momentum investments

Q1: houseview

quarter ended 31 March 2017

SA asset class returns

110
105
100
95

2016/12/30
2017/01/12
2017/01/25
2017/02/07
2017/02/20
2017/03/05
2017/03/18
2017/03/31

SWIX (100.3)
Listed property (99.3)
ALBI (103.4)
ILBs (100.4)
Cash (101.9)
Gold ETF (93.9)
Platinum ETF

Source: I-Net, Momentum Asset Management

The table below indicates Momentum's views on the outlook and one-year forecasts for key economic variables and asset classes. For a more detailed analysis, read the expanded houseview at the end of this document.

	One-year projection	Weighting bias
Growth	0.9% (2017 average)	Real economic activity likely bottomed in 2016. While higher anticipated global growth should spur export volumes, dampened sentiment (on account of unsettled politics and negative ratings action) should cap the recovery in domestic demand in 2017.
Inflation[1]	4.8%	Higher agricultural output expected to aid food disinflation, but a higher degree of exchange rate volatility (sparked by increased policy uncertainty and a downgrade to junk status) poses a significant upside risk to the expected inflation trajectory.
Currency[2]	R14.20 per US $1	Fresh domestic political upheaval has overshadowed previous gains in the rand that were driven by improving fundamentals across commodity exporters. A vulnerability to possible capital flow reversals could keep the rand on the back foot for a longer period.
Interest rates[3]	7.0% repo (10.5% prime)	Should domestic political disorder lead to a sustained weakening in the rand, the anticipated relief in inflation would be limited, weakening prospects for lower interest rates from the current 7% level.
Cash[4]	7.7%	Decent risk-adjusted returns are expected in a low-return environment, but re-investment risk rises as the local rate cycle peaks.
Government bonds[5]	10.9%	Expected disinflation fundamentally supportive. SA government bonds do not appear expensive versus history.
Inflation-linked bonds (ILBs)	8.0%	We continue to favour nominal bonds over inflation-linked bonds. Despite narrowing, the inflation premium still looks too high in our view.
Listed property[6]	14.4%	Strong property returns expected from the current property rating. Valuation has improved meaningfully against SA nominal bonds.
Equity[7]	11.7%	Higher commodity prices and a marginal domestic growth uptick are expected to drive a recovery in earnings. Valuations have improved meaningfully due to a sideways-tracking market over the past two-and-a-half years.
Global equities[8]	14.1%	A strong US dollar associated with global reflation and relative valuations are currently favouring equities over bonds. Moreover, equities tend to outperform bonds in a rising interest rate cycle.
Global bonds[9]	2.2%	A reflationary environment associated with rising US rates should be fundamentally negative for global bonds.
Global cash	4.9%	Notwithstanding likely additional interest rate increases in the US, interest rates continue tracking close to historical lows. As such, we expect the rand view to be the dominant driver of local currency returns.

1 Based on a blended combination of top-down (changes in the output gap, labour cost and foreign exchange dynamics) and bottom-up (view on sector-specific pricing power effects) models.
2 We start with our view on the US dollar (driven by our views on global risk appetite, growth differentials and rate differentials). We then determine our view on SA's current account balance (driven by expected change in net export prices and volumes, as well as change in net income and dividend payments). Finally, we take a view on the net impact of the change in net foreign capital inflows. Inflation differentials are not a driver of a one-year view on the rand.
3 Based on our view of projected inflation and growth.
4 Based on a combination of the one-year negotiable certificate of deposit (NCD) rate and the current SA repo rate.
5 Based on our view on the evolution of the yield curve, anchored by our short-rate view (for net capital gain or loss), adjusted for running yield of ten-year SA government bond benchmark (for income yield).
6 Based on our bond yield and inflation forecasts and expected distribution growth.
7 Based on our earnings estimates and the implied change in market rating associated with this expected earnings from our rating model.
8 A blend of expected returns from the US, other developed markets and emerging markets.
9 A blend of expected returns from sovereign, high-grade and high-yield fixed-income instruments.

What we expect will happen... (Quarter April 2017 to June 2017)

Growth	Inflation	The currency	Interest rates	Cash	Government bonds
A greater degree of political uncertainty is likely to keep consumer and business sentiment at depressed levels, limiting the recovery in domestic demand. A marginal recovery in SA growth in 2017 is expected to benefit from a gradual inventory rebuild and a slight uptick in exports, thanks to an anticipated recovery in global growth.	Higher agricultural output should aid food disinflation this year, following a devastating drought in 2016. However, the rand, recently jolted by increased political uncertainty and a sovereign ratings downgrade, has re-emerged as a key upside risk to the inflation trajectory. Despite nudging lower in the first quarter of 2017, longer-dated inflation expectations remain stubbornly anchored at the upper end of the inflation target band, posing an additional second-round inflation threat.	Earlier rand strength (benefiting from improving macro-fundamentals across commodity-exporting countries) was recently overshadowed by heightened local political uncertainty and an unfavourable move in SA's sovereign rating. In our view, the rand remains vulnerable to domestic political tensions and a potential reversal in foreign capital inflows.	Persistent rand weakness in light of continued political uncertainty could limit the anticipated relief in the inflation profile, ultimately raising the bar for interest rate cuts from the current 7% level.	Domestic cash is expected to deliver decent risk-adjusted returns in a low-return environment. However, reinvestment risk is set to increase in response to a likely peak being reached in the local interest rate cycle.	SA nominal bonds should be fundamentally supported by a strong anticipated domestic disinflationary trend, while attractive valuations are underlined by historically-high real rates, as well as an historically-elevated risk spread premium to US bonds.

What we expect will happen... (Quarter April 2017 to June 2017)

Inflation-linked bonds	Listed property	Equities	Global equities	Global bonds	Global cash
Despite narrowing, the inflation premium remains too high, leaving us favouring nominal bonds over inflation-linked bonds. Based on our view on domestic inflation, inflation carry is expected to dwindle going forward.	Listed property's relative valuation against nominal bonds has improved meaningfully since 2015 and is now close to its five-year average. We expect strong property returns from the current rating.	SA equity valuations have improved meaningfully. Not only has the market tracked sideways over the past two-and-a-half years, but a significant profit rebound from a low base is expected. Higher commodity prices and a mild domestic growth uptick are expected to drive the anticipated recovery in earnings. In addition, SA equities generally perform well during rising US interest rate cycles.	Global equities are likely to benefit from an expected firmer US dollar, a rising US interest rate cycle and favourable relative valuations. Regionally, we see strong earnings support for the Eurozone and Japan, while US margins appear to be at risk from a tightening labour market. A widening growth differential between emerging and developed markets is positive for relative emerging market performance, but higher US interest rates, a strong US dollar and trade protectionism pose risks.	Even though the valuation gap has narrowed, global bond valuations relative to global equities remain very expensive. Moreover, bonds tend to underperform equities in a reflation environment, where further interest rate hikes by the US Federal Reserve are envisaged in response to a tight labour market and higher inflation.	Even though interest rates are expected to climb further in the US, globally, interest rates are still tracking close to historical lows. As such, we expect the rand view to be the dominant driver of local currency returns.

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