Global Investment View

Quarter 3, 2018

Investec

Wealth & Investment

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Contents

Keeping faith in the cycle, while factoring in a Trump risk premium

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

By John Haynes

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

Commentary by:

John Hayes

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Special contributions by:

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In brief

- Although the pace has decelerated, the world is still enjoying synchronised growth in all of its key economic blocks.
- The combination of a soft patch in Europe and a strengthening US dollar (which is usually problematic for emerging markets) has however cast its durability into doubt.
- We believe temporary factors are to blame, and the concerns about the strength of the global cycle will soon abate.
- The US is enjoying robust good health. Low unemployment is underwritten by tax cuts and increases in Federal spending.
- However trends in Europe and emerging markets are more questionable.
- China has also seen some (modest) self-inflicted growth softening. This has been the consequence of the authorities following through on promises to clean up the shadow banking system.
- The risks of a policy mistake by the world's leading central banks has diminished. Led by the US, we are on a journey to normalise developed market monetary policy.
- However a Trump risk premium is justified for the medium term. A more aggressive trade stance in the US is now evident.
- Equity market valuations are supportive. For equities to become definitively expensive, much lower dividends or materially higher bond yields would be needed.
- Our judgement is that the economic (and earnings) cycle will extend into 2020 before it peaks. Were it not for the effects of the US's hostile engagement with China and an increasing number of her trading partners, we would likely be more positively positioned.

Summary of our key thoughts

The Group decided to retain its modestly "risk off" position. The central case remains that, driven by a supportive economic backdrop, owning risk assets will be rewarded relative to owning cash or fixed income over our forecast period (18 months).

Three specific judgements contributed to this positioning:

- We retain a positive view on the growth and resilience of the global economy and of corporate profits. This is a product of confidence in favourable fundamental trends in the three main engines of global economic growth – the US, Europe and China. In addition, with markets now more used to the idea of the imminent inevitability of monetary policy normalisation, the likelihood of a monetary policy mistake in developed markets, led by the US, has fallen.
- We view market valuations as attractive, even in the context of a maturing economic cycle. Our objective is to be aggressively positioned at a market trough and cautiously positioned at a peak. Since we do not have perfect foresight, we must look to move towards our most cautious (or, if approaching a trough, most aggressive) position ahead of time. As turning points approach, this will make us less forgiving on valuations than a trading brief might allow. Today our view of a cycle peaking in 2020 (our 18-month horizon) makes it too early to set our risk budget onto a descending glide-path as part of a journey towards the desired defensive goal.
- Finally however, given the US administration's use of deliberately engineered crises to achieve policy ends, we judge that a "Trump discount" must be applied. Whether or not one agrees with US objectives, there is an increasing likelihood that the method used will backfire. National interests must be publicly defended by a process of negotiation between counterparties, and global corporate confidence is a hostage in this process.

In summary, were it not for President Trump's hostile engagement with trading partners, we would be more positive. Unfortunately, he cannot be ignored. The pattern of brinkmanship is established and the targets are broadening. China is only the latest and biggest of his targets after the non-US Americas and a number of range-finding shots at Europe. Even if this is only a ploy, he is unlikely to declare victory until shortly before the mid-term elections (November). In the meantime, China's patience may be tested and the prospect of the world's two great single-state economic powers engaging in a public punch-up risks material collateral damage. A position of modestly underweight risk assets feels right to us.

Were it not for President Trump's hostile engagement with trading partners, we would be more positive. Unfortunately, he cannot be ignored.

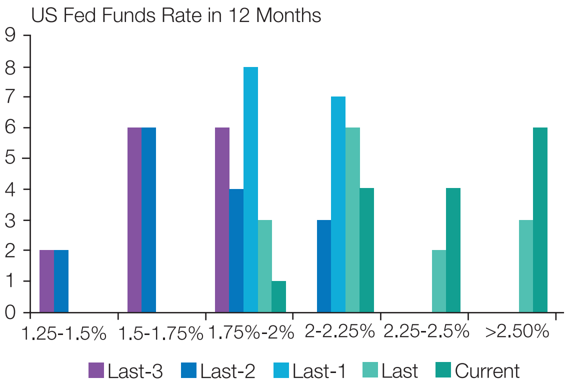
Explaining our positioning

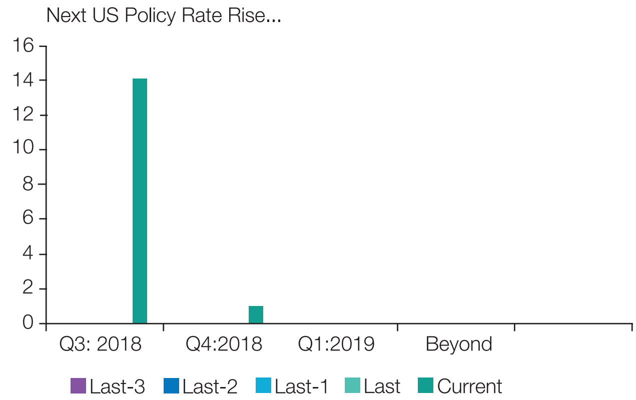
Economic fundamentals are good:

Although the pace has decelerated, the world is still enjoying synchronised growth in all of its key economic blocks (the US, Europe and China-centric emerging markets) for the first time since the Great Financial Crisis. The combination of a soft spot in Europe and a strengthening US dollar (which is usually problematic for emerging markets, which are usually exposed to US dollar borrowings) has cast its durability into doubt.

We believe temporary factors are to blame, and the concerns about the strength of the global cycle will soon abate.

The US is enjoying robust good health. Low unemployment is underwritten by tax cuts and increases in Federal spending on infrastructure and defence. These are projected to increase the annual budget deficit from around 3% of GDP to approximately 6% of GDP over the next two years. The pro-business / nationalist clarion call of the Trump administration has been good for business and consumer confidence. Inflation remains low and the Federal Reserve is only looking to normalise policy, not become restrictive.





Source: Investec Wealth & Investment

Trends in Europe and emerging markets are more questionable

Europe's soft patch can be explained by a combination of softer export orders due to the lagged effect of last year's substantial exchange rate strength and a confidence stutter as politics took an unexpected populist turn, most obviously in Italy but also in Germany and Spain. The impact of both factors is now diminishing and, although it is unlikely that growth will surprise positively again until late this year, populist success at the ballot boxes will accelerate the turn in the fiscal policy tide to become more stimulatory. Most importantly, employment trends remain good and the European Central Bank (ECB) retains a steady hand. European banks are now open for business and investor confidence in Eurozone systemic resilience was evident as Italy's election result was digested. Although the political picture is unlikely to get much clearer, with fewer headwinds and a more positive fiscal impetus in the pipeline, it will not take much good news for current concerns about growth to be recede.

China has also seen some (modest) self-inflicted softening in growth. This has been the consequence of following-through on promises to clean up the shadow banking system. The process of forcing the big banks to bring their shadow liabilities back onto their balance sheets was partly accommodated by a reduction in reserve requirements, but a diminished supply of incremental liquidity has been unavoidable. Looking at the bigger picture, this move and its sure-footed execution should be applauded as an example of good financial management by Chinese government. This is also evident in the stability of the yuan. China's leadership is also gaining respect for the maturity of its engagement with the US, its support for international trade and the positive initiatives it is promoting to encourage growth throughout their region (exemplified by the "one belt, one road" initiative). In short, China is accumulating "soft power" while the US is losing it. Unless provoked, an increasingly self-confident China is likely to be a source of growth and stability to the global economy for the foreseeable future.

Emerging markets have suffered the most in this recent period. Four "swing factors" have moved against them. The US has targeted Latin America in trade; two key export markets (Europe and China) have slowed naturally (see above); and the US dollar has strengthened. We expect imminent improvement in emerging markets. China and Europe's softening should soon reverse, commodity prices have remained resilient and we do not expect much further US dollar strength. The strength in the US dollar to date has been driven by growth and interest rate differentials widening because of strong US growth allowing policy normalisation ("good" factors) rather than by a flight of capital in anticipation of the end of the developed market-led global economic cycle ("bad" factors).

The overall picture is one of only modestly decelerated, but still synchronised and resilient, global growth in 2018 and 2019.

Policy mistake risks have reduced

Led by the US, we are on a journey to normalised developed market monetary policy. The Federal Reserve, under its new Chairman Jerome Powell, has increased its flexibility to change interest rates, which could mean faster rate rises. This is now clear to all investors and (absent shocking inflation data) the probability that fixed income markets become unsettled by the transition is much reduced. In this regard, the 3% nominal level on US 10-year Treasuries is important psychologically to many investors – we have tested the level once, but until yields have moved decisively through that level, we should be on high alert for volatility storms. In Europe, the sunset of quantitative easing is part of this process, but again investors appear to be comfortable with forward guidance on interest rates. Japan remains behind Europe.

Volatility spike negotiated – but higher baseline expected

The surge in volatility that we saw in February as investors woke up to a new monetary policy direction is unlikely to be repeated in the near term, however as the cycle matures, we should naturally expect a higher "baseline" level of volatility. This comes from two sources. Firstly, the "unsuppression" of medium term interest rates as quantitative easing (QE) programmes are unset. Secondly, as part of policy normalisation, the monetary policy settings between the developed market blocks will increasingly diverge as they are reset to reflect locally appropriate, rather than global conditions. At the minimum, an increase in exchange rate volatility must be expected as this process unfurls – most likely equity, interest rate AND exchange rate volatility will increase.

Equity market valuations are supportive

Our basis for equity market valuation uses time-tested measures, relating current dividends to current medium term risk-free rates. They indicate that equities are "fair value" in the US and cheap elsewhere. Note that over the past six months, given a flat global equity market (up 2% in US dollars), in our models the positive impact of the rise in earnings (over 5%) has been broadly offset by the rise in 10-year Treasury yields (from 2.4% to 2.9%). For equities to become definitively expensive, much lower dividends or materially higher bond yields would be needed. Since we expect healthily growing dividends over the forecast period and only modestly higher bond (discount) rates, we view the valuation backdrop (ex any Trump discount) as supportive.

A Trump risk-premium is justified for the medium term

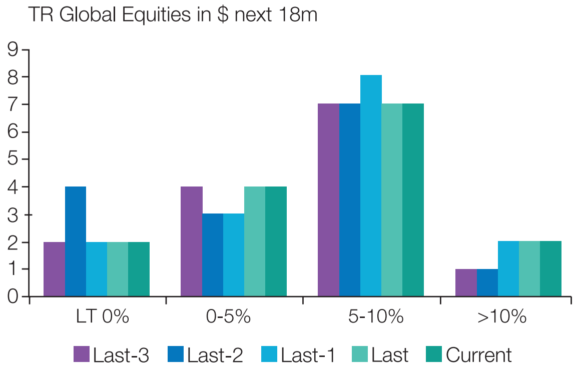
The turn to a more aggressive trade stance feared after the departures of Gary Cohn (former White House economic adviser) and Rex Tillerson (former Secretary of State) is now evident. America First is now not just a narrative, but explicit in policy.

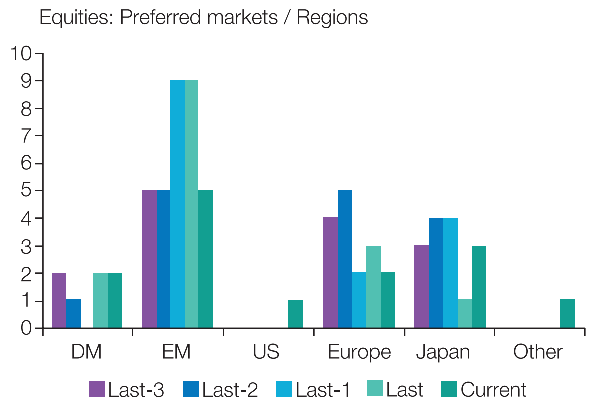
A trade war between the US and China is one of the few "dog whistles" that would be loud enough to reset the animal spirits among multinational corporations in a negative way. The most rational interpretation of the move to engage China (and Europe) in such a hostile way appears to be that it is a high-risk clarion call to Trump's electoral base ahead of the mid-term elections in November. Even if this Machiavellian interpretation is right in this instance, the implications of the world's most powerful economy pursuing only in its own interests are not positive and the use of manufactured crises to achieve policy ends is becoming an established pattern. The impacts of US policy on friend or foe are unpredictable – hence global equities in the Trump era deserve a higher risk premium than in more ordinary times.

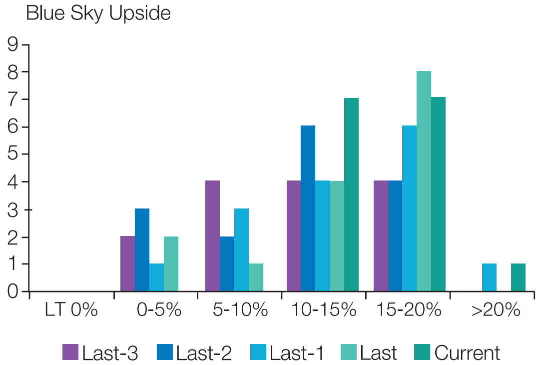
Blue sky potential is diminishing, but not ruled-out

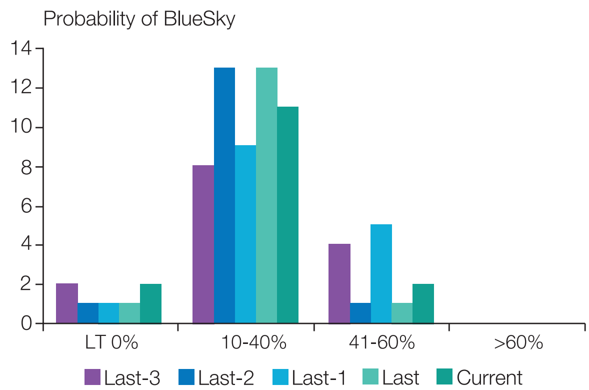
A risk appetite capitulation (what is called a "melt up") could still occur. The drivers of such a move would be earnings growth combined with increased confidence in the economic cycle being extended, compounded by aggressive corporate behaviour (M&A). An explicit trade accommodation with China, which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

Although the pace has decelerated, the world is still enjoying synchronised growth in all of its key economic blocks (the US, Europe and China-centric emerging markets) for the first time since the Great Financial Crisis.









Source: Investec Wealth & Investment

In Summary

The economic picture remains strong and there will be no policy mistake (either monetary or global commercial / political) to derail it; nor are valuations an impediment. With our judgement being that the economic (and earnings) cycle will extend into 2020 before it peaks, were it not for the US's hostile engagement with China and an increasing number of her trading partners, we would have likely been more positively positioned.

China and Europe's softening should soon reverse, commodity prices have remained resilient and we do not expect much further US dollar strength.

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

US escalates trade and diplomatic hostility against all trading partners (negative)

versus China: The unilateral imposition of tariffs on approximately US$50bn of Chinese imports into the US, after apparently engaging in fruitful discussions, followed by another US$200bn when China responded in kind is a dangerous step. Although the US is raising legitimate issues with China – specifically on intellectual property protection and a tariff protection system that reflects an emerging economy, not the second largest in the world and its largest trader – it is tackling these in a dangerous way.

versus the G7: The refusal to sign an anodyne joint statement after the last G7 meeting and the subsequent attack on Canadian Prime Minister Justin Trudeau underlines the seriousness of the rift between the US and her historical allies and the threat to the established framework.

versus Europe: Relentless hostility towards Germany particularly continues to be displayed. Trump repeatedly demonstrates that he feels no compunction about giving opinions on non-domestic issues, however ill-informed he may be. This has been tolerated, but tariffs will not. Targeting European car imports would be a grave mistake.

versus Latin America: The anti-immigration drive is a form of trade war.

A global trade war would marry growth recession with higher inflation, as alternative / more expensive supply chains are built and tariff costs are passed on. However, if the US continues to engage all of her perceived trade adversaries at once, the likelihood is less that a global trade war results, and more that the US becomes isolated. Such a re-organisation of the established world order would derail, at least temporarily, the healthy synchronised global growth that we are currently seeing.

European politics (negative)

Italian politics (negative)

An Italian populist coalition has formed a government. The partners have strongly nationalist and Eurosceptic leanings. This adds to European risk in the medium term – however the new administration appears to have heeded the warning shot from bond markets against radical new policy directions. Nevertheless, Italy is likely to "front run" the anticipated relaxation in Eurozone fiscal policy.

Spanish politics (negative)

A no-confidence vote removed Mariano Rajoy and the People's Party from government. The politics were purely local (anti-corruption, not anti-euro) and the succeeding socialist government pledged to keep fiscal policy unchanged. Nevertheless, the changed leadership heightens uncertainty.

German post-election political uncertainty recurring (negative)

To Donald Trump's tweeted delight, rifts in German coalition government have been openly exposed surrounding immigration policy. These appear to have been healed for the time being after smaller coalition parties re-pledged their support for Chancellor Angela Merkel, following a European Union-wide agreement on migration.

Tensions with North Korea subside (positive)

Donald Trump's meeting with Kim Jong-Un in Singapore has defused tensions. The risk of a war between North Korea and the West is now very low.

Our basis for equity market valuation uses time-tested measures, relating current dividends to current medium term risk-free rates. They indicate that equities are "fair value" in the US and cheap elsewhere.

Consensus estimates for global GDP growth rates are expecting (another) year of just under 4% in 2018 – a level projected to be sustained through 2019 and 2020.

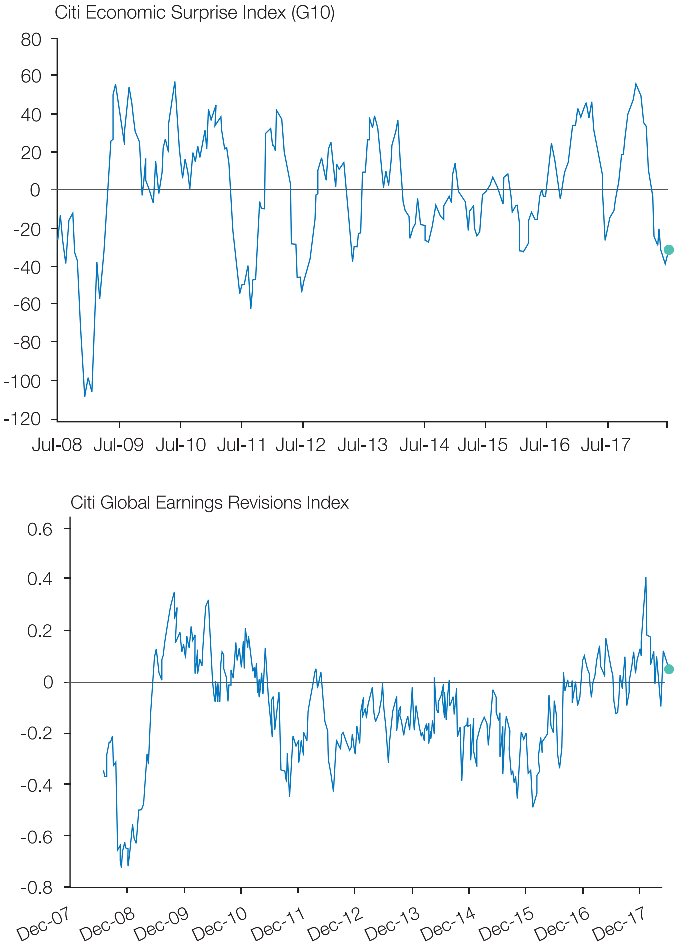
Other comments and clarifications

Global growth expectations

Consensus estimates for global GDP growth rates are expecting (another) year of just under 4% in 2018 – a level projected to be sustained through 2019 and 2020. Growth improvement is driven by emerging markets, which should grow at close to 6%, over 2.5 times faster than developed markets (2.2%). This supports double-digit corporate earnings growth forecasts next year – evenly spread between developed and emerging markets.

Note *that although GDP growth "surprises" have recently been negative, earnings surprises have held up, suggesting that over-optimistic economists, not company managements, are the current problem!*

Global economic surprises and earnings revisions



Source: Citibank

Global inflation to the end of 2019 is not forecast to exceed 3%, with deflationary global supply-side forces (technology-driven) balancing the positive impact on prices from higher demand.

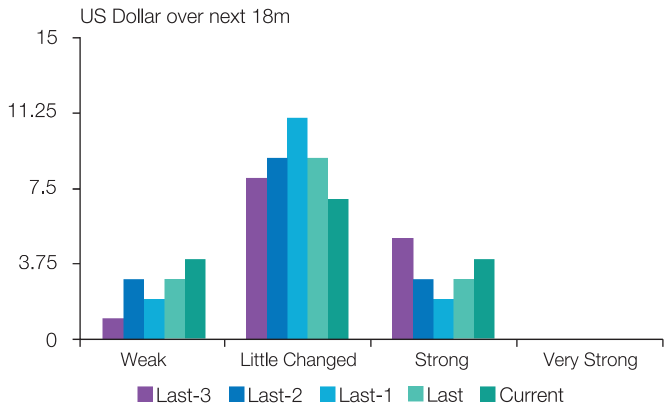
Inflation

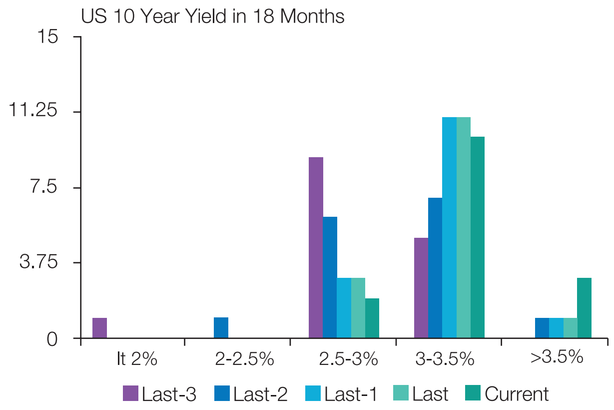
Global inflation to the end of 2019 is not forecast to exceed 3%, with deflationary global supply-side forces (technology-driven) balancing the positive impact on prices from higher demand. This assumption is clearly an important pre-condition for bond yields to remain anchored in ranges that do not threaten equity valuations.

US 10-year Treasury yield expectations

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

If the US continues to engage all of her perceived trade adversaries at once, the likelihood is less that a global trade war results, and more that the US becomes isolated.





Source: Investec Wealth & Investment

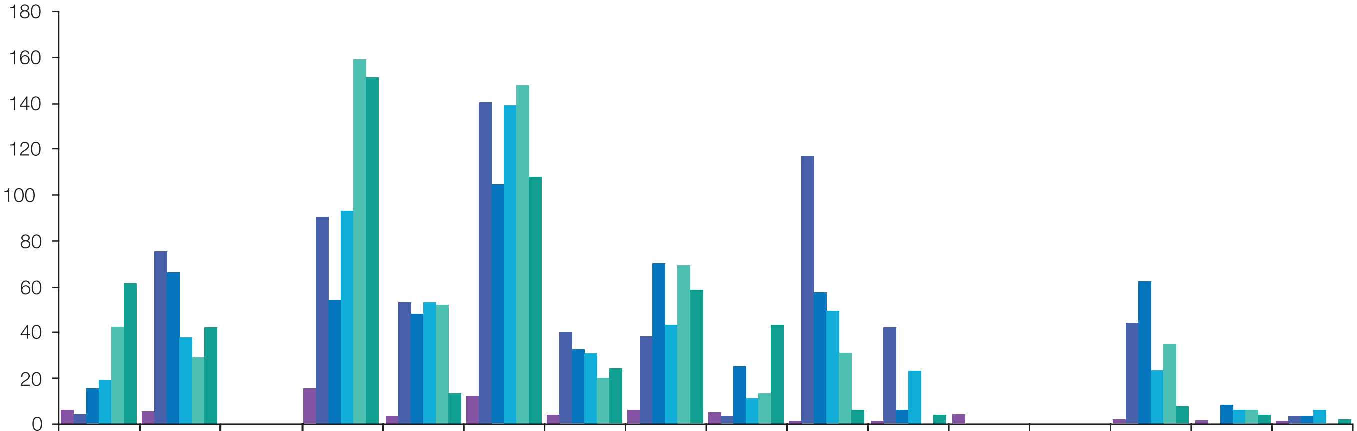
US dollar

The consensus of the Group (and we believe the broader market) is that the US dollar will be broadly unchanged on a trade-weighted basis over the coming 12 months.

The poor "maths" of threatening China are not lost on US businesses who will put pressure on the administration.

Icebergs – trade war dominates

Iceberg Threat Ranking - June 2018



	Systemic - Euro-Zone Melt-Down	Systemic - China Hard Landing	Systemic - Japan Hyper inflation / Economic Collapse	Systemic - Currency / Trade War	Systemic - Cyber Attack	Cyclical - Policy mistake DM	Cyclical - Policy Mistake EM	Cyclical - DM Recession	Cyclical - EM Recession	Geo-political War (Hot / Cold)	Geo-political Oil Price Shock	GeoPol ELECTDM	GeoPol ELECT EM	Geo-political Terrorism / Outrage	Other - Pandemic	Other - Environ mental (El Nino, Ag Prices)
Sightings	6	5	0	15	3	12	4	6	5	1	1	4	0	2	1	1
Threat (-4)	4	75	0	90	53	140	40	38	3	117	42			44	0	3
Threat (-3)	15	66	0	54	48	104	32	70	25	57	6			62	8	3
Threat (-2)	19	38	0	93	53	139	31	43	11	49	23			23	6	6
Threat (-1)	42	29		159	52	148	13	69	13	31	0			35	6	0
THREAT	61	42	0	151	13	108	24	58	43	6	4	0	0	7	4	2

Source: Investec Wealth & Investment

In this section we identify the potential icebergs or risks that could disrupt our outlook.

1) Trade war with China – a high impact systemic threat. China is the key target (although Europe is also in focus). This would be irrational for the following reasons

The maths don't work:

- Global trade intensity (exports plus imports) is 40% of GDP, so threatening this threatens all of the US's partners.
- A US trade deficit of $375bn, which is under 2% of GDP, is a **revenue** deficit. The **profit** deficit is much smaller – much of what the US imports from China is lower value-added (lower margin) than what China imports from the US.
- It is a mistake to assume that China's relationship with US businesses is limited to what it imports. There are major implications if China were to move beyond trade and target US business interests in China. It is estimated that US firms sold US$448bn worth of goods and services to China in 2017, US$168bn through trade and US$280bn through local operation by US subsidiaries in China. According to Evercore ISI, China accounts for 39% of GM's global vehicle unit sales and 24% of Fords. Although China has not threatened officially to target the US firms in China, as the trade tension builds up we see the risk rising. Even if not explicitly encouraged, a popular patriotic upsurge in China against US interests would undoubtedly result if the US were to provoke China too strongly.

The only rational interpretation of these moves by Trump is that it is intended to build popular support ahead of the mid-term elections.

It's hard to implement:

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

The US would suffer real damage:

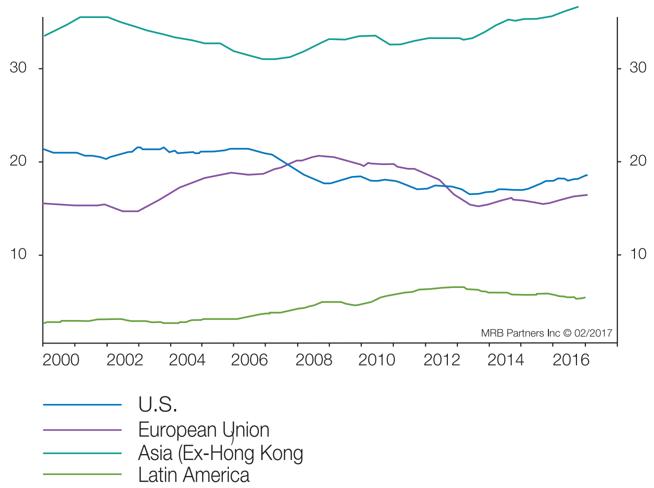
- China can afford a trade war with the US both

  in a material sense….

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

  The US deficit with China is approximately 2% of US GDP, so excluding the negative multiplier effects (import price impacts of paying higher prices for "tariff laden" or alternatively sourced goods) they would "gain" two thirds of a year's growth if the deficit were to be magically eliminated.
- BUT … thereafter the US would then be excluded from the world's most rapidly growing and highest impact (impact = growth times size) consumer economy – China is the world's second largest economy and consumption is growing at around 10% per annum.
- AND … China would (quite quickly) reconfigure its supply chain, increasing its trade with its other partners. The US today represents around 20% of China's exports, a far smaller share than Asia (40%), and in line with Europe (20%), both of whom are hungry to step into any breach (see chart) below.

China Exports To* (% of total):



Source: China Customs

… and politically

- The poor "maths" of threatening China are not lost on US businesses who will put pressure on the administration.
- The Chinese political leadership has a strong mandate (however harshly it is enforced) and has the resources to "take pain" for a period longer than an American Presidential Term, if necessary.

It is a mistake to assume that China's relationship with US businesses is limited to what it imports. There are major implications if China were to move beyond trade and target US business interests in China.

So what next?

- The only rational interpretation of these moves by Trump is that it is intended to build popular support ahead of the mid-term elections.
- China's measured reaction appears to recognise these "politics". China has stated publicly that it is willing to discuss all issues with the US and is likely to move to mobilise support from Europe and Asia behind the scenes. Similarly, it will lobby the US business community to bring pressure to bear, hoping to lower the temperature and re-establish a co-operative dialogue.
- However we are now in a tit-for-tat process. At the time of writing the US had announced US$253bn of Tariffs – raised from US$53bn in response to China's matching of those first tariffs.

In conclusion:

- The US is rejecting the existing global trading framework. Those with a stake in maintaining it are likely to fight back – possibly by excluding the US (the Trans-Pacific Partnership becomes the Euro-Pacific partnership?).
- The US using national security as grounds for its moves makes the tariffs administratively quick to implement and appeals to populist nationalist sentiments – however it is a very high risk strategy, because inflamed nationalist sentiment is hard to calm.
- Material damage to the global economic growth picture can no longer be ruled out, although stating these arguments against a strong global growth backdrop gives some room for error.
- The real winner could be the intended victim, China, which looks increasingly like a beacon of stability in an uncertain world.

2) The next largest risk factor identified is Developed Market Cyclical Policy Risk – a badly executed withdrawal of monetary policy stimulus, probably catalysed by an over-reaction to inflation data. The assessment of the risk factor has, however, fallen somewhat over the past quarter. We examine each of these in the bullet points below.

European systemic risk – rising, from a low base

- Financial system recapitalisation is complete.
- Cyclical risk is also low.
  BUT
- There is recurring political uncertainty.
- Impending monetary policy normalisation / QE tapering lies ahead.

China – internal systemic risk – low, but cyclical risk increasing

Systemic factors

- Integration into the global economy has passed the first major test (a "dirty float" of the yuan).
- Economic rebalancing is progressing well
- Debt accumulation has peaked.
- Politics is very stable.

Cyclical issues

- Monetary policy tightening is a by-product of closer supervision by the authorities of the shadow banking system.
- The housing market may also be cooled (probably through macro-prudential measures).

2018 scheduled political calendar - Low Risk

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

Geopolitics

- Key conflict flashpoints – the temperature has lowered.
- Donald Trump – an unknowable source of either positive or negative surprises.

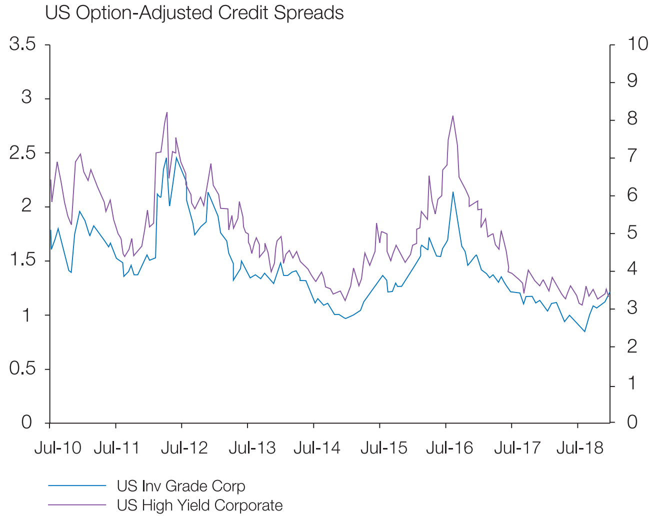
The US using national security as grounds for its moves makes the tariffs administratively quick to implement and appeals to populist nationalist sentiments – however it is a very high risk strategy.

3) Corporate leverage / private equity – a new iceberg?

- Fears of high overall corporate leverage look to be overblown. Work done by Empirical Research suggests that public companies have net debt coverage ratios that are at the upper end of recent history, but not excessive. They also have term structures that are not too exposed to rising rates.
- Generally, corporate debt "busts" are not serious – they are usually sector-focused and the debt is held by knowledgeable institutions who can afford the loss and understand it. Unlike in a banking bust, they do not impair the economy in a multiplied fashion.

The current cycle could see more of a shock from private equity (PE) debt, as:

- There a substantial amount of PE debt outstanding (over US$500bn) but its term structure is short, with 70% of it exposed to higher rates.
- Transaction prices and total debt outstanding are both still rising, even as financing costs are rising.
- There is a new generation of holders – including some financial institutions and, via funds and ETFs, a lot of private individuals.
- The possibility of a sudden widening in spreads destroying the business models of real businesses (they would be starved of capital until they are re-financed) must be considered.
- The absolute magnitude of the potential trouble in PE debt does not look too threatening (5% of total debt, so even a 25% haircut to the $500bn would see "affordable" systemic liabilities – relative to the levels of the Global Financial Crisis).
- This structure (recent growth in, and high level of PE debt) makes interest rate spreads a key "canary in the coal mine" to monitor (see below).



Source: Investec Wealth & Investment

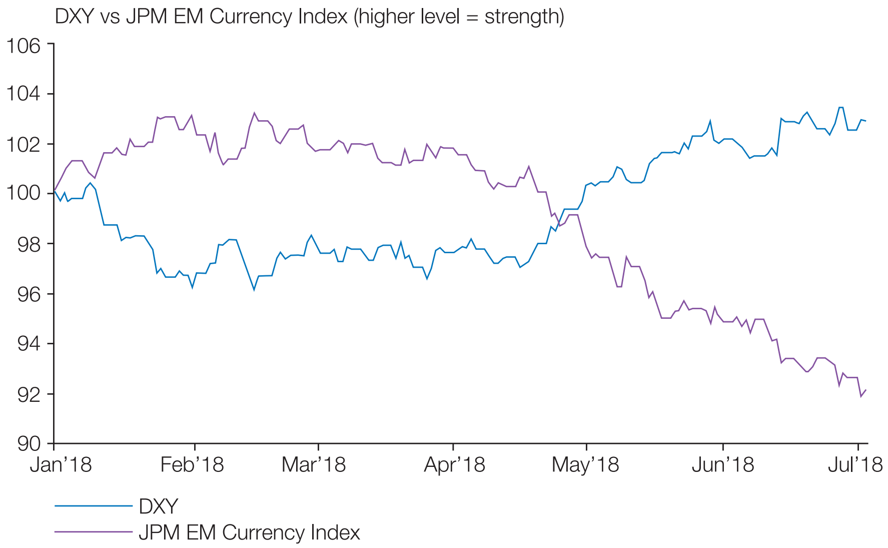
Asset allocation overview Q3 2018 – the positive effects of global growth

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

The positive outlook for global growth should be good news for emerging markets, SA equities and the rand.

The second quarter of 2018 was notable for the persistent weakness of emerging market (EM) equities, bonds and currencies and the persistent strength of the US dollar and US equities. A strong dollar against the euro and other developed economy currencies is usually associated with weaker EM exchange rates and recent developments in the currency markets were no exception to this general pattern (See figure 1 below).

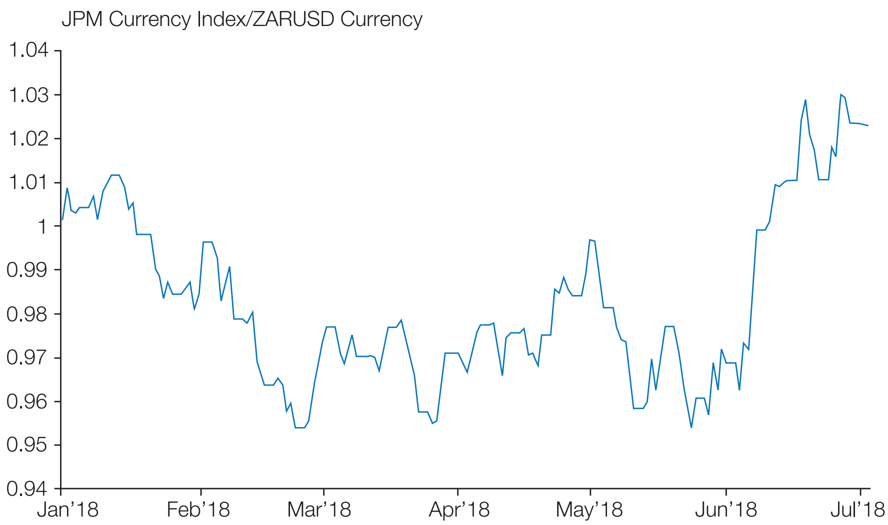
Figure 1: The US dollar index (DXY) and emerging market currencies



Source: Bloomberg, Investec Wealth & Investment

The rand also weakened relative to a basket of EM currencies, giving up the gains it had made vs its peers in 2017 and earlier in this year (see figure 2 below).

Figure 2: Rand vs emerging market currencies



Source: Bloomberg, Investec Wealth & Investment

EM equities, represented by the benchmark MSCI EM Index, have suffered a sharp drawdown from their year to date peak value of late January 2018. The US dollar value of the EM Index is down 18% from this peak, while the JSE All Share Index in US dollars is now trading 22% below its peak value of January 2018.

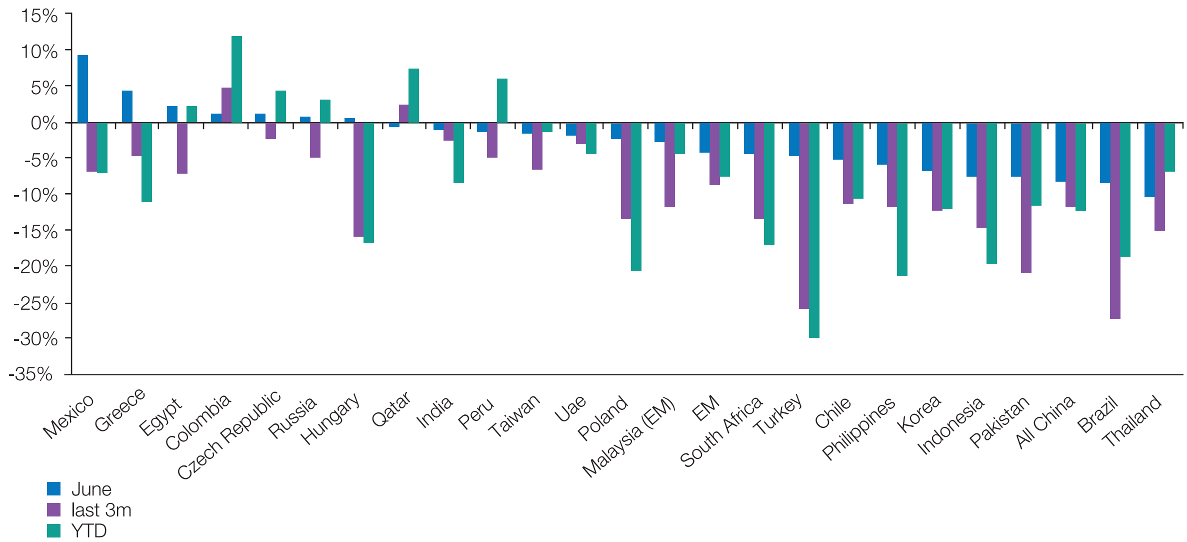
Figure 3: MSCI EM vs S&P 500

Source: Bloomberg, Investec Wealth & Investment

It is not consistent to be fearful of EM's in the light of a satisfactory outlook for global growth of 4%. A strong US economy – the reason for a strong dollar – is reason to be hopeful about the global outlook.

We compare different EM equity markets, ranked by their performance in June, in figure 3. The MSCI South Africa Index has been a middle of the EM pack performer over the month and year. The heavily weighted All China component of the EM Index has had a poor June and has lost nearly 13% of its US dollar value over the past quarter.

Figure 4: Emerging market returns



Source: Bloomberg, Investec Wealth & Investment

The strength in the US dollar and its equity and bond markets reflects less synchronised global growth compared to 2017. The US economy sustained its growth momentum while economic data from Europe disappointed. The state of the Chinese economy, where the authorities were attempting to rein in the shadow banking system, was a further cause of concern. The US Fed had every reason to continue on its path towards normalisation of interest rates, while interest rates in Europe and Japan were likely to be kept at historically low levels; hence the stronger dollar as capital flowed towards the US and away from the euro and EMs.

The outlook for global growth, as judged by the Global Investment Strategy Group, nevertheless remained largely unchanged at about 4% a year. Europe was judged to have suffered from a temporary slow patch and China more than capable of maintaining recent GDP growth rates of about 6%. However corporate earnings globally remained on an upward trajectory of about 10% annual growth for the next two years. The value of the S&P 500 and also the JSE as a representative EM equity market were judged, by way of a dividend discount models, to be at worst in fair, not overvalued, territory. And the expected earnings and dividend growth adds further to the case for equities.

Were it not for the dangers represented by Donald Trump to the established global economic and political order the GISG would have been well justified in raising its exposure to equity risk. See our commentary earlier in this Global Investment View.

The outlook for EM equities, bonds and currencies will also be influenced by the expected state of the global economy. Furthermore, the state of the global economy will influence the state of commodity, mineral and metal markets on which some EM economies remain dependent. It is not consistent to be fearful of EMs in the light of a satisfactory outlook for global growth of 4%. A strong US economy – the reason for a strong dollar – is reason to be hopeful about the global outlook.

It needs to be recognised that is it is not the safe haven character of the US that has driven the US dollar – but differentially fast growth. The strong dollar has nevertheless caused harm to EM economies, including SA. It adds to EM inflation and depresses domestic spending. Higher inflation can lead to higher short-term interest rates that do further damage to domestic demand without having any helpfully predictable influence on the exchange rate and so inflation to come. In other words, the strong dollar raises the danger of monetary policy errors everywhere else, including EM economies.

The question therefore for the asset allocation of SA portfolios and their exposure to risk is whether (or perhaps when) the strength of the global economy will reverse capital flight from emerging economies (and SA). In other words, when can investors in EM and SA assets expect local currency stability or strength to support the higher yields that EM financial markets are now offering? A combination of strong global growth and EM economic weakness is not a logically consistent expectation.

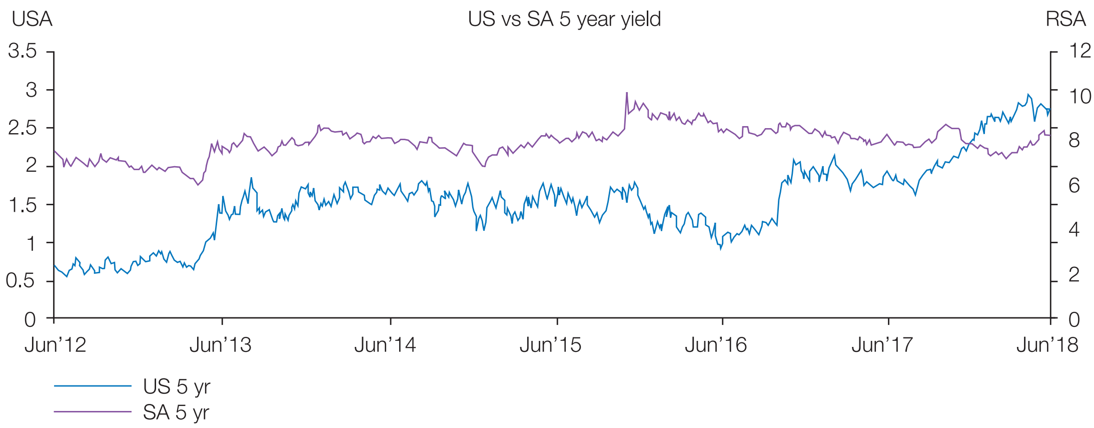
The time for a degree of rand recovery may be upon us. That is in the view of the committee. The committee almost unanimously forecast a degree of rand strength rather than further weakness.

It needs to be recognised that is it is not the safe haven character of the US that has driven the US dollar – but differentially fast growth.

A strong rand that derives its strength from global economic growth will help all sectors of the JSE. It will be particularly helpful to the South African plays listed on the JSE that depend on the state of the SA economy. A stronger rand means less inflation to suppress domestic spending and perhaps lower interest rates to encourage it. But the global plays listed on the JSE would see their dollar values improve with more optimism about global growth as would the resource companies that cater to global demands. Higher dollar values for these companies will only be partly offset by translation into rand values, should the rand gain exchange value.

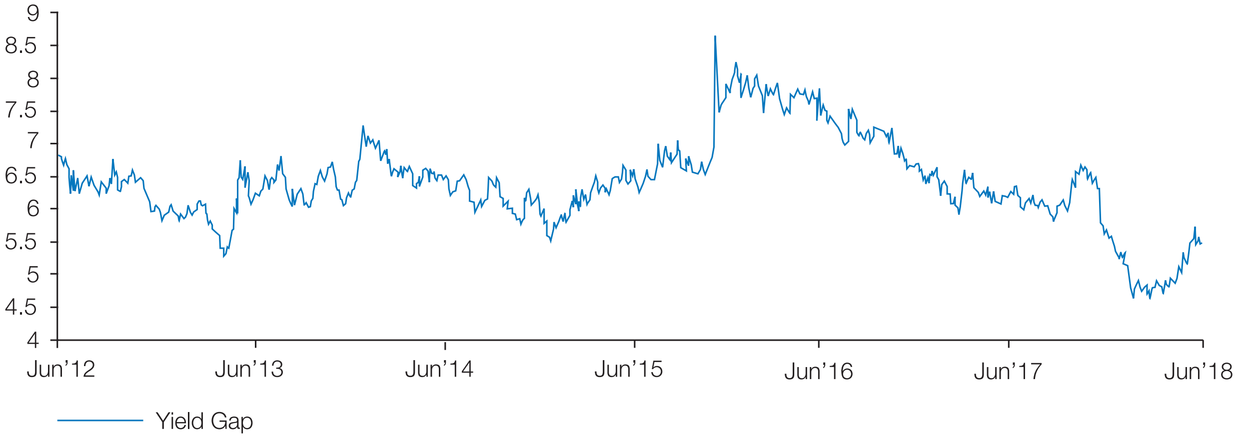
The promise of some rand strength – off currently much depressed rates of exchange – was enough for the committee to justify a neutral exposure to risk for SA balanced portfolios. Bond markets offer an equally attractive alternative, given a degree of rand strength. Indeed, the RSA bond markets to date may be considered to have performed well in the face of a weaker rand. Interest rate spreads with the US (that reflect the RSA risk premiums) and inflationary expectations have not widened materially, as we show below. These trends may reflect a degree of optimism about the prospects for the rand that make a neutral exposure to equity risk, as recommended by the committee, a valid position to take.

Figure 5: US and SA bond yields



Source: Bloomberg, Investec Wealth & Investment

Figure 6: Yield gap (SA five-year bonds minus US five-year bonds)



Source: Bloomberg, Investec Wealth & Investment

A strong rand that derives its strength from global economic growth will help all sectors of the JSE. It will be particularly helpful to the South African plays listed on the JSE that depend on the state of the SA economy.

SA market view and asset allocation – Seeing through the turmoil

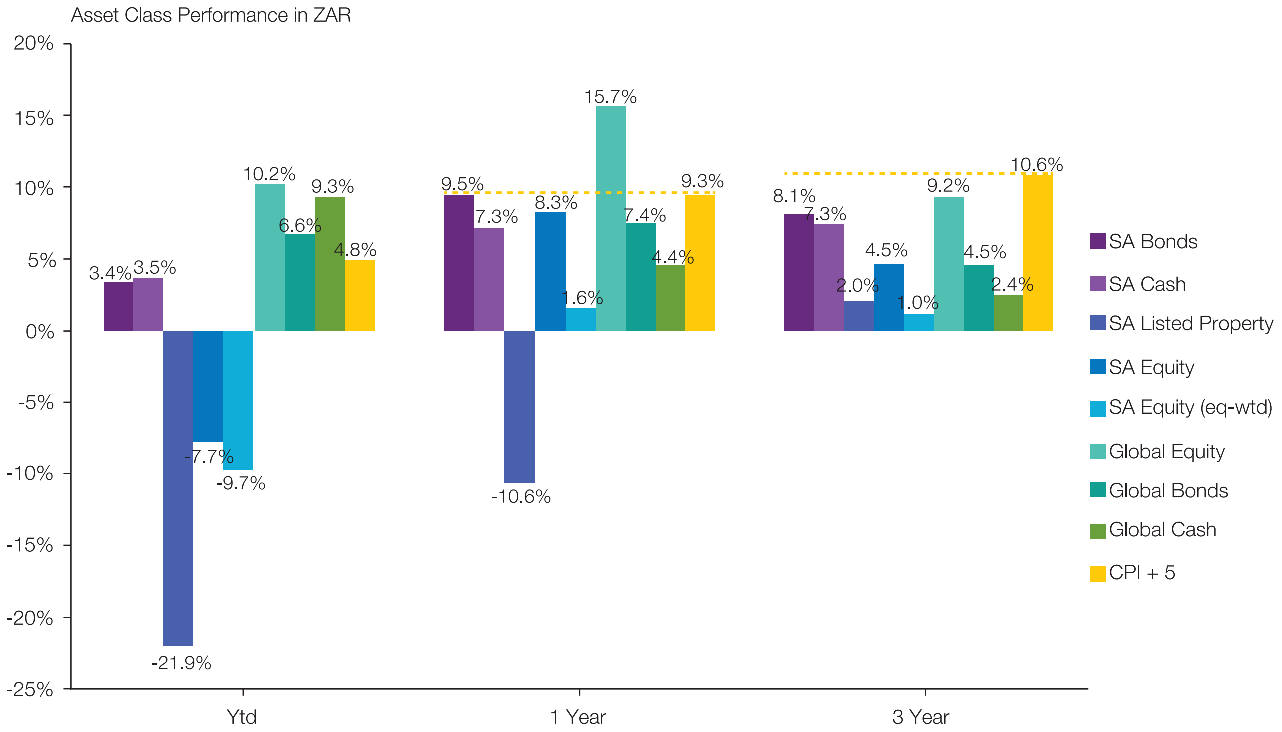
By Paul McKeaveney, chairman of the asset allocation committee, Investec Wealth & Investment SA

Despite the turmoil of the last quarter we have maintained our positive outlook for South African assets, largely premised on the input from the GISG that these effects are likely to be transitory and that the underlying strength in global growth and corporate profits would demand attention from investors. Valuations across the main domestic asset classes are also more attractive than they were in the previous quarter.

Performance review

Performance across domestic asset classes has been disappointing (see figure 1). Portfolios were supported by returns from offshore investments whether they have been in equities, bonds or cash, which means there was likely a common underpin, the weaker rand. The rand has weakened 10% against the US dollar, 7% against the euro and 7% against the British pound (figure 2). This has meant that although offshore equity markets have drifted sideways since December in US dollar terms, South African investors have still seen translation gains in their portfolios in rand terms.

Figure 1: Asset class performance



*YTD and 1 year to June 2018, 3 year to 31 May 2018

Source: Investec Wealth & Investment

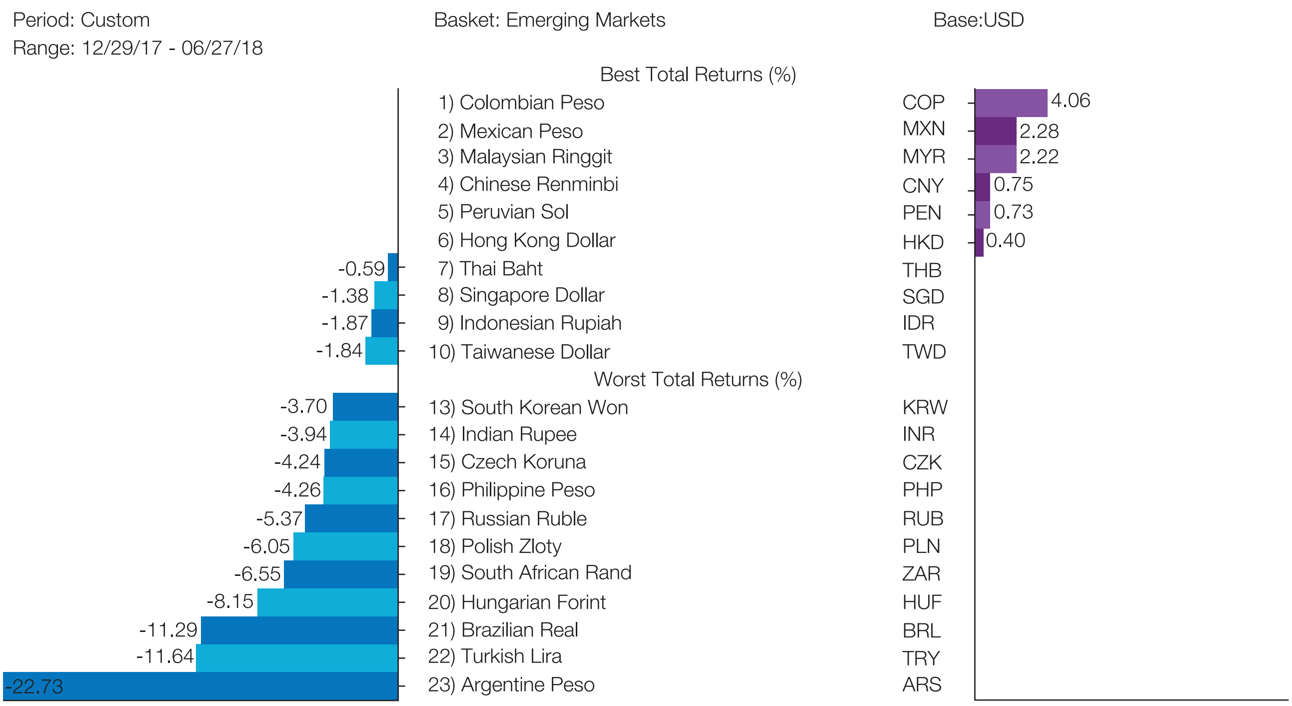
One of the issues that affects us most directly here in SA is the souring of appetite for emerging markets generally and SA specifically.

Figure 2: Rand vs US dollar, euro and British pound

Source: Bloomberg

There have been a number of issues that have worried investors in 2018, which will have been addressed in detail in the global investment strategy overview above. One of the issues that affects us most directly here in SA is the souring of appetite for emerging markets generally and SA specifically. One can see in figure 3 how the rand has held up relative to other emerging market currencies – the short answer is not that well.

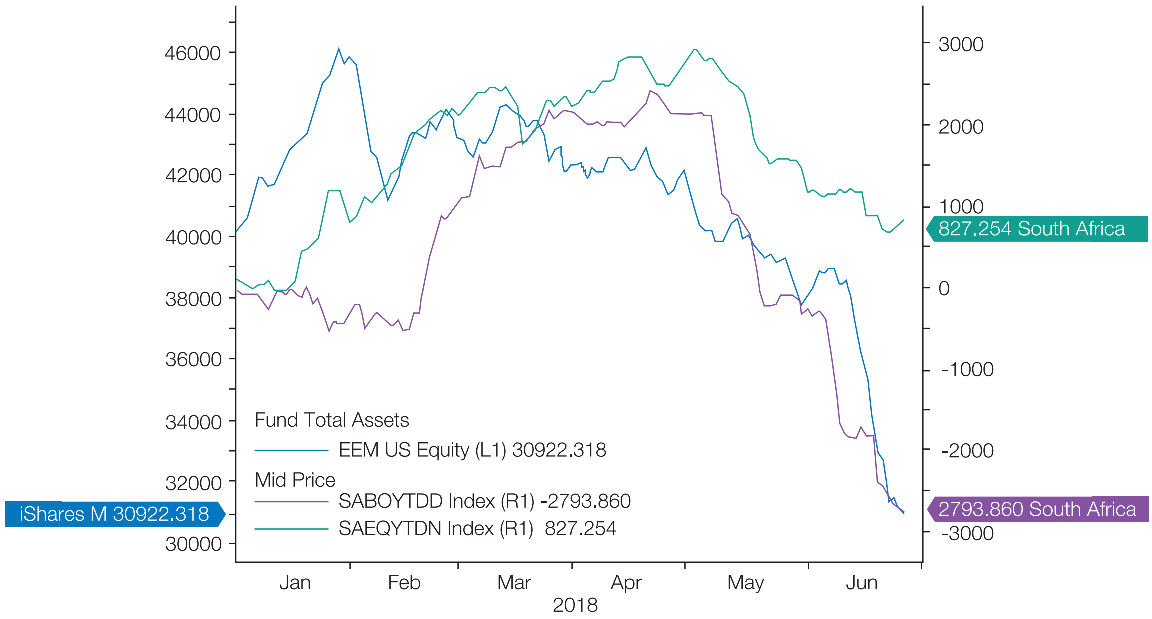
Figure 3: Relative performance of the rand



Source: Bloomberg

Looking at foreign purchases of South African bonds and equities in figure 4, one can see how, earlier in the year, foreign investors poured money into our equity and bond markets, before the massive reversal resulting in a net outflow of almost US$3bn from our bond market. But we (South Africa) are by no means alone: the blue line in figure 4 shows the total assets in the Ishares MSCI Emerging Market Equity ETF, which clearly shows the change in investor appetite for emerging market assets.

Figure 4: Foreign purchases of assets



Source: Bloomberg

So after all the excitement earlier in the year, what are we thinking from an asset allocation perspective?

Asset allocation review

Our asset allocation committee was much more upbeat a quarter ago, however we highlighted that the improved outlook was 1) over the medium to longer term and 2) that global dynamics would hold sway over outcomes for South Africa. Unfortunately the latter scenario has dominated market performance. Our asset allocation committee maintained its positive outlook for South African assets, largely premised on the input from the GISG that the softness in recent growth numbers out of Europe and China, as well as the escalation from trade war concerns was likely to be transitory and that the underlying strength in global growth and corporate profits would demand attention from investors. Coupled with the fact that valuations across the main asset domestic asset classes are that much cheaper than they were last quarter, has given us confidence to increase our risk-taking by continuing to move to an overweight South African equity position as well as to continue extending duration in SA bonds.

The South African equity market has de-rated to valuation levels consistent with a fair level.

Valuation

The South African equity market has de-rated to valuation levels consistent with a fair level. We look at aggregate market valuations in a number of ways, but our key model is one where we use dividends and interest rates to ascertain a fair value for the market, and then compare that to the current level. This measure shows a market at the index level close to fair value. Coupled with the fact that consensus earnings have managed to hold their ground for the time being, at around 12% for 2019 and slightly higher for 2018, would suggest that a return in the region of 12 to 15% over the next 12 months could be expected.

Fixed income

Last quarter the bond market looked slightly rich based on relative spreads as well as on our key measure. Bond yields have moved much higher in the past few months, with the bond that matures in 2030 offering a yield of 9.3%. Relative to our expectation of inflation, this offers an attractive entry point. We also acknowledge the risk that we still face from a fiscal perspective and so we are not adding more bond exposure outright, but are rather selling some of our shorter, lower yielding bonds and buying longer maturity, higher yielding bonds.

One of the issues that affects us most directly here in SA is the souring of appetite for emerging markets generally and SA specifically.

Property

South African property stocks continue to look to offer decent value versus long-term valuation metrics. Last time we highlighted that a basket of local property stocks was trading cheaper than long run averages and the subset of the universe we look at were all on price-to-book ratios of one or less.

The rand

The rand, on long and shorter term valuation models, looks to have overshot fair value – taking into account global and emerging market factors. That can sometimes mean that SA specifics have deteriorated, such that investors would need to be compensated for those risks. We don't think that the South Africa outlook has deteriorated to such an extent to warrant the level we see, so in summary we think the rand should be trading closer to R12.5 to R13 to the US dollar.

Money market

The forward rate agreement (FRA) curve (a popular measure of interest rate expectations) is pricing in three interest rate hikes of 25bps over the next 12 months, which, given our rand view, looks to be too hawkish.

Gold

We continue to hold physical gold in portfolios as a geo-political, inflation and South African risk hedge. Gold will typically underperform as real rates in the US go up (due to the opportunity cost of holding gold). Gold looks to be fairly valued now at current levels, based on our model which factors in US real rates and the value of the trade-weighted dollar.

We continue to slowly upweight South African risk assets, albeit at a slow and moderated pace.

Conclusion

In summary, we expect the factors that have undermined emerging markets (related to growth concerns) to moderate and we think that South African-related risk asset prices have overshot. As such, we continue to slowly upweight South African risk assets, albeit at a slow and moderated pace. Global and South African growth data readings will be key in understanding whether the underlying positive trend remains in place, or whether we are facing a more serious slowdown.

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	Q2 2018	Q3 2018	COMMENTS
Offshore Equity	⌄	⌄	Maintain slight underweight to global equities. Strong underlying trends but cognisant of Trump and the trade risk factors.
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	Q2 2018	Q3 2018	COMMENTS
SA Equity	⌃	⌃	More optimistic on outlook for SA assets but cognisant that we have reduced risk globally. Valuations looking reasonable.
SA Fixed Income	N	N	Concentrated in "belly" of the yield curve. Total returns look attractive on a 12 month view. Switching short bonds for longer duration bonds.
SA Cash	⌄	⌄	Offers positive real returns, lowers volatility and provides optionality
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)	N	⌃	ZAR looks cheap relative to fair value given our top down macro view.

SECTORAL/THEMATIC POSITIONING	Q2 2018	Q3 2018	COMMENTS
Global Plays	⌃	⌃	We have reduced our exposure to global plays in favour of domestic plays.
Commodities	⌃	⌃	Overweight commodity plays although upweight in quality and lower beta. Prefer diversified miners versus single commodity producers.
Gold Plays	⌄⌄	⌄⌄	Currently do not own any gold producers given poor fundamentals. Continue to own physical gold in balanced portfolios as a geopolitical hedge.
Interest Rate Plays	⌃	⌃	Adding to our interest rate play exposure on the back of the positive SA fundamental outlook.
SA Industrials	N	N	Valuations at interesting levels, especially in mid and small cap area of the market.

Members of the Global Investment Strategy Committee

John Haynes
Chairman & Head of Research
United Kingdom

Chris Hills
Offers positive real returns,
United Kingdom

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

Philip Shaw
Chief Economist
Investec PLC

John Wyn-Evans
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United Kingdom

Oliver Kirkby
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Darren Ruane
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