



MENTEMOVA

# HOUSEVIEW TACTICAL ASSET ALLOCATION

20 April 2023



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We have kept our TAA positions unchanged, 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

Our investment case has remained the same into May. We have remained moderately overweight in SA nominal bonds based on attractive hedged yields and marginally attractive real yields compared to equivalent inflation-linked bonds, especially over the longer maturities of the yield curve. We have maintained our moderately underweight position in offshore equities, the reason being that we believe the earnings outlook is yet to fully price in a moderate recession as negative operating leverage is expected to soften earnings per share over the upcoming results season. We have also maintained our moderately overweight position in offshore cash to ensure both a relatively neutral allocation to offshore overall and some protection in the event of a significant dent in global risk sentiment.

## TAA Overview

<b>Market overview</b>	<p>Despite the short-lived market turmoil that followed the collapse of Silicon Valley Bank and the meltdown of Credit Suisse in March, equity markets in general still ended higher for the first quarter. The gain was largely driven by investor optimism that cooling inflation would soon result in the hiking cycle coming to an end.</p> <p>The MSCI World Index returned 3.2% for the month of March, the MSCI Emerging Markets Index performed in line, returning 3.1%. The S&amp;P 500 and the Nikkei 225 returned 3.7% and 3.1% respectively over the same period. European equities, the STOXX 600 Index, returned -0.3%, as growth for the region was more resilient than the market expectation; but inflation was also stubbornly sticky. The ALSI Index declined by 1.3% in March but made a marginal recovery into April. The MSCI World Growth Index also continued to significantly outperform the Value Index in March, supported by falling bond yields.</p> <p>Major global bond indices delivered positive returns in March, with inflation-linked bonds delivering the best performance. Government bonds also outperformed corporate high yields over the same period as the backdrop of volatile markets saw widening credit spreads. Our local bonds, the ALBI, returned 1.3% in March while the IGOV outperformed slightly, returning 1.5%.</p> <p>The local property SAPY Index performed in line with global property indices in local currency terms in March, while the SAPY Index significantly outperformed global properties into April. The STOXX 600 Real Estate Total Return Index saw the worst performance in March, falling by</p>
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11.6% in local currency terms as investors grew concerned about higher vacancy rates and financing costs.

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

31 March 2023 (Local Currency)	1M	3M	YTD	1 Year	3 Year (annualised)	5 Year (annualised)	10 Year (annualised)	MTD 13 April 2023
FTSE/JSE ALSI Total Return	-1.3%	5.2%	5.2%	4.9%	24.2%	10.4%	10.2%	3.5%
FTSE/JSE Capped SWIX Total Return	-2.0%	2.4%	2.4%	0.2%	23.0%	6.5%	8.4%	3.7%
S&P 500 Total Return	3.7%	7.5%	7.5%	-7.7%	18.6%	11.2%	12.2%	1.0%
STOXX 600 Total Return	-0.3%	8.4%	8.4%	3.1%	15.3%	7.0%	7.3%	1.5%
Nikkei 225 Total Return	3.1%	8.5%	8.5%	3.1%	16.2%	7.7%	10.6%	0.4%
MSCI World Total Return	3.2%	7.9%	7.9%	-6.5%	17.0%	8.6%	9.4%	1.4%
MSCI ACWI Total Return	3.2%	7.4%	7.4%	-7.0%	15.9%	7.5%	8.6%	1.4%
MSCI EM Total Return	3.1%	4.0%	4.0%	-10.3%	8.2%	-0.5%	2.4%	0.8%
MSCI World Value Index	-0.6%	1.1%	1.1%	-4.3%	16.8%	5.8%	7.4%	1.9%
MSCI World Growth Index	7.0%	15.2%	15.2%	-9.6%	16.2%	10.7%	11.2%	0.8%
MSCI World Small Cap Index	-2.5%	4.4%	4.4%	-8.9%	18.1%	4.9%	8.2%	0.5%
FTSE UK Series FTSE All Share TR	-2.8%	3.1%	3.1%	2.9%	13.8%	5.0%	5.8%	2.6%
MSCI AC Asia Ex. Japan Index	3.5%	4.3%	4.3%	-8.6%	7.2%	0.3%	4.4%	0.0%
MSCI Europe Excluding United Kingdom Index	1.0%	10.2%	10.2%	5.3%	16.4%	8.3%	8.8%	1.1%
STEFI	0.6%	1.8%	1.8%	6.0%	4.8%	5.8%	6.2%	0.3%
ALBI	1.3%	3.4%	3.4%	5.8%	11.6%	6.9%	7.3%	-0.3%
IGOV	1.5%	0.9%	0.9%	4.9%	10.7%	4.5%	4.9%	0.1%
WGBI	3.8%	3.5%	3.5%	-9.6%	-5.3%	-2.3%	-0.6%	0.6%
Bloomberg Global Inflation-Linked Total Return Index	4.5%	4.5%	4.5%	-15.8%	-1.4%	-1.0%	0.5%	0.3%
Bloomberg US Agg Total Return	2.5%	3.0%	3.0%	-4.8%	-2.8%	0.9%	1.4%	0.5%
Bloomberg EuroAgg Total Return Index	2.0%	2.1%	2.1%	-10.6%	-4.7%	-2.0%	0.8%	-0.2%
Bloomberg Global Agg Corporate Total Return Index	2.8%	3.5%	3.5%	-6.9%	-0.8%	0.0%	1.3%	0.9%
Bloomberg US Corporate High Yield Total Return Index	1.1%	3.6%	3.6%	-3.3%	5.9%	3.2%	4.1%	0.9%
Bloomberg Pan-European High Yield Total Return Index	-0.4%	2.9%	2.9%	-4.6%	4.5%	1.0%	3.6%	0.3%
J.P. Morgan EMBI Global Core Hedged EUR	0.9%	1.2%	1.2%	-10.7%	-2.0%	-2.9%	0.2%	0.4%
SAPY Total Return	-3.4%	-5.1%	-5.1%	-3.4%	18.2%	-4.1%	1.3%	6.3%
MSCI US REIT Total Return	-2.5%	2.7%	2.7%	-19.2%	12.0%	6.0%	5.9%	-1.4%
S&P Global Property Total Return	-2.8%	0.3%	0.3%	-20.5%	6.4%	0.7%	3.0%	0.7%
STOXX 600 Real Estate Total Return	-11.6%	-4.7%	-4.7%	-37.2%	-5.4%	-5.8%	1.5%	2.5%
FTSE EPRA Nareit Global REITs TR Index	-2.8%	1.7%	1.7%	-19.6%	9.7%	2.8%	4.0%	-0.3%
Crude Oil	-4.9%	-7.1%	-7.1%	-26.1%	51.9%	2.6%	-3.2%	7.9%
Aluminium	1.7%	1.5%	1.5%	-30.9%	16.5%	3.8%	2.4%	-1.9%
Copper	0.4%	7.4%	7.4%	-13.3%	22.0%	6.0%	1.8%	0.7%
Gold	7.8%	8.0%	8.0%	1.6%	7.7%	8.2%	2.1%	3.6%
Platinum	4.1%	-7.4%	-7.4%	0.9%	11.2%	1.3%	-4.5%	5.7%
Nickel	-3.8%	-20.8%	-20.8%	-26.2%	27.4%	12.3%	3.6%	0.0%
Palladium	3.2%	-18.3%	-18.3%	-35.5%	-14.8%	9.0%	6.6%	3.2%
Iron Ore	4.2%	9.0%	9.0%	-14.5%	14.7%	14.6%	-1.0%	-4.8%
Bloomberg Commodity Index Total Return	-0.2%	-5.4%	-5.4%	-12.5%	20.8%	5.4%	-1.7%	2.3%
USDZAR	-3.1%	4.5%	4.5%	21.8%	-0.1%	8.5%	6.8%	1.4%
GBPZAR	-0.5%	6.6%	6.6%	14.3%	-0.3%	5.8%	4.6%	3.0%
EURZAR	-0.6%	5.7%	5.7%	19.3%	-0.7%	5.7%	5.0%	3.4%
JPYZAR	-0.6%	3.1%	3.1%	11.6%	-6.9%	3.7%	3.2%	1.6%
Dollar Index Spot	-2.3%	-1.0%	-1.0%	4.3%	1.2%	2.6%	2.1%	-1.5%

Source: Bloomberg

Commodities in general declined in March, with the Bloomberg Commodity Index falling by 0.2%, but it gained 2.3% into April. Gold was the best performer among precious metals in March, while industrial metals' performance was mixed – the copper and aluminium price advanced but the nickel price fell by 3.8% in March, declining by 20.8% for the first quarter. The Dollar Index declined by 2.3% against other major currencies in March and declined further by 1.5% into April, driven by changes in rate path expectations.

## Tactical views

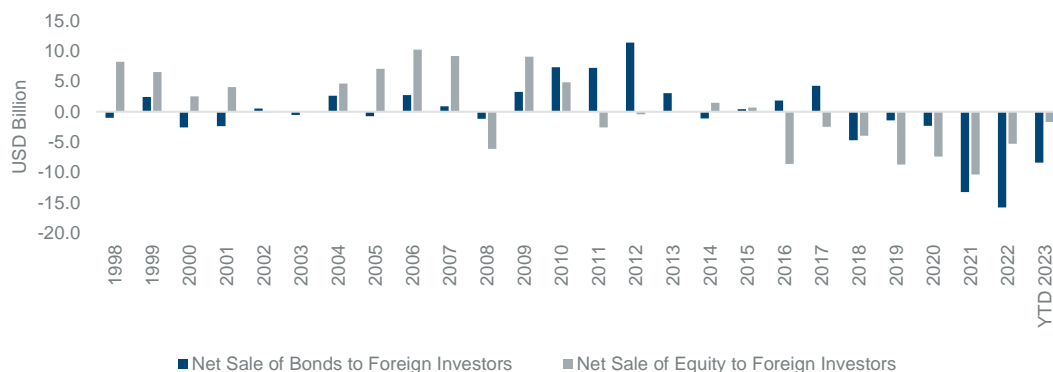
**Global risk sentiment continues to dominate the performance of South African asset classes while domestic economic growth stalls in the face of the persistent power crisis**

As shown in Figure 3, foreign investors continued to disinvest from SA bonds and equity into 2023, net selling \$8.4bn in SA bonds and \$1.7bn in SA equity for the year to date as at 13 April 2023. Events such as the recent banking sector turbulence in the US and Europe and the uncertainty over whether developed markets' inflation will cool in the face of sluggish growth or moderating wage levels, all impact global risk sentiment. Country-specific issues, such as extensive loadshedding and the lack of political will to implement economic reforms and combat



corruption (which have stunted domestic growth), have made local assets increasingly vulnerable to changes in the global risk appetite and liquidity conditions.

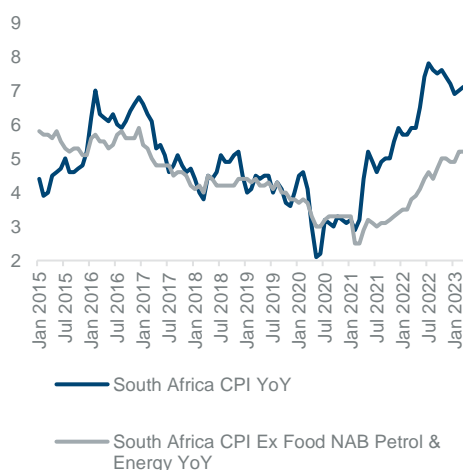
**Figure 3: Net sale of SA bonds and equity to foreign investors**



Source: Bloomberg

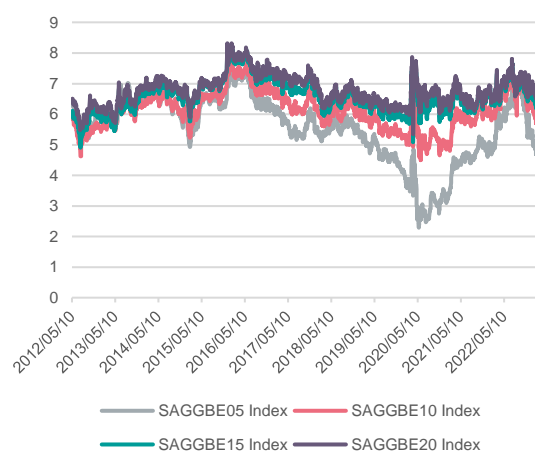
Inflation in South Africa continued to be stickier than the market expectation, with the CPI year on year up from 7.0% in February to 7.1% in March. The core CPI, which is a much better gauge of inflationary pressure in the underlying economy, remained at a level of 5.2% over the same period, as shown in Figure 4. According to Capitec Bank's latest financial results, interest rate hikes have had a major impact on the bank's clients' annual spend on servicing debt, i.e., increasing annual spend on home loans by 20%, vehicle financing by 15% and personal loans by 12%. At the same time, the cost of living has increased significantly for South African consumers. The transaction data on Capitec Bank's 20 million clients shows that the annual spend on groceries, fuel, cell phones and takeaways increased by 8%, 16%, 10% and 36% respectively over the financial year ending February 2023. While approval rates have been maintained, the volume of loan applications has surged and credit impairments have more than doubled for the bank. We believe this phenomenon is not unique to Capitec Bank; it indicates that South African consumers remain under tremendous pressure, with lower- to middle-income consumers more vulnerable than high-LSM consumers. The BER Consumer Confidence Index dropped from -8 in Q4 2022 to -23 in Q1 2023.

**Figure 4: South Africa CPI and core CPI YoY**



Source: Bloomberg

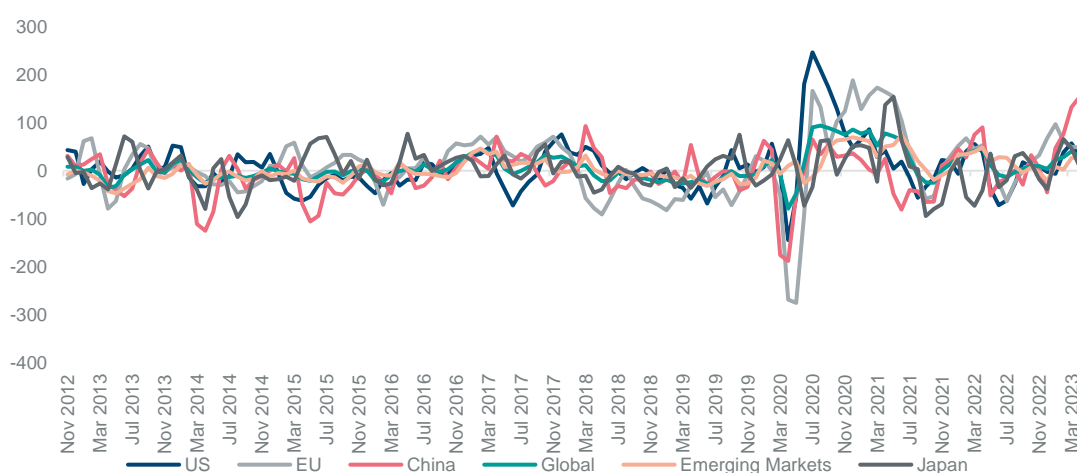
**Figure 5: South Africa breakeven inflation**





Most major economic regions produced macro data that exceeded market expectations, but most have also seen the number of positive surprises decline, as is evident in Figure 6. We saw the biggest jump from China as its economic activities rebounded from the sudden relaxation of the zero-Covid policy, the use of measures to support its property market and the loosening of regulatory limitations on its technology companies – all of which bolstered investor sentiment about the country. While the China rebound should be supportive of global commodity prices and the tourism sector, the South African manufacturing PMI contracted further, from 48.8 in February to 48.1 in March, due to the power crisis. Overall, the domestic economy is undergoing a period of stagflation, with elevated inflation but no economic growth.

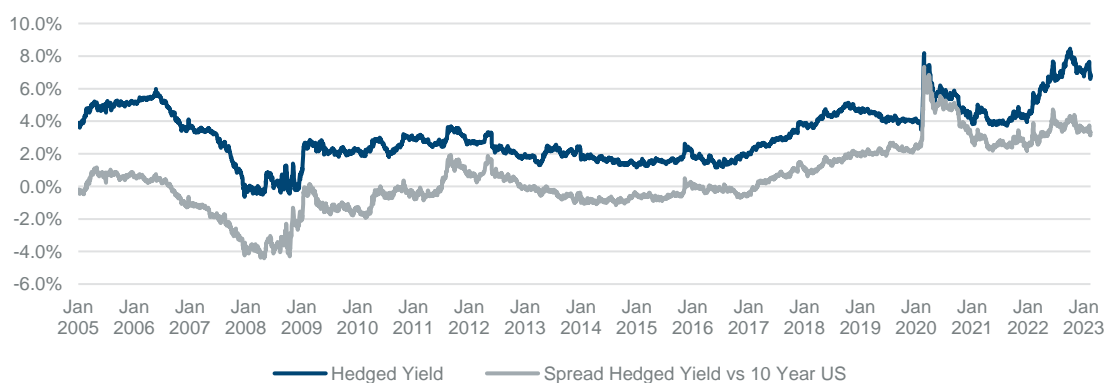
**Figure 6: Economic surprise indices**



Source: Bloomberg

The 10-year nominal SA government bond is trading at a discount to the implied 10-year yield, while the equivalent linker is trading at a slight premium as investors favour inflation-linked bonds for inflation protection. Both are trading at similar real yields. Based on breakeven inflation, as shown in Figure 5, longer-maturity inflation-linked bonds are fully valued. The hedged SA 10-year yield spread vs the US 10-year treasury has narrowed from 4.04% to 3.55% but is still at a considerably higher level than the historical average, as shown in Figure 7.

**Figure 7: South Africa 10-year USD-hedged yield and spread**

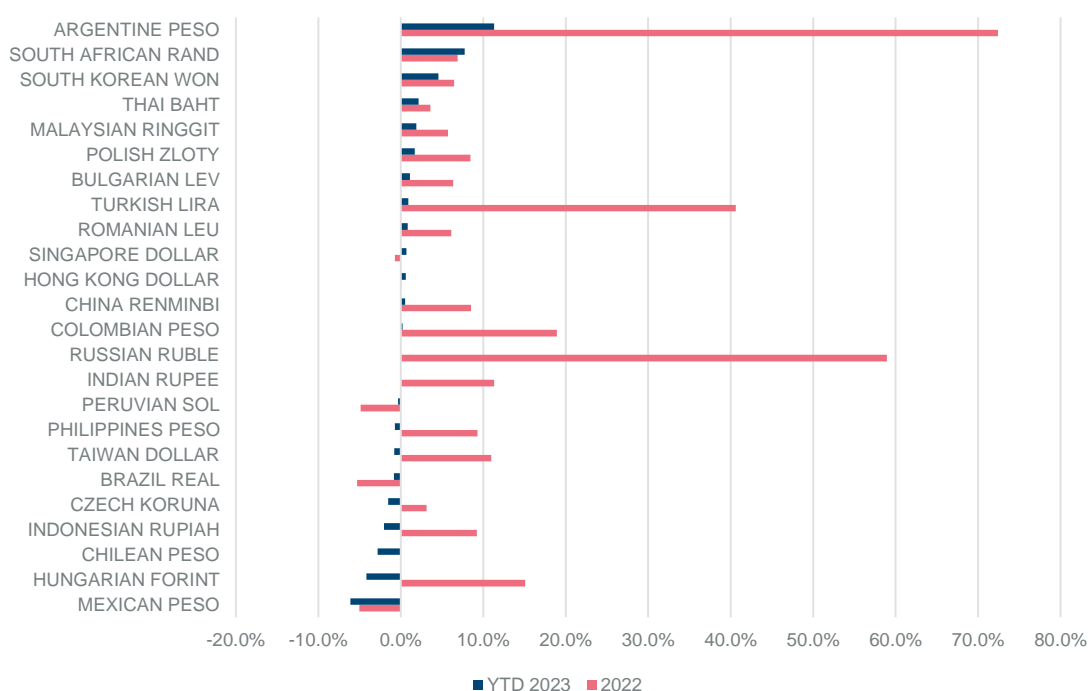


Source: Bloomberg



We maintained our moderately overweight position in local nominal bonds as longer-maturity nominal bonds offered marginally more compensation for inflation than their equivalent-maturity inflation-linked bonds. Local nominal bonds also remained attractive from a hedged-yield perspective as the hedged-yield spread remained elevated. The Rand has been one of the worst-performing emerging market currencies for the year to date, as shown in Figure 8. Therefore, at the current FX level, we believe there is limited further downside risk to the ZAR. But it remains vulnerable to any major shift in risk sentiment. For instance, negative risk sentiment from a US economic slowdown or recession could result in further weakening. If inflation continues to cool and the US economy remains strong, and with the Fed pausing rate hikes, the domestic currency could be given a boost.

**Figure 8: Emerging market currencies' performance**



Source: Bloomberg

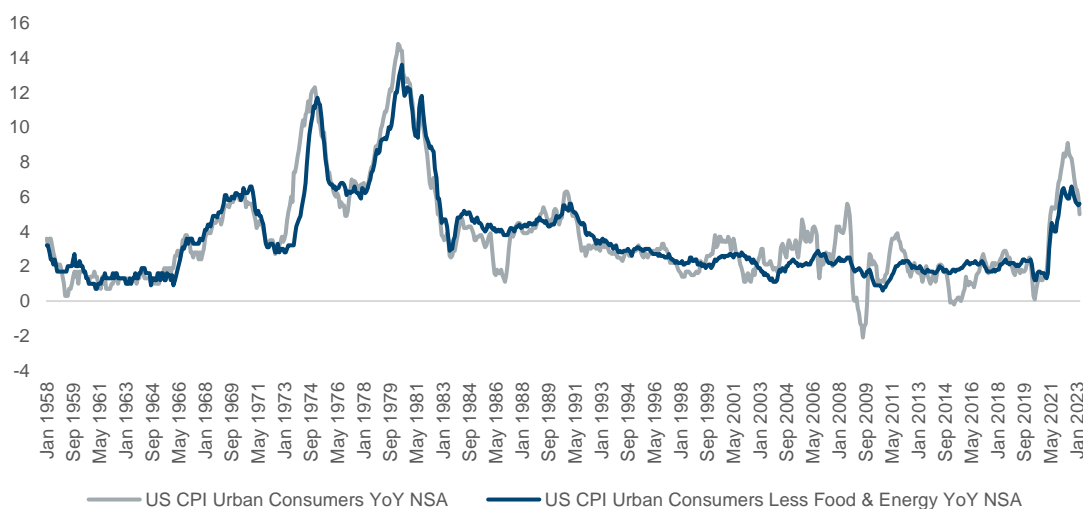
**Negative operating leverage will hurt earnings if inflation is reduced by falling demand, while companies are dealing with higher costs**

Inflation in the US cooled from 6.0% in February to 5.0% in March. Similarly, Eurozone inflation declined from 8.5% to 6.9% over the same period. The inflation rates are still at a level materially above the central bank targets, although they are trending lower. Also, the inflation landscape in each of these two regions is much lower than in the UK, with headline inflation cooling much more slowly, from 10.4% in February to 10.1% in March, as resilient economic activities prop up demand. We can see from Figure 9 that the US core inflation remains quite sticky. Furthermore, as shown in Figure 10, the US core goods inflation has plunged, but the US core services were the main driver behind the elevated core inflation. Shelter's weighting is over 50% in core services. Therefore, if housing prices continue to cool (the US House Price Index yearly growth declined steadily from 19.3% in April 2022 to 3.9% in April 2023), shelter inflation should reflect the same trend over time. There is a lag between house price and shelter inflation due to the frequency of lease renewals.



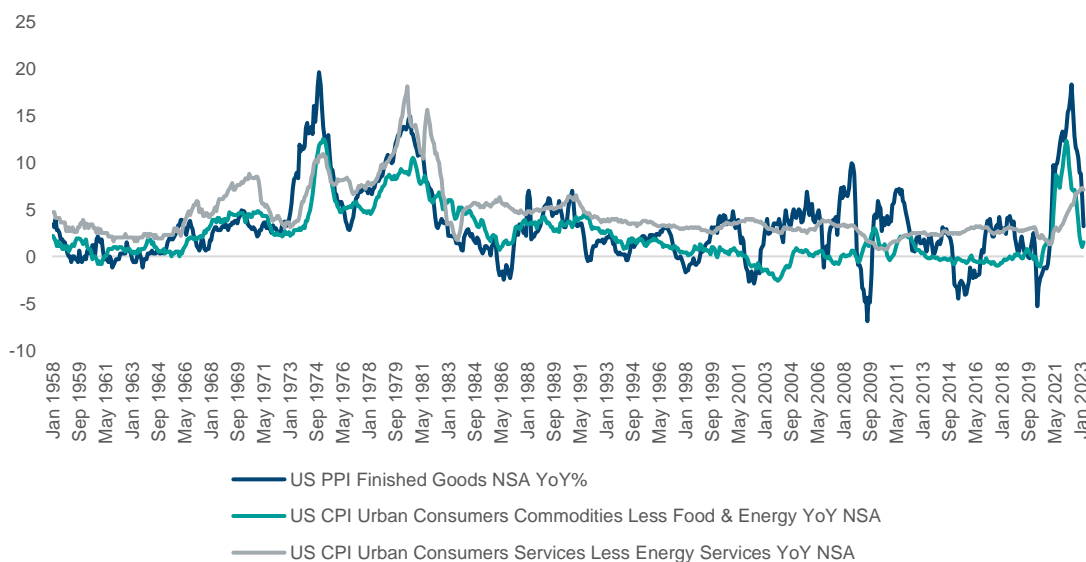
Labour markets in the US, UK, Eurozone and Japan remained very tight, with unemployment rates hovering around historical lows. However, the ADP employment changes and nonfarm payroll changes drifted lower in March. In addition, initial jobless claims also ticked up slightly but were still in the range of 190k to 240k per week over the past month. While the US average hourly earnings yearly change continued to cool steadily to reach 4.2% in March, from the peak of 5.9% in March 2022, the average weekly earnings three months year on year in the UK ticked up from 5.7% in January to 5.9% in February.

**Figure 9: US CPI and core CPI YoY**



Source: Bloomberg

**Figure 10: US core goods and services inflation YoY**



Source: Bloomberg

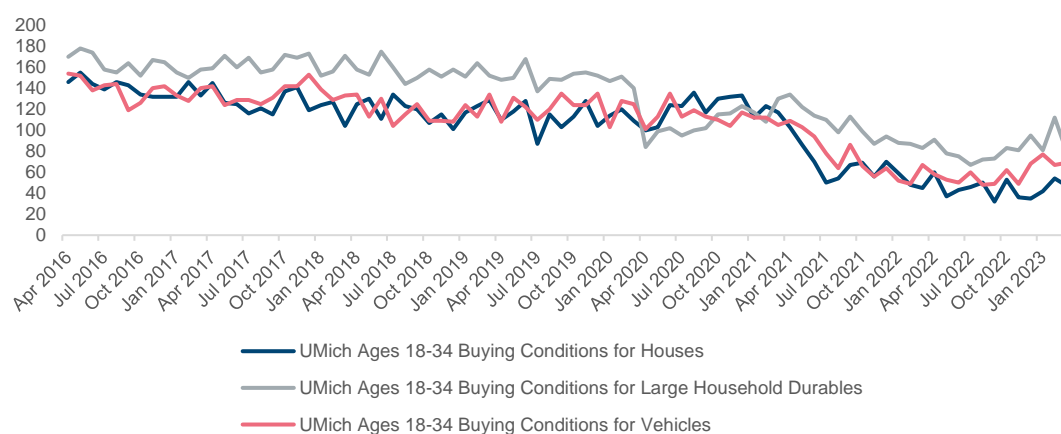
The ideal situation is for inflation to cool through wage growth and shelter cost moderation, without substantial negative adjustment to job numbers. Given the elevated core inflation and tight labour markets, this scenario is possible but highly uncertain. However, we continue to



expect a divergence in the interest rate trajectories in the developed countries going forward, as each experiences a different pace of inflation normalisation. The US FRA rates currently price in another 25bps hike and the rate peaking at that level before its downward path in late Q3 this year. The European FRA rates, however, are pricing in another 70bps hike over the next six months.

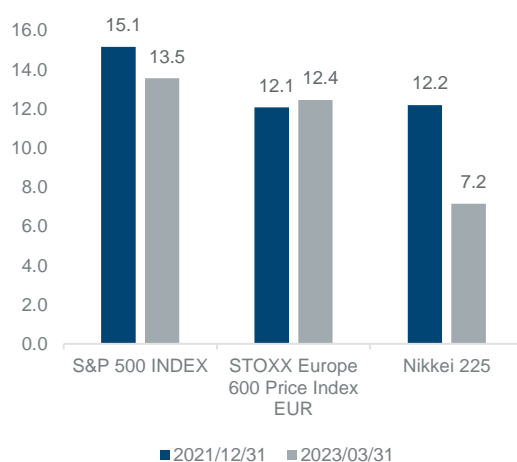
Despite the ongoing resilience in developed country labour markets, consumers are becoming increasingly cautious in their spending decisions as buying conditions remain subdued, as shown in Figure 11, and the effects of rate hikes ripple through the economies. US retail sales month on month contracted from -0.4% in February to -1.0% in March. With businesses delaying investment for future utilisation and inflation keeping capital consumption at elevated levels, aggregate demand is expected to soften. At the same time, operating costs over the near future may continue to be elevated due to inflation. Softening revenue and bloated costs are expected to lead to negative operating leverage, which translates into declining earnings growth and negative earnings estimate revisions.

**Figure 11: US buying conditions**



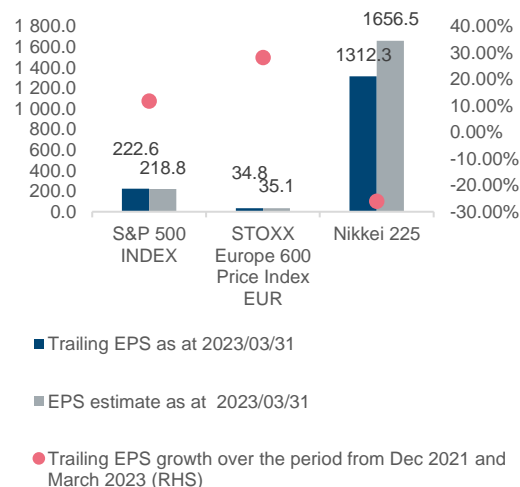
Source: Bloomberg

**Figure 12: Operating margin**



Source: Bloomberg

**Figure 13: Earnings per share**

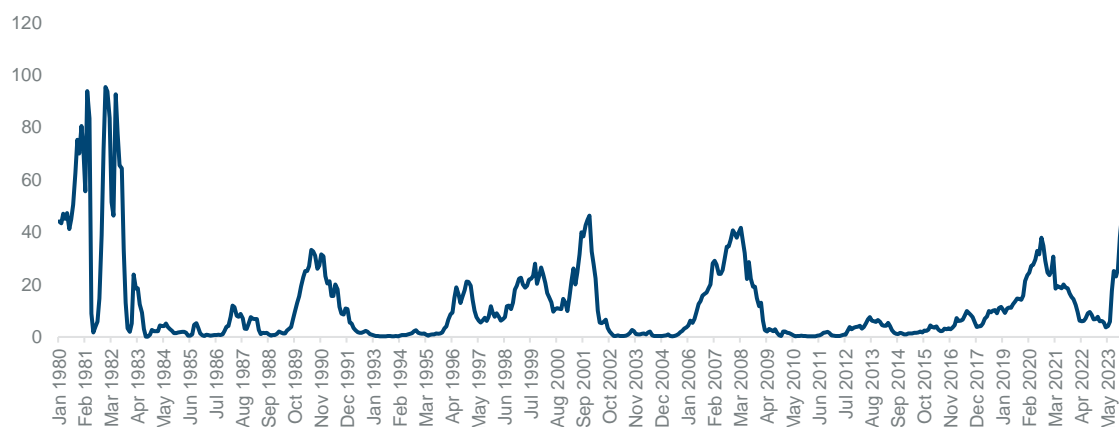




As shown in Figures 12 and 13, operating margins have declined for the S&P 500 and the Nikkei 225. However, earnings-per-share estimates are not yet priced into the reversion if the economic slowdown or recession does materialise, as reflected in the elevated probability of a recession, according to the New York Federal Reserve Bank. The probability of the US landing in a recession over the next 12 months has increased from 54.59% to 57.77%, as shown in Figure 14.

After conducting a thorough analysis, we have decided to maintain our moderately underweight position in offshore equities. We believe that the earnings outlook has not fully priced in a moderate recession, which is why we opted to maintain our position. Additionally, we are maintaining a moderately overweight position in offshore cash to ensure a relatively neutral allocation to offshore overall and provide some protection in case of any significant impact on global risk sentiment. It is important to note that we do not anticipate a significant material weakening of the ZAR against the USD.

**Figure 14: New York Fed US probability of recession in the next 12 months**



Source: Bloomberg



MENTENOVA

# CONTACT

**YANNI YANG, CFA<sup>®</sup>, FRM, CAIA**

**C** +27 84 802 3784 **T** +27 11 447 7716

**F** 086 272 1177 **E** [yyang@mentanova.co.za](mailto:yyang@mentanova.co.za)

3rd Floor, Oxford & Glenhove Building 2,  
114 Oxford Road, Rosebank, Johannesburg  
[www.Mentanova.co.za](http://www.Mentanova.co.za)