MARKET OBSERVATIONS

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With global growth cementing itself further during the third quarter (Q3) of the year, global equities continued their march higher, putting together the best run in 20 years: six consecutive quarters of gains have been propelled by a combination of accelerating global growth, still-easy monetary policy, subdued inflation and a weaker dollar (until recently). Although emerging market equities lost some steam in September, the MSCI All Country World Index, measuring 46 developed and emerging equity markets, reached record highs.

While growth prospects remained buoyant, data showing higher-than-expected August inflation across the US, UK and Eurozone prompted more hawkish comments from the respective central banks. This, in turn, led investors to expect interest rate tightening earlier than previously anticipated. While this sent developed market equities and currencies higher in September, it sparked sales of US and European bonds, as well as emerging market equities and currencies. In September, South African equities, bonds and the rand all pared their earlier quarterly gains.

ASSET CLASS	TOTAL RETURN: Q3 2017
Global equity – MSCI World (US$) (Developed)	5.0%
Global equity – MSCI Emerging Markets (US$)	8.0%
Global bonds – Barclays Global Agg Bond Index (US$)	1.8%
Global property – EPRA/NARIET Global Prop Index (US$)	1.3%
SA equity – FTSE/JSE All Share Index	8.9%
SA bonds – BEASSA All Bond Index	3.7%
SA listed property – SA Listed Property Index	5.7%
SA inflation-linked bonds – JSE CILI Index	1.4%
SA cash (STeFI Composite Index)	1.8%

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

GLOBAL GROWTH AND EQUITY GAINS CONTINUE APACE

In the US, Q2 GDP growth was revised significantly upward to 3.0% (q/q annualised) from its previous 2.6% estimate, on the back of higher household spending and business investment. At the same time, September saw: 1) a rise in US August CPI to 1.9% y/y (above expectations and closer to the Federal Reserve Bank's 2.0% target); 2) a clearly more hawkish tone from the Fed; and 3) speculation around the appointment of a more hawkish Fed Chairman to replace Janet Yellen – Kevin Warsh, a former Fed governor. These were among the primary reasons investors moved forward their expectations for the next 25bp interest rate hike to December. With rates anticipated to move higher sooner, US equities and the dollar became more attractive, prompting a move away from emerging market equities in particular at the end of the quarter.

At its September FOMC meeting, the Fed discounted damage to the economy from hurricanes Harvey, Irma and Maria as being of a short-term and relatively localized nature. Yellen's comments that it would be "imprudent" to keep monetary policy on hold until inflation reached the 2.0% target were widely interpreted as signaling another rate hike in December – 25bps was nearly fully priced in to the market. Yellen also announced details of the Fed's plans to unwind its $4.5 trillion balance sheet of securities accumulated during quantitative easing (QE), starting from October. However, the central bank still forecasts only three 25bp rate hikes in 2018, expecting ongoing steady growth and low unemployment to push inflation higher. US bond yields rose as a result of the Fed's somewhat more aggressive stance. At the same time, equities were supported, and US bonds hurt, by growing optimism over a growth boost from likely tax cuts under the Republican administration.

US stock markets again reached fresh record highs, but worries mounted over high valuations, with swings in sentiment towards tech stocks in particular. For Q3, the S&P 500 returned 4.5% and the Nasdaq 6.2% (but -0.1% in September). The Barclays Global Aggregate Bond Index (US$), a mixture of government and corporate bonds, returned 1.8% in the quarter. While US bonds were stronger for much of the period, they erased all of their gains in September as the likelihood of an earlier interest rate hike rose and data confirmed growing inflationary pressures. At quarter-end the 10-year UST yield was barely changed at 2.33% from 2.31% at the end of Q2. For US corporate bonds, investment-grade bond spreads narrowed slightly to 106bps over USTs, while high-yield spreads also narrowed somewhat.

In the Eurozone, the region's growth accelerated to 2.1% (q/q annualised) in Q2 from Q1's 1.9%, backed by a broad recovery in domestic demand from many euro-area countries, and helped by the European Central Bank (ECB)'s ongoing easy monetary policy. CPI at 1.5% in August was also higher than expected, due mainly to rising energy prices, while growth forecasts were revised further upward and the euro appreciated against the US dollar – the currency is 13% stronger against the greenback so far in 2017. Manufacturing PMI data for September in both France and Germany came in at the highest levels in six years. At its September meeting the ECB left interest rates on hold, while paving the way for a tapering of its quantitative easing programme. For the quarter, the Dow Jones Eurostoxx 50 returned 8.5%, while Germany's DAX 30 delivered 7.6% and the French CAC 40 7.8% (all in US$).

Meanwhile, the UK was growing at roughly half the pace of its EU neighbours, with the slow progress in negotiations over Brexit terms and rising uncertainty hampering investment. The weaker pound over the quarter continued to drive up the cost of imports and inflation: August CPI accelerated to 2.9% y/y, above the 2.8% expected. At its September policy meeting, the Bank of England said its concerns over inflation now outweighed those over Brexit-related risks to the economy, although it left its base interest rate unchanged. Investors now see the chances of an interest rate hike before year-end as much higher. The FTSE 100 returned 4.8% (in US$) over the quarter.

In Japan, Q2 GDP growth jumped to 4.0% (q/q annualised), far exceeding the 2.5% expected thanks to strong household consumption and business investment during the quarter. This marked six successive quarters of growth, the longest streak since 2006. However, inflation remained subdued at only 0.9% y/y in August, and excluding energy and food costs was flat. Investors are questioning the Bank of Japan's and Prime Minister Abe's aggressive four-year-long reflationary efforts, with growing calls to abandon the inflation target. Abe has called for an election on 22 October, which he is expected to win despite growing unpopularity. The Nikkei 225 Index returned 2.1% over the quarter (in US$).

In China, Q2 GDP growth surprised to the upside at 6.9% (q/q annualised), unchanged from Q1 and above 2017's official 6.5% growth target, with factory output boosted by improving global trade and higher domestic demand. The upcoming Communist party conference in October meant government and the central bank were focused on maintaining financial market stability, underpinning asset strength for the quarter. The equity market continued its remarkable performance with the MSCI China returning 14.8% in Q3: it has now delivered 43.4% for the year to 30 September. Notably, following Moody's downgrade in May, S&P downgraded the country's credit rating one notch to A+ from AA-, citing the "soaring debt burden". Although September manufacturing PMI rose to 52.4 from 51.7 in August, its fastest since 2012, analysts expect a small slowdown in GDP growth in the third quarter of 2017.

Other emerging market (EM) assets posted strong returns in Q3 as risk-hungry investors continued to seek out EM equities and bonds, although in September equity demand waned. Overall, the MSCI Emerging Markets Index returned 8.0% in US$ (but -0.4% in September). This compared to 5.0% from the MSCI World Index for developed markets. Among the larger EM equity markets in US$ terms for the quarter, Brazil's Bovespa was the strongest performer with a 23.3% total return, followed by the MSCI Russia (18.1%) and the MSCI China (14.8%). The poorest Q3 returns (in US$) came from the MSCI Turkey (0.4%) and the MSCI India (3.0%). The MSCI South Africa (in US$) produced 4.0%, for a 12.7% return year to date. In commodities, the price of Brent crude surged some 20.1% during the quarter to around $56.70 per barrel at quarter end, driven by mounting signs that the three-year market oversupply is finally easing on the back of production cuts by OPEC and other producers. Other commodity prices also moved higher in line with accelerating global growth and a weaker dollar towards the end of the period. Gold gained 3.1% largely on the back of North Korean tensions, and palladium rose 11.2%. Platinum, however, lost 1.5% on oversupply concerns. Among industrial metals, the bellwether copper gained 8.5%, zinc was up 16.4%, nickel increased 11.4%, lead rose 9.6% and aluminium was 8.7% higher.

SA RETURNS LIFTED BY BULLISH GLOBAL GROWTH SENTIMENT

South African equities notched up their best returns of the year so far in Q3 as the sluggish local economy was offset by strong global demand for emerging market assets, and higher commodity prices buoyed resources shares. Bonds and listed property, meanwhile, were underpinned by an improving interest rate and inflation outlook, as well as keen foreign demand.

A major local highlight for Q3 saw the economy emerge out of recession with Q2 GDP growth of 2.5% (q/q annualised). This was led by a rebound in agricultural production, while manufacturing production and household spending were also higher. However, fixed capital formation was down 2.6% during the quarter, reflecting the ongoing decline in investment this year. Low confidence, slow growth and political uncertainty continue to weigh on businesses despite relatively low capital costs and the positive global environment. In spite of the positive Q2 GDP data, several institutions further lowered their growth forecasts for SA, among them the World Bank (to 0.6% from 1.1% previously for 2017, 1.1% for 2018 and 1.7% for 2019).

On another negative note, a reported R13 billion shortfall in government revenue collections sparked concerns National Treasury would miss its annual budget deficit target, not only raising the spectre of higher taxes in a weak environment, but also increasing the likelihood of further credit rating downgrades. Meanwhile, although the SARB enacted a surprise 25bp rate cut in July – its first in five years – in September it left rates on hold; this despite August CPI coming in at 4.8% y/y, slightly higher than the 4.6% y/y recorded in July (on the back of higher energy prices) but within the SARB's 4-6% target range. The SARB cited growing upside risks to inflation arising from the weaker rand (in September), policy uncertainty, growing fiscal challenges and more possible downgrades.

The improving inflation and interest rate outlook helped drive SA nominal bond prices higher (and yields lower) as the BEASSA All Bond Index returned 3.7% for the quarter, while inflation-linked bonds (Composite ILB Index) produced a more muted 1.4%. Cash as measured by the STeFI Composite Index returned 1.8% and SA listed property delivered 5.7%. The FTSE/JSE All Share Index reached record highs in August before retreating in September, still posting an impressive 8.9% return for the quarter. Gains were led by a 17.7% return from Resources shares on the back of stronger commodity prices, while Industrials produced 7.4% and Financials delivered a 5.1% return. The rand, meanwhile, weakened fairly sharply in September along with many other emerging market currencies: for the quarter it was down 3.1% against a resurgent US dollar, 6.6% lower versus a rebounding pound sterling, and 6.9% weaker against a resilient euro.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

In our **global portfolios** we are underweight global bonds and global cash, and overweight global equities. In our higher return-targeting multi-asset funds we continue to be very near our maximum permitted 25% offshore weighting.

In **global fixed income**, despite recent rises in government bond yields, they continue to trade at very low levels historically. They remain at risk to rising interest rates in the US and UK, and increasingly in Europe as well, particularly should we see higher-than-expected inflation as we did in September. We continue to be underweight global sovereign bonds and underweight duration to reduce interest rate risk. After having used our global cash holdings to buy more investment-grade

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

US and European corporate bonds in the previous quarter, we are now underweight foreign cash, and overweight foreign corporate bonds. We hold little, if any, high yield corporate exposure.

For **global equities**, despite good price gains over the past six quarters and record stock market highs in some countries, the MSCI All Country World Index remains within its "fair value" range with a 12-month forward P/E ratio of 16X at the end of September from 15.8X at the beginning of the quarter – this due to strong corporate earnings growth over the period. Against the backdrop of broad global growth, we see better value in many regions compared to South Africa, which is why we prefer global equity to South African equity in our Inflation Plus Fund, given its 40% equity exposure limit. Our current equity positioning reflects a preference for cheaper areas where fundamentals remain encouraging including Europe, Japan, the global financial sector and smaller holdings in selected emerging markets such as Korea, Turkey and Indonesia, compared to global indices and the broad US market. More specifically, in our Inflation Plus Fund the top overweight markets comprise South Korea, Turkey and the UK, and top underweights are the US, Canada and France given their relative high valuations.

In Korea, for example, after five years of disappointing corporate earnings growth (and downgraded expectations), earnings growth has been surprising to the upside over the past 12 months: while the KOSPI has returned 20.4% in US dollars in the past year, its 12-month forward P/E ratio has fallen from 10.2X to 9.5X to end September thanks to rapid earnings growth. Growth contributors include large tech conglomerates like Samsung which are participating in the global "tech wave" that has sent the US Nasdaq index to record highs.

South African equities became more expensive in Q3, with the FTSE/JSE ALSI 12-month forward P/E rising to 14.6X at quarter-end from around 14X in Q2. Although local equities are still attractively priced in their "fair value" range, we see better opportunities offshore in the context of the Inflation Plus Fund's 40% total equity exposure limit. Consequently we moved slightly underweight SA equity in the Prudential Inflation Plus Fund during the quarter.

Prudential's equity holdings are similar to the previous quarter. Our portfolios are overweight stocks with solid foreign currency earnings like British American Tobacco, Capital & Counties, Anglo American and Exxaro, as well as international container transport group Trencor, which has upside to improving global trade trends. We also hold non-mining resources stocks like Sappi. We remain overweight in well-priced and high-yielding Financials including Old Mutual, Investec, Standard Bank and Barclays Group Africa. We have 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 have pared our holdings to a neutral position from overweight previously, as fundamentals for the sector have deteriorated somewhat in the recent period. Although benefitting from the improved inflation and interest rate outlook, deteriorating medium-term economic growth prospects in South Africa have increased the risks to the sector somewhat. We are comfortable maintaining a neutral position in listed property, which we believe is trading around its fair value with a forward distribution yield of 7.4% at quarter-end.

In **SA nominal bonds**, we remain overweight despite the fall in yields over the quarter (although September saw a partial retracement of this drop). We continue to prefer longer-dated government bonds due to the more attractive yields on offer. We are comfortable with the compensation provided for the extra risk involved.

Inflation-linked bonds saw their valuation fall to attractive levels relative to nominal bonds over the quarter (amid the improved inflation outlook). We took advantage of this to buy more ILBs, moving from an underweight position in our multi-asset portfolios to a neutral position. ■