MARKET OBSERVATIONS

BY MICHAEL MOYLE, HEAD OF MULTI-ASSET

PRUDENTIAL
INVESTMENT MANAGERS

QUARTERLY MARKET COMMENTARY | QUARTER 3 2018

The third quarter of 2018 saw a sharp escalation in the trade war between the US and China, in addition to still-strong US growth, rising US interest rates, a strengthening US dollar and financial crises in Turkey and Argentina. The result: developed equity markets (as measured by the MSCI World Index) returned 5.1% in US dollars, while emerging equity markets (as measured by the MSCI Emerging Markets) delivered -1.1% in US dollars due to heightened investor risk aversion. In South Africa, negative local economic news weighed on financial markets, as did poor global sentiment, with local bonds losing ground but the weaker rand underpinning rand hedges and Resource shares on the JSE.

Global bonds lost 0.9% (in US$) during the quarter, largely on the back of rising US interest rates. More bond issuance also weighed on the US Treasury bond market as the Trump tax cuts expanded the budget deficit. The yield on the benchmark 10-year US Treasury bond ended the quarter at 3.05% from 2.9% at the end of Q2. As widely expected, the US Federal Reserve hiked interest rates by 25bps at its September FOMC meeting, while also upping its 2018 growth outlook to 3.1%. The Fed also removed its policy description as "accommodative", signalling that it considers its benchmark target range, now at 2.0-2.25%, to be close to a "neutral" level, meaning it is no longer supportive of economic expansion, but neither is it a constraint. The Fed still foresees another 25bp hike this year (consensus in December) and three more 25bp hikes through 2019, as well as one in 2020. Fed Chairman Jerome Powell's post-FOMC comments that he didn't expect a near-term recession further boosted the US dollar and US stocks late in the quarter.

ASSET CLASS	TOTAL RETURN: Q3 2018
SA equity – FTSE/JSE All Share Index	-2.2%
SA bonds – BEASSA All Bond Index	0.8%
SA listed property – SA Listed Property Index	-1.0%
SA inflation-linked bonds – JSE CILI Index	0.5%
SA cash (STeFI Composite Index)	1.7%
Global equity – MSCI World (US$) (Developed)	5.1%
Global equity – MSCI Emerging Markets (US$)	-1.1%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	-0.9%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$)	-0.3%

Source: Prudential, Bloomberg, data to 30 September 2018

The US economy picked up steam, recording 2.9% GDP growth in Q2 (q/q annualised) stoked by Trump's tax cuts as consumer and business spending rose. Inflation remained under check as August CPI came in at 2.7% y/y from 2.9% in July, slower than forecast as rising energy costs were offset by declines in healthcare and apparel costs. The Fed's key core Personal Consumption Expenditure (PCE) measure for August was reported at 2.0%, hitting the target for the third time in 2018. Equity markets reflected the bullish sentiment as the S&P 500 returned 7.7%, the Nasdaq 8.6% and Dow Jones Industrial 30 Index 9.6% (all in US$), although September returns were much more muted due largely to rising trade tensions.

In contrast with the US, Eurozone growth slowed to 2.2% (q/q annualised) in Q2 from 2.5% previously, impacted by higher fuel prices and slower consumer spending, while August CPI decelerated to 2.0% y/y from 2.1% in July, softer than expected. The European Central Bank (ECB) kept its benchmark interest rate unchanged at 0% at its 13 September meeting, as had been expected, and officials said rates should remain at record lows for at least the next nine months. However, it also began scaling back its bond-buying programme. The Dow Jones Eurostoxx 50 returned -0.2% (in US$) for the quarter. Meanwhile, UK growth picked up slightly to 1.3% (q/q annualised) from 1.2% in the previous quarter, and the Bank of England surprised by hiking its interest rate by 25bps in August - the first time since the Financial Crisis. This was on the back of a strong labour market and credit growth, and despite worsening uncertainty over the outcome of Brexit as the government faces heightened internal party conflict and a renewed stalemate with the EU. The UK's FTSE 100 Index returned -1.8% (in US$) for the quarter.

After contracting by a revised 0.9% (q/q annualised) in Q1 2018, the Japanese economy rebounded to 1.9% growth in Q2, beating expectations of 1.4%. Apart from some once-off factors dampening Q1 growth, the rebound was attributed to a pickup in consumer spending amid a tight labour market and rising real incomes. However, the expansion is forecast to lose steam gradually as Japan's export-led economy is impacted by worsening global trade conditions, despite the central bank's supportive policies. The Nikkei 225 Index returned 6.3% (in US$) in Q3, reaching 27-year highs. In China, Q2 GDP growth came in at 6.7% (q/q annualised), as expected, slightly down on the 6.8% reported for Q1 due to slower industrial output and business fixed investment. Business confidence is being hit by growing concerns over the widening impact of US tariffs on Chinese exports, the full extent of which is set to be felt later in the year and is likely to exacerbate the slowdown. Chinese stocks were weaker as a consequence.

Emerging markets (EMs) in general experienced capital outflows during the quarter, with bonds hit particularly hard. Financial crises in Turkey and Argentina in late August and early September worsened already-poor investor sentiment, with the contagion effect spreading across most EMs. For the quarter the MSCI Turkey lost 20.5% (in US$), despite returning 20.6% in September, and the central bank was forced to hike interest rates by nearly 7.0% to 24% to protect a plunging lira. The MSCI China returned -7.4% and the MSCI South Africa delivered -7.2%, while MSCI Russia returned 6.6% and Brazil's Bovespa 5.0% (all in US$).

The price of Brent crude oil rose to a four-year high of US$82.55 per barrel and ended the quarter at US$81.92, up about 4.1% due to impending supply sanctions on Iran, as well as a late-September agreement by oil producers not to raise production levels. Looking at other commodities, gold was weaker on the back of the stronger US dollar, losing 4.9% for the quarter, while industrial metals prices also lost ground across the board.

MORE POOR CONDITIONS FOR SA

In South Africa, Q3 2018 was another difficult quarter for investors, as the rand, bonds and equities all came under selling pressure from the risk-averse global sentiment, as well as a further broad deterioration in the economy. The land expropriation debate also continued to exacerbate uncertainty. The rand was exceptionally volatile during the quarter, hitting its worst level of R15.69 to the US dollar on 5 September amid the strong sell-off in EM currencies and assets, and exacerbated by President Trump's exaggerated tweet about land seizures and white farmer killings. The local currency did recover somewhat to end the quarter at around R14.14 per US$, some 3.2%

weaker over the three months. It deteriorated 2.7% against the euro and ended 1.9% weaker versus the UK pound sterling over the quarter.

Headlining the disappointing data, South Africa's Q2 GDP data shocked the market with a contraction of -0.7% (q/q annualised), coming on the heels of a revised -2.6% in Q1 and putting the economy into a technical recession. This was well below the consensus forecast of 0.5% growth and was due primarily to a sharp fall in agricultural production, although household spending also suffered, particularly that on durable goods as consumer budgets came under pressure. The GDP contraction, in turn, sparked concerns over the government's longer-term fiscal policy and raised the spectre of further credit rating downgrades. Moody's, however, said the prospects of it changing its investment-grade sovereign rating in the next eight months were low, although it did halve its 2018 growth estimate to only 0.7%.

In a close vote at its September Monetary Policy Committee meeting, the SA Reserve Bank (SARB) kept interest rates on hold, as expected. While mindful of the poor state of the economy, it was more hawkish in tone, noting that inflation risks had risen due to rand depreciation and the higher oil price, as well as ongoing negative sentiment toward emerging markets. Governor Lesetja Kganyago said the Bank's current projections implied that five interest rate hikes of 25bps each would be necessary through 2020 to keep inflation within the 3-6% inflation target band. Although August CPI slowed to 4.9% y/y from 5.1% in July, economists expect it to rise closer to 6% towards year-end as second-round inflation effects take hold.

Among positive developments for the quarter, in an effort to help restore business and consumer confidence President Ramaphosa unveiled plans to re-prioritise government spending to help boost the ailing economy. These were largely greeted favourably, although with some scepticism around implementation. The President also made headway with attracting foreign investment totalling some US$35.5 billion from China and other countries, including US$2.5 billion for struggling Eskom. Some progress toward a constructive policy in the mining sector also came in the form of the retraction of the controversial Minerals and Petroleum Resources and Development Act (MPRD), which had alarmed investors. In addition, the government took steps in uncovering more details on corruption across several government departments with the start of the State Capture Inquiry on 20 August.

For the quarter, the BEASSA All Bond Index returned 0.8% - the yield on the benchmark R186 SA government bond barely moved, ending the quarter at around 9.0% from 9.1% at the beginning of the quarter. However, this masked substantial volatility as the benchmark yield traded as low as 8.57% and as high as 9.25% over the three months. Meanwhile, inflation-linked bonds delivered 0.5%, and cash as measured by the STeFI Composite Index produced 1.7%. For local equities, the FTSE/JSE All Share index (ALSI) returned -2.2% over the three months, led lower by Industrial counters with a -7.8% return (impacted by a decline in Naspers). Financials defied the lower-growth, weaker rand environment with a return of 2.8% and Resources were again the star performers, delivering 5.2%. Listed property produced -1.0% as the inflation and growth outlooks further deteriorated. For 2018 so far, the ALSI remains in negative territory with a -3.8% return.

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 total offshore exposure remains at around 25% in our higher return-targeting multi-asset funds. During the quarter we took advantage of the rand's weakness to hedge some of our portfolios' US dollar exposure.

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 globally. We remain 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 the US pushed valuations to higher levels there as we maintained our underweight in that market. Other developed markets like Germany and Japan remained broadly attractive, however, and valuation disparities between developed and emerging markets (EMs) widened further in Q3. Broad EM selling made many even more attractive compared to markets like the US. 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 and China. These overweight positions are financed primarily by an underweight in global bonds, as well as US equities to a lesser extent. Many regions offer better value than the South African equity market, 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 cheaper during the quarter: the FTSE/JSE ALSI 12-month forward P/E fell to around 12.8X at quarter-end from around 13.7X in Q2, below our long-term fair value estimate of 14.5X. At current levels the market is priced to deliver attractive medium-term returns.

As such, in keeping with our active management approach we added to our overweight position in SA equities during the quarter 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 still see better opportunities offshore. Consequently we did not add to equity holdings in that portfolio, remaining slightly underweight SA equities and overweight global equities.

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, given the pressure under which local consumers find themselves, but do hold a select overweight in Pick 'n Pay, having sold down our Foschini exposure during the quarter.

SA listed property became marginally cheaper over the quarter, but we continue to have a neutral exposure in our multi-asset portfolios. Even though the overall sector is priced to deliver attractive low double-digit returns over the medium term, we remain concerned about the risks to the sector, including slow growth and rising inflationary pressures.

In **SA nominal bonds**, despite volatility there was little change in valuations from the start and end of the quarter, and remained cheap compared to their longer-term average. Consequently, we maintained our overweight position in this asset class. 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. However, inflation remains a threat and the SA government and businesses have not yet done enough to eliminate the prospects of further credit rating downgrades, especially given the deterioration in the country's growth rate.

For **inflation-linked bonds**, following the quarter's small gains valuations were little changed. We continue to be neutrally positioned in this asset class. Real yields are attractive, 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 30 JUN 2018	POSITIONING 30 SEP 2018
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
Foreign equity	Overweight	Overweight
Foreign govt bonds	Underweight	Underweight
Foreign corporate bonds	Overweight	Overweight
Foreign cash	Underweight	Underweight

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