Global Investment View
Quarter 4, 2018

Investec
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Contents

Looking for trade war rapprochement

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

By John Haynes

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

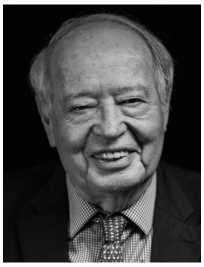
Commentary by:

John Haynes

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

Special contributions by:

Brian Kantor



Brian is Chief Economist and Strategist at Investec Wealth & Investment SA. He is Professor Emeritus at the University of Cape Town, where has held the positions of Dean of the Faculty of Commerce and Head of the School of Economics.

Paul McKeaveney

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

In brief

- We retain a positive view on the outlook for growth in the global economy and for corporate profits. The current economic cycle is driven by favourable internal fundamental trends in all three of the main engines of global economic growth – the US, Europe and China.
- On the trade war front, China is signalling a desire to de-escalate. And with US President Donald Trump approaching an opportune moment to declare victory ahead of the US mid-term elections in November, we are likely to have seen the worst of the "shock" impact. Rapprochement is the likely next step.
- Monetary policy transition risks are low. Markets have been given ample time to adjust to normalising US monetary policy, while Europe too has signalled it is on the same course.
- Valuations of risk assets are attractive. Although discount rates have risen this year, even in the US, the 10% US dollar rise in equity markets this year has been fully supported by tax-cut turbo-charged earnings growth.
- The above points argue for a pro-risk (overweight equities) stance, however our risk position is underweight because in making our assessment we are being forced to confront an unusually large number of possible challenges.
- We are explicitly making three key judgements: emerging market growth worries will be contained within the "fragile five", since China will likely ride through its trade war with the US and continue to grow solidly; Europe will prove resilient, both to Italian challenges and to Brexit; and the US and China can reach an accommodation on trade.
- We are further inclined to be less forgiving on equity valuations than usual. The cycle is maturing and, if inflation pressures do start to build, economic "good news" can soon become "bad news" for risk assets.
- Moreover, even if the US chooses to de-escalate its trade war with China, the current administration's use of deliberately engineered crises to achieve policy ends is now an established pattern.
- In short:
  - Independent of politics, the prospects for global growth, corporate profits and interest rates support out performance of risk assets over insurance assets over the coming 18 months.
  - This is especially so if the US adopts a more diplomatic approach with trading partners after the mid-term elections.
  - More robust resistance or retaliation from the US's trading partners could threaten this outlook however.
  - The White House "wild card" factor tilts us towards a more cautious risk stance than the fundamentals would suggest. A position of modestly underweight risk assets still feels right to us.

Summary of our key thoughts

The Global Investment Strategy Group decided to retain its modestly "risk off" stance. Our central case remains that, driven by a still supportive economic backdrop, owning risk assets will be rewarded relative to owning cash or fixed income over our forecast period (18 months).

Outside of the "fragile five" (Argentina, Brazil, Indonesia, South Africa and Turkey) the world is largely still enjoying synchronised growth in all of its key economic blocks (the US, Europe and China-centric emerging markets) for the first time since the Great Financial Crisis. The combination of a soft spot in Europe, a strengthening US dollar (which is usually problematic for emerging markets that are exposed to US dollar borrowings) and a highly aggressive US stance on trade, targeted largely (but not exclusively) at China, has cast its durability into doubt.

Emerging markets – the sickness isn't contagious

- Over the past six months, investors have been worried about emerging markets on fears that a firmer US dollar will cause problems for them, particularly those that borrow in US dollars. This is all happening at the same time that the US is putting economic pressure on China (a key demand engine for emerging economies), leading to fears of an escalating emerging market crisis, with adverse consequences for world growth.
- We do not believe this will happen. Aside from "the fragile five", US dollar strength has been driven by growth and interest rate differentials widening because strong US growth is allowing policy normalisation ("good" factors) rather than by a flight of capital in anticipation of the end of the developed market-led global economic cycle ("bad" factors).
- Emerging market dollar debt is at high levels, but the majority of the debt increase this cycle is corporate, rather than government – so outside of a few emerging markets (again the fragile five are in the frame), there is no widespread need to tighten policy to address government imbalances.
- Although there are a number of emerging economies that are in poor shape, they are well known. Volatility in them should not be a surprise or enduringly contagious. To the extent that the so-called "fragile five" form part of the equity or debt portfolios of investors or bankers, they are firmly in the "high risk" category. Cross-border lending is at low levels and, in a post-Global Financial Crisis world, capital is available to offset losses. In short, the "fragile five" may be a problem for specific banks and investors, but not for the system as a whole.
- Two additional factors support optimism. Unlike in the emerging market meltdown that occurred in the wake of the Great Financial Crisis, the external demand environment (developed markets and China) is good. Furthermore commodity prices (important revenue generators for many emerging markets) look well supported by both demand (China) and supply. It is encouraging that (possibly with the exception of South Africa, where the currency is often driven in the short term as much by sentiment towards emerging markets as a whole, as by local conditions) differing fundamentals have been reflected appropriately in the behaviours of emerging market currencies.
- Clearly China is the most important link in this chain. Our assessment that China's domestic economy remains healthy is crucial. We believe that China can and will use domestic stimulus to offset much of the material effect of any fall-off in export demand to the US precipitated by the trade war.

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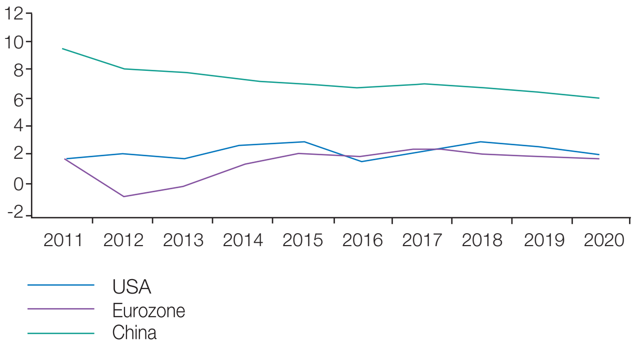
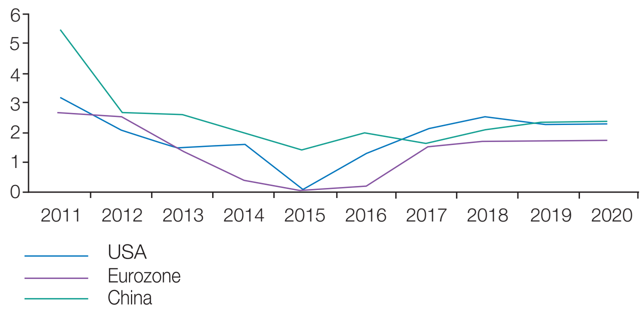
Real GDP (YoY%)



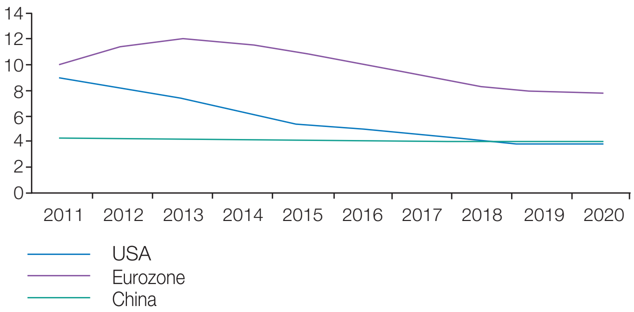
Source: Investec Wealth & Investment

CPI (YoY%



Source: Investec Wealth & Investment

Unemployment (%)



Source: Investec Wealth & Investment

Developed markets – America First

- The US economy, the world's largest, is enjoying robust good health. Low unemployment is underwritten by tax cuts and increases in federal spending, which are projected to increase the annual budget deficit from around 3% of GDP to approximately 6% of GDP over the next two years. The pro-business / nationalist clarion call of the Trump administration has been good for business and consumer confidence.
- The risk is that things are "too good". The virtuous circle (low unemployment leading to strong retail sales, leading to higher investment, leading to greater hiring, leading to higher wages) is in full swing and could, at this stage in the cycle, lead to inflation rising beyond the Federal Reserve's tolerance threshold. So far, inflation remains low and the Federal Reserve is only looking to normalise policy, not become restrictive.

However, we note that financial markets appear to be pricing in a more benign rate-increase trajectory than the Fed is guiding to (from the dot-plots). This may prove too optimistic!

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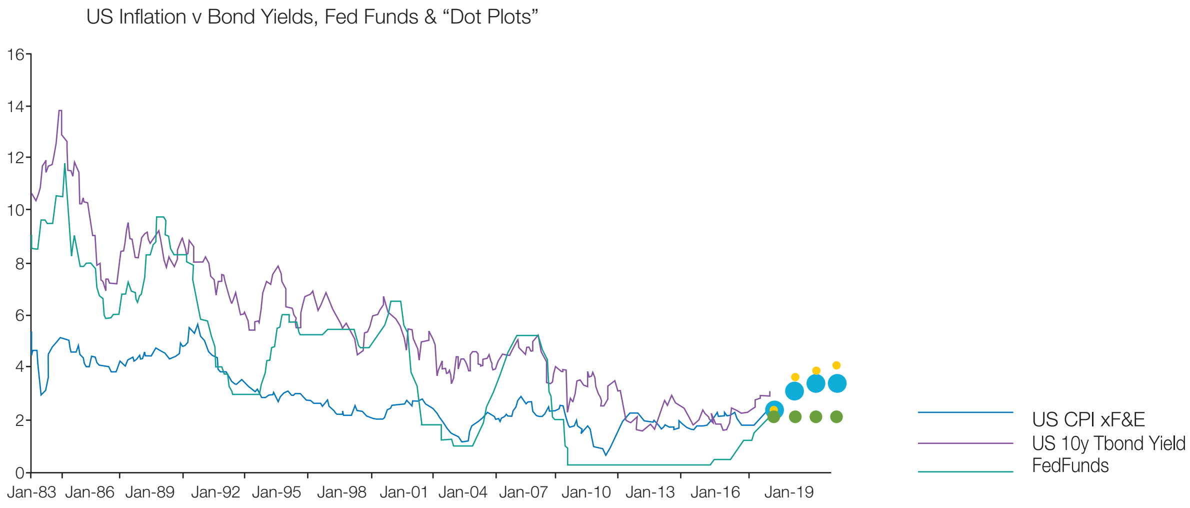
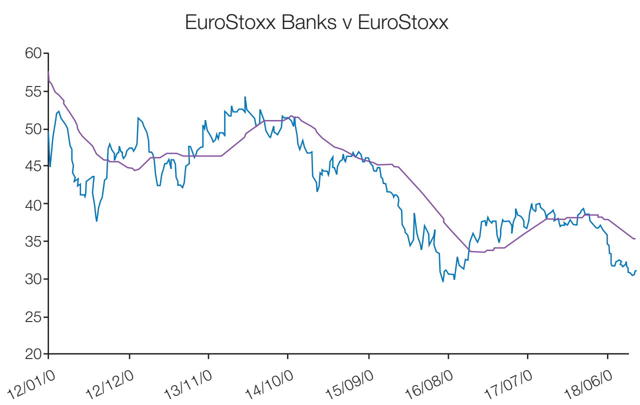


Source: Investec Wealth & Investment

Europe – Temporarily distracted by politics and emerging market links

- Europe's soft patch was initially due to a combination of generally modestly weaker export orders, in turn due to the lagged effect of last year's substantial exchange rate strength (the euro rose by 12% against the US dollar in 2017) and a confidence stutter as politics took an unexpected populist turn, most obviously in Italy but also in Germany and Spain.
- The performance of European banks over the past quarter has, however, suggested deepening concerns.
- Rather than the agenda of Italy's new populist coalition government, the cause appears to be European links to emerging markets, both from a trading perspective (colonial histories make Europe more tightly bound to the emerging world than the US) and also from the perspective of financial linkages. European banks' links to Turkey have come under a particular spotlight. As we have already said above, emerging market links may be a problem for specific banks and investors, but it is not for the European system as a whole.
- Tensions surrounding an imminent and possibly disorderly Brexit have not helped. Our position is that the impact on the UK economy of a hard Brexit (no deal) would be many times that of its effect upon Europe as a whole (five to 10 times the magnitude, according to estimates from a range of sources, including the OECD and the UK Treasury) which would be small. In addition, with central banks fully aware of the issue and its timing, any risk is conventional (reductions in demand / supply bottlenecks) rather than systemic (transmitted through the financial system).
- The three drag factors (emerging market links, Italian agitation and hard Brexit) are likely to diminish in influence over the coming six-month period. In some cases, current uncertainties may prove helpful in the longer term, as populist success at the ballot boxes will accelerate the much-needed turn in the fiscal policy tide to become more stimulatory. In the meantime, economic data trends are solid: employment and consumer confidence trends remain good and the ECB retains a steady hand. In spite of their share prices, European banks are now open for business and investor confidence in the systemic resilience of the euro area has been evident in credit spreads throughout this testing period. Looking ahead, we see fewer headwinds and a more positive fiscal impetus in the pipeline. It will not take much good news for current concerns about growth to recede.

Rather than the agenda of Italy's new populist coalition government, the cause [of Europe's problems] appears to be European links to emerging markets, both from a trading perspective and also from the perspective of financial linkages.



Source: Investec Wealth & Investment

China's leadership is gaining respect for the maturity of its engagement with the US, its support of international trade and the institutions that sustain it, together with the initiatives it is promoting to encourage growth throughout the region.that sustain it, together with the initiatives it is promoting to encourage growth throughout the region.

China – In control of its own destiny and playing the long game

- China has now largely completed the process of cleaning up the liabilities of the shadow banking system that caused a modest (and well-telegraphed) growth slowdown in early 2018 and now continues to grow solidly. The trade picture has recently weakened marginally not because of sanctions or tariffs, but because exports to the "fragile five" have suffered. Nevertheless, the authorities are on the watch for signs that trade war concerns are impacting domestic confidence (retail sales and investment) and have pledged to offset any effects with stimulus. Investors will watch the yuan to judge whether they can afford this. Premier Li Keqiang has publicly stated that China will not use the yuan as a weapon in a trade war, so clearly the Chinese is confident it is in a good position.

- China's leadership is gaining respect for the maturity of its engagement with the US, its support of international trade and the institutions that sustain it, together with the initiatives it is promoting to encourage growth throughout the region (this is exemplified by the one belt, one road /???? project). China is accumulating "soft power" as the US is losing it. Unless provoked, an increasingly self-confident China is likely to be a source of growth and stability to the global economy for the foreseeable future.

Other observations

The risk of policy mistake has reduced. Led by the US, we are on a journey to normalise developed market monetary policy. This is now clear to all investors and, absent shocking inflation data, the probability that fixed income markets become unsettled by the transition is much reduced. The 3% nominal level on US 10-year bonds was an important psychological test to many investors; we have now moved through that level again and investors have appeared to accept it, in the context of the rises in short rates, as a healthy maintenance of a positive yield curve (a good thing) rather than a sign of unaddressed inflation and an imminent sharp move upwards. In Europe, the sunset of quantitative easing (QE) is part of this process, but again investors appear to be comfortable with forward guidance on interest rates. Japan remains behind Europe.

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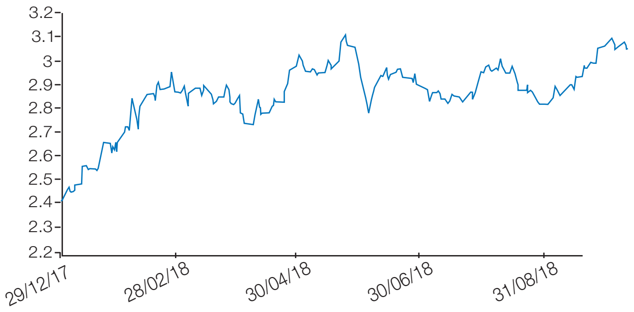
US 10 Year Treasury Yield



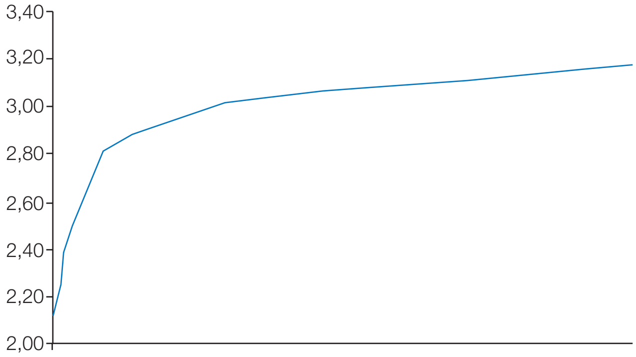
Source: Investec Wealth & Investment

The volatility spike has been negotiated – a higher baseline is now expected. The surge in volatility that we saw in February as investors woke up to a new monetary policy direction is unlikely to be repeated in the near term. However as the cycle matures, we should naturally expect a higher "baseline" level of volatility. This comes from two sources: firstly the "un-suppression" of medium-term interest rates as the sun sets of QE programmes. Secondly, as part of policy normalisation, the monetary policy settings between the developed market blocks will increasingly diverge as they are reset to reflect locally appropriate, rather than global conditions. At the minimum, an increase in exchange rate volatility must be expected as this process unfurls: most likely equity, interest rate AND exchange rate volatility will increase.

Equity valuations are supportive: Our basis for equity valuation uses time-tested measures relating current dividends to current medium-term risk-free rates. In the US (the most expensive market) current measures indicate equities are slightly above "fair value": the 10% dollar return of the S&P Composite this year has been matched by a tax-turbocharged rise in US earnings. Outside the US, 2018 has seen already cheap equity markets become significantly cheaper as earnings have grown (on track for double-digit growth outside the US) and share prices have fallen by 3%. For equities to become definitively expensive globally, much lower dividends (a recession) or materially higher bond yields would be needed. Since we expect healthily growing dividends over the forecast period and only modestly higher bond (discount) rates, we view the valuation backdrop (not taking into account any Trump discount) as supportive.

A Trump risk premium is justified for the medium term: "America First" is now not just a threat, but explicit in policy. A trade war between the US and China is one of the few "dog whistles" that is loud enough to negatively reset the animal spirits among multinational corporations. The most rational interpretation of the move to engage China (and Europe, Latin America and Canada) in such a hostile way appears to be that it is a high-risk clarion call to Donald Trump's electoral base ahead of the mid-term elections in November. Even if this Machiavellian interpretation is right, the implications of the world's most powerful economy pursuing only in its own interests are not positive and the use of manufactured crises to achieve policy ends is becoming an established pattern. The latest example of this is the confrontation with Iran, which has driven up the oil price to over US$80/barrel. Since the impact of US policies on friend or foe are now unpredictable, global equities in the Trump era deserve a higher risk premium than in more ordinary times.

US Yield Curve



Source: Investec Wealth & Investment

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The blue sky potential is diminishing, but not disappearing. A risk-appetite capitulation (the so-called "melt-up" scenario which pushes asset prices higher) could still occur. The drivers of such a move would be earnings growth, combined with increased confidence in the economic cycle being extended, compounded by aggressive corporate behaviour (merger and acquisition activity). An explicit trade accommodation with China would help.

In Summary

The global economic picture remains good, in spite of recent weakness in some emerging markets. The overall outlook is one of only modestly decelerated, but still largely synchronised and resilient, global growth in 2018 and 2019 (3.7% and 3.7%, according to recent forecasts from the IMF, reduced from 3.8% & 3.9% respectively). There should be no policy mistake (either monetary, or global commercial / political) to derail it and valuations are not an impediment.
Our judgement is that the economic (and earnings) cycle will extend into 2020 before it peaks. Were it not for the hostile engagement by the US with China and an increasing number of her trading partners, we would be more positively positioned.

Reasons for adding risk to SA portfolios

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

Should global growth exceed expectations, a case can be made for a more optimistic view of South African assets

When consideration is given to how much risk South African portfolios should expose themselves to in the 12 months to come, and how different asset classes should be allocated, a perspective provided by recent financial trends is called for. 2018 has proven to be a discouraging year for equity investors in almost all markets outside the US, including the JSE that has performed poorly even in depreciated rands. In so disappointing investors, the SA financial markets confirm once more how closely linked they remain to wider emerging market trends that in turn take their cue from the dominant emerging market economy, China.

In figure 1 below we show how different emerging equity markets, including the Shanghai Index, measured in US dollars, fell away significantly after the first quarter of 2018, as did the emerging market (EM) benchmark (as represented by the MSCI Emerging Market Index). By 1 October the EM benchmark had lost 11% of its US dollar value of 1 January, while the JSE in US dollars was down 18%, or 6% weaker in rands. The US benchmark, the S&P 500 Index, gained 8.5%. As we show in figure 2, the emerging market and US benchmarks' levels moved similarly and mostly sideways until April 2018, after which the S&P 500 moved mostly up and EM (including the JSE) moved mostly lower and significantly so.

Figure 1: Equity markets in 2018

Source: Bloomberg and Investec Wealth & Investment

Figure 2: Total returns in 2018

Source: Bloomberg and Investec Wealth & Investment

Most other developed economy equity markets have also performed poorly, both absolutely and relatively, when compared with the New York indices, year to date, as is shown in figure 3 below. The broad European index, the Stoxx 600, did almost as poorly in US dollars, as did the Hong Kong market with its heavy exposure to China. It is worthwhile noting that the information technology (IT) heavy Nasdaq Index did best out of the US indices. The Chinese-based IT heavyweights, including Tencent, in which Naspers has a large stake, were sold off heavily in 2018, especially when compared with their US counterparts (see figure 4 below).

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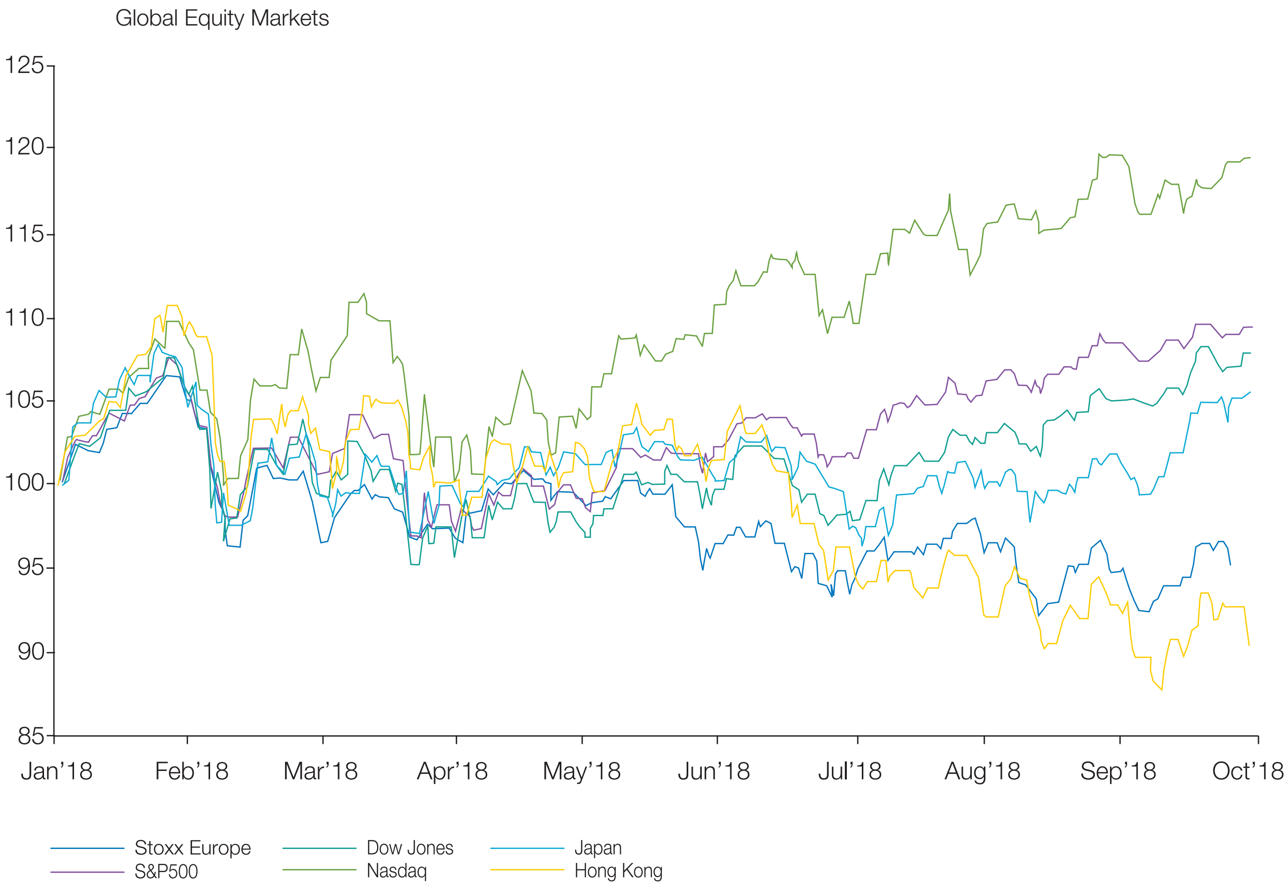
Figure 3: Global equity markets in 2018 (1 January 2018 = 100)

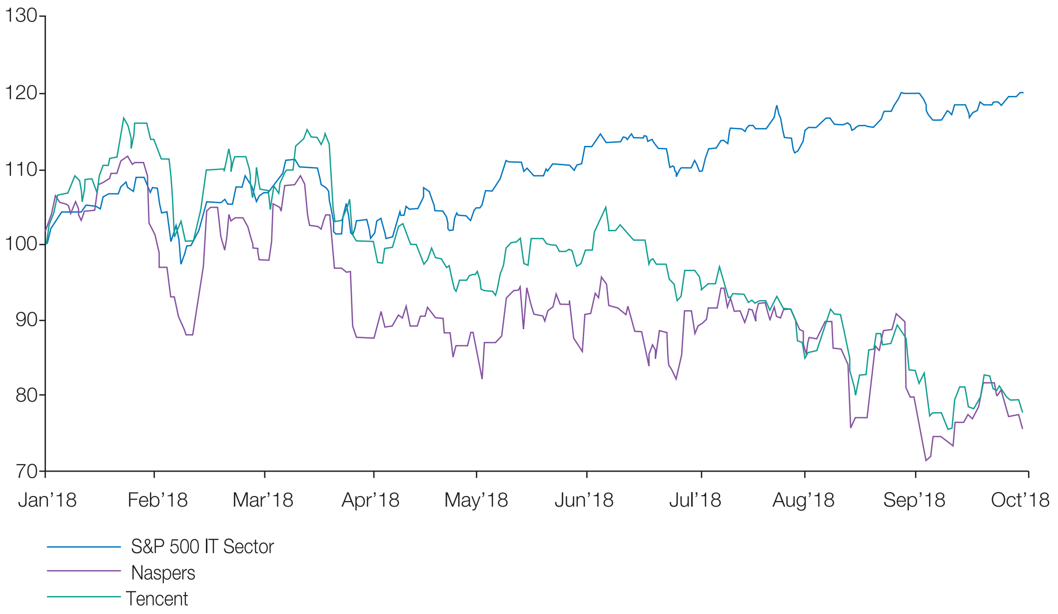


Source: Bloomberg and Investec Wealth & Investment

SA financial markets confirm once more how closely linked they remain to wider emerging market trends that in turn take their cue from the dominant emerging market economy, China.

The underperformance of IT giants Tencent and Naspers in 2018, compared to New York-listed IT companies, has been striking. Naspers and Tencent have lost over 20% of their beginning of year US dollar value, while the S&P 500 IT sector has gained 20%.

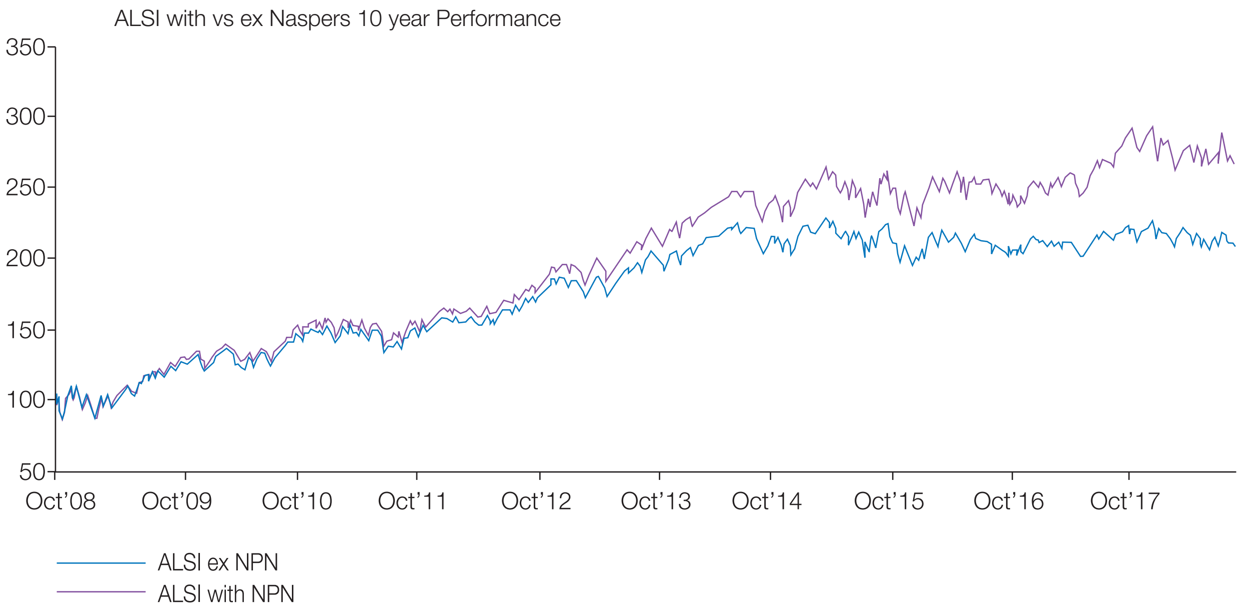
Figure 4: Naspers and Tencent compared with the S&P 500 Information Technology sub-sector (1 January 2018 = 100)



Source: Bloomberg and Investec Wealth & Investment

These recent trends have made the largest company quoted on the JSE, Naspers, a drag on performance this year. This comes after many years when a rapidly rising Naspers compensated for what would have been a pedestrian JSE were it not for the exposure to Chinese IT (see figures 5 and 6 below).

Figure 5: The JSE All Share Index with and without Naspers (2008=100)



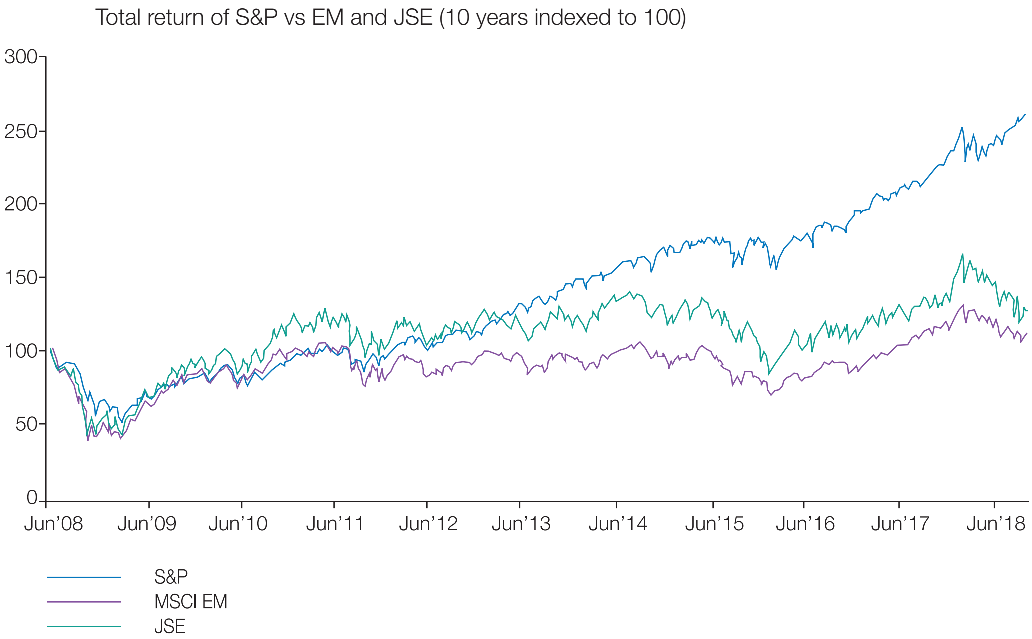
Source: Bloomberg and Investec Wealth & Investment

Figure 6: The JSE All Share Index with and without Naspers (1 January 2018 = 100)

Source: Bloomberg and Investec Wealth & Investment

This underperformance by the EM Index and the JSE, which tracks the EM average so closely, has been a feature of the equity markets since approximately mid-2012. US$100 invested in the S&P 500 before the Global Financial Crisis, with dividends reinvested, would now be worth US$250 while the JSE and the EM Indexes have provided very poor returns on average (see figure 7). The excellent returns provided by emerging markets in 2017 can also be identified in figure 7. 2017 was a year of highly synchronised global economic growth and was very good for emerging market equities, bonds and currencies, including South African securities and the rand.

Figure 7: Total index returns (2010=100)



Source: Bloomberg and Investec Wealth & Investment

These equity market outcomes were based upon fundamental forces. It is not sentiment but different economic outcomes that have driven the S&P higher and the EM indices sideways since 2012. The performances of the firms listed on the New York exchanges and those of emerging markets have been very different. The outperformance on the earnings and the dividend front of S&P listed companies between January 2014 and January 2017 is striking (see figure 8 below).

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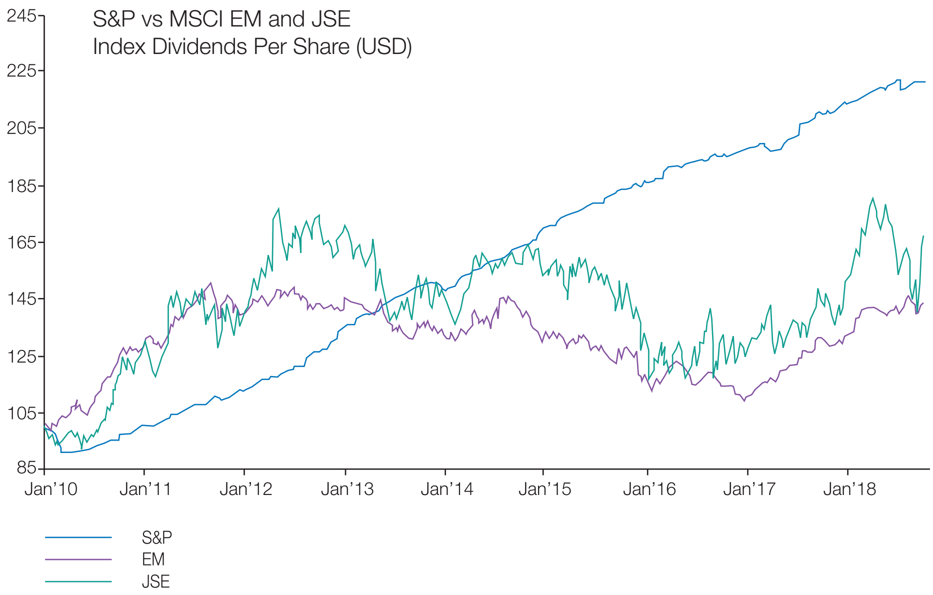
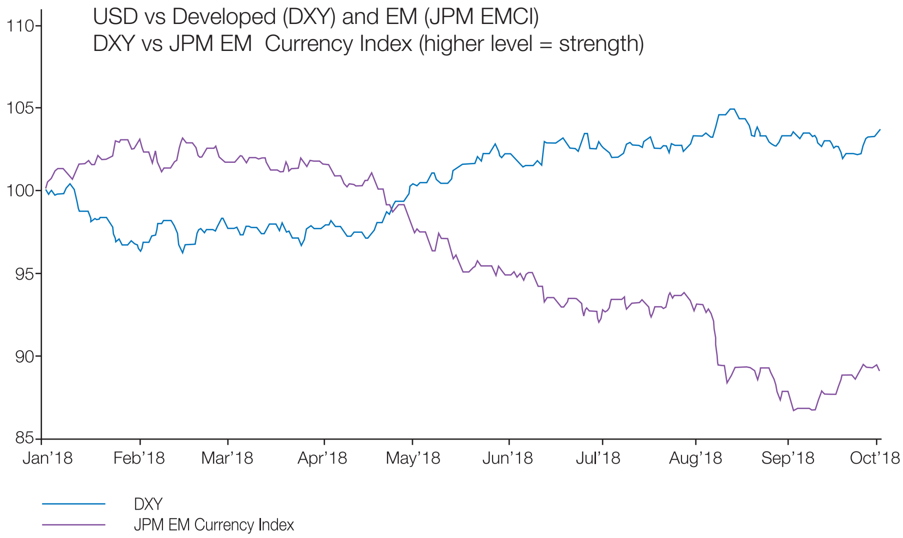
Figure 8: Index dividends per share in US dollars (2010=100)



Source: Bloomberg and Investec Wealth & Investment

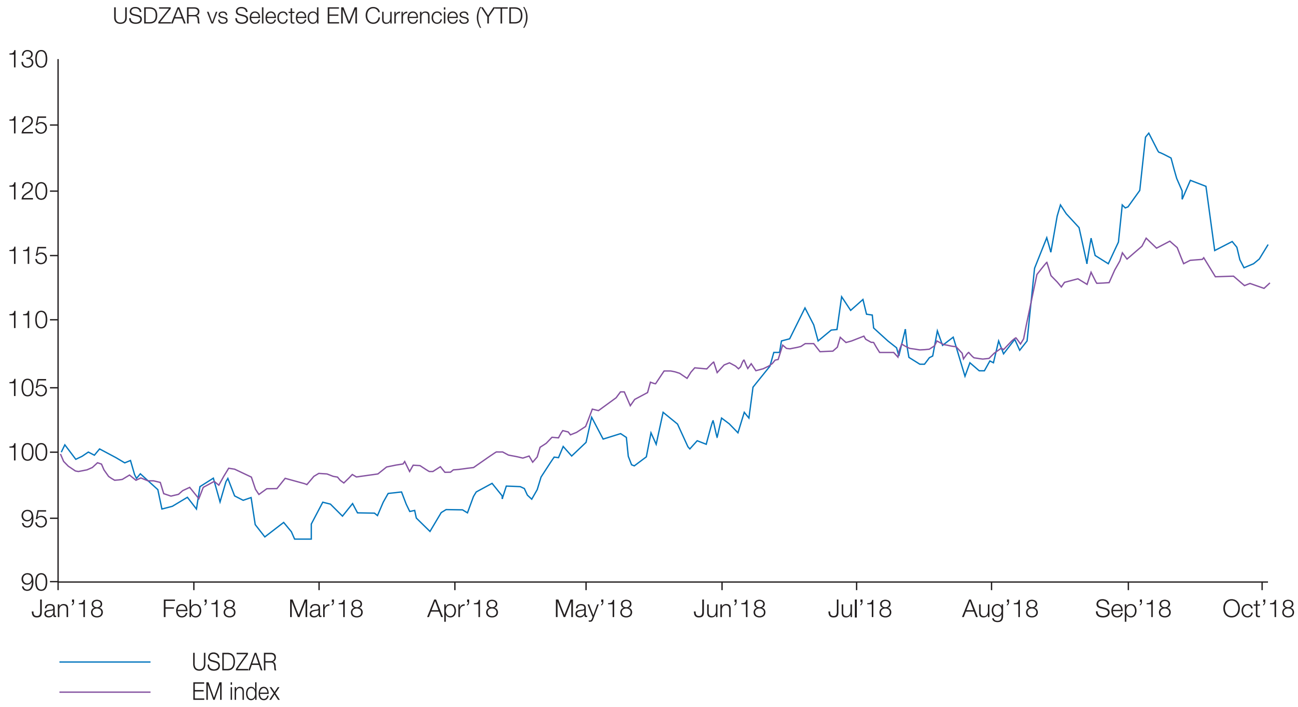
In figure 9 we show that the flow of dividends in US dollars paid by EM and JSE-listed companies increased strongly in 2017, only to fall back in 2018 as the dollar strengthened against the euro and other developed economy currencies. EM exchange rates weakened even more against the US dollar, as is usually the case with dollar strength (see figures 9 and 10 below).

Figure 9: US dollar vs developed market currencies (DXY) and emerging market currencies (JPM) (2018=100)



Source: Bloomberg and Investec Wealth & Investment

Figure 10: The USD/ZAR and the USD/EM basket of nine exchange rates (1 January 2018 = 100)



Source: Bloomberg and Investec Wealth & Investment

In 2018, doubts about the durability of growth outside the US, including in China, have grown enough to encourage a marked sell-off of EM stocks, bonds and currencies. Any thoughts that the US economy may be approaching recession have been disabused by the persistently strong US economy – and accompanied by little fear that the any dramatic increase in inflation will force the Fed's hand. A flatter yield curve – long-term rates rising by less than short term rates – has also helped restrain the cost of corporate debt to the advantage of both the credit and equity markets.

The key issue for investors and their exposure to risk, especially in riskier emerging market securities and currencies, is whether this pessimism about global growth and optimism about US growth and inflation and accompanying interest rates is justified – and the underperformance of EMs (and their less demanding valuations of equities, bonds and currencies) is therefore likely to persist. It is more pessimistic expectations of future economic and earnings growth, rather than current performance that has forced EM valuations lower.

Our view is that such pessimistic expectations, including of growth in China – all important for emerging markets as a whole – have been overdone. Our view is that China is, at worst, going to reveal a very soft landing for its economy. Satisfactory growth will be sustained, as will the demand for metals and minerals, for which China has become the largest buyer by far. Hence our recommendation of a more risk on position for SA portfolios, equivalent to about a 5% overweight exposure to equities.

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Stronger than currently expected global growth will be helpful to the exchange value of the rand. It will also be helpful to metal and mineral prices in US dollars, upon which JSE-listed resource companies depend. Their accordingly higher dollar values could compensate for a stronger rand, which would likely accompany a revival of metal prices. Better-than-expected global growth will also add US dollar value to JSE-listed companies, including Naspers, that generate much of their revenue and costs outside of South Africa. Rand strength, for global growth reasons, will be helpful for all sectors of the JSE, especially the purely South African plays such as banks and retailers. Rand strength restrains inflation and may even lead to lower interest rates to stimulate more spending and higher house prices.

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This is an optimistic scenario, shared widely by the members of the South African Asset Allocation committee. Our views on US equities that have performed so well to now is more cautious than our view on EM equities that have performed so poorly. The latter hence now offer value, in our opinion, given marginally slower but still highly satisfactory global growth and earnings and dividends to match. A belief that economic policy reforms in SA will reduce risks to investors and add value to SA assets is an additional reason for a degree of optimism.

SA market view and asset allocation – Seeing through the turmoil

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

The South African Asset Allocation Committee finds itself more upbeat than it has been for some time. Attractive valuations and a greater sense of urgency by government to repair the economy are among the reasons for this.

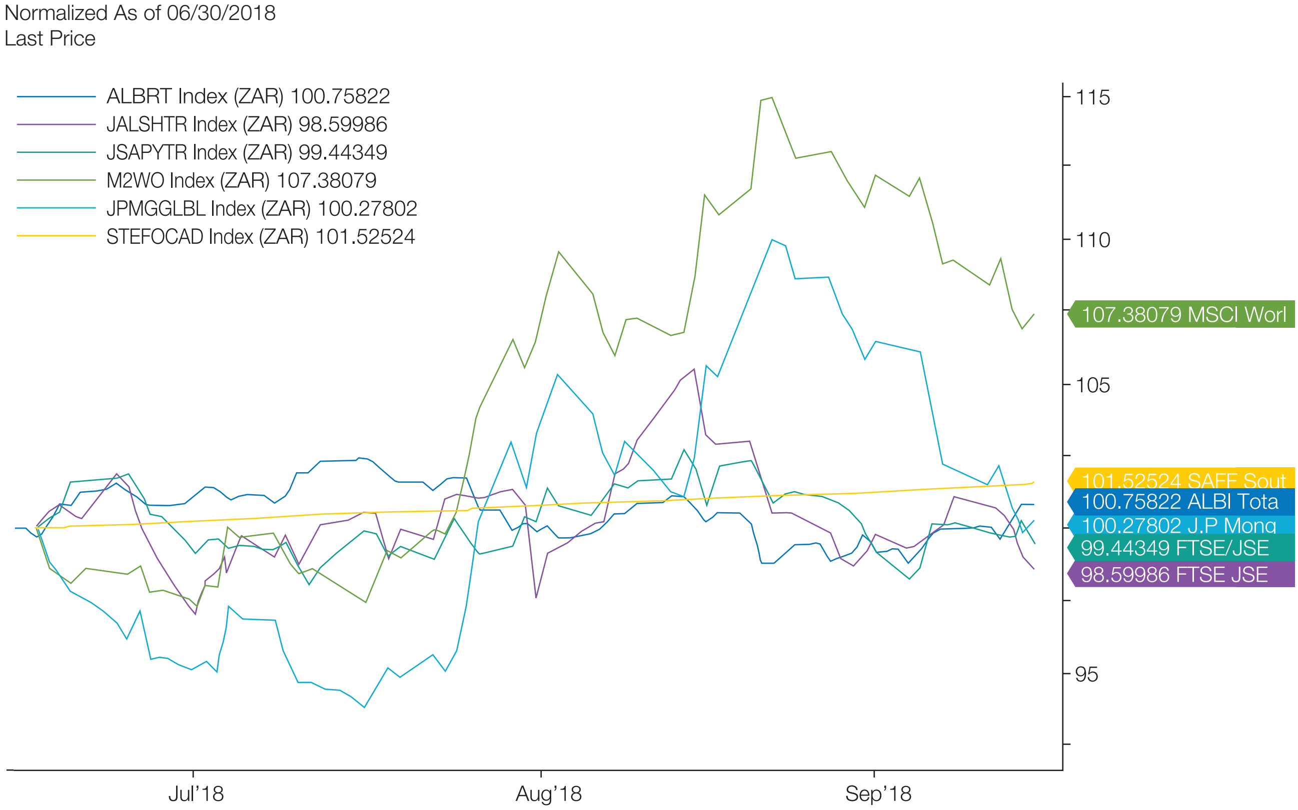
Performance review

The third quarter was a disappointing one from a return perspective for South African investors. Local assets classes struggled to take any clear direction over the quarter with returns in the range of -1% to +2%. Global equities were the clear winner when looked at in rand terms, up just over 7%. Global government bonds were also well up in rands at one point, before giving up those gains up in September.

Looking at the same asset classes on a year-to-date basis (to end September), there is extremely wide dispersion in performance between international equities and bonds (both in rand terms) on the one hand and domestic asset classes on the other. Global equities are up 22% and global bonds 11%, while local property is down 21%, bonds are up 5% and equities are down 4%. It's worth noting that the major reason for the poor property index performance remains the Resilient stable of companies which were down heavily in the first quarter. That said, the two largest counters in the index (Growthpoint and Redefine) are down 9% and 2% respectively, year-to-date.

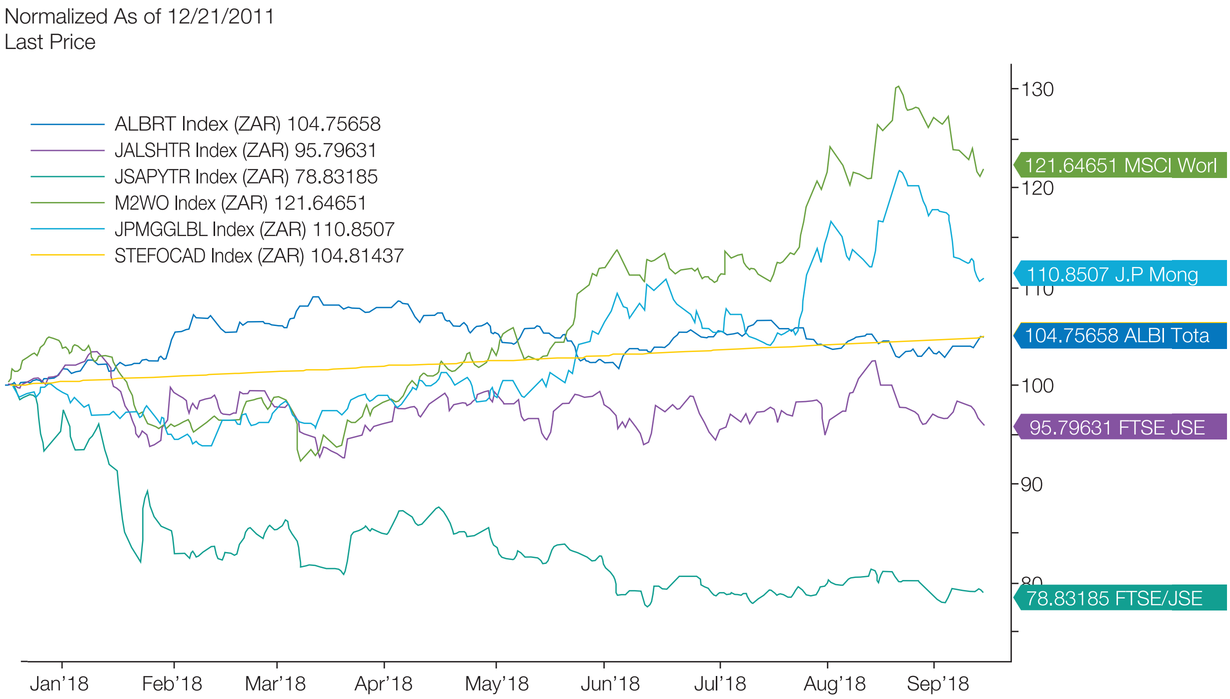
The rand remained extremely volatile over the third quarter, weakening to almost R15.50 to the US dollar before retracing to R14.2 at the end of the quarter. It was not entirely South African-specific issues that drove the rand, but rather general emerging market (EM) concerns. Looking at performance of the EM currencies against the US dollar, South Africa was close to the middle of the pack, down 3.5% over the quarter.

Figure 1: Asset class performance (Q3 2018)



Source: Bloomberg

Figure 2: Asset class performance (1 January – 30 September)

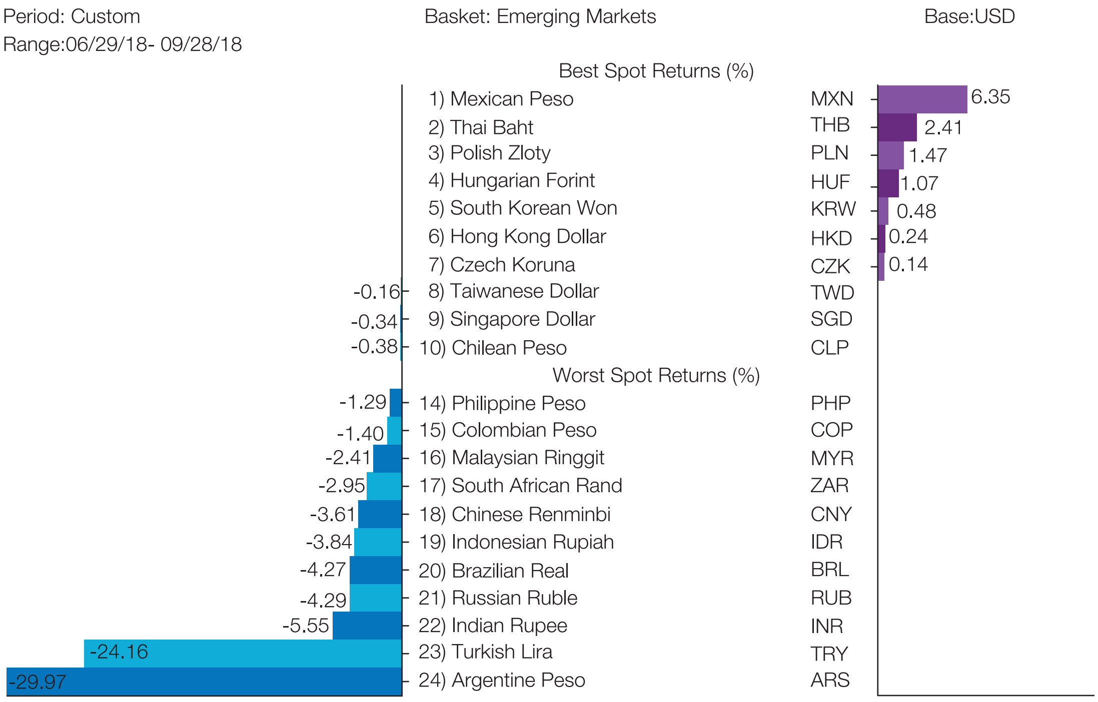


Source: Bloomberg

Figure 3: Rand vs US dollar

Source: Bloomberg

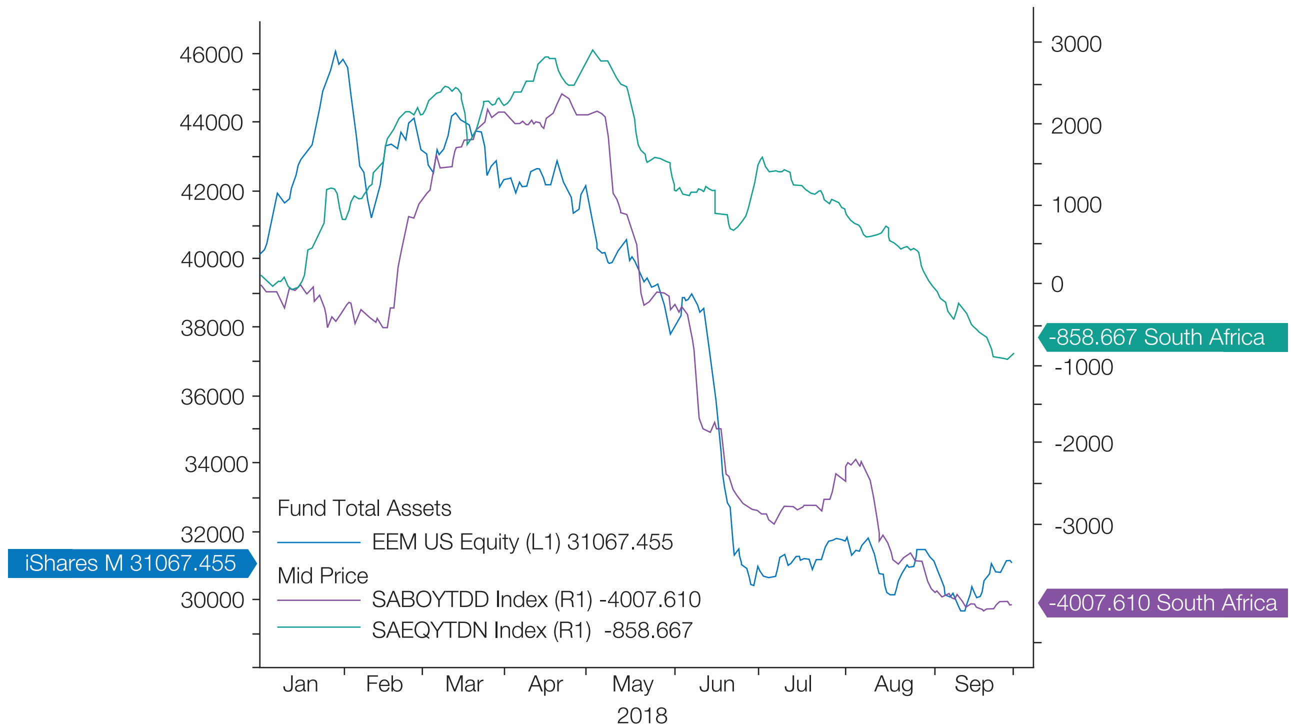
Figure 4: Emerging market currency performances vs US dollar Q3 2018



Source: Bloomberg

Looking at foreign flows into South African bonds and equities, one can see that we have yet to start seeing inflows into either market this year. EM equity flows have largely followed the same trend as the South African flows, which reinforces our comment above regarding investor concerns about emerging markets more generally.

Figure 5: Foreign inflows in 2018



Source: Bloomberg

Asset allocation review

Going into the second quarter of this year, we had a more upbeat view in terms of appetite for South African equity, property and bond assets, but we decided to “curb our enthusiasm” because we thought that it may take time for the South African self-help story to move the needle. We also felt that broader global issues, focused around trade and EM stresses, could contain any positive SA developments (at that point, South African risk assets had run up very strongly, effectively pricing in a turnaround). Both of the scenarios outlined above came to pass, with a slew of disappointing data as well as a lack of any clear plan to turn the economy around leaving investors disappointed with the perceived pace of improvement from the ruling party. More importantly, idiosyncratic EM issues threatened to spread to EMs more generally (see the Global Investment View commentary).

Going into the fourth quarter of 2018, we as the South African Asset Allocation Committee are more upbeat – SA risk assets are at similar, if not worse, valuation levels than they were before Cyril Ramaphosa won the ANC leadership race last December.

To give a brief insight into investment process, our South African Asset Allocation Committee meets a few days after the Global Investment Strategy Group (GISG). The output from the GISG is distributed to the South African Asset Allocation Committee to digest ahead of the meeting. Members of the committee are then sent a survey with a number of questions related to expected returns, icebergs, opportunities, risk, how they would position a domestic portfolio and space for general comments on the investment environment.

We then consolidate those views into a “risk score” for South African risk assets, which helps start the discussion and the debate. So when we talk about the committee’s views and risk score, we look at what those risk scores are, how many committee members upgraded versus downgraded, the direction of travel and the levels of the most negative members. This score and the survey then sets the basis for the lengthy debate within the committee the investment positioning for domestic portfolios.)

Going into the fourth quarter of 2018, we as the South African Asset Allocation Committee are more upbeat – SA risk assets are at similar, if not worse, valuation levels than they were before Cyril Ramaphosa won the ANC leadership race last December.

So when we say that we had a much more upbeat committee, this is in the context of 1) our highest risk score (+1 on a scale of -3 to +3) for a number of years; 2) no members with a negative scores; and 3) seven upgrades and no downgrades. So all in all, we were a more optimistic committee than we have been for some time.

In the discussions that followed, we agreed that we would look to move equity exposure up to 5% overweight (from cash) in a house view medium equity portfolio and maintain our other broad level asset class exposures as is. The current positioning reflects the suggested changes detailed in our asset allocation matrix below.

We feel like there is more of a sense of urgency within the government to address our anaemic growth rate.

The reasons for the move to up-weight further are as follows (with more detail on the global factors above):

- Global growth will remain synchronised and “strong enough”
- Idiosyncratic EM issues faced by the likes of Turkey, Argentina and Brazil are not going to cause a systematic EM sell-off. If there is a recovery in EM assets, South Africa should participate in that recovery to some extent.
- Chinese growth is expected to remain robust, which is important for commodity exporters and global growth more generally.
- Valuations in the South African market are more attractive on an absolute basis and as well as on a relative basis, and in certain sectors and areas of the market are more attractive than they have been in some time.
- We feel like there is more of a sense of urgency within the government to address our anaemic growth rate.
- While it may not feel like we are moving forwards quickly enough, we are moving forwards in terms of addressing corruption and delivery issues at the state-owned enterprises, SARS and other government-related institutions.
- Both local and international investors are generally underweight SA assets – if there is a change in appetite for EM or towards South Africa in particular, prices could move favourably.

In summary, we had a much more positive discussion with regards to South African equity market exposure than we have had for some time. Certain sectors of the market look attractive from a valuation perspective considering the prospect of a cyclical South African recovery as well as support from improved global EM dynamics. As such, we will be continue to up-weight domestic equity exposure from cash in a measured fashion.

Both local and international investors are generally underweight SA assets – if there is a change in appetite for emerging markets or towards South Africa in particular, prices could move favourably.

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 2018	Q4 2018	COMMENTS
Offshore Equity	﹀	﹀	Maintain slight underweight to global equities. Trump and trade related concerns keep us from being more positive.
Offshore Fixed Income	﹀	﹀	Low expected total returns from these starting yield levels. Risk spreads across fixed income asset classes are expensive.
Offshore Cash	︿	︿	Provides optionality to increase risk should we see an opportunity.
Offshore Property	N	N	Valuations reasonable relative to long term averages.
Offshore Alternatives	︿	︿	Offers attractive risk-adjusted returns relative to traditional long only assets classes. Variations include return enhanced, capital protected and low correlation products.

SA ASSET CLASSES	Q3 2018	Q4 2018	COMMENTS
SA Equity	︿	︽	More optimistic on outlook for SA assets in certain sectors. Valuations looking much more reasonable.
SA Fixed Income	N	N	Concentrated in "belly" of the yield curve. Total returns look attractive on a 12 month view. Have switched short bonds for longer duration bonds.
SA Cash	﹀	︾	Still offering attractive real return but see better total return opportunities.
SA Listed Property	︿	︿	SA focussed property counters look attractive on a valuation basis.
Preference Shares	︿	︿	Attractive yield advantage over taxable yields assets with possible repurchase underpin. Focus on the bank preference shares.
$/R (+ for ZAR strength)	︿	︿	ZAR looks cheap relative to fair value given our top down macro view.
Physical Gold		︿	Allocation to physical gold offers protection against SA and Global risks.

SECTORAL/THEMATIC POSITIONING	Q3 2018	Q4 2018	COMMENTS
Global Plays	︿	﹀	We have reduced our exposure to global plays in favour of domestic plays.
Commodities	︿	︿	Overweight commodity plays although up-weight 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	︿	︽	Adding to our interest rate play exposure on the back of the positive SA fundamental outlook.
SA Industrials	N	︿	Valuations at very interesting levels, especially in mid and small cap area of the market.

Members of the Global Investment Strategy Committee

John Haynes

Chairman & Head of Research
United Kingdom

Chris Hills

CIO,
United Kingdom

Professor Brian Kantor

Chief Economist & Strategist
Investec Wealth & Investment
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Philip Shaw

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