MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

12 December 2023

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We have made a few changes to our tactical asset allocation – moving from moderately underweight to neutral in offshore equity, moving from neutral to moderately overweight in offshore bonds and reducing offshore cash exposure slightly, 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

Here is our investment case for January:

- 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. There is a limit to the upside potential of this relative position, given the duration spread between SA nominal and inflation-linked bonds.
- Our base-case investment outlook that inflation will cool but remain above the Fed's target remains unchanged. But the Fed is signalling it is willing to cut rates even if inflation is above the target. While the market will reprice its profit and margin expectations as global growth slows over the medium term, short-term momentum is very strong, driven by the optimism of earlier and deeper rate cuts, market price-fuelled sentiment and January effects. We have therefore moved from moderately underweight to neutral in offshore equity.
- We have also chosen to move from neutral to moderately overweight in offshore bonds due to the upside risk of central banks pivoting more quickly than previously expected and the consistently attractive forward two-year return profiles demonstrated by bonds post the end of previous rate-hiking cycles. Despite increasing correlations between offshore equities and bonds, the latter would still offer some diversification if there are any serious market fallouts. The potential headwinds to the US and global economic growth remain, but none have materialised, thus fuelling this perfect soft landing to date.
- 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 the risk of higher operating costs and negative rental reversions. The market is not concerned about higher refinancing costs, given the latest rate outlook.
- 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 remains unchanged, but the difference in duration could limit the upside potential of this relative position

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. Brazilian 10-year bonds, however, are offering marginally higher real yields, given the latest inflation numbers, 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 6.6% to 7.3%. This suggests that nominal bonds continued to compensate investors more for inflation over the longer maturities.

Following our TAA meeting, SA headline consumer inflation showed a decline from 5.9% to 5.5% in November due to a cooling fuel price, which offset the elevated food price inflation. Core inflation rose from 4.4% to 4.5% over the same period, suggesting that inflation has not yet been fully tamed.

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 continue to ease domestic inflationary pressure – despite still-rising food price inflation. The market has been more optimistic on the rate cuts outlook than the Fed's guidance. But it seems it is getting it right, as the latest Fed's meeting – which took place after our TAA meeting – signalled three rate cuts coming in 2024, confirming what had been priced in by the market since November. The fact that the SA inflation-linked bonds benchmark has a longer duration than the ALBI suggests that the former can benefit more from a rate cuts-sparked rally if the rate cuts happened to be quicker and/or deeper than the market previously expected. This would limit the upside potential of this relative position between SA nominal and inflation-linked bonds.

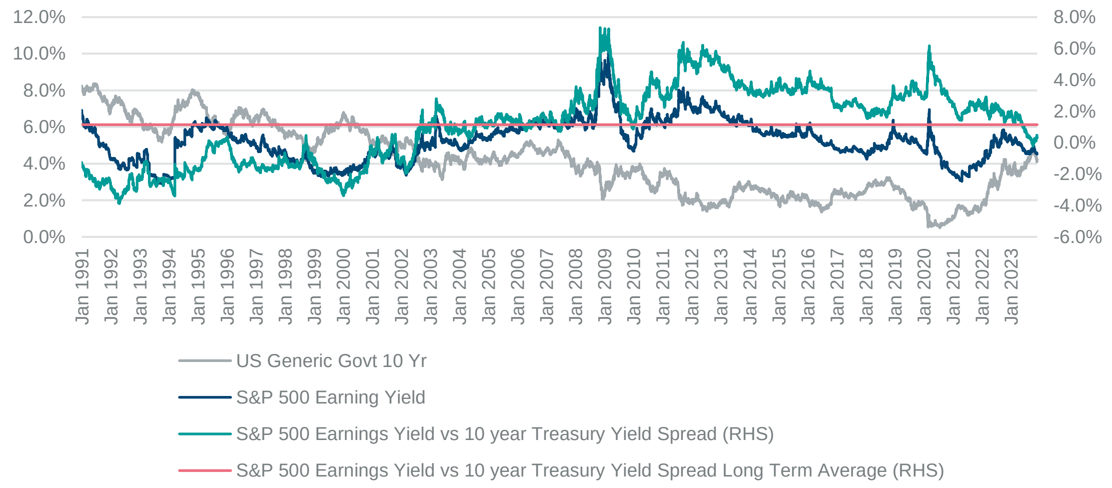
Figure 2: EM bond yields

	South Africa	India	Indonesia	Mexico	Brazil	Turkey
10 Year Yield	**11.65%**	**7.27%**	**6.61%**	**9.31%**	**10.94%**	**25.64%**
Inflation	5.9%	4.9%	2.86%	4.3%	4.8%	62.0%
Inflation Expectation	5.80%	6.60%	3.70%	5.60%	4.62%	54.20%
10 Year Real Yield	**5.75%**	**2.40%**	**3.75%**	**4.99%**	**6.12%**	**-36.34%**
10 Year Real Yield based on inflation expectation	5.85%	0.67%	2.91%	3.71%	6.32%	-28.56%
Currency Risk Premium	**3.90%**	**2.00%**	**1.02%**	**3.33%**	**4.14%**	**17.09%**
Sovereign Risk Premium	**3.53%**	**1.04%**	**1.36%**	**1.75%**	**2.57%**	**4.33%**
US 10 Year Yield	4.23%	4.23%	4.23%	4.23%	4.23%	4.23%
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

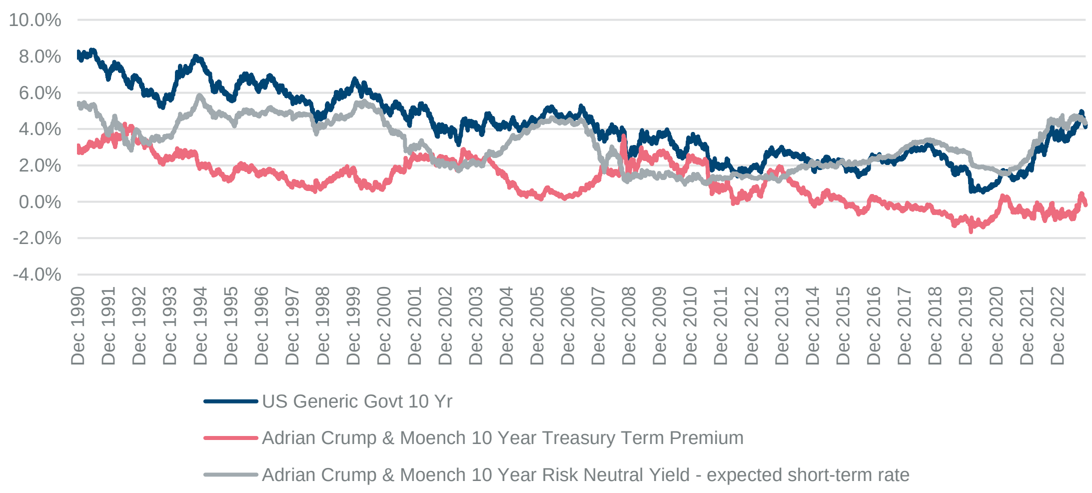
Foreign equity	**Fundamentals remain unchanged but near-term momentum is too strong to ignore** Our investment case for foreign equity remains unchanged from a fundamental perspective. However, we need to proceed with caution, given the strong short-term momentum. Our base-case investment outlook from last month was that inflation will cool but remain above the Fed's target rate (due to the structural issue in the US labour market), and that the market will reprice its profit and margin expectations as global (including US) growth slows and will potentially reprice its rate cuts expectations if inflation indeed proves to be stickier. We concluded then that 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 still hold the same view on the earnings outlook, but we think earnings may only come under pressure over the medium term, while in the short term, the market is looking for any reasons to propel it further. US headline inflation edged marginally lower from 3.2% to 3.1% in November, with core inflation remaining unchanged at 4.0%. While core services inflation is still too hot, the market is optimistic that the falling fuel price and rent inflation will pave the way for US inflation to enter the 2.0% to 2.5% range early next year. Equities and bonds further rallied after Fed Chair Powell's latest comments that the Fed is willing to cut rates even if the US economy does not enter a recession in 2024: "It could just be a sign that the economy is normalizing and doesn't need the tight policy." Unless a catalyst triggers some risk events, the slowdown in earnings growth may only become a concern in late January or February. In the very short term, we see strong momentum, driven by the optimism of earlier and deeper rate cuts, market price-fuelled sentiment and January effects, amid an abnormal business cycle post-Covid – the latter complicated by the combination of a prolonged period of extremely loose financial conditions, a monetary policy tightening cycle and a pro-cyclical fiscal policy in advanced economies. We have therefore decided to close our moderately underweight position in foreign equity.
Foreign bonds	**Global fixed income is attractive at the current yield level as the rate-hiking cycle comes to an end** Based on historical performance, the US 10-year treasury return profiles have been fairly consistent, delivering on average a 20% return after the last rate hikes. Global fixed income is also attractive at the current yield level if rate cuts trajectories do turn out as the market expected. It is still trading at the lowest earnings yield vs treasury yield spread over the past 20 years, as shown in Figure 3. It would also outperform global equities if there was any economic or market fallout from the transmission of tightening monetary policy to date. The potential downside is the impact on term premiums, as persistent government deficit spending would increase bond supply while central banks adopt quantitative tightening. Concerns in this regard seem to have retreated over the past few weeks, as shown in Figure 4. To manage the scenario of flight to safety (should it take place), as we have increased our offshore equity position from moderately underweight to neutral, we have at the same time increased our offshore bonds position. This is because both asset classes would do well if rate cuts materialise, with bonds still offering some diversification benefit despite increasing near-term correlations.

Figure 3: S&P 500 earnings yield vs US 10-year treasury yield



Source: Bloomberg

Figure 4: US 10-year bond yield disaggregation



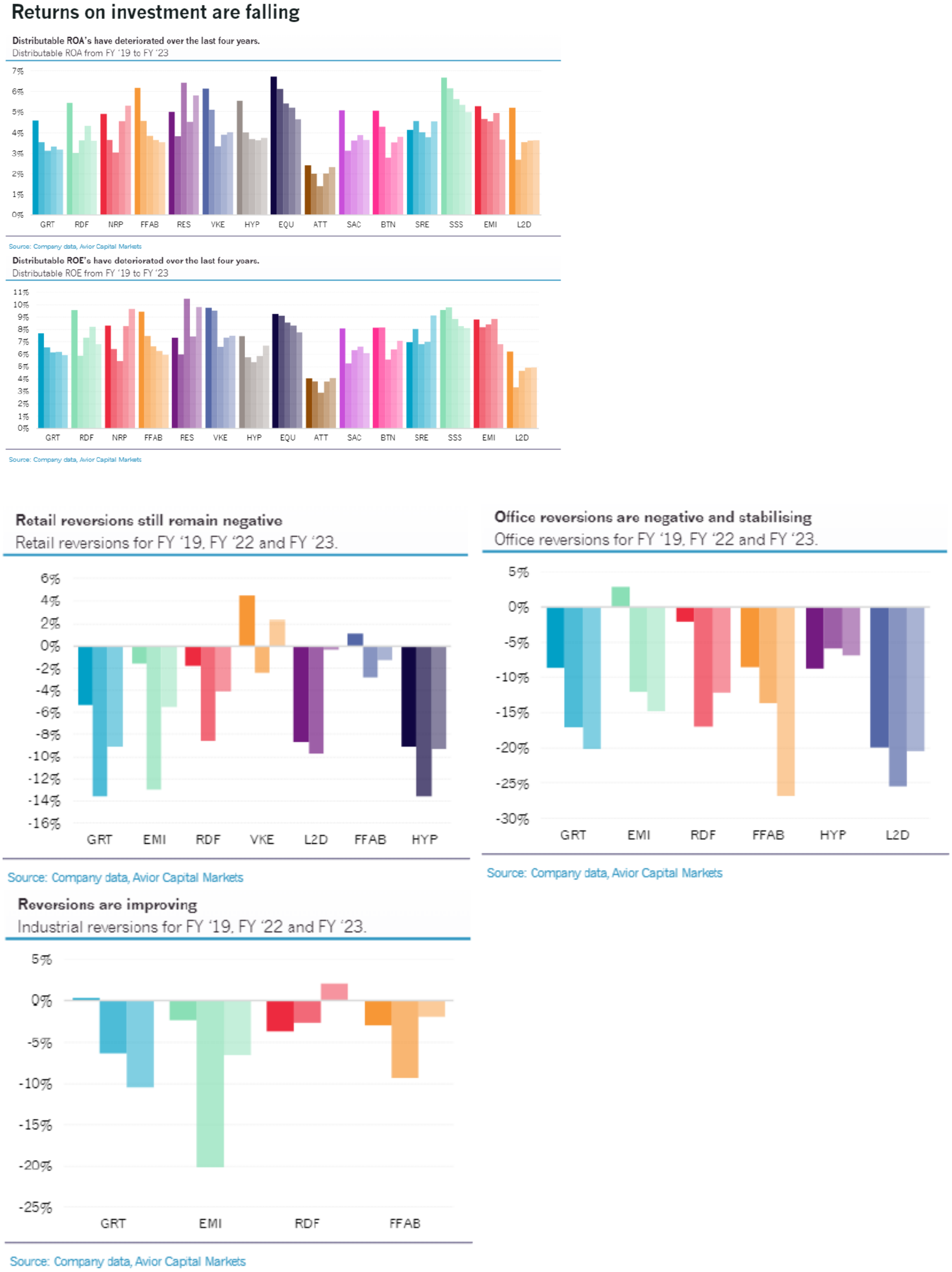
Source: Bloomberg

Local and foreign property

Investment thesis remains unchanged for local and foreign property as the rally continues

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 one can say that the high refinancing risk may subside if the Fed and other major central banks begin rate cuts as early as Q1 next year, other headwinds such as rising operating and municipal costs and subdued rental growth remain. Fundamentals remain weak, according to the latest research by Avior, as shown in Figure 5.

Figure 5: Performance of major counters of the SAPY Index



Source: Avior

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 space remain lacklustre.

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 R18.54/$ over the past week, it was volatile, touching R19.08/$ prior to the US CPI data release and the Fed meeting, before roaring back to the R18.5/$ level. While the tightening of US monetary policy is coming to an end, if the Fed cuts rates earlier than other major central banks, this may extend the losses of the US dollar against the GBP and EUR. As the weak China backdrop is not good for commodity prices, the ZAR 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. We have therefore chosen to remain overweight in foreign cash to ensure we are offshore-neutral.

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