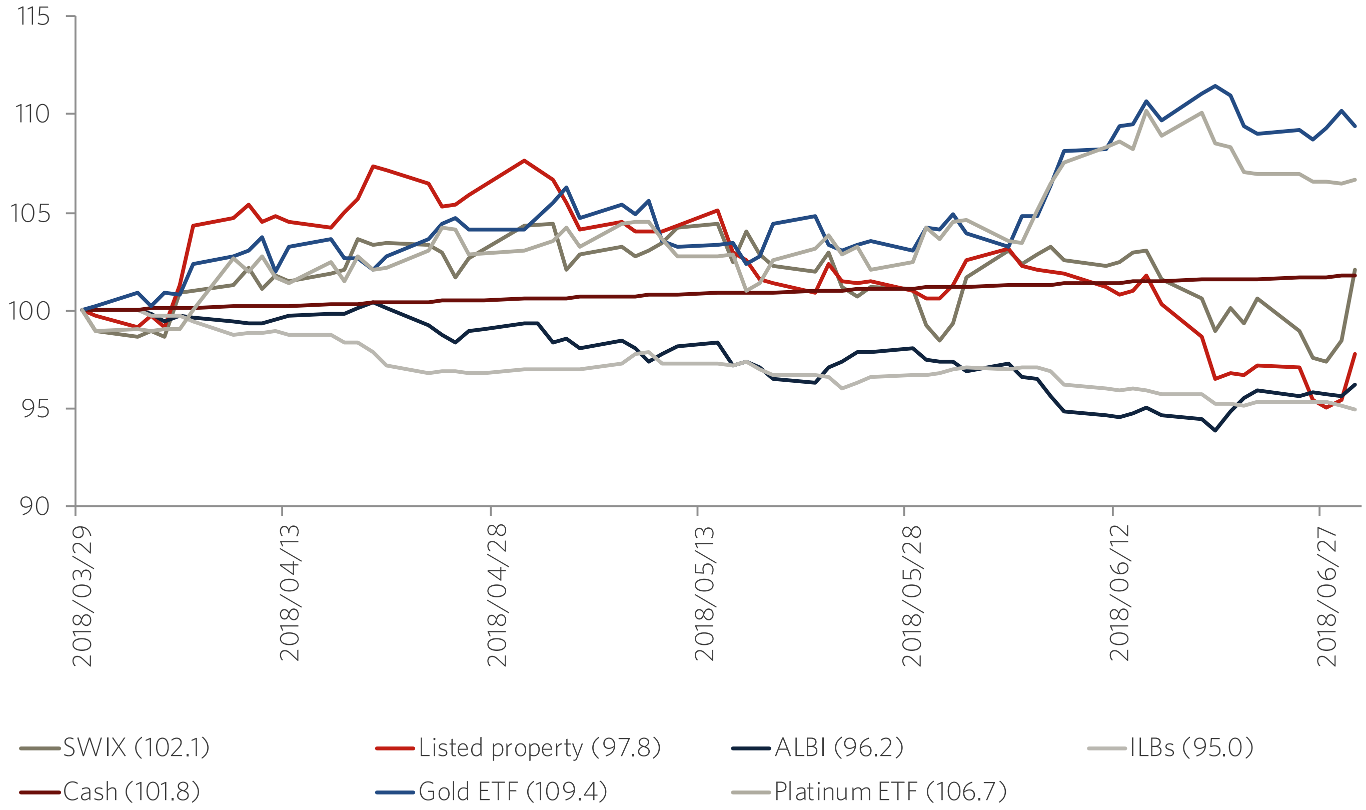
Houseview

July 2018

momentum
investments

SA asset class returns



Source: I-Net, Momentum Investments

Houseview summary

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 (Q3 2018 – Q2 2019)	1.9%	The consumer is likely to lead the recovery in the short term, while structural reforms are necessary to shift South Africa's (SA) growth potential higher in the medium to longer term.
Inflation [1]	5.7%	Headline inflation is expected to rise in upcoming quarters, but will likely remain within the target band in the medium term.
Currency [2]	R12.63 per US$1	Rand weakness is reflective of a firmer United States (US) dollar and rising global trade war fears. Although the recent sell-off is likely overdone, currency weakness is projected over the medium term, given the rand's poor defences against external shocks.
Interest rates [3]	6.75% repo (10.25 % prime)	A still negative output gap could prevent interest rate hikes from occurring sooner, but it remains important for the SA Reserve Bank (SARB) to maintain a healthy real interest rate profile in an environment where global liquidity additions are shrinking.
Cash [4]	7.3%	Domestic cash is expected to deliver lower absolute returns relative to domestic nominal bonds.
Government bonds [5]	11.4%	Despite offering meaningfully positive real yields, the SA bond market recently experienced a disproportionate quantum of outflows, given that SA is a liquid emerging market (EM) proxy.
Inflation-linked bonds (ILBs)	7.4%	Break-evens are likely to expand with domestic inflation rising, but nominal bonds are more attractive.
Listed property [6]	19.9%	Good property returns are expected from the current valuation level. The relative rating of listed property is at its cheapest level in five years against local bonds.
Equities [7]	13.0%	SA equities are not cheap on a valuation basis, but a weaker rand should drive earnings upgrades.
Global equities [8]	7.5%	As the environment shifts from 'goldilocks' (strong growth and low inflation) to reflation (strong growth and rising inflation), the last phase of the equity bull market should become less positive for equities and will likely correspond with higher volatility.
Global bonds [9]	-3.7%	Bond market fundamentals remain negative, with the valuation gap between bonds and equities remaining wide.
Global cash	0.6%	While interest rates are rising steadily in the US, global interest rates are still tracking close to historical lows. As such, we expect the rand view to remain the dominant driver of local currency returns for global cash.

[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 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 instrument

What we expect will happen... (Quarter July 2018 to September 2018)

Growth

Firm real wage growth, rising equity and house prices, a mildly positive jobs outlook and scope for additional credit support should underpin growth in household spend, while a robust global economy will continue to drive exports. Fixed investment is expected to recover with a delay, only once the dust around policy uncertainty has settled. In the medium term, a commitment to structural reform will prove essential to drive potential growth higher.

Inflation

Headline inflation is likely to rise from the 3.8% low reached in April 2018, however prints are expected to remain within the target band in the medium term. Further sustained rand weakness and higher international oil prices present the largest upside threats to the inflation trajectory, while higher-than-expected rainfall and healthy stock levels should keep a lid on food inflation.

Currency

The latest bout of rand weakness was linked to rising fears of global trade wars and heightened political uncertainty. Although the recent sell-off is seen to be overdone, the rand is expected to weaken moderately over the medium term, given its poor defences against external shocks and an anticipated decline in the terms-of-trade, in line with softer Chinese commodity demand and US dollar strength.

Interest rates

Despite a notable downward shift in inflation expectations, the SARB still views these as being too high. Nonetheless, it is likely too early to hike interest rates just yet in light of a still-negative output gap. A slow hiking cycle is expected to commence at the start of 2019, given the importance of maintaining attractive real interest rates in a global environment where liquidity is being added at a diminishing rate.

Cash

Domestic cash is expected to deliver lower absolute returns to nominal domestic bonds, but scope for interest rate hikes in 2019 and beyond should bolster returns from this asset class in due course.

Government bonds

Notwithstanding a meaningfully positive real yield in SA, a disproportionate outflow was observed in the SA bond market relative to the emerging market (EM) bond market sell-off. This proves SA is still seen as a liquid EM proxy. Currently, ex-ante real bond yields are trading around 90 basis points above its average recorded during the inflation targeting period, suggesting that the anticipated uptick in inflation has already been captured in local bond yields.

Inflation-linked bonds (ILBs)

Break-evens are expected to expand in line with a rising inflation trajectory, but nominal bonds are favoured on a one-year view relative to the expected return projected for ILBs.

Listed property

Healthy property returns are expected from the listed property asset class in the next year. The asset class is currently trading at its cheapest level (for the past five years) relative to local bonds.

Equities

The SA equity market is not cheap on a valuation basis. The globalisation of the SA equity market index and the performance of Naspers have caused the SA equity market to trade in line with developed market (DM) valuations, even though the median SA stock continues to trade in line with EM valuations. Going forward, a weaker rand should drive earnings upgrades.

Global equities

A move from a 'goldilocks' environment for equities (strong growth and low inflation) to reflation (strong growth and rising inflation) during the last phase of the equity bull market should be less positive for equities and will likely correspond with higher volatility. The US equity market generally peaks in the run-up to a recession, but the lead indicators of a US equity peak are still largely absent.

Global bonds

Global bond market fundamentals remain negative, with the valuation gap between bonds and equities remaining wide. Bonds are only likely to outperform equities closer to the economic downturn, which is anticipated to begin around 2020.

Global cash

While interest rates are rising in the US, global 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 for global cash.

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