MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

17 March 2022

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We have decided to maintain our TAA positions across most asset classes, with the exception of moving further into an overweight position in foreign cash, with SA 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 prior positions across most asset classes over the past month. We continue to prefer SA inflation-linked bonds for inflation protection amid elevated near-term pricing pressure. We also prefer local nominal bonds over offshore developed market government bonds from an implied yield, real yield and hedged yield perspective. In addition, we prefer foreign equity over foreign bonds as we move into the interest rate hiking cycle with low real rates and strong growth. We remain neutral in local equities and local properties amid less supportive liquidity conditions for EM risk assets.

TAA Overview

Escalating global inflationary pressures ramped up expectations of a series of interest rate hikes by major central banks, such as the US Federal Reserve, the Bank of England and the European Central Bank, during February. Investors had become increasingly concerned that the tightening of monetary policies to rein in inflation may dampen global economic growth. The conflict in Ukraine delivered a further blow to growth expectations in the second half of February. While the outcome of the Russia–Ukraine conflict remains largely uncertain at the stage, the most obvious economic impact so far is soaring energy and food prices, which have rattled the stock markets across the world.

The S&P 500 Index and the STOXX 600 Index were down 3.0% and 3.2% respectively in local currencies for the month of February. Nikkei 225 Index did slightly better, returning -1.7%. Both the MSCI World and the MSCI Emerging Markets indices ended in the red, returning -2.5% and -3.0% in USD terms. The ALSI and the Capped SWIX indices returned 2.9% and 2.7% in ZAR terms. The gains were driven by resources and financials, up 16.1% and 3.6% respectively, despite industrials plummeting by 7.73% over the same period. Global equity markets continued to slip into March. The MSCI Emerging Markets Index returned -12.2% for the month to date as at 15 March, with the MSCI China Index down 48.4% over the same period – prompted by investors growing concerned about the escalating tensions between China and the US, with the latter warning China against providing military or financial support to Russia, and also the economic impact of renewed lockdowns in major cities such as Shanghai as the country persisted with its zero-Covid policy. China now accounts for c.32% of the MSCI Emerging Markets Index. The MSCI China Index recouped some losses, returning -38.4% for the month to date as at 21

SA equities

March, after China's State Council pledged to support its financial markets. The ALSI Index was down 7.1% for the month to date as at 15 March with only the FINI15 in positive territory, up 1.44%, while the RESI20 Index fell on the back of lower commodity prices, returning -7.2%. Meanwhile, the INDI25 Index extended its loss, returning -11.76% over the same period. Naspers and Prosus continued to take pain as Tencent faced a record fine after the People's Bank of China discovered that its payment platform was violating anti-money-laundering rules, exacerbating an already challenging regulatory environment since the tightening of online gaming restrictions over recent years.

The ZAR was roughly flat in February but strengthened by 1.7% against the USD as higher commodity prices and suppressed import demand boosted the country's current account balance in Q4 2021. The oil price continued to climb into March, reaching USD128/barrel on 8 March before declining to USD100/barrel on 15 March, and remained volatile as the Russia-Ukraine conflict escalated and retaliatory sanctions were imposed.

Local bonds outperformed offshore bonds in February and for the month to date as at 15 March, with selloff continuing into March as central banks across the globe turned more hawkish in the face of high inflation.

Figure 2: Major indices and asset class returns in local currency

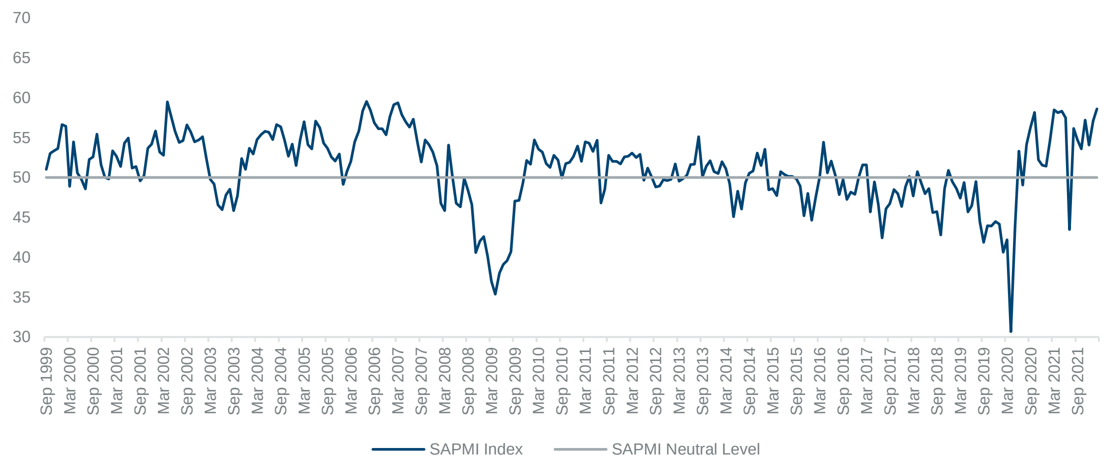
28 February 2022 (Local Currency)	1M	3M	YTD	1 Year	3 Year (annualised)	5 Year (annualised)	10 Year (annualised)	MTD 15 March 2022
FTSE/JSE ALSI Total Return	2.9%	8.8%	3.8%	20.5%	14.8%	12.0%	11.8%	-7.1%
FTSE/JSE Capped SWIX Total Return	2.7%	10.2%	5.1%	23.1%	11.3%	8.1%	10.4%	-5.2%
S&P 500 Total Return	-3.0%	-3.9%	-8.0%	16.4%	18.2%	15.2%	14.6%	-2.5%
STOXX 600 Total Return	-3.2%	-1.9%	-7.0%	14.3%	9.3%	6.8%	8.4%	-3.8%
Nikkei 225 Total Return	-1.7%	-4.5%	-7.8%	-6.9%	9.5%	8.8%	12.7%	-4.4%
MSCI World Total Return	-2.5%	-3.7%	-7.6%	11.2%	15.0%	12.6%	11.3%	-3.7%
MSCI ACWI Total Return	-2.6%	-3.6%	-7.3%	8.3%	14.0%	12.0%	10.4%	-4.6%
MSCI EM Total Return	-3.0%	-3.0%	-4.8%	-10.4%	6.4%	7.4%	3.6%	-12.2%
STEFI	0.3%	1.0%	0.7%	3.9%	5.3%	6.1%	6.1%	0.2%
ALBI	0.5%	4.1%	1.4%	9.0%	8.7%	8.9%	8.1%	-1.5%
IGOV	2.1%	5.7%	1.0%	12.2%	7.1%	4.6%	6.3%	-0.1%
WGBI	-1.1%	-3.7%	-3.1%	-6.5%	1.5%	2.0%	0.6%	-2.9%
SAPY Total Return	-3.3%	1.4%	-6.0%	22.4%	-5.8%	-5.8%	4.7%	-4.0%
MSCI US REIT Total Return	-3.2%	-2.0%	-9.9%	23.7%	10.0%	7.8%	9.6%	1.2%
S&P Global Property Total Return	-2.3%	-1.7%	-7.2%	11.1%	5.7%	6.1%	7.3%	-1.7%
STOXX 600 Real Estate Total Return	-2.8%	-5.1%	-6.5%	16.4%	5.4%	4.5%	8.6%	-1.6%
Crude Oil	10.7%	43.1%	29.8%	52.7%	15.2%	12.7%	-1.9%	-1.1%
Aluminium	11.5%	28.3%	20.0%	56.3%	20.8%	11.9%	3.8%	-2.7%
Copper	4.0%	4.7%	1.7%	8.9%	14.9%	10.6%	1.5%	0.2%
Gold	6.2%	7.6%	4.4%	10.1%	13.3%	8.9%	1.2%	0.5%
Platinum	2.5%	11.5%	8.1%	-12.2%	6.3%	0.4%	-4.6%	-5.6%
Nickel	0.0%	0.0%	0.0%	0.0%	-3.8%	2.6%	-1.6%	0.0%
Palladium	5.8%	43.1%	30.9%	7.1%	17.3%	26.5%	13.5%	-2.5%
Iron Ore	-4.7%	33.8%	10.7%	-23.7%	15.7%	6.4%	-1.1%	1.4%
USDZAR	-0.1%	-3.2%	-3.5%	1.7%	3.0%	3.2%	7.4%	-1.7%
GBPZAR	-0.3%	-2.3%	-4.4%	-1.9%	3.4%	4.9%	5.6%	-4.5%
EURZAR	-0.2%	-4.2%	-4.8%	-5.4%	2.5%	4.4%	5.6%	-4.0%
JPYZAR	-0.1%	-4.8%	-3.5%	-5.8%	1.9%	2.8%	3.7%	-4.5%

Source: Bloomberg

The SA Manufacturing PMI rose further from 57.1 in January to 58.6 in February, driven by improvements in business activity, inventories, new sales and employment. Local consumption continued to hold up well as the ripple effects of the Russia–Ukraine conflict were not yet reflected in domestic statistics. Total car sales were up 22.4% year on year and 6.9% month on month, while new car sales were up 18.4% compared to a year ago, which was down slightly compared to January.

Naamsa has expressed concerns that the geopolitical risk may expose the global auto industry to further supply chain-related disruptions, in addition to causing shortages of semi-conductors. While high commodity prices have supported the rand so far, elevated oil and food prices, and potentially more aggressive rate hikes by the SARB, will hurt domestic growth and consumption as the South African economy attempts to recover from the impact of Covid-19 and overcome other structural and macroeconomic hurdles. We remain neutral on SA equities amid less supportive liquidity conditions as central banks tighten their monetary policies to tame elevated inflation.

Figure 3: SA Manufacturing PMI to 28 February 2022

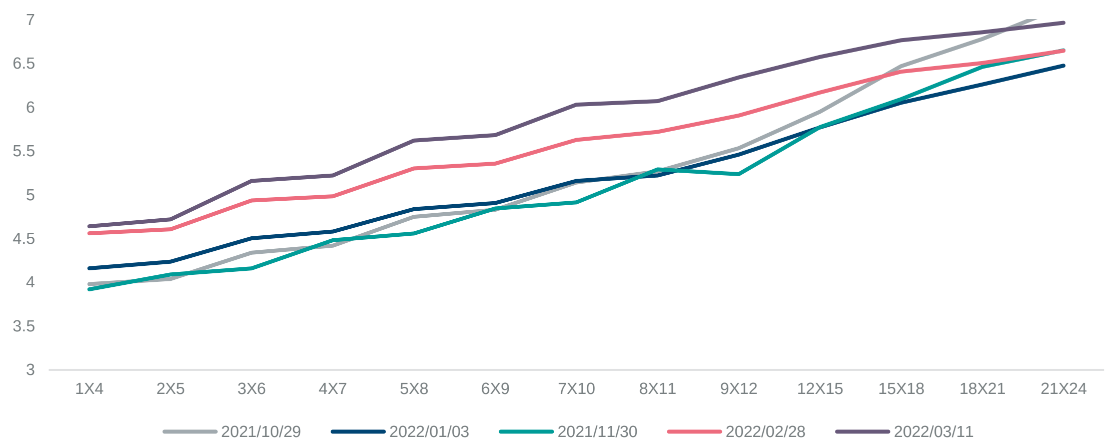


Source: Bloomberg

SA bonds

While local bonds have outperformed offshore bonds so far this year, we still saw a net outflow of this asset class from offshore investors. For the year to date as at 15 March, foreign investors net sold c.USD5bn-worth of local bonds and net bought c.USD1.5bn-worth of local equities. The market survey according to Bloomberg shows that consensus expects the SARB to increase its rate by 25bps on 24 March, while the FRA rates showed that the market expects the repo rate to rise from its current 4.0% to 6.6% in 12 months' time.

Figure 4: SA FRA rates



Source: Bloomberg

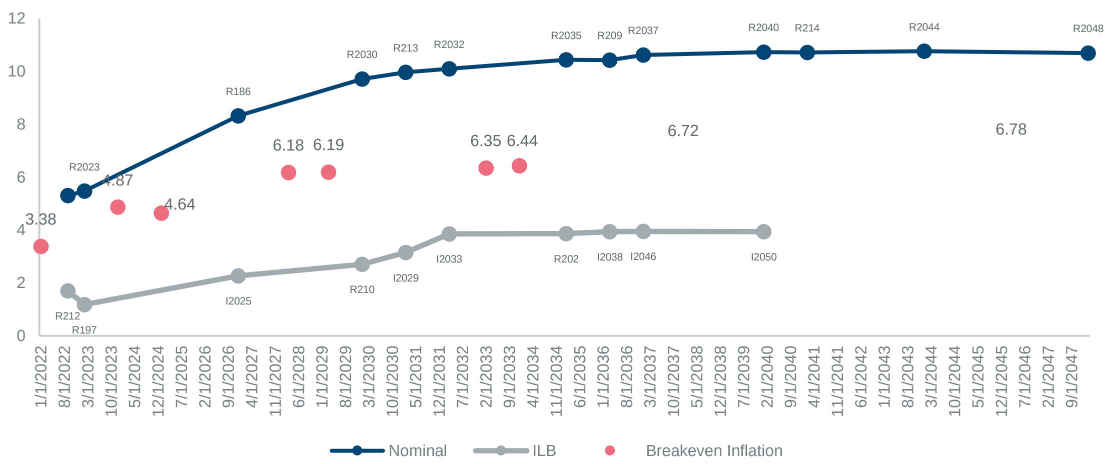
While SA bonds continue to be attractive from an implied yield and a hedged yield perspective, and to offer good value on a real-yield basis compared to other emerging-market nominal bonds as well as cash, we still expect that SA bonds could come under some pressure from elevated global inflation, rising interest rates and the uncertainty surrounding a potential Russian debt crisis. We have thus chosen to remain neutral in local bonds.

SA inflation-linked bonds

The headline and core CPI reached 5.7% and 3.5% respectively year on year for January, with Bloomberg showing the median expectation for February headline and core inflation to tick up to 5.8% and 3.6% respectively. Essential expenditures such as food, transportation and housing have continued to increase their contribution to the overall inflation figure since the second half of 2021, suggesting that underlying inflationary pressures are continuing to build.

The persistent upside inflationary risks stemming from ongoing supply-chain disruptions, the elevated oil price and currency volatility are likely to result in short-term inflation to surpass that of the short-term breakeven inflation. We therefore favour inflation-linked bonds for their embedded inflation protection in the current environment. We have therefore chosen to maintain our moderate overweight position in inflation-linked bonds.

Figure 5: SA breakeven inflation as at 11 March 2022



Source: Bloomberg

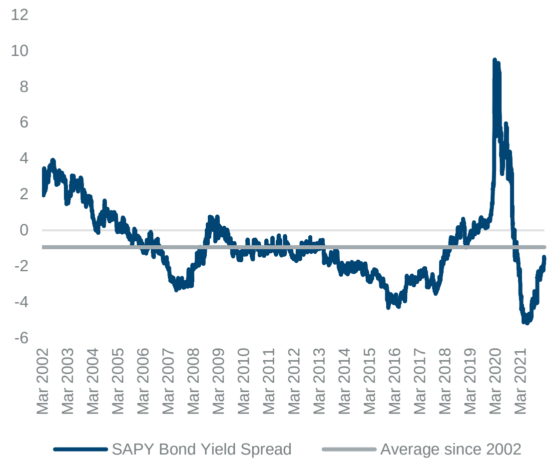
SA-listed property

The SAPY dividend yield continued to climb in February and into March as local listed property companies followed in the footsteps of their offshore counterparts, falling by nearly 7.0% since the beginning of February amid expectations of tightening of global monetary policies to combat inflation and tanking risk appetites due to escalating Russia–Ukraine tensions – especially affecting listed properties with direct or indirect exposures to Europe. The yield spreads between the SAPY and the ALSI and the SAPY and the 10-year bond yield suggest a neutral to moderate overweight position in this sector from a valuation perspective.

However, our investment case for the local property market remains unchanged as we expect it will face structural challenges on top of the interest rate hiking cycle and geopolitical uncertainty as well as issues in other property markets, such as the Evergrande debt crisis, thus dampening risk appetite for this asset class in the foreseeable future.

Figure 6: SAPY yield spread vs ALSI

Figure 7: SAPY yield spread vs 10-year bonds



Source: Bloomberg

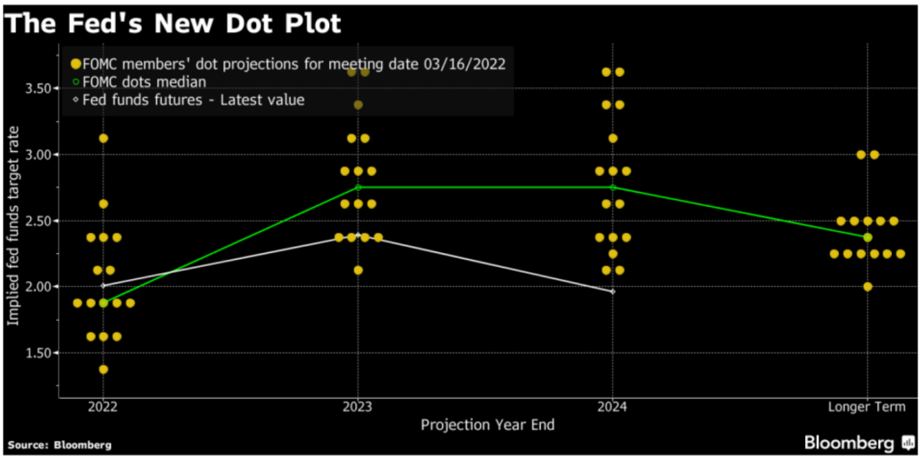
Offshore equities

February inflation in the US reached 7.9%, with underlying inflationary pressures continuing to build as both core goods and core services inflation increased their contribution to the headline inflation figure. March and April inflation figures will most likely rise further with the significant energy bill coming into effect. January retail sales in the US grew 3.8% month on month, beating the market expectation of 2.6% and signalling a strong rebound after Omicron delayed consumer spending. Meanwhile, February retail sales grew by 0.3%, roughly in line with the market expectation of 0.4%.

The US labour market has been tight, with initial and continuing claims continuing to decline and beat market expectations. The February unemployment rate declined to 3.8%, similarly outperforming the market expectation of 3.9%. In addition, US private-sector hourly wages rose by 5.5% and 5.1% in January and February respectively, year on year. The US housing market remained solid, as suggested by the (consensus-defying) number of mortgage loan applications, housing starts, building permits and existing home sales. The S&P 500 operating margin reached 16.1% for Q1 2022, the highest level since 1990.

High inflation and strong job gains prompted the US Federal Reserve to raise the benchmark rate by 25bps, as the market expected, at its March FOMC meeting. It also signalled six more increases for the remainder of this year, forecasting that the interest rate will reach 1.9% by the end of this year and 2.8% by December next year. While the Fed believes that the solid fundamentals indicate that the US economy is strong enough to weather the rate-hiking cycle, it did note that the current highly uncertain Russia–Ukraine conflict may create short-term upward inflation pressure which will weigh on the US economy.

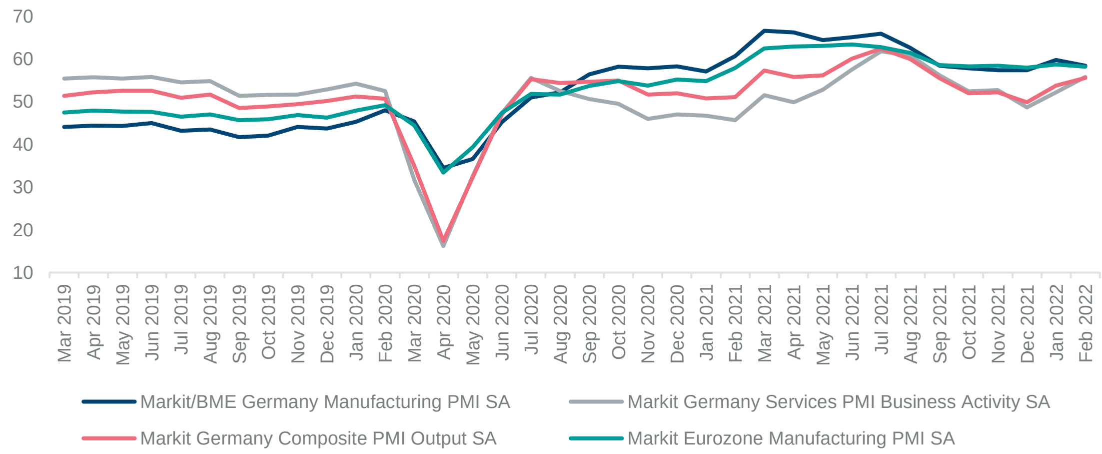
Figure 8: The Fed's dot plot



Source: Bloomberg

The Global Composite and Manufacturing PMI continued into the strong expansionary zone, with demand-driven supply-chain issues starting to show some signs of improvement. However, higher energy costs are a supply-related shock that cannot be ignored. The early 2022 selloff is making valuations more reasonable, creating an opportunity for long-term investors amid low real rates and strong earnings growth. We prefer offshore equities to offshore bonds as yields rise. We are also still of the view that risk sentiment will remain highly sensitive to any adverse developments impacting the policy environment, the corporate earnings outlook and geopolitics. In times of uncertainty, we prefer to take more moderately sized, relative risk positions, and therefore choose to remain neutral in offshore equities with an underweight position in offshore bonds.

Figure 9: Eurozone and Germany PMI



Source: Bloomberg

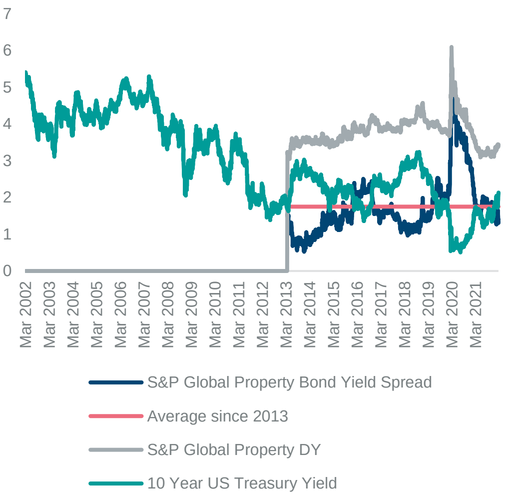
Offshore bonds

At this stage, as yields rise, we prefer inflation-linked fixed income assets for interest rate exposure and risk diversification. While yield movements in the short term may be overdone, higher inflation and increasing-term premiums demanded by investors over the longer term do not bode well for the investment outlook of developed-market government bonds. Developing-market debt may be more attractive from a valuation and income perspective, but we have exposures via our local bonds. We thus choose to remain moderately underweight in offshore bonds.

Offshore property	Valuation of global property weakened further, with price-to-tangible book value decreasing slightly from 1.45x to 1.4x over the past month, while return on equity rose from 7.7% at the end of January to 8.8% over the same period.

Figure 10: S&P Global Property dividend yield spread relative to the MSCI World Index

Figure 11: S&P Global Property dividend yield spread relative to the US 10-year treasury yield



Source: Bloomberg

The spread between the S&P Global Property yield and that of the MSCI World Index and the 10-year US treasury yield remains near long-term average levels, respectively. We therefore choose to stay neutral in offshore property.

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