

# MARKET OBSERVATIONS

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Global markets started the second quarter (Q2) of 2015 reflecting the disappointment of the Q1 contraction in the US economy, but by June sentiment had improved despite mounting worries over Greece. In the US, the Federal Reserve did further moderate its outlook for interest rates in the face of slower-than-expected growth and low inflation. In Europe, good news on the improving economy was overwhelmed towards the end of the quarter by the growing likelihood of a Greek default. Emerging markets generally remained in the doldrums, experiencing further currency weakness and lower commodity prices (with the notable exception of oil), while China slowed further (7.0% GDP growth in Q1 from 7.3% in Q4 2014) amid more efforts by the authorities to boost economic activity. And after a strong start to the year during which many financial markets reached very expensive levels, equities broadly tracked sideways and fixed income assets came under pressure from concerns over anticipated higher US interest rates, a reduction in deflationary fears in Europe and worse-than-expected developments in Greece, among other factors.

Asset class	Total return Q2 2015	12-month total return
Global equity – MSCI World Free (US\$)	0.5%	2.0%
Global equity – MSCI Emerging Markets (US\$)	0.8%	-4.8%
Global bonds – Barclays Global Agg Bond Index (US\$)	-1.2%	-7.1%
SA equity – FTSE/JSE All Share Index	-0.2%	4.8%
SA bonds – All Bond Index	-1.4%	8.2%
SA listed property – SA Listed Property Index	-6.2%	27.0%
SA inflation-linked bonds – Barclays ILB Index	1.6%	5.1%
SA cash	1.6%	6.3%

## Global markets

In the US, GDP growth forecasts for 2015 were revised downward to around 2.0% from as high as 3.1% previously, after data showed a -0.2% (q/q annualised) contraction in the economy during Q1, due largely to the severe winter weather and lower exports. However, forecasts for 2016 remained largely unchanged. Q2 data generally surprised to the upside, reflecting an improving economy as household spending gathered pace (up 0.9% in May, the strongest in nearly six years), on the back of rising disposable incomes and increasing employment. Inflation, by contrast, remained exceptionally low at 0.2% y/y (as measured by the US Federal Reserve's preferred price index linked to consumer spending). Unemployment also fell to 5.5%, while wages (a key measure for the Fed) finally started to rise: unemployment costs,

which include wages and benefits, were up 2.6% y/y in Q1.

As a result, the Fed again moderated its interest rate outlook at its June FOMC meeting, with the median view of the Committee for the federal funds rate at the end of 2015 falling to between 0.50%-0.75%. And while the FOMC does still anticipate a rate hike in 2015, the market consensus has now shifted its expectations for the first hike out to the first quarter of 2016. The market's relative near-term dovishness makes bonds somewhat vulnerable to an earlier-than-expected Fed rate hike. For the longer-term rate view, Fed funds futures also now reflect a somewhat more aggressive tightening path for interest rates beyond 2017.

After strong gains in Q1, the US dollar was effectively flat on a trade-weighted basis in Q2 as gains against emerging market currencies (particularly in Latin America and Asia) were offset by weakness against the euro and pound sterling. The rand weakened only 0.3% against the greenback over the quarter, while falling 5.8% against a very strong pound sterling and 2.9% against the euro.

With investors now believing in the robustness of the US recovery, combined with a sell-off in the European bond market as deflationary fears abated during the quarter, US Treasuries sold off fairly sharply and the yield curve steepened: the 30-year UST yield jumped from about 2.4% to 3.20%, and even the 2-year yield saw a significant 30bp repricing. Investment-grade and high-yield bond spreads widened by approximately 15bps and 20bps versus USTs, respectively.

On the equity front, the strong rally of Q1 continued only for the first two weeks of Q2, followed largely by range-trading and later losses on the back of uncertainty over Greece in June. The US S&P 500 returned 0.3% for the quarter (losing 1.9% in June), while the Nasdaq fared better with a 2.0% total return. US corporate 12-month

earnings expectations were revised upward on generally improved growth in the US and Europe. Meanwhile, Tokyo's Nikkei recorded a respectable 3.5% for the quarter, buoyed by Abe's ongoing QE programme and a weaker yen.

In Europe, GDP growth forecasts were maintained at 1.5% for 2015, indicating some success for the European Central Bank (ECB)'s QE programme launched in Q1. There was also good news on 17 April in the form of inflation data, with March CPI rising to -0.1% y/y from -0.3% in February. This sparked a major sell-off in European bonds as the deflation risk premium abated. Yields had been at record lows across many national markets, including many in negative territory. The 10-year German bund moved from a record-low yield of 0.049% in mid-April to end the quarter at 0.80%. The euro was also bolstered, gaining ground against other major currencies. It was Greece, however, and concerns over the impasse between its government and creditors, that caused the most damage to markets in June, with European equities worst hit.

European equity markets all lost ground for the quarter in euro terms, with Greece unsurprisingly the biggest loser with a 16% loss. Germany was also one of the poorer performers (the Dax fell 8.5%) after being the top performer in the previous quarter. Year to date German equities have still returned 14.9%, however. In US dollar terms, performance was better, with the Dax returning -5.1% and France's CAC 40 +1.0%.

In emerging markets (EMs), Russian equities again rallied strongly with a total return of 7.7% over the quarter, followed by Brazil (up 6.8% after -14.9% in Q1) and the MSCI China at 6.2% (all in US dollar terms). Some of the worst performers in US dollars were Nigeria (-12.9%), Malaysia (-7.8%) and Australia (-6.3). By comparison, South Africa lost only 0.6% in US dollars. The MSCI Emerging Markets Index recorded a total return of 0.8%, slightly outperforming developed markets (MSCI World Free Index) at 0.5%. General investor risk aversion sent many EM currencies weaker, while the rebound in the oil price amid weak economic growth in many EMs left some with policy dilemmas over interest rate increases.

Commodity prices generally remained under pressure, with the exceptions of oil and iron ore. The price of Brent crude rose by about 14% in US dollar terms to trade at \$62/barrel at the end of June, while iron ore gained 12.2% for the quarter. The platinum price was down about 6% after falling 5% in Q1, and gold was down 1%.

### South African markets

The local economic environment remained weak in Q2, dominated by the threat of rising inflation in the wake of a weaker rand and higher oil and electricity prices. May CPI rose to 4.6% y/y, and at its 21 May MPC meeting, the SA Reserve Bank (SARB) sounded a more hawkish tone on interest rates, highlighting increasing upside risks to inflation from the weaker currency, higher wage settlements (averaging 7% and more) and energy costs. It revised its average CPI forecasts higher to 4.9% y/y for 2015 and 6.1% for 2016.

The central bank also cautioned that it expects CPI to peak at 6.8% y/y in Q1 2016, before falling back to 6.0% in the following quarter and remaining "dangerously close" to its upper 6% CPI target over the medium term. Meanwhile, the BER reported average surveyed inflation expectations for 2015 rose to 5.6% in Q2 from 5.4% previously, while those for 2016 increased to 6.1% from 5.9%, another cautionary signal.

The SARB also revised its GDP growth forecasts lower, to 2.1% in 2015 and 2.2% in 2016, citing weak domestic demand and subdued economic output in the face of regular electricity outages. SA manufacturing output fell 2.0% y/y in April, due largely to the severe load shedding that disrupted production.

On a positive note, the energy regulator's refusal to allow a 25% hike in electricity tariffs helped remove an imminent threat to higher inflationary pressures (at least for the rest of this year). The current account deficit also improved further, to -4.8% of GDP in Q1 2015 from -5.1% of GDP in the last quarter of 2014, largely on the back of an improved services account. And the country posted a surprise trade surplus of R5.0 billion in May, attributable largely to higher auto exports. While trade data is volatile, this does extend an improving trend helped by the weaker rand.

Perhaps the best economic news came from inaction on the part of international credit rating agencies: Fitch and S&P both left South Africa's sovereign credit rating unchanged at investment grade levels, with fundamentals not having deteriorated enough to merit a downgrade. However, the agencies do remain concerned over the country's meagre growth prospects and "twin deficits" (budget and current account), and Fitch has retained its negative outlook.

After losing 5.6% against the US dollar in Q1, the rand managed to consolidate at lower levels against the greenback in Q2, weakening only 0.3%. However it fell by 5.8% against the pound sterling as that currency rallied in the face of accelerating UK growth and anticipated interest rate hikes. It also lost 2.9% against the euro, reversing some of the gains seen in the previous 12 months. As in the first quarter, local factors like weak growth, unreliable electricity supply, a high government budget deficit and further inflationary pressures from rising electricity tariffs and above-inflation wage settlements all helped to fuel expectations that the rand could remain under pressure over the near term. This is particularly plausible in the context of continuing speculation over the timing of US interest rate hikes.

### SA equities

After a surprisingly good start to the year, the FTSE/JSE All Share Index was basically flat for the second quarter, returning -0.2% in volatile trading amid investor fears over US interest rate rises, elevated valuations and a general "risk-off" environment. It did fare better than many of its emerging market counterparts, being dragged down in June particularly by the -4.7% return from the Basic Materials sector, reflecting the ongoing poor conditions in the mining industry in the face of the continued deterioration in Chinese growth. The ALSI does still retain a positive total return of 5.6% year to date. However, over the past 12 months its total return of 4.8% is now below that of SA cash at 6.3%. The best-performing sectors for the quarter were Telecoms (+9.3%), Consumer Services (+2.1%), Technology (+2.0%) and Consumer Goods (+0.6%). The worst were Healthcare (-8.6%), Industrials (-3.8%) and Financials (-2.3%).

## SA bonds

After already having sold off in Q1 on the back of rising inflation expectations from a higher oil price, SA bonds experienced more selling in Q2 in line with other global bond markets. The yield on the 10-year SA government bond rose by about 55bps during the quarter to much more attractive levels, with the yield curve steepening. The All Bond Index produced a total return of -1.4% for the quarter, with the longest-dated bonds (12+-years) the weakest performers with -2.9%, and the shortest-dated paper (1-3-years) the strongest at 1.0%. SA bonds have still managed to produce a total return of 8.2% for the 12-month period, beating equities and cash, but second to listed property.

The deterioration in inflation expectations over the quarter (on the part of both the SARB and the surveyed public) continued the trend started later in Q1, with forward rate agreements (FRAs) rising by about 40bps. Market participants now see three-month interest rates at 7.65% in two years' time, up from 7.25% at the start of the quarter. The market is also pricing in a SARB rate hike as soon as September, ahead of any hike in the US. The more bearish sentiment reflects the SARB's hawkish comments on interest rate policy as their ability to refrain from hiking rates has come under increasing pressure.

Inflation-linked bonds, meanwhile, rallied in the face of elevated inflation worries, posting a total return of 1.6% for the quarter. This equalled cash at 1.6%, making these two asset classes the strongest performers for the quarter. The inflation break-even rate (as measured by 10-year ILB yields versus conventional bonds) rose to 6.5% at quarter-end from 5.9%, 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 by far the poorest performer among local asset classes for the quarter, after having posted exceptionally strong returns for the past year – it has still returned 27% over the past 12 months.. After having reached very expensive levels compared to its own history and relative to long-dated bonds, property was 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 Q2 2015, we still have a preference for global equities over local equities in our global portfolios, and we remain overweight global equities and slightly underweight local equities. Locally we are underweight listed property despite recent weakness in that asset class. After having reduced our overweight allocation bonds to neutral in Q1, we have bought back some bonds so that we are slightly overweight in multi-asset portfolios, reflecting the improved value on offer.

**Global fixed income:** We remain underweight duration and continue to hold floating-rate notes (FRNs) in order to minimize interest rate risk, a position that paid off during Q2 given the sharp bond sell-off (especially in Europe). We remain positive on spread products in both investment-grade and high-yield corporate bond markets, given that we don't see an environment developing in which they would perform poorly (namely, an aggressive interest rate-hiking cycle or a recession that causes default rates to rise sharply).

**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 are 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.

We remain concerned over the lack of delivery of global equity earnings. From an historic valuation perspective, developed market equities (such as Germany) still appear to be fairly valued to somewhat cheap, while emerging markets continue to be risky. After largely trading sideways during Q2, many market P/E's remain elevated, so in the absence of improving earnings, markets may be vulnerable to disappointment.

**SA equity:** Despite recent weakness, we believe South African equities continue to be somewhat expensive, and so remain slightly underweight to neutral on this asset class. South Africa continues to be one of

the most expensive markets on a relative basis, yet actual earnings growth has been flat since mid-2013.

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, a position which has benefited our portfolios over the quarter. Our top overweight positions include Old Mutual, Investec, Barclays Africa and Netcare, while our top underweights comprise MTN, Remgro and Sanlam.

**SA listed property:** Despite improved valuations in listed property during the quarter, we remain slightly underweight. The sector is expensive relative to longer-dated bonds and compared to its own history, but remains supported by low real cash rates and is expected to deliver double-digit returns over the medium-term thanks to strong distribution growth and higher leverage.

**SA nominal bonds:** After having reduced our overweight and long-duration positions in nominal bonds in Q1, the notable weakness in bonds in Q2, particularly in the shorter end of the curve, again brought bonds to more attractive levels, prompting us to buy more bonds so that we are now again overweight in our multi-asset portfolios. We retain an overweight exposure to corporate bonds, which offer attractive yields over their government counterparts. During the quarter we bought a new 20-year government-guaranteed bond issue from Eskom, offering a very attractive yield of nearly 10%.

**Inflation-linked bonds:** In the wake of the strong rally in ILBs during the quarter on the back of rising inflation fears, ILBs now look somewhat expensive versus their conventional counterparts, after having been relatively cheap to fairly valued in Q1. We are therefore somewhat underweight in these assets in our multi-asset portfolios. Break-even inflation is now being priced in at approximately 6.5% (at 10 years), up from 5.9% at the end of March, a level we consider elevated. As such we see ILBs as expensively priced compared to their conventional counterparts. ■