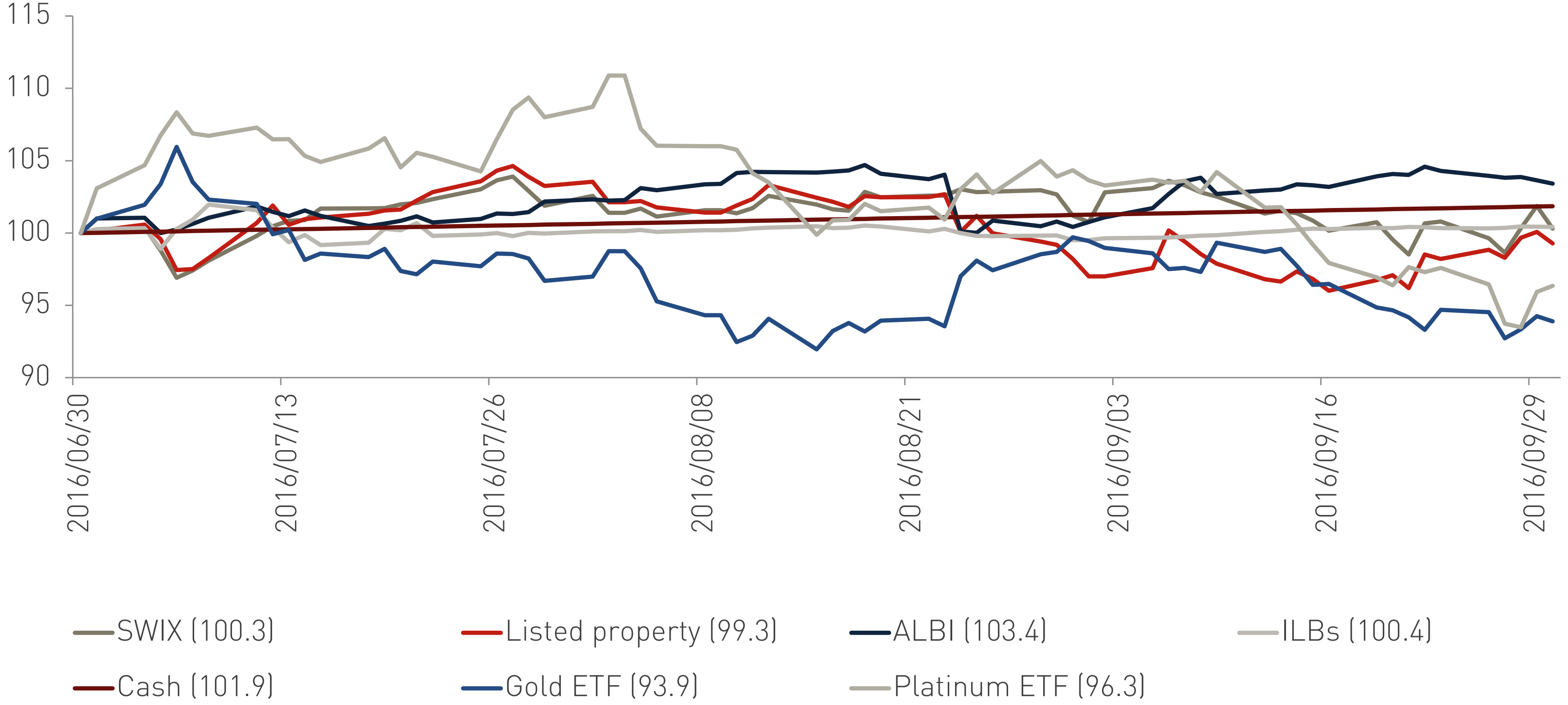
momentum
investments

Q3:
houseview

quarter ended 30 September 2016

SA asset class returns



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
Interest rates[1]	7.25% repo (10.75% prime)	The Reserve Bank has begun signalling that we are nearing an end to the current interest rate hiking cycle, but it maintains that the hurdle to interest rate cuts remains high given stubbornly-high inflation expectations and limited space for unfavourable shocks.
Inflation[2]	5.6%	The inflation profile is likely to improve in 2017 on lower food prices. Adverse movements in the currency and above-inflation wage settlements remain key sources of upside risk to headline inflation.
Currency[3]	R14.45 per US$1	Domestic political tensions and sovereign downgrade risks are overshadowing positive real carry trade, but an expected modest revival in commodity prices over the medium term remains rand-positive.
Cash[4]	7.7%	SA cash is expected to provide decent returns in a low-return environment, but reinvestment risk is rising as we near the end of the current interest rate hiking cycle.
Government bonds[5]	12.4%	Emerging market (and SA) carry trade still has legs given that 40% of developed market sovereign bonds are yielding negative returns, while local fundamentals are becoming more supportive.
Inflation-linked bonds (ILBs)	6.7%	Despite narrowing, the inflation risk premium inherent in SA inflation-linked bonds is still too high.
Listed property[6]	22.7%	Better valuations and a more favourable SA bond market outlook have improved future return prospects.
Equity[7]	11.0%	A recovery in earnings remains dependent on a sustainable rally in commodity prices, which is only likely to occur when the overhang in commodity supply abates. The ALSI is still expensive relative to its own history, but less so than in previous months.
Global equity[8]	8.7%	The fading drag from battered oil-related earnings and an expectation of improving macro data in key economies remains supportive for global equity earnings. Global equities are now superior as both a growth and income asset class.
Global bonds[9]	0.7%	Global bonds are offering less long-term value relative to equities. The real yield differential between emerging and developed market debt remains attractive for the former.
Global cash	3.2%	Globally, interest rates are still tracking at historical lows. As such, we expect the rand view to be the dominant driver of local currency returns.

[1] Based on our view of projected inflation and growth.

[2] 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.

[3] 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.

[4] Based on the current level of interest rates.

[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 September 2016 to December 2016)

Interest rates	Inflation	The currency	Cash	Government bonds	Inflation-linked bonds
The Reserve Bank softened its previously hawkish tone at the September Monetary Policy Committee meeting, signalling that we are nearing an end to the current interest rate hiking cycle. However, the hurdle to interest rate cuts remains high in the near term. In our view, the door remains open to a further hike of 25 basis points before year end given a still-rising inflation trajectory, stubbornly-high inflation expectations and elevated measures of underlying inflation.	Though the impact of previous currency weakness and an earlier drought are keeping inflation at the upper end of the target band, a reversal in the rand price of maize and stable international food prices point to a meaningful drop in the headline print in 2017.	The positive impact of global capital flows is being partly negated by domestic political tensions and near-term sovereign downgrade risks. Nevertheless, we expect the rand to trade with a strengthening bias over the medium term. We anticipate a modest recovery in commodity prices in the second half of 2017 (as the overhang in supply diminishes) to offset the potentially negative impact of a shallow US interest rate hiking cycle on emerging market currencies.	Reinvestment risk will need to be taken into account as we near the peak in the local interest rate hiking cycle. Even so, SA cash is still expected to provide decent returns in a low-return environment.	Emerging market carry trade still has legs, given that 40% of developed market sovereign bonds are yielding negative returns. In response to an attractive risk-return profile, foreign interest in SA nominal bonds has strengthened further. SA bonds also have fundamental support from indications that domestic interest rates are close to their peak in anticipation of lower local inflation during 2017.	Despite narrowing, the inflation risk premium inherent in SA inflation-linked bonds is still too high, leaving us with a preference for vanilla bonds over inflation-linkers.

What we expect will happen... (Quarter September 2016 to December 2016)

Property	Local equities	Global equities	Global bonds	Global cash
Recent underperformance from listed property has meaningfully improved its future return prospects, in our opinion, particularly against the backdrop of an improved domestic bond market outlook.	A recovery in SA earnings remains dependent on a sustainable rally in commodity prices, which is only likely to occur when the overhang in the global supply of commodities abates. In addition, we continue to view a firm US dollar as a key risk to earnings. The ALSI remains expensive relative to its own history, but less so than in previous months.	The fading drag from poor oil-related earnings and an expectation of improving macro data in key economies remains supportive for global equity earnings, but the uncertainty surrounding the US presidential election and the prospect for additional interest rate hikes before year end poses near-term risks. With equities yielding more than government bonds in all major developed markets, global equities are now superior as both a growth and income asset class.	Close to 40% of developed market sovereign bonds are negative yielding, offering less long-term value relative to equities. However, the real yield differential between emerging and developed market debt remains attractive for the former, even after adjusting for credit risk.	Globally, interest rates are still tracking at historical lows. As such, we expect the rand view to be the dominant driver of local currency returns.

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