Q1
2015

PRUDENTIAL
INVESTMENT MANAGERS

MARKET OBSERVATIONS

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Global markets in the first quarter (Q1) of 2015 were dominated by an unexpected moderation in US economic growth - and consequent moderation in the outlook for the US Federal Reserve's coming interest rate hiking cycle - as well as the start of quantitative easing (QE) by the European Central Bank (ECB). US GDP slowed largely as a result of particularly bad winter weather and a surprisingly strong surge in the US dollar (against almost all currencies), while the ECB easing was effective in lowering bond yields and sending the euro significantly weaker. The gloom surrounding weak growth in Europe and Japan, so prevalent at the end of 2014, started to lift amid signs of recovery in both economies. News from China and emerging markets appeared to play a smaller role than usual, although late in the quarter the Chinese government pledged to implement further economic stimulus to ensure it meets its 7.0% growth target for 2015. Asset values in both developed and emerging markets were given fundamental support by the flood of easy money during the quarter, bolstered by several emerging market central banks also cutting interest rates as inflation waned.

Asset class	Total return Q1 2015
Global equity – MSCI World Free (US$)	2.5%
Global equity – MSCI Emerging Markets (US$)	2.3%
Global bonds – Barclays Global Agg Bond Index (US$)	-1.9%
SA equity – FTSE/JSE All Share Index	5.9%
SA bonds – All Bond Index	3.0%
SA listed property – SA Listed Property Index	13.7%
SA inflation-linked bonds – Barclays ILB Index	0.2%
SA cash	1.6%

Source of table: Deutsche Securities

Global markets

In the US, economic data almost universally surprised on the downside during the quarter, with the exception being the labour market as unemployment fell to a low of 5.5% in February, accompanied by an ongoing absence of labour cost pressures. GDP for Q4 2014 came in at 2.2% (q/q annualised) after hitting 5.0% in the previous quarter, and forecasts for Q1 2015 have been lowered to around 1.2% (q/q annualised) from well over 2.0% after weaker-than-expected data for exports, retail spending, manufacturing and equipment investment (the latter linked to the low oil price). Much of the weakness has been attributed to the severe winter weather and the sharp appreciation in the US dollar (up approximately 12% versus the euro), which hurt exports and made imports more costly. Inflation remained benign, with February CPI at 0.0% y/y. These factors led the Federal Reserve, at its 18 March FOMC meeting, to significantly downgrade its own interest rate outlook: its new "dot plot", reflecting FOMC members' own expectations, showed the new median Federal Funds rate at the end of 2015 at 0.625%, down from 1.125% in its December statement, and at 1.875% at the end of 2016 versus 2.5% previously. Consequently, market participants have pushed out their first rate hike expectations to September from June this year, while also moderating their views on the pace and extent of Fed tightening.

This more dovish outlook helped spark a rally in US Treasuries (USTs) late in the quarter, after having gained strongly in January (thanks to oil price euphoria) and sold off in February and much of March. By 31 March the UST 10-year yield was about 30 basis points (bps) lower than it started the year, and as a whole USTs produced a total return of 1.75% for Q1. US investment grade corporate bonds fared even better with total returns of 2.25%, and US High Yield bonds were the strongest performers at 2.5% (all in US dollars), rebounding after a poor end to 2014 amid weakness associated mainly with commodity producer debt.

On the equity front, US stock prices were pushed higher despite the fact that company earnings continued to disappoint. The US S&P 500 returned 1.0% for the quarter (losing 1.6% in March), while the Nasdaq fared better with a 2.5% total return. Tokyo's Nikkei was much more impressive at 10.8% for the quarter, buoyed by QE and the news that the Japanese economy had emerged from two quarters of negative growth with 1.5% (q/q annualised) GDP growth in Q4 2014.

In Europe, the ECB's announcement of a larger-than-expected €1.1 trillion QE programme on 9 March produced significant market reactions. By the end of the quarter, yields on almost one-third of the Euro area's US$6.3 trillion of government bonds were negative (source: Bloomberg), even for maturities out to seven years. German 10-year bund yields, for example, finished Q1 some 80bps lower at a mere 0.20%. And after two consecutive quarters of losses, European equities rebounded sharply, with exceptional gains of between 18% and 22% for most markets (in Euro terms) for the quarter. In US dollar terms the gains were less impressive (given the Euro's depreciation) - Germany's Dax posted the strongest US dollar total return of the major markets at 8.3%. Economic indicators for the Euro area surprised consistently on the upside, buoyed by the weaker Euro and lower oil price, prompting the ECB to revise its 2015 GDP growth forecast to 1.5% from 1.0% previously.

In emerging markets (EMs), Russian equities staged a strong recovery (after losing 46% in 2014) with a total return of 18.6% in the first quarter, and the MSCI China also performed well, delivering 8.0% (both in US dollar terms). The worst performers were Turkey, down -15.8%, and Brazil, where the ongoing economic crisis and corruption scandal at Petrobras left the Bovespa with a total return of -14.9% (in US$). The MSCI Emerging Markets Index as a whole recorded a total return of 2.3% for the quarter, slightly underperforming developed markets (MSCI World Free Index) at 2.5%, a trend that has been in place since the end of 2012 where Emerging Equities have underperformed in 8 of the last 9 quarters. The weaker oil price, combined with the prevailing lack of investor risk aversion, allowed many EMs to cut interest rates, supporting EM bond markets. Some EM currencies were weaker as a result, with the Brazilian Real the biggest loser - down 20% against the US dollar over the quarter.

Significantly lower commodity prices remained a major theme for the quarter, alongside the resurgence of the US dollar. Although the price of Brent crude oil fell to a low of around $45/bbl in January, it recovered to $62/bbl in February before trading between US$55-60/bbl towards the end of the period. Iron ore prices fell another 20% in the quarter as more supply continued to come on stream, while platinum was down about 5% and gold little changed (both in US dollars).

South African markets

The local economic environment deteriorated over the quarter. Although there was a temporary reprieve from rising inflation thanks to the drop in the oil price - with CPI falling to 3.9% y/y in February – inflation is widely expected to have bottomed in the face of lagged effects from a weaker rand, a recovery in the oil price and the likelihood of further increases in electricity prices going forward. At its 26 March Monetary Policy Committee (MPC) meeting, the South African Reserve Bank (SARB) revised its 2015 average inflation forecast upward to 4.8% y/y from 3.8% y/y previously. However, it did leave its 2015 GDP growth forecast unchanged at 2.2%, while lowering its 2016 growth forecast marginally to 2.3%. The MPC cited the weak rand as the primary risk for inflation, while also noting that it had incorporated only an 11% hike for Eskom electricity tariffs in its forecasts for the year despite the utility's rumoured latest demand of a 25% increase. Should it receive a 25% increase, analysts estimate this could add another 0.3 or 0.4 percentage points to inflation this year.

After another volatile quarter, the rand ended 5.6% lower against the US dollar and 0.1% down versus sterling, but was 6.5% stronger against the Euro. On a trade-weighted basis it was actually stable over the three months. While it was largely US dollar strength that led to the weaker rand, local factors like weak growth, unreliable electricity supply, a high trade deficit and further inflationary pressures from rising electricity tariffs and the likelihood of above-inflation wage settlements all helped to fuel expectations that the rand will 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.

Markets reacted neutrally to the National Treasury's 2015/16 Budget, unveiled in February. Credit ratings agencies welcomed the tighter fiscal policy aiming to curb spending growth combined with revenue raising measures to reduce the budget deficit to 2.5% of GDP by 2018, but warned that further rating downgrades would be in order should the government not adhere to these plans. Upcoming public sector wage negotiations will be closely watched.

On a more positive note, South Africa's Q4 2014 current account deficit narrowed to a revised 5.1% of GDP q/q from 5.8% of GDP previously, and February's trade deficit improved to -R8.5 billion from -R24.3 billion, amid lower import costs (thanks to the lower oil price) and growing export volumes (thanks to the weaker rand and a pickup in overseas demand). The latter is a highly volatile figure, however, and did benefit from a hiatus in the government's alternative energy programme which requires expensive capital equipment imports like wind turbines and solar panels.

SA equities

The FTSE/JSE All Share Index returned a very respectable 5.9% for the quarter amid volatile trading, with very good early gains offset by a total return of -1.3% for the month of March. The best-performing sectors for the quarter were Technology (+25.9%), Consumer Services (+17.9%), and Financials (+11.2%), while the worst were Oil & Gas (-9.2%), Telecoms (-5.1%) and Industrials (+0.8%).

SA bonds

Early in the quarter SA bonds continued to benefit from the favourable global tailwind for fixed income assets as inflation expectations improved: the yield on the 10-year SA government bond rallied nearly 100bps in January, mirroring the gains in USTs. However, the rising oil price subsequently dented inflation expectations and bonds sold off as a result in February, retracing most gains until mid-March, when the Federal Reserve's more dovish interest rate stance helped local bond yields track lower once again. The 10-year bond yield therefore ended about 20bps lower for the quarter as a whole. The All Bond Index produced a total return of 3.0% for the quarter, with the longest-dated bonds (12+-years) the strongest performers with 4.0%, and the shortest-dated paper (1-3-years) the weakest at 1.8%.

In January, forward rate agreements (FRAs) also reflected a significant improvement in inflation expectations and interest rates, as 3-month interest rates were seen as low as 6.40% in two years' time, down a full 100bps from 7.40% at the start of the year. However, this more bullish sentiment was unwound following the SARB's MPC comments, which highlighted how constrained the Central Bank's monetary policy is by the weak currency. Market participants now see three-month rates at 7.25% in two years' time, as they remain concerned over the SARB's ability to be patient and refrain from hiking rates should future rand depreciation result in higher inflationary pressures.

Inflation-linked bonds, meanwhile, continued to experience relatively stable yields and recorded a total return of 0.2% for the quarter. This was lower than cash at 1.6%. The inflation break-even rate (as measured by 10-year ILB spreads versus conventional bonds) fell to 5.9% at quarter-end from 6.3%. This level is currently within our own longer-term inflation framework.

SA Listed Property

With a 13.7% total return, listed property again proved to be the star performer among local asset classes for the quarter. Along with bonds, listed property stocks rallied through January, but then tracked sideways rather than selling off, consequently outperforming bonds over the three months. In the last 12 months, listed property has returned 41.4% and is trading at a premium compared to longer-dated bonds.

Market valuations and prospective returns

At the end of Q1 2015, we still have a preference for global equities over local equities in our global portfolios, while locally we have reduced our overweight allocations to property and bonds to neutral, reflecting the strong performance from these asset classes.

Global fixed income: We are underweight duration and previously reduced interest rate risk on our US holdings in our specialist portfolios through our allocation to floating-rate notes (FRNs). We have maintained this defensive positioning in Q1, given the slight concern that a positive growth surprise in Europe might at some time undermine the current euphoria in the European bond market (reflected in this quarter's sharp drop in bond yields). 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).

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. Over the quarter these funds benefitted from our overweight holdings in German and Italian equities. We remain underweight commodity producers like Australia and Canada, as well as the US.

However, concerns are starting to emerge 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, but significantly less so than the end of 2014. P/Es have continued to rise, largely in the absence of any rise in "E". Given this, should there be an ongoing failure to deliver earnings, markets may be vulnerable to disappointment.

SA equity: We believe South African equities continue to be slightly expensive, and so remain neutral on this asset class. In fact, the local market is one of the most expensive on a relative basis – in the top 25% of the world's most expensively valued markets. Looking at earnings delivery, actual earnings growth since mid-2013 has been flat, while the market (excluding dividends) has risen some 30% in price terms.

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 and British American Tobacco (BAT), while our top underweights comprise Steinhoff, Remgro and Sanlam.

SA listed property: After the strong outperformance from listed property in Q4 2014 and Q1 2015, we further reduced our overweight positions in this asset class into market strength and are now largely neutral in our portfolios. Valuations are now expensive relative to longer-dated bonds and on an absolute historic basis, but are supported by low real cash rates.

SA nominal bonds: During the quarter we continued to reduce our overweight and long duration positions in nominal bonds following January's strong rally and curve flattening that brought yields to more expensive levels. Following this reduction we are now flat duration in our specialist bond funds, and are neutral bonds in our multi-asset portfolios. We retain an overweight exposure to corporate bonds, which offer attractive yields over their government counterparts.

Inflation-linked bonds: In the wake of January's strong rally in nominal bonds and underperformance from ILBs (carried over from December 2014), we continued to take advantage of attractive pricing to complete the process of increasing our holdings in ILBs, where we were underweight ILBs in certain portfolios. ILBs now look mostly fairly priced versus their conventional counterparts. The market is pricing in break-even inflation at 5.9% (as noted above), which is within the range of our own longer-term inflation framework. As such we see ILBs as neutrally priced compared to our long-term view. ■