Global Investment View

Quarter 3, 2019

Investec

Wealth & Investment

Portfolio Management | Stockbroking | Wealth Management

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Banking some gains

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

By John Haynes

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

Commentary by:

John Haynes

John is Head of Research at Investec Wealth & Investment UK, and leads the research team. He is Chairman of the Global Investment Strategy Group and the Asset Allocation Committee and is a member of the Stock Sector Committee. A graduate of Cambridge University and a CFA Charterholder, John has worked for Investec since 2001.

Special contributions by:

Chris Holdsworth

Chris Holdsworth joined Investec in 2007 and is 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).

Paul McKeaveney

Paul is a Senior Portfolio Manager and Chairman of the SA Asset Allocation Committee. He has a degree in Mathematics from the University of Stellenbosch and a First Class Honours degree in Financial Analysis and Portfolio Management from the University of Cape Town. He is a CFA Charter holder.

Banking some gains

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

The Global Investment Strategy Group reduced the Investec Wealth & Investment recommended risk budget to a modestly "risk off" position from Neutral - a stance that had been held since December 2018.

Our central case expectation remains that the current risk-asset friendly combination of global economic and corporate profits-growth together with low inflation will extend beyond the forecast horizon. However, we perceive that the environment will become more challenging as we move into 2020 – which will add a contentious American presidential election to the mix of already inflamed global superpower politics. With risk asset valuations fair in the context of both low-interest rates and continued growth in profits, there is a limited cushion against negative surprises, while the possibility of them has risen.

Although we expect risk assets to rise in the near term as immediate icebergs are negotiated (Trump/Xi @ G-20), we believe it prudent to take a more cautious view of prospects over our 18-month forecast horizon.

Rationale

- **Growth Prospects Underwritten by Central Banks**
  We retain a positive view on the outlook for growth in the global economy and hence for corporate profits.

The Federal Reserve and the ECB have responded to softer data trends and the warnings transmitted by bond markets by comprehensively reversing course. This has both quietened concerns of a policy mistake and also enhanced fundamental resilience against unpredictable political crosswinds. With this safety net back in place and no signs of inflation that could herald its removal, the end of the global economic cycle (recession, led by the US) has been pushed beyond our 18-month forecast horizon.

Although we expect risk assets to rise in the near term as immediate icebergs are negotiated (Trump/Xi @ G-20), we believe it prudent to take a more cautious view of prospects over our 18-month forecast horizon.

Assuming the heralded meeting at G-20 between President Trump and Xi Jinping averts an escalation of trade hostilities, the global growth trajectory for 2019 is expected to see a convergence between the US and the Rest of the World, with the year as a whole will generating only slightly slower global economic growth than in 2018. Consensus forecasts for 3.4% growth in 2019 & 2020 are the current mark.

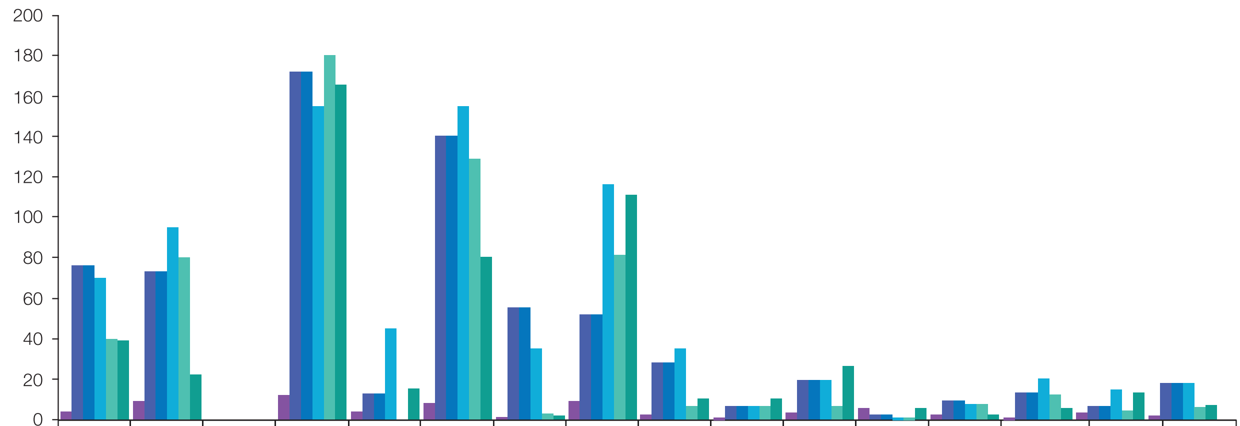
The US economy is expected to slow somewhat as the stimulus of tax-cuts wanes. But, if left to their own devices, Europe and the Emerging economies are expected to improve as the year progresses, helped by easier monetary conditions (as Dollar strength abates), better terms of trade (the effect of previous Dollar strength), lower oil prices and an improving political backdrop (both within regions & between regions). As always, improving prospects in EM rely upon the contribution from China, where tight money policies directed at shrinking the role of the "shadow" banking system are now being reversed at the same time as fiscal stimulus (both personal tax cuts and increased infrastructure spending) is increasing. Chinese actions have so far been effective at offsetting the impact of trade friction. This may become more difficult if the conflict escalates.

This respectable growth picture is enough to generate the mid-single digit earnings growth that the published consensus expects for global profits in Dollars. This may be unspectacular, but the important thing is that it is positive and therefore supportive to equities (bear markets tend not to happen when earnings grow), which are also not overvalued (see below). A settled trade environment would see some scope for earnings upgrades of 2019 forecasts but more importantly for investors to attach greater credibility to earnings growth projections for 2020 – which are currently pencilled-in at 10%.

- **Valuations of risk assets are “Fair” (Neither expensive nor cheap).** Based on our key measure, which discounts current (last year) equity dividends by current fixed income (risk-free) yields, this is true both in DM & EM. Since we expect mid-single digit earnings (and dividend) growth globally and do not expect a material rise in the global (US$) discount rate, similar returns should be expected from global equities. We expect emerging markets to outperform deleoped markets, since they should see a cyclical catch-up in earnings/ dividends.

The US economy is expected to slow somewhat as the stimulus of tax-cuts wanes.

Iceberg Threat Ranking - June 2019



	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 - Environmental (El Nino, Ag Prices)
Sightings	4	9	0	12	4	8	1	9	2	1	3	5	2	1	3	2
Threat (-4)	76	73	0	172	13	140	55	52	28	6	19	2	9	13	6	18
Threat (-3)	76	73	0	172	13	140	55	52	28	6	19	2	9	13	6	18
Threat (-2)	70	95		155	45	155	35	116	6	6	19	1	7	20	14	18
Threat (-1)	40	80	0	180	0	129	3	81	6	6	6	1	7	12	4	6
THREAT	39	22	0	165	15	80	2	111	10	10	26	5	2	5	13	7

A settled trade environment would see some scope for earnings upgrades of 2019 forecasts but more importantly for investors to attach greater credibility to earnings growth projections for 2020

Summary & Conclusion.

- Independent of political interference, the prospects for global growth, corporate profits & interest rates, together with solid valuation, all support the case for the outperformance of risk assets over insurance assets over the coming 18 months.

- However, our assessment of the risk premium demanded by elevated geopolitical risks has risen further – a function mainly of a material deterioration in the China/US relationship, with Gulf tensions unwelcome gilding of the lily. With her vital interests under attack (the treatment of Huawei has declared technology cold war), we are now as much dependant on China's reaction to provocation as any change in position from the wild-card(s) in the White House to determine the future course of investment markets. The likelihood of a hardening of China's position next year is high.

- Global Equities have recovered strongly this year (in the case of US Equities, to new highs) and our expectation of rapprochement in the near term between Trump & Xi suggests that we are likely to see them move further upwards in the coming months, but we see the situation as becoming more complex. As a result, we have reduced our position to Underweight risk assets by a notch.

- Given the nature of the risks facing us, our insurance asset of choice is cash / cash-proxies, rather than sovereign debt.

Recent Significant Events / Changes in Key Issues

				Impact	
Date	**Region**	**Type**	**Development**	**Macro**	**Sentiment**
June 2019	Europe	Macro	ECB Dovishness Becoming more explicit	↑	↑
June 2019	EM	Politics	HK Unrest	N	↓
June 2019	Global	Politics	Iran Tensions	N	↓
June 2019	Europe	Politics	Teresa May resigns	N	?
May 2019	EM	Other	Ebola outbreak	N	N
May 2019	Global	Politics	US-China Trade Tensions Hostilities Resumed & Redoubled (Huawei)	↓	⇊
April 2019	US	Politics	Mueller Report Released	N	↑
April 2019	Europe	Politics	European Elections	N	N
Jan 2019	US	Macro	Fed Dovish Pivot	↑	↑
Dec 2018	Europe	Politics	Brexit - Disorder	↓	↓
Dec 2018	China	Macro	Fiscal & Monetary Easing	↑	↑

Market Performance overview

By Paul McKeaveney Chairman of the Asset Allocation Committee and Chris Holdsworth, Chief Investment Strategist: Investec Wealth & Investment SA

The strong performance from risk assets that we saw in the first quarter of 2019 continued into the second quarter.

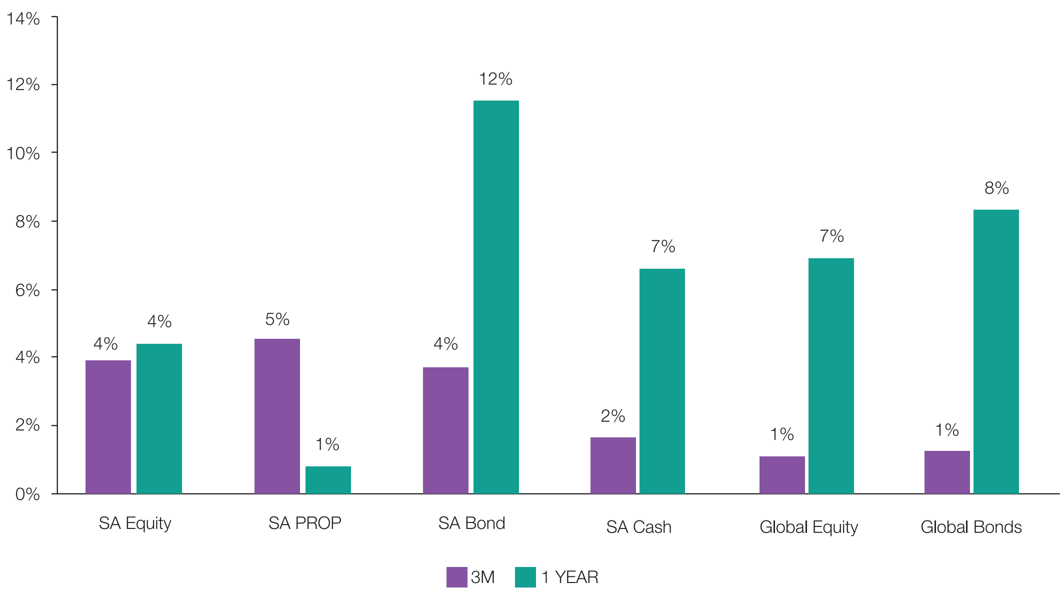
All main asset classes (from a SA investor perspective) delivered positive returns over the 3 months, with the performance skewed favourably to domestic asset classes versus offshore. The rand strengthened by close to 3% versus the US dollar over the 3 months (from 14.5 to 14.09). A large part of the risk-on rally we have seen YTD can be attributed to central banks and their more dovish stance (particularly in the case of the Federal Reserve).

Looking back a bit further over the 12-month horizon, South African bonds (as measured by the All Bond Index) have been the strongest performing asset class, returning 12% over the last 12 months. This has been a performance delivered in the context of a volatile domestic environment with the constant worry of a Moody's downgrade, an unresolved Eskom debt issue as well as a GDP growth rate amongst the lowest of large/medium sized economies. Domestic property (as measured by the SAPY) is the worst performer, driven by a combination of stock specific issues as well as a tough domestic environment. Offshore equities and bonds delivered cash beating returns over the 12 months.

The relatively low absolute returns over the 12 months from the main asset classes disguises the very volatile investment environment we have been in. Figure 2 provides a better explanation of "how we got there" and it was a rocky path indeed, with SA equities down over 10% at one point and global equities falling more than 15% from peak to trough.

The strong performance from risk assets that we saw in the first quarter of 2019 continued into the second quarter.

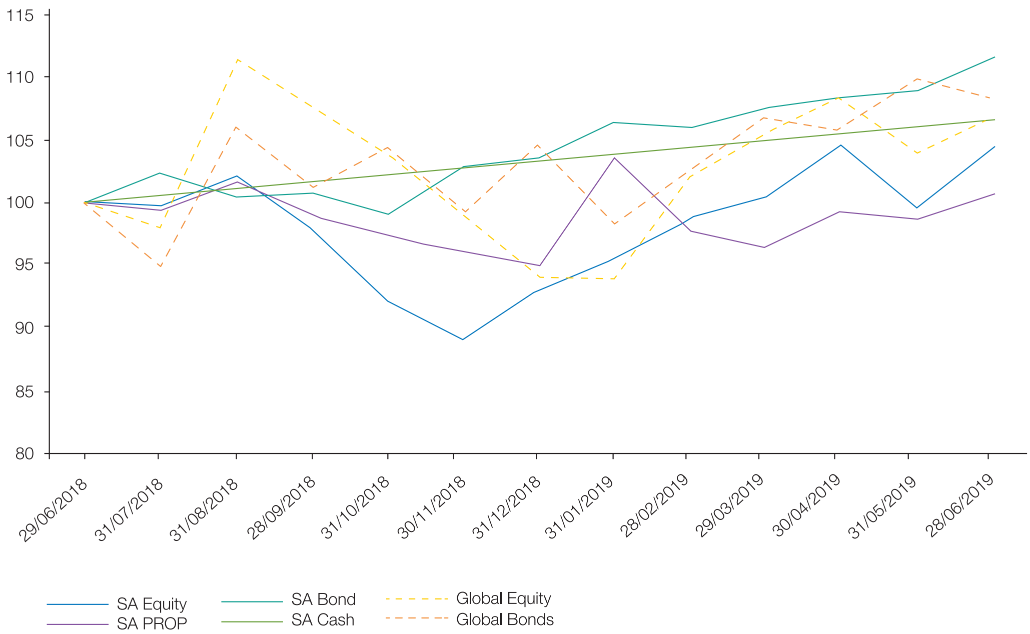
Asset Class Performance (ZAR) - 30.06.19



Source: Bloomberg, IWI calculations

South African bonds have been the strongest performing asset class, returning 12% over the last 12 months.

Asset Class Total Returns - 1 year to 30.06.19



Source: Bloomberg, IWI calculations

Figure 3 has the 10 top and bottom performers across the Top 40. Gold miners led the charge as the gold price finally showed some signs of life towards the end of the quarter (driven by lower real interest rates and an escalation in geopolitical worries), followed by MTN which saw a strong recovery after their well-documented issues in Nigeria have hung over the share price. At the bottom, we had Sasol which disappointed the market with an unexpected update on their Lake Charles project, followed by Sappi and British American Tobacco.

Negative Price Return	Members (42)	Return	Positive Price Return
	FTSE/JSE Africa Top 40 IX	3.83%	
	Best Performing		
	1) Gold Fileds LTD	44.05%	
	2) Anglogold Ashanti LTD	32.58%	
	3) MTN Group LTD	20.46%	
	4) ABSA Group LTD	15.71%	
	5) Financiere Richemont - DEP REC	14.21%	
	6) Anglo American Platinum LTD	13.69%	
	7) Multichoice Group LTD	11.44%	
	8) Clicks Group LTD	11.08%	
	9) Multi choice Group LTD	10.99%	
	10) The Foschini Group LTD	10.61%	
	Worst Performing		
	11) Bidvest Group LTD	-2.14%	
	12) Spar Group Limited/The	-2.63%	
	13) Old Mutual LTD	-3.06%	
	14) Capitec Bank Holdings LTD	-3.80%	
	15) Redefine Properties LTD	-6.80%	
	16) PSG Group LTD	-8.60%	
	17) Tiger Brands LTD	-8.96%	
	18) British American Tobacco PLC	-17.29%	
	19) Sappi Limited	-17.64%	
	20) Sasol LTD	-22.18%	

Asset allocation

SA themes:

Our asset allocation meetings continue to be dominated by the cyclical versus structural debate, coupled with robust discussions with regard to what is reflected in the valuations.

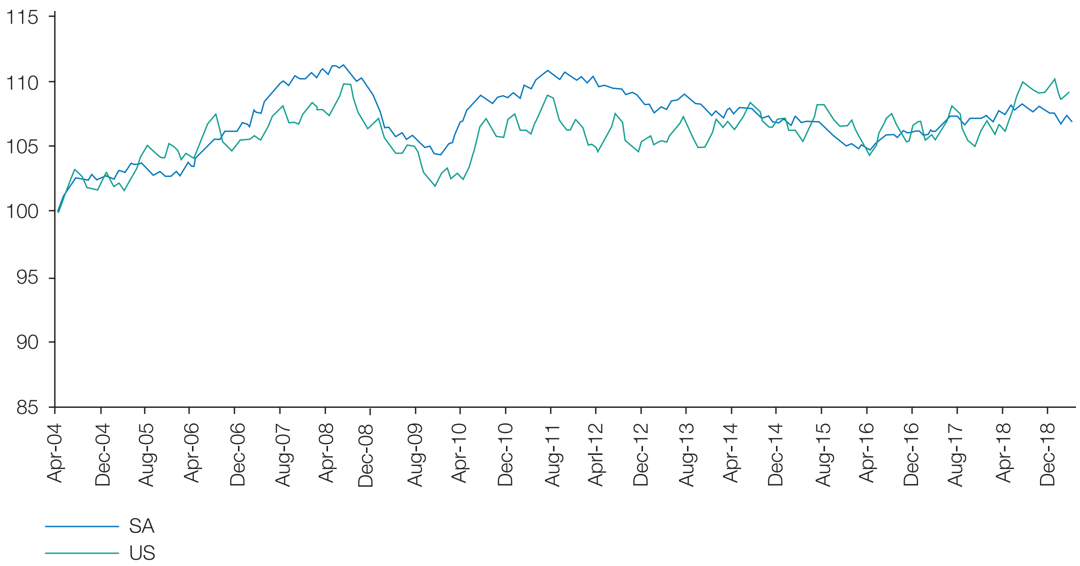
What can SA grow at?

The past decade has seen near zero growth in electricity supply in SA. The load-shedding in Q1 was very disruptive to growth and saw a GDP print of -3.2%. Given that Q2 saw a steady supply of electricity from Eskom, we can expect a bounce in growth in Q2. Given the data we have seen thus far, we are expecting growth of around 2.5%. However, the bounce is simply a normalisation given the fall in Q1; there is still an open question around what potential growth is likely to be for SA.

SA has not been the only country with near 0 growth in electricity over the past decade. The same is true for the US and Europe. Over the past decade, US growth averaged 2.2%. SA growth averaged 2% and EU growth averaged 1.6%. History shows that it is possible to grow modestly despite stagnant growth in electricity.

Simplistically, on the basis that electricity supply grows modestly and global growth remains above 3%, history and data in other countries suggest that SA can still grow at 2%. However, this won't be uniform across industries. The 2021 consensus sell-side forecast for GDP growth is just over 2% and the MPC's expectations are not materially different.

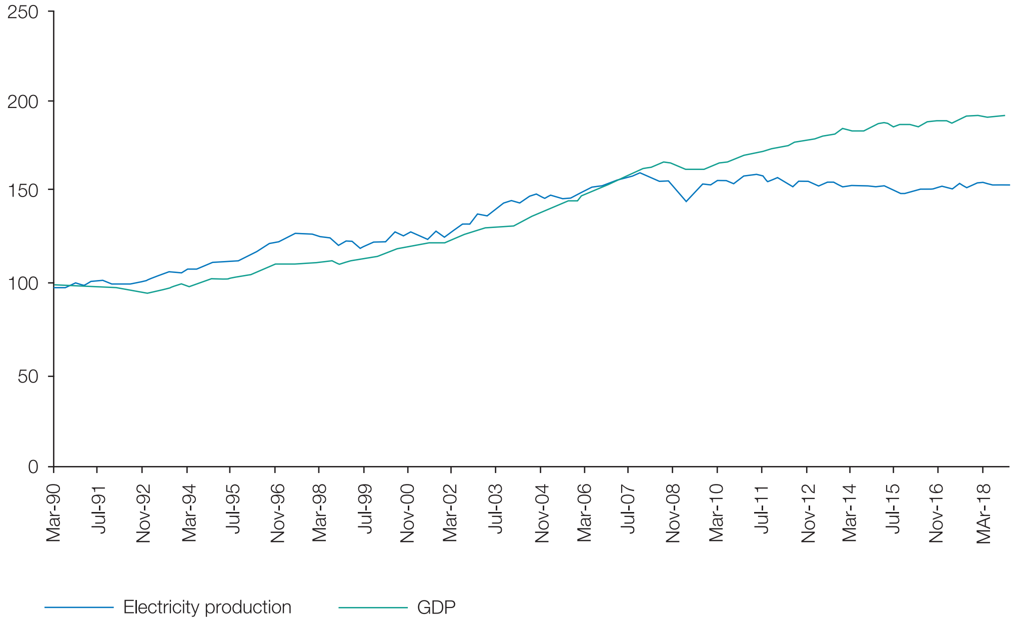
Rolling 12m electricity generation



Source: IEA, stats SA, Investec Wealth and Investment

The load-shedding in Q1 was very disruptive to growth and saw a GDP print of -3.2%.

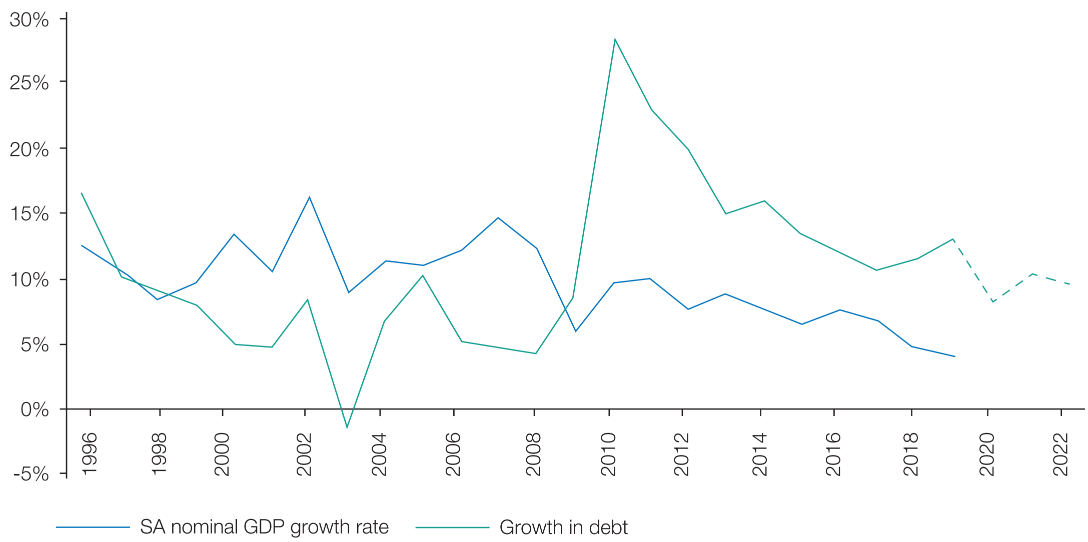
Electricity and GDP



Source: IEA, stats SA, Investec Wealth and Investment Stats SA

2% will however not be sufficient to see a debt to GDP stabilise given current expenditure plans. The budget forecasts SA government debt growth to slow down to just over 8% year on year in 2022. If potential growth is 2%, inflation would need to be around 6% to see debt to GDP stabilise. However, we don't think inflation will be that high and neither does consensus or the MPC. The net result is that we see at least one of the following happening:

1. Tax hikes (this will only temporarily help and will probably see quite negative growth consequences)
2. Reducing expenditure plans (some of this will naturally occur given lower inflation expectations but that is not sufficient). Lowering government expenditure may itself be negative for growth over the short term.
3. Selling off stakes in SOEs. This has been hinted at already. One has to wonder why the state has held onto its TKG stake given the current environment.
4. Issuing more debt with the risk of a downgrade.

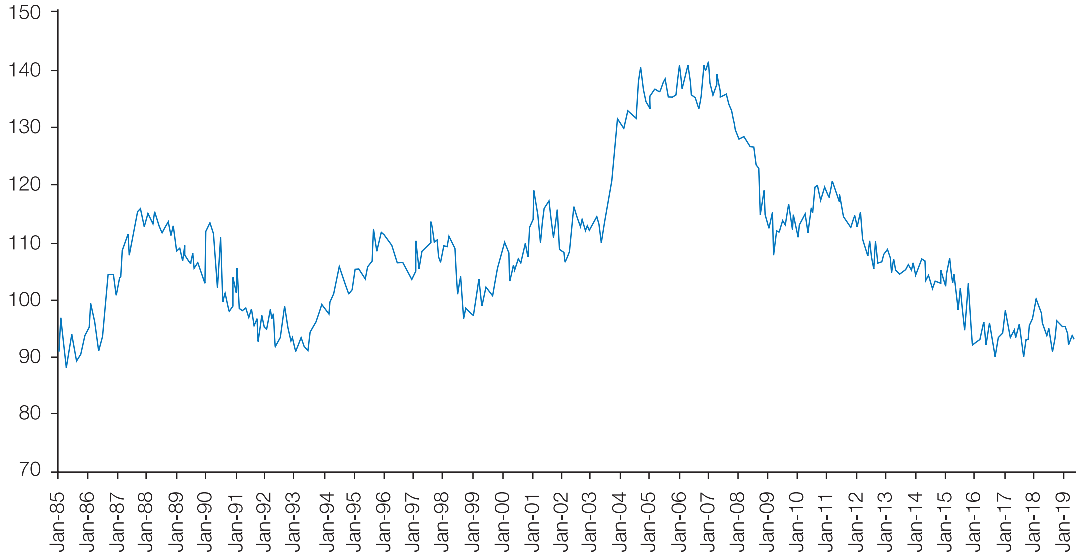


Source:Thomson Reuters,Treasury

We see a combination of 2,3 and 4 as being the most likely. This implies that NHI gets pushed down the road again and govt is compelled to issue more this year to help out ESKOM and cover a revenue shortfall given disappointing growth.

The concerns about growth and stability in SA have seen business confidence hit record lows. Business confidence is the key leading indicator for private sector job creation. Should we start to see a turn in conditions in SA and business confidence pick up, we expect that private sector job creation will follow in 12m. In the meantime, the SA consumer will receive some relief from a lower petrol price and what we expect will be a reduction in interest rates.

SACCI business confidence index



Source:Thomson Reuters

Valuation:

The P/E of the ALSI ex NPN suggests that we should not be pencilling in a return much above cash for the ALSI over the next 5 years.

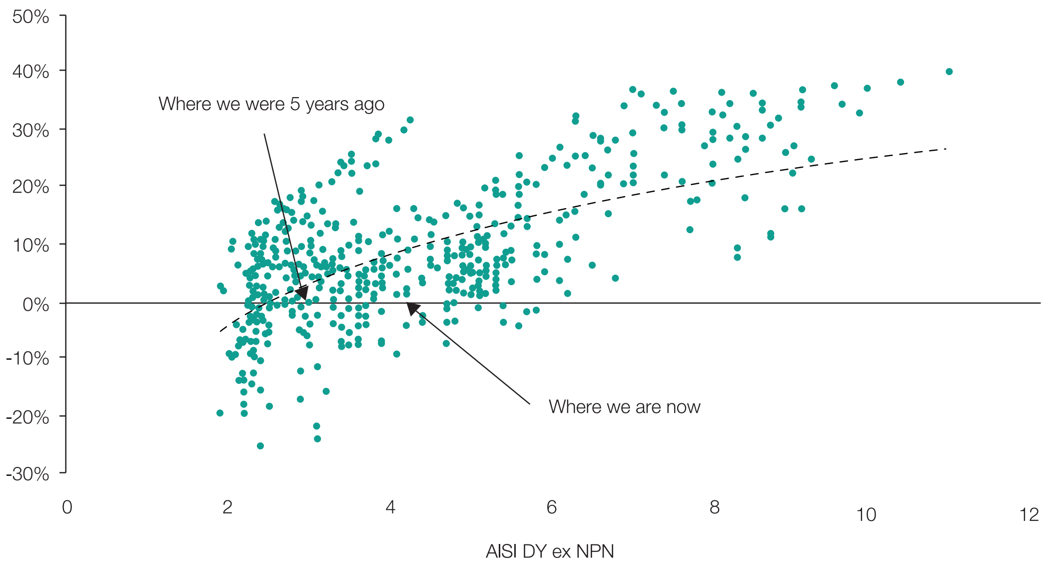
Subsequent 5 yr return for ALSI relative to cash (annualised)

AlSI P/E ex NPN

Source: I-Net, Investec Wealth and Investment

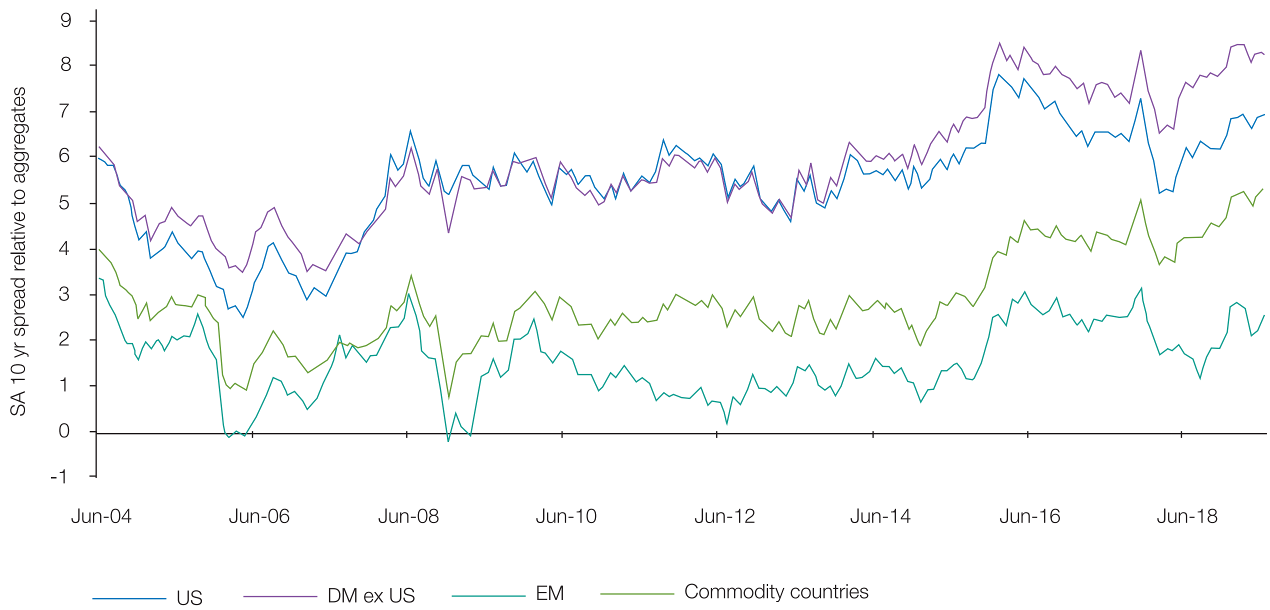
However, that ignores that earnings are very cyclically depressed. After stripping out NPN, earnings growth for the ALSI over the past decade has been below 4% p.a. Companies have been smoothing out dividends - while the market does not look cheap form a P/E perspective, it does from a DY perspective. If we accept that earnings are at a cyclical low and dividends provide guidance for a mid-cycle valuation then the market looks attractive. In this environment, we would not want to be underweight SA equities but instead, are neutral weight and waiting for signs that earnings growth will be picking up.

Subsequent 5 yr return for ALSI relative to cash (annualised)



Source: I-Net, Investec Wealth and Investment

Bonds in SA continue to trade at attractive yields. The spread between SA local currency bonds and peers remains near a record high or at a record high, whichever way the peers are grouped. While inflation is around 4.5% and the MPC has committed to keeping it close to 4.5% going forward, the SA long bond yield continues to be close to 9%. A downgrade by Moody's is not our base case but is largely priced in, in our view.



Source:Thomson Reuters and Investec Wealth and Investment

The market has taken the government's commitment to resolve Eskom's fiscal issues seriously. ESKOM 2025 USD denominated debt yields have dropped over 300bps year to date. There are several options on the table from a debt SPV to the government taking on ESKOM's debt directly to green bonds issued by Eskom tied to reducing carbon emissions. Government bond investors should well receive further progress on the Eskom debt issue in our view.

Interestingly, breakeven rates (the expected inflation rate implied by the bond market) for the next 5 years have fallen off materially in SA while longer-term inflation expectations have remained stubbornly high. As a result, inflation linkers look more attractive at the 5yr range while nominal bonds look more attractive at the 10yr range in our view.

By our estimation, the rand is around fair value at 14/$. Given weak growth in SA, modest inflation and DM central banks softening their tone, we expect a 25bp rate cut in July and another cut by year-end.

The concerns about growth and stability in SA have seen business confidence hit record lows.

Asset allocation

We have not made any major asset allocation changes this quarter. Our positioning is best thought of as "waiting in the wings". We would like to see some more positive developments in some of the issues below to begin to allocate more capital to domestic equity and property stocks. In the meantime, we are continued holders of our overweight fixed income position – the rationale for this was articulated in detail in last quarter's note.

Issues that we would like to see some tangible process on include:

1. Sustained risk-on appetite globally
2. Resumption of EM versus DM outperformance (from a growth and earnings perspective)
3. 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
4. No more load-shedding from Eskom – this was a major constraint to growth in the first quarter
5. More clarity on government policy, given the factionalism within the ruling party.
6. Interest rate cut – other central banks (including EM) 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
7. Improvement in business confidence – unlikely to see job creation unless this improves

Our positioning is summarised in the table

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 2019	Q3 2019	COMMENTS
Offshore Equity	N	⌄	Reducing risk slightly as we believe it prudent to take a more cautious view given a limited cushion against negative surprises, whilst the possibility has risen.
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 ALLOCATION	Q2 2019	Q3 2019	COMMENTS
SA Equity	⌃	⌃	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 look attractive. Expect SA to maintain IG status. Expressed through inflation-linked bonds and nominal bonds.
SA Cash	⌄	⌄	Still offering attractive real return but see better total return opportunities in risk assets.
SA Listed Property	N	⌄	Less of an interest rate play than historically - expect to be driven by fundamentals. Prefer to express the view through the fixed income market.
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 fairly valued on our models. Could 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	Q2 2019	Q3 2019	COMMENTS
Global Plays	⌃	⌃	We have reduced our exposure recently 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	⌃	⌃	Remain slightly overweight SA interest rate plays (includes retailers and banks)
SA Industrials	N	N	Valuations at attractive levels but generally more exposed to SA growth outlook.
Small/Midcap		⌃	Valuations are very attractive but appetite extremely low which may provide opportunity for patient investors.

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