Global Investment View

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A neutral stance, but watch out for political wild cards

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 and Switzerland. The Group meets quarterly to map out our outlook over the following 18 months, setting a risk budget and identifying some of the potential icebergs that lie in the global investor's path.

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A neutral stance, but watch out for political wild cards

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

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Our view is that risk assets (equities) will outperform insurance assets (bonds) over the next 18 months and that the risk that this assessment will be wrong has fallen in the period since our last meeting.

We base this view on a number of key observations:

The global economic outlook remains benign. The global economic cycle has been lengthened by the slowdown in 2019. Our central case is that the current US growth deceleration will level out imminently and that growth outside the US will converge (upwards) with the US at these lower levels.

Furthermore, **global monetary policy has swung back to an explicitly supportive setting in the US, the EU and China.** Fiscal policy is also broadly supportive: the US continues to run a large government deficit (4% of GDP), while China has loosened its purse strings to offset the effects of tariffs on trade and domestic retail sales. In Europe, the trend towards higher deficits that started in the South (Italy) is now moving north, as evidenced by Dutch plans to cut taxes. Germany remains so far unmoved, but is clearly feeling increasing pressure to recycle its savings into fiscal spending.

We have a more positive outlook for global corporate earnings in 2020. Expectations for 2019 are for flat earnings in US dollars, which is a significant "reset" from the beginning of the year. However, if our central case economic scenario holds, 2020 earnings look set to grow again as the rest of the world catches up (somewhat) with the US.

Consensus forecasts have growth at 10% for next year, but mid-single digits growth in 2020 may be a more realistic expectation.

Valuations of risk assets (equities) are attractive relative to insurance assets (fixed income). The Equity risk premium (the spread between expected earnings yields and the current risk free rate) has been large by historic standards for some time and it has increased further recently. The forward earnings growth outlook is now improving and it is "discounted" by (lower) risk free bond yields – hence the valuation picture for equities has improved.

Against these positive dynamics, we should point out that **cyclical and political risks remain.** The economic and monetary policy picture outlined above is a Goldilocks scenario (not too hot, not too cold).

The global economic outlook remains benign.

It is not easy to reconcile such low real and nominal bond yields (US 10 year Treasuries are yielding 1.8% and much of Europe is "enjoying" the head-scratching phenomenon of negative government bond yields across a material segment of the yield curve) with a positive growth outlook and high resource utilisation (employment).

Furthermore, global monetary policy has swung back to an explicitly supportive setting in the US, the EU and China.

We have a more positive outlook for global corporate earnings in 2020.

Our base expectation however is that:

- The US and China can reach an accommodation on trade. Imposition of the full slate of threatened US tariffs upon China and retaliation by China would risk a global stagflationary shock.
- China remains in control of its own destiny and, as the nexus of the wider emerging market growth story and an important trading partner for Europe too, absent an all-out trade war, will continue to grow solidly. Hong Kong's issues will not derail China.
- Europe will prove resilient to the internal political challenges presented most recently by Italy and Brexit (whatever form it should take). We note that a deal is still the most likely outcome. A "no-deal" would be a negative for Europe and more so for the UK. A chaotic no-deal would likely impact global risk appetite at least temporarily.
- US / Iranian tensions will not escalate.

In conclusion, barring political interference, the prospects for global growth, corporate profits and interest rates, together with solid valuations, all support the case for outperformance of risk assets over insurance assets over the coming 18 months.
Geopolitical risks remain elevated and although, thanks to the presence of a wild card in the White House, the risk-premium that we require to invest in global equities is higher than normal, that is currently reflected in prices.

Our view is that a more stable period in Sino-US relations is in prospect in the run-up to the US elections and this will provide a better backdrop for investors in risky assets, and a more difficult time for those in fixed income.

Based on the above, we have increased our recommended exposure to risk assets by a notch, to neutral. Underlining this assessment, our insurance asset of choice is cash and cash proxies, rather than sovereign debt.

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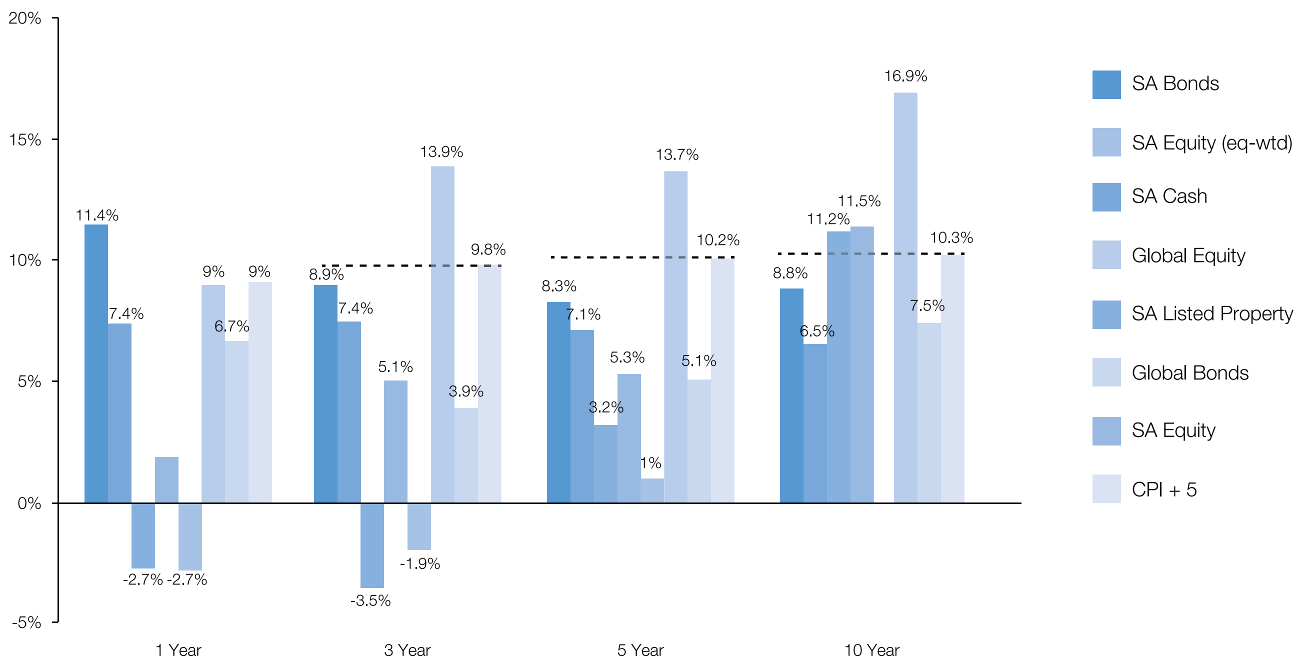
SA market view and asset allocation – Policy clarity, the tackling of the problems at Eskom and other SOEs and lower interest rates will all improve the outlook for South African assets

Overview

The past three months have seen negative returns for both domestic equity and property, as concerns about global trade and a slowdown in global growth have been reflected in emerging market risk assets (equities). SA bonds outperformed again and have now been the top performing domestic asset class over three months, 12 months, three years and five years. The weakness in the rand and the strength of US equities have led to strong returns from offshore equities, when measured in rands.

Asset Class Performance in ZAR to 30.09.2019



Source: Investec Wealth & Investment

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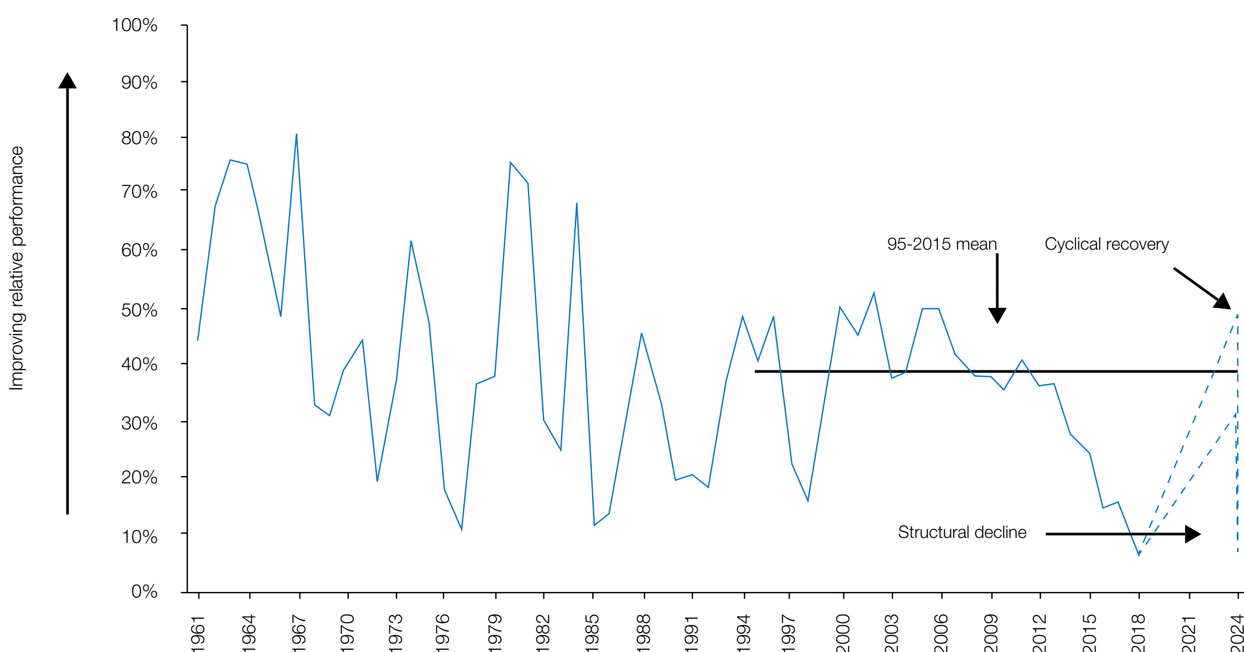
Asset allocation

Cyclical recovery or structural slowdown? One way of framing the local growth picture is by comparing growth in South Africa to the rest of the world. From 1960 through to 2018, SA has never been the fastest growing economy in the world. Typically from 95-2015 SA was ranked just above the bottom 38% of countries in the world. The post-2015 period has seen a steep deterioration.

Fewer than 10% of countries in the globe grew more slowly than South Africa in 2018. South Africa would be in structural decline is if it does not get back to the 1995-2015 average within the next five years.

SA GDP growth rank percent relative to rest of the world



Source: Investec Wealth and Investment, World Bank

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The IMF, SA Reserve Bank (SARB) and sell side consensus all expect growth for South Africa in 2021 of around 2%. This would put SA in the bottom 20% of countries, based on IMF forecasts for the rest of the global economy. IMF growth forecasts have South Africa in the bottom 40% of countries out to 2024. While the IMF, SARB and sell side are all expecting a cyclical pick-up in growth for South Africa, they are all implicitly simultaneously forecasting a continuation of the structural decline in South African growth relative to the rest of the world.

How accurate are growth forecasts? While official forecasts paint a bleak picture around potential growth over the foreseeable future, that in itself is not sufficient reason to believe that growth will be weak. In a recently published paper on the SARB's website, SARB staffers have examined the accuracy of SARB and sell-side GDP and inflation forecasts. They find that GDP errors (average of one quarter to six quarters ahead errors) have rarely been less than 0.5%. From 2011 to 2016 forecasts were consistently more than 1% off what was realised. They may be the best forecasts available but they have not been very good. Our base case is for South African growth to pick up over the coming three years as the binding constraint from electricity supply is released and business confidence gradually picks up.

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What does it matter for …

… South African bonds? Periods of low growth relative to the rest of the world see significantly higher spreads for South African nominal debt relative to developed market (DM) peers. The post-2003 average of such instances saw a spread of 6.5%. Currently the spread is 8.5%. The market is not just pricing in a structural decline but has added a large premium to that too.

Periods when South African growth has ranked just above the bottom 38% of countries, the spread of South African 10-year government debt over DM peers has been around 5%. By this analysis, South Africa bonds are cheap if one expects South Africa's relative growth to continue to be weak. An expectation of growth materially picking up relative to the rest of the world would imply a belief that South African bonds are exceptionally cheap.

While South African government debt continues to grow in line with expectations, nominal GDP growth continues to disappoint. The net result is that the debt-to-GDP ratio is deteriorating and we are likely to see the trajectory pushed up again at the Medium-Term Budget Policy Statement at the end of October.

There is a material risk that Moody's changes the outlook for South African sovereign debt to negative in November. However, we believe this is more than priced into government debt: five-year South African US dollar-denominated government debt trades at a higher yield than equivalent Brazilian debt despite Brazilian debt being rated worse than South African debt. In our view, real yields of 3.5% for South African 10-year inflation linker debt is attractive.

… the rand? Surprisingly, the real effective rand has been less sensitive to the relative performance of South African growth than bond yields. While the rand is typically weaker when growth is relatively weaker, the difference relative to when growth is more normal is smaller than one would expect.

At spot, the rand is trading roughly in line with where one would expect, given South Africa's relative growth performance. At R15.2 to the US dollar, we believe the rand to be slightly undervalued, with fair value around R14.

South Africa bonds are cheap if one expects South Africa's relative growth to continue to be weak.

… the South African equity market? The weighting and constituents of the JSE All Share Index insulate the broad index against the effects of slow domestic growth. In both the slow relative growth and the typical relative growth scenarios, the local index has, on average, performed in line with the emerging market index. While the South African growth outlook will have implications for sectors within the broad index (most notably retail, banking and small caps), from an asset allocation perspective ,the primary driver of South African equity performance is emerging markets.

There is a material risk that Moody's changes the outlook for South African sovereign debt to negative in November. However, we believe this is more than priced into government debt.

As per the GISG view, emerging market equities are roughly fairly valued given dividends and prevailing interest rates. We expect emerging market earnings to pick up and within that we expect South African earnings growth to pick up too. The net result is that, despite the risks to the global outlook, we are slightly overweight SA equities.

… cash? Given continuing monetary easing across much of the globe, inflation in South Africa that is remarkably well contained and still modest growth, we continue to expect the repo rate to be cut by 25bps (0.25 percentage points) by year end.

… property? We prefer to increase exposure to South African yields through the government bond market. Domestic property is likely to continue to come under pressure, given backwards revisions for retail space. There are also concerns about oversupply in the commercial space.

Given the above, we can draw up a **checklist of what's needed to increase our risk preference** in South Africa:

- Sustained **risk-on appetite globally.**
- A resumption in **emerging markets' outperformance** against developed markets (from a growth and earnings perspective).
- A **coherent plan on how to deal with Eskom and other SOEs** – we need a strong message on how the expenditure will be controlled. The current situation is unsustainable.

- No **more load-shedding from Eskom** – this was a major constraint to growth in 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. **South African risk assets typically perform very well in a downward interest rate environment.**
- **An improvement in business confidence** – we are unlikely to see job creation unless this improves Our positioning is summarised in the table.

At R15.2 to the US dollar, we believe the rand to be slightly undervalued, with fair value around R14.

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	Q3 2019	Q4 2019	COMMENTS
Offshore Equity	-	N	Global backdrop remains supportive of risk assets over "insurance" assets.
Offshore Fixed Income	-	-	Low expected total returns from these evaluations. 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	Q3 2019	Q4 2019	COMMENTS
SA Equity	+	N	Cautiously optimistic on outlook for SA equity market. Valuations look cheap to reasonable but need to see delivery in key areas and favourable EM backdrop.
SA Fixed Income	+	+	Total real returns continue to look attractive Expressed through inflation-linked bonds and nominal bonds with increasing preference for ILBs.
SA Cash	-	-	Still offering attractive real return but see better total return opportunities in risk assets.
SA Listed Property	-	-	Less of a domestic interest rate play than historically - expect to be driven by fundamentals. Prefer to express the view through the fixed income market
Preference Shares	+	N	Very strong performance has moved valuations close to fair value. Still attractive for investors looking for after-tax income.
$/R (+ for ZAR strength)	N	+	ZAR looks fairly valued on our models but we could easily see positive follow-through as $ weakens and/or EM risk appetite improves.
Physical Gold	+	+	Allocation to physical gold offers protection against SA and global risks.

SECTORAL/THEMATIC POSITIONING	Q3 2019	Q4 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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