MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

23 November 2023

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We have kept most of our TAA positions unchanged, except for reducing our exposures to offshore bonds to neutral, 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 largely unchanged into December.

- We have kept our relative positions unchanged for SA nominal bonds and SA ILBs, given the retreat in the oil price and the stability of the ZAR against the USD, which should ease domestic inflationary pressure.
- Based on our base-case investment outlook that inflation will cool but remain above the Fed's target, and driven by structural issues within the labour market, the market will reprice its profit and margin expectations as global growth slows and will also potentially reprice its rate cut expectations.
- We have maintained our moderately underweight position in offshore equity as the base case is not a scenario that is conducive to equities or bonds; it is more negative for equities as a slowdown in global growth would prevent earnings from catching up with valuations.
- We have also chosen to move from moderately overweight to neutral in offshore bonds due to a sharp increase in correlations between the performance of offshore equity and bonds, limiting bonds' diversification ability, as well as supply-side concerns which have driven up term premiums.
- We have maintained our moderately underweight position in both local and foreign property as we think government bonds are more attractive at the current level of yield and there is no risk of higher refinancing and operating costs.
- 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

SA bonds and SA ILBs	**SA nominal bonds' attractiveness over ILBs is unchanged but the duration has been the driver behind the month-to-date relative performance** Our preference for local nominal bonds over inflation-linked bonds remains largely unchanged. Local nominal bonds remain attractive from an implied and hedged yield perspective. However, our bonds are now offering a similar real yield to Brazilian equivalents, as shown in Figure 2. The 10-year inflation-linked bond yield continued to trade at a premium to its implied real yield, with the breakeven inflations across most of the maturities (especially beyond the 10-year) ranging

from 6.8% to 7.3%. This suggests that nominal bonds continued to compensate investors more for inflation over the longer maturities, as shown in Figure 3.

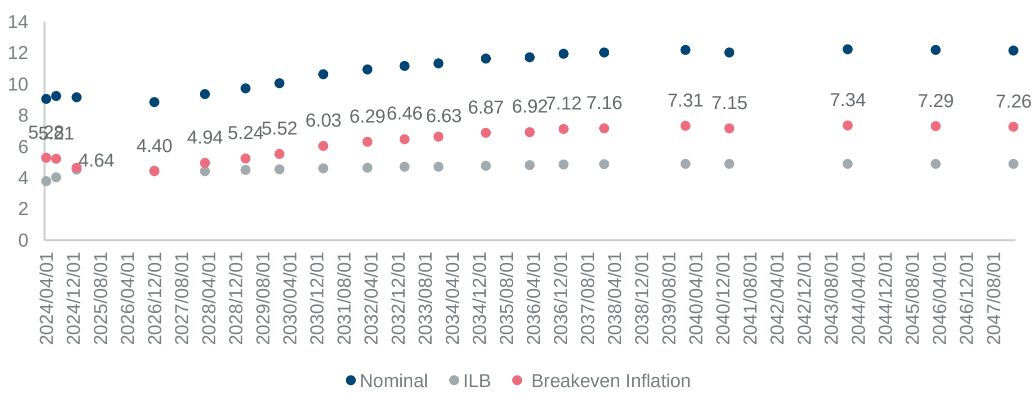
SA core inflation YoY declined from 4.5% to 4.4% over the past month, but headline inflation increased from 5.4% to 5.9% over the same period as it continued to be driven by a higher fuel price and elevated food inflation. We do, though, expect the upward inflationary risk to subside in the short term as the oil price dropped to c.$75 per barrel and the rand has managed to recover to R18.7/$. One of the main factors affecting the relative performance of SA nominal bonds and ILBs amid the market's frequent repricing of rate expectations is the difference in duration of the two asset classes. The modified duration of ALBI is 5.6 years while that of the Barclays/Absa South African Government Inflation-Linked Bond Index is 9.3 years, with the result that ILBs will be sensitive to changes in interest rate expectations. Since late October, the market has been discounting a softer US labour market and persistent disinflation, which has translated into pivot trades that have seen the risk assets rally. ILBs also outperformed the ALBI due to its longer duration. We kept our relative positions unchanged for SA nominal bonds and SA ILBs, given the retreat in the oil price and the stability of the ZAR against the USD, which should ease domestic inflationary pressure. At the same time, the market has priced in more rate cuts than the Fed's guidance, which means that repricing of further significant rate cut expectations is less likely.

Figure 2: EM bond yields

	South Africa	India	Indonesia	Mexico	Brazil	Turkey
10 Year Yield	**11.65%**	**7.22%**	**6.95%**	**9.47%**	**11.05%**	**28.21%**
Inflation	5.4%	4.9%	2.56%	4.3%	4.8%	61.4%
Inflation Expectation	5.80%	6.60%	3.70%	5.60%	4.70%	53.80%
10 Year Real Yield	**6.25%**	**2.35%**	**4.39%**	**5.21%**	**6.23%**	**-33.15%**
10 Year Real Yield based on inflation expectation	5.85%	0.62%	3.25%	3.87%	6.35%	-25.59%
Currency Risk Premium	**3.71%**	**1.65%**	**1.14%**	**3.27%**	**4.07%**	**19.43%**
Sovereign Risk Premium	**3.50%**	**1.14%**	**1.38%**	**1.76%**	**2.54%**	**4.35%**
US 10 Year Yield	4.44%	4.44%	4.44%	4.44%	4.44%	4.44%
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

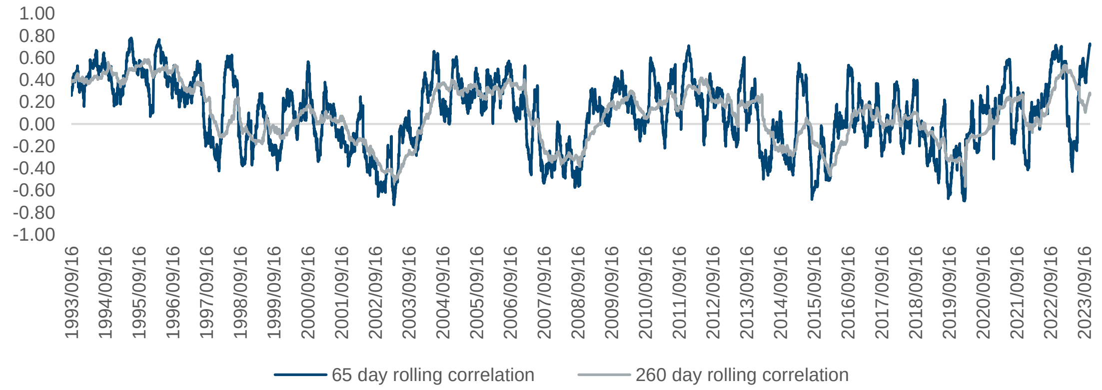
Foreign equity	**Risk assets' performance subject to heightened data-dependent volatility as macro uncertainty remains**

We have been underweighting foreign equity for the past year. The stellar performance of this asset class during this period prompted the following two key questions for the TAA committee: why the investment thesis did not work out and what position we should adopt going forward, based on our expectations versus what has been priced in by the market. The major offsets to the rapid tightening of monetary policy on US economic growth that we missed or underestimated are:

1. The adoption of a procyclical fiscal policy when the US economy has been very resilient.
2. The fact that demand exceeded supply to such an extent post-Covid that, despite the expected dampening in credit growth, aggregate demand and spending remained strong.
3. The fact that the US government funded the budget deficit by issuing treasury bills which then were funded through the Fed's reserve repo facility, resulting in limited liquidity impact on other asset classes.
4. Productivity gain within the US labour market.

What we have observed is an increasing correlation between the performance of the MSCI World and the FTSE WGBI Index, as shown in Figure 4. In October, when the market was pricing in a higher-rate-for-longer scenario, both equities and bonds fell. Now, into November, the market is pricing in a soft landing, given the latest cooling inflation print and strong Q3 GDP. Both equities and bonds were up, but equities significantly outperformed bonds as the latter grappled with supply concerns in the face of mounting government debt, which could drive yields higher through increasing term premiums. It appears that in this world of elevated volatility under macro uncertainty, bonds no longer provide much diversification for equity exposures.

Figure 4: Rolling correlations between the MSCI World and FTSE WGBI



Source: Bloomberg

The way we see it is that as long as growth remains strong, whether US inflation remains sticky at the current level of 3.2% or cools to the Fed's target, equities will outperform bonds. If the US economy goes into a recession due to overtightening, bonds may outperform equities during a short window period until the market starts repricing rate cuts. The quantum and speed of the Fed's intervention would depend on the severity of the recession and the level of inflation. A soft-landing situation (which is what the market is pricing in), where inflation cools to the Fed's 2%

target level and there is a non-recessionary growth slowdown and profitability decline, is good for both equities and bonds. However, while the market has priced in slightly more rate cuts, i.e., 75bps compared to the Fed's guidance of 50bps, it has not priced in too many earnings revisions, as shown in Figure 6.

Figure 5: US FRA rates

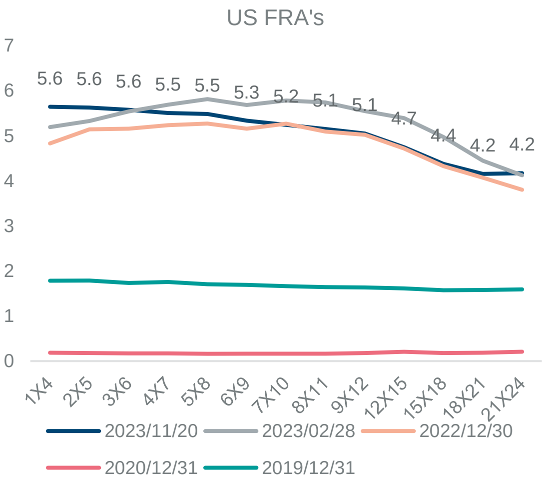
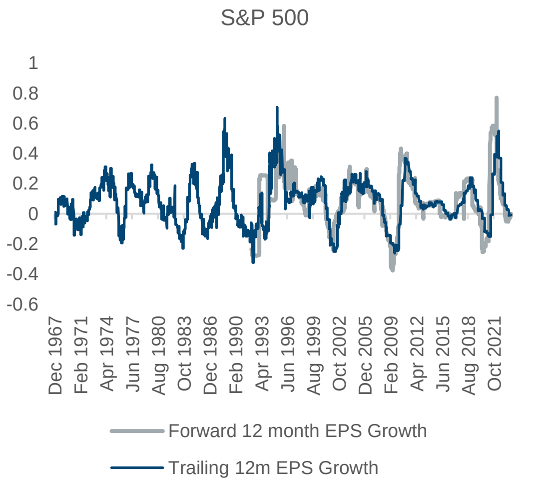


Figure 6: S&P 500 earnings per share growth



Source: Bloomberg

The excess savings and cash accumulated on both household and corporate balance sheets during Covid have largely provided for consumption and capex spending so far. Meanwhile, the locking in of low mortgage rates and the extended duration of corporate debt have contributed to the material lag between rising rates and economic impact, although we expect debt servicing costs to rise for households and corporates through new and outstanding borrowings. With excess savings being drawn down, the US government will have to fund deficit spending over time through the issuance of treasury bonds which will compete for capital with other asset classes. Real disposable consumption has to come down, given the below-trend real disposable income growth and fading pandemic savings. As the labour market cools, consumers are definitely feeling the pressure, which is evident in the persistent increases in motor vehicle loans, mortgages and credit card delinquencies, as shown in Figure 7.

Figure 7: US delinquency by loan type

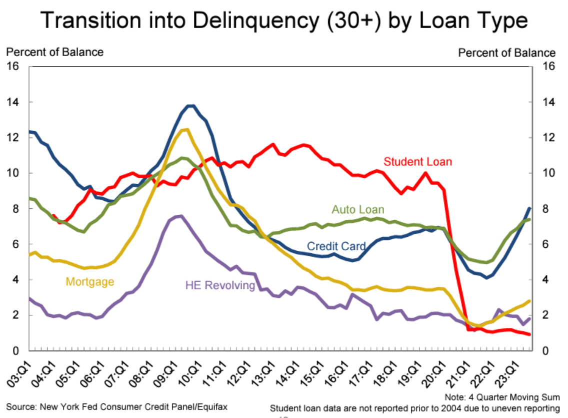
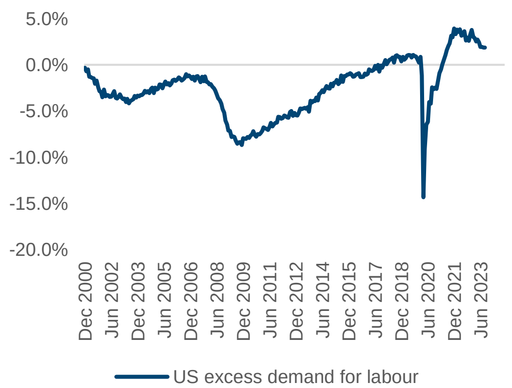


Figure 8: US excess demand for labour



Source: New York Fed, Bloomberg

While we agree with the market that inflation should continue to cool, we are sceptical that it will reach the 2.0% target, given the excess demand for labour in the US economy. We do expect inflation to cool as economic activities slow down, but there are structural issues, such as demographics, immigration and offshoring from China, that may – despite the slowdown – sustain wage growth above the broader inflation rate. The US core CPI for October was nearly completely accounted for by core services.

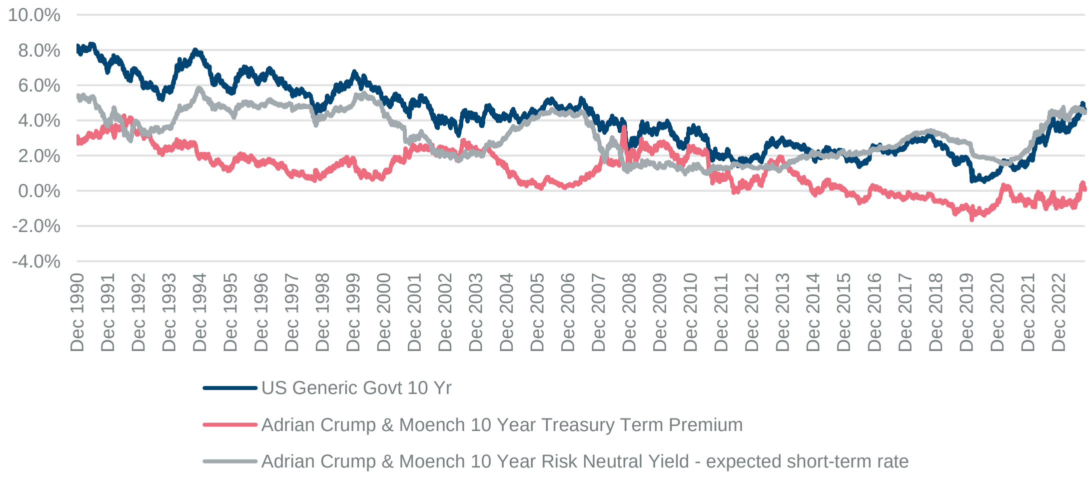
This leads to our base-case investment outlook: that inflation will cool but remain above the Fed's target rate, and the market will reprice its profit and margin expectations as global (including US) growth slows down and will potentially reprice its rate cut expectations if inflation indeed proves to be stickier. This is not a scenario that is conducive to equities or bonds; it is more negative for equities as the global growth slowdown would prevent earnings from catching up with valuations, despite some productivity gains in the US labour market. We have therefore remained moderately underweight in foreign equity. This position is subject to the risk that economic conditions may change quickly and that short-term momentum may remain strong throughout the festive season. We will continue to closely monitor macroeconomic developments.

Foreign bonds

Global fixed income attractive at the current yield level but increasing correlation with equities and supply concerns pare upside potential

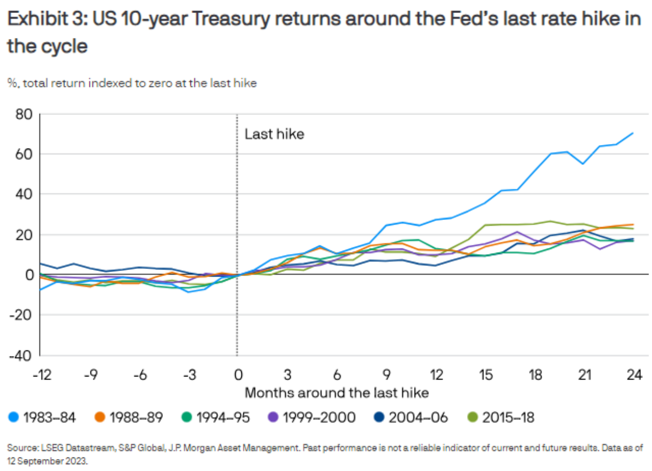
We have moved from moderately overweight to neutral in foreign bonds, as fixed income remains attractive relative to equity valuations at the current yield level. However, there is a sharp increase in correlations between the performance of offshore equity and bonds, limiting bonds' diversification ability, while supply-side concerns have driven up term premiums. According to the latest research by the global asset and wealth manager, Schroders, as rate hikes come to an end the future performance of S&P 500 depends on starting valuations, while the US 10-year treasury return profiles are fairly consistent, as shown in Figure 10. On the balance of risks, we therefore moved to neutral for foreign bonds as it would do well if there is a negative growth shock, which seems unlikely in the near future.

Figure 9: US 10-year bond yield disaggregation



Source: Bloomberg

Figure 10: Performance since last US 10-year treasury rate hikes



Source: Schroders

Local and foreign property

Investment thesis unchanged for local and foreign property after recent rally

From a valuation perspective, the picture remains the same. The SAPY Index is on par with ALSI, while the S&P 500 Global Property Index is cheaper than the MSCI World Index and both are trading at a premium to ALBI and the US 10-year treasury respectively. This suggests that the current level of valuation does not compensate investors adequately for the additional risk (over bonds) of investing in the property sector. While the management of real estate firms can use hedging strategies to provide some support to their bottom lines, high refinancing costs remain one of the biggest risks to the sector's earnings growth, unless rate cuts happen quickly. SA REITs are also exposed to rising operating and municipal costs, while rental growth remains subdued. According to the latest research by Avior, SA retail and office property rental reversions remain in negative territory. However, office property rentals are stabilising, with the industrial property sector being the most robust, with rental reversions improving. We have therefore remained moderately underweight in both local and foreign property as we think government bonds are more attractive at the current level of yield. Fundamentally, the prospects for retail and office spaces remain lacklustre, and the market may again reprice its rate cut expectations should inflation prove to be stickier than anticipated.

Foreign cash

We prefer to stay offshore-neutral and overweight in foreign cash

Our investment case for offshore cash remains unchanged in that, despite the ZAR having recovered to R18.50/$ over the past month, it will be susceptible to significant changes in global risk sentiment and increasing geopolitical tensions as well as local political uncertainty and the ongoing power crisis. 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. We have therefore chosen to remain overweight in foreign cash to ensure we are offshore-neutral.

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