Seed Market Overview

31 October 2019

Local Market

South Africa yet again survived a downgrade to sub-investment grade (junk status) by Moody's, although the outlook was changed from stable to negative. The Rand rallied and government bonds gained significantly as the worst case scenario was averted and the country clung to its last investment grade credit rating.

The outcome would have been worse had Moody's downgraded or placed the country on a ratings watch, which would have compelled them to review for a downgrade within 3 months. Changing the outlook to negative means a downgrade may be possible within 12-18 months, but at least we have more time to put our house in order.

Moody's remains concerned that there is material risk that the government will not succeed in arresting the deterioration of its finances through a revival in economic growth and fiscal consolidation measures.

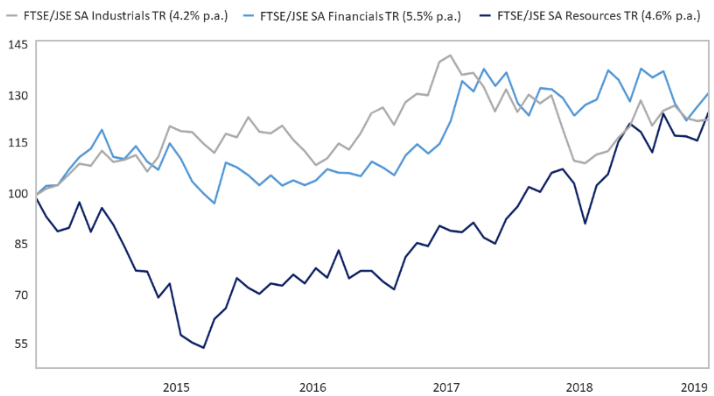
Tito Mboweni, the Finance Minister, has been talking tough and responded to Moody's announcement by stating that the country needed tough reforms to fix its fiscal problems, and that it is time for government, labour, business and civil society to work together to do so.

The ratings announcement came after Mboweni delivered the Medium Term Budget Policy Statement, which painted a bleak picture of the country's finances. Key challenges include stagnant growth, escalating debt, the public sector wage bill, and the fiscal risk posed by the state-owned entities.

On a more positive note, local market returns are looking healthier this year, with the FTSE/JSE All Share Index delivering a double-digit YTD (year-to-date) return to the end of October. The index is up 10.5% YTD, having risen a healthy 3.1% in October. The resources sector has been the key contributor to the index performance, up 21.2% this year.

Chart 1 (below) illustrates how volatile the sector's performance is. Understanding the sector well, and thereby positioning appropriately, can be a key driver of returns for local investors.

Chart 1 : South African Equity Market Sector Growth (5 Years - 31 Oct 2019)



Source: Morningstar Direct (31 October 2019)

Global Market

MSCI World Value (Global Value Stocks) delivered a strong return in September, outperforming MSCI World Growth (Global Growth Stocks) by 3.5%. This was the largest monthly outperformance by value over-growth in a positive month for the MSCI World Index over the last 10-year period. Value once again recorded good absolute returns in October, although growth rebounded to outperform during the month.

Value outperformance creates excitement for value investors who have endured the longest period of underperformance relative to growth. Chart 2 (below) illustrates how value's long-term outperformance on a rolling 10-year basis has experienced a turn over the last decade. With quantitative easing, growth stocks have outperformed even at high valuations, which is considered a risk to performance. Value investors have, over the years, warned about this risk and intimated that a reversal in performance is on the cards, such that investors should be sufficiently diversified by also owning value stocks.

The last decade has been a déjà vu of the late 1990's, with a long stretch of underperformance for value. Similar to the current situation, a key question is whether a structural change has occurred which renders the traditional value investment methods obsolete. According to Morningstar, some of the value managers that have succeeded in recent years have done so by casting their nets wider in search for value and, in some cases, redefining parameters of how they defined value. Some managers have drifted from value to a more blended approach, on the basis of traditional metrics possibly being insufficient to assess "value".

With growth, much like the late 1990's, investors are excited by what is new and disruptive. The low interest rate environment has allowed companies to grow by taking on debt, and investors have excess cash to invest in these companies. Whether growth continues to outperform value will remain a key topic of discussion for investors in the foreseeable future. For now, as shown by the YTD numbers of which growth is comfortably ahead by almost 10%, the trend from the last decade looks set to continue. However, as deep value investors suggest, September may just have been the warning signal investors require.

Chart 2 : Rolling 10 Year Value Annualised Outperformance Over Growth (Jan 1975 – Oct 2019)

Source: Morningstar Direct (31 October 2019)

Asset Class (ZAR)	MTD	YTD	1 Year	3 Years	5 Years	10 Years
Local Equity	3.1%	10.4%	11.5%	7.1%	5.8%	11.2%
Local Property	1.9%	3.2%	0.8%	-3.1%	2.3%	11.2%
Local Bonds	-0.3%	8.1%	13.0%	8.6%	7.5%	8.8%
Local Cash	0.5%	5.5%	6.6%	6.7%	6.5%	6.0%
Global Equity	2.1%	25.0%	14.9%	15.5%	13.9%	16.2%
Global Property	1.7%	31.0%	24.1%	13.8%	14.5%	18.9%
Global Bonds	-0.2%	12.1%	12.5%	6.4%	8.7%	9.0%
Global Cash	-0.5%	6.8%	4.5%	5.6%	7.6%	7.5%

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Seed Local Review

Equity

The JSE All Share Index returned a strong 3.1% in October, lifting the YTD return into double digits at 10.4%. Resources (7.3%) had an excellent month on the back of higher commodity prices, while Financials (3.3%) also performed well. Industrials (0.3%) lagged, as index heavyweights Naspers and AB InBev took strain. The Capped Swix Index has lagged the ALSI in terms of both performance and underlying earnings growth over the last year, and our models indicate that there is still reasonable value on offer. We therefore maintain our equity allocations at levels close to benchmark.

Property

The SA Property Index returned 1.9% in October, and this asset class is just positive (0.8%) on a 1-Year basis and still negative (-3.1%) on a 3-Year basis. The reduced risk of a no-deal Brexit has resulted in counters with UK exposure outperforming this month, while local counters continue to struggle on the back of SA's poor economic growth prospects and oversupply in some sectors. The SAPY offers an attractive 1-Year forward yield of 9.7%, but growth on these distributions are expected to be much lower than inflation..

Bonds

The ALBI closed down 0.3% this month, but bonds remain the top performing local asset class over 1, 3 and 5 Years. Ratings agency Moody's kept SA's sovereign debt rating at investment grade, but lowered the outlook from stable to negative. In response, the benchmark R186 Yield increased to 8.5% at month end, driven by the risk premium component which is at a 15-Year high. Our valuation model indicates that bonds remain slightly expensive, but the high yield in real terms is looking attractive compared to other asset classes.

Cash

Annual inflation decreased to 4.1% from last month's 4.3% and remains at the very low end of the SARB's target band. Finance Minister, Tito Mboweni, painted a bleak picture of SA's finances in the MTBPS, with the deterioration in the projected Debt/GDP Ratio a major concern and the growth forecast lowered to only 0.5% for the year. Cash currently delivers a very attractive 2.7% real yield. We appreciate the optionality in cash, but recognise that several other asset classes offer more value at the moment. As a result, we remain neutral.

Seed Global Review

Currency

The rand started the month off well, initially strengthening from R 15.13/$ to below R 14.60/$ as Emerging Markets and currencies seemed to benefit from improved sentiment. However, the ZAR lost significant ground towards month-end as the MTBPS failed to impress, and closed at R 15.09/$. The trade-weighted USD remains strong, and as a counter-cyclical currency is supported by weak global growth. At month end, the ZAR was 7% undervalued against the trade weighted basket of currencies on a purchasing power parity basis. Significantly, the ZAR was 29% undervalued versus the USD using the same methodology.

Equity

Global equity markets were up strongly for October, with the MSCI ACWI returning 2.7% and the MSCI Emerging Markets Index a solid 4.2%. An easing in trade war tensions led to renewed risk-on sentiment, which meant Value outperformed Growth, Emerging Markets beat Developed Markets and the Trade Weighted USD was on the back foot. Globally, economic activity is expected to pick up in the next few months, and cyclical sectors and economies should start outperforming defensives. We maintain a benchmark weight in global equity and continue to favour allocation to high quality stocks.

Fixed Income

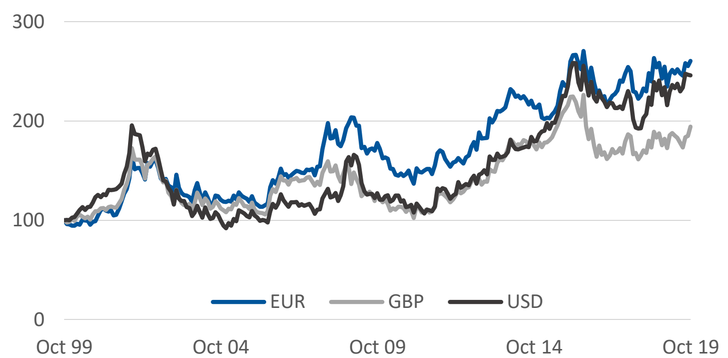
The US 10-Year treasury bond yield remained unchanged this month at 1.7%, with weak US manufacturing data offset by stronger employment numbers. In a widely expected move, the US Fed cut rates for a third time this year during October, while indicating that no further cuts should be necessary if the US economy keeps growing at a reasonable pace. BCA Research opines that yields should rise from this point in line with GDP forecasts, given that underlying US inflation is on the rise.

Alternative

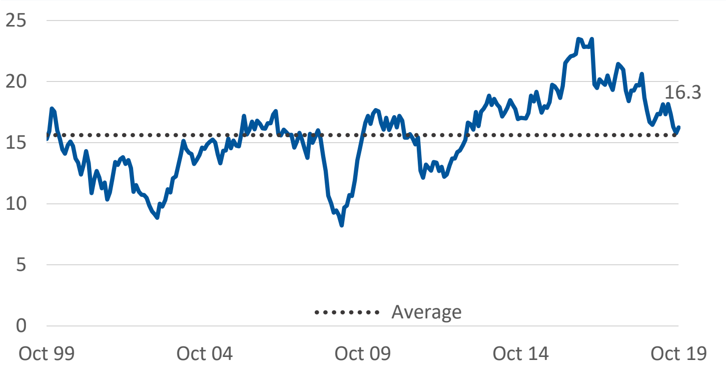
Other asset classes that can be considered include structured notes, private equity, direct real estate, commodities and hedge funds, and can provide investors with uncorrelated returns. However, as interest rates are slowly but surely rising, these alternative investments do become less attractive. These assets can still perform a useful role in multi asset portfolios, as they help provide more consistent returns.

ZAR vs USD

Currencies vs ZAR (rebased to 100)



ALSI PE Ratio



SA Government 10 Year Bond Yield