Q1
2014

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MARKET OBSERVATIONS

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The first quarter of 2014 proved to be one of contrasting sentiments in global markets. Developed markets started the year bullishly, but sentiment was subsequently dampened by poor weather in the US, slowing growth in China and rising geopolitical concerns in Ukraine. In contrast, January started very bearishly for emerging markets in the wake of the US Fed's tapering, but the balance of the quarter saw gradually improving investor sentiment.

Global markets

In the US, investors adjusted to the course of tapering monetary policy under new Federal Reserve Chairman Janet Yellen, as she continued with steady US$10 billion reductions in bond purchases. In late March her messaging reinforced the Fed's intentions of providing accommodative policy as long as necessary, citing the "considerable slack" in the labour market as evidence that the US economy was operating well below potential. US Treasuries saw a significant re-pricing as the 10-year yield fell about 30bps in January before stabilising around 2.7% for the remainder of the quarter. At quarter-end, Fed fund futures were pricing in a slightly more dovish scenario, with the first 25bp rate hike expected only in September 2015, and a total of 200bps in hikes by the end of December 2016.

At the same time, many US economic indicators disappointed over the quarter as severe winter weather held back sales growth, production and hiring. This coincided with concerns over credit quality and slowing economic activity in China, as that country also reported below-consensus data including industrial production, February exports and a weaker PMI. This, in turn, raised broader concerns about growth in Asia in general.

US equities, after exceptional gains in 2013, experienced a slowdown on the back of below-expected economic data and some profit-taking, with the S&P 500 Index up 1.8% (in US dollars, total return basis).. Other developed markets (DM) like the UK and Euro area also reported marginal gains: the UK's FTSE 100 lost 0.6%, while Germany's Dax 30 eked out a 0.1% gain and the French CAC 40 was up 2.4%.

DM equities outperformed emerging markets (EM) over the quarter, with the MSCI World Free Index gaining 1.4% compared to the 0.4% lost by the MSCI Emerging Markets Index. For emerging markets, the year got off to a very poor start as negative investor sentiment built up in the wake of the December tapering by the US Fed, combined with mounting worries over slowing EM growth. Investors deserted EM investments in droves, pulling funds out of EM ETFs in record numbers in January. The "Fragile Five" economies - Brazil, India, Indonesia, Turkey and South Africa - were particularly hard hit, forcing many (including SA) to hike interest rates amid rapidly depreciating currencies and rising inflation concerns.

The interest rate rises proved to be more effective in some countries than others, as over February and March (particularly) investors became more discerning and were attracted back to markets like India, Turkey and South Africa by the relatively high yields on offer, as they more appropriately reflected perceived risk. The Crimean crisis also helped focus attention on other (geopolitical) risks and away from South Africa and other "fragile" markets.

The best performing EM equities for the quarter (in US dollars) were the MSCI India (+8.2%), MSCI South Africa (+4.9%) and MSCI Turkey (+4.8%). The worst included the MSCI Russia (-14.4%), MSCI China (-5.9%) and South Korea's KOSPI 200 (-1.9%).

South African markets

Both SA equities and bonds managed to post gains in the first quarter of 2014 despite the early prevailing negative EM sentiment, with equities (+4.3%) outperforming listed property (+1.7%), bonds (+0.9%) and cash (+1.3%). The gains also came against the backdrop of some gloomy fundamental conditions, including rising inflation, downward revisions to 2014 GDP growth forecasts (to 2.7% by both the World Bank and SA government, from 3.2% and 3.0%, respectively), concerns about economic competitiveness (amid slowing Asian growth), protracted strikes in the mining industry and worries over the upcoming national elections.

One of the biggest factors driving SA markets in the quarter was the rand's rapid 6.8% depreciation against the US dollar in January. Coming on top of its 19% depreciation in 2013, the SA Reserve Bank (SARB) was forced to revise upward its inflation forecasts: factoring in the weaker exchange rate, CPI was forecast to average 6.3% for 2014, peaking at 6.6% in the fourth quarter - well above the Bank's upper target limit of 6.0%. As a result, in an attempt to curb inflation expectations and keep inflation in check, at its 27 January meeting the SARB surprised the market by raising the repo rate 50bps – its first increase in six years.

The hike also followed on the heels of sharp interest rate hikes in Turkey, Brazil, India and other emerging markets, and did help to stabilise sentiment towards South Africa – the rand subsequently gained 3.3% versus the US dollar in February and another 2.1% in March, to end the quarter down only 1.7% in total.

At its meeting on 27 March, the SARB's Monetary Policy Committee did not hike the repo rate further, citing a delicate balancing act between softer economic growth and higher inflation. In comments made the previous week, Governor Gill Marcus emphasized that the new rising rate cycle was likely to be more gradual and less aggressive than previous cycles – confirming our own "lower for longer" view on interest rates that we have held for some time now.

SA equities

Despite the negative EM sentiment, the FTSE/JSE All Share Index proved surprisingly robust, managing to gain 4.3% (on a total return basis) over the quarter as January's loss of 2.4% was more than recouped by buying in February (+4.9%) and March (+1.8%). Corporate earnings proved better than expected, with analysts generally revising upward their earnings expectations for the year ahead. The best-performing sector was basic materials (+8.6%), followed by financials (+6.1%), while industrials and healthcare both lost 1.2%.

SA bonds

Impacted by the SARB rate hike, SA bond yields jumped and the yield curve flattened in January, gradually recovering as global sentiment and risk appetite improved in February and March. Investors in long-dated bonds like Prudential were insulated from the weakness to some extent, and benefited from good returns by quarter-end. After heavy bond sales in January in which the All Bond Index lost 3.2%, foreigners turned buyers - March alone saw net foreign bond purchases of R3.0 billion. The All Bond Index managed to notch up 1.8% in March, for a total return for the quarter of 0.9%.

This masked substantial differences between maturities: bonds below 3-years gained 0.7%, 3-12-year bonds lost 0.5%-0.7%, 20-year bonds were up 3.0% and 30-year bonds gained 4.1%. This demonstrates how the unusually high yields prevailing at the long end of the yield curve have protected investors from losses, despite negative market conditions, and why Prudential's increased exposure to this area benefitted performance.

Forward rate agreements (FRAs) started the quarter pricing in expectations of a total 200bps of rate hikes over the next two years, before jumping to 300bps following the rate hike. As conditions improved, market views moderated back to a consensus of 200bps of rate hikes (with the repo rate at 7.5% by March 2015). In our view, this is still higher than we think likely, given our continued view of interest rates remaining lower for longer compared to previous rate cycles.

For the quarter, inflation linked bond (ILB) yields fell approximately 50bps, mirroring the move in conventional bonds, for a total return of 1.7%. At quarter-end, the market was viewing break-even inflation near 6.75%, which in our view is high, given the subdued global inflation environment, and hence our preference for nominal bonds over inflation linked.

SA Listed Property

Listed property stocks sold off substantially in January, with a total return of -7.1% for the month outpacing bond losses. However, the subsequent attractive yields saw investors return to the market to post a total return of 1.8% for the quarter.

Market valuations and prospective returns

Our views on relative asset class returns remain largely unchanged over the first quarter of 2014: we still prefer equities over bonds and cash. Since we believe interest rates are set to stay relatively low for longer, cash remains an unattractive option.

Our preference in the global fixed income space remains floating-rate corporate credit, even as spreads on US investment-grade and high-yield bonds versus government bonds continued to tighten over the quarter. In our view, this reflects relatively healthy corporate balance sheets, the benign growth outlook, and an absence of significant refinancing needs, all of which should keep default rates below their long-term average. According to Moody's, the default rate on high yield debt in 2013 was 2.9% compared with a long-term average of 4.7%, and a forecast for 2014 of 2.2%. Further modest spread compression is very possible over the next 18 months.

For **global equities**, this quarter has seen DM stocks become more expensive, and EM stocks cheaper: at quarter-end, DM stocks were trading at a forward P/E ratio of 15.4x,versus EM stocks at 10.3x. Despite the DM gains, from a long-term valuation perspective DM equities still appear to be on the cheap side of fair value, both in absolute terms and relative to cash and bonds. EM equities, while offering value, present risks as emerging markets transition to new, slower growth models, and are faced with continuing pressures from falling resource prices, credit bubbles, and negative demographic trends.

During January we took the opportunity to reduce some of our overweight global equity exposure in funds where it had moved above our strategic benchmark, with the rand having weakened to what we saw as fundamentally cheap levels (see comment in Trades section below). Our global asset allocation continues to favour equities over bonds or cash.

For **SA equity**, the ALSI's price-to-book ratio stood at 2.3x at quarter-end, basically unchanged from the end of December as companies continued to deliver good earnings in tandem with their share price gains. At the current level, we believe South African equities continue to be modestly expensive and remain neutral on this asset class. However, for domestic portfolios, local equities' potential real returns are attractive compared to other asset classes.

Following its weak performance in the first quarter, we remain neutral on listed property in our multi-asset funds. At quarter-end, SA REITs were trading on a forward yield of 7.8%, with valuations little changed. We believe listed property is capable of delivering low double-digit returns over the medium-term, while being mindful of the higher risks associated with interest-rate-sensitive assets like property currently.

For **SA bonds**, despite the rate hike the local yield curve remains steep when compared with its own history, so that investors in longer-dated bonds are still amply rewarded for the risk taken. We continue to prefer both longer-dated government bonds and corporate credit, and we do expect these fixed income assets to outperform cash over the medium term, given the attractive combination of assets we hold in our portfolios.

Inflation-linked bonds (ILBs) continue to be somewhat expensive, in our view, against their (long-dated) conventional counterparts although in an absolute sense real yields offer reasonable value as long as the monetary policy tightening is moderate in pace and magnitude. We believe the bond market is still overly pessimistic about SA inflation (with break-even at 6.75%), pricing in a significantly elevated inflation risk premium given the benign global inflation environment. As a result, we remain underweight both ILBs and cash.

Overview of larger trades in our income funds for Q1

- For our global unit trust funds in general, we sold exposure to fixed-rate US High Yield assets and switched into floating-rate US High Yield assets in order to remove interest rate risk from our portfolios in anticipation of rising US Treasury yields over the medium-term.
- In January we took the opportunity to re-balance some of our funds in which the foreign holdings had moved above their strategic allocation targets due to market movements (the weaker rand and strong equity returns in foreign currency terms). We sold some of our foreign equity and bond holdings pro-rata and used the proceeds to buy South African equities and bonds pro-rata. At that point the rand was at its most undervalued level since 2008, making further significant depreciation less likely. A third, more minor reason was that prospective returns from global equities had softened due to their strong recent performance. Following the rebalancing, we remain overweight global equities in funds where possible. (On some portfolios the combination of the nature of the benchmark and absolute return considerations prevents this.)

NOTE: This rebalancing did not apply to the Enhanced Income Fund, given its small exposure to global equity. For the Investment Solutions TAA Fund, the foreign equity holdings were not sold, but currency exposure was hedged with futures. ■