Global Investment View

Quarter 4, 2020

Wealth & Investment

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Asset Allocation Positioning.

Neutral position as Covid-19 becomes a manageable condition

The Global Investment View distils the thinking of the Global Investment Strategy 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.

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 +3 to -3).

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

The GISG remains optimistic that the impact of the resurgence of the virus in Europe will be limited and are encouraged by recent trends in the US. Whack-a-mole strategies to control it, rather than wholesale, widespread restrictions will be the order of the day.

The economic risks of Covid-19 are largely behind us:

Although the total number of cases in the world continues to rise, more than twice as many people are recorded to have recovered than are now recorded as having the virus (active cases). There are good reasons to believe that Covid-19 will continue to recede as a threat, for the following reasons:

1. Progress on a vaccine is occurring at great speed. There are more than 15 serious candidates, with four already in late stage human trials it is increasingly likely that there will be at least one new weapon in the anti-Covid-19 armoury by early next year.

2. New treatments (steroids, Interferon-B) and improved regimens are improving outcomes.

3. Better understanding of the virus has revealed ways to limit transmission (tracing and masks!).

4. Lower-than-feared mortality rates (0.5-1% of total infections, 0.1% of those under the age of 45), and a low likely threshold for herd immunity – since a high proportion of the population are now thought to be naturally immune (mainly the young, but the common-cold, also a corona virus, may confer some immunity to those who have recently had it).

These factors, whilst not adding-up to "Covid-19 case closed", support our belief that this is now a manageable condition. Any re-imposition of restrictions in major economies will therefore not be widespread or long-lasting.

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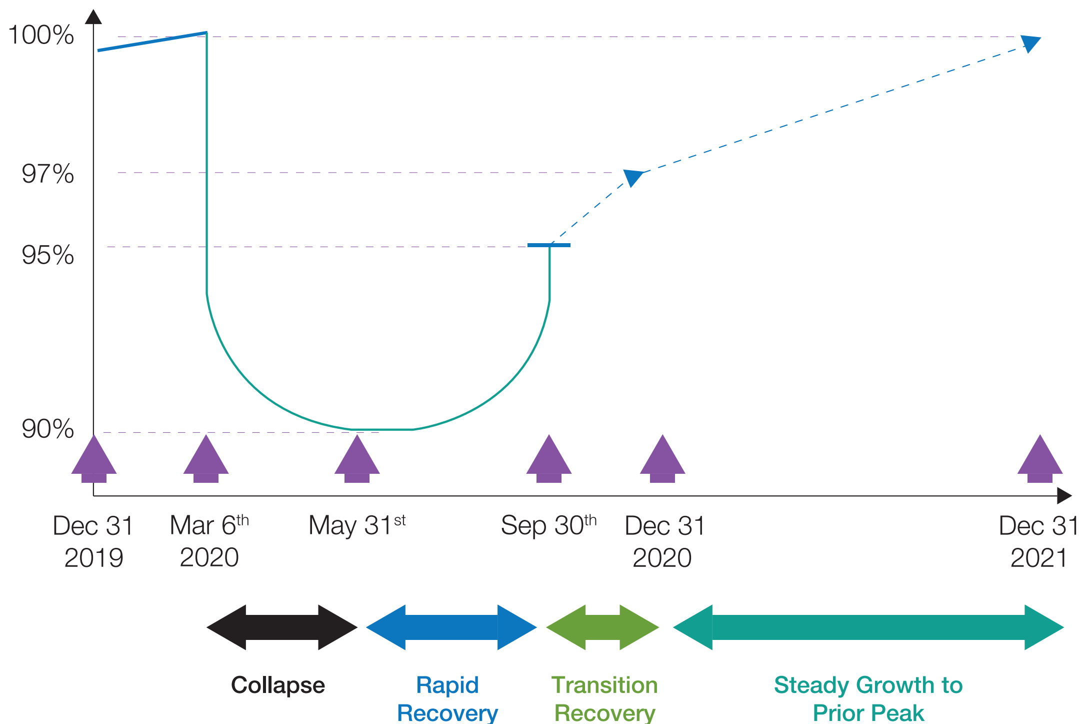
IW&I Scenario Analysis: Conceptual COVID Crisis Global GDP Growth Schematic

(This Illustration is compatible with IMF current Global GDP forecast of -3% growth in 2020)



Source: Bloomberg and Investec Wealth & Investment

Economic growth is tracking our (encouraging) central case.

Economic data, supplemented by never-before available real-time data from big data accumulators like Google, supports our "Mid U" shaped view of the path economic recovery. The global economy hit a low-point at the end of April, and bounced sharply initially.

The pace of the recovery has moderated recently however, as the US, which drove much of the early positive momentum, has seen a flattening out of activity as the virus re-imposed itself in key southern states.

Europe too has seen the initial sharp recovery in activity, tempered by local / regional re-imposition of restrictions. Nevertheless, it appears local lockdowns are effective and we would anticipate a pattern of rolling regional "releases and re-restrictions" to still allow for a solid recovery in aggregate in developed markets to the end of the year.

Aside from China, which is ahead of the pack globally, emerging markets are on a similar recovery course, although a month or so behind developed markets.

The Global Economy hit a low-point at the end of April, and bounced sharply initially.

The key variables are not Covid-19 or government reactions to control it, but consumer confidence and the pace of tapering of policy support (monetary and fiscal).

Whatever-it-takes monetary and fiscal policy will be with us for the foreseeable future. Monetary policy settings, under the control of central banks, but encouraged by supervising authorities, are set to remain hyper-accommodative until credible evidence of a material closing of the output gap is seen – and will likely be tolerant of inflationary blips before then.

Concerns about premature tapering of fiscal stimulus (US fiscal cliff, UK furlough schemes) will be temporary. With central banks complicit, bond markets in developed economies are providing governments with unprecedented fiscal freedom. Their electorates will not thank them for passing on the opportunity to "cushion" the restart of economic reality.

Risk assets are fair-value:

Our touchstone valuation measure, based on dividends (which we believe are the best measure of the long term normalised earnings power of equity markets) discounted by current risk-free rates, indicates global share markets are fairly valued (a reading of -2%, within a fair value range of +/- 20%) using global dividends in 2021 estimated to be 7% lower than the level paid-out in 2019, as currently implied by futures markets.

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SA market view and asset allocation – Maintaining our position in SA government bonds as the preferred asset class, but with gold for insurance

Overview

The South African asset allocation committee has kept its recommended asset allocation unchanged from last quarter. The key calls are a retained overweight in domestic bonds and gold.

Key themes for the quarter:

MPC improves the outlook for the SA consumer.

Business confidence is still meaningfully down year-on-year, implying little prospect for meaningful increases in private sector employment over the coming 12 months. During Q2, total salaries and wages dropped 9% year-on-year, equating to a R40bn reduction to consumer spend. However, this should be counterbalanced against imposed savings and stimulus from the government and the SA Reserve Bank.

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By our calculation, every 100bp (one percentage point) reduction in the repo rate saves SA consumers R22bn/ year. So far, the repo rate has declined 275bps from the rate in February.

The net result is that while a large number of South Africans are undoubtedly in a worse financial position than before the crisis, there will also be large pockets of consumers who find themselves in a stronger financial position and

The government is targeting raising some R1.3 trillion from the sale of rand-denominated bonds over three years. Foreigners have shown little appetite for domestic bonds, having sold R150bn worth over the past 12 month.

the asset allocation committee expect will shortly start increasing spending again.

Tough fiscal position in SA.

The government is targeting raising some R1.3 trillion from the sale of rand-denominated bonds over three years. Foreigners have shown little appetite for domestic bonds, having sold R150bn worth over the past 12 month. The vast amount of issuance is likely to keep yields elevated in SA for some time and SA is unlikely to regain investment-grade status within at least the next three years, in our view.

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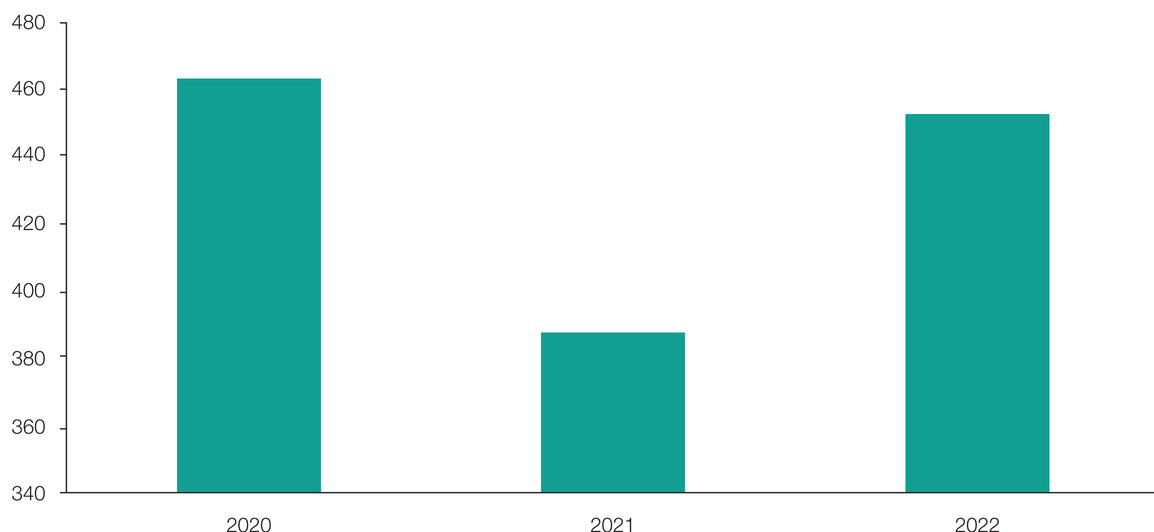
Expected Issuance of domestic long bonds (Rr)



Source: Treasury

Diversification in the local market.

A number of offshore sectors have been negatively correlated with the domestic bond market over the past 60 months, providing significant diversification benefits. The three most negatively correlated sectors are global bonds, US cash and gold. These three sectors also provide the most effective diversification against SA equity risk. Of the three, the committee has a preference for gold.

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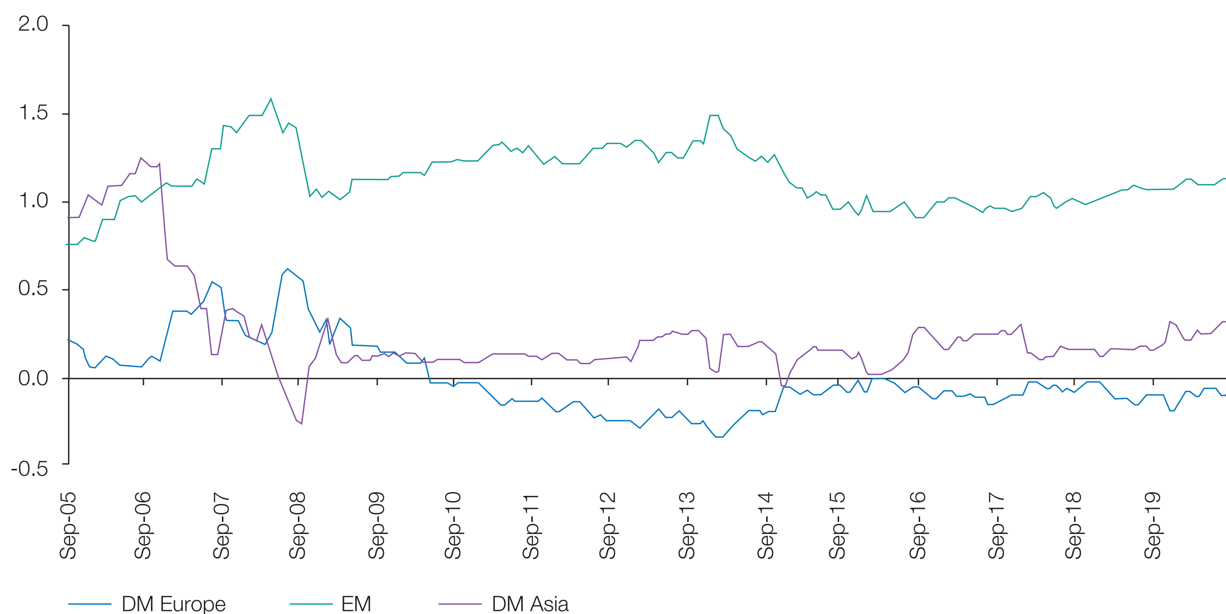
Rand outlook.

The rand is a strong play on emerging market currencies with a beta regularly above 1 and a very high R2. In effect, emerging market volatility explains nearly all of the deviation of the rand from purchasing power parity.

The committee's expectation of emerging market recovery is consistent with an expectation that the rand will recover. While there have been three persistent shocks to the real effective rand since 1970, the committee view is that the current move is unlikely to be one of those, and the committee expects that the rand will reach R15.5 to the US dollar, before it reaches R18.5.

ZAR beta against other currency indices



Source: Treasury

Summary on asset classes:

Equities: These currently screen cheap. The domestic equity market is pricing in cash flow return on capital over the next five years to be lower than that seen in the latest set of reported results. This is especially bearish relative to what is priced into both aggregate emerging and developed market indices.

The committee is overweight equities that are exposed to earnings outside of SA (global consumer names and commodity price plays). Conversely, the committee is underweight SA plays, since we prefer to take our SA exposure through the domestic bond market.

Bonds: While the SA government is likely to issue a large amount of debt over the coming two-and-a-half years, there is a large margin of safety priced into the current debt market.

By our estimation, even should long bond yields rise by over 200bps over the coming five years, the SA 10-year bond will return more than 8% a year vs. around 4% for cash. The slope of the yield curve in SA is abnormally steep.

The committee expects the repo rate to remain at around spot for the foreseeable pressure.

Cash: The committee expects the repo rate to remain at around spot for the foreseeable pressure. The Fed's commitment to keep rates low and the absence of any meaningful inflationary pressures in SA will likely see the MPC remain pat for some time.

Property: While the trailing yield of the property sector is high relative to 10-year bond yields, which are also high, there is valid reason to currently demand an extra margin of safety from the property space.

High levels of unemployment are likely to see office vacancies remain high for some time and retail faces structural headwinds. While there are opportunities within the broader sector, particularly among the property counters with the strongest balance sheets, we remain underweight the aggregate sector.

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Our checklist for risk preference in SA:

- Sustained risk-on appetite globally.
- Resumption of emerging market versus developed market outperformance (from a growth and earnings perspective).
- Coherent plan on how to deal with Eskom and other SOEs – we need a strong message on how the expenditure will be controlled. The current situation is unsustainable.
- No more load-shedding from Eskom – this was a major constraint to growth in the first quarter
- More clarity on government policy, given the factionalism within the ruling party.
- Interest rate cut – other central banks (including emerging markets) are cutting rates. Our real interest rate is extremely high in this context and we have ample room to cut. SA risk assets typically perform very well in a downward interest rate environment.
- Improvement in business confidence – 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	Q3 2020	Q4 2020	COMMENTS
Offshore Equity	N	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	Q3 2020	Q4 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	+	+	Still significant margin of safety in SA debt in our view.
SA Cash	–	–	We prefer to be exposed to the longer 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.
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	Q3 2020	Q4 2020	COMMENTS
Global Plays	+	+	Remain overweight as hedge to SA specific risk.
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	–	–	Still slightly underweight, overweight the geared plays.
Small/Midcap	+	+	Valuations are very attractive but appetite extremely low which may provide opportunity for patient investors.

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