MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

21 January 2021

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We kept our overweight position in SA nominal bonds, foreign equity and underweight position in foreign bonds 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				■	

Synopsis

We have made no changes to our TAA positions. While the Q4 rally pushed up valuations across asset classes, ongoing liquidity injections from global central banks are likely to keep reflationary/inflationary forces in check, which – with the second/third wave of the pandemic evidently easing – will provide further support for risk-on sentiment. However, upside risk to volatilities is also likely to be seen in the near term.

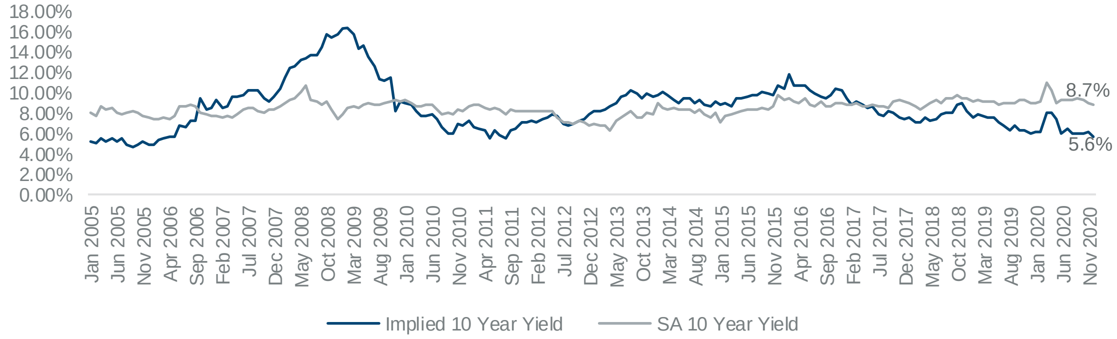
We continued to be overweight in SA nominal bonds as they remained attractive from an implied yield, real yield and hedged yield perspective. Furthermore, we believe foreign investment flows may get a boost as excess liquidity chases after yields. However, the recent rally is leaving little room for another credit rating downgrade, making debt stabilisation critical. We chose to stay neutral in SA inflation-linked bonds, SA equity and SA-listed property. Local inflationary expectations seemed benign in the short run. The fundamentals for domestic risk assets remained largely unchanged over the past month, weighed down by the same but more pronounced economic and structural woes, with some near-term improvement in domestic sentiment. We prefer offshore equities over offshore bonds, given the historically low yields and central banks' intentions to keep things that way – at least this year until economic conditions improve.

TAA Overview

SA Bonds	We saw strong net inflows, close to $2bn from offshore investors in November and December last year. The CDS spread normalised due to a supportive global environment, although the possibility of a fiscal cliff being reached remained. Fitch and Moody's downgraded SA's foreign currency sovereign rating to BB- and Ba2, respectively, with a negative outlook. S&P kept the rating unchanged at BB-, but with a stable outlook. The downgrades hardly affected risk appetite; investors were thirsty for a high yield and our undervalued local currency heightened the attractiveness of local bonds. SA nominal bonds remained attractive from an implied yield, real yield and hedged yield perspective. The annual budget in February could stir some near-term noises, but the fragile fiscal situation and execution risk around expenditure cuts are well understood, with any potential steps towards fiscal consolidation could benefit local debt. However, further slippage in sovereign ratings has not yet been priced in. It does not appear that excess liquidity from quantitative easing

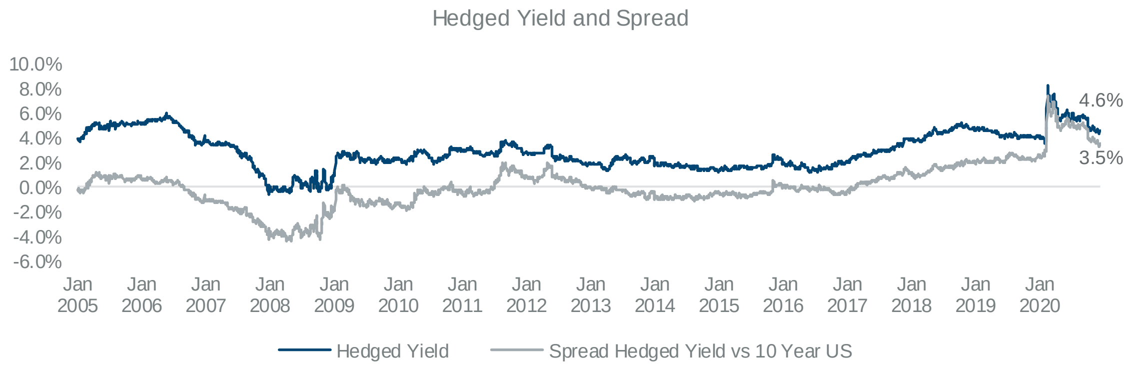
will be withdrawn anytime soon, as central banks around the world resort to accommodative policies to stabilise capital markets and lock in low rates to fund government debt. We therefore opt to remain moderately overweight.

Figure 2: South Africa 10-year nominal yield vs implied yield as at 30 December 2020



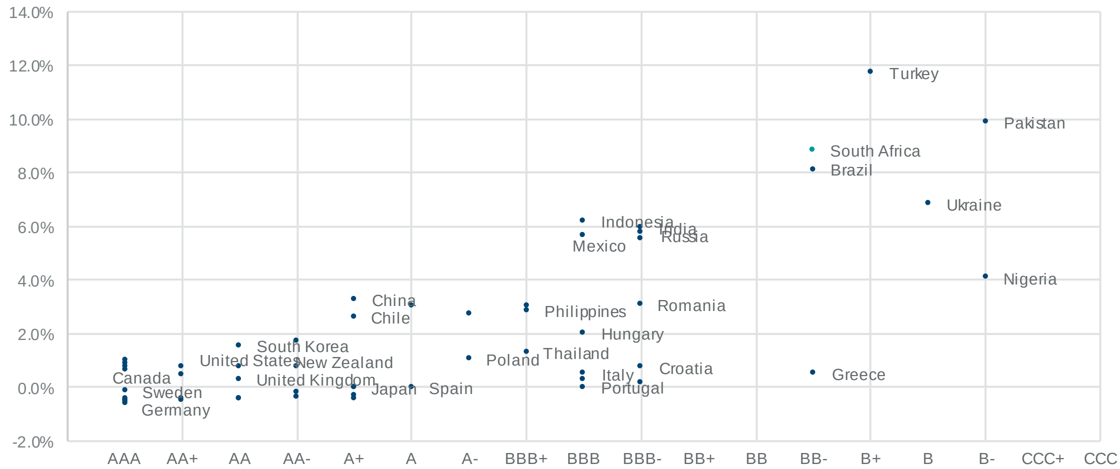
Source: Bloomberg

Figure 3: US$-hedged 10-year bond yield over time



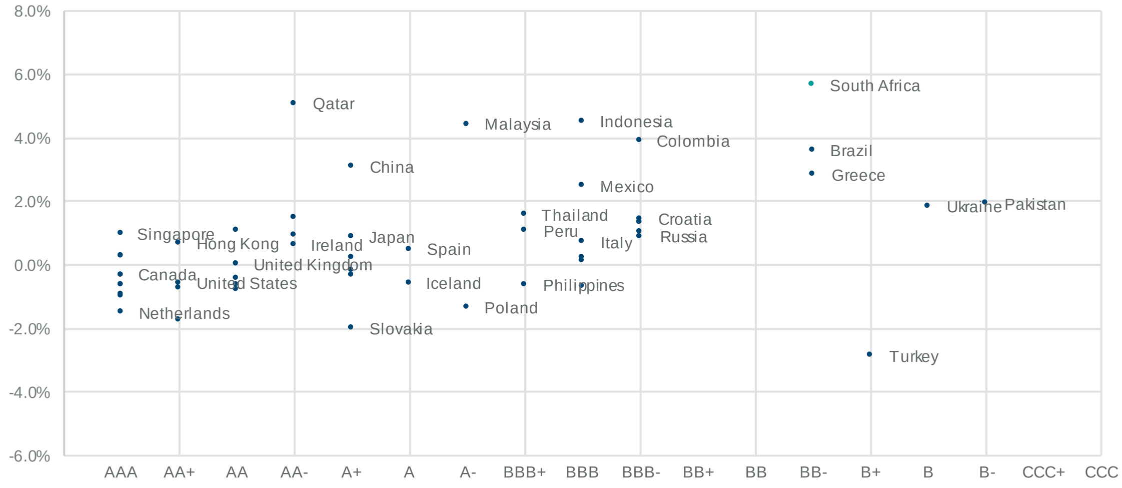
Source: Bloomberg

Figure 4: 10-year nominal yield vs S&P credit rating as at 15 January 2021



Source: Bloomberg

Figure 5: 10-year real yield vs S&P credit rating as at 15 January 2021

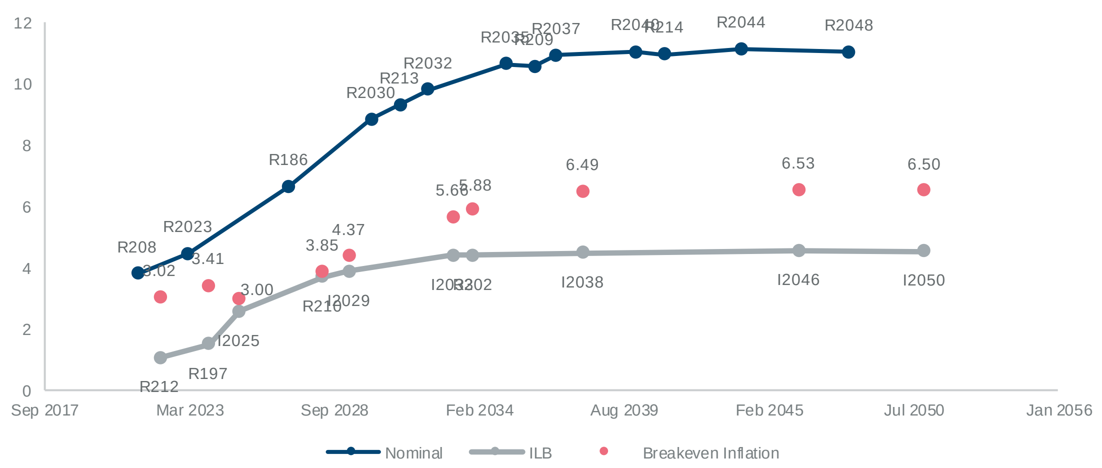


Source: Bloomberg

SA Inflation-Linked Bonds

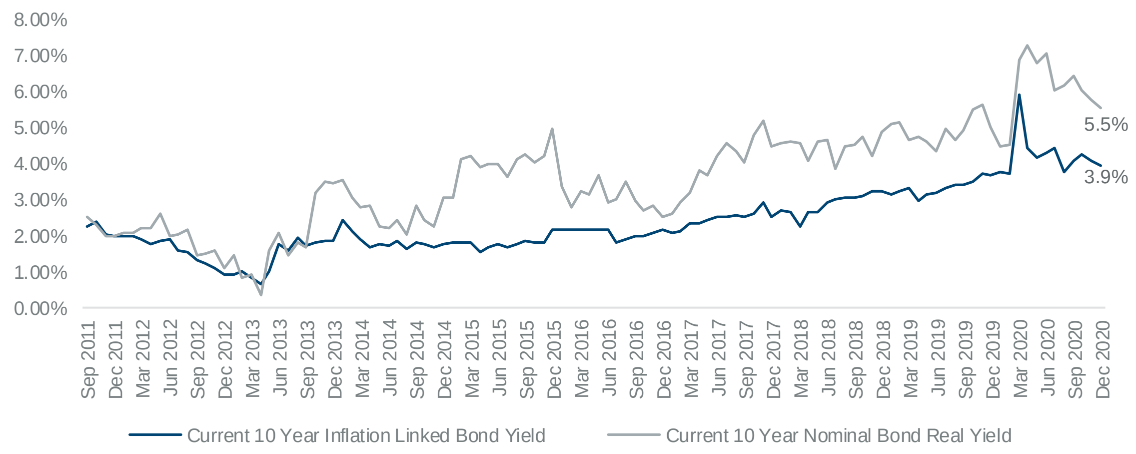
The ALBI Index outperformed the STEFI Index in 2020, but cash outperformed the IGOV Index as inflation hovered around the lower end of the target band of the South African Reserve Bank, briefly touching 2.2% in June last year. While monetary stimulus and fiscal pandemic relief may ultimately feed into higher inflation as asset price bubbles become increasingly prevalent, excess capacity and supply chain disruptions are the other main deflationary and reflationary forces, respectively. For South Africa, weak demand, tight money supply (relative to historical levels and muted private sector credit extensions)and a stronger rand should still keep inflation benign in the short term. We choose to stay neutral as we like inflation linkers over cash, since an all-time low repo rate is likely to remain in the near term. Inflation rates will mostly be higher in 2021, simply from the base effect. However, nominal bonds do offer a better inflation-adjusted yield.

Figure 6: SA nominal and real yields as at 15 January 2021



Source: Bloomberg

Figure 7: 10-year real yield of nominal bond vs inflation-linked bond as at 30 December 2020



Source: Bloomberg

SA Equities

Offshore equities had a good rally in 2020, with a full year return in ZAR further boosted by the 5.0% weakening in the rand over the period. Local equities began to catch up in the last quarter of 2020. The ALSI and the Capped SWIX were up by 9.8% and 11.5%, respectively, while offshore asset returns in ZAR were hurt by the 12.3% appreciation in the rand relative to the greenback. Emerging market assets benefited from optimism linked to a vaccine-related economic upswing, a more stable trade policy under a Biden administration and stronger-than-expected Chinese economic and trade data. China's Q4 GDP was up 6.5% year on year vs the market consensus from Bloomberg of 6.2% The country's industry-led recovery is resuming as industrial production was up 7.3% in December (vs 7.0% in November) and exports and imports were up by 18.1% and 6.5%, respectively, year on year, in December (beating the Bloomberg survey predictions of 15.0% and 5.7%). Dollar weakness and higher, demand-led commodity prices gave a further boost to the local resources counters.

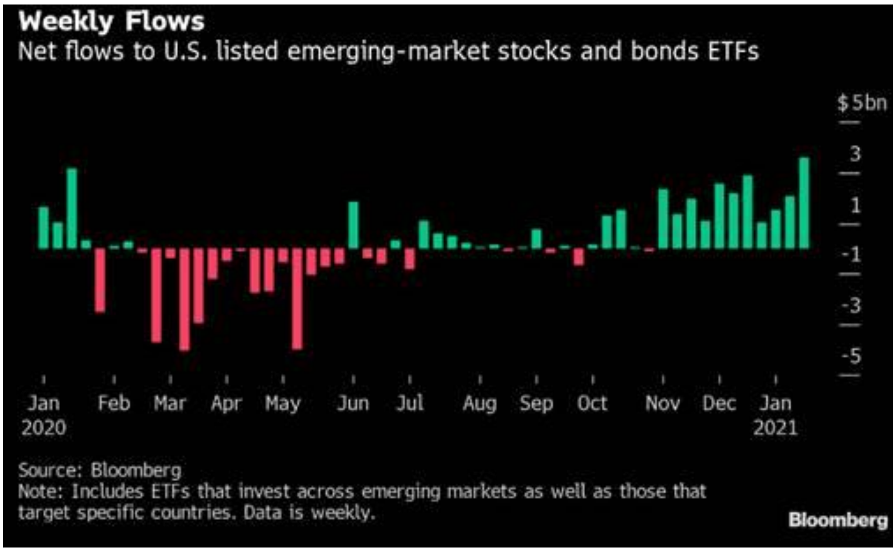
Figure 8: Major indices and asset class returns in ZAR

31 December 2020 (ZAR)	1M	3M	YTD	1 Year	3 Year (annualised)	5 Year (annualised)	10 Year (annualised)	MTD 20 January 2021
FTSE/JSE ALSI Total Return	4.2%	9.8%	7.0%	7.0%	3.1%	6.4%	9.6%	8.0%
FTSE/JSE Capped SWIX Total Return	5.5%	11.5%	0.6%	0.6%	-1.5%	3.2%		5.4%
S&P 500 Total Return	-1.3%	-1.4%	24.3%	24.3%	20.8%	14.0%	23.4%	4.2%
STOXX 600 Total Return	-0.3%	1.6%	12.0%	12.0%	10.1%	5.9%	14.6%	3.6%
Nikkei 225 Total Return	-0.6%	6.1%	29.6%	29.6%	18.1%	11.8%	18.9%	5.6%
MSCI World Total Return	-0.9%	0.3%	22.3%	22.3%	17.6%	11.6%	19.7%	4.3%
MSCI ACWI Total Return	-0.5%	0.9%	22.6%	22.6%	17.1%	11.6%	18.9%	5.1%
MSCI EM Total Return	2.0%	5.3%	24.6%	24.6%	12.7%	12.0%	12.7%	10.2%
STEFI	0.3%	1.0%	5.4%	5.4%	6.7%	7.0%	6.4%	0.2%
ALBI	2.4%	6.7%	8.7%	8.7%	8.9%	10.4%	8.2%	0.3%
IGOV	2.3%	5.5%	3.9%	3.9%	2.1%	3.0%	6.1%	1.1%
WGBI	-3.7%	-9.6%	15.6%	15.6%	11.0%	3.6%	10.8%	0.5%
SAPY Total Return	13.7%	22.2%	-34.5%	-34.5%	-20.7%	-8.4%	3.5%	-1.6%
MSCI US REIT Total Return	-1.8%	-1.9%	-3.0%	-3.0%	9.5%	3.7%	17.3%	2.9%
STOXX 600 Real Estate Total Return	1.0%	2.2%	4.2%	4.2%	7.7%	2.9%	15.1%	-1.5%
Crude Oil	3.4%	11.2%	-17.6%	-17.6%	-2.8%	5.7%	2.0%	10.0%
Aluminium	-8.0%	-1.4%	14.8%	14.8%	1.1%	4.5%	6.0%	1.6%
Copper	-2.7%	2.3%	32.0%	32.0%	8.3%	9.4%	6.1%	5.2%
Gold	6.8%	0.7%	25.1%	25.1%	13.4%	12.3%	2.9%	-1.4%
Platinum	5.2%	5.5%	16.4%	16.4%	11.0%	2.6%	3.0%	5.5%
Nickel	0.0%	0.0%	0.0%	0.0%	5.2%	5.7%	0.7%	0.0%
Palladium	-2.3%	-6.8%	32.1%	32.1%	39.7%	32.7%	21.1%	-1.5%
Iron Ore	17.6%	11.9%	86.7%	86.7%	36.8%	27.3%		8.4%
USDZAR	-5.0%	-12.3%	5.0%	5.0%	5.9%	-1.0%	8.3%	1.4%
GBPZAR	-2.5%	-7.2%	8.2%	8.2%	6.3%	-2.5%	6.9%	1.4%
EURZAR	-2.7%	-8.5%	14.4%	14.4%	6.5%	1.3%	7.3%	0.5%
JPYZAR	-4.1%	-10.5%	10.2%	10.2%	9.0%	2.0%	5.7%	1.3%

Source: Bloomberg

This risk-on sentiment continued into 2021, as depicted in the weekly inflows into the US-listed emerging-market ETFs below:

Figure 9: Weekly flows into emerging market ETFs



Source: Bloomberg

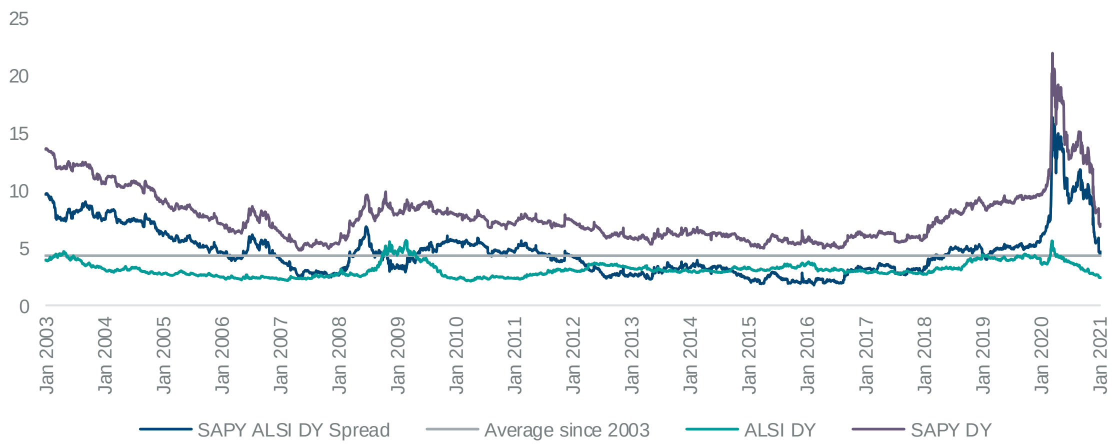
SA equity valuations based on price ratios and dividend yields were, unsurprisingly, thrown into the underweight score spectrum but to a lesser extent, compared to the developed market equities. For the developed market, the BEER ratio (10-year bond yield vs earnings yield), which was very low at 0.33, highlighted the distaste for developed market bonds.

Fundamentally, we saw some small gains with overall stabilisation serving to avert any further deterioration in the economic indicators. Retail sales were -3.6% year on year in October. While still negative, retail sales improved slightly to -2.5% in November. Total car sale losses also narrowed from -25.4% in October to -12.0% and -10.1% in November and December, respectively. On the trade front, export growth year on year remained strong into the last quarter, at 20.4% and 19.2% in October and November, respectively. However, import growth reflected the country's economic fragility and weak consumer demand, contracting by 6.1% and 7.9% in October and November, respectively.

Consumer and business sentiment indicators showed some signs of improvement. The Bureau for Economic Research Consumer Confidence Index and Composite Business Confidence Index improved from -23 and 24 in Q3 to -12 and 40 in Q4, respectively, The Chamber of Commerce and Industry Business Confidence Index made another consecutive gain in November, reaching a level of 93.4 from 92 in October. While consumer confidence still faces a steep uphill climb to get to pre-COVID levels, business confidence followed global trends, ahead of regional consumer sentiment, over the past year. The SA PMI index normalised to 50.3 in December as manufacturing activities cooled after the initial post-lockdown fervour. Residential building plans were up, year on year, by 5.6% in September and down by -0.4% in October as limited outbound travelling and extended home stays drove demand for renovation projects and upsizing in residential properties.

	We believe over the short term that risk-on sentiment will very likely provide some support and further gains, whereas downside risk, in contrast, has persisted. Domestic economic and structural challenges remain intact. Rising numbers of variants and mutations of the virus could potentially render current vaccines much less effective. While the country seems to have passed the peak of the second wave, unless vaccines are rolled out quickly we may face a third wave in the upcoming winter months. We therefore choose to stay neutral to reflect our cautiously optimistic view on SA equities, particularly as the path to a higher degree of normalcy both in South Africa and globally remains treacherous.
SA Listed Property	The risk-on rally saw SA-listed property deliver stellar returns in Q4 2020. Yield spreads relative to SA equities and the 10-year bond were compressed to long-term average and below long-term average, respectively. The SAPY dividend yield also fell below its rolling 1-year and 5-year averages. While property companies are finding ways to manage their balance sheets, the debt-to-equity level of the index resisted coming down from its current level of 77.

Figure 10: SAPY yield spread relative to FTSE/JSE All Share Index



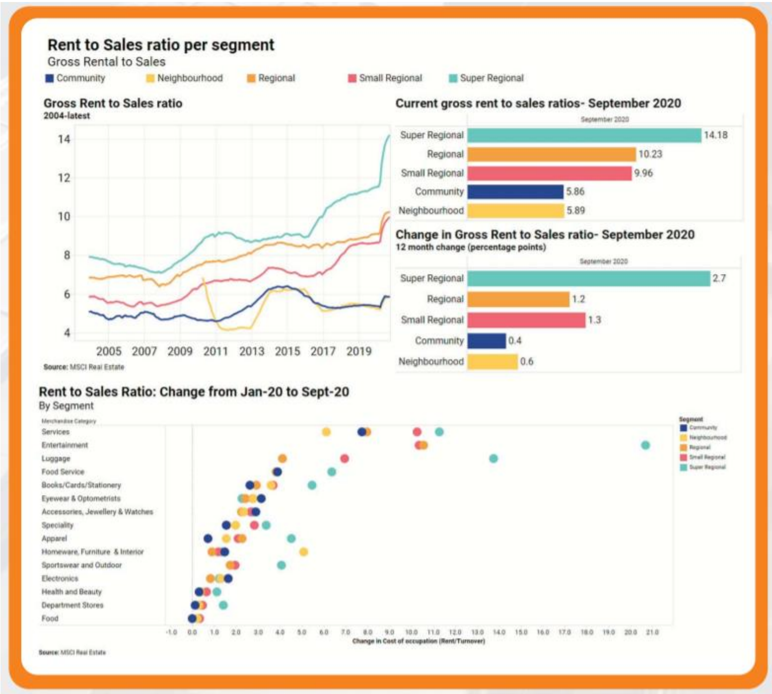
Source: Bloomberg

Figure 11: SAPY yield spread relative to 10-year bond

Source: Bloomberg

Retail trading density growth, year on year, plunged to -13.4% in Q3 and the rent-to-sales ratio jumped across segments – especially for super regionals, according to SAPOA. At the same time, vacancy rates increased. The elevated rent-to-sales ratio and high vacancy rates, together with weak consumer demand, will continue to exert downward pressure on rental reversions. While large retail chains have the financial capital to weather the COVID-19 storm, businesses that struggled before the pandemic and independent boutiques may have to conserve their resources to stay afloat.

Figure 12: Retail rent-to-sales ratio



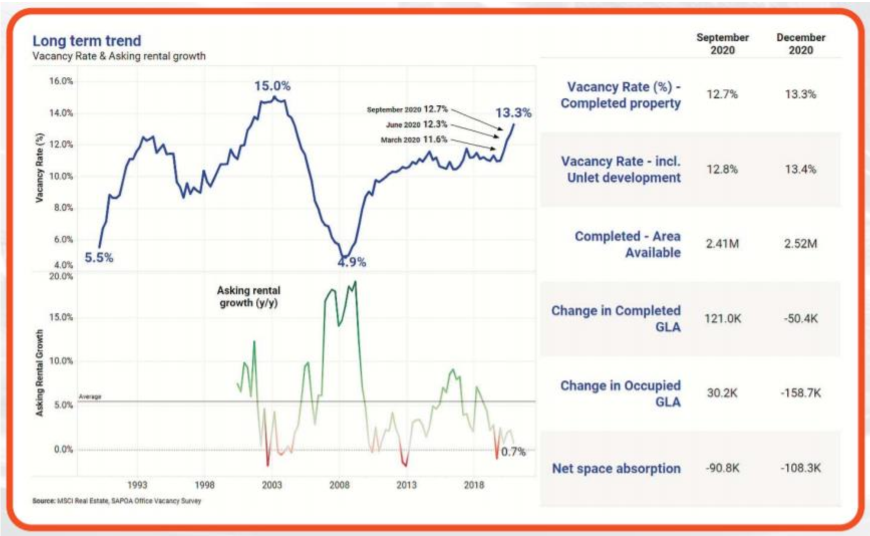
Source: SAPOA

Figure 13: Retail vacancy rates

Source: SAPOA

Office vacancies rose to 13.3% in Q4, just shy of the all-time high vacancy rate of 15%. Rental growth also softened from 2.2% in Q3 to 0.7% in Q4. Different nodes may experience divergent performance over this turbulent period as demand and supply mechanisms differ. While property firms find ways to defend their top line, there is another common enemy that they face. Bad debts as a percentage of gross income for the property sector jumped in 2020, albeit just below the 2009 level. In addition, other operating costs such as rates and taxes continued to outstrip inflation and account for an ever-increasing share of revenue. Despite the Q4 rally, the index still ended at -34.5% for the year, way behind the broad market, leaving room for some short-term gain if the dissipating second wave boosted risk appetite and consumption. However, we choose to stay neutral as we believe that any further significant recovery in the SAPY index will largely be reliant on a turnaround in the fundamentals, which has yet to be seen.

Figure 14: Office vacancy rate



Source: SAPOA

Offshore Bonds

Structurally accommodative monetary policies point to global bond yields likely staying in the lower range. Central banks remain committed to quantitative easing and providing further, direct fiscal support to minimise the economic fallout from the COVID-19 pandemic and to drive a more rapid recovery. However, real yields are likely to fall further amid expectations of rising inflation as recovery momentum builds up. Despite surging numbers of new cases, reintroduced curfews and selective lockdowns in much of the world into 2021, vaccine rollout programmes (especially in many developed countries) and improving economic indicators (in countries that have managed to curtail high infection rates) will most likely improve investors' overall risk appetite. Record-low yield levels also significantly reduced this asset's ability to act as a cushion against risk asset selloffs. We therefore choose to remain moderately underweight in offshore bonds.

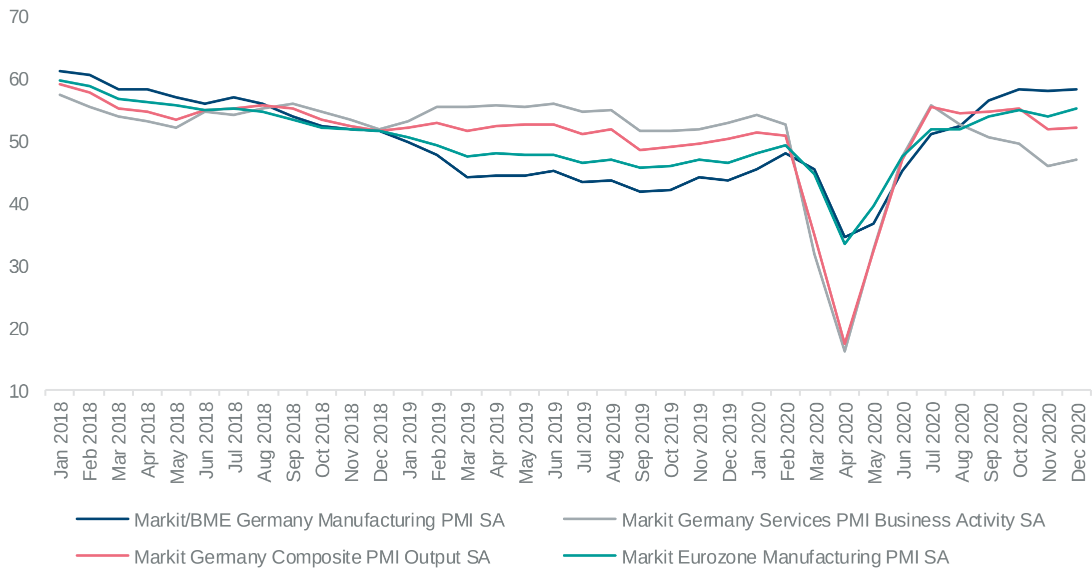
Offshore Equities

Offshore equities' valuation scores followed the same trend as that seen in local equities but leaning more towards underweight. Sentiment in the US, Europe and Japan remained largely flat over the past few months. Meanwhile, recovery in US consumer confidence stalled. The University of Michigan Consumer Sentiment Index trended around the level of 80 from September last year, while the Conference Board Consumer Confidence Index weakened from 101.3 in September to 88.6 in December. Manufacturing sector sentiment, however, was strong, despite activity being constrained by the resurgence in COVID infections and related containment measures. European consumer and business confidence took some small steps towards recovery, while Japanese consumer and business sentiment displayed a very similar pattern, still far behind pre-COVID 19 levels.

Economic fundamentals in these regions did not change much since our earlier TAA meeting in November. US retail sales, year on year, grew by 2.9% in December, showing a slight softening compared to 5.4% in October and 3.7% in November. European retail sales plummeted from 4.2% in October to -2.9% in November in the face of COVID turmoil in the region. US imports recovered from -3.28% in October to 0.27% in November, but export growth, year on year, remained in negative, double-digit territory at -12.54% in November. European exports and imports contracted by 8.7% and 8.9% in Q3. Initial claims under the US pandemic unemployment assistance program ticked up in January as surging cases and restrained economic activity dampened labour market recovery. The US housing market, however, remained strong due to all-time-low mortgage rates. US productivity, quarter on quarter, was up by 4.9% while labour costs were down by 6.6%, which should positively impact corporate earnings. European labour costs were up by 5.2% in Q2 and 1.6% in Q3, but without much productivity gain – a problem that has lingered for years.

While labour market recovery stalled and trade data lacked lustre, the Eurozone and Germany PMIs remained in strongly expansionary mode in December. The Germany Services PMI business activities, however, stayed below the neutral level of 50 due to COVID-related restrictions. Germany industrial production, month on month, and manufacturing orders, month on month, showed signs of losing momentum as the growth rate normalised. The US non-manufacturing sector continued to expand despite PMIs softening slightly from 58.4 in November to 54.8 in December.

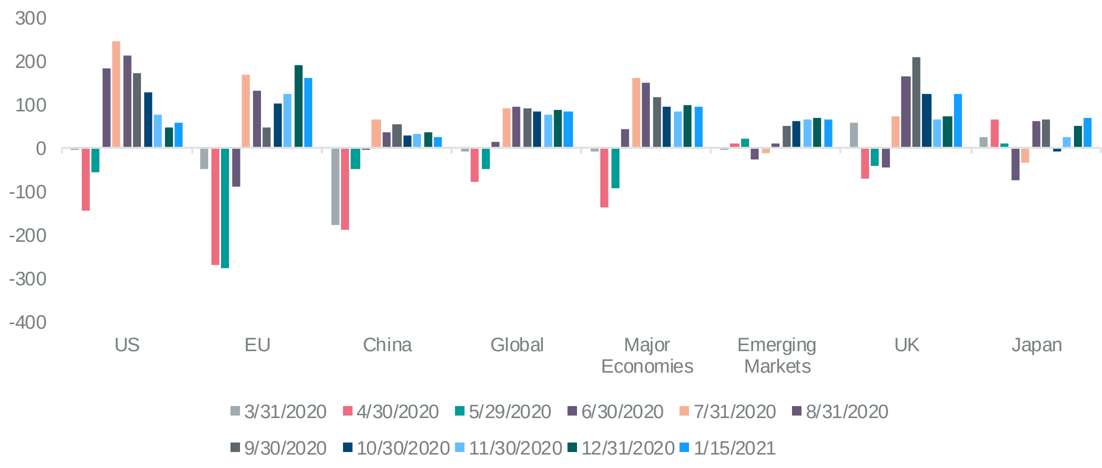
Figure 15: Eurozone and Germany PMIs



Source: Bloomberg

The economic surprise index remained in positive territory for most major economies, showing that the reported economic figures largely exceeded market expectations. US yield spreads between the 10-year and 3-month treasuries increased from 78bps in November to 100 bps in mid -January as investors expected economic growth and inflation to return in the medium term.

Figure 16: Economic surprise indices



Source: Bloomberg

With historically low offshore bond yields, and central banks remaining dovish – with some willing to overshoot their respective inflation targets to put their economies on a surer path to economic recovery after the pandemic – we continue to favour offshore equities over offshore fixed-income assets.

Furthermore, we have slightly increased the allocation to Emerging Market (EM) equities in the global equity building block. We anticipate a global economic recovery during 2021 as the world starts to shake off the COVID-19 pandemic. Economies fully reopening in the wake of large stimulus packages will stimulate global growth and inflation, which will be negative for the USD as the dollar is a counter cyclical currency. Dollar weakness is good for EM equities, and EM growth will also be supported by a widening US current account deficit, low and mostly negative real rates in the developed world and accommodative EM macro policies. However, we do prefer exposure to other emerging markets outside of South Africa, such as China and South Korea, with better economic fundamentals and pandemic containment measures, to recover most strongly from the virus hit.

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