MARKET MATTERS

26 NOVEMBER – 30 NOVEMBER 2018

DON'T GIVE UP YET

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It was a much better week for global equities. Unfortunately, the local equity market lagged and ended November in the red. It remains on course for the first negative calendar year since 2008 with a double-digit year-to-date loss.

For most South African investors, local shares will be the largest portion of their portfolios, given regulatory limits on offshore exposure in retirement funds. According to industry body Asisa's third quarter statistics, almost half of the R2.3 trillion invested in unit trusts are in domestic multi-asset funds. A further R406 billion is invested in South African equity funds, compared to R138 billion invested in offshore equity funds (this excludes direct offshore investments). The impact of the local market's disappointing performance is therefore felt widely. A silver lining is that since most investors are in multi-asset funds, the pain of equity declines is diluted. The bad news is that other asset classes have not exactly shot the lights out. Bonds and cash have returned 7% this year and global equities 11%. But local listed property has lost 25%.

GRIM READING

While the FTSE/JSE All Share Index delivered a healthy 20% return last year, it only returned 1.7% in 2015 and 0.3% in 2016. 2014 saw a decent 10% gain. With only two out of the last five years delivering a decent return, the overall experience from local equities has been dismal. At the end of November, the one-year return was -11%, while the three-year annualised return was only 3%. Over five years, the annualised return of 6% is only slightly above inflation.

The collapse in commodity prices in 2015 and into early 2016, coupled with rising political risk (particularly the shock axing of Finance Minister Nene in December 2015), weighed on the local market and it was only the strong performance of non-resource rand hedges that kept the market afloat. Mining shares rebounded in 2016 but the rand appreciated from bombed-out levels and weighed on the other rand hedges. The healthy 2017 return came almost entirely in the second half, unexpected and largely unconnected from the highly uncertain domestic environment. It helped that the largest share on the local bourse, Naspers, gained a staggering 70%.

This year, only a quarter of the counters on the All Share Index are in positive territory year-to-date. The bottom half contains some of the biggest shares on the market: Naspers (-16%), Richemont (-17%), MTN (-35%), British American Tobacco (-40%) and Aspen (-46%) are all in the top 20 shares on the JSE. Other top 20 shares with notable declines include Bidcorp

(-10%), Sanlam (-11%), Remgro (-13%) and Vodacom (-14%). What most of these shares have in common is that they would normally be considered rand hedges, but the 10% decline in the rand against the dollar this year has not helped them. The more recent trend – since late September – of a strengthening currency has compounded the problems for the rand hedges.

On the plus side, the 6% gain in the currency in November has meant that interest rate-sensitive shares have taken the surprise interest rate hike in their stride. Banks and retailers are among the strongest performers in November. While the volatile forward rate agreement (FRA) market is pricing in more rate hikes, the equity market is unfazed.

FOUR FACTORS

Broadly speaking, four factors will determine the future returns from local equities. The first is valuation. The local market is at its cheapest level in several years based on simple metrics like the price to earnings ratio and dividend yield. This doesn't mean that the market can't get cheaper in the short term, but it is a fairly reliable indicator of positive longer-term real returns.

The second factor is around whether the domestic economy can recover from its long stupor. At an index level, the JSE is more exposed to the global than the local economy, but the latter still matters. The local economy last grew more than 2.5% in real terms in 2011, and is not expected to achieve even 1% this year. Most forecasts suggest a gradual improvement in 2019 and 2020.

The recent data is mixed. The Bureau for Economic Research's two long-standing surveys gave contradicting signals. The Consumer Confidence Index fell in the third quarter, unsurprising given the record high petrol price at the time, but remained at a fairly high positive level, which suggests consumer spending should hold up. The Business Confidence Index, in contrast, fell further in the fourth quarter as weak demand overshadowed any sense of diminishing political uncertainty. One of the reasons the local economy has struggled to recover is the relentless cost-cutting by large South African companies. But it also means that the slightest improvement in economic growth can translate into reasonable profit growth.

The third and fourth issues are related. The level of the exchange rate matters for the local market since some shares are rand hedges and some benefit from a stronger currency. The exchange rate in turn will largely depend on global sentiment towards emerging markets, itself dependent on the risk appetite of investors in New York, London and other global financial centres and their views of where US interest rates are headed.

JUST BELOW

In a speech on Wednesday, US Federal Reserve chair Jerome Powell noted that the federal funds rate was "just below" the broad range of

estimates of the neutral level. (The neutral interest rate is the theoretical level where borrowing costs neither constrain nor boost economic activity.) This was quite a departure from a speech in early October where he noted that "we're a long way from neutral" and markets loved the implication that the Fed was only one or two hikes away from the peak. However, Powell left himself enough wiggle room since the broad range of estimates of the neutral rate is really quite broad, anywhere from 2.5% to 3.5%.

Ultimately, Powell and his colleagues will keep an eye on incoming data, and everything he has said up to now suggests he is pragmatic, trying to balance two risks: hiking too fast could cause a recession, and keeping rates too low for too long "could risk other distortions" in the form of higher inflation or destabilising credit booms. A December hike is still highly likely, and the debate over the path of US rates will continue in 2019, but for now the risk of Fed overkill is small. This is good for markets.

Another likely positive for global markets is the trade truce agreed to by the US and China over the weekend at the G20 summit in Buenos Aires. The two countries will not impose further tariffs during a three-month negotiating window. Anything might still happen between now and February, but this is a step in the right direction.

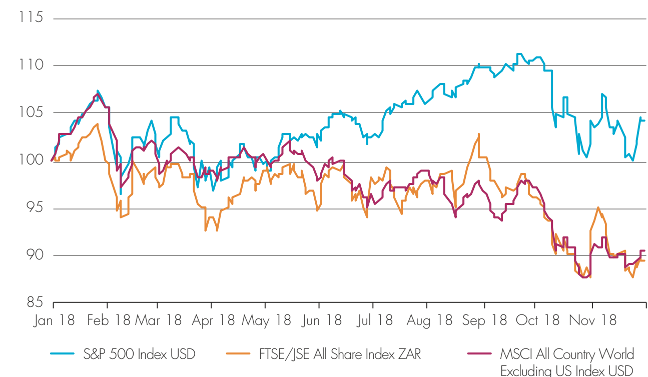
WHY BOTHER?

The Reserve Bank's rates hike means that cash has become a more attractive asset class, so why bother with the volatility that is associated with equities at all? Historically, equities have lagged cash over shorter periods, but handsomely outperformed over longer periods. However, it is important to remember that cash returns are steady but equity returns very lumpy. Most of the long-term outperformance can be attributed to brief surges in equity prices (chart 2). Miss them and you miss out. The other source of long-term outperformance is dividends. Cash yields are higher than equity dividend yields, and determined by prevailing short rates. But unlike interest from cash, dividends grow over time. At an index level, dividends have grown 14% per year over the past 20 years. The most recent five-year period, with weak commodity prices and a tough domestic economy, has still seen dividends grow 8% per year. For investors saving up for retirement, lower equity prices is a blessing in disguise, since they can buy more shares with reinvested dividends or regular contributions.

Retirees understandably tend to have a lower tolerance for volatility in their portfolios, and higher fixed interest yields is positive for them. But they shouldn't ignore equities as a source of income. A simple back-of-the envelope calculation suggests that an investment in an equity portfolio at the current yield of 3.5% will deliver the same income as a money market fund in roughly seven years if dividends grow at 14% per year and interest rates stay unchanged. Over this period, the capital value of the equity portfolio should increase quite a bit, while the value of the money market investment will remain unchanged. And of course dividends are more favourably taxed than interest income.

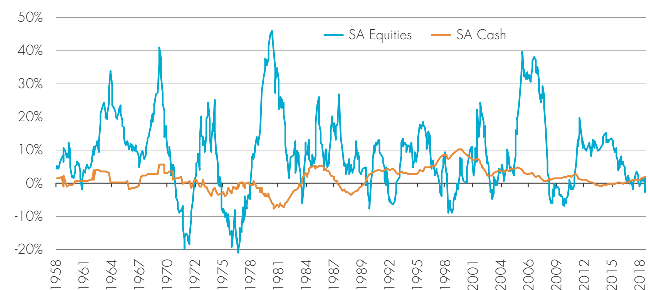
In summary, it has been an unusually tough year on the JSE, feeling for all intents and purposes like a slow-motion bear market and testing the patience of investors. However, markets have always been cyclical and historically patience has been rewarded time and time again. Don't give up yet.

CHART 1: EQUITY INDICES IN 2018, INDEXED TO 100



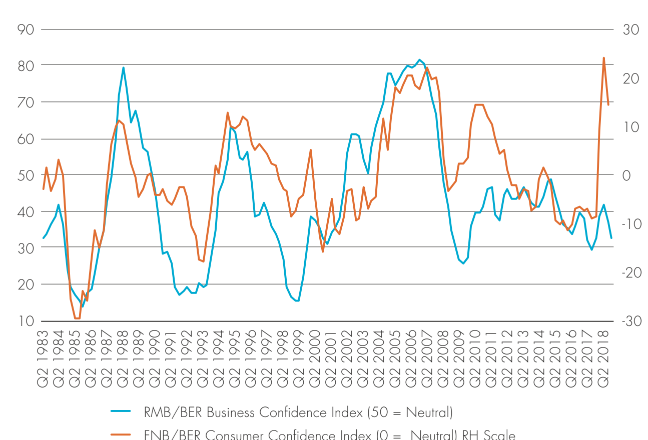
Source: Thomson Reuters Datastream

CHART 2: SA EQUITIES VERSUS CASH OVER ROLLING THREE-YEAR PERIODS, ADJUSTED FOR INFLATION



Source: Thomson Reuters Datastream

CHART 3: BER BUSINESS AND CONSUMER CONFIDENCE INDICES



Source: Thomson Reuters Datastream

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 035.0	3.04%	0.64%	-3.23%	-2.02%
United States	S&P 500	US$	2 760.0	4.82%	1.77%	3.22%	4.23%
Europe	MSCI Europe	US$	1 571.0	1.55%	-0.38%	-12.58%	-11.29%
Britain	FTSE 100	US$	8 901.0	-0.09%	-2.20%	-14.42%	-9.45%
Germany	DAX	US$	1 203.0	0.50%	-1.88%	-12.07%	-16.40%
Japan	Nikkei 225	US$	197.0	2.80%	1.53%	-2.51%	-2.61%
Emerging Markets	MSCI Emerging Markets	US$	998.0	2.99%	4.39%	-13.82%	-10.97%
Brazil	MSCI Brazil	US$	2 013.0	3.18%	-1.18%	-0.49%	3.39%
China	MSCI China	US$	74.2	2.74%	6.26%	-16.13%	-14.53%
India	MSCI India	US$	555.2	4.18%	9.50%	-9.13%	-4.77%
South Africa	MSCI South Africa	US$	467.0	5.18%	13.35%	-22.81%	-16.01%

EQUITIES - SOUTH AFRICA (TR UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	50 664.0	-0.07%	-3.29%	-14.86%	-15.24%
All Share	All Share (Total Return)	Rand	7 414.0	0.01%	-3.19%	-12.26%	-12.56%
TOP 40/Large Caps	Top 40	Rand	6 519.0	0.37%	-3.09%	-12.47%	-13.62%
Mid Caps	Mid Cap	Rand	14 824.0	-1.21%	-1.40%	-12.67%	-8.53%
Small Companies	Small Cap	Rand	18 109.0	-0.39%	-3.27%	-13.86%	-10.53%
Resources	Resource 20	Rand	2 391.3	-1.90%	-11.88%	4.60%	3.49%
Industrials	Industrial 25	Rand	12 084.0	0.67%	-0.97%	-20.06%	-23.81%
Financials	Financial 15	Rand	9 195.0	1.79%	2.59%	-5.27%	3.99%
Listed Property	SA Listed Property	Rand	1 861.1	-0.91%	-1.27%	-24.47%	-21.27%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	629.1	0.07%	3.87%	7.05%	13.05%
Government Bonds	BESA GOVI	Rand	622.7	0.05%	3.94%	6.21%	12.26%
Corporate Bonds	SB JSE Credit Indices	Rand	107.9	0.18%	-5.84%	-14.49%	-13.41%
Inflation Linked Bonds	BESA CILI	Rand	251.7	0.31%	-1.07%	-0.34%	4.54%
Cash	STEFI Composite	Rand	408.4	0.13%	0.58%	6.65%	7.25%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	59.1	0.58%	-21.15%	-11.73%	-6.13%
Gold	Gold Spot	US$	1 222.0	-0.08%	0.58%	-5.78%	-4.16%
Platinum	Platinum Spot	US$	798.0	-5.00%	-4.20%	-14.19%	-15.11%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	13.87	-0.12%	6.55%	-10.72%	-1.49%
ZAR/Pound	ZAR/GBP	Rand	17.67	0.45%	6.79%	-5.26%	5.04%
ZAR/Euro	ZAR/EUR	Rand	15.69	0.10%	6.48%	-5.31%	3.10%
Dollar/Euro	USD/EUR	US$	1.13	0.00%	0.09%	6.28%	5.31%
Dollar/Pound	USD/GBP	US$	1.28	0.49%	0.38%	5.87%	5.09%
Dollar/Yen	USD/JPY	US$	0.01	0.44%	0.43%	0.71%	0.99%

Source: I-Net, figures as at 30 November 2018

ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Quarter 3 GDP growth
- Current account balance
- Absa Manufacturing Purchasing Managers' Index
- Markit Purchasing Managers' Index
- Naamsa new vehicle sales

US

- New vehicle sales
- Non-farm payrolls and unemployment rate
- Consumer confidence

EUROPE

- Eurozone retail sales

CHINA

- Caixin Manufacturing Purchasing Managers' Index

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