In this note we summarise the three dimensions of capital markets insights that guide our tactical asset allocation decision process, namely: Regime, Returns and Risk.

We then explain how we have translated those insights into Relative-positioning decisions for our Hollard Prime Defensive, Balanced and Assertive Funds of Funds.

Regime dimension

The direction and magnitude of global capital flows is likely to be more muted than what we have experienced over the past few years.

Global capital flows into emerging market economies from developed market economies is supported by:

- Global growth continuing to broaden and strengthen across both developed and emerging market economies
- Inflation is rising in developed market economies as a result of rising oil prices and wage pressure as unemployment rate decreases. This supports global demand for commodities and benefits commodity exporting emerging market economies
- Some major central banks (ECB and Japan) continue to maintain accommodative monetary policies

However, continued strong flows into emerging market economies is compromised due to:

- Narrowing of interest differentials as developed markets central banks (US and UK) embark on a hiking interest rate cycle, thus reducing the attractiveness of carry trade
- Tightening global liquidity as interest rates rise in some developed market economies (US and UK) and as most developed market central banks start to wind down extraordinary monetary stimulus
- Following an extended period of monetary policy stimulus, there might be financial vulnerabilities which could surface and result in increased financial market volatility and flight to safe haven assets
- Anticipated US dollar strength as a result of the hiking cycle in the US exposes many emerging market economies to currency weakness
- Emerging market economies have been the beneficiaries of significant capital flows over the past couple of years and increased uncertainty in financial markets resulting from concerns of trade war and/or geopolitical risks could trigger a risk-off sentiment, resulting in a reversal of flows from emerging market economies

Thus, on balance, we expect the direction of global capital flows to be fairly neutral and magnitude to be muted over the short to medium term (i.e. 12-18 months). Against this backdrop, some caution is warranted but we continue to maintain a preference for growth assets (both developed and emerging markets equities) over global fixed income. The positive global economic growth, rising corporate earnings in developed market economies and low real interest rates should bode well for equities. Global fixed income assets are exposed to capital losses in a rising interest rate cycle.

We view an aggressive monetary policy normalisation by the Fed as a significant risk (given the US expansionary fiscal policy and its implication for US inflation) which could undermine the global growth recovery and result in greater financial market volatility.

Domestically, sentiment has improved under the new government leadership, with both consumer and business confidence rising significantly. To put this into perspective, the FNB/BER consumer confidence index surged to an all-time high level of +26 in Q1 2018 from an average level of -6.3 over the past 5 years. Similarly, the RMB/BER business confidence index rose to 45 in Q1 2018 from an average level of 40.8 over the past 5 years.

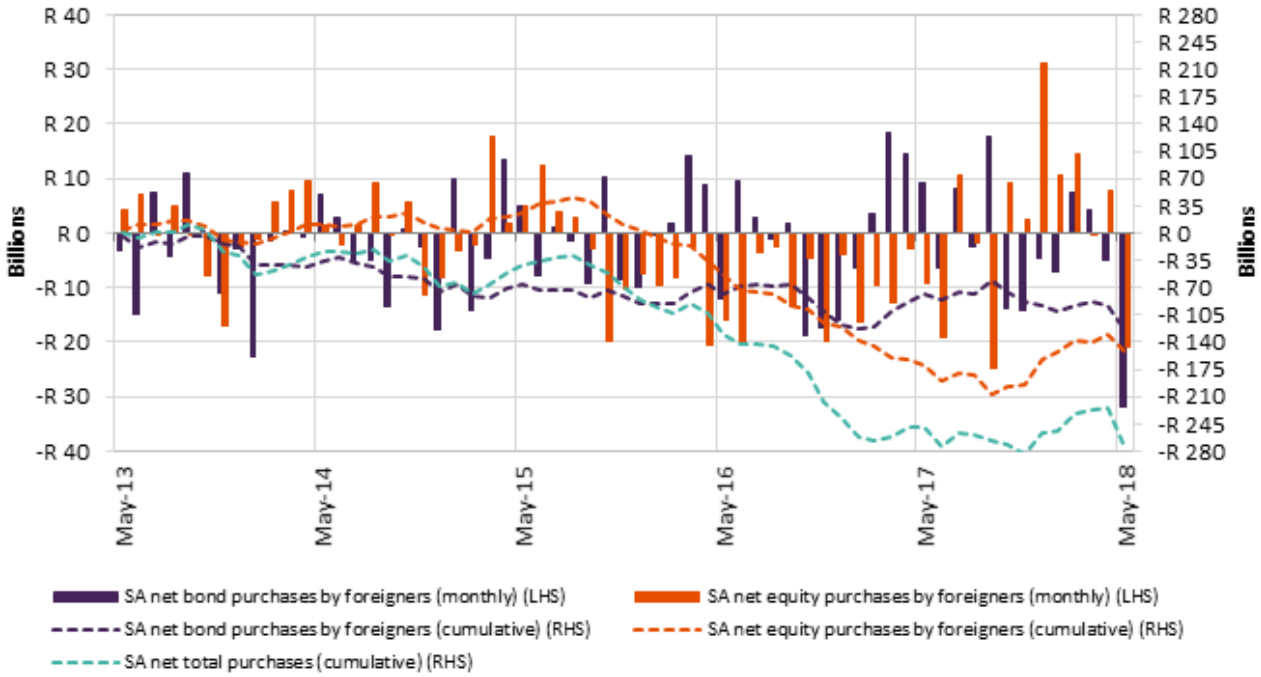
Politically: Under the new leadership, initiatives are being taken to reform the state owned enterprises (SOEs), eradicate corruption and restore fiscal discipline.

Economically: South Africa's economic growth forecast (real GDP) has been revised up by the IMF to 1.5% and 1.7% for 2018 and 2019 respectively. Inflation is within the target range of the Reserve bank and hence a moderate interest rates hiking cycle is expected.

Structurally: Progress on structural reforms has been slow. Uncertainty remains over the mining charter, and the government's stance on land reforms is likely to result in social tensions. There are also concerns over the government's ability to implement many of the needed structural reforms ahead of next year's election.

Nonetheless, the South African economy is on a positive path compared to last year and this has kept rating agencies at bay, with S&P recently affirming South Africa's credit rating at sub-investment grade with a stable outlook.

Figure 1: Net assets purchased by foreigners



In summary, the Regime dimension would favour a balanced exposure to growth and income assets. Amongst growth assets, globally we favour a balanced exposure to developed and emerging market equities and locally we favour equities which could benefit from a cyclical recovery (i.e. "SA-inc" focused and interest rate sensitive equities).

Returns dimension

Global assets: Our forward-looking valuations models suggest muted 12-month-forward total returns from developed markets equities (in the aggregate, or proxied by the US, UK, Eurozone and Japan) and far more enticing returns from emerging markets equities (in the aggregate, or proxied by Taiwan, India, China and South Korea), with Taiwan being a notable laggard among the latter grouping. Global developed markets real estate (rental- as opposed to development-oriented) continues to appear to have unenticing 12-month returns prospects, certainly relative to global developed markets equities. Global bonds, whether in developed or emerging markets, appear likely to offer close-to-zero total returns, or even negative in the US. Chinese bonds stand out as offering slightly above a 5% return.

Figure 2: Multi-asset class valuations

Local assets: On purely valuation grounds, South African equities appear to offer attractive 12-month-forward total returns of almost 20%. But while this and our scenarios for global equities are based on researched expectations for *inter alia* earnings growth, it's important to note that an underlying assumption is the absence of any significant re- or de-rating in price:earnings ratios over the period. Local income assets, whether cash, short-term or longer-dated bonds, all appear to offer 12-month returns of 7%-8%. Local listed property stocks in the aggregate appear to be offering slightly less than this, probably with much higher price volatility, leading us to prefer income assets. In summary, the valuation picture favours local and other emerging markets equities, and cautions against any listed property.

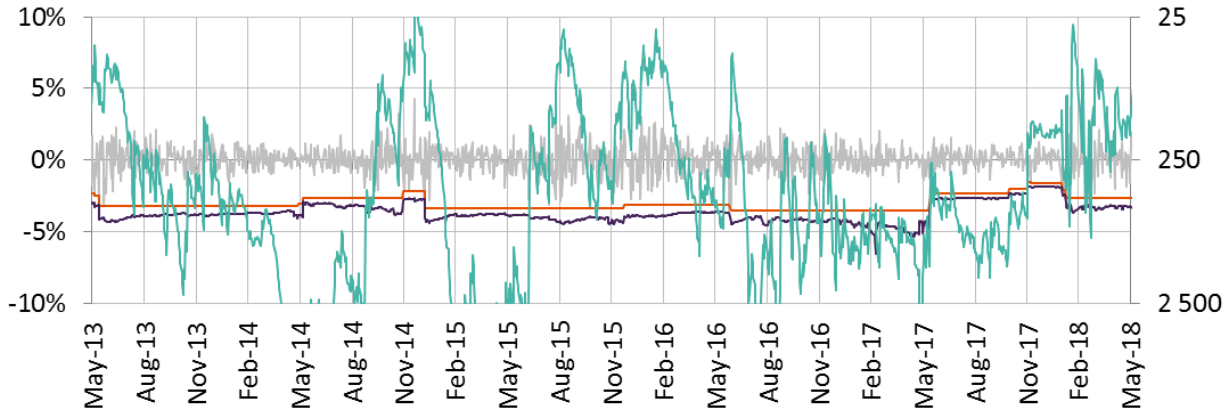
Risk dimension

Our proprietary risk models measure *inter alia* local and global equity market risks of extreme loss, volatility clustering and the probability of exceeding the worst returns of the last 250 days. They show that markets are pricing-in a "more-than-normal" downside risk for local and global developed and emerging market equities i.e. apparently it is risk-off for now.

Our momentum-focused technical analysis model (which applies only to South African assets) shows that the upward trend in SA equities has plateaued out after the recent sell-off and are now out of over-bought territory. SA listed property has led the way with all trends breaking down after the recent sell-off. Volatility levels have increased to levels last seen in early 2016.

With global interest rates expected to rise and equity markets volatility having risen to levels more consistent with previous low volatility regimes from an "abnormally" low volatility environment (as seen by elevated levels of the VIX index), the risks inherent in growth assets cannot be ignored. This calls for caution.

Figure 3: SA equity risks – probabilities of a new 250-day worst loss



Relative positioning

On the basis of the above three dimensions of insights, we have made the following tactical asset allocation changes across our Hollard Prime Defensive, Balanced and Assertive Funds of Funds.

Relative to each Fund of Fund's strategic positioning (i.e. sector average asset allocations), we have:

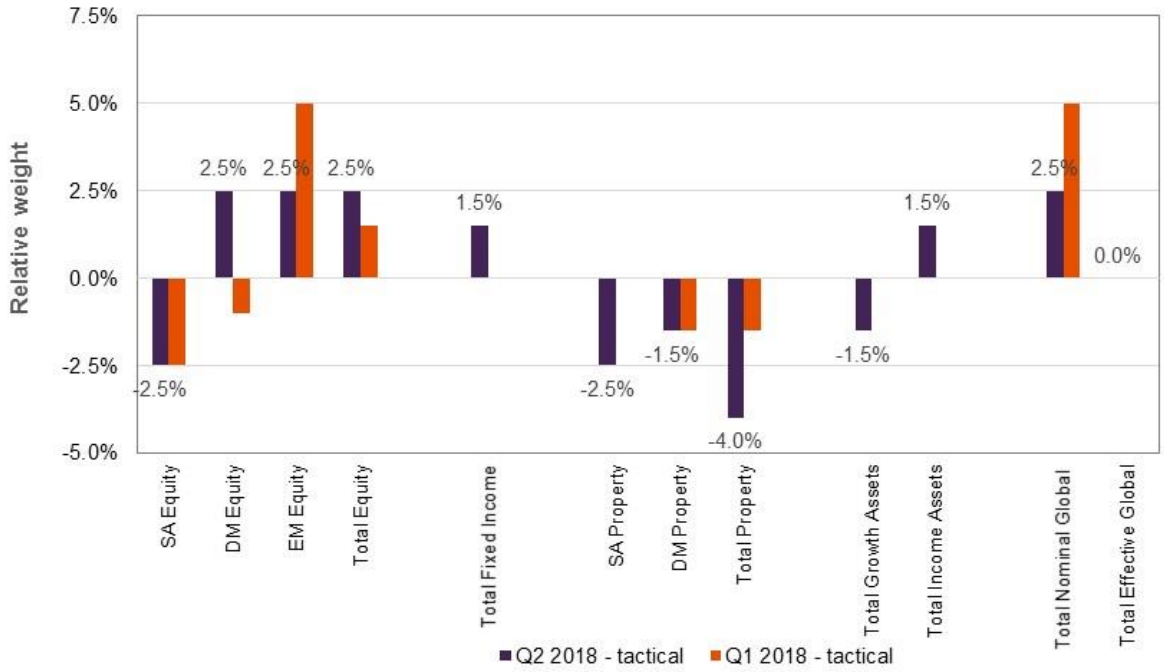
Growth assets
↔ kept exposure to SA equity unchanged at an underweight of -2.5%
↓ decreased exposure to SA listed property markets to an underweight of -2.5%
↑ increased exposure to developed markets equity to an overweight of 2.5%
↓ decreased exposure to emerging markets equity from an overweight of 5% to 2.5%
↔ kept exposure to developed listed property market at zero

Income assets
↔ kept exposure to SA cash unchanged at a large underweight, and to balance this…

↔ kept exposure to SA bonds (short duration) to a large overweight
↔ kept exposure to developed markets fixed income unchanged at an underweight of -5%

Currency
↔ kept nominal exposure to US dollar-denominated assets unchanged at +2.5%
(an estimated neutral effective exposure)

Figure 4: Asset class allocations – Hollard Prime Strategic Balanced Fund of Funds



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