

Global  
Investment View  
QUARTER 4 - 2017



# Global Investment View



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## Managing the transition out of QE

Overall the global situation identified in our last edition has endured – risk assets have continued to outperform bond assets and we maintain our view that taking risk will be rewarded over the next 18 months.

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 Darren Ruane*

Head of fixed income, Investec Wealth & Investment UK and acting chairman of the Global Investment Strategy Group

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## Summary of our key thoughts

Overall the global situation identified in our last edition has endured – risk assets have continued to outperform bond assets and we maintain our view that taking risk will be rewarded over the next 18 months. However some extra concerns have emerged over the past quarter, which we explain below, and we acknowledge that the economic and market cycle is well developed. The main factors affecting markets remain the benefit that risk assets, and particularly equities, are receiving from positive global growth momentum and worries over the potential fallout from quantitative tightening.

Outside of the major market forces mentioned above, other factors are present:

- Low inflation readings allow central bankers to remove monetary stimulus in a gradual way and thereby not spook economies or markets
- Political risks have diminished (although the recent uprising of populist sentiment in the German election may provide some read-throughs for the Italian election next year)
- Rising bond yields are not contaminating equity prices
- Valuations are closer to the expensive end of historic norms and market sentiment remains cautious
- Trump's worrying rhetoric in many fields, including trade and foreign policy, has not turned into hard actions
- Volatility remains at historically very low levels; and it would be unsurprising for a 10% market correction to happen at some point.

In addition there are a number of new issues to highlight since the last meeting:

North Korea has threatened nuclear war with the US and the US President has heightened tensions rather than de-escalated matters

- There is a new proposal for tax reform in the US, which could further buoy risk markets if enacted
- Finally, bond investors are likely to keep a close eye on changes to the make-up of the US Federal Reserve. Fears that President Trump could install his "own people" into key positions with a more dovish bias that could lead to higher inflation over the medium term has the potential to lift inflation premiums in long-dated government bonds.

Overall, although new risks have emerged, the main thesis of better economic growth balanced by central banks not wanting to negatively disrupt economies or markets provides for a neutral position. The prospect of price corrections are seen as buying opportunities.

## New issues to arise since our last edition

### Rising tensions with North Korea

2017 has been a difficult year for relations between North Korea and the rest of the world. Since early July, North Korea has tested a number of intercontinental ballistic missiles and exploded a nuclear device. Missiles have been tested over Japan and the rhetoric between North Korea and the US President has escalated. Despite the potential for a huge global event in the form of nuclear war or tensions that could increase its probability of happening, investment markets have taken the view that the likelihood of a war between North Korea and the West is very low. We mainly concur with the view taken by markets. However, investments that could protect portfolios in such an event may need to be considered, including US government bonds, gold and cash.

### Revival of potential tax reform in the US

The US Republican party has placed itself behind a joint White House/Congress Republican initiative for tax reform. The tax framework calls for a cut in the headline corporate tax rate from 35% to 20% which, although not as low as the 15% pledge given during President Trump's campaign, is a welcome commitment given the relatively high notional rate of 35%. In addition, a pledge was given to cut taxes for lower- and middle-income families. While many of the details of the tax reforms have not been provided, the good news for markets is that they have mostly discounted the possibility of Trump achieving many of the aims laid out in his presidential campaign, including tax reform. A fillip to business through lower taxes and the removal of worldwide taxation for US companies could allow overseas profits to be repatriated back to the US.

### Poor outcomes for mainstream parties in German election

The German federal election saw the Christian Democratic Union/Christian Social Union (CDU/CSU), led by Angela Merkel, winning 33% of the vote. The result saw an 8% fall in the share of the vote for CDU/CSU since the last election and the rise of former peripheral parties, and especially the Alternative for Germany party (with 12.6% of the vote). Current issues for Chancellor Angela Merkel include trying to win back the trust of those voters who moved away from the mainstream parties and forming an effective coalition government.

Investors, however, may ask questions about the appetite for German politicians to engage in further European integration given the strong outcome for non-mainstream parties. Of course, this comes at a time when the French President is seeking to reform Europe and introduce a framework that leads to more European integration, such as a single finance ministry with its own budget.

## Change in the make-up of the Fed in 2018

Over the past few months, it has become evident that the membership of the Fed could change materially over the coming six months. It is unknown if Janet Yellen, current Fed chair, will be offered another term when the current one ends in February 2018. Combined with other changes, President Trump could appoint up to five new members to the Fed's Board over the coming months. The potential change to the powerful position of chair will be closely watched by markets. New potential chairmen include Gary Cohn, the chief economic advisor to Donald Trump, and Kevin Warsh, a former governor of the Fed.

Markets are worrying that new members could help to steer monetary policy away from the current stance, in either a more dovish or hawkish strategy. A more dovish strategy could worry bond investors that the Fed will lose control of the US yield curve while a hawkish strategy may lead to concerns of an earlier-than-expected recession in the US.

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## Why we are retaining our neutral stance

### Positive global growth momentum continues

As 2017 has progressed, it has become clear that the global economy is strengthening. Three interest rate rises by the US Federal Reserve in the past nine months, higher purchasing managers' indices and falling unemployment rates are all signs of an acceleration in growth. Concerns about the global economy in recent years – as displayed through falling commodity prices, deflation, negative bond yields and overly restrictive fiscal policies – have mostly gone away and estimates for global growth rates have improved. For example, Bloomberg tracks growth forecasts from entities such as the OECD, World Bank, IMF and investment banks. The following changes to forecasts for global growth can be observed between June 2016 and September 2017: 2017 – 3.1% to 3.3%; 2018 – 3.2% to 3.4%; and 2019 – 3.3% to 3.4%. Estimates from the Investec economics team are higher than this: 2017 – 3.6%; and 2018 – 3.9%.

In addition, growth is emanating from all of the major regions at the same time. For example, in 2017, the major economic regions are forecast (according to Bloomberg consensus data) to achieve the following growth rates: Eurozone 2.1%, US 2.2%, emerging markets 4.4%, Japan 1.5% and China 6.7%. Positive growth momentum should help to lift corporate earnings over time.

	2015				2016												2017							
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	Jun	Jul	Aug	Apr	
<b>Global Economy</b>	1.4	1.5	1.7	1.7	1.9	1.8	1.6	1.7	1.6	1.6	1.6	1.5	1.8	1.7	1.8	2.0	2.3	2.2	2.0	2.1	1.9	1.7	1.7	
Developed	0.0	0.2	0.4	0.5	0.8	0.5	0.5	0.5	0.5	0.6	0.5	0.6	0.9	1.0	1.1	1.5	1.9	2.1	1.8	1.9	1.6	1.4	1.5	
Emerging	3.8	3.8	3.9	3.8	3.8	3.9	3.6	3.6	3.5	3.5	3.4	3.1	3.2	3.3	3.3	3.1	3.3	2.6	2.7	2.7	2.7	2.6	2.5	
<b>Global Economy</b>																								
<b>Eurozone</b>																								
Eurozone	-0.1	0.1	0.1	0.2	0.3	-0.2	0.0	-0.2	-0.1	0.1	0.2	0.2	0.4	0.5	0.6	1.1	1.8	2.0	1.5	1.9	1.4	1.3	1.3	1.5
France	0.1	0.2	0.1	0.3	0.3	-0.1	-0.1	-0.1	0.1	0.3	0.4	0.4	0.5	0.5	0.7	0.8	1.6	1.4	1.4	1.4	0.9	0.8	0.8	1.0
Germany	-0.1	0.2	0.2	0.2	0.4	-0.2	0.1	-0.3	0.0	0.2	0.4	0.3	0.5	0.7	0.7	1.7	1.9	2.2	1.5	2.0	1.4	1.5	1.5	1.8
Italy	0.2	0.3	0.2	0.1	0.4	-0.2	-0.2	-0.4	-0.3	-0.3	-0.2	-0.2	0.1	-0.2	0.1	0.5	1.0	1.6	1.4	2.0	1.6	1.2	1.2	1.4
Spain	-1.1	-0.9	-0.4	-0.1	-0.4	-1.0	-1.0	-1.2	-1.1	-0.9	-0.7	-0.3	0.0	0.5	0.5	1.4	2.9	3.0	2.1	2.6	2.0	1.6	1.7	2.0
Greece	-0.8	-0.1	-0.1	0.4	-0.1	0.1	-0.7	-0.4	-0.2	0.2	0.2	0.4	-0.1	0.6	-0.2	0.3	1.5	1.4	1.7	1.6	1.5	0.9	0.9	0.6
Ireland	-0.1	-0.1	-0.1	0.2	0.0	-0.2	-0.6	-0.2	-0.2	0.1	0.1	-0.4	-0.3	-0.4	-0.2	-0.2	0.2	0.3	0.6	0.7	0.0	-0.6	-0.2	0.4
<b>Developed</b>																								
Sweden	0.9	0.9	0.8	0.7	1.3	0.8	1.2	1.0	0.8	1.2	1.1	1.2	0.8	1.1	1.3	1.7	1.5	1.9	1.4	2.0	1.8	1.8	2.3	2.2
Switzerland	-1.3	-1.1	-1.2	-1.4	-1.5	-0.9	-1.0	-0.5	-0.5	-0.6	-0.5	0.0	-0.3	-0.3	-0.2	-0.2	0.3	0.7	0.5	0.7	0.4	0.4	0.6	0.5
UK	-0.1	-0.1	0.1	0.2	0.3	0.3	0.5	0.3	0.3	0.5	0.6	0.6	1.0	0.9	1.2	1.6	1.8	2.3	2.3	2.7	2.5	2.6	2.6	2.9
US	0.0	0.2	0.5	0.7	1.4	1.0	0.9	1.1	1.0	1.0	0.8	1.1	1.5	1.6	1.7	2.1	2.5	2.7	2.4	2.2	1.9	1.6	1.7	1.9
<b>Emerging</b>																								
Australia	1.9	1.8	1.8	2.0	2.3	2.1	1.7	1.5	1.0	1.5	1.0	1.2	1.3	1.5	1.5	1.8	2.1	2.1	2.2	2.6	2.6	2.3	2.7	2.6
Japan	0.0	0.3	0.3	0.2	-0.1	0.2	0.0	-0.3	-0.5	-0.4	-0.4	-0.5	-0.5	0.1	0.5	0.3	0.4	0.3	0.2	0.4	0.4	0.4	0.4	0.7
China	1.6	1.3	1.5	1.6	1.8	2.3	2.3	2.3	2.0	1.9	1.8	1.3	1.9	2.1	2.3	2.1	2.5	0.8	0.9	1.2	1.5	1.5	1.4	1.8
Indonesia	6.8	6.2	4.9	3.4	4.1	4.4	4.4	3.6	3.3	3.5	3.2	2.8	3.1	3.3	3.6	3.0	3.5	3.8	3.6	4.2	4.3	4.4	3.9	3.8
Korea	0.5	0.8	0.8	1.1	0.6	1.1	0.8	1.0	0.8	0.7	0.4	0.5	1.3	1.5	1.5	1.3	2.0	1.9	2.2	1.9	2.0	1.9	2.2	2.3
Taiwan	0.3	0.3	0.5	0.1	0.8	2.4	2.0	1.9	1.2	0.9	1.2	0.6	0.3	1.7	2.0	1.7	2.2	-0.1	0.2	0.1	0.6	1.0	0.8	1.0
India	4.4	5.0	5.4	5.6	5.7	5.3	4.8	5.5	5.8	5.8	6.1	5.0	4.4	4.2	3.6	3.4	3.2	3.7	3.9	3.0	2.2	1.5	2.4	3.4
Brazil	9.5	9.9	10.5	10.7	10.7	10.4	9.4	9.3	9.3	8.8	8.7	9.0	8.5	7.9	7.0	6.3	5.4	4.8	4.6	4.1	3.6	3.0	2.7	2.5
Mexico	2.5	2.5	2.2	2.1	2.6	2.9	2.6	2.5	2.6	2.5	2.7	3.0	3.1	3.3	3.4	4.7	4.9	5.4	5.8	6.2	6.3	6.4	6.7	
Russia	15.7	15.6	15.0	12.9	9.8	8.1	7.3	7.3	7.3	7.5	7.2	6.9	6.4	6.1	5.8	5.4	5.0	4.6	4.3	4.1	4.1	4.3	3.9	3.3

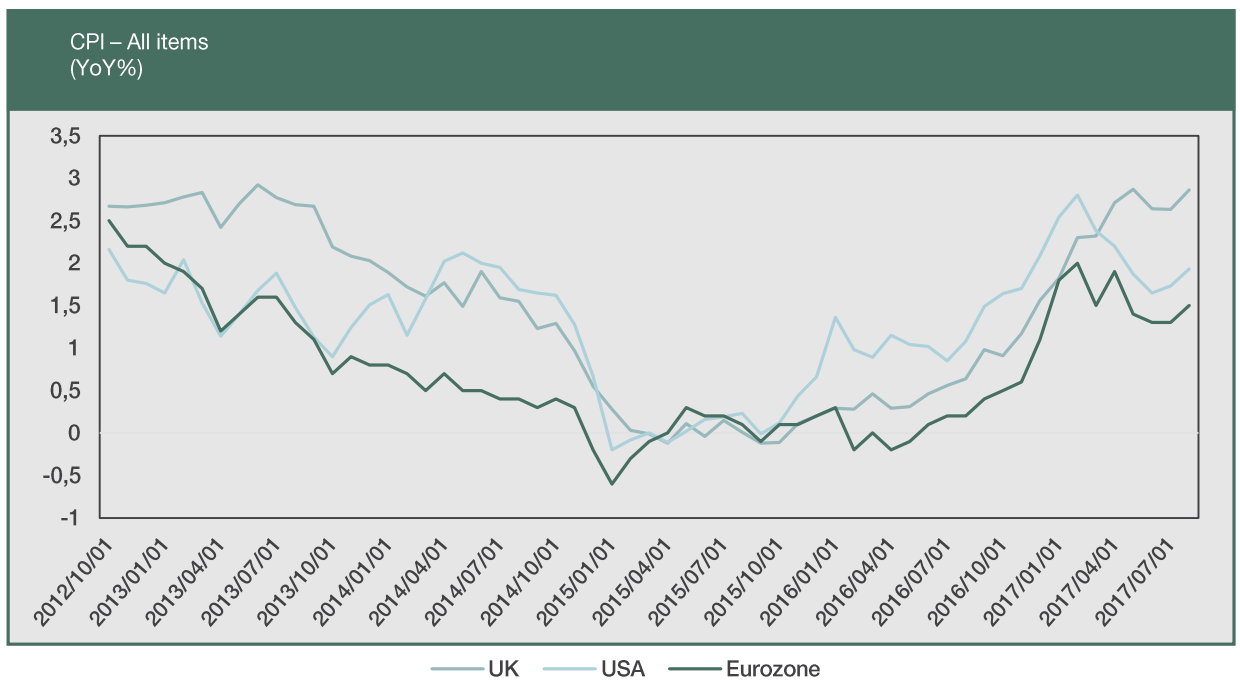
Source: Bank of Mexico, DGBAS, ECB, FactSet, Federal Reserve, Goskomstat of Russia, IBGE, India Ministry of Statistics & Programme Implementation, Japan Ministry of Internal Affairs & Communication, Korean National Statistical Office, Melbourne Institute, National Bureau of Statistics China, Riksbank, Statistics Indonesia, Swiss National Bank, UK Office for National Statistics (ONS), J.P. Morgan Asset Management. Figures are % change year on year. Heatmap colours are based on z-score of year on year inflation rate relative to five-year history. *Guide to the Markets – UK*. Data as of 30 September 2017.

## Inflation remains subdued and should not lead to interest rate surprises

Bloomberg tracks global consumer price inflation levels and the low points of 2.8% reached in 2015 and 2016 are not forecast to be significantly outpaced in subsequent years. In fact, global inflation over the next three years (2017-19) is not forecast to exceed 3.0%. In a recent communication, US Fed chair Janet Yellen suggested that this year's low inflation readings were a mystery. One of the biggest challenges for central bankers has been attempting to understand why the very low unemployment rates experienced in countries such as the US (4.4%) and UK (4.3%) have not translated into high wage inflation. Instead, wage growth has struggled to rise significantly above general inflation and has been one reason behind the rise of populism in many countries.

Some reasons provided for this include globalisation (workers are competing globally), the replacement of human jobs by robots, the rise of the gig economy and low labour productivity due to a lack of capital investment.

Providing that inflation remains low, investors are currently benefiting from a "Goldilocks" environment of low interest rates driven by low inflation and improving growth rates. In this environment, the highest yielding and most risky asset classes should benefit the most. The clear risk to this view is an inflation shock or a series of higher-than-expected inflation prints. Central banks may raise interest rates by more than expected, potentially leading to a recession and negative price movements for all asset classes except for cash.



Source: J.P. Morgan; MSCI earnings

## Reduced political risks

At the start of the year, there were significant concerns in markets for the potential of President Trump to disrupt the political, economic and market status quo. As we noted in our previous edition, much of Trump's rhetoric has been bluster and the voices around him have guided him to sensible decisions (with the notable exception of the US withdrawal from the global climate change agreement), and we believe this is still the case.

The worries around the French elections and the potential for the Eurozone to be broken up by an anti-EU party in the form of the National Front have also faded into the memory. The new French president has embarked on a number of necessary reforms and is so far sticking to the promises he made at the time of the election.

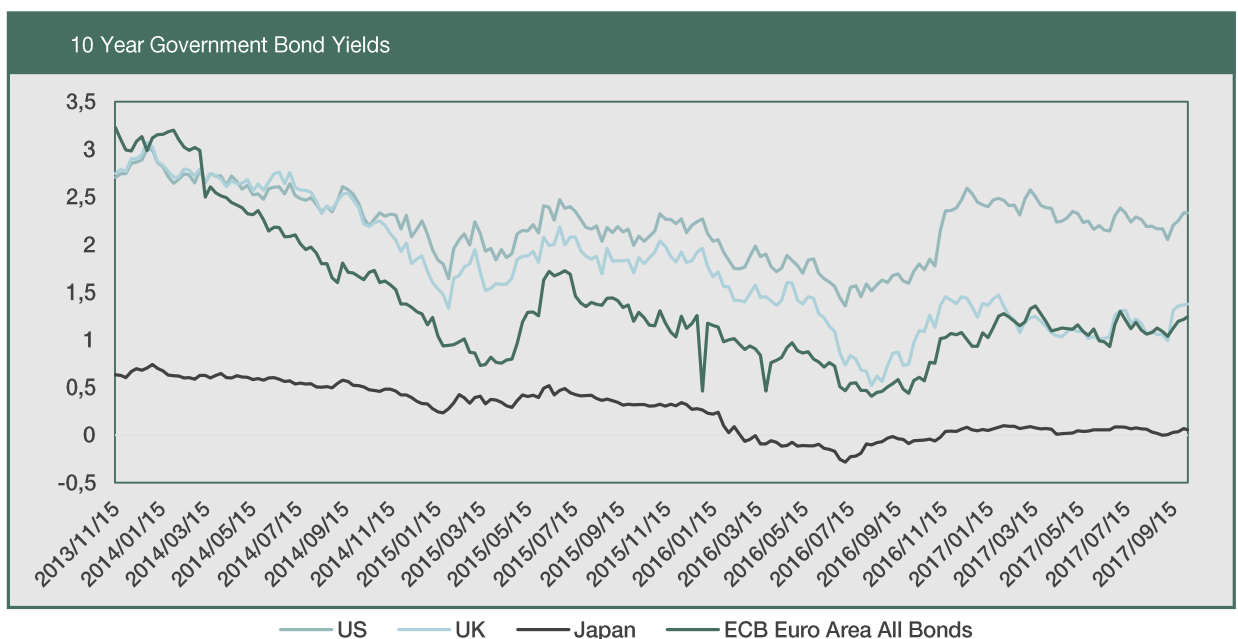
Overall, political risk has diminished as a major concern for investors since the shock results of Brexit and Trump's election in 2016. However, there will always be political events to worry about. Shinzo Abe, Prime Minister of Japan, called a snap election for 22 October in a bid to capitalise on his standing in the polls and continue with current policies into the next decade. Abe is expected to win the election with a comfortable majority. An Italian election is required by May 2018 and current polls suggest that the anti-EU parties including the Five Star Movement, Northern League and Forza Italia could win more than 50% of the vote. Catalonia's call for separation from Spain has been growing over time and could increase tensions in Europe. Finally, last year's issues of Trump and Brexit have not gone away and the incumbent UK government seems destined to pull itself apart in political in-fighting.

## Rising bond yields appear to be a sign of improving economies, which could minimise the effects on other asset classes

As we noted in our last edition, rising bond yields need not be something to be feared if the rise occurs because of a rise in real growth rates, and is accompanied by only moderate inflation. In such a case, it can be argued that the positives (such as higher corporate profits) from the increase in growth rates will outweigh the negatives from higher interest rates.

Price movements of risk assets over the past year have been positive during periods of rising bond yields. Towards the end of 2016 and early into 2017, the improving global growth picture was accompanied by rising bond yields AND rising equity prices. This led to a rotation in equity markets from growth to value styles. The more hawkish tone coming from major central banks in September has also failed to dislodge equity market prices. 10-year yields in the core countries have risen by as much as 30 basis points in recent weeks, yet risk assets' price appreciation has continued.

2017 has been a good year so far for equity prices, with analysts' consensus global EPS growth of 15% matched by the 16.5% gain in the first nine months of the year for the MSCI World Index.



Source: J.P. Morgan; MSCI earnings

## The emerging market backdrop is positive

In our previous edition we noted that the performances of emerging market economies and assets had been volatile over the past few years. This appears to be reversing in 2017, notwithstanding recent US dollar gains. The US dollar has underperformed in 2017, with the US Dollar Index lower by 9% in the first three quarters of 2017. In turn, emerging market currencies have been boosted, increasing returns assets in US dollar terms and placing downward pressure on domestic emerging market inflation while also providing room for easier monetary conditions. China has changed from being a source of worry for 2017 to a source of strength, while energy and commodity prices have recovered from the lows of 2016.

## Valuations – “neither cheap nor expensive”

Generally, it is difficult to find value in markets currently. Despite an increasingly hawkish tone from central bankers, interest rates are forecast to stay relatively low for an extended period and are not sufficiently high for many investors to tempt them from remaining fully invested in markets. Bond yields are historically low. Government bond yields are materially below nominal growth rates although central banks may help to maintain them at low levels into the medium term. Corporate bonds, in the form of investment grade and high yield securities, are close to their tightest credit spread levels since the financial crisis. Further outperformance of credit markets will take investors into pre-financial crisis territory (although not yet signalling alarm bells). Equity markets generally appear the most attractive of the main asset classes, although absolute value is harder to find. In a world where lower risk asset classes offer relatively small returns, investors continue to be forced to take on more risk to achieve returns in excess of inflation.

2017 has been a good year so far for equity prices, with analysts' consensus global EPS growth of 15% matched by the 16.5% gain in the first nine months of the year for the MSCI World Index. (However, it should be noted that global profits have benefited from US dollar weakness and the rebound in energy and commodity prices). If economic growth continues on the same trajectory, the EPS growth forecast should be realised. Clearly, 2017, as the first synchronised global growth year since 2010, has been beneficial to global profits. For 2018, Citi have lifted their global growth estimate from 3.1% to 3.3%, which provides for an 11% EPS growth forecast. Citi note that, on a bottom-up basis, analysts are predicting 10% global EPS growth. Citi's analysis suggests that 2018 should be another synchronised global economic growth year, which are quite rare (there have only been seven since 1990).

Overall, the sense is that higher corporate profits are required to drive prices higher. While equity valuations are not cheap, the better earnings outlook resulting from improved economic fundamentals suggest that equities could deliver up to 10% over the forecast 18-month time horizon. The US equity market appears expensive in absolute terms, although better value can be found outside of the US where there is some room for price/earnings expansion. Also, profits might grow faster due to either economic recovery (EU/Japan) or stronger GDP (emerging markets).

## No euphoria yet

Market surveys of fund managers' attitudes to taking investment risk continue to suggest a high degree of caution. Hence we feel there is room for risk markets to outperform these modest expectations.

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One of the biggest challenges for central bankers has been attempting to understand why the very low unemployment rates experienced in countries such as the US (4.4%) and UK (4.3%) have not translated into high wage inflation.

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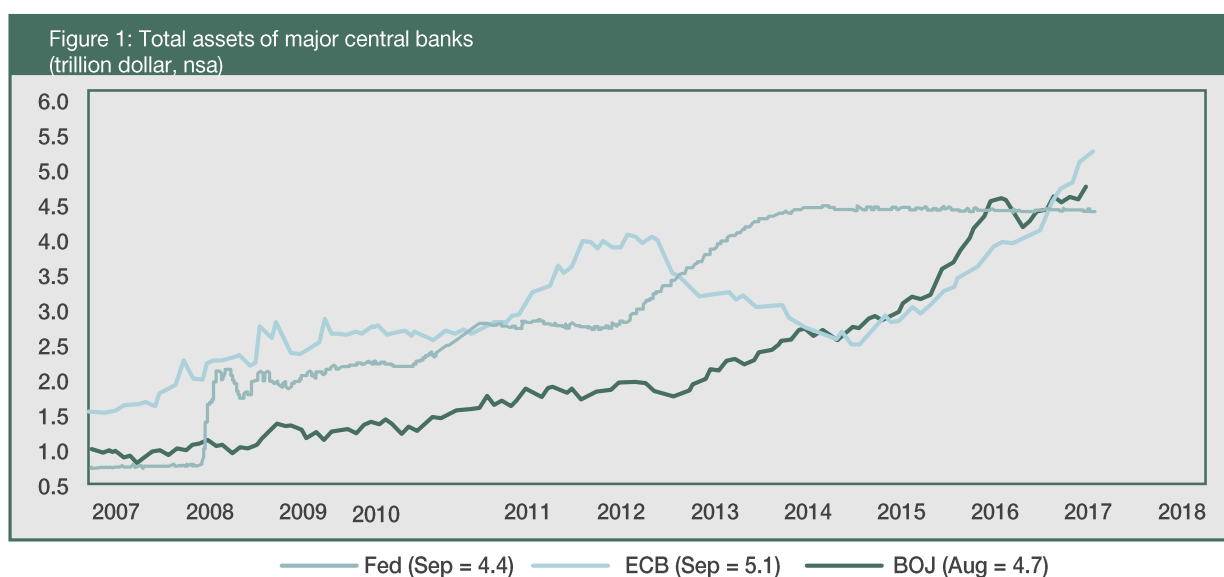
## However, we do not believe it is right to take more than a neutral stance because:

### The path to central bank normalisation continues

The path to central bank normalisation has continued since the last meeting. The US Federal Reserve has been telegraphing to markets since early 2017 that further interest rate rises would occur and its \$4.5 trillion balance sheet would be scaled down over time. Since then we have seen two rate rises from a range of 0.5-0.75% to a range of 1-1.25% and a further quarter point rate increase is expected in December. In addition, the Fed signalled that October would see the commencement of balance sheet normalisation that was laid out in June 2017.

The European Central Bank (ECB) has also signalled a more hawkish strategy compared with past meetings. Its September meeting provided guidance that plans will be agreed at the October meeting for an end to the bond purchase programme.

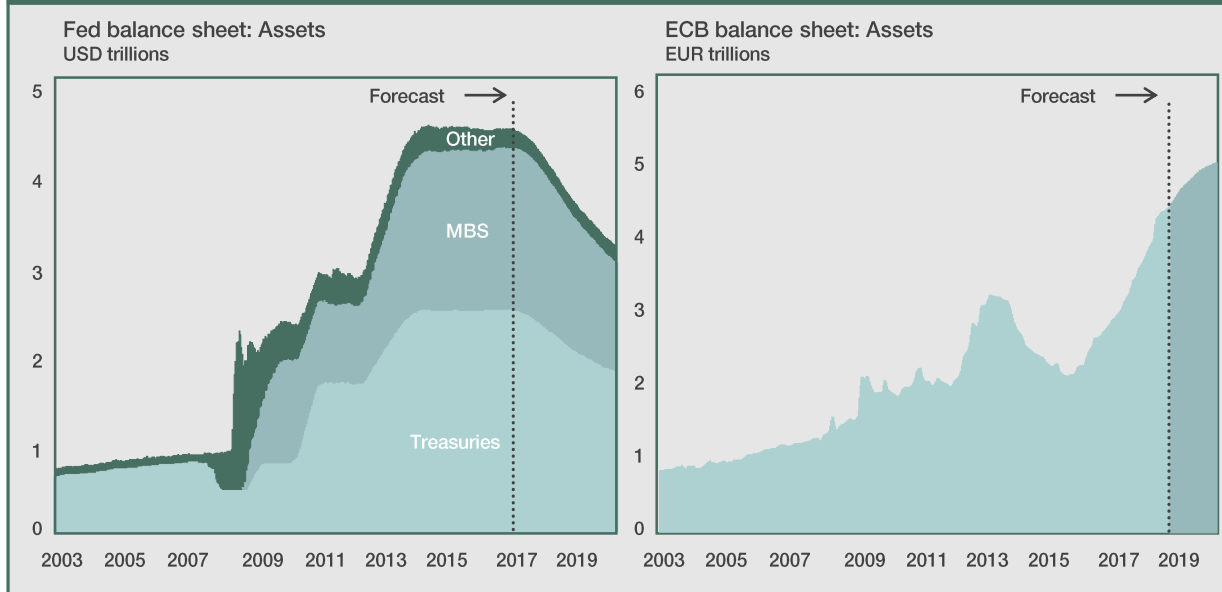
ECB mainstream bond purchases began in March 2015 and the ECB's balance sheet has grown from €2 trillion at commencement to €4.3 trillion currently. Our overall view is that bond purchases should end by the second half of 2018 but an interest rate rise was unlikely for some time after this. Even the UK's Bank of England (BoE) joined the more hawkish tone of major central bankers by indicating at its September meeting that its base interest rate was likely to rise in November despite concerns over potentially weaker consumer spending, temporary higher inflation and Brexit. Some commentators believe that this coming period may be the BoE's only chance to raise rates over the next few years and the signal with regard to interest rate risk is more important than the quantum of rate moves. Only the Bank of Japan, of the major developed markets' central banks, has committed to its expansionary policy of continued asset purchases into the future.



The move from quantitative easing (QE) to quantitative tightening (QT) is regarded as the biggest risk to the current price levels of both risk and bond assets. Since QE commenced after the financial crisis, the prices of all assets have risen in value. For example, since the start of 2009 (to the end of September 2017), the following positive total returns have been achieved: MSCI World Index – 12.3% p.a.; Barclays Global Aggregate Index (hedged) – 6.5% p.a.; BoA ML Global High Yield – 13.1%. It is likely that future returns will be lower than those achieved in the recent past given the higher starting point for valuations. In addition, there is uncertainty around the impact on all asset classes as liquidity is withdrawn from markets.

In addition, there is uncertainty around the impact on all asset classes as liquidity is withdrawn from markets. The opinion of the Group is that central banks can reduce liquidity in markets without leading to material price corrections. This view is based on (1) central banks clearly signalling to markets their QT intentions, (2) the timescale for liquidity reduction being sufficiently long and (3) economic growth supporting corporate profits and earnings per share growth over time. All of these conditions are currently in place. However, we are closely watching for evidence that central banks might lose control over the process or if inflation returns to the system and prompts a quicker pace of QT than is currently expected.





Source: (left) FactSet, US Federal Reserve, J.P. Morgan Asset Management. Fed balance sheet forecast is based on a monthly reduction of USD 10bn, starting in Oct 2017 and then stepping up the monthly reduction by a further USD 10bn in each subsequent quarter until reaching a maximum of USD 50bn reduction per month, depending on the monthly maturity schedule of the balance sheet. (right) ECB, Thompson Reuters Datastream, J.P. Morgan Asset Management. Balance sheet forecast does not include Targeted Longer Term Refinancing Operations (TLTRO). Forecast assumption is for the European Central Bank to keep purchases to EUR 60 bn per month from Oct 2017 to Dec 2017 and then reduce monthly purchases to EUR 40bn in Jan 2018, then to EUR 20bn in July 2018 and to zero asset purchases at the end of 2018. *Guide to the markets* – UK. Data as of 30 September 2017.

## China may introduce reforms in 2018 that unsettle markets

China as a potential source of market turmoil has moved from being central stage in late 2015 and 2016 to being more of an afterthought by mid-2017. Following the marked expansion in Chinese credit at the end of 2015 and into 2016, fears of a hard economic landing in China in 2017 were at the forefront of investors' minds, particularly given the influence that growth in China (as the world's second largest economy) has on global growth and also on demand for (and prices of) commodities. However, the latest GDP figures released by China show growth of 6.9% year on year (Q2 2017), with a probable outperformance of the 6.5% government growth target for 2017.

In fact, even given the moderate slowdown in GDP data in 2016, the country has not expanded on a year-on-year basis at less than 6.7% since the financial crisis. Also, the Chinese yuan has been strengthening against the US dollar for most of 2017. It may be that China's future growth potential has moved down the list of factors that international investors worry about. Given the forthcoming 19th National Congress of the Communist Party, which commences on 18 October, it is unlikely that Chinese authorities will allow negative headlines around either economics or politics to come to the fore at this time.

However, some concerns were expressed about the potential for 2018 and beyond to see the introduction of further reforms and China projecting its increased economic and military might in the world. In the past, reform has led to increased state control over state-owned enterprises and private enterprises. In addition, the crackdown on graft has seen former Communist Party officials imprisoned and their assets seized. As such, further reform could provide uncertainty. One view is that, because some investors may have become complacent about the outlook for China's economic performance and, given China's importance to the rest of the world, it should be moved up the list of potential problems.

One good news sign is that the negative rhetoric emanating from President Trump against China before his presidency has mostly gone away. No doubt, this year's weakness of the US dollar against most currencies, including the yuan, should have helped in this process.

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The move from quantitative easing (QE) to quantitative tightening (QT) is regarded as the biggest risk to the current price levels of both risk and bond assets.

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## Volatility levels may be too low

At the time of writing, the VIX Index – which measures the implied volatility of option prices on the S&P 500 and is regarded as a barometer of fear in the market – was again trading below a value of 10, which has only previously been seen in 1994 (prior to the US bond market collapse), 2005 and 2007 (prior to the Global Financial Crisis). The Inflation Index is believed to be a mean reverting index and its average over the long-term is around 20. As a result, risk asset investors should (in theory) find better buying opportunities once the VIX has normalised.

However, a new mean level of VIX going forward could be 15 as a result of continued monetary policy ease from global central banks i.e. low interest rates will always make investors want to take on more risk during price falls. Also, it could be argued that the financial crisis should be stripped from the long term average number given that it is a very unusual event.

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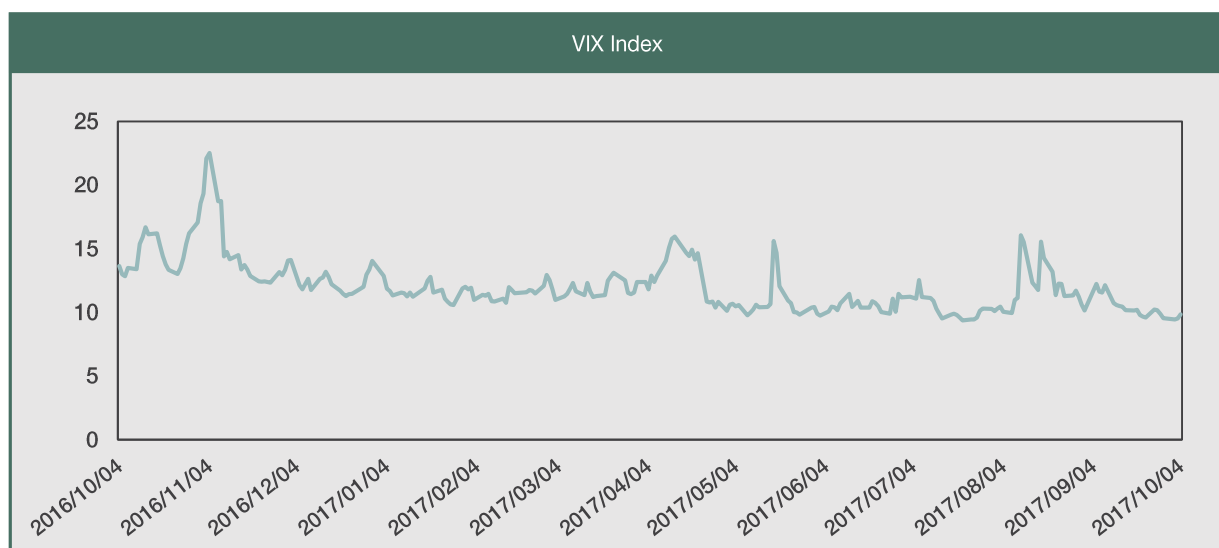
It may be that China's future growth potential has moved down the list of factors that international investors worry about.

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## A price correction may be overdue

A recent note from Goldman Sachs showed that, not only has the rally in US equities since March 2009 entered the record books as the second-longest bull run but, the recent price appreciation is the fifth longest streak in history without a 5% correction and, should the pattern continue, it will become the longest streak ever by mid-December. Work by Professor Robert Shiller in Project Syndicate has further indicated that the cyclically-adjusted price-to-earnings ratio, at 30, has traded at higher levels on only two occasions, in 1929 and 1997-2002. However, Shiller also admitted that stock market valuations provided lousy signals for market timing. Many owners of equities recognise the lower potential returns from the asset class going forward but are “reluctantly long” given the relative lack of appeal of other asset classes. Also, markets could continue to “melt up” in an environment of generally supportive monetary policy and improving growth fundamentals, with bonds and cash less attractive in this scenario.

It would be unsurprising if a price correction were to occur, especially over the 18 month time horizon. However, if the current environment prevails, falling prices should generally be considered as a buying opportunity.



Source: Bloomberg

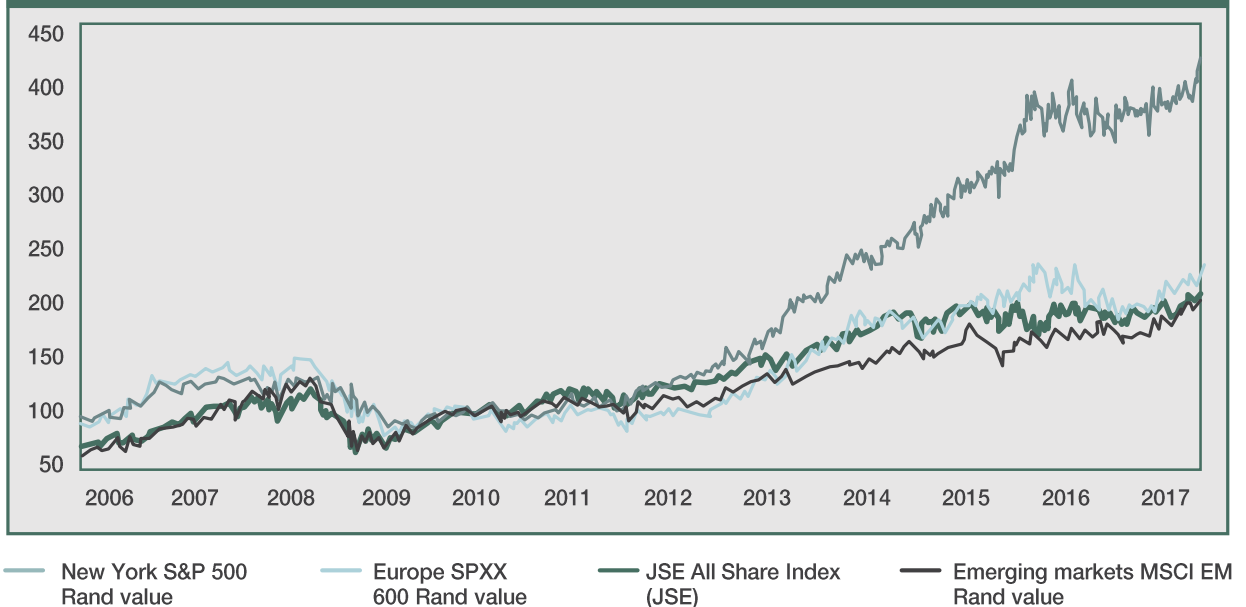
## Market view – A tribute to QE (and its reversal)

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

The much improved state of global economies and equity markets is a tribute to QE – and a call for its reversal. However reversal may well add to market volatility.

US equity markets have been reaching fresh highs, as has the JSE, although the latter has been in weaker Rands, not US dollars. When market indices are converted into Rands as in figure 1 below, it may be seen how superior the performance of the S&P 500 has been. The S&P 500 has performed strongly in recent years, increasing its rand value by 400% since 2010. It has gained about twice as much as the JSE, the MSCI Emerging Market Index and also European stocks (represented by the EuroStoxx 600) in rand value since 2010. The S&P 500, in strong US dollars, has doubled since January 2010 in the aftermath of the Global Financial Crisis while the other indices have barely maintained their US dollar values of early 2010.

Figure 1: Equity market performance, 2010 to October 2017 in Rands (2010 = 100)

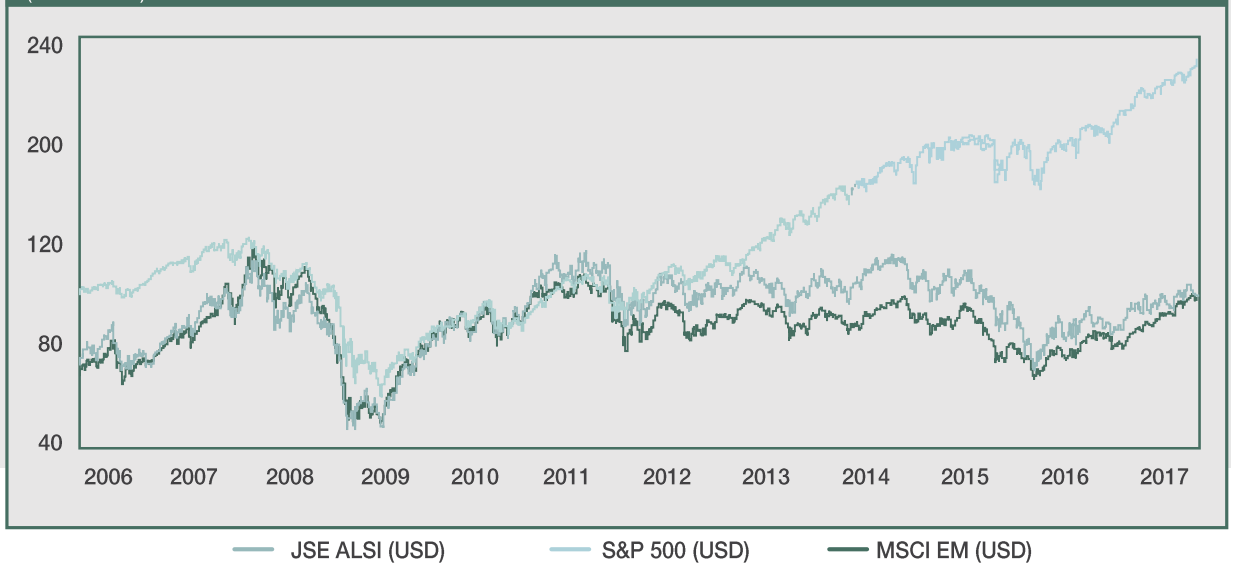


Source: I-Net, Bloomberg and Investec Wealth and Investment

It should be recognised that the JSE has performed as well or as comparatively poorly as emerging market (EM) and European equities. This pattern of the JSE behaving very much as your average EM equity and in line with the EM Index is a long established one. JSE earnings per share and EM earnings per share, in a common currency, tend to match quite closely. It should be also recognised that the companies listed on the JSE are as much or more exposed to operations outside of slow growing South Africa; hence their comparatively good earnings growth.

For banks, holding extra cash rather than making additional loans in the previously normal way, was an understandable choice. The extra cash held by US banks also earns interest, a further incentive to hoard rather than lend cash.

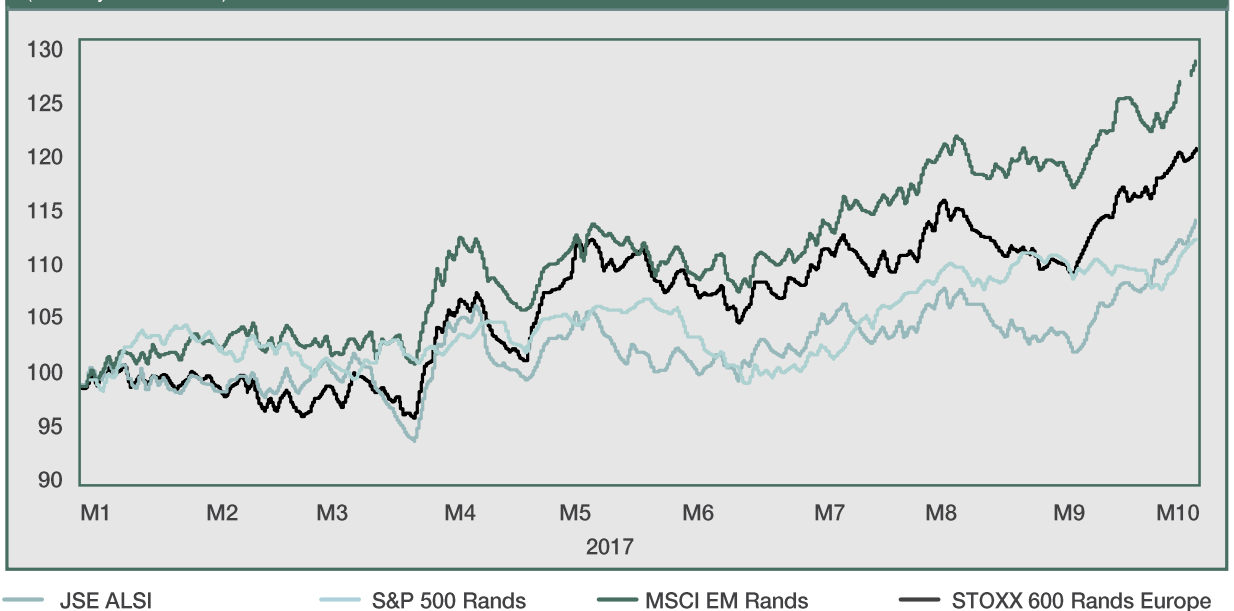
Figure 2: Equity market performance in US dollars, 2010 to October 2017 (2010 = 100)



Source: I-Net, Bloomberg and Investec Wealth and Investment

This US equity outperformance was arrested in mid-2016, after which emerging and European equity markets have made a strong recovery, both absolutely and relatively to the other markets. The recovery off a low base in commodity and metal prices, so important to EM companies, also dates from 2016, reflecting a long awaited pick up in global growth rates. This year the outstanding equity performers have been emerging and European equities. As figure 3 below shows, the JSE has lagged well behind EMs this year, yet keeping pace with the S&P 500. All indices shown in figure 3 are measured in common Rands at prevailing exchange rates.

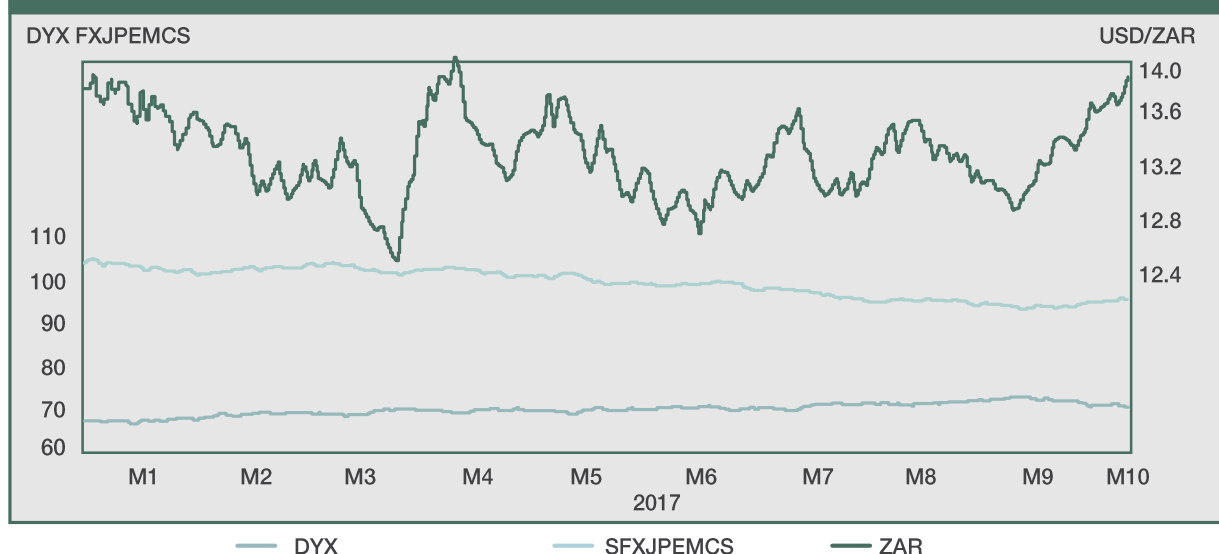
Figure 3: Equity market performance in 2017 in Rands (January 2017 = 100)



Source: I-Net, Bloomberg and Investec Wealth and Investment

This pattern of the JSE behaving very much as your average EM equity and in line with the EM Index is a long established one.

Figure 4: The performance of the US dollar vs major currencies (DXY) and emerging market currencies (JP Morgan EMCS), January 2017 to 9 October



Source: I-Net, Bloomberg and Investec Wealth and Investment

The US dollar since 2010 to 6 October 2017 has gained about 18.6% against the currencies of its developed market peers (DXY Index), 40.2% on the average EM exchange rate (FEXJPM Index) and 62% on the rand. It has been an extended period of dollar and US stock market strength.

The common factor linking the relatively strong US currency and the US stock market has been the relatively strong performance of the US economy after the Global Financial Crisis, allowing US interest rates to remain well above European or Japanese rates. The good news is that growth in economic activity in the rest of the world has been accelerating, while growth in the US has been well maintained and perhaps accelerating. Hence the degree of dollar weakness and EM currency strength seen in 2017 (see figure 4 below that shows that the DXY has declined by 8.6% in 2017 and the EM currency Index has gained 5.03% this year).

The fundamental forces of synchronised global growth and growth in the earnings of listed companies have been supportive of higher equity valuations everywhere. The Global Investment Strategy Group (GISG) judges that equity valuations, while generous by most measures of past performance, are not overvalued, especially when adjusted for currently low interest rates. Moreover they are supported by the forecasts of strong global earnings growth to come – including growth from companies that make up the EM Indices, including the JSE. JSE All Share Index earnings per share grew by 30% p.a. to September 2017 and are expected to grow by a further 18% in 2018. These bottom up forecasts of earnings are holding up well when subject to continuous revision by research analysts.

The recovery of the US European and Japanese economies, after the Global Financial Crisis, surely had much to do with stimulatory monetary policy, that arguably was practised sooner and more aggressively and consistently in the US than in Europe. The main instruments of recent monetary policy have been massive injections of central bank cash into the banking systems, described as Quantitative Earnings (QE), combined with very low policy-determined interest rates.

The success of QE in promoting the economic recovery, that is now broadening, calls for the resumption of something more normal in monetary affairs and that would be a reversal of QE and a reduction of central bank balance sheets and increases in short and long term interest rates from their currently abnormally low levels.

How this normalisation will be realised and how it will affect financial markets and interest rates in particular has been an important focus of the GISG. The judgment has been that the uncertainties inherent in the future of monetary policy in the developed economies adds to risks to portfolios. It is part of the reason why GISG has retained a neutral risk stance for two recent quarters despite the good economic news. A further reason for caution was the assessment of the uncertainties associated with the Trump administration.

The scale of QE, that is cash creation since 2008, has been extraordinary. The issue to explain why this injection of cash has not led to more spending, much more inflation and a much greater expansion in the banking systems and in bank deposits than has occurred? Monetary theory prior to QE would have predicted more of all of the above.

Providing an explanation for these reactions, or rather lack of them, may help explain why the reversal of QE and the removal of cash from the US and other economies may also be less eventful than might ordinarily be predicted of substantial increases and then decreases in the supply of central bank cash to an economy. As the scale of QE was unprecedented, so will be the reversal of QE though probably it will be more gradual.

The markets in the years to come will have an all-consuming interest in how it all works out: an interest that might well add volatility to market outcomes and a reason for some caution about how well it will all work out and how easily the market place the market place will be with upcoming monetary policy settings.

The total assets of the major central banks, US, Europe and Japan grew from just over US\$3 trillion in 2007 to their current levels of over US\$13 trillion, an amount that is still increasing despite a “tapering” of US Fed asset purchases in the market place. The Fed balance sheet grew from less than US\$1 trillion in 2008 to over US\$4 trillion by 2014. The Fed balance sheet is still to contract, as may be seen in the figures below.

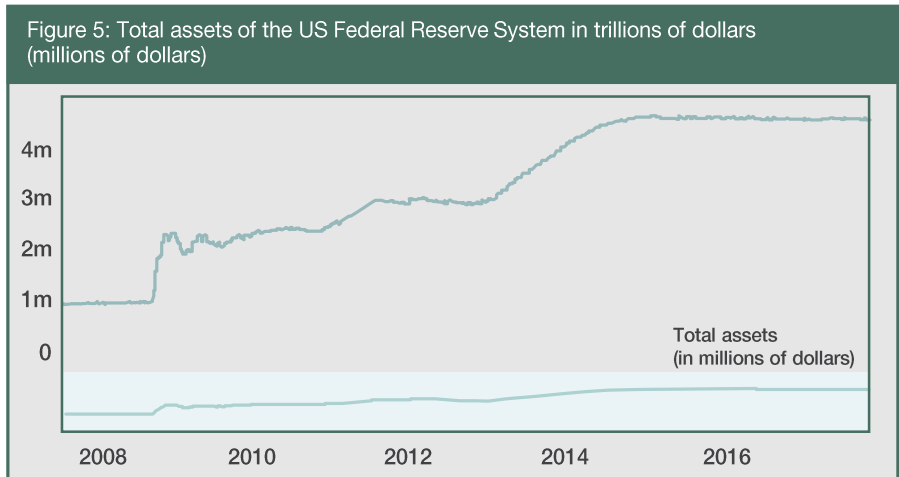
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The common factor linking the relatively strong US currency and the US stock market has been the relatively strong performance of the US economy after the Global Financial Crisis.

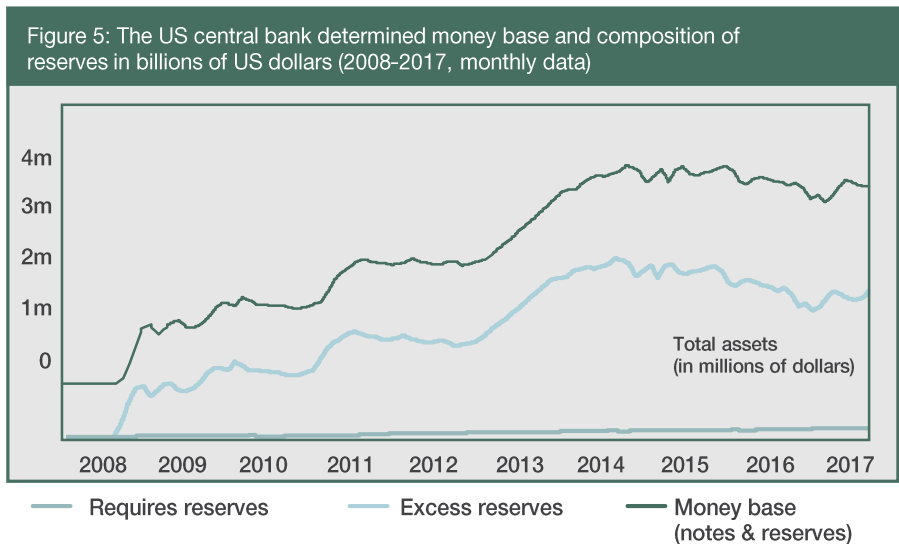
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The counterpart to these asset purchases is to be found on the liabilities side of the Fed balance sheet, in the form of the deposits held by the retail banks with their central banks. These constitute a large part of their cash reserves held traditionally to insure the convertibility of their deposits into cash on demand of their depositors and to meet demands for cash from other banks. The key fact to recognise is that almost all of the trillions of dollars of cash created by the Fed and other central banks, through its asset purchase programmes, ended up back on the Fed and other central bank balance sheets in the form of these extra cash reserves; reserves far in excess of the cash reserves these banks were required to hold to secure the convertibility of their deposit liabilities into cash.

Federal Reserve commercial member banks before 2008 held minimal excess reserves. They exploded thereafter, peaking at US\$2.5 trillion in 2014. These excess reserves or, if you like, cash hoards, have since declined but remain at very high levels as we show below.



Source: Federal Reserve Bank of St Louis. Fred Data Base and Investec Wealth and Investment



Source: Federal Reserve Bank of St Louis. Fred Data Base and Investec Wealth and Investment

Higher interest rates, faster growth and a larger ratio of bank deposits to the money base, would be a sign of economic normalisation and generally be welcome.

This US money multiplier has declined from nine times in 2007 to the current 3.5 as we show below in figure 6. Consistent with this trend, the commercial banks' ratio of cash assets to deposits on 27 September was nearly 20% - an extraordinarily high cash reserve ratio. The equivalent ratio of required bank cash reserves with the Reserve Bank to total bank deposits is of the order of 2.5% and accordingly the M3 to the money base (M0) ratio in SA is of the order of 14 times and remains a highly stable one.

A further limit to bank lending, other than the minimal cash to deposits reserve requirements, is imposed by minimum bank equity capital to bank asset ratios. Extra bank lending now requires both extra cash and extra capital, given the thrust of regulation emanating from Basel. It has been widely agreed that banks were undercapitalised before 2007. Banks therefore have been required to add to their ratios of capital to loans. These regulations have been a restraint on bank lending as have the lessons learned from the scale of bad bank debts incurred that led to the Global Financial Crisis. So has been a reluctance of customers of banks to borrow more given their concerns in the aftermath of the crisis. For banks, holding extra cash rather than making additional loans in the previously normal way, was an understandable choice. The extra cash held by US banks also earns interest, a further incentive to hoard rather than lend cash.

It seems clear that any reduction in central bank assets will be accompanied by strength in the real economy. Furthermore, increases in policy-determined interest rates will probably follow increases in economic activity and higher rates of inflation. Central bankers are unlikely to wish to disrupt the economic recovery they have worked so effectively to stimulate.

Furthermore reductions in the supply of cash to the banking system will be offset by reductions in the cash reserves they hold, a process it would seem that is already partly under way in the US (see figure 5 above). Indeed, given the volume of excess cash reserves held currently by banks, the danger remains of too much rather than too little bank lending. Should excess cash reserves be exchanged on a significantly larger scale for bank loans, the Fed would have to accelerate its bond sales and raise short term interest rates, including the rate paid to banks for cash deposited at the Fed. Such developments would mean a US economy growing significantly faster.

Higher interest rates, faster growth and a larger ratio of bank deposits to the money base, would be a sign of economic normalisation and generally be welcome. But there is the possibility of many a slip twixt central bank cup and lip. And there is also the danger that markets will misinterpret the signals coming from central banks. The risk of greater volatility accompanying the search and reach for a new normal in monetary affairs is a relevant one requiring a degree of caution on risk taking in global markets over the next 12 to 18 months – as recommended by the GISG.

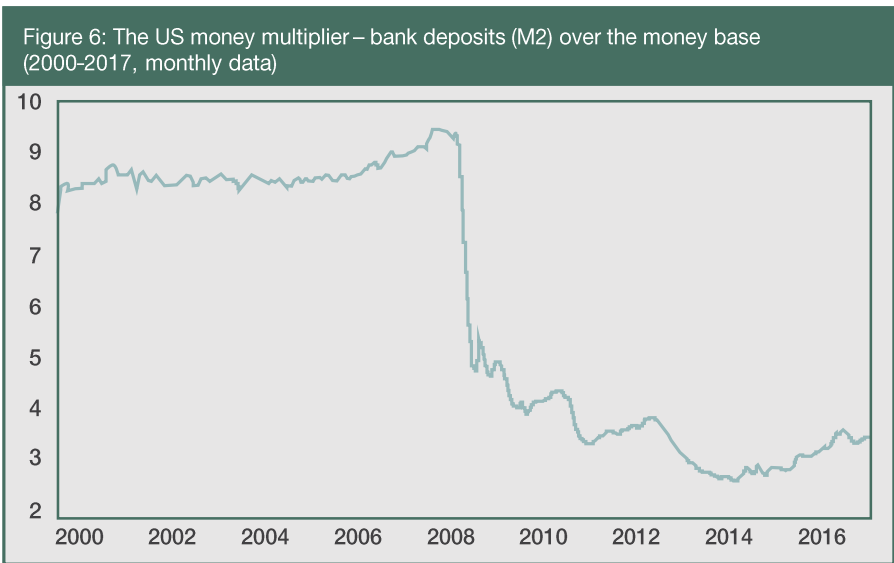


Figure 6: The US money multiplier – bank deposits (M2) over the money base (2000-2017, monthly data)

## SA market view and asset allocation – Positive and nimble

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

The SA team marginally more positive than it was last quarter, though not enough to lift the aggregate risk score higher from the current neutral position. Although South Africa is in the middle of a particularly difficult economic and political period, a lot the risks are reflected in current asset prices.

### Market overview

Global Equities (MSCI World Equity Index) continued their strong run, returning 5% over the third quarter. This performance means that global equities have delivered 16% to investors on a year-to-date basis. Global bonds (as represented by the JPM Global Aggregate Bond Index) also managed to deliver a positive return of 1.6%. Emerging market equities (as represented by the MSCI Emerging Markets Index) continued their stellar run, finishing the quarter up 7% as investors have become more comfortable with the growth and earnings outlook. This takes the total return for emerging market equities to 27.8% for the year, in US dollars. The CBOE Volatility Index (VIX) still reflects a high degree of tolerance towards market risk, ending the quarter at 9.5, which is well below longer term averages.

The JSE All Share Index returned 4% in US dollars, which, while a welcome performance, again significantly underperformed broader emerging markets. Investor concerns about the state of the economy and an uncertain political landscape have held back the performance of JSE generally. In local currency terms, the JSE was up a healthy 8%, led by the resources sector which was up 18% over the quarter.

Interest-bearing assets delivered a strong performance, with bonds (ALBI) and property (SAPY) both outperforming cash (represented by the STEFOCAD), returning 3% and 6% respectively, versus a cash return of 2%.

The rand weakened against the US dollar by 4%, as well as against the euro and the pound by 7%. The rand was also weaker against a basket of emerging market currencies. The escalation of rhetoric about North Korea helped push gold to a recent high of US\$1,347/oz., before losing ground and finishing the quarter at US\$1,280/oz. Oil (Brent) had a very strong quarter, up 20% to US\$58/barrel, which is good news for commodity markets generally and oil-exporting nations in particular.

### Positioning of the committee

The committee was marginally more positive than it was last quarter but not enough to lift the aggregate risk score higher from the current level of zero (neutral). There were no major changes in views of major investment themes. South Africa is in the middle of a particularly difficult economic and political period and as a committee we found it difficult to increase the risk-taking in any of the major asset classes. The political outlook is uncertain, the probability of the country receiving further downgrades is still very much front of mind and economic growth rates are still languishing at close to 0% at a time where global emerging markets are growing very strongly. Our equity market has continued to see considerable foreign investment outflows at a time when global emerging markets are seeing very strong inflows. We are clearly not a sought after investment destination.

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The equity market (once one adjusts for the elephant in the room that is Naspers, which accounts for 23% of the SWIX on a forward PE of 31x), is much closer to its long term average than it has been in recent history.

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We hope that it [the Reserve Bank] takes the next opportunity to provide the economy with some support, but a weakening rand and higher petrol prices may mean that the opportunity has been missed for now.



### Pricing in risk

However, as mentioned above, and despite all the major headwinds facing the country, the committee was slightly more positive, mainly because a lot of the risks were reflected to a certain extent in current prices of assets in the market place. As an example, we recently highlighted that the rand was not reflecting much SA-specific risk recently and now that the rand has weakened again against a basket of emerging market currencies, so it has effectively started to reflect some of the SA risks. The bond market, from a credit default swap perspective (which is the cost of insuring our hard currency debt), is already pricing a below investment-grade status and local currency bonds continue to look attractive relative to US Treasury bonds and relative to the inflation outlook domestically. Finally, the equity market (once one adjusts for the elephant in the room that is Naspers, which accounts for 23% of the SWIX on a forward PE of 31x), is much closer to its long term average than it has been in recent history but also, from a relative basis, South Africa has de-rated substantially against the average emerging market as well as the global market. The point is that a lot of the bad news is reflected in prices.

### Opportunity missed?

Our view on the bond market is still that investors are more likely to be rewarded on a risk-adjusted basis by focusing on the “belly” of the yield curve as well as by holding corporate bonds, where possible.

We were disappointed that the Monetary Policy Committee (MPC) of the Reserve Bank did not take the opportunity to cut interest rates at the end of September.

We hope that it takes the next opportunity to provide the economy with some support, but a weakening rand and higher petrol prices may mean that the opportunity has been missed for now.

Gold continues to offer our portfolios protection, this having being especially evident during the risk-off periods related to North Korea.

### Offshore growth assets justified

We like to evaluate from time to time whether there were any major asset allocation calls that we could have made better from both a total return perspective as well as risk-adjusted perspective. Over the last two years there has not been much to separate the local asset classes (equity, bonds, property and cash) and over one year, local equities have outperformed their local counterparts (bonds, property and cash), but with more risk. Cash on a risk-adjusted basis over two years would not have been a bad place to invest (returning 7% annualised) but that's before tax and not that far ahead of inflation. The best performer over one and two years has been global equities by some way (+14% annualised over two years and +17% over the last year). As such a full allocation to offshore growth assets has been warranted.

### Remaining nimble

We are not making any major asset allocation moves into the fourth quarter. Our more recent asset allocation moves have been to reduce fixed income in the front end of the yield curve, where bonds were discounting a number of interest rates cuts which for now look to be off the table. We reduced our SA property exposure slightly and have used the proceeds to bolster our cash holdings to provide ourselves with optionality. We have moved the currency position back to neutral. Given the amount of major market-moving news flow likely to come in the next couple of months, we plan to be as nimble as possible and our cash overweight allows us to hopefully take advantage of any market volatility and opportunity.

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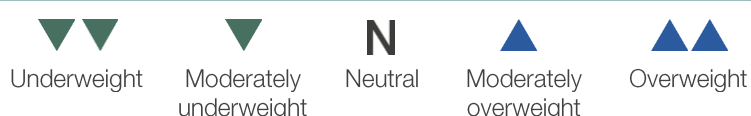
Given the amount of major market-moving news flow likely to come in the next couple of months, we plan to be as nimble as possible.



## Asset allocation positioning:

The metrics below show our asset allocation positioning for global, domestic and by theme.

Global Asset Allocation	Q4 2017	Q3 2017	Comments
Offshore Equity	N	N	Neutral global equities. Valuations not cheap but underpinned by strong growth and higher corporate earnings. Central Banks to remain investor friendly.
Offshore Fixed Income	▼	▼	Low expected total returns from these starting yield levels. Core government bonds offer insurance characteristics versus risk assets. Corporate bonds spreads are tight..
Offshore Cash	▲	▲	Prefer cash to core government bonds. Provides optionality to increase risk should we see a sell-off.
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	Q4 2017	Q3 2017	Comments
SA Equity	N	N	On balance more positive given better valuation entry point but SA specific risks continue to curb our risk-taking.
SA Fixed Income	▼	▼	Concentrated in "belly" of the yield curve. Inflation trajectory should support attractive total returns. MPC decision not to cut Repo Rate was disappointing.
SA Cash	▲	▲	Offers positive real returns, lowers volatility and provides optionality. Also own floating rate notes which provide a yield pick-up.
SA Listed Property	▼	▼	Valuations on the domestic side continue to look rich amid a slow growth outlook. See better growth prospects offshore.
Preference Shares	▲	▲	Attractive yield advantage over taxable yields assets with possible repurchase underpin.
\$/R (+ for Rand strength)	N	▼	ZAR is currently above fair value, reflecting degree of SA specific risk. We had previously flagged that it was too strong
Sectoral / Thematic Positioning	Q4 2017	Q3 2017	Comments
Global Plays	▲	▲	Overweight global plays. High quality businesses generally but have been reducing given valuation gap between domestic and interest 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	▲	▲	Slightly overweight given valuation underpin and possibility of a more supportive interest rate cycle although the pause button has been pressed.
SA Industrials	▼	▼	Remain underweight for now. Valuations approaching very interesting levels, especially in mid and small caps.



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**Chris Hills**

CIO  
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**Professor Brian Kantor**

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