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MARKET OBSERVATIONS

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The main feature of the fourth quarter (Q4) of 2014 was an unexpected rally in global fixed income markets, sparked by positive pronouncements on easy monetary policy by both the European Central Bank and Bank of Japan in September. This was accompanied by general weakness across equity markets, with emerging markets (EMs) and currencies faring the worst. As the US economy continued to gain strength, conditions in Europe and Japan remained weak, and Chinese growth slowed to 7.3% y/y, its weakest level in five years. The sharp drop in the oil price (and other commodities to a lesser extent) fuelled expectations for lower inflationary pressures and stronger consumer spending in the months ahead, which consequently bolstered forecasts for a more moderate interest rate hiking cycle by the US Federal Reserve in 2015.

Asset class	Total return Q4 2014	Total return 2014
Global equity – MSCI World Free	1.1%	5.5%
Global equity – MSCI Emerging Markets	-4.4%	-1.8%
Global bonds – Barclays Global Agg Bond Index (US$)	-1.6%	0.7%
SA equity – FTSE/JSE All Share Index	1.4%	10.9%
SA bonds – All Bond Index	4.3%	10.2%
SA listed property – SA Listed Property Index	11.1%	26.6%
SA inflation-linked bonds – Barclays ILB Index	2.2%	11.2%
SA cash	1.5%	6.0%

Global markets

In the US, economic data continued to surprise on the upside during the quarter, particularly in December. While unemployment reached a six-year low of 5.8%, GDP for Q3 came in at a surprising 5.0% (q/q annualized) and forecasts for 2015 GDP growth remained steady at 3.0% y/y. Despite this, there are as yet no signs of labour cost pressures: average hourly earnings growth has held between 1.9% and 2.3% for the past two years. Amid the benign inflationary environment (November CPI was 1.3%), 30-year US Treasury (UST) yields rallied about 40 basis points (bps), reflecting investors' belief that inflation and growth will continue to be constrained over the medium term. In fact, their expectations are considerably lower than those of the Fed. Inflation expectations (as reflected by the yield differential between UST 10-year nominal and inflation-linked bonds) fell from 2.0% to 1.7%, the lowest level since 2010 and some 60bps lower than August.

Unsurprisingly, Fed Fund futures show the market now expects the Fed Funds rate at December 2016 at only 1.6%, down from 1.8% at the start of the quarter and consistent with the bond market rally. The Fed's first rate hike is priced in for the third quarter of 2015, although debate has now shifted to whether the Fed may have to raise rates sooner due to the stronger-than-expected growth data. US credit spreads versus USTs widened over the quarter, reflecting concerns over rising default rates and in particular deteriorating prospects for small US commodity (especially oil) producers that have issued debt in the high yield market. While investment grade corporate bond yields rose about 25bps to +145bps, high yield bonds rose about 100bps to +550bps, with the energy sector jumping a meaningful 300bps.

On the equity front, investors took heart from the improving growth, with the S&P 500 Index returning 4.9% for the quarter, although a shaky December shaved 0.3% from the total. For 2014 as a whole, the S&P's total return was 13.7%, with US equities posting by far the strongest performance among developed markets for the year.

European equities posted losses for the second quarter in a row. Indicators continued to surprise on the downside, although less negatively than in previous quarter. GDP growth forecasts for 2015 were revised downwards, with the Eurozone as a whole downgraded from 1.4% to 1.1% y/y. Germany saw a material revision down to 1.3% from 1.8% previously, while Italy came down to 0.4% from 0.9%. France's Cac 40 was the worst performer among major markets, down 6.9% for the quarter and 9.8% for the year, while the UK's FTSE 100 lost 4.1% for the quarter and 5.2% for the year. The most strain was taken by the Southern European markets, hit by the announcement of early elections in Greece in 2015, where polls show the anti-austerity Syriza party is in the lead. However, the prospects for further monetary stimulus improved, as investors increasingly believe that European Central Bank (ECB) president Mario Draghi will be able to overcome substantial opposition (largely from Germany) to implement more extensive quantitative easing measures in 2015.

Table source: Deutsche Securities

In Japan, the success of Abenomics remained uncertain as that economy slipped further into the doldrums, recording a second successive quarter of negative growth - Q3 GDP growth was recorded at -1.9% q/q annualized. Other indicators have demonstrated less negative trends, however, and Prime Minister Abe's strong re-election victory has given him more leeway to enact further measures to spur growth. Japan's Nikkei 225 Index managed to lose 1.1% for the quarter and 4.5% for the year (not total return).

In China, the likelihood that the government would meet its 7.5% growth target for 2014 became increasingly improbable, with Q3 GDP growth reported at 7.3%. While the Central Bank continues to pump liquidity into the system with targeted bank lending and fewer controls on home purchases, no outright monetary easing is likely. Analysts expect the authorities to lower the country's 2015 growth target to 7.0% y/y.

Developed market equities, as measured by the MSCI World Free Index (in US$), posted a total return of 1.1% for the fourth quarter. Emerging market (EM) equities, by contrast, were mostly weaker, hit by slower growth and pervasive negative sentiment. EM currencies universally weakened versus the US Dollar, with the Russian Rouble, Mexican Peso and Korean Won performing particularly poorly. The Rand performed better than most, losing only 1.5% against the Dollar over the quarter and gaining 1.8% against both the Euro and Sterling. The MSCI Emerging Markets Index recorded a -4.4% total return, dragged down by Russia (-32.8%) and Brazil (-14.8%). Turkey was the best performer, rebounding 11.6%, while China also gained 7.2. Among major emerging markets, India provided the highest returns in 2014, gaining 23.9%, and Turkey was up a notable 19.1%. The worst performing major EMs in 2014 were Russia (-45.9%) and Brazil (-13.8%).

Meanwhile, sovereign credit default swap levels jumped, and EM US-dollar sovereign bond spreads widened against USTs by approximately 60bps, with the JP Morgan EMBI+ sovereign spread now at about +390bps, reflecting heightened concerns over worsening conditions in Russia, Brazil and other EMs.

Significantly lower commodity prices remained a major theme of the quarter on the back of slower Chinese and global growth, as well as the resurgence of the US dollar. The price of Brent crude oil dropped to under $55/barrel at quarter-end, for a remarkable 38% plunge during the quarter and 47% for the year, while platinum, iron ore and natural gas prices were all about 6-7% lower and gold was roughly unchanged.

South African markets

The local economic picture proved mixed. On the positive side, consumer price inflation fell to 5.8% in November from 5.9% the previous month, and the SA Reserve Bank (SARB) lowered its 2014 CPI forecast to 6.1% from 6.2%, and its 2015 projection to 5.3% versus 5.7%. Core inflation (excluding petrol, food and electricity prices) was also at 5.8% in November, and is forecast to average 5.6% and 5.7% in 2014 and 2105, respectively, largely unchanged.

Investors were favourably impressed in October by the National Treasury's Medium-Term Budget Policy Statement, in which the government pledged to enact fiscal consolidation in order to shrink the budget deficit to 2.5% of GDP by 2018 from a high 4.1% this year. This helped both Fitch and Standard & Poor's to avoid downgrading their sovereign credit ratings for South Africa, although Moody's did cut is ratings to Baa2 (with a stable outlook). This leaves both the Moody's and Fitch ratings (Baa2 and BBB) at the second-lowest investment grade level, and the S&P rating at the lowest investment grade level (BBB-) for foreign currency debt.

On the negative side, the Q3 current account balance remained persistently high at R230 billion or 6.0% of GDP. Growth concerns also continued to weigh: Q3 GDP growth came in at 1.4% (q/q annualised, off of a low base) and the SARB again revised downward its forecasts for 2014 and 2015 to 1.4% and 2.5% (from 1.5% and 2.8%) respectively. Given the above, the SARB left the repo rate unchanged at 5.75% at its November MPC meeting, citing slow growth and improving inflation, but also warned of the weak rand as a key risk to inflation going forward.

The rand depreciated modestly versus the US dollar over the quarter, down only 1.5% - however, it was a case of starting the quarter at weak levels and ending it even weaker, as at one point the currency moved above R11.75/USD in December, a level last seen at the heights of the 2008 crisis. It was less weak on a trade-weighted basis as the Euro and Yen also fell against the US currency.

SA equities

It was a volatile quarter for the FTSE/JSE All Share Index, reaching near-record highs before retracing the gains to lose 0.2% in December and return 1.4% for the quarter. For the year, local stocks posted a gain of 10.9%. The best-performing sectors for the quarter were Consumer Services (+18.8%), Healthcare (+14.2%), and Financials (+10.8%), while the worst were Oil & Gas (-28.1%), Basic Materials (-15.3%) and Telecoms (-5.1%).

SA bonds

Despite the weaker rand over the quarter, SA bonds benefitted from the favourable global tailwind for fixed income assets as inflation expectations improved. Bond yields declined about 30bps across the curve in total, and by quarter-end forward rate agreements (FRAs) were pointing to 3-month interest rates at 7.45% in two years' time, down from 7.65% at the beginning of October. Both bonds and FRAs were off their best levels seen in November, however, as December rand weakness versus the US dollar saw some retracement in both bond yields and inflation expectations.

The All Bond Index returned 4.3% over the quarter, with total returns for 2014 reaching 10.2%, nearly comparable with local equities' 10.9%. For the quarter, longer-dated bonds (12+ years) continued to post the best returns at 5.4%, compared to 2.5% for 1-3 year bonds and 4.1% for 7-12 year bonds.

Inflation-linked bonds, meanwhile, remained stable over the quarter with the real yield on the 10-year ILB steady at 1.6%, recording a total return of 2.2% for the quarter. This was higher than cash at 1.5%. Similar to the move in the US, the inflation break-even rate (as measured by 10-year ILB spreads versus conventional bonds) fell to 6.3% at quarter end from 6.7% (although it did drop below 6.0% during the period).

SA Listed Property

Listed property again proved to be the star performer among local asset classes for the quarter with an extremely strong 11.1% total return, and an impressive 26.6% return for the year. As investors we still like listed property for its strong distribution growth prospects over the medium term.

Market valuations and prospective returns

Our views on relative asset class returns remain largely unchanged through the fourth quarter of 2014: we still prefer equities and listed property over bonds and cash, and global equities over local equities in our global portfolios.

Global fixed income: We are underweight duration and previously reduced interest rate risk on our US holdings through our allocation to floating-rate notes (FRNs). In the corporate credit market, we believe spreads have reacted disproportionately to credit concerns and the fall in commodity prices. We do not expect a sharp increase in corporate default rates as US interest rates rise, since this is typically due to a deteriorating macroeconomic environment, rather than being attributable to Fed rate hikes. We are therefore content to remain modestly overweight floating-rate credit assets versus government bonds.

Global equities: Our global asset allocation continues to favour equities over bonds or cash, and global equities over local SA equities, as global equities remain more attractively valued than SA equities on measures like Price-Earnings and Price-Book value ratios. In our higher return targeting multi-asset funds we are very near our maximum permitted 25% weighting in this asset class. From a long-term valuation perspective, developed market equities (such as Germany) still appear to be fairly valued to somewhat cheap, both in absolute terms and relative to cash and bonds. Emerging market equities, although offering even better value, generally present higher risks. In our fund positioning, we are overweight Germany and Italy, and underweight commodity producers like Australia and Canada, as well as the US. We recently reduced our overweight to Korean equity in the wake of our concern over the rapid depreciation of the Japanese Yen against the Korean Won, which in turn led us to reduce our earnings expectations for Korean companies given that the two countries compete closely in the same markets.

SA equity: We believe South African equities are fair to slightly expensive, and so remain neutral on this asset class. However, for domestic portfolios, local equities' potential real returns are attractive compared to other asset classes. We continue to favour certain financial stocks over expensive industrials. Our top overweight positions include Old Mutual, Investec and British American Tobacco (BAT), while our top underweights comprise Steinhoff, Remgro and Sanlam.

Listed property: After having moved to overweight in this asset class in our multi-asset funds in Q2, listed property's outperformance in Q4 continued to benefit our fund performance. Given the strong gains over the quarter, we decided to reduce our overweight position somewhat, but remain moderately overweight. Although valuations now look less attractive relative to longer-dated bonds, property is expected to continue to deliver inflation-beating distribution growth.

SA nominal bonds: During the quarter we reduced our long duration position following the strong rally that brought yields to more expensive levels. Following this reduction we are still slightly long duration in our nominal bond funds, expressed through an increased allocation to longer dated bonds given the steepness of the yield curve. Despite the decline in yields over the quarter, longer-dated bonds remain relatively attractive at 8.6% to 8.75%, offering good medium-term value, in our opinion. We are flat duration in inflation-linked funds.

We also retain an overweight exposure to corporate bonds, which offer attractive yields over their government counterparts. New bond issues we purchased for certain portfolios included floating-rate notes (FRNs) from: Industrial Development Corporation (3-years), Capital Property Fund (3-years), MMI Group (10.5-years, callable in 5.5 years), and Development Bank of South Africa (3-years). Another purchase was the Old Mutual Life Assurance 10-year fixed rate bond, callable in 5 years.

Inflation-linked bonds: Following the strong rally in conventional bonds during the quarter, we took advantage of attractive pricing to sell some of our conventional bond holdings and buy back ILBs, where we were underweight ILBs in certain portfolios. ILBs now look less expensive versus their conventional counterparts, although in 2015 lower oil prices might still drive headline inflation into the lower half of the SARB's 3%-6% inflation target band, which could see further declines in breakeven inflation. The FRA market reflects this, in that it has now priced in a slightly less ambitious rate-hike scenario over the next 24 months, thanks to the improving inflation outlook and slower growth expectations.