MARKET OBSERVATIONS

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QUARTERLY MARKET COMMENTARY

QUARTER 1 2020

The first quarter of 2020 was completely dominated by the rapid spread of the COVID-19 virus around the globe. Its negative impact made itself felt in every corner of the globe, taking a heavy toll on human lives and economic activity as global lock-downs were implemented. All types of assets, including many traditional safe-havens like government bonds, were hit by wholesale selling, which was exacerbated by forced liquidation of many leveraged investors needing urgent liquidity. Uncertainty pervaded investor sentiment as the extent and severity of the virus and its impact on economic growth remained unknown. The IMF warned of a coming global recession worse than that of the 2008 Global Financial Crisis (GFC), while ratings agency Fitch projected a 1.9% contraction in global growth for 2020. South Africa fared worse than most countries due to its already-precarious government finances and recessionary economic environment, which were exacerbated by Moody's downgrade of its sovereign credit rating to below investment-grade status in late March.

ASSET CLASS	Total return Q1 2020 (Rand and US$)
SA equity – FTSE/JSE All Share Index (Rand)	-21.4%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	-26.6%
SA listed property – FTSE/JSE SAPY (Rand)	-48.2%
SA bonds – BEASSA All Bond Index (Rand)	-8.7%
SA inflation-linked bonds – JSE CILI Index (Rand)	-6.6%
SA cash - STeFI Composite Index (Rand)	1.7%
Global equity – MSCI All Country World (Total) (US$ net)	-21.4%
Global equity – MSCI World (Developed) (US$ net)	-21.1%
Global equity – MSCI Emerging Markets (US$ net)	-23.6%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	-0.3%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net)	-30.4%

Source: Prudential, Bloomberg, data to 31March 2020

As shown in the table, in US$ terms, global equities (the MSCI All Country World Index, ACWI) returned -21.4% for the quarter, while developed markets delivered -21.1% and emerging markets produced -23.6%. For SA investors, the rand's 27.4% depreciation against the dollar (and by similar amounts against other major currencies) helped to cushion global investments in rand terms – for example, the MSCI ACWI returned 0.2% in rands. Global bonds delivered -0.3% for the quarter in US$ (but 27.0% in rands) and global property returned -30.4%. This was despite widespread emergency monetary easing and market support from the major central banks.

In the US, to counteract the effect of spreading lockdowns across the country, the US Federal Reserve undertook an emergency 100bp interest rate cut and US$700bn in bond buybacks, while the government announced record fiscal stimulus measures to counter the anticipated surge in unemployment and stress on corporate and individual earnings. Markets did not react positively to the Fed's move, with volatility remaining high. Analysts are expecting US GDP growth to contract by around 3.3% for the year, although estimates vary widely. In the equity market, the S&P 500 lost 19.6% in US$ for the quarter.

In the UK and Europe, central banks and governments followed the US's lead, although with interest rates already at record low levels, they were unable to cut interest rates as much. The BoE lowered its base interest rate from 0.75% to 0.25%, and then again to a record-low 0.1% a week later. The ECB established a new 750bn-euro emergency facility to stabilise Eurozone bonds. While both areas announced aggressive fiscal measures, these weaker monetary measures combined with already-lacklustre growth led to fears of worse recessions than the US, with forecasts of -3.9% GDP growth for the UK and -4.2% GDP growth for the EU (by Fitch). In the equity markets, the FTSE 100 returned -28.7% in US$ for the quarter, while Germany's DAX produced -26.6% and the French CAC 40 delivered -27.8% in US$.

In Japan, the economy was already weak with a much worse-than-expected contraction in GDP growth of -7.1% q/q annualised in Q4 2019, due largely to the impact of the new local consumption tax. With interest rates already at -0.10%, the Bank of Japan left rates on hold but announced a doubling in its purchases of bonds and riskier exchange-traded funds to shore up the economy and markets. However, investors were underwhelmed by the move. Late in March Prime Minister Shinzo Abe unveiled an unprecedented Y60 trillion (US$556 billion) stimulus package to help households and small businesses. The Nikkei 225 returned -18.7% for the quarter.

In turn, the Chinese government announced a US$7bn support package for the economy, and the PBoC cut its base interest rate by 20bps. In Wuhan province, the epicentre of the outbreak, and other areas of China, some businesses started to reopen as the worst of the pandemic passed, hopefully pointing to the future of other areas of the globe as well. Analysts estimated Chinese economic growth for 2020 would more than halve to around 2.5% from 5.6% previously. Hong Kong's Hang Seng Index returned -15.5% for the three months and the MSCI China returned -10.2% in US$.

Among other emerging equity markets, in US$ terms Brazil's Bovespa proved to be the hardest hit with a -51.0% return for the quarter, while the MSCI South Africa returned -40.3%. The MSCI Russia delivered -36.3% and the MSCI Turkey -30%, also in US$.

The price of Brent crude oil was hammered by both expectations of slowing demand and the start of a price war between OPEC and Russia, in which Russia

refused to agree with OPEC's demands to lower its production targets to prevent oversupply. The oil price plummeted by 65.6% during the quarter, starting at approximately US$67 per barrel and then hitting a low of under US$25 per barrel before rebounding to end March at around US$34 per barrel.

As for other commodities, only gold and palladium were immune from the Coronavirus sell-off. Gold gained a mere 6.0% for the quarter, despite its safe-haven status, while palladium was up 19.2%. Platinum fell 25.3%. Industrial metals prices, meanwhile, all lost between 17% and 22% as investors factored in a slowdown in global demand until economies recover from the impact of the shutdowns around the world.

SOUTH AFRICA HIT BY GLOBAL AND LOCAL FEARS

South African assets and the rand were hit harder by the global sell-off than most emerging markets. This was due to the already-fragile state of the economy, given that it had entered into a recession in Q4 2019 with GDP shrinking by 1.4% q/q annualised. Plus the more liquid nature of the local financial markets made it an easy option for wholesale selling of emerging market risk by global investors amid the flight to safety.

On top of this, government bond and rand sales were exacerbated by Moody's downgrade of the sovereign credit rating to non-investment grade status on 27 March (a move that was widely expected), as well as by the SA government's announcement of some fiscal tax and spending measures to help individuals and small businesses weather the local shutdown, which are expected to push the government budget deficit further into the red. This extra spending rendered February's National Budget plans to reduce the deficit essentially redundant. The extent of the bond sales attributable to the downgrade was unclear, making it difficult to gauge the amount of selling that will come later once South Africa exits the World Government Bond Index of investment-grade bonds. The latter was postponed until after shutdowns are lifted.

Meanwhile, at its 19 March MPC meeting the SA Reserve Bank revised its GDP growth forecast for SA to -0.2% in 2020 from 1.4% previously, which many believed to be optimistic under the current conditions. It also announced a much larger-than-expected 100-basis point reduction in the repo rate to 5.25% in a bid to offer some economic relief. Additionally, it undertook a bond repurchase programme to support the government bond market for the first time. This helped to pare losses in SA bonds: nominal yields on the 20-year government bond had shot up from around 10% to above 14% briefly, before settling at around 12.3% after the SARB intervention. The BEASSA All Bond Index delivered -8.7% in Q1 2020, while SA inflation-linked bonds returned -6.6%. Cash (as measured by the STeFI Composite) produced 1.7% for the three-month period.

The local equity market experienced its worst quarter since September 1998, and March saw its weakest monthly performance since the start of the GFC in 2008. Companies with global earnings did fare better than local "SA Inc" shares. The FTSE/JSE All Share Index returned -21.4% for Q1 2020, led by Listed Property (SAPY Index) with a -48.2% return. Financials were the second-worst performers with -39.5%, followed by Resources with -25.3% and Industrials at -8.4%.

Finally, the rand depreciated sharply against all three major currencies amid the coronavirus sell-off, falling 27.4% against the US dollar, 19.5% against the pound sterling and 24.7% versus the euro.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

Starting with our view on **offshore asset portfolios**, we have been overweight **global equities** for some time now and our portfolios' performance has benefited from this positioning during the quarter, thanks to the broad diversification it offers. We were underweight the more expensive US market in favour of selected European and emerging market equities. Although global equities were already more expensive than SA equities prior to the downturn, they have fallen less than the local market (as a result of this quarter's risk-off sentiment). This has opened up a larger valuation differential between domestic and offshore equities - SA equities are now even cheaper than global equities. We have taken advantage of this by reducing some of our global equity positions to buy more cheaply valued but high-quality SA equities and SA nominal bonds (in the process buying cheap rands with expensive foreign currency). Despite this, our best view portfolios remain overweight global equities.

We have been very underweight **developed-market government bonds** given the negative real yields prevailing, and their unattractiveness relative to global equities. Thanks to the flight to safety and aggressive monetary easing by central banks, these yields have moved even more negative. For example, 10-year German bunds are yielding -0.5%, 10-year UK gilts 0.3% and 10-year US Treasuries 0.7%, and real returns are even lower after inflation. We continue to avoid these assets and instead hold US and European **investment-grade corporate bonds and selected emerging-market government bonds** which offer very attractive real yields. For instance, 10-year Mexican government bonds are yielding 7.2%, 10-year Indonesian bonds 7.9% and 10-year Brazilian bonds 7.8% (all in US$). These assets have suffered as investors have sought sanctuary elsewhere, but in some cases they are priced in line with the worst of the GFC conditions. We are cautiously looking to acquire extremely attractive assets in both global equities and global bonds that are offering some of the highest returns that we have seen in our investment careers.

We aim to position the portfolios with higher weightings of very high-returning global assets while maintaining a mix of assets that have diversified return profiles. We have no direct high-yield bond exposure in the global corporate bond space, and are analysing this sector intently to gauge the opportunities.

The **SA equity market** was already trading at a very attractive price-book value ratio of 1.5X in February, and subsequently fell to around 1.0X by the end of March, some 20% cheaper than it was during the GFC. Even though the recent sharp pull-back in prices has hurt our portfolios, when we bought

ASSET CLASS PREFERENCES: 5-YEAR PERIOD

Prudential Best Investment View*

ASSET CLASS	POSITIONING 31 DEC 2019	POSITIONING 31 MAR 2020
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.

these companies they were already well priced and offered attractive return prospects. They are now priced some 30% cheaper. We think this provides a once-in- a-generation opportunity to acquire selected, good quality domestic stocks that we are now taking advantage of.

Our house view portfolios continue to hold resources stocks with exposure to global growth and foreign currency earnings like **Anglo America and Exxaro**, as well as global giants such as **Naspers** and **British American Tobacco** (BAT). Naspers (and Prosus) derive the majority of their value from Tencent – the Chinese internet and media giant. E-commerce businesses may prove more resilient in the initial phases of the Coronavirus crisis, as users continue to use if not increase the services they offer. Tencent has one of the most valuable platforms in China, and while some of its revenue streams may suffer (such as advertising), we think the overall business will hold up better than the average South African company.

BAT is another large equity position in our best view portfolios. Tobacco tends to be more defensive in downturns – and has so far proven to be so in the current sell-off. BAT was inexpensive going into the crisis and currently trades on a forward P/E of 8X, which we feel is attractive relative to other defensive stocks.

The likes of **Shoprite**, **Spar** and **Pick 'n Pay** have held up remarkably well relative to the rest of the market. This is not surprising given the defensive nature of the sector in general and the hoarding of food stuffs. We currently hold Pick 'n Pay (in an overweight position) and Spar (in an underweight position).

Our higher-risk holdings include **Sasol**, as well as some of the gaming stocks we hold, where closure of casinos and limited payout slot machines brings a temporary but painful full stop to their businesses. These stocks were very attractively priced going into the Coronavirus episode, but current headwinds, the oil price war and the weak SA economy, respectively, may all create increasing requirements for equity rights issues to pay down debt (Sasol has already flagged its intention to do so). At this stage we are not selling our Sasol exposure, which is now quite small in our portfolios, since we think there is a large potential upside.

We have been using part of the proceeds from our offshore equity sales to buy up exposure to certain SA stocks at excellent valuations as share prices have fallen to levels even lower than those seen during 2008. We are being careful to choose high-quality businesses that, in our assessment, can survive reduced earnings and cash flows for an extended period of time. There are many high-quality SA companies with sound business models and strong, well-capitalised balance sheets that have become very cheap in this sell-off, where we do hold positions. We are confident that these positions should add above-market returns to our portfolios over the next five years.

As **SA listed property stocks** have sold off more than other asset classes during the quarter, the property weighting in our portfolios has fallen relative to other asset classes. This makes our portfolio positioning now even further underweight, reflecting significant macroeconomic uncertainty exacerbated by the pandemic. We are comfortable with this reduction, as the risks around property company earnings have worsened given the deterioration in the economic outlook. Some of the companies that we own are now priced at extreme levels of cheapness, with quality listed property companies offering forward dividend yields in excess of 20% and prices at less than 50% of their book value.

We were already modestly overweight **SA nominal bonds** in our portfolios at the beginning of the year, when longer-dated maturities of 15-20 years were offering very attractive real yields of 4.5-5.0%. This was well above our long-run fair value assumption of 2.5%, and we were happy to own bonds at these levels. Now these bonds are priced to give investors a real yield of nearly 8.0% on a medium-term view, an extraordinary prospective return. A weak economy means inflation is also not likely to be a significant risk factor for some time to come. Consequently, we have been adding modestly to our active nominal bond positions in our portfolios, particularly longer-dated tenors, out of the proceeds from our offshore equity holdings.

We were neutral in **inflation-linked bonds** prior to the market downturn, and ILBs are now offering a very attractive future return for investors of over 6.0%, which is guaranteed if they are held to maturity. Despite this, we are comfortable with this neutral positioning because we believe better value exists in SA equity and SA longer-term nominal bonds, given their current extraordinary pricing: both have the potential to offer more attractive returns over the medium-term and are much more liquid. ■