# MARKET OBSERVATIONS

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**After recording one of the weakest-ever starts to a year in January 2016, global financial markets managed to recover some ground amid considerable volatility. The quarter was characterised by further downgrades to growth and inflation forecasts on a broad basis, which weighed on developed market equities. This was accompanied by more monetary easing in the major economies, and the US Federal Reserve adopting a more moderate approach in its rate hiking path, which underpinned bonds and led to a softer US dollar. Also notable was a rally in commodity prices later in the quarter that lifted emerging markets equities and currencies.**

**After falling to $27 per barrel, the price of Brent crude oil rallied in March to end the quarter up 9.2% near $39. Gold experienced a healthy 16% increase to trade around $1220 per ounce, and iron ore managed to rebound from $40 to $56 per tonne. While developed market equities broadly experienced losses amid earnings concerns, emerging markets (with some exceptions like China) saw strong gains as sentiment improved.**

| ASSET CLASS | TOTAL RETURN Q4 2015 |
|---|---|
| Global equity – MSCI World Free (US$) | -0.2% |
| Global equity – MSCI Emerging Markets (US$) | 5.8% |
| Global bonds – Barclays Global Agg Bond Index (US$) | 5.9% |
| SA equity – FTSE/JSE All Share Index | 3.9% |
| SA bonds – All Bond Index | 6.1% |
| SA listed property – SA Listed Property Index | 10.1% |
| SA inflation-linked bonds – Barclays ILB Index | 2.0% |
| SA cash | 1.7% |

## GLOBAL SLOWDOWN CONTINUES

IIn the US, GDP growth slowed to 1.4% in Q1 2016 (q/q annualised) from 2.1% in the previous quarter, and forecasts for 2016 were revised downward to 2.1% from 2.4% previously. The outlook for headline consumer inflation was also downgraded to 1.3% for the year, versus 1.5% previously. At its 15 March meeting, the US Federal Reserve FOMC left interest rates on hold, citing the weaker global environment and some disappointing data indicating a slowdown in wage growth and jobs growth. Fed policymakers moderated their views on the future path for US interest rates, lowering their median forecast for the Fed Funds rate at year-end to around 0.86% from 1.4% in December and effectively eliminating two 25bp rate hikes from their forecast. The Fed Funds futures market followed suit: the probability of an April hike is now seen at nil, (and the Fed Funds rate reaching only 0.6% by year-end from 0.9% previously). A dovish speech by Fed Chairman Janet Yellen on 29 March reinforced this more cautious view, helping push the dollar weaker and supporting US equity and bond markets.

The Barclays Global Aggregate Bond Index (US$), a mixture of government and corporate bonds, posted a total return of 5.9% in the quarter. US Treasury (UST) bonds rallied in response to the lower interest rate outlook, with the 10-year yield falling to 1.8% from 2.3%, its strongest quarterly rally since June 2012. US high-yield bond spreads vs USTs improved slightly, from 695 basis points (bps) to 680bps, but this masked considerable volatility and weakness in the resources and basic industries sector. Metals & mining sector bonds actually rallied by about 300bps to 1500bps, a still-elevated level. In the equity market, the S&P 500 started the year losing about 9% (in price terms) through mid-February, and then rebounded about 11% to end the quarter in positive territory with a 1.3% total return. Fears of negative corporate earnings revisions due to growth concerns proved to be overdone and were finally overcome by bargain-hunting and the prospect of easier monetary conditions.

In the Eurozone, inflation fell to -0.2% in February from 0.4% in January – largely due to the drop in the oil price – and growth prospects for 2016 were trimmed to 1.5% from 1.7%. ECB President Mario Draghi sprang into action to cut the central bank's benchmark interest rate to zero, and the overnight bank deposit rate to -0.4%. Monthly bond repurchases were increased, and the stronger-than-expected stimulus helped return some confidence to European markets. German bunds rallied strongly over the quarter, with the 10-year yield falling from 0.63% to 0.17%. In equities, by contrast, the Dow Jones Euro Stoxx 50 Index (US$) returned -3.3% for the three months (although it returned +7.1% in March alone). France's CAC 40 returned -0.5% and Germany's DAX -2.7%, while the FTSE 100 returned -2.4%.

Japan is on the brink of recession after the country posted -0.4% growth in the final quarter of 2015 and the 2016 growth outlook was revised down significantly, to only 0.7% from 1.2% in January. February CPI was only 0.3% y/y. With its aggressive easing policy looking ineffective, the Bank of Japan cut its main interest rate to -0.1% in January in a move that surprised markets. Over the quarter the Nikkei returned -5.0% (but was up 5.8% in March).

In China, the government introduced a GDP growth target range of 6.5% -7% for 2016, moving away from a specific target (7% in 2015) for the first time since 1995. The economy expanded 6.9% in 2015 and the consensus forecast is a slowdown to 6.5% this year. The government also announced further expansionary policies, such as cutting the



**Source of table:** Deutsche Securities data to 31March 2016 minimum home loan down payment to 20%, and reducing the bank reserve requirement ratio for the fifth time in just over a year. The MSCI China returned -4.8%, trimming its early-quarter losses with a +11.9% return in March.

Other emerging markets, meanwhile, were supported by the rally in commodity prices and the weaker US dollar in the quarter. Brazil's Ibovespa was the strongest performer in US dollar terms, gaining 28.9% after losing 41% in 2015. The MSCI Turkey gained 21.7%, MSCI Russia 15.8% and MSCI South Africa 13.9%.

## LOWER GROWTH, RISING INFLATION SPARK STAGFLATION WORRIES IN SA

It was another eventful quarter in South Africa, as fears of a sovereign foreign currency rating downgrade to "junk" (or non-investment grade) status were just one factor casting a shadow over markets. Worsening inflation prospects prompted the South African Reserve Bank (SARB) to hike interest rates by a surprise 50bps in January and another 25bps in March, citing the weaker rand and sharply higher food prices as the major risks. "Stagflation" concerns mounted as GDP growth came in at 0.6% (q/q annualised) in the last quarter of 2015, for a total of 1.3% for the year, while headline CPI hit 7.0% y/y in February. The SARB now expects CPI to average 6.6% in 2016 and 6.4% in 2017, peaking at 7.3% y/y in the last quarter of this year. The Central Bank also lowered its GDP growth forecasts, to 0.8% from 0.9% in 2016, 1.4% from 1.6% in 2017, and 1.8% in 2018.

During the quarter rating agency Moody's placed South Africa's Baa2 foreign currency credit rating on negative review. The market widely expects a downgrade to Baa3 in the coming weeks, which would still be one notch above junk status, and in line with S&P and Fitch. The latter two agencies could then downgrade the country to junk level following their own reviews in June.

On a more positive note, the rand managed to recover some of its December-January losses later in the quarter, supported by a softer US dollar, stronger commodity prices and higher local interest rates. The 31 March Constitutional Court ruling on Nkandla also proved positive, reinforcing the rule of law and the country's constitutional democracy to ultimately boost investor confidence. This pushed the currency from just above R15/USD on the day to end the quarter well below that key level, at around R14.70/USD. Having started the quarter at around R16.5/USD, it gained 5.4% against the greenback, 0.4% against the euro and 8.0% versus sterling (which was weaker on Brexit concerns) over the three months.

The National Treasury's 2016/17 Budget was generally welcomed positively by investors and the ratings agencies, demonstrating more fiscal consolidation than in November's Medium-Term Budget, with the deficit planned to shrink from 3.2% of GDP in the current fiscal year to 2.4% of GDP by 2018/19. However, there was some disappointment over the absence of income tax hikes and other more aggressive measures that would have demonstrated even greater intent by government to maintain fiscal responsibility, and there is scepticism about their ability to rein in expenditure, particular regarding public sector wages.

Meanwhile, having been under considerable pressure in December and January, local bonds managed to stage a recovery in February and March, helped by rising commodity prices and the return of offshore investor demand. The SA 10-year bond rallied about 62bps to reach 9.09% by quarter-end, while shorter-dated bonds lost ground due to the SARB rate hikes. The All Bond Index returned 6.1% in Q1. Yields on inflation-linked bonds (ILBs) were largely unchanged at quarter-end, with the 10-year real yield at 1.8%, while the 15-year yield fell to 1.9% from 2.1% in January. ILBs returned 2.0% in the quarter, while cash returned 1.7%.

Break-even inflation expectations for 10 years started the quarter at 7.5% and spiked to around 8% as inflation concerns grew, before ending the quarter back around 7.5%. This is still too high in our view, implying a failure by the SARB in its inflation-targeting mission, and not taking account of low global inflation and weak local growth. Over the quarter, forward rate agreements (FRAs) priced in the SARB's rate hikes in the shorter dates, while 24-month interest rate expectations were largely unchanged at still-elevated levels around 8.5%. This indicates the market has "frontloaded" the SARB's rate hikes and not raised its views on interest rate levels in two years' time, although it still implies substantial further monetary tightening to come, an expectation we are doubtful will be realized.

In SA equities, the FTSE/JSE All Share Index returned 3.9% for the quarter, underpinned by a surge in resources counters, particularly gold (+93%), platinum (+75%) and industrial metals miners (+93%). For the quarter, the best-performing sectors were basic materials (+18.1%), industrials (+7.6%) and telecoms (+6.7%). The worst-performing sectors were consumer goods (-2.8%) and consumer services (-1.0%).

Listed property, after suffering sharp losses last quarter following Nene-gate, saw a very strong rebound in the past three months, with the listed property index posting a total return of 10.1% (9.5% in March alone).

## HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

In the first quarter of 2016, SA nominal bonds – particularly those with 10-year and longer maturities – continued to offer very good value compared to listed property and cash, so we took advantage of this to buy more bonds, moving from slightly to moderately overweight in our multi-asset portfolios. Other local asset classes either remained expensive or fairly valued on a medium-term view: we continue to be underweight listed property and inflation-linked bonds, considering them expensive.

Our views on global assets have changed little compared to the previous quarter: we still prefer global equities over local equities in our global portfolios, and we remain overweight global equities and global corporate bonds, and underweight global sovereign bonds and cash.

In **global fixed income,** we are underweight duration and continue to hold floating-rate notes (FRNs) in order to reduce interest rate risk. We remain positive on both investment-grade and high-yield corporate bond markets, and bought back some US high-yield bond exposure during the quarter as yields rose to very attractive levels.

For **global equities**, our global asset allocation continues to favour equities over bonds and cash, and global equities over local SA equities, as global equities remain more attractively valued than SA equities on measures like Price-Earnings (P/E) and Price-Book value ratios. In our higher return-targeting multi-asset funds we continue to be very near our maximum permitted 25% offshore weighting. From an historic valuation perspective, developed market equities (such as Germany) still appear to be the best value, while emerging market risks are elevated. We also remain underweight commodity producers like Australia and Canada, as well as the US. Given slowing global economic growth, corporate earnings growth remains vulnerable to downward revisions.

**South African equities** were trading largely around their longer-term fair value at the end of the quarter. Economic growth prospects for 2016 continue to be downgraded, increasing the risk of earnings disappointments.

Our SA equity positioning currently differs in our two flagship multi-asset class funds. For our Inflation Plus Fund, with a real return target of CPI + 5%, we are underweight SA equities in favour of offshore equities because we see better value in the latter asset class. For our Balanced Fund, we favour SA equities over other local asset classes (apart from local bonds) because of our view that they will offer better real returns over the medium term on a risk-adjusted basis.

For domestic portfolios, we continue to prefer certain financial stocks over expensive industrials, and remain underweight resources. We believe the recent commodity rally has not been underpinned by fundamentals: we remain concerned that there is a commodity supply overhang that will continue to put downward pressure on most commodity shares. In our view, gold, iron ore and platinum are particularly challenged.

Among our top overweight positions on a medium-term view are British American Tobacco, Investec, Sappi and Old Mutual, while our top underweights include Aspen, Medi-Clinic, Remgro and Sanlam.

In **SA listed property**, as the sector became more expensive over the quarter, we took advantage of this to move underweight in our multi-asset class portfolios and buy more attractive local longer-dated nominal bonds. Listed property companies (excluding developers) are currently priced to return approximately 15% p.a. over the medium-term (assuming no change in the market's valuation of property). Earnings remain challenged by the rising interest rate environment and weak economic growth outlook.

In **SA nominal bonds,** our portfolios are now moderately overweight conventional bonds, from being only slightly overweight in the previous quarter. 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. We would maintain that the risks over the near-term have been overstated by the market, so that current real yields from long-dated government bonds of over 3% are very attractive. Longer dated corporate bonds offer even more attractive real yields of over 5% over the medium-term, compensating for the risk, and so offer an excellent opportunity as well.

**Inflation-linked bonds** remained relatively expensive compared to conventional bonds over the quarter, leading us to remain underweight in these assets in our multi-asset portfolios. The break-even inflation rate of 7.5% appears exceptionally elevated compared to our long-term inflation benchmark of 6.0%.

## LOOKING AHEAD

The risks associated with investing in South Africa remain elevated. With GDP growth slowing further and inflation rising to 7% during the quarter (and forecast higher in coming months), the likelihood of eventually being downgraded to non-investment grade status has risen. Investors can expect continued volatility in financial markets over the medium term.