Global Investment View

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Wealth & Investment

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The Global Investment View distils the thinking of the Global Investment Strategy Group (GISG) that brings together the insights of Investec Wealth & Investment's professionals in the UK, South Africa 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.

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A modest growth acceleration in 2020 should support the outlook, but beware the new world disorder

By Chris Holdsworth, chief investment strategist, Investec Wealth & Investment and member of the Global Investment Strategy Group

The Global Investment View distils the thinking of the Global Investment Strategy Group (GISG) that brings together the insights of Investec Wealth & Investment's professionals in the UK, South Africa 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 GISG maintains its **increase in risk budget score to neutral, from slightly negative previously.**

Our view is that risk assets (equities) will outperform insurance assets (bonds) over the next 18 months. This assessment is based upon a belief that the global economic cycle is resilient and continues to support equity investors, but this is offset by a recognition of the high potential for geopolitical-originated growth shocks. Since this balance is reflected in the valuations of risk assets relative to insurance assets, a neutral position is appropriate.

To unpack our position in more detail:

The global economic outlook is supportive: 2019 saw a material deceleration in global economic growth, from 3.6% to 3.0% (according to IMF estimates), as a manufacturing recession took hold. This was driven entirely by the trade war declared by the US on China and was the main contributor to the decline in the global trade growth rate, from 3.6% in 2018 to an estimated 1.1% in 2019 (IMF). We subscribe to the IMF's view that 2020 will see a modest re-acceleration in global GDP growth, to around 3.4%, driven by the following factors:

- **Trade war impacts diminish:** The shock of the tariff spat is now wearing off. Although the Presidential election year may see a narrative of competitive China bashing, the operating environment for global companies will be more certain and global trade growth should improve markedly.
- **A strong foundation:** The consumer and the service sectors are the bedrock of growth in the global economy. Employment levels in the developed world are very high, wages are growing in both nominal and real terms, and balance sheet pressures are low. This is supporting consumer confidence, spending and a healthy service sector, which has been less affected by the manufacturing/trade recession than historically would have been anticipated.

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- **Global monetary policy:** has swung back decisively to an explicitly supportive setting. Three interest rate cuts by the Federal Reserve have seen recession fears fade. Outside the US, Europe and China have also eased policy over the past six months and have committed to do more should the need arise. The dovish setting across the globe looks likely to remain in place for some time, given low and stable inflation.
- **Broadly supportive fiscal policy**. The US continues to run a large government deficit (4% of GDP), while China has loosened its purse strings as an offset to the effects of tariffs on trade and domestic retail sales.

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- **Europe is a swing factor.** Europe has suffered disproportionately from the global trade recession. Internal political challenges have not helped, including Brexit. These headwinds look set to diminish. A return to robust health looks far away, however, as the weapon of extreme monetary policy stimulus through negative interest rates looks to have become ineffective, or even harmful, while Germany is facing ever louder calls to relax its own policies and the EU spending rules to allow for Europe-wide fiscal stimulus. Looking longer term, an emergency investment programme to tackle climate change may break the logjam, if it gains support as a political platform.
- Emerging markets are expected to enjoy better conditions. China, global trade and the US dollar look set to all be supportive (or at least not negative) in 2020.

A more positive outlook for global corporate earnings in 2020

Forecasts for 2019 are for -1% global earnings growth in dollars, which is a significant negative "reset" from the beginning of the year. However, if our central case economic scenario holds good, 2020 earnings look set to grow again as the rest of the world catches up (somewhat) with the US. Consensus has 9% forecast for next year, but mid-single digit growth in 2020 is a more realistic expectation.

Valuations – risk assets (equities) are fairly valued relative to insurance assets (fixed income)

Lower bond yields (the discount rate) have ensured that global equities remain similarly fairly valued at the end of 2019 from what they were at the beginning – even though equities have risen by over 20% and dividends by less than 10%. A rise in equities, in line with earnings growth is the central case expectation, with a shortfall in growth or a rise in US 10 year Treasury bond yields above 2.5% (currently 1.84%) – absent faster growth – being the key threats to this outlook.

The broadly positive picture described above is balanced by our judgement that the risk premium that we need to invest in equities must be larger than usual to account for:

Cyclical risk: The economic and monetary policy picture outlined above is a Goldilocks scenario (not too hot, not too cold). It is not easy to reconcile low real and nominal bond yields (US 10-year Treasuries are yielding 1.8% and much of Europe is experiencing the head-scratching phenomenon of negative government bond yields across a large segment of the yield curve) with a positive growth outlook and high resource utilisation (employment). Good productivity performance has clearly been key, but consensus could quickly shift to expect either slower growth (threatening the profit outlook) or faster growth, which would bring the supportive monetary policy trajectory into question. In this context, US inflationary surprises in the form of higher-than-expected inflation would be the soft underbelly of a risk asset / stock market recovery.

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Elevated specific geopolitical risks: We are explicitly making several key judgements:

- The US and China can reach an accommodation on trade. We do not expect material positive developments from China/US trade relations, but we also expect no further deterioration. The most likely Chinese strategy, having weathered the impacts of tariffs imposed so far and clearly having also lost trust in Donald Trump as a reliable deal counterparty, would be to give him neither victory nor defeat prior to the US elections at the end of next year.

- China remains in control of its own destiny and, as the nexus of the wider emerging market growth story and an important trading partner for Europe too, absent an all-out trade war, will continue to grow solidly.

- Hong Kong will not derail China. The possibility that China could provoke international condemnation by heavy handed intervention in Hong Kong, thus exacerbating trade tensions, must be considered. China therefore has a lot to gain by demonstrating patience and a lot to lose by interfering. We expect that locals will be left to sort out a local problem and that protesters will lose momentum with time, under pressure from those locals suffering economic harm as a result of the current disturbances.

- Europe will prove resilient to internal political challenges (presented most recently by Italy) and also to Brexit, whatever form it takes. Although the UK election may not have solved matters, a chaotic no-deal (which could have impacted the world outside the UK) looks to have been removed from the table for the near term. Even if there is no “result”, Europe has even more time to prepare, increasing the odds that any harm will be largely done to the UK, not to continental Europe.

A new world disorder: The current US administration’s use of deliberately engineered crises to achieve policy ends is now an established pattern. US/Iran, US/North Korea, US/China, US/Europe. Corporate confidence is a hostage in this process. A “Trump tariff” in risk assets is therefore justified, albeit one that may be reducing with familiarity. The 2020 US Presidential election, which will pit Donald Trump against a (probably) left-wing Democrat, will be a test of the degree to which investors have become immunised to Trump’s polarising rhetoric. Our sense is that global (and US) financial markets would view a change in Presidency to a centrist Democrat, with a split congress, as the optimal outcome. In other words – more of the same policies, just a different CEO.

Independent of political interference, the prospects for global growth, corporate profits and interest rates all support the case for outperformance of risk assets over insurance assets over the coming 18 months. With valuation only “Neutral” however, the tilt towards risk assets should be no more than average – or a “Neutral” risk budget.

A note on volatility. The last year has been benign from a portfolio “risk-adjusted return” perspective. (returns divided by volatility). This will not continue. Not only do we expect greater equity market volatility in a fractured geopolitical landscape, but ultra-low bond yields have increased bond market duration and therefore volatility. This will inevitably make “balanced portfolios” more volatile too.

Our sense is that a “barbell” strategy is being adopted as logical – specifically, full weightings in global equities (pure risk) offset by very large holdings in very short duration risk free instruments, or cash, with gold playing a part in extreme barbells (a barbarous relic for barbarous times). Our neutral risk budget overall does not preclude such strategies.

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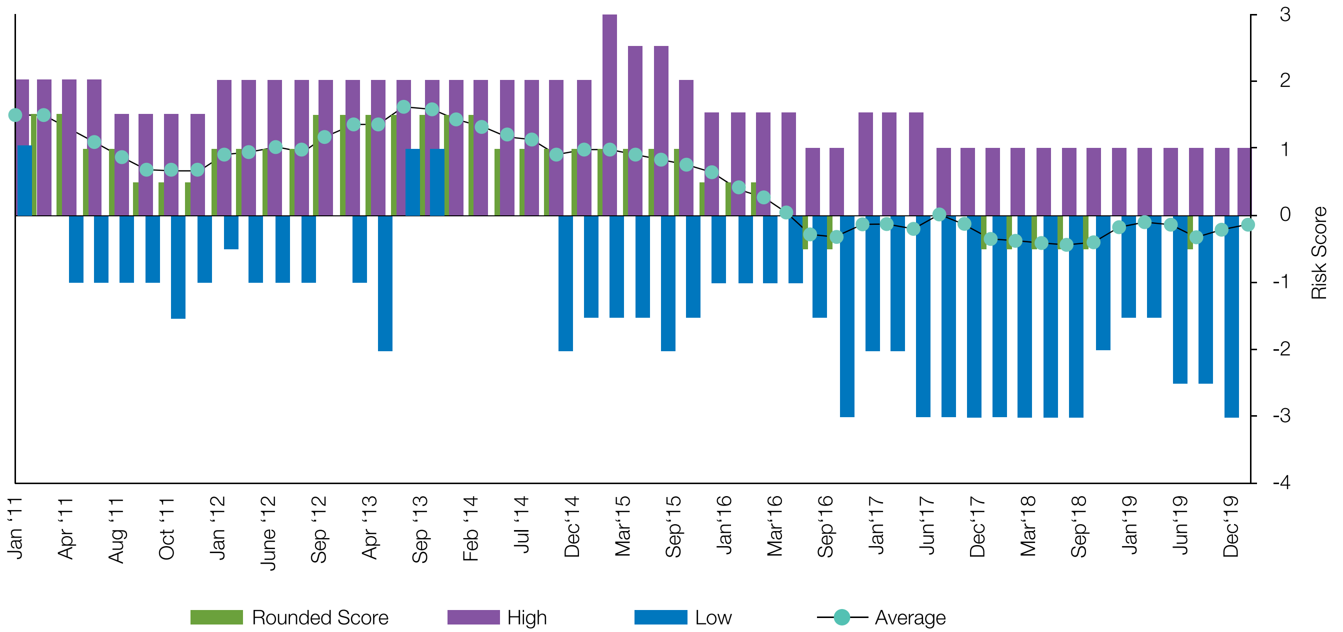
Voting Results



Source: Investec Wealth and Investment, World Bank

Independent of political interference, the prospects for global growth, corporate profits and interest rates all support the case for outperformance of risk assets over insurance assets over the coming 18 months.

SA market view and asset allocation – bonds preferred as downgrade looks fully priced in.

Overview

Our preferred asset class is domestic bonds, with an underweight in cash and domestic property. While state finances continue to deteriorate, by our estimate the risk of a downgrade is already more than fairly reflected in fixed income prices. SA equity in aggregate tracks emerging market equity. While we remain optimistic about the outlook for emerging market growth over the year ahead, we believe domestic bonds will offer better risk-adjusted returns over the medium term.

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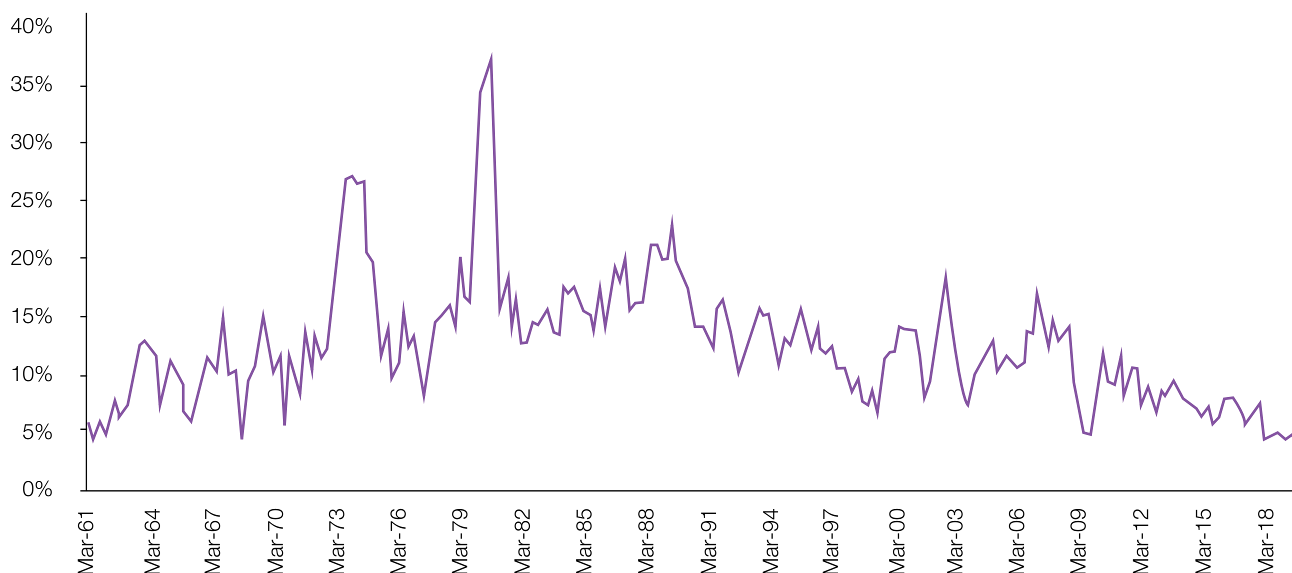
Deteriorating state finances

Nominal GDP growth in SA has been in steep decline over the past decade. Year-on-year growth in the third quarter of 2019 was 3.7%, the lowest growth rate on record. Nominal GDP growth has been well below National Treasury's forecasts and we expect it to again revise down its estimate for nominal GDP growth over the coming two years. This is likely to put upward pressure on the debt-to-GDP trajectory to be presented in the Budget in February. In response, we expect the government to raise taxes and cut expenditure relative to previous forecasts. The net result is that we expect the debt-to-GDP trajectory to increase over the short term but then be reduced markedly further out, relative to the forecast presented in the October Medium Term Budget Policy Statement (MTBPS). This may well be insufficient to avoid a downgrade from Moody's in March.

Yoy nominal GDP growth



Source: Investec Wealth and Investment and Thomson Reuters

There is limited scope for increasing taxes. The tax-to-GDP ration is back near its 2007/8 peak. Raising company income tax will likely simply see more companies shifting their domicile out of the country. Raising VAT and personal income tax will likley be deeply unpopular. We expect that the brackets for personal income tax will not be shifted for inflation (which will be less effective than before given weak wage growth) and the fuel levy will be increased again. This implies that a spike in the oil price between now and February would potentially remove an avenue for increased state revenue and jeopardise state finances. The net result is that an overweight exposure to SA bonds requires exposure to oil.

We expect modest aggregate wage growth (3%-5%) over the coming year. In addition, consumers will be paying more indirect taxes. This is partly offset by improving consumer credit health and the possibility of rate cuts over the coming 12 months. Given still very low business confidence, we expect little private sector job creation over the coming 12 months. The net result is that we remain concerned about the strength of the SA consumer over the coming 12 months. Given the turn in global purchasing managers indices and the hedge against SA-specific risks, the committee has pencilled in higher expected returns for both global consumer firms and commodity price plays, relative to firms exposed to the domestic economy.

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What this means for …

… equities: As noted above, emerging market equities are roughly fairly valued given dividends and prevailing interest rates. We expect emerging market earnings to pick up and within that, we expect SA earnings growth to pick up too. However, domestic bond yields are very attractive. The net result is we are neutral SA equities.

… bonds: While SA government debt continues to grow in line with expectations, SA nominal GDP growth continues to disappoint. As we note above, a deteriorating debt-to-GDP ratio creates a material risk that Moody's downgrades SA government debt in March. However, we believe this is more than reflected in current yields. Five-year SA US dollar-denominated government debt trades at a higher yield than equivalent Brazilian debt despite the latter being rated worse than South African debt. In our view, the real yield of 3.5% for SA 10-year inflation-linked debt is attractive.

… cash: Given continuing monetary easing across much of the globe, inflation in SA that is remarkably well contained and growth still modest, we expect the repo rate to be cut by 25-50bps over the coming 12 months.

… property: We prefer to get exposure to SA yields through the government bond market. SA domestic property is likely to continue to come under pressure as retail space is revised backwards. There are also concerns about oversupply in the commercial space.

Given still very low business confidence, we expect little private sector job creation over the coming 12 months. The net result is that we remain concerned about the strength of the SA consumer over the coming 12 months.

Given the above, we can draw up a **checklist of what's needed to increase** our risk preference in South Africa:
Sustained **risk-on appetite** globally.
Resumption of **emerging market versus developed market** outperformance (from a growth and earnings perspective).
A **coherent plan on how to deal with Eskom** and other SOEs – we need a strong message on how the expenditure will be controlled. The current situation is unsustainable.
No more load-shedding from Eskom – this was a major constraint to growth in 2019.
More **clarity on government policy,** given the factionalism within the ruling party.
Interest rate cut – other central banks (including emerging markets) are cutting rates. Our real interest rate is extremely high in this context and we have ample room to cut. **South African risk assets typically perform well in a downward interest rate environment.**
An improvement in business confidence – unlikely to see job creation unless this improves. Our positioning is summarised in the table below:

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 2019	Q1 2020	COMMENTS
Offshore Equity	N	N	Global backdrop remains supportive of risk assets over "insurance" assets.
Offshore Fixed Income	-	-	Low expected total returns from these valuations especially in core developed market government bonds.
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 ALLOCATION	Q4 2019	Q1 2020	COMMENTS
SA Equity	N	N	Cautiously optimistic on outlook for SA equity market. Valuations look cheap to reasonable but need to see delivery in key areas and favourable EM backdrop.
SA Fixed Income	+	+	Total real returns continue to look attractive. Expressed through inflation-linked bonds and nominal bonds with increasing preference for ILBs.
SA Cash	-	-	Still offering attractive real return but see better total return opportunities in risk assets.
SA Listed Property	-	-	Less of a domestic interest rate play than historically - expect to be driven by fundamentals. Prefer to express the view through the fixed income market.
Preference Shares	N	N	Very strong performance has moved valuations close to fair value. Still attractive for investors looking for after-tax income.
$/R (+ for ZAR strength)	+	+	ZAR looks slightly cheap valued on our models and we could easily see positive follow-through as $ weakens and/or EM risk appetite improves.
Physical Gold	+	+	Allocation to physical gold offers protection against SA and global risks.

SECTORAL/THEMATIC POSITIONING	Q4 2019	Q1 2020	COMMENTS
Global Plays	+	+	We have reduced our exposure recently to global plays in favour of SA domestic plays.
Commodities	+	+	Overweight commodity plays although upweight in quality and lower beta. Prefer diversified miners versus single commodity producers.
Precious Metals		--	Do not own any gold or platinum producers given our equity investment philosophy. Continue to own physical gold in balanced portfolios as a geopolitical hedge.
SA Plays		N	Neutral SA interest rate plays (includes retailers and banks).
Small/Midcap	+	+	Valuations are very attractive but appetite extremely low which may provide opportunity for patient investors.

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