THE LEAN YEARS DON'T LAST FOREVER

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Political concerns have dominated markets in recent months. It has mostly been US President Donald Trump throwing his weight around (tariffs, Iran, North Korea), but in the past week Italy has been the source of market unease. The attempt by Italy's two populist parties to form a government including an anti-euro finance minister was blocked by the Italian president. The issue is not the instability of Italy's governments. After all, the country has on average changed government once a year since the end of World War 2. The issue is that Italy is now a key part of the Eurozone (its third largest economy, in fact), and any hint that a new government might pull out of the single currency will cause chaos. Unlike 'Brexit', where the UK will continue to use the pound once the UK exits the European Union, an 'Italeave' or 'Quitaly' event would result in the redenomination of all debts, assets and contracts into a new, probably weaker currency.

We saw this movie with Greece between 2011 and 2014, but Italy is much bigger and systemically more important than Greece. It is too big to fail, but also too big to bail out, as often noted. However, this also means that Italy is much less likely to take the painful choice of leaving the euro (Greece bit the bullet of painful austerity instead of leaving). By Friday, markets breathed a sigh of relief after a second attempt at forming a government succeeded, this time with a less controversial choice of finance minister and a more technocratic cabinet overall. This might not be the last time these concerns bubble to the surface, given that the Italian people are right to feel aggrieved. Italy's economic performance has been dismal over the past decade, and real per capita incomes never recovered to pre-crisis (2008) levels.

RETURNS **UNDER PRESSURE**

The more pressing issue for investors is that returns from the main asset classes (with the notable exception of local fixed interest) have been disappointing over the past three years. The largest component of a typical Regulation 28 compliant balanced fund is local equities. The annual return including dividends over three years on the FTSE/JSE All Share Index was 5.4% at the end of May. Year-to-date returns are -4.3%, with May itself having been a deeply negative month (-3.5%). The FTSE/JSE Capped SWIX, our preferred local equity benchmark since it limits concentration risk, returned 3.5% per year over three years due to a more realistic and responsible weighting to Naspers, which returned 19% per year over the three years.

If we just focus on more recent returns, the underperformance is fairly widespread across sectors. Financials and Industrials were deeply negative in the first five months of 2018, while Resources have returned 8%. However, within the latter sector, gold and platinum miners have lost in excess of 20% this year while the heavyweight diversified miners have gained 17%. While Naspers enjoyed an incredible run over the past few years, 2018 has not been great, with a 12% decline to end May. British American Tobacco, the other mega-cap Industrial stock, is down 20% year-to-date.

LOCAL IS **GLOBAL**

It seems ironic that the local market is struggling so much at a time when optimism about the local economy has increased sharply. But the JSE no longer reflects the local economy, now that its largest constituents are global firms. It is also true that optimism in the local economy has probably increased faster than activity. This week's first quarter GDP release is likely to be disappointing, but the overall economic outlook is still an improvement on the previous few years.

In fact, it is increasingly the case that major equity markets do not closely reflect their domestic economies anymore, being dominated instead by multinational firms that sell their wares across the globe, instead of focusing on a single market. Therefore, when thinking about investments, we need to take the health of the global economy into account. The OECD (a think-tank representing the world's most advanced economies) stated in its latest economic outlook that, "trade and financial integration since the mid-1990s has made economies more dependent on developments abroad…Integration is particularly apparent in financial markets, with a common global factor increasingly determining domestic equity and government bond prices."

What makes it tricky is that the global revenues of multinational firms are translated into their home currencies at prevailing exchange rates. In the case of South Africa, the rand ended May 5% stronger than the 2017 average rand-dollar exchange rate (of R13.30). The stronger currency not only reduces the rand returns from global markets, but also the rand earnings of global companies. With South African balanced funds now allowed up to 30% exposure to offshore assets (more if Africa is included), the typical South African balanced fund probably has direct and indirect global exposure in excess of 50%. If the rand's strong run since January 2016 is running out of steam, it will be beneficial to local returns.

The OECD's latest global growth forecast confirms the view that the underlying economic picture remains healthy, despite a sluggish first quarter, especially in Europe. Global growth of close to 4% is expected over the next two years, in line with the long-term average. In other words, not historically strong growth, but the best patch in several years. There are risks to this optimistic outlook – there always are. These include the increased protectionist stance of the US and the risk of a surging dollar if the Federal Reserve (Fed) hikes rates too aggressively. But with inflation still subdued, the Fed need not be in a hurry. The first inflation indication from May, the average hourly wages of workers, increased 2.7% year-on-year. This is still remarkably low given that unemployment declined to 3.8%.

VALUATIONS REASONABLE

Global equities (MSCI All Countries Word Index) were marginally positive in May and also year-to-date in US dollar terms. Over the past 12 months, global equity returns are a decent 12% and 8% over three years annualised. Given the recent weakness in price and strong earnings growth, equity

markets are reasonably valued based on traditional valuation methods such as forward price: earnings (PE) ratios. These PE ratios across the major markets are somewhat above long-term averages, but not dramatically so, as long as expected earnings growth materialises. While global growth is solid and valuations reasonable, there is no reason to believe that the return outlook from equities has fundamentally deteriorated. One simply has to be patient.

FAT YEARS **AND LEAN YEARS**

The valuation of the local market is skewed by the size and rating of Naspers, which trades at a forward PE ratio of 24 due to its exposure to the Chinese internet giant, Tencent. Excluding Naspers, the local market is not expensive.

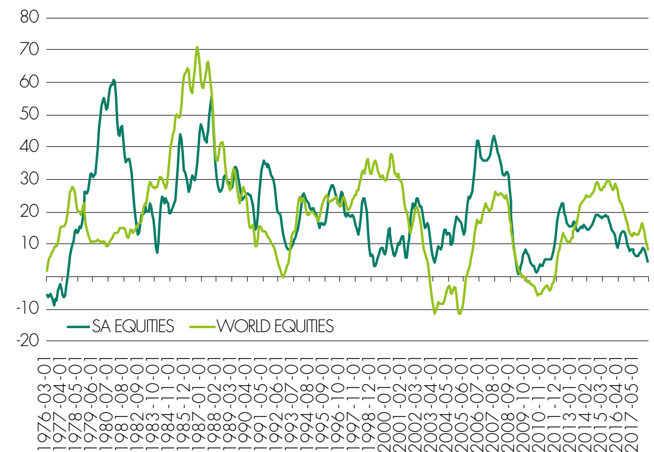
Chart 1 shows the rolling three-year annualised returns of the local and global equity markets (both in rand and with dividends reinvested) over the past 40 years. Equity returns have been trending lower since 2015, and this is clearly a source of concern for investors. However, the chart clearly shows that returns are cyclical, with fat years followed by lean years. Over time, there are more fat years than lean ones, and the average annual growth over this entire period is 20%. Staying out of the market means betting against this strong upward trend. You might get it right for a while, but over time the odds are stacked against you.

DIVERSIFICATION HELPS

The impact of equity volatility can of course be cushioned by diversifying across other classes. Taking the other major asset classes in turn, developed market bonds are not attractive despite recent rate rises (though the knee-jerk sell-off in Italian debt created a terrific opportunity for the brave). Local bonds have stood out, delivering 5% year-to-date, 11% over 12 months and 8% per year over three years. But it remains an attractive asset class given high yields and low inflation. The Reserve Bank's conservative stance of maintaining positive real interest rates also supports local fixed interest returns. Local property, for so long the darling asset class of local investors, slumped 19% this year, largely due to corporate governance and sustainability concerns over the Resilient stable of companies. It means that listed property is barely positive over three years. This too is a sector that has internationalised dramatically over the past decade, with 40% to 50% of revenue generated outside South Africa (depending on the choice of benchmark). The sell-off has created a much more attractive entry level, but the tough operating environment is likely to put downward pressure on distribution growth.

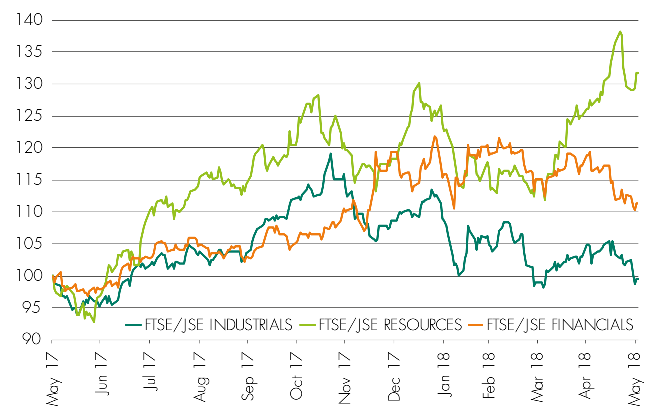
Unfortunately, nobody can manufacture returns (except through running a Ponzi scheme). We have to work with what the market gives us and then attempt to add some value through valuation-based active asset allocation and selecting the right fund managers within each asset class to do security selection. The market has not been giving us much. However, the return outlook from a diversified portfolio has not dramatically and permanently declined.

CHART 1: ROLLING THREE-YEAR RETURNS FROM LOCAL AND GLOBAL EQUITIES IN RAND



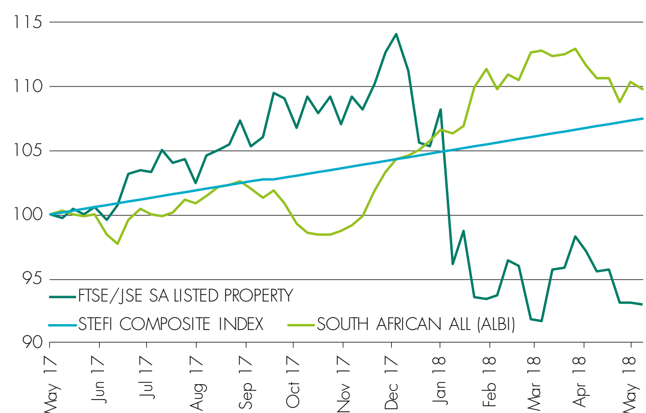
Source: Thomson Reuters Datastream

CHART 2: JSE FINANCIALS, INDUSTRIALS AND RESOURCES INDICES, REBASED TO 100



Source: Thomson Reuters Datastream

CHART 3: SA BONDS, CASH AND LISTED PROPERTY OVER THE LAST YEAR, INDEXED TO 100



Source: Thomson Reuters Datastream

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 109.0	-0.09%	0.76%	0.29%	9.67%
United States	S&P 500	US$	2 735.0	0.51%	1.11%	2.28%	12.55%
Europe	MSCI Europe	US$	1 732.0	-1.03%	0.87%	-3.62%	2.55%
Britain	FTSE 100	US$	10 281.0	-0.08%	0.72%	-1.15%	5.74%
Germany	DAX	US$	1 402.0	-1.41%	0.57%	-0.87%	7.19%
Japan	Nikkei 225	US$	202.5	-1.36%	-0.76%	0.19%	13.27%
Emerging Markets	MSCI Emerging Markets	US$	1 130.0	-0.62%	0.80%	-2.42%	12.10%
Brazil	MSCI Brazil	US$	1 790.0	-4.84%	-0.50%	-11.52%	3.65%
China	MSCI China	US$	92.1	0.50%	0.85%	4.13%	28.14%
India	MSCI India	US$	569.7	1.41%	0.30%	-6.76%	5.50%
South Africa	MSCI South Africa	US$	545.0	-0.73%	3.02%	-9.92%	7.28%

EQUITIES - SOUTH AFRICA (TR UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	57 282.0	0.64%	2.00%	-3.74%	8.40%
All Share	All Share (Total Return)	Rand	8 243.0	0.65%	2.00%	-2.45%	11.66%
TOP 40/Large Caps	Top 40	Rand	7 308.0	0.66%	2.20%	-1.88%	12.60%
Mid Caps	Mid Cap	Rand	15 629.0	0.22%	0.70%	-7.93%	3.96%
Small Companies	Small Cap	Rand	20 619.0	0.48%	0.59%	-1.92%	2.59%
Resources	Resource 20	Rand	2 593.4	3.51%	1.85%	13.44%	37.02%
Industrials	Industrial 25	Rand	14 200.0	-0.34%	2.54%	-6.06%	3.16%
Financials	Financial 15	Rand	9 373.0	0.10%	1.57%	-3.44%	21.22%
Listed Property	SA Listed Property	Rand	2 031.6	1.00%	1.22%	-17.55%	-5.73%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	939.9	0.26%	0.00%	-0.86%	1.62%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	615.7	-0.94%	-0.46%	4.76%	9.63%
Government Bonds	BESA GOVI	Rand	611.6	-0.99%	-0.49%	4.30%	9.21%
Corporate Bonds	SB JSE Credit Indices	Rand	119.2	-0.19%	-0.12%	-5.57%	-15.47%
Inflation Linked Bonds	BESA CILI	Rand	256.6	0.60%	0.06%	1.57%	3.76%
Cash	STEFI Composite	Rand	394.5	0.13%	0.02%	3.02%	7.39%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	76.6	0.56%	-1.78%	14.34%	53.22%
Gold	Gold Spot	US$	1 294.0	-0.61%	-0.84%	-0.23%	2.21%
Platinum	Platinum Spot	US$	900.0	0.22%	-1.42%	-3.23%	-3.43%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	12.69	-1.67%	0.05%	-2.46%	1.56%
ZAR/Pound	ZAR/GBP	Rand	16.94	-1.89%	-0.30%	-1.18%	-1.95%
ZAR/Euro	ZAR/EUR	Rand	14.80	-1.67%	0.36%	0.42%	-2.35%
Dollar/Euro	USD/EUR	US$	1.17	0.00%	-0.09%	2.65%	-4.27%
Dollar/Pound	USD/GBP	US$	1.33	-0.29%	-0.37%	1.13%	-3.36%
Dollar/Yen	USD/JPY	US$	0.01	0.12%	0.64%	-2.79%	-1.43%

Source: I-Net, figures as at 1 June 2018

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ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Standard Bank Purchasing Managers' Index
- Manufacturing production

US

- Job openings and labour turnover
- ISM Services Index

EUROPE

- Eurozone retail sales

CHINA

- Caixin Purchasing Managers' indices
- Imports and exports

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