MARKET OBSERVATIONS

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PRUDENTIAL
INVESTMENT MANAGERS

QUARTERLY MARKET COMMENTARY

QUARTER 4 2018

Global equities suffered a rout in the fourth quarter of 2018, as investors took fright over mounting evidence of slowing global growth (as the US joined other countries in reporting disappointing economic data), and some even predicted an imminent recession. Other factors included anticipation of more detrimental impacts from rising US interest rates, a possible escalation in the US-China trade war, Brexit-inspired turmoil, and increasing instability in the White House. US equity markets experienced exceptional tumult in the closing weeks of the year, posting the largest-ever one-day gain, as well as the worst December losses since the Great Depression in 1931. In fact, 2018 ended as one of worst years ever for investors in terms of the breadth of poor returns: Deutsche Bank reported on 20 December that 93% of the global assets it follows recorded negative returns for the year on a US dollar-adjusted basis, the highest percentage since it started collecting data in 1901. Apart from cash, it was largely the traditional safe-haven assets like US Treasuries, German bunds and Japanese government bonds that managed to deliver positive performance over the year.

ASSET CLASS	TOTAL RETURN: Q4 2018	TOTAL RETURN: 2018
SA equity – FTSE/JSE All Share Index	-4.9%	-8.5%
SA bonds – BEASSA All Bond Index	2.7%	7.7%
SA listed property – SA Listed Property Index	-4.0%	-25.3%
SA inflation-linked bonds – JSE CILI Index	0.4%	0.3%
SA cash (STeFI Composite Index)	1.8%	7.2%
Global equity – MSCI World (US$) (Developed)	-13.4%	-8.7%
Global equity – MSCI Emerging Markets (US$)	-7.5%	-14.6%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	1.2%	-1.2%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$)	-6.0%	-6.0%

Source: Prudential, Bloomberg, data to 31 December 2018

During the quarter global uncertainty also worsened in the face of President Trump's more aggressive criticism of the US Federal Reserve (Fed)'s policy and its Chairman, and the growing impact of the US administration's imposition of steep tariffs on some 12% of US imports in 2018, a figure that could rise still further should US-Chinese trade negotiations fail in 2019. Added to this was confirmation of a further deceleration in China's growth rate, making it less able to help pull the global economy out of a downturn. For the quarter, US equities were punished: the S&P 500 returned -13.5% for a 2018 return of –4.4%, the Dow Jones Industrial 30 Index delivered -11.3% and -3.5% in 2018, and the Nasdaq produced -16.8% for Q4 and was flat for the year (all in US$).

The Fed adopted a somewhat more dovish stance at its December FOMC meeting. Although it hiked the benchmark interest rate by 25bps as widely expected, it also eliminated one 25bp interest rate hike from its 2019 rate outlook and lowered its 2019 GDP growth forecast to 2.3% from 2.5% previously. Still, the market had been pricing in an even easier stance, sparking further equity weakness. Both the market and Fed are now forecasting only two 25bp rate hikes in 2019. Meanwhile, US Treasuries (USTs) rallied later in the quarter, for a 2018 return of 0.9% in US$. They were helped by a number of factors, including their safe-haven status, slowing growth and rate hike expectations, and the Democrats' win of the House in the November mid-term elections, which effectively ruled out further tax cuts through 2020 and also led investors to lower their rate hike expectations. The benchmark 10-year UST yield ended 2018 at around 2.7%, well off the year's 3.2% high seen in mid-November. In contrast, US investment-grade corporate bonds saw their yields rise and spreads versus their UST counterparts widen by approximately 50bps over the year to produce a return of -2.5% in US$ for 2018, while high-yield bonds returned -2.1%. This was largely as a result of the Fed's rate hikes, higher risk aversion and credit quality concerns. In Q4, the Bloomberg Barclays Global Aggregate Bond Index (US$) returned 1.2%, while for the year its return of -1.2% reflected weaker global corporate bonds and emerging market bonds, plus the stronger US dollar.

In the EU, Q3 GDP growth slowed to a disappointing 1.7% (q/q annualised) from 2.2% in Q2, attributed to weaker manufacturing activity and poorer business sentiment. The Italian government's dispute with the EU over its budget deficit forecast created more questions over its future within the grouping, denting financial markets and the euro. This was resolved in December with an agreement favouring the EU's lower deficit target, but worries remain over the populist-led government. Social unrest in France and sluggish German growth also added to the region's woes. The European Central Bank (ECB) in December ended its €2.6 trillion bond buying programme as previously announced, although it also pledged to keep interest rates at record lows at least through mid-2019. The Dow Jones Eurostoxx 50 returned -12.9% (in US$) for the quarter and -16.2% for the year, its worst performance since the 2008 Global Financial Crisis.

The UK government descended into further turmoil during Q4 as opposition to the Brexit deal agreed by PM Theresa May with the EU came from all fronts, increasing the probability of "no deal", the very worst outcome for the UK economy. The BOE left its interest rate unchanged at its November meeting, but cited rising risks to future growth from Brexit despite solid GDP growth of 1.5% (q/q annualised) in Q3 2018. The UK's FTSE 100 Index returned -11.7% (in US$) for the quarter and -14.0% for the year.

The Japanese economy contracted by 1.2% (q/q annualised) in Q3 2018 compared to its 3.0% expansion in Q2, due to a slowdown in exports, an increase in imports and declines in private spending and public fixed investment. The Bank of Japan said the downside risks to growth were rising due to tariff threats from the US (particularly on its auto exports) and a slowdown in the global economy, and kept interest rates on hold at its December meeting as expected, while also continuing to buy securities. Japanese growth is expected to slow later in 2019 due to the anticipated negative impact of a new consumption tax on spending and consumer prices. The Nikkei 225 Index returned -14.4% (in US$) in Q4 and -8.5% for the year.

In China, GDP growth slowed to 6.5% (q/q annualised) in Q3 from 6.7% the previous quarter and below the 6.6% expected, due partly to the impact of financial deleveraging and subdued consumer spending, as well as anxiety over the impact of Trump's trade war on economic growth – China has the most to lose of any other country. December manufacturing PMI dropped to 49.4 from 50 in November, the first contraction since 2016. The Shanghai Composite Index reflected these worries, ending the year with a loss of 25%. The decline hit all 10 sectors of the market and trading volumes fell to levels last seen in 2014.

For 2018 as a whole, developed equities in US$ posted a -8.7% total return, the worst year for developed equity markets since the 2008 Global Financial Crisis. Still this was better than the -14.6% in US$ return recorded by emerging markets. Among the 2018 returns in large emerging markets (in US$), the MSCI Turkey was the biggest loser with a total return of -41.1%, the MSCI South Africa

returned -24.3%, South Korea's KOSPI produced -22.0%, the MSCI China recorded – 18.7% and the MSCI India delivered -7.3%, while Brazil's Bovespa returned -1.8%. The MSCI Russia was one of the only markets in the black with a small 0.2% return.

The price of Brent crude oil plunged by 36% during the fourth quarter, from a four-year high of over US$82 per barrel in October to around $52 at year end, representing an annual decline of nearly 20%. This was attributable to somewhat weaker demand from slowing global growth, but more so to oversupply as production continued at record levels, as well as a general lack of confidence in oil producers' December agreement to further curtail production in the new year. Looking at other commodities, gold gained ground on rising investor risk aversion, up 7.7% for the quarter but down 1.6% for the year. Industrial metals prices were broadly lower on decelerating demand in Q4, for a decline of between 16-25% in 2019.

ANOTHER VOLATILE QUARTER FOR SOUTH AFRICA

Despite good news regarding South Africa's emergence from recession with Q3 2018 GDP growth of 2.2% (q/q, annualised), concerns over rising government and state-owned enterprise (SOE) debt, slow economic growth and worsening creditworthiness combined with the risk-averse global sentiment to weigh on local markets in Q4 2018. The rand depreciated further against the strengthening US dollar, losing 1.8% as it started October around R14.14 per US$ and ended December around R14.50. This masked considerable volatility, however, as it strengthened to as low as R13.70 in the period. The local currency was virtually unchanged against the euro and pound sterling in Q4 amid turmoil arising from the Italian budget deficit and Brexit uncertainty. For the year as a whole, however, the rand was substantially weaker versus all three major currencies, down 16.9% against the US dollar, 11.4% against the euro and 10.6% versus the pound sterling.

Following December's sharp global equity sell-off, the FTSE/JSE All Share Index returned -4.9% in Q4 2018, for a full year return of -8.5%. Returns were broadly negative, with only Resources in positive territory in 2018 with a 17.8% return (spurred by the weaker rand, improving operational performance and cheap valuations). Financials were in the red with -8.8%, and Industrials delivered -17.6% for the year, led by big declines in large stocks like Naspers and British American Tobacco. Listed property produced a disastrous -25.3% in 2018, never recovering from Q1's accusations of accounting irregularities at the Resilient group of companies, as well as growing concerns over more widespread financial engineering in the sector and downward earnings revisions at several other companies later in the year.

SA nominal bonds (BEASSA All Bond Index) managed to return 2.7% during the last quarter of 2018, with the 10-year bond starting the period around 9.0% and ending around 8.93%. However, the yield jumped to over 9.4% in mid-October, before rebounding in December. During the quarter, sentiment towards SA bonds was dented by newly appointed Finance Minister Tito Mboweni's medium-term budget in October, which forecast low growth and higher debt. It also raised the spectre of further credit rating downgrades. Another driver was the SA Reserve Bank's surprise 25bp interest rate hike in November. Despite CPI at 5.2% y/y, well within the 3%-6% target band, the SARB cited a worsening inflation outlook (largely on the weaker rand) as the main reason for its move, and its desire to maintain inflation around the 4.5% midpoint of its target band. Consensus CPI for 2019 is 5.3%, and the market is expecting one further 25bp interest rate hike in 2019.

For the year, SA bonds produced a 7.7% return: along with Q4 gains, their strong Q1 rally amid the positive "Ramaphoria" sentiment managed to almost offset subsequent weakness in Q2 and Q3. Solid local demand also overcame high foreign sales: Offshore investors sold a net R70 billion in SA bonds in 2018 as a whole, representing a material capital outflow of around R100 billion from April onwards after having bought a net R30 billion in Q1. Meanwhile, for the quarter inflation-linked bonds delivered 0.4%, and cash as measured by the STeFI Composite Index produced 1.8%. For 2018, ILBs returned 0.3 % and cash 7.2%.

Among the quarter's other developments weighing on the SA economy was Eskom's re-introduction of load shedding around the country in the first half of December, with the possibility that it could recommence in mid-January. The land expropriation debate also continued to exacerbate uncertainty, as did political manoeuvring ahead of the 2019 general election. The market consensus for 2018 GDP growth was revised down to 0.7%, while for 2019 it was lowered to 1.5% from around 2.0% previously.

Some positive developments saw accelerating mining and manufacturing activity for October, which surprised analysts, and new appointments of capable managers at several SOEs. President Ramaphosa's Cabinet reshuffle and general messaging during the quarter reinforced positive sentiment around his commitment to fighting corruption and maladministration; while several investigations into fraud and malpractice at SOEs also progressed.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

Starting with our view on **offshore asset 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.

This view holds true in our higher return-targeting multi-asset funds, where our total offshore exposure remains at around 25% (within Regulation 28 limits).

In November we took advantage of rand strength against the US$ to sell the currency hedges that we had added in September when the US$ was above R15.50, adding value to our portfolios. We believe that despite forecasts for rising US interest rates, EM currencies may not fare as poorly against the US dollar as many expect. The greenback has already been strengthening against a broad basket of emerging market (EM) currencies for the past eight years, outperforming them by 17% or so (and by 25% against the rand) and rendering many EM currencies cheap on a purchasing power parity (PPP) basis. This would suggest that potential headwinds exist for the US currency to make further significant gains from here – investors can't rely on expectations of more US interest rate hikes to drive the greenback stronger from its current levels versus the rand and other EM currencies, especially against the backdrop of weaker US (and global) growth.

At the same time, although recent US economic data has pointed to some slowing (notably a plateauing in housing starts and building permits), several factors make us sceptical that the US is facing an imminent recession. The New York Fed's Probability of Recession indicator, although having risen from around 11 at the start of 2018 to 15 at year-end, is still well below its historical levels indicating recession, which were over 40 before the most recent downturns in both 2001 and 2007-8. US corporates have continued to report strong earnings growth, and the US consensus GDP growth forecast for 2019 is 2.6%, with inflation up to a healthy 2.2% y/y and two 25bp interest rate hikes expected. The consensus global growth forecast for 2019 is still 3.5%, only a moderate deceleration from 3.7% in 2018, and China's GDP growth is anticipated to be 6.2%. These figures suggest markets appear to have overdone their concerns over a drastic growth slowdown. In addition, while the US-China trade war is a real threat, so far much less has actually been implemented than threatened, so the notion that the full extent of each side's proposals will be actioned in 2019 is a stretch.

In **global fixed income**, US government bonds are slowly becoming less expensive as interest rates and yields rise there. However, in the UK, EU and Japan they are still near record-low levels, such that taken as a whole, valuations remain relatively unattractive versus equities, and are still 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. These assets are now slightly cheap and have the potential for stronger returns going forward should the US interest rate hiking cycle start to slow and/ or be curtailed as expected.

ASSET CLASS PREFERENCES: 5-YEAR PERIOD

Prudential House View**

ASSET CLASS	POSITIONING 30 SEP 2018	POSITIONING 31 DEC 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.

For **global equities**, widespread losses made asset valuations even more attractive and we maintained our overweight position. Emerging markets and currencies were especially well valued on many measures: for example, South Korea's KOSPI was trading at less than 1x its 12-month forward price/book value. Although the US saw bigger losses than most other markets over the quarter, it was coming off a relatively expensive base and so we maintained our underweight in that market. We believe other global markets offer better value.

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 became cheaper during the quarter, as prices dropped but forward earnings moved largely sideways (with some volatility). Using one measure, the FTSE/JSE SWIX's 12-month forward P/E fell to around 11.8X at quarter-end from around 12.6X in Q3, 19% cheap compared to its long-term fair value estimate of 14.5X. Notably, companies' trailing (reported) earnings have risen substantially in the past two years, and are forecast to rise further, with the market's 12-month forward earnings growth estimated around 25%. This means that even if this anticipated earnings growth does not materialise, there is still a fair amount of room for earnings to disappoint.

On the back of more attractive valuations, during the quarter we added further to our overweight position in SA equities, buying out of cash in our higher-equity multi-asset portfolios like the Prudential Balanced Fund and where other institutional mandates allowed. 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 SA equity holdings in that portfolio, remaining slightly underweight SA equities and overweight global equities.

Our house view portfolios (like the Prudential Balanced Fund) still hold resources stocks with exposure to global growth and foreign currency earnings 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.

Going into 2019 we are cautiously optimistic regarding SA equity market returns due to the prevailing excessive levels of pessimism reflected in share prices and valuations. The recent flurry of announcements around small cap companies being taken private is an interesting phenomenon, as it potentially provides some evidence that broader underlying trading conditions may not be as depressed as previously reported, or that the cycle may well have troughed.

Although **SA listed property** became marginally cheaper over the quarter, we continue to have a neutral exposure in our multi-asset portfolios to balance the risk/return factors. At the end of 2018 the sector is priced to deliver attractive, low-double-digit returns over the next five years. Some 80% of listed property companies were trading at a discount to their NAV's at year-end. Despite this, we remain concerned about the quality of earnings and possibility of further downward revisions to earnings forecasts in the short-term.

Apart from the well-publicised issues at the Resilient group of companies, many property companies have been relying on financial engineering and other non-rental and once-off income sources to continue to grow their distributions. Risks to rental earnings growth are also relatively high given pressure on landlords to reduce their rentals, particularly in the retail space where retailers are facing sluggish consumer spending. Equally, oversupply in office space is negative for listed property earnings currently. However, we are mindful that these are largely shorter-term risks (given that property is a lagging sector in any economic recovery phase), and that improving economic growth should help the sector to produce attractive returns over the medium term, especially relative to other local asset classes.

In **SA nominal bonds**, valuations remained cheap at year-end compared to their longer-term fair value despite the quarter's gains. We continue to be overweight in this asset class and still prefer longer-dated government bonds due to the more attractive yields on offer. We are also comfortable with the compensation bonds offer given the risk involved, while recognising that 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 return of 0.4%, valuations were little changed. ILBs produced a nominal return of 0.3% for the year, and their performance has been disappointing for the past six years due to falling inflation and rising real yields. We remain neutrally positioned in this asset class. Real yields are attractive at around 3.0% for 10-years, the highest level in a decade, but we still believe that better value exists elsewhere – in long-dated nominal bonds and equities. ■