Q2
2014

PRUDENTIAL
INVESTMENT MANAGERS
All things considered.

MARKET OBSERVATIONS

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Global markets generally benefitted from improving investor sentiment and economic trends in the second quarter of 2014, with equities in particular continuing to post good gains amid this "risk-on" environment. Geopolitical concerns sparked in Q1 by the Ukraine crisis faded, markets shrugged off increasing turmoil in Iraq, and confidence was underpinned by clear signs of a rebound in the US after its severe winter. Meanwhile, the European Central Bank and Chinese government both took further measures to boost flagging economic growth – the ECB through easier monetary policy and China through targeted lending strategies. This seemed to pay off in China, as officials pointed to higher Q2 growth than the 7.4% reported for Q1.

Global markets

In the US, Federal Reserve Chairman Janet Yellen continued with steady US$10 billion reductions in bond purchases, while maintaining her "lower for longer" stance on interest rates. This was despite data showing a rapidly improving labour market and rising inflation. Significant upside surprises came from the monthly non-farm employment data, while inflation – both headline and core CPI – also came in consistently higher than expected, rising to 2.1% y/y and 2.0% y/y, respectively, in May. However, retail sales and manufacturing data disappointed, and average hourly earnings growth remained steady at 2.0% y/y. The latter is being watched closely by the Fed to provide an indication of how much slack persists in the labour market even as unemployment fell to 6.1% in May – and its weakness helped reinforce the central bank's continued accommodative policy.

The Fed's still-dovish stance helped sustain the previous quarter's rally in US Treasuries, as 10-year UST yields fell about 20 basis points (bps) over Q2. Banks also continued to seek UST's for capital requirements. In the US High Yield market, bond spreads versus USTs contracted another 30bps, with the Index at 350bps by quarter-end. Although some have warned that spreads are below long-term fair value, we remain positive given the health of corporate balance sheets and expectations that default rates will remain subdued amid a moderate economic growth, low-interest-rate environment.

Fed fund futures, a measure of the market's expectations for short-term interest rates, were also somewhat more dovish, in line with the fall in longer-dated bond yields, pricing in the first rate hike in Q3 2015, but with benchmark rates now projected to end 2016 at 1.6%, versus 1.9% previously. This is somewhat more optimistic than the Fed's own interest rate projections, making the market vulnerable to disappointment should the Fed change its tapering approach unexpectedly.

US equities, and indeed most equity markets around the globe, were underpinned by ongoing easy monetary policies (the ECB implemented negative deposit rates, for example), spurring keen buying of more risky assets. The S&P 500 produced a total return of 5.2% (in US dollars) to reach fresh record highs (returning 24.6% over 12 months to end June), while the MSCI World Free Index returned 5.1% and the MSCI Emerging Markets Index 6.7% (14.7% over 12 months). The best performing developed markets in USD were the Nasdaq (returning 7.0% for the quarter) and the UK's FTSE 100 (5.8%), while top emerging markets (EM) included Turkey (15.4%), India (12.7%) and Russia (10.8%).

In global bond markets, the average spread on EM sovereign bond issues in US dollars versus US Treasuries fell 60bps over the period, a measure of the prevailing bullish sentiment. This is the lowest differential since May 2013, when the Fed's "tapering" announcement first sparked sharp sell-offs in EM assets.

Positive EM sentiment also helped buoy the currencies of the "Fragile Five" economies, pummelled in the previous quarter: the Brazilian real was up 2.0% vs the US dollar, the Russia rouble up 3.5% and the Turkish lira up 0.8% over the period. The South African rand, however, was among the worst performers, weakening 0.9%.

South African markets

Both SA equities and bonds posted surprisingly good gains in Q2 2014 despite predominantly bearish local news, as the global "risk-on" sentiment dominated markets. SA equities (+7.2% on a total return basis in rand) outperformed listed property (+4.4%), bonds (+2.5%) and cash (+1.5%). The good news surrounding the successful national elections was overwhelmed by the lengthy platinum sector strike, a poor Q1 GDP performance (the economy contracted 0.6% q/q due largely to the strike), sharply higher inflation and a downgrade in South Africa's sovereign credit rating to the bottom of the investment grade scale.

This bearish news was partially reflected in the weaker rand performance (as above) compared to its EM counterparts, as well as in South Africa's credit default swap spreads – the 5yr CDS spread improved only 10bps (to end the quarter at 180bps over its US equivalent) compared to the 60bp improvement in EM sovereign bond spreads (as above).

South African 10-year government bonds also gave up 30bps of their earlier 40bps gains, with the yield ending the quarter only10bps stronger.

Although headline inflation remained well above the SARB's 6.0% upper target limit at 6.6% in May, the broad market view is that it is likely to have peaked. Importantly, core inflation was unchanged over the quarter at 5.5%, due to inflationary pressures stemming largely from food and fuel (both excluded from the core CPI measure). This, as well as the weak state of the economy, contributed to the SARB refraining from hiking the repo rate further at its May Monetary Policy Committee meeting. However, concerns re-emerged that the Bank could raise rates at its July meeting.

SA equities

The FTSE/JSE All Share Index was one of the better-performing markets over the quarter, gaining 7.2% (on a total return basis) for a 12-month return of 32.7%. The Index continued to scale fresh record highs, driven principally by the large global rand-hedge industrial shares like British American Tobacco, Naspers, Richemont and SABMiller. By sector, top returns came from Consumer Goods (+ 13.4%), Healthcare (+9.7%) and Oil & Gas (+8.8%), while Basic Materials proved to be the laggard (+1.8%).

SA bonds

The All Bond Index produced a total return of 2.5% in Q2 2014, led by longer dated (7-12-year) bonds with a 2.9% return, while 1-3-year bonds produced only 1.8%. While the yield curve managed to flatten slightly, sentiment was dented by the credit rating downgrade (although not severely) and inflationary concerns. This benefitted inflation-linked bonds (ILBs), which saw a strong return of 5.9% for the quarter. Looking at 10-year ILB spreads versus conventional bonds, inflation break-even moved up from 6.7% to 6.85% by the end of the quarter. In our view this remains high, given the subdued global inflation environment, and hence our preference for nominal bonds over inflation linked.

Forward rate agreements (FRAs) reflected an improved interest rate outlook early in the quarter, but then deteriorated under the influence of the poor inflation data. By quarter-end, views were similar to those late in the first quarter, with the consensus of approximately 200bps of rate hikes (with the repo rate near 7.5%) by June 2016. In our opinion, this is still higher than we think likely, given our continued view of interest rates remaining lower for longer compared to previous rate cycles.

SA Listed Property

After posting a subdued 1.8% return in Q1, listed property tracked sideways for most of the quarter before staging a late rally to return a respectable 4.4% in Q2. Buyers returned as yields started looking attractive compared to nominal long-dated bonds. With reasonably strong distribution growth expected over the medium-term, it remains an attractive asset.

Market valuations and prospective returns

Our views on relative asset class returns remain largely unchanged through the second quarter of 2014: we still prefer equities over bonds and cash, although listed property has become relatively more attractive versus bonds over the quarter. Since we believe interest rates are set to stay relatively low for longer, cash (both local and offshore) remains an unattractive option.

Global fixed income: Our preference in this space remains floating-rate corporate credit, even as spreads on US investment-grade and high-yield bonds versus government bonds tightened by about 30bps over the quarter. While some warnings surfaced that spread levels are low compared to history, we remain positive. This is based on relatively healthy corporate balance sheets, the benign growth outlook, and an absence of significant refinancing needs, all of which should keep default rates below their long-term average.

Global equities: Our global asset allocation continues to favour equities over bonds or cash. Despite continuing strong gains in international equity markets, from a long-term valuation perspective developed market equities still appear to be fairly valued to somewhat cheap, both in absolute terms and relative to cash and bonds. As multiples continue to expand, earnings growth needs to keep pace: we are keeping a close eye on corporate earnings. As in Q1, emerging market equities, while still offering value, present risks as emerging markets transition to new, slower growth models, and are faced with continuing pressures from falling resource prices, credit bubbles, and negative demographic trends.

SA equity: We believe South African equities continue to be moderately expensive (by 10%-15%) on any measure, and so remain neutral on this asset class. However, for domestic portfolios, local equities' potential real returns are attractive compared to other asset classes.

Listed property: With listed property yields having become more attractive relative to bonds and cash in Q2, we moved to slightly overweight in this asset class in our multi-asset funds from neutral previously. Despite the impact of negative office rental reversions, the consensus distribution growth projection for SA REITS still exceeds CPI inflation over the next two years. In light of these growth prospects, it is noteworthy that SA REIT yields exceed those from ILBs by a wide margin.

At quarter-end, SA REITS were priced to deliver a one-year forward distribution yield of 7.8%, which exceeds ILB yields by nearly 6%. This underscores the merits of the investment case of property relative to bonds - while property continues to deliver inflation- beating distribution growth (and assuming existing yields stay constant), it would outperform ILBs by around 6% p.a. We believe listed property is capable of delivering total returns of between 9% and 12% over the medium-term, while being mindful of the higher risks associated with interest-rate-sensitive assets like property currently.

SA nominal bonds: Taking advantage of the rally in the R186 (10-year) bond to below 8.0% during the quarter, we opted to take some profits by selling some of our longer-dated bond holdings. This reduced the scale of our long duration, although our portfolios remain slightly long duration, expressed by our ongoing overweight in the long end of the yield curve. We also still prefer long-dated corporate bonds. Some new bond issues we bought into over the quarter included 16-year bonds from Airports Company South Africa (ACSA) and five-year bonds from Growthpoint Properties.

Inflation-linked bonds: ILBs continue to be somewhat expensive, in our view, against their (long-dated) conventional counterparts, but are not unattractively priced relative to cash. We believe the bond market is still overly pessimistic about SA inflation with break-even at 6.85%, pricing in a significantly elevated inflation risk premium given the benign global inflation environment. As a result, we prefer conventional bonds versus ILBs.