MARKET OBSERVATIONS

BY GARETH BERN, PORTFOLIO MANAGER

PRUDENTIAL INVESTMENT MANAGERS

QUARTERLY MARKET COMMENTARY — QUARTER 3 2016

It was the ongoing "search for yield" that shaped global financial markets in the third quarter (Q3) of 2016, as US rate hike expectations were again pushed out to December, and other major economies continued to be stuck on their low-growth, low-inflation, low-interest rate paths. Although markets remained volatile, equity markets, and especially emerging markets, were the biggest beneficiaries of the renewed "risk-on" sentiment. Bonds and gold, on the other hand, were less well supported, while commodity prices were mixed, although the surprise OPEC agreement to limit oil production sent the oil price climbing back to around $50 per barrel at the end of the quarter.

ASSET CLASS	TOTAL RETURN Q3 2016
Global equity – MSCI World Free (US$) (Developed)	5.0%
Global equity – MSCI Emerging Markets (US$)	9.0%
Global bonds – Barclays Global Agg Bond Index (US$)	0.8%
SA equity – FTSE/JSE All Share Index	0.5%
SA bonds – All Bond Index	3.4%
SA listed property – SA Listed Property Index	-0.7%
SA inflation-linked bonds – JSE CILI Index	0.5%
SA cash	1.9%

STILL-LOW US INTEREST RATES, HIGHER RISK APPETITE DRIVES MARKETS

In the US, weaker-than-expected GDP growth of 1.2% (q/q annualised) in the second quarter (half the 2.5% consensus) was somewhat offset by strong employment data showing a firmer labour market and a pick-up in wages, as well as an acceleration in consumer inflation to 1.1% y/y in August. As became expected, the US Federal Reserve again left interest rates on hold at its September policy meeting, while signalling the increasing likelihood of a rate hike in December. However, the US central bank also scaled back its projections for future hikes: the Fed's consensus for 2017 fell to only two hikes for the year, versus three previously. The interest rate market took the Fed's signals to heart, pushing up the chances of a December rate hike to 60%, while still expecting a total rate increase of 50 basis points (bps) over the next 2.5 years.

The Barclays Global Aggregate Bond Index (US$), a mixture of government and corporate bonds, posted a total return of 0.8% in the quarter after its strong performance in Q2. The 10-year US Treasury (UST) bond yield strengthened about 20bps, as did investment-grade corporate bond spreads versus USTs. US high-yield corporate bonds benefited from both the stronger investor risk appetite and the improved outlook for the energy market: spreads vs USTs fell steadily over the quarter from around 613bps to 497bps, with energy sector bond spreads dropping from about 800bps to 673bps. In the equity market, the S&P 500 returned 3.9% amid a continued decline in corporate quarterly earnings growth spurred by weakness in energy companies, political uncertainty and lower industrial production. However, the Nasdaq returned 10.7% for the quarter, reflecting the good growth and prospects of tech companies.

In the Eurozone, Q2 GDP growth halved to only 0.3% q/q from 0.6% q/q the previous quarter, although on an annualised basis this represented growth of 1.6% versus 1.7% previously – slow but steady. The French and Italian economies reported near-zero expansion (with the weakness of Italian banks gaining news headlines early in the quarter), while Germany remained the main growth engine. Consumer inflation stayed very low at 0.2% y/y in August, while the ECB left its aggressive easing programme unchanged at its September policy meeting. The German 10-year bund yield remained negative at -12bps, and for the first time ever two highly rated, large European companies issued corporate bonds paying negative yields (investors will have to pay a small amount to the company for the privilege of lending them money). Brexit worries eased somewhat amid better-than-expected economic data from the UK and some recovery in British markets, with the FTSE 100 returning 4.7% in the quarter. France's CAC 40 returned 6.7% and Germany's DAX 10.1% (all in US$).

In recognition of the increasing ineffectiveness of monetary policy to further boost growth, the Japanese government in August announced a Y28 trillion fiscal stimulus package, including cash handouts to 22 million low-income earners. The country's GDP growth nearly stalled in Q2 at only 0.2% (q/q annualised) on the back of declining exports and business investment, from 2.0% in Q1. The Nikkei 225 Index returned 8.3% over the quarter, while the yen continued its appreciation versus the US dollar, due largely to the move lower in expectations for real US interest rates.

In China, Q2 GDP growth held steady at 6.7% (q/q annualised), slightly above consensus and within the government's 6.5%-7.0% target for the year. The Chinese central bank has kept interest rates at record lows and reduced bank reserve requirements to buoy the economy, although consumer spending has been somewhat softer. Financial market volatility has eased significantly in recent months due to suspected government intervention: the MSCI China returned 14.0% (in US$) over the three months, the strongest among large emerging markets.

Source of table: Prudential, data to 30 September 2016

Similarly to the previous quarter, other emerging markets continued to be supported by the improvement in investor risk appetite. Five-year credit default swap spreads (a measure of sovereign default risk) trended lower across most emerging markets, with South Africa's spread down over 30bps. Brazil's Bovespa kept up its run, gaining 12% in Q3 for a return of 62% year-to-date in US dollar terms. The MSCI South Africa gained 6.4%, MSCI Russia returned 8.9% and South Korea's KOSPI 10.5%, while the MSCI Turkey lost 5.3% (all in US$) following the failed coup attempt and credit rating downgrade to "junk" status by a second ratings agency. EM bonds and currencies were also generally stronger.

After having eased for much of the quarter, the price of Brent crude oil surged back to the $50 per barrel level at quarter end after OPEC agreed to limit production. Gold lost 0.5% as its safe-haven status lost its appeal, but among notable commodity price gains, tin and lead each rose 18% and palladium jumped nearly 23%.

MORE POSITIVE NEWS FOR SA IN Q3

It was another largely positive quarter for South African financial markets, buoyed by both global demand for local assets and improving data, while the likelihood of a credit rating downgrade to junk status diminished somewhat. Q2 GDP growth came in at a stronger-than-expected 3.3% (q/q annualised), avoiding a technical recession (defined as two consecutive quarters of negative growth). The SA Reserve Bank also revised upward its growth forecasts: for 2016 to 0.4% from 0.0%; for 2017 to 1.2% and for 2018 to 1.6%. August CPI fell to a lower-than-expected 5.9% y/y from 6.0% y/y in July, and the SARB revised downward its inflation forecasts for 2016 and 2017, while leaving interest rates unchanged at its September meeting as expected. The SARB Governor signalled that the rate hiking cycle may be nearing an end, although any rate cuts would face a high bar.

Moody's itself put the likelihood of a downgrade for South Africa at about 33% at year end. Meanwhile, the rand extended its winning streak against the US dollar and other major currencies, appreciating by 7.3% against the greenback, 6.1% versus the euro and 10.0% against sterling during the quarter, amid good global investor demand, as well as significant inflows from the conclusion of AB InBev's purchase of SABMiller. Also supporting the currency was a significant narrowing of the current account deficit, to 3.1% of GDP in Q2 from 5.3% in Q1.

Meanwhile, local bonds were helped by the improving local interest rate and inflation outlooks, rising commodity prices and offshore investor demand. The SA 10-year bond rallied about 15bps to 8.66% by quarter-end, while the All Bond Index returned 3.4% in Q3. Inflation-linked bonds (ILBs) returned 0.5% in the quarter. Also reflecting the improved outlook for South Africa's credit rating and good offshore demand, the spread on South Africa's 10-year US dollar bond yield over the 10-year UST fell from 320bps to 244bps at quarter-end, and National Treasury saw excellent investor demand for its issue of US$3.0 billion in US dollar bonds: 12-year bonds at a premium of 274bps over USTs and 30-year bonds at 272bps over USTs – both low by historic standards.

In the primary bond market, several property companies and financial services companies raised debt during the quarter, with strong demand seen for short-term, high-quality issues. Auction pricing cleared below guidance levels for many issues.

Looking at the difference in yields between conventional bonds and ILBs, 10-year breakeven inflation expectations fell from near 7.0% to 6.80% at quarter-end. Cash (the STeFI composite) returned 1.9%. In the Forward Rate Agreements (FRAs) market, any further interest rate hikes have now nearly been priced out of the market: three-month interest rates are now seen at 7.40% in two years' time, down from 7.80% at the end of June. No rate cuts are forecast, either.

In SA equities, the FTSE/JSE All Share Index returned 0.5% for the quarter, dragged down by a -2.1% return in Industrial shares. Resources returned 8.1%, and Financials returned 0.9%. Listed Property lost 0.7%, although recovered to return 1.1% in September. Total return from the ALSI year to date is 4.8%.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

In **global fixed income**, we remain underweight duration and continue to hold cash and shorter-term bonds in order to reduce interest rate risk. We are still positive on both investment-grade and high-yield corporate bonds in the US and Europe relative to government bonds, where we see yields as unsustainable in the medium term. Gains during the quarter in these holdings benefited our portfolios, although we now see spreads versus USTs at fair value, rather than cheap as they were the previous quarter. During the quarter we took profits on the US dollar-denominated South African government and dollar Eskom debt we purchased in Q2, which outperformed the domestic equivalents.

For **global equities**, the rally in many global equity markets over the past three months has brought valuations more in line with those of South Africa. Consequently we have moved from our previously overweight to a neutral allocation in global equities versus SA equities. However, we continue to favour equities over global bonds and cash in our global asset allocation portfolios. In our higher return-targeting multi-asset funds we continue to be very near our maximum permitted 25% offshore weighting. Our overweight exposures continue to be 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. With the US equity market looking expensive relative to the cost of protection, we decided to buy some downside protection in the form of put options. We also took advantage of the very cheap levels of certain UK-listed property stocks in the wake of Brexit to increase exposure to these assets out of global cash. Elevated risk premiums were reflected in pricing measure like yields vs ILBs, discounts to NAV and yields vs the FTSE 100. As in Q2, equity risk premiums (the yield on equities vs bonds) remain elevated and are in some cases close to the peaks seen in the Global Financial Crisis, providing a significant valuation buffer that should help to protect equities in the event of growth disappointment.

South African equities remained slightly expensive over the quarter compared to their long-term fair value. However, with global equity valuations moving higher (for example, the US S&P 500 trading on a forward P/E of around 16.8x), there is no longer a significant valuation difference between the two. In general in our multi-asset funds we continue to be neutrally weighted in local equities on an asset allocation basis. The medium-term prospects for SA earnings to recover to their trend level continue to depend extensively on a recovery in commodity prices.

In our domestic portfolios, we remain underweight expensive global heavyweights like Aspen and Steinhoff. By contrast, we are holding British American Tobacco as one of our top overweights as a solid defensive stock. We also retain our defensive positioning in Resources, being underweight miners like Anglogold and Implats, while preferring non-mining shares like Sappi and Mondi. Financial stocks remain undervalued, attractive on a risk/reward basis, despite the risks of a sovereign downgrade at year-end. Among our top overweights are Old Mutual, Investec and Barclays Group Africa, and, to a lesser extent, First Rand and Standard Bank. We remain underweight in Retailers, preferring to gain our consumer exposure via well-priced consumer services providers like City Lodge, Tsogo Sun and Sun International. On a medium-term valuation basis we prefer Netcare to Mediclinic, and MTN to Vodacom.

In **SA listed property**, as the sector became cheaper over the quarter, we took advantage of this to buy more and move to a slightly overweight position, from neutral, in our multi-asset class portfolios, buying out of cash. Valuations are attractive versus ILBs and nominal bonds. In the absence of a material de-rating in the market's valuation, listed property is priced to deliver double-digit returns over the medium term, comfortably above inflation.

In **SA nominal bonds**, our multi-asset portfolios are still modestly overweight conventional bonds, benefiting from the market rally during the quarter. 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 is still a real threat to both sectors. While SA bond spreads have continued to narrow versus USTs, yields are still pricing in an elevated risk premium. In our SA bond funds we have moved to neutral duration from long, taking profits as longer-dated paper rallied.

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. Although the break-even inflation rate has fallen to 6.8%, it still appears elevated compared to our long-term inflation benchmark of 6.0%.

LOOKING AHEAD

Despite improving outlooks for local inflation, interest rates and growth (the latter to a very marginal extent) over the quarter, and a supportive global environment, material risks remain for a possible credit rating downgrade, including the currently elevated political risk around the Finance Minister. Investors can expect continued volatility as we approach year end and move closer to a US interest rate hike and credit rating decisions by the three global ratings agencies. Moody's will be announcing its decision on 25 November, S&P on 2 December and Fitch also in early December.