MENTENOVA

# HOUSEVIEW TACTICAL ASSET ALLOCATION

21 October 2021

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We have decided to maintain our TAA positions in offshore equity, offshore bonds and offshore cash, while moving to moderate overweight in local inflation-linked bonds and neutral in local listed property, with local cash being the balancing figure.

**Figure 1: Houseview Tactical Asset Allocation**

| Asset class | -- | - | Neutral | + | ++ |
|---|---|---|---|---|---|
| SA cash | | ■ | | | |
| SA bonds | | | ■ | | |
| SA inflation-linked bonds | | | | ■ | |
| SA listed property | | | ■ | | |
| SA equity | | | ■ | | |
| Foreign cash | | | | ■ | |
| Foreign bonds | | ■ | | | |
| Foreign equity | | | | ■ | |
| Foreign property | | | ■ | | |

## Synopsis

We reiterate our positions in SA nominal bonds, SA equity, offshore equity, offshore bonds, offshore property and offshore cash, with our investment cases for these asset classes remaining largely unchanged over the past month. We moved from neutral to moderate overweight in SA inflation-linked bonds as we believe short-term inflation may remain elevated and we favour their inflation-protection capability. We also moved from moderate underweight to neutral in SA listed property as fundamentals have improved and we see limited contagion risk from Chinese property companies.

## TAA Overview

| | |
|---|---|
| **SA equities** | Equities held up in general over the quarter, despite investors' concerns about the peak in the rate of global economic growth, supply chain disruptions and rising inflation. Developed market equities were largely flat in Q3 after the moderate decline in September which wiped out the quarter's prior gains. Chinese equities struggled in the latest quarter as regulations hurt sentiment and earnings growth outlook, dragging emerging market equities lower over the quarter. The ZAR depreciation of 5.5% against the US dollar over the quarter, however, helped to amplify the offshore returns in rand terms.<br><br>The WGBI declined by -1.2% over the quarter as initial declines in US and European government bond yields were reversed in September – the result of the hawkish shift in the tone of the Fed and the BOE, together with ongoing inflationary concerns.<br><br>Stronger demand and a sluggish supply response from OPEC drove energy prices consistently upwards. Despite a sharp rise in the aluminium price, chip shortages (affecting auto manufacturing) and concerns about slower growth resulted in price declines across other industrial metals – from platinum, palladium and copper to iron ore. |

**Figure 2: Major indices and asset class returns in ZAR**

| 30 September 2021 (ZAR) | 1M | 3M | YTD | 1 Year | 3 Year (annualised) | 5 Year (annualised) | 10 Year (annualised) | MTD 19 October 2021 |
|---|---|---|---|---|---|---|---|---|
| FTSE/JSE ALSI Total Return | -3,1% | -0,8% | 12,2% | 23,2% | 8,6% | 7,8% | 11,5% | 4,0% |
| FTSE/JSE Capped SWIX Total Return | -1,4% | 3,2% | 16,9% | 30,3% | 6,5% | 5,0% | 10,6% | 2,7% |
| S&P 500 Total Return | -0,6% | 6,2% | 19,4% | 17,7% | 18,5% | 19,2% | 24,2% | 0,8% |
| STOXX 600 Total Return | -1,2% | 4,0% | 13,2% | 15,1% | 10,7% | 11,3% | 15,6% | -0,4% |
| Nikkei 225 Total Return | 8,5% | 8,4% | 4,4% | 10,7% | 12,0% | 14,6% | 18,2% | -7,1% |
| MSCI World Total Return | -0,1% | 5,7% | 16,8% | 17,2% | 16,2% | 16,6% | 20,7% | 0,2% |
| MSCI ACWI Total Return | 0,0% | 4,6% | 14,8% | 15,9% | 15,6% | 16,0% | 19,8% | 0,1% |
| MSCI EM Total Return | 0,1% | -2,9% | 2,0% | 7,4% | 11,3% | 11,7% | 13,4% | -0,7% |
| STEFI | 0,3% | 1,0% | 2,8% | 3,8% | 5,8% | 6,4% | 6,2% | 0,2% |
| ALBI | -2,1% | 0,4% | 5,4% | 12,5% | 9,1% | 8,5% | 8,3% | 0,3% |
| IGOV | 0,3% | 2,0% | 9,9% | 15,9% | 5,5% | 3,5% | 6,3% | 0,7% |
| WGBI | 1,9% | 4,3% | -3,1% | -12,4% | 6,0% | 3,3% | 7,6% | -4,3% |
| SAPY Total Return | -0,8% | 5,9% | 26,4% | 54,4% | -6,8% | -5,6% | 5,5% | -0,8% |
| MSCI US REIT Total Return | -1,5% | 6,6% | 26,7% | 24,2% | 12,5% | 8,9% | 18,5% | 1,4% |
| S&P Global Property Total Return | -0,8% | 4,7% | 16,4% | 15,1% | 9,3% | 7,7% | 16,3% | -0,2% |
| STOXX 600 Real Estate Total Return | -6,6% | 2,8% | 5,5% | 7,8% | 6,3% | 6,2% | 14,6% | 2,6% |
| Crude Oil | 12,1% | 10,3% | 56,1% | 73,7% | 0,4% | 12,0% | 3,7% | 4,1% |
| Aluminium | 9,6% | 19,6% | 48,7% | 46,7% | 13,9% | 13,5% | 9,6% | 4,6% |
| Copper | -2,2% | 0,6% | 18,5% | 21,3% | 15,1% | 15,1% | 9,1% | 9,1% |
| Gold | -3,1% | -0,7% | -7,4% | -6,8% | 13,8% | 6,0% | 0,8% | 0,7% |
| Platinum | -0,8% | -5,0% | -7,1% | -1,9% | 8,1% | 0,7% | 1,8% | 3,6% |
| Nickel | 0,0% | 0,0% | 0,0% | 0,0% | 0,0% | 4,2% | 1,9% | 0,0% |
| Palladium | -19,3% | -27,5% | -19,5% | -25,0% | 23,8% | 23,9% | 19,4% | 5,5% |
| Iron Ore | -18,0% | -39,8% | -18,9% | -9,3% | 24,8% | 18,1% | | -1,1% |
| USDZAR | 3,7% | 5,5% | 2,5% | -10,0% | 2,1% | 1,9% | 6,4% | -3,6% |
| GBPZAR | 1,7% | 2,8% | 1,1% | -6,2% | 3,3% | 2,7% | 4,9% | -1,3% |
| EURZAR | 1,8% | 3,0% | -2,7% | -11,0% | 2,1% | 2,5% | 4,9% | -3,2% |
| JPYZAR | 2,6% | 5,4% | -4,7% | -14,7% | 2,9% | 0,0% | 2,6% | -6,2% |

*Source: Bloomberg*

SA equity valuations based on price ratios and dividend yields continued to suggest a moderate overweight position. Sentiment was roughly flat, with the South African Chamber of Commerce and Industry Business Confidence Index declining marginally from 93.2 in July to 91 in September. The SA PMI index was also dented slightly from 57.9 in August to 56.8 in September but remained in the strong expansionary zone.

Retail sales remained subdued, down by 1.3% in August, year on year. Retail sales, however, grew by 4.9% in August, month on month. Both figures were significantly below the market expectations of 2.0% and 9.5% respectively. Total and new car sales, in contrast, continued to recover, growing by 4.1% and 8.8% respectively in September, month on month. Export and import growth were both positive year on year, gaining 22.3% and 27.7% respectively and growing by 9.7% and 8.0% respectively in August, month on month. Private credit extension remained soft but continued to make small gains, from 0.61% in July to 1.12% in August, year on year. Overall, the economic data continued to suggest that local consumer demand remains vulnerable but trade activities were strong.

We reiterate our neutral position in SA equities. While the valuation was attractive, sentiment and fundamentals remained largely unchanged. Domestic consumption remained weak and vulnerable owing to the record-high unemployment rate. Economic growth continued to be contingent on policy reforms and hampered by energy constraints. We still believe that while many emerging markets are in the early to mid-cycle in terms of economic recovery from the COVID-19 pandemic, some may be forced to start tightening their monetary policies because of inflationary pressures and the tapering actions of the developed markets' central banks.

**SA bonds**

We saw investors returning to emerging market equity and bond ETFs in the week ending 15 October. Investors poured $720.7m into US-based emerging market ETFs, ending three weeks of outflows that totalled $1.9bn. More than half the inflow went to KraneShares CSI China Internet Fund. However, that inflow came before the publishing of the Chinese data on 18 October, which showed a cooling housing market and Q3 economic growth negatively impacted by power shortages. SA equity US-listed ETFs saw an inflow of $6.3m, while bond ETFs saw a net inflow of $3.1m over the same week.

The implied vs actual yield spread narrowed slightly from 559bps on 17 September to 536bps on 15 October. The 10-year nominal yield spread over the US 10-year treasury yield showed a moderate rise, from 7.61% to 7.74% over the past month. The US dollar-hedged 10-year yield continued to offer value, but widened slightly from 3.7% to 4.0%, with the spread over the US 10-year nominal yield also increasing from 229bps to 247bps. SA nominal bonds still appeared attractive compared with Brazilian nominal bonds, based on real yield and calculated from reported inflation. Our investment case remains unchanged. While valuation is attractive, we continue to believe that the imminent US Fed tapering may exert some pressure on the hedged yield and erode the rationale for carry trade amid uncertain EM currency outlook.

**Figure 3: SA bond yields vs EM peers as at 20 October 2021**

| | South Africa | India | Indonesia | Russia | Mexico | Brazil | Turkey |
|---|---|---|---|---|---|---|---|
| **10 Year Yield** | **9,74%** | **6,39%** | **6,09%** | **7,41%** | **7,47%** | **11,52%** | **19,96%** |
| Inflation | 5,0% | 4,4% | 1,60% | 3,3% | 6,0% | 10,3% | 19,6% |
| Inflation Expectation | 4,40% | 6,20% | 1,80% | 6,10% | 5,50% | 7,90% | 17,30% |
| **10 Year Real Yield** | **4,74%** | **2,04%** | **4,49%** | **4,11%** | **1,47%** | **1,27%** | **0,38%** |
| 10 Year Real Yield based on inflation expectation | 5,34% | 0,19% | 4,29% | 1,31% | 1,97% | 3,62% | 2,66% |
| **Currency Risk Premium** | **5,10%** | **3,18%** | **2,96%** | **4,37%** | **4,17%** | **6,89%** | **13,49%** |
| **Sovereign Risk Premium** | **3,01%** | **1,58%** | **1,49%** | **1,40%** | **1,66%** | **3,00%** | **4,83%** |
| US 10 Year Yield | 1,64% | 1,64% | 1,64% | 1,64% | 1,64% | 1,64% | 1,64% |
| **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*

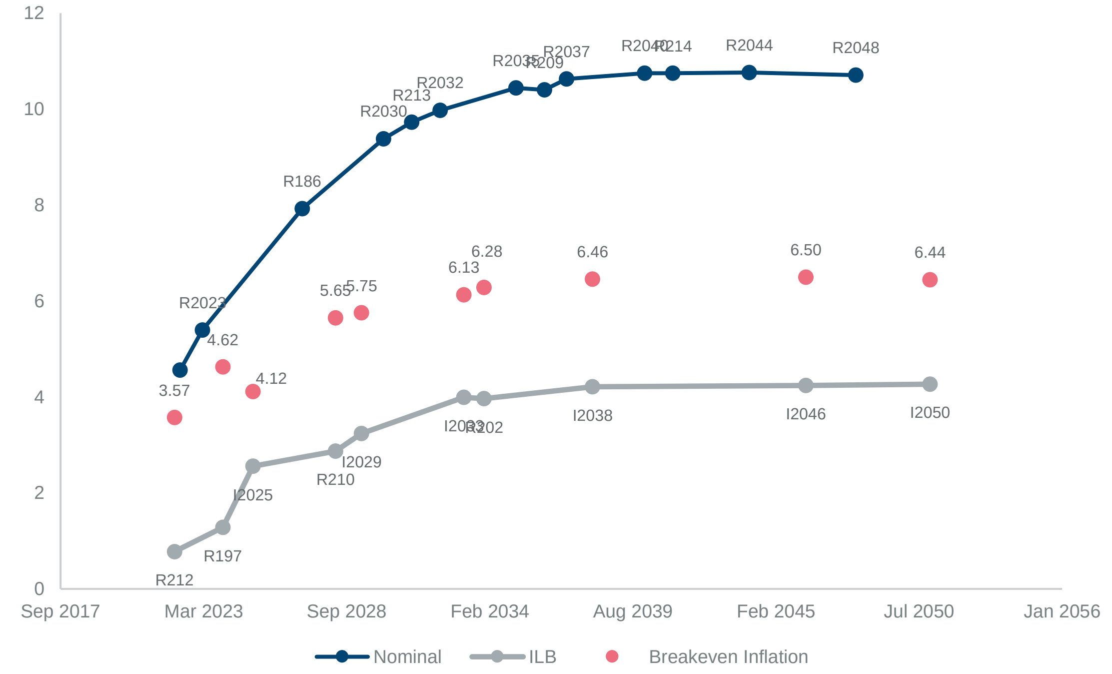
**SA inflation-linked bonds**

The IGOV Index outperformed the ALBI in September, returning 0.3% vs -2.1%; it also outperformed the latter in the third quarter, returning 2.0% vs 0.4%. Breakeven inflation declined by about 47bps on the shorter end and increased by about 12bps on the longer end of maturities, driven by near-term inflation expectations. Average breakeven inflation over all maturities increased from 5.33% to 5.55% over the past month. The spread between the 10-year nominal bond real yield and the 10-year inflation-linked bond yield widened slightly from 145bps in August to 153bps in September.

The forward rate agreement (FRA) rates indicated that the market expects interest rates to rise by around 25bps by early 2022 while also pricing in a more aggressive pace of rate hikes, where the interest rate could reach the pre-pandemic level by the second half of 2023.

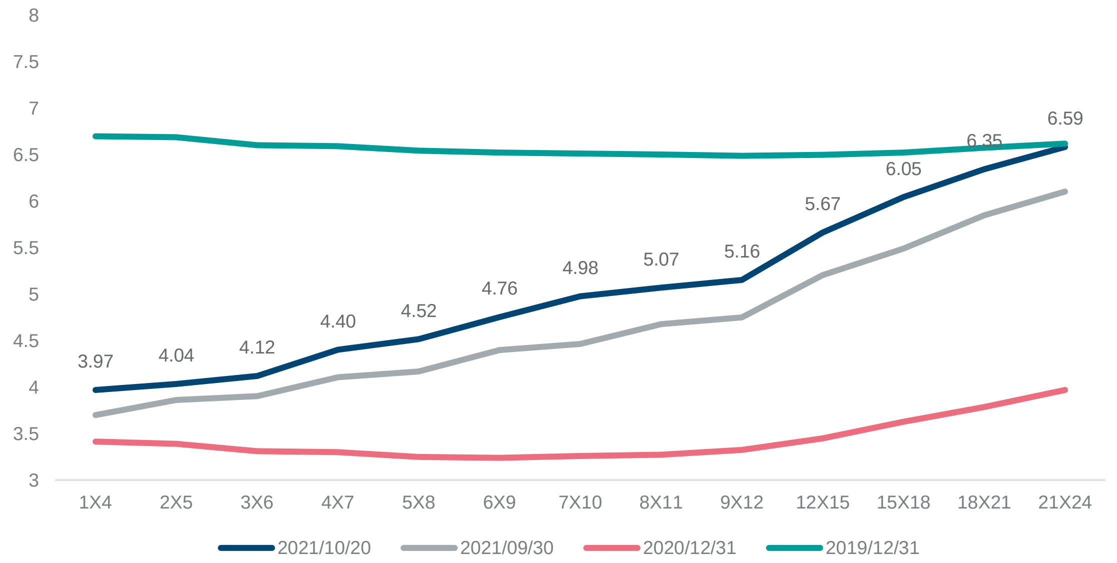
The CPI increased from 4.9% in August to 5.0% in September, year on year, with core inflation ticking up from 3.1% to 3.2% over the same period. The elevated, short-term inflation was mainly driven by higher fuel prices, with core inflation suggesting benign demand pressure in the underlying economy. While supply chain issues will eventually ease, strong global demand and a sluggish response from energy suppliers seem to suggest that even if the heightened global inflation proves to be transitory, there is an upside risk that the current level of inflation may be more persistent than previously expected. We therefore favour the ability of inflation-linked bonds to provide protection against unexpected price movements and changed our neutral stance on inflation-linked bonds to moderate overweight.

**Figure 4: SA nominal and real yields as at 20 October 2021**




*Source: Bloomberg*

**Figure 5: Forward rate agreement rates**



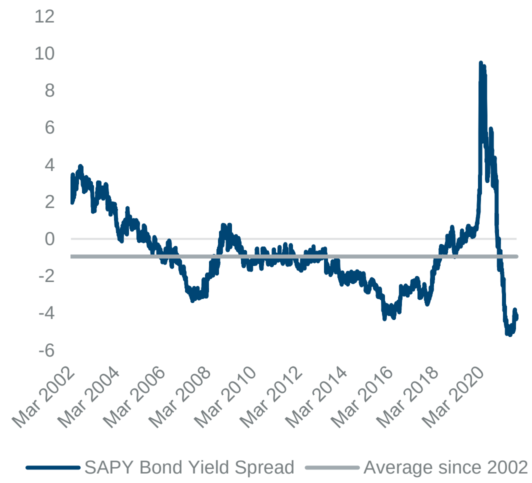

*Source: Bloomberg*

**SA-listed property**

SA-listed property returned 26.4% for the year to date, as at 30 September – one of the best-performing asset classes, driven by broadening restart optimism. The yield spread relative to SA equities and the 10-year bond remained significantly below the long-term average. The SAPY dividend yield continued to trend below its 5-year rolling average but closer to the 1-year rolling average. The price-to-tangible book value was unchanged at 0.8x in September.

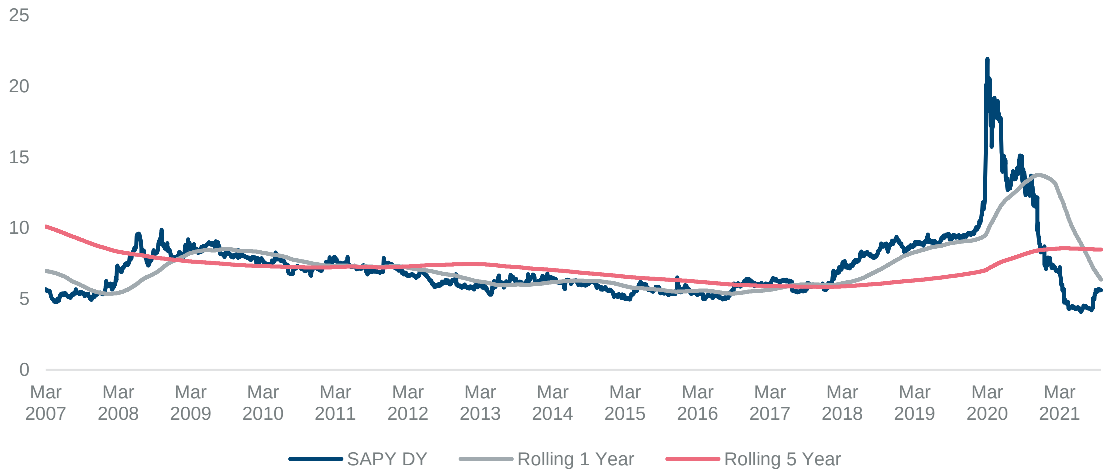
**Figure 6: SAPY yield spread relative to FTSE/JSE All Share Index**


**Figure 7: SAPY yield spread relative to 10-year bond**



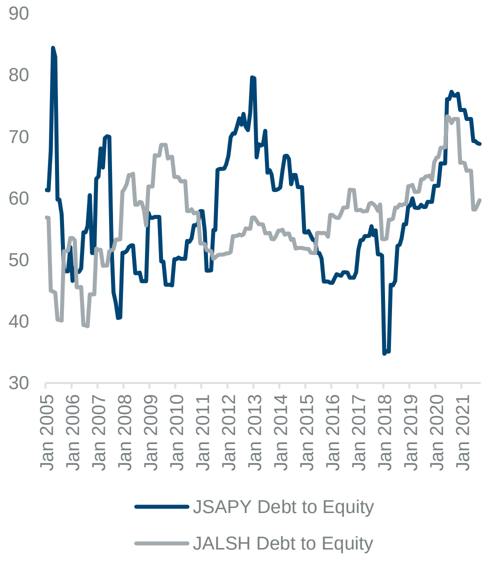
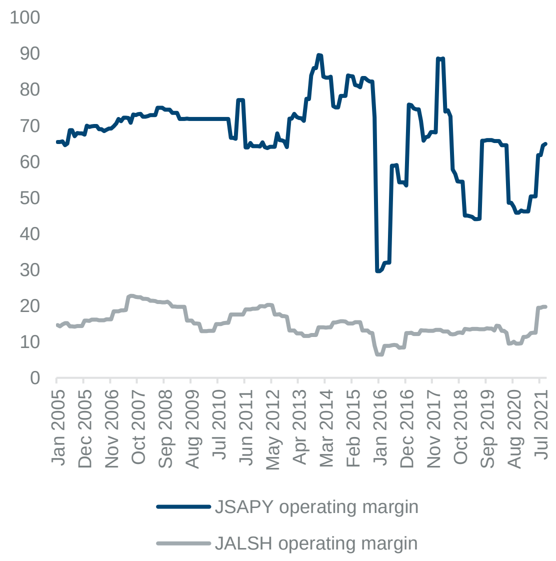
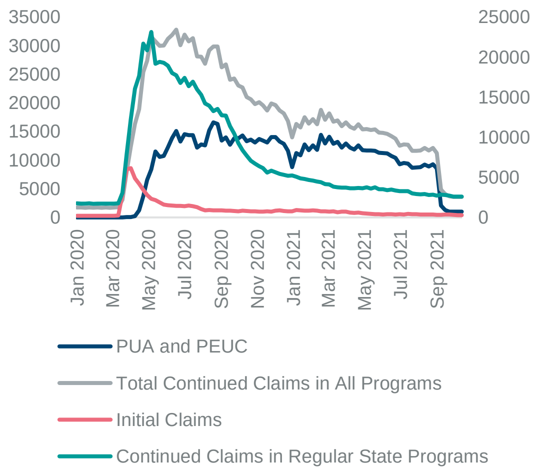
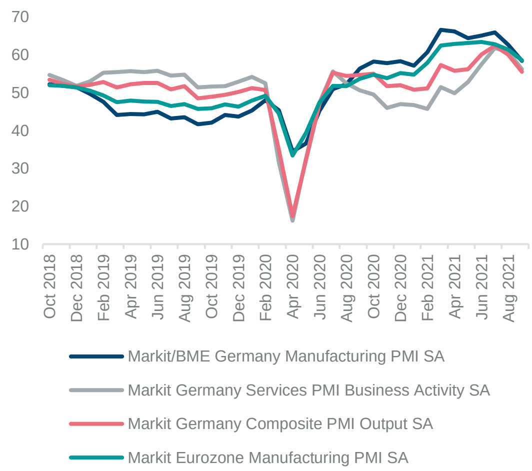

*Source: Bloomberg*

**Figure 8: SAPY yield relative to 1-year and rolling 5-year rolling averages**




*Source: Bloomberg*

Fundamentally, we have observed a persistent improvement in the debt-to-equity ratio and the operating margin of the SAPY. We moved from moderate underweight to neutral in local listed property, as fundamentals improve, despite persistent structural and secular challenges facing the local property sector. In terms of the potential contagion effect from Chinese property companies' debt crisis, we see the local property sector carrying less contagion risk than offshore property as local property companies are mostly exposed to Europe outside of the home market, with near-zero China exposure.

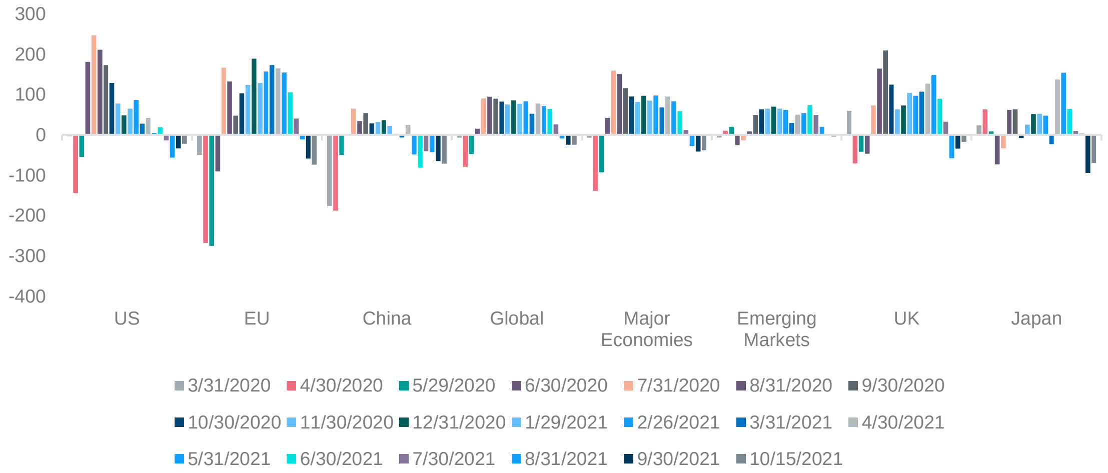
| | |
|---|---|
| | **Figure 9: SAPY debt-to-equity ratio**  **Figure 10: SAPY operating margin**  *Source: Bloomberg* |
| **Offshore equities** | Valuation scores continue to suggest moderate underweight in offshore equities, while sentiment and economics scores remained largely unchanged.<br><br>Consumer sentiment in the US was dealt a blow, most likely due to inflation eroding purchasing power. The University of Michigan Consumer Sentiment Index declined from 72.8 in September to 71.4 in October, the Conference Board Consumer Confidence Index weakened from 115.2 in August to 109.3 in September, and the Bloomberg US Weekly Consumer Comfort Index declined from 57.7 in September to 51.2 in October. US manufacturing confidence was unchanged in September, production outlook improved slightly but business activity weakened over the same period. Consumer confidence in the Eurozone continued to make small gains, improving from -5.3 in August to -4 in September, while economic sentiment was largely unchanged. Japanese consumer confidence also edged higher in September, from 36.4 in August to 37.9 in September.<br><br>**Figure 11: US jobless claims**  **Figure 12: Eurozone and Germany PMIs**  *Source: Bloomberg* |

US retail sales were up 0.7% in September, month on month, weakening from 2.0% in August. Trade data was positive, with exports gaining 0.5% in August, month on month, and imports growing by 1.4% over the same period. Labour market conditions remain challenging as the US job market has struggled to align supply and demand. Jobless claims have fallen to new lows with pandemic benefits expiring and employers trying to fill vacancies.

Eurozone manufacturing PMI and Germany PMI numbers dropped in September but remained in the expansionary zone. Virus dynamics have improved in Japan, and we expect activity to continue to pick up in the region.

We saw the economic surprise indices remain in negative territory, as reported economic figures fell short of market expectations on average. The Bloomberg CFTC CME E-Mini S&P 500 net commercial futures positions ended in short positions by 12 October, but non-commercial futures positions turned net long, suggesting that speculators have turned slightly more bullish.

**Figure 13: Economic surprise indices**




*Source: Bloomberg*

We reiterate our moderate overweight position in offshore equities. The Fed stated that it would slow down asset purchases by as early as November this year, while expecting its interest rate to increase to 1.75% by mid-2024. The BOE also turned hawkish, saying it could raise its interest rate before the year end. The ECB's tone is less hawkish, suggesting it would reduce the pace of asset purchases, but – unlike the Fed – not yet consider slowing it to zero. While most central banks are suggesting that rate hikes are on the cards due to inflationary pressures, most still see the current level of price appreciation to be transitory. Since the main driver of the current inflation is supply-side constraints, using the interest rate (which is a demand-side monetary policy tool) may lead to unintended consequences, such as putting the global economic recovery at risk. We therefore believe that rate hikes are more likely to take place after central banks end their respective quantitative easing programs.

We also favour offshore equities, given the strong earnings numbers and improving return-on-equity ratios, despite the possibility of the growth rate moderating after the strong rebound in previous quarters. Some sectors may be more exposed to energy price hikes, such as materials and heavy industrials, but materials and industrials accounted for only 4.1% and 10.3% respectively in the MSCI World Index. The downside risk is that the northern hemisphere is approaching the winter season and another wave of COVID-19 may slow down growth. However, the upside risk is that strong consumer savings accumulated during the pandemic may lead to strong demand while a strong capex cycle should also boost consumption.

**Figure 14: STOXX 600 PE ratio vs ROE**

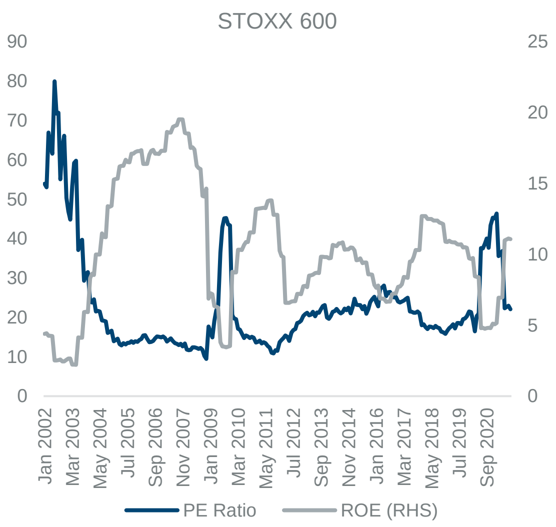



**Figure 15: NIKKEI 225 PE ratio vs ROE**

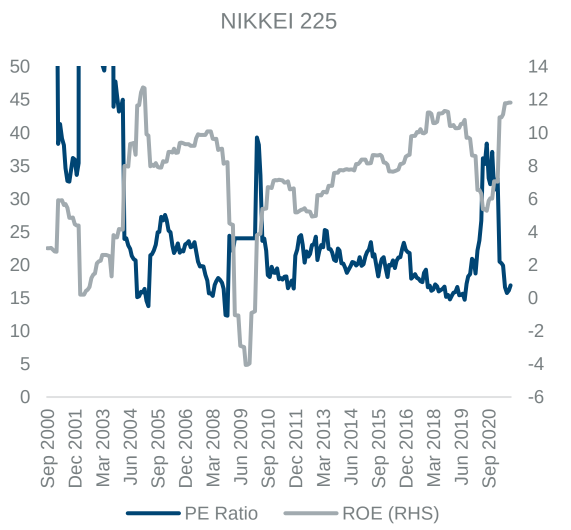
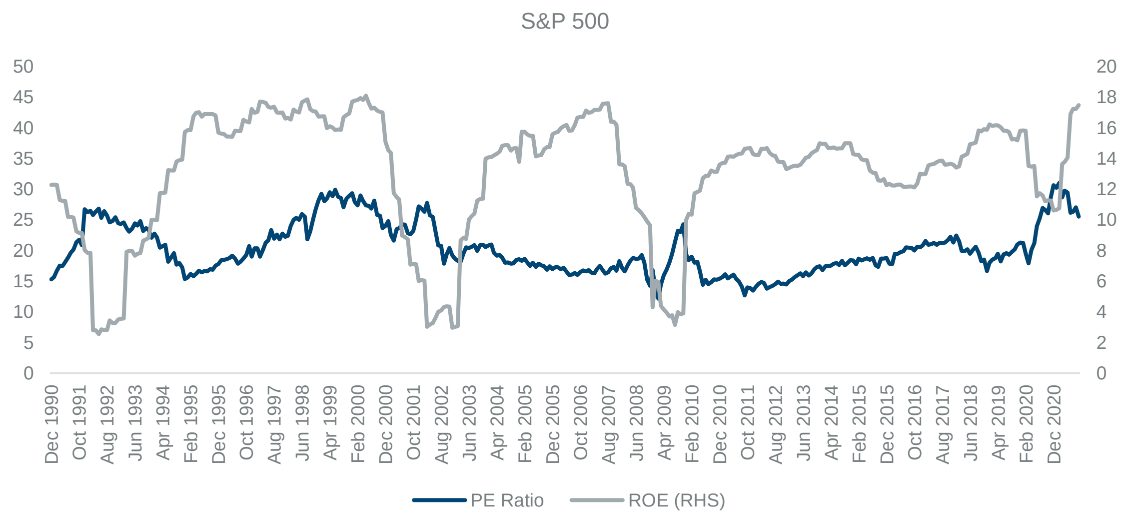


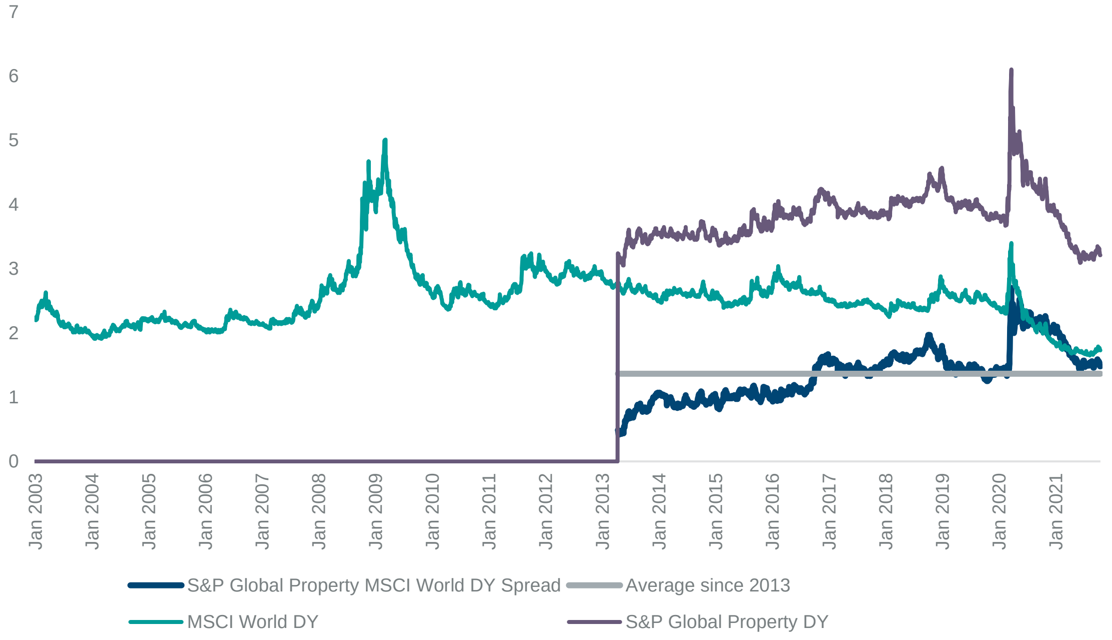

**Figure 16: S&P 500 PE ratio vs ROE**




*Source: Bloomberg*

**Offshore bonds**

We remain moderately underweight in offshore bonds as hawkish central bank policy stances and high inflation do not bode well for this asset class. Even if central banks start to raise interest rates earlier than expected, the real interest rate will remain negative. The balance of risk for gradually higher yields, expectations of ongoing earnings growth in the coming years and easy monetary policy (relative to its own history) should, overall, support pro-risk asset allocation.

| Offshore property | Valuation of global property was largely unchanged over the past month, with price-to-tangible book value decreasing slightly from 1.48x to 1.42x, while return on equity was flat at 5.74%.<br><br>**Figure 17: S&P Global Property dividend yield spread relative to the MSCI World Index**<br><br><br><br>*Source: Bloomberg*<br><br>The spread between the S&P Global Property yield and that of the MSCI World Index and the 10-year US treasury yield stood at long-term average levels respectively. We therefore choose to stay neutral in offshore property. |
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