MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

24 August 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 unchanged into September.

- We continue to favour local nominal bonds over inflation-linked bonds due to the former offering better compensation for inflation.
- We have maintained our moderately underweight position in offshore equities as we expect the slowdown will exert pressure on upcoming earnings growth, resulting in the risk of derating for global equities.
- We have also chosen to remain moderately overweight in offshore bonds as we are approaching peak rates – with upside potential should the Fed pivot sooner than market expectations.
- We have used our offshore cash position to maintain offshore neutrality and as a tool to offer some protection in the event of a significant dent in global risk sentiment.

TAA Overview – Relative Positions

SA Bonds and SA ILBs	**Relative play on local nominal and inflation-linked bonds as inflation cools** We continue to prefer local nominal bonds over inflation-linked bonds for two reasons. The first reason is that the 10-year nominal bond is being traded at a slight discount to its implied yield, while the 10-year inflation-linked bond yield is at a premium to its implied real yield, as shown in Figures 2 and 3. The second reason for adopting this relative position is that the breakeven inflations across most of the maturities, especially beyond the 10-year, range from 6.0% to 7.5%. With inflation and core inflation falling within the SARB target range, nominal bonds compensate investors more for inflation over the longer maturities, as shown in Figure 4.

Figure 2: SA 10-year nominal bond yield

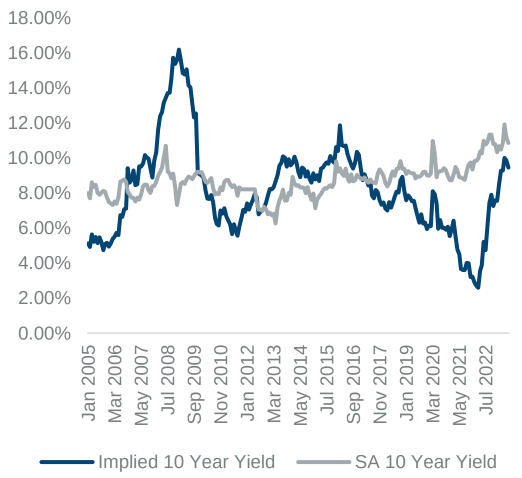
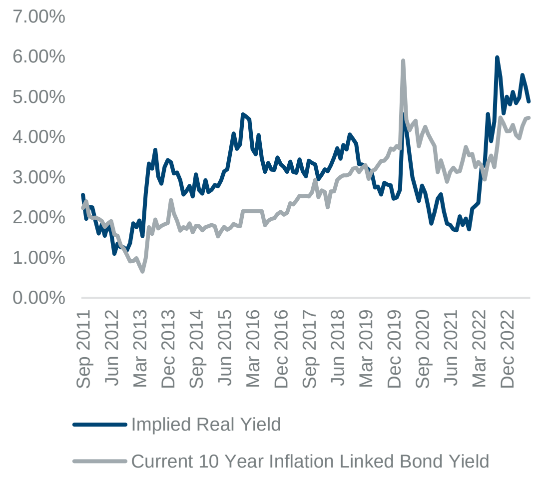


Figure 3: SA 10-year inflation-linked bond yield



Source: Bloomberg

Figure 4: SA nominal and inflation-linked bonds relative value table

Using existing bonds with adjustments	5 years	10 years	15 years	20 years	25 years
Real bond yield	4.3%	4.3%	4.3%	4.7%	5.0%
Less: real bond yield	4.3%	4.4%	4.5%	4.6%	4.9%
Equals: implied breakeven rate	4.9%	6.1%	6.5%	6.7%	7.4%
Breakeven rate from Bloomberg	5.6%	6.9%	7.5%	7.7%	
Less: adjustment for inflation risk premium	0.60%	0.90%	0.90%	1.00%	1.10%
Equals ïmplied average inflation compensation embedded in nominals	4.3%	5.2%	5.6%	5.7%	6.3%

Source: Bloomberg

Foreign Equity

Slowdown will exert pressure on upcoming earnings growth, resulting in the risk of derating

US equities had a strong Q2 earnings season, given the resilience of US consumers. However, we are seeing downside risks on the horizon. Global manufacturing PMI numbers have largely been in the contractionary zone since September last year. There are some early signs that the manufacturing sector is troughing. However, services PMI in the Eurozone and the UK are weakening, falling from expansionary levels to borderline neutral. At the same time, labour markets in the developed world are cooling. But excess demand continues to drive higher levels of wage growth than are needed to tame services inflation, such that central banks can sustainably bring inflation levels down to their respective targets, as shown in Figures 5 and 6. The US average hourly earnings for all employees on private non-farm payrolls increased by 4.2% year on year in July, while UK average weekly earnings over three months year on year jumped from 6.9% in May to 8.2% in June. This is good for consumers in the US, for instance, as accumulated excess savings during the pandemic are drawn down and some fiscal support programmes come to an end. In addition, the real wage growth turning positive since May this year will help to support consumer spending. The issue here is that it will increase the chances of central banks keeping rates higher for longer, putting the lid on the secondary inflation effect and any risk of high inflation recurring.

Figure 5: US excess demand for labour

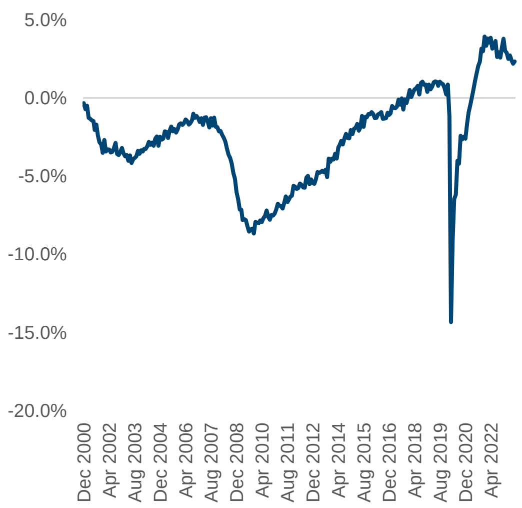


Figure 6: US and UK wage growth year on year

Source: Bloomberg

The tightness of the US labour market was driven partly by companies hoarding workers and partly by the participation rate which stood at 62.6% for July – below the 63.3% pre-pandemic level. As global growth slows down in the face of a tightening liquidity environment, an increasing number of companies will start looking to cost cutting as earnings fall and outlooks turn negative. US consumers have so far experienced limited direct impact from the rate hikes as most took advantage of the low interest rates during the pandemic and the fixed rates on their mortgages. Companies also had a good Q2 earnings season. However, there are some cracks showing on corporate balance sheets. From September last year, we were already seeing a sharp rise in the number of US New Bankruptcy Cases Chapter 11 Total Filings, as shown in Figure 7. Meanwhile, the NACM US Credit Managers Combined Sectors Filings for Bankruptcies Index (which is based on a survey of 500 credit managers) fell from 57.1 in August 2022 to 50.2 in August 2023. (A figure above 50 represents growth in the economy.)

Figure 7: US bankruptcy filings

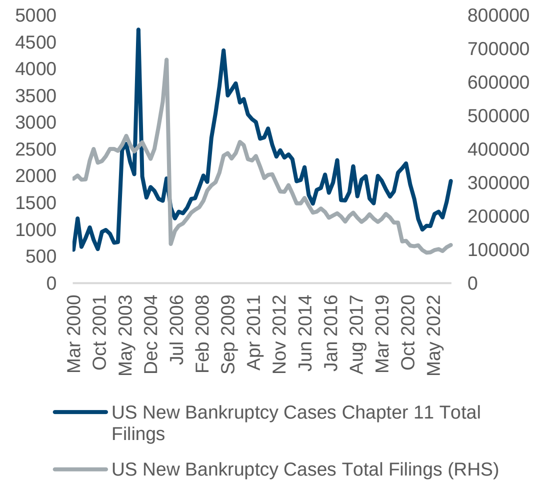
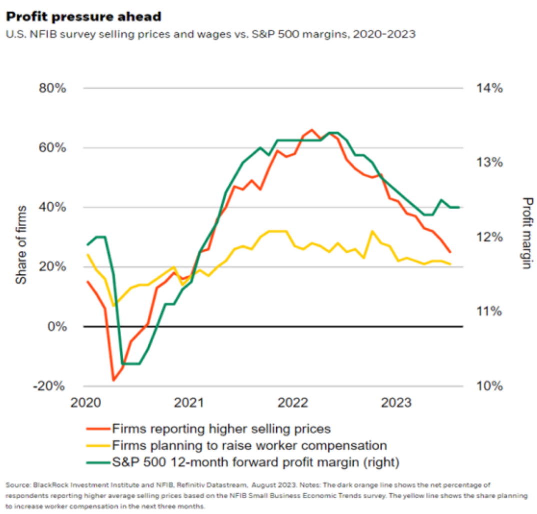


Figure 8: US and UK wage growth year on year



Source: Bloomberg, BlackRock

According to BlackRock's recent research, the S&P 500 12-month forward profit margin has been declining. However, the more concerning issue is that the percentage of US firms reporting higher selling prices has dropped from 60% in 2022 to just over 20%, while the share of firms planning to raise workers' compensations has largely remained stable. This is an indication of profit pressure ahead, with risks of some rerating.

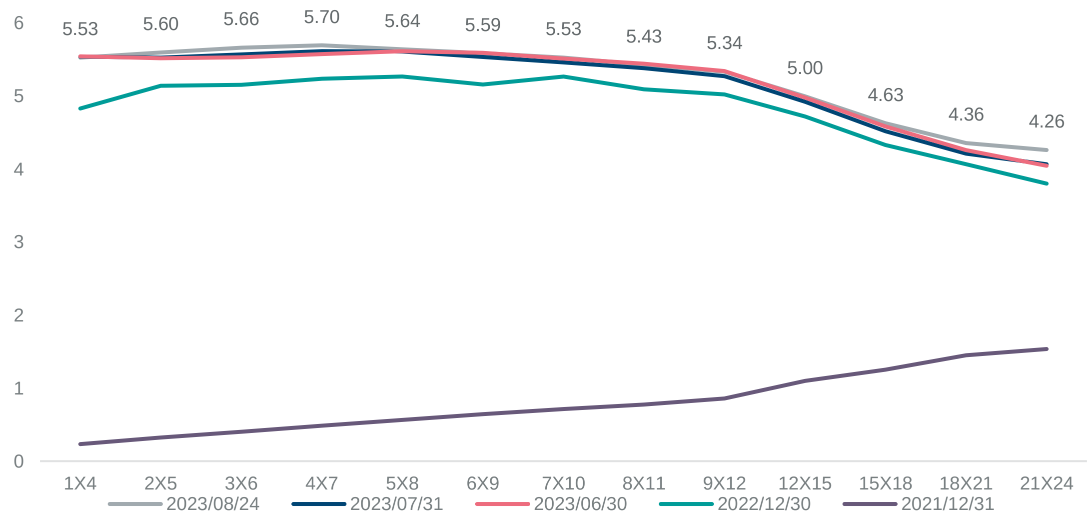
We have therefore remained moderately underweight in foreign equity as we see approaching headwinds of negative operating leverage and consumers exhausting the pandemic-related financial buffers. However, there is a risk to this scenario. US fiscal policies remain largely expansionary as the Congressional Budget Office has projected the budget deficit to be 5.8% for 2023, the short-term positive momentum may be sustained until the next earnings season and China may table more impactful policies to turn around its economy.

Foreign Bonds

More upside movement as we move closer to the peak rates, while the Fed could pivot earlier if inflation continues to weaken

The recent sell-off in the bond markets was mainly driven by markets pricing in higher rates for longer and an expected surge in Treasury bill issuance to fund the US budget deficit. The changes in the expected path of the Fed's rate policy will be a major driver of short-term bond performance. We have remained moderately overweight in foreign bonds as we are moving closer to the peak rates, with the FRA rates peaking at 5.7% vs the current federal funds' rate upper limit of 5.5%. There is upside potential should the market price in the Fed's pivot earlier than expected.

Figure 9: US forward rate agreement rates



Source: Bloomberg

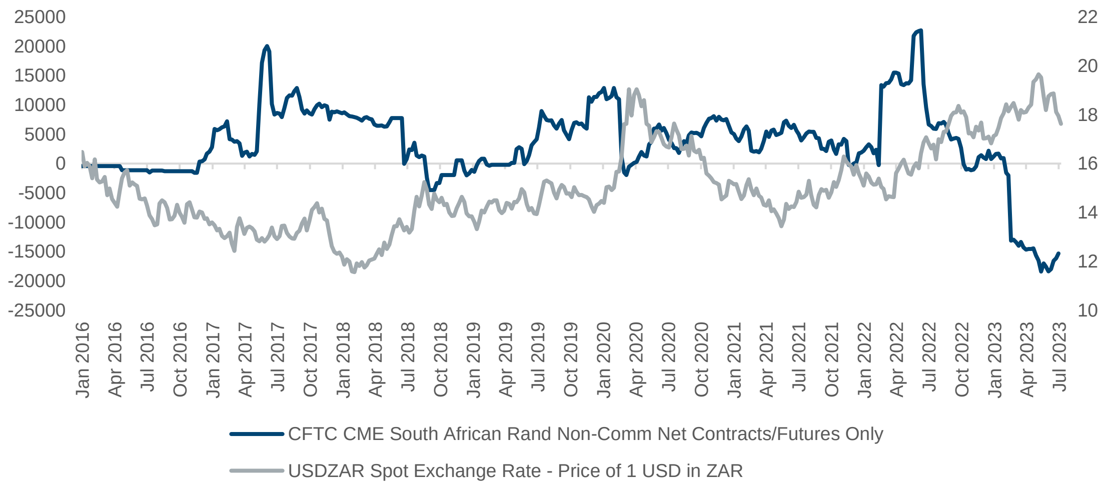
Foreign Cash

We prefer to be offshore neutral given the rand's volatility amid global risk sentiment swings

We have seen the rand depreciate by 7.8% in May (from R18.3/$ to R19.73/$) and appreciate by 4.5% and 5.1% for the two consecutive months of June and July (recovering to R17.88/$) before falling again by 5.3% (to R18.83/$) on 24 August when we had our monthly TAA meeting.

These movements exclude intra-month volatilities. We have also observed unprecedented speculative short futures positions on the currency, which are yet to be closed, as shown in Figure 10. The rand also tends to become a casualty when the global risk appetite retreats. Our moderately overweight position in foreign cash ensures we are offshore neutral. For instance, in the event of a significant dent in global risk sentiment, foreign exchange movements often cushion offshore returns in ZAR.

Figure 10: USDZAR and speculative futures positions



Source: Bloomberg

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