MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

22 June 2023

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We have kept most of our TAA positions unchanged, apart from reducing our significantly overweight position in foreign cash to moderately overweight, 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 relatively unchanged into July. We have maintained our moderately underweight position in offshore equities. While we may have entered into this defensive position six to eight months early, the current fundamentals do not support the recent rally. Headwinds, such as negative operating leverage, new debt ceiling deals resulting in the reduction of fiscal support measures and reduced liquidity, will continue to weigh on companies' earnings outlook. We have also remained moderately overweight in offshore bonds because of their diversification benefits in the event of a recession and the attractiveness of short-term income and potential capital appreciation as the end of the rate hiking cycle approaches. We have reduced our significantly overweight position in offshore cash to moderately overweight as there seems to be some improvement in the electricity crisis, although the geopolitical landscape remains highly uncertain and the currency market is experiencing elevated volatility. We also see this offshore cash position offering some protection in the event of a significant dent in global risk sentiment.

TAA Overview

Market overview	Equity markets delivered broadly negative returns in May as central banks continued to hike rates, with investors weighing up the likelihood of the US defaulting on its debt obligations if the Democrats and Republicans failed to reach a deal on the debt ceiling negotiations. The S&P 500 managed to outperform other equity indices in general by posting a return of 0.4% in May, while the STOXX 600 Index, MSCI World Index and MSCI Emerging Market Index delivered returns of -2.5%, -0.9% and -1.7% respectively over the same period. The Nikkei 225 Index was up by 7.0% in May, driven mainly by a better-than-expected Q1 GDP figure (annualised QoQ of 2.7% vs market expectation of 1.9%). Meanwhile, investors are growing increasingly optimistic that the country is on its way out of its deflationary stagnation phase, based on the country's recent inflation data. The MSCI World Growth Index outperformed the MSCI World Value Index by 6.9 percentage points as investors priced in low macro risk exposures and a tailwind driving growth stocks if the Fed continued to pause rate hikes. Chinese equities, proxied by the MSCI China All Shares Index, underperformed against the MSCI AC Asia Ex. The Japan Index fell by 7.93% in May, with the weaker-than-expected macro data indicating that the post-Covid economic rebound was losing momentum, which weighed on investor sentiment. Equity markets have rebounded into June on the back of upbeat economic data, providing some comfort to investors that while rates may stay higher for longer, the risk of recession is less imminent.

For SA, both the ALSI and the Capped SWIX Indices were firmly in the red, delivering returns of -3.9% and -5.8% in May. This was in the wake of the power crisis continuing to dent SA companies' profit margins and economic uncertainty rising in the face of US allegations that SA was supplying weaponry to Russia. This negative sentiment also appeared in the SA bond markets. The ALBI Index, which fell by 4.8% in May, was outperformed by the IGOV Index, which fell by 2.4%. Global bond markets were also largely in the red as bond yields rose, while the WGBI was down by 2.2%. Headline inflation continued to cool but core inflation remained sticky in the Eurozone, the UK and the US where, given their robust labour markets, investors weighed the risk of central banks continuing to hike rates, resulting in rates peaking at higher-than-initially expected levels.

Global property markets plunged in May. The S&P Global Property Index returned -4.5%, the STOXX 600 Real Estate Index fell by 8.7% and our local SAPY Index fell by 5.3%, as significant increases in financing costs from rate hikes dampened the prospects for this sector. Bond markets and property markets recovered some ground in June alongside equities. The Bloomberg Commodity Index returned -5.6% for the month of May, with oil, precious metals and industrial metals all in the red. Gold performed relatively better, falling by 1.4% compared to other precious metals. Industrial metal prices were weighed down by the weaker demand outlook in the event that China's slowdown continued. The oil price was up by c.5.0% into June as production cuts and US inventory replenishment would support the price in the short term. Industrial metals such as iron ore also saw material recovery due to the anticipation of a further stimulus effort from China. The Dollar Index gained 2.6% against other major currencies in May but weakened by 2.0% into June, driven by changes in rate outlooks. The ZAR depreciated by 7.8% against the USD in May but appreciated by 7.8% into June as risk sentiment improved.

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

31 May 2023 (Local Currency)	1M	3M	YTD	1 Year	3 Year (annualised)	5 Year (annualised)	10 Year (annualised)	MTD 18 June 2023
FTSE/JSE ALSI Total Return	-3.9%	-1.9%	4.5%	8.5%	18.5%	9.9%	9.5%	4.6%
FTSE/JSE Capped SWIX Total Return	-5.8%	-4.5%	-0.2%	1.1%	16.8%	6.2%	7.6%	6.6%
S&P 500 Total Return	0.4%	5.7%	9.6%	2.9%	12.9%	11.0%	12.0%	5.6%
STOXX 600 Total Return	-2.5%	-0.5%	8.2%	4.6%	11.6%	6.0%	6.9%	3.4%
Nikkei 225 Total Return	7.0%	13.6%	19.6%	15.9%	14.4%	9.0%	10.5%	9.1%
MSCI World Total Return	-0.9%	4.1%	8.8%	2.6%	11.5%	8.3%	9.2%	5.9%
MSCI ACWI Total Return	-1.0%	3.6%	7.9%	1.4%	10.6%	7.3%	8.4%	6.1%
MSCI EM Total Return	-1.7%	0.2%	1.2%	-8.1%	3.9%	-0.3%	2.3%	7.7%
MSCI World Value Index	-4.5%	-3.1%	-1.5%	-4.0%	11.5%	5.3%	6.7%	5.9%
MSCI World Growth Index	2.4%	11.4%	19.9%	9.3%	10.8%	10.8%	11.3%	5.7%
MSCI World Small Cap Index	-2.7%	-5.2%	1.5%	-3.8%	9.6%	3.6%	7.6%	6.7%
FTSE UK Series FTSE All Share TR	-4.6%	-4.2%	1.6%	0.4%	10.2%	2.9%	5.3%	2.7%
MSCI AC Asia Ex. Japan Index	-1.8%	-0.5%	0.4%	-7.8%	3.3%	-0.3%	3.9%	6.8%
MSCI Europe Excluding United Kingdom Index	-2.1%	1.2%	10.4%	7.7%	12.5%	7.6%	8.3%	3.2%
STEFI	0.7%	1.9%	3.1%	6.5%	4.9%	5.8%	6.2%	0.3%
ALBI	-4.8%	-4.6%	-2.7%	0.3%	5.6%	6.2%	6.7%	3.7%
IGOV	-2.4%	-0.6%	-1.2%	-1.2%	7.9%	4.6%	4.6%	2.1%
WGBI	-2.2%	1.9%	1.7%	-5.5%	-6.3%	-2.1%	-0.5%	0.5%
Bloomberg Global Inflation-Linked Total Return Index	-3.1%	1.0%	0.9%	-10.4%	-4.2%	-1.1%	0.3%	1.8%
Bloomberg US Agg Total Return	-1.1%	2.0%	2.5%	-2.1%	-3.6%	0.8%	1.4%	-0.2%
Bloomberg EuroAgg Total Return Index	0.4%	2.5%	2.6%	-5.6%	-5.0%	-1.7%	0.7%	-0.5%
Bloomberg Global Agg Corporate Total Return Index	-1.9%	2.0%	2.7%	-2.4%	-3.0%	0.3%	1.3%	0.7%
Bloomberg US Corporate High Yield Total Return Index	-0.9%	1.1%	3.6%	0.0%	2.9%	3.1%	4.0%	1.6%
Bloomberg Pan-European High Yield Total Return Index	0.9%	1.0%	4.3%	0.9%	2.1%	1.4%	3.4%	1.1%
J.P. Morgan EMBI Global Core Hedged EUR	-1.0%	0.2%	0.5%	-5.3%	-4.9%	-2.5%	0.2%	1.5%
SAPY Total Return	-5.3%	-3.6%	-5.3%	-2.3%	15.7%	-4.4%	1.8%	3.7%
MSCI US REIT Total Return	-3.1%	-4.7%	0.4%	-11.9%	8.2%	4.4%	5.7%	4.8%
S&P Global Property Total Return	-4.5%	-5.4%	-2.3%	-14.7%	2.9%	-0.3%	2.8%	4.9%
STOXX 600 Real Estate Total Return	-8.7%	-14.7%	-8.0%	-32.3%	-8.3%	-7.2%	0.5%	3.4%
FTSE EPRA Nareit Global REITs TR Index	-3.8%	-5.1%	-0.7%	-13.2%	6.1%	1.6%	3.9%	4.0%
Crude Oil	-8.6%	-13.4%	-15.4%	-40.8%	27.2%	-1.3%	-3.2%	5.4%
Aluminium	-4.7%	-5.4%	-5.6%	-19.4%	13.2%	-0.4%	1.7%	1.1%
Copper	-5.9%	-9.7%	-3.4%	-14.4%	14.6%	3.4%	1.0%	5.9%
Gold	-1.4%	7.4%	7.6%	6.8%	4.3%	8.6%	3.5%	-0.2%
Platinum	-7.4%	4.4%	-7.1%	3.0%	6.0%	1.9%	-3.7%	-1.2%
Nickel	-15.5%	-16.8%	-31.5%	-27.8%	18.6%	6.2%	3.3%	0.0%
Palladium	-9.2%	-3.5%	-23.7%	-31.7%	-11.0%	6.7%	6.2%	3.5%
Iron Ore	-7.6%	-15.8%	-11.9%	-26.2%	1.3%	9.8%	-1.4%	10.4%
Bloomberg Commodity Index Total Return	-5.6%	-6.5%	-11.4%	-22.5%	17.2%	3.2%	-1.9%	7.6%
USDZAR	7.8%	7.5%	15.8%	26.1%	4.0%	9.2%	6.9%	-7.8%
GBPZAR	6.8%	11.2%	19.2%	24.5%	4.2%	7.8%	4.8%	-5.1%
EURZAR	4.7%	8.7%	15.6%	25.7%	2.7%	7.3%	4.9%	-5.8%
JPYZAR	5.4%	5.0%	8.9%	16.5%	-4.5%	3.9%	3.5%	-9.5%
Dollar Index Spot	2.6%	-0.5%	0.8%	2.5%	2.0%	2.1%	2.3%	-2.0%

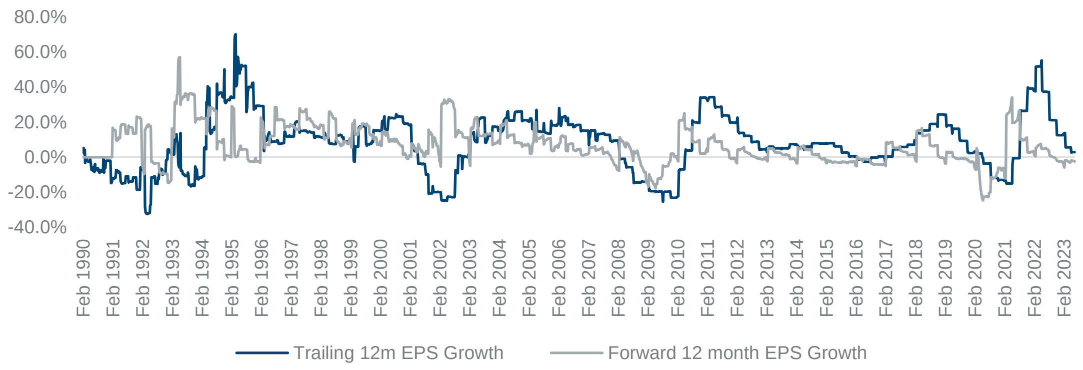
Source: Bloomberg

Tactical views

Recession risk not fully priced in as market anticipates an immaculate disinflation

The forward 12-month EPS growth rates have been declining but the market has not yet priced in any significant negative reversions, as shown in Figure 3 and Figure 4. While valuations for the US market have stabilised and improved in recent months, returns on equity have softened, as shown in Figure 5.

Figure 3: S&P 500 EPS growth

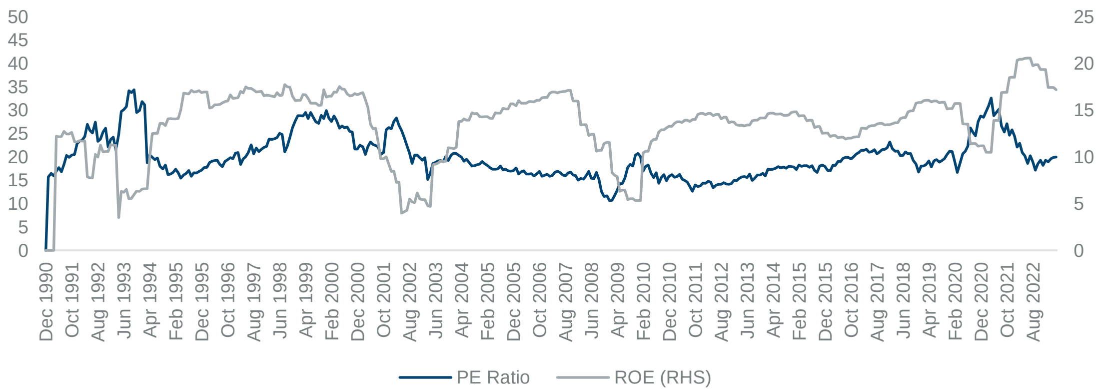


Source: Bloomberg

Figure 4: STOXX 600 EPS growth

Source: Bloomberg

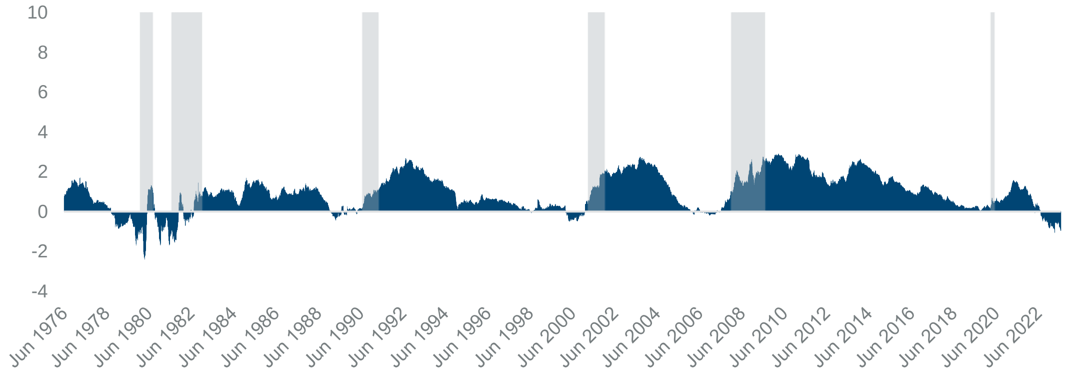
Figure 5: S&P 500 PE and ROE



Source: Bloomberg

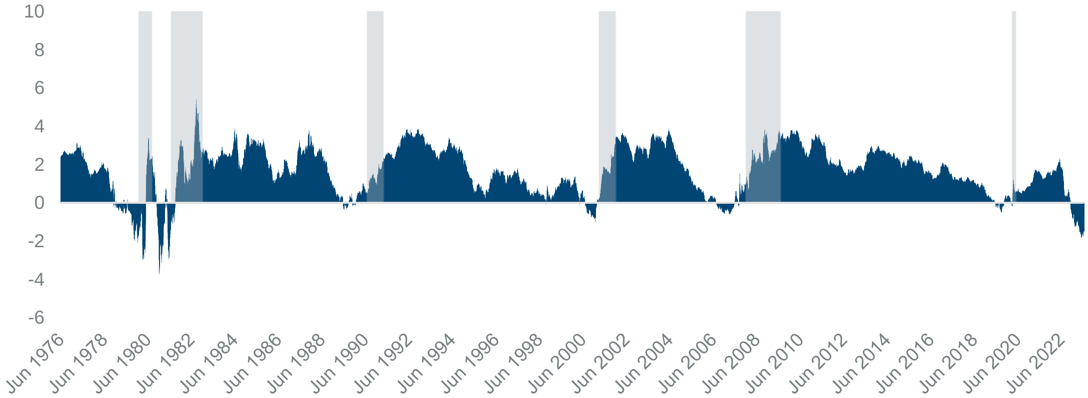
Based on traditional indicators, the risk of recession in the US remains elevated. The US yield curve is seeing its greatest inversion since the early 1980s, as shown in Figure 6 and Figure 7. According to the New York Fed, the probability of the US entering a recession (within the next 12 months) increased to 70.85% based on the steepness of the inversion. While the yield curve inversion has been a good predictor of oncoming recessions in general, we do acknowledge that the lead time to recession may vary significantly and remain uncertain.

Figure 6: US 10-year vs 2-year treasury yield spread



Source: Bloomberg

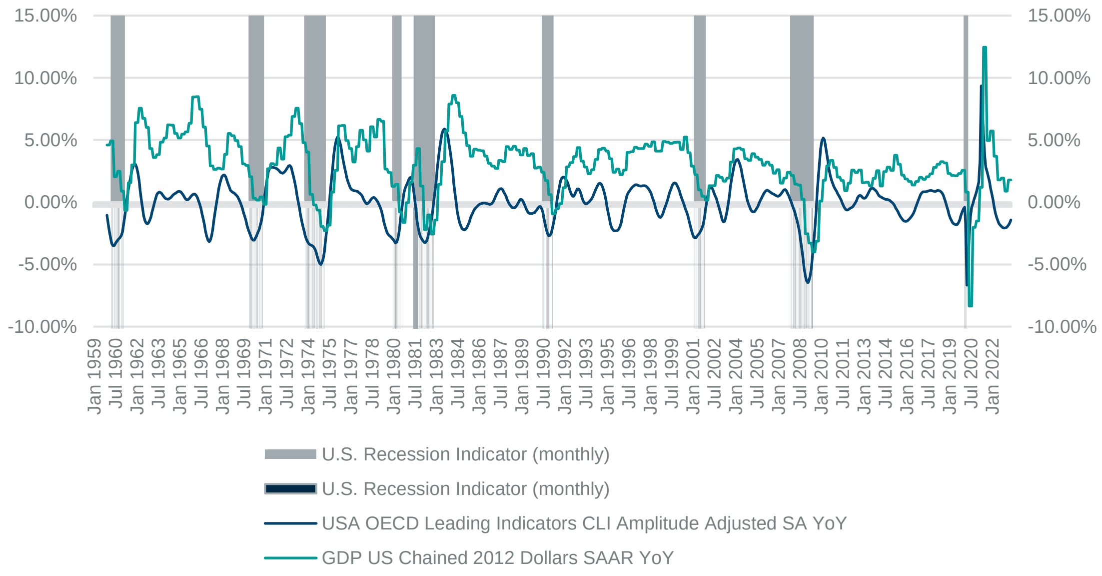
Figure 7: US 10-year vs 3-month treasury yield spread



Source: Bloomberg

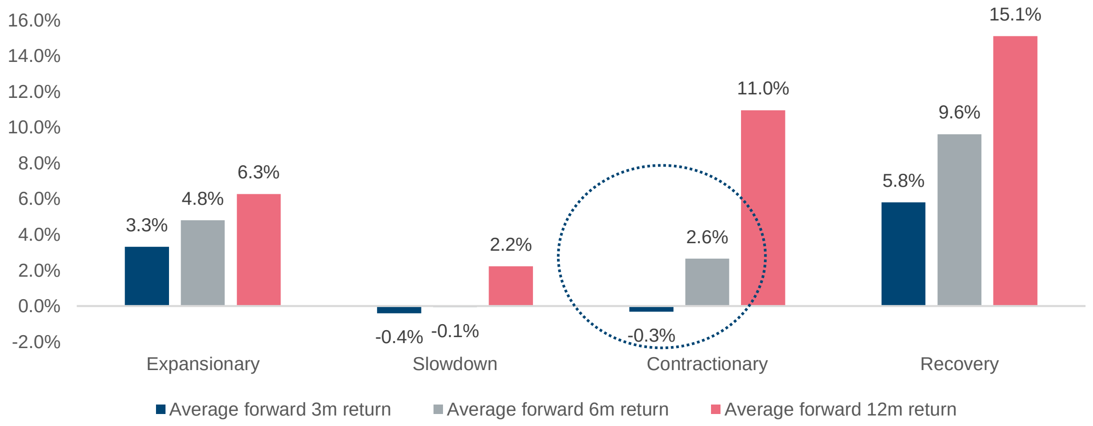
The US OECD Leading Indicator, as shown in Figure 8, seemed to justify the market optimism that the US economy would be able to avoid a recession or, if the recession was to take place, that it would be a shallow one. However, if we use the US OECD Leading Indicator to depict the stage of the business cycle, the average forward 3-month return, based on the past track record of the S&P 500, indicates that there is a very limited upside over the short term (see Figure 9). We arrive at our tactical asset allocation decisions using a 3-month outlook horizon. We classify the business cycle stages using the following rules: Expansion (leading indicator >100 and positive monthly change), Slowdown (leading indicator > 100 and negative monthly change), Contractionary (leading indicator < 100 and negative monthly change), Recovery (leading indicator < 100 and positive monthly change). The US OECD Leading Indicator suggests that the contraction of the US economy is under way. While the indicator has fallen below 100 since July last year and the monthly change has been negative, the slope has been flattening, indicating that the pace of contraction is not worsening.

Figure 8: US OECD Leading Indicators and GDP YoY%



Source: Bloomberg

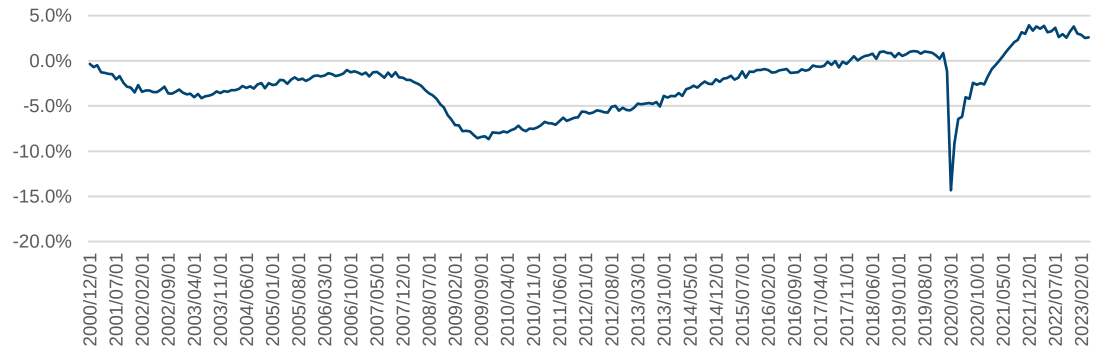
Figure 9: Average forward returns of the S&P 500 over different phases of the business cycle



Source: Bloomberg

If the contraction is under way in the US, what is very different this time compared to previous recessions is the resilience of the labour market – not only in the US but in most developed market economies, which has partly contributed to the elevated core inflation in these countries. Recently, there have been some early signs of the US labour market cooling as initial jobless claims have been edging higher. However, the change in non-farm payroll numbers has continued to beat market expectations, indicating that it is relatively easy to find a job. This is because there is still significant excess demand in the US labour market, as shown in Figure 10. The robustness of the labour market has also been supported by the widening divergence between the manufacturing and services sectors across the globe. In this regard, the manufacturing PMI numbers have largely been below the neutral level of 50, while the services PMI numbers have been in strong, expansionary territory, above the level of 55. We have also seen US labour costs rising but productivity falling, which should have a negative impact on company earnings.

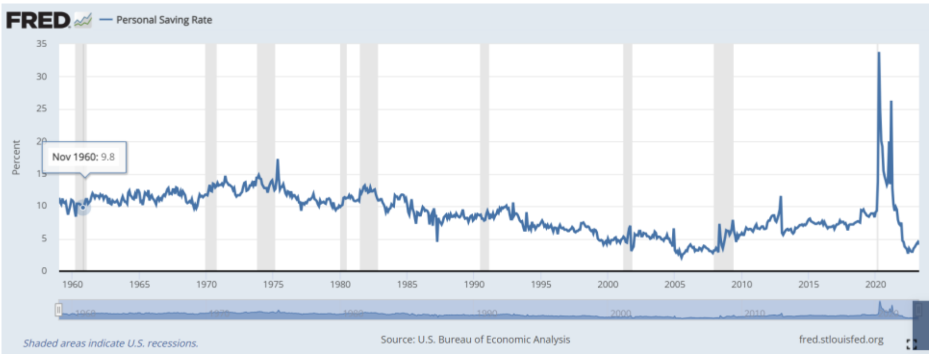
Figure 10: US labour market excess demand % supply



Source: Bloomberg

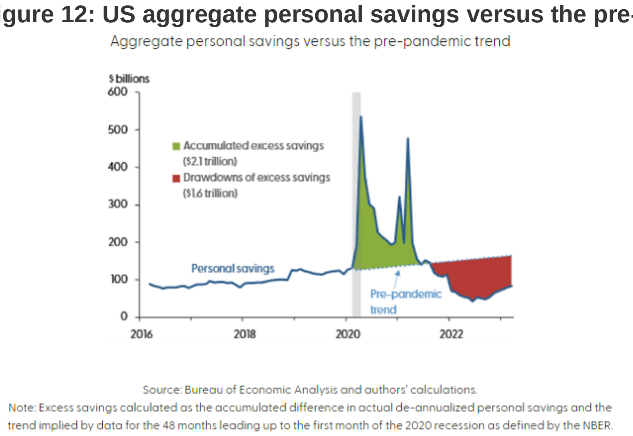
We have been maintaining our moderately underweight position in offshore equity since October last year. This is mainly because we believe the earnings outlook is yet to fully price in a moderate recession, as negative operating leverage is expected to soften earnings per share over the near term in a tightening liquidity environment. We have been focusing heavily on the impact of monetary policy. However, what we have not been taking into account – resulting in our possibly adopting, too early, a defensive, moderately underweight position in offshore equity – is the underappreciated resilience of US consumers, which has supported consumer spending and corporate earnings to date.

Figure 11: US personal savings rate



Source: US Bureau of Economic Analysis, Federal Reserve Bank of St. Louis

Figure 12: US aggregate personal savings versus the pre-pandemic trend



Source: Federal Reserve Bank of San Francisco

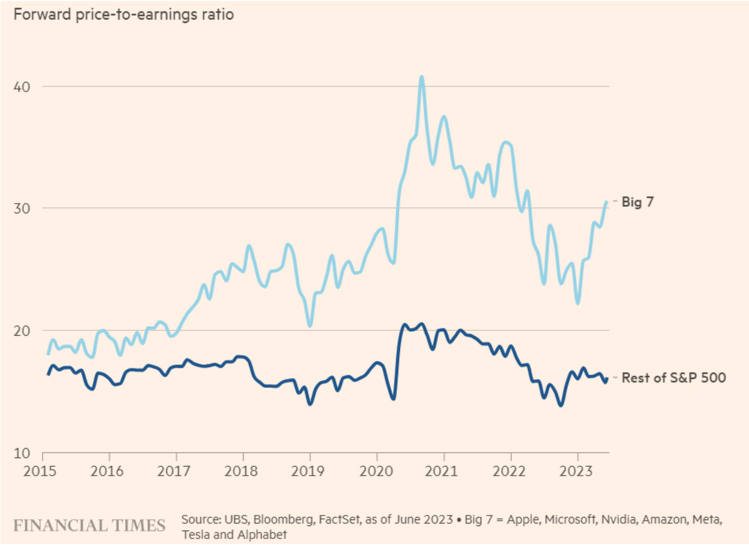
Firstly, there is the excess household savings and wealth accumulated during the pandemic due to the fiscal stimulus. According to the Federal Reserve Bank of San Francisco, US households have accumulated excess savings of $2.1 trillion since the onset of the pandemic recession. The US personal savings rate was close to 35.0% at the peak of the pandemic recession. This has dropped to close to 4.0% over the past year as shown in Figure 11, which has seen the drawdown of the excess savings of $1.6 trillion based on the analysis of the Federal Reserve Bank of San Francisco. As a result, US households still have another $500 billion to support consumer spending in the near term as shown in Figure 12. We did not overlook this in our previous investment analyses, but we underestimated the impact of other fiscal support programmes that provided a further economic buffer to US consumers, such as the impact of the Inflation Reduction Act of 2022 (which unleashed an estimated $500 billion in new spending and tax credits for clean energy and health care), the drawdown of the strategic fuel reserve, the moratorium on student loan repayments, the supplemental nutrition assistance programme, and reduced copayments for certain medications for the lower-income population. In the first eight months of fiscal year 2023, the US had already borrowed $1.2 trillion, according to the Committee for a Responsible Federal Budget, which reached $2.1 trillion over the past 12 months. These fiscal programmes have jointly contributed to the robustness of US consumer spending over the past year. However, these programmes are now at risk of being cut or reformed in the wake of the latest debt limit deal which requires the US government to reduce its spending by around $2 trillion over the next 10 years.

The recent US market rally has been a narrow one, driven mainly by the Big 7 (i.e., Apple, Microsoft, Amazon, Nividia, Meta, Alphabet and Tesla), as tech and big banks have delivered a relatively strong earnings season. However, a broad-based market rally would be needed to sustain this bull run.

Figure 13: S&P 500 vs S&P 500 equally weighted for the year to date, 2023

Source: Financial Times

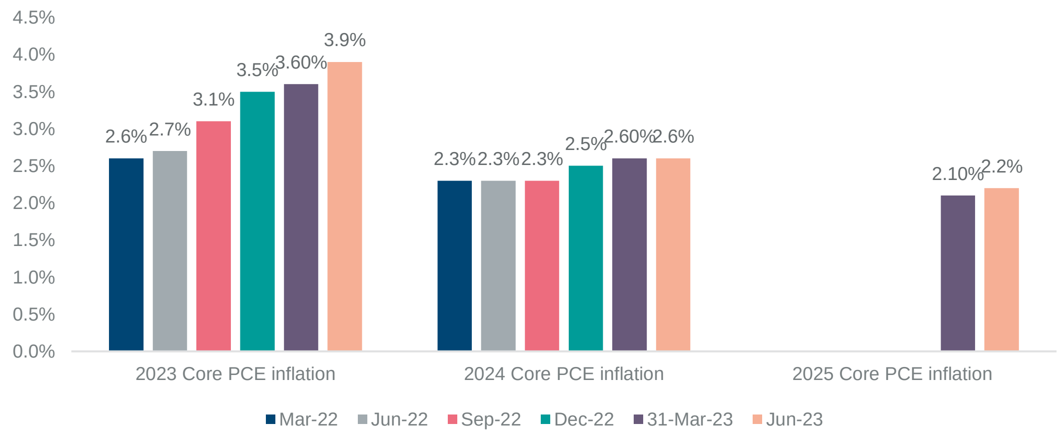
Figure 14: Forward price-to-earnings ratio for the Big 7 and the rest of the S&P 500



Source: Financial Times

Given that the US core inflation rate for May stood at 5.3%, there is still some margin above the Fed's estimate for this year. With the labour market showing early signs of cooling but remaining tight due to excess demand and a strong services sector, we expect the Fed to keep rates high for longer.

Figure 15: US Fed core PCE inflation estimates



Source: Federal Reserve Board

While valuation multiples have expanded since late last year, fundamentals are not supportive under the current environment. AI will boost productivity in the long run, but we expect that companies will have to increase their technology spend in the short term. Earnings have also been declining. In terms of Q1 results, the S&P 500 revenue was down by 0.4% but earnings fell by 6.8%, confirming that the negative operating leverage environment is under way, which is not reflected in the valuation. Excess inventory will also further dent the pricing power of some companies. The new debt deal also creates new headwinds for the US economy. The reduction of benefits under several US domestic fiscal support programmes will drag on the country's GDP – in sharp contrast to how they have boosted consumer spending. US banks have been extending credit at a similar pace, unaffected by the rate hikes. With the new debt ceiling deal, a

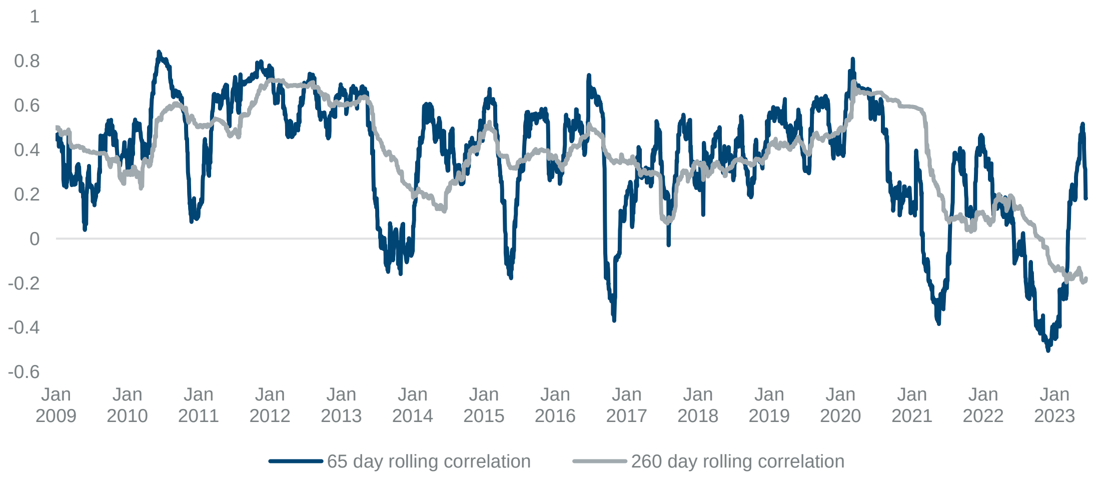
$1.2 trillion treasury issue is expected, with US banks likely to take up $500 billion of that. This will result in less liquidity, affecting credit extension. These headwinds suggest that the current valuation is not sustainable.

In contrast, if US economic growth does surprise on the upside, this would translate into high inflation or inflation cooling at a slower rate, resulting in more monetary tightening to bring it down to the Fed target of 2.0%. This would tip the US into a recession, but only later. The risk to our investment case is that if inflation eases at a good pace, central banks will pause rate hikes. This will support the earnings outlook for the remainder of 2023 and major economies around the world will avoid any kind of recession – the perfect scenario.

Underweight offshore equity has been one of the main detractors in our tactical asset allocations for the year to date. However, by assessing what we have or might have missed in our investment case and taking into account the recent month's macro and market developments, we are more comfortable with our moderately underweight position in offshore equity – although we do think we have entered into this position six to eight months early.

We have remained moderately overweight in offshore bonds as we see this asset class offering diversification benefits in the event of a recession, as long-term correlations between the US treasury and S&P 500 have been negative, while short-term correlations have also declined as shown in Figure 16. We have also preferred short-term bonds for their income potential. Moreover, while we may see a few more hikes in the short term, we are ever closer to the end of a rate-hiking cycle. If rate cuts do materialise later this year or early next year (as is currently priced in by the markets), there will be capital appreciation in longer-duration bonds.

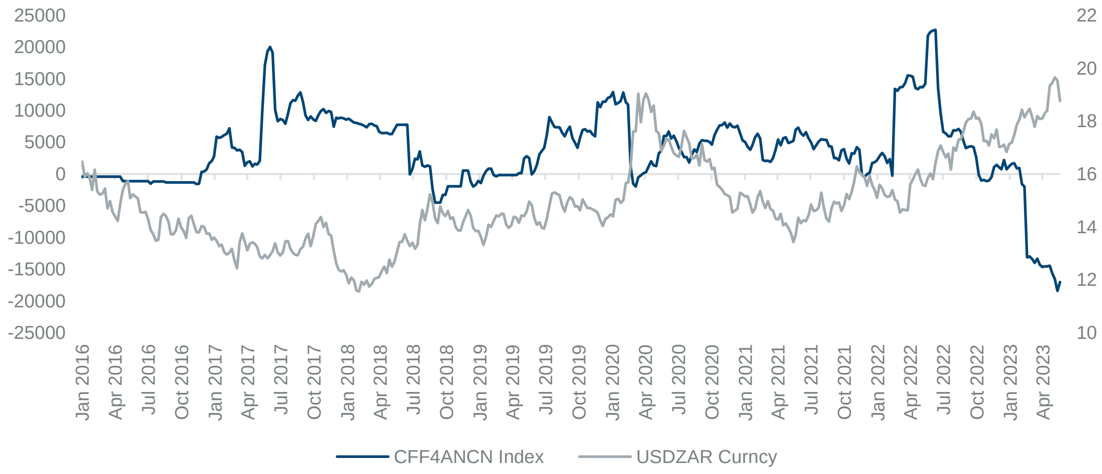
Figure 16: Correlation between S&P 500 and US 10-year treasury



Source: Bloomberg

We increased our overweight position in offshore cash last month in view of the increased geopolitical uncertainty and the enormous pressure exerted on the ZAR by domestic economic woes. While we still prefer to have some overweight in offshore cash as a protective measure in the event of a significant dent in global risk sentiment, there has been some improvement in the loadshedding situation. There are also some nascent signs of speculators closing up some short positions on the currency. We have seen heightened volatility around the currency and are therefore more comfortable with a moderately overweight position in offshore cash than a significantly overweight position.

Figure 17: CFTC CME South African Rand Non-Comm Net Contracts/Futures position and the USD/ZAR exchange rate



Source: Bloomberg

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