Global Investment View

Quarter 1, 2019

Investec

Wealth & Investment

Portfolio Management | Stockbroking | Wealth Management

Contents

Going neutral on supportive economics and improved valuations

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

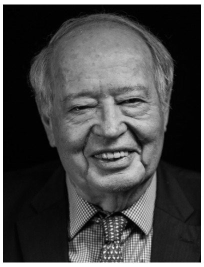
Commentary by:

John Haynes

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.

Going neutral on supportive economics and improved valuations

By John Haynes, head of research, Investec Wealth & Investment UK and chairman of the Global Investment Strategy Group

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.

The Global Investment Strategy Group (GISG) opted to increase its risk budget score to neutral, from the modestly negative position that had been maintained since December 2017.

This improved outlook is based on the view that investor complacency has now evaporated, but that fears that either economic (monetary policy) or geopolitical miss-steps will bring the earnings growth cycle to an imminent end are now overdone.

We still see a supportive economic backdrop, with improved valuations, particularly in emerging markets. This gives us confidence that owning risk assets will be rewarded relative to owning cash or fixed income over our forecast period (18 months).

We're positive about the outlook for growth in the global economy and hence for corporate profits

Concerns about the global macro-economic outlook have increased recently as forecasts for growth have been reduced in both Europe and emerging markets, due to stresses in the so-called "Fragile Five" and also from a combination of self-inflicted (Italy) and externally generated (Trump Trade) political issues.

We think these concerns are now overdone. 2019 should see growth convergence generating similar overall global economic growth to 2018. The US economy will slow and the stimulus of tax-cuts will not be repeated, but Europe and the emerging economies are expected to improve, helped by easier monetary conditions, better terms of trade, lower oil prices and an improving political backdrop.

This should be sufficient to sustain global US dollar corporate profits growth close to mid-single digits - lower levels than in 2018, but still supportive of equities.

Monetary policy transition risks are low

Markets have been given ample time to adjust to the normalising US monetary policy stance and investors are aware that Europe has embarked on the same course. Furthermore the turmoil in selected emerging markets earlier in 2018 has not proven contagious.

The current focus on the flattening yield curve in the US is understandable, but with US/ European government debt spreads at historic highs, no sign of stress in credit markets, inflation data well behaved and with the Federal Reserve now signalling a "data-dependent" path forwards (while acknowledging that interest rates are close to neutral), there appears to be little prospect of either a deliberate or accidental tightening of monetary policy to levels that would hurt growth.

Valuations of risk assets are attractive, particularly outside the US

Although discount rates rose in 2018 the picture has now improved as the rise in interest rates has been offset by a combination of growth and equity market declines. Absent developments that would require a higher risk premium, the solid earnings and dividend growth expected in 2019 should be fully reflected in risk asset prices.

So why not more positive? Our decision to adopt a neutral stance – rather than a positive one as the above would ordinarily justify – takes into account the following risk factors:

Cyclical risk:

We're forgiving on equity valuations more than usual because the cycle is maturing. If inflation pressures do start to build beyond the level factored into markets, it would be bad news for risk assets.

Specific geopolitical risks:

On this we are explicitly making three key judgements:

- The US and China can reach an accommodation on trade
- China, the nexus of the wider emerging market growth story, will continue to grow solidly
- Europe will prove resilient to resurgent populism embodied in German elections, Italian challenges, French unrest and also to Brexit, whatever form it should take.

A new world disorder: The current US Administration's use of deliberately engineered crises to achieve policy ends is now an established pattern and corporate confidence is a hostage in this process. A "Trump Tariff" in risk assets is justified.

Global Summary

2018 was one of the strongest starts for global equities in at least 30 years. Performance remained very strong for equity investors right up until the middle of September, with the S&P500 hitting a record high on the 20th September 2018. Things unravelled quickly from there, with the S&P500 pulling back almost 15% by the end of the year to finish -4.4% for 2018, having been up 11% up until September.

What made the year especially poor (one of the poorest on record from this perspective) was the fact that almost all other major asset classes (in USD) also produced negative returns for the calendar – meaning that there were not many places to hide.

In fact, only USD cash managed a positive return for the year. We show a “periodic table” (figure 1) for global asset classes in USD over the last 10 years below.

A number of factors contributed to the volatility and asset class drawdowns over the year. These included tightening financial conditions in the US, trade wars, slowing growth expectations in US, China and Europe and falling oil prices.

Figure 1

Markets in the Red, 2008 - 2018

Calendar Year Total Return for 17 Asset Classes

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
10 - Year UST	MSCI EM	REITS	10 - Year UST	MSCI China	Russell 2000	REITS	MSCI Japan	Commodities	MSCI China	2 - Year UST
2 - Year UST	MSCI China	Russell 2000	Inflation Bonds	MSCI Europe	S&P 500	S&P 500	REITS	Russell 2000	MSCI EM	U.S. HY
U.S. Agg Bond	Global HY	Commodities	EM HC Sov	Global HY	MSCI Japan	10 - Year UST	10 - Year UST	U.S. HY	MSCI Europe	U.S. Agg Bond
EM LC Debt	U.S. HY	MSCI EM	U.S. IG	REITS	MSCI Europe	MSCI China	EM HC Sov	Global HY	MSCI Japan	10 - Year UST
U.S. IG	Commodities	MSCI Japan	U.S. Agg Bond	MSCI EM	U.S. HY	U.S. IG	S&P 500	S&P 500	S&P 500	REITS
Inflation Bonds	MSCI Europe	U.S. HY	REITS	EM HC Sov	Global HY	EM HC Sov	2 - Year UST	MSCI EM	Russell 2000	U.S. IG
EM HC Sov	EM HC Sov	S&P 500	U.S. HY	Russell 2000	MSCI China	U.S. Agg Bond	U.S. Agg Bond	EM HC Sov	EM LC Debt	S&P 500
U.S. HY	REITS	Global HY	Global HY	S&P 500	REITS	Russell 2000	U.S. IG	REITS	Global HY	Global HY
Global HY	Russell 2000	EM LC Debt	S&P 500	U.S. HY	2 - Year UST	Inflation Bonds	MSCI Europe	U.S. IG	EM HC Sov	Inflation Bonds
Commodities	S&P 500	EM HC Sov	2 - Year UST	EM LC Debt	U.S. IG	U.S. HY	Global HY	EM LC Debt	REITS	EM HC Sov
MSCI Japan	U.S. IG	10 - Year UST	EM LC Debt	U.S. IG	U.S. Agg Bond	2 - Year UST	Russell 2000	Inflation Bonds	Inflation Bonds	EM LC Debt
Russell 2000	EM LC Debt	U.S. IG	Russell 2000	Inflation Bonds	MSCI EM	Global HY	U.S. HY	MSCI Japan	Commodities	Commodities
S&P 500	Inflation Bonds	U.S. Agg Bond	Commodities	MSCI Japan	Inflation Bonds	MSCI EM	Inflation Bonds	U.S. Agg Bond	U.S. HY	Russell 2000
REITS	MSCI Japan	MSCI China	MSCI Europe	U.S. Agg Bond	EM LC Debt	EM LC Debt	MSCI China	MSCI China	U.S. IG	MSCI Japan
MSCI Europe	U.S. Agg Bond	MSCI Europe	MSCI Japan	10 - Year UST	10 - Year UST	MSCI Japan	EM LC Debt	2 - Year UST	U.S. Agg Bond	MSCI Europe
MSCI China	2 - Year UST	Inflation Bonds	MSCI EM	Commodities	EM HC Sov	MSCI Europe	MSCI EM	10 - Year UST	10 - Year UST	MSCI EM
MSCI EM	10 - Year UST	2 - Year UST	MSCI China	2 - Year UST	Commodities	Commodities	Commodities	MSCI Europe	2 - Year UST	MSCI China

Source: Neuberger Berman

Markets in 2018 – Reasons to be less fearful of equities

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

The fall in equities in 2018 has meant that valuations have become less demanding. The investment case for global equities is that fears of an economic slowdown are exaggerated – which would be good news for equities in 2019.

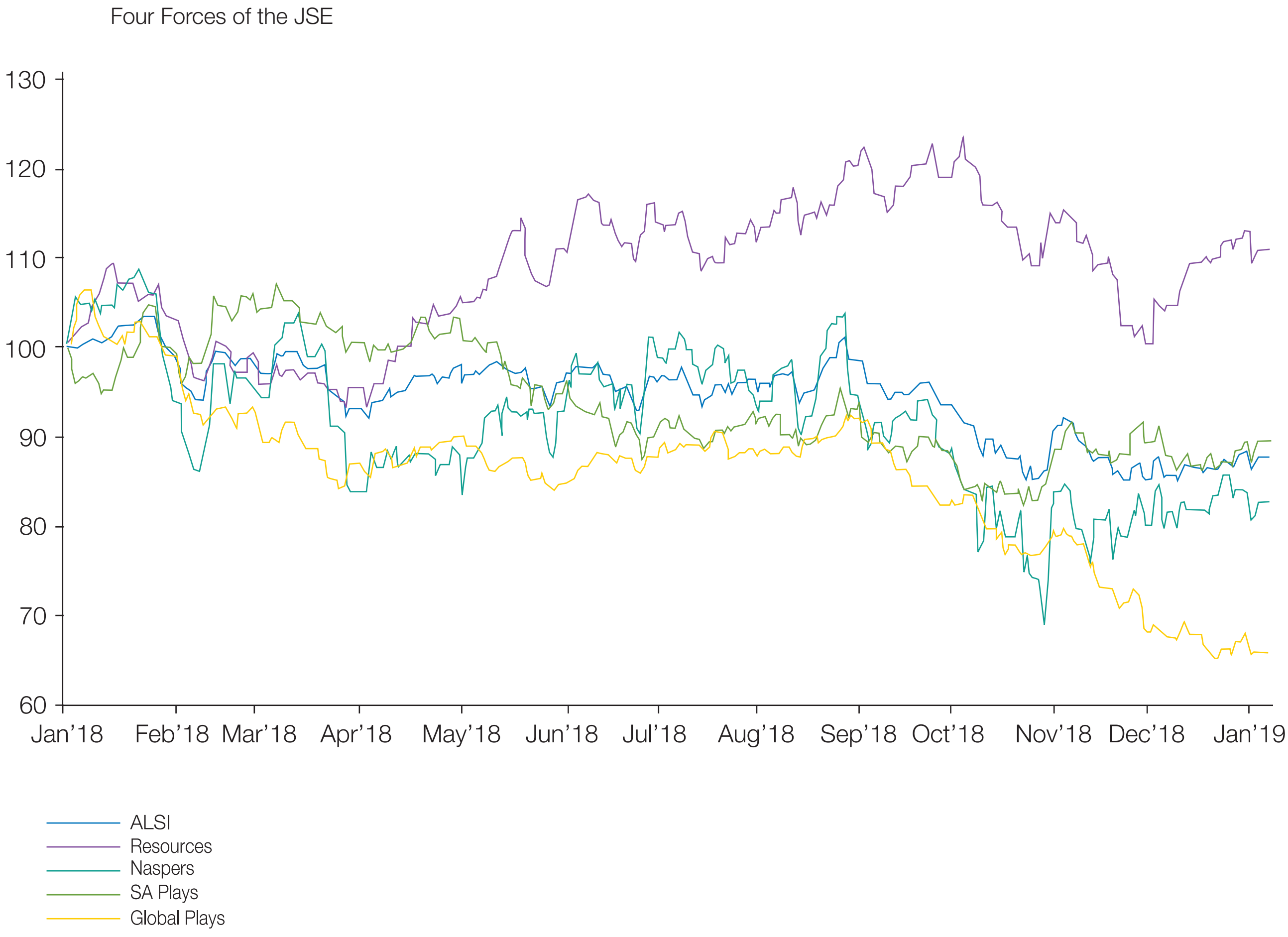
Most JSE investors would have been pleased to put 2018 behind them. Only the resource sector of the JSE provided some joy – ending the year up by about 10%.

The global plays on the JSE lost over 30% of their value in response to unfavourable company news as well as unhelpful market-wide events.

Naspers, which accounts for about 20% of the JSE All Share Index weighting, did better than the other 13 global plays, but still lost 20% of its market value in 2018.

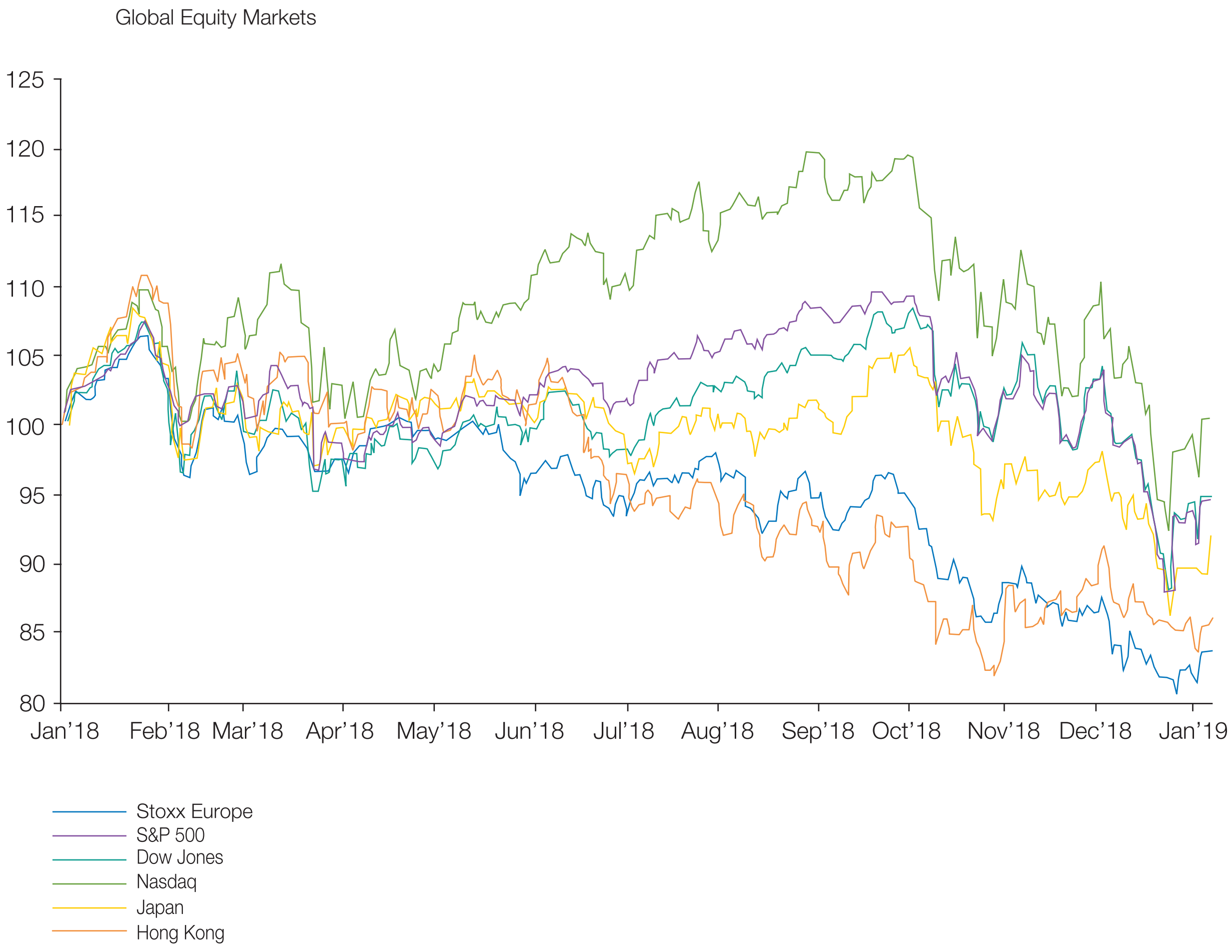
Escaping the travails of the JSE in 2018 was not an easy task, especially after the S&P 500 also fell away so badly late in the year. But US companies still did better than most as may be seen in figure 2 below. The JSE tracked the European and Chinese indexes closely lower in 2018, when measured in US dollars.

Figure 1: A tough 2018 on the JSE – relieved by resource counters



Source: Bloomberg and Investec Wealth and Investment

Figure 2: Global equity markets in 2018



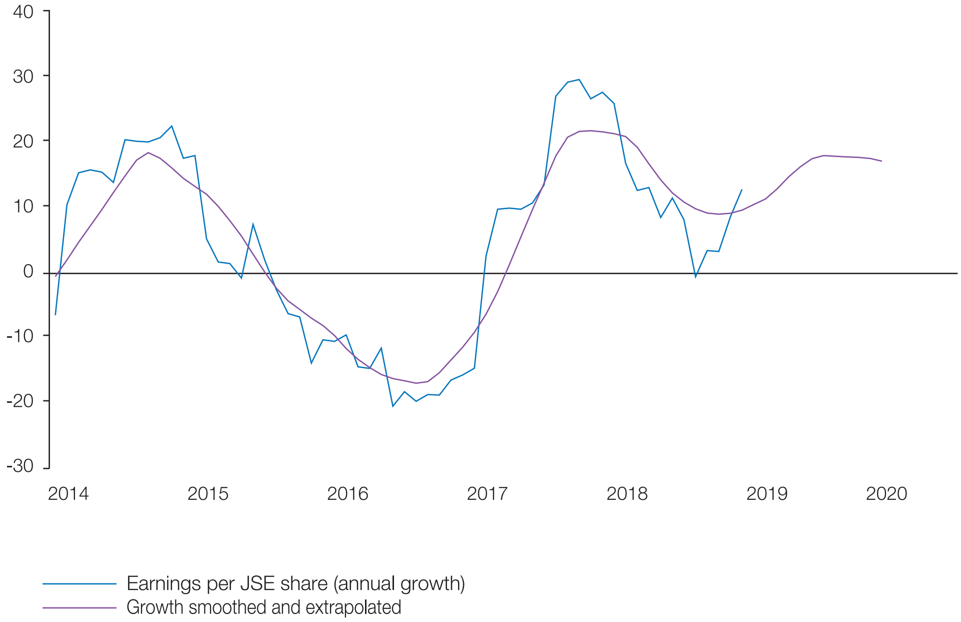
Source: Bloomberg and Investec Wealth and Investment

Dispatches from the earnings front

The cycle of JSE All Share Index earnings per share bottomed out in mid-2018 and then gathered momentum to year end when index earnings per share were growing at a 10% annual rate. These growth rates are expected to rise further – according to a time series forecast. The pick-up in earnings growth, measured in US dollars, has been more muted given dollar strength.

Naspers, which accounts for about 20% of the JSE All Share Index weighting, did better than the other 13 global plays, but still lost 20% of its market value in 2018.

Figure 3: JSE earnings cycle – annual growth in rand earnings per indexed share

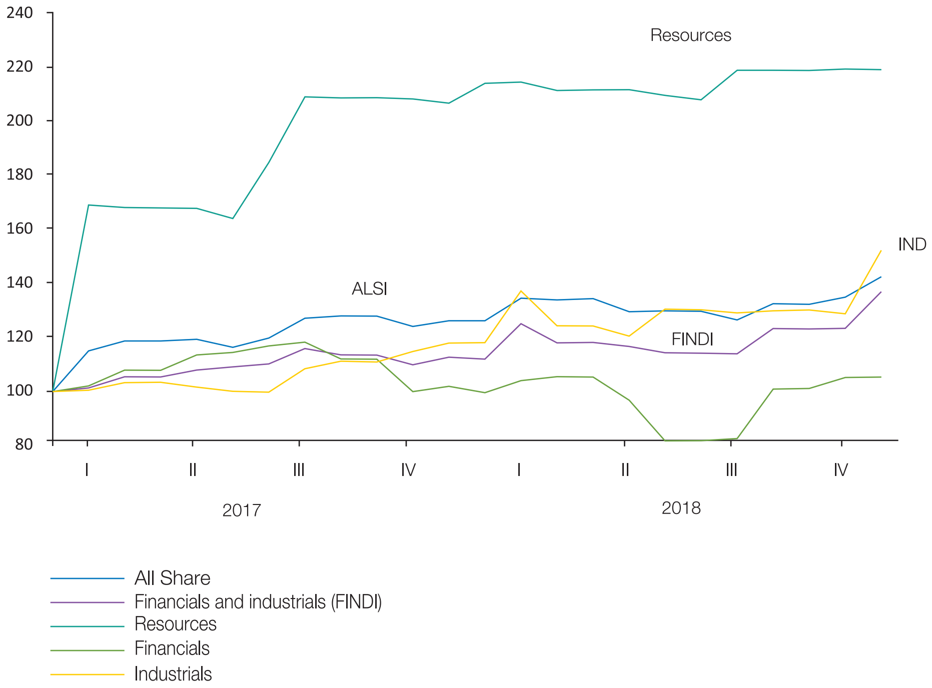


Source: Bloomberg and Investec Wealth and Investment

The reported earnings of resource companies had recovered very strongly in 2017 and then stabilised at higher levels in 2018. It was this doubling of resource earnings in 2017 that gave support to the value of resource companies.

Earnings of the other major sectors of the JSE – especially the earnings of financial companies – lagged. However by year end, 2018 earnings of JSE industrial companies – a market-weighted Index dominated by large global companies – were more than 40% up on earnings levels in early 2017.

Figure 6: JSE index earnings per share (2017=100)



Source: Bloomberg and Investec Wealth & Investment

It is worth recognising how much JSE earnings per share have declined in US dollar terms in recent years. They fell away after the commodity super cycle that ended in 2011. JSE Index earnings per share, in US dollars, now run at only 86% of their levels of early 2011 and 40% lower than peak earnings of 2012. It is these declining earnings that explain the lower US dollar value of the JSE. Economic fundamentals matter when it comes share values.

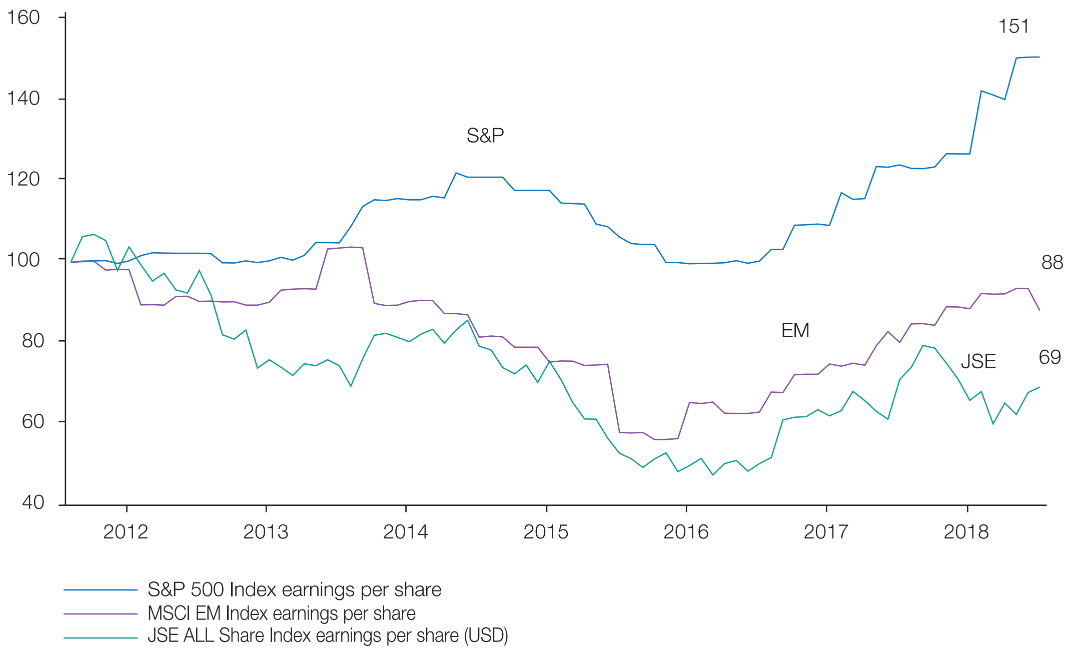
The correlation of emerging market (EM) and JSE dollar values is the result of similar underlying trends in earnings. JSE and EM earnings have still to regain 2014 levels. By contrast, the strong and consistently good performance registered by S&P 500 companies since 2012 is shown below.

The outperformance of the US market has been due to improved sentiment about future earnings. It has been justified by better fundamentals as revealed in figure 8. Compared to 2012, S&P index earnings per share are up 51%, EM earnings are 12 % lower than in 2012, while JSE earnings, in US dollars, have declined some 30%.

JSE Index earnings per share, in US dollars, now run at only 86% of their levels of early 2011 and 40% lower than peak earnings of 2012.

Compared to 2012, S&P index earnings per share are up 51%, EM earnings are 12 % lower than in 2012, while JSE earnings, in US dollars, have declined some 30%.

Figure 8: Earnings flows – S&P vs EM vS JSE (2012=100)



Source: Bloomberg and Investec Wealth & Investment

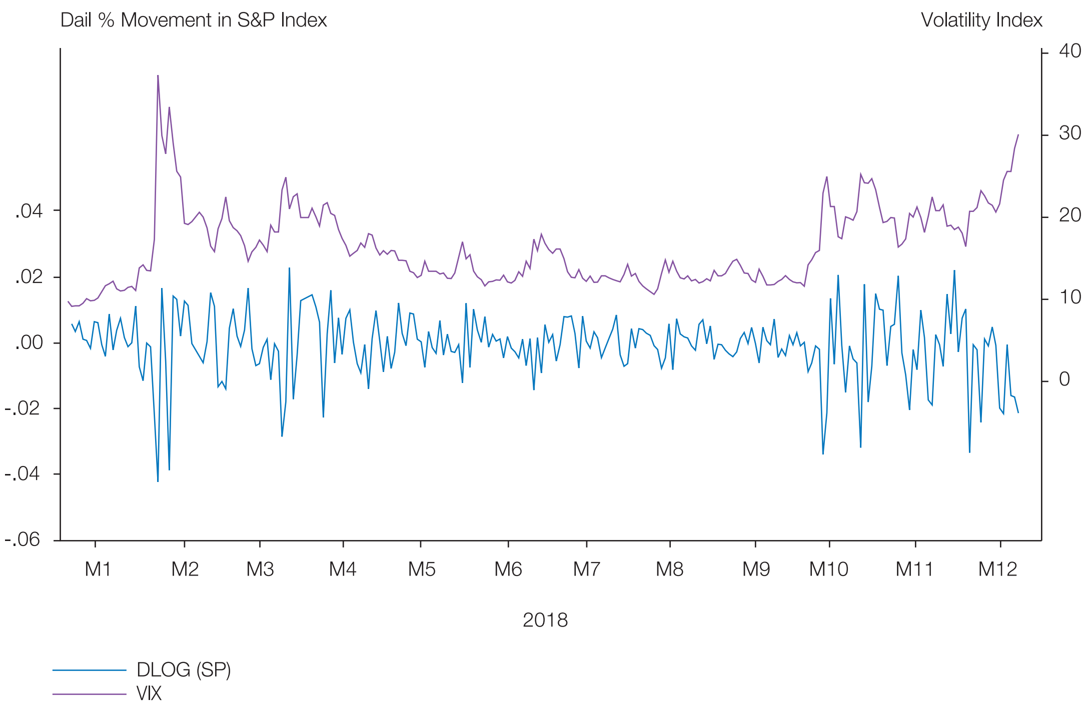
Recognising the value gap in global equity markets

The return and earnings cycles in EMs and in the US have been moving in opposite directions. Returns on the JSE have fallen away as earnings have picked up as they have done elsewhere, thus opening up a widening value gap.

A conclusion – be less scared of equities

Market expectations of earnings to come from global equity markets have been revised sharply lower. As a result, current valuations have become less demanding of earnings and dividends. This is the good news about the recent uncomfortable market moves that represent heightened uncertainty about the economic developments to come, reflected in increased volatility. As volatility rises, share prices almost always decline, as they have done recently.

Figure 12: Volatility on the S&P 500 in 2018



Source: Bloomberg and Investec Wealth & Investment

Market expectations of earnings to come from global equity markets have been revised sharply lower. As a result, current valuations have become less demanding of earnings and dividends.

Also moving the markets have been comments by Fed Chairman Powell that he was sensitive to market sentiment and that higher short-term rates were not inevitable.

The investment case for global equities is that fears of an economic slow down are exaggerated and will by some degree be disabused by economic events. The good US employment numbers for December represented such a market moving event. Also moving the markets have been comments by Fed Chairman Powell that he was sensitive to market sentiment and that higher short-term rates were not inevitable.

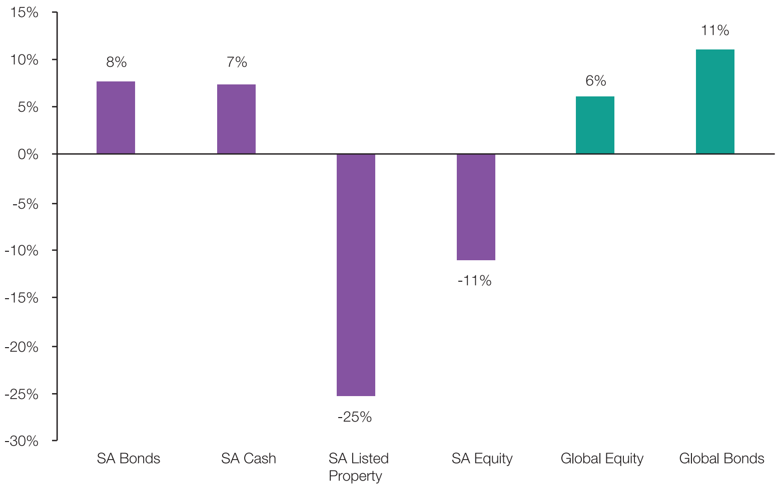
The Investec Wealth & Investment Global Investment Strategy Group (GISG) met in early December and decided to recommend an increase in its exposure to risky assets in balanced portfolios. The case for global equities – based on even more undemanding valuations – has become somewhat stronger than it was in early December 2018.

South Africa Summary

South Africa was not spared from the year end rout, and in fact was one of the worst equity market performers in USD over the period. Emerging markets more generally were the worst performing global asset class in the selection above so we had a lot of company.

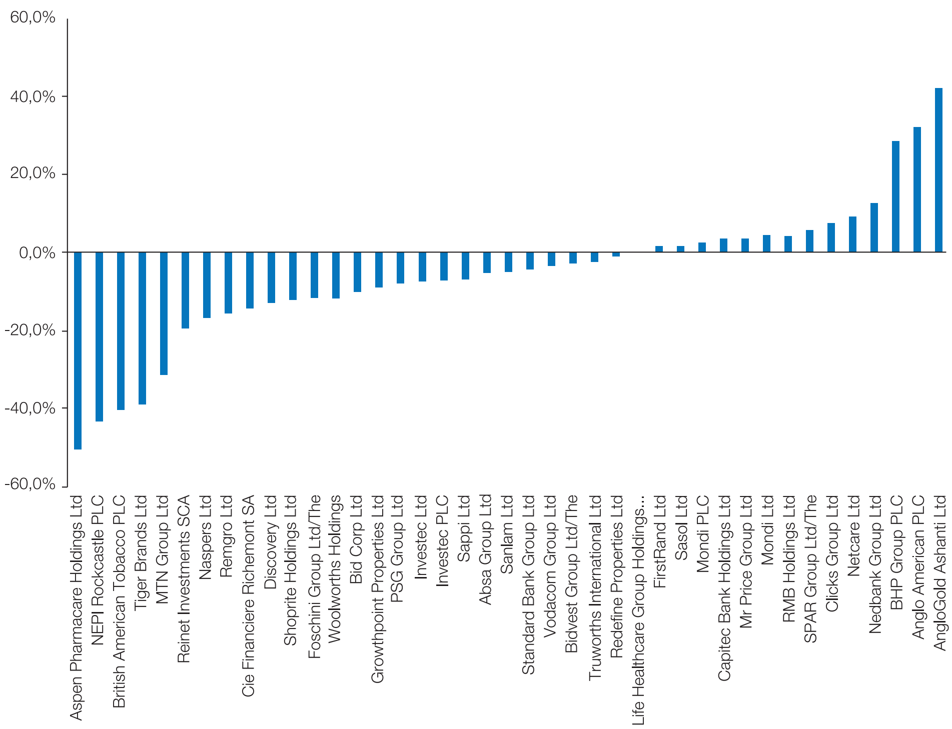
From an SA multi asset investor perspective, we were cushioned slightly by positive returns from our bond market as well as offshore equities and bonds (in addition to domestic cash). Some real damage came in the property sector, where the sell-off in the Resilient/Fortress/Nepi stable of stocks helped drive the index down 25% for the year. Our equity market was down 11% (as measured by the JSE Capped Swix Total Return) for 2018 (figure 2). Looking at the Top 40 constituent performance for 2018 below, one can appreciate the breath of the sell-off across the market with only seven stocks producing a total return in excess of inflation (figure 3).

Figure 2: 2018 Total Returns for SA Investors



Source: Bloomberg

Figure 3: Top 40 Constituent Total Returns for 2018



Source: Bloomberg

Asset allocation summary for 2018

From an asset allocation perspective, we had been up weighting domestic risk asset classes in a very measured fashion through the year, focussing on expected risk adjusted returns. Initially we started with purchases of fixed income, then adding to property after the massive sell-off before starting to add equity exposure with aim to get to an overweight equity position by the 4th quarter.

We also looked for value in the midcap areas of the market given that this sector had already taken a knock a number of months previously. Our gold position also worked well for portfolios as the gold price rallied in rand terms over the year. The net effect of this was internal benchmarking beating returns but disappointing returns at the absolute level for clients.

Outlook

Our view on positioning in portfolios has not changed materially, and in fact we see further value in pockets of the domestic multi asset landscape. Our investment committee was incrementally more positive on the outlook for bonds, property and equity premised on a number of factors. The rationale for maintaining our risk on position and continuing to selectively upweight is predicated on the following:

- Global growth is still strong enough for corporate earnings to deliver close to consensus earnings of 10% in 2019 and 8% in 2020.
- Equity markets have overly discounted the risk of an earnings recession
- We think the developed/emerging market cycle may be turning. Emerging markets are an increasingly attractive investment destination given the valuation underpin and long term growth dynamics.
- Even though it may not feel like it sitting in South Africa, SA earnings and price performance largely tracks broader emerging markets – as such emerging market outperformance will support SA market performance.
- We think the domestic growth may well surprise on the upside – seeing better than expected results from some data points including retail sales volumes, manufacturing, freight volumes as well as restaurant sales.
- Valuations on a number of measures are now outright cheap or reasonable.
- International and local investors are very underweight domestic equities – any change in sentiment would see broad based buying of the more liquid shares on our market.
- We think our bond yield is too high based on the spread versus US Treasury bonds, as well as other emerging markets. Any move lower will be supportive of the group of stocks thought of as interest rate plays (retailers, banks and property stocks).
- At the same time some of our big global play stocks had a very poor 2018 (think BTI, APN, MTN) on the back of company specific issues. We could well see a rebound from two very different areas of the market at the same time, for different reasons.
- Lastly, where portfolios do have direct offshore assets, we see the rand being relatively close to our estimate of fair value. As such it should not present too much of a headwind for hard currency assets in portfolios.

We continue to debate the cyclical versus structural issues facing SA corporate profitability and the SA economy in general. Ultimately there are probabilities associated to both outcomes and time will tell which direction we move towards. In the interim, we believe assets can still be undervalued, even in the face of structural issues. As we adjust the probabilities ascribed to these scenarios, we will adjust our risk-taking appropriately.

In summary, we are cautiously optimistic on the outlook for investors going into 2019. Our views and portfolio positioning are summarised below.

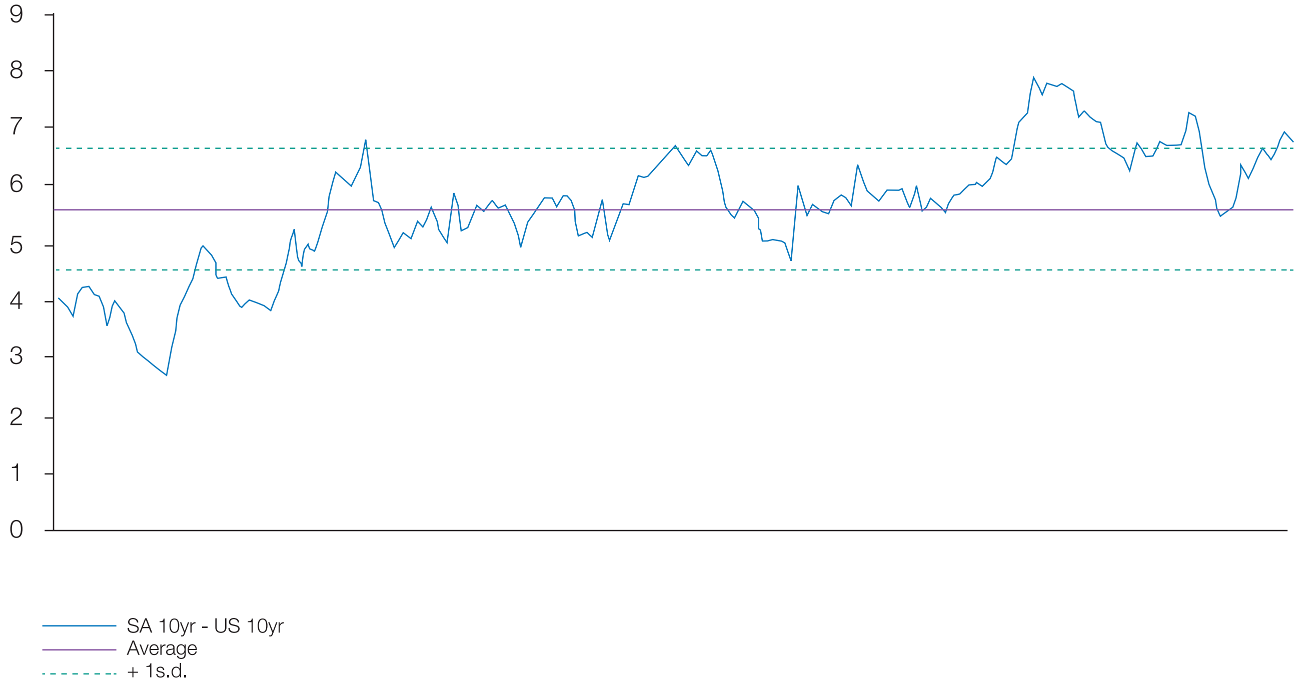
Figure 4:

Median P/E

Source: I - Net

Figure 4

SA 10 yr Spread over US



Source: Thompson Reuters

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	Q4 2018	Q1 2019	COMMENTS
Offshore Equity	⌄	N	Move back to neutral equities on valuation underpin. Equity markets look to have over-reacted.
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	Q4 2018	Q1 2019	COMMENTS
SA Equity	︽	⌃	More optimistic on outlook for SA equity market generally. Valuations looking much more reasonable.
SA Fixed Income	N	N	Concentrated in "belly" of the yield curve. Total returns look attractive on a 12 month view. Have switched short bonds for longer duration bonds.
SA Cash	︾	⌄	Still offering attractive real return but see better total return opportunities.
SA Listed Property	⌃	⌃	SA focussed property counters look attractive on a valuation basis.
Preference Shares	⌃	⌃	Attractive yield advantage over taxable yields assets with possible repurchase underpin. Focus on the bank preference shares.
$/R (+ for ZAR strength)	⌃	⌃	ZAR looks slightly cheap relative to fair value given our top down macro view
Physical Gold	⌃	⌃	Allocation to physical gold offers protection against SA and Global risks.

SECTORAL/THEMATIC POSITIONING	Q4 2018	Q1 2019	COMMENTS
Global Plays	⌄	⌃	We have reduced our exposure to global plays in favour of domestic plays.
Commodities	⌃	⌃	Overweight commodity plays although up-weight 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 very 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

Chris Hills
CIO,
United Kingdom

Professor Brian Kantor
Chief Economist & Strategist
Investec Wealth & Investment
South Africa

Philip Shaw
Chief Economist
Investec PLC

John Wyn-Evans
Head of Strategy
United Kingdom

Oliver Kirkby
Portfolio Manager & Analyst
South Africa

Darren Ruane
Head of Fixed Income
United Kingdom

John Barkhan
Head of International Division
United Kingdom

Nik Kidd
Senior Investment Director
United Kingdom

Stephen Trowbridge
Senior Investment Director
United Kingdom

Oliver Battersby
Senior Investment Director
United Kingdom

Paul Deuchar
Head of Portfolio Management SA
South Africa

Ryan Friedman
Portfolio Manager &
Head of Multimanager
South Africa

Paul McKeaveney
Portfolio Manager & Chairman SA
Asset Allocation Committee
South Africa

Neil Urmson
Wealth Manager
South Africa

Annelise Peers
CIO
Switzerland

Ian Quigley
Head of Investment Strategy
Ireland