Q3
2014

PRUDENTIAL
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MARKET OBSERVATIONS

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Although the first two months of the third quarter saw continued market strength as a result of the same sanguine investor sentiment that dominated the second quarter of the year, in September nerves came to the fore amid mounting expectations of more aggressive interest rate hikes in the US next year. Combined with a continued slowing of growth globally (apart from the US and UK), this sparked fairly heavy selling across equity and bond markets, both developed and emerging, reversing much of the previous two months' gains. Easier monetary policy continued in Europe and Japan, where the former reported ever-worsening growth and deflationary concerns, while China also provided ongoing stimulus in response to more evidence of a slowdown in growth below the government's 7.5% y/y target for 2014.

Asset class	Total return Q3 2014
Global equity – MSCI World Free	-2.1%
Global equity – MSCI Emerging Markets	-3.4%
Global bonds – Barclays Global Bond Index	-3.1%
SA equity – FTSE/JSE All Share Index	-2.1%
SA bonds – All Bond Index	+2.2%
SA listed property – SA Listed Property Index	+7.2%
SA inflation-linked bonds – Barclays ILB Index	+1.0%
SA cash	+1.5%

Global markets

In the US, amid a raft of positive data surprises in September, it was the Federal Reserve's 17 September FOMC meeting that proved to be the tipping point for investor concerns. Although the Fed maintained its language of keeping rates low "for a considerable time" after ending its bond purchases, as Chairman Janet Yellen cited continued labour market weakness, FOMC members' expectations for median interest rates in 2015 and 2016 (as shown by the Fed's "dots plot") moved higher – a clearly more hawkish stance than the previous quarter. This sent the US dollar higher against most currencies, short-term US rates higher and bonds weaker, and drove selling across emerging market assets. Commodity prices were also sent lower on the stronger US dollar and weaker global growth, combined with oversupply in certain commodities.

A positive surprise came from US Q2 GDP data (notably off of a very low base), revised up to 4.6% y/y from 4.2% y/y, after contracting 2.1% in Q1, while unemployment fell to 6.1% in August, the lowest since 2008. Meanwhile, inflation pressures were still contained, with September CPI at 1.7% y/y below expectations of 1.9% y/y. The US dollar rallied against most currencies on interest rate expectations: from 1.37 to 1.26 USD/Euro), from 102 to 110 yen/USD, and from 10.60 to 11.30 Rand/USD.

Reflecting the new "risk-off" sentiment, US Fed Funds futures, a measure of the market's expectations for short-term interest rates, moved up 15bps to reflect the benchmark interest rate at 1.8% by December 2016, while 10-year US Treasury yields rose from 2.3% to 2.5%, reversing all of their previous gains earlier in the quarter. US high-yield bond spreads over Treasuries widened significantly, from +350bps to +440bps, amid concerns that rising interest rates would detract from the attractiveness of high-yield assets, while investment-grade corporate bonds fared better, moving from +110bps to +120bps.

On the equity front, the US S&P 500 posted a -1.4% total return in September, but still managed to end the quarter with a positive 1.1%.Year to date the total return is 8.3%, and over 12 months still a strong 19.7%.

In contrast, Europe remained in the doldrums. ECB President Mario Draghi's statement at Jackson Hole calling for additional stimulus signalled a marked reassessment of the Eurozone's longer-term growth prospects (although it is yet to be seen how much stimulus will be deployed). In Q2, Germany was barely growing (at 1.2% y/y), French GDP was flat, and Italy contracted 1.2%, although Spain and Portugal showed some signs of recovery. A number of European countries were also in outright deflation, while across the region CPI fell to 0.3% in September, a five-year low. (0.7% as measured by core CPI).

Developed market equities, as measured by the MSCI World Free Index (in US$), posted a -2.1% total return for the third quarter (-2.7% in September alone). Germany's Dax was the worst performer at -11.1%, followed by France's Cac 40 (-7.7%), and the

Table source: Deutsche Securities

UK FTSE 100 (-6.0%). The best performer was the US Nasdaq 100, up 5.4%. Emerging market equities, as measured by the MSCI Emerging Markets Index, recorded a -3.4% total return, led by Russia (-15.1%), Turkey (-11.8%) and Brazil (-8.4%) for the quarter, while South Africa was down 6.5% (US$ total returns). India was the best performer, at +2.3%.

Emerging market equities were hit by slower growth and pervasive negative sentiment, with Russia's economy being squeezed by global sanctions, Turkey impacted by the neighbouring wars in Syria and Iraq, and Brazil slipping into recession. Overall, GDP growth expectations for 2014 were downgraded by about 1.0% across the main emerging markets, with the consensus for China's 2014 GDP growth revised down to 7.3%, below the government's 7.5% target.

Significantly lower commodity prices were also a major theme of Q3 on the back of slower Chinese and global growth, as well as the resurgence of the US dollar. The price of Brent crude oil dropped from $112 to $95/barrel, platinum fell from $1500 to $1300/ounce, gold was down by $100 to $1220/ounce and iron ore from $91 to $81/metric ton.

South African markets

The combination of weaker commodity prices and "risk-off" sentiment proved to be a "double whammy" for South African markets in the third quarter. With the rand losing 5.8% against the US dollar over the period, fears of imported inflation gathered pace and in turn pushed interest rate expectations higher: by quarter-end forward rate agreements (FRAs) were pointing to 3-month interest rates at 7.60% in two years' time, up from 7.10% at their best level in August.

Bearish economic data also weighed on local markets. The Q2 current account balance widened to 6.2% of GDP, above the consensus forecast of 5.6%, and August CPI came in at 6.4% y/y, also above expectations of 6.2%y/y. Food prices unexpectedly remained stubbornly high in SA despite maize prices having fallen globally about 20% since the start of the year. At some point this should filter through, putting downward pressure on the local food price basket. Core inflation (excluding petrol, food and electricity prices) crept up to 5.8% in August from 5.7% in July.

Meanwhile, a broad consensus of private economists downgraded SA's 2014 GDP growth forecast to 1.7% from 1.9% previously, while the SARB lowered its own GDP forecast to 1.5% y/y from 1.7%, with the risks "still on the downside". Given the above, the SARB left the repo rate unchanged at 5.75% at its September meeting, citing the "anaemic" state of the economy, but also warned of the weak rand as a key risk to inflation going forward.

Analysts also warned about the SA government's deteriorating fiscal balance in the wake of slower growth. Five months into the 2014/15 fiscal year, revenues are lower, and spending higher, than budgeted, extrapolating a full-year fiscal deficit at -5.8% of GDP versus the budgeted -4.0% (according to NOAH Capital Markets). This would be seen as another risk to South Africa's sovereign credit rating. Given the above, the SARB left the repo rate unchanged at 5.75% at its September meeting, citing the "anaemic" state of the economy, but also warned of the weak rand as a key risk to inflation going forward. "At this stage it is difficult to assess the extent to which normalisation of US monetary policy is already priced in to the [rand's] rate," Governor Gill Marcus said in her statement.

SA equities

Like most other equity markets, the FTSE/JSE All Share Index retreated from its previous highs, with the Index returning to levels last seen in mid-May. It lost 2.6% on a total return basis in September alone to record a return of -2.1% for the quarter. Year to date, local stocks have still posted a total return of 9.4%, and 15.4% for the past 12 months. By sector, health care was a top performer with a total return of 10.6% for the quarter, followed by telecoms (+7.8%) and technology stocks (+2.1%). Financials were flat (0.4%), while the biggest losers were basic materials (-7.5%) and consumer goods (-4.5%).

SA bonds

Bonds also came under selling pressure on the "risk-off" trade, with net outflows from foreigners only partially offset by equity purchases. Although losing 1.6% in September, the All Bond Index managed to return 2.2% over the quarter, with year-to-date returns now at 5.7%. Longer-dated bonds (12+ years) continued to post the best returns at 2.5%, compared to 1.2% for 1-3 year bonds and 1.8% for 7-12 year bonds. One-year (money market) rates moved up from 7.1% to 7.4% (back to levels on offer immediately after January's rate hike), while 9-year bond yields jumped about 50bps in September to end the quarter at 8.13%. Longer-dated bond yields were mostly unchanged, with the 20-year bond at around 8.85%, as September weakness reversed earlier gains in the quarter. As a result, the local yield curve flattened somewhat, continuing the trend seen since the end of January: the difference between 3-month cash and 20-year yields has fallen from around 400bps to 275bps at quarter end.

Inflation-linked bonds, meanwhile, continued to benefit somewhat from heightened inflationary concerns, recording a total return of 1.0% for the quarter. This was lower than cash at 1.5%. Looking at 10-year ILB spreads versus conventional bonds at quarter end, inflation break-even was at 6.7%, very similar to the previous quarter. Our view remains unchanged that this is relatively elevated, given the subdued global inflation environment, and hence our preference for nominal bonds over inflation linked.

The impact on the corporate bond market by the rescue of African Bank in August was evidenced by credit spreads versus government bonds moving slightly wider – where bonds traded - as investors demanded higher reward for the perceived greater risk. While there was no fear of contagion of further failures among lenders, the write-down on senior debt imposed by the FSB – in which senior bondholders suffered losses and were "bailed in" to the rescue - had never occurred before. This created uncertainty for investors. Some primary bond issues by smaller, lower-rated borrowers were also delayed as a result of less risk appetite among investors.

SA Listed Property

Listed property was the star performer among local asset classes in Q3, managing to post a positive total return of 2.2% in September and 7.2% for the quarter. This gives it a year-to-date return of 14%, and 15.1% over 12 months. As investors we like listed property for its strong distribution growth prospects over the medium term.

Market valuations and prospective returns

Our views on relative asset class returns remain largely unchanged through the third quarter of 2014: we still prefer equities and listed property over bonds and cash, and global equities over local equities in our global portfolios.

Global fixed income: Despite the bearish moves in the global bond markets over the quarter, with credit spreads under pressure, we have not changed our view – we had already reduced interest rate risk on our US holdings in the previous quarter. We do not expect a sharp increase in corporate default rates as US interest rates rise, since this is typically due to a deteriorating macroeconomic environment, rather than being attributable to Fed rate hikes. So, we are content to remain modestly overweight floating-rate credit assets versus government bonds.

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 and Price-Book value ratios. In our multi-asset funds we are very near our maximum permitted 25% weighting in this asset class. From a long-term valuation perspective, developed market equities (such as Germany) still appear to be fairly valued to somewhat cheap, both in absolute terms and relative to cash and bonds. Emerging market equities, although offering even better value, generally present higher risks from slowing growth, falling commodity prices, credit bubbles and negative demographic trends. In our fund positioning, we are overweight Korea, Germany and Italy, and underweight commodity producers like Australia and Canada, as well as the US.

SA equity: We believe South African equities continue to be moderately expensive, and so remain neutral on this asset class. However, for domestic portfolios, local equities' potential real returns are attractive compared to other asset classes. We continue to favour certain financial stocks over expensive industrials. Our top overweight positions include Old Mutual, Investec and British American Tobacco (BAT), while our top underweights comprise Steinhoff, Remgro and Sanlam. In September's sell-off, our exposure to the Consumer sector added value through holdings such as AVI and BAT. Our underweight to gold stocks also added relative value, but this was offset to some extent by our position in Lonmin.

Listed property: After having moved to slightly overweight in this asset class in our multi-asset funds in Q2, listed property's outperformance in Q3 has benefitted our fund performance. With valuations still looking attractive relative to longer bonds, and expected to continue to deliver inflation-beating distribution growth, we remain moderately overweight. We also added some listed property to our "cash-plus" benchmarked funds during Q3.

SA nominal bonds: Although the yield curve has been flattening since January (as noted above), it still remains steep by historic terms – reflecting the low level of the repo rate (still below inflation). Long-dated bond yields have been remarkably stable, retaining relatively attractive yields of around 9.0% (8.85% for the 20-year bond) and still representing good medium-term value, in our opinion. At about 400bps (4.0%) more than cash and 300bps more than shorter-dated bonds, this is still sufficient reward for the risk over the medium-term. As noted last quarter, we are still slightly long duration in our nominal bond funds, expressed by our ongoing overweight in the long end of the yield curve. We are now flat duration in inflation-linked funds, and have shortened duration in our funds benchmarked against cash, having sold some holdings mid-quarter following the strong market rally.

We also still prefer long-dated corporate bonds, which offer attractive yields over their government counterparts. In the aftermath of African Bank, new bond issues have slowed, but new bond issues we bought into over the quarter included those from First Rand (5-years) and Investec (5.5-years), and floating rate notes (FRNs) from Investec (3-years), First Rand (2.7-years), Standard Bank (3-years) and Mercedes Benz (3-years).

Inflation-linked bonds: Given our medium-term views of a relatively subdued interest rate cycle in SA, ILBs continue to be somewhat richly priced against their conventional counterparts. The FRA market's expectations of another 150bps in rate hikes over the next 24 months also appear ambitious, given the local growth outlook.

However, in the short-term, given the sharply weaker rand and potential for further rand depreciation, it does make sense that the market would extrapolate a steeper rise in inflation and interest rates – we saw the same market reaction earlier in the year when the rand weakened to similar levels. Given that we do not believe it is possible to forecast exchange rate moves, however, we place no weight on this variable in our investment decisions. On inflation, over the medium-term we remain sceptical that companies would be able to push through price increases to consumers given the weak consumer demand in SA. As a result, on a medium-term view we see ILBs as expensive and continue to prefer (long-dated) conventional bonds versus ILBs.