MARKET OBSERVATIONS

BY DAVID KNEE, CHIEF INVESTMENT OFFICER

PRUDENTIAL INVESTMENT MANAGERS

QUARTERLY MARKET COMMENTARY

QUARTER 2 2021

During the second quarter (Q2) of 2021, more progress in vaccine rollouts worldwide, as well as positive corporate earnings reports and economic news, continued to lift equity returns, particularly in developed markets, even as concerns emerged over high valuations. Bonds – both government and corporate credit – also recorded solid performances, retracing some of their Q1 losses and buoyed by reassurances from central banks that easy monetary policies would not be halted any time soon. It was no coincidence that cheaper, out-of-favour equities like Listed Property were among the strongest performers, while more expensive sectors like Resources underperformed.

ASSET CLASS	Total return Q2 2021 (Rand and US$)
SA equity – FTSE/JSE All Share Index (Rand)	0.05%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	0.6%
SA listed property – FTSE/JSE All Property Index (Rand)	11.1%
SA bonds – FTSE/JSE All Bond Index (Rand)	6.9%
SA inflation-linked bonds – JSE CILI Index (Rand)	3.0%
SA cash - STeFI Composite Index (Rand)	0.9%
Global equity – MSCI All Country World (Total) (US$ net)	7.4%
Global equity – MSCI World (Developed) (US$ net)	7.7%
Global equity – MSCI Emerging Markets (US$ net)	5.0%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$ net)	1.3%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net)	9.7%

Source: Prudential, Bloomberg, data to 30 June 2021

Meanwhile, the approval of even more US government spending helped support the global growth outlook, as did improving conditions in the UK and Europe. However, emerging market equities lagged those of developed markets, and South African equities broadly underperformed their EM peers due largely to the market's high Resources exposure, after outperforming in Q1. In contrast, South African nominal government bonds posted strong returns compared to those of many other countries over the three months.

As shown in the table, in US$ terms, global equities (the MSCI All Country World Index) returned 7.4% for the quarter, with emerging markets lagging developed markets at 5.0% and 7.7%, respectively. For SA investors, the rand's 3.3% appreciation against the US dollar would have dented global investment returns. Global bonds delivered 1.3% for the quarter, regaining some of the losses recorded in Q1 as inflation fears receded somewhat. And finally, global property posted another quarter of good gains with a 9.7% return. As in previous quarters, central banks kept interest rates broadly unchanged at very low, accommodative levels – less concerned about inflation than investors – and some governments continued to enact fresh fiscal support packages for consumers and businesses.

In the US, the economy gathered speed as Q1 GDP growth was recorded at a final 6.4% (q/q annualised) and Q1 consumer spending jumped 11.1% y/y, amid a ramp-up in factory production and signs of labour shortages in some areas. Bullish sentiment was further stoked by the bipartisan approval of a five-year, US$1.2trn infrastructure spending plan.

At its June policy meeting, the US Federal Reserve (Fed) left interest rates unchanged, easing investor concerns over rising inflation, while also signalling two 0.25% interest rate hikes by the end of 2023. Longer-dated US Treasuries rallied on the accommodative stance, helping flatten the UST yield curve after its steepening trend in previous quarters. This was despite headline consumer inflation of 5.0% y/y in May, its highest rate in nearly 13 years, which policymakers consider to be temporary.

Spurred by the improving growth outlook, US equity markets continued to rally for the quarter (although June gains were more subdued), with the S&P 500 delivering an 8.5% return, the Dow Jones Industrial 30 5.1%, and the technology-heavy Nasdaq 100 11.4% (all in US$).

In the UK, the rapid spread of the Covid-19 Delta variant, in the face of the country's successful implementation of its vaccination programme, proved to be a setback for the economy's anticipated full reopening in June, dampening market sentiment to some extent. The latest GDP figures proved equally bleak as the economy shrank by 6.1% y/y in Q1 2021. Despite this, the Bank of England upgraded its growth forecast for the year to 7.25% from 5% in February, and left its key interest rate unchanged as expected, while warning against any "premature tightening" until it reached its GDP growth and inflation goals.

In the EU, Q1 GDP contracted by 1.7% y/y, disappointing most analysts on the back of slower-than-expected vaccine programme rollouts and the emergence of more contagious virus variants which forced extended lockdown measures. On the other hand, later in the quarter, consumer and business sentiment recorded strong rebounds, albeit not yet reaching pre-Covid levels.

Meanwhile, the European Central Bank (ECB) left interest rates on hold at its June policy meeting, with President Christine Lagarde injecting some bullish sentiment by emphasizing that growth in the region should pick up amid stronger global growth and consumer spending, and that the central bank would continue its bond purchases and other supportive monetary measures. Unlike the US Fed, she refrained from signalling when the ECB might start to ease its accommodative policy. Consumer inflation in the EU rose to 2.3% y/y in May, due largely to a low annual base effect.

For the quarter, French equities far outperformed their regional counterparts as the CAC 40 delivered 10.1%, the UK's FTSE 100 5.8%, and the German DAX 4.4% (all in US$).

Japan's economic contraction for Q1 2021 was revised down to -3.9% y/y from a previously estimated -5.1% y/y, beating market expectations of -4.8% y/y. However, further restrictions to economic activity due to the worsening spread of the Coronavirus, particularly in the Tokyo region, have led many to expect Q2 growth to be weaker, and again in negative territory. The Bank of Japan left its key short-term interest rate unchanged at -0.1% in June, and also extended the deadline for its pandemic-relief programme from September 2021 to March 2022. In a further move to boost growth, policymakers unveiled a new scheme to provide funds to financial institutions that invest or extend loans related to climate change issues. Japan's CPI hovered around 0%, higher than previous deflation due to the rise in global oil prices, although inflation expectations were unchanged.

In China, GDP growth slowed to 0.6% q/q in Q1 2021 from 3.2% the previous quarter. The People's Bank of China again left its lending rates on hold in June, while noting in its Q1 monetary report that it was more worried about an uneven economic recovery, weak consumer spending and lack of private business investment than rising prices. The government continued its crackdown on the large local IT and fintech companies, introducing more regulations regarding financing and microlending in a bid to curb "monopolistic" practices online.

For the second quarter of 2021, Japan's Nikkei 225 returned -1.6%, the MSCI China produced 2.3% and Hong Kong's Hang Seng delivered 2.9% (all in US$).

Among other large emerging equity markets, in US$ terms Brazil's Bovespa was by far the best performer with a 22.3% return, rebounding from a disastrous Q1, while the MSCI Russia delivered 14.4%. The MSCI India posted a respectable 7.0% and South Korea's KOSPI 6.3%, but the MSCI South Africa and MSCI Turkey both ended in the red with -1.3% and -0.2%, respectively, all in US$.

After gaining over 22% in the first quarter of 2021, the spot price of Brent crude oil rose another 18.2% in Q2, for an increase of 45% so far in 2021, fuelling inflation around the globe. As for commodity prices, most were higher over the quarter with the exception of platinum, which lost 7.4%. The gold price gained 4.5% for the quarter, and palladium was up 3.5%, giving it a 40% gain over the past 12 months. Industrial metals were also stronger: nickel rose 14.6%, aluminium 11% and copper 6%.

South Africa

Economic growth surprised to the upside in South Africa as Q1 2021 GDP growth measured 4.6% q/q annualised, notably higher than the 2.5% market forecast. Despite the gradual recovery, Stats SA noted that the economy's absolute size was equivalent to that last seen in Q1 2016, five years earlier. Covid-19 vaccine supplies continued to make their way into the country and the government's vaccination programme made headway, but this progress was overshadowed in June as the third wave of Covid infections gathered pace, driven by the more transmissible Delta variant. This prompted President Cyril Ramaphosa to reintroduce Level 2, and subsequently Level 4, lockdown measures, again curtailing vital economic and social activity.

Meanwhile, the South African Reserve Bank kept its benchmark interest rate unchanged at a record low of 3.5% at its 20 May MPC meeting, warning that slow progress on vaccinations, limited energy supply and policy uncertainty continue to pose downside risks to the economic outlook. This was despite the jump in consumer inflation to 4.4% y/y in April and 5.2% in May, attributed largely to the previous low base. The central bank raised its growth forecasts for 2021 from 3.8% to 4.2%, but lowered its projections for 2022 and 2023 to 2.3% and 2.4% respectively. It is also projecting two 25bps interest rate hikes in 2021.

During the quarter global credit rating agencies S&P and Fitch reaffirmed South Africa's long-term sovereign credit rating at BB-, citing an upturn in near-term economic performance and improved public finances as contributing factors. Moody's, however, postponed its review on South Africa's credit rating, which currently sits at Ba2 with a negative outlook.

The FTSE/JSE ALSI was roughly flat for the second quarter, returning 0.05%, while the FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for most of our client mandates, returned 0.6%.The standout sector was Listed Property (the All Property Index) with an 11.1% total return. Financials delivered 7.5% and Industrials eked out 0.8%, but the Resources Index returned -5.0%. This performance reflected the value still seen in "SA Inc" counters, which have lagged during the recovery, and the growing view that Resources shares may be reaching the end of their bull run.

SA bonds posted a strong 6.9% return (as measured by the FTSE/JSE All Bond Index), remaining sought-after sources of yield for global investors compared to many other sovereign bonds. The yield curve between 10-year and 20-year bonds also flattened by 34bps, with the spread now down at 120bps from its peak of 216bps during the Coronavirus crisis in May 2020 and highlighting lower investor risk perceptions. Meanwhile, SA inflation-linked bonds produced 3.0% (Composite ILB Index) on the back of somewhat softer demand for inflation protection, and cash (STeFI Composite) delivered 0.9%.

Finally, the rand appreciated against the major global currencies over the quarter, rising strongly from its oversold position in April and May before retracing some gains in June. It gained 3.3% against the US dollar, 3.1% versus the pound sterling and 2.4% against the euro over the three months.

How have our views and portfolio positioning changed?

Starting with our view on **offshore asset allocation**, we remained slightly overweight global equities versus global bonds, global property and cash during the quarter. Within our global equity positioning, as US equities continued to be expensive compared to other markets, our portfolios kept their underweight positioning in the US market in favour of selected European and emerging market equities. We have been aiming to position the portfolios with higher weightings of very high-returning global assets while maintaining a mix of assets that have diversified return profiles. At quarter-end we were overweight emerging market equities and underweight developed market equities.

At the same time, our portfolios have shifted to a very marginally overweight position in **global government bonds** from neutral in the previous quarter, having added small selective exposure to emerging market government bonds as yields remained particularly attractive. We remained underweight in **investment grade corporate credit** given our view that yields are no longer sufficiently high for the risk, with our aggregate global bond exposure continuing to be slightly underweight in total at quarter-end.

Our best investment view portfolios were still overweight **SA equities** in Q2. SA equity valuations (as measured by the forward Price/Earnings ratio of the FTSE/JSE Capped SWIX Index) became somewhat more attractive over the quarter, moving from around 9.7X at the beginning of the quarter to around 9.2X at quarter-end as equity prices moved sideways but earnings expectations rose. This improvement in valuations was insufficient to cause us to change our allocation to SA equity as competing assets also remained attractive.

Within SA equities, in broad terms our exposure to large global companies (in particular Resources groups and Naspers) did not work in our favour

ASSET CLASS PREFERENCES: 5-YEAR PERIOD
Prudential Best Investment View*

ASSET CLASS	POSITIONING 31 MAR 2021	POSITIONING 30 JUNE 2021
SA equity	Overweight	Overweight
SA listed property	Underweight	Underweight
SA bonds (govt and corp)	Overweight	Overweight
SA inflation-linked bonds	Overweight	Overweight
SA cash	Underweight	Underweight
Foreign equity	Overweight	Overweight
Foreign govt bonds	Neutral	Overweight
Foreign corporate bonds	Underweight	Underweight
Foreign cash	Neutral	Overweight

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

over the quarter due to rand appreciation and underperformance from these shares. However, our continued overweight to financial stocks added to portfolio value with contributions from Investec, Absa, Standard Bank, Remgro and Old Mutual as notable performers. Other good returns came from our exposure to retailers like Foschini and Truworths, as well as Richemont and PPC. A large detractor to performance over the period was our holding in Naspers, which was under threat from Chinese regulators and garnered negative investor sentiment regarding its proposed share exchange with associate company Prosus. Our basic resources holdings such as Amplats, Implats and Northam also detracted from value as this sector underperformed.

We have maintained our positioning in **SA listed property** in Q2 2021. Listed property has been the best-performing sector (and asset class) so far this year, recording a 20.1% return over the six months to end-June, but earnings have been broadly flat and the sector's forward earnings yield has fallen from 11.5% to 10.25% due to price appreciation. In our view, although it is encouraging that earnings have not deteriorated further and we may be reaching the end of the downward trend with the current earnings stabilisation, it is still too early to call. Our positioning therefore reflects our belief that risks around property company earnings remain high, combined with the continuing relatively high debt levels in the sector. We have ensured that we are holding high-quality companies with strong balance sheets within our small exposure to the sector, like Growthpoint.

SA nominal bonds enjoyed strong returns in Q2, and our portfolios benefitted from their overweight exposure to these assets. We continue to be overweight in this asset class and tilted towards longer-dated maturities, which returned more than their shorter-dated counterparts over the three months (12+-year maturities returned 10.1% in Q2 vs the All Bond Index's 6.9% return). With the yield on the R209 15-year bond ending June at 10.1%, for example, these securities remain attractive relative to other income assets and their own longer-term history. We believe they will more than compensate investors for their associated risks.

We kept our exposure to **inflation-linked bonds (ILBs)** during the quarter. The gap between ILB and cash real yields narrowed on the back of the rally in ILBs as the 10-year ILB rallied by 80bps, while cash real yields were steady. In addition, ILB real yields are still attractive compared to their own history and our long-run fair value assumption of 2.5%.

Lastly, our best investment view portfolios maintained their substantial underweight in **SA cash**, since prospective real returns from this asset class are negative and other SA assets relatively more attractive. ■