

# Global Investment View

Quarter 2, 2018



 **Investec**

Wealth & Investment

## Contents

2

Summary of key thoughts

7

European politics

10

Why good news is not always enough to take equity markets higher

19

Asset allocation positioning

4

New issues since our last meeting

9

Identifying the icebergs

17

SA market view and asset allocation

20

Members of the Global Investment Strategy Committee

## Managing the transition, looking beyond the volatility

The Global Investment View distils the thinking of the Global Investment Strategy Group (the Group) that brings together the insights of Investec Wealth & Investment's professionals in the UK, South Africa, Ireland and Switzerland. The Group meets quarterly to map out our outlook over the following 18 months, setting a risk budget and identifying some of the potential icebergs that lie in the global investor's path.

*By John Haynes*

Head of Research, Investec Wealth & Investment UK and Chairman of the Global Investment Strategy Group

### Commentary by:

John Hayes

John is Head of Research at Investec Wealth & Investment UK, and leads the research team. He is Chairman of the Global Investment Strategy Group and the Asset Allocation Committee and is a member of the Stock Sector Committee. A graduate of Cambridge University and a CFA Charterholder, John has worked for Investec since 2001.



### Special contributions by:

Brian Kantor

Brian is Chief Economist and Strategist at Investec Wealth & Investment SA. He is Professor Emeritus at the University of Cape Town, where has held the positions of Dean of the Faculty of Commerce and Head of the School of Economics.



Paul McKeaveney

Paul is a Senior Portfolio Manager and Chairman of the SA Asset Allocation Committee. He has a degree in Mathematics from the University of Stellenbosch and a First Class Honours degree in Financial Analysis and Portfolio Management from the University of Cape Town. He is a CFA Charter holder.



## In brief

- The world is enjoying synchronised growth in all of its key economic blocks.
- This is supportive for strong (double digit) corporate profit growth.
- The fiscal policy tide is turning stimulatory at the same time that the global growth engine is firing strongly.
- This is most notable in the US, where spending on infrastructure and defence is projected to increase the annual budget deficit from 3% to 6% over the next two years.
- Europe is also looking to push on past the austerity of the last few years.
- However financial market volatility has increased as investors fear a policy mistake.
- At a minimum, diverging global monetary policy will result in increasing currency volatility.
- The Trump risk premium still justified – nonetheless, while a trade war is a concern, ultimately we think this will not turn out to be a big deal. China has the political willpower to outlast the US and relies less upon US demand than most believe.
- Equity valuations are not an impediment.
- All else being equal, we will be looking to take advantage of any weakness to buy assets at reasonable valuations.

## Summary of our key thoughts

We have maintained our position at slightly underweight, or modestly “risk off”. This primarily reflects the near term concern that investors have not fully priced-in the normalisation of monetary policy which in turn is consequent upon the positive economic outlook. Simmering commercial geopolitical tensions can only amplify anticipated market volatility.

We expect that there will be a favourable outcome in both cases – there will be no developed market monetary policy “mistake” and concerns over the US’s suddenly aggressive trade stance will abate (at least initially) as counterparties seek appeasement over war. Our central case remains therefore that, driven by a supportive economic backdrop, owning risk assets will be rewarded relative to owning cash or fixed income over the next 18 months. Further sharp falls in equity markets could see us move quickly to a more positive risk stance.

### Explaining our position

#### Reduced fundamental uncertainty

The world is currently enjoying synchronised growth in all of its key economic blocs (the US, Europe and China-centric emerging markets) for the first time since the Great Financial Crisis (GFC). Synchronised growth is a powerful phenomenon because not only does it imply higher growth in absolute terms, but it is also likely to be resilient. Why? Because in this environment investors and multinational businesses feel local “bumps” less acutely (they will almost certainly be offset by favourable developments elsewhere) and so can make long-term capital investment plans more securely. Higher capital investment results in more jobs and higher wages, a self-sustaining virtuous circle. The resulting expectation is for strong (double digit) global corporate profit growth.

---

## Synchronised growth is a powerful phenomenon because not only does it imply higher growth in absolute terms, but it is also likely to be resilient.

---

### Increased policy uncertainty

Populist success at the ballot boxes has turned the fiscal policy tide to become stimulatory just as the previously stuttering economic growth engine has fired into healthy life. This is true most obviously in the US (the budget of tax cuts and increased Federal spending on infrastructure and defence introduced by President Donald Trump is projected to increase the annual budget deficit from around 3% of GDP to over 6% of GDP over the next two years) but it is also the case in Europe, where German chancellor Angela Merkel appears to support French president Emmanuel Macron in looking to move Eurozone policy beyond its prior austerity.

The inevitable consequence of this picture is that the highly stimulatory, co-ordinated monetary policy regime that has been in place to defeat deflation is no longer needed. Indeed, the risks are rising that fiscal stimulus will increase inflationary pressures to the extent that a rise in inflation forces a more rapid tightening in monetary policy than investors are expecting.

The Federal Reserve, under its new chairman Jerome Powell is already signalling a faster pace of interest rate rises and, judging by the forward interest rate curve, investors are beginning to believe the rate trajectory implied by the “dot plots”.

### More volatility all round

This change in mind-set explained the equity market jitters in February (before President Trump turned to target China with trade tariffs) but, even absent heightened trade tensions (see below) we are still cautious that there may be a “policy mistake” to come. Why? Firstly, we are expecting more visible inflation pressures in the US, and secondly, because the interaction of US monetary policy with the rest of the world cannot be fully understood or, therefore, discounted. With the US so far ahead of others in the post GFC recovery, monetary policy settings between the developed market blocs will increasingly diverge as they are reset to reflect locally appropriate, rather than global conditions. At the minimum an increase in exchange rate volatility must be expected as this process unfurls – most likely equity, interest rate AND exchange rate volatility will increase.

---

# The Federal Reserve, under its new chairman Jerome Powell is already signalling a faster pace of interest rate rises and, judging by the forward interest rate curve, investors are beginning to believe the rate trajectory implied by the “dot plots”.

---

## Ultimately the transition will be resolved positively

When will “transition risks” be behind us? Another way of looking at the current situation is to note that there is a contradiction between low real interest rates and (now) universal expectations of strong economic and profit growth. We think this will be resolved not by lower growth expectations, but by a rise in real (and nominal) interest rates. Given the Federal Reserve’s control of short term interest rates and also (to a degree) of medium term rates (the pace of rolling-off quantitative easing can be varied), the process should not become disorderly and threaten growth. The 3% nominal level on US 10-year bonds is important psychologically to many investors, so until US 10-year Treasury yields have moved decisively through that level, we should be on high alert for volatility storms.

## Unless growth is Trumped by mismanaged commercial geopolitics

A trade war between the US and China is one of the few dog whistles that would be loud enough to negatively reset the animal spirits among multinational corporations. In spite of (at the time of writing) the imposition of some US\$50bn of tariffs on Chinese imports by the US, logic suggests that this is still very unlikely. Not only is China in a strong financial and economic position to push back, but it relies less upon US demand than many believe. Ultimately, in a battle of wills, there is little doubt that China has the political staying power to outlast a reckless US administration. Not only is the Trump administration’s support highly questionable at home, but further moves may rebound upon them internationally. In short, the US may not spark a worldwide trade war – but only a commercial struggle that unites the rest of the world against it. Knowing this, the most rational interpretation of the move appears to be that it is a high-risk clarion call to Trump’s electoral base ahead of the mid-term elections in November.

## A Trump risk premium is justified for the medium term

As we write this, China’s measured response gives encouragement that, this time at least, a negotiated agreement addressing the specific issues targeted by the tariffs may be forthcoming. However a turn to a more aggressive trade stance feared after the departures of Gary Cohen and Rex Tillerson is now evident. America First is now not just a narrative, but explicit in policy. The implications of the world’s most powerful economy pursuing only in its own interests are not positive. Since the impact of US policy on friend or foe are unpredictable, global equities in the Trump era deserve a higher risk premium than in more ordinary times.

## Equity market valuations are not an impediment

Our basis for equity valuation uses time-tested measures relating current dividends to current medium-term risk-free rates. They indicate that equities are “fair value” in the US and cheap elsewhere. For equities to become definitively expensive, much lower dividends or materially higher bond yields would be needed. Since we expect healthily growing dividends over the forecast period and only modestly higher bond (discount) rates, we view the valuation backdrop (ex any Trump discount) as supportive.

## Blue sky potential is diminishing, but cannot be ruled out

A risk appetite capitulation (melt up) could still occur. The drivers of such a move would be earnings growth combined with increased confidence that the economic cycle will be extended, compounded by aggressive corporate behaviour (in the form of merger and acquisition activity). An explicit trade accommodation with China, which is also likely to confound the sceptics and deliver solid growth over the forecast period, would certainly help.

## In summary...

The economic picture is strong and there will be no policy mistake (either monetary or global commercial / political) to derail it. Valuations are not an impediment, however we are still moving through a period of heightened policy transition risk. This is occurring both in global monetary policy and in global commercial policy (Brexit / US-China / US-Nafta / China-SE Asia). We cannot predict the turns in the trade narrative, but even excluding this additional factor, we continue to expect heightened volatility until it is clear that investors have discounted a more hawkish Federal Reserve. All else being equal, we will be looking to take advantage of any weakness.

# New issues since the last meeting (positive or negative impact in brackets)

## China / US trade tensions (negative)

Investors are right to be concerned about this issue, which has now come to the fore as a result of the imposition of tariffs (at the time of writing) on approximately US\$50bn of Chinese imports into the US. Why? Simply put, because it could rewrite the roadmap, replacing the prospect of healthy synchronised global growth with a real possibility of synchronised recession. Worse still, a trade war would marry growth recession with higher inflation, as alternative, more expensive, supply chains are built and tariff costs passed on.

However we don't think that Trump's tariffs will turn into a trade war, for the following reasons:

### The math(s) don't work

Global trade intensity (exports + imports) is 40% of GDP, so threatening this threatens all of the US's partners. Furthermore, a US trade deficit of \$375Bn, which is under 2% of GDP, is a revenue deficit. The profit deficit is much smaller, since much of what the US imports from China is lower value-added (margin) than what China imports from the US.

### It's hard to implement

Simply transferring the production to a third party or country (say, Vietnam) will circumvent them. According to one report, making iPhones in Vietnam (but supplied by the same Chinese-owned "outsourcer") would shrink the China / US deficit by around US\$50bn.

## The US would lose

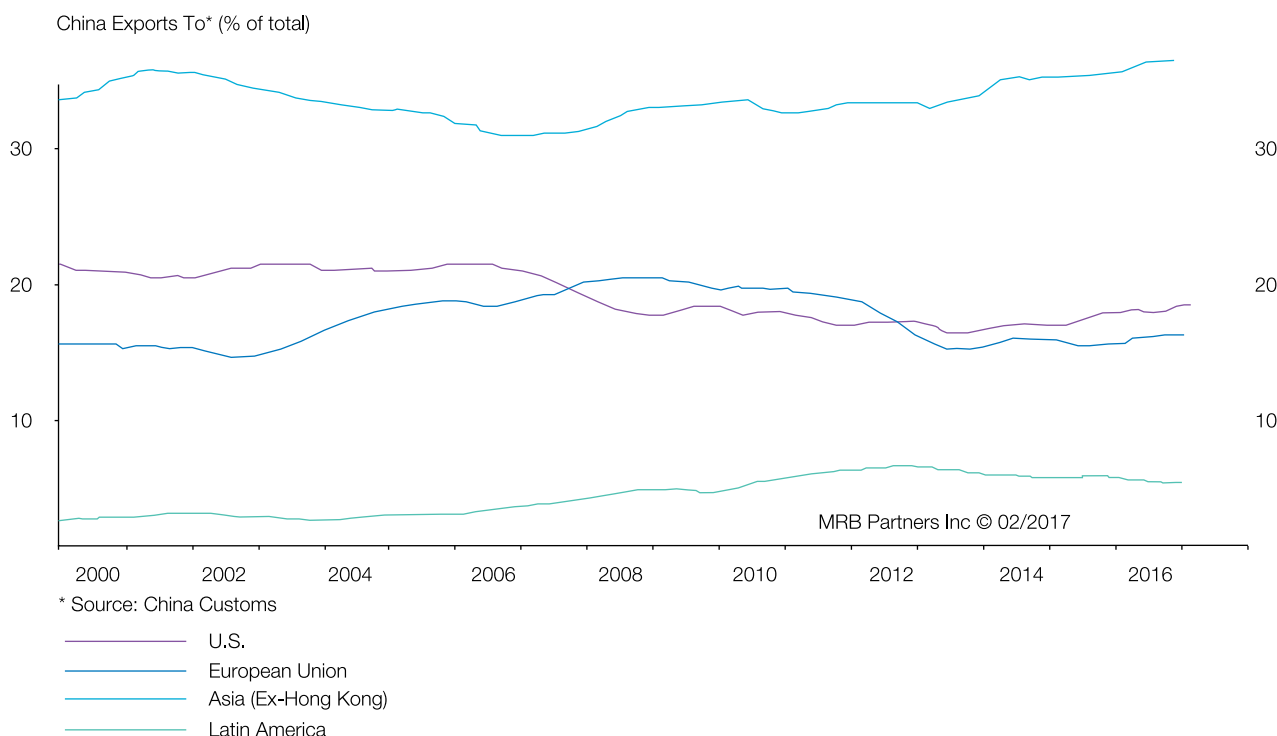
China can afford a trade war with the US. Chinese exports to the US account for approximately 4% of GDP, while the trade surplus with the US (both trade and services) is around 3% of GDP. Since China is growing at around 6% (real) per annum, excluding multiplier effects, China would "lose" only half a year's growth if the US trade deficit with China disappeared altogether.

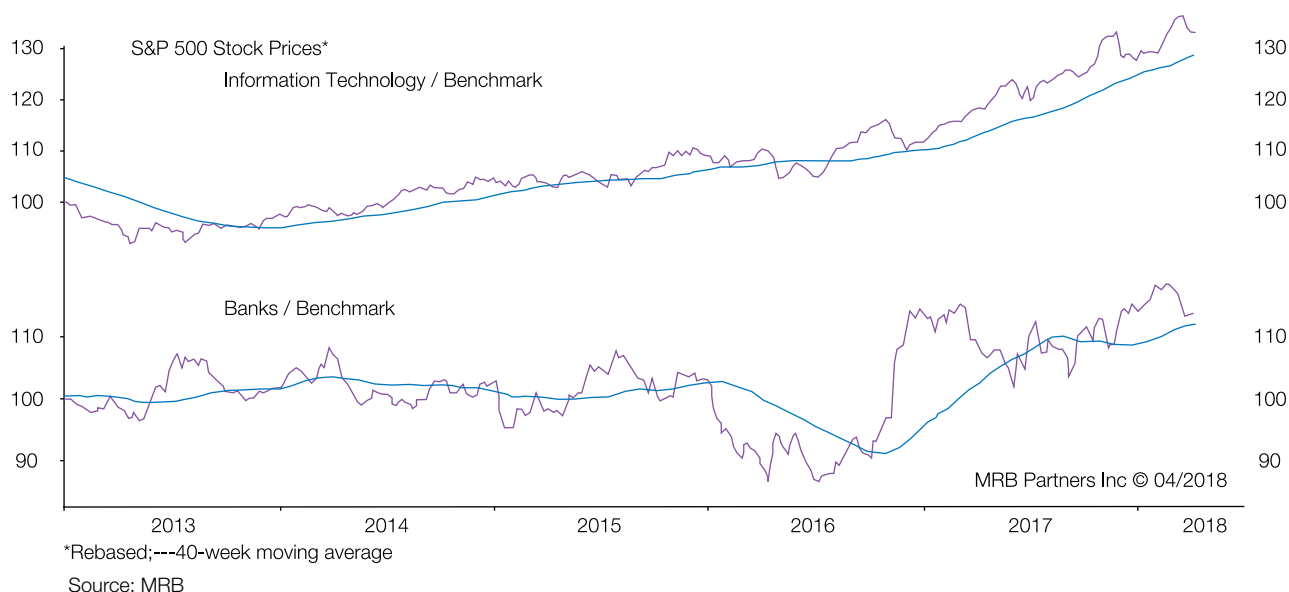
The US deficit with China is approximately 2% of US GDP, so excluding the negative multiplier effects (import price impacts of paying higher prices for "tariff laden" or alternatively sourced goods), the US would "gain" two thirds of a year's growth if the deficit was magically eliminated.

However ...

... thereafter the US would then be excluded from the world's most rapidly growing and highest impact (impact = growth times size) consumer economy – China is the world's second largest economy and consumption is growing at around 10% per annum.

Furthermore, China would (quite quickly) reconfigure its supply chain, increasing its trade with its other partners. The US today represents around 20% of China's exports, a far smaller share than Asia (40%), and in line with Europe (20%), both of whom are hungry to step into any breach (see chart below).





**Another way of looking at the current situation is to note that there is a contradiction between low real interest rates and (now) universal expectations of strong economic and profit growth. We think this will be resolved not by lower growth expectations, but by a rise in real (and nominal) interest rates.**

#### The US would also lose politically

The poor “math” of threatening China is not lost on US businesses who will put pressure on Trump. The Chinese political leadership has a strong mandate (however harshly it is enforced) and has the resources to “take pain” for a period far longer than a US presidential term, if it has to.

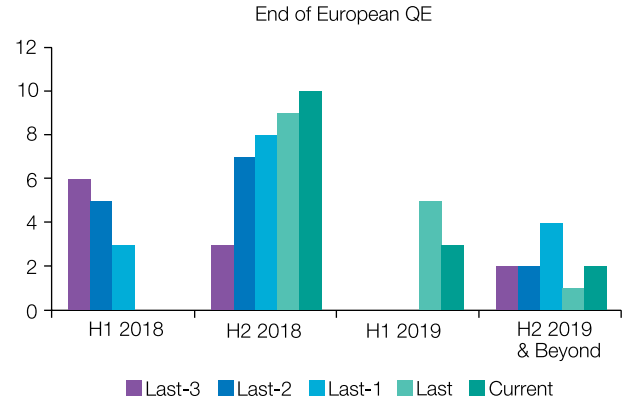
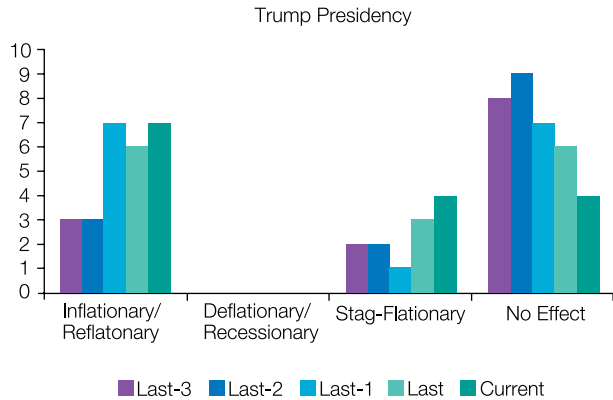
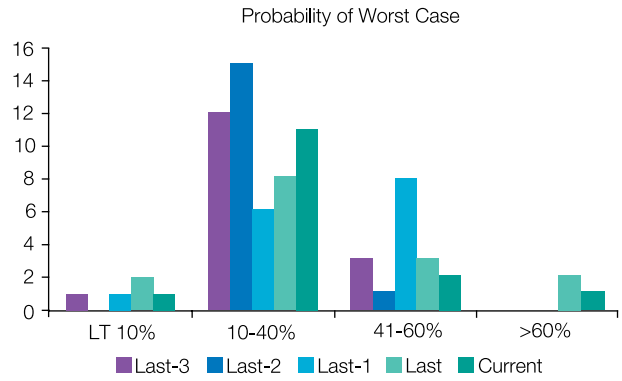
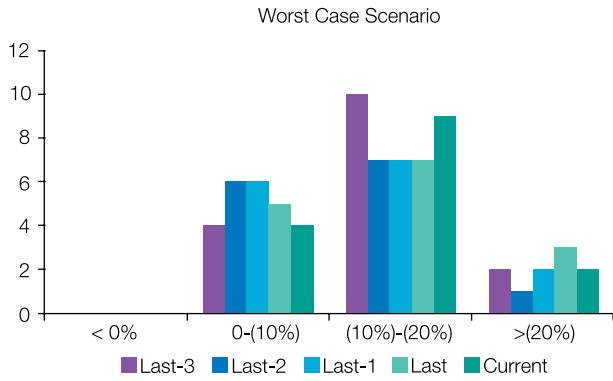
A popular patriotic upsurge in China would undoubtedly result if the US provokes China too strongly. Buyers’ strikes are likely to be far more pronounced in China than in the US (abandon your Nike sneakers and iPhone anyone?).

#### So what’s next?

The only rational interpretation of this move by Trump is that it is intended to build popular support ahead of the mid-term elections. China’s measured reaction is a positive, and appears to recognise these politics. China has stated publicly that it is willing to discuss all issues with the US and is likely to move to mobilise support from Europe and Asia behind the scenes. Similarly, it will lobby the US business community to bring pressure to bear, hoping to lower the temperature and re-establish a co-operative dialogue.

Provided the US does not ratchet up the heat further, no significant escalation beyond this is, we believe, likely.

In conclusion, we do not think this issue will escalate to cause material damage to the global economic growth picture. The real winner, longer term, will be China, which looks like a beacon of stability in an uncertain world.



Source: Investec Wealth & Investment

**Not only is China in a strong financial and economic position to push back, but it relies less upon US demand than many believe. Ultimately, in a battle of wills, there is little doubt that China has the political staying power to outlast a reckless US administration.**

## European politics

### The Italian election was inconclusive (neutral to negative)

Italian politics saw a populist parties win a majority of the votes, but, as expected, no single party win a majority. Italy is likely to front run the anticipated relaxation in Eurozone fiscal policy.

### The German post-election political uncertainty has been resolved (positive)

After an inconclusive election and a three-month hiatus, Angela Merkel has closed a coalition deal.

## Global

### Russian tensions (negative)

President Vladimir Putin was re-elected by a landslide, but the diplomatic atmosphere increasingly resembles the cold war as Europe reacts strongly to the (denied) nerve agent attack on a UK resident.

### Tensions with North Korea subside further (positive)

Trump has agreed to meet with North Korean President Kim Jong-Un. Tensions hit a peak at the end of November when North Korea tested a long range ICBM that could reach the US. Since then, North Korea has opened dialogue with the south, using attendance at the winter Olympics in South Korea as a platform. Investment markets continue to take the view that the likelihood of a war between North Korea and the West is very low.

## Other comments and clarifications

### Global growth expectations

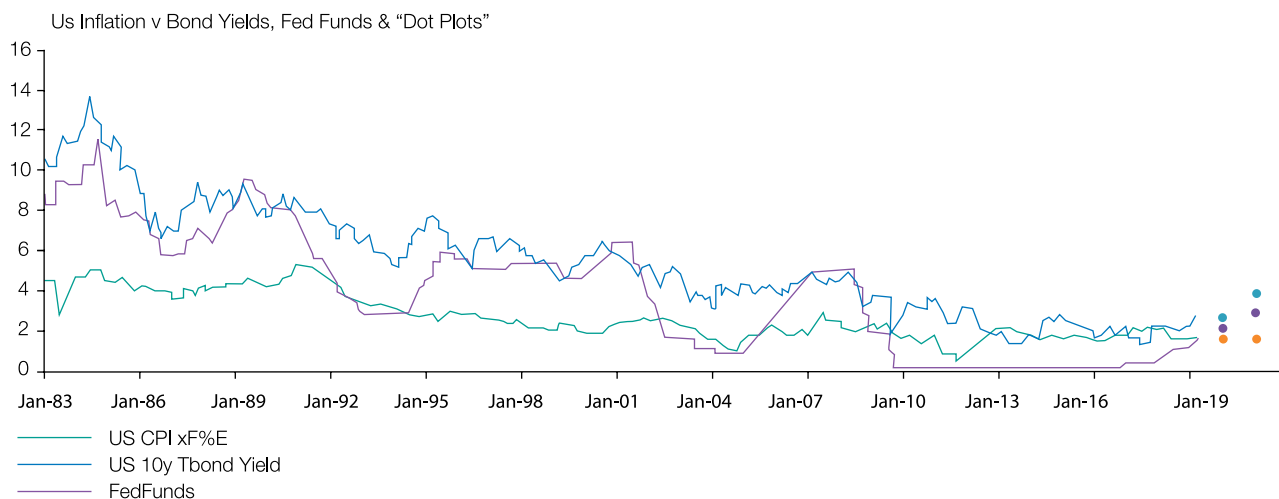
Estimates for global GDP growth rates continue to improve with the consensus expecting (another) year of just under 4% in 2018 – a level projected to be sustained through 2019 and 2020. The growth improvement is driven by emerging markets, which should grow at close to 6%, over two-and-a-half times faster than developed markets (2.2%). This supports double digit corporate earnings growth forecasts next year – these are evenly spread between developed and emerging markets.

### Inflation

Global inflation over the next three years is not forecast to exceed 3% as deflationary global supply-side forces (technology-driven) are expected to balance the positive impact on prices from higher demand. This assumption is clearly an important pre-condition for bond yields to remain anchored in ranges that do not threaten equity valuations.

### US 10-year Treasury yield expectations

The GISG agrees with consensus forecasts of 3% to 3.5% for US 10-year yields in 12 months' time, which would not threaten equity valuations in a growing earnings environment. Re-establishing the historical premium versus inflation could see a ceiling of 4% - a level that would threaten growth.

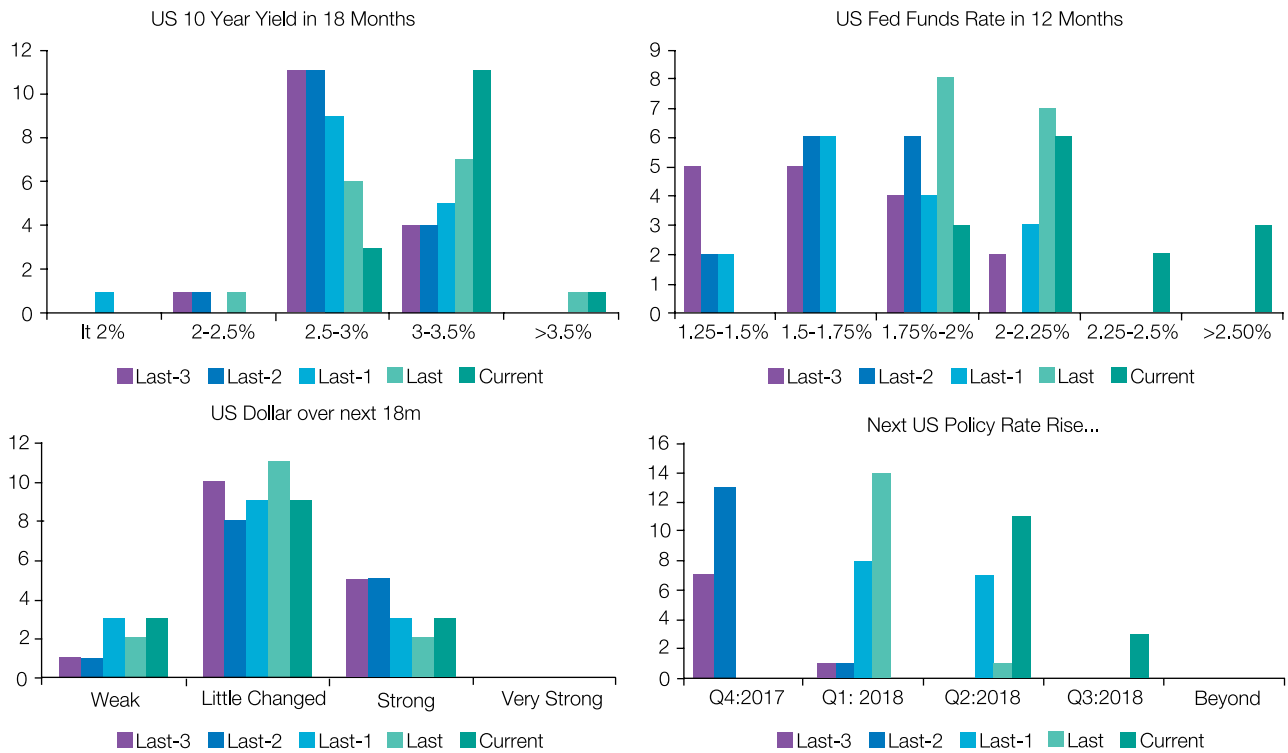


Source: Investec Wealth & Investment



## US dollar

The GISG consensus (and that of the broader market, we believe) expects the dollar to be broadly unchanged on a trade-weighted basis over the coming 12 months.



Source: Investec Wealth & Investment

**The only rational interpretation of this move by Trump is that it is intended to build popular support ahead of the mid-term elections. China's measured reaction is a positive, and appears to recognise these politics.**

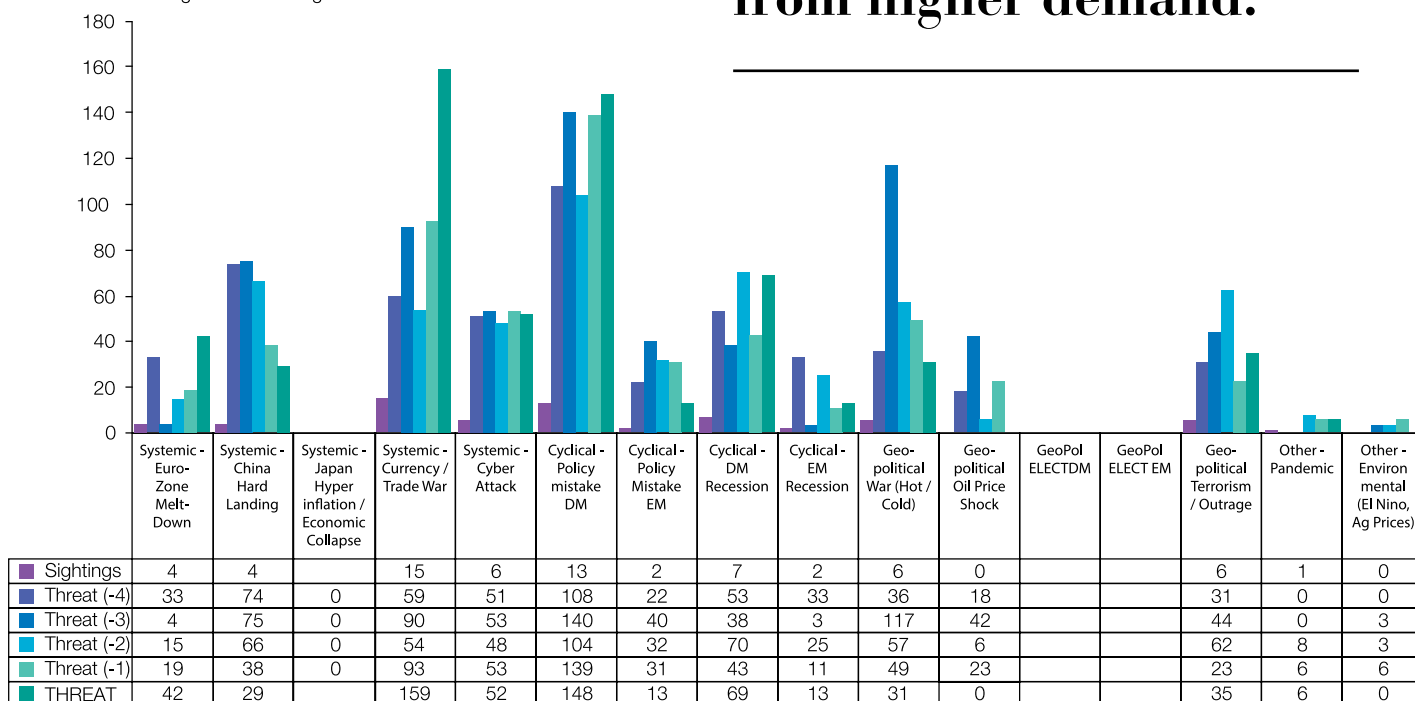
## Identifying the icebergs – Systemic risks less pressing than cyclical risks

It is notable that the icebergs identified previously have receded over time, to occupy very little of the GISG's debating time. Systemic risks have receded to be less pressing than cyclical risks (but see above under "New issues" for comment on trade war risk).

As in our previous Global Investment View, the top risk factor remains what we call "developed market cyclical policy risk". In other words, a badly executed withdrawal of monetary policy stimulus, probably catalysed by an over-reaction to inflation data.

**Global inflation over the next three years is not forecast to exceed 3% as deflationary global supply-side forces (technology-driven) are expected to balance the positive impact on prices from higher demand.**

Iceberg Threat Ranking - March 2018



Source: Investec Wealth & Investment

### European systemic risk – low and receding further:

- Financial system recapitalisation is complete.
- Electoral challenges are largely behind the Eurozone.
- Cyclical risk is also low.
- The key risk factor is monetary policy normalisation / QE tapering ahead.

### China – systemic risk low, cyclical risk increasing

#### Systemic factors

- Integration with the global economy has passed the first major test (a dirty float of the yuan).
- Economic rebalancing is progressing well.
- Debt accumulation has peaked. Furthermore, although debt levels are high, debt is self-funded.
- Politics is very stable.

### Cyclical issues

- Cyclical risk is more debatable, but the last sharp slow-down was in 2015/6 – there is no reason to expect another self-engineered broad-based retrenchment in the near term.
- However, it is likely that heat in the housing market may be cooled (probably through macro-prudential measures) and outside observers are always prone to "shoot first and ask questions later" where China is concerned.

### 2018 scheduled political calendar - low risk

- US mid-term elections – a low risk event from the financial markets' perspective.

### Geopolitics

- Key conflict flashpoints – temperatures have been lowered.
- Donald Trump – an unknowable source of either positive or negative surprises!

# Why good news is not always enough to take equity markets higher – equity markets in the first quarter of 2018

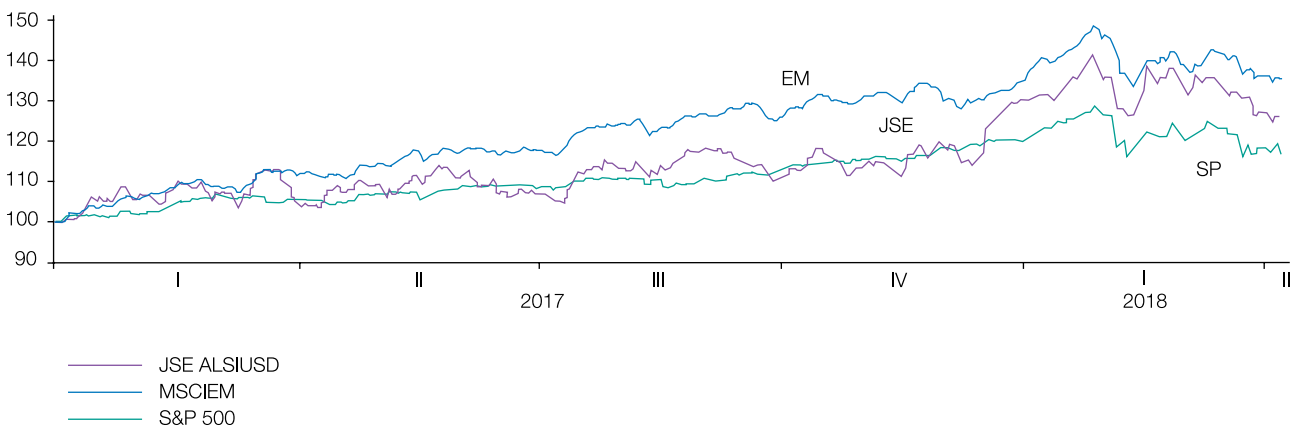
By Brian Kantor, chief strategist and economist, Investec Wealth & Investment

Good SA news was a mixed blessing for the JSE in 2017 and the start of 2018. The JSE will benefit from a stronger global economy

After a very strong move higher in 2017, global equity markets reversed course in January (see figure 1). The JSE (in US dollar terms), the MSCI Emerging Market Index and the S&P 500 are all down about 8% since 30 January (see figure 2). The JSE All Share Index in rands is also down 8% since then. The indices moved lower in March, with the range of day-to-day and even intraday moves in the key equity indices widening sharply, after an extended period of abnormally low day-to-day moves in both directions. Increased volatility and lower valuations usually coincide, and this has been the case recently.

Our asset allocations were set earlier in anticipation of an increase in volatility – that is in expectation of higher levels of equity risk. We had reduced our exposure to equities from a neutral 60% in balanced global portfolios to about 55% in December 2017.

Figure 1: Equity markets in 2017-18. JSE, MSCI EM and the S&P 500, all in US dollars (January 2017=100)

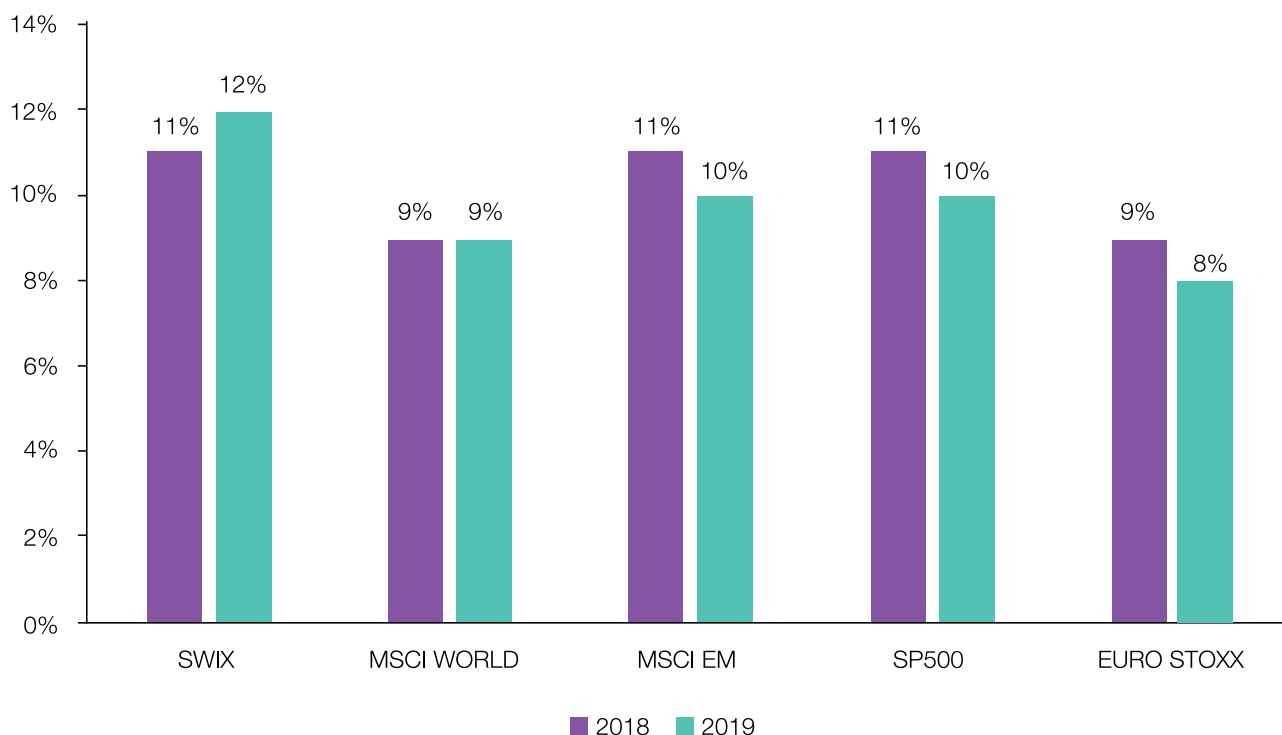


Source: Bloomberg and Investec Wealth & Investment

What then surprised the equity markets in March? Equity markets for much of 2017 and the start of 2018 had raised the value (perhaps complacently) of the average emerging market company: by over 40% in US dollar terms in the 13 months to the end of January. The JSE, in US dollars, was up by 36% over the same period and the S&P 500 by 26%.

Interrogating the usual suspects may not provide convenient explanations. The earnings outlook has not deteriorated. Indeed, the prospects for operating profits and earnings have remained promising as we show in figure 2. These earnings forecasts depend on the outlook for global growth; the remains well synchronised.

Figure 2: Consensus earnings growth



Source: Bloomberg and Investec Wealth & Investment

The pace of the economic recovery, while satisfactory by the undemanding standards of the recent past, may well have reached something of a peak. The danger of any recession in the US nevertheless remains a remote one. And a slower pace of growth has a helpful aspect: it reduces the danger of the Fed pushing interest rates too high too soon, long a concern of the market place.

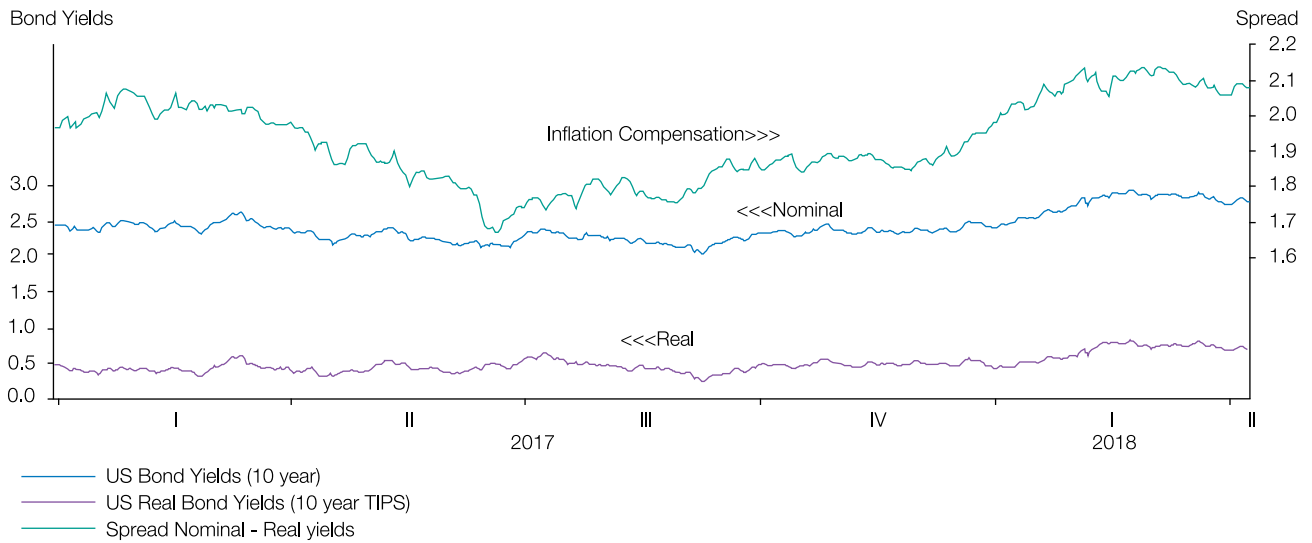
That concern might have been reflected in higher long term interest rates, with which future earnings or dividends are discounted. But, helpfully, these interest rates have remained at what must be regarded as abnormally low levels. That output growth rates in the US and in employment, while still very satisfactory, may be slowing should be helpful in restraining key long term bond yields in the US. The gap between long and shorter term bond yields has narrowed recently, a further sign that the bond market has moderated its view on the outlook for short-term rates. Short rates are still expected to rise this year – but may do so for a less extended period of time.

More helpful for investors in bonds, and by implication also for investors in equities, for which the expected return from bonds are the ultimate competition, is that not only have long rates stabilised

because expectations of inflation have remained subdued. The difference between the yield on a vanilla bond and that of an inflation-protected alternative is the compensation investors receive for assuming inflation risks. This extra reward for taking on risk increased in 2017, but has remained close to 2% for 10-year US Treasury bonds.

Of further importance is that real inflation-linked yields, while also somewhat higher than a year ago, remain low by the standards of history. These persistently low real yields indicate that the global economy remains characterised by an abundance of savings and a relatively slow rate of capital expenditure. Ours remains a fundamentally low-return world in which low (expected) rates of returns from equities should perhaps be good enough to justify exposure to them. This is especially the case when valuations are based upon forward earnings and dividends. Current long-term interest rates appear as at worst fair and with recent developments in the markets – lower values and unchanged earnings growth – undervalued (see figure 3).

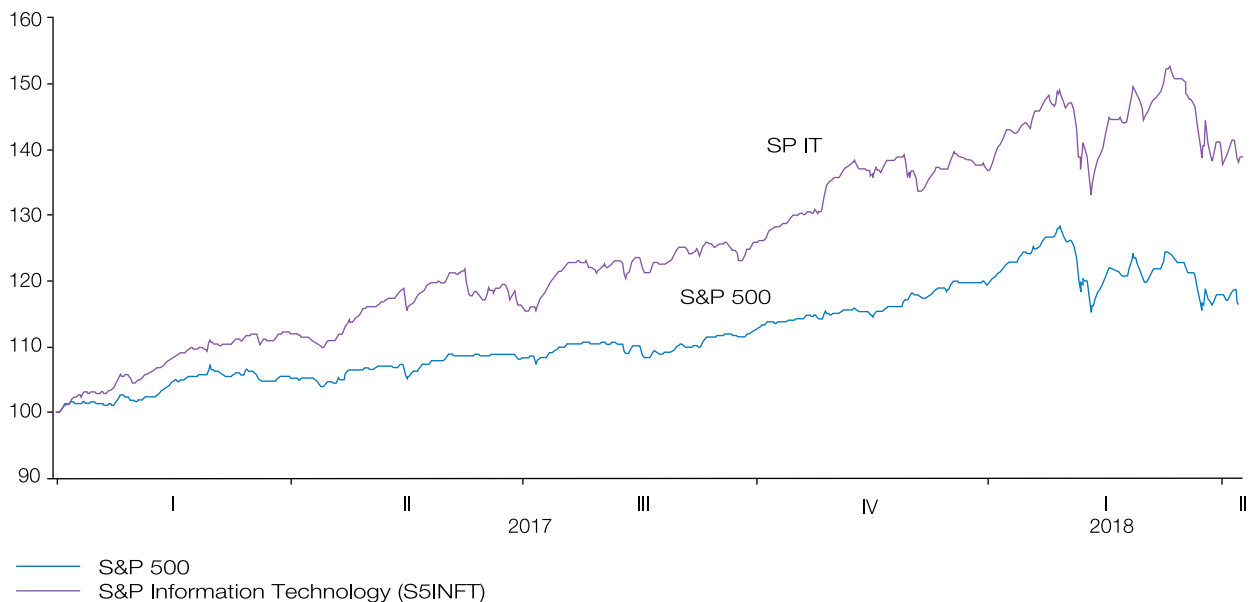
Figure 3: US long-term interest rates (10 year Treasury bond yields) and inflation compensation in the US



Source: Bloomberg and Investec Wealth & Investment

So then why the worries that have sent volatilities higher and share prices lower? One word might suffice: Trump. The US president has threatened trade wars, whose likelihood and impact on the global economy remains highly uncertain – enough to encourage volatility. Furthermore, the outlook for the tech sector that has been such a consistent front runner for the S&P 500 has also become clouded – not least by Trump’s hostility to Amazon while Facebook faces up to its own political challenges in managing big data.

Figure 4: S&P 500 and the IT sector of the S&P 500 (2017=100)



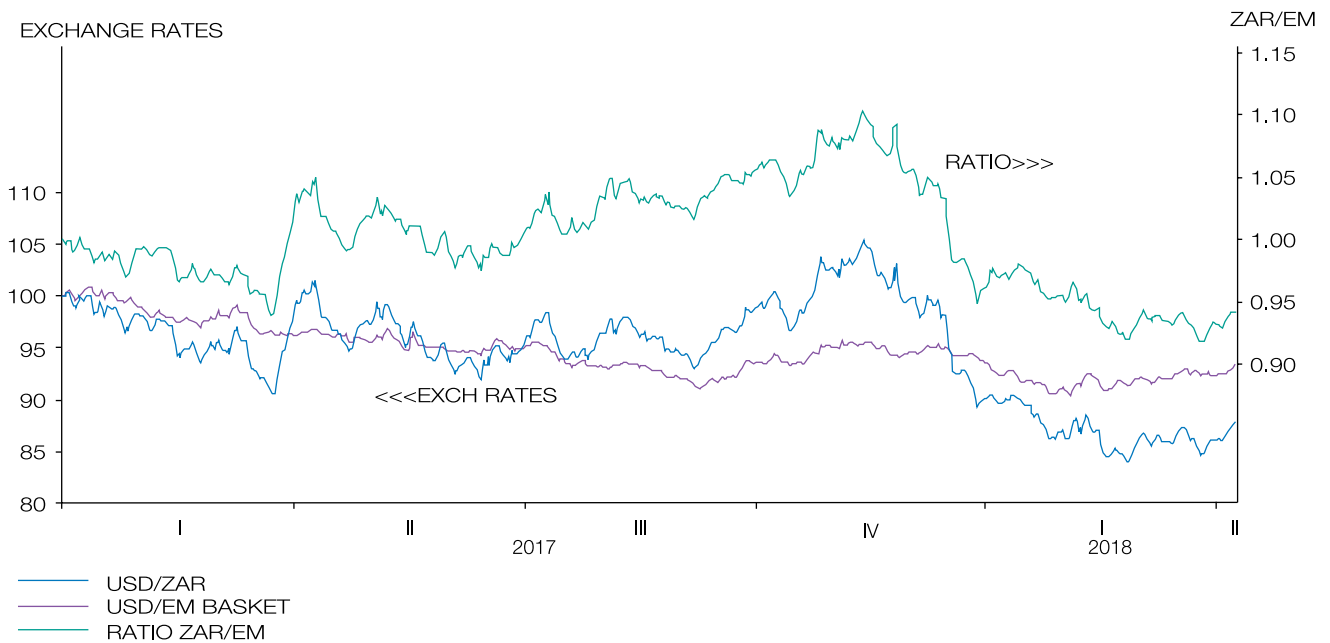
Source: Bloomberg and Investec Wealth & Investment

What can take the market ahead is less Trump uncertainty, less damage from trade wars and political intervention with it. All are very possible and able to provide upside surprises for the markets, but it is not exactly a riskless scenario given an unpredictable US president.

The JSE remains very much a component of global markets and global forces and is particularly vulnerable to the forces that drive emerging market equities and bonds. Naspers, a large (20%) component of the JSE, also take its cue from the direction taken by global tech firms. But SA-specific events will also affect the exchange value of the rand as it will the outlook for inflation and interest rates, though what now happens in SA may well have become less influential in the markets, given more stable political circumstances.

South African specific events were particularly important for SA financial markets in late 2017. These influences are well represented by the performance of the rand and SA bonds relative to emerging market peers. As we show in figure 5, the rand has gained both absolutely against the US dollar since late November (by some 15%) but has also improved by about the same proportions against a basket of its peers- indicating clearly the specific SA forces at work.

Figure 5: The US dollar vs the rand and an emerging market currency basket (2017- 2018)

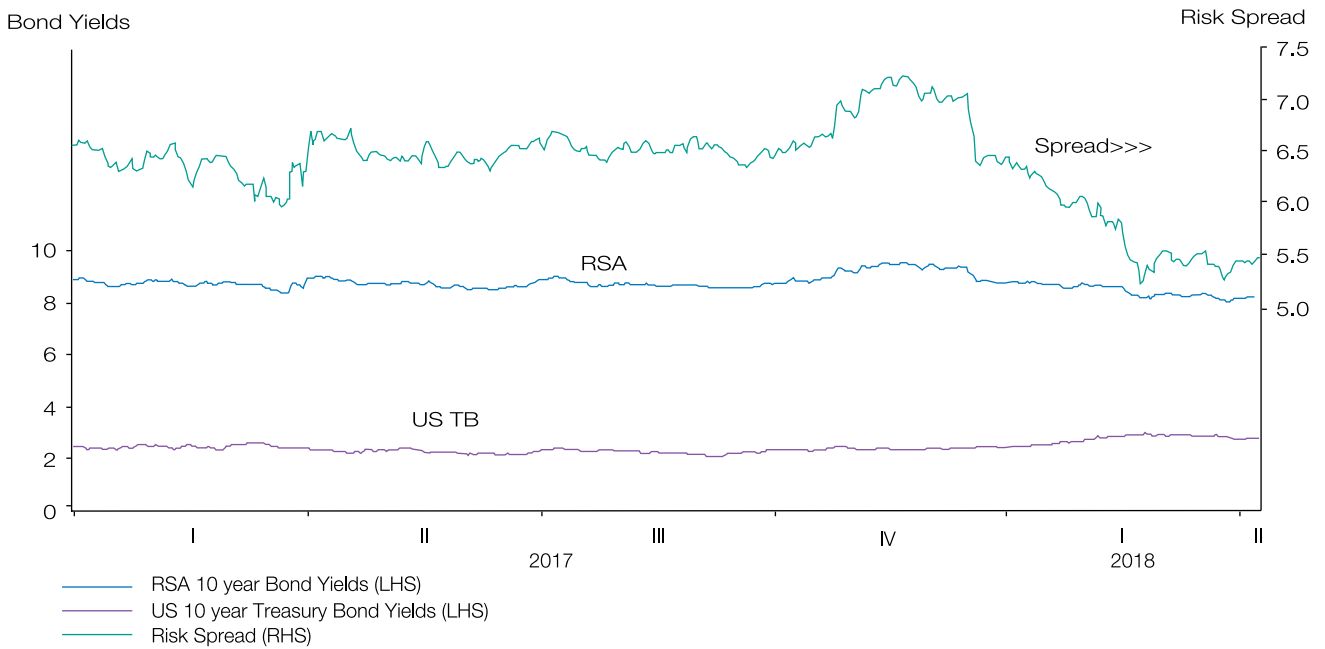


Source: Bloomberg and Investec Wealth & Investment

This ratio of the rand to emerging market exchange rates has since stabilised to a much higher degree – taking its direction from the dollar and other emerging market currencies, as may also be seen in the rand/ emerging market ratio shown in the right hand scale of figure 5 above. The behaviour of the US dollar versus emerging market currencies may become the essential force moving the rand stronger or weaker. The outlook for growth in emerging market economies and the earnings of emerging market companies will be crucial in attracting portfolio flows that will drive emerging market exchange rates – including the rand. This outlook is as indicated a promising one, also given undemanding current values and comparably favourable earnings forecasts. The earnings outlook for the JSE is as favourable as the emerging market average.

The good news to date about the political state has been reflected by significantly smaller risk spreads provided by the difference in RSA and USA bond yields and by the spread between nominal bond yields and their inflation-protected alternatives. The risk spread is by implication the annual rate at which the rand is expected to weaken against the US dollar. The inflation expected in SA over the next 10 years has declined consistently with the improved outlook for the rand.

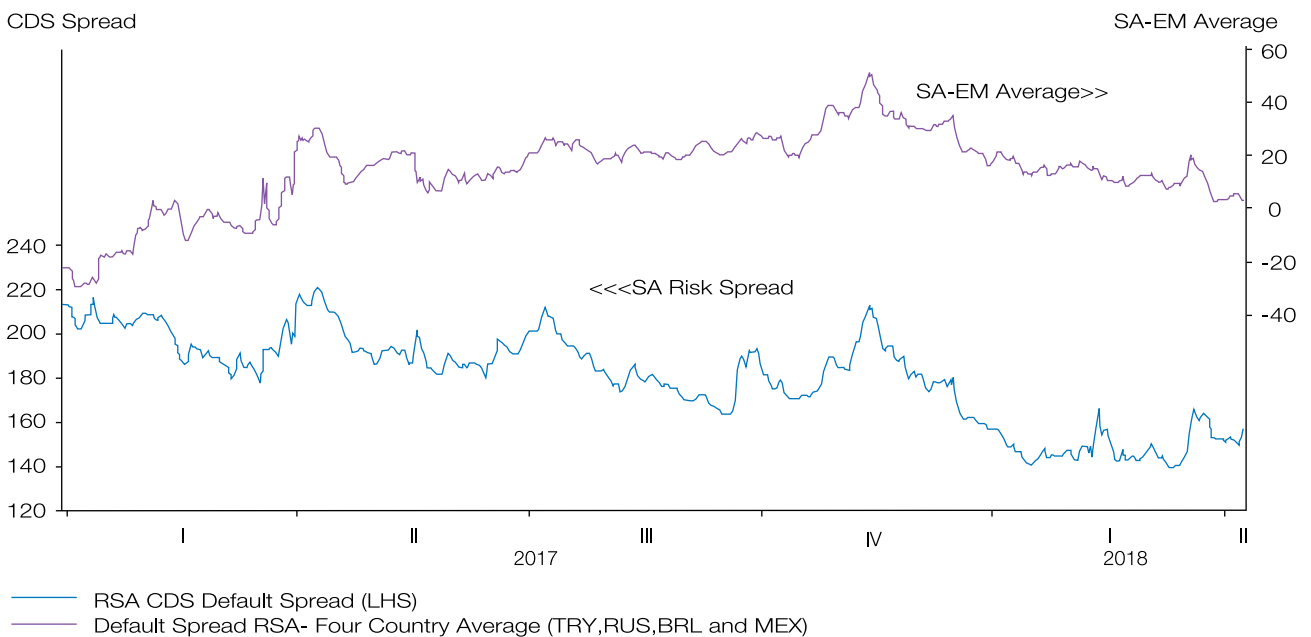
Figure 6: Long term interest rates, in SA and the US, and yield spread (2017-2018)



Source: Bloomberg and Investec Wealth & Investment

The SA sovereign risk premium – represented by the difference between an RSA dollar-denominated bond and its US Treasury bond equivalent has also declined sharply – as has the difference between the cost of insuring a RSA dollar bond and that of its emerging market peers. RSA dollar-denominated debt is now trading as investment grade.

Figure 7: RSA sovereign risk compared to emerging market average sovereign risk



Source: Bloomberg and Investec Wealth & Investment

The good political news about SA may well be in the market. It will take surprisingly good economic news out of SA, unexpectedly stronger growth, without more inflation supported by a stable rand, to drive long term interest rates and inflationary expectations still lower. Less inflation has helped domestic spending to gain some momentum. The decision to cut short-term interest rates will help further to encourage household spending. The money market however does not expect the Reserve Bank to lower interest rates further over the next 12 months. There is however ample room for interest and inflation rates to surprise on the downside – as well as for economic activity to surprise on the upside. As we have shown above, the earnings outlook for the JSE, represented by the SWIX Index, is as promising as the emerging market average.

As will have been noticed, rand strength for SA reasons is a mixed blessing for the JSE as a whole. It is very good news for the SA economy plays. However it harms the rand value of the global economic plays that account for about half of the JSE All Share Index. The SA plays (retailers and banks for example) have become much more valuable in rands since November while the global plays have lost a significant degree of their rand value and the JSE in rands has moved mostly sideways.

Figure 8; Performance of the JSE and its components in 2017-2018: SA plays vs global consumer plays (2017=100)



Source: Bloomberg and Investec Wealth & Investment

The ultimate SA play – RSA bonds – have proved an outstanding outperformer in the three months to March. The All Bond Index returned over 8% over the quarter while the All Share Index gave a negative total return of 6%.

The most favourable scenario for the JSE as a whole is rand strength derived from global forces. It can drive the US dollar value of the global plays listed on the JSE high enough to more than offset rand strength. Rand strength (whatever the cause) always helps the performance of the SA economy plays. A strong global economy means higher metal prices and can add significantly to the value of resource companies listed on the JSE.

The improved prospects for an upside surprise in the form of a stable rand and strength in emerging market markets generally has encouraged our SA asset allocation committee to raise our exposure to risk and equities, particularly given undemanding current valuations. Our previous allocation was risk neutral – we now recommend a modest 5% overweight exposure to equities in balanced SA portfolios.



SA FTSE/JSE Performance, Valuations & EPS growth

	Price performance (%)				Dividend yield (%)			DPS growth (%)		P/E ratio (X)			EPS growth (%)	
	1 mth	3 mth	6 mth	2018 YTD	Dec 17	Current	12m Fwd	2018E	2019E	Dec 17	Current	12m Fwd	2018E	2019E
<b>ALL SHARE</b>	-1.0	-0.1	3.7	-2.4	2.8	3.0	3.2	3.9	6.7	21.2	19.3	14.9	12.2	10.4
<b>SA RESOURCES</b>	-4.3	-0.4	-0.7	-4.8	3.1	3.9	4.0	1.9	-1.5	14.9	14.0	11.5	2.4	-3.3
Oil & Gas	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Basic Materials	-4.3	-0.4	-0.7	-4.8	3.1	4.0	4.0	1.9	-1.5	14.9	14.0	11.5	2.4	-3.3
<b>SA FINANCIAL &amp; INDUSTRIAL</b>	-0.2	-0.1	4.9	-1.8	2.7	2.8	3.0	4.8	10.1	23.9	21.3	16.1	17.0	16.3
<b>SA INDUSTRIALS</b>	-0.4	-0.1	1.3	-2.6	2.0	2.1	2.3	3.8	10.1	28.5	24.9	18.5	23.9	19.9
Industrials	-6.7	-1.4	12.3	-1.8	2.4	2.5	3.5	19.8	-2.3	17.7	17.3	12.8	19.1	15.7
Consumer Goods	-2.6	-9.2	-20.7	-7.5	2.9	3.1	4.0	6.6	10.7	19.2	12.8	13.2	12.5	11.5
Health Care	-2.0	0.0	-7.9	-4.5	1.6	2.0	2.3	11.9	10.8	23.9	21.0	15.7	22.5	10.7
Consumer Services	2.3	5.2	15.5	0.3	1.0	1.0	1.0	9.8	15.0	47.3	48.5	26.0	27.0	30.9
Telecommunications	-1.3	-2.0	-0.9	-4.7	5.4	5.6	4.8	-17.6	10.8	22.8	28.7	16.4	80.5	16.3
<b>SA FINANCIALS</b>	<b>0.2</b>	<b>-0.1</b>	<b>12.9</b>	<b>-0.1</b>	<b>4.2</b>	<b>4.1</b>	<b>4.5</b>	<b>5.9</b>	<b>10.2</b>	<b>18.0</b>	<b>16.5</b>	<b>12.5</b>	<b>7.6</b>	<b>10.7</b>

Source: IRESS, FactSet, SBG Securities analysis  
Prices at cob 19 March 2018

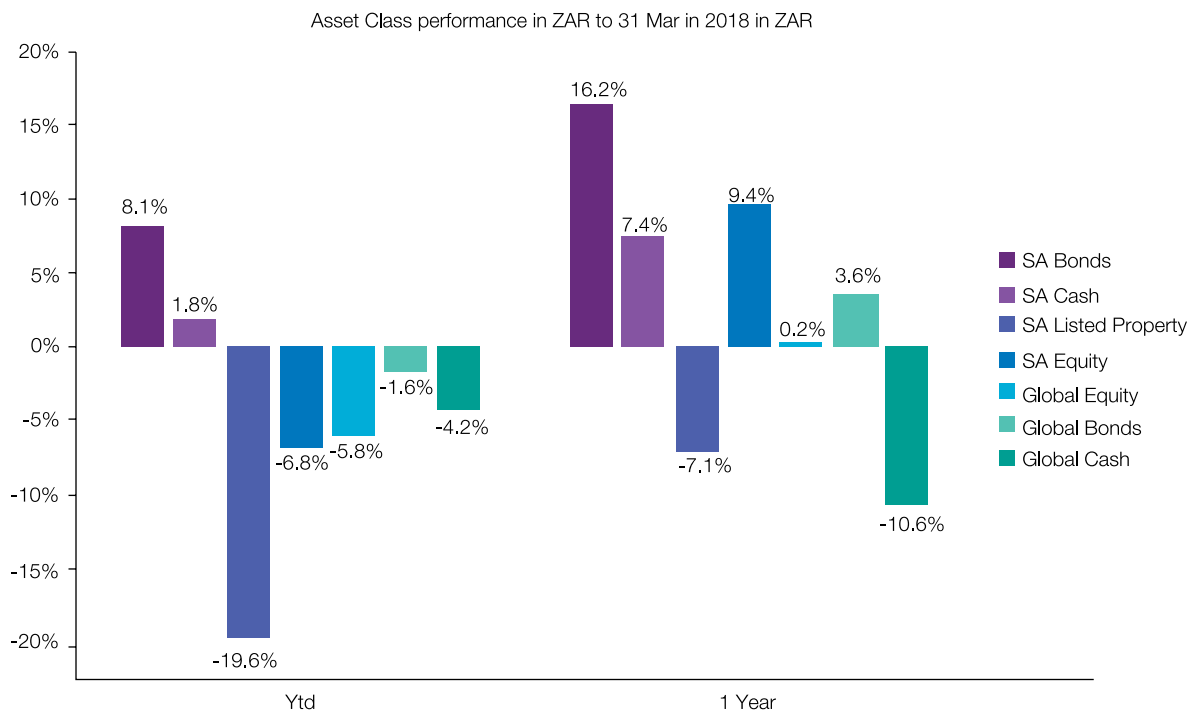
# SA market view and asset allocation – Finding value in the medium term

By Paul McKeaveney, chairman of the asset allocation committee, Investec Wealth & Investment SA

While the easy money has been made for now, we think there could be more to come in the medium to longer term and as such are looking for pockets of value to allocate capital to. We are positive on the possible outcomes for South Africa and for assets that are related to how well the economy performs.

## Bonds stand out

Looking at a high level summary of asset class performance for a South African investor, in other words all in rand, SA bonds have been the standout performer over one year and over the last three months. We have encouraged clients to buy fixed income over the last few quarters and investors who followed this positioning have been well rewarded. Listed property blew up spectacularly this year because of issues specific to the Resilient stable (by contrast, Growthpoint for example returned 18% over one year, compared with the index, which was down 7%). The strong rand dented returns from offshore assets (as well as assets listed locally but with offshore exposure). So far this year there have not been many good asset classes to own, with bonds and cash delivering the only positive returns.



Source: Investec Wealth & Investment

## Taking a more upbeat position

The SA Asset Allocation Committee is now much more upbeat on the prospects for SA risk assets. This was reflected through an upweighting of our risk score for SA equities as well as in the expectations for returns from other asset classes such as fixed income and property. Our discussion centred around the improved outlook over the medium to longer term, as opposed to in the very near term. We decided to upweight SA equity exposure from our long-held neutral view as well as to add to domestic listed property. These upweights are to be funded out of cash.

SA equities at the index level are considered to be fairly priced to slightly expensive, depending on the valuation measure (price-to-book, dividend yield and price-to-earnings). Our preferred measure, based on the “Fed model” (using dividends and interest

---

**So far this year there have not been many good asset classes to own, with bonds and cash delivering the only positive returns.**

---

rates), shows a market that is fairly valued. Consensus earnings growth estimates are in the 10% to 12% area for 2018 and 2019. Pulling all that together and adding the dividend yield to earnings estimates implies a total return expectation of 12% to 15% over the next 12 months. Thinking broadly about the types of stocks on the market, domestic plays could perform well based on our view of a recovering SA economy, while the rand is much less of a headwind for global plays (which have been weak in hard currency as well). Commodities could perform well, given where we are in the global economic cycle.

SA fixed income has had a very strong run and looks to be fairly valued now. We model fair value for SA bonds as a function of US interest rates and emerging market bond spreads. Recently there had been a wide gap between “fair value” and the actual yield, which reflected SA-specific risk; this gap has now closed. We expect 12-month returns to be between 8% and 10%.

---

## **Thinking broadly about the types of stocks on the market, domestic plays could perform well based on our view of a recovering SA economy, while the rand is much less of a headwind for global plays.**

---

### **After the property fall – value in the second tier**

SA listed property, which has had a fantastic long-term performance track record, came horribly unstuck on the back of stock-specific issues (see above). Looking at a basket of SA-focused property counters and comparing the yield versus the 10-year government bond, reveals that there is decent value compared with long-term averages. We are essentially saying that we think that property sector has lagged the strong run in fixed income and that there is value in the second tier property stocks in particular. Other measures such as price-to-book also look reasonable.

We debated whether to continue holding our gold position. US real interest rates have a very strong explanatory power for the gold price in US dollars (higher interest rates typically result in a lower gold price). Given that we expect higher real rates in the US over time, we would ordinarily look to be cutting this position back. However given the risks that President Donald Trump in particular could pose to asset prices, we decided to hold off on reducing the position for now.

Preference shares look to be offering good value on a number of measures that we look at. These include a credit spread measure as well as against preference shares listed offshore. The five large bank preference shares yield around 11% currently.

### **Looking for pockets of value**

We summarise the asset allocation changes in the table below. We are a lot more positive on the possible outcomes for SA and for assets that are related to how well the economy performs. The easy money has been made for now, after a strong performance in domestic assets since December.

However we think there is a lot more to come in the medium to longer term and as such are looking for pockets of value to allocate capital to across the domestic asset class spectrum.

So why we aren't taking more risk or allocating more capital? Firstly, as noted in the global discussion above, we have been downgrading global equities and if there is a turn in equity markets globally, SA will follow them down despite any positive developments here. Secondly, domestic asset prices are, broadly speaking, fairly valued now so one has to be quite selective about how the views are expressed. We are positioning for a stronger SA in the medium term, not overnight.

---

## **We think there is a lot more to come in the medium to longer term and as such are looking for pockets of value to allocate capital to across the domestic asset class spectrum.**

---

# Asset allocation positioning:

The metrics below show our asset allocation positioning for global, domestic and by theme.

⚡	UNDERWEIGHT
⚡	MODERATELY UNDERWEIGHT
N	NEUTRAL
⬆	MODERATELY OVERWEIGHT
⬆	OVERWEIGHT

GLOBAL ASSET ALLOCATION	Q1 2018	Q2 2018	COMMENTS
Offshore Equity	⚡	⚡	Maintain underweight global equities. Given where we are in the cycle we would like to “move closer to the door”.
Offshore Fixed Income	⚡	⚡	Low expected total returns from these starting yield levels. Risk spreads across fixed income asset classes are expensive.
Offshore Cash	⬆	⬆	Provides optionality to increase risk should we see an opportunity.
Offshore Property	N	N	Valuations reasonable relative to long term averages.
Offshore Alternatives	⬆	⬆	Offers attractive risk-adjusted returns relative to traditional long only assets classes. Variations include return enhanced, capital protected and low correlation products.

SA ASSET CLASSES	Q1 2018	Q2 2018	COMMENTS
SA Equity	N	⬆	More optimistic on outlook for SA assets but cognisant that we are reducing risk globally. Valuations looking more attractive. The Rand less of a headwind.
SA Fixed Income	N	N	Concentrated in “belly” of the yield curve. Has been a very strong performance, likely to be more muted from here.
SA Cash	N	⚡	Using cash to increase equity and property. Still relatively attractive on a real return basis.
SA Listed Property	N	⬆	Moving slightly overweight. SA focussed property counters look attractive on a valuation basis, especially outside of the large caps.
Preference Shares	⬆	⬆	Attractive yield advantage over taxable yields assets with possible repurchase underpin. Focus on the bank preference shares.
\$/R (+ for ZAR strength)	N	N	The Rand is currently at fair value - expect to be rangebound and driven by EM sentiment and political newsflow in the near term.

SECTORAL/THEMATIC POSITIONING	Q1 2018	Q2 2018	COMMENTS
Global Plays	⬆	⬆	We have reduced our exposure to global plays.
Commodities	⬆	⬆	Overweight commodity plays although upweight in quality and lower beta. Prefer diversified miners versus single commodity producers.
Gold Plays	⚡	⚡	Currently do not own any gold producers given poor fundamentals. Continue to own physical gold in balanced portfolios as a geopolitical hedge.
Interest Rate Plays	⬆	⬆	Adding to our interest rate play exposure on the back of the positive SA fundamental outlook.
SA Industrials	⚡	N	Valuations at interesting levels, especially in mid and small cap area of the market.

# Members of the Global Investment Strategy Committee

## John Haynes

Chairman & Head of Research  
United Kingdom

## Stephen Trowbridge

Senior Investment Director  
United Kingdom

## Chris Hills

CIO  
United Kingdom

## Oliver Battersby

Senior Investment Director  
United Kingdom

## Professor Brian Kantor

Chief Economist & Strategist  
Investec Wealth & Investment  
South Africa

## Paul Deuchar

Head of Portfolio Management SA  
South Africa

## Philip Shaw

Chief Economist  
Investec PLC

## Ryan Friedman

Portfolio Manager &  
Head of Multimanager  
South Africa

## John Wyn-Evans

Head of Strategy  
United Kingdom

## Paul McKeaveney

Portfolio Manager & Chairman SA  
Asset Allocation Committee  
South Africa

## Oliver Kirkby

Portfolio Manager & Analyst  
South Africa

## Neil Urmson

Wealth Manager  
South Africa

## Darren Ruane

Head of Fixed Income  
United Kingdom

## Annelise Peers

CIO  
Switzerland

## John Barkhan

Head of International Division  
United Kingdom

## Ian Quigley

Head of Investment Strategy  
Ireland

## Nik Kidd

Senior Investment Director  
United Kingdom

Although information has been obtained from sources believed to be reliable, Investec Securities Proprietary Limited (1972/008905/07) or its affiliates and/or subsidiaries (collectively "ISL") does not warrant its completeness or accuracy. Opinions and estimates represent ISL's view at the time of going to press and are subject to change without notice. Past performance is not indicative of future returns. The information contained herein is for information purposes only and readers should not rely on such information as advice in relation to a specific issue without taking financial, banking, investment or other professional advice. ISL and/or its employees and/or other Investec Companies may hold a position in securities or financial instruments mentioned herein. The information contained in this document alone does not constitute an offer or solicitation of investment, financial or banking services by ISL. ISL accepts no liability for any loss or damage of whatsoever nature including, but not limited to, loss of profits, goodwill or any type of financial or other pecuniary or direct or indirect or consequential loss howsoever arising whether in negligence or for breach of contract or other duty as a result of use of the reliance on information contained in this document, whether authorised or not. This document may not be reproduced in whole or in part or copies circulated without the prior written consent of ISL.

Investec Wealth & Investment a division of Investec Securities Proprietary Limited, 1972/008905/07. Member of the JSE Equity, Equity Derivatives, Currency Derivatives, Bond Derivatives and Interest Rate Derivatives Markets. An authorised financial services provider No.15886. A registered credit provider registration number NCRCP262. The disclaimer is deemed to form part of this message in terms of Section 11 of the Electronic Communications and Transactions Act 25 of 2002.

