QUARTER 3
GLOBAL MARKET OUTLOOK

Receding growth and rising political tension.

Is it the return of the central bank puppet masters?
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Despite the economic clouds darkening domestically, the second quarter of the year continued to witness an uptick in domestic equity markets. Drilling down further, of the 8 sub-sectors on the JSE all but two have made notable advances in the first half of 2019. The 2 sectors which continue to be plagued by a very tough operating environment domestically as well as ongoing regulatory and margin pressure in their offshore businesses are Healthcare and Industrials respectively. With Healthcare losing almost 20% of its value thus far in 2019 and domestic Industrials losing just under 6%, it is apparent that it has not just been plain sailing with a rising tide lifting all boats. Stock specific issues at Aspen, Netcare and Mediclinic as well as declining volume growth at a number of domestic facing Industrial businesses have continued to keep investors at bay. Domestic GDP data released during the course of June provided some insights into just how tough an environment it has been locally with the economy contracting by 3.2% during the first quarter of 2019. Such a poor growth outcome has continued to result in elevated unemployment (remaining stubbornly high at just below 30%) weighing on consumption driven demand and ultimately business confidence. With many JSE management teams of domestic businesses indicating that the current environment is even tougher than the global financial crisis of 2008/09, it is no wonder that such businesses continue to battle to grow volumes, pass on cost increases onto customers and escape the quagmire of negative sentiment weighing on their ratings. When all is considered, the below table provides a summary of how all major sub-sectors on the JSE have performed year to date and how this has impacted longer dated performance:

<table>
<thead>
<tr>
<th>SA INDICES</th>
<th>1 Month</th>
<th>3 Months</th>
<th>6 Months</th>
<th>1 Year</th>
<th>3 Years (Ann)</th>
<th>5 Years (Ann)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BASIC MATERIALS</td>
<td>10.16%</td>
<td>2.41%</td>
<td>20.88%</td>
<td>21.46%</td>
<td>20.67%</td>
<td>6.54%</td>
</tr>
<tr>
<td>CONSUMER GOODS</td>
<td>8.43%</td>
<td>5.63%</td>
<td>18.71%</td>
<td>-5.10%</td>
<td>-4.86%</td>
<td>0.91%</td>
</tr>
<tr>
<td>TECHNOLOGY</td>
<td>4.36%</td>
<td>2.80%</td>
<td>5.02%</td>
<td>20.04%</td>
<td>-14.37%</td>
<td>-6.15%</td>
</tr>
<tr>
<td>TELECOMS</td>
<td>4.12%</td>
<td>18.65%</td>
<td>15.94%</td>
<td>7.24%</td>
<td>-3.95%</td>
<td>-5.75%</td>
</tr>
<tr>
<td>FINANCIALS</td>
<td>1.29%</td>
<td>5.44%</td>
<td>4.96%</td>
<td>5.66%</td>
<td>6.22%</td>
<td>7.09%</td>
</tr>
<tr>
<td>CONSUMER SERVICES</td>
<td>0.59%</td>
<td>4.00%</td>
<td>6.23%</td>
<td>-6.70%</td>
<td>9.04%</td>
<td>15.37%</td>
</tr>
<tr>
<td>HEALTHCARE</td>
<td>-0.53%</td>
<td>-8.26%</td>
<td>-19.91%</td>
<td>-41.52%</td>
<td>-25.72%</td>
<td>-12.78%</td>
</tr>
<tr>
<td>INDUSTRIALS</td>
<td>-4.14%</td>
<td>-2.02%</td>
<td>-5.84%</td>
<td>-10.75%</td>
<td>-0.62%</td>
<td>0.43%</td>
</tr>
</tbody>
</table>

Source: Iress, 27four Investment Managers
What is apparent from the table above is that a stagnant economy for some time has continued to weigh on the SA facing Industrial sector with returns lagging the majority of sub-sectors over all periods up to 5 years annualised. With such harsh economic conditions continuing to weigh on investment, employment, sentiment and growth, the interest rate cut provided at the start of the third quarter is likely to provide some reprieve for investors, consumers and businesses alike. The chart below provides an indication of the individual shares that have driven overall Capped SWIX performance year to date in 2019:

![Top 10 And Bottom 10 Contributors To Capped SWIX Absolute Return](image)

Source: Iress, 27four Investment Managers

When breaking down the numbers presented above what is staggering to note is that 5 Rand hedged shares (NPN, AGL, IMP, AMS and CFR) have generated two thirds of the total return delivered by the Capped SWIX Index year to date. When combined with the fact that 8 out of the bottom 10 detractors from performance are domestic facing businesses, further evidence is presented of just how damaging a stagnating economy has been for investors and businesses alike. What is clear is that investors continue to seek out high liquidity global exposure on the JSE irrespective of a Rand which has held firm against the Dollar as developed market investors have continued to seek out yield. As investor angst remains elevated, market participants continue to seek out exposure with some prospects of picking up on any growth in the global economy and have shunned domestic exposure with little prospects of a supportive backdrop. In addition to this, liquidity has been completely sucked out the market like a vacuum with investors only sticking to trading liquid baskets. This has resulted in a great deal of frustration for asset managers holding a number of mid-cap opportunities of what they believe to be great businesses from a bottom-up perspective. In an environment of diminishing liquidity and investor skittishness with foreigners being net sellers of JSE equities to the tune of almost R42 billion year to date, there has been no marginal buyers of such mid-cap businesses irrespective of the opportunity they present given no new marginal buyer in a low liquidity highly skittish environment. The chart below provides some indication of the extent to which liquidity has diminished on the JSE with volumes traded falling some 40% from their peaks in early 2018 during the “Ramaphoria” rally. Value traded has declined by some 25% over the same period.
Given this unsupportive backdrop, there will need to be some kind of external catalyst which results in value being unlocked from a number of the domestic facing businesses listed on the JSE. It is broadly accepted that in order for positive momentum to prevail in these shares, South Africa needs to resolve the 3 pressing “E’s” as follows:

1. **Earnings growth:** A reversal in fortunes for earnings for these companies will result in greater interest and more committed capital being allocated to these shares. Earnings growth for a number of these businesses requires some level of support from the economic backdrop.

2. **Eskom to stabilise:** Without a stable and dependable electricity supply there is unlikely to be large scale fixed investment in South Africa to drive higher business and consumer confidence to spur growth. This is notwithstanding the well documented pressure Eskom continues to place on government finances.

3. **Easier monetary policy:** The hope is that lower interest rates will spur increased consumption and lift earnings for a number of domestic companies by the bootstraps.
What businesses and investors will ultimately be hoping is that an interest rate cut by the Reserve Bank can stimulate the following positive reinforcement cycle:

- **Interest rate cut provides reprieve to indebted consumers and increases consumption**

- **Increased consumption drives earnings growth for embattled domestic Industrial stocks**

- **Earnings growth and improved operational performance spurs greater investment from such companies**

- **Government spending can increase which drives further growth through the multiplier effect**

- **Increased tax collections alleviates some of the strain on the fiscus**

- **Greater investment creates jobs and increases company profitability which increases tax collections**

With inflation expectations now becoming anchored at or near the mid-point of the target band for the foreseeable future, the Reserve Bank felt comfortable reducing interest rates in order to stimulate the economy. Given the complete lack of demand push inflation, as evidenced by a mere 0.89% nominal growth in retail mortgages and instalment credit year on year in South Africa, market participants have come to perhaps expect further monetary stimulus from the Reserve Bank with potentially another interest rate cut before the end of the year. This might prove to be overly optimistic as Governor Kganyago reiterated that monetary policy cannot be a silver bullet to fixing the economy. Ultimately structural reforms need to be implemented by government which may result in some further short-term pain. While the monetary policy committee has lowered their expectation for inflation very marginally from 4.5% to 4.4% for 2019, it has remained unchanged for 2020 and 2021 at 5.1% and 4.6% respectively. Ultimately then, further interest rate cuts may very well depend on the pace of easing by major central banks globally enabling South Africa to lower policy rates while still maintaining a yield spread and preventing a rapid outflow of capital and inflationary depreciation of the Rand. Ultimately in the overall context of the domestic equity market, a concentrated rally during the first half of the year has ensured that opportunity continues to be presented. With prices remaining in check and earnings growth remaining moderate over a grouping of a number of diversified companies, inves-
tors will be well poised to remain invested, ride out bouts of short term volatility and enjoy the fruits of equity market appreciation over the long term. One salient point to note is that inflation has moderated sharply in South Africa over the recent past. What this means for risk asset returns is that natural uplift in earnings over time due to inflationary increases and returns on investment for companies deploying capital are likely to be lower thus translating in possibly a lower absolute return from equities over the short to medium term than previous cycles but this would still ultimately translate into the same, if not slightly higher, real return above inflation that equity market investors have come to expect over the long term. The chart below shows how the current dividend yield of the market excluding Naspers stacks up relative to history. On this metric, the equity market is the most attractively priced that it has been since the global financial crisis indicating a healthy level of cash generation and total return to shareholders despite a challenging growth environment. When looking at trailing P/E multiples, the equity market continues to flag as attractively priced with trailing P/E multiples being the lowest they’ve been in some 6 years.

While these enticing valuations have attracted a number of investors to become increasingly bullish on the outlook for equities, investors would be best advised to remain exceptionally cautious in proceeding and remaining ever vigilant of being caught in value traps or companies with no real credible plan of emerging from a tough operating environment. The market has been exceptionally harsh on those poor quality companies trapped in a spiral of increasing debt in order to offset declining operational performance and no end in sight of how to emerge from a decline in profitability. These companies are generally excessively leveraged to the domestic economic environment with very few levers to pull in order to drive growth internally or adjust the strategic direction of the company. These are often companies which sell commoditised products with little scope for differentiation, no material control over total supply in the market and very thin operating margins. Often overcoming the confluence of so many negative operating factors proves too great a burden for a company and when combined with poor management directing capital allocation, a spiral of excessive debt crippling operational performance of the company and weighing on free cashflow and cash profits attributable to shareholders become inevitable. While there has been a number of such companies which have come to light domestically over the course of the last 2 years, perhaps the most relevant currently is Tongaat Hulett. With the company selling a commoditised product in the form of sugar and completely losing control of supply in South Africa with the relaxation of import tariffs on sugar flooding the market with supply, margins and Cashflows within the business continued to come under strain. This placed a great deal of strain on the business and ultimately resulted in escalating debt at the same time as cashflows came under pressure. In addition to this, questionable accounting practices regarding the booking of profits from the property division within the business has ultimately resulted in what is a likely permanent impairment to capital from an almost 80% decline in the
share price over the course of 2019 to the
time the shares were suspended in June. Ulti-
mately, the takeaway lesson is that there is no
price at which such a poor quality investment
should be considered an attractive opportunity
and investors are best advised to stay away.
Perhaps the greatest tell-tale regarding the
poor quality nature of Tongaat was the ex-
tent to which headline earnings differed from
Cashflows from operations. While completely
compliant with IFRS reporting, adjustments
incorporated into headline earnings and ac-
counting profits including accounting for land
sales before proceeds were received as well as
accounting for non-cash sugar cane valuation
uplifts all served to increase accounting profits
for the company without actually realizing any
cashflows to shareholders of the business. The
chart below summarized the differences be-
tween headline earnings relative to Cashflows
from operations and investing for the com-
pany since 2010:

Ultimately the almost R8 billion in net debt
accumulated by the company was almost 4.5
times greater than the market capitalisation
of the company at the time the shares were
suspended for trading on the JSE.

While not as extreme as the rapidly deterio-
rating quality and prospects for Tongaat Hu-
ett, another way to demonstrate the impor-
tance of being conscious of quality no matter
what the valuation of the company might be
can be found when comparing domestic banks
to retailers. Both sectors are ultimately lev-
eraged to the state of the domestic economy
and are reliant on a strong economy driving
employment growth as well as consumption
and investment demand. One would then ex-
pect that both companies would have been
subject to impaired performance given the
fragile economic backdrop which would have
in turn impacted share price movements over
the recent past. The chart below demonstrates
how banks have performed relative to retail-
ers since Nenegate in December 2015:
Apart from a very brief period of Nenegate in December 2015, a 3 month period at the back end of 2016 and the second half of 2018, there has been consistent outperformance of domestic banks over their retail counterparts. With banks continuing to grow their earnings in the high single digits to low double digits across the board (even amongst the worst performing banks) coupled with maintaining healthy returns on equity well into the double digits, the banking sector has managed its way through a tough operating environment in a far superior way to the retailers. This has resulted in such businesses maintaining if not increasing their dividend yields should there not be scope for reinvestment given the ailing economy and with the stable operational performance supporting margins and managing of credit books, total returns to shareholders have been supported in a far more sustainable manner than those available in the retail sector. Ultimately, higher quality businesses with better quality management facing similar issues of a stagnant economy has resulted in a far superior outcome once again highlighting the fact that it’s not purely valuations that should entice investors. Notwithstanding this fact, the banking sector continues to offer attractive valuations when compared to the overall market and given its improved operational performance when compared to retailers may continue to find ongoing support from investors looking to nibble their way back into domestic facing businesses. The chart below provides an indication of just how attractively valued the sector is currently when compared to history:

Source: Iress, 27four Investment Managers
Yet another example of a higher quality stock with exposure to the domestic economy which has reaped rewards for investors is Multichoice. The company delivered an impressive set of numbers in their maiden set of results as a standalone company with a 6% increase in revenue to R50.1 billion. Perhaps more importantly, the company continued to report robust subscriber growth despite the challenging economic times domestically and pressure on their premium packages. As evidence of the tough operating trading environment weighing on the company like any domestic facing business, average revenue per user continued to decline in South Africa falling from R335 a month in the 2018 financial year to R322 in 2019. Ultimately, the subscriber base grew by some 500 000 users in South Africa. Notably, subscribers in Africa (7.7 million) surpassed subscribers in South Africa (7.4 million) for the first time ever given the Africa business adding in excess of 1 million subscribers in the 2019 financial year. What is then evident is that a stagnant domestic economy has resulted in consumers continuing to be added but in the lower package segments given the falling average revenue per user. This highlights the importance of capital allocation and strategic management who consciously decided to segment the market and offer more value based packages in addition to investing in rolling out such packages particularly across Africa. Such an investment is now paying dividends with losses on the African business narrowing given subscriber growth and in addition the South African business has held up on the back of additions within the value segment. An ongoing effort to reduce losses in the African business and concerted effort on cost containment, keeping cost increases below revenue increases, resulted in trading profit increasing by 10% and consolidated free cashflow doubling to R3.3 billion.

Ultimately, when weighing up risk vs. return and how to position your portfolio within domestic facing businesses, Multichoice stacks up exceptionally favourably on the risk end of the spectrum given the high quality nature of the company and the very definitive path towards improving profitability and resuming dividends to shareholders when compared to a leveraged domestic Industrial company or Retailer. The chart below provides some insights as to both the gross and operating margins of the business which are exceptionally healthy and the ongoing delivery of the targets stated by management to narrow losses from the African business. The difference between the gross profit and operating profit margins indicates an ability to achieve ongoing efficiencies in delivering favourable outcomes for shareholders. This was probably most unfortunately highlighted when Multichoice announced that they would be retrenching 2000 employees given investment in alternate ways of interacting with and servicing clients. In addition to the healthy margins and strong free cash generation from the company, the company has a very definite moat in that content costs account from some 41% of total costs to the business which is a significant barrier to entry for competition. With below 1% economic growth in South Africa and Africa facing other infrastructure problems, there is unlikely to be significant competition to such a business and even where there is competition the quantum of spend on content is always a very fine balance in having the right content and not over-paying such that a return on investment cannot be achieved.
Perhaps the most critical driver of Multichoice’s future success lies in the ability to be able to get the Africa business to break-even in the foreseeable future and eventually profitability in the next 3 years. To this end, the company has 2 definitive advantages over their competition:

1. **Experience of operating in Africa:** To this end, Multichoice has learnt many lessons about what capital allocation decisions are worth taking and which are not. Managing content spend of international sport at the right level and balancing this with the appropriate amount of local content spend which is vital in the African market is a key lesson. As evidence of this, local content is a mere 13% of the total content broadcasted but has a 26% share of what is actually consumed across Africa. In South Africa the local content market share is as high as 33%. Local content spend is just under 40% of total content spend for the group.

2. **DTH (Direct to Home) Vs. DTT (Digital Terrestrial Television):** Important differentiator in reaching urban, densely populated regions as well as more rural areas. As much as 46% of Africa subscribers on DTH technology (constituting 82% of Africa revenues). Concurrently, roll out of DTT technology is critical in servicing the mass market segment across Africa in a cost efficient way and offer specific local content in specific languages in areas speaking different languages. Multichoice is largely through their major capex cycle of migrating to DTT within the large African countries.

Source: Company annual reports, 27four Investment Managers
While it is evident that Multichoice is a much higher quality, much lower risk access point to a recovery in the South Africa Incorporated component of the market, there is ultimately no free lunch as the stellar performance of the share since unbundling from Naspers has implied that a lot of positivity is ultimately priced into the share.

While the global yield carry trade continues to be very positive for South Africa, there are signs that funding pressures on the South African fiscus are having an impact with the yield curve steeping somewhat coming into the second half of the year. When one considers that Moody’s, who are the last major rating agency to have South Africa on an investment grade credit rating, are coming out with an updated review of South Africa’s credit rating in November, there is likely to be heightened volatility within bond markets leading up to this point. Ultimately the outlook for the update is looking somewhat precarious with our own Reserve Bank slashing expectations for growth from 1% to 0.6% for 2019 and only modestly recovering to 1.8% in 2020 and 2.1% thereafter, well below the 3% targeted growth promised by President Cyril Ramaphosa. In addition to this, when one considers that Moody’s already adds back all Eskom debt back onto the sovereign balance sheet in their calculations of debt to GDP given the ongoing willingness of the sovereign to continue to bail out Eskom with cash injections, it appears that their assessment of debt to GDP is likely to exceed 70% well above the 60% consolidated target communicated by Finance Minister Tito Mboweni. Considering such factors, it would seem appropriate that financial markets have already priced South Africa as sub-investment grade. This is exactly the case as depicted in the chart below:

<table>
<thead>
<tr>
<th>International Credit Rating</th>
<th>India</th>
<th>Indonesia</th>
<th>Russia</th>
<th>Mexico</th>
<th>South Africa</th>
<th>Brazil</th>
<th>Turkey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: Prescient Investment Management, Bloomberg</td>
<td>BBB-</td>
<td>BBB-</td>
<td>BBB-</td>
<td>BBB+</td>
<td>BB</td>
<td>BB-</td>
<td>B+</td>
</tr>
</tbody>
</table>
While Brazil is rating one notch below South Africa, the sovereign risk premium is line with that of Brazil. This would thus indicate that markets are already expecting a credit rating downgrade for South Africa from Moody’s and when one considers that South Africa now offers just over 4% currency risk premium and assuming that purchasing power parity holds over the long term with US inflation at between 1.5% and 2%, there is an implied inflation rate of 6% for South Africa. This would seem to indicate some further value in South African bonds given inflation at the mid-point of the target band which is further supported by nominal yields in South Africa being higher than those of Brazil despite the superior credit rating.

While the risk that Eskom poses to the South African fiscus continues to dominate the headlines domestically, there continues to be a sense of unease regarding the risks posed by domestic nominal bonds. With debt to equity rising sharply at the state owned entity (from around 1.4 times in 2015 to 2.4 times at the last reported results) and invoiced municipal arrears debt continuing to climb (in excess of R16 billion at the last reported financials) the entire country remains on tenterhooks with regards to how the crisis at Eskom is going to be resolved. Coupled with ongoing leadership challenges faced at the utility with the departure of the 7th CEO in the last 5 years, the board, management team and Public Enterprises Minister continue to have their work cut out for them in restoring the utility to stability. Ultimately however, global investors appear to continue to look through this noise and the risk to South African finances as the bond market continues to be the beneficiary of strong inflows year to date. Renewed dovish sentiments from all major global central banks has continued to lay the groundwork for a global search for yield and a compression in yields across the globe. The chart below provides an indication of how favourably South Africa stack up on a real yield adjusted differential basis when compared to the US. What is evident from this chart is that while yield spreads continue to remain wide when compared to the US, this differential has remained above the long term average for some time and what is perhaps more noteworthy is that this differential has been range bound above this trend for some two years now and given the strong rally in yields witnessed thus far in 2018 we are somewhere near the lower end of this range bound spread of the last two years. Ultimately however, this yield spread argument is likely to maintain relevance and support inflows into the bond market as long as interest rates globally remain at abnormal levels.
Global financial market prices during the second quarter ultimately remained all about the expectation for central banks to keep policy accommodative. Statements made by the U.S. Federal Reserve during the course of the quarter when deciding to keep interest rates on hold assured markets that the central bank remains ready to react to any deterioration in economic data given the lack of inflation within the world’s largest economy. The European Central Bank, the Bank of England and the Bank of Japan all followed suit in keeping policy accommodative and flexible ultimately laying the ground work for all central bankers to do the same and provide a strong boost to global risk assets as bond yields compressed sharply across the world. This ultimately propelled equity markets to record highs with benchmark gauges such as the S&P 500 surpassing the 3000 point level for the first time ever intra-quarter.

As corporate profits in the US stagnate after a decade of soaring, it seems that central bank support by keeping interest rates low is a crucial component to keep driving equity markets higher. To put some of the numbers into context, corporate profits in the US have risen by some 455% over the course of the last decade to ultimately result in profits as a share of GDP being 35% higher today than their long term average. Approximately 33 cents of every $1 of global corporate profits are generated by US firms with these companies generating $1 billion in profits every 5 hours. The supportive backdrop for US corporates saw US annual corporate profits peaking at 12% of GDP but that number has now stagnated at 10% of GDP since 2012. The chart below shows how US corporate profits as a share of GDP accelerated until 2012 and have since plateaued:

Source: The Economist, “After years of plenty America Inc is struggling to crank out more earnings”

One of the reasons sighted for slowing corporate profit growth has been the impact of reversing the gains made by globalisation over the course of three decades more recently. With increased anti-free trade rhetoric been bandied about as evidenced by escalating trade tensions between the US and China impacting corporate activity with non-US share of profits at US based companies falling from 35% a decade ago to 25% today, the reverse in the major tailwinds to earnings growth appears to be structural. In addition to this, when investors consider that a materially tighter labour market within the US has resulted in wage bills increasing by some 5% last year, it appears that in addition to slowing top line growth, margins are also likely to come under increased pressure after expanding to unsustainable levels over the course of the last decade. Ultimately, it appears that there is likely to be an ongoing reversal of the strong outperformance of earnings growth relative to GDP growth which has been witnessed for some time now and possibly resulted in increased concentration of wealth in the hands
of providers of capital. Finally, the sheer volume of debt racked up by corporates has almost forced the hand of the Federal Reserve to keep interest rates low in order to avoid excessive debt burdens and servicing costs from strangling corporates. To put the quantum of debt into context, corporate debt to GDP has risen to 74%, well in excess of the peak in 2008 and with 40% of the stock of debt in highly leveraged companies’ hands; the gravity of the debt problem is put into perspective. Anecdotally, companies have been making concerted efforts to reduce the amount of leverage more recently. One of the companies attracting the greatest amount of scrutiny with regards to the amount of debt hindering the operational ability of the company is brewing giant Anheuser Busch Inbev. Despite the fact that the company is responsible for producing 1 in every 4 beers sold globally, a mounting debt pile of around $106 billion after being highly acquisitive in their growth strategy raised significant concerns from investors as beer market share across the world and particularly in the US came under significant pressure falling from around a 60% market share to around a 40% market share currently. With beer market shares and volume growth coming under pressure, share prices in the world’s largest brewer came under significant pressure at one point leading into 2019 and as a consequence the company was forced to address market concerns regarding the debt profile. With total debt coming in at 4.6 times EBITDA, concerns from the market were valid. What has ultimately been committed by the company is to reduce that leverage to 4 times EBITDA by the end of 2020. With the company receding on plans to list the Asian business in a separate IPO in Hong Kong earlier in the 3rd quarter, alternate arrangements needed to be made to raise somewhere in the region of $10 billion to reduce the debt pile. Eventually the Australian business was sold off to Asahi brewers in Japan for a price tag of $11.3 billion. With the company indicating that the full value of the proceeds will be used to pay down debt and further commitments to cut net debt down further to $80 billion bringing the net debt down to the targeted level 12 months ahead of schedule.

There have been a number of factors which have weighed on the ability of equities to deliver even better performance over the recent past. While increased leverage and declining capital allocation efficiency with regards to the rate of increased profitability for marginal changes in invested capital have been two of the major factors hindering further gains in equity returns, bouts of severe geopolitical tensions such as the flaring up of US and China trade tensions, a disorderly BREXIT process or ongoing tensions between the US and Iran have been some of the other factors contributing to the heightened uncertainty weighing on equity markets. The chart below quantifies the impact of this uncertainty and to what extent it has weighed on developed market risk assets outside of purely the expectation for equity market growth:
Ultimately, global investors remained fixated on the following themes in the short to medium term:

**Theme 1**

Becoming accustomed once again to a low yield world and the distortions on asset prices:

With global central banks once again turning exceptionally dovish, bond yields globally have once again sharply compressed. What this has ultimately meant for risk assets is that equity prices have pushed sharply higher once again expanding trading valuations into somewhat expensive territory especially within the US. While growth remains paramount to the outlook for global equities to this point given these extended valuations, companies that are able to deliver on the expectation of growth are likely to be rewarded richly given the declining discount rate making any level of earnings growth exponentially more valuable in an equity security valuation given the markedly lower discount rate. The converse of this is that any company unable to deliver material earnings growth is likely to be excessively punished as market uncertainty heightens and investors are likely to flock to the comfort of growth or high cash generation while the opportunity cost of not being overly exposed to the greater certainty of fixed income assets remains low. The greatest drawback of having such lower interest rates for the time being is the ongoing pressure on global central banks to keep interest rates at low levels as the investor community and the economy overall becomes increasingly less resilient to the prospects of higher rates pushing up the cost of servicing debt or increasing the equity discount rate in a more normalized world resulting in the perverse outcome of very severe reactions from investors with regards to de-rating asset prices at the first prospects of higher rates. The greatest conundrum for investors in such an environment of lower rates for longer is what role fixed income securities would play in their asset allocation portfolios. With income levels remaining very depressed given the low yield environment and the prospects of earning greater dividends from being invested in equities, investors have very little reason to remain invested in fixed income other than as a hedge against short term equity market volatility given increased macroeconomic uncertainty with heightened geopolitical tensions and the ongoing threat to corporate profitability as a result of a slowing global economy. The chart below provides an indication of just how severe the low yield environment really is and how entrenched it has become with as much as 50% of all global developed market bond yields now trading at a yield below 1% with around about half of that stock of debt trading at a negative yield.

![Global Developed Market Government Bond Yield Distribution](source: Bloomberg, 27four Investment Managers)
Chinese economic growth remains critical especially to the prospects for emerging markets: What is becoming abundantly clear is that the global economy and emerging markets in particular remain highly dependent on ongoing robust economic growth out of China. Whether the reason for this fixation on Chinese growth is to provide some degree of comfort that geopolitical tensions between the world’s two largest economies are not about to derail the global economy or if it is to provide comfort to consumers and entire economies across the globe that the growing consumer market out of China remains robust and will continue to demand output at a prolific rate, Chinese economic growth numbers appear to be scrutinised in antagonising detail each quarter. While the latest GDP print out of China for the second quarter of 2019 came in at 6.2%, its lowest level in three decades, market participants continue to expect ongoing stimulus out of Beijing to manage any slowdown in the world’s second largest economy. The implication of such a growth number is a sign that the trade tensions with the US are having a meaningful impact on Chinese economic growth. Confidence in both the corporate and household sector is currently running low —one reason why the current recovery appears anemic, even after significant stimulus in late 2018. Chinese policymakers are likely to revert to trusted tools such as infrastructure spending and other fiscal stimulus to counter the slowdown. Significant monetary easing or a sharp currency depreciation is unlikely. This would run counter to Beijing’s prime objective to maintain financial stability and prevent a rerun of the destabilising capital outflows seen in 2015-2016. Estimates of the net impact of the rising trade tensions on economic growth vary and are often based on models that find it difficult to quantify the fallout of trade disruptions. This suggests risks could be skewed to the downside. The shake-up of longstanding supply chains could disrupt corporate spending plans, while a softer job market could pressure consumer spending. The chart below provides an indication of the efforts made by the government to ramp up stimulus within the Chinese economy as trade tensions with the US began to escalate. Investors can expect more of the same action going forward.

**Chinese Stimulus In Response To Rising Trade Tensions**

Source: Blackrock Investment Institute
The relevance of emerging market allocations in any global portfolio: While the great benefit which investors have reaped from emerging markets over the last 3 decades has primarily been a narrative of a convergence of emerging economies to those of the developed markets as these economies increased investment, reaped the rewards of increasing productivity and then ultimately grew at a much more rapid rate on a GDP per capita basis, the structural underperformance of this grouping of economies both from a growth and stock market performance perspective over the more recent past has raised a lot of pertinent questions from global investors as to whether this narrative still holds and if global emerging markets still have relevance in a portfolio of global assets. Perhaps once of the greatest hindrances to emerging markets of late has been the slowdown in China given how critical this economy has been to the merging market narrative. Through the emergence of the commodity super cycle, the rise of global supply chains and increased cross border trade, emerging market economies enjoyed a golden period of rapid growth, increasing profitability and increased capital inflows. Perhaps the greatest misfortune is that these emerging market economies did not effectively use these golden years to implement structural reforms that would stand them in good stead during the leaner times when an element of de-globalisation occurs and China begins to slow as is the case in the current day economy. With global uncertainty and volatility heightened and with developed market economies actually outperforming emerging market economies with respect to GDP per capita growth rates in real terms ever since 2015, investors are left disillusioned by the emerging market narrative and left wondering whether the golden period witnessed by these economies over the course of the last 30 years is an exception rather than a structural shift. The chart below provides a summary of how foreign direct investment into emerging markets has faltered over time which has ultimately resulted in slowing relative growth and reduced sustainable company profitability and earnings growth in composite. This has been the primary driver behind deteriorating emerging market stock market performance over the recent past. It should be noted however that these statistics are in aggregate and there still remains individual markets and assets who have managed to buck this trend and perform extraordinarily well.

Source: The Financial Times, "Does investing in emerging markets still make sense?"
## Asset Allocation

### Outlook Summary

**How to read this table:**

- Previous allocation (as of Quarter 2 2019)  
- Current allocation (as of Quarter 3 2019)

<table>
<thead>
<tr>
<th>Comments</th>
<th>Max Weight</th>
<th>Underweight</th>
<th>Neutral</th>
<th>Overweight</th>
<th>Max Weight</th>
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<tbody>
<tr>
<td>SA Equity</td>
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<td>SA Bonds</td>
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<td>SA Inflation Linked Bonds</td>
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<td>SA Listed Property</td>
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<td>SA Cash</td>
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### SA EQUITY

<table>
<thead>
<tr>
<th>12 month expected risk</th>
<th>12 month expected return</th>
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</thead>
<tbody>
<tr>
<td>8% - 10%</td>
<td>10% - 12%</td>
</tr>
</tbody>
</table>

#### Economic Factors and Variables Used
- Forward dividend yield
- Earnings growth expectations
- Forward P/E multiple

#### Resultant Positioning
With dividend yields on the All Share Index currently at around 3% and earnings growth expectations for the market in composite at between 7.5% and 8% for the next 12 months, this provides a base return of between 10.5%-11%. Given equity multiples on a forward basis at under 12X earnings (in line with the long run average multiple of the JSE) there is no de-rating in multiples that is expected to impair this return given the reasonable scattering of companies with the ability to compound earnings and returns into the medium term. While there has been notable multiple expansion over the course of 2019 to date which has supported stronger than expected returns, it would not be prudent to assume further multiple expansion in composite giving the building macroeconomic headwinds and concerns likely to affect investor sentiment.

### SA CASH

<table>
<thead>
<tr>
<th>12 month expected risk</th>
<th>12 month expected return</th>
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<tbody>
<tr>
<td>0% - 2%</td>
<td>6% - 8%</td>
</tr>
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</table>

#### Economic Factors and Variables Used
- Repo rate

#### Resultant Positioning
With the higher weighted average duration money market funds currently yielding around 7% and interest rates not expected to move more than 1% in either direction over the next 12 months, this provides a fairly stable backdrop to anchor return expectations for money market to in line with where they currently stand with a possible bias to very marginally lower should we receive another interest rate cut.
### SA INFLATION LINKED BONDS

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>• Inflation</td>
<td>With the latest inflation print coming in at around 4.5%, coupon adjustments will provide this return to bond holders. Real yield compression across the entire inflation linked bond curve continues to persist making shorter dated instruments even more attractively priced and bringing longer dated instruments more in line with long term inflation assumptions. Given the disappointing performance relative to nominal bonds for more than 18 months now valuations overall (even on the longer end of the curve) have become more interesting.</td>
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<tr>
<td>• Inflation</td>
<td>With nominal yields on 10 year bonds currently around 8.5%, bond yields would need to move materially higher or lower resulting in a capital gain or loss event for returns to deviate substantially away from current yields. With nominal bonds offering a 4% real return on the 10 year bond and real yield differences relative to global developed market bonds high it is difficult to foresee an environment which results in a significant increase in yields and consequent impairment to returns. Further action from global central banks remains critical to sentiment, foreign flows and hence this total return argument. It appears for now the Federal Reserve has become increasingly dovish which could support the yield compression witnessed thus far in 2018. Investors should however continue to trade actively on big yield moves even in this more supportive environment.</td>
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### SA Listed Property

**Economic Factors and Variables Used**
- Current distribution yields
- Distribution growth expectations
- Price/NAV

**Resultant Positioning**
When one considers that of the total return of 241% delivered by the listed property sector over the course of the last decade that 172.5% of this was driven by distributions, some context is given as to how crucial distribution payments are for the sector. With current yields in the region of 9% and distribution growth in the low single digits expected on a forward looking basis, the sector is poised for high single digit returns assuming no further de-rating of prices relative to NAV. The degree of unsustainable one off measures to boost distribution growth has been a concern and still needs to be completely worked out the base. Edcon and its direct and indirect impact on the sector remains an additional medium term risk.

### Offshore Equity

**Economic Factors and Variables Used**
- Forward dividend yield
- Earnings growth expectations
- Forward P/E multiple

**Resultant Positioning**
With mid to high single digit earnings growth forecast for global equities in composite for 2019 and a current dividend yield of 2%, returns are likely to come in at high single to low double digits in US Dollar terms in the absence of any material change to ratings. P/E multiples have once again expanded considerably after a strong rally in global equities through 2019. The expanded multiples will need to be warranted through earnings delivery on an ongoing basis which given the relatively robust although slowing marginal rate of growth within the US and global economy is not out the question.
### Offshore Bonds

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**Economic Factors and Variables Used**
- Global inflation
- Global interest rates

**Resultant Positioning**
While the recent reversal to highly accommodative and dovish central banks has placed an anchor on bond yields, interest rate sensitivity of the asset class has increased with the lower levels of bond yields across the world. Total returns are completely dependent on the ongoing support from global central banks to deliberately keep rates artificially low. The quantum of negative yielding debt continues to be a source of significant risk for global fixed income investors.

### Offshore Listed Property

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**Economic Factors and Variables Used**
- Current distribution yields
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**Resultant Positioning**
With distribution growth of between 4% and 6% expected for 2019 coupled with a current yield of around 4% in composite, an attractive return is arrived at for global listed property. When combined with the fact that global property trades at around an 8.5% discount relative to net asset value with improving fundamentals, this low double digit base case return is likely to be supplemented by a further price appreciation relative to net asset value.
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