MARKET OBSERVATIONS

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QUARTERLY MARKET COMMENTARY

QUARTER 4 2020

Despite the global pandemic and financial crisis of 2020, it proved to be a surprisingly good year for many investors based solely on the total returns recorded by many different asset classes around the world. The fourth quarter ended on a very buoyant note in financial markets, as investors shrugged off the rising second and third waves of Coronavirus infections and bought up riskier assets, pushing many equity markets to record highs. Investor sentiment was boosted largely by the development and initial rollouts of effective vaccines across large economies like the US, UK, EU, Russia and China, and the election of Democrat Joe Biden as US President. Late December also saw the US Congress' agreement of a fourth stimulus package and the UK and EU's finalisation of a Brexit deal, among other factors. South African equities were carried along by the bullish mood despite the imposition of tighter lockdown conditions, helping the FTSE/JSE All Share Index to end in positive territory for the year (up 7.0% in rand terms).

ASSET CLASS	Total return Q4 2020 (Rand and US$)	Total return 2020 (Rand and US$)
SA equity – FTSE/JSE All Share Index (Rand)	9.8%	7.0%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	11.5%	0.6%
SA listed property – FTSE/JSE SAPY (Rand)	23.6%	-37.5%
SA bonds – BEASSA All Bond Index (Rand)	6.7%	8.7%
SA inflation-linked bonds – JSE CILI Index (Rand)	5.4%	4.2%
SA cash - STeFI Composite Index (Rand)	1.0%	5.4%
Global equity – MSCI All Country World (Total) (US$ net)	14.7%	16.3%
Global equity – MSCI World (Developed) (US$ net)	14.0%	15.9%
Global equity – MSCI Emerging Markets (US$ net)	19.7%	18.3%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	3.3%	9.2%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net)	13.6%	-11.4%

Source: Prudential, Bloomberg, data to 31 December 2020

As shown in the table, in US$ terms, global equities (the MSCI All Country World Index) returned a strong 14.7% for the quarter, with developed market returns lagging emerging markets at 14.0% and 19.7%, respectively. For SA investors, the rand's 12.3% appreciation against a weaker US dollar dented offshore investment returns. Global bonds delivered 3.3% for the quarter, culminating in a surprisingly robust 9.2% return for 2020. And finally, global property posted a significant Q4 rebound with a 13.6% return, but ended the year as the weakest asset class with a return of -11.4%. As in the third quarter, central banks kept interest rates broadly unchanged at very low, accommodative levels, and governments continued to enact fiscal support packages for consumers and businesses.

In the US, investors took heart from President-Elect Joe Biden's Cabinet choices, which partly signalled a return to "safe" Obama-era policies and a vigorous stance on combatting the pandemic. The passage of another round of fiscal stimulus measures, combined with the start of vaccinations country-wide, led many to expect a faster economic recovery.

At its 16 December meeting, the Federal Reserve left interest rates unchanged but pledged to keep them at the current low levels until the economy recovered. Notably, it also raised its forecasts for GDP growth: to -2.4% for 2020 from -3.7% previously; to 4.2% from 4.0% in 2021; and to 3.2% from 3.0% in 2022. The Fed also reported it expects unemployment to continue to improve, falling to 6.7% for 2020 (compared to 7.6% previously), 5% in 2021 (5.5% previously) and 4.2% in 2022 (4.6% previously).

US equity markets hit fresh record highs in December as the S&P 500 returned 12.2% for the quarter and 18.4% for the year as a whole, while the Dow Jones Industrial 30 delivered 10.7% and 9.7%, respectively, and the technology-heavy Nasdaq 100 produced 13.1% for the quarter and a stunning 48.9% in 2020 (all in US$).

In the UK and EU, news was dominated by the approval of effective Covid-19 vaccines and the start of their distribution in both regions. In the last week of the year, the conclusion of a last-minute Brexit deal after over four years of negotiations also lifted stock markets. In the UK, lockdown restrictions were tightened sharply as a new, more infectious variant of Covid-19 was identified, while many EU countries also introduced various new tightening measures. The Bank of England kept its main interest rate unchanged at its meeting on 17 December: despite the eventual positive effects of the vaccines, it cited high uncertainty around growth given December data showing the country's tenuous Q3 recovery nearly grinding to a halt.

Meanwhile, the European Central Bank (ECB) projected that the Euro area's real GDP will contract by 7.3% in 2020, rebounding to 3.9% growth in 2021 and 4.2% growth in 2022. The ECB left interest rates on hold at its 10 December policy meeting, but expanded certain other monetary measures to boost regional economies.

For the quarter, the UK's FTSE 100 returned 17.2%, the German DAX 12.7% and France's CAC 40 12.8% (in US$). For 2020, the FTSE 100 badly underperformed its regional counterparts due to the more detrimental impact of Covid-19 in that country and the uncertainty over a no-deal Brexit. UK stocks ended the year in the red with a -8.7% return, while the German bourse delivered 13.7% and French stocks produced 3.6%.

Asian bourses hit record highs in December amid optimism over the new vaccines, as well as accelerating growth in the region on the back of recoveries in consumer demand and business activity. Chinese industrial output rose 7.7% y/y in November, and Japanese Q3 GDP growth of 22.9% y/y showed a strong recovery underway, even as the government announced a new US$700bn stimulus package. There were even gains for Hong Kong's Hang Seng despite harsh jail sentences given to several high-profile pro-democracy activists under the territory's new security laws. These new laws, introduced earlier in the year, helped keep equity returns for 2020 nearly flat as investors feared further negative repercussions for business activity.

In China, the People's Bank of China (PBoC) left its benchmark interest rate steady at its meeting on 21 December amid the pickup in the economy. The Chinese economy grew by an annualised 2.7% q/q in Q3 2020, with its Manufacturing PMI hitting a decade-high 54.9 in November. The Bank of Japan also kept its policy interest rate on hold at its policy meeting on 18 December amid the ongoing recovery, but extended its special Covid-19 financing programme for businesses by six months.

In the fourth quarter, Japan's Nikkei 225 delivered 21.2%, the MSCI China 11.2% and Hong Kong's Hang Seng 16.2% (in US$). For 2020 as a whole, the Nikkei returned 24.5% and the MSCI China 29.7%, while Hong Kong stocks were subdued with a marginally positive 0.2% return.

Among other large emerging equity markets, in US$ terms South Korea's KOSPI was the strongest performer at 35.4%, followed by the MSCI Turkey with 30.3%, the MSCI South Africa with 22.2%, the MSCI Russia with 22.0% and the MSCI India with 21.2%. For the year, it was the South Korean market that came out on top with a 41.1% return in 2020, and the MSCI China also performed strongly with 29.7%. In US$ terms for the year. The Turkish, South African and Russian markets were in the red, with annual returns of -8.6%, -3.5% and -11.6%, respectively (all in US$)..

The spot price of Brent crude oil closed 26.5% higher from the previous quarter at around US$52 per barrel, propelled higher by expectations of a quicker and stronger recovery in global growth. The gold price rose only 0.3% in Q4 as risk-aversion abated during Q4, but still posted a total gain of 24.3% for the year. Platinum and palladium gained ground over the three months, up 23.0% and 1.9%, respectively. Industrial metals also gained strongly in the last quarter of the year on growth optimism, with copper up 17.1%, aluminium 13.9% higher, nickel rising 15.0% and zinc 12.9% higher.

SOUTH AFRICA ENDS 2020 ON A HIGH INVESTMENT NOTE

In South Africa, a strong resurgence of the Coronavirus locally led to stricter lockdowns, but global risk-on investor sentiment prevailed, putting the local bourse in positive territory for the year. The country closed 2020 with over 1 million Coronavirus infections and 30,000 deaths, the highest on the African continent. Amid a dearth of detailed government plans to acquire and roll out one or more vaccines, market participants worried over the impact of possible rollout delays until mid-2021.

In more positive news, SA GDP growth for Q3 2020 surprised to the upside at 13.5% q/q (6.1% annualised) compared to the 13.1% expected, and Q4 consumer confidence recovered to -12 pts from -23 pts in the third quarter. The South African Reserve Bank (SARB) left the repo rate unchanged at 3.5% during its November meeting, stating that further easing was unlikely in the near term but hinting at increases in Q3 and Q4 of 2021. The central bank is now projecting an 8.0% contraction in the economy for 2020, improving to 3.5% growth in 2021 and a 2.4% expansion in 2022. Inflation also remained subdued, with headline CPI slowing to 3.2% y/y in November from 3.3% y/y in October.

On the credit ratings front, Moody's and Fitch both downgraded SA's sovereign credit rating further into "junk" territory. Moody's lowered the country's rating to Ba2 from Ba1 with a negative outlook, citing further weakening in the country's fiscal strength over the medium term as a main trigger, while Fitch cut the sovereign credit rating to BB- from BB and assigned a negative outlook, citing high and rising government debt as a main trigger behind the cut. Standard & Poor's maintained its credit rating for South Africa at BB- with a stable outlook.

Despite this, Fitch later upgraded South Africa's largest five banks' National Long-Term credit ratings to 'AA+' from 'AA', which it said reflected an improvement in their creditworthiness relative to the best credits in the country. And in another important development, the courts handed the SA government a win in its wage battle against unions, saying that no existing collective agreement with fiscal implications can be enforced if it is not backed by National Treasury.

However, South Africa's manufacturing production fell by 3.4% y/y in October versus -1.9% in September, and the Purchasing Managers Index (PMI), which indicates business activity, edged down to 50.3 pts in November from 51.0 pts in October. It is, however, still above the key 50 point level that separates expansion from contraction.

The BEASSA All Bond Index (ALBI) managed to deliver an impressive 6.7% return in Q4 2020, boosted by foreign investors tempted by South Africa's relatively high yields. Bonds in the 1-3 year maturities lagged longer-dated bonds, flattening the yield curve and partly reversing the trend seen in the earlier part of the year. For 2020 as a whole, the ALBI returned 8.7%. SA inflation-linked bonds returned 5.4% for the quarter and 4.2% for 2020, and cash (as measured by the STeFI Composite) produced 1.0% for the three-month period and 5.4% during 2020.

The FTSE/JSE All Share Index delivered 9.8% in Q4, led by strong gains in Listed Property and Financials.

ASSET CLASS PREFERENCES: 5-YEAR PERIOD

Prudential Best Investment View*

ASSET CLASS	POSITIONING 30 SEPT 2020	POSITIONING 31 DEC 2020
SA equity	Overweight	Overweight
SA listed property	Underweight	Underweight
SA bonds (govt and corp)	Overweight	Overweight
SA inflation-linked bonds	Overweight	Overweight
SA cash	Underweight	Underweight
Foreign equity	Overweight	Overweight
Foreign govt bonds	Underweight	Underweight
Foreign corporate bonds	Overweight	Overweight
Foreign cash	Neutral	Neutral

*Our best investment view preferences are implemented where all fund mandates allow. Positioning will differ in portfolios with constraints in their mandates.

This meant that the ALSI ended 2020 in positive territory, returning 7.0% after losing 30% at its low in mid-March. For the quarter, Listed Property (SAPY Index) was the star performer, returning 22.2%, while Resources shares (J258 Index) delivered 8.3%, Financials (J580 Index) produced 19.5% and Industrials (J257 Index) returned 7.4%.

For 2020 as a whole, the JSE's offshore-focused sectors produced the strongest returns, with Resources at 21.2% and Industrials at 12.0%. Locally-oriented sectors were in the red as Financials delivered -19.7% for the 12 months and Listed Property -34.5%.

Finally, the rand gained good ground against all three major global currencies during the quarter due to ongoing US dollar weakness and the stronger appetite for risk assets, hitting around R14.6/USD in December and near levels last seen in early 2020. The local currency was up 12.3% against the US dollar, 7.3% versus the pound sterling and 8.2% against the euro. Over 2020, the rand depreciated versus the three currencies, losing 4.6% against the US dollar, 9.0% versus the pound sterling and 14.4% against the euro.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

Starting with our view on **offshore asset allocation**, during the quarter we added to our US dollar exposure, selling rand as the rand strengthened against the greenback from around R16.7/US$ to around R14.7/US$ over the three months. This helped to further reduce SA-specific risks and added to portfolio diversification. Otherwise we remained slightly overweight global equities.

Within our global equity positioning, as US equities remained expensive compared to other markets in Q4, our portfolios continue to be underweight the US market in favour of selected European and emerging market equities. We have been aiming to position the portfolios with higher weightings of very high-returning global assets while maintaining a mix of assets that have diversified return profiles.

We remain **underweight developed market government bonds**, although during the quarter we added to our holding in 30-year US Treasury bonds as the yield rose, a position we first took in Q2. We are overweight US and European **investment-grade corporate bonds and selected emerging-market government bonds**, which offer much more attractive real yields.

Our best investment view portfolios continue to be overweight **SA equities.** SA equity valuations (as measured by the Price/Book value ratio of the FTSE/JSE Capped SWIX Index) were trading at around 1.6X at the end of December, up from around 1.4X at the beginning of the quarter, but still very attractive compared to the market's long-term P/B average of around 2.1X.

Within SA equities we continue to prefer large, global companies that offer sound, high-quality diversification such as Naspers, British American Tobacco, Anglo American, Remgro and MTN. Implats is another overweight holding that added to portfolio value in 2020. We have also maintained our overweight in the local banking sector, with exposures to Absa, Standard Bank and Investec given the attractive valuations they offer. Banking stocks rallied strongly in the fourth quarter as the outlook for the economy and consumer financial health improved markedly.

We have kept our substantially underweight positioning in **SA listed property** in Q4. This positioning reflects the significant uncertainty surrounding the outlook for the SA economy and property company distributions, as well as the relatively high debt levels in the sector. The risks around property company earnings remain high, and as such we have ensured that we are holding high-quality companies with strong balance sheets within our small exposure to the sector, like Growthpoint.

During the quarter we maintained our overweight in **SA nominal bonds**, and continue to favour longer-dated maturities even as bonds rallied. As of 30 December, 10-year government bonds yields were still elevated compared to their history, offering around 9.1% compared to 9.6% at the start of the quarter, and equating to an after-inflation (real) yield of around 4.1% (assuming inflation of 5.0% over the next decade). This is substantially above our long-run fair value assumption of a 2.5% real yield. We believe these yields will more than compensate investors for the risks associated with the government's precarious fiscal position and possible further credit rating downgrades.

We kept our overweight exposure to **inflation-linked bonds** during the fourth quarter of 2020. The gap between ILB and cash real yields continues to be very wide, with real yields on cash currently negative. ILB real yields are also attractive compared to their own history and our long-run fair value assumption of 2.25%.

Lastly, our best investment view portfolios remain underweight **SA cash**, since prospective real returns from this asset class are negative. ■