MARKET OBSERVATIONS

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QUARTERLY MARKET COMMENTARY

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The second quarter of 2016 was another characterised by high volatility in most financial markets, with the UK vote to leave the European Union ending the quarter on a significant negative surprise. This further heightened global uncertainty, fuelling expectations of even slower global growth, and lower inflation and interest rates for longer. Bond markets and gold were among the greatest beneficiaries of this ongoing trend, while equity returns were muted. Emerging market assets benefited from the continuing rally in commodity prices and a sporadic revival of investor risk appetite.

ASSET CLASS	TOTAL RETURN Q2 2016
Global equity – MSCI World Free (US$) (Developed)	1.0%
Global equity – MSCI Emerging Markets (US$)	0.7%
Global bonds – Barclays Global Agg Bond Index (US$)	2.9%
SA equity – FTSE/JSE All Share Index	0.4%
SA bonds – All Bond Index	4.4%
SA listed property – SA Listed Property Index	-0.4%
SA inflation-linked bonds – JSE CILI Index	4.4%
SA cash	1.8%

GLOBAL SLOWDOWN FUELLED FURTHER

In the US, the consensus outlook for 2016 GDP growth was revised downward to 1.85% from around 2.0% previously, while forecasts for 2016 consumer inflation (CPI) fell to 1.25% y/y from 1.7% y/y previously (CPI less food, energy and shelter measured only 1.4% y/y in May, driven largely by housing price increases). At its 14-15 June meeting, just before the UK Brexit vote on 23 June, the US Federal Reserve again left interest rates on hold amid uneven US economic data (particularly for employment), slowing exports and the weaker global environment. There was again a substantial moderation among Fed policymakers of their views on the future path for US interest rates, lowering their median forecast for the Fed Funds rate (at end 2018) to 2.4% from 3.0% in March. The surprise Brexit vote sparked severe market turbulence which hit global financial stocks, UK equities and the pound sterling the hardest, caused a flight to safe-haven assets like gold, and prompted the Fed to note that this had further increased risks to global growth. The US market also revised downward its own rate hike expectations: Fed Fund futures are now factoring in a total rate increase of only 50 basis points (bps) over the next 2.5 years.

The Barclays Global Aggregate Bond Index (US$), a mixture of government and corporate bonds, posted a total return of 2.9% in the quarter. US Treasury (UST) bonds rallied in response to the lower interest rate outlook, with the 10-year yield falling to 1.45% from 1.80%, with much of this occurring post-Brexit. US high-yield bond spreads vs USTs improved, from 680bps to 613bps at quarter-end, led by a rally in the energy sector (where spreads fell from 1300bps to about 800bps) on the back of the higher oil price. In the equity market, the S&P 500 returned 2.5%, underpinned by the prospect of easier monetary conditions, although company earnings have fallen about 2% since January.

In the Eurozone, the 2016 GDP growth forecast was revised upward slightly to 1.6% from 1.5%, driven largely by Germany. However, this occurred prior to the Brexit vote. Inflation projections, by contrast, were cut to only 0.24% for the year. The ECB promised to support markets amid the Brexit turbulence, keeping its aggressive easing programme on track. German bunds rallied and the 10-year yield turned negative for the first time, ending the quarter at -12bps. European equities were hit by Brexit: the Dow Jones Euro Stoxx 50 Index (US$) returned -5.1% for the three months, France's CAC 40 returned -3.3% and Germany's DAX -5.5%. In the UK, the FTSE 100 returned -1.8% and economists predicted a recession as the elevated uncertainty prompted businesses to postpone planned investment and expansion plans, and move their headquarters elsewhere.

Japanese growth expectations continued to deteriorate as the 2016 GDP forecast was cut to only 0.5% from 0.7%, and the inflation outlook turned to deflation of -0.5% for the year. May inflation came in at -0.4% y/y. As the chances for even more monetary easing increased, Japanese bonds continued to rally and the Nikkei 225 Index returned 1.5% over the quarter. The yen experienced a notable 10% appreciation versus the US dollar, due largely to the move lower in expectations for real US interest rates.

In China, Q1 GDP growth was reported at 6.7% (q/q annualised), a slight slowdown from 6.8% in Q4 2015, but in line with expectations and comfortably within the government's 6.5%-7.0% target for the year. A buoyant housing market, plus the government's higher infrastructure spending and increased bank lending are helping stabilise growth after the slowdown in the second half of 2015. The MSCI China returned 0.3% over the three months, helped by a 1.2% return in June.

Other emerging markets continued to be supported by firmer commodity prices and a general improvement in risk appetite towards emerging markets. Five-year credit default swap spreads (a

Source of table: Prudential, data to 30 June 2016 measure of sovereign default risk) fell across most emerging markets (Brazil and Russia declined the most at about 50bps, and South Africa fell 25bps). Brazil's Ibovespa was again the strongest performer in US dollar terms, returning 14.1%. The MSCI South Africa gained 7.7%, MSCI Russia returned 4.2% and MSCI India 3.7%, while the MSCI Turkey lost 7.7% but is still up nearly 10% year to date (all in US$). EM bonds and currencies were also generally stronger.

The price of Brent crude oil gained 25.5% to trade near $50/barrel at quarter end. Gold gained 7.2% to $1,320/ounce, and there were notable moves in nickel (up 11.3%) and zinc (up 16.3%).

LOCAL SENTIMENT IMPROVES AMID POSITIVE SURPRISES

Following all the negative developments of the first quarter of 2016, Q2 brought some measure of relief for South African markets, driven by positive surprises including the decisions by all three major ratings agencies not to downgrade the sovereign credit rating to "junk" status, but to maintain it at investment grade. While this did not completely relieve bond and interest rate market uncertainties, it did push them out to year-end, when new ratings reviews will be conducted. Inflation data surprised positively over the quarter, coming in at 6.1% y/y in May versus 6.4% expected, and led by lower-than-expected food inflation.

The rand also halted its slide against the US dollar and other major currencies, appreciating by 0.3% against the greenback, 2.7% versus the euro and 8.1% against sterling, amid improved sentiment from very oversold levels. Other emerging market currencies saw mixed performances. Somewhat paradoxically, the "lower for longer" view on global interest rates and inflation arising from the Brexit "leave" vote proved positive for South Africa's own currency, interest rate and inflation outlook, helping moderate views on the local interest rate cycle.

Following 75bps of rate hikes in Q1, the South African Reserve Bank (SARB) kept interest rates on hold during the quarter amid the improving inflation outlook, stable rand and a weaker local economy – SA GDP growth contracted by a larger-than-expected 1.2% in Q1 2016. While raising its 2016 CPI forecast to 6.7% y/y from 6.6% y/y, the SARB lowered its 2017 CPI forecast to 6.2% y/y (down from 6.4% y/y) and 2018 CPI to 5.4% y/y. The Central Bank also lowered its GDP growth forecasts again, to 0.6% from 0.8% in 2016, 1.3% from 1.4% in 2017, and 1.7% from 1.8% in 2018.

Meanwhile, local bonds continued their recovery begun in February, helped by the improving local interest rate outlook, rising commodity prices and offshore investor demand. The SA 10-year bond rallied about 30bps to 8.80% by quarter-end, finally reaching pre-Nenegate levels, while the All Bond Index returned 4.4% in Q1. Inflation-linked bonds (ILBs) also gained ground, returning 4.4% in the quarter. Looking at the difference in yields between conventional bonds and ILBs, 10-year breakeven inflation expectations fell from 7.30% to 7.0% at quarter-end, after peaking at 7.70% in mid-May. Cash returned 1.8%. In the Forward Rate Agreements (FRAs) market, views on future interest rates have moderated still further: three-month interest rates are now seen at 7.80% in two years' time, down from 8.26% at the end of March, a 45bp decline. The market now expects at the most 2 more 25bp rate hikes from the SARB in just under two years' time.

In SA equities, the FTSE/JSE All Share Index returned 0.4% for the quarter, hit by a 3.0% decline in June as UK-related shares suffered in the wake of Brexit. Total return from the Index year to date is 4.3%. Although Resources shares returned 6.4% as commodity prices gained ground, Financials lost -4.3% (partly due to the Brexit effect), Listed Property lost 0.4% (following a stellar Q1 return of 10.1%) and Industrials eked out a 0.5% gain.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

In the second quarter of 2016, in the wake of the continuing rebound in SA nominal bonds we took some profits and reduced our moderately overweight bond positions in our multi-asset portfolios, but remain modestly overweight.

With listed property moving weaker during the quarter and improving in value after strong gains in Q1, we closed our previously underweight position and are now neutral listed property in our multi-asset funds. Our views on other local asset classes have not changed.

For global assets, we added to global equities, funded from the sale of global high-yield bonds. The bonds had benefitted both from the rally in government securities as well as the compression in credit spreads. In equities we added to defensive, high-quality cash flow-generating assets.

In **global fixed income**, we are underweight duration and continue to hold cash and floating-rate notes (FRNs) in order to reduce interest rate risk. We remain positive on both investment-grade and high-yield corporate bond markets relative to government bonds where we see yields as unsustainable in the medium term: gains during the quarter in these holdings benefited our portfolios. We also have exposure to US dollar-denominated South African government and dollar Eskom debt that performed well as US Treasuries rallied. The currency exposure on these SA-domiciled issuers is hedged back to rand.

For **global equities,** our global asset allocation continues to favour equities over bonds and cash, and global equities over local SA equities, as global equities remain more attractively valued than SA equities on measures like Price-Earnings (P/E) and Price-Book value ratios. In our higher return-targeting multi-asset funds we continue to be very near our maximum permitted 25% offshore weighting. Our overweight exposures tend to be concentrated in European markets where long-standing growth concerns have kept valuations on the cheap side of fair value, as well as selected Emerging Markets including India, funded by underweights in the US, Japan and a variety of other smaller markets including Australia. While we acknowledge earnings remain vulnerable to slowing global growth (earnings across the S&P 500-listed companies have fallen approximately 2% since January), equity risk premiums (the yield on equities vs bonds) are in some cases close to the peaks seen in the Global Financial Crisis, providing a huge valuation buffer that will protect equities in the event of growth disappointment.

South African equities were trading at a forward P/E of 15.6x at quarter-end, a level we find slightly expensive compared to their longer-term fair value, and compared to certain offshore equity markets. The earnings of companies listed on the JSE remained largely flat over the quarter, having declined from a peak of R31/share in Q4 2014 to R10/share at quarter-end, due largely to the impact of the fall in commodity prices. The medium-term prospects for SA earnings to recover to their trend level depend extensively on a recovery in commodity prices. In general we are neutrally weighted in local equities on an asset allocation basis.

In our domestic portfolios, Financial stocks remain attractive on a risk/reward basis, despite the risks of a sovereign downgrade and other potential challenges. Key overweights remain Investec and Old Mutual. We also have strong overweights in Barclays Africa and First Rand, followed by Standard Bank. We are underweight in Retailers, where pressure on the consumer, restrictions on the availability of unsecured credit and rising food prices have hampered margins. We retain our defensive positioning in Resources stocks, given concerns over balance sheet strength. We did add gold company exposure given the boost to earnings stemming from the higher rand gold price during the quarter. Among our other top overweight positions on a medium-term view are Sappi, Tiger Brands and Netcare, while our top underweights include Aspen, Medi-Clinic, Remgro and Steinhoff.

In **SA listed property**, as the sector became cheaper over the quarter, we took advantage of this to buy more and close our underweight in our multi-asset class portfolios, buying out of cash. We are now neutral in this asset class. Listed property companies (excluding developers) continue to be priced to return approximately 15% p.a. over the medium-term (assuming no change in the market's valuation of property), with no real pricing change from the previous quarter. The earnings outlook for these companies improved somewhat over the quarter given the lowered expectations for inflation and interest rates, although the weak economic environment remains a challenge, particularly for those exposed to the office sector where there is over-supply.

In **SA nominal bonds,** our portfolios are still modestly overweight conventional bonds, having sold down the position from moderately overweight in the previous quarter. Within this, we are also overweight longer-dated bonds versus shorter paper due to the more attractive yields on offer, while retaining our overweight exposure to corporate bonds. The recent fall in yields has been driven predominately by global, rather than local, factors, although avoiding a rating downgrade certainly helped. However, with the 10-year SA bond spread versus the 10-year US Treasury now at 725bps, a full 100bps above its pre-Nenegate level, there is still a significant risk premium priced in. Given that global bond yields are continuing to fall in the wake of Brexit and the outlook for more easing from developed central banks, SA bonds are likely to be a beneficiary of any extended global search for yield among investors going forward. At the same time, the likelihood of rate hikes by the SARB in the second half of 2016 has fallen.

Inflation-linked bonds remained somewhat expensive compared to conventional bonds over the quarter, leading us to maintain our underweight in these assets in our multi-asset portfolios. Although the break-even inflation rate has fallen to 7.0%, it still appears elevated compared to our long-term inflation benchmark of 6.0%.

LOOKING AHEAD

Although this quarter's developments have proved mostly positive for interest rate markets, investment risks remain elevated, particularly with global growth rates even more under threat, and SA GDP growth showing few signs of improvement. The likelihood of eventually being downgraded to non-investment grade status remains real. Investors can expect continued volatility in financial markets over the medium term.