HOUSEVIEW TACTICAL ASSET ALLOCATION

18 January 2024

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We have made several changes to our tactical asset allocation – moving from moderately underweight to neutral in SA inflation-linked bonds, SA and offshore property, and moving from moderately overweight to neutral in offshore cash and bonds, 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 February:

- We have maintained our overweight position in SA nominal bonds, while adjusting exposure to SA inflation-linked bonds (ILBs) to neutral. This decision takes into account the duration differential between nominal bonds and ILBs as well as the constraints posed by strong demand for and limited liquidity of the latter. These considerations temper the upside potential of the relative positions.
- There is potential for the market to reevaluate expectations surrounding rate cuts, thus impacting both offshore equities and bonds due to their positive correlations. However, the resilience of the US economy stands out, as evidenced by productivity gains, real wage growth, a robust household debt balance, accelerated advances in AI and fiscal spending leading into the election year, thus providing support for US equities. We have therefore transitioned from moderately underweight to neutral in offshore bonds, as strong economic data may defer rate cuts previously anticipated by the market.
- Shifting from moderately underweight to neutral in both local and foreign property, as the end of rate hiking cycle approaches, alleviates refinancing risk, despite lacklustre fundamentals.
- We have adjusted our offshore cash position to neutral to maintain offshore neutrality.

TAA overview – changes in positions

SA bonds and SA ILBs	**Maintaining a moderately overweight position in SA bonds and upgrading SA ILBs from moderately underweight to neutral** 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. The 10-year inflation-linked bond yield continued to trade at a premium to its implied real yield, with the breakeven inflation 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. Brazilian 10-year bonds, however, offer higher real yields with a better S&P credit rating, as shown in Figure 2.

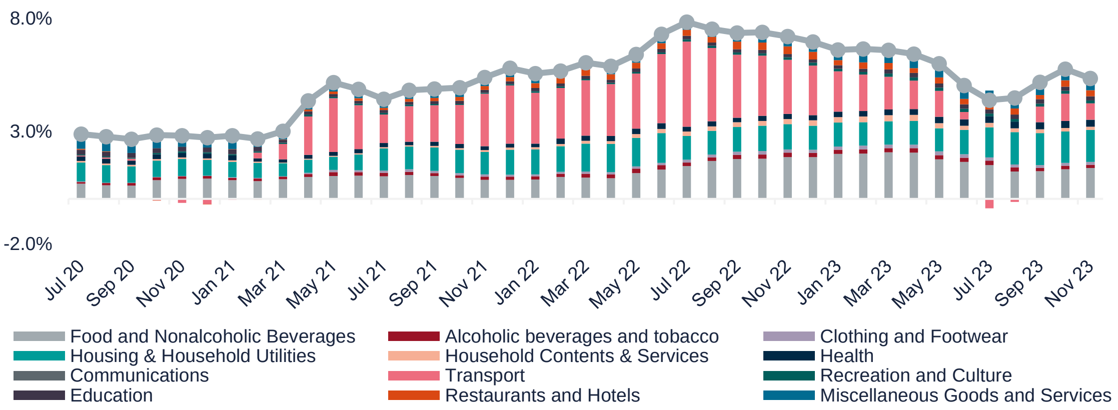
Figure 2: EM bond yields

	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	**4.09%**	**2.04%**	**1.07%**	**3.42%**	**4.33%**	**17.35%**
Sovereign Risk Premium	**3.33%**	**1.00%**	**1.31%**	**1.67%**	**2.38%**	**4.06%**
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

While the December inflation data will only be released on 24 January, recent months of CPI data and the fact that food and housing remained elevated suggest that the downward trend in inflation may be bumpy and sticky.

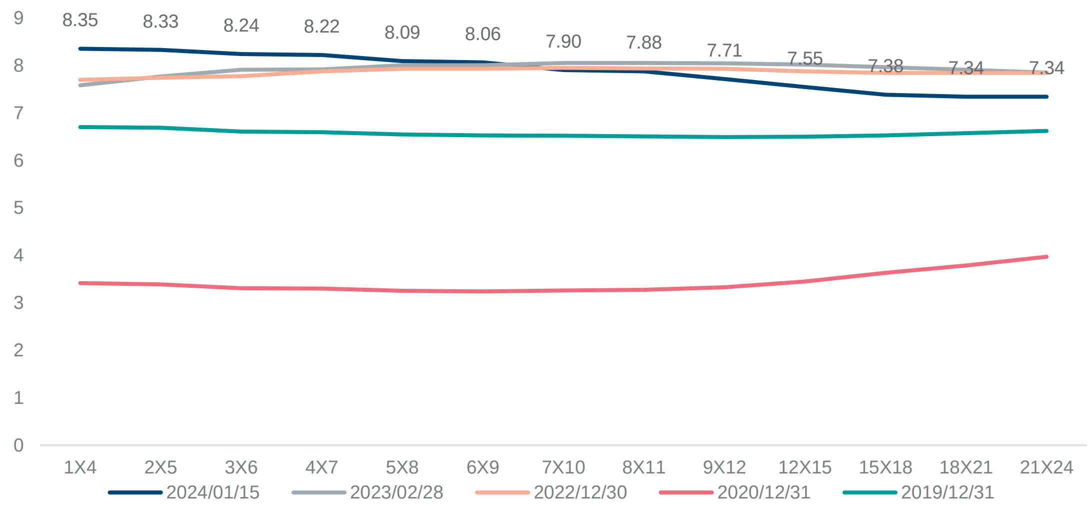
Figure 3: SA CPI contribution



Source: Bloomberg

We have kept our overweight position in SA nominal bonds unchanged but increased our SA ILBs exposure to neutral. The market has been more reasonable regarding the rate cut expectations for SA than the US, pricing in three cuts of 25bps by the SARB, as implied by the FRA rates in Figure 4. Given the duration difference between the ALBI and SA inflation-linked bonds benchmark, ILBs may benefit if the market prices in further rate cuts. In addition, the lack of liquidity and demand for ILBs from local banks also compromises the upside potential of the pair trade of going for long SA nominal bonds and short ILBs. Since inflation is not yet tamed and both asset classes are more attractive than cash at the current yield levels, as we approach the end of the rate-hiking cycle, we prefer to remain moderately overweight in SA nominal bonds and neutral in SA inflation-linked bonds.

Figure 4: SA FRAs



Source: Bloomberg

Foreign bonds

Downgrading from moderately overweight to neutral

We still prefer offshore bonds, given their attractive real yields and fairly consistent historical return profiles post the end of the rate-hiking cycles. However, over the short term, they will be subjected to some repricing if the market adjusts its rate-cut expectations. According to the FRA rates, the market has priced in roughly 6 rate cuts in 2024, double that of the FOMC's guidance.

Figure 5: FOMC rate expectations

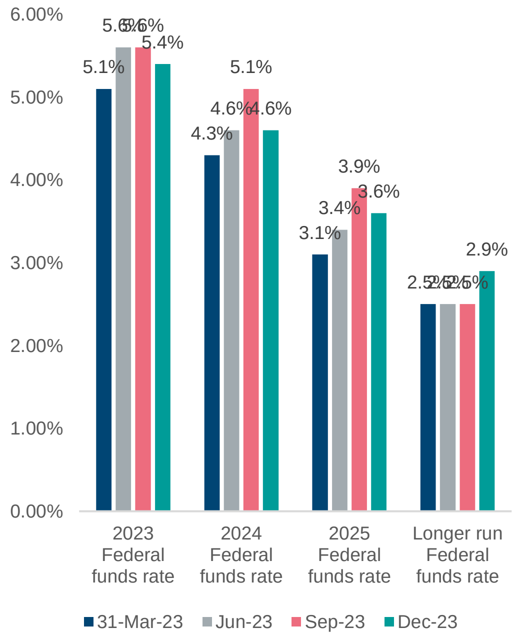
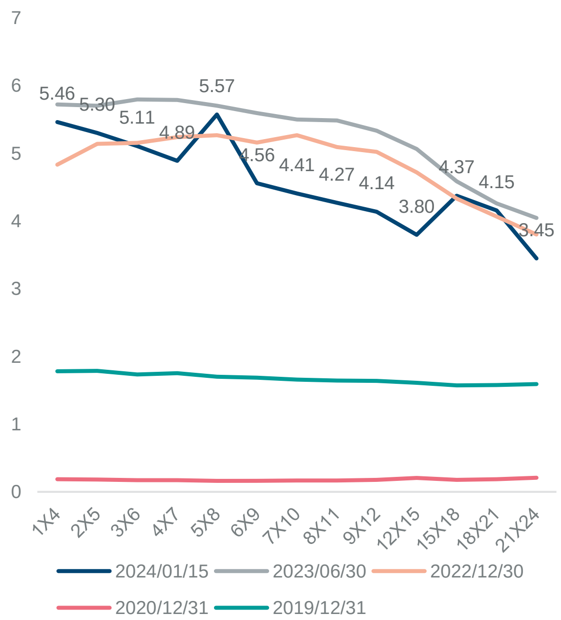


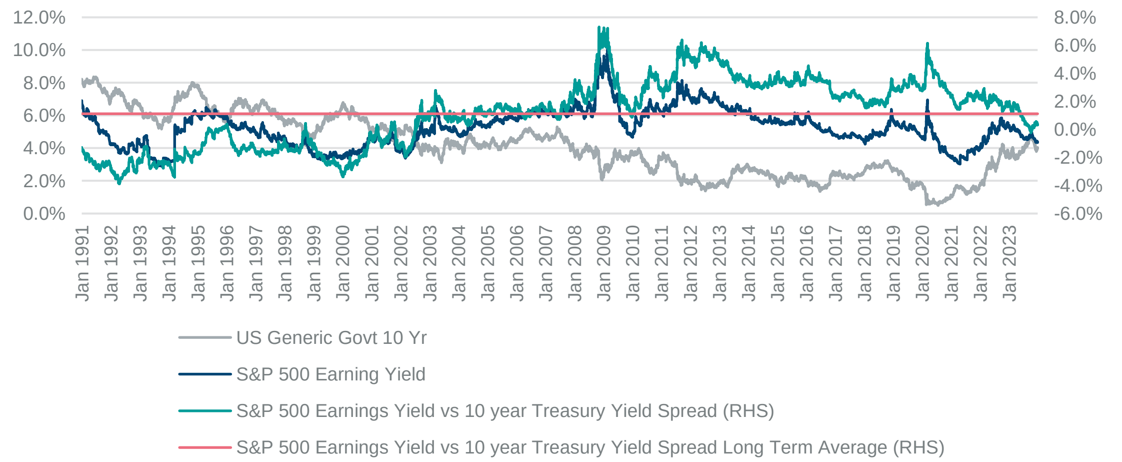
Figure 6: US FRAs



Source: Federal Reserve, Bloomberg

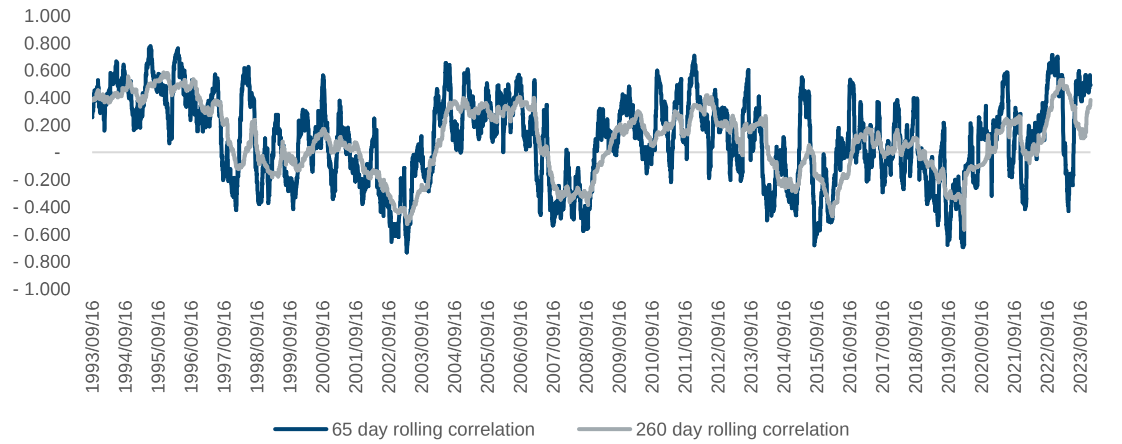
While offshore bonds remain more attractive than offshore equities, their appeal has diminished as the spread closes in on longer-term averages, as illustrated in Figure 7. Adjustments in rate outlooks could impact both offshore stocks and bonds, given their positive correlations in terms of returns. Global fixed income would become more appealing in the event of an economic or market fallout. However, the resilience of the US economy, characterised by productivity gains, strong household balance sheets and positive real wage growth (similar trends observed in other developed countries), is expected to sustain consumption and demand in the foreseeable future. Anticipating no significant fiscal spending cuts in this election year, upbeat economic data could defer central bank rate cuts, impacting fixed income more negatively than equity. Geopolitical conflicts may introduce supply chain pressure and trigger a resurgence in energy prices, posing an upside risk to inflation which cannot be overlooked. Consequently, we have adjusted our offshore bond position from moderately overweight to neutral.

Figure 7: S&P 500 earnings yield vs US 10-year treasury yield



Source: Bloomberg

Figure 8: S&P 500 and US 10-year treasury correlations



Source: Bloomberg

Local and foreign property	**Moving from moderately underweight to neutral** From a valuation standpoint, the current landscape remains consistent. The SAPY Index aligns with ALSI, while the S&P 500 Global Property Index is more affordable than the MSCI World Index. Both, however, trade at premiums to ALBI and the US 10-year treasury, respectively. Last month, we highlighted that this was an indication that the current valuation level inadequately compensated investors for the added risk compared to bonds within the property sector. Despite weakened fundamentals, optimism stemming from recent rate cut expectations has driven both asset classes up by 11.6% and 14.5% in local currency terms in Q4 2023. While market pricing may reflect excessive rate-cut expectations, the fact that major central banks are signalling peak rates and a willingness to ease monetary policy in the face of disinflation bodes well for listed property sectors, reducing the refinancing risk. Consequently, we have adjusted our position from moderately underweight to neutral in both local and foreign property. The anticipated monetary easing is expected to offer some support to these sectors. However, the lacklustre fundamentals do not warrant a further upgrade at this stage.
Foreign cash	**Moving from moderately overweight to neutral** As we have maintained a neutral stance on other offshore asset classes, we have adjusted our position from moderately overweight to neutral for offshore cash to uphold offshore neutrality. The Rand continues to trade at a 10% discount to its 5-year average level and over 30% for long-term horizons against the USD. Potential pressure on the USD may occur if the Fed cuts rates earlier than other major developed countries. However, the challenging backdrop in China is unfavourable for commodities, and the SA's domestic fiscus may come into focus as windfall taxes from the recent commodity boom diminish.

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