DON'T STOP THINKING ABOUT TOMORROW

Dave Mohr and Izak Odendaal, Old Mutual Multi-Managers

Halfway through the year, there are two key questions: What is the outlook for investment returns after a decidedly soft patch on markets? And have the prospects for the local economy completely deteriorated? The answers are linked of course, but not as much as most think.

Since the global financial crisis, many commentators have warned that we are entering a 'low return environment' of more or less permanently subdued returns. Interest rates had fallen to close to zero across the developed world and expectations for economic growth were scaled back significantly. Yet the low return environment never seemed to arrive. Low interest rates just fell even lower (with capital gains for bondholders) and companies managed to squeeze out profits even in a sluggish economy, leading to healthy returns for shareholders. But the low return question is resurfacing.

The simple reality is that some asset classes offer prospects for decent returns and some don't. With an appropriately diversified portfolio, it should still be possible to outperform inflation and build real wealth in the years to come. No one has a crystal ball, and therefore the best place to start is with what is currently priced into various asset classes.

Fixed interest assets across the developed world still aren't attractive. Even though the US Federal Reserve is hiking short-term interest rates, and expected to continue hiking gradually, longer-term rates are still pricing in a subdued outlook for growth in the coming decade or so. Therefore, the US yield curve – the difference between short and long rates – is at the flattest level in 11 years. In Japan and the main European economies, yields are barely positive and thus very unattractive.

Global equity markets are flat year-to-date, but corporate earnings have surged, while solid global growth means earnings expectations remain high. This means forward price-to-earnings (PE) ratios have declined. Based on the consensus earnings expectations for the coming 12 months, global markets are broadly speaking trading at average valuations, and therefore should be able to deliver returns in line with the long-term average. Although most PE ratios are pretty useless as a market timing tool, they are a reliable indicator of longer-term returns. Buying equities at below-average PE ratios has historically resulted in above-average returns over time and vice versa. The key question here is whether the consensus earnings estimates are too high. Given that global growth is still robust, they don't seem to be. But that view depends on the current trade spats not escalating.

LOCAL IS GLOBAL

The forward PE ratio of the local equity market has increased to well above its long-term average, and at first glance, it means the JSE is expensive. But as Chart 1 shows, recent years have seen the local market valuation converging with global market valuation. This makes sense, as the JSE is now dominated by globally focused companies. The biggest, Naspers, trades at a high valuation due to its stake in fast-growing Chinese internet giant Tencent. Therefore, the local market appears expensive seen in isolation, but in a global context it is fairly priced. In fact, from the perspective of a global investor, the JSE might be very cheap, given that it is still at the same level as four years ago (including dividends) in US dollar terms, and not much higher than where it was eight years ago. Chart 2 shows the FTSE/JSE All Share Index in dollars and rand. The divergence since 2011 is striking, and it starts at the point where the rand's sharp depreciation against the dollar began (the rand was still trading at R7 to the dollar at that point). From the perspective of a local investor, the JSE clearly doesn't mind a weak currency.

Local fixed interest is probably the easiest call to make: starting with cash and moving out on the very steep yield curve, yields are well above inflation. The 10-year government bond yield at 8.8% is double the current inflation rate (Chart 3), but longer-dated bonds are obviously prone to volatility amid the current sell-off of emerging market debts.

It is trickier to say that local property will deliver average returns. Local listed property delivered once-in-a-generation returns from the early 2000s, supported by very high starting yields, changes in the management of the property assets and more recently, internationalisation. Yields are fairly attractive, but the domestic operating environment is very tough and companies are lowering their guidance for the growth in distributions (the rental income that gets paid out to investors). The weakening rand supports the 40% to 50% of the sector that is offshore. However, the offshore exposure is concentrated in Eastern Europe and the UK, and a more diversified global property approach is preferable.

The increasingly global nature of both local equities and listed property is the main reason why the health of the domestic economy matters less to local investors than it used to.

ECONOMY STUCK IN LOW GEAR

But it still matters, and South Africa's economy is still stuck in a low gear. All indications are that there was very little growth in the first half, if at all. Three of the most up-to-date economic indicators released last week illustrate this.

The Absa/BER Purchasing Managers' Index showed that conditions in the manufacturing sector remain very tough. It fell back to 47.9 index points (50 being the neutral level) in June, and the average level for the second quarter was barely above that of the first. Theoretically, the manufacturing sector should benefit from the global economic upswing, but it clearly is not. Moreover, it is also at risk of a global trade war, given that steel and vehicles are big exports for us.

The Standard Bank PMI, which is produced by global research house Markit and covers the whole private sector, not just manufacturing, was in positive territory in June. The services sectors continue to outperform volatile mining and manufacturing, but here too there is no evidence yet of strong growth. Finally, new vehicle sales numbers for June were up from a year ago, but still well below the recent cycle peak in 2013.

It should be noted that the companies on the JSE that are domestically focused tend to primarily be in the services sectors (banks, retailers, telecoms) with limited representation of manufacturers. Construction shares on the JSE have shrunk to the point of near insignificance.

What really hurts the economy is that other commodity prices have not followed oil higher (apart from coal). With the price of our main import (oil) increasing and our main exports (iron ore, platinum, gold) declining, our so-called terms of trade have worsened. This will put pressure on the current account deficit, as well as on consumers and businesses because of higher fuel prices. With the rand hovering around R13.50 and the oil price still above $77 per barrel, despite Donald Trump's best efforts at talking (or rather tweeting) it down, this means another petrol price hike potentially looms in August.

FUEL PRICE FRUSTRATIONS

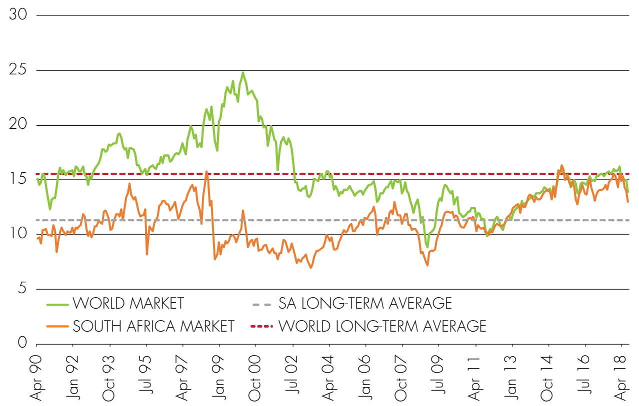
Can anything be done about the petrol price? The simple reality is that South Africa imports most of its petroleum products from abroad at prevailing global prices and exchange rates. This situation is unlikely to change until there is a meaningful shift to electric vehicles. The only way to lower the fuel price would be for government to reduce the fuel and RAF levies – which would have to be replaced with other forms of taxation – or to deregulate the setting of the price completely. The latter could bring the price down by increasing competition and squeezing wholesale and retail margins, but could result in a situation where fuel is much more expensive or simply unavailable away from the large urban centres. Subsidising the fuel price is a costly and distortive exercise that other developing economies are trying to move away from.

What matters from an inflation point of view is the extent to which companies can pass on the higher fuel price to consumers. In the current tough environment, they have limited scope. In fact, if consumers spend more on transport, they will have less to spend on any discretionary items. The second round impact of fuel prices is probably limited, and the Reserve Bank is unlikely to respond with higher interest rates. It is, however, keeping a hawkish eye on global capital flows and the exchange rate.

INVESTING FOR TOMORROW TODAY

The weak state of the local economy should worry us as citizens and taxpayers, but the outlook is not completely bleak. Fixed investment spending should pick up during the course of the year as business confidence improves. Consumer balance sheets are fairly healthy (in aggregate) and the rand is at a much more competitive level. As investors, however, we are less exposed to the fortunes of the local economy, especially with the recent Regulation 28 changes that allow for 30% offshore exposure. The trick is to always keep an eye on valuations and remain appropriately diversified, rather than 'fleeing' the country by piling blindly into rand hedges and offshore investments. Fear and greed do not make for a sound investment philosophy.

CHART 1: FORWARD PRICE-TO-EARNINGS RATIOS FOR SOUTH AFRICAN AND WORLD EQUITIES



Source: Thomson Reuters Datastream total market indices

CHART 2: FTSE/JSE ALL SHARE IN RAND AND DOLLARS, REBASED TO 100

Source: Thomson Reuters Datastream

CHART 3: SOUTH AFRICA 10-YEAR GOVERNMENT BOND YIELD, %

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$	2 096.0	0.34%	0.34%	-0.33%	9.80%
United States	S&P 500	US$	2 737.0	0.70%	0.70%	2.36%	13.57%
Europe	MSCI Europe	US$	1 715.0	0.70%	0.70%	-4.56%	2.82%
Britain	FTSE 100	US$	10 051.0	-0.36%	-0.36%	-3.37%	5.63%
Germany	DAX	US$	1 374.0	1.18%	1.18%	-2.77%	5.77%
Japan	Nikkei 225	US$	194.7	-3.38%	-3.38%	-3.64%	10.66%
Emerging Markets	MSCI Emerging Markets	US$	1 054.0	-1.50%	-1.50%	-8.98%	4.77%
Brazil	MSCI Brazil	US$	1 652.0	0.30%	0.30%	-18.34%	-2.02%
China	MSCI China	US$	83.5	-3.12%	-3.12%	-5.62%	16.03%
India	MSCI India	US$	557.4	-0.60%	-0.65%	-8.78%	2.64%
South Africa	MSCI South Africa	US$	511.0	1.19%	1.19%	-15.54%	6.90%

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	57 314.0	-0.52%	-0.52%	-3.68%	9.62%
All Share	All Share (Total Return)	Rand	8 264.0	-0.51%	-0.51%	-2.20%	12.94%
TOP 40/Large Caps	Top 40	Rand	7 354.0	-0.74%	-0.74%	-1.26%	14.41%
Mid Caps	Mid Cap	Rand	15 365.0	1.17%	1.17%	-9.48%	3.55%
Small Companies	Small Cap	Rand	19 954.0	0.68%	0.68%	-5.08%	1.11%
Resources	Resource 20	Rand	2 650.9	-2.15%	-2.15%	15.95%	35.20%
Industrials	Industrial 25	Rand	14 406.0	-0.81%	-0.81%	-4.70%	7.79%
Financials	Financial 15	Rand	9 064.0	1.09%	1.09%	-6.62%	16.55%
Listed Property	SA Listed Property	Rand	1 959.4	1.13%	1.15%	-20.48%	-10.25%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	941.9	0.33%	0.33%	-0.65%	2.53%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	619.0	1.28%	1.28%	5.33%	12.14%
Government Bonds	BESA GOVI	Rand	614.8	1.36%	1.36%	4.86%	11.68%
Corporate Bonds	SB JSE Credit Indices	Rand	114.5	0.50%	0.50%	-9.27%	-17.62%
Inflation Linked Bonds	BESA CILI	Rand	250.8	-0.17%	-0.17%	-0.72%	1.82%
Cash	STEFI Composite	Rand	397.1	0.13%	0.13%	3.70%	7.35%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	77.6	-2.12%	-1.82%	15.76%	61.58%
Gold	Gold Spot	US$	1 256.0	0.24%	0.24%	-3.16%	2.53%
Platinum	Platinum Spot	US$	840.0	-1.18%	-1.18%	-9.68%	-7.89%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	13.54	1.43%	1.45%	-8.54%	-0.93%
ZAR/Pound	ZAR/GBP	Rand	17.89	1.34%	1.34%	-6.43%	-2.79%
ZAR/Euro	ZAR/EUR	Rand	15.83	1.36%	1.36%	-6.10%	-3.19%
Dollar/Euro	USD/EUR	US$	1.17	0.00%	-0.17%	2.65%	-2.56%
Dollar/Pound	USD/GBP	US$	1.32	-0.09%	-0.15%	2.12%	-1.66%
Dollar/Yen	USD/JPY	US$	0.01	-0.01%	-0.01%	-1.77%	-2.61%

Source: I-Net, figures as at 6 July 2018

ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Mining and manufacturing production

US

- Job openings and labour turnover
- Consumer and producer inflation
- Consumer confidence

CHINA

- Inflation
- Loan growth
- Trade balance

EUROPE

- Germany ZEW Economic Sentiment
- Eurozone industrial production

Whilst every care has been taken in compiling the information in this document, the information is not advice and Old Mutual Multi-Managers and/or its associates, do not give any warranty as to the accuracy or completeness of the information provided and disclaim all liability for any loss or expense, however caused, arising from any use of or reliance upon the information. Please note that there are risks associated with investments in financial products and past performances are not necessarily indicative of future performances.

OLDMUTUAL

HELPLINE +27 21 524 4430 | **FACSIMILE** +27 21 441 1199 | **EMAIL** ommmclientquery@ommm.co.za | **INTERNET** www.ommultimanagers.co.za

Old Mutual Multi Managers ("OM m|m") is a business unit of Old Mutual Life Assurance Company (South Africa) Limited ("OMLACSA"), a licenced Financial Services Provider, Reg. No: 1999/004643/06. OM m|m is authorised to provide financial services on the OMLACSA license, FSP 703.