MARKET OBSERVATIONS

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QUARTERLY MARKET COMMENTARY

QUARTER 2 2018

It was another volatile quarter for global financial markets, hit by growing fears of a global trade war as the US, EU and China (plus others) ratcheted up tariff threats. This combined with some weaker-than-expected economic data, rising US interest rates and continuing risk-averse sentiment among global investors to weigh on both bond and equity markets, with emerging markets particularly hard-hit by asset sales. Developed equity markets ended the quarter returning 1.7% in US dollars, while emerging equity markets delivered -8.0%. In South Africa, the previous quarter's optimism over the election of Cyril Ramaphosa appeared to be wearing thin already on the back of a string of disappointing local economic news and a much weaker rand.

Global bonds lost 2.8% during the quarter, led lower by rising US interest rates and accelerating inflationary pressures. Confronted with a robust economy and inflation forecasts starting to overshoot its 2% inflation target, the US Federal Reserve took a hawkish stance, hiking interest rates by 25bps at its June FOMC meeting as widely expected, while also adding an extra 25bp hike to its 2018 forecast. This saw the yield on the benchmark 10-year US Treasury bond rise to 3% before retracing to end the quarter around 2.9%, barely above its end Q1 level. Shorter-dated bond yields rose even more, such that the difference between the 2-year yield (at about 2.5%) and the 10-year yield narrowed to around 40bps, its lowest since the global financial crisis. A negative differential (when shorter-dated bond yields are higher than longer-dated bonds, such that the yield curve is inverted) is a leading indicator of a global recession, a factor that captured the attention of many investors.

ASSET CLASS	TOTAL RETURN: Q2 2018
Global equity – MSCI World (US$) (Developed)	1.7%
Global equity – MSCI Emerging Markets (US$)	-8.0%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	-2.8%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$)	5.1%
SA equity – FTSE/JSE All Share Index	4.5%
SA bonds – BEASSA All Bond Index	-3.8%
SA listed property – SA Listed Property Index	-2.2%
SA inflation-linked bonds – JSE CILI Index	-4.5%
SA cash (STeFI Composite Index)	1.8%

Source: Prudential, Deutsche Securities, data to 30 June 2018

This supported a key theme for the quarter - the spreading view that global economic growth might slow sooner than expected. US Q1 GDP growth was revised downward to 2.2% (q/q annualised) versus the 2.3% expected. At the same time, in the Eurozone, Q1 GDP growth slowed to 2.5% (q/q annualised) from 2.8%, with the slowdown most visible in key economies Germany and France, and attributed to extreme winter weather, strikes in France and other temporary factors. German business confidence also continued to slump in Q2.

However, the US economy remained very robust, with unemployment at 3.8% in May - its lowest level since 2000 – and the latest manufacturing and non-manufacturing data still very elevated on an historic basis. The latest container volume survey (a proxy for measuring world trade) also picked up after taking a dip earlier in the year, showing that fears could possibly be overdone. And even amid concerns about US trade policy, the Fed raised its 2018 GDP forecast to 2.8% from 2.7% previously.

The European Central Bank (ECB) kept its benchmark interest rate unchanged at its June meeting, as had been expected, and also ruled out prospects of a rate hike until mid-2019 at the earliest. However, it did vote to end its bond-buying programme at the end of the year, discounting the Eurozone's slower growth as a temporary phenomenon. Its forecasts call for around 2.0% growth for 2018. Meanwhile, UK growth was reported at only 1.2% (q/q annualised) for Q1, and the Bank of England kept its rates on hold at its May meeting as inflation steadied and the pound strengthened somewhat – the central bank is reluctant to hike rates while Brexit uncertainty remains high.

After two years of growth, the Japanese economy contracted by 0.6% (q/q annualised) in Q1 2018, attributed to slower consumer spending on the back of harsh winter weather and higher food prices. However, the Bank of Japan's expansionary monetary policy remains in place, and real consumer incomes are rising, underpinning expectations of renewed growth for Q2. In China, Q1 GDP growth came in at 6.8% (q/q annualised), steady from the previous quarter and in line with expectations. There were growing signs of a slowdown in Q2, though, in the form of disappointing May data for industrial output, retail sales and investment. Compounded by growing concerns that US tariffs could considerably dent growth prospects (some forecasts point to a decline of up to 0.5% of GDP), sentiment became more negative, helping send Chinese stocks weaker.

Emerging markets in general experienced large capital outflows during the quarter from both bond and equity markets. Brazil and Turkey were among the largest losers due to particularly adverse local conditions: Brazil's Bovespa lost 26.5% for the three months, while the MSCI Turkey lost 25.7% (both in US$). South Korea's KOSPI returned -9.2% and the MSCI South Africa delivered -11.7% (also in US$).

In commodities, the price of Brent crude gained 13.1% during the three months to trade at over US$77 per barrel at the end of June, with supply constraints offsetting an OPEC-Russia agreement to increase their production targets somewhat. Commodity prices were broadly lower as markets reflected the rising threat of weaker global growth and trade: gold lost 5.5%, platinum was down 8.5% and palladium fell 1.8%. Among industrial metals, zinc lost 11.5%, tin was down 6.4% and copper lost 0.8%, while nickel gained 11.9% and aluminium was up 8.4%.

SA HIT BY POOR GLOBAL SENTIMENT AND LOCAL DATA

In South Africa it was a tough quarter for investors, as the rand, bonds and equities all came under selling pressure amid the risk-averse global sentiment, as well as from largely unfavourable domestic data. The land reform debate also added to uncertainty. Resources shares were a notable exception, helped by the stronger US dollar.

South Africa's Q1 GDP growth shocked the market with a sharp contraction of -2.2% (q/q annualised), well below the +1.5% expected, as agricultural, mining and manufacturing production all shrank. This, in turn, raised concerns over the government's longer-term ability to adhere to its budget. The much weaker rand (losing 15.2% versus the US dollar, 9.8% against the euro and 8.9% versus the pound sterling), tax increases (notably VAT and the fuel levy) and rising petrol price also brought up the spectre of higher inflation to come, denting business confidence.

Taking note of the building inflationary pressures, but the headwinds facing the local economy as well, the SA Reserve Bank (SARB) kept interest rates on hold at its May Monetary Policy Committee meeting, as expected. Its statement sounded more hawkish than previous meetings, however. The SARB expects the rand to remain volatile amid outflows from emerging markets generally as US interest rates continue to rise, representing a significant upward risk to SA inflation in the months ahead. Taking the SARB's cue, the market no longer expects the central bank to lower interest rates this year.

Among positive developments for the quarter, the Ramaphosa government made progress on reforms - Public Enterprises Minister Pravin Gordhan took several steps forward in cleaning up state-owned enterprises, appointing new boards and new management at several of the troubled entities. The minimum wage came into effect, and secret ballots for strikes were also introduced among the unions. In a vote of confidence, all three global ratings agencies maintained their credit ratings for South Africa despite the weaker growth, although cautioned that much reform still needed to take place.

Despite these positives, local bonds experienced more than R60 billion in net outflows during May and June, overwhelming the R25 billion in inflows in Q1. The BEASSA All Bond Index returned -3.8% for the quarter, while the yield on the benchmark 10-year SA government bond rose to just under 9.0% at quarter-end, from 8.0% at the start of April, a significant 100bp move on the back of the broader risk-averse sentiment. Meanwhile, inflation-linked bonds were even weaker, delivering -4.5%, while cash as measured by the STeFI Composite Index produced 1.8%. For local equities, the FTSE/JSE All Share index (ALSI) managed to return 4.5% over the three months, propped up almost entirely by Resources stocks, which delivered 21.7% on the back of the stronger US dollar and still-expanding global growth. For 2018 so far, the ALSI remains in negative territory with a -1.7% return. Industrials managed to deliver 4.0%, helped by large global shares, but Financials produced -6.0%, giving up their gains following Rampahosa's election, due largely to their more localised earnings. Property shares returned -2.2% amid the deteriorating inflation and growth outlook.

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 many markets, particularly when viewed relative to bonds, and much higher potential returns over the medium term. Our offshore exposure remains at around 25% in our higher return-targeting multi-asset funds.

In **global fixed income**, as in previous quarters, despite rising government bond yields, 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**, gains in developed markets over the quarter lifted valuations slightly, but these are still modestly cheap on a broad basis, having started the quarter at about 10% cheap. However, valuation disparities between developed and emerging markets widened in Q2, with markets like the Nasdaq returning 7.3% and S&P 500 3.4%, while many emerging markets were punished, making many materially cheap. In line with our active management approach, during the quarter we pared our overweight equity position modestly as developed markets became more expensive. We continue to prefer the global banking sector, which has underperformed the broader market, as well as certain developed markets where equities are undervalued but fundamentals for earnings growth remain positive, including Germany and Japan, and selected emerging markets such as South Korea, Indonesia, Turkey and China. These overweight positions are financed primarily by an underweight in global bonds, as well as US equities to a lesser extent. As in the previous quarter, we still 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, and therefore have the potential to improve if the current government has even modest success in lifting the rate of potential growth.

South African equities moved to more attractive valuations during the quarter: the FTSE/JSE ALSI 12-month forward P/E fell to around 13.7X at quarter-end from around 14.1X in Q1. This is slightly cheaper than our long-term fair value estimate of 14.5X. At current levels the market is priced to deliver attractive medium-term returns. As such we remain overweight local equity in our higher-equity multi-asset portfolios like the Prudential Balanced Fund and where mandates allow. 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.

During the quarter we took profits and sold down our overweight Resources position following the sector's 20%+ gains in recent months. However, our portfolios still hold resources stocks with exposure to global growth like Anglo American, BHP Billiton, Exxaro, Sasol and Sappi, as well as global giants such as Naspers and British American Tobacco. We have also maintained our overweight exposure to financial shares including Old Mutual, Standard Bank and Barclays Group Africa, which have offered attractive valuations with relatively high dividend yields. Meanwhile, we are still underweight retail stocks in our house view portfolios, but do hold select overweights in Pick 'n Pay and Foschini.

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 still largely due to the effect of the Resilient group's share prices. Excluding the four Resilient companies, the asset class is trading modestly above its fair value range. It is priced to deliver attractive low double-digit returns over the medium term, but we also remain concerned about the risks in the sector, including slow growth and rising inflationary pressures.

In **SA nominal bonds**, following the quarter's sizeable rise in yields, valuations became more attractive compared to their longer-term average and we see them as cheap. Consequently, we added longer-dated bonds to our modestly overweight position with yields at levels over 9.0%. This was funded from cash holdings. We continue to prefer longer-dated government bonds due to the more attractive yields on offer, and are comfortable with the compensation bonds offer given the risk involved. 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 given the government reforms underway and reinstated fiscal probity, but inflation remains a threat and the SA 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, especially after this quarter's weakness, but we still believe that better value exists elsewhere – in long-dated nominal bonds and equities. ■

ASSET CLASS PREFERENCES: 5-YEAR PERIOD

Prudential House View**

ASSET CLASS	POSITIONING 31 MAR 2018	POSITIONING 30 JUN 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

**Our house view preferences are implemented where all fund mandates allow. Positioning will differ in portfolios with constraints in their mandates.