MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

21 September 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 October.

- We continue to favour local nominal bonds over inflation-linked bonds due to the former offering better compensation for inflation; SA nominal bonds also became more attractive relative to Brazilian equivalents.
- We have maintained our moderately underweight position in offshore equities as we expect an intensifying US monetary policy to counter the inflationary effect of a pro-cyclical fiscal policy, eventually resulting in a significant slowdown – albeit with an extended lag effect.
- We have also chosen to remain moderately overweight in offshore bonds as it is a good risk diversifier during a recession and there is massive upside potential should the Fed pivot sooner.
- 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	**Local nominal bonds continued to be more attractive than inflation-linked bonds, despite inflation ticking up** We continue to prefer local nominal bonds over inflation-linked bonds as our investment case remains unchanged. 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. Inflation is ticking up slightly and could potentially rise more if the oil price continues to climb, with the rand remaining at the R19/$ level. If the rand weakens to R19.5/$ and the oil price rises to $95, it will translate into a 16.5% YoY increase in the fuel price for September and a 76bps contribution to CPI YoY. With the breakeven inflations across most of the maturities, especially beyond the 10-year, ranging from 6.8% to 7.5%, this suggests that the nominal bonds continued to compensate investors more for inflation over the longer maturities, as shown in Figure 2. In addition, over the past month, our 10-year nominal bond has been trading at a more attractive real yield compared to the Brazilian equivalent, as shown in Figure 3, which further supports our moderately overweight position in local nominal bonds.

Figure 2: SA nominal and inflation-linked bonds relative value table

Using existing bonds without adjustments	5 years	10 years	15 years	20 years	25 years
Nominal bond yield	9.85%	11.71%	12.51%	12.69%	12.62%
Less: real bond yield	4.36%	4.94%	5.16%	5.16%	5.17%
Equals: implied breakeven rate	5.49%	6.77%	7.35%	7.53%	7.45%
Less: adjustment for inflation risk premium	0.80%	1.00%	1.10%	1.30%	1.40%
Equals implied average inflation compensation embedded in nominals	4.69%	5.77%	6.25%	6.23%	6.05%

Source: Bloomberg

Figure 3: EM bond yields

	South Africa	India	Indonesia	Mexico	Brazil	Turkey
10 Year Yield	**12.07%**	**7.20%**	**6.69%**	**9.60%**	**11.31%**	**27.24%**
Inflation	4.7%	6.8%	3.27%	4.6%	4.6%	58.9%
Inflation Expectation	5.90%	6.60%	3.70%	5.52%	4.80%	47.70%
10 Year Real Yield	**7.37%**	**0.37%**	**3.42%**	**4.96%**	**6.70%**	**-31.70%**
10 Year Real Yield based on inflation expectation	6.17%	0.60%	2.99%	4.08%	6.51%	-20.46%
Currency Risk Premium	**4.06%**	**1.30%**	**0.66%**	**3.29%**	**4.01%**	**17.94%**
Sovereign Risk Premium	**3.68%**	**1.56%**	**1.70%**	**1.98%**	**2.97%**	**4.97%**
US 10 Year Yield	4.33%	4.33%	4.33%	4.33%	4.33%	4.33%
S&P Rating - Foreign Currency	**BB-**	**BBB-u**	**BBB**	**BBB**	**BB-**	**Bu**
Moody's Rating - Foreign Currency	**Ba2**	**Baa3**	**Baa2**	**Baa2**	**Ba2**	**B3**

Source: Bloomberg

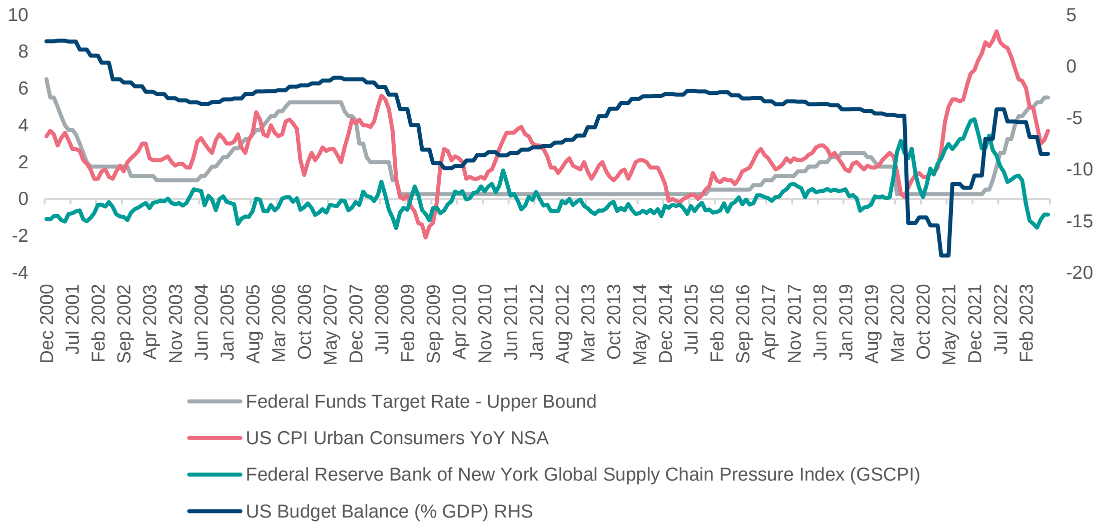
Foreign equity

While the market is pricing for a perfect soft landing, there is downside risk on the horizon

The US economy will likely enter into a recession within the next 12 months, as shown in the traditional recession indicators of, for example, the inversion of the yield curve, the Conference Board leading indicator suggesting weaker economic activity ahead, and the NFIB Small Business Optimism Index showing that the net percentage of small business owners who are negative about the economic prospects has increased from 37% in June 2022 to 61%. The exception is the OECD leading indicator which shows that the US economy is at the recovery stage. The market, however, is pricing in a goldilocks scenario (i.e., cooling inflation and economic resilience), as reflected in the cyclicals outperforming the defensives, in the narrow corporate high-yield spread, and in stocks outperforming bonds year on year. The Fed has also recently upgraded its economic forecasts with stronger economic and job growth figures than previously anticipated, thus increasing the probability of a soft landing where it will manage to bring down inflation without causing too much economic pain. However, due to the strong economic performance, the Fed's latest forecast shows that it expects to reach a 2.0% inflation rate only in 2026, thus pushing out the rate-easing cycle.

What we saw is that falling inflation to date was mainly driven by supply chain improvements and energy and food price reductions. The Fed began tightening its policy just as the US inflation was about to peak, as shown in Figure 4. Owing to Covid handouts, excess savings, a pro-cyclical fiscal policy, tight labour markets and the majority of mortgages having a fixed rate for 30 years, US consumers have experienced limited direct impact from the rate hikes to date. The consequence of this is a longer-than-usual monetary policy lag effect relative to other economies and the delayed onset of a slowdown. The combination of fiscal expansion and monetary tightening has also built a bullish environment for the USD.

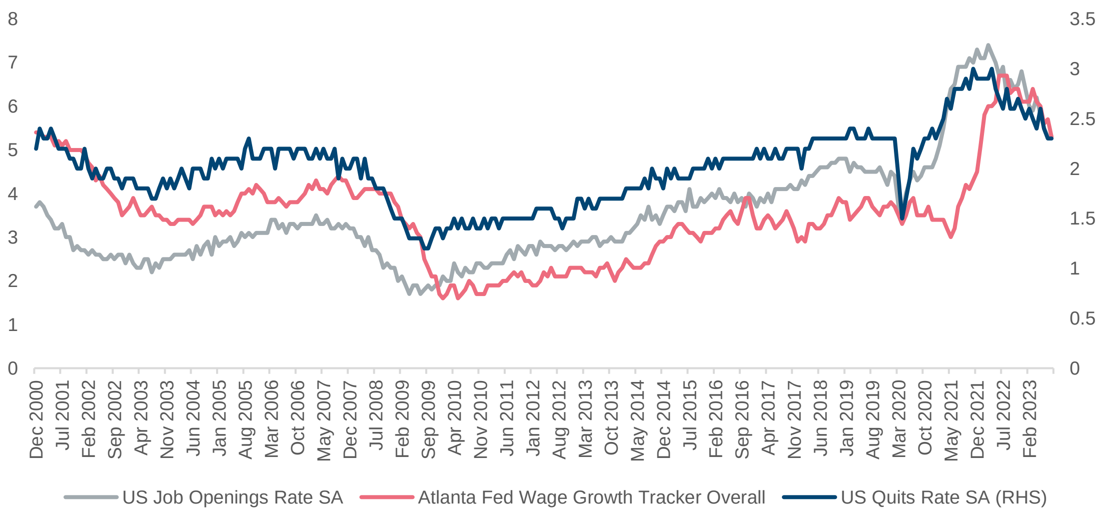
Figure 4: US Federal funds target rate, budget deficit % of GDP and inflation



Source: Bloomberg

Looking ahead, our base case is for the rate to stay high for longer, with the possibility of a shallow or mild recession. Firstly, the US labour market is cooling but remains tight, as shown in Figure 5. Together with an expansionary fiscal policy, the monetary policy intensity needs to scale up to bring wage growth down to sustainably achieve the 2.0% inflation target, which then increases the risk of overtightening.

Figure 5: US labour market



Source: Bloomberg

Secondly, excess savings accumulated over the Covid period are close to being drawn down and some fiscal support programmes are falling away. These factors, together with the cooling of the labour market, will see US consumers coming under increasing pressure and becoming more cautious with their spending. Thirdly, while US equities may be supported by productivity gains and a manufacturing investment boom, other major economies such as those in the Eurozone and China are seeing their manufacturing PMI and services PMI drop below the neutral level of 50. Banks, under pressure from a negative net interest rate margin, will continue to tighten their credit-lending standards, thereby leading to liquidity drying up in the economy. Most of the S&P 500 returns over the past year were due to re-rating and not earnings growth. Current high bond yields also cap the upside of equities. This is one of the steepest rate-hiking cycles in history, as shown in Figure 6. Whether the US and other major economies can come through unscathed remains to be seen.

Figure 6: Fed rate hiking cycle history

First Fed Rate Hike	Fed Funds Rate Above Equilibrium	Recession	Rate Hike (BPs)	Months Of Hiking	First Hike → Recession	Above Equilibrium → Recession
Mar/1972	Jun/1973	Nov/1973	400	26	20	5
Aug/1977	Sep/1979	Jan/1980	1175	32	29	4
Oct/1980	Oct/1980	Jul/1981	650	5	9	9
Mar/1983	Jul/1983		294	18		
Dec/1986	May/1988	Jul/1990	394	30	44	26
Feb/1994	Nov/1994		300	13		
Aug/1999	Nov/1999	Mar/2001	150	10	19	16
Jun/2004	Dec/2005	Dec/2007	425	25	43	24
Dec-2015*		Feb/2020	225	37	51	
Mar/2022	Dec/2022	??	525	16		
	Average				31	14
	Median				29	13

*NOTE: FED FUNDS RATE ALMOST REACHED NEUTRAL IN DEC-2018

Source: BCA Research

Figure 7: Average monthly returns over over various US business cycles

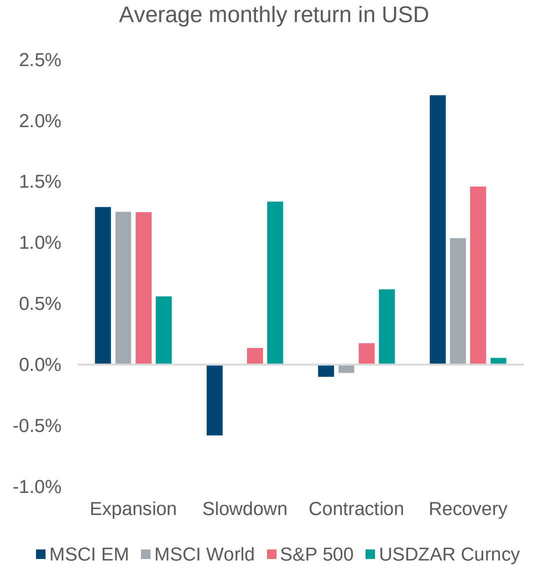
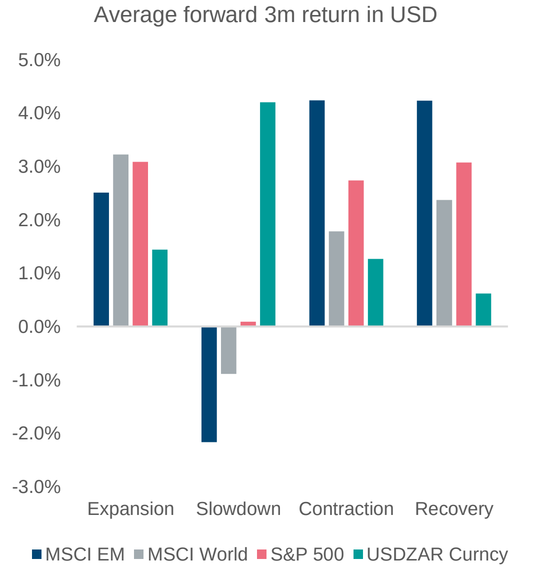


Figure 8: Average forward 3-month returns various US business cycles



Source: Bloomberg

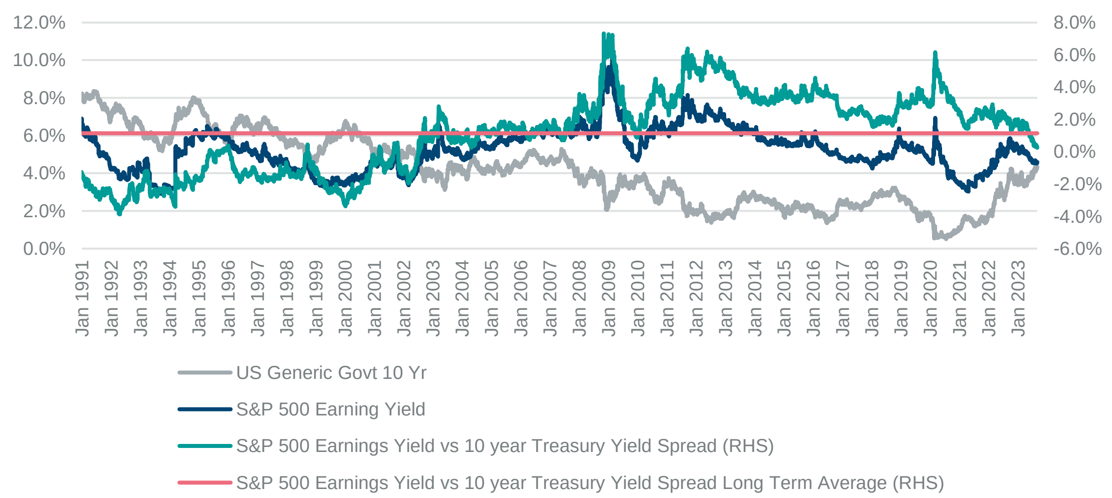
On the positive side, a slowdown is usually the most challenging environment for risk assets, as shown in Figures 7 and 8. However, this time it is different as inflation is already falling, so the Fed can act quickly to support the economy. We have therefore remained moderately underweight in foreign equity as we see approaching headwinds of negative operating leverage, consumers exhausting the pandemic-related financial buffers and an asymmetrical upside vs downside risk for global equities.

Foreign bonds

Global fixed-income yields have surged due to increasing fiscal spending, despite inflation expectations remaining well-anchored

The recent soaring of US treasury yields was driven by the combination of a resilient economic growth rate, a hawkish Fed and an expansionary fiscal policy. Since our base case is that there will be a material slowdown or a mild recession in the US economy, bond yields should come down if that scenario plays out as a Fed pivot would take place. From a valuation perspective, the S&P 500 earnings yield vs the US 10-year treasury yield spread has dipped below the long-term average as shown in Figure 9, indicating the increasing relative attractiveness of bonds. Lastly, while bonds have suffered from capital depreciation as yields have surged, it is offering good income as the US 10-year treasury yield climbs above 4.6%.

Figure 9: S&P 500 earnings yield vs 10-year US treasury



Source: Bloomberg

We have remained moderately overweight in foreign bonds as we are moving closer to the peak rates and there is upside potential should the Fed pivot earlier than expected.

Foreign cash

We prefer to stay offshore-neutral, with history suggesting that the ZAR tends to weaken during a US slowdown and recession

While the ZAR is trading at a discount to its 10-year average and has remained one of the cheapest EM currencies at this level, the near-term outlook remains bullish for the USD. It will be susceptible to significant changes in global risk sentiment and geopolitical events and developments. The combination of the tight US monetary policy, a weak China backdrop and a high real yield is supportive of the US dollar and not good for commodity prices. Also, the fact

	that SA has widened in Q2 does not help the ZAR. The ZAR also tends to depreciate most during a US slowdown, as shown earlier in Figures 7 and 8. We therefore choose to remain moderately overweight in foreign cash to ensure we are offshore-neutral.

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