MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

19 May 2022

HOUSEVIEW TACTICAL ASSET ALLOCATION

We have decided to maintain the majority of our TAA positions across most asset classes, except for moving from a moderate overweight position to a neutral position in SA inflation-linked bonds, moving from neutral to a moderate underweight position in SA-listed property and increasing our active weight in offshore 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, except for SA inflation-linked bonds and SA-listed property. We prefer SA nominal bonds over SA inflation-linked bonds for inflation compensation, and the breakeven inflations implied by the inflation-linked bonds suggest this asset class is fully valued. While SA nominal bonds continue to be attractive from an implied yield and a hedged yield perspective, while also offering good value on a real-yield basis compared to other emerging-market nominal bonds as well as local inflation-linked bonds and cash, we still expect that SA bonds could come under some pressure amid subdued risk sentiment. We have thus chosen to remain neutral in local nominal bonds and reduce our overweight in inflation-linked bonds to neutral.

In view of China's deteriorating macro outlook, growing inflation pressures and tighter monetary policies in developed markets and emerging markets, on top of domestic growth constraints, we are happy to stay neutral in SA equities as we continue to see risk skewing to the downside. Given the leverage inherent in the property sector and the fact that both local listed property and offshore listed property remain vulnerable to prevailing geopolitical uncertainty, we have chosen to be moderately underweight in both local and offshore property, in a balancing act to reduce risk in the overall portfolio. Offshore bond yields have surged but may move higher as investors demand a higher-term premium for holding longer maturity bonds. We continue to prefer offshore equities to offshore bonds as yields have risen and equity valuations have moved to offer better entry points. However, we have chosen to remain neutral in offshore equities as we continue to believe that the risk sentiment will remain highly sensitive to any adverse developments impacting the policy environment, the corporate earnings outlook and geopolitics. Our overweight position in offshore cash is more of a step to keep our offshore exposure neutral than an active bet on the currency movements.

TAA Overview

Global equities continued to decline in April and into May as the prospects of substantially tighter US monetary policy, lockdowns in China and the war in Ukraine weighed on investor sentiment. The S&P 500 tanked by 8.7% in April, while the MSCI World Index and the MSCI Emerging Market Index fell by 8.3% and 5.5% respectively over the same period. The same indices continued to slump by roughly another 5.0% for the month to date, as at 18 May 2022. The Rand weakened by 8.1% and 1.5% in April and May (for the month to date) respectively, helping to cushion offshore asset class losses over the period. From a style perspective, US growth stocks fell the most, down 16.7%, with low volatility and value (and to a lesser extent momentum) stocks outperforming the S&P 500 Index for the quarter to date, as at 16 May 2022, as investors reduce their risk exposures and expect these styles to perform relatively better over the interest rate hiking cycle. For SA equities, low volatility and momentum outperformed the ALSI.

Fixed income also remained under pressure, with the World Government Bond Index (WGBI) down 5.9% in April, having fallen by 12.0% over the first four months of this year, and declining by 0.4% in May (for the month to date). SA inflation-linked bonds (IGOV) outperformed nominal bonds (ALBI) for the year to date, as at 30 April 2022. Selloff in property stocks continued into May, while the MSCI US REIT Total Return Index and the S&P Global Property Total Return Index fell by 9.7% and 7.0% respectively in May – again indicating that investors are avoiding interest rate-sensitive sectors amid the early stages of a rate hiking cycle. From the forward rate agreements, we can see that markets have priced the rate to reach 1.0% and 3.0% in the UK and US by year end and the Eurozone rates to move into positive territory as early as Q3. While the FRA rate curves were flattened in the US and EU, the SA FRA rate implied that the market expects a slightly faster pace of hikes compared to a month ago. Following our monthly TAA meeting, the South African Reserve Bank hiked the repo rate by 50bps, taking it to 4.75%, in line with expectations, according to the Bloomberg survey of economists. Dollar strengthening and growth concerns also hurt some industrial metals' performance over the past month.

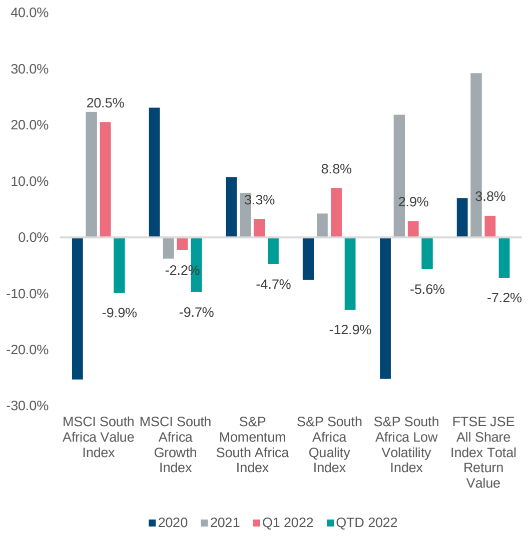
Figure 2: Major indices and asset class returns in local currency

30 April 2022 (Local Currency)	1M	3M	YTD	1 Year	3 Year (annualised)	5 Year (annualised)	10 Year (annualised)	MTD 18 May 2022
FTSE/JSE ALSI Total Return	-3.7%	-0.8%	0.0%	13.2%	11.3%	9.8%	11.2%	-4.5%
FTSE/JSE Capped SWIX Total Return	-3.9%	0.1%	2.5%	14.7%	8.6%	6.5%	9.8%	-3.7%
S&P 500 Total Return	-8.7%	-8.2%	-12.9%	0.2%	13.8%	13.7%	13.7%	-4.9%
STOXX 600 Total Return	-0.7%	-3.0%	-6.7%	5.4%	7.3%	5.7%	8.6%	-3.2%
Nikkei 225 Total Return	-3.5%	0.3%	-5.9%	-5.0%	8.5%	9.0%	13.0%	0.2%
MSCI World Total Return	-8.3%	-8.0%	-12.9%	-3.1%	11.0%	10.7%	10.6%	-4.5%
MSCI ACWI Total Return	-8.0%	-8.3%	-12.8%	-5.0%	9.9%	10.0%	9.8%	-4.4%
MSCI EM Total Return	-5.5%	-10.4%	-12.1%	-18.1%	2.6%	4.7%	3.3%	-3.9%
STEFI	0.4%	1.0%	1.4%	4.0%	5.1%	6.0%	6.1%	0.2%
ALBI	-1.7%	-0.7%	0.2%	8.4%	7.6%	8.2%	7.8%	0.1%
IGOV	2.0%	3.4%	2.2%	11.7%	6.6%	5.1%	6.2%	-0.8%
WGBI	-5.9%	-10.1%	-12.0%	-14.2%	-1.9%	-0.2%	-0.4%	-0.4%
SAPY Total Return	-1.4%	0.2%	-2.7%	12.2%	-5.3%	-5.2%	4.5%	-3.4%
MSCI US REIT Total Return	-4.5%	-1.5%	-8.3%	11.6%	9.6%	8.6%	8.9%	-9.7%
S&P Global Property Total Return	-5.1%	-3.4%	-8.3%	1.4%	4.3%	5.7%	6.9%	-7.0%
STOXX 600 Real Estate Total Return	-6.0%	-8.4%	-11.9%	0.7%	2.1%	2.5%	7.5%	-5.4%
Crude Oil	1.3%	19.9%	40.6%	62.6%	14.5%	16.1%	-0.9%	-0.2%
Aluminium	-12.6%	1.0%	8.7%	27.3%	19.3%	9.8%	3.7%	-6.4%
Copper	-5.8%	2.8%	0.5%	-0.6%	15.1%	11.2%	1.5%	-5.5%
Gold	-2.1%	5.6%	3.7%	7.2%	13.9%	8.4%	1.3%	-4.2%
Platinum	-4.8%	-8.1%	-3.0%	-21.9%	1.9%	-0.1%	-5.0%	-0.1%
Nickel	0.0%	0.0%	0.0%	0.0%	-1.4%	6.3%	-1.2%	0.0%
Palladium	2.6%	-1.2%	22.2%	-20.9%	18.8%	23.0%	13.0%	-13.3%
Iron Ore	-6.2%	0.8%	17.1%	-27.5%	14.9%	15.3%	-0.8%	-6.0%
USDZAR	8.1%	2.6%	-0.9%	8.9%	3.4%	3.4%	7.3%	1.5%
GBPZAR	3.5%	-3.9%	-7.9%	-0.8%	2.2%	2.8%	4.6%	-0.2%
EURZAR	3.1%	-3.5%	-8.0%	-4.2%	1.3%	2.7%	4.9%	1.0%
JPYZAR	1.4%	-8.9%	-12.1%	-8.1%	-1.7%	0.3%	2.3%	2.9%

Source: Bloomberg

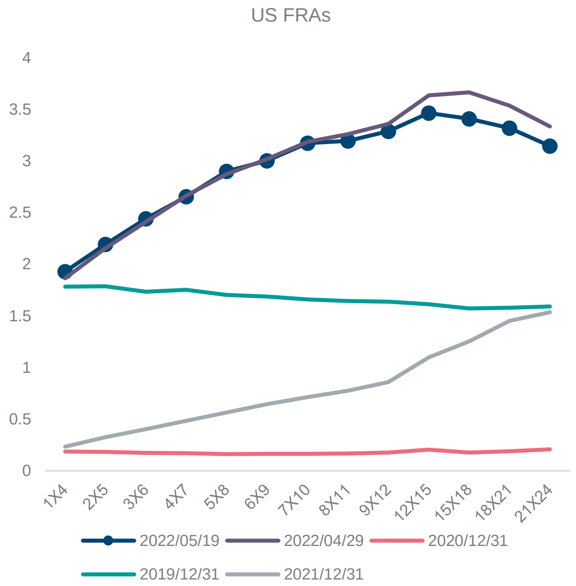
SA equities

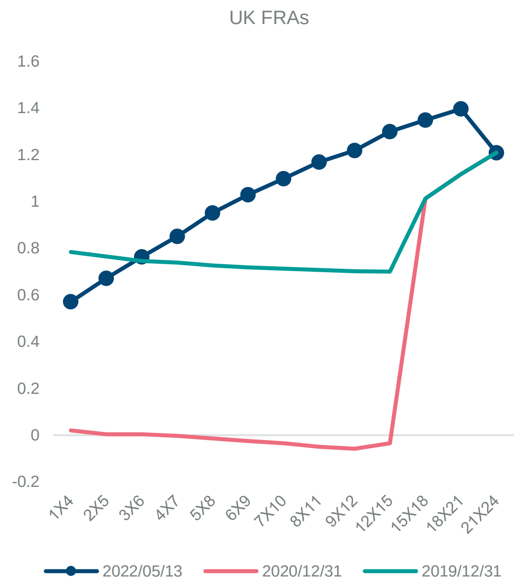
Figure 3: US and SA style indices performance in local currency

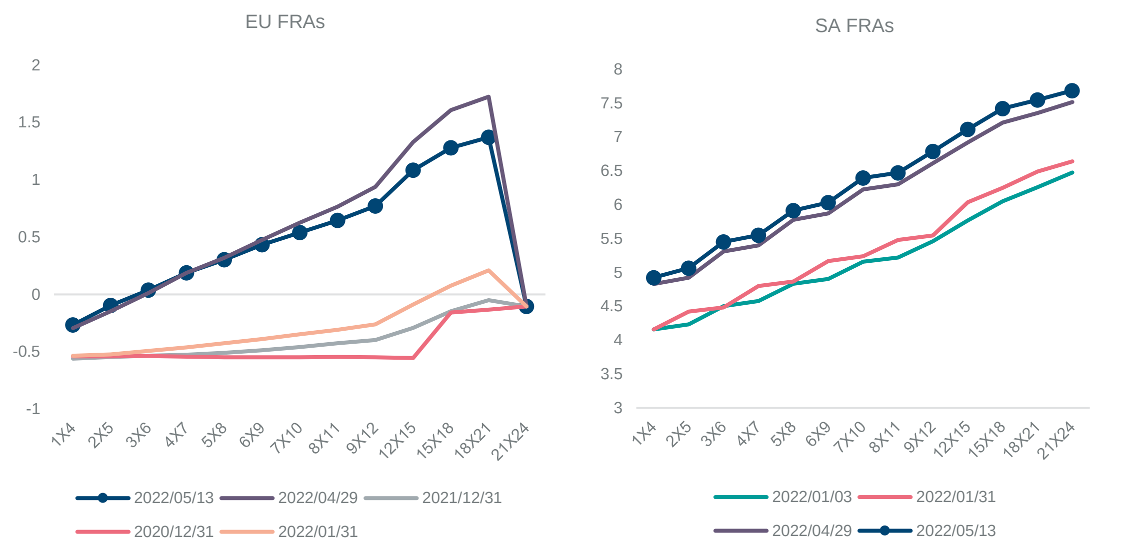


Source: Bloomberg

Figure 4: FRA rates





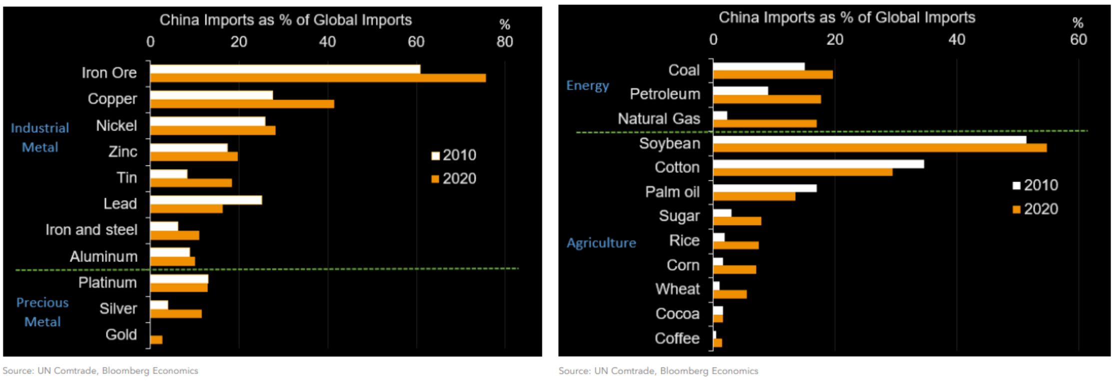


Source: Bloomberg

Fundamentally, SA's macroeconomic data was mixed. Retail spending turned positive, rising by 1.3% in March from -0.9% in February YoY, but continued to weaken month on month, roughly in line with market expectations. Residential building plans slowed but non-residential building plans continued to recover. Manufacturing production improved month on month in March but less than market expectations. The PMI plunged sharply from 60 in March to 50.7 in April; except for employment, all sub-indices declined with business activity falling the most. Exports for March were up 30.9% and 10.6% month on month and year on year respectively. Car sales growth was positive year on year but weakened month on month in April. Credit extensions also continued to pick up in March. Economic surprise indices were positive for most major economies in April, except for Japan, suggesting that while there is some deterioration in macroeconomic data, market expectations were certainly overly pessimistic.

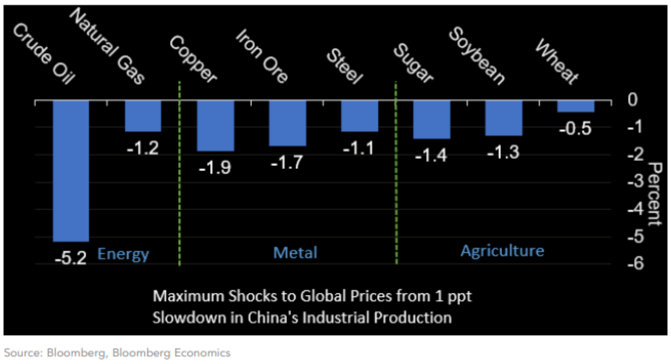
We mentioned in our TAA last month that, so far, the spill-over from the Russia–Ukraine conflict has had a net positive effect on South Africa as higher export commodity prices have translated into favourable terms of trade, while higher mining revenue has offset some of the economic hit to domestic growth. The lockdowns in China will exacerbate global supply chain problems, despite monetary and fiscal policy helping to offset some of the impact (policy makers have yet to deliver fully on their promises of easing). As policymakers continue to prioritise the country's zero-COVID strategy over economic growth, China's growth target of 5.5% for 2022 is becoming increasingly difficult to achieve. Declining prices of industrial metals will hurt mining revenue and terms of trade. However, in an inflationary environment, investors will continue to pursue net long commodities for hedging of inflation and diversification purposes. With many commodity futures in backwardation (which indicates shortages and a tendency towards stickiness), the overall scenario will still be favourable for the commodity exporters, despite a smaller upside due to growing growth concerns.

Figure 5: China imports as a share of global imports



Source: Bloomberg

Figure 6: Impact of a slowdown in China's industrial production on global commodity prices



Source: Bloomberg

With China's deteriorating macro outlook, higher inflation pressures and tighter monetary policies in developed markets and emerging markets, on top of domestic power constraints and other idiosyncratic headaches, we continue to prefer to stay neutral in SA equities as we see risk skew to the downside.

SA bonds

Foreign investors continued to offload SA local bonds over the past month. For the year to date, as at 12 May, foreign investors net sold $6.6bn of SA bonds and net bought $0.5bn of SA equities, compared to net selling $5.8bn and net purchasing $1.0bn respectively in April.

While SA bonds continue to be attractive from an implied yield and a hedged yield perspective, while offering good value on a real-yield basis compared to other emerging-market nominal bonds as well as local inflation-linked bonds and cash, we still expect that SA bonds could come under some pressure amid elevated global inflation, rising interest rates and subdued risk sentiment. We have thus chosen to remain neutral in local bonds.

Figure 7: SA 10-year nominal bond real yields vs other EM peers

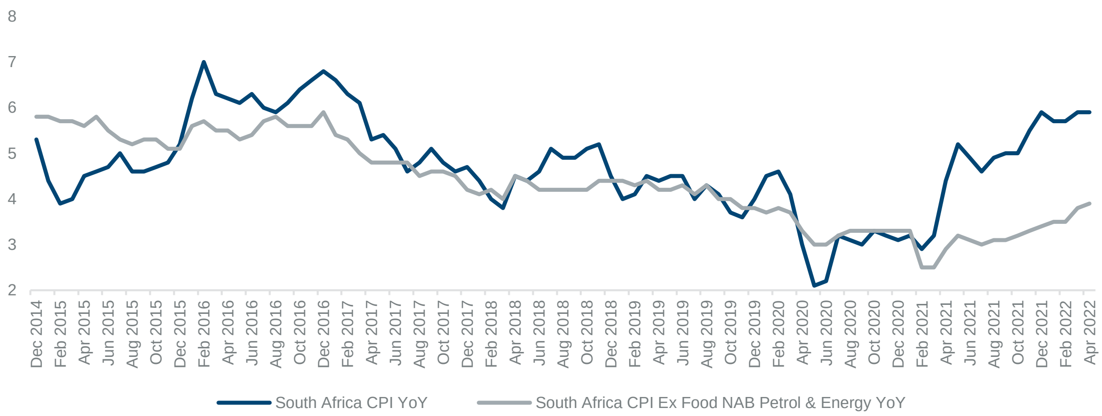
	South Africa	India	Indonesia	Russia	Mexico	Brazil	Turkey
10 Year Yield	**10.41%**	**7.35%**	**7.33%**	**15.99%**	**8.87%**	**12.46%**	**24.69%**
Inflation	5.9%	7.8%	3.47%	3.3%	7.7%	12.1%	70.0%
Inflation Expectation	4.50%	6.20%	1.60%	6.70%	5.70%	8.30%	19.60%
10 Year Real Yield	**4.51%**	**-0.44%**	**3.86%**	**12.69%**	**1.19%**	**0.33%**	**-45.28%**
10 Year Real Yield based on inflation expectation	5.91%	1.15%	5.73%	9.29%	3.17%	4.16%	5.09%
Currency Risk Premium	**4.52%**	**2.89%**	**2.96%**	**11.70%**	**4.32%**	**6.58%**	**16.97%**
Sovereign Risk Premium	**3.01%**	**1.58%**	**1.49%**	**1.40%**	**1.66%**	**3.00%**	**4.83%**
US 10 Year Yield	2.88%	2.88%	2.88%	2.88%	2.88%	2.88%	2.88%
S&P Rating - Foreign Currency	**BB-**	**BBB-u**	**BBB**	**NR**	**BBB**	**BB-**	**B+u**
Moody's Rating - Foreign Currency	**Ba2**	**Baa3**	**Baa2**	**NR**	**Baa1**	**Ba2**	**B2**

Source: Bloomberg

SA inflation-linked bonds

April CPI and core CPI were in line with market expectations, up 5.9% (consensus 5.9%) and 3.9% (consensus 3.8%) respectively. Transport and food inflation remain high but other items such as housing, education and health care, which tend to be less cyclical, are also on the rise. The core inflation chart indicates that underlying inflationary pressure remains.

Figure 8: SA inflation



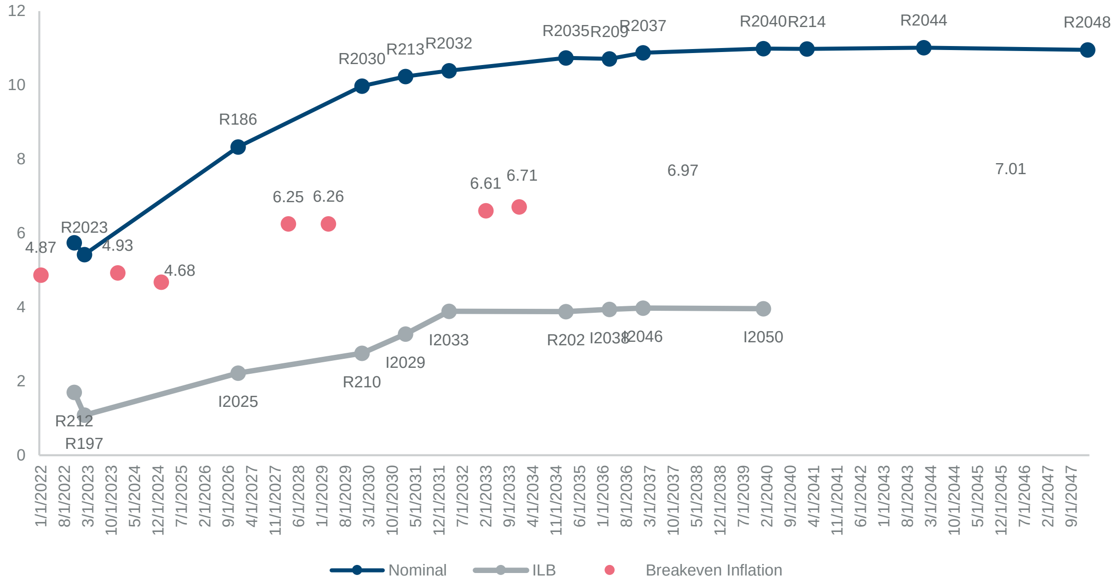
Source: Bloomberg

Figure 9: SA inflation rates per category

	Latest Weight	July 2021 YoY	August 2021 YoY	September 2021 YoY	October 2021 YoY	November 2021 YoY	December 2021 YoY	January YoY	February YoY	March YoY	April YoY
Housing & Utilities	22.6%	3.8%	3.8%	4.0%	4.0%	3.9%	4.3%	4.3%	4.4%	4.8%	4.8%
Food & Non Alcoholic Beverages	19.2%	6.7%	6.9%	6.6%	6.1%	5.5%	5.5%	5.7%	6.4%	6.2%	6.0%
Miscellaneous Goods & Services	14.8%	4.2%	4.2%	4.3%	4.3%	4.2%	4.3%	4.6%	3.2%	3.2%	3.8%
Transport	14.7%	8.0%	9.9%	10.1%	10.9%	15.0%	16.7%	14.5%	14.3%	15.7%	14.7%
Alcoholic Beverages & Tobacco	5.9%	5.2%	5.0%	4.2%	4.0%	4.8%	4.8%	4.7%	4.8%	5.9%	6.3%
Recreation & Culture	4.9%	1.7%	1.9%	1.6%	1.4%	1.3%	1.4%	1.9%	2.0%	1.7%	1.5%
Household Contents & Services	4.3%	1.3%	1.3%	1.8%	1.8%	1.9%	2.1%	2.2%	2.6%	3.0%	3.3%
Clothing & Footwear	4.0%	1.8%	2.0%	1.9%	1.9%	1.8%	1.7%	1.5%	1.6%	1.6%	1.7%
Restaurants & Hotels	3.4%	2.3%	2.7%	3.2%	4.1%	3.7%	4.2%	5.0%	6.1%	6.7%	5.6%
Communication	2.6%	-0.5%	-0.5%	-0.6%	-0.6%	-0.6%	-0.6%	-0.9%	-0.9%	-0.9%	-0.9%
Education	2.3%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%	4.4%	4.4%
Health	1.3%	3.6%	3.5%	3.6%	3.8%	3.8%	3.7%	3.4%	4.9%	4.9%	4.7%

Source: Bloomberg

Figure 10: SA breakeven inflation as at 12 May 2022



Source: Bloomberg

Breakeven inflation suggests that inflation-linked bonds are fully valued over the medium term and getting expensive vis-à-vis the longer maturities. The modified duration of the IGOV Index is around 9 to 11 years, suggesting that the inflation-linked bond index is fully valued based on the breakeven inflations. Despite persistent upside inflationary risks stemming from ongoing supply chain disruptions, the elevated oil price and expected currency volatility in the near future, the inflation-linked bond index as a whole is getting expensive, the 10-year inflation linked bond yield is on par with its implied real yield, and nominal bonds offer much better compensation for inflation. We therefore moved from moderate overweight to neutral on SA inflation-linked bonds.

Figure 11: SA inflation-linked bonds yield and implied yield

Source: Bloomberg

SA-listed property

Our investment case for the local property market was largely unchanged. The yield spreads between the SAPY and the ALSI and the SAPY and the 10-year bond yield suggest a neutral position in this sector from a valuation perspective. Fundamentally, real estate usually performs well in an inflationary environment as rentals tend to increase with inflation. However, the inflation hedging ability is subject to supply/demand dynamics.

For example, in an inflationary environment, one would prefer shorter leases and property sectors with more pricing power. While the SAPY Index has a decent offshore exposure (largely Europe), SA continues to have a significant geographical exposure. As the COVID-related constraints are relaxed and activities pick up, some sectors' prospects remain subdued. In the office sector, for instance, there was excess supply before the onset of COVID and many people in the services sectors are still working remotely. The post-COVID world may never be the same, with employees having grown accustomed to having the flexibility to work from home and seeing this as a huge benefit when seeking employment. Many office leases also tend to be very long term. While contracts will stipulate some level of escalation, they will not catch up with the elevated inflation we are seeing. In addition, with excess supply, landlords have less pricing power. However, long-term leases do provide stability in rental income and lower vacancy rates.

Overall, the near future for this sector remains challenging as property companies try to balance vacancies with achieving same-space real rental growth. Given the leverage inherent in the sector, making this asset class more sensitive to rate hikes than the broad equity asset class, and with our listed property sector having material exposure to Europe, we expect it to remain vulnerable to the geopolitical uncertainty offshore as well. We therefore lowered the sector's weight from neutral to moderately underweight in a balancing act to reduce risk in the overall portfolio.

Figure 12: SAPY yield spread vs ALSI

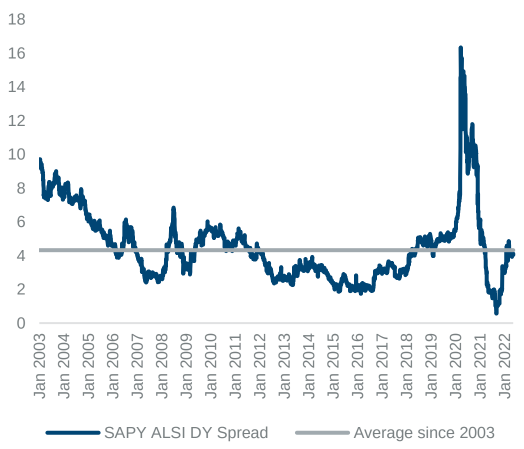
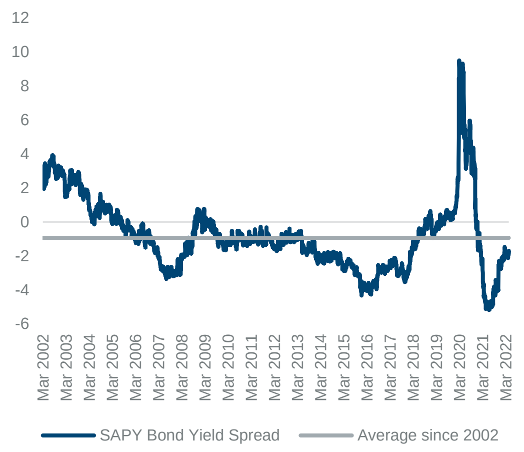


Figure 13: SAPY yield spread vs 10-year bonds



Source: Bloomberg

Offshore equities

We continue to see inflation rates breaching the upper target levels of central banks in the short term. Central banks across the globe are facing the dilemma of taming inflation or supporting growth, but for now it seems inflationary fears have trumped recession worries.

Figure 14: Global inflation rates

		Sep 2020	Oct 2020	Nov 2020	Dec 2020	Jan 2021	Feb 2021	Mar 2021	Apr 2021	May 2021	Jun 2021	Jul 2021	Aug 2021	Sep 2021	Oct 2021	Nov 2021	Dec 2021	Jan 2022	Feb 2022	Mar 2022	Apr 2022
WOININFL Index	Global	2.8	2.6	2.3	2.1	2.1	2.2	2.6	3.1	3.6	4.1	4.2	4.2	4.3	4.6	5.2	5.7	6.0	6.4	7.0	8.0
CSIIGL Index	Citi Inflation Surprise Index - Global	-3.2	-3.2	-5.4	0.0	5.3	17.7	15.7	21.6	34.8	38.5	40.5	42.8	47.7	43.9	58.1	82.9	70.5	74.0	80.0	80.8
CSIIG10 Index	Citi Inflation Surprise Index - Major Economies	-0.9	1.0	-2.8	6.4	10.6	26.6	19.7	25.3	43.4	48.3	55.3	57.5	62.3	58.8	71.9	107.8	97.6	104.7	113.5	107.4
CSIIEM Index	Citi Inflation Surprise Index - Emerging Markets	-6.6	-9.4	-9.3	-9.5	-2.6	4.3	9.6	16.1	21.9	23.9	18.2	20.7	25.8	21.6	37.3	45.4	29.9	27.9	29.9	40.8
FRCPIYOY Index	France	0.0	0.0	0.2	0.0	0.6	0.6	1.1	1.2	1.4	1.5	1.2	1.9	2.2	2.6	2.8	2.8	2.9	3.6	4.5	4.8
GRCP20YY Index	Germany	-0.2	-0.2	-0.3	-0.3	1.0	1.3	1.7	2.0	2.5	2.3	3.8	3.9	4.1	4.5	5.2	5.3	4.9	5.1	7.3	7.4
GKCPNEWY Index	Greece	-2.0	-1.8	-2.1	-2.3	-2.0	-1.3	-1.6	-0.3	0.1	1.0	1.4	1.9	2.2	3.4	4.8	5.1	6.3	7.2	8.9	10.2
IECPIYOY Index	Ireland	-1.2	-1.5	-1.1	-1.0	-0.2	-0.4	0.0	1.1	1.7	1.6	2.2	2.8	3.7	5.1	5.3	5.5	5.0	5.6	6.7	7.0
ITCPNICY Index	Italy	-0.6	-0.3	-0.2	-0.2	0.4	0.6	0.8	1.1	1.3	1.3	1.9	2.0	2.5	3.0	3.7	3.9	4.8	5.7	6.5	6.2
SPIPCYOY Index	Spain	-0.4	-0.8	-0.8	-0.5	0.5	0.0	1.3	2.2	2.7	2.7	2.9	3.3	4.0	5.4	5.5	6.5	6.1	7.6	9.8	8.3
SWCPYOY Index	Sweden	0.4	0.3	0.2	0.5	1.6	1.4	1.7	2.2	1.8	1.3	1.4	2.1	2.5	2.8	3.3	3.9	3.7	4.3	6.0	6.4
SZCPIYOY Index	Switzerland	-0.8	-0.6	-0.7	-0.8	-0.5	-0.5	-0.2	0.3	0.6	0.6	0.7	0.9	0.9	1.2	1.5	1.5	1.6	2.2	2.4	2.5
UKRPCJYR Index	United Kingdom	0.5	0.7	0.3	0.6	0.7	0.4	0.7	1.5	2.1	2.5	2.0	3.2	3.1	4.2	5.1	5.4	5.5	6.2	7.0	7.0
CPI YOY Index	United States	1.4	1.2	1.2	1.4	1.4	1.7	2.6	4.2	5.0	5.4	5.4	5.3	5.4	6.2	6.8	7.0	7.5	7.9	8.5	8.3
AUCPIYOY Index	Australia	0.7	0.7	0.7	0.9	0.9	0.9	1.1	1.1	1.1	3.8	3.8	3.8	3.0	3.0	3.0	3.5	3.5	3.5	5.1	5.1
JNCPIYOY Index	Japan	0.0	-0.4	-0.9	-1.2	-0.7	-0.5	-0.4	-1.1	-0.8	-0.5	-0.3	-0.4	0.2	0.1	0.6	0.8	0.5	0.9	1.2	1.2
BZPIIPCY Index	Brazil	3.1	3.9	4.3	4.5	4.6	5.2	6.1	6.8	8.1	8.4	9.0	9.7	10.3	10.7	10.7	10.1	10.4	10.5	11.3	12.1
CNCPIYOY Index	China	1.7	0.5	-0.5	0.2	-0.3	-0.2	0.4	0.9	1.3	1.1	1.0	0.8	0.7	1.5	2.3	1.5	0.9	0.9	1.5	2.1
INFUTOTY Index	India	7.3	7.6	6.9	4.6	4.1	5.0	5.5	4.2	6.3	6.3	5.6	5.3	4.4	4.5	4.9	5.7	6.0	6.1	7.0	7.8
IDCPIY Index	Indonesia	1.4	1.4	1.6	1.7	1.6	1.4	1.4	1.4	1.7	1.3	1.5	1.6	1.6	1.7	1.8	1.9	2.2	2.1	2.6	3.5
MXCPYOY Index	Mexico	4.0	4.1	3.3	3.2	3.5	3.8	4.7	6.1	5.9	5.9	5.8	5.6	6.0	6.2	7.4	7.4	7.1	7.3	7.5	7.7
RUCPIYOY Index	Russia	3.7	4.0	4.5	4.9	5.2	5.7	5.8	5.5	6.0	6.5	6.5	6.7	7.4	8.1	8.4	8.4	8.7	9.2	16.7	17.8
SACPIYOY Index	South Africa	3.0	3.3	3.2	3.1	3.2	2.9	3.2	4.4	5.2	4.9	4.6	4.9	5.0	5.0	5.5	5.9	5.7	5.7	5.9	5.9
KOCPIYOY Index	South Korea	0.9	0.1	0.6	0.6	0.9	1.4	1.9	2.5	2.6	2.4	2.6	2.6	2.4	3.2	3.8	3.7	3.6	3.7	4.1	4.8
TWCPIYOY Index	Taiwan	-0.6	-0.3	0.1	0.1	-0.2	1.4	1.2	2.1	2.5	1.8	1.9	2.3	2.6	2.6	2.9	2.6	2.8	2.3	3.3	3.4

Source: Bloomberg

Global manufacturing PMIs have cooled in most regions. Recent lockdowns have negatively impacted most Chinese macroeconomic indicators, from the housing market and industrial production to business activities. The economic slump in China could bring some relief to the oil price and the US inflation outlook, but the lockdown-induced supply shock is also yet to materialise in the economic data of major trading partners.

US consumer confidence dropped and the housing market continued to cool amid rising rates, but the labour market remains tight. US retail spending in March was better than market expectations but the outlook is bearish as consumer confidence wanes, shown in the University of Michigan buying conditions indices. The manufacturing PMI dropped materially but industrial production was up month on month as the tight labour market limited hiring and lowered the employment sub index. The services PMI softened marginally and terms of trade remain robust. The CPI of 8.3% for April was higher than the market expectation of 8.1% but lower than the 8.5% seen in March. Consumer consumption remains a key driving force behind US economic growth. Core CPI for goods declined. Core CPI for services is less cyclical than goods inflation but continued to trend upwards. The PPI data suggests an increasing probability that the US CPI is peaking. For Q1, US labour productivity also fell by 7.5% quarter on quarter, while US unit labour costs increased by 11.6% over the same period. Clearly, such tight labour market condition do not bode well for productivity and corporate profitability.

Figure 15: The Global Manufacturing PMI

	Apr 2020	May 2020	Jun 2020	Jul 2020	Aug 2020	Sep 2020	Oct 2020	Nov 2020	Dec 2020	Jan 2021	Feb 2021	Mar 2021	Apr 2021	May 2021	Jun 2021	Jul 2021	Aug 2021	Sep 2021	Oct 2021	Nov 2021	Dec 2021	Jan-22	Feb-22	Mar-22	Apr-22
Global Manufacturing PMI	39.6	42.4	47.9	50.6	51.8	52.4	53.1	53.8	53.8	53.6	54	55	55.8	56	55.5	55.4	54.1	54.1	54.3	54.2	54.2	53.2	53.6	53	52.2
Developed Markets	36.8	39.5	46.4	49.8	51.2	52.1	52.8	53.8	54.8	55.2	56.5	58.5	59.3	59.8	59.5	59.8	58.3	57.1	56.6	56.9	56.6	56.3	56.6	56.5	56.3
Emerging Markets	42.7	45.4	49.6	51.4	52.5	52.8	53.4	53.9	52.8	52.1	51.5	51.3	52.2	52	51.2	50.6	49.6	50.8	51.6	51.2	51.7	50	50.9	49.2	48.1
Eurozone	33.4	39.4	47.4	51.8	51.7	53.7	54.8	53.8	55.2	54.8	57.9	62.5	62.9	63.1	63.4	62.8	61.4	58.6	58.3	58.4	58	58.7	58.2	56.5	55.5
France	31.5	40.6	52.3	52.4	49.8	51.2	51.3	49.6	51.1	51.6	56.1	59.3	58.9	59.4	59	58	57.5	55	53.6	55.9	55.6	55.5	57.2	54.7	55.7
Germany	34.5	36.6	45.2	51	52.2	56.4	58.2	57.8	58.3	57.1	60.7	66.6	66.2	64.4	65.1	65.9	62.6	58.4	57.8	57.4	57.4	59.8	58.4	56.9	54.6
Italy	31.1	45.4	47.5	51.9	53.1	53.2	53.8	51.5	52.8	55.1	56.9	59.8	60.7	62.3	62.2	60.3	60.9	59.7	61.1	62.8	62	58.3	58.3	55.8	54.5
Spain	30.8	38.3	49	53.5	49.9	50.8	52.5	49.8	51	49.3	52.9	56.9	57.7	59.4	60.4	59	59.5	58.1	57.4	57.1	56.2	56.2	56.9	54.2	53.3
Greece	29.5	41.1	49.4	48.6	49.4	50	48.7	42.3	46.9	50	49.4	51.8	54.4	58	58.6	57.4	59.3	58.4	58.9	58.8	59	57.9	57.8	54.6	54.8
Ireland	36	39.2	51	57.3	52.3	50	50.3	52.2	57.2	51.8	52	57.1	60.8	64.1	64	63.3	62.8	60.3	62.1	59.9	58.3	59.4	57.8	59.4	59.1
Australia	44.1	44	51.2	54	53.6	55.4	54.2	55.8	55.7	57.2	56.9	56.8	59.7	60.4	58.6	56.9	52	56.8	58.2	59.2	57.7	55.1	57	57.7	58.8
Sweden	36.1	40.1	48.8	52.2	54.4	56.6	58.9	59.7	64.8	62.6	61.7	64.1	68.7	66.1	65.4	64.5	60.1	64.6	64.4	63.1	62.1	62.4	58.6	57.3	55
Denmark	35.5	53	53	54.8	51.4	53.6	62.9	46.7	41.6	42.8	46.1	65.6	66.6	65.5	65.5	69.7	67.3	65.2	71.9	68.1	64.4	60.9	50.7	62.1	63
UK	32.6	40.7	50.1	53.3	55.2	54.1	53.7	55.6	57.5	54.1	55.1	58.9	60.9	65.6	63.9	60.4	60.3	57.1	57.8	58.1	57.9	57.3	58	55.2	55.8
US	36.1	39.8	49.8	50.9	53.1	53.2	53.4	56.7	57.1	59.2	58.6	59.1	60.5	62.1	62.1	63.4	61.1	60.7	58.4	58.3	57.7	55.5	57.3	58.8	59.2
Japan	41.9	38.4	40.1	45.2	47.2	47.7	48.7	49	50	49.8	51.4	52.7	53.6	53	52.4	53	52.7	51.5	53.2	54.5	54.3	55.4	52.7	54.1	53.5
China	49.4	50.7	51.2	52.8	53.1	53	53.6	54.9	53	51.5	50.9	50.6	51.9	52	51.3	50.3	49.2	50	50.6	49.9	50.9	49.1	50.4	48.1	46
Indonesia	27.5	28.6	39.1	46.9	50.8	47.2	47.8	50.6	51.3	52.2	50.9	53.2	54.6	55.3	53.5	40.1	43.7	52.2	57.2	53.9	53.5	53.7	51.2	51.3	51.9
South Korea	41.6	41.3	43.4	46.9	48.5	49.8	51.2	52.9	52.9	53.2	55.3	55.3	54.6	53.7	53.9	53	51.2	52.4	50.2	50.9	51.9	52.8	53.8	51.2	52.1
Taiwan	42.2	41.9	46.2	50.6	52.2	55.2	55.1	56.9	59.4	60.2	60.4	60.8	62.4	62	57.6	59.7	58.5	54.7	55.2	54.9	55.5	55.1	54.3	54.1	51.7
India	27.4	30.8	47.2	46	52	56.8	58.9	56.3	56.4	57.7	57.5	55.4	55.5	50.8	48.1	55.3	52.3	53.7	55.9	57.6	55.5	54	54.9	54	54.7
Brazil	36	38.3	51.6	58.2	64.7	64.9	66.7	64	61.5	56.5	58.4	52.8	52.3	53.7	56.4	56.7	53.6	54.4	51.7	49.8	49.8	47.8	49.6	52.3	51.8
Mexico	35	38.3	38.6	40.4	41.3	42.1	43.6	43.7	42.4	43	44.2	45.6	48.4	47.6	48.8	49.6	47.1	48.6	49.3	49.4	49.4	46.1	48	49.2	49.3
Russia	31.3	36.2	49.4	48.4	51.1	48.9	46.9	46.3	49.7	50.9	51.5	51.1	50.4	51.9	49.2	47.5	46.5	49.8	51.6	51.7	51.6	51.8	48.6	44.1	48.2
South Africa	30.3	43.7	53.3	49.4	55.8	58.5	60.9	52.6	50.3	50.9	53	57.4	56.2	57.8	57.4	43.5	57.9	56.8	53.6	57.2	54.1	57.1	58.6	60	50.7

Source: Bloomberg

Figure 16: University of Michigan Buying Conditions Indices

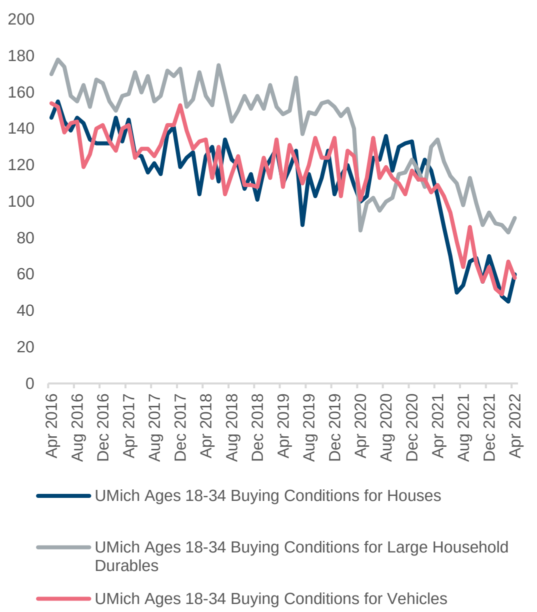
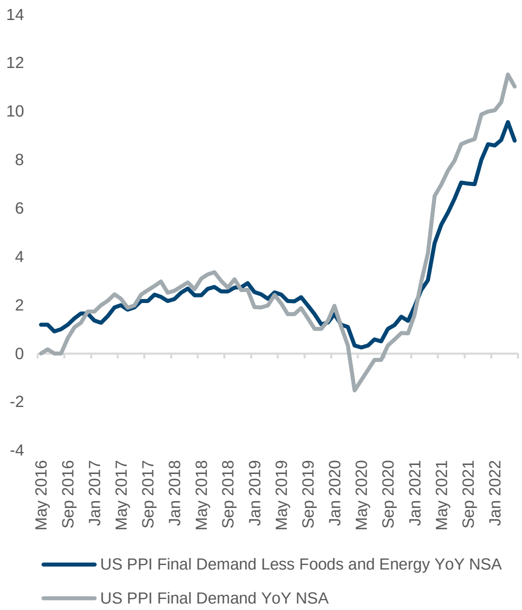


Figure 17: US PPI Index



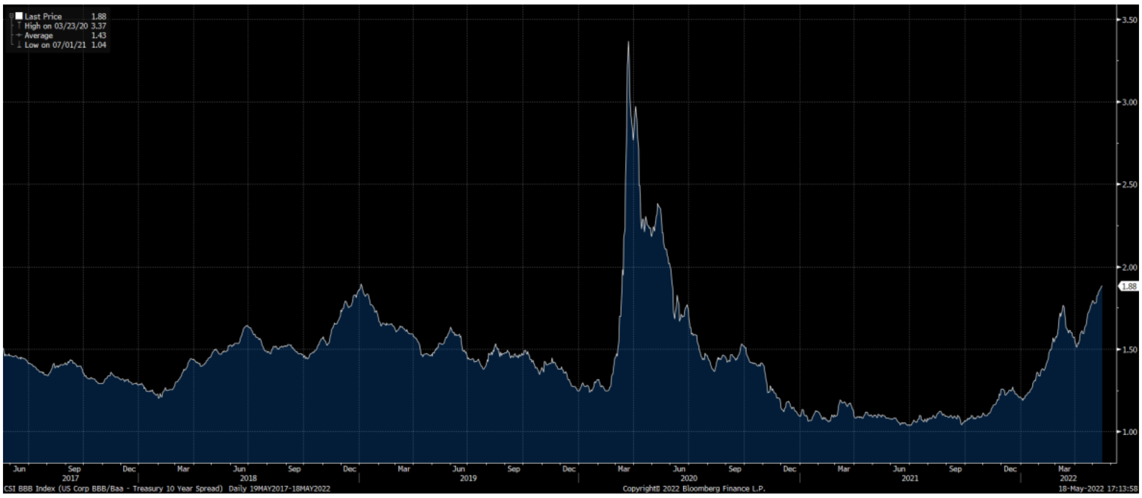
Source: Bloomberg

Consumer and business confidence deteriorated in the Eurozone. However, expectations of economic growth have improved, despite being negative. Retail sales weakened significantly and the services sector continued to improve, while industrial production dropped but was better than market expectations. Car sales also continued to contract amid higher oil prices. We believe that while the ECB president, Christine Lagarde, has flagged a July rate hike, the pace of policy tightening in the Eurozone will likely be behind that of the US and UK; also, changing circumstances could easily drive the ECB to slow down its rate hikes to support a softer economy.

Macro data is largely improving in Japan. Consumer confidence, retail spending and services sector activities all picked up. The labour market remains resilient. Industrial data, however, was lacklustre as production remained under pressure, vehicle sales continued to contract, fixed investment declined and trade statistics were mixed. Services spending dropped sharply as businesses struggled to pass cost inflation onto consumers. CPI was 1.2% for March year on year, up from 0.9% in February, and the market now expects it to rise to 2.5% for April. The government fuel subsidy should cap overall increases, but upside inflationary pressures remain. Overall, the Bank of Japan yield curve control (YCC) programme is under increasing pressure. Rising commodity prices and the weakening of the yen would increase imports and squeeze corporate profits. The gross domestic income (GDI), which has a strong link to corporate profits, was down 2.7% on an annualised basis in Q1 2022, also painting a bearish outlook for Japanese corporate earnings.

Expectations of a sharp slowdown in China have yet to translate into a major global risk-off event. However, should financial conditions tighten significantly, the Fed could also slow down its pace of monetary policy tightening. The yield spread between BAA-rated corporate bonds and the 10-year US treasuries, a variable in the Fed board model and the New York Fed DSGE model, has picked up significantly this year.

Figure 18: US corporate BBB/Baa and US 10-year treasury yield spreads



Source: Bloomberg

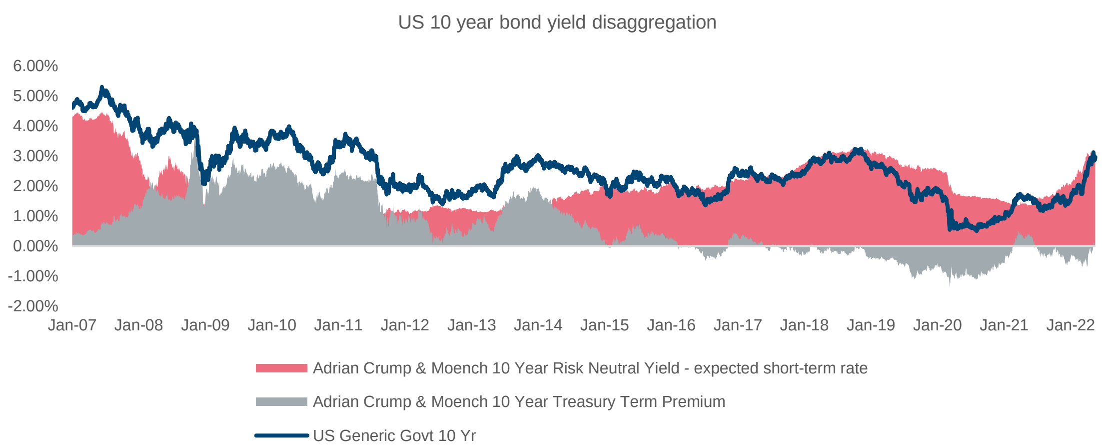
According to research conducted by Goldman Sachs Asset Management, the S&P 500 has seen one of its worst starts to the year in the post-World War II period. However, historical data suggests that markets tend to recover in the face of supportive fundamentals. That is, for non-recessionary years, with more than 13% drawdowns, the average annual return for the year is around 2%. It is a combination of geopolitical risk and wrong polices that produce a toxic outcome.

We continue to prefer offshore equities to offshore bonds as yields rise, but we choose to remain neutral in offshore equities as we believe that the risk sentiment will remain highly sensitive to any adverse developments impacting the policy environment, the corporate earnings outlook and geopolitics. However, historical data for now suggests that there is a meaningful upside for the S&P 500 for the remainder of 2022.

Offshore bonds

Yields have surged but may move higher as investors demand a higher-term premium for holding longer maturity bonds. The US 10-year bond yield disaggregation indicates that most of the surge in yields was largely driven by higher-than-expected short-term rates.

Figure 19: US 10-year bond yield disaggregation



Source: Bloomberg

While more higher yields may cap the upside potential of equity, equity tends to outperform bonds during rate hiking cycles, as suggested by Figure 20 below which shows the S&P 500 Index outperforming the FTSE World Government Bond Index for the past three rate hiking cycles. The current shape of the US yield curve is that of a bear steepener, implying rising inflation expectations and investors waiting for rate hikes to come to an end before buying longer maturity bonds. We therefore remain moderately underweight in offshore bonds, more as a relative play between offshore equities and bonds.

Figure 20: Performance of asset classes over the past three rate hiking cycles

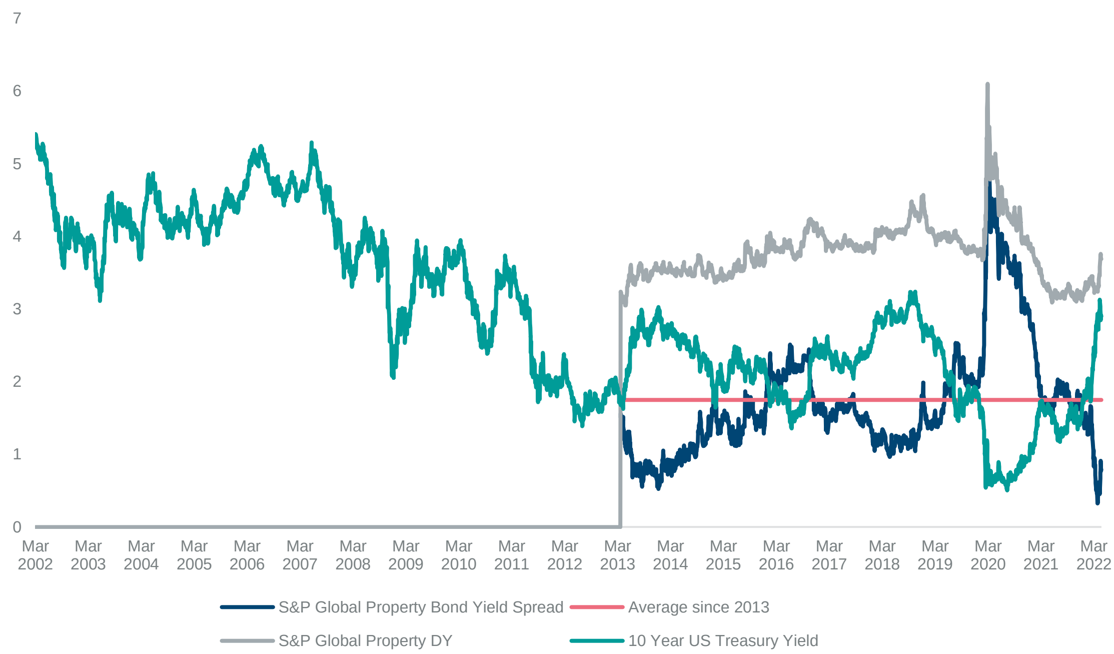
Returns in ZAR	S&P 500 Total Return Index	FTSE JSE All Share Index Total Return Value	MSCI World Gross Total Return USD Index	MSCI Emerging Markets Gross Total Return USD Index	FTSE World Government Bond Index (WGBI) USD	Bloomberg Commodity Index Total Return	FTSE/JSE ALBI Total Return Index	S&P Global Property USD Total Return Index	S&P 500 Value Total Return Index	S&P 500 Growth Total Return Index	S&P 500 Quality U.S. Dollar Gross Total Return Index	S&P 500 Momentum U.S. Dollar Gross Total Return Index	S&P 500 Low Volatility Total Return Index	USDZAR Spot Exchange Rate - Price of 1 USD in ZAR	DOLLAR INDEX SPOT	Federal Funds Target Rate - Upper Bound
30-Jun-93 31-Dec-00	669.8%	166.3%	459.1%	146.4%	236.2%	319.9%	222.0%					1012.1%	500.6%	126.9%	17.0%	3.5%
31-Dec-03 30-Jun-07	51.9%	200.3%	76.6%	179.0%	14.5%	48.9%	34.6%	137.5%	67.5%	37.6%	60.3%	58.3%	56.8%	5.4%	-5.8%	4.3%
31-Mar-15 30-Jun-19	80.4%	26.5%	62.1%	41.7%	31.1%	-1.4%	37.6%	44.9%	63.1%	95.9%	68.1%	94.2%	86.9%	16.1%	-2.3%	2.3%
YTD 2022	-14.0%	-3.6%	-14.5%	-16.2%	-11.0%	33.2%	0.2%	-13.0%	-4.4%	-22.6%	-13.6%	-12.2%	-3.2%	-0.2%	8.0%	0.8%

Source: Bloomberg

Offshore property

The valuation of global property has improved after the recent selloff but remains neutral from a dividend yield spread perspective and expensive vs the 10-year treasury bonds. Fundamentally, debt to equity has been stable and the operating margin and return on equity have largely improved, having recouped most of the pandemic-induced losses. However, this sector remains more sensitive to rate hikes than equities in general, despite the sector's inflation-hedging properties. We choose to be moderately underweight – but could be swayed if sentiment improves or the economic data results in slower tightening than market expectations.

Figure 21: S&P Global Property dividend yield spread relative to the US 10-year treasury yield



Source: Bloomberg

CONTACT

YANNI YANG, CFA®, FRM , CAIA
C +27 84 802 3784 **T** +27 11 447 7716
F 086 272 1177 **E** yyang@mentenova.co.za

3rd Floor, Oxford & Glenhove Building 2,
114 Oxford Road, Rosebank, Johannesburg
www.Mentenova.co.za