MENTENOVA

HOUSEVIEW TACTICAL ASSET ALLOCATION

18 February 2021

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We kept most of our tactical asset allocation views unchanged, maintained an overweight position in foreign equity and an underweight position in foreign bonds. However, we moved our local bond position from moderate overweight to neutral with SA cash being the balancing figure.

Figure 1: Houseview Tactical Asset Allocation

Synopsis

We made one change to our TAA positions – reducing the moderate overweight position in local nominal bonds to neutral. They remained relatively attractive from an implied yield, real yield and hedged yield perspective. But the level of attractiveness declined as yield spreads were compressed and the upcoming budget speech appeared likely to turn the spotlight on the weak and fragile fiscal conditions, with expenditure cuts and effective growth-oriented and investment-friendly reforms ever more crucial for putting the country back onto a growth trajectory and stabilising debt. Implementation risk remains high and a further credit rating downgrade has not yet been priced in.

We chose to stay neutral in SA inflation-linked bonds, SA equity and SA-listed property, with our investment cases for these three asset classes remaining largely unchanged over the past month. We also continued to prefer offshore equities over offshore bonds, as interest rates are likely to remain low in the near term with the vaccine rollout programmes set to boost economic growth in the second half of 2021.

TAA Overview

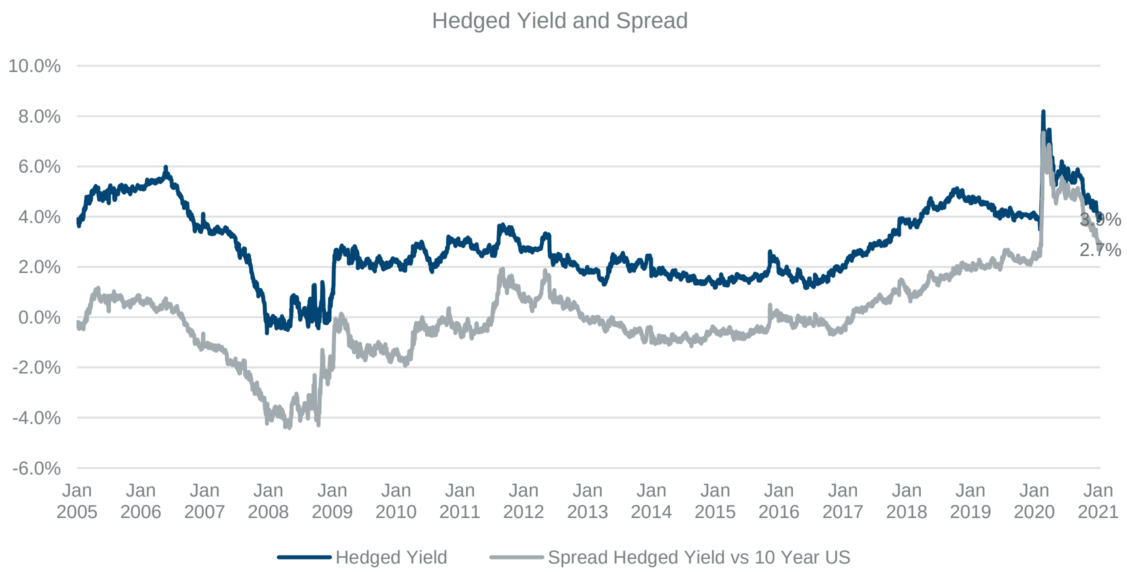
SA bonds	For the year to date, as at 12 February 2021, foreign investors had net bought US$0.85bn (around R12bn) worth of local bonds as unusual levels of liquidity continued to boost the global risk appetite. The 10-year nominal bond still offers some value as it was trading at 8.5%, above the implied 10-year yield of 5.9%. However, the 10-year nominal yield spread over the US 10-year Treasury narrowed to 7.66%, exceeding the long-term average by just 140 bps. The US dollar-hedged 10-year yield also declined from 4.6% to 3.9% over the past month. SA nominal bonds may appear attractive over Brazilian nominal bonds based on real yield, calculated using reported inflation. However, with a much higher inflation outlook based on the Bloomberg survey of economists, SA bonds are roughly trading on a par with Brazilian bonds, with rating agencies assigning a relatively more positive outlook to the latter. The consensus in the market is that global monetary policies will remain expansionary for an extended period as central banks and governments look to stimulus to soften the impact of the pandemic and speed up economic recovery. However, we do expect some volatility in the short run, given the upcoming Budget speech on 24 February. Pandemic-related economic fallouts,

relief programmes and financial bailouts of SOEs, together with an ever-shrinking tax base, are putting increasing pressure on the fiscus and making the public sector wage bill a key target area for negotiation to curb mounting expenditure and contain the budget deficit. We believe that the execution risk of the planned expenditure cuts remains extremely high. Together with shrinking relative attractiveness or a lower margin of error based on real yield, hedged and implied yield, we have decided to reduce our moderate overweight position in SA nominal bonds to neutral, despite the backdrop of an accommodative monetary environment.

Figure 2: South Africa 10-year nominal yield vs implied yield as at 31 January 2021

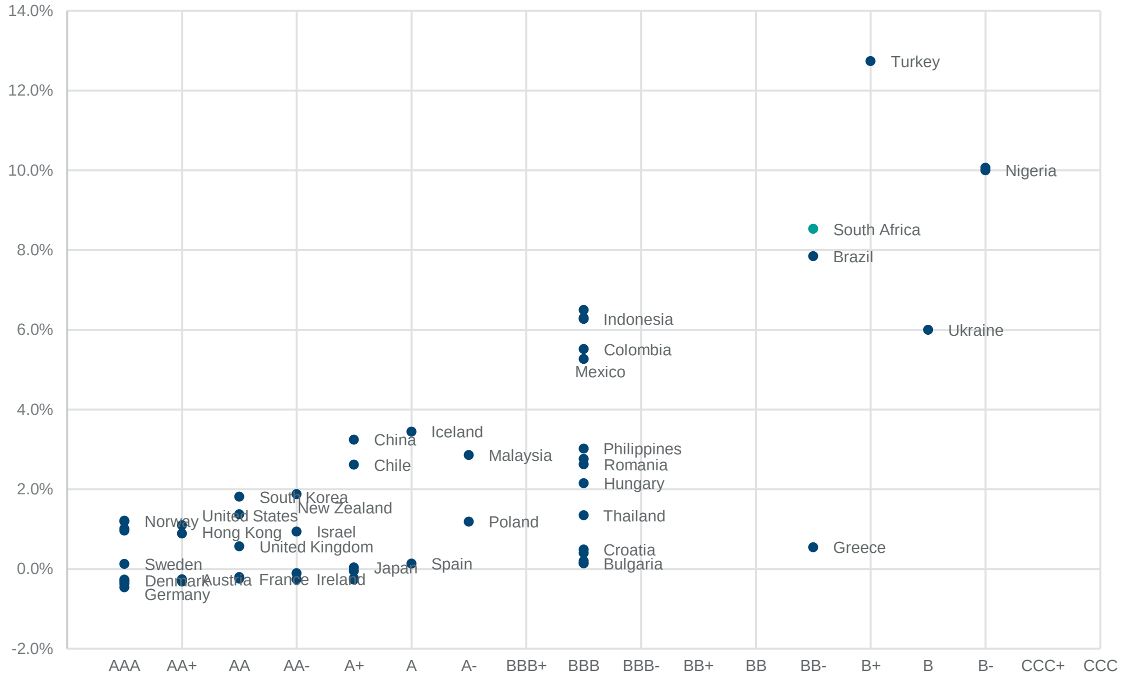
Source: Bloomberg

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



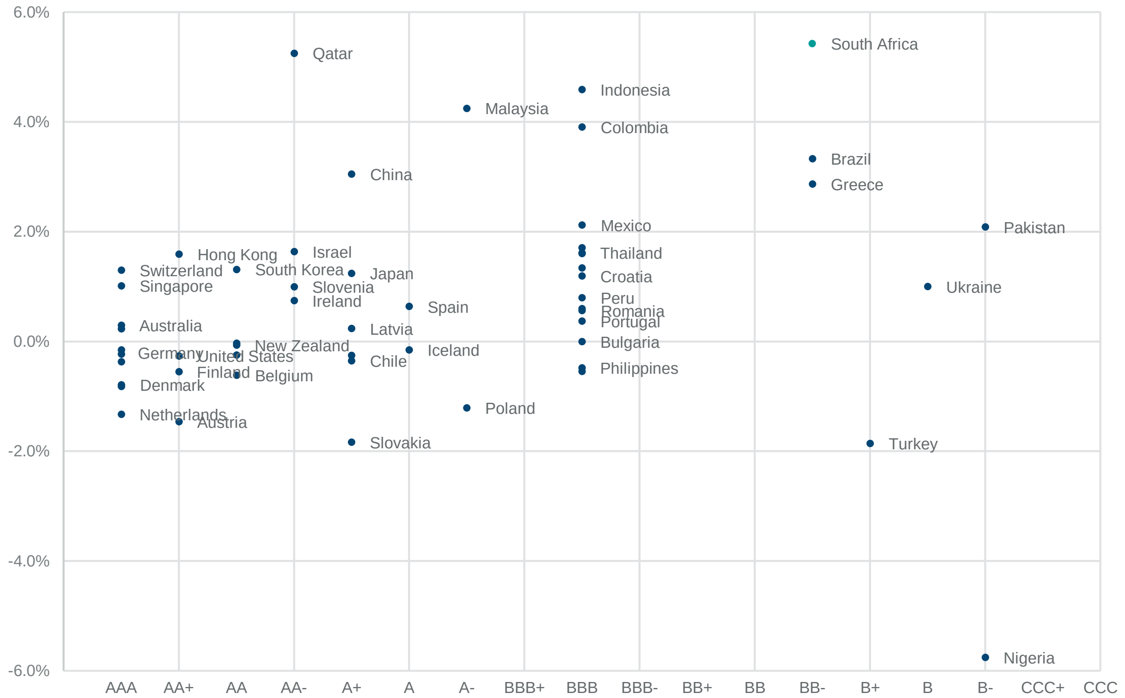
Source: Bloomberg

Figure 4: 10-year nominal yield vs S&P credit rating as at 12 February 2021



Source: Bloomberg

Figure 5: 10-year real yield vs S&P credit rating as at 12 February 2021



Source: Bloomberg

Figure 6: SA bond yields vs EM peers as at 12 February 2021

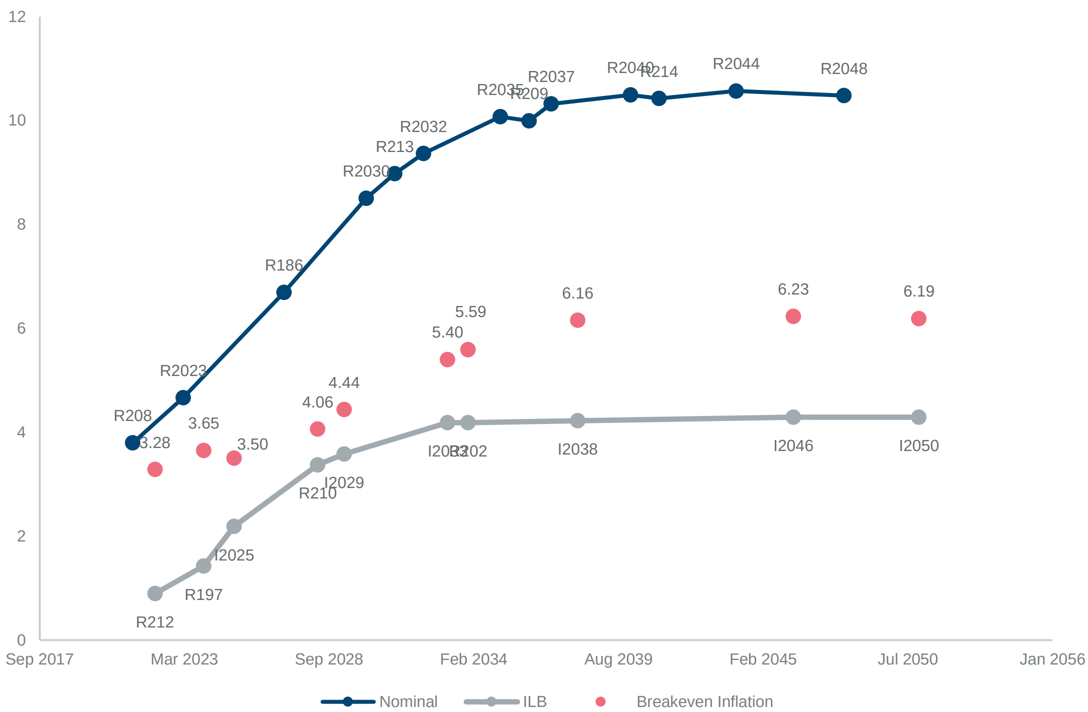
	South Africa	India	Indonesia	Russia	Mexico	Brazil	Turkey
10 Year Yield	**8.52%**	**5.99%**	**6.22%**	**6.56%**	**5.59%**	**7.85%**	**12.98%**
Inflation	3.1%	4.1%	1.55%	3.3%	3.5%	4.6%	15.0%
Inflation Expectation	3.98%	6.40%	2.30%	3.80%	3.50%	3.50%	11.90%
10 Year Real Yield	**5.42%**	**1.93%**	**4.67%**	**3.26%**	**2.05%**	**3.29%**	**-1.99%**
10 Year Real Yield based on inflation expectation	4.54%	-0.41%	3.92%	2.76%	2.09%	4.35%	1.08%
Currency Risk Premium	**4.32%**	**3.47%**	**3.71%**	**3.91%**	**2.89%**	**4.22%**	**8.34%**
Sovereign Risk Premium	**2.99%**	**1.31%**	**1.29%**	**1.44%**	**1.50%**	**2.42%**	**3.43%**
US 10 Year Yield	1.21%	1.21%	1.21%	1.21%	1.21%	1.21%	1.21%
S&P Rating - Foreign Currency	**BB-**	**BBB-**	**BBB**	**BBB-**	**BBB**	**BB-**	**B+**
Moody's Rating - Foreign Currency	**Ba2**	**Baa3**	**Baa2**	**Baa3**	**Baa1**	**Ba2**	**B2**

Source: Bloomberg

SA inflation-linked bonds

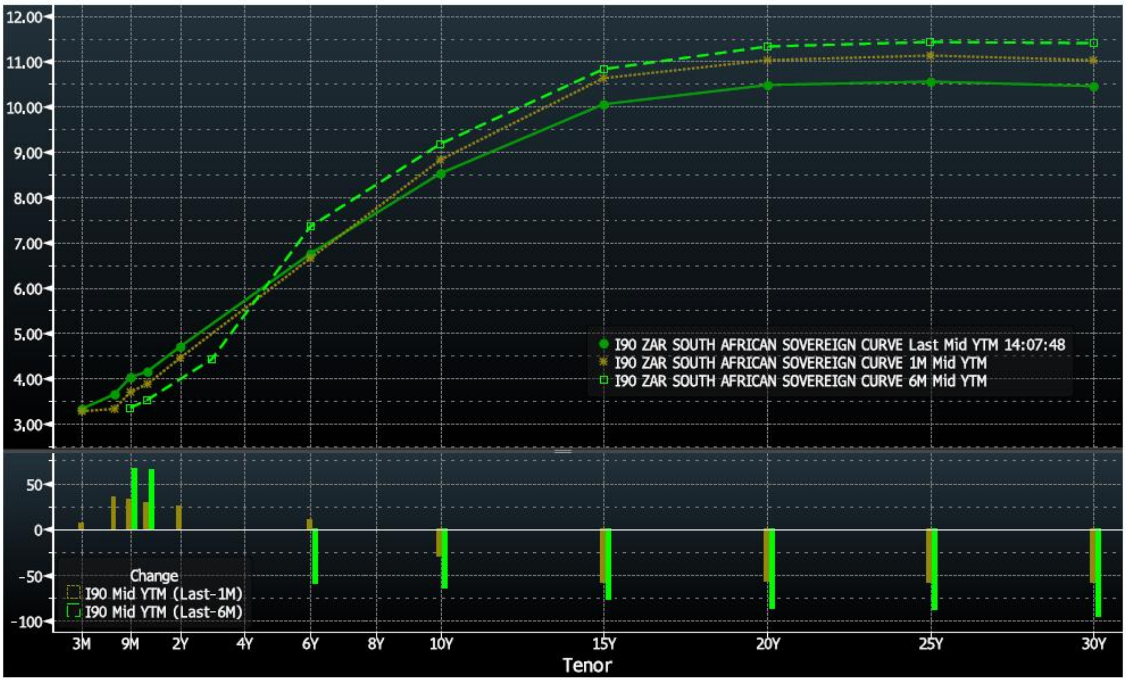
Reflation bets saw the IGOV index outperform the ALBI in January, returning 2.1% vs 0.8%. It also delivered 1.5% vs 1.9% in the ALBI index for the month to date, as at 12 February. Both the nominal and inflation-linked yield curves flattened over the past month, driven by rate-cut expectations and a strong risk appetite. But the inflation-linked yield curve shifted down across all maturities due to a higher inflation expectation, leading to strong demand for this asset class.

Figure 7: SA nominal and real yields as at 12 February 2021



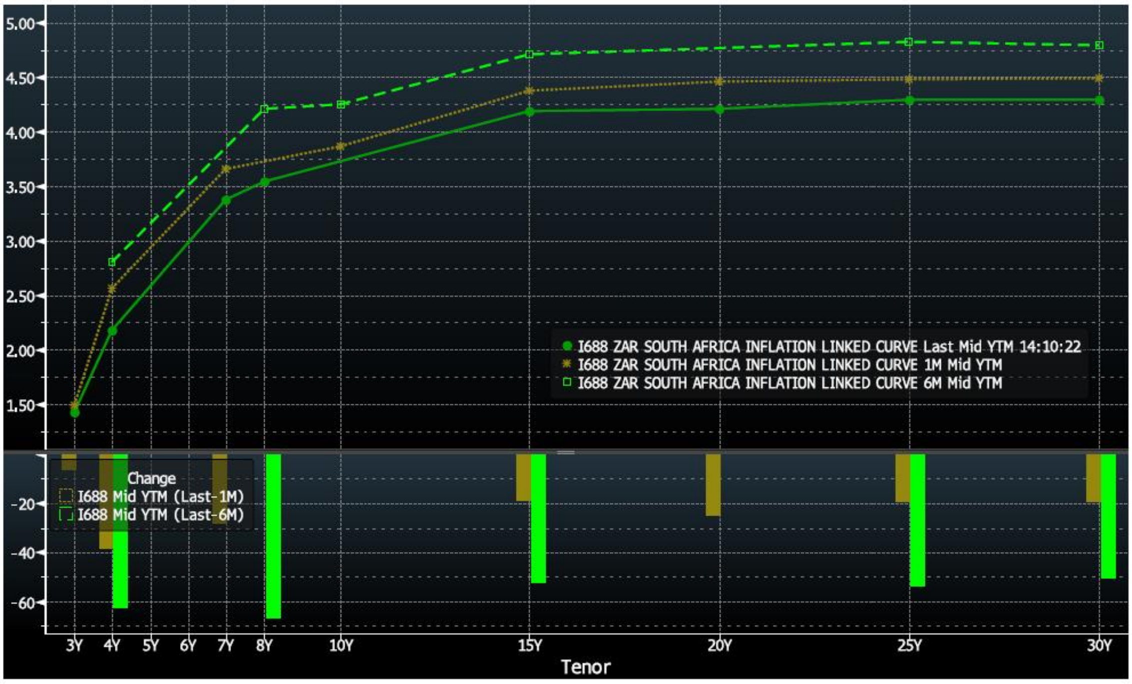
Source: Bloomberg

Figure 8: SA nominal yields as at 12 February 2021



Source: Bloomberg

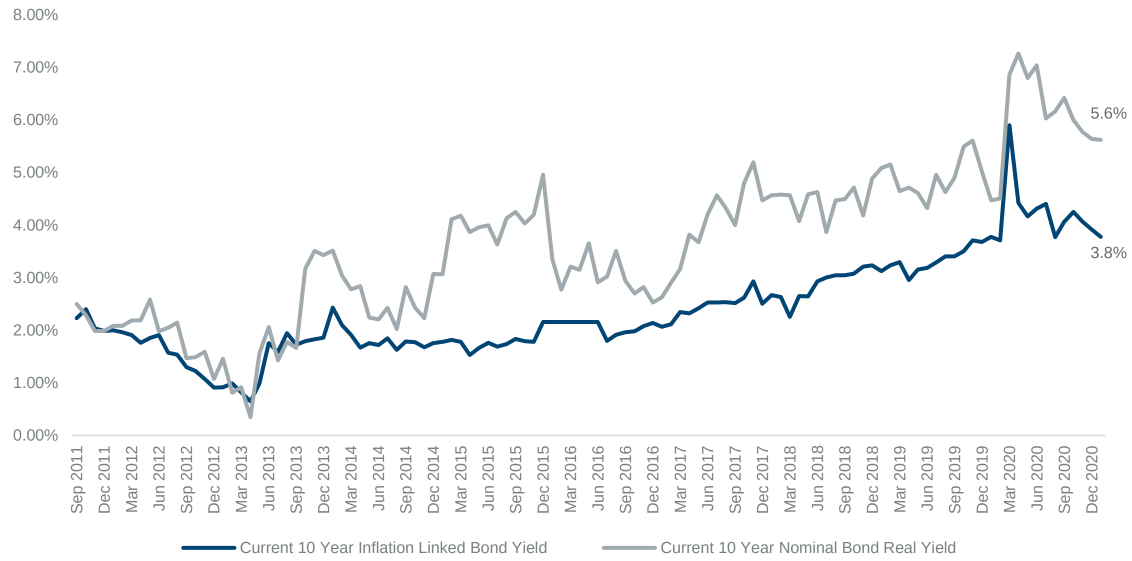
Figure 9: SA inflation-linked yields as at 12 February 2021



Source: Bloomberg

While nominal bonds appear to offer better inflation-adjusted yields, we expect inflation to edge towards the 4% level in the short run. The base effect and sharp fuel price increases will be partly offset by weak demand, which constrained retailers and producers from passing rand depreciation onto consumers last year. However, together with supply chain disruptions and policy-induced asset price bubbles, there is an increasing upside risk to inflation, albeit at a moderate range. We choose to stay neutral as fiscal slippage and the state of public finances remain fragile, with a potential further downgrade should structural reforms and expenditure curbs continue to disappoint.

Figure 10: 10-year real yield of nominal bond vs inflation-linked bond as at 31 January 2021



Source: Bloomberg

SA equities

After a strong start to 2021, most equity markets shed their gains as January came to a close. Developed market equities ended the month down by 1%, although emerging markets significantly outperformed, ending January up by about 3% in US dollar terms. Rand weakness, however, helped developed market equities land in the green in ZAR terms.

Global vaccination programmes and the promise of further fiscal and monetary stimulus by central banks and governments initially prompted the market to overlook concerns about pandemic-driven restrictions. Over the month of January, concerns grew over delays in getting the supply of vaccines to Europe. Developed market volatility, proxied by the VIX, also spiked as retail investors coordinated a short squeeze on some hedge funds. Robust economic data and a moderate winter wave of Covid infections pointed to continued support for risky assets in north Asia.

Strong returns from China contributed to the outperformance of emerging market equities. Emerging markets saw strong net inflows as more investors embraced a growing risk-on sentiment. Inflows to US-listed emerging market ETFs that invest across developing nations totalled US$885 million in the week ending 12 February, after net inflows of $1.29 billion seen in the previous week. South African ETF inflows fell behind most of the country's EM peers.

Figure 11: Major indices and asset class returns in ZAR

31 January 2021 (ZAR)	1M	3M	YTD	1 Year	3 Year (annualised)	5 Year (annualised)	10 Year (annualised)	MTD 13 February 2021
FTSE/JSE ALSI Total Return	5.2%	21.2%	5.2%	14.5%	4.8%	8.1%	10.4%	5.9%
FTSE/JSE Capped SWIX Total Return	3.1%	20.0%	3.1%	6.4%	-0.3%	4.3%		6.9%
S&P 500 Total Return	2.5%	6.5%	2.5%	19.0%	21.2%	15.1%	22.3%	1.5%
STOXX 600 Total Return	2.0%	12.8%	2.0%	9.3%	10.6%	7.2%	13.4%	0.1%
Nikkei 225 Total Return	3.4%	12.5%	3.4%	27.7%	19.3%	14.0%	18.4%	1.9%
MSCI World Total Return	2.6%	8.8%	2.6%	17.7%	18.2%	13.0%	18.7%	1.5%
MSCI ACWI Total Return	3.1%	9.4%	3.1%	19.3%	17.7%	13.1%	18.0%	1.7%
MSCI EM Total Return	6.8%	13.0%	6.8%	30.2%	13.8%	14.4%	12.7%	2.9%
STEFI	0.3%	0.9%	0.3%	5.1%	6.5%	6.9%	6.3%	0.1%
ALBI	0.8%	6.6%	0.8%	8.2%	8.5%	9.6%	8.6%	1.9%
IGOV	2.1%	6.4%	2.1%	6.2%	3.3%	3.3%	6.4%	1.5%
WGBI	2.3%	-5.1%	2.3%	8.5%	12.8%	3.3%	10.1%	-4.9%
SAPY Total Return	-3.2%	29.3%	-3.2%	-34.6%	-18.8%	-8.5%	3.6%	9.8%
MSCI US REIT Total Return	3.8%	7.1%	3.8%	-7.2%	14.0%	4.6%	16.4%	1.0%
STOXX 600 Real Estate Total Return	-0.7%	9.8%	-0.7%	-3.8%	8.3%	3.3%	13.9%	-4.7%
Crude Oil	11.8%	39.3%	11.8%	-2.5%	1.1%	9.0%	1.6%	7.0%
Aluminium	3.5%	-0.1%	3.5%	16.5%	4.4%	4.5%	5.2%	1.2%
Copper	4.8%	9.2%	4.8%	43.2%	12.2%	10.5%	5.5%	1.5%
Gold	-2.7%	-1.7%	-2.7%	16.3%	11.2%	10.6%	3.3%	-1.3%
Platinum	4.2%	18.8%	4.2%	13.8%	11.2%	3.4%	2.4%	11.6%
Nickel	0.0%	0.0%	0.0%	0.0%	3.2%	5.4%	-0.9%	0.0%
Palladium	-5.5%	-5.8%	-5.5%	-0.9%	40.4%	33.7%	19.2%	2.3%
Iron Ore	5.7%	24.4%	5.7%	85.3%	40.7%	29.2%		-0.5%
USDZAR	3.2%	-6.7%	3.2%	0.9%	8.6%	-0.9%	7.8%	-4.0%
GBPZAR	3.4%	-1.3%	3.4%	4.8%	7.3%	-1.7%	6.1%	-2.9%
EURZAR	2.6%	-2.7%	2.6%	10.6%	7.8%	1.4%	6.5%	-4.3%
JPYZAR	1.8%	-6.8%	1.8%	4.4%	10.1%	2.0%	5.2%	-4.3%

Source: Bloomberg

Figure 12: Weekly flows into emerging market ETFs for the week ending 12 February 2021

Liquidity boom

China, Taiwan, and India cornered the maximum flows

	Total	Equity	Bond	AUM ($ bn)
Total EM	885	1,052	-167	354
Asia Pacific	929	939	-10	267
EMEA	-56	40	-97	49
Americas	12	72	-61	38
China*	611	594	17	138
Taiwan	121	121	0	45
India	120	122	-1	33
South Korea	55	52	3	28
Brazil	39	44	-5	21
South Africa	16	22	-6	11
Russia	-18	-10	-8	10
Saudi Arabia	7	13	-6	8
Mexico	-4	3	-7	8
Thailand	20	18	2	7

Note: *Includes Hong Kong; EM is emerging markets; EMEA is Europe, the Middle East and Africa
Source: Bloomberg

Source: Bloomberg

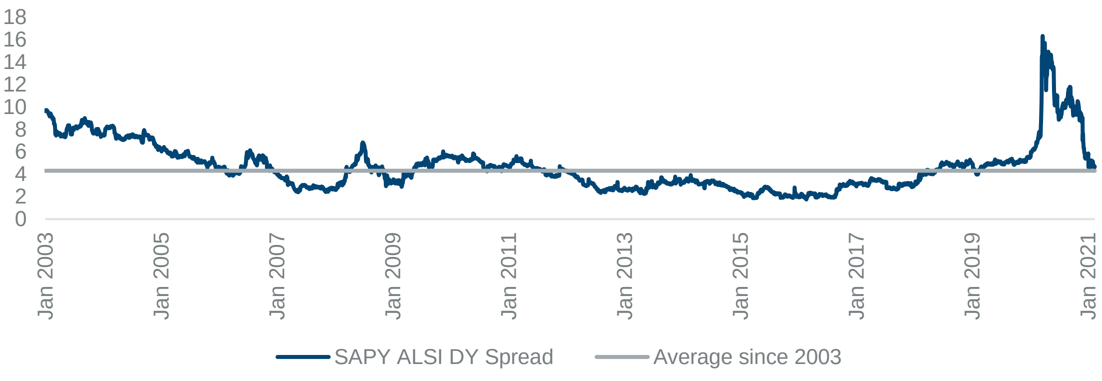
SA equity valuations based on price ratios and dividend yields continued to suggest moderate underweight. Business sentiment indicators showed some improvement and stabilisation. The Chamber of Commerce and Industry Business Confidence Index had another two months of small consecutive gains in December and January, reaching levels of 94.3 and 94.5, respectively. Fundamentally, retail sales growth was -0.2% year on year in December, compared to -2.5% in November. Total and new car sale losses, however, worsened from -10.1% and -14.4% in December to -13.9% and 18.0% in January, signalling weak recovery momentum in the face of weak consumption. On the trade front, export growth year on year remained strong and imports were boosted by the crude oil price recovery. They were up by 22.4% and 5.6%, respectively, in December.

We still believe over the short term that risk-on sentiment will very likely provide some support and further gains, but further improvement in domestic economic conditions requires immediate growth-oriented reforms and policy support. However, public finances have been constrained by mounting debt pressure. While the second wave of the pandemic has evidently subsided, the vaccine rollout has been very slow, increasing the risk of a third wave in the upcoming winter months. We therefore choose to stay neutral to reflect our cautiously optimistic view on SA equities.

SA listed property

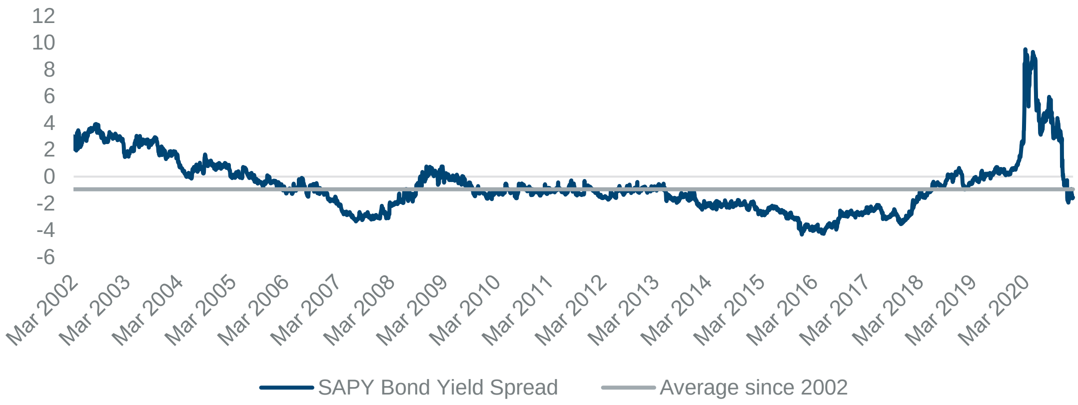
SA listed property had a strong month to date as at 12 February, returning 8.2% after posting a small loss of -3.2% in January. Yield spreads relative to SA equities and the 10-year bond, respectively, were compressed to the long-term average. The SAPY dividend yield continued to trend below its rolling 1-year and 5-year averages.

Figure 13: SAPY yield spread relative to FTSE/JSE All Share Index



Source: Bloomberg

Figure 14: SAPY yield spread relative to 10-year bond

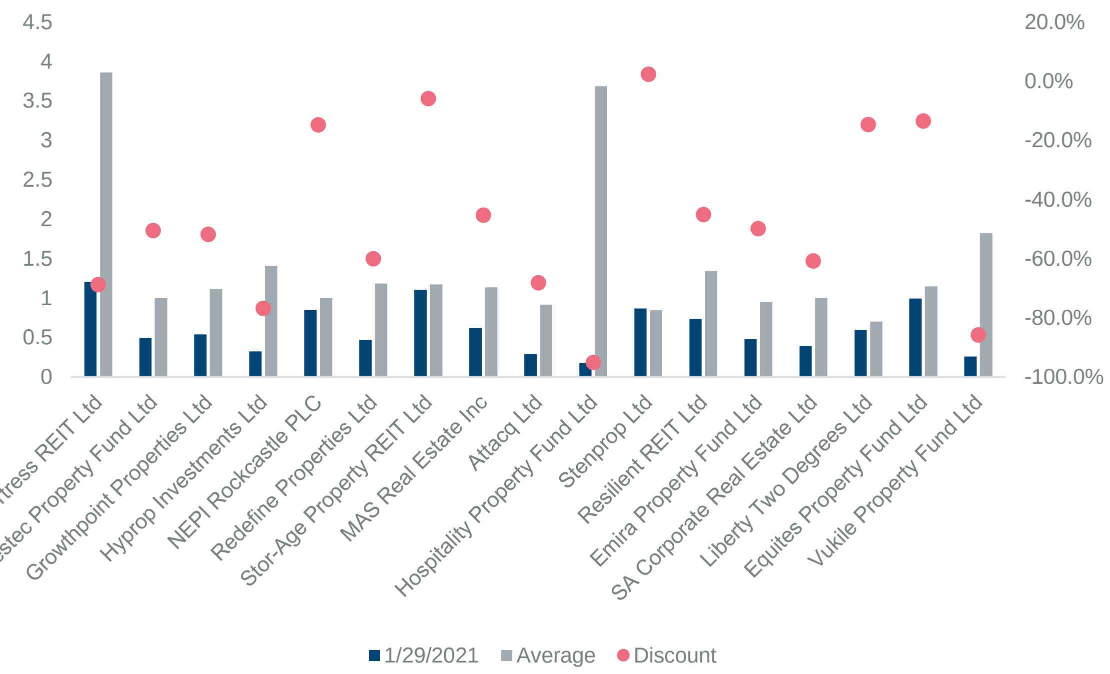


Source: Bloomberg

As the second wave has subsided, we may see further recovery in sentiment and an extended footprint. However, fundamentally, an elevated rent-to-sales ratio, high vacancy rates, an oversupply in both retail and office space, together with weak consumer demand, will continue to exert downward pressure on rental reversions. The likelihood of the third wave of the pandemic also largely depends on the success of the vaccine rollout. However, there are pockets of opportunity within the sector, as suggested by price-to-tangible book value per share, with some counters still trading at a huge discount relative to their long-term history.

We choose to stay neutral as we believe that any further, significant recovery in the SAPY index will depend on economic conditions and recovery in consumer demand, with a third wave uncertainty overhang.

Figure 15: Price-to-tangible book value per share



Source: Bloomberg

Offshore bonds

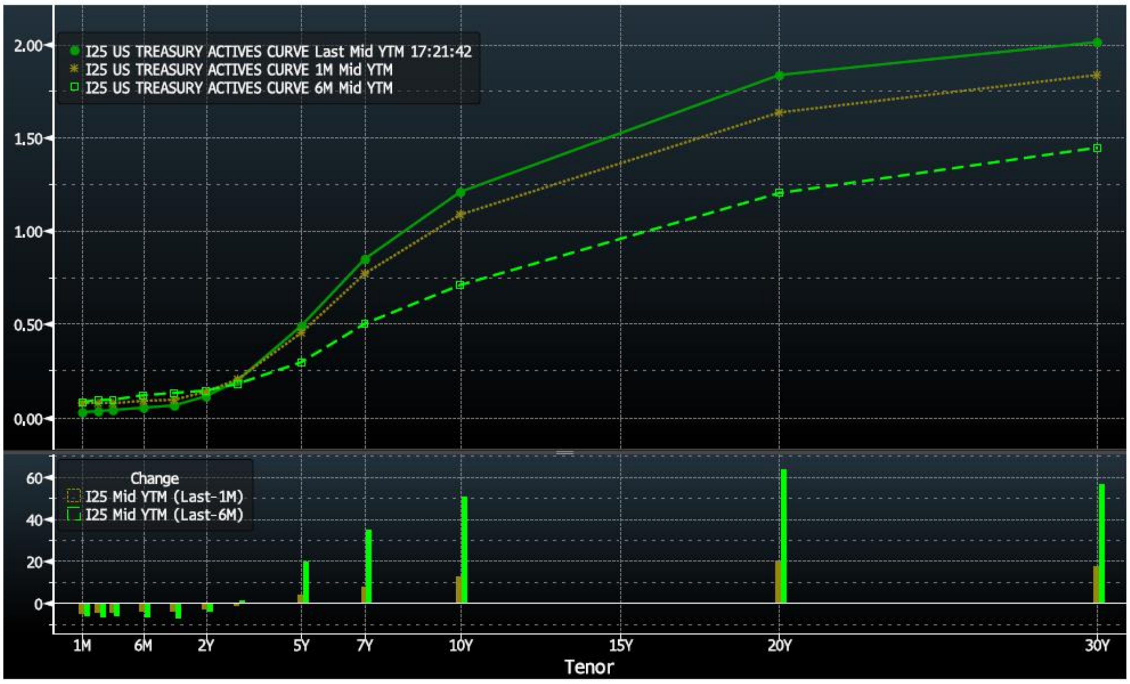
We choose to remain moderately underweight in offshore bonds as central banks and governments remain committed to quantitative easing and stimulus support, which means that global bonds are likely stay in the lower range. At the same time, reflationary bets or inflation concerns are driving a preference for inflation-linked bonds over nominal bonds. In addition, should economic growth gather pace in the second half of 2021 due to a successful vaccine rollout campaign, this would drive an additional risk appetite for growth assets, despite also raising concerns then about the end of the monetary policy easing cycle.

Offshore equities

Offshore equities' valuation scores were more bearish than those of local equities. Sentiment in the US, Europe and Japan remained largely unchanged over the past few months, with US consumer and business sentiment stabilised but recovery having stalled, despite its continuing to lead over that of Europe and Japan.

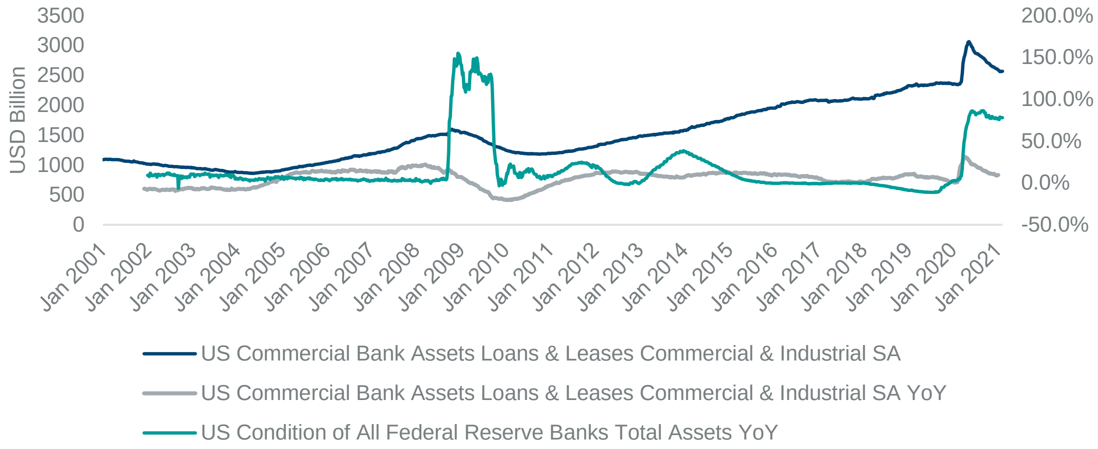
The macro data painted a mixed picture of the US economy. US export growth year on year continued to make small but steady consecutive improvements, from -12.54% in November to -10.18% in December. Imports hovered at around 0% year on year, hardly changing from 0.27% in November to -0.23% in December. The housing market remained strong, with construction starting to rising in December and property valuations being upbeat. US productivity, however, softened in Q4 to -4.8% QoQ, but labour costs were up by 6.8% over the same period. The probability of recession in the next 12 months, according to the New York Fed, dropped from 14.36% to 12.19% over the past month. The 10-year vs 2-year Treasury spread widened from 95bps to 110bps as inflation concerns translated into a steeper yield curve. At the same time, the Fed's liquidity injection failed to translate into Main Street commercial loan growth. The services PMI continued in its expansionary mode, increasing from 57.7 in December to 58.7 in January, with business activities also increasing from 54.8 to 58.3 over the same period. Labour market recovery, however, has stalled as the pandemic has proceeded through the winter.

Figure 16: US yield curve as at 12 February 2021



Source: Bloomberg

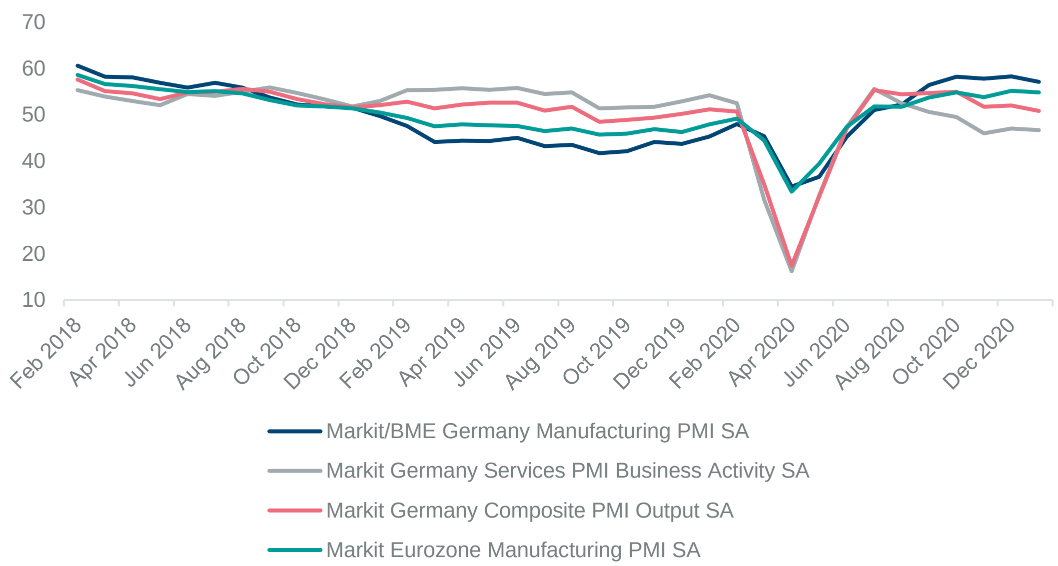
Figure 17: US Fed balance sheets vs commercial bank loans



Source: Bloomberg

Consumer confidence in the Eurozone weakened from -13.9 in December to -15.5 in January. Economic sentiment, however, improved slightly from 90.4 to 91.5 over the same period, but is still well below the long-term average of 99.5. The business climate index for the Eurozone was still in negative territory in December at -0.41, but industrial production in December was up by 0.7% year on year – the first time it had been positive since April 2019. Retail sales were up by 0.6% in December after a dismal November, which saw year on year growth shrink by 2.9%. The Eurozone and Germany PMIs remained strongly expansionary in January. Germany industrial production and orders month on month showed signs of losing momentum as the growth rate normalised. European equities remained highly cyclical as the effect of the ongoing pandemic and a slow vaccine rollout were reflected in weak activity, thus raising investors' concerns about delayed economic recovery.

Figure 18: Eurozone and Germany PMIs

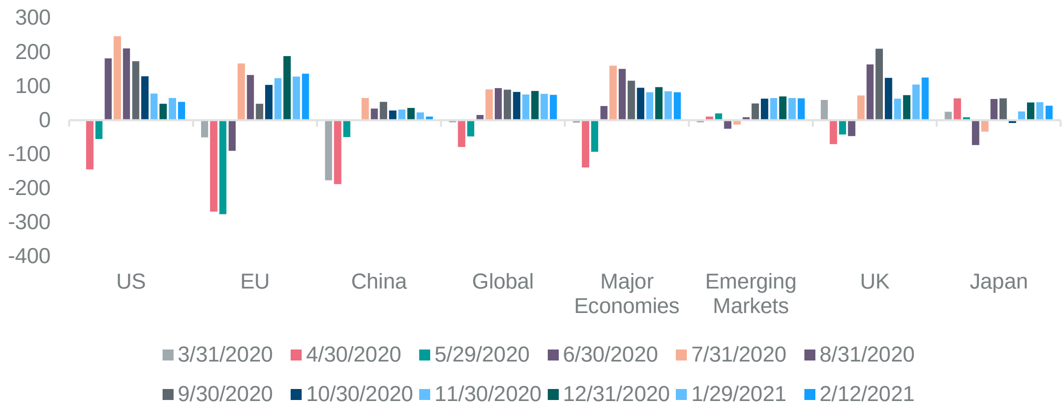


Source: Bloomberg

The recovery in sentiment in Japan paused in December and January. Trade data also disappointed, with December exports and imports showing negative year on year growth rates of -9.1% and -12.0%, respectively. The inflation rate, in turn, plunged to -1.2% in January. The good news is that the operating margin of the Nikkei 225 Index recovered from 5.8% in June 2020 to 8.3% in December 2020.

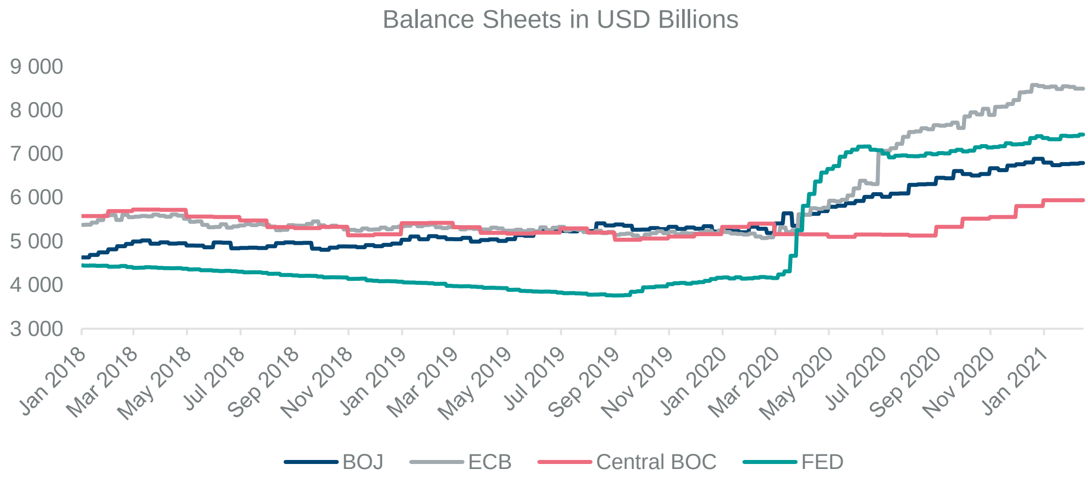
The economic surprise index remained in positive territory for most major economies, showing that the reported economic figures largely exceeded market expectations, but the margin of upside surprise has narrowed.

Figure 19: Economic surprise indices



Source: Bloomberg

Figure 20: Central bank balance sheets as at 12 February 2021



Source: Bloomberg

Our views on offshore equities have remained unchanged. We continue to favour offshore equities over offshore bonds as near-term yields are likely to remain low, with central banks committed to stimulus to quicken the pace of economic recovery. Tactically, we are overweight in equities as we expect the growth rebound to accelerate, as the rollout of vaccines remains on

	track, and rates to stay low. We are, however, aware of the so-called everything rally, driven by the unusual levels of liquidity provided by major central banks. Nevertheless, there are areas of regional equity markets that are reasonably priced.

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