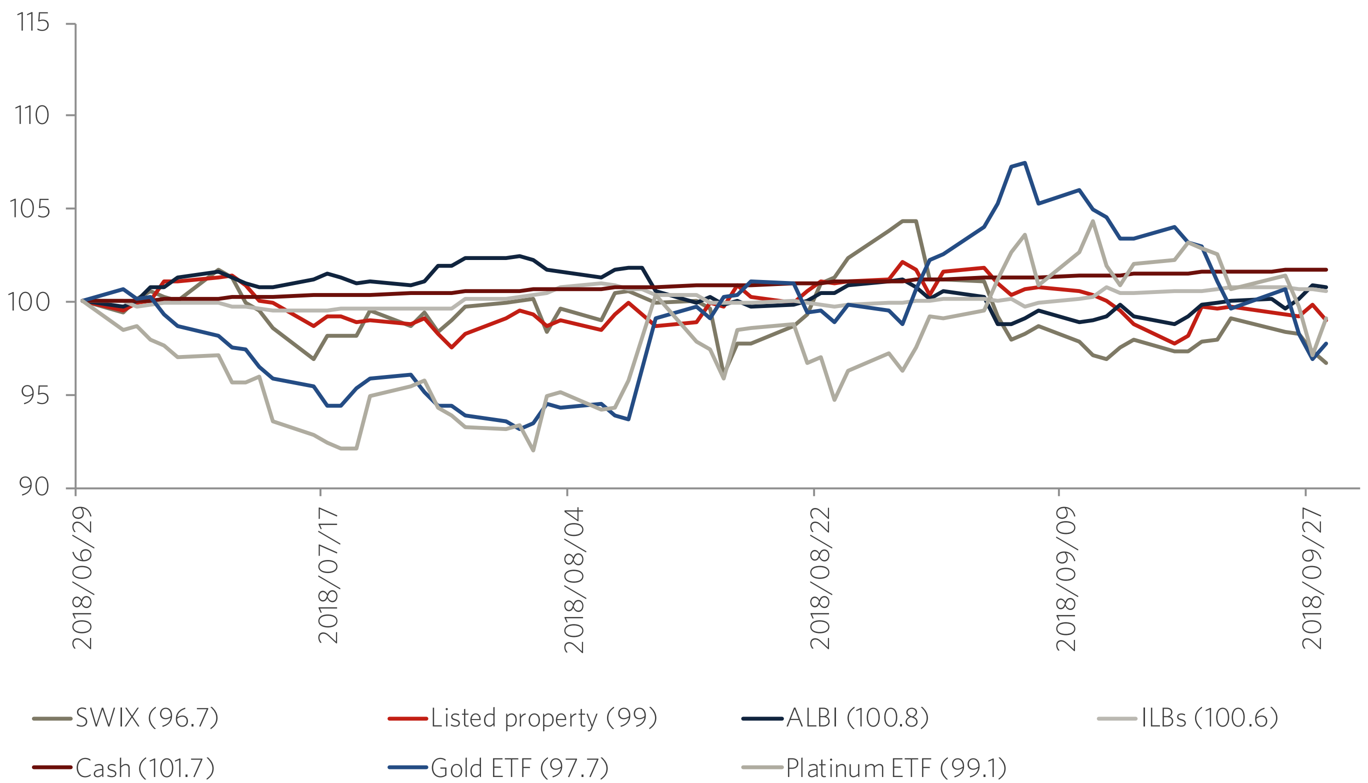
Houseview

October 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 (Q4 2018 – Q3 2019)	1.4%	The outlook is likely somewhere between an unrealistic 'Ramaphoria' environment and an unreasonable 'Ramageddon' scenario. Structural reform is imperative to resolve South Africa's (SA) stark inequality problem.
Inflation [1]	5.7%	Inflation is expected to rise, but remain within the target band in the medium term. The rand, oil prices and electricity tariffs are the major upside threats.
Currency [2]	R13.65 per US$1	The weaker rand is reflecting contagion fears stemming from idiosyncratic risks in a handful of emerging market (EM) economies. The real effective exchange rate points to the recent sell-off being overdone and some likely retracement in the coming months.
Interest rates [3]	6.75% repo (10.25 % prime)	A shallow interest rate hiking cycle is anticipated as the SA Reserve Bank (SARB) urges inflation expectations closer to the midpoint of the target band. Healthy real interest rates are necessary in an environment where global liquidity additions are shrinking.
Cash [4]	7.5%	Domestic cash is expected to deliver lower absolute returns relative to domestic nominal bonds in the next year, but relative risk-adjusted returns are attractive.
Government bonds [5]	10.1%	Despite offering meaningfully positive real yields relative to history, the SA bond market was disproportionately punished in the recent Turkey turmoil, given that SA is a liquid EM proxy.
Inflation-linked bonds (ILBs)	7.5%	Break-evens are likely to expand with domestic inflation rising, but nominal bonds are more attractive on a one-year view.
Listed property [6]	10.9%	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]	13.4%	The dualistic nature of the SA equity market provides built-in rand diversification for investors.
Global equities [8]	4.2%	A less equity-friendly environment due to anticipated contracting global liquidity is around the corner, but valuations still favour global equities over global bonds for now.
Global bonds [9]	-2.3%	Bonds are only likely to outperform equities closer to the economic downturn, which is anticipated to begin around 2020.
Global cash	-2.8%	While interest rates are rising steadily in the United States (US), global interest rates are still tracking close to historical lows. As such, we expect the appreciating rand view to remain the major detractor 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 October 2018 to December 2018)

Growth

Although there is a sense of greater political stability domestically, a slow reform agenda has continued to constrain growth. While a 'Ramaphoria'-type growth environment is unrealistic for the near term, 'Ramageddon' is viewed as a low probability scenario. The country is likely past the peak point of consumer vulnerability; however, corporates are still facing a tough environment which will delay fixed investment.

Inflation

Headline inflation is expected to rise, but should remain within the target band in the medium term. Although low food inflation and a dulled rate of currency pass-through have kept inflation outcomes surprising to the downside, the rand, international oil prices and electricity tariffs are still viewed as the major upside threats to the inflation outlook.

Currency

Recent rand weakness has reflected contagion fears stemming from idiosyncratic risks in a handful of EMs. In Momentum Investments' opinion, the recent sell-off was overdone relative to the country's own macro-fundamentals. An assessment of the real effective exchange rate points to some retracement in the currency in the coming months.

Interest rates

While weaker-than-anticipated growth outcomes could delay the first interest rate hike to the beginning of 2019, it will remain necessary to maintain a healthy real interest rate level in an environment where global liquidity additions are shrinking. A shallow interest rate hiking cycle is anticipated as the SARB continues to urge inflation expectations closer to the midpoint of the target band.

Cash

Domestic cash is expected to deliver lower absolute returns to domestic nominal bonds, but relative risk-adjusted returns are attractive, while scope for interest rate hikes should bolster returns from this asset class in due course.

Government bonds

EM real yield differentials are tracking close to recent historical highs. Current SA ex-ante real yields are trading 105 basis points above the post inflation-targeting average. SA government bonds suffered recently from the Turkey contagion due to its own twin deficits, but SA still has a relatively more favourable net foreign asset position and inflation targeting credibility.

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

Good property returns are expected from the current valuation, but micro/company-specific risks need to be monitored closely. The asset class is currently trading at its cheapest level relative to local bonds for the past five years and is now in line with its ten-year average.

Equities

The dualistic nature of the SA equity market provides built-in rand diversification for investors. Earnings per share upgrades in 2018 have been led by rand weakness observed. Naspers has inflated the SA equity market valuation, which would trade more in line with EM if Naspers is excluded, rather than in line with developed market when Naspers is included.

Global equities

A less equity-friendly environment due to anticipated contracting global liquidity is around the corner, but valuations still favour global equities over global bonds for now. Bear market signals have started to emerge, but are not yet pointing to an imminent bear market. With US dividend yields falling below US government bond yields, equities are no longer a superior income asset.

Global bonds

Firm growth, rising inflation and central bank quantitative easing tapering should put upward pressure on bond yields. 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 steadily in the US, global interest rates are still tracking close to historical lows. As such, we expect the appreciating rand view to remain the major detractor of local currency returns for global cash.

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