MARKET OBSERVATIONS

BY DAVID KNEE, CHIEF INVESTMENT OFFICER

PRUDENTIAL
INVESTMENT MANAGERS

QUARTERLY MARKET COMMENTARY

QUARTER 2 2019

The second quarter of 2019 (Q2) was a true rollercoaster for investors around the world, as market sentiment seemed to whipsaw from positive to negative on the back of ever-changing US-China trade news and evolving central bank policy. April's solid equity gains turned into sharp losses in May, only to rebound again in June, leaving investors with good returns across the board, although not as strong as those recorded in Q1. Propelling gains were the easier monetary outlooks adopted by many central banks in the face of building evidence of a growth slowdown, as well as better news on US-China trade negotiations seeming to outweigh the negative news on that front by the end of the quarter. Emerging markets also benefitted somewhat from the more bullish sentiment and the lower global interest rate outlook. For South African investors, local equities and bonds posted decent gains in rand terms, and the rand managed to rally against all the major currencies for the quarter thanks to a rebound in June after some weakness in May.

As shown in the table below, in US$ terms, global equity (the MSCI All Country World Index) returned 3.6% for the quarter, with developed markets posting 4.0% and emerging markets producing 0.6%. Global bonds delivered 3.3% and global property 1.0%, buoyed by the Fed's unexpectedly more dovish interest rate outlook.

ASSET CLASS	TOTAL RETURN: Q2 2019 (RAND & US$)
SA equity – FTSE/JSE All Share Index (Rand)	3.9%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	2.9%
SA listed property – FTSE/JSE All Property Index (Rand)	1.5%
SA bonds – BEASSA All Bond Index (Rand)	3.7%
SA inflation-linked bonds – JSE CILI Index (Rand)	2.8%
SA cash - STeFI Composite Index (Rand)	1.8%
Global equity – MSCI All Country World (Total) (US$ net)	3.6%
Global equity – MSCI World (Developed) (US$ net)	4.0%
Global equity – MSCI Emerging Markets (US$ net)	0.6%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	3.3%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net)	1.0%

Source: Prudential, Bloomberg, data to 30 June 2019

In the US, the advent of 1 July 2019 made the current economic expansion the longest (albeit most pedestrian) recovery in US history. GDP growth came in surprisingly high for Q1 2019 at 3.1% (q/q annualised, revised), due to an improved trade surplus and higher inventories, short-term factors that masked sizeable drops in consumer and business spending, as well as weaker housing investment and declines in manufacturing production. The jobs market remained exceptionally strong, with unemployment at 3.6% at a 50-year low. Wage and inflationary pressures were subdued, however: May CPI came in at only 1.8% y/y and earnings rose only 3.1% y/y, leaving space for rate cuts. At its June meeting, the Federal Reserve left interest rates unchanged, but Chairman Jerome Powell signalled the Bank was ready to support the economy with lower rates if necessary. Its latest "dot plot" (forecasting the expected rates path) was changed to indicate a rate cut sometime in 2020. This was very positive for equities and bonds. For the quarter, the US 10-year Treasury yield fell notably, from around 2.4% to 2.0% at quarter-end. In the equity market, the US S&P 500 returned 4.3%, the Nasdaq 4.2% and the Dow Jones Industrial 3.2%.

In the UK, Prime Minister Theresa May was forced to resign after failing to deliver Brexit. The new contest for PM only served to extend policy uncertainty, and the chances of a "no deal" rose substantially with Boris Johnson seen as the favourite. The pound sterling weakened as a consequence. Amid broadly slowing UK and EU growth, the Bank of England downgraded its 2019 growth forecast from 1.7% to 1.2%, and the ECB suggested it would adopt "additional stimulus" if growth and inflation didn't improve. Meanwhile, in more positive news the Italian government reached a deal with the EU Commission over debt-reduction measures, avoiding a fiscal crisis. The UK's FTSE 100 returned 0.9% for the quarter, while Germany's DAX produced 9.1% and the French CAC 40 delivered 7.7% (all in US$).

Japan's economy accelerated by a surprising 2.1% in Q1 2019 (q/q annualised), but concerns remained over weak exports, depressed capital spending and downbeat consumer sentiment. As such, the Bank of Japan kept its easy monetary policy in place, and a debate emerged over the planned imposition of a new consumption tax later in the year. For Q2, the Nikkei 225 returned 3.3% in US$.

In China, meanwhile, Q1 2019 GDP growth came in at 6.4%, largely in line with consensus expectations. However, the IMF trimmed its 2019 growth forecast for the country to 6.2% from 6.3% previously. Although renewed optimism over a positive outcome for US-China trade negotiations pushed the MSCI China 8.1% higher in June, it was still one of the only large equity markets in the red for the quarter with a -3.9% return (all in US$). Hong Kong and Singapore markets were also dented by trade fears, as well as by the exceptionally large Hong Kong protests over proposed new extradition measures to China that were eventually set aside.

Among other emerging markets, strong performers for the quarter included the MSCI Russia with 17.3% and Brazil's Bovespa at 7.4%. Aside from China, the weakest markets were South Korea's KOSPI 200 (-1.3%), the MSCI India (0.5%) and the MSCI Turkey (3.1%), all in US$.

After a 27% rise in the previous quarter, the price of Brent crude oil weakened by 2.7% in Q2 on the back of slowing global growth concerns and rising US production. The fall was mitigated by a renewed OPEC and Russia pact to extend supply cuts through the end of 2019, as well as fears of supply disruptions in the Strait of Hormuz and Iran after ship bombings in the Strait and additional sanctions affecting the latter. After starting the quarter at around US$67 per barrel, it ended around US$65. In other commodities moves, industrial metals like nickel, copper, aluminium and zinc lost ground on deteriorating global growth, but gold gained on its safe haven status amid the trade war and the palladium price also rose on good demand.

SOUTH AFRICAN RETURNS IN POSITIVE TERRITORY

SA equities and bonds both managed to post decent gains in Q2 2019, helped by the more upbeat global sentiment and lower interest rate outlook, but dented somewhat by the stronger rand. Developments were mixed over the quarter. First, Q1 GDP surprised by contracting 3.2% (q/q annualised), the largest downturn in a decade. As a consequence, many institutions – including the SA Reserve Bank, IMF and Moody's – downgraded the country's 2019 growth forecast to only 1.0%. With CPI under control at 4.5% y/y in May, the SARB left interest rates on hold and lowered its interest rate outlook to include one 25bp rate cut by the first quarter of 2020. Still, it remains concerned about future inflationary pressures arising from the weaker rand, as well as higher costs from fuel and electricity, among other sources.

The ANC's comfortable 57.5% win in the national elections boosted investor confidence that Cyril Ramaphosa would be able to pursue a course including difficult structural reforms and curbing corruption. The new cabinet was well received as well, although investors were disappointed by the lack of detail in plans to reform Eskom and deal with its high debt levels in the President's State of the Nation Address. Detracting from the positive sentiment were contradictory ANC statements around the nationalisation of the SARB and attacks on the central bank's independence that undermined investor confidence.

The FTSE/JSE ALSI returned 3.9% for the quarter, led by Financials with 5.4%, which were bolstered by the easier interest rate outlook. Industrial counters delivered 4.0%, Resources produced 2.4% and Listed Property returned 1.5%. The FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for the majority of our client mandates, returned 2.9%.

SA bonds also rallied on the easier interest rate outlook globally and in South Africa, as the BEASSA All Bond Index delivered 3.7% in Q2: the yield on the benchmark R186 bond (due 2026) fell from around 8.6% at the start of the quarter to end at 8.1%, a significant move. The SA yield curve steepened as the longer-dated R209 bond (due 2036) only fell slightly - to 9.4% from 9.5%. SA inflation-linked bonds returned 2.8% over the three months, while cash (as measured by the STeFI Composite) delivered 1.8%. Despite a wide trading range over the quarter in which the rand weakened to over R15/US$ but subsequently rebounded, the local currency managed to gain 2.5% versus the greenback, 4.5% against a struggling UK pound sterling and 1.1% versus the euro.

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.

The global equity risk premium on offer remains substantially above historic norms, reflecting the extraordinarily low government bond yields, which fell further during the quarter as a result of global interest rate expectations being revised downward. 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 are still trading at slightly expensive levels, but are less expensive than other developed markets like the UK, EU and Japan, where government bond yields remain at exceptionally low levels. Consequently, the asset class as whole remains unattractive versus equities. We are underweight global sovereign bonds and underweight duration, preferring to hold investment-grade US and European corporate bonds. These assets are slightly cheap and have the potential for stronger returns going forward now that US interest rates could possibly head lower from here, or at least stay steady.

For **global equities**, we have maintained our overweight position as a whole given the very high risk premium from equities versus 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 Italy, Germany, Japan and Singapore. 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.

In our mandates with equity constraints like the Prudential Inflation Plus Fund (at 40%), we switched some of our foreign equity exposure into SA equity holdings due to the widening of the valuation differential to very attractive levels in June.. This did not change our overall underweight SA equities/ overweight global equities positioning for these funds, however.

South African equity valuations did not change materially over the quarter, hence we retained our overweight position in SA equities in our house view portfolios like the Prudential Balanced Fund. In May we did add slightly to our SA equity holdings in the Balanced Fund by selling SA nominal bonds as valuations became less attractive in the latter, but this did not alter our broad overweight in SA bonds.

Our house view portfolios (like the Prudential Balanced Fund) 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). In general these stocks did not add as much value to our portfolios as in the previous quarter due to the stronger rand over the period and subdued gains in the Resources sector. Sasol was one of the largest detractors from fund performance over the quarter after its share price came under pressure when in May it reported a major $1.1 billion overrun in costs for its Lake Charles chemicals project in the US. Its share price lost over 13% on the day and more in subsequent days. Other detractors included Sappi, BAT and our underweights in gold counters like Anglogold and Goldfields.

We have also maintained our overweight exposure to financial shares including Old Mutual, Investec plc, Standard Bank and Absa, which have offered attractive valuations with relatively high dividend yields. Apart from Old Mutual, these holdings added good value over the quarter. At the same time 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.

We remain cautiously optimistic regarding SA equity market returns over the medium term due to the prevailing excessive levels of pessimism reflected in share prices and valuations.

In **SA listed property** we are 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 around the quality of earnings and possibility of further downward revisions to earnings forecasts for listed property. The sector faces 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.

In our real return mandates like the Prudential Inflation Plus Fund where we hold significant listed property exposure, we trimmed our holdings slightly in June to take more risk off the table given we are not convinced that current earnings forecasts fully reflect market fundamentals. We did not do this for our house view portfolios, which already have very low listed property exposure.

In **SA nominal bonds**, valuations remained cheap over the quarter compared to their longer-term fair value, although they did become more expensive relative to SA equities. Hence we sold some bonds in the Prudential Balanced Fund to buy more SA equities. We continue to be overweight SA bonds, and still prefer longer-dated government bonds (like the R209) due to the more attractive yields on offer above 9%. We are also comfortable with the compensation bonds offer given the risk involved, while recognising that 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**, real yields remain attractive for long-dated tenors. However, we continue to be neutrally positioned in this asset class because 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. ■

ASSET CLASS PREFERENCES: 5-YEAR PERIOD

Prudential House View**

ASSET CLASS	POSITIONING 31 MAR 2019	POSITIONING 30 JUN 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 house view preferences are implemented where all fund mandates allow. Positioning will differ in portfolios with constraints in their mandates.