# MARKET OBSERVATIONS

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PRUDENTIAL
INVESTMENT MANAGERS

## QUARTERLY MARKET COMMENTARY

**QUARTER 3 2019**

**A marked escalation in the US-China trade war and further deceleration in global growth, plus the additional uncertainty around the start of efforts to impeach President Trump, kept most global equity returns either flat or in the red in the third quarter of 2019 (Q3). Bond market returns were also subdued as a consequence of the US Federal Reserve (Fed)'s perceived unwillingness to lower interest rates sharply – despite its 50bps of cuts during the quarter and easing measures in several other countries as well. Amid the increasingly bearish environment in July and August, investor sentiment turned even more cautious, to the benefit of safe havens like gold and bonds (the latter to a lesser extent), while emerging markets suffered losses. Only in September was there some relief for equities, with an uptick across most markets as risk appetite improved. However, this wasn't enough to erase the quarter's losses in many markets. For South African investors, local equities posted negative returns, while bonds were only marginally positive, and the rand depreciated notably against all the major currencies for the quarter after having rallied in Q2.**

**As shown in the table below, in US$ terms, global equities (the MSCI All Country World Index) were flat for the quarter, with developed markets delivering 0.5% and emerging markets returning -4.2%. Global bonds produced 0.7% and global property 5.7%, buoyed by the Fed's rate cuts.**

| ASSET CLASS | TOTAL RETURN: Q3 2019 (RAND & US$) |
|---|---|
| SA equity – FTSE/JSE All Share Index (Rand) | -4.6% |
| SA equity – FTSE/JSE Capped SWIX All Share (Rand) | -5.1% |
| SA listed property – FTSE/JSE All Property Index (Rand) | -4.2% |
| SA bonds – BEASSA All Bond Index (Rand) | 0.7% |
| SA inflation-linked bonds – JSE CILI Index (Rand) | 0.2% |
| SA cash - STeFI Composite Index (Rand) | 1.8% |
| Global equity – MSCI All Country World (Total) (US$ net) | 0.0% |
| Global equity – MSCI World (Developed) (US$ net) | 0.5% |
| Global equity – MSCI Emerging Markets (US$ net) | -4.2% |
| Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$) | 0.7% |
| Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net) | 5.7% |

**Source:** Prudential, Bloomberg, data to 30 September 2019

US-China trade hostilities ramped up significantly during the quarter: from 1 September the US imposed new tariffs worth US$112 billion on Chinese goods including clothing, shoes and other basic commodities. China retaliated with a further US$75 billion in tariffs (including on crude oil) and a halt in buying some US agricultural goods.

Meanwhile, the Fed lowered interest rates by 25bps in both July and September, in the face of the prospective negative impacts of the trade war and slower global growth. However, it downplayed the prospect of further cuts given the still-expansionary local economy. The latest Fed inflation rate forecasts show no rate changes for the rest of 2019 and 2020, although Fed policymakers were divided in September: 7 members wanted at least one more 25bp cut in 2019 versus 10 advocating against. US GDP growth for Q2 2019 surprised positively at 2.0% y/y, with wage and inflationary pressures remaining subdued. The rate cuts combined with the risk-averse sentiment and surplus global capital to send the 10-year US Treasury (UST) yield down from around 2.0% at the start of the quarter to a low of 1.5% in early September, before weakening again to around 1.7% at quarter-end. The 30-year UST yield, meanwhile, dropped very near a historic low of 1.95% in August. In the equity market, the US S&P 500 returned 1.7%, the Nasdaq 1.3% and the Dow Jones Industrial 1.8% - all in US$. The Barclays US Treasury Index returned 2.4% for the quarter, while the Barclays US High Yield Bond Index returned 1.3%. The Bloomberg Barclays Global Aggregate Bond Index (US$) delivered 0.7%.

The UK moved further into a Brexit-related crisis during Q3 as new PM Johnson's move to suspend Parliament was found to be unlawful by the UK Supreme Court, and Parliament reconvened to pass a measure preventing a no-deal Brexit. With Johnson calling for fresh elections and threatening to ignore Parliament, the foundation of British democratic institutions was challenged. Amid the heightened uncertainty, the pound fell to its lowest level in 12 years against the US dollar and Q2 GDP growth slowed to 1.3% (q/q annualised) versus 2.1% (q/q annualised) in Q1. The BOE left its base interest rate unchanged at 0.75% in September. The UK's FTSE 100 returned -2.2% for the quarter in US$, and government gilts (bonds) delivered 3.2%.

In the 19-member Eurozone, growth slowed further as the area's Q2 GDP fell to 1.1% (q/q annualised) from 1.2% previously, impacted significantly by Germany's export-led economy which slumped to 0.4% growth (q/q annualised) vs 0.9% the previous quarter. Germany's September manufacturing PMI dropped to 41.7, its biggest contraction in 10 years. The European Central Bank (ECB) opted to cut interest rates by 10bps to -0.5% (below market expectations of a 20bp cut) and pledged to keep rates at accommodative levels. The ECB also pledged to resume its corporate bond repurchase programme to add stimulus from 1 November. Bond yields across the EU consequently fell further into negative territory. Faced with negative interest rates and relatively high budget deficits in member countries, the EU has little room to add further stimulus should growth falter further. In more positive news, Italy's politicians managed to form a coalition government, and also avoided EU budget deficit sanctions. For the quarter, Germany's DAX produced -4.0% and the French CAC 40 delivered -1.7%, while the Barclays Euro Treasury Index returned -0.6% (all in US$).

Japan's growth decelerated in Q2 2019 to 1.3% (q/q annualised) from 2.2% in Q1 as its export-driven economy continued to be impacted by the US-China trade war and weak business and consumer sentiment. The Bank of Japan left its key interest rate on hold at -0.1% in September, but signalled it could implement more stimulus measures as soon as October. Investors and economists are anxious about the planned imposition of a new consumption tax planned for October. For Q3, the Nikkei 225 returned 2.8% and the Barclays Global Treasury Japan Index posted 0.2% (both in US$).

In China, 16 consecutive weekends of large and increasingly violent protests in central Hong Kong started to make their impact felt on the island's economy in the form of lost consumer sales and business turnover. Although the HK government eventually formally withdrew its bill easing extradition conditions to the mainland, residents' protests swelled over concerns about losing their democratic rights.

At the same time, Chinese exports continued their decline, impacting China's overall Q2 GDP growth which came in at 6.2% (q/q annualised), the lowest in 27 years. However, subsequent data showed that the government's stimulus (in the form of tax cuts, infrastructure spending and lower bank reserve requirements) had started to work, as fixed investment, industrial output and retail sales have all risen more recently. Hong Kong's Hang Seng Index returned -7.9% for the quarter, and the MSCI China returned -4.7%, both in US$.

Among other emerging markets, the only strong performance in US$ for the quarter came from the MSCI Turkey, with an 11.7% return. The weakest market was the MSCI South Africa at -12.4%, while the MSCI India recorded -5.2%, South Korea's KOSPI -4.8%, Brazil's Bovespa -4.6% and the MSCI Russia -0.9%, all in US$.

The price of Brent crude oil fell during Q3, starting off July at around US$65 per barrel and ending September at around US$62 per barrel. In between, however, it weakened to near US$60 per barrel on the back of softer global growth and then spiked some 13% to over US$68 per barrel in reaction to the 17 September drone strike on Saudi Arabia's oil production facilities, which impacted over 50% of the oil giant's supply. The spike lasted only a day, as Saudi Arabia reported it would be able to recover most of its production very quickly. However, longer-term concerns remain over the protection of Saudi facilities and rising tensions between Iran and Saudi Arabia. Other commodity prices were mixed, as gold gained 5.8% (up 25% in the past year on its safe-haven status), palladium jumped 10%, platinum rose 11.7% and lead was up 8.9%. However, the prices of aluminium, copper and zinc were all down between 4-8%.

## SOUTH AFRICA ALSO HIT BY GLOBAL DETERIORATION

The news that South Africa's Q2 2019 GDP growth came in at a stronger-than-expected 3.1% q/q (or 0.9% q/q annualised) was widely welcomed, avoiding a technical recession after Q1's 3.2% contraction. This helped to lift market sentiment somewhat, but the very low absolute level remained a serious concern. Business confidence fell to a record low of 21 and manufacturing production contracted 1.1% y/y in July, down from +3.6% in June. Besides local issues, the economy reflected the deteriorating global conditions, which were negative for emerging markets in general.

The SARB lowered its base interest rate by 25bps to 6.5% at its July MPC meeting as expected, but, concerned about the unfavourable global backdrop and potential rand weakness, it kept rates on hold in September (also as expected). In addition, it cut its GDP growth forecasts for 2020 and 2021 to 1.5% (from 1.8%) and 1.8% (from 2.0%) respectively. Its latest quarterly projection model pointed to no interest rate changes through year-end. Inflation remained well under control, with CPI at 4.3% y/y in August, up from 4.0% in July.

Worries about potential further credit rating downgrades and the rising national budget deficit continued to weigh on the local market as well, as the financing requirements for Eskom and other SOEs mounted. Ratings agency Fitch downgraded its outlook for SA's sovereign rating from stable to negative, while Moody's commented that Eskom's capital structure was "unsustainable". However, Moody's also said there was a "low likelihood" of it downgrading the country at its next review on 1 November, but as analysts pointed out, this was likely due to the stable, rather than negative, outlook it currently has for SA's rating.

Among positive developments, Finance Minister Tito Mboweni unveiled a 77-page economic strategy blueprint in August aimed at reversing the country's fall in growth and competitiveness. It was met with generally positive reviews, although many suggested reforms drew on earlier proposals. President Cyril Ramaphosa also appointed an 18-member Economic Advisory Council (EAC) comprised of both local and foreign well-known experts to help develop reform policies, and he reappointed Lesetja Kganyago to a second five-year term as SARB governor, helping avoid any investor concerns over central bank policy continuity and expertise.

SA equities were volatile and traded lower during the quarter on the negative international sentiment and growth concerns (both global and local). The FTSE/JSE ALSI returned -4.6% for the quarter; Resources was the worst-performing sector with a return of -7.3% (Resources 10 Index). Financials delivered -6.8%, Industrial counters produced -2.5% and Listed Property returned -4.2%. The FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for most of our client mandates, returned -5.1%.

After a strong rally in Q2, SA bond yields rose slightly over the quarter under some selling pressure, but the BEASSA All Bond Index still managed to deliver 0.7% in Q3. The yield on the benchmark R186 bond (due 2026) increased from around 8.1% at the start of the quarter to end at 8.3%. The SA yield curve continued to steepen as longer-dated bond yields (20+ years) rose more (and prices fell more) than their medium-term counterparts (7-12 years). SA inflation-linked bonds returned only 0.2% over the three months as the inflation outlook improved, while cash (as measured by the STeFI Composite) delivered 1.8%. For the rand, another volatile quarter saw the local currency weaken 7.5% against the US dollar, 4.0% against the pound sterling and 2.9% against the euro.

## 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. As in the previous quarter, the global equity risk premium on offer remains substantially above historic norms, reflecting the extraordinarily low government bond yields, which fell further during the quarter. This view holds true in our higher return-targeting multi-asset funds, where our total offshore exposure remains at around 25%.

In **global fixed income**, US government bonds became more expensive during the quarter, but remain cheaper than other developed markets like the UK, EU and Japan, where a wide range of government bond yields are in negative territory and continued to fall in Q3. Consequently, the asset class remains unattractive versus equities. We are underweight global sovereign bonds and underweight duration, preferring to hold investment-grade US and European corporate bonds.

For **global equities**, 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 - 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

## ASSET CLASS PREFERENCES: 5-YEAR PERIOD

### Prudential House View**

| ASSET CLASS | POSITIONING 30 JUN 2019 | POSITIONING 30 SEP 2019 |
|---|---|---|
| SA equity | Overweight | Overweight |
| SA listed property | Underweight | 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.

undervalued but fundamentals for earnings growth remain positive, including Italy, Germany, Japan and Singapore. We also find selected emerging markets attractive, including 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** moved cheaper during Q3 on most valuation measures: the 12-month forward P/E of the Capped SWIX Index (the benchmark for most of our equity funds) fell from around 12.0X to around 10.9X at quarter-end. On a price/book value (P/B) basis, the Capped SWIX ended the quarter at 1.6X, cheaper than the longer-term median of around 2.1X. We remain overweight SA equities in our house view portfolios like the Prudential Balanced Fund, and are comfortable with our equity allocation levels.

Our house view portfolios continue to hold resources stocks with exposure to global growth and foreign currency earnings like Anglo American, Exxaro, Sasol and Sappi, as well as global giants such as Naspers and British American Tobacco (BAT). These stocks recorded a mixed performance during the quarter, helped by the weaker rand. However, the Sasol, Sappi and Exxaro share prices came under selling pressure on the back of earnings concerns. For Sasol this was due to continued cost and related concerns at its Lake Charles cracker project in the US, as explained in our Q2 commentary. Sappi reported weaker-than-expected earnings on the back of poor graphic paper demand and falling prices of dissolving wood pulp. Meanwhile, Exxaro suffered from the sharp fall of the iron ore price and higher costs over the quarter.

We have also maintained our overweight exposure to financial shares including Old Mutual, Investec plc, Standard Bank and Absa, which have offered attractive valuations with relatively high dividend yields. At the same time, we are still underweight retail stocks like Clicks, Mr Price, Shoprite, and Truworths 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 next three to five years due to the prevailing excessive levels of pessimism reflected in share prices and valuations.

In **SA listed property** we continue to be underweight in our house view portfolios given the higher risks to earnings going forward despite the attractive valuations prevailing in the asset class. We remain concerned about the earnings outlook for the sector, as it faces ongoing 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. We are also underweight in our real return mandates like the Prudential Inflation Plus Fund where we hold significant listed property exposure.

**SA nominal bonds** rallied early in Q3 with the R186 (due 2026) trading below 8% from 8.5% in the previous quarter. As a consequence, we reduced exposure to this part of the curve and bought longer-dated 2044 debt yielding 1.6% more. We therefore increased portfolio duration slightly in both our house view and real return portfolios. We continue to be overweight SA bonds, and still prefer longer-dated government bonds due to the more attractive yields on offer. 10-year real yields ended the quarter at 3.8%-3.9%, well above our long-run fair value assumption of 2.5%. We are comfortable with the compensation bonds offer given the risk involved, as yields have risen while the risk of downgrade also rose further during the quarter.

**For inflation-linked bonds**, real yields remain attractive for long-dated tenors. However, we continue to be neutrally positioned in this asset class as 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. ■