MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

17 June 2021

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We have decided to move most of our TAA positions to neutral; except we have continued to stay moderately overweight in SA bonds.

Figure 1: Houseview Tactical Asset Allocation

Synopsis

We reiterate our overweight position in local nominal bonds as they remained attractive from a real and hedged yield perspective. We chose to stay neutral in SA inflation-linked bonds, SA equity, SA-listed property and offshore property, with our investment cases for these asset classes remaining largely unchanged over the past month. Local sentiment showed further improvement, but we remained concerned about the impact of the slow vaccination process and the third wave of COVID on the local economy's recovery path. We continued to prefer offshore equities to offshore bonds, due to strong corporate earnings and a positive growth outlook for the remainder of the year, with short-term rates remaining low (despite the latest FOMC meeting pointing to rate hikes taking place earlier – in 2022 rather than 2023). However, we expect upcoming labour market and inflation data, as well as concerns over potential tapering discussions, to result in heightened market volatility in the near term. We therefore choose to stay neutral from a risk management point of view.

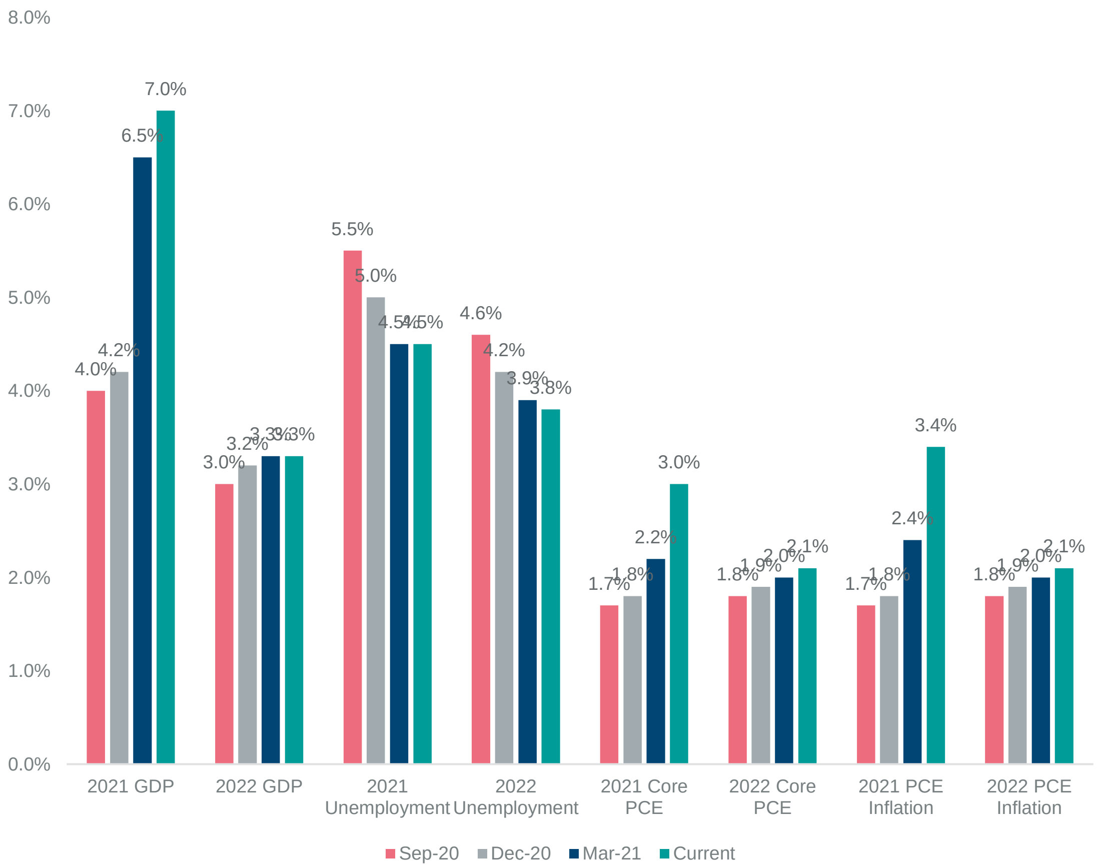
TAA Overview

Offshore bonds	Investors have been focusing on inflation data over the past few months to gauge near-term central bank policy responses. The outcome from last week's FOMC meeting has caused some market jitters as investors have adjusted their positions and scaled back from reflation trades in the wake of the US Federal Reserve's hawkish pivot. Eleven (11) out of 18 officials now expect at least two rate hikes in 2023, with seven officials anticipating interest rate increases by the end of 2022. In addition, the Fed has made upward revisions to several US economic projections. It raised the GDP growth estimate for 2021 from 6.5% to 7.0%, while core PCE inflation and PCE inflation for this year jumped by a full percentage point higher than the March projections, from 2.2% and 2.4% respectively to 3.0% and 3.4%. The Fed Chair, Jerome Powell, has acknowledged that recent monthly inflation in the US has increased beyond the anticipated base effect due to larger-than-expected bottleneck effects from supply and demand imbalances. Subsequent to the FOMC meeting, we saw the US 30-year treasury yield dropping from 2.21% to 2.07%, the US 2-year treasury yield increasing from 0.21% to 0.27%, and the 10-year vs 2-year treasury yield spread narrowing from 137bps to 120bps.This was as the Fed rate hike bets dampened long-term inflation and real-rate expectations, while raising short-term real-rate expectations.

Figure 2: FOMC members' dot projections for the meeting on 16 June 2021

Source: Bloomberg

Figure 3: Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents



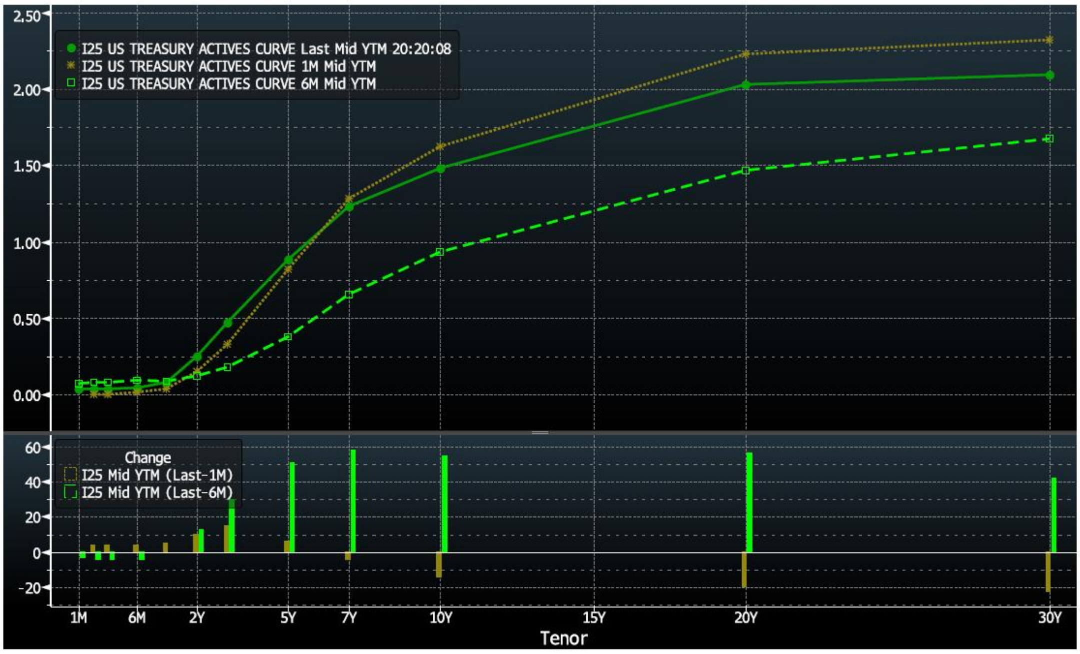
Source: Bloomberg

Figure 4: US treasury yields and breakeven inflation rates

Source: Bloomberg

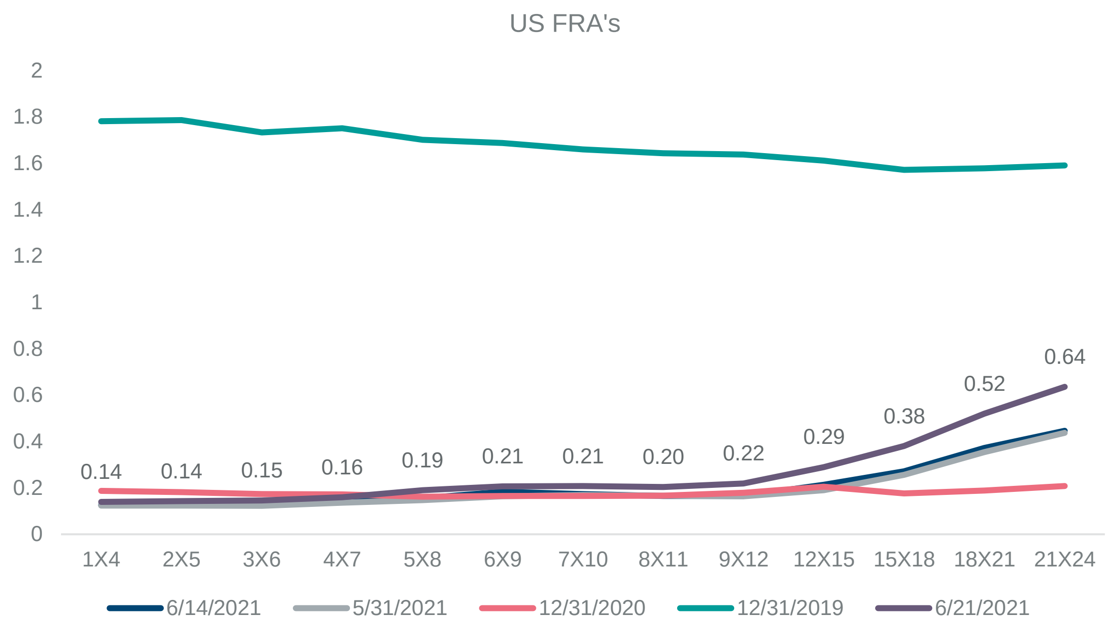
While the Fed is not raising rates anytime soon, the movements in the dot plot raised concerns that the Fed may speed up the pace of monetary tightening. The US yield curve flattened as a result of investors repricing inflation risk, pushing short-term rates higher and reducing the risk that US inflation will remain above 2.0% over the long term. The FRA rates also adjusted in line with the Fed's rate outlook.

Figure 5: US yield curve as at 21 June 2021



Source: Bloomberg

Figure 6: US forward rate agreements rate



Source: Bloomberg

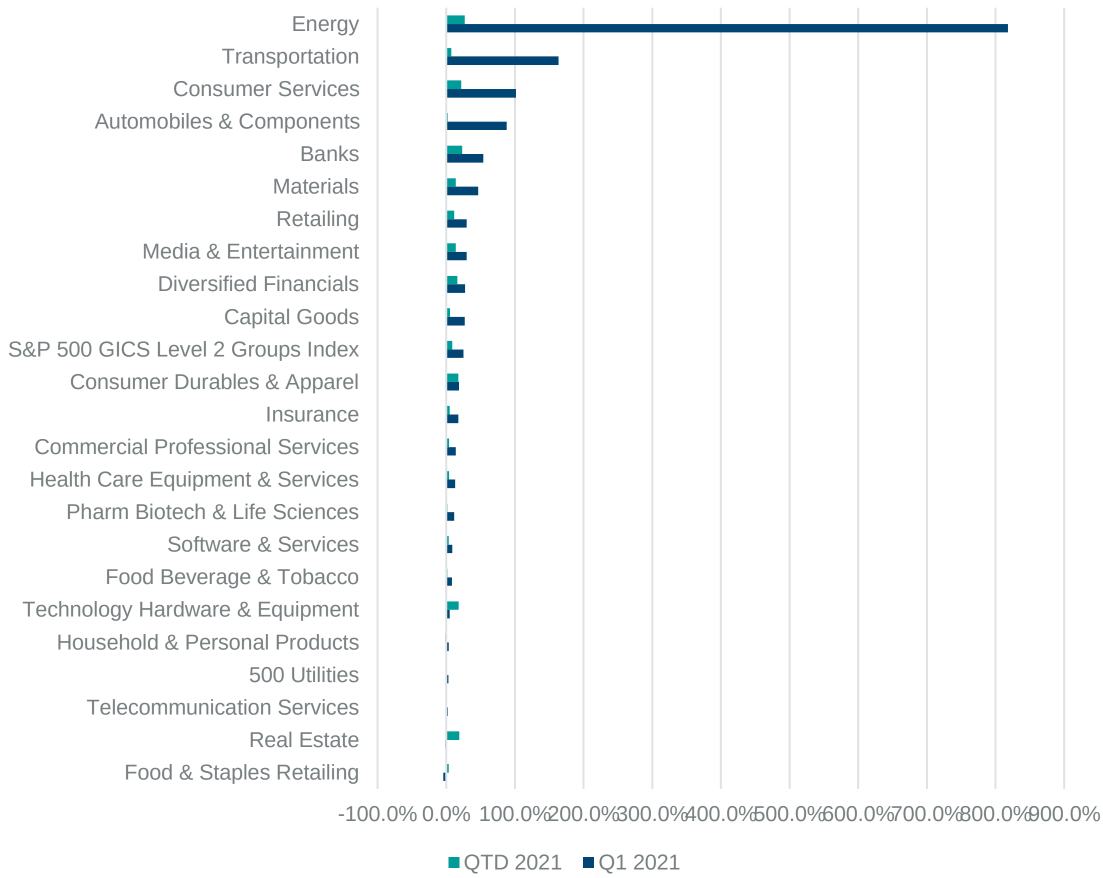
We still prefer offshore equities over offshore bonds as global sentiment and economics continue to improve, with further reopening and declining numbers of new infections in the developed world and earnings growth continuing to favour equities over bonds. However, the recent bond selloff may be a bit overdone as the Fed's policy stance and forecasts are susceptible to change – depending on the US labour market's recovery and the persistence of heightened inflation, which partially depends on how quickly supply imbalances can be resolved. We do expect volatility ahead as markets are more likely to move sideways as the market parses central bank statements and upcoming economic data. We also moved our offshore bonds position to neutral to keep a neutral total offshore allocation. The rapid spread of the delta variant of the coronavirus, together with the relatively slow pace of the vaccine rollout, make emerging markets more vulnerable than developed markets, potentially widening the growth gap between the two worlds, amid concerns of tighter global financial conditions.

Offshore equities

Valuation scores for offshore equities remained largely unchanged over the past month, with local equities preferred over offshore equities. Sentiment in the US and the EU continued to lead that in Japan. The University of Michigan Consumer Sentiment Index softened slightly from 88.3 in April to 82.9 in May. The Conference Board Consumer Confidence Index and the Bloomberg US Weekly Consumer Comfort Index both remained solid, from 117.5 in April to 117.2 in May and from 54.6 in May to 55.4 in June respectively. Overall, manufacturing confidence was resilient, with business activity softening slightly from 37.3 in April to 34.9 in May, while the production outlook trended lower from 34 to 15.7 over the same period. We suspect bottlenecks in the supply chains and longer lead times have played a role here. Sentiment in the EU made some noteworthy gains. Consumer confidence improved from -8.1 in April to -5.1 in May, exceeding the long-term average of -10.0. The region's economic sentiment jumped from 110.3 in April to 114.5 in May. The Eurozone capacity utilisation rate also jumped from 77.5 in Q1 to 82.5 in Q2. Sentiment in Japan was less resilient and failed to make any sizable gains, with consumer confidence nationwide trending lower from 34.8 in April to 34.3 in May. Consumers' sentiments about present economic conditions in Q1 2021 also did not improve from Q4 2020, according to the survey conducted by the Bank of Japan.

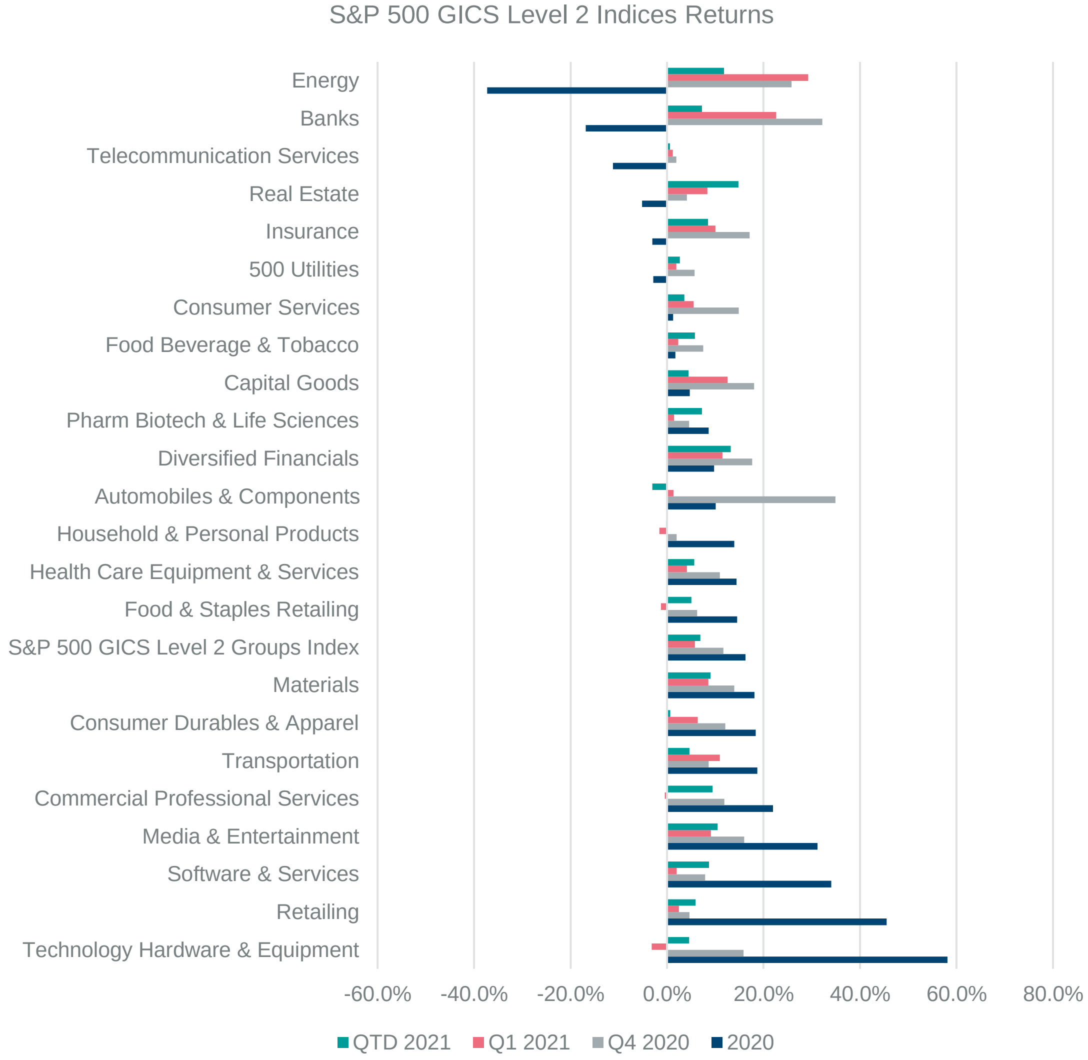
The macro data continued to indicate some improvements in all three economies. US export and import growth year on year jumped to 36.6% and 34.9% respectively in April, driven by the base effect and recovery in domestic demand. Month-on-month export growth was up by 1.1% but import growth was down by 1.4%. The unemployment rate declined from 6.1% in April to 5.8% in May, with a persistent decline in initial and continuing jobless claims. ADP employment change posted a gain of 978,000 non-farm jobs in May, beating the market expectation of 650,000. The Bureau of Labor Statistics non-farm payrolls added 559,000 jobs in May, posting a much smaller miss of 116,000, compared to April. While US labour productivity output per hour for the non-farm business sector was up by 5.4% quarter on quarter in Q1 2021, labour costs were also up by 1.7% quarter on quarter. The US economic recovery is gathering momentum as business restrictions are lifted and social activity increases across the country, with business activity in the services sector jumping from 64.7 in April to 70.4 in May. The services PMI continued in expansionary mode, moving upwards slightly from 62.7 in April to 64.0 in May. The probability of a recession in the next 12 months, according to the New York Fed, ticked up from 5.95% to 6.11% over the past month. Sector rotations continued into Q2, underpinned by an improving earnings outlook in most sectors and interest rate expectations.

Figure 7: S&P 500 GICS Level 2 indices QTD 2021 earnings estimate revision



Source: Bloomberg

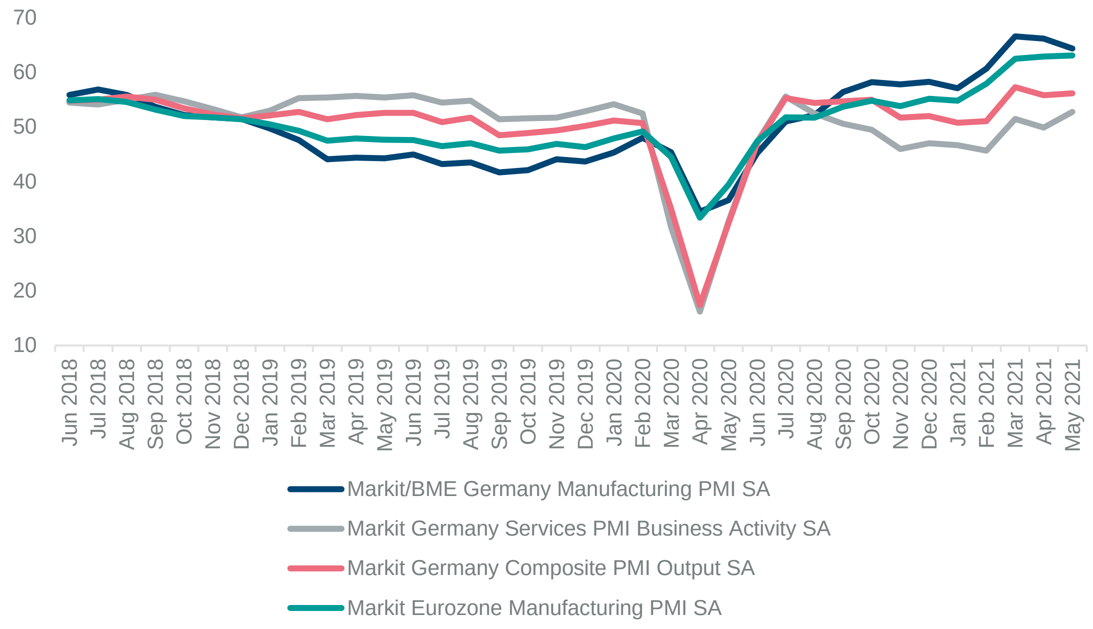
Figure 8: S&P 500 GICS Level 2 indices returns



Source: Bloomberg

Retail sales growth year on year in the EU jumped from 12.0% in March to 23.9% in April, mainly due to the base effect, but retail sales contracted by 3.1% in April month on month. Export and import growth improved from -5.6% and -7.6% in Q4 2020 to -0.3% and -3.8% in Q1, respectively, year on year. We have also seen the unemployment rate ticking lower in Q4 2020 in Germany, France, the UK and the Eurozone. The Eurozone and Germany manufacturing PMIs and Germany services PMI remained in the expansionary zone in May. In the US, 43.4% of companies that offered an outlook on their future earnings in May gave a positive outlook, while roughly one-third gave a neutral outlook. Retail sales in Japan were down by 4.5% in April, month on month. Industrial production ticked up from 4.0% in March to 15.8% in April, year on year, with month-on-month growth up by 2.9%. Export growth year on year improved from -6.0% in March to -8.2% in April, but imports remained lacklustre, making a small gain from -9.4% in March to -8.2% in April.

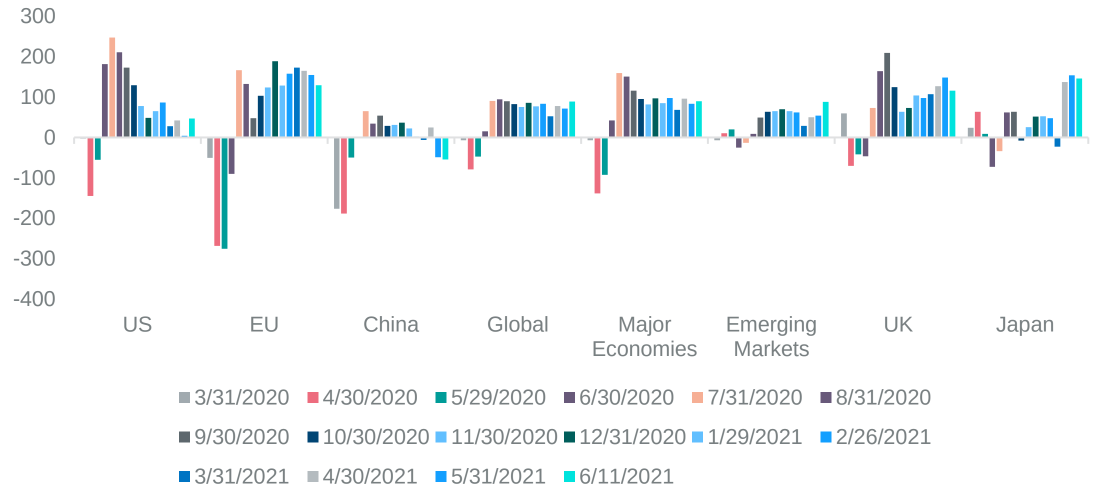
Figure 9: Eurozone and Germany PMIs



Source: Bloomberg

In the Asia-Pacific region, we observed that China's GDP year on year for Q1 2021 was up by 18.3%, slightly missing the consensus figure of 18.5%. China's manufacturing and non-manufacturing PMIs remained in expansionary territory, at 51.0 and 55.2 respectively, in May. China's exports and imports also grew by 18.1% and 39.5% respectively in May. Korea's exports and imports followed the same trend, up by 45.6% and 37.9% respectively year on year in May. China's retail sales were up by 0.81% in May, the fourth month of consecutive month-on-month gains. The return on equity for the S&P 500 improved further from 13.64% to 13.90% from April to May. The return on equity for the STOXX 600 and the NIKKEI 225 remained largely unchanged over the same period.

Figure 10: Economic surprise indices



Source: Bloomberg

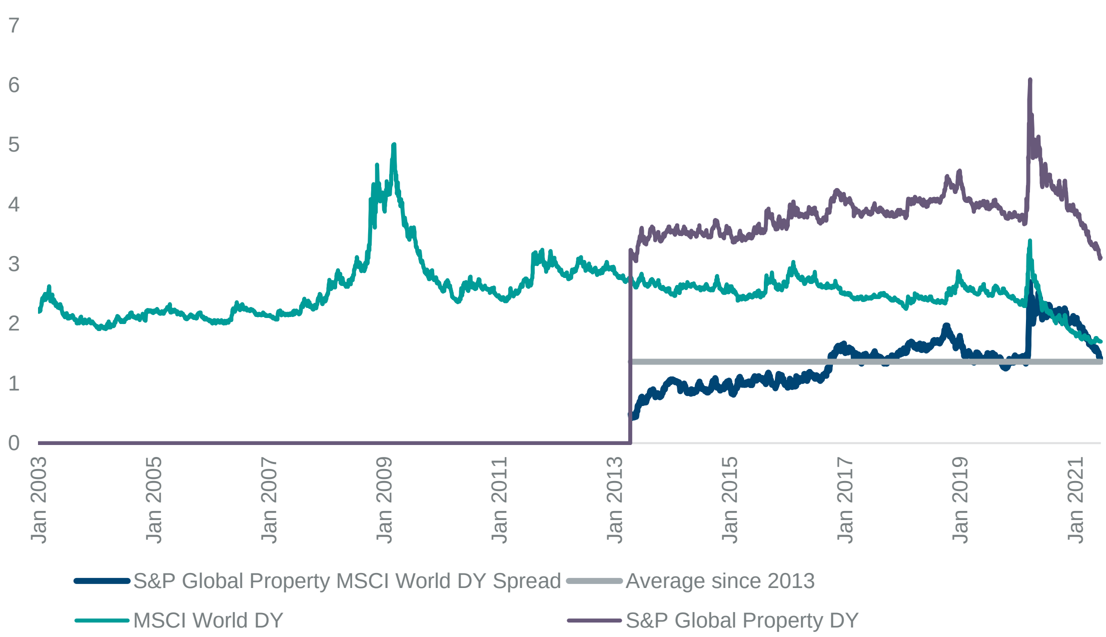
The economic surprise index remained in positive territory for most major economies, showing that the reported economic figures largely exceeded market expectations.

Our views on offshore equities have remained unchanged. However, we have seen global equity indices trading around record levels for much of the second quarter. This round of global inflation spikes has mainly been driven by one-time reopening effects (including surging demand and supply chain bottlenecks) and base effects. The persistence of the price implications will depend on how the underlying factors unfold. Yet, with wages rising as labour demand increases and with input costs rising due to strong commodity prices and supply chain issues, there are still (even if the recent inflation ultimately proves to be transitory) additional inflationary pressures in the very short term. While we still believe that a 2013-like tapering tantrum is unlikely, major central banks are signalling that the COVID-induced, unconventional and accommodative monetary conditions are unlikely to continue forever. That sort of inflationary uncertainty and speculation about the pace of tapering and interest rate decisions will likely continue for the next few months, with markets showing increasing sensitivity to headlines, with bouts of surging and sell-off. We therefore changed our offshore equity position from moderate overweight to neutral, largely from a risk management perspective.

Offshore property

From a valuation perspective, global property appears to be neutral, with the spread between its yield and that of the MSCI World Index converging to the long-term average. While its price-to-tangible-book value ticked up from 1.45x in April to 1.48x in May, fundamental measures such as debt to equity, operating margin and return on equity have largely remained unchanged over the past month. We therefore chose to stay neutral in offshore property.

Figure 11: S&P Global Property dividend yield spread relative to the MSCI World Index



Source: Bloomberg

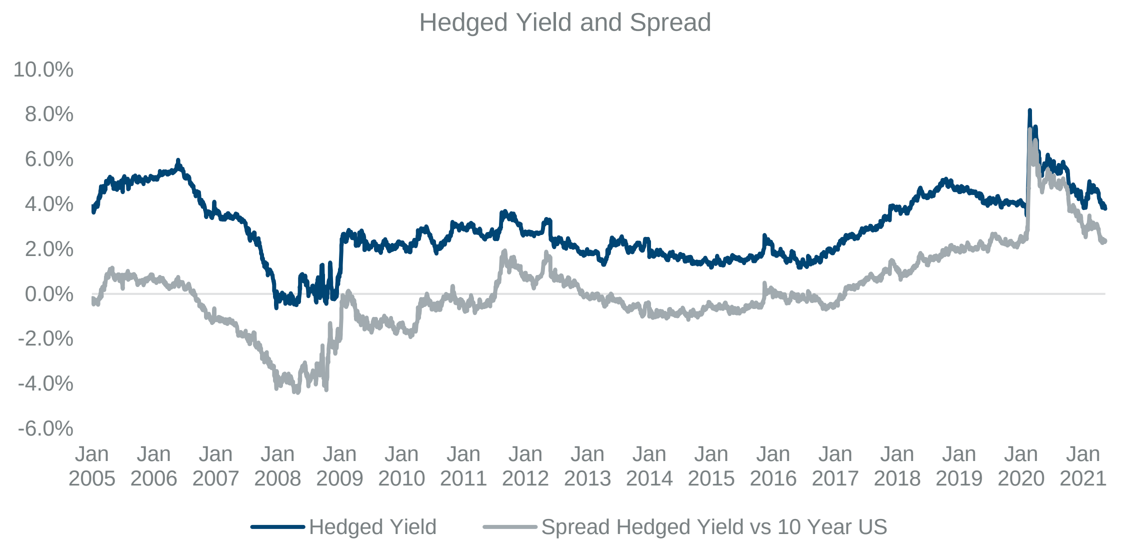
SA bonds

Turning to domestic markets, net outflows of foreigners' holdings of SA bonds improved into June, with net year to date sales of SA bonds as at 11 June 2021 rising (since our previous TAA meeting) from -$2.8bn to -$2.6bn. Furthermore, foreign investors' appetite for local equities waned, with net sales of around US$400m over the same period. However, from a US-listed ETF flow perspective, we have been seeing more flows into local equities than local bonds over the past three weeks. The 10-year nominal bond remained attractive as it was trading at 8.9%, above the implied 10-year yield of 3.7%. The implied vs actual yield spread widened from 450bps to 520bps from 30 April to 31 May. The 10-year nominal yield spread over the US 10-year treasury yield narrowed slightly from 7.65% to 7.32%, exceeding the long-term average by 105bps. The US dollar-hedged 10-year yield continued to offer value, despite narrowing slightly from 4.1% to 3.8% over the past month. At the same time, the hedged yield premium over the US 10-year yield narrowed from 242bps to 2231bps.

Figure 12: South Africa 10-year nominal yield vs implied yield as at 31 May 2021

Source: Bloomberg

Figure 13: US$-hedged 10-year bond yield over time



Source: Bloomberg

SA nominal bonds still appeared attractive compared to Brazilian nominal bonds, based on real yield and calculated using reported inflation. In this regard, the real yield spread of SA 10-year over Brazilian 10-year increased from 220bps to 337bps over the past month. The spread of the 10-year bond yield adjusted for expected inflation, based on the Bloomberg survey of economists, narrowed from 86bps to 71bps over the same period.

Figure 14: SA bond yields vs EM peers as at 14 June 2021

	South Africa	India	Indonesia	Russia	Mexico	Brazil	Turkey
10 Year Yield	**8.99%**	**6.01%**	**6.35%**	**7.09%**	**6.66%**	**9.28%**	**18.09%**
Inflation	4.4%	4.3%	1.68%	3.3%	5.9%	8.1%	16.6%
Inflation Expectation	4.10%	6.20%	2.20%	5.10%	4.06%	5.10%	15.00%
10 Year Real Yield	**4.59%**	**1.72%**	**4.67%**	**3.79%**	**0.77%**	**1.22%**	**1.50%**
10 Year Real Yield based on inflation expectation	4.89%	-0.19%	4.15%	1.99%	2.60%	4.18%	3.09%
Currency Risk Premium	**4.89%**	**3.12%**	**3.52%**	**4.17%**	**3.60%**	**5.32%**	**12.57%**
Sovereign Risk Premium	**2.65%**	**1.44%**	**1.38%**	**1.46%**	**1.61%**	**2.50%**	**4.07%**
US 10 Year Yield	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%
S&P Rating - Foreign Currency	**BB-**	**BBB-**	**BBB**	**BBB-**	**BBB**	**BB-**	**B+**
Moody's Rating - Foreign Currency	**Ba2**	**Baa3**	**Baa2**	**Baa3**	**Baa1**	**Ba2**	**B2**

Source: Bloomberg

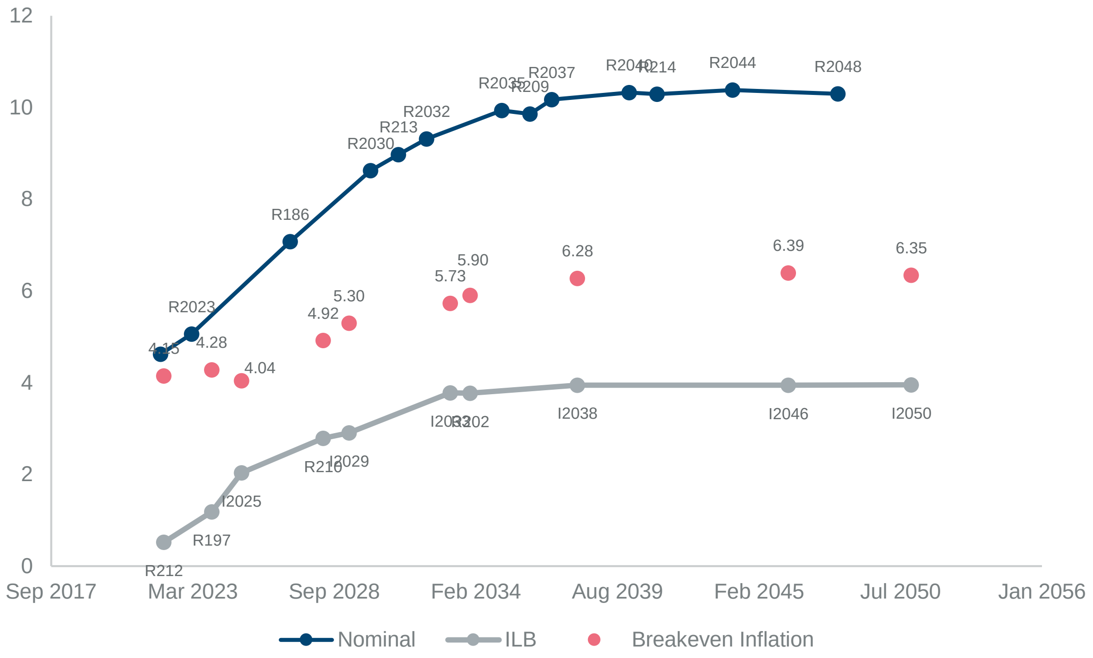
S&P Global and Fitch Ratings affirmed South Africa's long-term sovereign credit rating on 24 May at BB-, with S&P and Fitch maintaining their stable and negative outlooks respectively. S&P warned that the slow pace of vaccination was a potentially new medium-term constraint to growth recovery. Fitch, in turn, noted continued substantial risks to debt stabilisation but commented on the substantial progress that had been made in respect of independent power producers, which would now be able to produce 100 megawatts (up from 1 megawatt previously) of generating capacity without a licence. While this would ease the power supply constraints over the medium to long term, it was unlikely to have much impact in 2021.

Improving terms of trade, higher commodity prices and a healthy trade surplus should give the economy some short-term cyclical uplifts. We maintained our overweight position in local nominal bonds, mainly on the basis of valuations, which continued to look appealing from a real yield and hedged yield perspective.

SA inflation-linked bonds

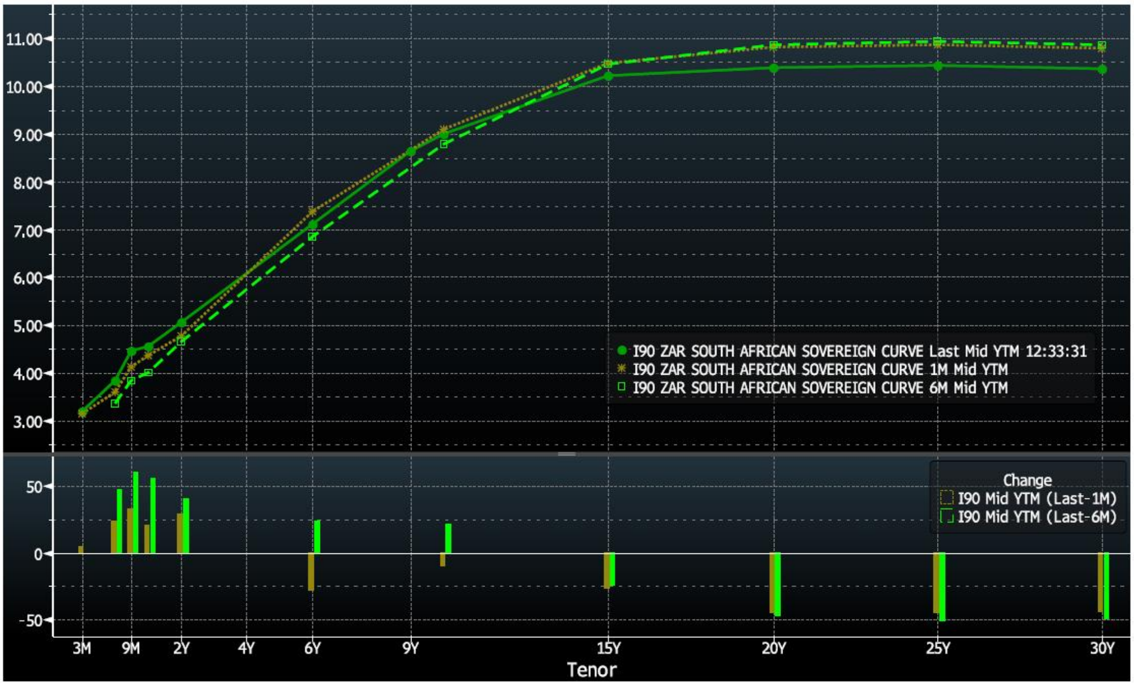
The IGOV Index performed in line with the ALBI in May, returning 3.4% vs 3.7%, but underperformed against the latter for the month to date, as at 16 June, returning 0.7% vs 1.4%. Breakeven inflation increased by c.5bps on the shorter end and decreased by c.26bps on the longer end of maturities, driven by near-term inflation expectations. Both the nominal yield curves and inflation-linked bond yield curves have flattened over the past month.

Figure 15: SA nominal and real yields as at 14 June 2021



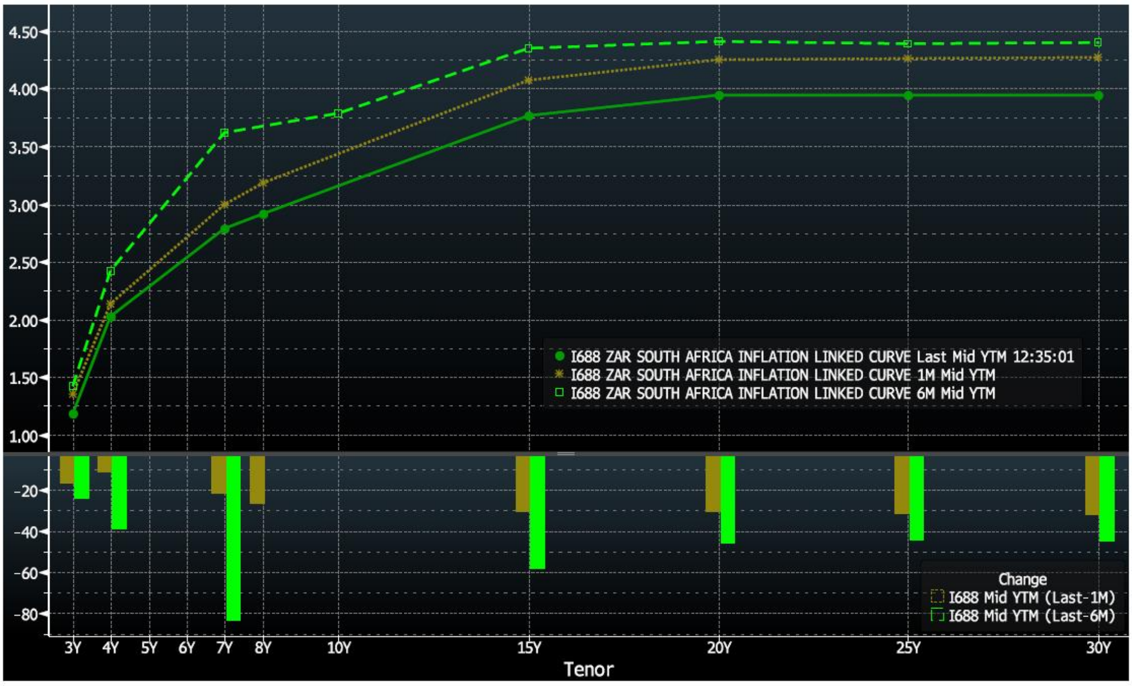
Source: Bloomberg

Figure 16: SA nominal yields as at 14 June 2021



Source: Bloomberg

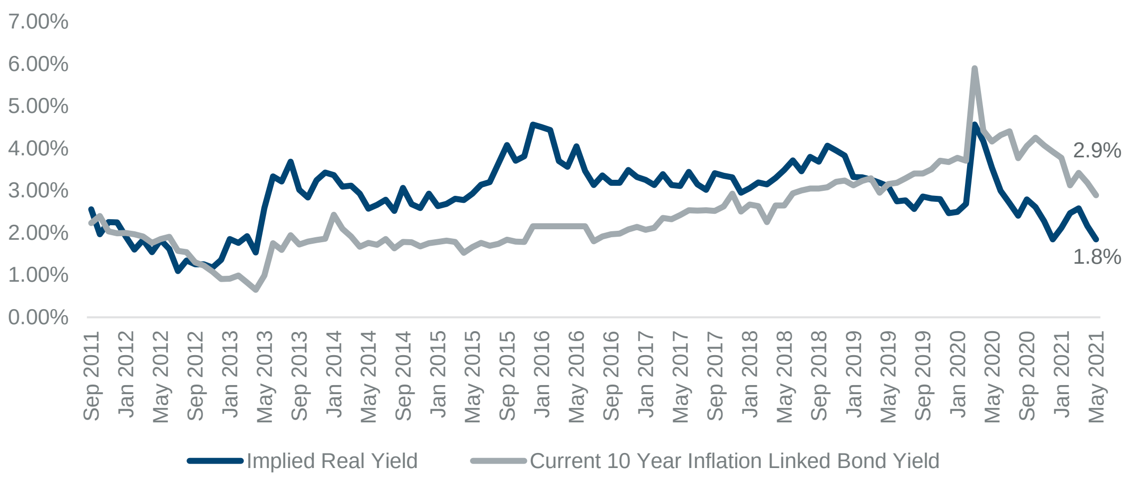
Figure 17: SA inflation-linked yields as at 14 June 2021



Source: Bloomberg

The spread between the 10-year nominal bond real yield and the 10-year inflation-linked bond yield widened slightly from 102bps to 110bps from April to May.

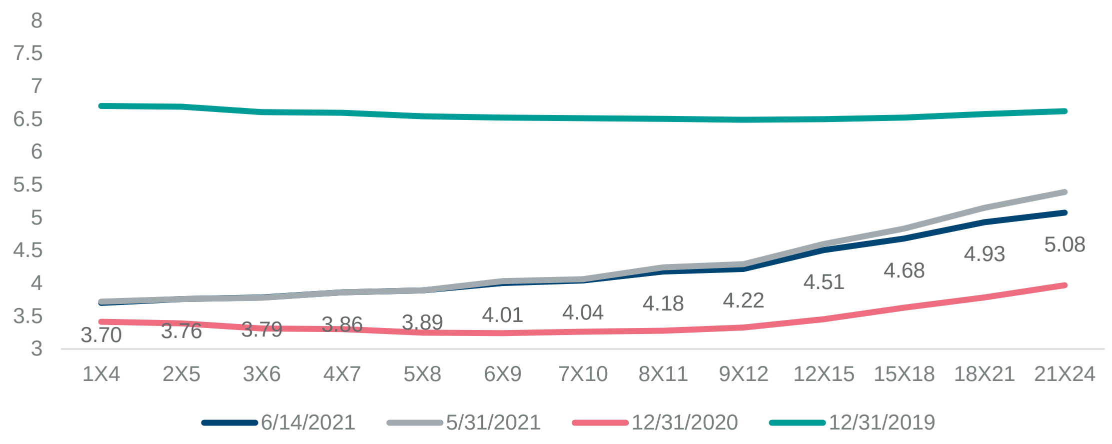
Figure 18: 10-year real yield of nominal bond vs inflation-linked bond as at 31 May 2021



Source: Bloomberg

The forward rate agreement (FRA) rates indicated that the market still expects interest rates to rise by at least 25bps by the end of 2021 but to price in less aggressive, longer-term rate movements. Although we favour inflation-linked bonds' ability to provide protection against unexpected inflation, from a valuation perspective we favour nominal bonds. Therefore, we reiterate our neutral stance on inflation-linked bonds.

Figure 19: Forward rate agreement rates



Source: Bloomberg

SA equities

Major equity indices closed in green for May in local currency terms, but the strong ZAR performance in May has diluted offshore denominated returns. The rand weakened by 2.1% for the month to date, as at 16 June, due to the strong dollar. This was driven partly by strong US job data from the ADP National Employment Report and partly by the likelihood that the Fed would unwind some of its asset purchases in the light of recent inflation data.

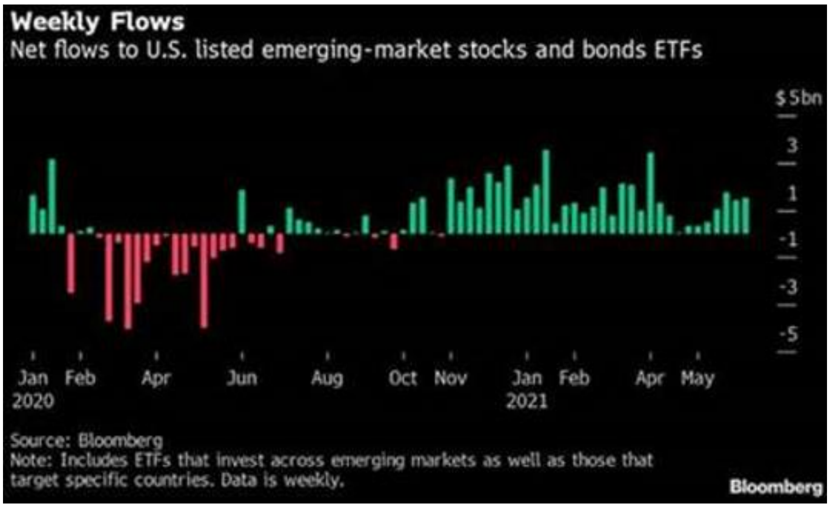
Figure 20: Major indices and asset class returns in ZAR

31 May 2021 (ZAR)	1M	3M	YTD	1 Year	3 Year (annualised)	5 Year (annualised)	10 Year (annualised)	MTD 16 June 2021
FTSE/JSE ALSI Total Return	1.6%	4.2%	16.0%	38.1%	10.0%	8.0%	11.0%	-0.9%
FTSE/JSE Capped SWIX Total Return	2.9%	7.6%	16.8%	40.8%	6.1%	4.7%		-0.9%
S&P 500 Total Return	-4.3%	0.5%	5.6%	9.8%	21.2%	14.1%	22.7%	0.3%
STOXX 600 Total Return	-1.0%	2.4%	6.3%	12.4%	12.5%	7.1%	13.6%	1.9%
Nikkei 225 Total Return	-5.1%	-11.5%	-6.1%	3.2%	14.1%	10.3%	18.3%	1.0%
MSCI World Total Return	-3.7%	-0.4%	4.6%	10.5%	18.1%	11.9%	19.0%	1.0%
MSCI ACWI Total Return	-3.6%	-1.2%	4.0%	11.4%	17.5%	11.8%	18.2%	0.8%
MSCI EM Total Return	-2.9%	-6.3%	0.6%	18.5%	13.0%	11.3%	12.1%	-0.5%
STEFI	0.3%	0.9%	1.5%	4.2%	6.1%	6.7%	6.3%	0.2%
ALBI	3.7%	3.0%	3.9%	11.1%	8.4%	9.8%	8.4%	1.4%
IGOV	3.4%	5.2%	9.5%	15.5%	4.8%	3.9%	6.7%	0.7%
WGBI	-4.2%	-9.4%	-9.8%	-19.8%	6.7%	0.0%	8.9%	-0.3%
SAPY Total Return	-2.9%	9.8%	15.4%	37.3%	-10.9%	-7.3%	4.9%	2.9%
MSCI US REIT Total Return	-4.2%	3.2%	11.1%	8.3%	13.8%	4.4%	16.6%	4.1%
S&P Global Property Total Return	-3.4%	-0.1%	5.8%	4.9%	9.5%	4.0%	14.7%	3.0%
STOXX 600 Real Estate Total Return	0.3%	3.9%	0.2%	6.4%	7.7%	2.0%	12.7%	2.9%
Crude Oil	-2.2%	-5.0%	25.4%	53.4%	-1.1%	4.1%	1.8%	7.2%
Aluminium	-1.6%	4.6%	17.6%	25.6%	5.5%	7.0%	6.5%	-0.8%
Copper	-0.8%	2.5%	23.9%	49.3%	17.5%	14.0%	8.4%	-6.0%
Gold	7.8%	10.0%	0.4%	10.2%	13.7%	9.4%	2.2%	-5.0%
Platinum	-6.1%	-9.6%	4.0%	11.1%	12.5%	1.3%	2.7%	-5.6%
Nickel	0.0%	0.0%	0.0%	0.0%	-2.8%	5.9%	1.2%	0.0%
Palladium	-8.6%	10.3%	8.3%	14.2%	45.9%	35.3%	22.1%	-1.3%
Iron Ore	3.5%	10.1%	23.1%	66.2%	52.4%	30.1%		7.2%
USDZAR	-5.2%	-9.1%	-6.5%	-21.7%	2.7%	-2.6%	7.3%	2.1%
GBPZAR	-2.5%	-7.2%	-2.8%	-9.9%	5.0%	-3.0%	5.7%	0.5%
EURZAR	-3.5%	-7.9%	-6.4%	-13.8%	4.2%	-0.8%	5.5%	0.2%
JPYZAR	-5.4%	-11.6%	-11.8%	-23.0%	2.4%	-2.4%	4.2%	1.0%

Source: Bloomberg

Accelerated vaccine rollout programmes have shortened the time needed to inoculate 75% of the global population from 11 months to eight months, according to Bloomberg's COVID-19 vaccine tracker. At the same time, we continued to see positive net inflows into emerging markets in early June – mostly into equities – as global economic recovery optimism bolstered investment risk appetite.

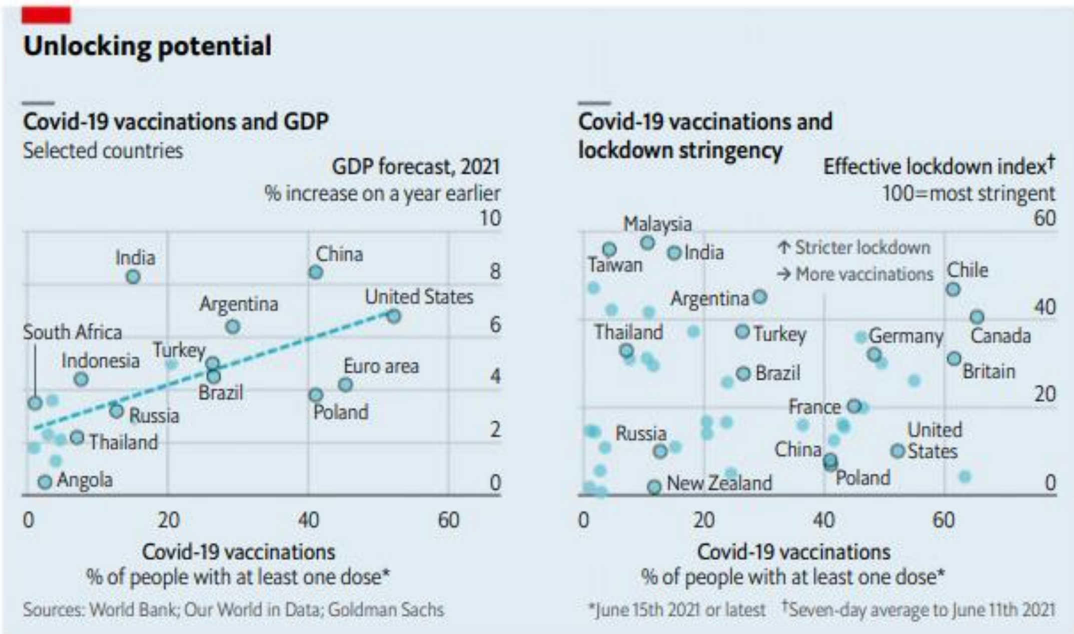
Figure 21: ETF net flows into developed and emerging market ETFs for the week ending 13 June 2021



Source: Bloomberg

What concerns us is that the slower vaccination rate, observed mostly among developing nations, will result in a new economic divide between the developing and developed world. Some developing countries that have vaccinated faster than their developing peers may also enjoy quicker growth recovery and get larger GDP forecast upgrades from the World Bank. Quicker vaccination reduces restrictions on social interactions and lowers the risk of future outbreaks. South Africa has clearly fallen behind other EM peers in the area of vaccination roll-out.

Figure 22: COVID-19 vaccination rate and GDP forecast



Source: The Economist

SA equity valuations based on price ratios and dividend yields continued to suggest a moderate underweight position. Sentiment improved further, with the Bureau for Economic Research Composite Business Confidence Index improving from 35 in Q1 to 50 in Q2. The Chamber of Commerce and Industry Business Confidence Index also improved from 94.7 in April to 97 in May. The SA PMI index increased from 56.2 in April to 57.8 in May, strongly in expansionary territory, with the employment subindex dropping from 54.4 in April to 49.6 in May, just below the neutral level of 50. The rising number of building plans passed in recent months are also a sign of improving consumer and business sentiment.

Total and new car sales were up, month on month, from -19.1% and -16.2% respectively in April to 7.1% and 5.3% in May. Export and import growth year on year jumped from 42.5% and 22.7% respectively in March to 211.0% and 22.7% in April, due to base effects. However, month-on-month growth contracted by 3.9% and 4.6% respectively in April. Private credit extension remained lacklustre, declining from -1.52% in March to -1.76% in April, year on year, as growth in household credit extension failed to offset a decline in corporate credit demand.

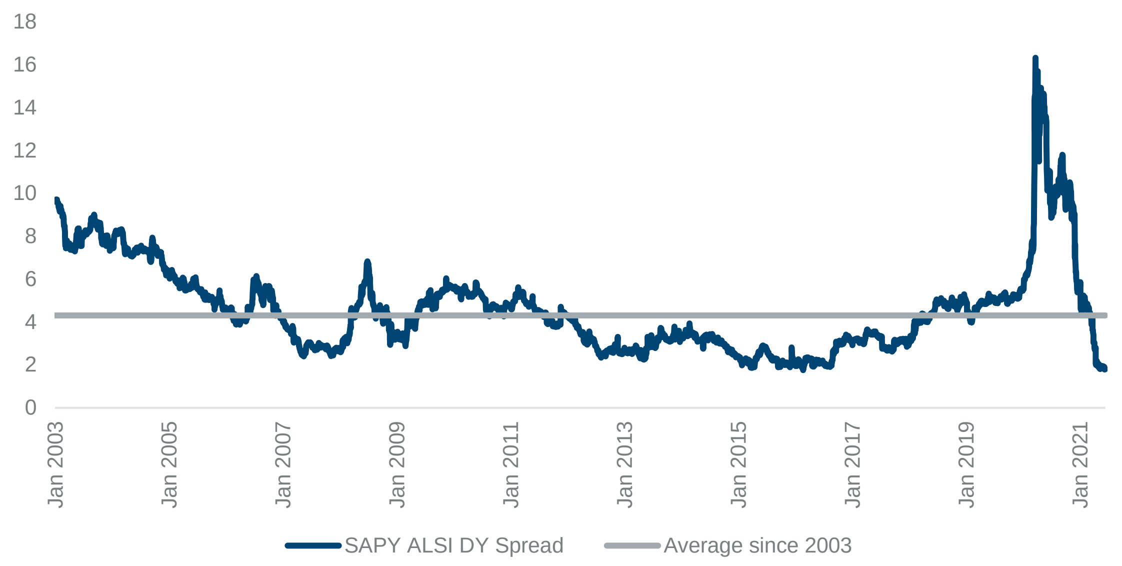
Surprisingly, however, South Africa's GDP growth for Q1 2021 was up, with a seasonally adjusted annual rate of 4.5% quarter on quarter – compared to the consensus estimate of 3.2%. All sectors made a positive contribution to GDP, except for agriculture. South Africa's retail sales volume data also followed international trends, showing declining food retail figures as consumers spent more on the hospitality sector. While furniture, household appliances and DIY categories benefited from COVID-induced lifestyle changes and remained strong, the apparel sector has also improved since the end of 2020.

We reiterate our neutral position in SA equities, with the valuation remaining unchanged, along with strong sentiment and mixed fundamentals performance over the past month. Global economic recovery continued to gather momentum, especially in most developed countries and those developing markets that had introduced a rapid vaccine rollout programme and had managed to contain new infections. However, South Africa's path to recovery is increasingly at risk as the third wave of COVID-19 takes its toll in Gauteng, the country's main economic hub, after a slow start to responding to the virus, compared to emerging market peers. Some positive, vaccine-related news is that the CoronaVac application has reached an advanced stage, while it was recently announced that there is a plan to make mRNA COVID-19 vaccines locally. These initiatives should accelerate the vaccination programme in the foreseeable future and may help to prevent future outbreaks.

SA-listed property

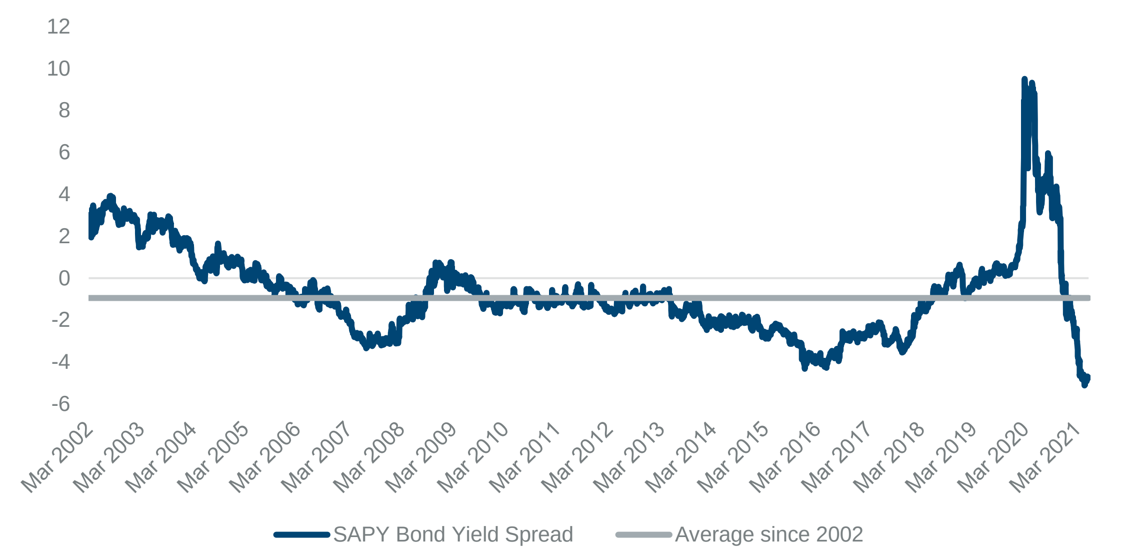
SA-listed property returned -2.9% in May after delivering a strong performance in April, when it returned 11.7%. For the month to date, as at 16 June, the SAPY index had returned 2.9%, following the same direction as that of global property indices. The yield spread relative to SA equities fell significantly below its long-term average, while the yield spread relative to the 10-year bond fell to an all-time low from its long-term average. The SAPY dividend yield continued to trend below its 1-year and 5-year rolling averages. The price-to-tangible-book value remained mostly unchanged at 0.73 in May.

Figure 23: SAPY yield spread relative to FTSE/JSE All Share Index



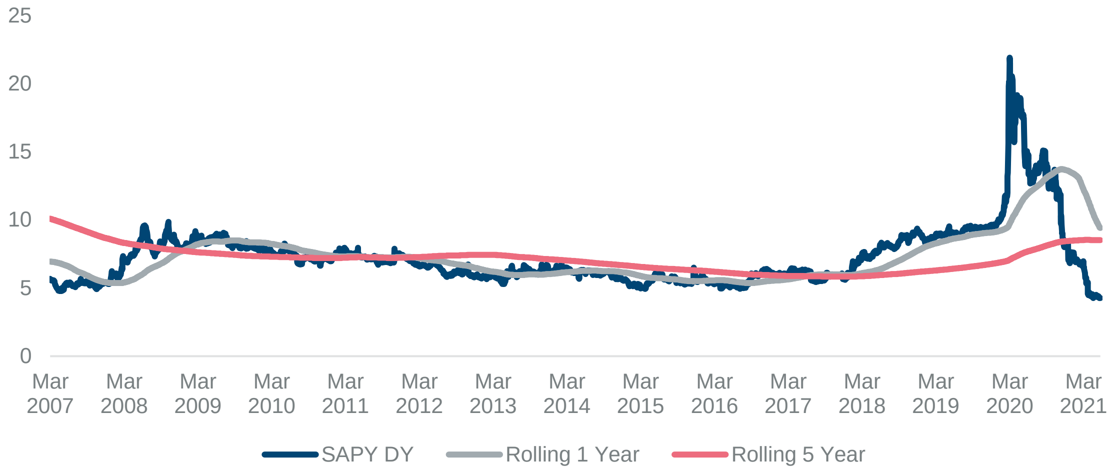
Source: Bloomberg

Figure 24: SAPY yield spread relative to 10-year bond



Source: Bloomberg

Figure 25: SAPY yield relative to 1-year and rolling 5-year rolling averages



Source: Bloomberg

Rental collections for REITs have improved from a low of 65% in April 2020 to 107% in December 2020. Despite the high vacancy rates experienced by the office sector, the sector's performance has so far exceeded market expectations, due to the structure of the leases and the fact that most companies have continued to pay their rentals despite most of their workforce working remotely, according to ABSA's commercial property insights. Consumers continue to prefer open-air-style, smaller retail centres over super regional and regional centres. The industrial sector outperformed the other two sectors as online retails drove demand for distribution and warehousing centres.

We are comfortable to stay in a neutral position as, despite fundamentals such as debt-to-equity ratio and operating margin staying largely unchanged over the past month, structural and secular challenges facing the local property sector persist. Nevertheless, the sector is benefiting from the picking up in consumer and business sentiment, with the path to recovery dependent on the performance of the underlying economy.

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