PRUDENTIAL BALANCED FUND
31 MARCH 2018

PRUDENTIAL
INVESTMENT MANAGERS

QUARTERLY COMMENTARY

MULTI-ASSET

MARKET OVERVIEW

After further strong gains in January, the 15-month global equity bull market came to an abrupt end in February in the form of a sharp market correction. This was brought on by worries over an accelerated pace of US interest rate hikes as the US economic expansion and inflation gathered pace, and later, increasing fears of a global trade war provoked by unpredictable Trump policies and concerns over stricter regulation of the global tech giants like Amazon and Facebook. Although much of the losses were retraced, volatility became a key market feature in February and March. Developed equity markets ended the quarter returning -1.3%, while emerging markets were in the black with a 1.4% total return.

Global bonds, meanwhile, managed to deliver 1.4% over the quarter, helped by gains in European bonds and a weaker US dollar, while US Treasuries were moderately softer in the wake of investor jitters over inflation and the US Federal Reserve's somewhat more hawkish tone under new Fed Chairman Jerome Powell. The Fed met market expectations by hiking interest rates 25bps at its March meeting, and also added extra rate hikes to its expectations for 2019-2020, while confirming its view of a more robust US economy (lifting its forecasts for 2018 GDP growth to 2.7% from 2.5% previously). However, it did keep its 2018 rate predictions unchanged at two further 25bp increases. The yield on the benchmark 10-year UST rose to around 2.8% from 2.4% at the beginning of the quarter. Global property also lost ground, producing -5.5% as it was also dented by worries over rising inflation and interest rates.

Global economic fundamentals remained supportive, with data broadly stronger. US jobless claims fell to their lowest level in 45 years and unemployment dropped to 4.1%, while February CPI crept up to 2.2% y/y from 2.1% y/y. In Europe, views of an ultra-slow exit by the European Central Bank from its easy monetary policy were reinforced amid accelerating growth but very subdued inflation (at only 1.1% y/y in February). In the UK, meanwhile, prospects brightened thanks to a long-awaited agreement with the EU on a Brexit transition deal and parts of the final exit treaty.

For South African investors, it was a mixed quarter as December's positive sentiment continued into the new year and encouraging developments underpinned interest-rate markets, but equities were hurt by the global correction and listed property sold off sharply in the wake of alleged fraudulent activity at the Resilient group of four property companies. Positive offshore returns were more than offset by the stronger rand, which continued to firm in the aftermath of the "Ramaphosa rally".

Notable positive local developments included the favourable reception by global investors and the credit ratings agencies of February's 2018/19 Budget and the new President's cabinet appointments, and some progress towards improving state-owned enterprise (SOE) corporate governance. Another encouraging milestone came in late March when Moody's decided not to downgrade South Africa's sovereign local currency rating to junk status, while also upgrading its outlook to stable from negative and lifting SA's 2018 GDP growth forecast to 2.0% from 1.0%. S&P Global and other international institutions also lifted their growth expectations to around 2.0%. This brighter outlook benefitted from Stats SA's February announcement of 3.1% (q/q saa) GDP growth in Q4 2017 – much higher than the 1.5% market consensus – as well as upward revisions to the previous four quarters of GDP data, which surprisingly confirmed that the country had not experienced a recession in 2017. While the modest recovery was welcomed, economists and investors still worry that much more needs to be done to accelerate growth to a meaningful rate that will create jobs.

Lower-than-expected inflation (at 4.0% y/y in February) and the SARB's 25bp rate cut in March (which had largely been priced into the market) also supported bonds for the quarter, helping produce a remarkable 8.1% return from the BEASSA All Bond Index and 4.1% from inflation-linked bonds. The yield on the benchmark 10-year SA government bond fell to 8.0% at quarter-end, from 8.6% at the start of January. The forward rate agreement (FRA) market is pricing in an almost-even chance of a further 25bp rate cut in the next six months. The rand gained 3.8% against the US dollar for the three months, 1.3% versus the Euro and was flat against a rebounding pound sterling. This was despite some concerns over the implications of the ANC's potential wider use of land expropriation without compensation.

In contrast, local equities could not escape the global downturn, with the FTSE/JSE All Share Index (ALSI) returning -6.0% for the quarter. The market was partly dragged down by weakness in Naspers (dropping 16.2% with a 17% weighting in the ALSI), but was also caused by a shocking -19.6% return from the listed property sector. This arose from persistent worries over alleged fraudulent practices at the Resilient group of four property companies, which drove their share prices down by over 50% for the quarter. Industrials as a sector delivered -8.0% for the quarter, Financials produced -3.6% and the Resources Top 10 Index returned -2.7%.

PERFORMANCE

The fund returned -2.8% over the quarter, while for the 12 months to 31 March it returned 6.1% (both net of fees). The main contributors to relative returns versus the benchmark were the fund's overweight position in domestic bonds, and its underweight in SA cash. Its neutral position in SA listed property also added some relative value. The primary detractor from relative performance was the fund's overweight in global equity. In absolute return terms, it was listed property holdings that detracted the most over the quarter, while Resources shares also broadly detracted from value, as did the fund's exposure to Naspers. The fund's financial shares like Standard Bank and Old Mutual added value.

STRATEGY AND POSITIONING

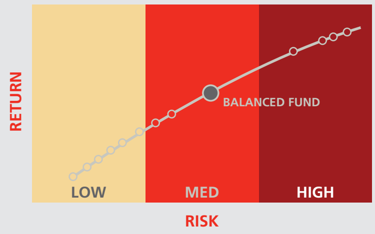
In global fixed income, as in previous quarters, despite rising government bond yields, they continue to trade at very low levels (and high valuations) historically, and remain at risk to rising interest rates in the US and UK, and increasingly in Europe as well. We continue to be underweight global sovereign bonds and underweight duration in the fund to reduce interest rate risk, preferring to hold investment-grade US and European corporate bonds.

ANNUALISED PERFORMANCE	A CLASS	BENCHMARK	T CLASS	X CLASS	B CLASS
1 year	6.1%	3.4%	6.6%	6.4%	6.9%
3 years	5.2%	3.4%	5.7%	5.4%	5.9%
5 years	9.9%	7.4%	n/a	10.2%	10.8%
7 years	11.4%	8.9%	n/a	n/a	12.3%
10 years	10.1%	7.9%	n/a	n/a	11.1%
Since inception	13.9%	11.9%	5.9%	10.7%	14.2%

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

ASSET CLASS RETURNS	TOTAL RETURN Q1 2018
Global equity – MSCI World (US$) (Developed)	-1.3%
Global equity – MSCI Emerging Markets (US$)	1.4%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	1.4%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$)	-5.5%
SA equity – FTSE/JSE All Share Index	-6.0%
SA bonds – BEASSA All Bond Index	8.1%
SA listed property – SA Listed Property Index	-19.6%
SA inflation-linked bonds – JSE CILI Index	4.1%
SA cash (STeFI Composite Index)	1.8%

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:
R18 675 184 508

Sources: Prudential, Morningstar & Deutsche Securities

For global equities, in line with our active management approach, we lowered the global equity exposure in our house view portfolios in January as prices ran ahead of fundamentals, only to raise it again in February after the sharp market correction made valuations more attractive - the net result was to return to the same overweight position as in the previous quarter. The outlook for corporate earnings growth remains positive against the backdrop of upside surprises to broad global growth. Our current global equity positioning reflects a preference for cheaper areas where fundamentals are encouraging but valuations remain attractive, including Europe, Japan, the global financial sector and smaller holdings in selected emerging markets such as Korea, Turkey and Indonesia. These positions are financed by an underweight in US equities and in global bonds.

South African equities moved to more attractive levels during the quarter, more in line with, to somewhat cheaper than, their long-term fair value. The FTSE/JSE ALSI 12-month forward P/E fell to around 14.1X at quarter-end from around 15.4X in Q4 2017. At current levels the market is still priced to deliver attractive medium-term returns. SA equity earnings have been depressed relative to their long-term trends, particularly in Resources and Financials. In the context of the Balanced Fund's 75% total equity exposure limit (set by the ASISA category), we are able to be overweight both global equities and SA equities in the fund.

Our individual equity exposure is similar to the previous quarter. We sold all of our small (underweight) Steinhoff holdings in December, cushioning our portfolios from further losses in 2018. Equally, we were underweight the Resilient group of four companies and sold down those holdings across our client portfolios. Currently, our portfolios hold stocks with potential upside to strong global growth like Naspers, British American Tobacco, Richemont, Anglo American and BHP Billiton – the latter two representing lower risk to commodity price weakness given their diversification. Over the quarter, however, rand strength and the global selloff in tech (and other) stocks negatively impacted these companies. We also hold non-mining resources stocks like Sappi, as well as international container transport group Trencor, which has upside to improving global trade trends. We remain overweight in well-priced and high-yielding Financials including Old Mutual, Investec, Standard Bank and First Rand, which have offered relatively high dividend yields while also providing a valuation cushion in the event of further credit rating downgrades. These stocks performed positively over the quarter. Offsetting this overweight position, we have chosen to remain underweight in retail stocks given the challenging local consumer environment.

In SA listed property, we continue to have a neutral exposure in the Balanced Fund. Even though the sector has fallen sharply in value, this is due almost entirely to the decline in the share prices of the Resilient group of four property companies, whereas the rest of the sector has experienced rising share prices over the quarter (up an average of approximately 4.0%). Excluding these companies, we believe the asset class continues to trade around its fair value range and is priced to deliver attractive returns in the low double-digits over the medium term. Regarding Resilient group, we remain underweight the four companies in aggregate in our portfolios - we await further clarity on their planned measures to improve governance and we have engaged with the companies with some suggestions in this regard. We believe that even if we do see a re-rating of Resilient group shares, we would not expect their valuations to return to their same previously elevated levels.

In SA nominal bonds, following the quarter's rally valuations are at fair levels. Consequently, we have reduced our allocation to bonds, but remain modestly overweight. We continue to prefer longer-dated government bonds due to the more attractive yields on offer, and are comfortable with the compensation bonds offer. We take comfort from the integrity of the SA Reserve Bank and their stated goal of anchoring inflation expectations around 4.5%, the mid-point of their targeted 3.0-6.0% band. Downside risks have eased somewhat in the wake of the quarter's positive developments, although the ratings agencies have warned that the government and businesses have not yet done enough to eliminate the prospects of further credit rating downgrades.

For inflation-linked bonds, we continue to be neutrally positioned in this asset class. Real yields are attractive, even after this quarter's rally, but we still believe that better value exists elsewhere – in long-dated SA nominal bonds and equities. Going forward, the relatively low inflation environment will depress nominal returns from these instruments. ■

Sources: Prudential, Morningstar & Deutsche Securities