Global Investment View

Quarter 2, 2020

Wealth & Investment

Portfolio Management | Stockbroking | Wealth Management

Contents

2

The Global Investment Strategy Group (GISG) has increased its risk budget score to risk on (by 0.5 on a scale of -1 to +3), from neutral previously.

4

SA market view and asset allocation – SA government bonds our preferred asset class.

10

Asset Allocation Positioning.

A modest tilt towards more risk; long-term earning power of the global economy recognised

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.

Commentary by:

John Haynes

John is Head of the UK Research team, based in London. He is Chairman of the Global Investment Strategy Group and a member of the Asset Allocation Committee. John started his career at Robert Fleming & Co as an analyst and fund manager on the US Equity desk. He then became the first non-founding partner at Taube Hudson Stonex Partners, where he gained experience in European and Far Eastern markets, before joining Investec in 2001. John graduated from Cambridge University with a degree in Chinese and Computer Sciences, and is a CFA Charter holder.

Chris Holdsworth

Chris Holdsworth joined Investec in 2007 and is the Chief Investment Strategist for Wealth & Investment South Africa. His research covers asset allocation and sector selection, both locally and internationally. Chris comes from the research team in Investec's equity business, where he has been an investment analyst for 12 years, covered investment strategy for six years and has headed up the research team for two years. He is also a member of the Global Investment Strategy Group (GISG).

The Global Investment Strategy Group (GISG) has increased its risk budget score to risk on (by 0.5 on a scale of -1 to +3), from neutral previously.

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

We believe now is the time to add risk to portfolios. After substantial falls in price, risk assets (equities and corporate bonds in particular) have become attractively priced relative to their long term prospects, while asset classes like sovereign fixed income now fully reflect their "insurance value".

A resilient financial system

Crucial to this view is our judgement that the financial system itself is resilient and that the monetary and fiscal policy measures taken by central banks and governments worldwide will substantially protect the fabric of the world economy while it is in voluntarily "shut down" (on a rolling basis) to control the viral load on healthcare systems. When the smoke clears, we believe the intrinsic value (long-term earnings power) of the global economy will have been only modestly impaired by this traumatic, but temporary, experience.

In these extraordinary times, we are being extraordinarily well compensated not to bet against our governments, our monetary authorities, our brightest and best scientists (even if no cure is produced, a medical control regime for the source of the problem is inevitable, given the resources and expertise dedicated to finding it) and our own resilience as individuals.

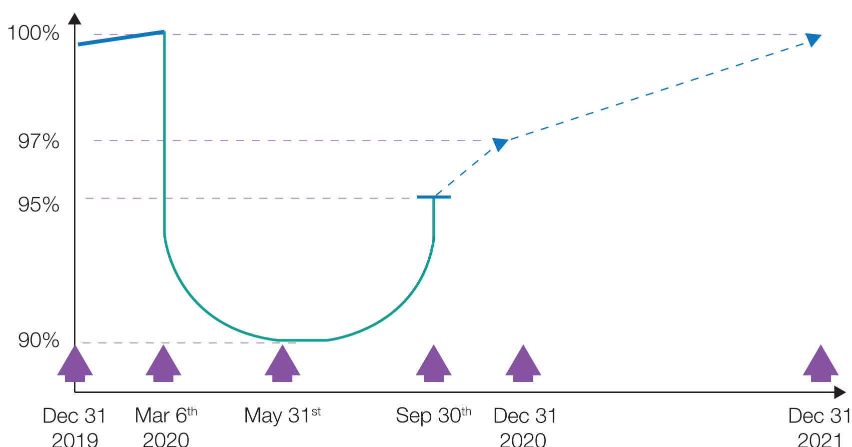
> **When the smoke clears, we believe the intrinsic value (long-term earnings power) of the global economy will have been only modestly impaired by this traumatic, but temporary experience.**

This move does not call the bottom in share markets. In the next couple of months, the news flow will be appalling. A visible picture of human suffering will unfold before our eyes at the same time as economic data reminiscent of the depression era. It will be hard to hold fast, let alone increase risk exposures in such conditions.

Economic Road Map
Global Real GDP - Conceptual Model

23/03/20 - Source IW&I

22



Source: Bloomberg and Investec Wealth & Investment

A modest tilt

Recognising that our job is to do what is right, not what is easy, our advice is to scale in to the “risk-on” position by first rebalancing to correct risk under-weightings produced by recent market movements. We would note too that our risk-on tilt is modest. If equity markets fall further and our central expectation that “this too will pass” if not challenged, we would expect to add further to our recommended risk budget.

Our view is that risk assets (equities) therefore 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.

Our view is that risk assets (equities) therefore will outperform insurance assets (bonds) over the next 18 months.

SA market view and asset allocation – SA government bonds our preferred asset class

Overview

Despite the current market conditions, we are cautiously optimistic, choosing to allocate our +1 risk budget predominantly to bonds rather than equity. We continue to debate the cyclical versus structural issues in SA, and remain alert for any challenges to our view, or opportunities to take advantage of.

Specifically, the committee has increased its recommended allocation to **SA government bonds.** SA government debt currently trades at a significant premium to inflation as well as a significant premium to similarly rated peers.

However, because of uncertainty around distribution growth (or negative growth), the committee has reduced its recommended allocation to property. **SA-listed property,** in aggregate, should no longer be considered the high yield play it once was.

As a result of the increased allocation to SA risk through domestic bonds, the committee has a preference for **offshore exposure in the equity market** over domestic stocks.

Overall, the committee believes Covid-19 related concerns will start to be priced out of equity markets within the next three months.

Despite the current market conditions, we are cautiously optimistic, choosing to allocate our +1 risk budget predominantly to bonds rather than equity.

Performance summary

The only domestic **asset** class with a positive return over the past 12 months has been cash. Over three years, only bonds and cash amongst domestic assets have provided positive returns. Offshore equities and bonds have outperformed their domestic equivalents over every period from one to 10 years. SA property was by far the worst performing domestic asset class (down 50% over the past year) and is now down significantly over the past five years.

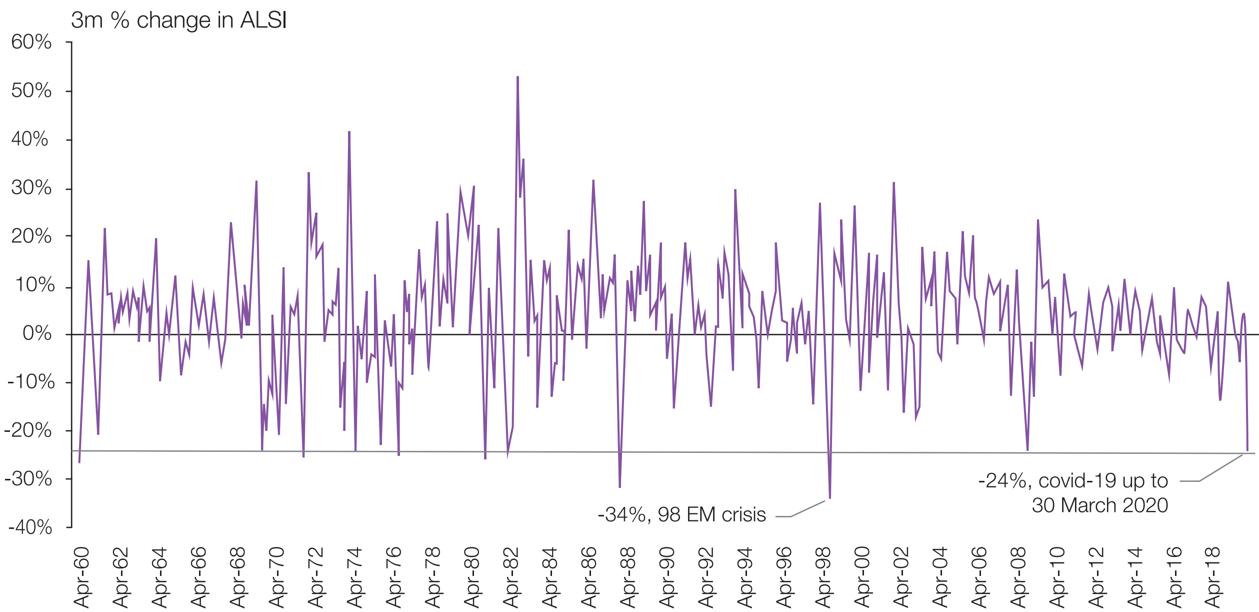
SA-listed property, in aggregate, should no longer be considered the high yield play it once was.

A growth shock is coming, the question is – what is in the price?

The three-month decline in equity markets across the world has been nothing short of breath taking. In SA we have only seen similar falls in 1998 and 1987. The fall in UK equities has been one of the largest in 300 years. The fall in US equities has been one of the largest since the 1930s.

Overall, the committee believes Covid-19 related concerns will start to be priced out of equity markets within the next three months.

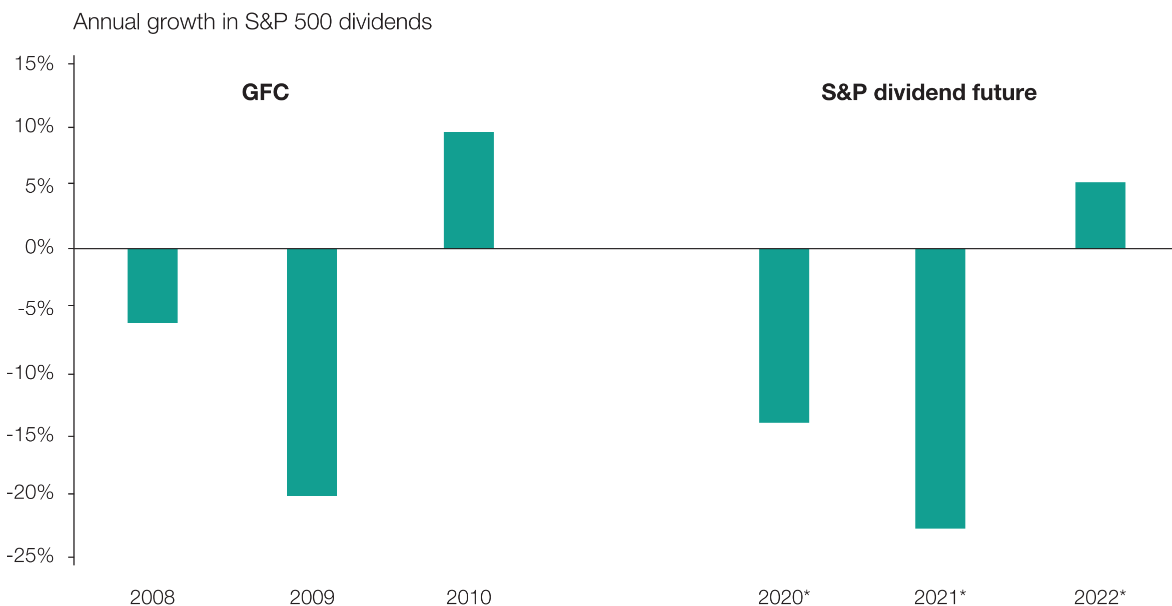
The SA equity market has taken a beating



Source: IRESS and Investec Wealth and Investment

Forecasts for GDP growth over the coming 12 months vary widely, with some suggesting that growth in the US in Q2 may be as low as -34% (Goldman Sachs). Q2 growth in SA could be as low as -14% (JPMorgan). At this point, forward price/earnings ratios are somewhat meaningless, with analysts in aggregate yet to fully incorporate the expected slowdown in global activity into their estimates. However, using dividend futures (S&P 500), at spot prices we see that the market is pricing in a decline in dividends over the next two years that is slightly worse than that seen during the global financial crisis. If we expect any outcome for global dividends that is better than what we saw during the financial crisis, then the S&P 500 is cheap. The chart below shows the year-on-year growth of S&P 500 dividends during the global financial crisis on the left-hand side vs what is currently priced in on the right-hand side.

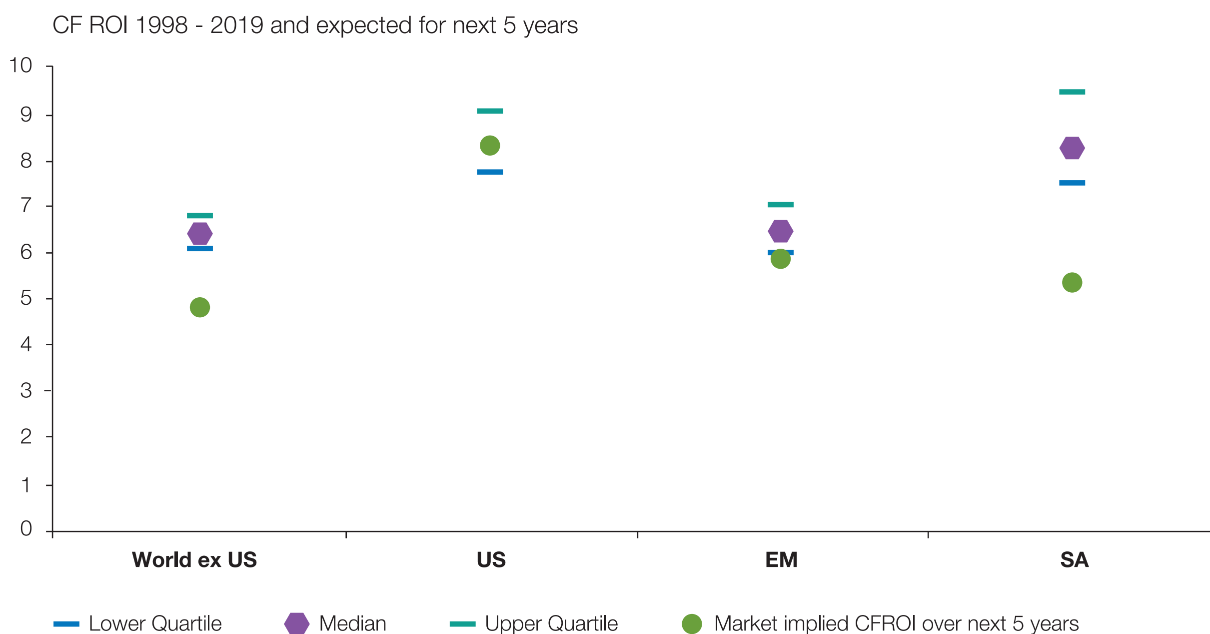
The market is pricing in a steep decline in S&P 500 dividends



Source: Refinitive

Markets are pricing in weak returns on invested capital (ROIC) from the global equity market ex the US and particularly weak ROIC for the SA equity market.

Backing out implied CFROIC across the globe



Source: HOLT and Investec Wealth and Investment

Will we see structural reform in SA?

Following Moody's downgrade of SA's sovereign debt, Finance Minister Tito Mboweni indicated that he had been given the green light to drive structural reform in the SA economy. However, given Moody's explicitly stated belief that the wage bill will come in above budget, words will no longer suffice. As it is government has gone back to the public sector unions with an offer of a 4.4% increase for 2020 instead of the 0% in the budget – an offer that the unions have rejected. However, there is one other avenue for structural reform that is already showing potential: Eskom has stated that it is able to take advantage of the current slowdown and low demand for electricity to accelerate maintenance.

Explaining the call, in favour of SA bonds

Despite the intervention by the SA Reserve Bank to buy government bonds in the market, SA bond yields still look attractive relative to any grouping of peers. The slope of the yield curve is currently so steep that should yields move up by 100bps over the next 12 months (which is not the committee's view), long-dated bonds will outperform cash. Even if bond yields were to increase by 100bps per annum over the foreseeable future, SA bonds would still outperform cash.

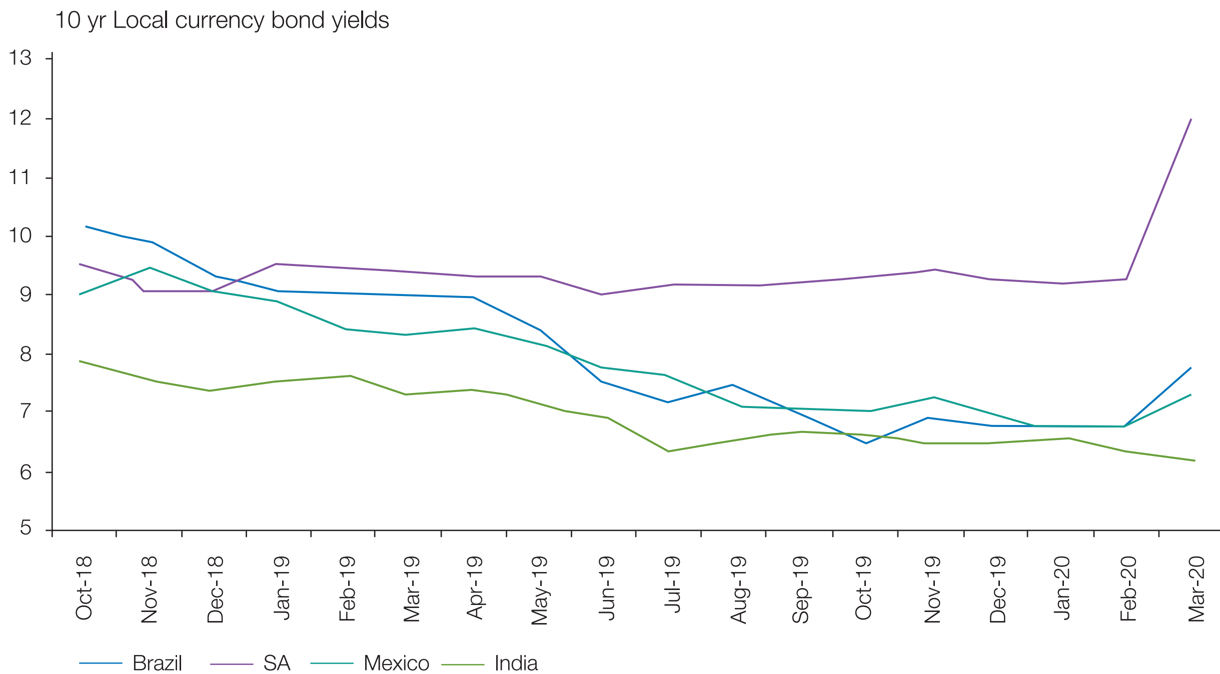
On this basis, the asset allocation committee has decided to recommend a double overweight in SA bonds to be split between inflation linkers and nominal bonds.

On the other hand, the committee has recommended a double underweight in SA property. Property has traditionally been considered a combination of a bond play and a yield play but this may no longer be the case. Given the slowdown in the economy, a number of property counters may well have to reduce their distributions markedly.

Following Moody's downgrade of SA's sovereign debt, Finance Minister Tito Mboweni indicated that he had been given the green light to drive structural reform in the SA economy.

Eskom has stated that it is able to take advantage of the current slowdown and low demand for electricity to accelerate maintenance.

Equity market performance and GDP over the past 10 years – not much of a link

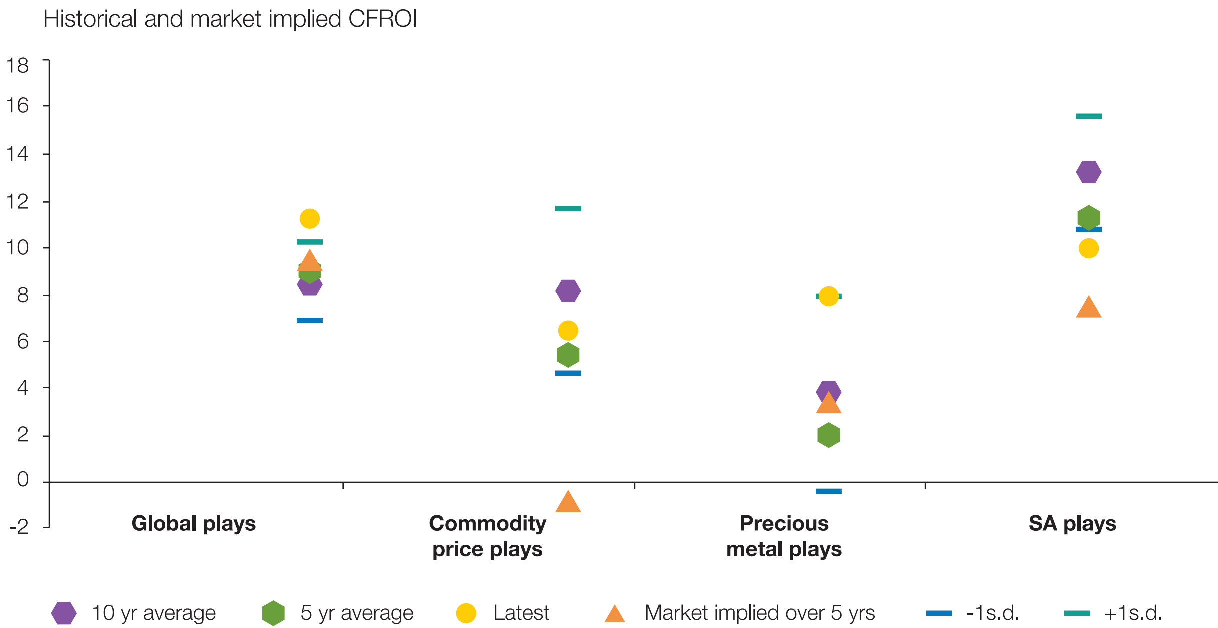


Source: Thomson Reuters

SA equities

The aggregate market in SA appears cheap thanks to the SA plays and commodity price pricing in extrememly weak return on invested capital over the next five years relative to history. The asset allocation committee has however chosen to obtain SA-specific risk through government bonds. Therefore within SA equities, the preference is for commodity price plays and global plays, rather than companies heavily exposed to the SA economy (SA Inc). The rather busy chart below shows the range of Cash Flow Return on Invested Capital (CFROIC) for each domestic sector as well as what the market is pricing in over the next five years for each sector (the yellow triangle). For both commodity price plays and SA plays, the market is already pricing in very low levels of return on capital over the forseeable future. For both sectors there is a high likelihood of companies surprising on the upside.

Backing out implied CFROIC across the local market

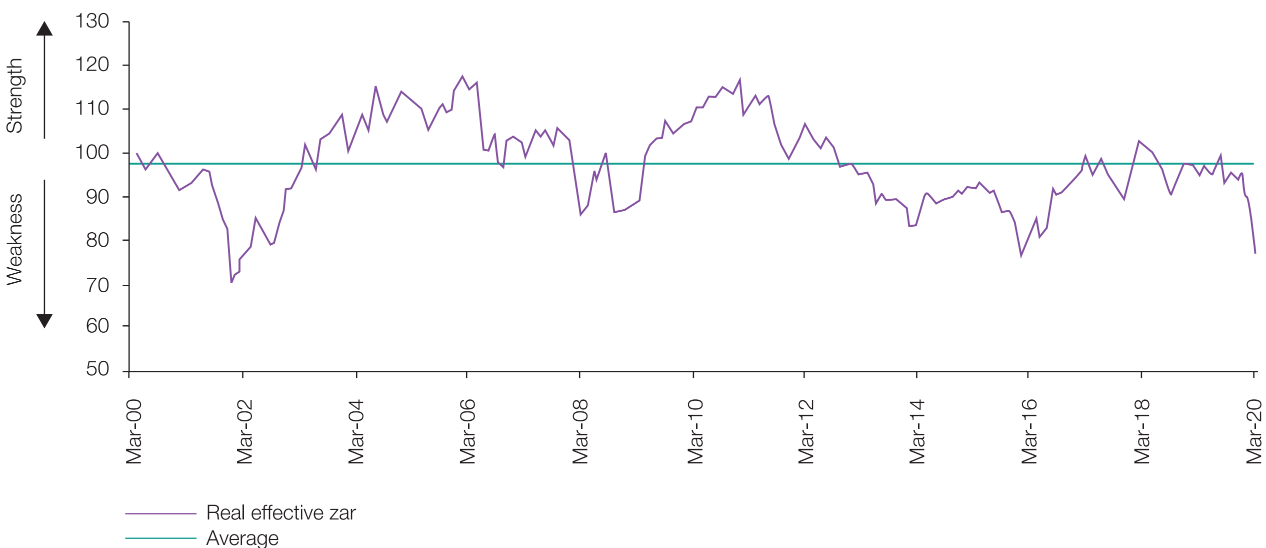


Source: Bloomberg and Investec Wealth & Investment

The rand remains extremely oversold

The trade-weighted, inflation-adjusted rand has rarely been as weak as it is now. Despite concerns about growth over the coming months in SA, the committee is of the view that the rand will strengthen over the coming 12 months. Various regions in China are already back to operating at close to capacity. This tells us that we should expect a sizeable pick up in activity about a month or so after lockdowns end in each region around the world. The pick-up in activity should be helpful for SA exports. In addition, we suspect that much of the desperate need for liquidity for global investors that struck a few weeks ago has been fulfilled. The net result is that we expect a risk on trade over the coming few months that should benefit all emerging market currencies, the rand included.

Inflation-adjusted, trade-weighted rand near record levels of weakness



Source: Thomson Reuters and Investec Wealth and Investment

Therefore within SA equities, the preference is for commodity price plays and global plays, rather than companies heavily exposed to the SA economy (SA Inc).

In summary

Equities: While the committee's risk score has improved and the team is looking to deploy cash, the preference at this point is for domestic bonds. Within equities, commodity price plays and global names are preferred given the increase in SA exposure through the bond allocation.

Bonds: SA bonds currently offer a large margin of safety. Yields are significantly above where we think inflation will be and significantly above peers (even similarly rated peers). Bond yields, both real and nominal, currently offer significant compensation for risk.

Cash: We expect further cuts to the repo rate over the coming 12 months.

Property: SA domestic property is likely to continue to come under pressure because of backwards revisions for retail space. There are also concerns about oversupply in the commercial space.

Our checklist for increasing our risk preference in SA looks like this:

- Sustained risk-on appetite globally
- Resumption of emerging market versus developed market outperformance (from a growth and earnings perspective)
- 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 the first quarter
- 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. SA risk assets typically perform very well in a downward interest rate environment
- Improvement in business confidence – We are 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	Q1 2020	Q2 2020	COMMENTS
Offshore Equity	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	Q1 2020	Q2 2020	COMMENTS
SA Equity	N	–	We have drifted underweight, we will increase the equity allocation at a later point, at the moment we are allocating more to bonds.
SA Fixed Income	+	++	Both ILB and nominal bonds offer compensation for risk that is extraordinarily large.
SA Cash	–	–	We see better total return opportunities in risk assets.
SA Listed Property	–	– –	Deep concern about distribution growth over the coming 12 months.
Preference Shares	N	+	Attractive for investors looking for after-tax income.
$/R (+ for ZAR strength)	+	++	ZAR looks deeply undervalued by our estimate.
Physical Gold	+	+	Allocation to physical gold offers protection against SA and global risks.

SECTORAL/THEMATIC POSITIONING	Q1 2020	Q2 2020	COMMENTS
Global Plays	+	+	GISG risk score is positive. Prefer SA risk through domestic bonds.
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	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.

Global Investment Strategy Group

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

Andrew Shard
Divisional Director /
International Investments
United Kingdom

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

Chris Holdsworth
Chief Investment Strategist
South Africa

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.