Investec
Wealth & Investment

Global Investment View

QUARTER 3 - 2017

Global Investment View

Out of the Ordinary®

Investec Wealth & Investment

QUARTER 3 - 2017

Picking up momentum

With some of the risks identified in our previous edition having receded and global growth continuing to pick up momentum, we maintain our view that taking risk will be rewarded over our forecast period (18 months). Recent signs that central banks are looking to potentially tighten (or 'normalise') monetary policy could upset this outlook and prevents us from taking a more than neutral stance.

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 Darren Ruane

Head of fixed income, Investec Wealth & Investment UK and acting chairman of the Global Investment Strategy Group

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Watch the interview with Ryan Friedman by Patrick Lawlor

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Summary of our key thoughts

- Some of the risks that were evident at the time of our last Global Investment View have receded. Political risk, especially, was a front-runner in the list of concerns, with continued worries over the upcoming French elections and the uncertainty created by a Trump presidency. In the end, the French elections saw a market-friendly result in the election of pro-EU and pro-euro President Emmanuel Macron and his party. Some of the fears of a Trump presidency, such as a tilt to protectionist policies and greater political clashes with other world leaders, have not transpired.

- Global growth continues to pick up momentum and inflation remains low, despite falling unemployment rates in the West. Improving nominal growth trends should lead to double digit global earnings growth in 2017, although equity valuations are considered to be only fair value. Sentiment in markets is thought to be moderate and there are few signs of the euphoria that preceded previous market crashes.

- The obvious market spoiler could be central bank normalisation. The Group believes that, over many years, global asset prices have been helped by waves of monetary stimulus and there are concerns about the impact on all markets if stimulus is withdrawn. There have been recent signs that central banks outside of the US are considering tightening their monetary policies.

- Overall, the expectation is that risk assets will potentiallly produce positive returns over our 18-month forecast horizon period. However, market setbacks should provide the opportunity to invest at cheaper prices, even if the list of short term market disrupters have diminished. A neutral score was agreed and the general tone of the meeting was constructive, with a marginal underlying increase in the long-term risk score.

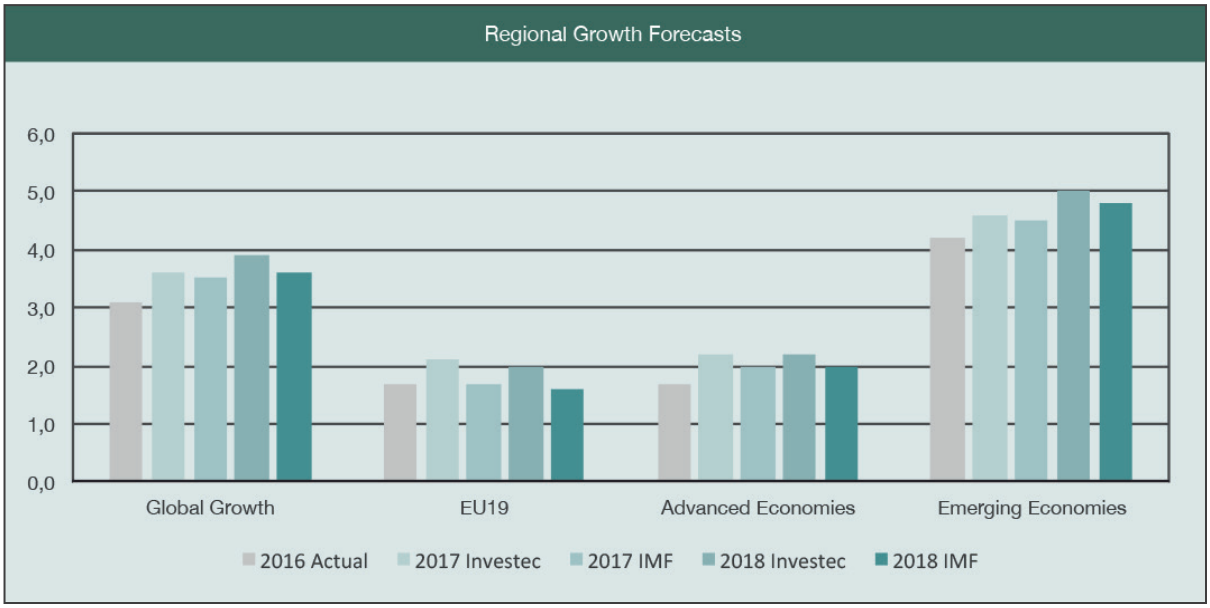
Explaining why we are maintaining our neutral position

Global growth momentum remains positive

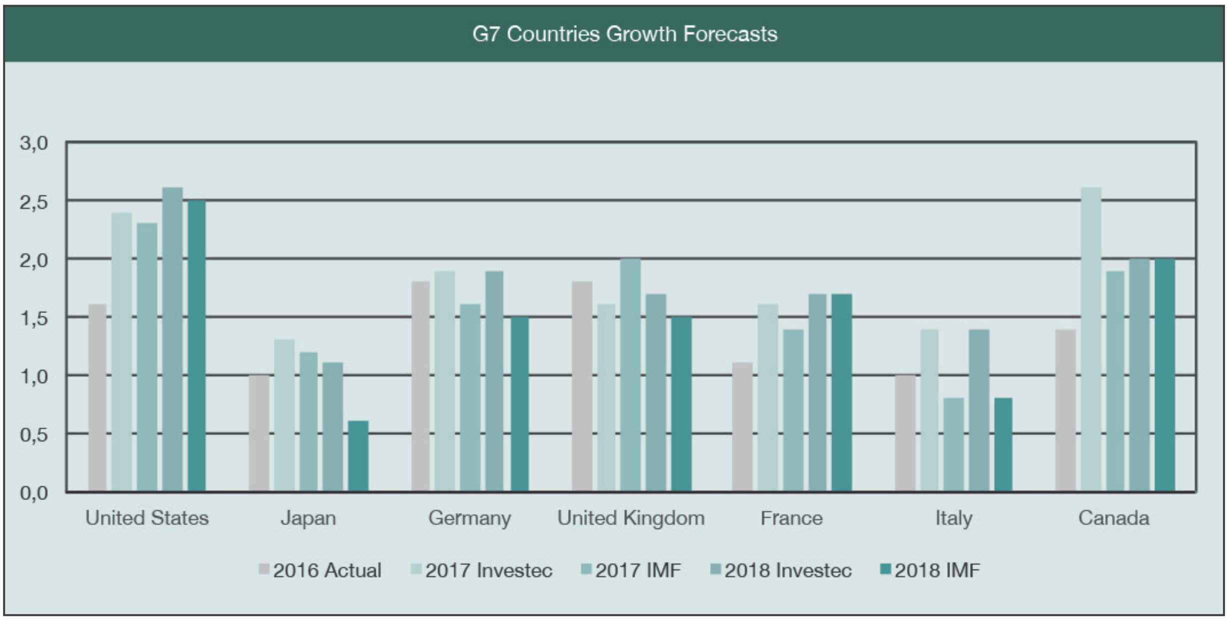
Global growth is forecast to increase by 3.6% in 2017 (Investec Economics; IMF: 3.5%) and 3.9% in 2018 (Investec Economics; IMF: 3.6%). This is a notable increase from the 3.1% growth rate achieved in 2016. Both developed world and emerging economies are forecast to accelerate, with growth in 2018 forecast to be 2.2% (1.7% actual in 2016) for developed economies and 5.0% for emerging economies (4.2% actual in 2016). The Eurozone economy has steadily improved from the meagre growth rates seen in the aftermath of the Eurozone sovereign crisis in 2010-2012, with around 2% growth rates expected this year and next. Gold stars are awarded in Europe to previous laggards that include 2018 growth rates of 2.9% (Spain), 2.2% (Portugal) and 4% (Ireland). The outlook for Japan's economy remains challenged at 1.1% growth for 2018, although even this level is reasonable relative to previous years.

Importantly, growth is synchronising in all of the major economic regions for the first time since early 2011, providing a benign backdrop to markets relying on improving growth fundamentals. (Note: Data are from Investec Economics unless otherwise stated.)

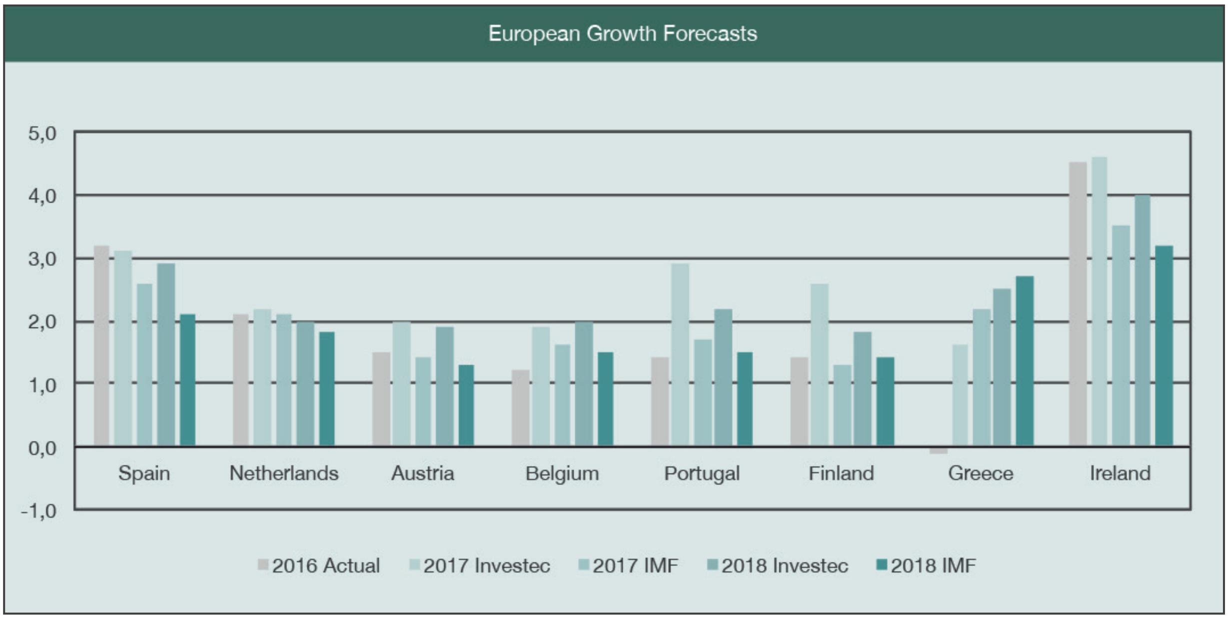
> Global growth continues to pick up momentum and inflation remains low, despite falling unemployment rates in the West.



Source: Investec Economics & IMF



Source: Investec Economics & IMF



Source: Investec Economics & IMF

Source: Investec Economics & IMF

Inflation is subdued and should not lead to surprise interest rate rises

One potential negative shock factor for markets is a recovery in inflation, which would lead to expectations of sustained price rises. In this scenario, economic growth (particularly consumer spending) may slow should wages not keep pace with inflation, interest rates may need to rise faster than expected to keep a lid on price rises and companies' working capital requirements may increase in nominal terms.

Over recent months, observed inflation and inflation expectations have moderated. Following the reversal in weak energy prices between the first quarter of 2016 and the first quarter of this year, inflation numbers may consequently have peaked earlier this year. For example, the US Federal Reserve's (Fed) preferred measure of inflation (Personal Consumption Expenditure – PCE) has fallen from 1.8% for January to 1.4% for May. In fact, the Fed has not hit its 2% target using the PCE measure since 2012. In Europe, the European Central Bank (ECB) will be happy that the euro area inflation rate rose to the target rate of 2% for the first time since early 2013, although it has since fallen to 1.4%. Inflation is not rising significantly, despite low unemployment rates in some Western economies (and particularly the US, with its 4.3% unemployment rate). Reasons given for low wage inflation rates include continued globalisation, greater automation (the rise of the robots) and weak productivity rates.

Inflation expectations have equally fallen. Since the height of the reflation trade in mid-January, the US 10-year breakeven inflation rate (expectations of US CPI over the next 10 years) has fallen from 2.1% to 1.7%. In Europe, the important five-year forward rate (as used by the ECB to determine inflation expectations) has fallen from 1.8% to 1.6%.

Political risks have diminished

At the time of our last edition, President Donald Trump had been in power for little more than two months and the French election had yet to occur. Both of these "events" were seen as market-moving and much uncertainty prevailed.

A number of concerns surfaced regarding Trump. Firstly, there was the prospect of a trade war. On the campaign trail, Trump spoke about tearing up the North America Free Trade Agreement (NAFTA), with Mexico particularly in his sights. Secondly, Trump promised to call China a currency manipulator, which could affect the relationship and trade between the two countries. Thirdly, Trump spoke about the America First policy, which potentially included the US's relationship with Europe. The fear for global investors was that Trump would prioritise domestic growth at the expense of global growth. So far, much of Trump's rhetoric has been bluster and the voices around Trump have guided him to sensible decisions (with the notable exception of the US withdrawal from the global climate change agreement).

In early March, Marine Le Pen of the National Front was polling at more than 27% of the vote and fears permeated that she could win the election. Given the National Front's policies of having a referendum on France leaving the EU and the euro, stakes for markets were high. In the end, Macron, with his newly established En Marche! Party, won the presidential election and subsequently performed strongly in the legislative election. Macron's strongly pro-European stance was taken as market positive and European equity markets rallied on the result.

Rising bond yields may be a sign of improving economies, so the effects on other asset classes could be muted

One of the greatest current fears for investors is the normalisation of global monetary policy. Theory states that a rising discount factor (higher bond yields) leads to lower asset prices. However, the reason behind the rise in yields should be considered. For example, if the rise in bond yields occurs because of a sustained rise in inflation and inflation expectations, higher interest rates may dampen the outlook for both bonds and equities. However, if the rise in bond yields occurs because of a rise in real growth rates, which are accompanied by moderate inflation, then it can be argued that the positives (such as higher corporate profits) from the increase in growth rates may outweigh the negatives from higher interest rates.

This was observed in practice in the fourth quarter of 2016. An improving global economy, coupled with the hopes of reflation from a Trump presidency, saw the 10 year US Treasury yield rise from 1.6% to 2.6%. Over the same time period, the US equity market rose by nearly 4%. The expected fallout from a sharp rise in yields did not occur because the better growth environment was the dominant factor.

> Macron's strongly pro-European stance was taken as market positive and European equity markets rallied on the result.

Fears of a Chinese hard economic landing have diminished

Following the marked expansion in Chinese credit at the end of 2015 and into 2016, fears of a hard economic landing in China in 2017 have been at the forefront of investors' minds, particularly in the light of the influence that China (as the world's second largest economy) has on global growth and also on demand for (and prices of) commodities. However, the latest GDP figures released by China show growth of 6.9% year-on-year (first quarter 2017), and there is a probability that the 6.5% government growth target for 2017 will be exceeded. At the recent World Economic Forum (June 2017), Chinese premier Li Keqiang said there would be no hard landing. The premier said that the government had taken measures to tighten credit this year, with market-based interest rates moving quickly higher.

In addition, there is a strong belief in the Group that there is a reduced probability of an economic or market upset from China later this year given that the 19th National Congress of the Communist Party is coming up. The Congress decides on the leadership of the Communist Party over the following five-year period. However, some concern was also expressed at the potential for further anti-corruption purges that may occur in the aftermath of the gathering (probably in 2018) or for international conflicts given the expected continuation of Xi Jinping as General Secretary.

Finally, fears over a weakening in the Chinese currency (yuan) against the US dollar, which could lead to more protectionist rhetoric from Trump, have diminished in recent months thanks to an easing in the dollar. In fact, Chinese authorities appear to be intervening to strengthen the yuan, despite any obvious external pressure.

The backdrop to emerging market assets is positive

Over the past few years, the performances of emerging market economies and assets have been volatile. However, the current backdrop to emerging market (EM) investing seems benign. Firstly, with other major central banks making tightening monetary noises, the US dollar has underperformed in 2017, with the US Dollar Index lower by 6% over the first half of the year. In turn, emerging market currencies have been boosted, increasing returns on EM assets in US dollar terms and placing downward pressure on domestic EM inflation while also providing room for easier monetary conditions. Secondly, China has changed from being a source of worry for 2017 to a source of strength. Finally, energy and commodity prices have recovered from the lows of 2016.

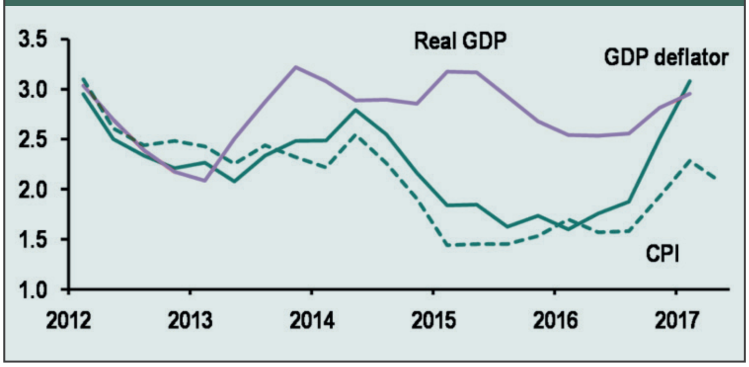
Valuations are "not cheap but not expensive"

The main good news story for 2017 is the recovery in corporate earnings. A recent report by JP Morgan highlights some of the tailwinds supporting this. Firstly, the backdrop of global nominal GDP growth, trending at 6.1% over the first quarter of 2017, is very encouraging and is a 1.5 percentage point increase over the average annual pace of the previous two years. Secondly, the better growth trend has led to a recovery in global capital expenditure, which rose an estimated 5% in the first quarter. Next, the latest data indicate that corporate earnings continue to firm and JP Morgan estimates that profits should rebound by 10-15% in 2017. In addition, global earnings per share have jumped 15% over the 12 month period to May, broken down by 17% for developed markets and 13.3% for emerging markets.

However, there are some headwinds emerging. Oil prices are slipping again. Earnings from energy companies have rebounded materially given the bounce-back in energy prices but this benefit may now slow. US economic growth momentum has slowed since the initial post-election exuberance over the pro-growth policies promised during the Trump campaign.

In terms of valuations, our sense is that higher corporate profits are required to drive prices higher. While equity valuations are not cheap, the better earnings outlook articulated above suggests that equities could deliver up to 10% growth over the forecast 18-month time horizon. The US equity market appears expensive in absolute terms, and better value may be found outside of the US where there is some room for price/earnings expansion.

Figure 1: Global growth and inflation
%4-quarter change (through GDP through 1Q17, CPI through 2Q17 estimate



Source: J.P. Morgan; MSCI earnings

While equity valuations are not cheap, the better earnings outlook articulated above suggests that equities could deliver up to 10% growth over the forecast 18-month time horizon.

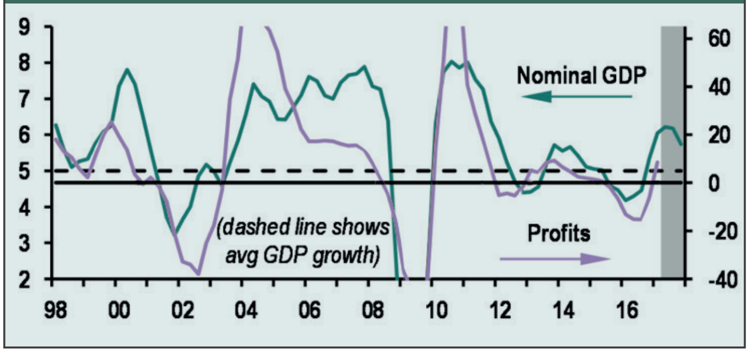
Goldilocks market with few short term market disrupters

The current market environment and shorter term outlook was likened to a "Goldilocks" scenario. Markets have been grinding higher in the face of improving real growth rates, low inflation, low interest rates and reduced political risk. At this point last year, investors were facing events such as Brexit, the US election, a number of important European elections and an Italian referendum. Many of the immediate concerns have passed without incident and there are few obvious short-term obstacles.

But sentiment is not euphoric

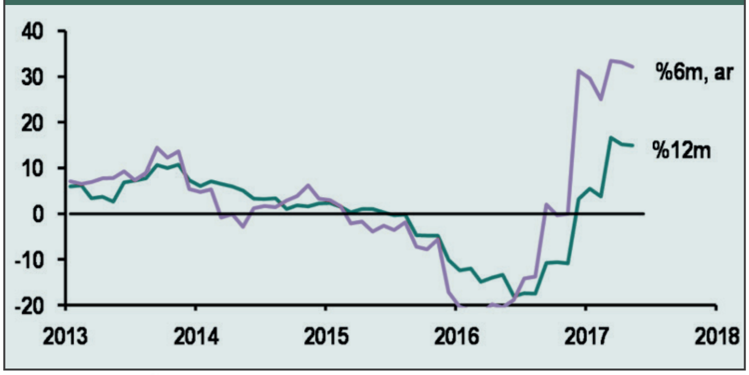
For some time, market surveys of fund managers' attitudes to taking investment risk and holdings of cash have suggested a high degree of caution. It is difficult to find fund management groups adopting high levels of investment risk because of the uncertainty over the underlying monetary environment. Consequently, there is room for risk markets to outperform modest expectations and move higher in price terms.

Figure 2: Global nominal GDP and corporate profits
%4-qtr change both scales



Source: J.P. Morgan; MSCI earnings

Figure 3: Global corporate profits
%change of 12m reported earnings per share, annualized rate



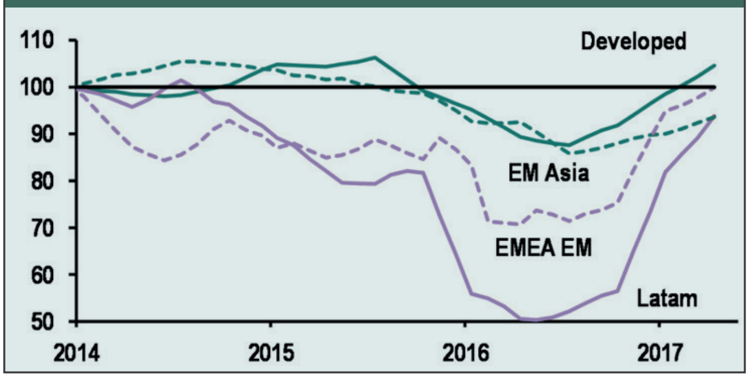
Source: J.P. Morgan; MSCI earnings

Why we aren't taking a more positive stance

Central bank normalisation

The greatest fear of the Group is the unintended consequences of a faster-than-expected tightening (or 'normalisation') in the monetary policies of the developed world's central banks. It is argued by many commentators that years of easy monetary policies around the world have contributed to both the outsized returns from all asset classes and low levels of volatility. However, the tide may be starting to turn.

Figure 4: corporate profits
Index Jan 2014=100, earnings per share



Source: J.P. Morgan; MSCI earnings

The Fed has been on a course of raising interest rates since December 2015. Although the initial increase of a quarter point was modest, the past six months (December to June meetings) have seen further three quarter point rises as well as an expectation of at least one more rate rise later this year. In addition, the Fed has been discussing the potential reduction of its balance sheet size for some time. Timing of the commencement of a 'run-down' in the balance sheet is focusing around September or December. Inflation outcomes in the US have been much lower than expected. As noted above, the Fed's preferred measure of inflation (Personal Consumption Expenditure) has not been above its 2% target since 2012. The Fed appears to believe that the US economy's very low level of unemployment (4.3%) will eventually lead to higher prices.

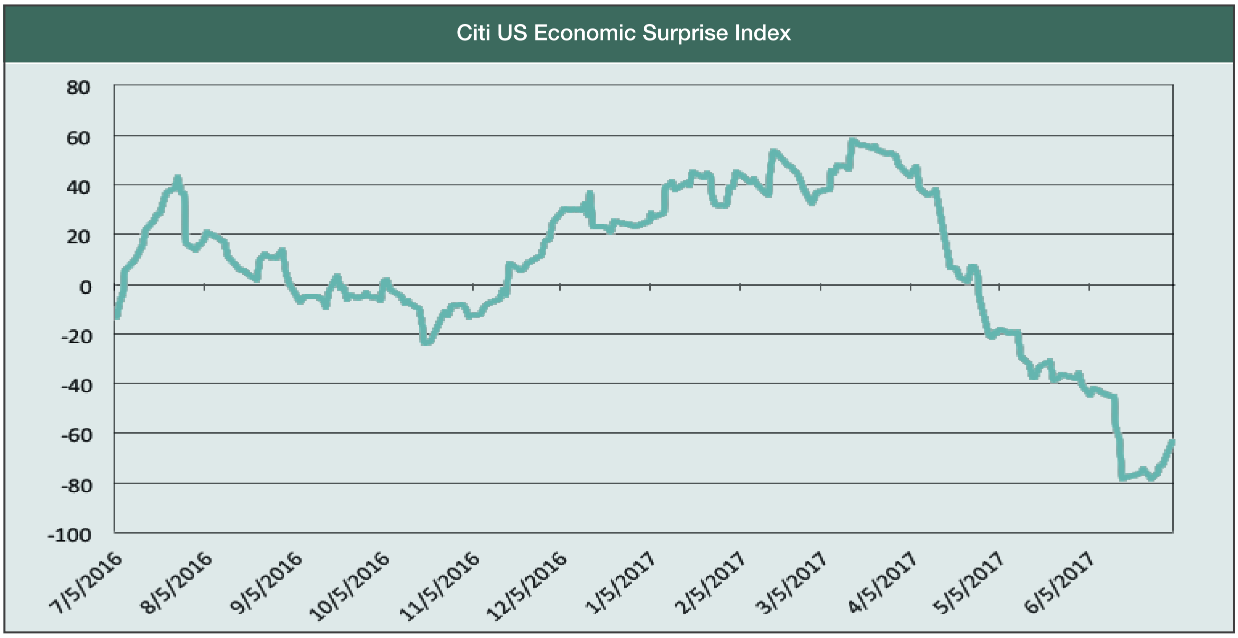
The good news so far is that Fed policy has been well communicated to markets and its relatively slow pace has not caused any upset to risk markets.

However, in the very week that the Group sat to discuss the outlook, interpretations of central bank policies from other major central banks spooked markets. Mario Draghi of the ECB pointed to reflationary forces and economic recovery in Europe. As a result, market participants are pricing in a further tapering of its quantitative easing (QE) policy in the autumn, with a final halt to bond purchases at the end of 2018.

However, no rate rises are expected over our 18-month forecast time horizon. In the UK, a recent spike in inflation coupled with modest economic growth could see an interest rate rise as soon as August (indeed the latest MPC meeting minutes revealed three members voting for a rise). Upward interest rate pressure is also being experienced in Canada and New Zealand.

The US economic growth outlook has diminished

The start of 2017 saw a huge amount of optimism around the US economy. The global economy was improving and provided a positive environment for US domestic growth. A new President entered the White House with a pro-growth agenda of reducing taxes (personal and business), repatriating cash from US companies' overseas divisions to the US parent (for capex in the US economy), infrastructure spending and cutting regulation. President Trump's hope was to increase growth from the sub-par level of 2% over recent years, to 3-4%. Things have turned out a little differently. Trump's attempts to reform health care have been pushed back, leading to concerns about a number of Trump's pro-growth policies. In addition, hard economic data from the US economy has not lived up to the very positive survey data recorded earlier in the year. For example, the Citi US x



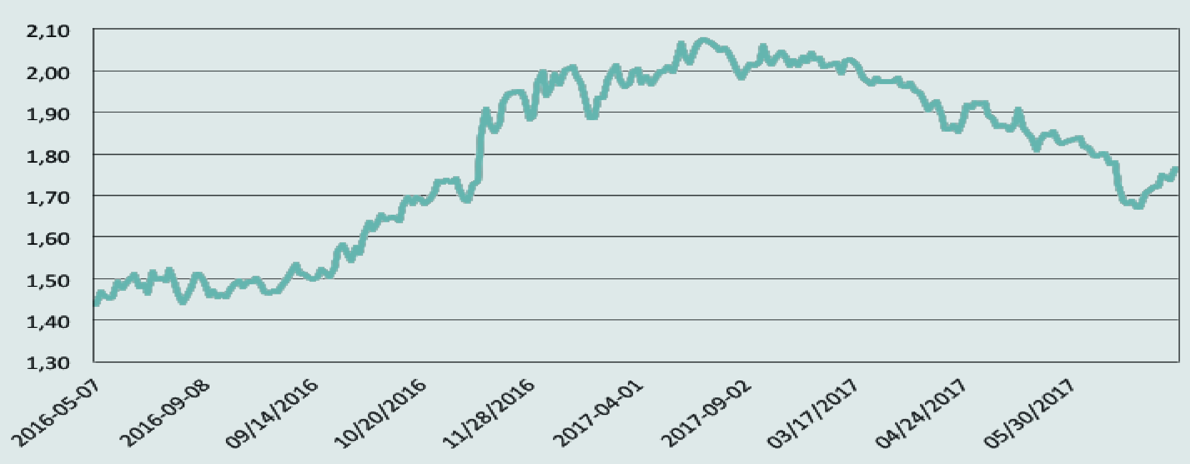
Source: J.P. Morgan; MSCI earnings

The most important conclusion is over the size and pace of central bank normalisation. It remains the view of the Group that central banks will carefully and slowly row back on their QE policies, allowing risk assets to provide positive returns. There is meaningful scope for policy errors, while central bank 'noise' around monetary tightening has the potential to increase volatility in the short term.

> The Fed's preferred measure of inflation (Personal Consumption Expenditure) has not been above its 2% target since 2012.

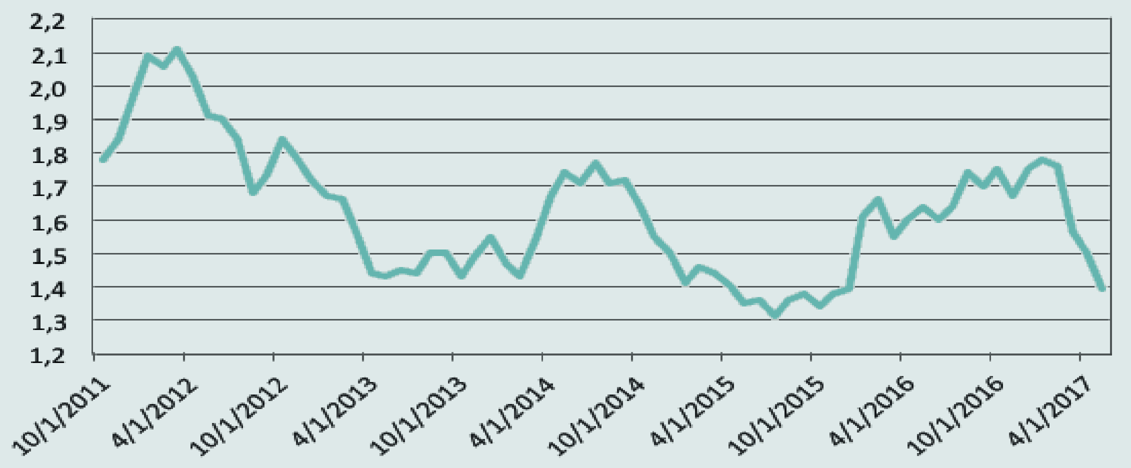
In addition, the US yield curve has bull flattened to close to its tightest spreads since 2007 and some analysts are suggesting that this is indicating the nearing of a US recession. For example, the yield difference between a 10 year and a two-year Treasury is 90bps (0.9 percentage points). During periods of economic recovery, the yield spread is often trading at more than 250bps (2.5 percentage points). On reflection, the Group opined that there are sufficient distortions in bond markets, especially with central bank and government purchases, to make the yield curve a less reliable economic indicator.

US 10 Year Breakeven Rate



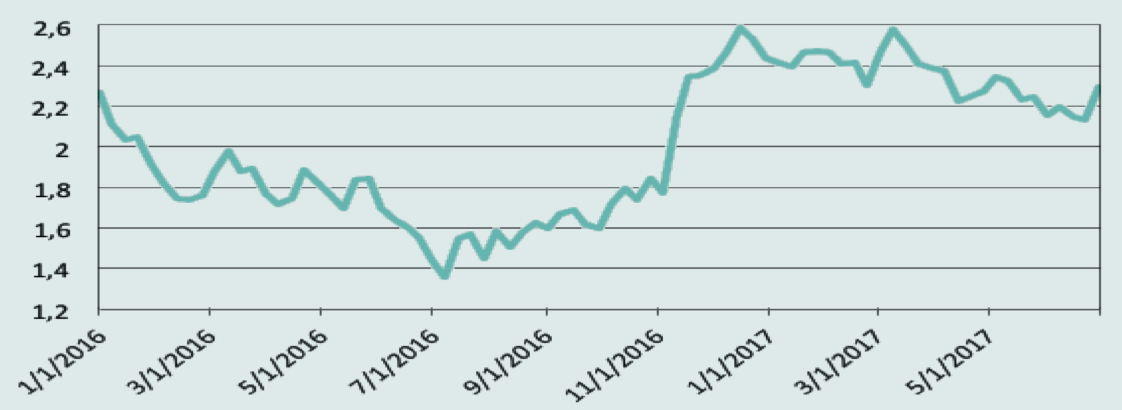
Source: Bloomberg

US Personal Consumption Expenditure



Source: Bloomberg

US 10 Year Treasury Yield



Source: Factset

The weak oil price in 2014-2016 was associated with weaker demand in the global economy. However in 2017, oil price weakness is seen as more of a supply problem than a demand problem

The impact of weaker oil prices

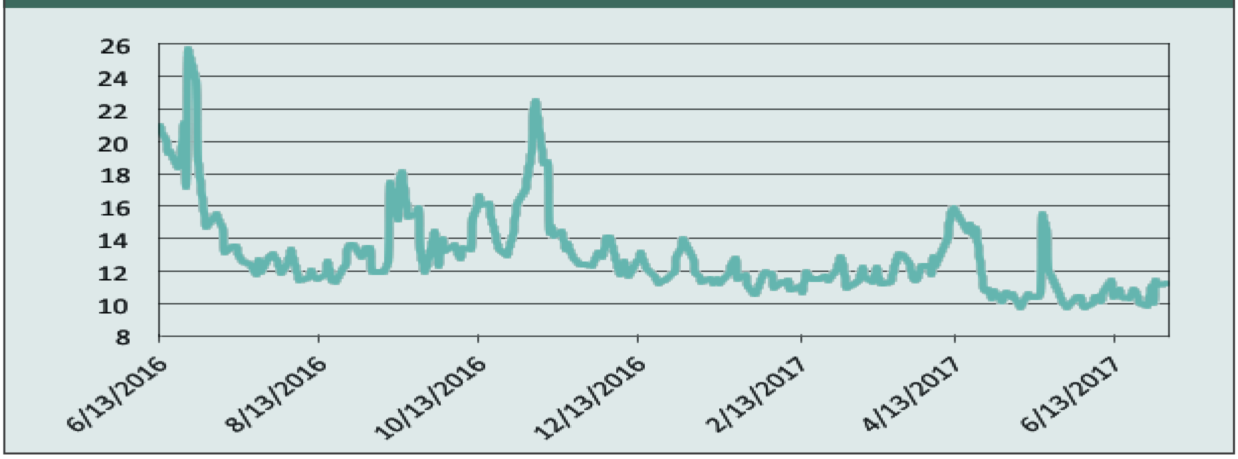
In the energy and commodity price collapse of 2014 to early 2016, the wider impact on markets and economies was material. The outlook for company earnings and for resource-dependent countries' GDP growth and inflation, among other variables, were negatively impacted. In 2017, the Brent crude oil price fell from a high of $57 a barrel to $45 by mid-June. Oil price weakness should be a source of concern for investors. However, there are a few positives associated with further oil price weakness this time round. The weak oil price in 2014-2016 was associated with weaker demand in the global economy. However in 2017, oil price weakness is seen as more of a supply problem than a demand problem. Furthermore, oil-related companies and countries have learned to live with a more challenging oil price environment. Finally, there are signs of price distortions in the oil market. Hedge fund actions are suggesting they have lost faith in OPEC's attempt to underpin the oil price. However, these positions can change very quickly and this may allow the oil price to settle at its economic level.

Volatility level may be too low

Volatility in markets is low by historic standards. One measure of volatility that is commonly used is the Vix Index (The CBOE Volatility Index, to use its fuller name) and its current level of 10 has only been experienced in 1994 (prior to the US bond market collapse), 2005 and 2007 (prior to the global financial crisis). The Vix is believed to be a mean reverting index and its average over the long-term is around 20. As a result, risk asset investors should (in theory) find better buying opportunities once Vix has normalised.

However, it can be argued that a new mean level of Vix could be 15 as a result of continued monetary policy easing by central banks i.e. low interest rates will always make investors want to take on more risk during price falls. Others argue that the financial crisis should be stripped from the long term average number, given that it is a very unusual event.

VIX Index



Source: Bloomberg

Bank profits and price correction overdue

It can also be argued that recent gains in risk assets like equities have reduced the potential for further price gains in the future. Investors are eight years into a market and economic cycle. As a consequence, so the argument goes, it may be sensible to bank some of the recent gains and adopt a more cautious strategy.

In addition, it would not be a surprise if a risk event occurred in the forecast time horizon that would allow investors to gain access to markets at cheaper levels than today. Of course, the problem with this strategy is the opportunity cost of missed returns (if markets grind higher) as well as the low returns associated with holding onto cash.

The Vix is believed to be a mean reverting index and its average over the long-term is around 20. As a result, risk asset investors should (in theory) find better buying opportunities once Vix has normalised.

SA market view and asset allocation – Neutral but factoring in local uncertainties

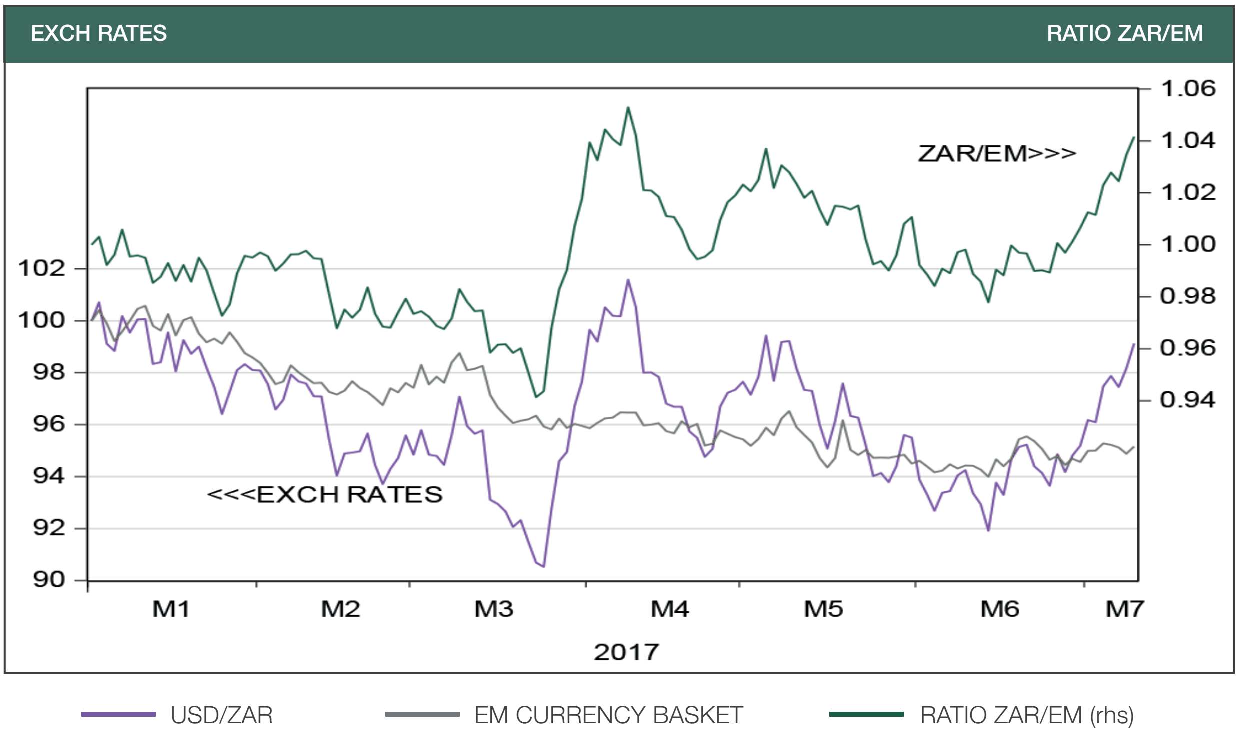
By Professor Brian Kantor, chief economist and strategist, Investec Wealth & Investment

FThe SA Asset Allocation Committee (SAAAC), like the Global Investment Strategy Group (GISG), maintained a neutral stance over the next 18 months. This neutral position is equivalent to a 60% weight for the most risky equities in a balanced portfolio of stocks, bonds, cash, property and alternative assets.

As noted by Darren Ruane above, equity markets have been unusually subdued in recent months – the VIX Index of volatility on the S&P 500 (also known as the fear index) has remained at well-below average levels. Unusually low stock market volatility could however be taken as complacency in the market place. That volatility will revert to something like its long term averages can be asserted with some certainty. The uncertainty is how long it will take to revert to this average.

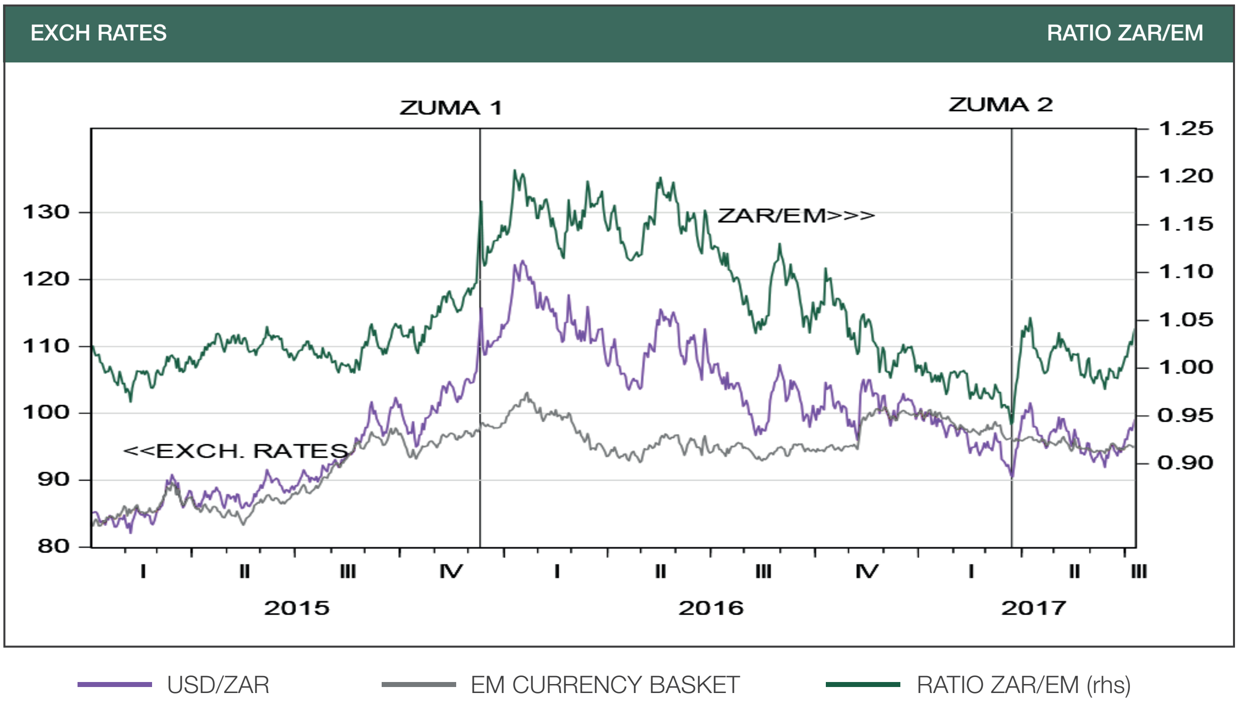
On the day the GISG committee met, Mario Draghi, President of the European Central Bank, revealed his own improved state of mind, given better growth and inflation data from Europe. He gave a clear signal that the end of quantitative easing in Europe was being contemplated, with tapering to follow in due course as economic data would justify. The market reacted with a stronger euro and a weaker US dollar. With past pressures on emerging markets in mind, the US dollar strengthened marginally against most emerging market currencies.

The rand, for SA-specific political reasons, has gone from outperformer in 2016-17, to underperformer when measured against other emerging market currencies. The rand has weakened by about 4% against a basket of nine emerging market currencies since early June 2017 and in a relative sense is about as weak as it was when President Jacob Zuma sacked Finance Minister Pravin Gordhan in late March (See figure 1 below).



Source: Bloomberg and Investec Wealth and Investment

The same ratio of exchange rates was as high as 1.20 in February 2016, indicating rand strength both against the US dollar and other emerging market currencies in 2016-2017. For a longer history of these key relationships, including the impact on exchange rates of the earlier Zuma intervention in the SA Ministry of Finance in December 2015, see figure 2 below. We will refer further to these developments in our discussion of asset allocation for South African portfolios.



Source: Bloomberg and Investec Wealth and Investment.

The GISG recognised that while volatility in developed financial markets was abnormally low, improved equity valuations were rational and not exuberant, given prevailing interest rates and likely support of strong earnings growth across the global listings. Unusually, these growth rates have been in the process of upward revision.

It was understandably easier for the GISG to position itself for the global economy and markets than its SA counterpart. It has been a very fraught period in SA's political and economic history. A damaged presidency, damaging to investment sentiment and the willingness of households to spend and borrow, has been accompanied by an economy already in recession. Fears of radical interventions in the policy mix have heightened and can be interpreted as something of an intended distraction from the assault on the President and his allies.

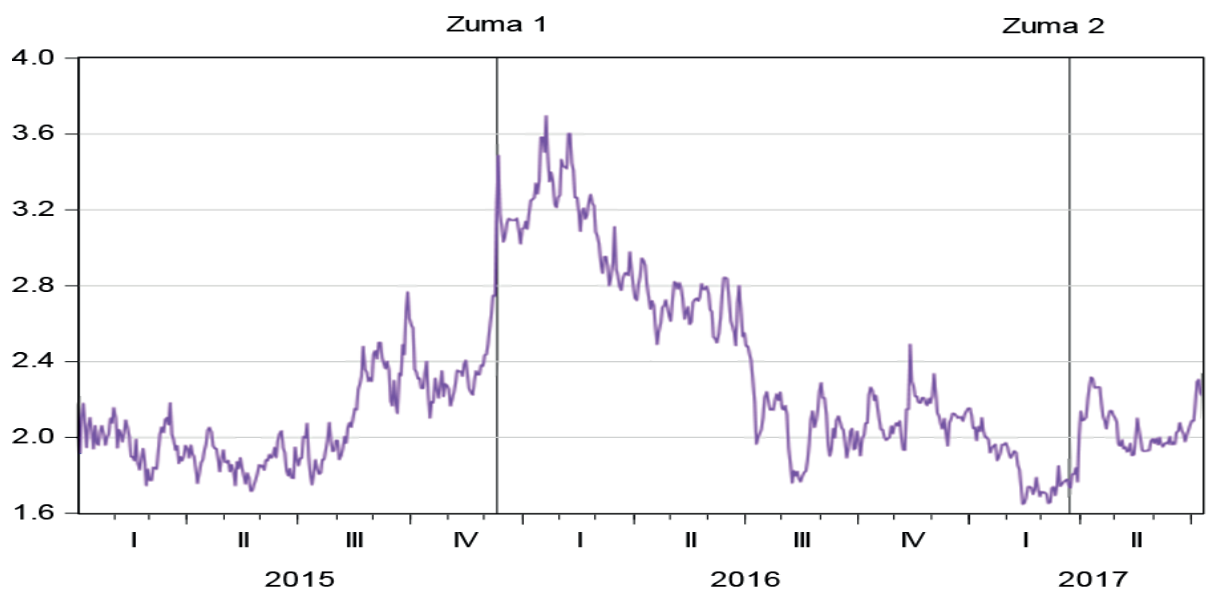
It should be added however that the ANC Conference held after the meeting of the SAAAC in early July 2017 appears to have demonstrated strong support for what might be called the established policy mixes of the ANC and the government. The middle ground of the party seemed to hold up well against more radical propositions, ahead of the decisive ANC congress in December that will elect new leaders.

This period of political uncertainty has however been accompanied by a generally strong rand as was illustrated in figure 2. The stronger rand exchange rate (see figures 1 and 2) and lower risk spreads (see figures 3 and 4) has mostly taken its cue from global emerging market trends rather than SA politics. Indeed, for much of 2016 and 2017 the rand has gained more against the US dollar than the average emerging market currency. It recovered much of the ground lost in December 2015.

In figure 3 we show the SA risk incorporated in the RSA bond market. This risk is best illustrated by the spread between the RSA bonds denominated in US dollars and bonds of the same duration issued by the US Treasury. The spreads since 2015 are shown below. The spread widened in December 2015 as Zuma replaced the then Minister of Finance Nhlanhla Nene. This risk – the extra yield investors were demanding as compensation for the presumed additional risk of a debt default – then fell away sharply in 2016 and early 2017. It increased much more modestly in March and July 2017 with further political turbulence in SA. In this the risk spreads behaved like the rand against other EM currencies.

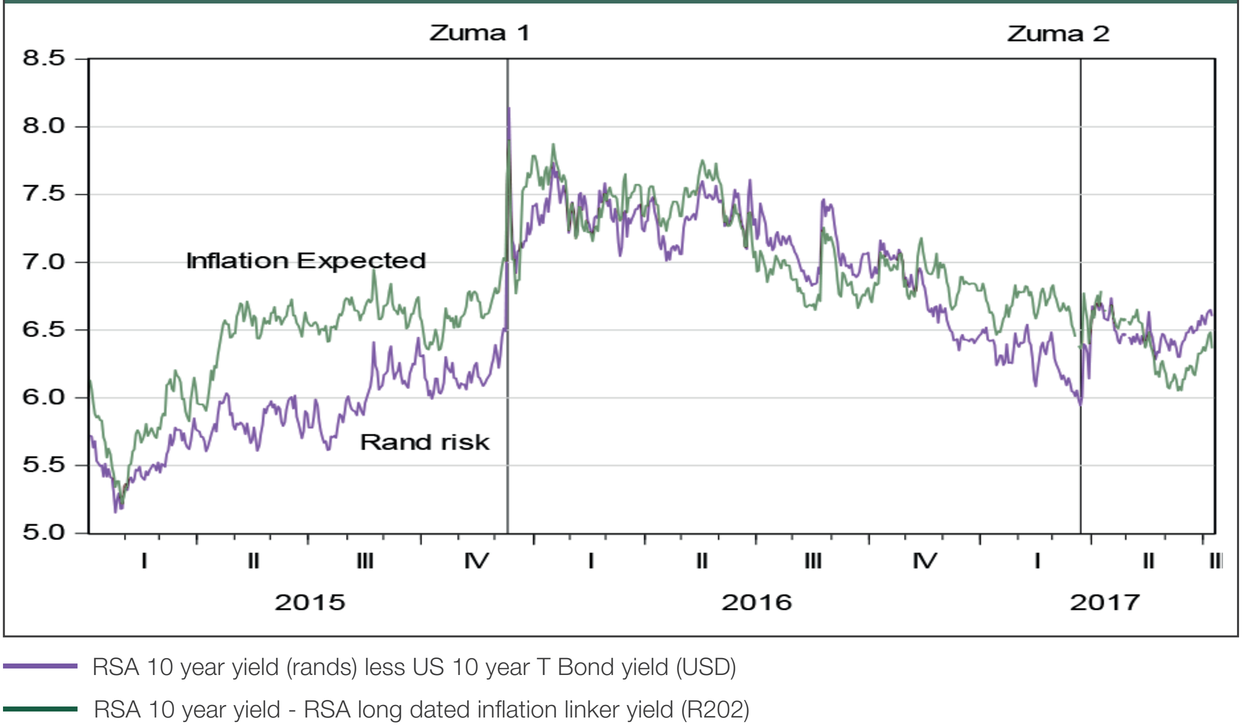
Local currency bond yields and their spreads over US Treasuries reveal a very similar pattern. They widened on the initial Zuma intervention in December 2015 and have receded since, though they are not back to the spreads of early 2015, as was the case with the RSA dollar-denominated debt, the so-called Yankee bonds. At worst this nominal spread was over 7.5% in Q2 2016. These local currency spreads have also ticked up recently, as has the spread between vanilla RSA bonds and their inflation-protected equivalents. This interest spread, nominal- real yields, may be regarded as compensation for expected inflation and is therefore a very good proxy for inflationary expectations. The spread between the RSA 10-year rand yield and the 10-year US Treasury is, by definition, the rate at which the rand is expected to depreciate against the US dollar, currently around 6.5% and roughly and consistently the same rate as expected inflation.

Figure 3: Measures of SA political risk – the spread between RSA US dollar-denominated bonds and US Treasury Bonds (both five year)



Source: Bloomberg and Investec Wealth and Investment.

Figure 4: Measures of rand exchange rate risk RSA yields (10 year) minus US Treasury Bond yields (10 year) and inflation compensation



Source: Bloomberg and Investec Wealth and Investment

It might be concluded that the SA currency and bond markets, given recent favourable trends, are anticipating a favourable outcome regarding the Zuma presidency, namely his eventual loss of influence over economic policy. Such a view came to seem less certain when the independence of the Reserve Bank came under radical threat and the rand fell away marginally against peer currencies, though it was a threat explicitly rejected by the recent ANC Conference, a development that did not arrest rand weakness relative to other emerging market currencies, but may yet do so.

The JSE over the past year and a half has moved mostly sideways when measured in the stronger rand. When measured in US dollars, good gains were registered (see figure 5 below). The JSE in US dollars also tracked the emerging market equity benchmark very closely through much of the period, a long-established and consistent pattern, even though, the JSE has been a distinct underperformer since mid-June 2017 in US dollars (compared with the emerging market average). This underperformance is a reflection of the recently weaker rand against other emerging market currencies, as well as unease about the direction of SA economic policy.

The stronger rand is a headwind for the rand value of the important group of companies listed on the JSE that are plays on the global economy. The dollar value of this important group of stocks in the All Share Index is determined offshore and then translated into their rand value, at prevailing exchange rates. Most obviously affected are the dual-listed stocks, the likes of British American Tobacco, Richemont, AB-Inbev, Anglo American and BHP Billiton. Other things equal a stronger rand will mean a lower rand value for these companies.

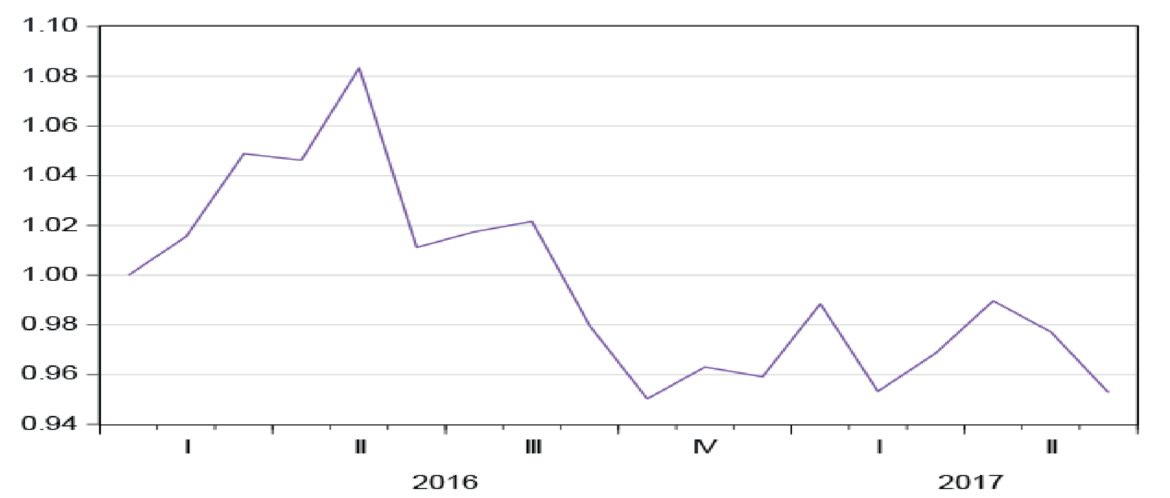
Unless their US dollar value rises by more than the rand/dollar exchange rate, their rand value will decline. When the rand gains as much as 20% against the US dollar over a 12-month period, as it has at times, this becomes a very demanding return for such stocks. Few of the dual listed companies have succeeded in beating the rand, given the degree of rand strength. Hence much of the sideways movement in the rand value of the JSE can be accounted for by the strength of the rand itself.

But a strong rand could be expected to encourage domestic spending and the value of companies exposed to the SA consumer, as inflation comes down and interest rates follow. Inflation has declined and can be expected to decline further. At the time of writing, interest rates had not yet followed and the SA economy has entered a recession with household spending remaining depressed. The SA economy plays, especially the small and mid-cap companies exposed to the SA economy, as well as the larger retailers and banks, have not enjoyed any meaningful favour from investors – local and foreign.

In these circumstances the rand value of the JSE All Share Index is more likely to benefit from rand weakness than rand strength. Rand weakness for SA-specific reasons, when the global outlook is improving, makes the global plays on the JSE especially attractive for SA investors. Rand strength in the longer term would be very helpful for the SA economy, especially when lower inflation is accompanied by lower interest rates.

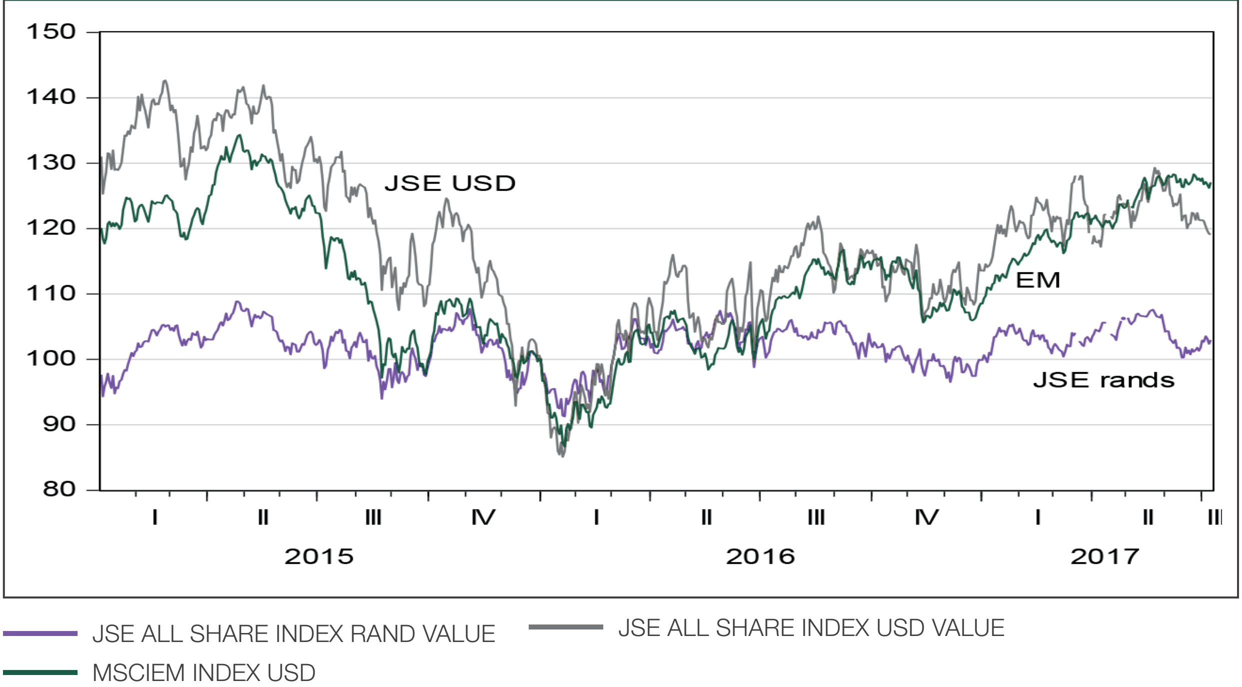
The dilemma for the construction of SA portfolios for rand investors is clear enough. More SA political risk and the accompanying expectation of rand weakness encourages more exposure to equities with offshore exposure and a preference for offshore investment. Rand weakness means more inflation and higher bond yields, higher short-term interest rates and a weaker SA economy. Recent developments on the stock and bond markets illustrate these forces at work. Over the past 18 months of rand strength, the bond market has outperformed the stock market by about 6%, with the All Bond market delivering 15% over the 18 months and the share market 9.4%, modest returns by historic standards given an increase in the CPI of about 8.7% over the same period.

Figure 5: Stocks over bonds (JSE All Share Index/ All Bond Index) 2016-2017, month-end data



Source: I-net and Investec Wealth and Investment

Figure 6: Equity market performance, JSE All Share Index (rand and US dollar) vs MSCI EM (2015-2017), January 2016 = 100



Source: I-net and Investec Wealth and Investment

Rand strength – of the unexpected kind experienced for much of the past eighteen months and consistent with stronger emerging markets and less SA political risk – calls for less exposure to equities and more exposure to long-dated fixed-interest bonds and less exposure to direct investments offshore. Persistent rand strength, with an improved political climate must however eventually be helpful to the earnings and valuations of the SA economy plays.

It is however not easy to confidently believe in the prospect of an improved outlook for political developments in SA. A persistent bias to protect portfolios against rand weakness is understandable, especially when balanced portfolio funds of the kind we reference are required to hold no more than 25% of assets offshore. These portfolios, if unconstrained, would presumably have a much larger average weight offshore.

Our SA Asset Allocation committee therefore found it appropriate to follow the lead given by the GISG and retain a neutral exposure to equities, both onshore and offshore. This SA portfolio, as indicated, is intended to be hedged against the possibility of rand weakness. It also offers a degree of protection against rand strength through the rand bond holdings.

Rand strength, especially for reasons specific to SA, would see equity underperformance balanced by exposure to a strengthening bond market and good returns from the offshore portfolio. Rand strength for better global growth reasons, associated with stronger emerging and developed equity markets, would help the neutrally balanced portfolio. Rand weakness for global reasons would again be less helpful to the JSE and total returns. The performance of offshore equities, which is kept at a full 25% weight in our portfolio, would suffer should global growth and global earnings disappoint.

The JSE indices, particularly the Financial and Industrial Index (FINDI), appears as significantly overvalued by historical standards when trailing earnings and interest rates are factored in. This in itself makes it harder to strongly recommend JSE-listed equities. However there is an important proviso when making such value judgments. The indices have come to be dominated by Naspers. The FINDI now accords a 27% weight to Naspers, and after its recent results announcement (reported in US dollars), Naspers trades at over 100 times its headline earnings when converted into rands. Clearly much growth in earnings is expected from Naspers and its holding in Tencent. But such a heavy dependence of the index on one company vitiates any judgments about index values. The key consideration when reviewing the JSE has become the value in Naspers.

In these politically uncertain circumstances, a well-hedged risk-neutral position for SA portfolios seems appropriate. The asset allocation mix selected has been indicated below as are some of the implications.

Asset allocation positioning:

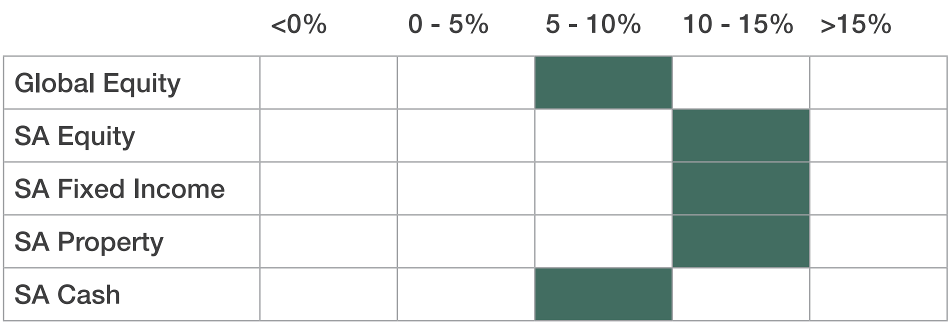
The metrics below show our asset allocation positioning for global, domestic and by theme.

Global Asset Allocation	Q3 2017	Q2 2017	Comments
Offshore Equity	N	N	Neutral global equity. Improved return from risk assets as a result of better growth and earnings prospects
Offshore Fixed Income	▼	▼	Low expected total returns from these starting yield levels. Still offers some insurance characteristics versus risk assets.
Offshore Cash	▲	▲	Prefer cash to core government bonds.
Offshore Property	N		Valuations reasonable relative to long term average
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	Q3 2017	Q2 2017	Comments
SA Equity	N	N	Do not see SA market attractive enough to upweight. Global Plays will help cushion a sell-off for SA specific risks. Selected small and mid caps approaching interesting levels.
SA Fixed Income	▼	▼	Concentrated in the front and middle of the yield curve. Inflation trajectory could support attractive total returns. Looking to move upweight in time.
SA Cash	▲	▲	Offers positive real returns, lowers volatility and provides optionality. Also own floating rate notes.
SA Listed Property	▼	▼	Valuations on the domestic side look rich and growth outlook more muted. Local property counters will be correlated to interest rates
Preference Shares	▲	▲	Attractive yield advantage with possible repurchase underpin. Also look attractive from a real yield perspective for taxable investors
$/R (+ for Rand strength)	▼	▼	ZAR is currently at fair value based on fundamental inputs but not pricing any in SA specific risk.

Sectoral/Thematic Positioning	Q3 2017	Q2 2017	Comments
Global Plays	▲	▲	Overweight global plays. High quality businesses generally but have been reducing given valuation gap between domestic and interest plays.
Commodities	▲	▲	Overweight commodity plays - upweight in quality, lower beta and underweight SA. Prefer diversified miners versus single commodity producers.
Gold Plays	▼▼	▼▼	Currently do not own any gold producers given poor fundamentals. Own physical gold in balanced portfolios.
Interest Rate Plays	▲	▲	Slightly overweight on a view that we may see a change in direction in the SA interest rate cycle, but lower conviction than we had at the start of the year
SA Industrials	▼	▼	Remain underweight for now. Growth prospects looking tough but opportunities may present themselves.

▼▼	▼	N	▲	▲▲
Underweight	Moderately underweight	Neutral	Moderately overweight	Overweight



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