MENTENOVA

# HOUSEVIEW TACTICAL ASSET ALLOCATION

20 May 2021

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We have maintained our TAA positions over the past month, continuing to stay moderately overweight in SA bonds and foreign equity and moderately underweight in foreign bonds.

**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

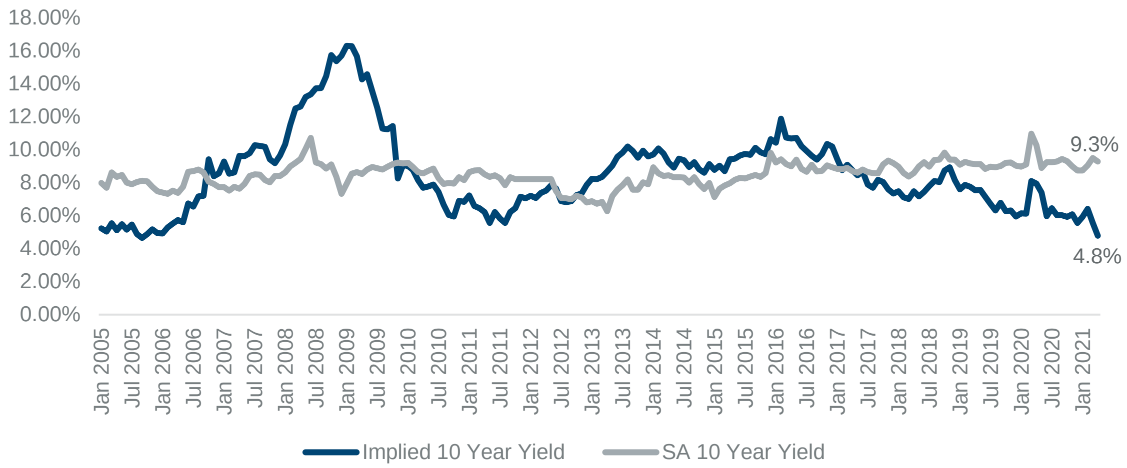
We reiterate our overweight position in local nominal bonds and offshore equity and our underweight position in offshore bonds. Local nominal bonds have remained attractive from a real and hedged yield perspective. We also continued to prefer offshore equities to offshore bonds as short-term interest rates are likely to remain low, with the jury being out on whether the recent global inflation rebound will persist. Should economies show further substantial recovery and inflation hit unwelcome levels, potential interest-rate normalisation and surging yields could hurt growth assets, especially in emerging markets, such as South Africa, which are already under immense fiscal pressure. In contrast, a rapid vaccine rollout and the strong corporate earnings posted so far this year are likely to boost growth in the second half of 2021. We chose to stay neutral in SA inflation-linked bonds, SA equity, SA-listed property and offshore property, with our investment cases for these asset classes remaining largely unchanged over the past month.

## TAA Overview

| SA bonds | |
|---|---|
| | In the wake of the progress made with vaccination campaigns, which should allow a gradual relaxation of containment measures and further progress towards normalcy, investor optimism about the global economic rebound has given way to concerns about inflation and COVID-19 resurgence in some South-East Asian countries. This is despite policymakers signalling that they intend to maintain an accommodative stance for the time being. South Africa's economic growth prospects are weighed down by energy supply constraints, with the slow vaccine rollout being an additional burden, while the country's fiscal turnaround is contingent on wage negotiations, with the risk of spending overruns remaining elevated.<br><br>Net outflows of foreigners' holdings of SA bonds slowed into May, with net sales of around US$167m over the past month since our previous TAA meeting. Furthermore, foreign investors' appetite for local equities waned, with net sales of around US$300m over the same period. For the year to date, as at 20 May 2021, foreign investors had net sold US$2.7bn and US$0.9bn worth of local bonds and equities respectively. The 10-year nominal bond remained attractive as it was trading at 9.3%, above the implied 10-year yield of 4.8%. The implied vs actual yield spread widened from 400bps to 450bps over the past month. The 10-year nominal yield spread over the US 10-year Treasury yield remained relatively steady at 7.65%, exceeding the long-term average by 139 bps. The US dollar-hedged 10-year yield continued to offer value, despite |

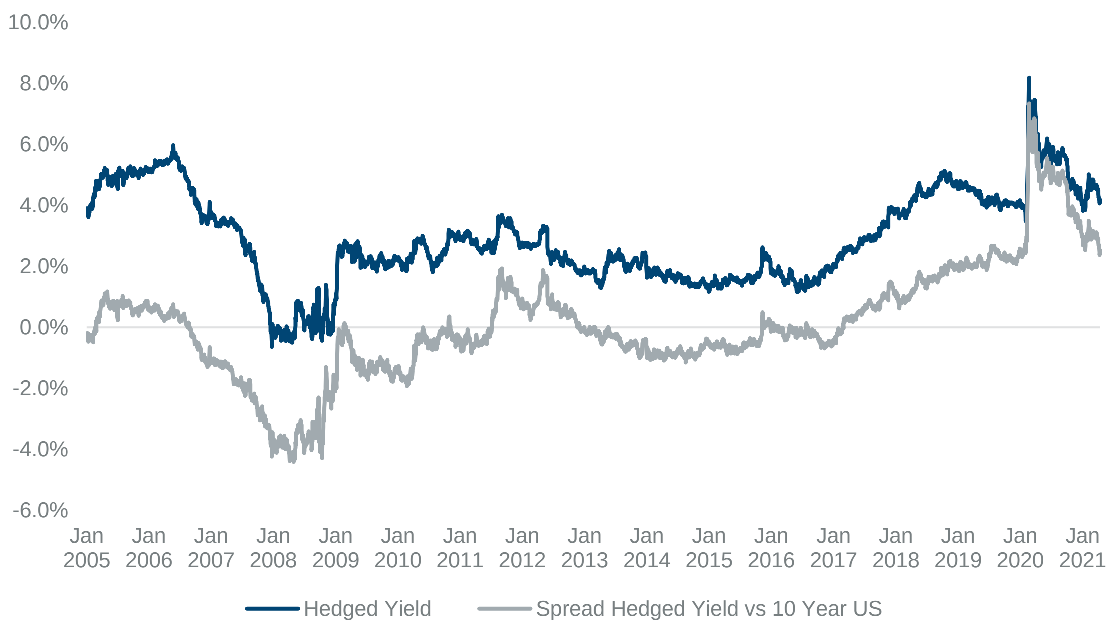
narrowing slightly from 4.6% to 4.1% over the past month. At the same time, the hedged yield premium over the US 10-year yield also narrowed from 300bps to 242bps.

**Figure 2: South Africa 10-year nominal yield vs implied yield as at 30 April 2021**




*Source: Bloomberg*

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




*Source: Bloomberg*

SA nominal bonds still appeared attractive compared to Brazilian nominal bonds, based on real yield and calculated using reported inflation, despite the real yield spread of SA 10-year over Brazilian 10-year decreasing from 290bps to 220bps over the past month. The spread of the 10-year bond yield adjusted for expected inflation, based on the Bloomberg survey of economists, also ticked up from 80bps to 86bps over the same period.

**Figure 4: SA bond yields vs EM peers as at 25 May 2021**

| | South Africa | India | Indonesia | Russia | Mexico | Brazil | Turkey |
|---|---|---|---|---|---|---|---|
| **10 Year Yield** | **9.25%** | **5.97%** | **6.44%** | **7.07%** | **6.71%** | **9.39%** | **18.36%** |
| Inflation | 4.4% | 4.3% | 1.42% | 3.3% | 6.1% | 6.8% | 17.1% |
| Inflation Expectation | 4.10% | 6.20% | 2.20% | 5.10% | 4.06% | 5.10% | 15.00% |
| **10 Year Real Yield** | **4.85%** | **1.68%** | **5.02%** | **3.77%** | **0.63%** | **2.63%** | **1.22%** |
| 10 Year Real Yield based on inflation expectation | 5.15% | -0.23% | 4.24% | 1.97% | 2.65% | 4.29% | 3.36% |
| **Currency Risk Premium** | **4.78%** | **2.84%** | **3.44%** | **4.01%** | **3.54%** | **5.21%** | **12.50%** |
| **Sovereign Risk Premium** | **2.92%** | **1.57%** | **1.44%** | **1.51%** | **1.61%** | **2.62%** | **4.30%** |
| US 10 Year Yield | 1.56% | 1.56% | 1.56% | 1.56% | 1.56% | 1.56% | 1.56% |
| **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*

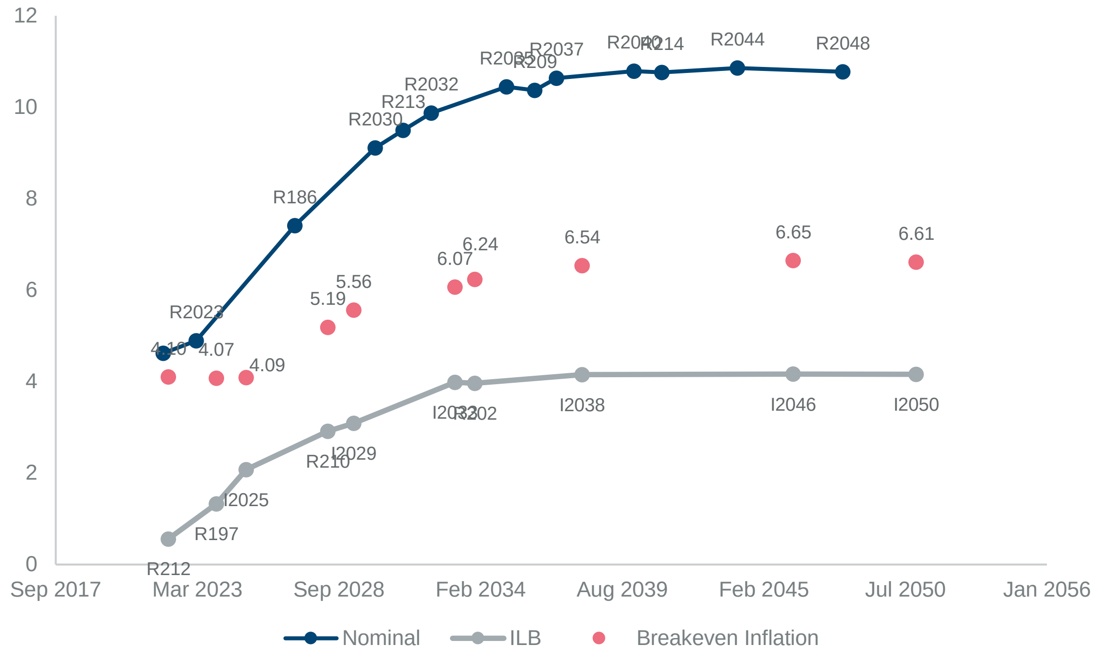
In Fitch's latest note, it is stated that the government is unlikely to meet its goal of a public-sector wage freeze. Furthermore, debt stabilisation conditions remain challenging due to low trend growth, electricity shortages and strained public finances. Intensifying socioeconomic tension, which could impede policy reforms, was also noted in Moody's research note. Foreign investors' appetite for South African government debt has been capricious. After the sell-off in April, investors net bought US$370m local government debt on 7 May. This was the biggest inflow since November, driven by the declining Treasury rates prompting the search for yields.

A healthy trade surplus, powered by rising commodity prices, should continue to support the rand in the coming months as speculators remain bullish about the local currency, as shown in the CFTC CME South African rand non-commercial futures contracts net positions. However, terms of trade gains will probably be eroded by oil prices that are returning to pre-pandemic levels. Overall, global conditions at present still look supportive of South Africa's bond issuance, despite rising US Treasury yields. We maintained our overweight position in local nominal bonds mainly based on valuations, which continued to look appealing from a real yield and hedged yield perspective.

## SA inflation-linked bonds

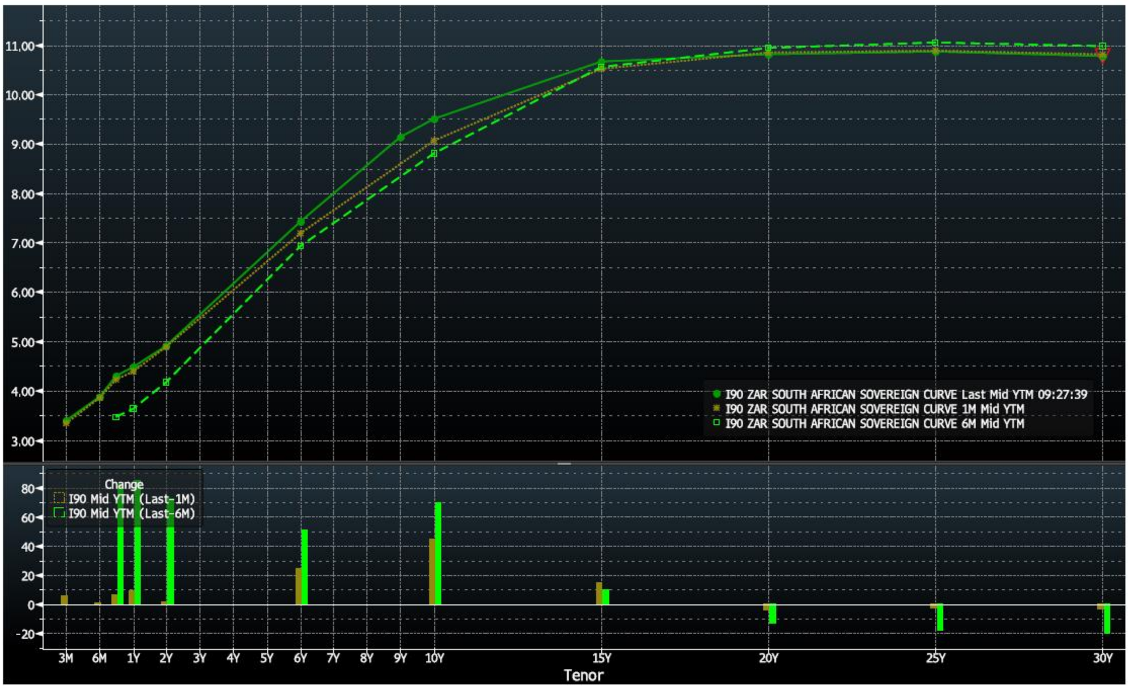
The IGOV Index underperformed against the ALBI in April, returning 1.1% vs 1.9%, with the trend persisting into May. For the month to date, as at 25 May 2021, it returned 2.3%, underperforming against the ALBI, which delivered 3.7% over the same period. Breakeven inflation increased by c.10bps on the shorter end and decreased by c.5bps on the longer end of maturities, driven by near-term inflation expectations. Both the nominal yield curves and inflation-linked bond yield curves stayed relatively unchanged over the past month, except the yield picked up over the 9- to 10-year maturities.

**Figure 5: SA nominal and real yields as at 19 May 2021**



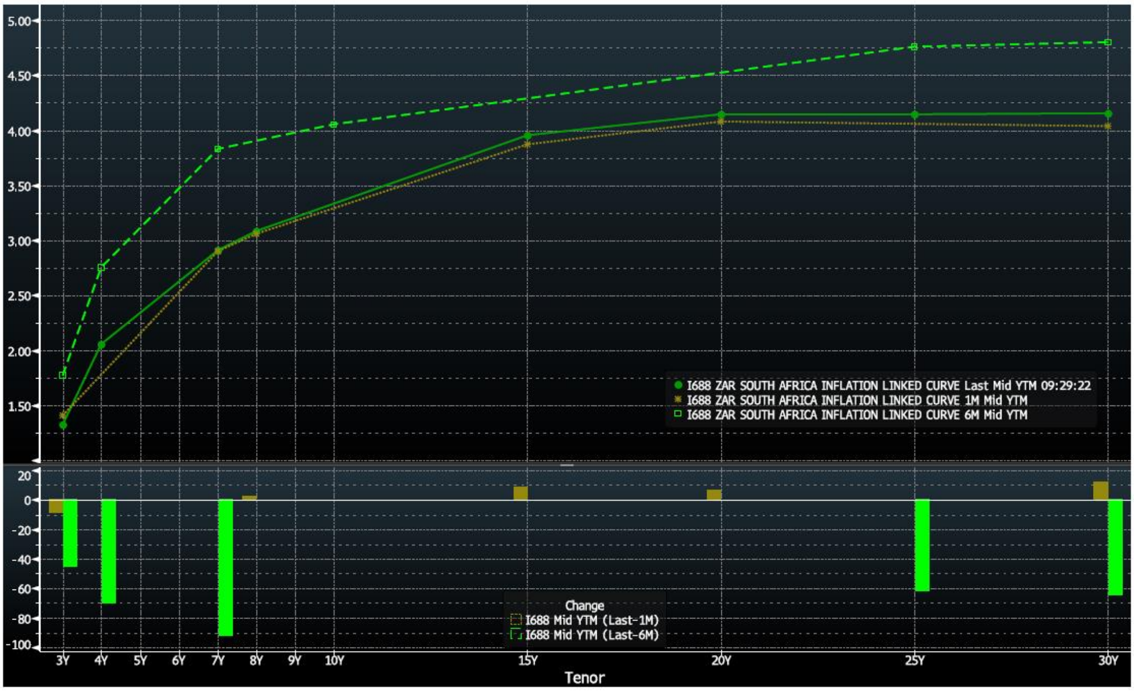

*Source: Bloomberg*

**Figure 6: SA nominal yields as at 17 May 2021**




*Source: Bloomberg*

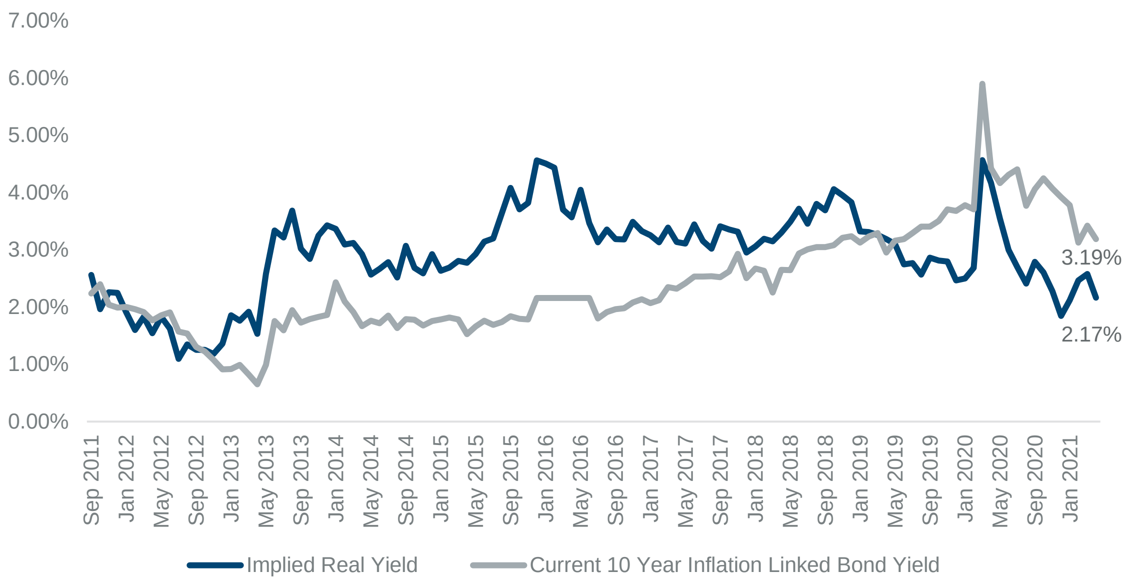
**Figure 7: SA inflation-linked yields as at 17 May 2021**




*Source: Bloomberg*

The spread between the 10-year nominal bond real yield and the 10-year inflation-linked bond yield narrowed from 320bps to 102bps from March to April.

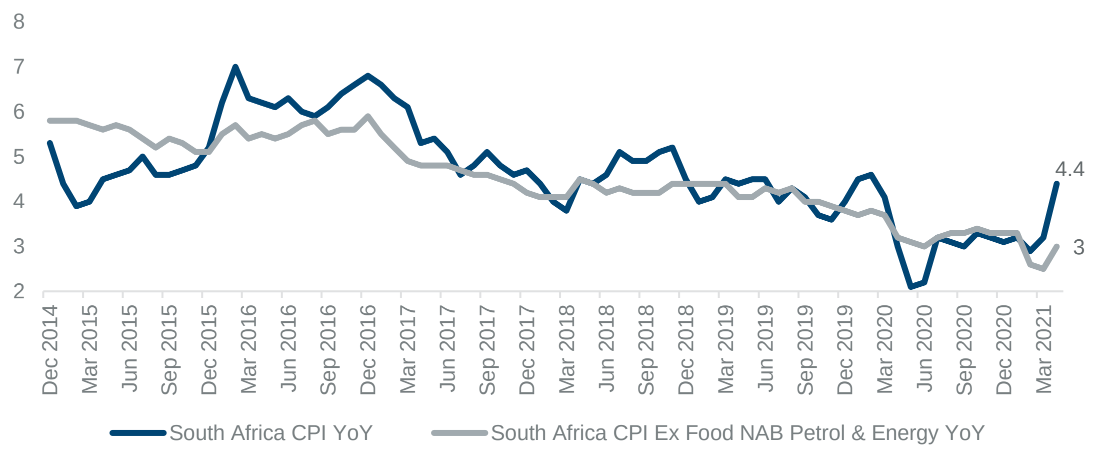
**Figure 8: 10-year real yield of nominal bond vs inflation-linked bond as at 30 April 2021**




*Source: Bloomberg*

CPI and core CPI YoY for April turned out to be 4.4% and 3.0% respectively, both exceeding the market expectations (according to the Bloomberg survey) of 4.3% and 2.8%. With transport and food seeing the highest year-on-year price movements of 10.6% and 6.3% respectively, inflation hikes in these categories will tend to further exacerbate income inequality. Core inflation and overall inflation moved in the same direction in April as other categories such as apparel goods, restaurants and hotels have warmed up to some extent. South Africa's producer prices increased by 5.2% year on year in March, which also exceeded the market expectation of 4.5%.

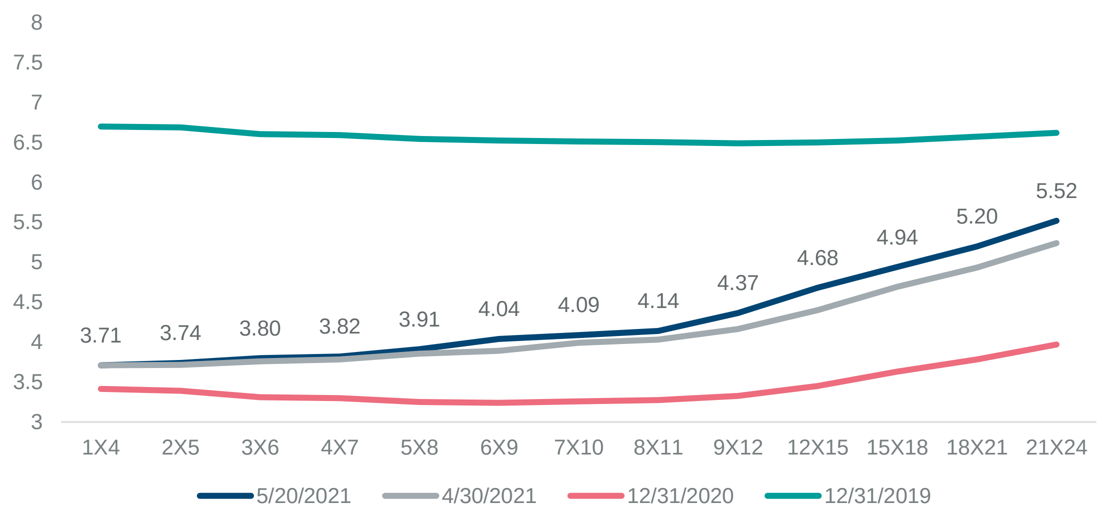
**Figure 9: SA CPI YoY and Core CPI YoY**




*Source: Bloomberg*

The forward rate agreement (FRA) rates indicated that the market expects interest rates to rise by at least 25bps by the end of 2021. While there are rising concerns about price pressures building up across value chains, base effects and supply bottlenecks could contribute to the transitory price increases, with evidence of persistence in inflation overshoots yet to be established. Although we favour inflation-linked bonds' ability to provide protection against unexpected inflation, from a valuation perspective we favour nominal bonds and therefore we reiterate our neutral stance on inflation-linked bonds.

**Figure 10: Forward rate agreement rates**




*Source: Bloomberg*

## SA equities

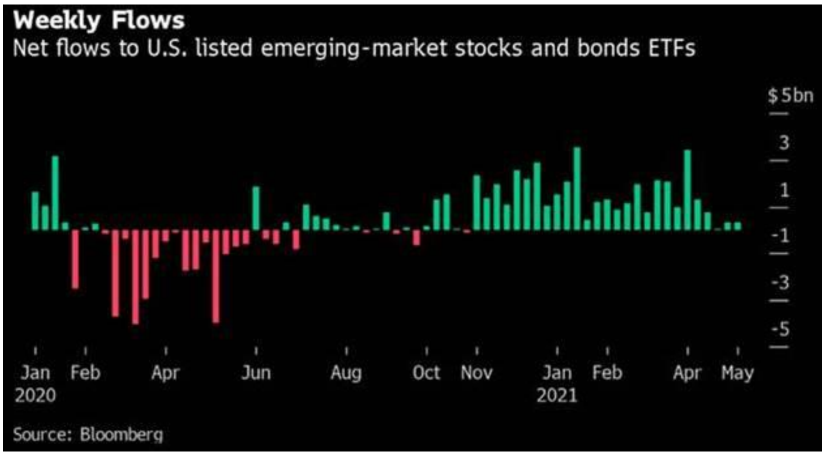
Major equity indices continued to make positive gains for the month of April and recovered some lost ground towards late May after a shaky start. The rand has so far strengthened by another 1.9% this month and has also trimmed offshore returns. Global property indices posted strong performance in April as summer optimism saw the reopening of sensitive categories. Accelerated vaccine rollout programmes have shortened the time needed to inoculate 75% of the global population from 17 months to 11 months, according to Bloomberg's COVID-19 vaccine tracker. At the same time, we continued to see positive net inflows into developed markets, while net inflows into emerging markets were concentrated mainly in China and Brazil.

**Figure 11: Major indices and asset class returns in ZAR**

| 30 April 2021 (ZAR) | 1M | 3M | YTD | 1 Year | 3 Year (annualised) | 5 Year (annualised) | 10 Year (annualised) | MTD 25 May 2021 |
|---|---|---|---|---|---|---|---|---|
| FTSE/JSE ALSI Total Return | 1.0% | 8.6% | 14.2% | 36.4% | 8.1% | 8.0% | 10.7% | -1.3% |
| FTSE/JSE Capped SWIX Total Return | 0.8% | 10.1% | 13.5% | 36.2% | 3.2% | 4.2% | | -0.2% |
| S&P 500 Total Return | 3.3% | 7.6% | 10.4% | 14.5% | 24.8% | 17.8% | 23.5% | -4.1% |
| STOXX 600 Total Return | 2.6% | 5.2% | 7.4% | 13.3% | 12.3% | 9.3% | 13.8% | -0.5% |
| Nikkei 225 Total Return | -2.0% | -4.3% | -1.1% | 11.2% | 16.7% | 13.9% | 19.1% | -4.8% |
| MSCI World Total Return | 2.7% | 5.8% | 8.5% | 14.5% | 20.6% | 15.0% | 19.6% | -3.3% |
| MSCI ACWI Total Return | 2.4% | 4.6% | 7.9% | 14.8% | 19.8% | 14.8% | 18.8% | -3.4% |
| MSCI EM Total Return | 0.6% | -3.0% | 3.5% | 17.0% | 13.5% | 13.3% | 12.5% | -4.4% |
| STEFI | 0.3% | 0.9% | 1.2% | 4.3% | 6.2% | 6.8% | 6.3% | 0.3% |
| ALBI | 1.9% | -0.6% | 0.1% | 14.7% | 6.4% | 8.7% | 8.2% | 3.7% |
| IGOV | 1.1% | 3.7% | 5.8% | 13.0% | 3.6% | 3.1% | 6.5% | 2.3% |
| WGBI | -0.8% | -7.9% | -5.8% | -20.2% | 8.5% | 2.5% | 9.8% | -3.4% |
| SAPY Total Return | 11.7% | 22.8% | 18.8% | 40.3% | -11.8% | -7.4% | 5.2% | -5.0% |
| MSCI US REIT Total Return | 6.0% | 11.8% | 16.0% | 7.8% | 17.6% | 7.8% | 17.7% | -4.2% |
| S&P Global Property Total Return | 3.3% | 6.8% | 9.5% | 3.7% | 11.8% | 6.7% | 15.5% | -3.5% |
| STOXX 600 Real Estate Total Return | 5.4% | 0.6% | 0.0% | 4.3% | 7.0% | 4.0% | 13.1% | -0.8% |
| Crude Oil | 3.8% | 14.7% | 28.1% | 108.6% | 1.3% | 7.3% | 1.6% | -2.3% |
| Aluminium | 6.3% | 15.5% | 19.5% | 25.7% | 7.3% | 7.7% | 6.6% | -5.3% |
| Copper | 9.7% | 19.2% | 24.9% | 48.5% | 18.8% | 14.6% | 8.7% | -3.4% |
| Gold | 3.6% | -4.2% | -6.8% | 4.9% | 10.4% | 6.5% | 1.2% | 7.4% |
| Platinum | -0.6% | 6.4% | 10.8% | 21.4% | 15.7% | 2.6% | 3.5% | -4.9% |
| Nickel | 0.0% | 0.0% | 0.0% | 0.0% | 1.1% | 5.6% | 0.1% | 0.0% |
| Palladium | 9.8% | 25.4% | 18.6% | 17.0% | 52.4% | 36.8% | 23.3% | -10.0% |
| Iron Ore | 17.1% | 12.5% | 18.9% | 74.9% | 50.1% | 23.3% | | 1.0% |
| USDZAR | -1.9% | -4.4% | -1.4% | -21.8% | 5.2% | 0.4% | 8.2% | -4.3% |
| GBPZAR | -1.7% | -3.6% | -0.3% | -14.2% | 5.3% | -0.7% | 6.2% | -2.0% |
| EURZAR | 0.5% | -5.5% | -3.0% | -14.2% | 5.0% | 1.3% | 6.0% | -2.5% |
| JPYZAR | -0.7% | -8.4% | -6.8% | -23.3% | 5.1% | -0.2% | 5.1% | -3.8% |

*Source: Bloomberg*

**Figure 12: ETF net flows into developed and emerging market ETFs for the week ending 7 May 2021**




*Source: Bloomberg*

SA equity valuations based on price ratios and dividend yields continued to suggest moderate underweight. Sentiment remained largely unchanged, with the SA PMI index softening from 57.4 in March to 56.2 in April, with all five subindices of the PMI index being in expansionary territory for the first time since early 2012.

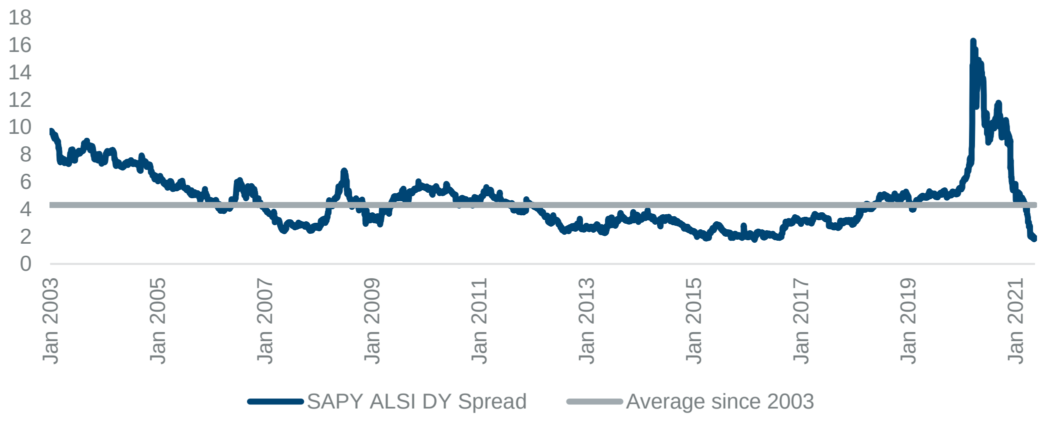
Retail sales in constant prices weakened from 4.93% in February to -2.44% in March, year on year, and recovery stalled as retail sales growth, month on month, plunged from 6.9% in February to -3.7% in March. Total and new car sales were also down, from 17.8% and 12.6% respectively in March, month on month, to -19.1%% and -16.2% respectively in April. Export and import growth, year on year, jumped from 17.5% and 4.0% respectively in February to 42.5% and 22.7% respectively in March, thanks partly to easy base effects. Yet even from a month-on-month perspective, exports and imports rose by 28.9% and 16.3% respectively, leading to a trade surplus of R52.8bn compared to a surplus of R31.0bn in February. Private credit extensions remained lacklustre, declining from 2.62% in February to -1.52% in March, year on year.

Global growth continues to gather momentum, with relatively rapid vaccine roll-out campaigns and containment of new infections in key markets such as the US, China and the UK. Moreover, surging global demand and a commodity boom have certainly benefited South Africa on the trade front. However, recovery in domestic consumption remains vulnerable as higher fuel, food and utility costs continue to erode incomes, with households still trying to recover from the financial impact of the COVID-19 crisis. We reiterate our neutral position in SA equities as valuation and fundamentals remained largely unchanged over the past month, with mixed performances in the economic data reported. The sustainability of the recovery is increasingly at risk of further surges in the COVID-19 positivity rate and the slow progress in administering vaccines.

**SA-listed property**

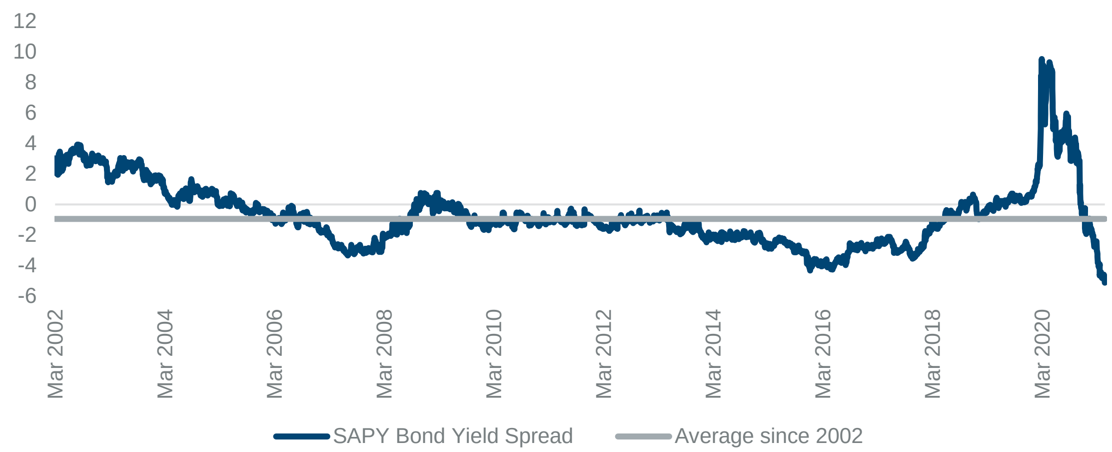
SA-listed property delivered a strong performance in April, returning 11.7%, and then fell by 5.0% for the month to date as at 25 May 2021. The yield spread relative to SA equities fell significantly below its long-term average, while the yield spread relative to the 10-year bond fell to an all-time low from its long-term average. The SAPY dividend yield continued to trend below its rolling 1-year and 5-year averages. The price-to-tangible-book value recovered steadily from a low of 0.46 in October 2020 to 0.75 in April 2021.

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



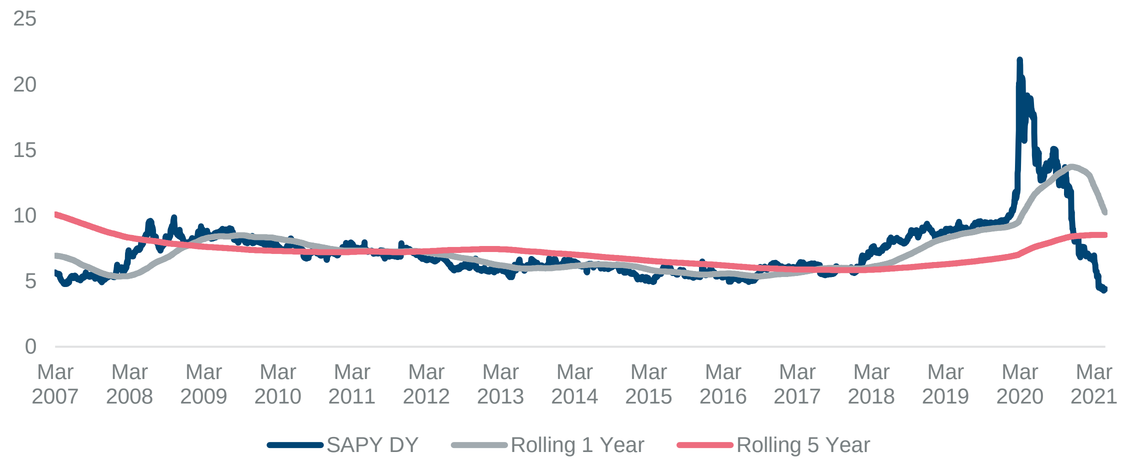
*Source: Bloomberg*

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




*Source: Bloomberg*

**Figure 15: SAPY yield relative to rolling 1-year and rolling 5-year averages**




*Source: Bloomberg*

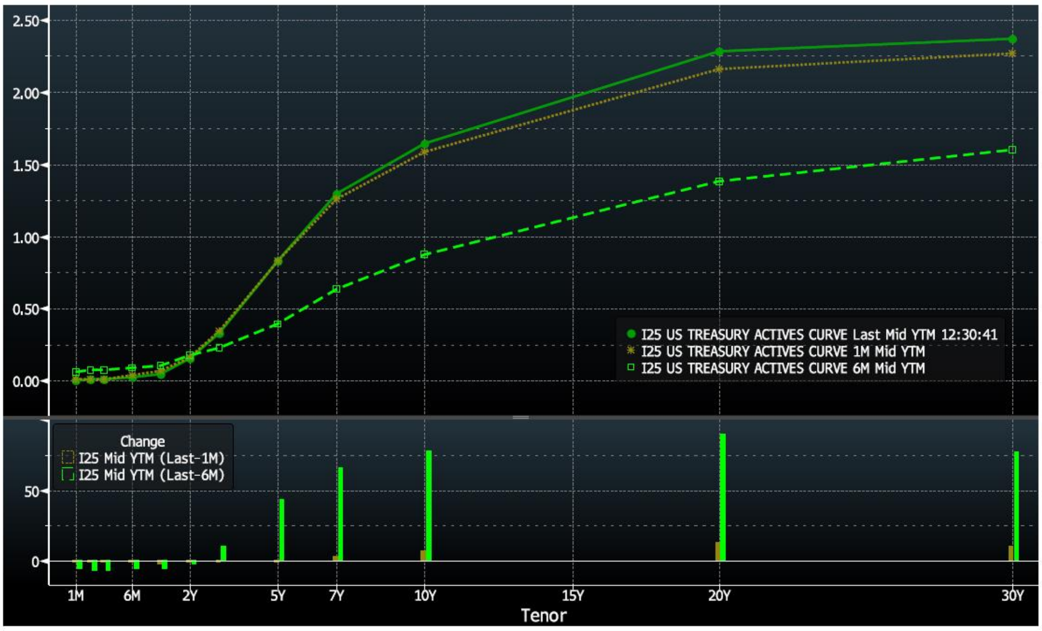
Fundamentals such as debt-to-equity ratio and operating margin stayed largely unchanged over the past month. While structural and secular challenges facing the local property sector persist, market sentiment vis-à-vis the sector has been buoyed by the fact that no further major COVID-19-related lockdowns or restrictions have so far taken place in South Africa this year. While we also see some value in the listed property sector from a discount to NAV perspective, most of the listed property companies have significantly lowered dividend pay-outs, with the sector's recovery ultimately tied to the economic growth of the country. We will only be comfortable moving from a neutral to overweight position in listed property if the country weathers the imminent third wave of COVID-19 and the vaccine programme is accelerated.

**Offshore bonds**

The 10-year vs 2-year Treasury spread widened slightly from 144bps to 149bps and the yield curve steepened slightly over the same period. The yield on the 10-year US Treasury bond ticked up slightly to 1.67% last week. The US reported an inflation rate of 4.2% year on year for

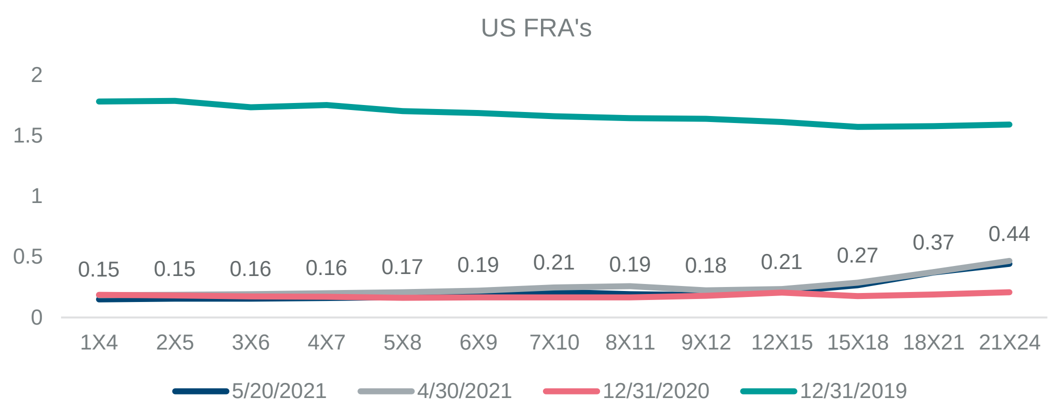
April, exceeding the market expectation of 3.6%. The Federal Reserve acknowledged the short-term price pressures, with the FOMC guarding against upside inflation, but remained sceptical that such transitory increases would meet the bar for policy action. Larry Summers, the former US Treasury secretary, has sharply rebuked the Federal Reserve for its loose monetary policies, creating a "dangerous complacency" in financial markets which may force the Fed into knee-jerk tightening of the monetary policy which could shock the market and hurt the real economy. And the US is not alone in facing an inflation rebound. The Eurozone also saw its April CPI at 1.6% year on year. While the risk of a taper tantrum is low for now, the debate as to whether the inflation rebound is transitory or will persist is likely to unnerve the market over the next few months.

**Figure 16: US yield curve as at 18 May 2021**




*Source: Bloomberg*

**Figure 17: US forward rate agreements rate**




*Source: Bloomberg*

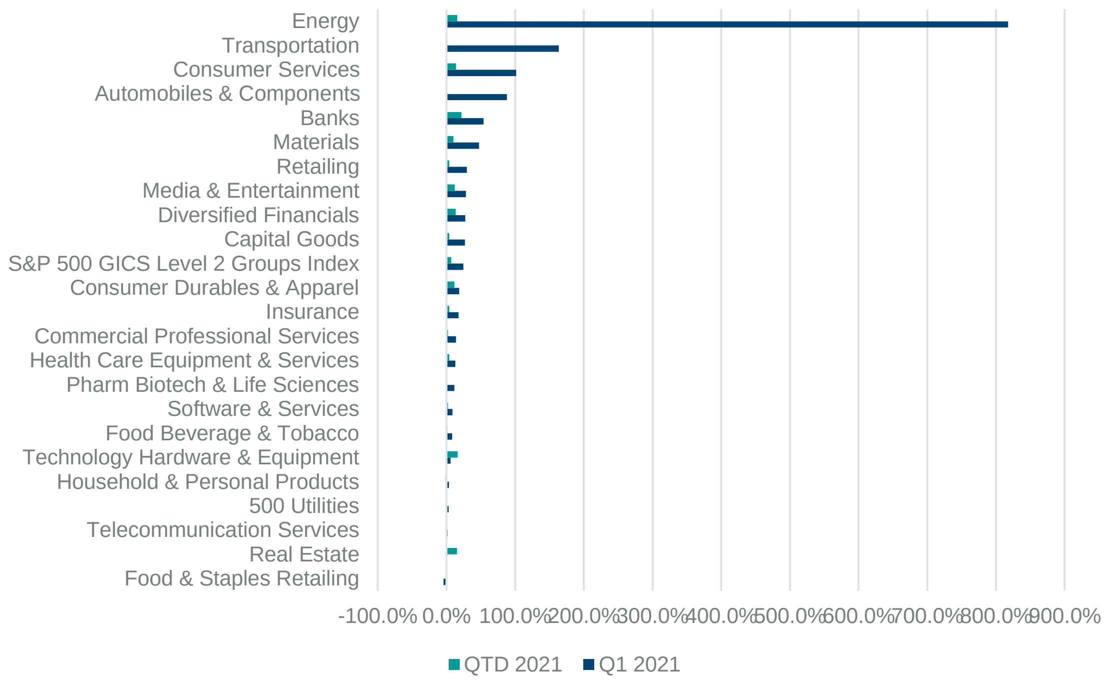
The accelerated economic recovery has sent yields surging as investors worry about inflation overshoots. We believe short-term rates are likely to stay at historically low levels as central banks, from the Fed to the ECB, are not phasing out asset purchases in the foreseeable future. We reiterate our moderate underweight position in offshore bonds as economic and earnings growth should favour equities over bonds.

**Offshore equities**

Valuation scores for offshore equities remained largely unchanged over the past month, favouring local equities over offshore equities. Sentiment in the US and the EU leads that in Japan. The University of Michigan Consumer Sentiment Index softened slightly from 86.5 in April to 82.8 in May. The Conference Board Consumer Confidence Index and the Bloomberg US Weekly Consumer Comfort Index both improved, from 109.7 in March to 121.7 in April and from 53.9 in April to 54.6 in May respectively. Overall manufacturing confidence was resilient, with business activity jumping from 28.9 in March to 37.3 in April, while the production outlook ticked lower from 48 to 34 over the same period. Sentiment in the EU also made some notable gains. Consumer confidence improved from -10.8 in March to -8.1 in April, exceeding the long-term average of -10.0. The region's economic sentiment jumped from 100.9 to 110.3 over the same period. The business climate trended higher from 0.29 in March to 1.13 in April. Sentiment in Japan was less resilient, with consumer confidence nationwide trending lower from 36.2 in March to 34.8 in April.

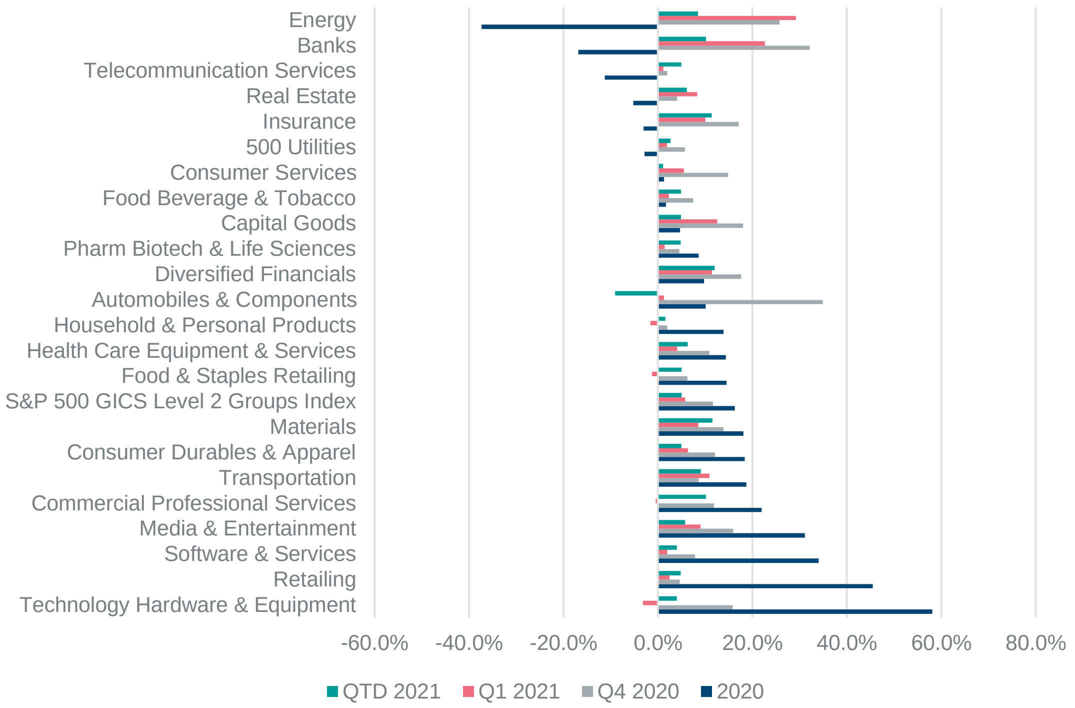
The macro data indicated some improvements in all three economies. US retail sales surged by 51.22% in April, year on year, but softened by -0.76%, month on month. Industrial production improved from 1.04% in March to 16.49% in April, year on year, and grew 0.7% for the month. US export and import growth year on year jumped to 8.06% and 18.13% respectively in March, driven by the base effect as global trade and logistics were heavily impacted by COVID-19 in the first two quarters of last year, but month-on-month growth was also up by 6.6% and 6.3% respectively. The services PMI continued in expansionary mode, slightly softening from 63.7 in March to 62.7 in April.

**Figure 18: S&P 500 GICS Level 2 Indices Q1 2021 earnings estimate revision**




*Source: Bloomberg*

**Figure 19: S&P 500 GICS Level 2 indices returns**

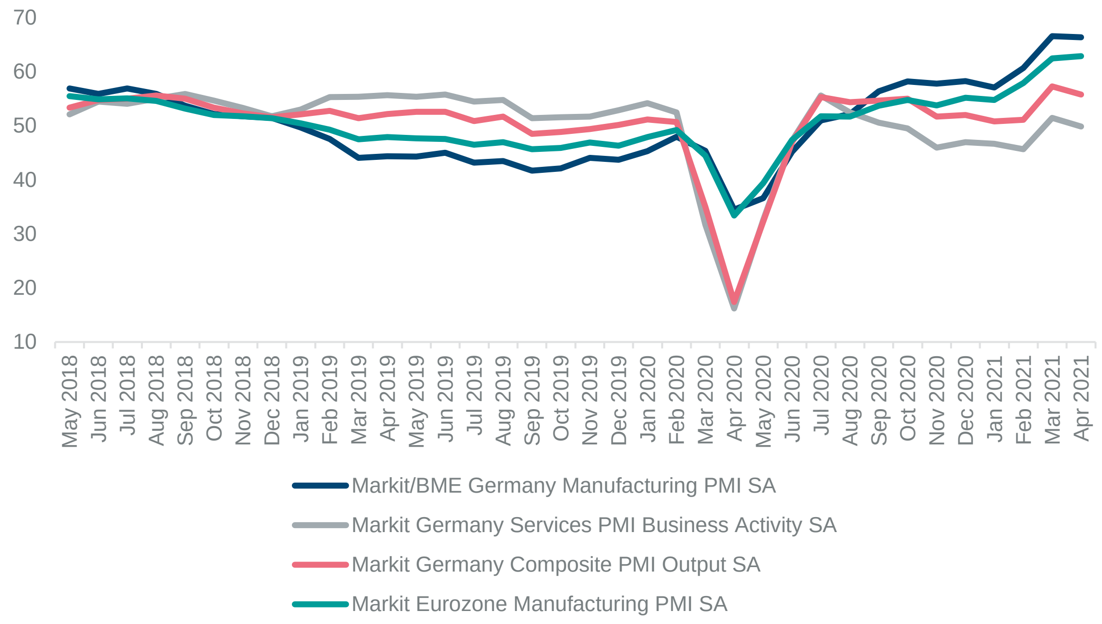



*Source: Bloomberg*

Labour productivity for Q1 was up by 5.4% quarter on quarter, but labour costs were down by 0.3% over the same period. The US unemployment rate was up from 6.0% in March to 6.1% in April as the US labour market added only 266,000 jobs to its non-farm payroll in April, significantly below the market expectation of 1 million in April and 916,000 in March. Many sectors, especially the hospitality sector, experienced a labour crunch. Some economists blame this on the ongoing flow of unemployment benefits which act as a disincentive for people to return to work. Others believe that waves of retirements, fears about COVID-19 and childcare challenges also contribute to the phenomenon. Many companies have already started increasing their hourly pay to entice workers, while others are resorting to technology and automation to ease the workflow disruption. The probability of a recession in the next 12 months, according to the New York Fed, dropped from 6.26% to 5.95% over the past month. Sector rotations continued into Q2, underpinned by an improving earnings outlook in most sectors.

Retail sales growth, year on year, in the EU jumped from -2.9% in February to 12.0% in March, mainly due to the base effect but retail sales still grew by 2.7% in March. The Eurozone and Germany manufacturing PMIs and Germany services PMI remained in the expansionary zone in April. In the US, 60% of companies that offered an outlook on their future earnings in April gave a positive outlook. European companies have also delivered a significant breadth of earnings so far, with 57% of the 68 companies that RMB Morgan Stanley tracked having so far beaten their earnings per share estimates and 14% having fallen short of expectations. Retail sales in Japan were up by 1.2%, month on month. Industrial production ticked up from -2.0% in February to 4.0% in March, year on year. Exports and imports, however, remained lacklustre, making small gains but hovering in negative territory.

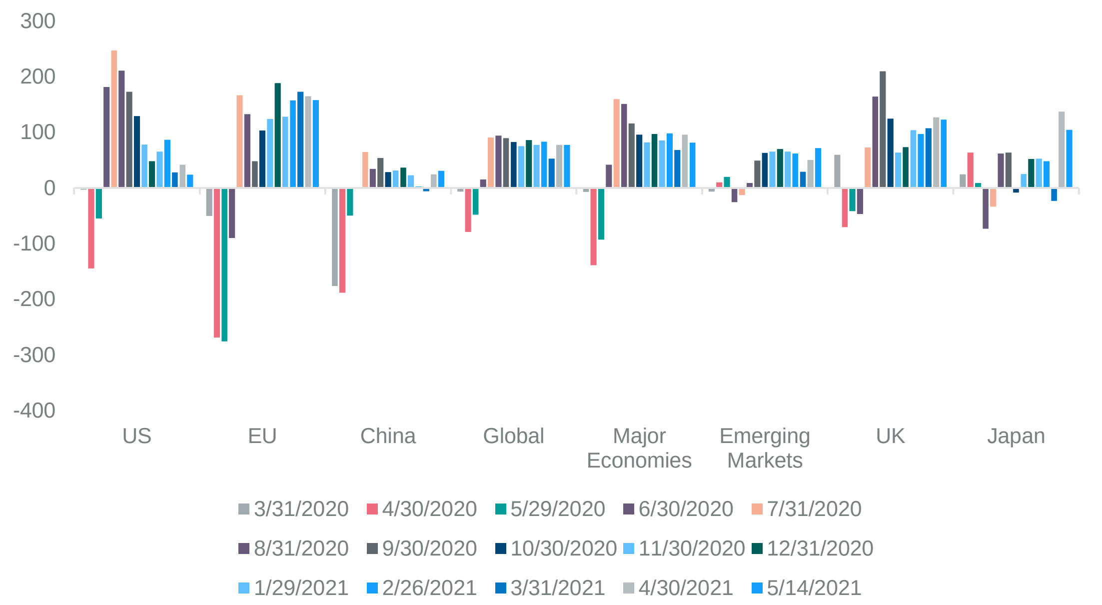
**Figure 20: Eurozone and Germany PMIs**



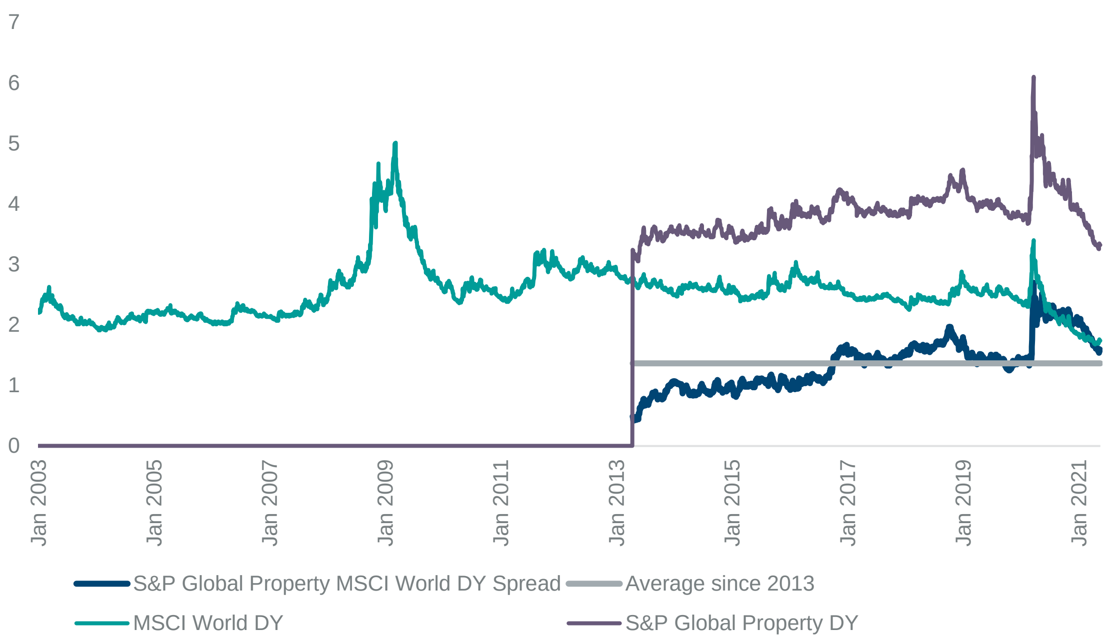

*Source: Bloomberg*

In the Asia-Pacific region, we observed the Chinese manufacturing and non-manufacturing PMI remained in the expansionary territory of 51.1 and 54.9 respectively in April. The return on equity for the S&P 500 improved from 10.63% to 13.64% from December 2020 to April 2021. The return on equity for the STOXX 600 and the NIKKEI 225 improved from 5.16% to 6.82% and from 7.03% to 10.92% respectively over the same period.

**Figure 21: Economic surprise indices**




*Source: Bloomberg*

| | |
|---|---|
| | The economic surprise index remained in positive territory for most major economies, showing that the reported economic figures largely exceeded market expectations.<br><br>Our views on offshore equities have remained unchanged, despite the possibility of interest rate normalisation and rising yields in advanced economies posing a significant threat to risk assets and emerging market assets. For now, the Fed and most central banks of major economies have largely pledged to keep their ultra-loose monetary policies in place, believing that the unexpected surge in consumer prices stems from temporary forces. Furthermore, the Fed holds the view that the US job market needs far more time to get people back to work. |
| **Offshore property** | From a valuation perspective, global property appears to be neutral, with the spread between its yield and that of the MSCI World Index converging to the long-term average. While its price-to-tangible-book value rebounded to its pre-pandemic level, from 0.26x in late 2020 to 1.45x in April 2021, fundamental measures such as debt to equity, operating margin and return on equity have yet to show any nascent signs of improvement. We therefore chose to stay neutral in offshore property.<br><br>**Figure 22: S&P Global Property dividend yield spread relative to the MSCI World Index**<br><br><br><br><br>*Source: Bloomberg* |

MENTENOVA

# CONTACT

**FRANCOIS VAN DIJK, CFA®**
**C** +27 82 851 0112 **T** +27 11 447 7716
**F** 086 272 1177 **E** fvandijk@Mentenova.co.za

3rd Floor, Oxford & Glenhove Building 2,
114 Oxford Road, Rosebank, Johannesburg
www.Mentenova.co.za