# MARKET OBSERVATIONS

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**The fourth quarter of 2015 (Q4) was generally a more positive one in global financial markets compared to the previous quarter, but for South African investors it was a period best forgotten. Although global growth remained slow, importantly, two major sources of market uncertainty improved: the US Federal Reserve finally raised interest rates 25 basis points (bps) in December as expected, and Chinese economic data stabilised and surprised positively over the three months.**

**As has been the trend this year, developed markets fared better than emerging markets (EMs), with commodity prices and EM currencies continuing on their weakening path. The price of Brent crude oil fell by 23.6%, and iron ore declined a disastrous 25%. Gold, meanwhile, was down 4.7% and platinum lost 4.4%. This sustained global deflationary pressures as the European Central Bank expanded its quantitative easing (QE) programme and Japan and China continued with their broader policy support. While there were no significant changes to Chinese GDP growth forecasts during Q4, there were modest but consistent downward revisions for the US, the Eurozone and many emerging markets, with a reduction in the OECD's global 2015 GDP forecast in November to 2.9% from 3.0% and to 3.3% from 3.6% in 2016. This was due largely to a greater-than-expected slowdown in emerging markets, the OECD reported.**

| ASSET CLASS | TOTAL RETURN Q4 2015 | 12-MONTH TOTAL RETURN |
|---|---|---|
| Global equity – MSCI World Free (US$) | 5.6% | -0.3% |
| Global equity – MSCI Emerging Markets (US$) | 0.7% | -14.6% |
| Global bonds – Barclays Global Agg Bond Index (US$) | -1.2% | -3.2% |
| SA equity – FTSE/JSE All Share Index | 1.7% | 5.1% |
| SA bonds – All Bond Index | -6.4% | -3.9% |
| SA listed property – SA Listed Property Index | -4.7% | 8.0% |
| SA inflation-linked bonds – Barclays ILB Index | 0.9% | 3.7% |
| SA cash | 1.1% | 5.9% |

## GLOBAL: EMERGING MARKETS SLOWDOWN STILL WEIGHS ON GLOBAL GROWTH

In the US, GDP growth registered 2.1% (q/q annualised) in the third quarter compared to 3.9% in Q2, which Federal Reserve Chairman Janet Yellen characterised as "moderate" but sustainable in a rising rate environment. Growth has been driven largely by stronger US consumer spending thanks to much cheaper oil and greater job security. Very strong October jobs data bolstered the Fed's case for a rate hike (with non-farm payrolls rising by 271,000 and average hourly earnings growing 2.5%), although economic data surprised increasingly on the downside in the latter half of the quarter. Yellen reinforced the message that the US rate hiking cycle would be "gradual", helping to reassure investors, and this was reflected in the decline in the Fed's own views of the future path of interest rates (as shown in its "dot plot"): by December 2017 it now projects the Fed Funds rate at 2.4% versus 2.6% previously, and by December 2018 at 3.3% from 3.4% previously. By contrast, market expectations of interest rates remained significantly lower than those of the Fed, as Fed Fund futures show a rate of only 1.3% by December 2017, an indication that the market remains more concerned about growth and less about inflation than the Fed.

Thanks to a strong performance in October, the S&P 500 returned 7.0% (in US dollars) for the quarter, but lost ground in December amid rising investor concerns over earnings – it returned only 1.7% for the year. The same was true in the US REIT (listed property) market, where the return was about 1.0% for the year. US Treasuries sold off prior to the Fed's actual rate hike, in response to the central bank's clear hiking signal in its 29 October statement, with the 10-year yield rising 25bps, but subsequently tracking sideways. US high-yield bonds lost more ground, impacted by weaker commodity prices as mining and energy company debt spreads widened by as much as 200bps compared to US Treasuries, taking both sectors to yields well in excess of 10% over US government bonds. Other high yield sectors were a mixed bag of winners and losers, but price action in general was modest compared to the gyrations of the commodity and energy issuers. The Barclays Global Aggregate Bond Index (US$), a mixture of government and corporate bonds, posted a total return of -1.2% in the quarter, for a total of -3.2% for the year.

In the Eurozone, growth remained modest, while inflation was only 0.1% y/y in November. Q3 GDP growth did improve to 1.6% (q/q annualised), while 1.5% is forecast for 2015 as a whole and 1.8% in 2016, boosted by the ECB's QE programme and continuing falls in Eurozone unemployment. A further expansion of the QE programme announced on 3 December disappointed markets: 10-year bond yields sold off by about 20bps, equities fell 2-3% and the euro strengthened as a result. The ECB also lowered the bank deposit rate by 10bps to -0.3%. Over the quarter, the Dow Jones Euro Stoxx 50 Index (US$) returned 2.8%, for a total return of -4.5% for 2015.

In Japan, the growth outlook remained softer than other developed economies due its greater export exposure to weak Asian demand, as well as its fiscal



**Source of table:** Deutsche Securities data to 31 December 2015 spending constraints caused by high government debt levels. GDP growth is now expected at 0.6% in 2015 and 1.0% in 2016, highlighting the need for Abe's continuing supportive economic policies. Despite poor domestic growth, over the quarter the Nikkei returned 9.2%, and 10.6% for 2015, making it the best performing of all the major developed markets, assisted by the weak yen that has boosted exports.

In China, concerns have been mounting over the ability of policy makers to engineer a 'soft landing' and pessimism around the future outlook reflected itself in economic indicators like retail sales and industrial production generally surprising positively against economists' forecasts. Q3 GDP growth at 6.9% (q/q/ annualised) also beat the 6.8% consensus. The Chinese central bank has pulled out all the stops to support the economy, including cutting interest rates for the sixth time in a year in October. Its December Outlook Report for 2016 projected 2015 GDP growth at 6.9% and 6.8% for 2016 but these figures are widely viewed as being heavily 'massaged' and indicators such as bank lending and electricity consumption paint a much bleaker picture. After its wild gyrations in Q3, Chinese equities were calmer and stronger over the quarter, with the Shanghai Composite Index up about 15% to end the year with a 9.4% gain.

Other emerging markets, meanwhile, remained under serious pressure from falling commodity prices, the stronger dollar and investor caution, although the Fed's rate hike has finally relieved some uncertainty – there was a small but generally positive response in EM currencies to the actual hike, as it had largely already been priced into assets before the move. It has been a horrible year in general for EM and commodity-driven economies: Brazil's economy is now expected to contract by 3.1% in 2015 and 1.2% in 2016, while Russian GDP is seen at -4.0% for 2015 and -0.4% for 2016. Over the quarter, the MSCI Emerging Markets Index (US$) recorded a total return of 0.7%, and -14.6% for the year. This compares to 5.6% for developed markets (MSCI World Free Index, US$) in Q4 and -0.3% in 2015. In US dollar terms, Brazilian equities lost 41.8% for the year, Turkey was down 31.6% and South Africa returned -25.1%. India and South Korea both lost 6.1% for the year, while Russia managed to gain 5.0% (although that follows on from a close to 50% decline in 2014).

## SA ECONOMY, INTEREST RATE MARKETS DEALT LASTING BLOW BY NENE-GATE

In South Africa, amid the negative global impact from further weakness in commodity prices and the rand, local markets were hit hard by "Nene-gate" - the surprise dismissal of Finance Minister Nhlanhla Nene by President Zuma on 9 December. This came shortly after the downgrade of SA's sovereign credit rating to BBB- by Fitch and being placed on negative outlook by S&P, and in reaction the rand, bonds and financial shares all sold off sharply on 10 and 11 December. Zuma did show that he was receptive to the resulting flood of criticism by his about-face in appointing the experienced and well-respected Pravin Gordhan as the new Finance Minister in place of unknown ANC backbencher Des van Rooyen. And although markets did subsequently retrace some losses, bonds and the rand remained significantly weaker through December. This reflects elevated political risk and a loss of confidence in policymakers among investors, which will be difficult to overcome. Fears of significantly higher inflation on the back of the much-weakened rand and the drought, and even possible irresponsible fiscal policy, have badly dented the bond market.

The rand had been trading weaker over the quarter prior to Nene-gate on the back of broader EM currency weakness, moving up from about R13.8/US dollar at the start of October to R14.5 on 9 December. The local currency then peaked at just over R16/US dollar by 11 December before recovering somewhat to trade near R15.5/US dollar at year-end. For the quarter the rand lost 10.8% versus the US dollar, 8.3% against sterling, and 8.3% versus the euro, and in 2015 it depreciated 25.3% against the US dollar, 21% versus sterling and 16.8% versus the euro.

Meanwhile, bond yields had been grinding higher earlier in the quarter, factoring in the SA Reserve Bank's 25bp rate hike in October (for a cumulative 125bp rise over the cycle to date), the expected US rate hike and the credit rating downgrades. Over the two days of Nene-gate alone, bond yields jumped some 180bps, with the 10-year yield moving from 8.80% to a peak of 10.60%. By quarter-end this had fallen back to around 9.50%, still leaving yields 75-80bps higher than before Nene's dismissal, exacerbated by thin trading conditions. One-year interest rates rocketed even higher, up 120bps and leading to some yield curve flattening. The All Bond Index lost 6.4% in Q4, for a 2015 total return of -3.9%.For the year, 1-3 year bonds returned 4.1%, and 12+ year bonds returned -7.0%. Yields on inflation-linked bonds rose about 30bps during the quarter, with ILBs returning 0.9% in the quarter and 3.7% in 2015. Cash returned 1.1% for the quarter and 5.9% for the year.

The degree to which inflation fears have risen and become endemic is shown by the movement in the FRA (forward rate agreement) market and break-even inflation rate (the difference in yields between the 10-year conventional and inflation-linked bonds): FRAs for three-month interest rates in two years' time have risen from 8.0% at the start of the quarter to 9.0% at the end of Q4, a full 1.0 percentage point increase in market expectations, reflecting a huge repricing of the money market. Break-even inflation has also risen 100bps – from about 6.5% at the start of the quarter to 7.5% by year-end. This is approaching the 8.0% level seen in 2008 when headline inflation was at an elevated 12% y/y; yet the latest CPI was 4.8% y/y in November, and has been weaker than market expectations in seven out of the past nine months. Core inflation was 5.1% y/y in November.

Such a high level of inflationary fear is surprising given the actual and forecast data: the SARB's latest CPI forecasts call for an average 4.6% y/y in 2015, 6.0% in 2016 and 5.8% in 2017. Independent economists forecast CPI to average 5.9% in 2016 according to Bloomberg's survey. Globally inflation remains low – interestingly, US break-even inflation has been at very low levels recently of about 1.5% compared to an average of 2% over the past 17 years, although it did rise 10-15bps over the quarter.

In SA equities, financial stocks were the worst hit by Nene-gate as investors anticipated higher costs for them in a higher interest rate environment. Share prices of banks like First Rand plummeted nearly 30% over the two days before recovering all but 4% of this later in December. The FTSE/JSE All Share Index returned 1.7% in Q4 for a total return of 5.1% in 2015 in rand terms. For the quarter, the best-performing sectors were consumer services and consumer goods, up 10.2% and 14.3%, respectively. Telecoms was the worst-performing sector (on the back of MTN's Nigerian fine), down 19.1%, followed by technology (-11.3%) and basic materials (-8.7%). For 2015, consumer goods and consumer services were also the top returning sectors with 31.2% and 27.1%, respectively. Telecoms lost 28.2% and basic materials were down 20.7%.

As an interest rate-sensitive asset, listed property also suffered from Nene-gate, with the listed property index having been down 2-3% before the fiasco and plunging 13.9% on 10 and 11 December, before regaining 7.9% on 14 December. By quarter-end it posted a total return of -4.7%, but managed to return 8.0% in 2015 to be the year's top-performing rand asset class yet again.

## HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED IN Q4?

During the fourth quarter, as certain local assets became significantly cheaper, we took advantage of this to adjust the asset allocation in our multi-asset portfolios. However, 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 largely neutral SA equities. Locally, we have moved from underweight listed property to neutral, and from slightly overweight conventional bonds to more overweight. This has reduced our cash holdings by purchasing bonds and property from cash. Lastly, we remain underweight inflation-linked bonds, given our view that the market is far too pessimistic about long-term inflation in South Africa.

In **global fixed income,** we are underweight duration and continue to hold floating-rate notes (FRNs) in order to minimize interest rate risk. This risk has fallen to an extent now that the Federal Reserve has implemented its first rate hike. 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% weighting in hard currency assets. From an historic valuation perspective, developed market equities (such as Germany) still appear to be the best value, given that EM equities remain very risky since macroeconomic risks still appear to be skewed to the downside.

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.

Despite recent weakness, we believe **South African equities** continue to be somewhat expensive, and so remain neutral in this asset class in our multi-asset portfolios. South Africa continues to be one of the more expensive emerging markets on a relative basis, yet actual earnings growth has been disappointing, with the commodity stocks worst hit. Economic growth prospects for 2016 have been downgraded. Given the more bearish outlook we have increased our holdings of equity put options as insurance in a downturn.

For domestic portfolios, we continue to expect local equities to offer reasonable real returns over the medium-term, despite looking expensive against fixed income assets. We continue to favour certain financial stocks over expensive industrials, and remain underweight resources, all positions that added value to our portfolios in 2015. Notwithstanding, December saw an acceleration in the depreciation of the rand which hurt the banks (in which we hold an overweight position), while benefitting from some resource counters such as gold stocks (where we are underweight).

Among our top overweight positions are British American Tobacco, Investec, Sappi and Old Mutual (most of which have quite significant offshore operations that will provide some hedge against the weakening rand), while our top underweights include Aspen, Medi-Clinic, Remgro and Sanlam.

In **SA listed property,** we took advantage of the weakness in the sector during the quarter to close our underweight position and buy more listed property assets out of cash holdings as valuations reached attractive levels. We are now neutral listed property in our multi-asset portfolios. As of year-end this asset class was very expensive versus long-dated nominal bonds, but less so against ILBs and cash.

In **SA nominal bonds,** we had already begun buying bonds into weakness during the quarter, ahead of Nene-gate, and bought more subsequent to this. As we had already been slightly overweight bonds going into the quarter, our portfolios are now more overweight conventional bonds. 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** became even more expensive relative 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% currently priced into the market appears exceptionally elevated compared to our long-term inflation benchmark, which remains at 6.0%.

## LOOKING AHEAD

There is no denying that the risks associated with investing in South Africa have risen over the quarter, particularly political risk. With GDP growth slowing further and the rand weakening significantly on top of the ongoing drought, there is more upside risk to inflation going forward, and a greater chance of eventually being downgraded to non-investment grade. South Africa's high current account deficit and relatively large budget deficit make it dependent on foreign investment inflows, which have dwindled in recent months. All of this means that South Africa is likely to face similar pressures in 2016 as those in 2015; consequently investors can expect continued volatility in financial markets over the medium term.

However, as yet there has been no indication from government that it will depart from its responsible fiscal policy – the Medium Term Budget Policy Statement in October merely continued with the government's three-year plans, albeit not making provision to reduce the budget deficit further below 5% of GDP. Nor are there yet any serious inflationary pressures coming through in a global environment of slow growth and low inflation.

At Prudential we believe we our multi-asset portfolios are best positioned to manage these conditions in order to meet their risk and return mandates. As 2016 progresses, we will continue to look for opportunities to buy appropriate assets at cheap valuations, and take advantage of any downturns to build attractive portfolios for our clients.