MARKET OBSERVATIONS

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PRUDENTIAL
INVESTMENT MANAGERS

QUARTERLY MARKET COMMENTARY

QUARTER 1 2019

After the sharp losses suffered at the end of 2018, investors were able to take heart in the first quarter (Q1) of 2019 with markets rebounding as a few negative factors appeared to reverse themselves. Although evidence of slowing global growth continued to mount, global equities and bonds rallied strongly after the US Federal Reserve announced a substantial change of view and decided to pause (and perhaps even end) its interest rate hiking cycle. At the same time, other developed market central banks undertook more growth-supportive moves, and considerable progress was reportedly made in resolving the US-China trade dispute. On the negative side, an even more chaotic Brexit environment and the uncertainty engendered by Trump's unpredictability remained bearish factors for markets. Emerging markets also benefitted from the more bullish sentiment and the Fed's rate pause, but some like Turkey and Venezuela faced idiosyncratic challenges. However, for South African investors, local equities and bonds posted respectable gains in rand terms thanks to several positive developments.

ASSET CLASS	TOTAL RETURN: Q1 2019
SA equity – FTSE/JSE All Share Index (Rand)	8.0%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	3.9%
SA bonds – BEASSA All Bond Index (Rand)	3.8%
SA listed property – SA Listed Property Index (Rand)	1.5%
SA inflation-linked bonds – JSE CILI Index (Rand)	0.5%
SA cash - STeFI Composite Index (Rand)	1.8%
Global equity – MSCI All Country World (Total) (US$ net)	12.2%
Global equity – MSCI World (Developed) (US$ net)	12.5%
Global equity – MSCI Emerging Markets (US$ net)	9.9%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	2.2%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net)	14.3%

Source: Prudential, Bloomberg, data to 31 March 2019

As shown in the table above, in US$ terms, global equity (the MSCI All Country World Index) returned 12.2% for the quarter, with developed markets posting 12.5% and emerging markets producing 9.9%. Global bonds delivered 2.2% and global property 14.3%, buoyed by the Fed's unexpectedly more dovish interest rate outlook.

In the US, it was the Fed's more dovish rate stance that proved to be the key for turning last year's losses into this quarter's gains. The Bank emphasized that it would be "patient" when it came to further raising interest rates, given that the case for hiking had weakened in the face of slowing global and US growth. This eased fears that inexorably higher rates could choke off growth. US GDP growth for Q4 2018 was revised down to 2.2% (q/q annualised) from 2.6% previously, sharply lower than the 3.4% in Q3 2018. Dismal US retail sales data were a key highlight. Not only did the Fed opt to keep rates on hold at its January and March FOMC meetings, but on 20 March its "dot plot" showed it had slashed its own interest rate expectations from two 25bp rate hikes in 2019 to zero, and only one 25bp hike in 2020. This was very positive for equities, and also helped push longer-dated US Treasury bond yields lower, such that the yield curve "inverted" for the first time since 2007 (where 3-month interest rates were higher than those for 10-year bonds). Some interpreted this as a sign of a looming recession. For the quarter, the US 10-year Treasury yield fell from around 2.68% to end at 2.41%.

Adding to the general positive news was the end of the 35-day US government shutdown in January, and that good progress was reportedly being made in the US-China trade negotiations to avert higher tariffs and a full-blown trade war. This was particularly beneficial for the global growth outlook, especially for trade-dependent countries like China, Japan and South Korea, and helped push the US dollar stronger for the quarter against most other currencies (although not the yen). For the quarter, the US S&P 500 returned 13.6%, the Nasdaq 16.9% and the Dow Jones Industrial 11.8%.

In the UK, agreement was reached with the EU to extend the Brexit deadline into April, and PM Theresa May effectively lost control over determining a way forward, forced to hand over to Parliament. However, MPs rejected every possible option for structuring the future relationship, worsening the chaos within government. Meanwhile, UK GDP growth slowed to 1.4% (q/q annualised) in Q4 2018 from 1.6% previously, with the EU area equally pedestrian at 1.4% for the quarter. This deteriorating growth was a factor in keeping interest rates on hold across both regions, as well as in the US Fed's interest rate view. The European Central Bank even introduced a new cheap long-term loan plan for banks to help avoid further deceleration, as Germany's manufacturing data was negative for three months in a row. The UK's FTSE 100 returned 11.6% for the quarter, while the Dow Jones Eurostoxx 50 produced 10.2% (both in US$).

During the quarter it was revealed that the Japanese economy returned to growth in Q4 2018 after a contraction in Q3, although exports remained sluggish amid trade uncertainty and the slowdown in Chinese growth. Japanese GDP is forecast to reach around 1.0% in 2019, supported by the Bank of Japan's ongoing easy monetary policy, but expected to be hit by a new consumption tax on spending and consumer prices to take effect later in 2019. For Q1, the Nikkei 225 returned 6.5% in US$.

In China, meanwhile, 2018 GDP growth came in at 6.6%, its weakest in 28 years but meeting consensus expectations. The government's new 2019 growth target is even lower at 6.0%-6.5%. There was, however, renewed optimism amid the positive US-China trade news; government pro-growth measures, including easier bank credit, took effect; and manufacturing activity accelerated – China's PMI recorded its highest rise since 2012. This helped the MSCI China post a return of 17.7%, making it the best performing large emerging market in Q1.

Among other emerging markets, strong performers for the quarter included the MSCI Russia with 12.2% and Brazil's Bovespa at 8.0%. The weakest markets were the MSCI Turkey (-3.0%), South Korea's KOSPI 200 (3.4%) and the MSCI South Africa (4.6%), all in US$.

The price of Brent crude oil recovered sharply in Q1 2019 to gain 27%, ending March at around US$67 per barrel. This was attributable to additional sanctions on Iran being considered by the US and a halt in operations from a key Venezuelan export terminal. Looking at other commodities, gold gained 0.8%, palladium was up 9.5% and platinum rose 6.8% for the three months. Industrial metals prices were broadly higher, especially nickel (21.6%) and zinc (19.1%).

SA BENEFITS FROM GLOBAL AND SOME LOCAL POSITIVES

South African assets were boosted over the quarter primarily by the easier global monetary outlook, recording gains across all asset classes. This mixed with some still-gloomy sentiment locally. The economy emerged with growth of 0.8% in 2018, slightly above expectations. Still, this was a very weak absolute growth level, and the SARB is now projecting only 1.3% GDP growth for 2019 (down from 1.7% previously), not including the negative impact of any ongoing electricity cuts. In some growth-positive news, retail sales growth recovered somewhat to 1.2% y/y in January from the shocking -1.6% y/y in December.

While SA's more global-influenced stocks generally posted strong gains, the subdued local economy weighed on "SA Inc." stocks like Financials, Retailers and Listed Property. The FTSE/JSE ALSI returned 8.0% for the quarter, led by Resources stocks with 16.2% and Industrials with 7.4%. Listed Property lagged with a 1.5% return, and Financial counters were in the red with -0.4%. The performance of the FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for the majority of our client mandates, was much less robust, returning 3.9% on the back of its more limited exposure to the larger global stocks like BAT, Naspers and Anglo American, all good performers for the quarter.

Apart from the Fed's rate pause, which bolstered bond markets around the world, SA bonds rallied on several local factors, as the BEASSA All Bond Index delivered 3.8% for Q1: the yield on the benchmark R186 bond (due 2032) fell from around 8.9% at the start of the quarter to end at around 8.6%. These supportive factors included good investor demand, subdued inflation (February CPI at 4.1% y/y, below the SARB's 4.5% midpoint target) and the SARB's decision to keep interest rates on hold at both its January and March MPC meetings. The SARB's latest interest rate projection model showed only one 25bp rate hike this year. Also importantly, Finance Minister Tito Mboweni's February Budget was greeted favourably by most analysts, reinforcing the government's commitment to reining in the budget deficit and cutting spending, while also reforming and reducing wastage at the parastatals.

The bond rally also occurred against the backdrop of the expected 29 March Moody's sovereign credit rating report. While many were pessimistic, Moody's final decision not to review the rating and leave it at investment grade with a stable outlook granted the country a big reprieve on the final trading day of the quarter, with the R186 rallying 10bps on the day. Further bond gains were, however, only reflected after quarter-end.

However, the SARB remains concerned about future inflationary pressures arising from the weaker rand, as well as higher costs from fuel and electricity, among other sources. SA inflation-linked bonds, meanwhile, again performed rather poorly in the low-inflation environment, returning 0.5% over the three months, while cash (as measured by the STeFI Composite) delivered 1.8%. Despite US dollar strength, the rand lost only 0.5% versus the greenback, but 2.1% against the UK pound sterling, while gaining 1.3% against the euro, which was hit by growth concerns and more dovish interest rate expectations.

Other worries remained Eskom's generation capacity and the negative impact of load-shedding on growth in 2019, the land expropriation debate, nationalisation of the SARB, and last but not least, the upcoming May elections.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

Starting with our view on **offshore asset portfolios**, we remain underweight global bonds and global cash, and overweight global equities, with the latter offering attractive valuations in many markets (particularly when viewed relative to bonds), and much higher potential returns over the medium term.

The global equity risk premium on offer remains substantially above historic norms, reflecting the extraordinary low government bond yields, which fell further during the quarter as a result of global interest rate expectations being revised downward. This view holds true in our higher return-targeting multi-asset funds, where our total offshore exposure remains at around 25% (below Regulation 28 limits).

In **global fixed income**, despite the rally over the quarter, US government bonds are still trading at slightly expensive levels, but are less expensive than other developed markets like the UK, EU and Japan, where government bond yields remain at exceptionally low levels. Consequently, the asset class as whole remains unattractive versus equities. We are underweight global sovereign bonds and underweight duration, preferring to hold investment-grade US and European corporate bonds. These assets are slightly cheap and have the potential for stronger returns going forward now that the US interest rate hiking cycle is on hold.

For **global equities**, some developed markets have become more expensive after the quarter's gains, but we have maintained our overweight position as a whole given the very high risk premium from equities versus bonds. Emerging markets and currencies continue to be especially well valued on many measures, while the US market is relatively expensive and other markets offer better value.

We continue to prefer the global banking sector, which has underperformed the broader market, as well as certain developed markets where equities are undervalued but fundamentals for earnings growth remain positive, including Germany and Japan, and selected emerging markets such as South Korea, Indonesia and China. These overweight positions are financed primarily by an underweight in global bonds, as well as US equities to a lesser extent.

South African equities gained ground over the three months, but this masked some volatility intra-quarter. In mid-February the JSE fell to very attractive levels relative to SA bonds, and we opted to buy more SA equity exposure in our Prudential

ASSET CLASS PREFERENCES: 5-YEAR PERIOD
Prudential House View**

ASSET CLASS	POSITIONING 31 DEC 2018	POSITIONING 31 MAR 2019
SA equity	Overweight	Overweight
SA listed property	Neutral	Underweight
SA bonds (govt and corp)	Overweight	Overweight
SA inflation-linked bonds	Neutral	Neutral
SA cash	Underweight	Underweight
Foreign equity	Overweight	Overweight
Foreign govt bonds	Underweight	Underweight
Foreign corporate bonds	Overweight	Overweight
Foreign cash	Underweight	Underweight

**Our house view preferences are implemented where all fund mandates allow. Positioning will differ in portfolios with constraints in their mandates.

Balanced Fund and where other institutional mandates allowed, reducing local cash and some bond holdings (to a lesser degree) to fund the purchases. Despite the positive index return over the quarter, valuations on SA equities actually fell as earnings expectations improved: the Capped SWIX's forward price-to-earnings (P/E) ratio fell to 11.17X at end-March from 11.8X in January. On a price-to-book (P/B) valuation measure, the Capped SWIX's current level of 1.64X is now even cheaper versus its longer-term median of 2.1X.

In the context of the low-equity Inflation Plus Fund's 40% total equity exposure limit, we still see better opportunities offshore. Consequently we did not add to SA equity holdings in that portfolio, remaining slightly underweight SA equities and overweight global equities.

Our house view portfolios (like the Prudential Balanced Fund) continue to hold resources stocks with exposure to global growth and foreign currency earnings like Anglo American, BHP, Exxaro, Sasol and Sappi, as well as global giants such as Naspers and British American Tobacco. With the exception of Sappi, these holdings generally benefitted our portfolios for the quarter. We have also maintained our overweight exposure to financial shares including Old Mutual, Standard Bank and Absa, which have offered attractive valuations with relatively high dividend yields. These holdings generally detracted from value over the quarter. Meanwhile, we are still somewhat underweight retail stocks in our house view portfolios, given the pressure under which local consumers find themselves,

We remain cautiously optimistic regarding SA equity market returns over the medium term due to the prevailing excessive levels of pessimism reflected in share prices and valuations.

In **SA listed property** we are marginally underweight in our house view portfolios given the higher risks to earnings going forward compared to the attractive valuations prevailing in the asset class. We remain concerned around the quality of earnings and possibility of further downward revisions to earnings forecasts for listed property. The sector faces headwinds arising from pressure on landlords to reduce their rentals, particularly in the retail space where retailers are facing sluggish consumer spending. Equally, oversupply in office space is negative for listed property earnings currently. This slight underweight generally added value to our house view portfolios for the quarter.

In **SA nominal bonds**, valuations remained cheap over the quarter compared to their longer-term fair value despite the quarter's 3.8% return from the asset class. We continue to be overweight, although we trimmed our position slightly to buy even more attractive SA equity during the quarter. We still prefer longer-dated government bonds due to the more attractive yields on offer. We are also comfortable with the compensation bonds offer given the risk involved, while recognising that the SA government and businesses have not yet done enough to eliminate the prospects of further credit rating downgrades, especially given the deterioration in the country's growth rate.

For **inflation-linked bonds**, following the quarter's return of 0.5%, the real yield remains very attractive, having risen to 3.3% for 10-years. However, we remain neutrally positioned in this asset class because we believe better value exists in SA equity and nominal bonds, where long-dated nominal bonds have the potential to offer more attractive value over the medium-term and are much more liquid. ■