MARKET OBSERVATIONS

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PRUDENTIAL
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The final quarter of 2017 proved to be another strong one for global growth and stock markets, as numerous equity indices around the world in both developed and emerging economies rose to new records and posted double-digit returns for the year as a whole. The longstanding rally looked set to continue into the new year amid ongoing optimism over the health of the global economy, still-subdued inflation, supportive monetary policies and bullish investor sentiment, given an additional fillip by the enactment of major corporate tax cuts in the US. The US Federal Reserve continued its very gradual tightening, the Bank of England hiked interest rates for the first time in a decade, and the European Central Bank (ECB) kept interest rates unchanged. Global bonds posted a muted return amid mixed sentiment over prospects for rising inflation and interest rates.

For South African investors it was a surprisingly positive quarter, with all local asset classes managing to post solid returns, especially in the wake of the rally sparked by market-friendly Cyril Ramaphosa's election as the new President of the ANC in December. Despite the installation of a divided ANC leadership committee with competing policy approaches, investors interpreted Ramaphosa's election as an opportunity for the country to introduce much-needed reforms, reduce corruption, and lift business and consumer sentiment. Greater prospects for improved fiscal responsibility also helped the credit rating outlook. Combined with Moody's credit rating reprieve in November, this more optimistic sentiment helped lower risk perceptions among both local and offshore investors, driving strong rallies in South African bonds and the rand. SA equities, although returning a respectable 7.4% for the quarter, were adversely affected in December by the collapse in the share prices of Steinhoff and its associated companies, counterbalanced partly by a rise in domestically oriented shares (including banks and retailers) post the ANC elective conference.

ASSET CLASS	TOTAL RETURN: Q4 2017	TOTAL RETURN: 2017
Global equity – MSCI World (US$) (Developed)	5.6%	22.4%
Global equity – MSCI Emerging Markets (US$)	7.5%	37.3%
Global bonds – Bloomberg Barclays Global Agg Bond Index (US$)	1.1%	7.4%
Global property – EPRA/NARIET Dev Global Prop Index (US$)	3.8%	10.4%
SA equity – FTSE/JSE All Share Index	7.4%	21.0%
SA bonds – BEASSA All Bond Index	2.2%	10.2%
SA listed property – SA Listed Property Index	8.3%	17.2%
SA inflation-linked bonds – JSE CILI Index	1.0%	2.9%
SA cash (STeFI Composite Index)	1.8%	7.5%

Source: Prudential, Deutsche Securities, data to 31 December 2017

2017 A BUMPER YEAR FOR GLOBAL GROWTH AND EQUITY RETURNS

In the US, the latest GDP data (Q3) showed growth accelerating to 3.3% (q/q annualised) from 3.1%, propelled by higher business investment and rising inventories, while consumer confidence reached a 17-year high in November. This marked the 32nd consecutive quarter of US economic expansion since the 2009 recession, the third longest since 1945. Meanwhile, consumer inflation remained at moderate levels: November CPI came in at 2.2% y/y, in line with expectations, with the small rise from October's 2.0% y/y attributable mainly to rising oil prices. Taking this expansion together with full employment and the large corporate tax cuts passed by the US legislature in December, analysts expect inflation to become more problematic in 2018 – market consensus is for four 25bp Fed rate hikes in the new year following its 25bp increase in December. However, new Fed Chairman Jerome Powell is expected to proceed gradually - in line with his predecessor, Janet Yellen, he is seen as having a dovish approach to managing monetary policy. Into 2018 the Fed will also continue to wind down its balance sheet, having started in October with an outstanding $4.5 trillion in US Treasury bonds and mortgage-backed securities that it will slowly allow to mature, without reinvesting the proceeds. Under its current plan, this would drop below $3.0 trillion by 2020. For the longer-term, the Fed has said its intention is to keep its balance sheet "appreciably below that seen in recent years but larger than before the financial crisis".

US stock markets again reached fresh record highs this quarter, with the Dow Jones Industrial Average approaching 25,000 at year-end and returning an exceptional 28.1% to investors for 2017. For Q4, the S&P 500 returned 6.6% (21.8% in 2017) and the Nasdaq 7.3% (33% in 2017, an amazing year thanks to its technology-heavy composition). The Bloomberg Barclays Global Aggregate Bond Index (US$), a mixture of government and corporate bonds, returned 1.1% in the quarter, although much of this was driven by a weaker US dollar, which enhanced mediocre returns from non-US bond markets. It returned 7.4% for the year.

US Treasury bonds (USTs) posted small capital losses in Q4, while the US yield curve (the difference between short-term and 10-year yields) moved to its flattest in over 10 years. This perhaps reflects a view that while the Federal Reserve will continue to tighten policy next year, the peak in US rates will be well below that of previous cycles since inflation remains well contained. At quarter-end, the 10-year UST yield was trading around 2.4% from 2.3% at the end of Q3. For US corporate bonds, investment-grade bond spreads narrowed slightly over USTs, while high-yield spreads were roughly unchanged over the three months.

In the Eurozone, the region grew a stronger-than-expected 2.5% (q/q annualised) in Q3, up from a revised 2.3% in Q2, as the recovery became more broad-based across many euro-area countries, and helped by the ECB's ongoing easy monetary policy. Economic growth is now forecast at 2.2% y/y for 2017, the fastest in a decade. Despite the unemployment rate falling to a nearly nine-year low of 8.8%, inflation remained becalmed with CPI at 1.5% y/y in November. Meanwhile, the euro continued its appreciation in Q4 – the currency was the strongest performer against the US dollar in 2017, gaining 12.7% for the year as investors bet on accelerating Eurozone growth while the US business cycle aged. At its December meeting the ECB left interest rates on hold as expected, given subdued inflation. For the quarter, the Dow Jones Eurostoxx 50 (in US$) returned -0.8%, but 24.3% for 2017.

Meanwhile, the UK continued to face a Brexit-inspired dilemma, with uncertainty curtailing economic growth but fuelling inflation from the weaker pound. Although progress was finally made in Brexit negotiations during the quarter, Q3 GDP growth was only 1.5% (q/q annualised), while November CPI surprised to the upside at 3.1% y/y. The Bank of England opted to raise interest rates by 25bps in November, its first hike since 2007 - investors now expect no further hikes until late 2018. The FTSE 100 returned 6.0% (in US$) over the quarter and 22.6% for the year.

In Japan, Q3 GDP growth came in at 1.4% (q/q annualised), down from a revised 2.6% in Q2, but still solid as expanding exports compensated for softer consumer demand. This marked seven successive quarters of growth. However, core inflation was still tepid at only 0.9% y/y in November. Prime Minister Abe comfortably won the snap election he called in October, the result seen as an endorsement to continue his efforts to speed up economic growth. Japanese stocks experienced their best year since 2013 on stronger corporate profits growth: the Nikkei 225 Index returned 12.1% over the quarter (in US$) and 25.7% for 2017.

In China, Q3 GDP growth slowed marginally as expected, to 6.8% (q/q annualised) from 6.9% in Q2, dented by the government's attempts to rein in property market speculation and reduce debt. This is still above 2017's official 6.5% growth target, with factory output boosted by improving global trade. The equity market continued its remarkable performance with the MSCI China returning 7.6% in Q4: it was among the world's strongest markets in 2017 with a total return of 54.3%.

Other emerging market (EM) assets posted strong returns in Q4 as risk-hungry investors continued to seek out EM equities. Overall, the MSCI Emerging Markets Index returned 7.5% in US$ for the quarter, and an impressive 37.3% in 2017. This compared to5.6% and 22.4%, respectively, from the MSCI World Index for developed markets. Among the larger EM equity markets in US$ terms for the year, South Korea's KOSPI returned 41.3%, the MSCI Turkey 39.1%, the MSCI India 38.8% and the MSCI South Africa 36.8% (helped by the stronger rand versus the US$).

In commodities, the price of Brent crude jumped some 16% during the quarter to end the year at over US$66.50 per barrel, up nearly 18% for 2017 as a whole as OPEC and other producers successfully curbed supply in the latter half of the year and look set to extend production cuts through the end of 2018. Other commodity prices also gained ground in Q4, extending their strong gains over the year in line with accelerating global growth and a weaker dollar. Palladium topped commodity gains in 2017 with a 57.8% price rise on the back of its increasing usage in vehicles, while platinum posted an annual gain of only 2.8% on oversupply concerns. Industrial metals reflected the higher global growth trend: aluminium was the second-best performer in 2017 at 32.4%, while copper and zinc both experienced 30.5% rises. Gold gained 13.5% for the year, largely on the back of North Korean tensions.

RAMAPHOSA RALLY LIFTS SA RETURNS FOR 2017

Despite the sluggish local economy, elevated political risk and further credit rating downgrades during the quarter, South African assets performed surprisingly strongly. Although bonds and listed property experienced sharp sell-offs after the revelation of SA's deteriorating fiscal position in October's Medium-Term Budget Policy Statement (MTBPS), they both managed a relief rally following Moody's postponement of its credit rating decision in late November, and saw even better gains in the "Ramaphosa rally" amid the post-ANC conference exuberance in December. Investors were keen to snap up the attractive yields on offer. The BEASSA All Bond Index returned 2.2% for the quarter and a strong 10.2% for the year. Inflation-linked bonds (Composite ILB Index) produced a more muted 1.0% for Q4 and 2.9% in 2017, while cash as measured by the STeFI Composite Index delivered 1.8% in the quarter and 7.5% for the year. Finally, SA listed property produced 8.3% in Q4, for an unexpectedly robust total return of 17.2% in 2017.

Equities, meanwhile, were helped by global enthusiasm over the quarter: the FTSE/JSE All Share Index hit new record highs in November, rising briefly to 61,299 points before retracing about 3% to close December at around 59,500 points. The market suffered a significant drop in early December on the back of the plunge in the share prices of Steinhoff and associated companies such as Steinhoff Africa Retail (STAR) and Brait. This was partially offset by the Ramaphosa rally, led by retail and banking stocks, but rand strength hit the share prices of those companies with significant offshore earnings, including industrial and resources counters.

For the quarter, the ALSI returned 7.4%, thanks to a 16.0% return from Financials and a 22% return from retailers, both boosted by the stronger rand and an improved local outlook. Resources returned 3.6% and Industrials as a sector delivered 4.7%, with Property returning 8.3%. For 2017 as a whole, the ALSI had a remarkable year given the poor local fundamentals, producing a total return of 21.0%, most of which came in the second half. Among the sectors, it was Industrials that returned the most with 22.5% (led by Naspers with a total return of 72%), while Financial stocks delivered 20.6%, listed Property 17.2% and Resources 16.8%. Excluding Naspers, the ALSI would have returned only around 13% for the year.

The quarter's political and credit ratings news managed to overshadow some of the fundamentals: SA's Q3 GDP growth was reported at 2.0% (q/q, annualised), with agriculture, mining and manufacturing the main drivers of the expansion. In the first nine months of 2017, the South African economy grew by 1.0% y/y. At the same time, November CPI eased to 4.6% y/y from 4.8% in October, helping underpin interest-rate-sensitive assets like bonds and listed property. Despite the improving inflation data, the SA Reserve Bank (SARB) opted to leave interest rates on hold over the quarter, citing upside risks to inflation from possible rand weakness, further downgrades and political uncertainty. However, the recent rand rally could mitigate the SARB's view, helping to ease inflationary pressures in 2018.

Finally, the rand also benefited from the December Ramaphosa rally, as well as the positively perceived Moody's reprieve. Despite Q4's high volatility, the local currency managed to appreciate 8.8% against the US dollar and 7.5% against the euro over the period. For the entire year it gained 10.1% versus the greenback and 1.9% versus UK sterling, but depreciated 2.2% against the robust euro.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

In **our global portfolios** we are underweight global bonds and global cash, and overweight global equities, with the latter offering attractive valuations in certain markets and much higher potential returns over the medium term. In our higher return-targeting multi-asset funds we continue to be very near our maximum permitted 25% offshore weighting.

In **global fixed income**, despite recent rises in government bond yields, they continue to trade at very low levels (and high valuations) historically,

ASSET CLASS PREFERENCES: 5-YEAR PERIOD

Prudential House View**

ASSET CLASS	POSITIONING 30 SEP 2017	POSITIONING 31 DEC 2017
Foreign equity	Overweight	Overweight
Foreign sovereign bonds	Underweight	Underweight
Foreign corporate bonds	Overweight	Overweight
Foreign cash	Underweight	Underweight
SA equity	Overweight	Overweight
SA listed property	Neutral	Neutral
SA bonds (govt and corp)	Overweight	Overweight
SA inflation-linked bonds	Neutral	Neutral
SA cash	Underweight	Underweight

**These preferences are implemented where all fund mandates allow. Positioning will differ in portfolios with constraints in their mandates. For example, the Prudential Inflation Plus Fund is currently underweight SA equities due to its 40% total equity exposure limit, where we prefer to hold more offshore equities at the expense of SA equities. However, the Prudential Balanced Fund is overweight SA equities as its higher equity limit allows us to be overweight both global and SA equities.

and remain at risk to rising interest rates in the US and UK, and increasingly in Europe as well. We continue to be underweight global sovereign bonds and underweight duration to reduce interest rate risk, preferring to hold investment-grade US and European corporate bonds.

For **global equities**, the strong rallies seen over the past seven quarters in many countries has been driven in part by a re-rating of the MSCI All Country World Index, but strong corporate earnings growth has kept the Index within its fair value range. Against the backdrop of upside surprises to broad global growth, we see better value in many regions compared to South Africa, which is why we continue to be overweight global equities. However, SA equity earnings have been depressed relative to their long-term trends, particularly in Resources and Financials, and have the potential to improve, assisted by a favourable global tailwind. Therefore, where mandates allow we are also overweight local equities.

Our current global equity positioning reflects a preference for cheaper areas where fundamentals are encouraging but valuations remain attractive, including Europe, Japan, the global financial sector and smaller holdings in selected emerging markets such as Korea, Turkey and Indonesia. These positions are financed by an underweight in US equities and in global bonds.

South African equities became somewhat more expensive in Q4 2017 despite losing some ground later in the quarter: the FTSE/JSE ALSI 12-month forward P/E rose to around 15.4X at quarter-end from around 14.6X in Q3. This is modestly expensive compared to its long-term fair value, but excluding Naspers (which is now over 20% of the market and which should be valued relative to global technology stocks), the market is still at fair value and priced to deliver attractive medium-term returns. As such we are overweight local equity in our higher-equity multi-asset portfolios like the Prudential Balanced Fund. However, in the context of the low-equity Inflation Plus Fund's 40% total equity exposure limit (a limit set by the ASISA category), we see better opportunities offshore. Consequently we continue to be slightly underweight SA equities in the Prudential Inflation Plus Fund and overweight global equities, with total equity exposure close to the maximum allowed.

Our individual equity exposure is similar to the previous quarter. During the year we held an underweight exposure to Steinhoff due to our long-standing concerns over numerous issues. We sold all of our Steinhoff holdings on the morning following the resignation of its CEO. Currently, our portfolios hold stocks with ample foreign currency earnings like Naspers, British American Tobacco, Richemont, Anglo American and BHP Billiton – the latter two representing lower risk to commodity price weakness given their diversification. We also hold non-mining resources stocks like Sappi, as well as international container transport group Trencor, which has upside to improving global trade trends. We remain overweight in well-priced and high-yielding Financials including Old Mutual, Investec, Standard Bank and First Rand, which have offered relatively high dividend yields while also providing a valuation cushion in the event of further credit rating downgrades. In retrospect, these financial companies weathered 2017's volatility well. Offsetting this overweight position, we have chosen to remain underweight in Retail stocks given the challenging local consumer environment.

In **SA listed property,** we have a neutral exposure in our multi-asset portfolios, having pared our holdings from overweight in the previous quarter as fundamentals for the sector deteriorated somewhat. Although benefiting from the improved inflation and interest rate outlook, deteriorating medium-term economic growth prospects in South Africa, as well as the credit rating downgrades, have increased the risks to the sector somewhat. We are comfortable maintaining a neutral position in listed property, which we believe is trading around its fair value and priced to deliver attractive inflation-beating returns over the medium term.

In **SA nominal bonds,** we are modestly overweight as valuations are on the cheap side of fair value at year end. This is despite the strong December "Ramaphosa rally" that saw 10-year yields fall (and valuations rise) from attractive levels of well over 9% to around 8.6% at year-end. During the quarter we added to our bond position in the wake of their sell-off following the MTBPS in November, and reduced this position after the December rally. We continue to prefer longer-dated government bonds due to the more attractive yields on offer, and are comfortable with the compensation bonds offer for the extra risk involved when considering further downgrade prospects.

For **inflation-linked bonds,** we continue to be neutrally positioned in this asset class. Real yields are attractive, even after the Ramaphosa rally, but better value exists elsewhere – in long-dated nominal bonds and equities. Our funds were largely underweight this asset class during 2017 until later in Q3, when their valuation fell to more attractive levels relative to nominal bonds (amid the improved inflation outlook). At that point we took advantage of this to buy more ILBs and moved to a neutral exposure. ■