Portfolio Manager Quarterly Comment

Market overview

Quarter 3 of 2018 was characterised by a growing dislocation in the economic performance of the US in contrast to the rest of the world. Even more stark has been the difference in the prospects of the US and several of the major emerging markets (EMs), which have been plagued by concerns around trade tensions, the impact of higher US policy rates, and various idiosyncratic issues. The latter include the continued trade spat between the US and China, the likelihood of a messy election in Brazil, the threat of further sanctions on Russia, and (most prominently) Turkey seeing a massive sell-off in its currency and bonds when a war of words between Presidents Erdogan and Trump added to the already fragile situation that country's economy has been in. Turkey eventually settled the market to some extent by hiking rates by a substantial 6.25%, joining a group of several EMs that have hiked rates in recent months. In contrast, it's been plain sailing over in the US, with growth reaching 4.2% in the second quarter of 2018, equity markets at historic highs, and the back-end of the treasury curve seemingly oblivious to any of the three hikes seen from the Federal Reserve so far this year.

South Africa suffered no less from EM weakness than most of its peers, with a strong July for the Rand and bonds being undone by the significant turbulence seen in the latter two months of the quarter. Perhaps the most unsettling news for the nation over the period was the release of second-quarter GDP, which confirmed that SA's economy had suffered a second consecutive quarter of negative growth (-0.7% quarter-on-quarter, following on from -2.6% in the first quarter). Again, the largest contributor to the quarter's disappointing growth outcome was the agricultural sector, which saw a particularly severe decline of 29%. Under these circumstances, it remains to be seen how the economy can reach anything like the 1.0% or higher forecasts for 2018 GDP growth that many economists still maintain. The country was at least spared the prospect of higher interest rates when the SA Reserve Bank narrowly avoided hiking the repo rate at its September meeting (owing mainly to CPI continuing to surprise on the downside, as well as the general weakness of the economy).

In his bid to challenge the stagnation seen in the local economy, President Ramaphosa continued on his crusade to kick-start a wave of foreign direct investment into South Africa, managing to get Saudi Arabia and the United Arab Emirates to each pledge USD10 billion in investment, with China pledging a further USD15 billion (including a large loan to Eskom that has raised some questions).

In keeping with the challenging macroeconomic environment, all domestic asset classes had an unimpressive quarter. The FTSE/JSE Shareholder Weighted Index (SWIX) returned -3.3%, with only the Resources and Financial indices bucking the trend. Nominal bonds returned a mere 0.8%, while inflation-linked bonds returned 0.4%. Cash was the top performer, yielding 1.8%. The Rand was 33% weaker over the quarter, sliding from R13.71/$ to R14.15/$.

Global equity market returns in the quarter demonstrated the divergence between EM and developed market (DM) stock markets, with the MSCI EM Index down 1.0% in Dollar terms while the MSCI World Index surged 5.0%.

Asset allocation

Local nominal bonds with prospective real yields of close to 4% are attractively priced. We continue to add bonds opportunistically to our funds. At current yields it makes valuation sense to do so. Local (enhanced) cash instruments, both in the credit space and negotiable certificates of deposit, are attractively valued and we have been continually enhancing our cash through the purchase of good quality instruments at decent yield pick-ups over money market rates. Currently, cash on a risk-reward measure stacks up well relative to some of the higher duration assets within the local bond universe. Local equities have been increased, on an effective level. Using a bottom-up, fundamentally driven valuation analysis of the equity market, we believe this asset class to be currently trading at attractive valuation levels and offering reasonably good value with a potential upside to intrinsic value in excess of 25%, excluding Naspers.

On the international side, we maintain our preference for equities and select property over fixed income assets. This is based on relative valuation measures where fixed income assets are still not offering as attractive prospective returns as we expect from the equity asset class. Even though ten-year US Treasuries have now weakened to above 3%, sovereign bonds in the other major developed countries are trading at yields well below our 2% long-run inflation assumption. Given our required 1% real return from developed market bonds, global sovereign bonds remain unattractive.

Investment strategy

The current environment is one that is fraught with concerns for any investor looking to manage volatility. Headlines from our major EM peers have not provided any amount of comfort to markets, which had already been questioning the resilience of EM economies in a world of rising DM rates. Add to that a feeble local economy and the result has been a volatile Rand and the troubling combination of higher bond yields and depressed equity market values. To his credit, President Ramaphosa has been talking a good game in encouraging international investment into the country at various international forums, but his efforts are being somewhat undermined by stubbornly weak economic growth, and concerns about how the country’s land restitution policy will play out (something that even made it onto President Trump’s twitter commentary).

The sell-offs in both local bonds and equities in the third quarter mean that both asset classes can be considered cheap at current valuations, at least in comparison with historic levels. Our long-term fair value for the generic 10-year nominal bond yield is 3% real, which, given our long-term CPI expectation of 5.25%, comes to 8.25%. In comparison, the 10-year rate as at the end of September was 9.19%, suggesting an almost 1% additional yield sweetener at current levels. Equity valuations are also attractive, with our bottom-up analysis of the market showing it to be trading at well below its intrinsic or fair value.

Given the heightened levels of uncertainty surrounding current markets and the accompanying volatility experienced, we opportunistically embrace the valuations, albeit with a measure of caution. Under these circumstances, our approach has been to increase exposure to asset classes that we consider cheap in a cautious manner, and using derivatives to protect against downside risk while giving us what we consider to be acceptable upside participation. We have also taken advantage of elevated money market rates to invest in term cash instruments that offer attractive premiums over inflation with little volatility. We remain unexcited by inflation-linked bonds that yield in the region of 3% when nominal bonds and term cash instruments yield above 4%.

As regards international markets, we are increasingly uncomfortable with valuations in US equities relative to their long-run history. US bonds remain unattractive in an environment of steady hiking of interest rates by the Federal Reserve. Although European valuations are relatively more reasonable, that region also has to contend with the impact of Brexit as well as an Italian economy that is still on wobbly legs. When combined with the fact that many major EMs also face all manner of challenges, we remain comfortable in our current, diversified allocation to foreign equities and may look for further opportunities to invest in domestic assets, which we consider more attractively valued.

Equities

The FTSE/JSE Shareholder Weighted Index (SWIX) was down 3.3% this quarter, dragged lower by industrial stocks, which were down 7.8%. Resources once again had a strong quarter (up 5.2%), accumulating gains of 21% this year. Steel production has been very strong – a sign that the global economy is resilient - but there are concerns about the Global PMI rolling over and that a trade war would impact commodity demand negatively.

In the resources space, Impala Platinum (overweight) led the pack this quarter (up 35.8%) disclosing plans to close unprofitable shafts in its lease area, reduce production by 230 000 ounces and curtail the cash burn. The company experienced large losses of over R10 billion at the end of June, mainly due to the impairment of its Rustenburg shafts. We also witnessed strong performance from Anglo American Platinum (up 29.7%) and African Rainbow Minerals (up 24.7%). Financials recovered modestly by 2.8% after a dismal second quarter. The industrial sector suffered the biggest sell-off as the market punished any earnings disappointment heavily. Even traditionally defensive businesses like Shoprite have found it tough going in the rest of Africa with sales in its rest-of-Africa business dropping 7%!

The SIM house view portfolio outperformed its benchmark by approximately 43 bps this quarter. Our overweight position in Resources stocks drove our performance, especially our overweight position in Impala Platinum. Another overweight position, Exxaro, was up 19.9% as it delivered solid results and the market anticipates it to complete the disposal of its titanium business, Tronox. Sasol (overweight) also performed well, up 10.5%, with Brent oil up 7% this quarter in Rand terms. The oil price is at four-year highs with supply concerns augmented by the US threatening to boycott Iranian exports. On the financial side, the fund benefited from the overweight position in Old Mutual, which unbundled its stake in UK wealth manager Quilter and came back home for a primary listing on the JSE. Old Mutual was up 14.2% in the quarter, outperforming the SWIX. On the downside, the underweight position in Discovery detracted from performance after the insurer delivered results which beat expectations as its UK business appeared to turn the corner. The stock was up 15.3% in the quarter but trades at a hefty premium to embedded value.

The Industrial sector suffered the sharpest downdraft with some heavyweights being subject to panic selling. MTN, a stock where we have a marginal overweight position, sold off 17.2% this quarter with yet another unexpected move by the Nigerian government. The Nigerian Central Bank demanded the return of US$8 billion of dividends, which had been paid out over the past decade. The stock was sold off so sharply that the market implied a zero value for the Nigerian business – MTN's most profitable operation. While the government's actions ahead of forthcoming elections remain unpredictable, our estimate is that the risk is now more than discounted in the share price and that a lengthy legal battle is likely to mean that some level of sanity will prevail. Aspen, where we have an underweight position, also sold off by 34.4% on the back of results which were marginally below expectations, and the sale of its Chinese infant milk formula business for R13 billion to French company Lactalis, which again fell short of the market's expectations. The stock, which used to trade on high-teen multiples, has now derated to low-teen multiples as its operations were plagued by operational issues and some contract losses.

SIM equity strategy

As long-term value investors, our investment philosophy is based on taking long-term views and relying on fundamental analysis to make informed investment decisions. This means often avoiding glamour stocks which are the flavour of the day and also not panicking when the market irrationally sells off. It has been a difficult time for the JSE as emerging markets remain out of favour. The resources position we accumulated over the past few years when the sector was decimated is now bearing fruit. With the current sell-off in some blue-chip stocks, we are able to accumulate positions in stocks which are offering excellent upside to intrinsic value, which should yield outsized returns in the years to come.

Equity outlook

Post the Steinhoff debacle, market participants are increasingly jittery and the level of over-reaction to negative news has become extreme. Aspen used to be the darling of the exchange and evolved from being a local generics manufacturer to becoming a global pharmaceutical company with manufacturing capabilities in Europe, Australia and South Africa as well as distribution reach in Africa, Europe, Australasia and Latin America. Following an acquisition spree, the company is laden with debt and participants seem prepared to sell at any price to exit on the first sign of disappointing news.

Since the beginning of the year, we have seen the South African equity market decline along with other emerging markets. This fall can partly be attributed to the escalating global trade war started by the US. We are of the opinion that this fall is overdone in the local equity market. Given consensus earnings forecasts, our market now trades on a one-year forward price-earnings (PE) ratio of 11, if we exclude Naspers. Including Naspers, the forward PE is closer to 12.5.

We believe a PE ratio of about 13 to 14 is more appropriate for the SA equity market given our required real return of 6% for local equities.

International

Headlines over the quarter continued to be overshadowed by tariff imposition rhetoric out of the US (in particular the Trump administration). Added to this, Fed Chair Jerome Powell hiked rates again on 26 September to 2.25%, citing that rates were still extremely accommodative and that the bank was still "a long way" from neutral. At least one more rate hike is expected this year with three more in 2019. The US economy remains resilient with jobless claims now at half-century lows. US growth of 4.1% for the June quarter is at four-year highs, accelerating from the beginning of the year and boosted by strong final demand and exports as counterparties tried to stockpile ahead of a tariff war. The Global Purchasing Managers Index (PMI) is rolling over from strong growth – except for the US. Globally, capex spending has also slowed from over 5% to 3%. The main risk to US economic growth remains high inflation ignited by a tight labour market and higher commodity prices, which will be exacerbated by US tariffs on steel and aluminium products. The implication of this is that the Fed may have to hike rates more rapidly. The first round of 5% tariff increases ($830 billion) is expected to impact GDP growth by 0.5% (and 0.2% on global growth) and drive inflation up by 0.5% on a one-off basis. On the European front, the main concern remains Italy, whose budget deficit is projected to spike from 0.8% to

2.4% as political parties try to make good on electoral promises. In the UK, demand remains upbeat, despite the uncertainty over Brexit terms that need to be finalised over the next month for the UK to officially exit the EU in March 2019. Japan's GDP growth advanced sharply in the second quarter, driven by business spending. In China, the government is taking measures to boost infrastructure spend by increasing bank liquidity to maintain credit growth around 11% p.a. and facilitating local government bond financing. Chinese GDP growth is expected to weaken marginally from 6.8% to just below 6.5%, aided by robust consumer demand and stable total social financing, as long as the tariff war does not escalate further. However, there remains a concern about the high level of corporate debt in China. China is focusing on defensive easing by allowing local authorities to issue bonds.

For the quarter in dollar terms, the MSCI World Index recorded a return of 5.0% while the MSCI EM Index declined 1.0%. Global bonds, as measured by the Bloomberg Barclays Capital Aggregate Bond Index, declined by 0.9% over the quarter. The local currency weakened by 3.3% versus the US Dollar.

Looking to our international asset positioning within the funds, we remain constructive on global equities over fixed income from a relative valuation perspective. Although developed equity markets, specifically the US market, have rerated to expensive levels relative to their long-run history, we retain a preference for equities over bonds on the basis of pure relative valuation measures. Our global property assets have an average dividend yield of about 6.7%, which too compares favourably to the yields on global sovereign bonds.

Bonds

The back drop for EMs deteriorated sharply during the past quarter as the global super powers (China and the United States) continue to wage "war" on the trade front. The Turkish Lira and Argentine Peso were the worst performing currencies against the Dollar, declining by about 40% over the quarter. Turkey has been in a diplomatic standoff with the US over the incarceration of an American citizen. In Argentina, investors are worried that the country may soon default on its debt. The Rand traded to a low of R15.58/USD before recovering to R14.12/USD as South Africa is seen by some investors as having similar vulnerabilities as Turkey: current deficits and large external financing requirements.

US 10-year bond yields rose from 2.95% to 3.06% leading to a sell-off in other DM bond yields. In Germany and Britain 10-year bond yields rose 17bps, while Japanese benchmark 10-year yields rose 9bps. Bond yields in the US were pressured by increased supply and chances of more rate hikes.

In South Africa the sharp fall of the Rand and the rise in oil prices resulted in a deterioration of the inflation outlook. But the Reserve Bank decided not to increase the repo rate at the September meeting given the -0.7% GDP outcome for the second quarter and the lower than expected 4.9% CPI for August. The yield on the benchmark R186 bond rose 11bps during the quarter from 8.88% to 8.99%. However, the FTSE/JSE All Bond Index managed to return a positive 0.78% for the quarter as short-dated bonds offset the capital losses on long-dated bonds. We think South African bonds offer value when the 10-year bond yield is between 8.25% and 8.50%.

Credit market issuance improved in the third quarter after a disappointing first half of the year, headlined by a R3.3 billion issue of senior bonds from FirstRand Bank in July (with maturities of 3 to 7 years), R2.25 billion of 3-year floating rate notes issued by Mercedes-Benz in August, and R3.6 billion of senior bonds issued by Absa Bank in August (also with maturities of 3 to 7 years). Other notable issues included R700m of 8-year notes issued by Discovery Limited in August, R1.5 billion in 10 non-call 5-year subordinated notes issued by Nedbank Group, and R1 billion in 3- and 5-year notes issued by Woolworths Holdings. A number of new securitisation issues also took place, the largest of which was R1.2 billion of 3-year notes issued by Amber House in July. Little issuance was seen from SOEs, with the exception of Land Bank's R1.5 billion issue of 3- and 5-year notes in September. Credit spreads have continued to tighten amidst strong investor demand.

The outlook for DM bonds remains poor given a combination of lower liquidity as central banks buy less government bonds, increasing inflation and larger deficits in the US. We think yields in the US will end 2018 closer to 3%, perhaps even a little higher. However, guidance from the ECB to keep rates on hold until the end of summer 2019 will have a dampening effect on yields in Europe. The trade war between China and the US is leading to risk aversion and capital flight toward developed markets. Oil prices have risen further and pose a threat to our constructive view on bonds.

In October the Minister of Finance will deliver the Medium Term Budget Policy Statement (MTBPS). The market will be looking for continued commitment to the expenditure ceiling and for bond issuance to remain unchanged. Government has already committed to a R50 billion stimulus package, to be announced at the MTBPS. Should this stimulus package not be financed within the expenditure framework previously announced, this would be negative for the bond market.