PRUDENTIAL
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MARKET OBSERVATIONS

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It proved to be a difficult third quarter (Q3) of 2015 for investors, with global financial markets buffeted by uncertainty arising from both a slowing Chinese (and global) economy and the postponement of interest rate hikes in the US. In July the successful Greek bailout agreement made for a positive start to the quarter, but the ongoing sharp selloff in the Chinese equity market – which had started in June – proved to be the catalyst for more widespread global selling. A general investor flight to safety materialised in August and continued into September, with emerging markets bearing the brunt of the losses and nearly US$11 trillion wiped off global equity values over the quarter. Equities have been hit by concerns over deteriorating global growth prospects (and consequently corporate earnings) as Chinese data surprised to the downside, the Japanese economy contracted, emerging market economies weakened and the Euro area remained mired in a zero-inflation environment. Meanwhile, holders of higher-yielding debt became more worried about creditworthiness. Deflationary pressures globally were spurred by a 22.1% drop in the price of Brent crude oil during the quarter, while commodity prices slumped 16% (Bloomberg Commodity Index). Even the US was showing signs of an industrial slowdown after robust 3.9% Q2 growth (q/q annualised), due to the stronger US dollar and weaker global demand.

Asset class	Total return Q3 2015	12-month total return
Global equity – MSCI World Free (US$)	-8.3%	-4.6%
Global equity – MSCI Emerging Markets (US$)	-17.8%	-19.0%
Global bonds – Barclays Global Agg Bond Index (US$)	0.9%	-3.3%
SA equity – FTSE/JSE All Share Index	-2.1%	4.8%
SA bonds – All Bond Index	1.1%	7.0%
SA listed property – SA Listed Property Index	6.2%	25.8%
SA inflation-linked bonds – Barclays ILB Index	0.9%	5.1%
SA cash	1.6%	6.4%

Global markets

In the US, GDP growth surprised to the upside in Q2 amid healthy consumer and business spending, but there was some softening in the second half of Q3, with high-frequency data only meeting expectations (rather than surprising to the upside). Industrial production slowed, and there was a steady three-month decline in consumer sentiment. Non-farm payrolls data disappointed in August, as did average hourly earnings. US equities were impacted by bearish sentiment, with the S&P 500 losing 6% in August, its worst month since 2012. At its much-anticipated meeting on 24 September the Federal Reserve's FOMC opted to postpone its first interest rate hike, citing a worsening outlook for global growth and financial market volatility, as well as some continuing labour market slack. While Fed Chairman Janet Yellen still pointed to a rate hike later in 2015, the FOMC revised downward its own expectations for the trajectory of future rate hikes, such that by mid-2018 it sees the Fed Funds rate at only 1.3%, compared to 2.0% at its previous meeting – a material change. The futures market, meanwhile, was pricing in only a 40% chance of the first rate hike coming in December.

The Fed's inaction proved negative for equities, highlighting that markets are now most focused on wanting stronger economic activity (rather than easy money). The S&P 500 returned -6.4% for the quarter, and -0.6% over 12 months. The yield on the 10-year US Treasury bond rallied by about 30 basis points (bps) in the flight to safety, unwinding most of Q2's losses, while investment-grade corporate bonds saw yields rise about 30bps. US high-yield bonds sold off as yield jumped 160bps versus US Treasuries, driven by a 400bp-increase in energy producers and 300bp-rise in metals & mining.

In China, the surprise devaluation of the yuan on 11 and 12 August (by about 3% in total) came as a shock to markets after 20 successive years of yuan appreciation (since 2005 the yuan has appreciated 33% against the US dollar), especially amid stock market volatility. While the People's Bank of China argued that it was a "free market reform" reflecting the country's relative economic slowdown, it sparked fears of global currency wars, especially between emerging market exporters. This, in turn, triggered widespread selling of emerging market assets. The Shanghai Composite Index fell 28.6% over the quarter and was down 41% from its mid-June peak, despite unprecedented government intervention to shore up the market. Its failure to do so further undermined faith

Source of table: Deutsche Securities in the government's ability to bolster the slowing economy. However, the Chinese government did implement a raft of fresh measures over the quarter to stimulate growth.

In Japan, data was disappointing as Q2 GDP growth came in at -1.6%, driven by lower exports (thanks to a stronger yen) and softer consumer spending. Industrial production fell 0.8% in July and 0.5% in August, fuelling talk of further monetary stimulus and more government spending, despite high debt levels. Citing the poor outlook for growth and inflation, S&P downgraded the country's sovereign rating one notch to A+. The Nikkei returned -11.6% in Q3, and 0.2% over 12 months.

Conditions were somewhat brighter in the Euro area early in the quarter as Greek default worries faded. However, Q2 GDP growth disappointed at 1.2% (q/q annualised), as German, French and Italian growth were all below consensus. Industrial production growth was sluggish, inflation fell 0.1% y/y in September and August unemployment was unchanged at 11%, prompting calls for an expansion of the European Central Bank's quantitative easing programme. The Dow Jones Eurostoxx 50 Index returned -9.1% for the quarter, its worst in four years, for a return of -12.9% over 12 months.

Emerging markets experienced a horrible quarter, which included the downgrade of Brazil's credit rating to junk status by S&P in September to BB+ on the back of the rapid deterioration in the country's economy and public finances. The MSCI Emerging Markets Index recorded a total return of -17.8%, while developed markets (MSCI World Free Index) were better at -8.3% (both in US dollars). In US dollar terms, the Bovespa returned -33.8% for the quarter, while the MSCI Turkey returned -19.5%, the MSCI South Africa lost 18.5%, and the MSCI Russia fell 14.4%. Even the MSCI India was down 6.7%. The Emerging Markets Bond Index (in US dollars) experienced a 75bp rise in yields to a spread of 475bps over US Treasuries (Brazilian yields spiked 300bps). Versus the US dollar, the Brazilian real was down 21%, the rouble lost 15.7%, the rand depreciated 12.0% and the Turkish lira fell 11.6%.

South African markets

The local economic environment continued to deteriorate in Q3, with the risk of recession growing as Q2 GDP growth came in at a worse-than-expected -1.6% due to significant contractions in the mining, manufacturing and agricultural sectors and exacerbated by the ongoing drought. The sharp fall in commodity prices offset the export benefits of the weaker rand, while inflationary pressures eased as August CPI surprised at only 4.6%, driven by weak consumer demand, the lower oil price and rising retail competition.

At its 23 July MPC meeting, the SA Reserve Bank (SARB) decided to raise the repo rate by 25bps to 6.0% in the face of the upside risk to inflation from the weaker rand, higher inflationary expectations, forecast higher food prices and an expected breach in the Bank's upper 6% CPI target band in Q1 2016. However, by the time of its 23 September meeting, inflationary pressures had abated to a certain extent and, combined with the weaker local and global economies, the MPC opted to leave rates on hold. The SARB's latest forecast sees CPI averaging 4.7% in 2015 versus 5.0% previously, and peaking at 6.7% (previously 6.9%) in Q1 2016. The Bank also lowered its GDP growth forecast for the country by 0.5 percentage points in each of the forecast periods: to 1.5% in 2015, 1.6% in 2016 and 2.1% in 2017.

On a positive note, the current account deficit improved to only -3.1% of GDP in Q2 from -4.8% in Q1, and Moody's confirmed South Africa's credit rating at Baa2 with a stable outlook in September despite the weaker growth outlook, citing the government's commitment to rein in debt and government deficits. This followed similar action from Fitch and S&P earlier in the year.

After consolidating against the US dollar in the previous quarter, the rand was caught up in the emerging markets selloff in Q3, losing 12% against the greenback, 12.4% against the euro and 8.9% against sterling. The local currency has now lost 17.2% against the US dollar in 2015. In the context of deteriorating local and global economic growth, the rand remains vulnerable to further losses in the near-term, especially in the run-up to the first US interest rate hike.

SA equities

After returning -0.2% in the second quarter, the FTSE/JSE All Share Index returned -2.1% in Q3 in rand terms, paring gains in 2015 to 3.4% year–to-date and 4.8% over the 12-month period. The Index actually returned 1.0% in rand terms in September, kept in positive territory largely by the surge in the share price of SABMiller on the back of the InBev takeover bid. The Telecoms sector was the quarter's worst performer, down 16.8%, while the Basic Materials sector lost 14.4% (down 8.9% in September alone) and Healthcare lost 7.9%. Industrials were down 3.1% and Financials down 1.1%. The best (and only positive) performance came from Consumer Goods, returning 16.1% for the quarter

SA bonds

After weakening for most of 2015 so far, SA bonds sold off further in Q3, with the yield on the 10-year SA government bond rising by about 15bps to 8.40%. The yield curve flattened markedly as we saw a significant re-pricing of risk at the shorter end of the curve: 2-year paper rose about 50bps and 3-year paper 40bps. The All Bond Index produced a total return of 1.1% for the quarter, with the longest-dated bonds (12+-years) the weakest performers at 0.9%, and the shortest-dated paper (1-3-years) the strongest at 1.8%. SA bonds have still managed to produce a total return of 7.0% for the 12-month period, beating equities and cash, but second to listed property.

With the medium-term outlook for inflation remaining poor thanks to rand depreciation and the impact of the drought, interest rate expectations rose again over the quarter: forward rate agreements (FRAs) increased by about 20bps, indicating that market participants now see three-month interest rates at 7.80% in two years' time, up from 7.60% at the start of the quarter. Compared to Q2, the market is now expecting a more severe magnitude of rate hiking cycle despite weaker economic growth and three months of falling core CPI data which surprised positively.

Inflation-linked bonds gained ground with a total return of 0.9% for the quarter and 5.1% over 12 months. Cash, meanwhile, returned 1.6% for the quarter and 6.4% for 12 months. The inflation break-even rate (as measured by 10-year ILB yields versus conventional bonds) was largely unchanged at 6.6% at quarter-end after peaking at 7.0% mid-period amid growing concerns over the weaker rand and inflationary pressures, a level we consider relatively high compared to our own longer-term inflation framework.

SA Listed Property

With a total return of 6.2%, listed property was the stellar performer among local asset classes for the quarter; it has returned 25.8% over the past 12 months. It has also reversed its losses of Q2, meaning it remains on the expensive side of fair value compared to its own long-term history and relative to long-dated bonds. Property is also vulnerable to worsening inflation and interest rate expectations, and still faces headwinds from sluggish SA economic growth and higher interest rates, among other factors.

Market valuations and prospective returns

At the end of Q3 2015, we still have a preference for global equities over local equities in our global portfolios, and we remain overweight global equities and largely neutral local equities. Locally we are underweight listed property and ILBs, and remain slightly overweight local bonds. During the quarter we bought long-dated Brazilian bonds in the face of the sharp rise in Brazilian yields and underperformance of the real versus the rand (the real depreciated some 23% against the rand). We believe the selling has been overdone and a lot of bad news priced into the Brazilian market.

Global fixed income: We remain underweight duration and continue to hold floating-rate notes (FRNs) in order to minimize interest rate risk. We remain positive on spread products in both investment-grade and high-yield corporate bond markets, and bought back some US high-yield bond exposure during the quarter as these instrument rose to very attractive levels.

Global equities: Our global asset allocation continues to favour equities over bonds or 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 this asset class. We continue to favour European markets, which we believe still appear to be fairly valued, particularly after the Greece-related downturn, and remain underweight commodity producers like Australia and Canada, as well as the US.

Following this quarter's sell-off, equity market valuations have move to more attractive valuations; however, the most attractive (i.e. emerging markets) also remain the most risky, and we are still cautious in this area. Given slowing global economic growth, corporate earnings growth remains vulnerable to downward revisions. From an historic valuation perspective, developed market equities (such as Germany) still appear to be the best value.

SA equity: Despite recent weakness, we believe South African equities continue to be somewhat expensive, and so remain slightly underweight to neutral in this asset class in our multi-asset portfolios. We have opted to hold additional cash in the face of a lack of sufficiently attractive opportunities on the JSE. South Africa continues to be one of the most expensive markets on a relative basis, yet actual earnings growth has been disappointing.

For domestic portfolios, we continue to expect local equities to offer reasonable real returns over the medium-term, despite looking somewhat expensive against fixed income assets. We continue to favour certain financial stocks over expensive industrials, and remain underweight resources. Among our top overweight positions are Old Mutual, Investec, Barclays Africa and Pick 'n Pay, while our top underweights include MTN, Aspen, Remgro and Sanlam.

SA listed property: We have been slightly underweight listed property for much of the year in our multi-asset portfolios, and this quarter's strong performance has led us to maintain this positioning. The sector is expensive relative to longer-dated bonds and compared to its own history, but remains supported by low real cash rates. It is expected to deliver double-digit returns over the medium-term thanks to strong distribution growth and higher leverage.

SA nominal bonds: After having bought back bonds following the weakness seen in Q2 (so that we were overweight in our multi-asset portfolios), this quarter's weakness has prompted us to maintain this position as well as being long duration. We also retain our overweight exposure to corporate bonds, with attractive spreads at around 170bps over their government counterparts, in line with BBB-rated US corporates. Having looked somewhat cheap over the quarter, we would have preferred to add some exposure to this asset class, but the paucity of new issues has made it difficult to do so. We did invest in bond issues from Toyota Financial Services and Investec Bank over the quarter.

Inflation-linked bonds: With ILBs remaining expensive during the quarter versus their conventional counterparts, we have remained slightly underweight in these assets in our multi-asset portfolios at the end of Q3, where we have opted for cash holdings as an alternative. Break-even inflation is now being priced in at approximately 6.6% (at 10 years), around the same level seen at the end of June, a level we consider elevated compared to our long-term inflation benchmark of 6.0%.