M&G Investments

Q3 2021

# Market Observations

# David Knee

## Chief Investment Officer

The third quarter of 2021 saw a notable shift toward investor risk aversion compared to the first half of the year, as several mounting concerns around global growth took their toll on financial markets. Among the most influential were: the relentless spread of the Covid Delta variant; indications of a sooner-than-expected start to the US Fed's (and other central banks') policy tightening; and stricter Chinese regulatory policies. Global bond markets came under pressure, and many equity markets produced negative returns, with emerging markets and currencies lagging developed markets. Technology and Resources counters were among the worst performers, the latter due to the fall in commodity prices (apart from oil), especially in September.

| Asset class | Total return Q3 2021 (ZAR and US$) |
|---|---|
| SA equity – FTSE/JSE All Share Index (Rand) | -0.8% |
| SA equity – FTSE/JSE Capped SWIX All Share (Rand) | 3.2% |
| SA listed property – FTSE/JSE All Property Index (Rand) | 6.5% |
| SA bonds – FTSE/JSE All Bond Index (Rand) | 0.4% |
| SA inflation-linked bonds – JSE CILI Index (Rand) | 2.0% |
| SA cash - STeFI Composite Index (Rand) | 1.0% |
| Global equity – MSCI All Country World (Total) (US$ net) | -1.1% |
| Global equity – MSCI World (Developed) (US$ net) | 0.0% |
| Global equity – MSCI Emerging Markets (US$ net) | -8.1% |
| Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$ net) | -0.9% |
| Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net) | -0.3% |

Source: M&G Investments, Bloomberg, data to 30 September 2021

In South Africa, the broader equity market was only marginally negative (in rand terms) over the quarter. Good gains in retail and property stocks helped to largely offset losses in some Resources shares, as well as Naspers and Prosus. At the same time, SA bonds bucked the global trend with positive returns. However, the rand lost ground against the major global currencies.

As shown in the table, in US$ terms, global equities (the MSCI All Country World Index) returned -1.1% for the quarter, with emerging markets lagging developed markets at -8.1% and 0.0%, respectively. For SA investors, the rand's 5.4% depreciation against the US dollar would have added to global investment returns. Global bonds delivered -0.9% for the quarter, dented by fears of a quicker end to easy global monetary policies as growth improved and inflation fears rose. And finally, global property was also in the red with a -0.3% return.

In the US, the economy grew at a robust 6.7% (q/q annualised) pace in Q2 2021, fuelled by further recoveries in manufacturing, services and consumer spending. Combined with an acceleration in inflation and improving employment data, the US Federal Reserve signalled that its long-standing easy monetary policy was set to be tapered. It expects to purchase fewer assets in the fourth quarter, and to start hiking interest rates gradually in 2023, somewhat sooner than expected by the market. This weighed on US Treasuries and the equity market, and prompted some analysts to scale back their growth estimates.

US equities delivered subdued and mixed returns for the quarter, with the main losses coming in September as sentiment deteriorated. The S&P 500 delivered 0.6%, the Dow Jones Industrial 30 -1.5%, and the technology-heavy Nasdaq Composite -0.2% (all in US$).

Both the Bank of England and the European Central Bank followed the US Fed's tighter policy forecast in September, although their monetary tightening is expected to be less aggressive. The former said that the case for modest tightening had strengthened amidst rising inflation concerns, while the latter announced it would start tapering the pace of its net asset purchases due to improved economic and financial conditions. UK GDP growth was revised higher to 5.5% (q/q annualised) for Q2 2021, while the Euro Area's jumped to 2.2% (q/q annualised). For the quarter, the UK and major European bourses were all in the red, as the FTSE 100 produced -0.5%, the CAC 40 delivered -1.8%, and Germany's DAX posted -4.0% (all in US$).

Japan's economy finally recorded positive growth, with a 0.5% (q/q annualised) GDP expansion in Q2 compared to -1.1% in Q1. Consumer spending, private investment and government spending all contributed to the turnaround, but the world's third-largest economy is still lagging in its recovery compared to other countries. The spread of the Delta variant, particularly in the Tokyo region, has been one of the main factors hampering progress. The Bank of Japan left its key short-term interest rate unchanged at -0.1% at its September meeting, as expected. But unlike its counterparts, it continued to reinforce its message that the current very low levels would stay in place for as long as necessary.

In China, the economy grew at 1.3% (q/q annualised) in Q2, slightly above the 1.2% consensus. However, as Q3 wore on, there were increasing indications that this growth was losing steam, compounded by further concerns over the negative impact on growth of the government's regulatory crackdown, and the possibility of a liquidity crisis prompted by troubles at Evergrande, China's second largest private property developer. This in turn sparked selling in global Resources stocks. At the same time, uncertainty over Evergrande continued, as the government did not assure lenders that it would assume its debt.

After announcing a surprise cut to banks' reserve requirements in July, the People's Bank of China left its base interest rates on hold in September, while indicating that there was still room for further cuts if necessary to support the country's growth recovery. This did dampen some expectations of a further rate cut in the shorter-term, but also heightened concerns of a bigger-than-expected economic slowdown in the third and fourth quarters of the year.

For the third quarter of 2021, Japan's Nikkei 225 returned 2.4%, the MSCI China produced -18.1% and Hong Kong's Hang Seng delivered -14.1% (all in US$).

Among other large emerging equity markets, in US$ terms, Brazil's Bovespa was the worst performer with a -19.4% return, while South Korea's KOSPI delivered -13.0% and the MSCI South Africa -5.5%. The top performer was the MSCI India with a 12.7% return, followed by the MSCI Russia with 9.9% (all in US$).

The spot price of Brent crude oil gained 4.5% in Q3, and has risen nearly 52% for the year to date. The sharp increase has been fuelling global inflation, with the price at around US$80 per barrel at quarter-end. Other commodity prices were mostly weaker over the quarter - the main exception was aluminium, which gained 13.0%. Otherwise, gold was down 2.0%, platinum fell 11% and palladium plunged some 30%, impacted by a sharp drop in demand as automobile production was slowed by the shortage of microchips. Nickel fell 1.5% and copper lost 3.7%

## South Africa

Economic growth for Q2 2021 surprised to the upside at 1.2% (q/q annualised) compared to the consensus of 0.7% q/q, and up from the revised 1.0% q/q recorded in the previous quarter. This amounted to 19.3% y/y growth due to the low base of the previous year. Growth was uneven across sectors, with transport, agriculture and services posting the strongest performances, while manufacturing contracted. However, news was dominated by the July riots sparked by the jailing of Jacob Zuma - National Treasury estimated the resulting damage could subtract around 0.9 percentage points from 2021 GDP growth.

Growth prospects were also hit by the higher lockdown levels imposed as a result of the spiking "third wave" of the coronavirus pandemic during the quarter, which came despite the continued rollout of the government's vaccine programme. The ebbing of the wave towards quarter-end was a positive sign that vaccinations were making progress in combatting the Delta variant of the virus, also paving the way for a further reopening of the economy.

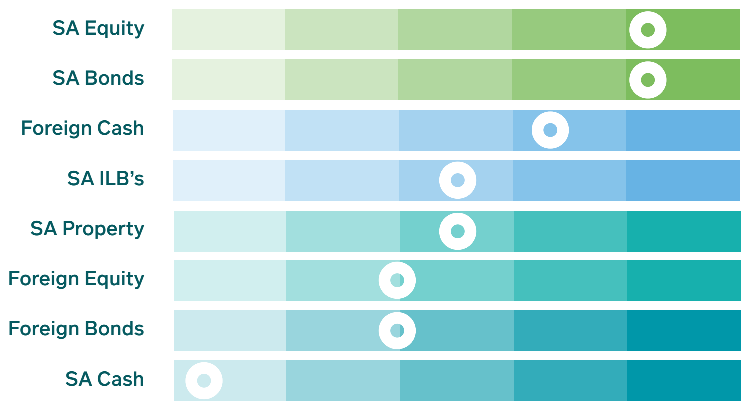
At its September MPC meeting, the South African Reserve Bank kept its benchmark interest rate unchanged at a record low of 3.5%, but sounded more hawkish as it indicated that its first 25bp hike would be coming in the last quarter of the year, as well as further 25bp increases in each quarter of 2022 and 2023. Importantly, Governor Lesetja Kganyago floated the idea that the SARB may want to reduce its inflation target range from the current 3%-6% to below the inferred 4.5% mid-point target.

Good news came in the form of record-breaking trade surpluses on the back of the rise in commodity prices earlier in the quarter, in turn creating higher-than-expected tax receipts from mining companies. This alleviated some pressure on the government's expected budget deficit, allowing Treasury to cut some planned bond issuance. However, with commodity prices falling later in the quarter, concerns returned over the perilous state of government finances.

The FTSE/JSE ALSI returned -0.8% during Q3 (losing 3.1% in September alone on the back of the higher global investor risk aversion). However, the more locally-exposed FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for most of our client mandates, returned 3.2% for the quarter and -1.4% in September The local market outperformed many of its emerging market peers in Q3, helped by its better relative value and improved company earnings prospects during the period. The standout sector was Financials, which delivered a 13.2% return, followed by Listed Property (the All Property Index) with 6.5%. The Resources 10 Index retraced some of its previous strong performance with a -3.8% return amid growing concerns over a Chinese economic slowdown, and the Industrials sector was partially impacted by its Naspers/Prosus exposure, posting a -4.3% total return.

## Asset Class Preferences

### 5-year period
### Best investment view*




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

SA bonds still managed to eke out a 0.4% positive return during the quarter (as measured by the FTSE/JSE All Bond Index), losing 2.1% in September as US Treasuries and global bonds recorded negative returns. The local yield curve continued to flatten as longer-dated bonds outperformed, reflecting South Africa's relatively steeper curve at the beginning of the period. Meanwhile, SA inflation-linked bonds again outperformed their nominal counterparts as inflation fears gained ground, producing 2.0% (Composite ILB Index), and cash (STeFI Composite) delivered 1.0%.

Finally, the rand depreciated against the major global currencies over the quarter, retracing some of its gains seen earlier in the year amid the higher risk-off sentiment and a stronger US dollar, particularly in September. It lost 5.4% against the US dollar, 2.9% versus the pound sterling and 3.0% against the euro over the three months. This helped boost returns for SA investors with offshore exposure.

## How have our views and portfolio positioning changed?

Starting with our view on **offshore asset allocation**, our portfolio positioning shifted during Q3 as we opted to reduce our **global equit**y exposure slightly in favour of global cash, which helped to lower risk. As such, among global asset classes we now prefer cash to equities and bonds. Within our global equity positioning, we remained cautious in our exposure to US equities, as this market continued to be expensive compared to most other countries. Instead, our portfolios favour selected European and other developed market equities, and some 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, thereby cushioning them against unforeseen shocks.

At the same time, we kept a marginal preference for **global government bonds** in Q3, out of **investment grade corporate credit**, having added small selective exposure to emerging market government bonds in Q2 as yields remained particularly attractive. We believe that corporate yield spreads are no longer sufficiently high for the risk. In aggregate, our portfolios continued to be tilted slightly away from global bonds in total at quarter-end, in favour of global cash.

Our best investment view portfolios like the M&G Balanced Fund still heavily favoured **SA equities** at the end of Q3. SA equity valuations (as measured by the 12-month forward Price/Earnings ratio of the FTSE/JSE Capped SWIX Index) de-rated slightly over the quarter, moving from around 9.2X at the beginning of the quarter to around 9.1X at quarter-end. With investor risk concerns rising, equity price gains didn't keep pace with improvements in company earnings expectations. This improvement in valuations was too small to cause us to increase 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) did not work in our favour over the quarter due to the relative underperformance from these shares, including Implats and Amplats, which were hit by the plunge in PGM prices. 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 overweight exposure to MTN and Sasol, and our more recent reduction in our Resources holdings (apart from platinum) also helped portfolio performance.

We have maintained our positioning in **SA listed property** in Q3 2021. We see these assets as being fairly valued based on the risk involved. Listed property remains the best-performing sector (and asset class) in 2021, recording a 27.9% return over the nine months to end-September. It also continues to have good long-term growth prospects, with the All Property Index now reflecting a 12-month forward dividend yield at around 9%, plus further growth expected on top of this. However, listed property is a lagging sector in the cycle, as earnings are usually only impacted negatively once rental contracts come to an end and new rents are set at lower levels (negative reversions) – and this is still happening. So while the logistics and self-storage segments have been the most resilient and are performing well, retail is still weak and the office segment even weaker, plagued by high vacancies. On the positive side, new speculative developments in these segments have halted during the pandemic and the retail supply-demand balance is healthier, which should lead to improving rental growth over the medium term.

Our broad view based on earnings reports is that risks in the listed property sector have improved since the beginning of the year, and our holdings within the sector reflect this. While we have not raised our overall holdings, we have shifted some exposure away from the higher-valued counters into more attractively-valued companies with higher return prospects.

**SA nominal bonds** managed to record a marginal positive return in Q3, and our portfolios benefitted from our continued preference for these assets. During the quarter we added to our holdings as nominal bonds' relative valuations became more favourable. We also took some profits in our longer-dated bond positions and bought somewhat shorter-dated bonds on the back of the yield curve flattening during the quarter. As such we shifted away from our previous 15+-year focus to a 10-12-year focus, where valuations have become more attractive on a relative basis. We believe nominal bonds remain attractive relative to other income assets and their own longer-term history and will more than compensate investors for their associated risks.

**Inflation-linked bonds (ILBs)** outperformed their nominal counterparts during the quarter. Although we are not holding ILBs in our best investment view portfolios, we do hold them in our real return portfolios like the Inflation Plus Fund.

The outperformance by ILBs led us to take some profits in our real return portfolios and buy more nominal bonds during Q3, as the latter's relative valuation became more favorable. Although we reduced our exposure, ILB real yields are still relatively attractive compared to their own history and our long-run fair value assumption of 2.5%. In Q3 the gap between ILB and cash real yields narrowed, as cash real yields were steady.

Lastly, our best investment view portfolios remained heavily tilted away from SA cash as our least preferred asset class, since prospective real returns are negative and other SA assets more attractive on a relative basis. □