MARKET OBSERVATIONS

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QUARTERLY MARKET COMMENTARY

QUARTER 4 2019

The year ended on a high note for global equities as investors were able to breathe a sigh of relief on the back of a firm Phase 1 trade agreement between the US and China, and a decisive Tory victory in the UK's snap general election that paved the way for a less-uncertain Brexit. These December developments helped to improve sentiment towards global growth in 2020, as did the backdrop of easy monetary policy put in place by major central banks. South African investors also benefitted from the bullish global sentiment, outweighing largely negative local developments as both local equities and bonds delivered positive returns for the quarter, while the rand gained ground against all three major currencies.

ASSET CLASS	TOTAL RETURN: Q4 2019 (RAND & US$)	TOTAL RETURN: 2019 (RAND & US$)
SA equity – FTSE/JSE All Share Index (Rand)	4.6%	12.0%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	5.3%	6.8%
SA listed property – FTSE/JSE SAPY (Rand)	0.6%	1.9%
SA bonds – BEASSA All Bond Index (Rand)	1.7%	10.3%
SA inflation-linked bonds – JSE CILI Index (Rand)	-0.9%	2.6%
SA cash - STeFI Composite Index (Rand)	1.7%	7.3%
Global equity – MSCI All Country World (Total) (US$ net)	9.0%	26.6%
Global equity – MSCI World (Developed) (US$ net)	8.6%	27.7%
Global equity – MSCI Emerging Markets (US$ net)	11.8%	18.4%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	0.5%	6.8%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net)	0.8%	23.0%

Source: Prudential, Bloomberg, data to 31 December 2019

The fourth quarter (Q4) of 2019 was characterised by an increasingly bullish (albeit still volatile) market environment from October onwards after both President Trump's announcement that a Phase 1 trade deal would be announced "within weeks", and UK Prime Minister Boris Johnson's success in passing a Brexit deal through Parliament. US equities reacted by reaching fresh record highs in late December, while global equities recorded their best annual gains since 2009. Emerging market equities outperformed developed markets in Q4 after a long period of underperformance.

Global bonds, meanwhile, delivered only marginally positive returns in Q4 as the US Federal Reserve (Fed) signalled in October it was not likely to lower interest rates further and left rates on hold at its 11 December meeting.

As shown in the table, in US$ terms, global equities (the MSCI All Country World Index) returned 9.0% for the quarter and 26.6% for the year, while developed markets delivered 8.6% for the quarter and 27.7% for the year. Emerging markets produced 11.8% for Q4 and 18.4% in 2019. Finally, global bonds delivered 0.5% for the quarter and 6.8% for the year, and global property returned 0.8% and 23.0%, respectively, both buoyed by the Fed's rate cuts during the year.

In retrospect, the strong performances from global equity and especially global bond markets were the biggest surprises of the year. Going into 2019, many investors had been concerned that the decade-long equity bull market was coming to an end as it had surpassed the duration of all other bull markets in history, and global growth had slowed. They had seen company earnings growth decelerate and the impact of stimulative growth policies wane. For bonds, the market was expecting four interest rate hikes from the Fed for the year to fight expected rising inflation. Instead, they were faced with a serious Sino-US trade war, worsening Brexit uncertainty and slower-than-expected global growth. All of this prompted far more monetary easing than forecast (three 25bp rate cuts from the Fed) and, because markets are forward-looking, positive revisions to 2020 prospects. No one could have forecast that 2019 would be the strongest year for global equities in a decade, and that, even more impressively, global bonds would deliver 6.8% in total returns from their already-historically-high price (low yield) levels at the start of the year. Real global bond yields began 2019 at around 0%, offering poor long-term prospective returns which in theory should have discouraged investors from buying more (yet they did). Global equities had at least started the year at more attractive valuations.

During the quarter, the IMF lowered its global growth forecasts to 3.0% for 2019 and 3.4% for 2020, based on the broad slowdown in manufacturing and investment seen in the latter part of the year, as well as Brexit uncertainty and the impacts of the US-China trade war. But on 13 December, President Trump announced he was ready to sign a Phase 1 trade pact with China, averting planned new tariffs on another $160bn of Chinese products set to take effect on 15 December. Among other concessions, China has pledged some $400 billion in tariff cuts on 859 types of products from the US and other trading partners starting 1 January, as well as promising to buy more US agricultural products. This sparked a pre-Christmas equity rally in stocks around the world, also boosting emerging market currencies.

In the US, the US Fed cut its base interest rate by 25bps in October, but also suggested that no further cuts were likely for the foreseeable future. As expected, it left rates unchanged at its December meeting, and its "dot plot" forecast pointed to no changes through 2020 and one 25bp rate hike in 2021. The central bank also noted that the US economic outlook was favourable as it went into 2020 with moderate growth (Q3 GDP at 2.1% y/y), historically low unemployment (at 3.5%) and inflation under control (the Fed's benchmark inflation measure at 1.7% y/y in November).

Despite the October rate cut, the improved growth outlook and equity rally saw the 10-year US Treasury yield move higher, from 1.7% at the start of the quarter to 1.9% at end-December. The Barclays US Treasury Index produced -0.8% for Q4 and 6.9% for 2019 in US$. In the equity market, the S&P 500 returned 9.1% for the quarter and 31.5% for the entire year, with technology stocks being the stand-out performers (all in US$).

In the UK, some significant uncertainties around Brexit were alleviated in Q4 after the snap general election called by PM Johnson on 12 December resulted in a resounding win for his Tory party, setting a clear path toward Brexit on 31 January. Although detailed terms must still be negotiated, Johnson has a substantial Parliamentary majority to work with to implement his proposals. In the meantime, Q3 GDP growth fell to 1.0% (y/y) versus 1.3% (y/y) in Q2, its slowest since early 2010, and ratings agency Moody's warned in November that it could downgrade the UK's government debt. The BOE left its base interest rate unchanged at 0.75% in November. The UK equity market and the pound sterling rallied on the added certainty, with the FTSE 100 returning 10.4% for the quarter and 22% for the year in US$.

In the Eurozone, Q3 GDP growth was revised upward to 1.2% y/y, higher than expected and unchanged from Q2, while inflation rose to 1.0% y/y in November from 0.7% y/y previously. Optimism over Brexit clarity would likely help underpin the European economy as well, analysts said. Currently, the European Central Bank (ECB) is projecting Eurozone growth at 1.2% for 2019, 1.1% for 2020 and 1.4% for 2021. Christine Lagarde, the ECB's new President, kept interest rates on hold at its December meeting and confirmed that its bond buying stimulus programme had re-started on 1 November. In European equity markets (in US$), Germany's DAX produced 9.6% for the quarter and 22.9% for the year and the French CAC 40 delivered 8.6% and 28.1%, respectively.

Japan's growth accelerated to a stronger-than-expected 1.8% y/y in Q3 despite the US-China trade war. The Bank of Japan left its key interest rate on hold at -0.1% in both October and December, but signalled it could implement more stimulus measures should the recent increase in sales tax start to hurt consumers. The Nikkei 225 returned 8.3% in Q4 and 21.9% for the year in US$.

The Chinese economy continued to slow, posting 6.0% y/y GDP growth in Q3 2019 after 6.2% y/y previously. Ongoing democracy protests in central Hong Kong targeting popular shopping areas weighed on consumer spending and tourism, sending the territory into a rare recession. The trade war also had a very negative impact on Chinese exports and manufacturing during Q4, which analysts say could start to turn around – albeit slowly – from 1 January when Phase 1 of the US-China trade agreement takes effect. The government's ongoing stimulus measures, including tax cuts, infrastructure spending and lower bank reserve requirements, have helped to cushion the slowdown, but Q4 saw increasing pressure on the People's Bank of China (PBOC) to initiate further monetary easing. Hong Kong's Hang Seng Index returned 9.1% for the quarter and 13.7% for the year, and the MSCI China returned 14.7% and 23.7%, respectively, all in US$.

Among other emerging markets, the strongest equity performance for Q4 in US$ came from the MSCI Russia with a 17.1% return, while Brazil's Bovespa posted 14.3% and the MSCI South Africa 13.2%. The weakest market was the MSCI Turkey, which was flat. For the year, the MSCI Russia delivered by far the highest return with 53.2%, followed by the Bovespa with 26.8% and the MSCI China at 23.7%. The MSCI South Africa delivered a relatively disappointing 10.7% in US$ in 2019, but higher than the 7.6% from the MSCI India and the 8.2% from South Korea's Kospi 200.

The price of Brent crude oil gained about 8% over the quarter, rising from around US$62 per barrel at the start of October to close the year at around US$67 per barrel as markets anticipated an uptick in demand in 2020 as a result of improving US-China trade and global growth. Oil prices gained about 22% in 2019 on the back of the supply cuts by OPEC and its partners and latterly the Q4 Phase 1 trade deal. For 2020, analysts expect the oil price to remain relatively contained as the US becomes a net petroleum exporter for the first time (helping offset the impact of OPEC cuts), as well as continued moderate global economic growth.

Precious metal prices all rose during Q4, with palladium ending a stellar year with a 52.5% price gain in 2019. Platinum was up 22.4% and gold rose 19% for the year thanks to its safe-haven status. Other commodity prices were mixed for the 12 months: Nickel gained 32.1% and copper rose 3.2%, but zinc lost 8.7%, lead was down 4.3% and aluminium fell 3.7%.

SOUTH AFRICA BENEFITS FROM GLOBAL RALLY

Positive global investor sentiment lifted South African equities and the rand in Q4, helping to offset some of the foreign outflows experienced earlier in the year, as well as further negative developments locally. These came in the form of a bearish, but realistic, Medium-Term Budget Policy Statement (MTBPS) in October which lowered South Africa's growth projections and raised government's debt burden forecasts from around 60% to 71% of GDP in 2022/23 – a worryingly high level that sparked talk of further credit rating downgrades and even possible IMF intervention. Following this, both S&P and Moody's lowered their credit outlook on SA sovereign debt to negative. The resumption of load-shedding in December and the possibility of it extending well into 2020 added further to the gloom, given the negative impact it will have on growth going forward.

As expected, the SARB kept interest rates steady at its November MPC meeting, saying the risks of rand weakness and slow growth outweighed the subdued inflation environment (at only 3.6% in November, a nine-year low). Governor Lesetja Kganyago emphasized the importance of anchoring inflation expectations below the 4.5% midpoint of the SARB's 3-6% inflation target, rather than boosting growth, thereby putting more pressure on the government to enact reforms and a fiscally responsible 2020 budget. The central bank's model is forecasting one 25bp interest rate cut in Q3 2020.

Meanwhile, the SARB lowered its growth forecasts to 0.5% for 2019, 1.4% for 2020 and 1.7% for 2021. This reduction was justified as Q3 GDP growth was announced at a lower-than-expected -0.6% y/y, possibly setting the stage for a technical recession. On a brighter note, Q3 business confidence rose to 26pts, its first increase in two years, after hitting a 20-year low of 21pts in the previous quarter.

SA bonds came under selling pressure earlier in the quarter amid the backdrop of rising government debt levels and a deteriorating credit rating outlook. However, this was offset to some extent by the December rally sparked by increased demand among investors looking for attractive real yields, as local bonds offered among some of the highest real yields in the world. The SA yield curve continued to steepen as investors preferred bonds with tenors under 10 years compared to their longer-dated counterparts. The BEASSA All Bond Index managed to deliver 1.7% in Q4 and 10.3% for the year. SA inflation-linked bonds returned -0.9% over the three months, and only 2.6% for the year as the inflation outlook improved, while cash (as measured by the STeFI Composite) delivered 1.7% in Q4 and 7.3% in 2019.

SA equities were buoyed by the improved global growth outlook and "risk-on" sentiment in Q4, which underpinned technology stocks and resources companies in particular. This made for a relatively narrow rally for the local equity market. The FTSE/JSE ALSI returned 4.6% for the quarter, with Resources returning an impressive 13.8%. Financials delivered 2.8%, Listed Property produced 0.6% and Industrial counters were flat. The FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for most of our client mandates, returned 5.3%. For the year, the ALSI returned 12.0%, thanks largely to the Resources sector which delivered 28.5%. This far outpaced the 8.9% from Industrials, 0.6% from Financials and 1.9% from Listed Property.

Finally, the rand rallied against all three major currencies in Q4, along with most other emerging market currencies. It gained 7.6% against the US dollar, 0.9% against a much stronger pound

ASSET CLASS PREFERENCES: 5-YEAR PERIOD

Prudential Best Investment View*

ASSET CLASS	POSITIONING 30 SEP 2019	POSITIONING 31 DEC 2019
SA equity	Overweight	Overweight
SA listed property	Underweight	Underweight
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 best investment view preferences are implemented where all fund mandates allow. Positioning will differ in portfolios with constraints in their mandates.

sterling and 4.9% versus the euro. For the year the rand appreciated 2.7% versus the US dollar and 4.5% against the euro, but lost 0.5% against the pound sterling.

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. During the quarter we reduced our overweight exposure to global equities in response to the strong market performance, and on the back of a year of high equity market returns which was not matched by the same extent of improvement in the global macroeconomic environment. However, because the global equity risk premium on offer remains substantially above both historic norms and global government bond yields, we remain overweight global equities. This view holds true in our higher return-targeting multi-asset funds, where our total offshore exposure remains at around 25%.

In **global fixed income**, US government bonds became somewhat cheaper during the quarter, but remain cheaper than other developed markets like the UK, EU and Japan, where a wide range of government bond yields are in negative territory. Consequently, the asset class remains unattractive versus equities. We are underweight global sovereign bonds and underweight duration, preferring to hold investment-grade US and European corporate bonds.

For **global equities**, we reduced our overweight position during the quarter, taking profits on the back of the strong equity rally and in light of our view that the global economic outlook is not as robust as that reflected in current equity valuations. However, we have remained overweight as a whole given the very high risk premium from equities versus global bonds. Emerging markets and currencies continue to be especially well valued on many measures, while the US market is relatively expensive - other 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. We also find selected emerging markets attractive, including 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.

Following December's rally, **South African equities** became marginally more expensive during Q4 on most valuation measures: the 12-month forward P/E of the FTSE/JSE All Share Index rose from around 10.9X to 11.6X and the earnings yield fell from 8.6% to around 8.1% in December alone. However, both are still cheaper than the market's longer-term fair value, in our view. We remain overweight SA equities in our house view portfolios like the Prudential Balanced Fund, and are comfortable with our equity allocation levels. We are cautiously optimistic regarding SA equity market returns over the next three to five years due to the prevailing excessive levels of pessimism reflected in share prices and valuations.

Our house view and real-return portfolios continue to hold resources stocks with exposure to global growth and foreign currency earnings like **Anglo American, Exxaro, Sasol and Sappi**, as well as global giants such as **Naspers** and **British American Tobacco (BAT)**. All of these overweight positions added value to our portfolios for the quarter, with rebounds for Sasol, Sappi and Exxaro after suffering losses in Q3.

We have also maintained our overweight exposure to financial shares including **Old Mutual**, **Investec plc**, **Standard Bank** and **Absa**, which offer attractive valuations with relatively high dividend yields. While Investec added value to our house view portfolios for Q4, the latter two counters detracted from value. We believe Investec's unbundling and separate listing of **Investec Asset Management** from the bank operations set for Q1 2020 should unlock value, as the asset management profits and dividends that were historically trapped in the bank will now be distributed directly to shareholders. The unbundling should leave both the UK and the South African banking operations in a well-capitalised position from which they can grow into the future. With a refreshed management team that is now prioritising returns and addressing sub-optimal businesses, we think returns on equity will improve over time. The demerger should also allow for more industry-focused boards and management teams that could unlock further value.

As long-time holders of **Trencor**, we believe its unbundling of global shipping container group **Textainer** during the quarter will unlock value -- both stocks could be substantial beneficiaries of improvements in the US-China trade war going forward. **Remgro**, another group in which we are overweight, also announced an unbundling of its stake in **First Rand** for Q1 2020. We believe this is likely to reduce the discount in the share price of the holding company going forward.

Also supporting returns was the rally in **Quilter** and **Capital & Counties** shares, thanks to the strong Brexit-related rebound in the UK market. We took some profits in these holdings in December. Later in the quarter **Naspers** and **Prosus** shares fell and then recouped some losses after Prosus failed to win a takeover bid for UK-based food delivery group Just Eat in a bidding war – this as the market had considered the bid too costly. On a net basis, our overweight Prosus positioning detracted from returns for the three months.

Meanwhile, we are still underweight retail stocks like **Clicks, Mr Price, Shoprite** and **Truworths** in our house view portfolios, given the pressure under which local consumers find themselves. Strategically, we do have a holding in **Woolworths** and a small exposure to **Pick 'n Pay.**

In **SA listed property** we continue to be underweight in our house view portfolios given the higher risks to earnings going forward despite the attractive valuations prevailing in the asset class. We remain concerned about the earnings outlook for the sector, as it faces ongoing headwinds arising from 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. We are also underweight in our real return mandates like the Prudential Inflation Plus Fund where we hold significant listed property exposure.

We remain modestly overweight in **SA nominal bonds** in our house view portfolios, given the very attractive yields on offer, particularly in the longer-dated maturities above 10-years where real yields reached 4.5% during the quarter. This is very high relative to most other emerging market bonds, even those with worse credit ratings than ours. It is also well above our long-run fair value assumption of 2.5%. This part of the yield curve has not rallied as much as the R186 (due 2026), for example. We therefore kept our long portfolio duration as well. We are comfortable with the compensation bonds offer given the risk involved (such as a Moody's credit rating downgrade).

For **inflation-linked bonds**, real yields remain attractive for long-dated tenors. However, we continue to be neutrally positioned in this asset class as we believe better value exists in SA equity and nominal bonds, where long-dated nominal bonds have the potential to offer more attractive value over the medium-term and are much more liquid. ■