MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

20 September 2022

HOUSEVIEW TACTICAL ASSET ALLOCATION

We have decided to keep our tactical asset allocation mostly unchanged for October, except for reducing our neutral position in offshore equity to moderately underweight, 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 have reiterated our prior positions across most asset classes. We have chosen to remain moderately overweight in SA nominal bonds, based on attractive valuations, improving fiscal conditions and better compensation for inflation than that offered by SA inflation-linked bonds. We have kept our moderately underweight position in SA inflation-linked bonds as the breakeven inflations implied by the inflation-linked bonds suggest that this asset class is fairly valued or slightly expensive over the medium- to long-term maturities, despite the upside risk to inflation in the short term. With the SARB front-loading its rate hiking cycle, increasing the repo rate by 75bps again in September, we do expect central bank actions to curb runaway inflation. The dollar story and the global risk sentiment have been the dominant driver behind the emerging market debt performance. We have not yet seen the return of foreign investors' appetite for SA bonds. Our position in SA nominal and inflation-linked bonds was more of a relative play.

Owing to the leverage inherent in listed property, making this asset class more sensitive to rate hikes than the broader equities, we have remained moderately underweight in local and offshore listed properties in an environment where central banks have given their singular attention to taming inflation. Given the slowing growth, entrenched inflation and higher finance costs, posing risks to corporate earnings, we have therefore moved from neutral to moderately underweight in offshore equities. Local equities, too, are facing similar challenges and other idiosyncratic issues, such as the prolonged, severe power crisis; however, given their more favourable valuation, we have chosen to remain neutral. Offshore bonds valuation is looking more attractive but does not yet warrant a moderate overweight; therefore, we have chosen to remain neutral with an overweight position in offshore cash, as we expect the dollar to remain strong due to continued increases in interest rates.

TAA Overview

Market overview	Following the rebound in July and into the first half of August, markets slumped in the second half of August as central banks indicated that they remained committed to bringing inflation under control, despite inherent risks to the growth outlook. The Fed Chairman Jerome Powell's 'Monetary Policy and Price Stability' speech at the Jackson Hole policy symposium in late August re-emphasised the Fed's commitment to reducing inflation, as price stability is the main focus of the FOMC. However, to do that will require the US economy to go through a sustained period of slower economic growth and softening labour market conditions. He also highlighted the

importance of bringing inflation quickly under control to prevent the unanchoring of inflation expectations. As a result of his speech, the market was largely pricing in a 75bps increase in September, which materialised on 21 September.

Most asset classes finished in the red for the month of August in their respective local currencies against an uncertain global economic backdrop. The FTSE/JSE ALSI Index was down by 1.8% last month. The S&P 500 and the MSCI World Index were both down by 4.1%. The MSCI Emerging Markets Index fared better, up by 0.5% due to relatively better economic momentum in many other emerging markets balancing out the weakness in China. The MSCI World Value Index fell by 3.0%, but continued to outperform the MSCI World Growth Index which fell by 5.3%, as bond yields rose. The ALBI and the IGOV both outperformed the global fixed income sectors in August in local currencies. Local property fell in line with the MSCI US REIT Index, and the S&P Global Property Index with the European property sector took much more pain as higher interest rates, the broader tightening in financial conditions and the Ukraine war have derailed the sector's recovery from the pandemic. The crude oil price was down by 12.3% in August with industrial metals also largely falling as the global economy continued to cool down, evident in the lower PMI numbers. The US dollar strengthened by 2.6% against other major currencies last month and continued to make gains into September, supported by the Fed's hawkish stance. With the ZAR depreciating by 3.0% against the US dollar, it did provide some cushion for USD-denominated assets.

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

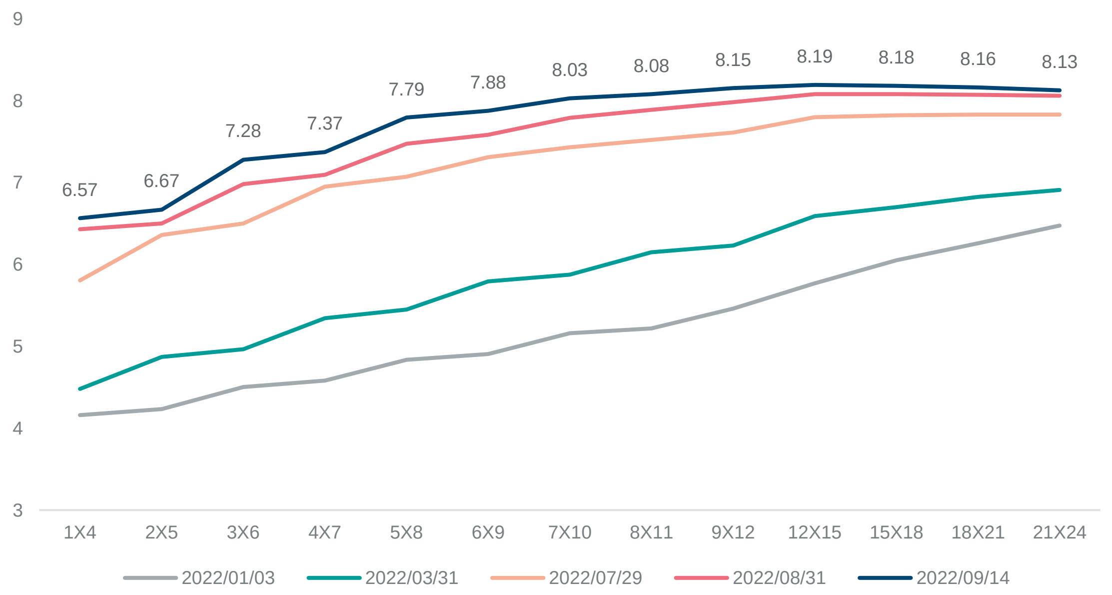
31 July 2022 (Local Currency)	1M	3M	YTD	1 Year	3 Year (annualised)	5 Year (annualised)	10 Year (annualised)	MTD 14 August 2022
FTSE/JSE ALSI Total Return	4.2%	-4.5%	-4.4%	4.7%	10.6%	8.2%	10.6%	2.6%
FTSE/JSE Capped SWIX Total Return	2.8%	-4.3%	-1.9%	7.2%	8.9%	5.4%	9.1%	3.5%
S&P 500 Total Return	9.2%	0.4%	-12.6%	-4.6%	13.4%	12.8%	13.8%	3.7%
STOXX 600 Total Return	7.7%	-1.8%	-8.4%	-2.6%	6.8%	5.6%	8.1%	0.7%
Nikkei 225 Total Return	5.3%	3.8%	-2.3%	3.9%	11.0%	9.0%	14.5%	2.7%
MSCI World Total Return	8.0%	-1.2%	-13.9%	-8.7%	10.1%	9.4%	10.8%	3.3%
MSCI ACWI Total Return	7.0%	-1.8%	-14.4%	-10.1%	9.0%	8.4%	9.9%	3.2%
MSCI EM Total Return	-0.2%	-6.3%	-17.6%	-19.8%	1.3%	1.3%	3.2%	2.7%
MSCI World Value Index	4.6%	-2.5%	-7.7%	-2.2%	7.0%	6.0%	8.9%	2.6%
MSCI World Growth Index	11.5%	-0.2%	-20.5%	-15.7%	12.3%	12.2%	12.5%	3.8%
MSCI World Small Cap Index	9.1%	-1.9%	-15.3%	-13.9%	7.5%	6.6%	10.3%	4.4%
FTSE UK Series FTSE All Share TR	4.4%	-1.2%	-0.4%	5.5%	3.2%	4.0%	7.2%	1.5%
MSCI AC Asia Ex. Japan Index	-1.1%	-5.1%	-17.2%	-19.7%	2.6%	2.0%	5.4%	1.5%
MSCI Europe Excluding United Kingdom Index	8.1%	-1.6%	-10.2%	-4.9%	7.6%	6.4%	9.6%	0.8%
STEFI	0.4%	1.2%	2.6%	4.3%	4.9%	5.9%	6.1%	0.2%
ALBI	2.4%	0.3%	0.5%	2.9%	6.9%	8.0%	7.0%	2.8%
IGOV	-1.3%	-0.3%	1.8%	8.8%	6.7%	5.1%	5.6%	1.4%
WGBI	1.8%	-1.5%	-13.3%	-16.6%	-3.6%	-1.2%	-0.6%	-0.6%
Bloomberg Global Inflation-Linked Total Return Index	4.5%	-4.3%	-14.1%	-14.7%	0.3%	1.3%	1.5%	-1.8%
Bloomberg US Agg Total Return	2.4%	1.5%	-8.2%	-9.1%	-0.2%	1.3%	1.6%	-0.8%
Bloomberg EuroAgg Total Return Index	4.1%	0.2%	-8.5%	-10.4%	-2.9%	-0.1%	2.1%	-1.0%
Bloomberg Global Agg Corporate Total Return Index	2.8%	-0.4%	-13.2%	-15.3%	-1.4%	0.4%	1.7%	-0.3%
Bloomberg US Corporate High Yield Total Return Index	5.9%	-1.0%	-9.1%	-8.0%	1.9%	3.1%	4.9%	1.6%
Bloomberg Pan-European High Yield Total Return Index	5.1%	-3.4%	-9.9%	-9.8%	-0.4%	1.0%	4.7%	1.5%
J.P. Morgan EMBI Global Core Hedged EUR	3.2%	-3.9%	-19.3%	-20.9%	-6.3%	-2.9%	0.5%	2.3%
SAPY Total Return	8.8%	-2.4%	-5.0%	9.7%	-6.1%	-6.4%	2.7%	1.9%
MSCI US REIT Total Return	9.0%	-5.2%	-13.1%	-2.7%	6.6%	6.9%	8.0%	2.8%
S&P Global Property Total Return	6.8%	-6.1%	-13.9%	-9.4%	1.5%	3.2%	5.8%	1.9%
STOXX 600 Real Estate Total Return	13.4%	-9.8%	-20.6%	-19.2%	-0.3%	0.8%	5.3%	1.1%
FTSE EPRA Nareit Global REITs TR Index	8.4%	-5.4%	-13.3%	-6.5%	3.1%	4.6%	6.3%	2.1%
Crude Oil	-4.2%	0.6%	41.4%	44.1%	19.1%	15.9%	0.5%	-10.8%
Aluminium	1.8%	-18.5%	-11.4%	-3.9%	11.4%	5.3%	2.8%	-2.2%
Copper	-4.1%	-19.0%	-18.5%	-18.6%	10.1%	4.4%	0.5%	2.2%
Gold	-2.3%	-6.9%	-3.5%	-2.7%	7.7%	6.8%	0.9%	2.1%
Platinum	0.3%	-4.3%	-7.2%	-14.5%	1.3%	-0.9%	-4.4%	7.3%
Nickel	4.1%	-25.7%	13.0%	20.7%	17.7%	18.3%	4.1%	0.0%
Palladium	9.8%	-8.4%	11.9%	-20.0%	11.9%	19.2%	13.7%	4.4%
Iron Ore	-9.7%	-21.9%	-8.6%	-41.6%	-3.8%	7.4%	-1.3%	0.7%
Bloomberg Commodity Index Total Return	4.3%	-5.6%	23.5%	27.2%	16.2%	8.8%	-1.0%	1.2%
USDZAR	2.1%	5.3%	4.3%	13.8%	5.0%	4.7%	7.2%	-2.7%
GBPZAR	2.0%	1.8%	-6.3%	-0.4%	5.1%	3.0%	4.6%	-2.9%
EURZAR	-0.4%	1.9%	-6.2%	-1.9%	2.3%	1.7%	5.3%	-2.1%
JPYZAR	3.8%	2.3%	-10.0%	-6.5%	-1.9%	0.8%	1.7%	-2.6%
Dollar Index Spot	1.2%	2.9%	10.7%	14.9%	2.4%	2.7%	2.5%	-0.3%

Source: Bloomberg

Tactical views

The Bureau for Economic Research Consumer Confidence Index showed some improvement in Q3, moving from -25 to -20. Retail sales saw a yearly growth rate of 8.6% in July from -2.5% in June, while the month-on-month growth rate of -0.1% was also better than the market expectation of -0.6%. The manufacturing PMI improved from 47.6 in June to 52.1 in July and the trade balance surplus of R24.8bn in July also beat market expectations. However, loadshedding weighed on the Q2 GDP which grew by 0.2%, falling short of the market expectation of 0.6%. The prolonged, severe power constraints will continue to hurt the local economy, with the yearly growth in manufacturing production having weakened in July. The current account went into deficit in Q2, mainly driven by a shortfall on the services, income and current transfer accounts, which will place the ZAR under further pressure amid global growth concerns, weak economic data for China and commodity prices negatively affected by the strong USD. Subsequent to our TAA meeting, the CPI number for August was released: the annual consumer price inflation rate was 7.6%, in line with the expectation from the Bloomberg survey of economists, and was also down from 7.8% in July. The main contributors were food and non-alcoholic beverages, which were up by 11.3% year on year, and transport which had a yearly growth rate of 21.2%. Moreover, the CPI data showed a similar trend to that of the US data, with goods inflation showing signs of peaking but services inflation picking up. The local goods inflation rate of 10.9% in August was lower than the July figure of 11.5%, while services inflation began to come through – up by 4.3% in August, from 4.2% in July. The SARB increased the repo rate from 5.5% to 6.25% on 22 September, in line with market expectations.

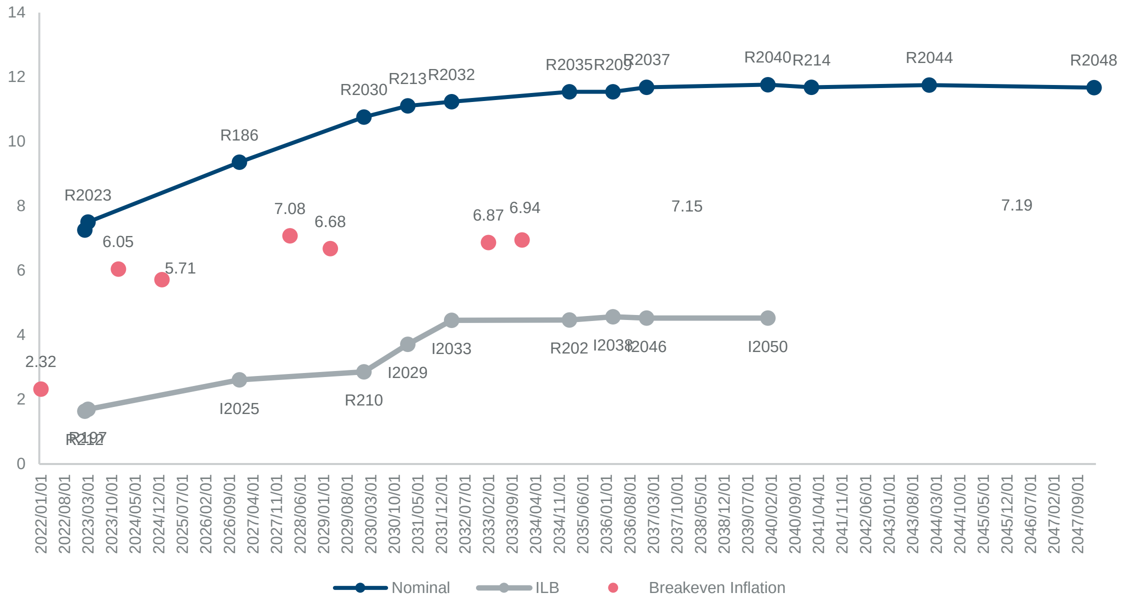
Figure 3: SA FRA rates



Source: Bloomberg

We have chosen to retain our moderately overweight position in SA nominal bonds and moderately underweight position in SA inflation-linked bonds. Despite SA bonds offering attractive valuations and potential income, the dollar story and global risk sentiment have been and will continue to be one of the dominant factors determining their performance. Emerging market (including SA) bonds may be under pressure as the yield spread vs that of the US treasury narrows and investors potentially opt for less risky, safe-haven assets. At the same time, the SARB has front-loaded its rate hiking cycle and we expect the SARB to continue with this trend, in tandem with the Fed, to achieve price stability. While there is still some upside inflation risk, given fair valuations of the inflation-linked bonds and the SARB having acted early enough to curb inflation, we do believe that inflation will be below the breakeven level over the medium term. Therefore, we have chosen to have the relative play on nominal and inflation-linked bonds.

Figure 4: SA nominal and real yields



Source: Bloomberg

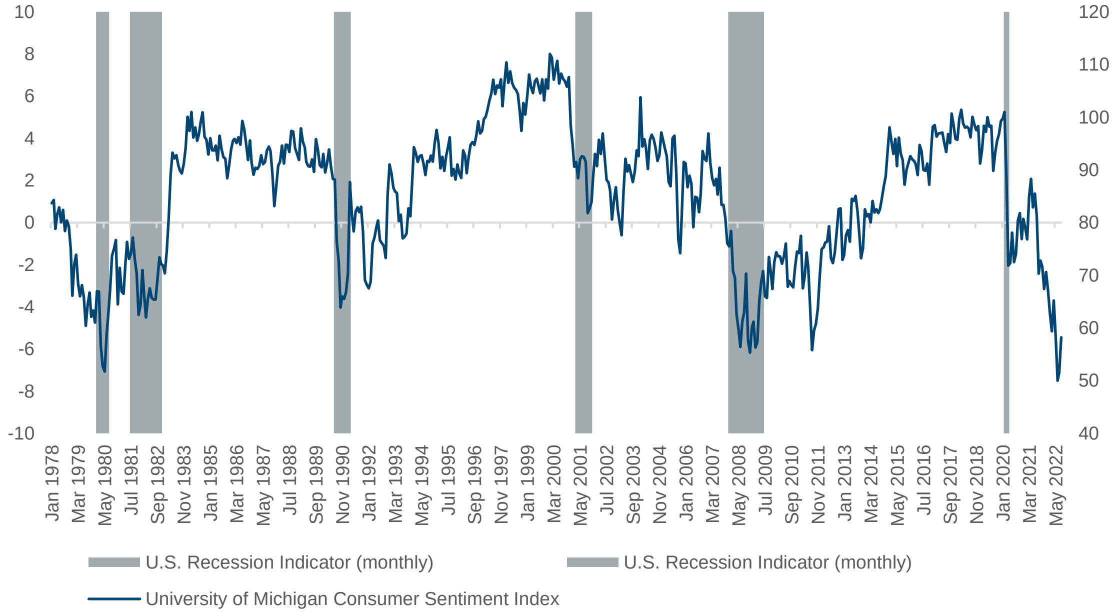
We have chosen to remain neutral in SA equities. The downside risks are that SA consumers will remain under severe pressure from elevated food and fuel prices and high unemployment. Loadshedding will also continue to weigh on the local economy, risking its recovery from the pandemic. The ZAR will also come under pressure as commodity prices soften in the face of the uncertain global growth outlook, weak China activities and a strong USD. However, SA equities are trading at better valuations than in developed markets. Tourism and the hospitality sectors may also continue to show positive growth rates.

From a valuation perspective, our dashboard suggests that we should go neutral in both asset classes. However, as central banks give singular attention to fighting inflation amid persistent inflation pressures and weaker growth, together with the leverage inherent in the listed property sector which makes it relatively more sensitive to rate hikes than broader equities, we prefer to remain moderately underweight in both local and offshore properties.

US consumer sentiment improved slightly in August and retail sales were also up by 0.3% month on month in August, beating the market expectation of -0.1%. The labour market remains tight; however, the US unemployment rate increased from 3.5% in July to 3.7% in August, while non-farm payrolls weakened in August, albeit still better than market expectations. US labour force participation rates have improved from the trough of the pandemic but remain below pre-COVID levels. Housing activities continued to cool in the US, evident in lower new and existing home sales and persistently negative weekly growth in mortgage applications. Buying conditions for houses and large household durables improved but remain largely depressed. The ISM manufacturing PMI remained in the expansionary zone at 52.8 in August; however, both factory and durable goods orders contracted in July. The ISM services PMI remained strong at 56.9 over the same period.

The US CPI year-on-year growth rate reached 8.3% in August, lower than 8.5% in July but higher than the market expectation of 8.1%. Goods inflation is showing signs of peaking but services prices are picking up.

Figure 5: University of Michigan Consumer Sentiment Index



Source: Bloomberg

Figure 6: US labour force participation rates by race

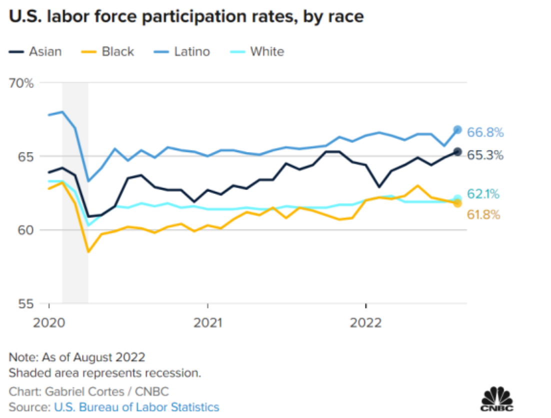
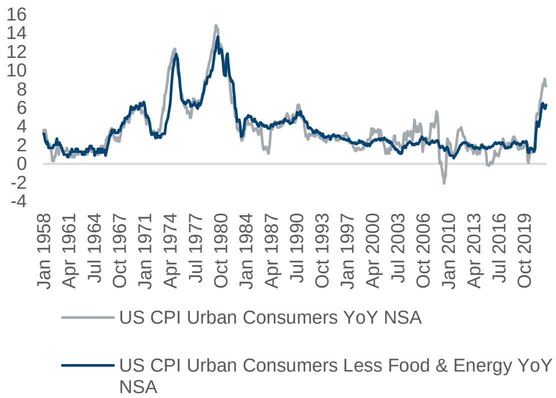
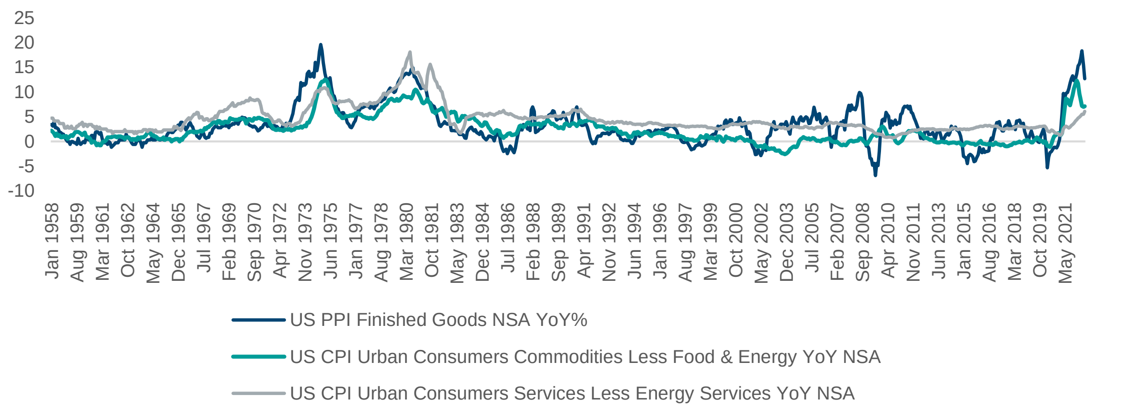


Figure 7: US CPI and core CPI



Source: CNBC, US Bureau of Labor Statistics, Bloomberg

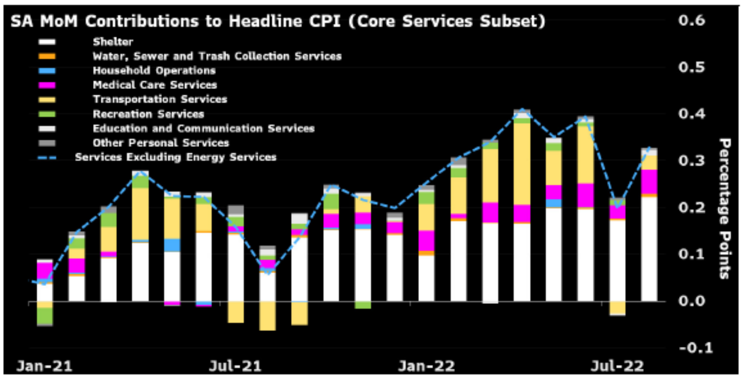
Figure 8: US PPI, goods CPI and services CPI



Source: Bloomberg

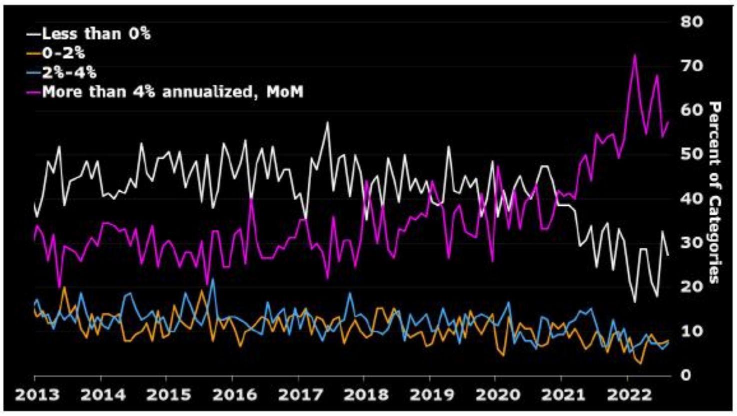
We are seeing shelter inflation continuing to climb, with transportation services and medical care services also picking up. In addition, close to 60% of the categories are showing inflation, with more than 4.0% annualised. This data indicates that the US inflation rate is broad-based, with sufficiently strong inflationary pressures to offset the commodity price disinflation. Consequently, this points to more persistent inflationary pressures, which is also one of the reasons why the Fed is worried about expectations of high inflation becoming entrenched. Markets are, however, pricing in rate cuts towards the end of 2023.

Figure 9: US contribution to headline CPI from core services



Source: Bloomberg Economics

Figure 10: US percentage of CPI categories with different levels of annualised inflation



Source: Bloomberg Economics

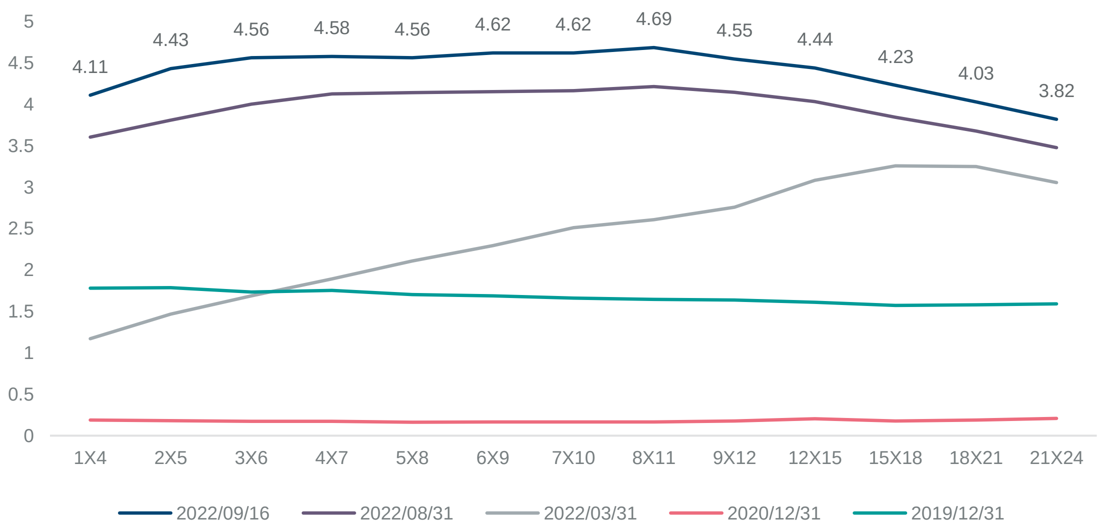
US treasury yield spreads are also flashing warning signs of a recession ahead. The dynamics of slowing growth, elevated inflation and tightening liquidity have driven the yield curve inversion, which disincentivises long-term lending and erodes the time value of money, creating a difficult economic environment.

Figure 11: US 10-year vs 2-year treasury yield

Figure 12: US 10-year vs 3-month treasury yield

Source: Bloomberg

Figure 13: US FRA rates



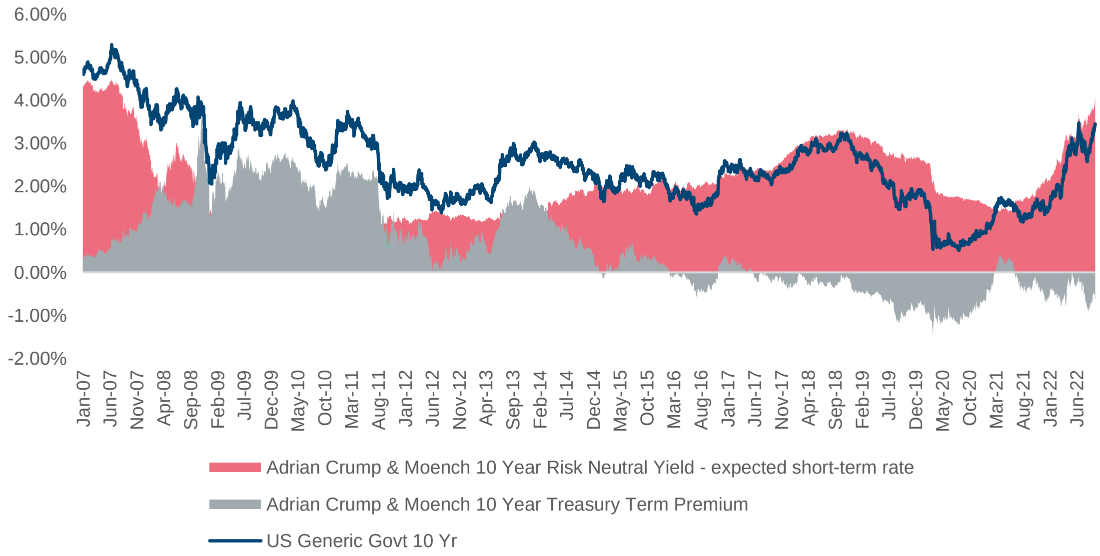
Source: Bloomberg

Inflation in the Eurozone has continued to push higher. The CPI and core CPI for August reached 9.1% and 4.3%, from 8.9% and 4.0% respectively in July. The unemployment rate remains unchanged at 6.6%. The S&P Global Eurozone manufacturing and services PMI weakened from 49.7 and 50.2 in July to 49.6 and 49.8 respectively in August. The substantial reduction in gas flows through the Nord Stream 1 pipeline has pushed European energy prices to new heights, while the region is resorting to more liquefied natural gas imports and the reactivation of coal-fired power stations to navigate this energy crisis. In addition, the region's recession risk remains elevated due to the energy constraints. The Caixin China manufacturing PMI dropped from 50.4 in July to 49.5 in August, while the services PMI remained strong at 55 in August. The yearly growth rate in both China exports and imports fell over the period. With China's and Japan's August CPI standing at 2.5% and 3.0% respectively, which was very different from the rest of the world, the central banks of these two countries will remain focused on keeping rates low to support growth, embarking on a very different rate path trajectory.

We have reduced our neutral position in global equities to moderately underweight. We believe that slowing growth and rising input costs will pose risks to elevated corporate profit margins. Global supply chain pressure has continued to soften but services inflation is picking up, while goods inflation seems to need more time to come down materially. In the short term, we expect inflation to remain elevated, with broad-based inflationary pressures offsetting commodity price disinflation. Our base case is that the Fed will continue to hike rates at the current pace to rein in inflation and to prevent the unanchoring of inflation expectations, thus showing a willingness to pay the price of overtightening as the monetary policy has a lag effect on the economy.

Lastly, we have also chosen to remain neutral in offshore bonds. The US 10-year bond yield disaggregation indicates that most of the surge in yields was driven by higher-than-expected, short-term rates. Bond valuations are becoming more attractive but are not yet high enough for us to move to moderately overweight, as there is still a risk that investors may demand a higher-term premium for holding longer maturity bonds. We have also chosen to remain overweight in offshore cash to ensure relatively neutral offshore exposure, as our base case expectation is for the USD to strengthen further in a volatile macro and liquidity-tightening environment.

Figure 14: US 10-year bond yield disaggregation



Source: Bloomberg

MENTENOVA

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