Global Investment View

Quarter 3, 2020

Wealth & Investment

Portfolio Management | Stockbroking | Wealth Management

Contents

2

The Global Investment Strategy Group (GISG) has maintained its risk budget score neutral (a score of 0, on a scale of -1 to +3).

4

SA market view and asset allocation – Retaining SA government bonds as our preferred asset class; gold as an insurance policy.

10

Asset Allocation Positioning.

Neutral position reflects diminishing economic risks of Covid-19

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 maintained its risk budget score neutral (a score of 0, on a scale of -1 to +3).

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

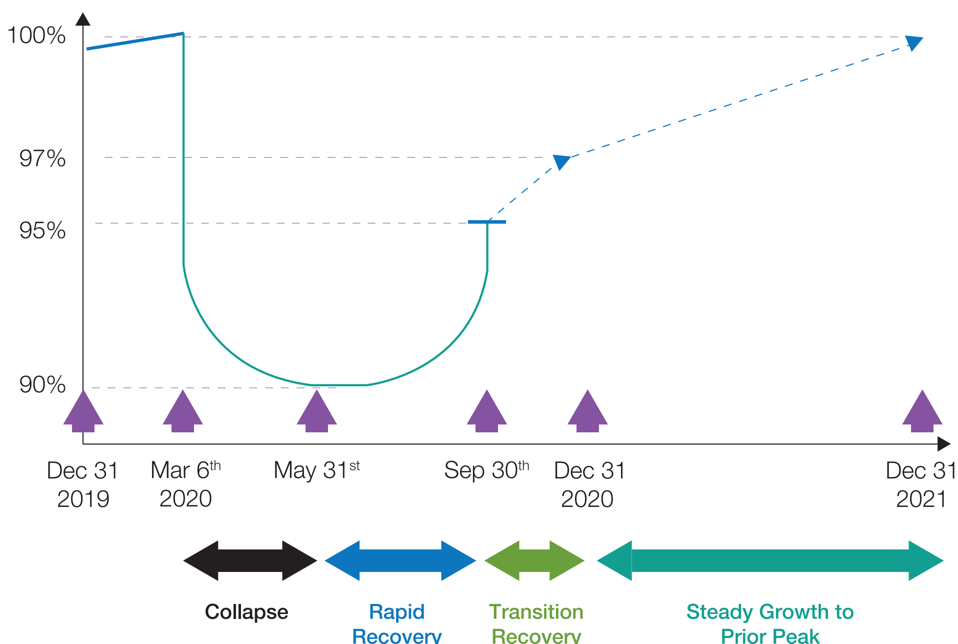
Investors are beginning to look past Covid-19 and we believe it is right to do so. The outlook for corporate profits and dividends has ceased to deteriorate and investment markets are discounting a reasonable scenario. Covid-19 risks have not been removed, but they are diminishing and are largely near term. Risks are balanced, to the upside as well as to the downside, but the magnitude of investment downside has been underwritten by "whatever it takes" global fiscal and monetary policy harmonisation.

Investors are beginning to look past Covid-19 and we believe it is right to do so.

Altogether, a neutral risk position, which partly takes into account the anticipated near-term heightened volatility, appears right to us.

When Covid-19 is decisively put behind us, the consequences of the policy to contain it will be confronted. At that time, the removal of support and the de-synchronisation of global fiscal and monetary policy may cause a "Bernanke moment" of vertigo in financial markets. That, however, would almost certainly be a consequence of a positive outcome and so should not be feared today. Altogether, a neutral risk position, which partly takes into account the anticipated near-term heightened volatility, appears right to us.

IW&I Scenario Analysis: Conceptual COVID Crisis Global GDP Growth Schematic



Source: Bloomberg and Investec Wealth & Investment

Our view is that the most likely outcome is “mid U”, reflected in the schematic shown above, which in GDP terms is aligned to the view of Investec Wealth & Investment and slightly more conservative than the most recent IMF projections.

The Covid-19 collapse has been traumatic.

The lockdowns have put the social economy into hibernation, which is a substantial portion of the service sector-dominated whole, particularly in developed markets, which represent two-thirds of the global economy.

…**but the “whatever it takes” action by governments and central banks has ensured that the global economic fabric remains substantially intact.**

Under the ultimate stewardship of the US Federal Reserve, still the cornerstone of the global financial system, the financial “plumbing” (the interaction of the banking system with financial markets) has been tested and found resilient in the face of an unprecedented demand for liquidity, as the mood of investors and businesses worldwide switched from optimism to fear almost overnight. There will be no re-run of the Global Financial Crisis (GFC) when the financial system became a multiplier of economic damage. At the same time, fiscal programmes of unimagined scale and scope in peacetime have been passed. They already sum to more than twice the magnitude, relative to global GDP, of the stimulus applied in the GFC, but critically they have been agreed in a fraction of the time.

A new cycle will then begin, and can be long-lived.

After the initial sharp retracement of lost ground, global growth will resume and the gap to the previous high will be gradually eliminated. The output gap created by crisis will ensure that the new cycle has a decent time to run, even beyond that point. Fiscal policy will become a primary policy tool. This is overdue, outside the US. Monetary policy has run out of power to support a global economy with excess savings. Fiscal policy is the right remedy for insufficient demand.

There will be no re-run of the Global Financial Crisis (GFC) when the financial system became a multiplier of economic damage.

By our estimate, global equities are pricing in a 20% decline in dividends over the coming 12 months.

We think that this estimate is likely to be conservative, in other words, there is a material chance of dividends surprising on the upside over the coming 12 months. However, given the prevailing uncertainty, a reasonable margin of safety in equities is warranted, hence our decision to remain at neutral.

By our estimate, global equities are pricing in a 20% decline in dividends over the coming 12 months.

SA market view and asset allocation – Retaining SA government bonds as our preferred asset class; gold as an insurance policy

Overview

The SA asset allocation committee has retained its overweight recommendation in SA bonds. Despite the deteriorating SA fiscal position, the SA bond market offers a significant margin of safety. In addition, should the state's fiscal position deteriorate by more than the committee's expectation, we expect that the state will intervene to shift the burden to taxpayers and/or pensioners, which ultimately will disadvantage "SA Inc" (shares whose fortunes are linked to the performance of the local economy) equities relative to bonds.

While SA equities appear cheap, the medium-term outlook for the SA economy is fraught with uncertainty. In other words, the large margin of safety currently priced into SA equities is well deserved. Commodity producers have a large margin of safety priced in too, but the current global recovery and still weak rand are likely to provide significant support to their share prices, in our view. Within the SA equities universe, we have a clear preference for commodity producers over SA Inc shares.

The committee's favoured hedge against risk over the coming 12 months is gold. It is the only asset class for which the committee has a double overweight recommendation. Rapid global money supply growth raises the possibility of higher-than-expected global inflation down the line. We expect that gold will prove an effective hedge should this play out, while also providing a hedge against a possible increase in SA-specific risk.

The SA asset allocation committee has retained its overweight recommendation in SA bonds.

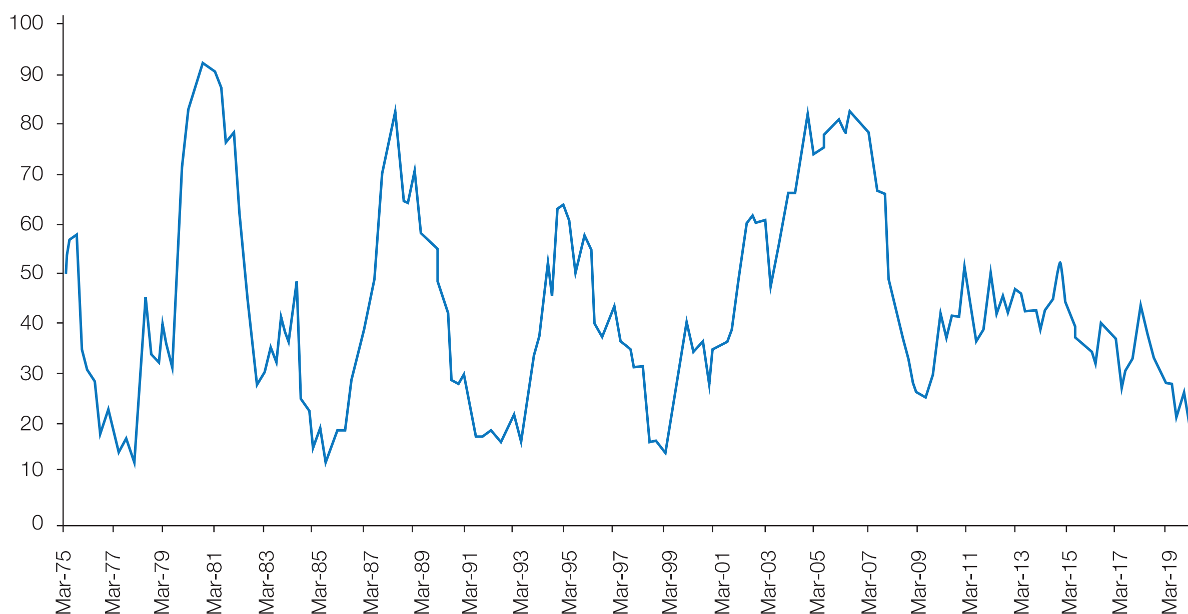
While SA equities appear cheap, the medium-term outlook for the SA economy is fraught with uncertainty.

Risks to the outlook in SA

There are many immediate obstacles for SA to clear. While an increase in electricity demand points to a recovery underway, it also raises the prospect of constrained power supply. Eskom is forecasting SA electricity demand to get back in line with last year's level in two months' time. We therefore don't expect to be out of the loadshedding woods until August next year at least. Business confidence is at the lowest level ever recorded. Wage growth has been in line with inflation for two years and we expect will come in below inflation, for at least six months. Real wage growth is strongly correlated with SA Inc equity performance. The key leading indicator for real wage growth is business confidence. It is going to take some time before we get excited about SA Inc shares, despite their attractive valuation.

The committee's favoured hedge against risk over the coming 12 months is gold. It is the only asset class for which the committee has a double overweight recommendation.

BER Business confidence survey



Source: Thomson Reuters

Having said that, more than 50% of SA-listed equities have a price/earnings ratio below 10. The only two other occasions that this has happened in the past 20 years wasin 2003 and at the height of the GFC, both of which proved to be profitable periods to invest in the SA equity market. It is possible to back out the cash flow return on invested capital priced into each sector of the local equity market. By our estimate, commodity producers are pricing in abnormally low retuns on capital over the foreseeable future, despite firm evidence of a global recovery and assistance from a weaker rand. While SA Inc plays appear cheap using the above mentioned screen, we prefer to retain an underweight position until SA business confidence starts to pick up.

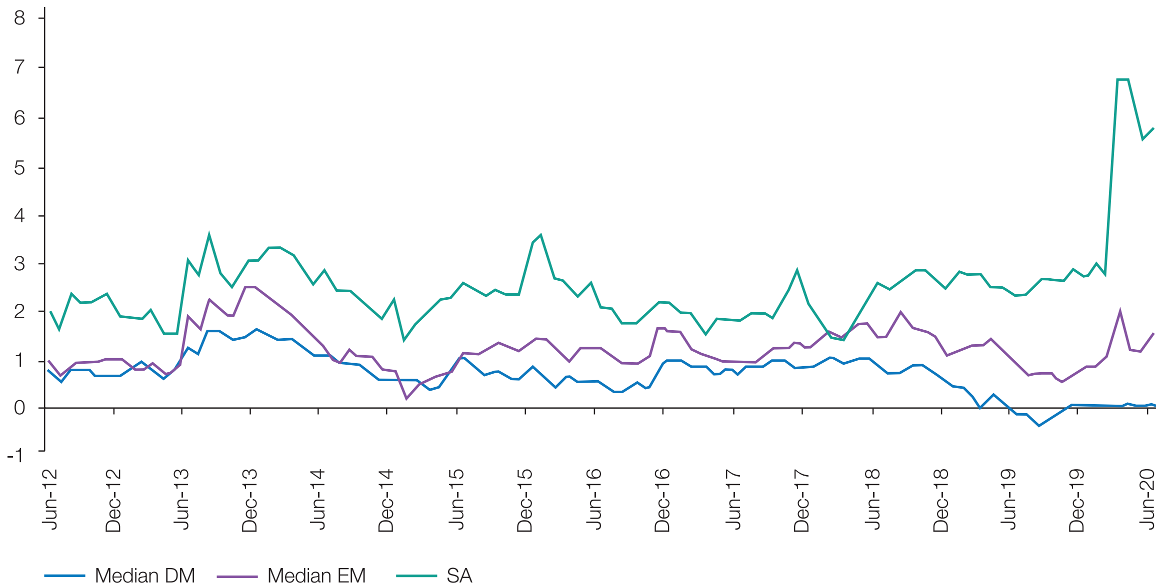
Eskom is forecasting SA electricity demand to get back in line with last year's level in two months' time.

Staying overweight SA bonds

The SA yield curve is abnormally steep relative to both developed and emerging market peers. The margin of safety in SA bonds is so large that by our estimate, the SA 10-year bond yield would have to increase by nearly one percentage point (100 basis points) per annum for the foreseeable future to underperform cash. Our base case is for SA bonds to return over 9% over the coming 12 months.

It is going to take some time before we get excited about SA Inc shares, despite their attractive valuation.

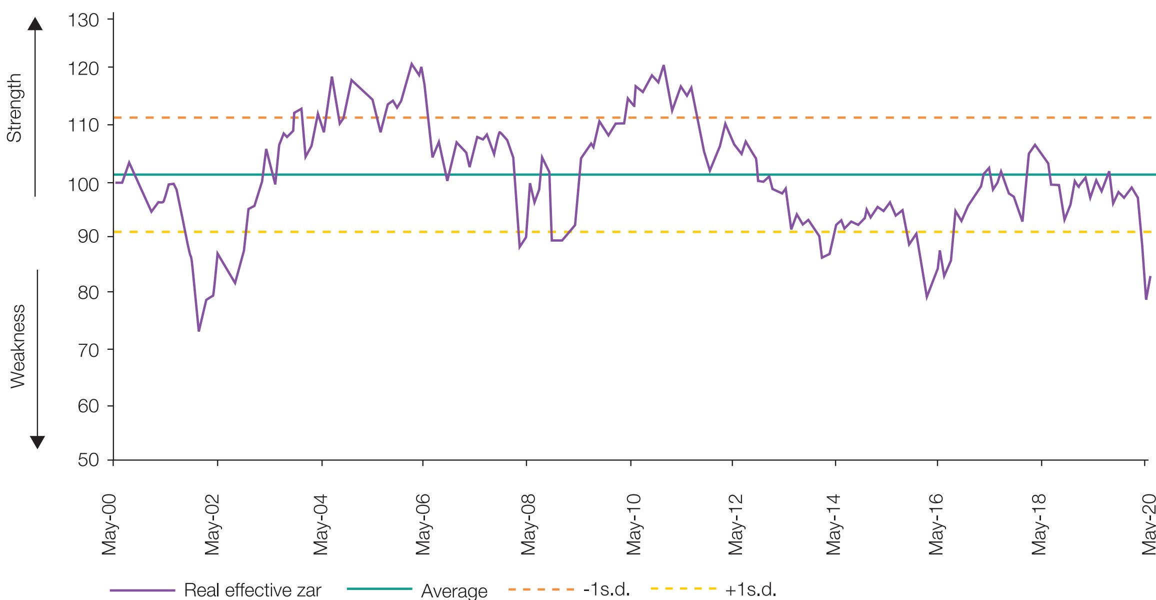
Slope of yield curve



Source: Investec Wealth & Investment and Thomson Reuters

The trade-weighted, inflation-adjusted rand has rarely been as weak as it is now. Despite concerns about growth over the coming three months in SA, the committee is of the view that the rand will strengthen over the coming 12 months. At the same time, the committee expects that it will take significantly longer than 12 months for the rand to get back to fair value.

Despite concerns about growth over the coming three months in SA, the committee is of the view that the rand will strengthen over the coming 12 months.



Source: Thomson Reuters and Investec Wealth & Investment

In summary

Equities: These appear cheap, according to our screen. We are overweight equities exposed to markets outside of SA (global consumer names and commodity price plays). We are underweight SA plays (SA Inc) and we prefer to take our SA exposure through the domestic bond market.

Bonds: SA bonds still offer a large margin of safety. Should the worst case scenario for SA government debt materialise, we expect that SA Inc shares will take more pain than SA bonds.

Cash: Cash rates are currently low in both nominal and real terms in SA, so we prefer to allocate to risk through the domestic bond market.

Property: We prefer increased exposure to SA yields through the government bond market. SA domestic property is likely to continue to come under pressure given backwards revisions for retail space.

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

- Sustained risk-on appetite globally.
- Resumption of emerging versus developed market outperformance (from a growth and earnings perspective).
- Coherent plan for dealing with Eskom and other state-owned entities (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 cuts – 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 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	Q2 2020	Q3 2020	COMMENTS
Offshore Equity	+	N	Global risk assets are fair value given the risks to recovery.
Offshore Fixed Income	-	-	DM bonds offer little value in our view. We see material upside risk to global bond yields.
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 2020	Q3 2020	COMMENTS
SA Equity	-	-	Valuation looks cheap but we need to see firm signs of improvement in SA to increase SA equity risk exposure.
SA Fixed Income	++	+	Bond yields still attractive even post the recent rally. Still significant margin of safety in SA debt in our view.
SA Cash	-	-	We prefer to be exposed to the long end of the curve.
SA Listed Property	--	-	Less of a domestic interest rate play than historically - expect to be driven by fundamentals. Prefer to express the view through the fixed income market. Not as negative as we were last quarter.
Preference Shares	+	+	Very strong performance has moved valuations close to fair value. Still attractive for investors looking for after-tax income.
$/R (+ for ZAR strength)	++	+	ZAR looks very cheap according to our models but SA specific risk remains elevated.
Physical Gold	+	++	Allocation to physical gold offers protection against SA and global risks particularly the risk of higher inflation down the line.

SECTORAL/THEMATIC POSITIONING	Q2 2020	Q3 2020	COMMENTS
Global Plays	+	+	Remain overweight consistent with global asset allocation.
Commodities	+	+	Favoured sector to play a global recovery and hedge SA risk.
Precious Metals	--	-	Precious metal producers offer a hedge against SA risk and leverage to a global recovery and weak ZAR.
SA Plays	N	-	Increasing concern about risks in the local market.
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.