MARKET OBSERVATIONS

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QUARTERLY MARKET COMMENTARY

QUARTER 1 2017

The first quarter of 2017 (Q1) saw a very positive start to the year as global financial markets were underpinned by generally improving macroeconomic data and bullish investor sentiment that drove good demand for both developed and emerging market assets. In the US, the "Trump reflation" trend continued, pushing equity markets still higher, while surprisingly robust growth in the UK and steady growth in Europe bolstered markets there. China experienced one of its strongest starts to a year in equities, helped by low market volatility and improving economic and corporate fundamentals. By contrast, in South Africa, after 11 weeks of improving conditions (with a strengthening rand and brightening outlooks for inflation, interest rates and growth), the local economy and financial markets were hit by a Cabinet reshuffle replacing the Finance Minister and his Deputy, as well as consequent downgrades of the sovereign credit rating to sub-investment grade by S&P Global and Fitch.

ASSET CLASS	TOTAL RETURN: 2017
Global equity – MSCI World Free (US$) (Developed)	6.4%
Global equity – MSCI Emerging Markets (US$)	11.4%
Global bonds – Barclays Global Agg Bond Index (US$)	1.8%
SA equity – FTSE/JSE All Share Index	3.8%
SA bonds – BEASSA All Bond Index	2.5%
SA listed property – SA Listed Property Index	1.4%
SA inflation-linked bonds – JSE CILI Index	-0.6%
SA cash (STeFI Composite Index)	1.8%

Source: Prudential, Deutsche Securities, data to 31 March 2017

US REFLATION TREND CONTINUES AS GLOBAL PROSPECTS IMPROVE

In the US, as in the previous quarter, stronger-than-expected GDP growth (at 2.1% in Q4 2016 q/q annualised) combined with a tighter jobs market, as well as firming inflation, to reinforce the widely expected Fed rate hike of 25bps in March. FOMC members' consensus forecasts indicated a further two 25bp rate hikes in 2017 given the underlying healthy economy. In turn, the interest rate market was also discounting at least another two 25bp increases this year.

The Barclays Global Aggregate Bond Index (US$), a mixture of government and corporate bonds, managed to return 1.8% in the quarter, reversing some of Q4's sharp losses as 10-year yields of over 2% attracted investors. US investment grade corporate bond spreads versus USTs narrowed only marginally to 122bps from 129bps, while high-yield bond spreads fell by around 37bps (led by telecom and healthcare companies rather than the energy sector this quarter). A slightly weaker US dollar vs the yen and euro also lifted bond returns from these markets. In the equity market, stocks rallied strongly, boosted by hopes of higher government spending, corporate tax cuts and deregulation under Trump: the S&P 500 returned 6.1%, the Dow Jones 5.2% and the Nasdaq 12.1% for the quarter.

In the Eurozone, worries of a populist victory in the Netherlands' election were put to rest as the far-right party lost by a sound margin. French elections will be the next test: the anti-euro nationalist party is expected to perform well. The region's Q4 2016 GDP growth was reported steady at 1.8% (q/q annualised), fuelled by the ECB's ongoing easy monetary policy, while inflation picked up to 2% y/y in February, mostly on the back of higher energy costs. The Dow Jones Eurostoxx 50 returned 8.3%, while Germany's DAX returned 8.8% and the French CAC 7.1% (all in US$). Although Britain served its formal "Brexit" notice to the EU in March and its ability to negotiate favourable exit terms appeared increasingly difficult, UK economic data was upbeat and the FTSE 100 returned 5.3% (in US$) over the quarter. Sterling remained weak, however, spurring more inflation worries for 2017, and the Bank of England refrained from raising interest rates.

In Japan, Q4 2016 GDP growth disappointed slightly at 1.0% q/q annualised from a revised 1.4% in the previous quarter - private consumption was essentially flat while export growth accelerated. The Finance Minister said the economy remained in a "moderate recovery" after four quarters of expansion, with the job market improving. Core inflation also rose to 0.2% y/y in February due to higher energy prices. The Nikkei 225 Index returned 4.5% over the quarter (in US$).

In China, 2017 started strongly with the MSCI China posting a total return of 12.9% (in US$) in Q1 – its best start in years – amid improving corporate fundamentals, solid investor demand and low volatility. The yuan's exchange rate stabilised on the back of the improving global trade outlook, and concerns over growth and previous market volatility receded. GDP growth for Q4 2016 was reported at 6.8% (q/q annualised), slightly above the 6.7% expected, as consumer spending accelerated and the property market rebounded.

Other emerging market assets, including both bonds and equities, recorded good gains amid renewed investor demand for risk assets. Overall, the MSCI Emerging Markets Index returned an impressive 11.4% in US$, compared to 6.4% from the MSCI World Free Index for developed markets. The MSCI India was the strongest performer with a 17.1% total return over the quarter, followed by South Korea's KOSPI (+16.5%), the MSCI China (+12.9%), Brazil's Bovespa (+11%) and the MSCI Turkey (+10.9%) all in US$. The MSCI South Africa returned 4.6% for Q1 in US$.

In commodities, the oil price softened somewhat to trade around US$50/barrel at quarter-end from around $55 at the start of the year as the effects of a curtailed supply stemming from the OPEC agreement were offset to some extent by rising supplies from the US. Brent crude fell 7.0% over the quarter. Most other commodity prices were firmer, however, on signs of improving global growth and re-emerging inflationary pressures. Gold gained 8.9% in Q1, while platinum rose 5.2% and palladium was up 19.1%. Other good gains were recorded by aluminium (+14.6%), lead (+16.6%) and zinc (+7.5%).

SA DOWNGRADES, POLITICAL UNCERTAINTY ROIL MARKETS

Much has been written about the Cabinet reshuffle and resulting credit rating downgrades by S&P Global (and later Fitch) to sub-investment grade that occurred at the end of March/early April. The appointment of an inexperienced leadership team at National Treasury without a solid reputation for fiscal probity has undermined confidence in the Treasury's ability to implement sound fiscal policy (as contained in the latest Budget) and reforms, as well as to maintain high standards of governance. This, in turn, has caused heightened political risk and uncertainty among investors and consumers. The sovereign downgrade will lead to higher overseas borrowing costs for both government and SA banks. Fortunately these foreign borrowings are not at high levels by global standards, and therefore for now the impact is relatively muted.

The immediate impact of these moves saw the rand depreciate about 8% against the US dollar during the last trading week of March (starting from when the Finance Minister was recalled from his UK investor roadshow). This erased most of the good gains recorded by the local currency over the quarter, having begun the quarter at R13.73/US$, appreciated to R12.3/US$ and post the news, jumped to around R13.8/US$ in early April; however, it still managed to appreciate over the three-month period by 2.2% against the US dollar, by 1.2% against the pound sterling and by 0.8% versus the euro. Market reaction was not nearly as severe as the sharp sell-off at the time of Nenegate in December 2015,

Meanwhile, SA 10-year nominal bond yields rose from around 8.4% (prior to news of the Finance Minister's recall) to around 8.9% on 31 March, before rising above 9% in the first week of April. This also reversed some of the good gains accumulated over the quarter in response to strong foreign investor demand for EM assets. For the quarter, the BEASSA All Bond Index returned 2.5%. As of 17 March, however, it had returned 4.2% for 2017 (over the first 11 weeks of the year). Inflation-linked bonds (ILB Composite Index) lost 0.6% in the quarter as inflation expectations adjusted higher. Cash (the STeFI Composite) returned 1.8%.

Equities were the top performing local asset class for the quarter, with the FTSE/JSE All Share Index returning 3.8%. This reflected a relatively strong performance from industrial counters (+6.6%) given their rand-hedge characteristics, and resources (+2.7%) as commodity prices continued to rise. Financials (particularly banking shares) were hardest hit by the turmoil with a total return of -1.1% over the three months. Listed property was also sold off in late March as an interest-rate-sensitive asset, but managed to return 1.4% in Q1.

At the SA Reserve Bank's Monetary Policy Committee (MPC) meeting on 29-30 March, the MPC left the repo rate unchanged at 7.0%, citing an improved inflation outlook and subdued energy prices. February CPI slowed to 6.3% y/y from 6.6% y/y in January as food prices fell; however, this welcome development was quickly overtaken by the subsequent Cabinet reshuffle and downgrades. GDP growth for Q4 2016 slumped to -0.3% q/q annualised, from an upwardly revised 0.4% q/q annualised in Q3, as mining and manufacturing output shrank. For 2016 as a whole, the economy grew by 0.3% versus 1.5% in 2015, and growth is expected at 1.1% in 2017.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

In global fixed income, although government bond yields have stayed on a rising trend, especially in the US (with the yield on the 10-year US Treasury bond at around 2.42% at quarter-end), they continue to be expensive given the very low base from which they started. We remain underweight sovereign bonds and underweight duration, and continue to hold cash and shorter-term bonds in order to reduce interest rate risk. We are neutral on both investment-grade and high-yield corporate bonds in the US and Europe, as corporate spreads versus USTs have narrowed to be largely priced at fair value to slightly expensive.

For global equities, the ongoing rally in many global equity markets (especially the US) has kept valuations at levels more expensive than those of South Africa, on the basis of both 12-month forward P/E and price-to book measures. In the US, equity prices rose slightly more than earnings growth. As such, we have retained our neutral positioning in global equities in our portfolios as markets remain generally fairly priced, and are underweight global bonds to global cash. In our higher return-targeting multi-asset funds we continue to be very near our maximum permitted 25% offshore weighting. Our overweight exposures are concentrated in European markets where long-standing growth concerns have kept valuations on the cheap side of fair value, as well as selected emerging markets including India, funded by underweights in the US, Japan and a variety of other smaller markets including Australia. Over the quarter equity risk premiums (the yield on equities vs bonds) narrowed, but still provide a substantial valuation buffer that should help to protect equities in the event of growth disappointment.

South African equities moved to somewhat more expensive valuations over the quarter compared to their long-term fair value, with the FTSE/JSE ALSI 12-month forward P/E rising to 14.1x at quarter-end from 13.8x in Q4 2016. Earnings growth improved largely on the back of higher earnings from resource companies (due to rising commodity prices), while earnings from financial and industrial stocks tracked sideways. Share price increases outpaced earnings growth, however. In our multi-asset funds we continue to be overweight in local equities on an asset allocation basis.

ASSET CLASS	POSITIONING
Foreign equity	Neutral
Foreign sovereign bonds	Underweight
Foreign corporate bonds	Neutral
Foreign cash	Overweight
SA equity	Overweight
SA listed property	Overweight
SA bonds (government and corporate)	Overweight
SA inflation-linked bonds	Underweight
SA cash	Underweight

Rand hedge stocks have benefitted from the state of heightened uncertainty, and should continue to do so in the short term. Prudential's portfolios are overweight stocks like Naspers, British American Tobacco, Exxaro, Sasol, Anglo American and Glencore. We also hold non-mining stocks like Sappi. We have also been overweight in Financials, although we pared our overweight position in the sector prior to the downgrade: our ongoing overweights include Old Mutual, Investec and Barclays Group Africa. We have been underweight in Retailers given the challenging consumer environment, but do continue to hold selective overweights in Foschini and Pick 'n Pay. We have preferred to gain our consumer exposure via well-priced and more defensive consumer services providers like Sun International.

In SA listed property, we have maintained our overweight exposure in our multi-asset funds, with yields at even more attractive levels following the late March/early April sell-off. At quarter-end, listed property companies (excluding developers) were priced to return approximately 16% p.a. over the medium-term (assuming no change in the market's valuation of property), comfortably above inflation and, we believe, ample compensation for the risk involved.

In SA nominal bonds, we took some profits in mid-March (before the sell-off) when prices had rallied to reach attractive levels, trimming our moderately overweight position. However, we subsequently bought back part of this holding as yields rose following the sell-off, with the 10-year government bond trading above 9.0%. Consequently, we are still modestly overweight bonds in our multi-asset funds. Within this exposure, we are also overweight longer-dated bonds versus shorter paper due to the more attractive yields on offer, while retaining our overweight exposure to corporate bonds.

Inflation-linked bonds remained somewhat expensive compared to conventional bonds over the quarter, leading us to maintain our underweight in these assets in our multi-asset portfolios in favour of SA equities, listed property and nominal bonds. The 10-year break-even inflation rate fell to a low of around 6.3% in mid-March before jumping to 6.5% at month-end, lower than the 6.8% seen in the previous quarter, but still elevated compared to our long-term inflation benchmark of 6.0%.

LOOKING AHEAD

South Africa's new sub-investment grade credit rating status and uncertainty around our fiscal policy implementation, governance standards and political risk will keep financial market volatility elevated in the months ahead. Importantly, the extent of further rand depreciation following the downgrades will determine how much higher inflation and interest rates will rise over the medium term, which in turn would impact on interest-rate-sensitive assets like bonds and listed property.

As prudent valuation-based investment managers, we believe there will be opportunities created by the greater uncertainty now prevailing that could allow us to buy assets at attractive valuations where the risks are appropriate. This will benefit clients over the medium to long term. Having recently reduced our bond exposure as the market rallied, for example, these setbacks have presented an opportunity to reacquire some of those securities at significantly lower prices. ■