actually looking at individual share prices to ascertain attractive levels under different scenarios. For example, should the Old Mutual Implied Rate fall to 2.5 to the US dollar – still a premium over the black market exchange rate, the market capitalization of Delta at today's price of $1.63 would be $800 million. That would be an attractive and low value if Zimbabwe is indeed at the dawn of a new economic era. At 2.5 the Old Mutual price would fall to just over $6 from $9.35 today. If the Delta share price continues to fall from today's levels then it becomes that much more attractive.

Determining a fair exchange rate is not easy, especially when the future remains uncertain and the timing of an economic reform programme is unclear. We have stated in our various Strategy Notes this year that *"Ultimately we remain strong believers that the end game will be an IMF backed economic reform programme but under a Government that has the will and the strength to implement such a mandate. We very much doubt that this will happen using a bond note currency – to debase a local currency twice in under ten years is hardly a good way to build the trust of the people. Adopting the dollar or the rand or a currency board remain the only workable solutions until trust can be rebuilt. As we have seen elsewhere in Africa, a successful reform programme in this country will do wonders for long term asset values in Zimbabwe."* If we do dollarize again, or convert to the rand, we doubt that it would be at a rate of one to one. Purchasing power parity and the black market would suggest a rate of 2 to 2.5 potentially but all will depend on the timing of reform.

Finally it is interesting that two of the more successful IMF backed reform programmes in recent economic history have occurred under a military backed Government. Chile in the 1980s under General Pinochet and Egypt at the moment under General Sisi. A country needs strong leadership to drive through the necessary and at times unpopular reforms. For Zimbabwe, the change to date comes with huge popular support. The coming weeks will be watched by all with interest. In the meantime the stock market is acting rationally for such a change. We will keep our clients in touch with our thoughts as time progresses.

John Legat
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