PRUDENTIAL BALANCED FUND
31 MARCH 2017

PRUDENTIAL
INVESTMENT MANAGERS

QUARTERLY COMMENTARY

MULTI-ASSET

PERFORMANCE

The Fund's return was slightly positive over the quarter. The main contributors were the positive returns from domestic and international equities. The improved view of the outlook for growth under a Trump Presidency continued to lift spirits, pushing equity markets still higher, while growth in the UK and Europe bolstered markets there. Domestic bonds also contributed favourably as it was one of the stronger performing local asset class. The main contributor to the Fund's performance relative to the market, was its strong returns from international equity stock selection that led to outperformance over the MSCI AC World Index. Other contributors were the Fund's holding of short dated global high yield bonds and international cash that outperformed their respective benchmark indices. The overweight position in local fixed income securities also contributed as a favourable tailwind from improving inflation and international investor sentiment outweighed the negative implications from a change in Finance Minister at the end of the quarter.

MARKET OVERVIEW

The first quarter of 2017 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.

In the US, as in the previous quarter, stronger-than-expected GDP growth combined with a tighter jobs market, as well as firming inflation, reinforced the widely expected Fed rate hike of 25bps in March. 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, 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. The Nikkei 225 Index returned 4.5% over the quarter (in US$). The MSCI China posted a total return of 12.9% (in US$) in Q1 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). 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.

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%.

Locally, 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%.

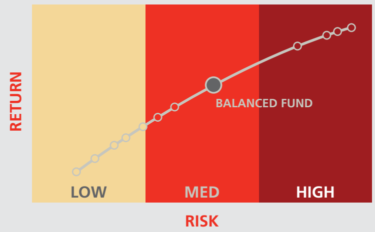
Equities were the top performing local asset class for the quarter, with the FTSE/JSE All Share Index returning 3.8%. This reflected a relatively strong performance from industrial counters (+6.6%) given their rand-hedge characteristics, and resources (+2.7%) as commodity prices continued to rise. Financials (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.

ANNUALISED PERFORMANCE	A CLASS	BENCHMARK	T CLASS	X CLASS	B CLASS
1 year	4.1%	2.2%	4.6%	4.2%	4.8%
3 years	7.9%	6.2%	n/a	8.2%	8.7%
5 years	12.8%	10.0%	n/a	n/a	13.6%
7 years	12.1%	9.7%	n/a	n/a	13.1%
10 years	9.9%	8.1%	n/a	n/a	10.9%
Since inception	14.3%	12.4%	5.5%	11.7%	14.7%

Inception dates: X Class: 2 January 2013, B Class: 1 July 2002, T Class: 2 January 2015

RISK/RETURN PROFILE:



FUND MANAGERS:

David Knee, Duncan Schwulst, Michael Moyle and Johny Lambridis

ASISA CATEGORY:

South African - Multi-Asset - High Equity

BENCHMARK:

ASISA South African - Multi-Asset - High Equity Category Average

INCEPTION DATE:

2 August 1999

FUND SIZE:

R15 698 297 538

Sources: Prudential, Morningstar & Deutsche Securities

PORTFOLIO MANAGER COMMENTS

Global sovereign bond yields continue to be expensive, and we believe investors will likely be disappointed by returns going forward, particularly in a global environment of rising interest rates. 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. 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. The Fund continues to be overweight in local equities on an asset allocation basis.

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, the Fund has maintained its overweight exposure, 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, the Fund is still overweight bonds. 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 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%.

In SA nominal bonds, we added to our modestly overweight positioning in our multi-asset funds during the quarter following the Trump-related sell-off in the local bond market, given the good value on offer. Our multi-asset portfolios have benefitted from our generally overweight bond positioning during the year. Within this, 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. With South Africa's interest rate and inflation outlooks improving, risks to bonds and listed property have moderated somewhat, although the possibility of a credit rating downgrade in 2017 is still a real threat. While SA bond spreads have continued to narrow versus USTs, yields are still pricing in an elevated risk premium.

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. The 10-year break-even inflation rate remained around 6.8%, still elevated compared to our long-term inflation benchmark of 6.0%.

LOOKING FORWARD

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. ■

ASSET CLASS RETURNS IN RANDS	Q1 2017	YTD
SA Equity (FTSE/JSE All Share Index)	3.8%	3.8%
SA Property (FTSE/JSE SA Listed property Index)	1.4%	1.4%
SA Bonds (BEASSA All Bond Index)	2.5%	2.5%
SA Inflation-linked Bonds (RSA Composite Inflation-linked Bond Index)	-0.5%	-0.5%
SA Cash (STeFI Composite)	1.8%	1.8%
Global Equity (MSCI World Free Index - US$)	6.5%	6.5%
Global Equity (MSCI Emerging Markets Index – US$)	11.4%	11.4%
Global Bonds (Barclays Global Aggregate Bond Index – US$)	1.8%	1.8%
Rand (Rand/USD move)	-2.2%	-2.2%

HOW TO INVEST

0860 105 775

prudential.co.za

query@myprudential.co.za

Application forms

Invest now

Application forms and all required documentation must be faxed to **+27 11 263 6143** or e-mailed to **instructionsa@myprudential.co.za.**

Sources: Prudential, Morningstar & Deutsche Securities