Quarterly Insights – June 2019

from our Investment Management Team

Hollard. investments

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 the Hollard Prime Strategic Defensive, Balanced and Assertive Funds of Funds.

Regime dimension

Changes in global growth and disruption of the global trade norms are the main themes driving financial markets in 2019. The IMF projected a decline in growth in 2019 for 70% of the global economy. And what started as a somewhat contained US-China trade dispute has broadened into rising friction over tech dominance and global supply chains across industries.

We expect global capital to continue to flow from developed to emerging market economies in the medium to long-term as the search for yield resurges. However, in the near term the above-mentioned themes will continue to weigh negatively on the demand for risk assets.

Growth differential: Growth slowdown in developed market economies is expected to be broad-based across US (waning of fiscal stimulus), Europe (weak industrial production and falling exports from Germany), UK (uncertainty around the Brexit outcome) and Japan (planned increase in consumption tax rate). Growth differentials between developed and emerging market economies remain benign, but the latter are likely to benefit from stimulus measures in China.

Inflation differential: Both realised and expected inflation in most developed market economies are at or below central bank target levels due to falling energy prices and weak demand. Similarly, inflation metrics in emerging market economies have moderated as inflationary pressures from currency depreciation were offset by falling energy and commodity prices. A narrowing inflation differential between developed and emerging market economies should increase the probabilities of currency stability for emerging market economies.

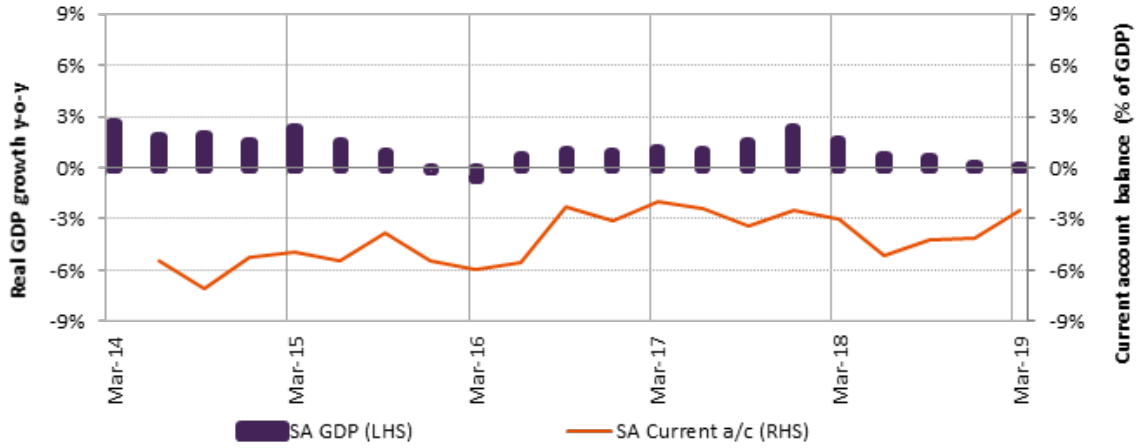
Interest rate differential: The slowdown in global growth, falling inflationary pressures and persisting US-China trade frictions have called for accommodative monetary policies across both developed and emerging market economies. Developed market bonds are pricing in higher interest rate cuts than emerging markets bonds. In addition, the interest rate differential between developed and emerging market economies and a continuation of an accommodative monetary policy stance by developed markets' central banks is likely to reinforce the search for yield and the carry trades.

We expect global capital flows into both developed and emerging market equities to be muted in the short- to medium-term. We maintain the view that global fixed income is a low yielding asset and exposes investors to increasing reinvestment risk.

Locally, the SA economy remains lacklustre with a contraction of -3.2% (vs expected -1.8%) for Q1 2019. Anaemic domestic demand, weak productive capacity and lack of investment by the private sector is likely to keep the growth outlook weak. SA inflation is low at 4.4% (April 2019), which is close to the midpoint of the SARB's target. Upside risks to the consumer price inflation outlook arise from a volatile exchange rate, upward pressure on the oil price and rise in electricity tariffs. The SARB is maintaining a dovish stance which implies that monetary policy is likely to remain accommodative. The FRA market is now pricing in

close to 90% probability of a 25bps rate cut over the next 12 months which signals the market's low confidence in South Africa's growth prospects.

Figure 1: SA economic growth and current account



The risk of a downgrade by the rating agency Moody's has increased, following the inclusion of Eskom's government-guaranteed debt in the government's balance sheet. This has increased the government debt burden significantly with Moody's expecting a rise in government debt-to-GDP ratio to above 70% by 2023. Our concern is that the margin of safety or institutional resilience from policy mistakes and any further fiscal slippage has deteriorated for the SA economy. In the absence of a positive growth story in the near-term, the market is likely to 'hard-code' the above-mentioned narrative into SA's sovereign and equity risk premiums.

In light of the above, our medium-term view is that appetite for SA growth assets is likely to be weak. In contrast, the SA fixed income assets which are currently offering high real yields are likely to benefit from the carry trade and search for yield.

Returns dimension

Global assets: Our forward-looking valuations models suggest 12-month-forward total returns of about 10%-15% from both developed and emerging equities markets in the aggregate, with more uncertainty about the latter. Our expectations for significant individual markets peg the US, UK, Eurozone and Japan all in the 5%-10% range. Amongst emerging markets, we expect 5% or less from South Korea, 5%-10% from China and Taiwan, and 10%-15% from India. Global developed markets real estate (rental- as opposed to development-oriented) continues to have muted 12-month returns prospects, slightly below global equities markets, of about 0%-5%. Global bonds, whether in developed or emerging markets, appear likely to offer near-zero total returns. Indian bonds stand out as offering just over a 5% return, and the US and China at just below a 5% return.

Local assets: South African equities appear to offer reasonable 12-month-forward total returns of about 15%-20% assuming no re-rating in price:earnings ratios from current levels. Note that this is without making any adjustment to the consensus earnings growth expectations for NPN and MTN. Locally listed property stocks in the aggregate appear to be offering a return of 5% or less, assuming prices move in line with distribution growth, from current levels. Local income assets, whether cash, short-term or longer-dated bonds, all appear to offer 12-month returns of roughly 7%-9% with slight compensation offered for taking longer-term investment risk.

In summary, the valuation picture favours local equity and short-dated fixed income, and global developed and emerging markets equities. Conversely, developed markets bonds as well as listed property in both developed and local markets are noticeably less enticing.

Figure 2: Multi-asset class valuations

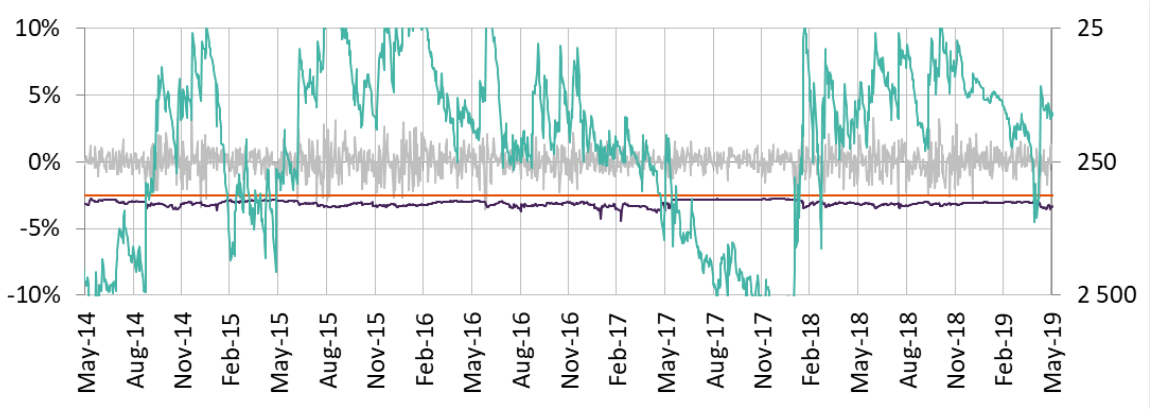
Risk dimension

Our proprietary risk models measure inter alia local and global equity market risks of extreme loss, volatility clustering and the probability of exceeding a threshold return of -2.50%. They show that markets are pricing-in a "worse-than-normal" downside risk for local, developed and emerging market equities i.e. apparently it is risk-off for now as markets are unnerved by the implications of a protracted global trade war.

Our momentum-focused technical analysis model which measures market sentiment shows emerging markets (including SA growth assets) remaining in over-sold territories as volatility increases. Developed market equities and property are leading on both strength of trend and reversing out of oversold levels.

Our assessment of the risk dimension is that growth assets are highly sensitive to any trade war related developments which have led to periods of heightened volatility. Ongoing increase in volatility can be expected and a cautious approach is warranted.

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



Relative positioning

A summary of the insights drawn from the three dimensions are as follows:

Asset class		Regime	Returns	Risk – Tail Risk	Risk – Technical analysis
Equity	*SA Equity*	↓ **2**	↑ **5**	↓ **2**	↓ **2**
	DM Equity	→ **3**	→ **3**	→ 3	→ **3**
	EM Equity	→ **3**	↑ **4**	↓ **2**	↓ **2**
Fixed Income	*SA Fixed Income*	↑ **4**	↑ **4**		
	DM Fixed Income				
Property	*SA property*	↓ **1**	↓ **2**	↓ 2	↓ **1**
	DM Property	↑ **4**	→ **3**		↑ **5**
Total Global Assets		↑ **4**		↑ 4	

The scale (plus arrows) represents the 'quintile' measure which gives expression to the strength (plus direction relative to previous quarter) of our relative positioning view, per asset class and dimension.

	Very unattractive	Unattractive	Neutral/Unchanged	Attractive	Very attractive
Quintile	↓ **1**	→ **2**	→ **3**	↑ **4**	↑ **5**
Relative positioning	↓ **-5.00%**	↓ **-2.50%**	↓ **0.00%**	↓ **2.50%**	↓ **5.00%**

We have made the following tactical asset allocation changes across the Hollard Prime Strategic 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%
↔ kept exposure to SA listed property unchanged at an underweight of -2.5%
↔ kept exposure to developed markets equity unchanged at an overweight of 4%
↔ kept exposure to emerging markets equity unchanged to a neutral relative weight of 0%
↔ kept exposure to developed markets listed property unchanged at an overweight of 1%

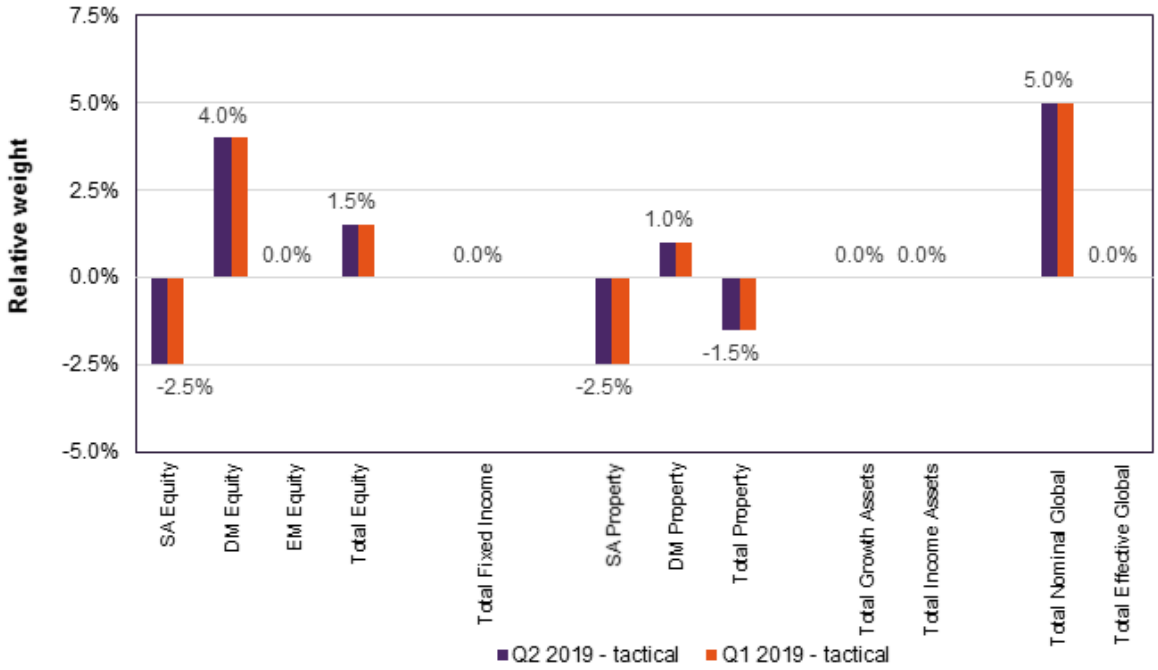
Income assets

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

Currency

↔ kept nominal exposure to US dollar-denominated assets unchanged at an overweight of +5.0%

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



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