MARKET OBSERVATIONS

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PRUDENTIAL
INVESTMENT MANAGERS

After further strong gains in January, the 15-month global equity bull market came to an abrupt end in February in the form of a sharp market correction. This was brought on by worries over an accelerated pace of US interest rate hikes as the US economic expansion and inflation gathered pace, and later, increasing fears of a global trade war provoked by unpredictable Trump policies and concerns over stricter regulation of the global tech giants like Amazon and Facebook. Although much of the losses were retraced, volatility became a key market feature in February and March. Developed equity markets ended the quarter returning -1.3%, while emerging markets were in the black with a 1.4% total return.

Global bonds, meanwhile, managed to deliver 1.4% over the quarter, helped by gains in European bonds and a weaker US dollar, while US Treasuries were moderately softer in the wake of investor jitters over inflation and the US Federal Reserve's somewhat more hawkish tone under new Fed Chairman Jerome Powell. The Fed met market expectations by hiking interest rates 25bps at its March meeting, and also added extra rate hikes to its expectations for 2019-2020, while confirming its view of a more robust US economy (lifting its forecasts for 2018 GDP growth to 2.7% from 2.5% previously). However, it did keep its 2018 rate predictions unchanged at two further 25bp increases. The yield on the benchmark 10-year UST rose to around 2.8% from 2.4% at the beginning of the quarter. Global property also lost ground, producing -5.5% as it was also dented by worries over rising inflation and interest rates.

ASSET CLASS	TOTAL RETURN: Q1 2018
Global equity – MSCI World (US$) (Developed)	-1.3%
Global equity – MSCI Emerging Markets (US$)	1.4%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	1.4%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$)	-5.5%
SA equity – FTSE/JSE All Share Index	-6.0%
SA bonds – BEASSA All Bond Index	8.1%
SA listed property – SA Listed Property Index	-19.6%
SA inflation-linked bonds – JSE CILI Index	4.1%
SA cash (STeFI Composite Index)	1.8%

Source: Prudential, Deutsche Securities, data to 31 March 2018

Global economic fundamentals remained supportive, with data broadly stronger. US jobless claims fell to their lowest level in 45 years and unemployment dropped to 4.1%, while February CPI crept up to 2.2% y/y from 2.1% y/y. In Europe, views of an ultra-slow exit by the European Central Bank of its easy monetary policy were reinforced amid accelerating growth but very subdued inflation (at only 1.1% y/y in February). In the UK, meanwhile, prospects brightened thanks to a long-awaited agreement with the EU on a Brexit transition deal and parts of the final exit treaty.

The Japanese economy slowed in Q4 2017 to 0.1% (q/q, saa), but still notched up an eighth consecutive quarter of growth, the best since 1989. In China, GDP growth was reported at a stronger-than-expected 6.9% for 2017, better than the government's annual target of 6.5% and up from 6.7% in 2016. The government has kept its target unchanged for 2018, while economists expect a slowdown to around 6.5% for the year, as lending tightens and investment slows as the government's efforts to lower financial risks take further effect.

SA SEES IMPROVING CONDITIONS AND SENTIMENT

For South African investors, it was a mixed quarter as December's positive sentiment continued into the new year and encouraging developments underpinned interest-rate markets, but equities were hurt by the global correction and listed property sold off sharply in the wake of alleged fraudulent activity at the Resilient group of four property companies. Positive offshore returns were more than offset by the stronger rand, which continued to firm in the aftermath of the "Ramaphosa rally".

Notable positive developments included the favourable reception by global investors and the credit ratings agencies of February's 2018/19 Budget and the new President's cabinet appointments, and some progress towards improving state-owned enterprise (SOE) corporate governance. Another encouraging milestone came in late March when Moody's decided not to downgrade South Africa's sovereign local currency rating to junk status, while also upgrading its outlook to stable from negative and lifting SA's 2018 GDP growth forecast to 2.0% from 1.0%. S&P Global and other international institutions also lifted their growth expectations to around 2.0%. This brighter outlook benefitted partly from Stats SA's February announcement of 3.1% (q/q saa) GDP growth in Q4 2017– much higher than the 1.5% market consensus – as well as upward revisions to the previous four quarters of GDP data, which surprisingly confirmed that the country had not experienced a recession in 2017. While the growth upgrade was welcomed, economists and investors still worry that much more needs to be done to accelerate growth to a meaningful rate that will create jobs.

Lower-than-expected inflation (at 4.0% y/y in February) and the SARB's 25bp rate cut in March (which had largely been priced into the market) also supported bonds for the quarter, helping produce a remarkable 8.1% return from the BEASSA All Bond Index and 4.1% from inflation-linked bonds. The yield on the benchmark 10-year SA government bond fell to 8.0% at quarter-end, from 8.6% at the start of January. The forward rate agreement (FRA) market is pricing in an almost-even chance of a further 25bp rate cut in the next six months. The rand gained 3.8% against the US dollar for the three months, 1.3% versus the euro, and was flat against a rebounding pound sterling. This was despite some concerns over the implications of the ANC's potential wider use of land expropriation without compensation.

In contrast, local equities could not escape the global downturn, with the FTSE/JSE All Share Index (ALSI) returning -6.0% for the quarter. The market was partly dragged down by weakness in heavyweight

Naspers (losing 16.2% during the quarter and with a 17% weighting in the ALSI), but was also caused by a shocking -19.6% return from the listed property sector. This arose from persistent worries over alleged fraudulent practices at the Resilient group of four property companies, which drove their share prices down by over 50% for the quarter. Industrials as a sector delivered -8.0% for the quarter, Financials produced -3.6% and the Resources Top 10 Index returned -2.7%.

In commodities, the price of Brent crude gained 5.1% during the three months to trade at around US$70 per barrel from $66.50 at the start of the year, as OPEC producers successfully continued their restrictions and some new geopolitical supply constraints somewhat outweighed the rising supply from US shale. The oil price has now risen 33% in the last 12 months. Meanwhile, gold gained 1.7% as investors became somewhat more risk-averse, and platinum was nearly unchanged. Industrial metals were mixed: aluminium fell 7.7% and copper 7.3%, but nickel gained 4.3% and tin was up 5.4%.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

In our **global portfolios** we remain underweight global bonds and global cash, and overweight global equities, with the latter offering attractive valuations in most markets and much higher potential returns over the medium term. As valuations fell over the quarter, we added moderately to our position. Our offshore exposure is around 25% in our higher return-targeting multi-asset funds.

In **global fixed income**, as in previous quarters, despite rising government bond yields (including this quarter's sell-off in the US), they continue to trade at very low yields (and high valuations) historically, and remain at risk to rising interest rates in the US and UK, and increasingly in Europe as well. We continue to be underweight global sovereign bonds and underweight duration to reduce interest rate risk, preferring to hold investment-grade US and European corporate bonds.

For **global equities**, the correction experienced in many markets made valuations more attractive in most countries, with global markets roughly 10% cheap on a broad basis at quarter-end. However, this masks individual market differences – for example, the US S&P 500 is trading close to its long-term fair value, while South Korea is about 30% cheap. In line with our active management approach, we lowered the global equity exposure in our house view portfolios in January as prices ran ahead of fundamentals, only to raise it again in February after the sharp market correction, so the net result was to return to the same overweight position as in the previous quarter. The outlook for corporate earnings growth remains positive against the backdrop of upside surprises to broad global growth. At the same time, we see better value in many regions compared to South Africa, which is why we continue to be overweight global equities in our house view portfolios. SA equity earnings have been depressed relative to their long-term trends, particularly in Resources and Financials, and have the potential to improve, assisted by a favourable global tailwind. Therefore, where mandates allow we are also overweight local equities.

Our current global equity positioning reflects a preference for cheaper areas where fundamentals are encouraging but valuations remain attractive, including Europe, Japan, the global financial sector and smaller holdings in selected emerging markets such as South Korea, Turkey and Indonesia. These positions are financed primarily by an underweight in global bonds, as well as US equities to a lesser extent.

South African equities moved to more attractive valuations during the quarter, to a level somewhat cheaper than their long-term fair value: the FTSE/JSE ALSI 12-month forward P/E fell to around 14.1X at quarter-end from around 15.4X in Q4. At current levels the market is priced to deliver attractive medium-term returns. As such we are overweight local equity in our higher-equity multi-asset portfolios like the Prudential Balanced Fund. However, in the context of the low-equity Inflation Plus Fund's 40% total equity exposure limit, we see better opportunities offshore. Consequently we continue to be slightly underweight SA equities in the Prudential Inflation Plus Fund and overweight global equities, with total equity exposure close to the maximum allowed.

Our individual equity holdings are similar to the previous quarter. We sold all of our small (underweight) Steinhoff holdings in December, cushioning our portfolios from further losses in 2018. Equally, we were underweight the Resilient group of four companies and sold down those holdings across our client portfolios. Currently, our portfolios hold stocks with exposure to strong global growth like Naspers, British American Tobacco, Richemont, Anglo American and BHP Billiton – the latter two representing lower risk to commodity price weakness given their diversification. We also hold non-mining resources stocks like Sappi, as well as international container transport group Trencor, which has upside to improving global trade trends. During the quarter we trimmed our long-standing overweight position in Financials in our house view portfolios, but still hold overweight exposure to financial shares including Old Mutual, Investec, Standard Bank and First Rand, which have offered relatively high dividend yields that should benefit if SA economic growth continues to improve. Offsetting this overweight position, we have chosen to remain underweight in retail stocks in our house view portfolios given the challenging local consumer environment.

In **SA listed property**, we continue to have a neutral exposure in our multi-asset portfolios. Even though the sector has fallen sharply in value, this is due to the effect of the Resilient group's share prices, whereas the rest of the sector has experienced rising share prices over the quarter (up approximately 4.0%). Excluding the four Resilient companies, we believe the asset class continues to trade around its fair value range. It is priced to deliver attractive low double-digit returns over the medium term. Regarding Resilient group, we remain underweight the four companies in aggregate in our portfolios - we await further clarity on their planned measures to improve governance and we have engaged with the companies with some suggestions in this regard.

In **SA nominal bonds**, following the quarter's rally, valuations are at fair levels. Consequently, we have reduced our allocation to bonds, but remain modestly overweight. We continue to prefer longer-dated government bonds due to the more attractive yields on offer, and are comfortable with the compensation bonds offer. We take comfort from the integrity of the SA Reserve Bank and their stated goal of anchoring inflation expectations around 4.5%, the mid-point of their targeted 3.0-6.0% band. Downside risks have eased somewhat in the wake of the quarter's positive developments, although the ratings agencies have warned that the government and businesses have not yet done enough to eliminate the prospects of further credit rating downgrades.

For **inflation-linked bonds,** we continue to be neutrally positioned in this asset class. Real yields are attractive, even after this quarter's rally, but we still believe that better value exists elsewhere – in long-dated nominal bonds and equities. Going forward, the relatively low inflation environment will depress nominal returns from these instruments. ■

ASSET CLASS PREFERENCES: 5-YEAR PERIOD

Prudential House View**

ASSET CLASS	POSITIONING 31 DEC 2017	POSITIONING 31 MAR 2018
Foreign equity	Overweight	Overweight
Foreign govt bonds	Underweight	Underweight
Foreign corporate bonds	Overweight	Overweight
Foreign cash	Underweight	Underweight
SA equity	Overweight	Overweight
SA listed property	Neutral	Neutral
SA bonds (govt and corp)	Overweight	Overweight
SA inflation-linked bonds	Neutral	Neutral
SA cash	Underweight	Underweight

**These preferences are implemented where all fund mandates allow. Positioning will differ in portfolios with constraints in their mandates. For example, the Prudential Inflation Plus Fund is currently underweight SA equities due to its 40% total equity exposure limit, where we prefer to hold more offshore equities at the expense of SA equities. However, the Prudential Balanced Fund is overweight SA equities as its higher equity limit allows us to be overweight both global and SA equities.