MARKET OBSERVATIONS

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Global growth maintained a steady pace in the second quarter of 2017 (Q2), making it another positive period for global investors as unemployment rates fell and trade growth accelerated. Bullish investor sentiment continued to drive good demand for both developed and emerging market assets, although later in the quarter equity market momentum lost some steam amid worries over some heady valuations, particularly in the US tech sector. In contrast, in South Africa investment returns were hit by worsening investor sentiment following the June credit rating downgrades and a second quarter of negative GDP growth, as well as rising political uncertainty caused by widening government corruption scandals and policy disagreements. Keen foreign investor demand for high-yielding SA bonds drove solid returns in those assets, as well as contributing to rand appreciation for the quarter.

ASSET CLASS	TOTAL RETURN: Q2 2017
Global equity – MSCI World Free (US$) (Developed)	4.0%
Global equity – MSCI Emerging Markets (US$)	6.3%
Global bonds – Barclays Global Agg Bond Index (US$)	2.6%
Global property – EPRA/NARIET Property Index (US$)	2.7%
SA equity – FTSE/JSE All Share Index	-0.4%
SA bonds – BEASSA All Bond Index	1.5%
SA listed property – SA Listed Property Index	0.9%
SA inflation-linked bonds – JSE CILI Index	1.0%
SA cash (STeFI Composite Index)	1.9%

Source: Prudential, Deutsche Securities, data to 30 June 2017

US LOSES SOME STEAM, BUT GLOBAL TRADE AND GROWTH REVIVAL INTACT

US markets were stronger during the quarter although the Trump "reflation" trend lost some steam in June, with President Trump's company-friendly policies looking to be increasingly delayed. The S&P 500 and Dow Jones reached fresh record highs as US corporate earnings continued to grow, but worries grew over high valuations, and tech stocks experienced a sell-off in June amid fears of a bubble. For Q2, the S&P 500 returned 3.1% and the Nasdaq 4.2% (but -2.4% in June). As widely expected, the US Federal Reserve hiked interest rates by 25bps at its June FOMC meeting, and continued to signal one further 25bp rate hike in 2017 and three more hikes for 2018. This is little changed from its (and the market's) previous forecasts, with the market pricing in a 40% chance of a hike in December, and only 20% in September. The Fed cited nearly full employment and rising inflation as the main factors behind the rate rise. Analysts considered May's dip in core CPI to 1.4% y/y, along with the softening in Q1 GDP growth to 1.2% (q/q annualised) from 2.1% previously, to be a temporary aberration in the stronger longer-term trend.

The Barclays Global Aggregate Bond Index (US$), a mixture of government and corporate bonds, returned 2.6% in the quarter. US bonds were mixed as sentiment swung between worries over rising US interest rates, the Fed's upcoming bond sales (unwinding of its balance sheet) and growing inflationary pressures, versus more bearish perspectives on the US growth outlook. US Treasuries returned 1.2% for the quarter, while the 10-year UST yield was barely changed at 2.31% from 2.39% at the end of Q1. For US corporate bonds, investment-grade bond spreads narrowed slightly to 112bps over USTs from 120bps at the beginning of the quarter, while high-yield spreads widened to 408bps from 391 previously.

In the Eurozone, the French elections were the latest to sweep away populist fears as reformist Emmanuel Macron comfortably won the Presidential vote and a large Parliamentary majority for his new party – this despite very low voter turnout. The region's Q2 GDP growth came in at 1.7% (q/q annualised), similar to the previous quarter's 1.8% rate, the latest data confirming a continuing recovery amid rising consumer spending and business investment and falling unemployment across most member states. At its June meeting, the European Central Bank (ECB) left its base interest rate unchanged, ruled out further rate cuts and said it was considering ways to gradually end its bond-buying stimulus.The Dow Jones Eurostoxx 50 returned 6.5%, while Germany's DAX delivered 6.8% and the French CAC 9.2% (all in US$). The UK, meanwhile, saw a disastrous snap-election outcome for PM Theresa May as her Conservative party lost its Parliamentary majority – forcing her to soften her negotiating stance on exiting the EU (Brexit). Amid Brexit uncertainty, UK growth eased somewhat and sterling continued to weaken, spurring higher inflation. The FTSE 100 returned 4.7% (in US$) over the quarter, but -1.5% in June. In Japan, Q1 2017 GDP growth accelerated to 2.2% (q/q annualised) from a revised 1.2% in the previous quarter, as private consumption revived and exports continued to improve. Bank of Japan (BOJ) comments indicated the central bank believes wages and prices will begin to pick up later this year to achieve the bank's 2% inflation target in 2018. Yet analysts agree that the BOJ is unlikely to ease off of its monetary stimulus any time soon given the country's past 20 years of very low growth and inflation levels. The Nikkei 225 Index returned 5.2% over the quarter (in US$).

China's good start to the year continued in Q2 as the equity market again posted a strong performance (the MSCI China returned 10.7% in US$), and Q1 GDP growth surprised to the upside at 6.9% (q/q annualised). A negative development was Moody's unexpected one–notch downgrade to the country's sovereign credit rating to A1 from Aa3, citing worries over the government's ability to de-leverage the financial system's high debt levels while maintaining steady growth. However, government officials discounted this concern amid strong growth in exports and other firm data. However, many analysts do expect a slowdown later in the year as the effects of government stimulus fade – in May the Chinese Premier ruled out further large fiscal stimulus as unnecessary. Other emerging market assets, including both bonds and equities, recorded good gains in Q2 amid renewed investor demand for risk assets. Overall, the MSCI Emerging Markets Index returned 6.3% in US$, compared to 4.0% from the MSCI World Free Index for developed markets. Among the larger EM equity markets in US$ terms for the quarter, the MSCI Turkey was by far the strongest performer with a 19.8% total return, followed by China (as above) and South Korea's KOSPI (8.6%). The poorest Q2 returns (in US$) came from the MSCI Russia (-9.8%) and Brazil's Bovespa (-7.3%). The MSCI South Africa returned 3.6% for Q2 in US$. In commodities, the oil price continued to fall due to surging supplies of US shale oil, which more than offset OPEC supply cuts. Brent crude fell 9.3% during the quarter and is down 15.7% so far this year. Other commodity prices were also largely softer, retracing some of their previous good gains. Gold fell 0.6% and platinum was down 2.6%, but palladium gained 5.4%. Among industrial metals, nickel was down 6.2%, while lead lost 2.5% and aluminium was 2.0% lower.

SLOW GROWTH, POLITICAL UNCERTAINTY WEIGH ON SA RETURNS

South Africa moved closer to "full" sub-investment grade status in June as Moody's downgraded the country's sovereign credit rating by one notch from Baa2 to Baa3, with a negative outlook indicating that a further cut – to sub-investment grade level – is likely. The economy also unexpectedly moved into a technical recession with Q2 GDP growth announced at -0.7% (following -0.3% in Q1), and SA's Q2 business confidence fell to its lowest level since 2009. Some good news emerged when both S&P Global and Fitch refrained from further downgrading SA's credit rating on 1 and 2 June, although these foreign currency ratings are already in sub-investment grade territory.

At the SA Reserve Bank's Monetary Policy Committee (MPC) 25 May meeting the MPC left the repo rate unchanged at 7.0%, citing lower inflation (May inflation was 5.4% y/y) and weaker growth and inflation prospects. The central bank lowered its 2017 and 2018 growth forecasts to 1.0% and 1.5%, respectively. While suggesting strongly that the rate hiking cycle was at an end, the Governor also cautioned that any downward move was unlikely in the near term. Nevertheless, the forward rate agreements market is pointing to an increasing likelihood of at least a 25bp rate cut later this year.

Attracted by South Africa's relatively high bond yields following the April downgrades, foreign investors were keen buyers of local bonds during Q2, which helped drive positive returns as well as rand strength in the three months. The BEASSA All Bond Index returned 1.5% in Q2 and 4.0% for the year to date. The 10-year government bond yield fell from around 8.9% to 8.75% by end-June, off its best levels of around 8.4% during the quarter. Inflation-linked bonds (ILB Composite Index) returned 1.0% in the quarter, and cash (the STeFI Composite) returned 1.9%.The rand, meanwhile, continued its appreciation versus the US dollar, gaining 2.6%, while it lost 4.3% against the euro and 1.0% versus the UK pound.

The FTSE/JSE All Share Index delivered a total return of -0.4% for Q2, dragged lower by a combination of rand/US dollar strength, commodity price softness and credit rating downgrades. The local market has returned 3.4% year to date. With a return of -7.1%, Resources shares were the worst performers due to the fall in commodity prices. Industrial shares delivered 2.2%, helped by strong gains in Naspers, while Financials were flat at 0.0%, dented by the downgrades. Listed property, meanwhile, returned 0.9%, underpinned partly by falling inflation and an improved interest rate outlook.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

In **global fixed income,** government bond yields continue to be expensive given the very low levels at which they are trading from an historic perspective. They are also at risk to rising interest rates in the US, and increasingly in Europe as well. We remain underweight sovereign bonds and underweight duration, and continue to hold cash and shorter-term bonds in order to reduce interest rate risk. During the quarter we bought more corporate bonds (mainly investment-grade) in the US and Europe out of global cash holdings, as these assets moved to more attractive valuations. We are now overweight corporate bonds from a neutral position previously.

For **global equities**, despite strong market performance over the past 12 months or so, many regions remain attractively valued, particularly given the fundamental backdrop of broad global macroeconomic improvement, with strong economic indicators feeding through to company earnings. As such, our portfolios have moved overweight global equities from a neutral position in the previous quarter. We have added exposure to certain markets where we see good value, also taking advantage of the sizeable equity risk premium available (compared to bonds) in international markets. This should help protect equities in the event of growth disappointment. Our current equity positioning reflects a preference for cheaper areas where fundamentals remain encouraging including Europe, Japan, the global financial sector and selected emerging markets such as Korea, Turkey and Indonesia, compared to global indices and the broad US market.

In our global portfolios we are underweight global bonds and overweight global equities and global cash, although our global cash holdings have been reduced after our purchase of additional global equity and corporate bond exposure. In our higher return-targeting multi-asset funds we continue to be very near our maximum permitted 25% offshore weighting.

South African equity valuations improved marginally over the quarter to become slightly cheaper versus their long-term fair value, as future corporate earnings growth estimates rose as equity prices fell. The FTSE/JSE ALSI 12-month forward P/E fell to 13.9x at quarter-end from 14.1x in Q1 2016. We retained our overweight exposure in the Prudential Inflation Plus Fund during the quarter based on these valuations and their relatively higher long-term prospective returns compared to other local asset classes.

Prudential's portfolios are overweight stocks with solid foreign currency earnings like British American Tobacco, Anglo American, Exxaro and Sasol, as well as international container transport group

ASSET CLASS	POSITIONING 31 MARCH 2017	POSITIONING 30 JUNE 2017
Foreign equity	Neutral	Overweight
Foreign sovereign bonds	Underweight	Underweight
Foreign corporate bonds	Neutral	Overweight
Foreign cash	Overweight	Overweight
SA equity	Overweight	Overweight
SA listed property	Overweight	Overweight
SA bonds (government and corporate)	Overweight	Overweight
SA inflation-linked bonds	Underweight	Underweight
SA cash	Underweight	Underweight

Trencor, which has upside to improving global trade trends. We also hold non-mining global stocks like Sappi. We remain overweight in well-priced and high-yielding Financials including Old Mutual, Investec, Standard Bank and Barclays Group Africa. We maintained our underweight in Retail stocks given the challenging consumer environment, but do continue to hold selective overweights in Foschini and Pick 'n Pay. We have preferred to gain our consumer exposure via well-priced and more defensive consumer services providers like Sun International.

In **SA listed property**, we retained our overweight exposure in our multi-asset funds during the quarter, with valuations remaining somewhat on the cheap side of long-term fair value. At quarter-end, listed property companies (excluding developers) were priced to return approximately 16% p.a. over the medium-term (assuming no change in the market's rating/valuation of property), comfortably above inflation and, we believe, ample compensation for the risk involved. Even with the market pricing in a de-rating of around 4%, somewhat higher than Q1, the medium-term prospective return would be approximately 12% p.a.

In **SA nominal bonds**, we took some profits over the quarter amid the market rally, trimming our moderately overweight position in favour of buying more inflation-linked bonds in our multi-asset funds. However, we are still modestly overweight nominal bonds. Within this exposure, we prefer longer-dated bonds versus shorter paper due to the more attractive yields on offer, while retaining our overweight exposure to corporate bonds.

Inflation-linked bonds saw their valuation fall to attractive levels relative to nominal bonds in mid-June (amid the improved inflation outlook) as the 10-year break-even inflation rate dropped briefly below our long-term inflation benchmark of 6.0%. We took advantage of this to buy more ILBs around this level and sell nominal bonds, although we remain underweight ILBs in our multi-asset portfolios.

LOOKING AHEAD

South Africa's slow growth, the possibility of further credit rating downgrades, and heightened political and policy uncertainty, are local factors that are likely to keep market uncertainty elevated in the months ahead. Globally, the trend of rising interest rates in the US is diverging with South Africa's outlook for steady and possibly falling interest rates; this could deter foreign investment inflows. These factors will all weigh on the direction of the rand and in turn determine local inflation and interest rate trends. However, history shows that asset returns move in cycles, so these trends should eventually turn and asset returns improve over time.

As prudent valuation-based investment managers we know how important it is to maintain a broadly diversified portfolio in uncertain conditions, and stay invested in growth assets like equities and listed property through the current low-return market cycle, to build a successful investment portfolio over the long term. We will continue to take advantage of the opportunities created to buy assets at attractive valuations where the risks are appropriate. ■