MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

19 October 2023

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We have kept most of our TAA positions unchanged, except for reducing our exposures to SA and offshore property, with SA cash being the balancing figure.

Figure 1: Houseview Tactical Asset Allocation

Asset class	--	-	Neutral	+	++
SA cash				X	
SA bonds				X	
SA inflation-linked bonds		X			
SA-listed property		X			
SA equity			X		
Foreign cash					X
Foreign bonds				X	
Foreign equity		X			
Foreign property		X			

Synopsis

Our investment case has remained unchanged into November.

- We continue to favour local nominal bonds over inflation-linked bonds due to the former offering better compensation for inflation, despite a moderate upside inflation risk in the near term.
- We have maintained our moderately underweight position in offshore equities as we see approaching headwinds of negative operating leverage, consumer consumption under pressure as corporates start cost-cutting to defend their margins, and the risk of overtightening.
- 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 moved from neutral to moderately underweight in both local and foreign property as we think government bonds are more attractive at the current level of yield and without the risk of a substantial debt maturity wall looming in a fundamentally weak operating environment.
- 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 and heightened geopolitical frictions.

TAA overview – relative positions

<table>
<tr>
<td>SA bonds and SA ILBs</td>
<td>Relative bets on SA nominal and ILBs unchanged despite upward inflation risk

Our preference for local nominal bonds over inflation-linked bonds remains unchanged. Local nominal bonds remain attractive from an implied and hedged yield perspective. Our bonds also offer a better real yield than Brazilian equivalents, as shown in Figure 2. However, one can argue that part of that is due to pricing in a higher sovereign risk, as Brazil was upgraded by Fitch in late July. Meanwhile, our fiscus remains vulnerable in the face of struggling SOEs, slow growth, and a lack of efficiency and productivity.

SA core inflation YoY declined from 4.8% to 4.5% over the past month, but headline inflation increased from 4.8% to 5.4% over the same period, driven by a higher fuel price and elevated food inflation. Despite an upward inflationary risk in the short term, the 10-year inflation-linked bond yield continued to trade at a premium to its implied real yield, with the breakeven inflations</td>
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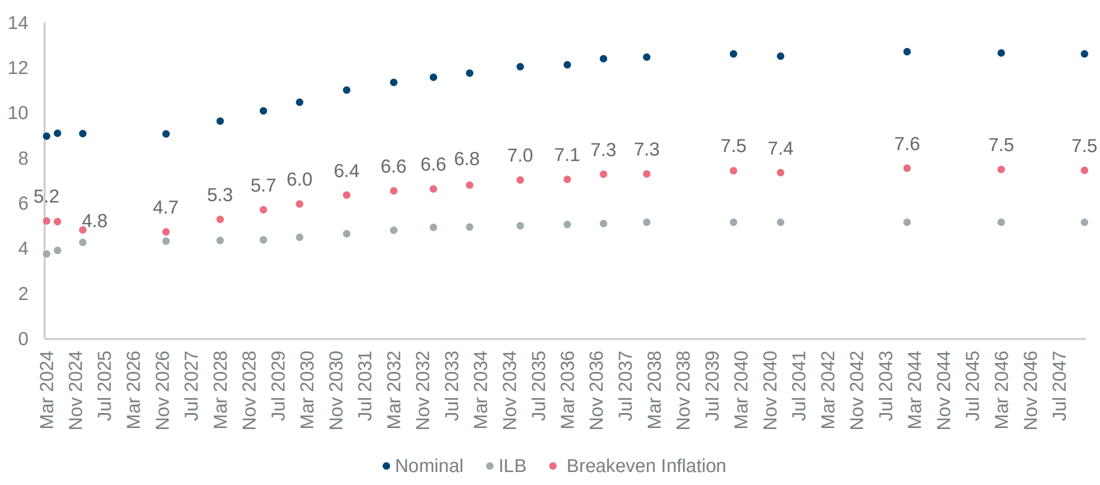
across most of the maturities, especially beyond the 10-year, ranging from 6.8% to 7.5%. This suggests that nominal bonds continued to compensate investors more for inflation over the longer maturities, as shown in Figure 3.

Figure 2: EM bond yields

	South Africa	India	Indonesia	Mexico	Brazil	Turkey
10 Year Yield	**12.32%**	**7.32%**	**6.79%**	**9.78%**	**11.83%**	**27.27%**
Inflation	4.8%	5.0%	2.28%	4.5%	5.2%	61.5%
Inflation Expectation	5.80%	6.60%	3.70%	5.60%	4.70%	53.30%
10 Year Real Yield	**7.52%**	**2.30%**	**4.51%**	**5.33%**	**6.64%**	**-34.26%**
10 Year Real Yield based on inflation expectation	6.52%	0.72%	3.09%	4.18%	7.13%	-26.03%
Currency Risk Premium	**3.89%**	**1.36%**	**0.51%**	**3.10%**	**4.30%**	**17.85%**
Sovereign Risk Premium	**3.82%**	**1.35%**	**1.66%**	**2.07%**	**2.91%**	**4.81%**
US 10 Year Yield	4.61%	4.61%	4.61%	4.61%	4.61%	4.61%
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

Figure 3: SA nominal yields, inflation-linked bond yields and breakeven inflation



Source: Bloomberg

Foreign equity

Fading tail winds and fat tail risks put US economic resilience to the test

Over the next three to six months, we will see the US consumer resilience that has been witnessed so far put to the test due to fading tailwinds, such as a drawdown of excess savings, the withdrawal of certain fiscal support programmes, a cooling labour market, and tighter liquidity and banking lending standards. At the same time, there is an elevated tail risk due to geopolitical frictions in the Middle East and the possibility of financial accidents resulting from an overtightening of monetary policy to counter a procyclical fiscal policy.

Despite growth in real disposable income since mid-2022, it has been largely below trend since late 2021. However, real disposable consumption has returned to trend, funded by pandemic savings, as shown in Figure 4. With pandemic excess savings having been drawn down, US consumers have had to increasingly resort to credit cards to fund their purchases. With the labour market cooling (though excess demand for labour is still elevated), we have recently seen increases in auto loan and credit card delinquencies, as shown in Figure 5. Should labour market conditions significantly worsen, there is a further risk of deterioration in the quality of banking assets, on top of the negative impact from the bond market bloodbath and net interest margin pressure. We are not sure if this will escalate into a banking sector crisis, but small and regional banks are definitely more vulnerable. Just as the past tailwinds worked in sync to drive US consumer resilience, fading tailwinds may operate in perfect harmony with some tail risks this time.

Figure 4: US real disposable income and consumption

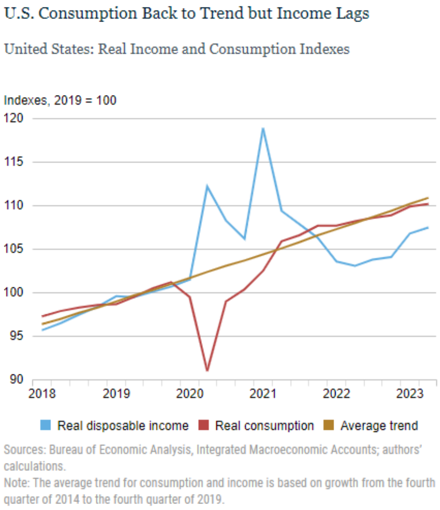
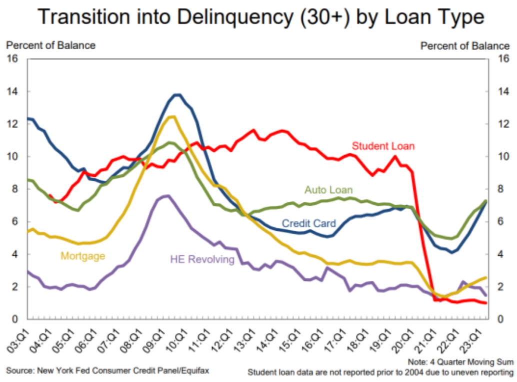


Figure 5: US delinquency by loan type



Source: New York Fed

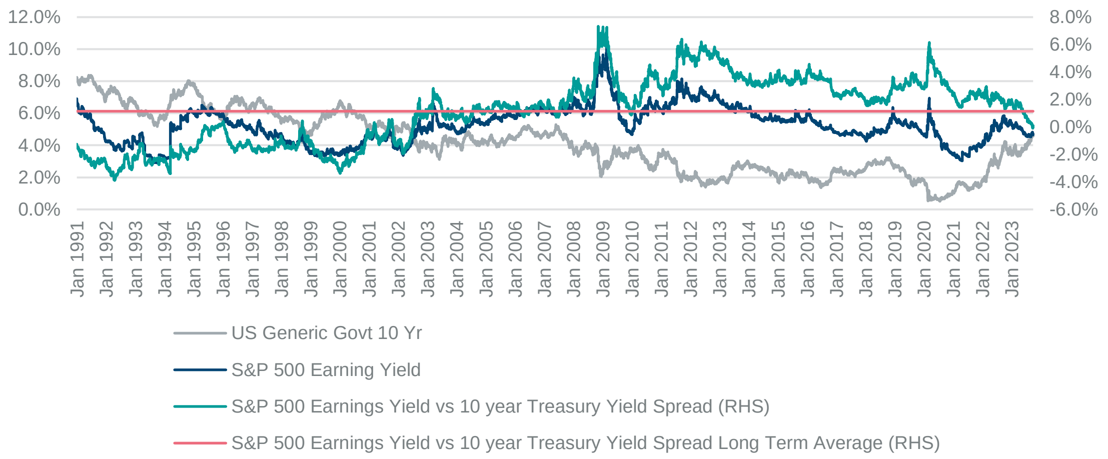
We have therefore remained moderately underweight in foreign equity as we see approaching headwinds of negative operating leverage, consumer consumption under pressure as corporates start cost cutting to defend their margins, and the risk of overtightening.

Foreign bonds

Global fixed income becoming increasingly attractive at the current yield level with an asymmetric return outlook

We have remained moderately overweight in foreign bonds as fixed income is at its cheapest level relative to equity since the early 2000s, as shown in Figure 6. There is a further downside risk in that the yield may drift higher if US growth remains strong, if the Chinese government implements more impactful stimulus packages, if investors demand a higher-term premium and if there is a short-term reacceleration in inflation. But there is a bigger upside potential in that the bond yields may fall dramatically if there is a significant slowdown in activities and some unintended financial accidents take place.

Figure 6: S&P 500 earnings yield vs 10-year US treasury



Source: Bloomberg

Local and foreign property

Property valuations less attractive than bonds and fundamental weaknesses remain

While local property is slightly more attractive than ALSI based on valuation and global property is materially more attractive than MSCI World, given the performance YTD, both are less attractive than local and global bonds respectively, as shown in Figures 7 and 8. Fundamentally, they displayed weakness either in falling return on equity (ROE) or elevated vacancies and negative rental reversions. This sector is vulnerable to higher finance costs in a higher-rate-for-longer environment. While sectors such as data centres, warehouses and signal towers will continue to perform well in a world of increasing digitisation and AI adoption, traditional sectors such as retail, office and industrial REITs (manufacturing and logistics) still make up a third of the Index and that excludes diversified REITs. We have therefore moved from neutral to moderately underweight in both local and foreign property as we think government bonds are more attractive at the current level of yield and without the risk of a substantial debt maturity wall looming.

Figure 7: SAPY DY vs SA 10-year bond yield

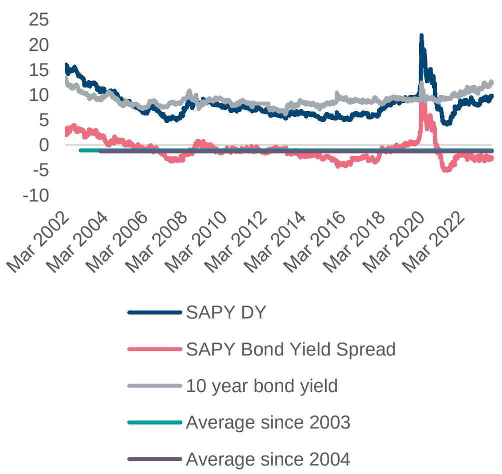
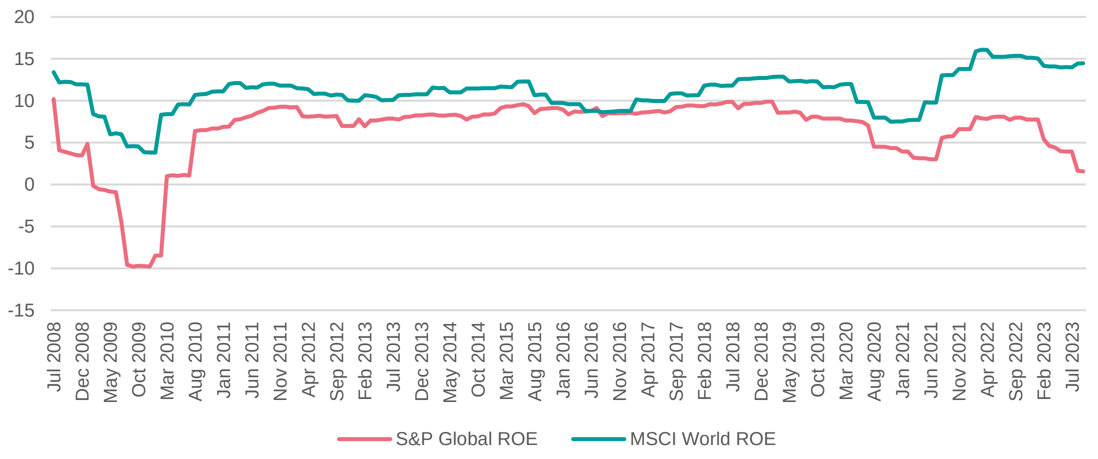


Figure 8: S&P Global Property DY vs 10-year US treasury yield

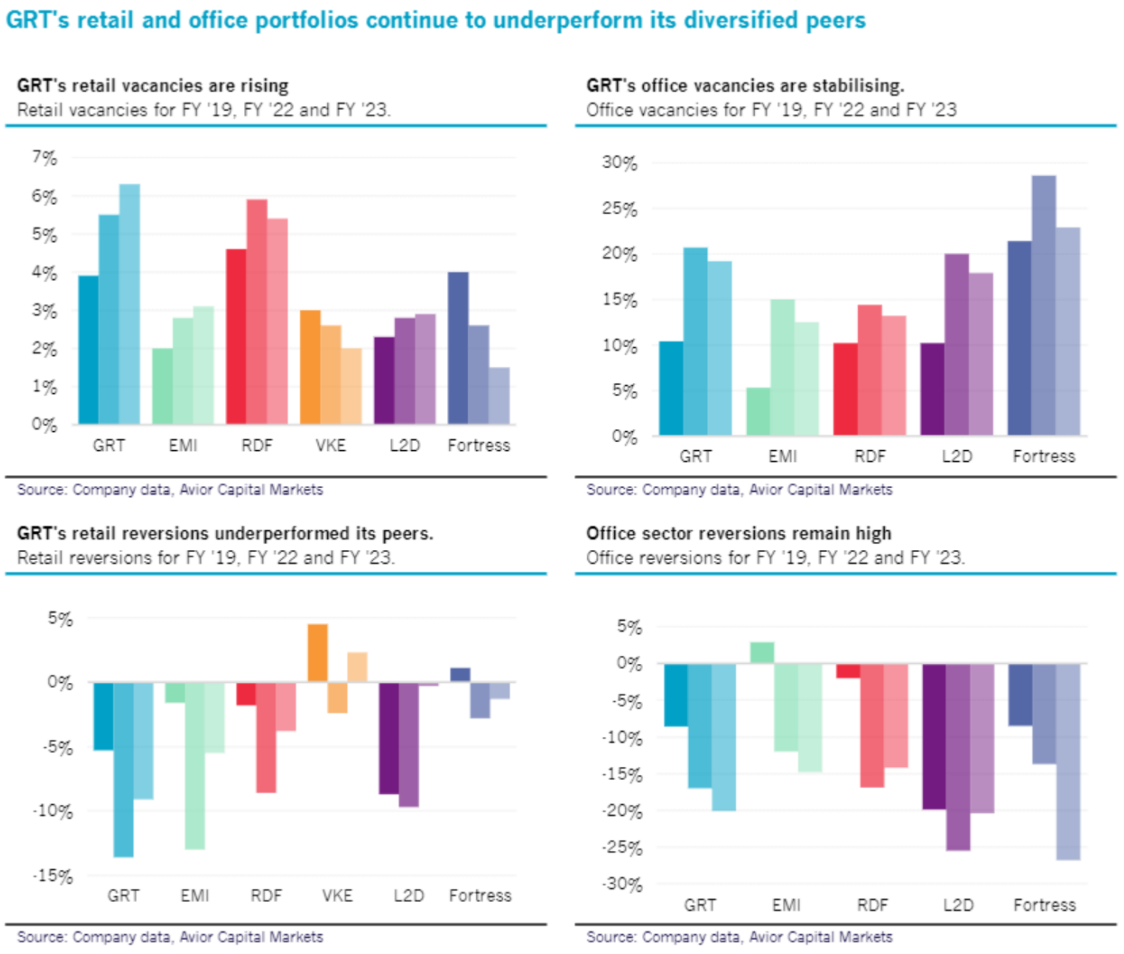
Source: Bloomberg

Figure 9: S&P Global Property Index ROE vs MSCI World ROE



Source: Bloomberg

Figure 10: Retail and office vacancies and rental reversions for major SA property counters



Source: Avior

Foreign cash	**We prefer to stay offshore-neutral and overweight in foreign cash** Our investment case in offshore cash remains unchanged in that despite the ZAR remaining 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 increasing geopolitical tensions and local political uncertainty. The combination of 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. In addition, we do not mind building up a bit of liquidity at this stage of the late cycle. We therefore choose to remain overweight in foreign cash to ensure we are offshore-neutral.

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