Investec
Wealth & Investment

Global Investment View

QUARTER 1 - 2018

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Lowering the risk tolerance, acknowledging the blue sky

The Global Investment View distils the thinking of the Global Investment Strategy Group (the Group) that brings together the insights of Investec Wealth & Investment's professionals in the UK, South Africa, Ireland and Switzerland. The Group meets quarterly to map out our outlook over the following 18 months, setting a risk budget and identifying some of the potential icebergs that lie in the global investor's path.

By John Haynes

Head of Research, Investec Wealth & Investment UK and Chairman of the Global Investment Strategy Group

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Watch Patrick Lawlor interview Alexandra Nortier and Paul Deuchar.

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Summary of our key thoughts

Our positioning has moved from neutral to slightly underweight – that is, we have reduced our appetite to risk to slightly below what we consider par. We do this despite our central case expectation that over our forecast period (18 months), owning so-called risk assets (e.g. equities, commodities and emerging market assets) may be rewarded relative to owning cash or fixed income, while we also acknowledge the possibility of a more positive scenario for risk assets. We set out our thinking in more detail below.

Rationale – why underweight?

Our view is that both the magnitude of expected returns on risk assets and the certainty of those returns being delivered is falling. Tactically, a material correction in share markets is overdue in our opinion, mainly because of the risks inherent in the withdrawal of monetary stimulus ("transition risk"). This is particularly the case if inflation data forces the pace.

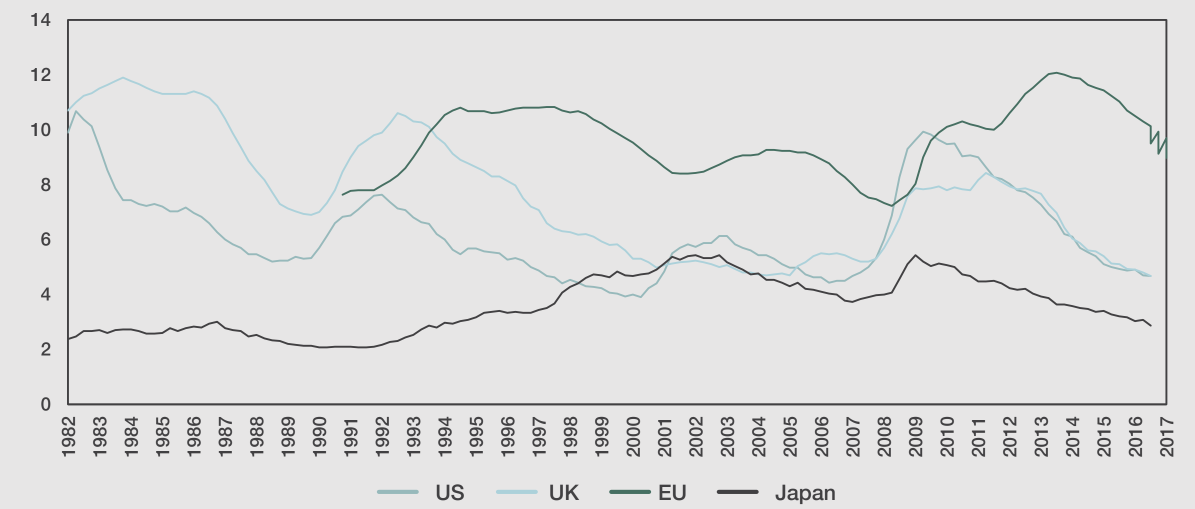
This aligns with an awareness that, taking a medium-term view, we must begin the process of becoming more defensive while market conditions are still strong and well ahead of a potential economic peak (in 2019), which markets may anticipate in 2018. Despite these concerns, we retain a sanguine view on equity valuation in the context of synchronising global economic growth and strong profit momentum. We have therefore chosen to make only a small adjustment at this stage, which could be reversed if the long-awaited correction arrives sooner rather than later.

Key points behind our positioning

An unusually favourable economic climate

For the first time since the Global Financial Crisis (GFC) we are experiencing a period of synchronised global growth. The three main engines of the world economy (the US, Europe and China) are all pulling together, providing a powerful force for upside surprises in corporate earnings. This is leading to a virtuous circle of increasing investment, employment and consumer confidence worldwide, or at least in those countries where politics does not intervene to impede it.

**Figure 1: Unemployment Rate (%)
(EHUPUS Index)**



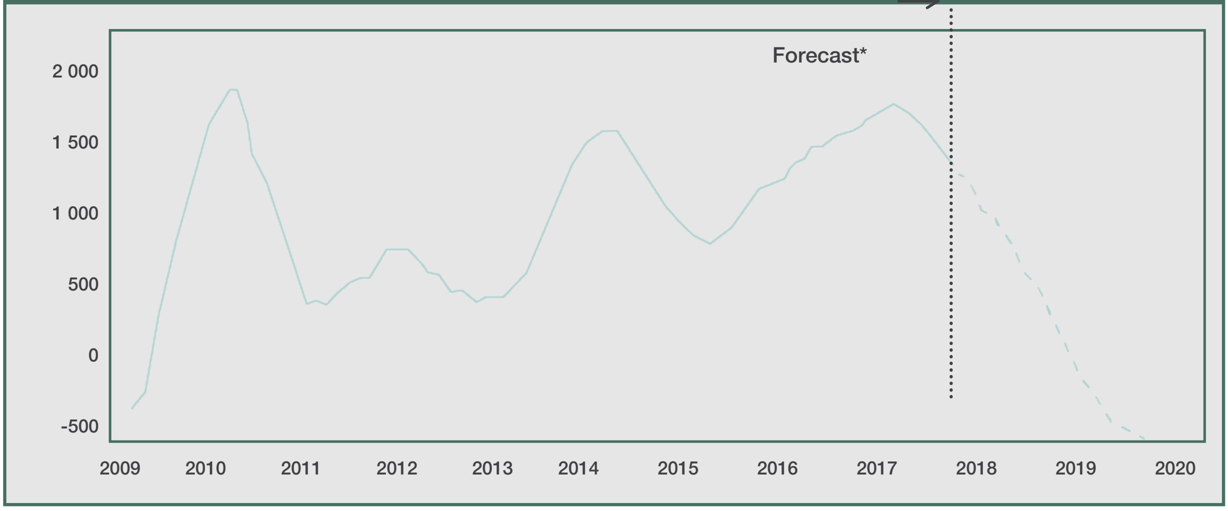
Source: Iress and Investec Wealth & Investment

> Earnings declines cause bear markets, not high valuations. High valuations simply magnify the effect of any earnings declines in stock prices, so valuations need to be monitored for downside risk.

Normalisation of monetary policy will test nerves

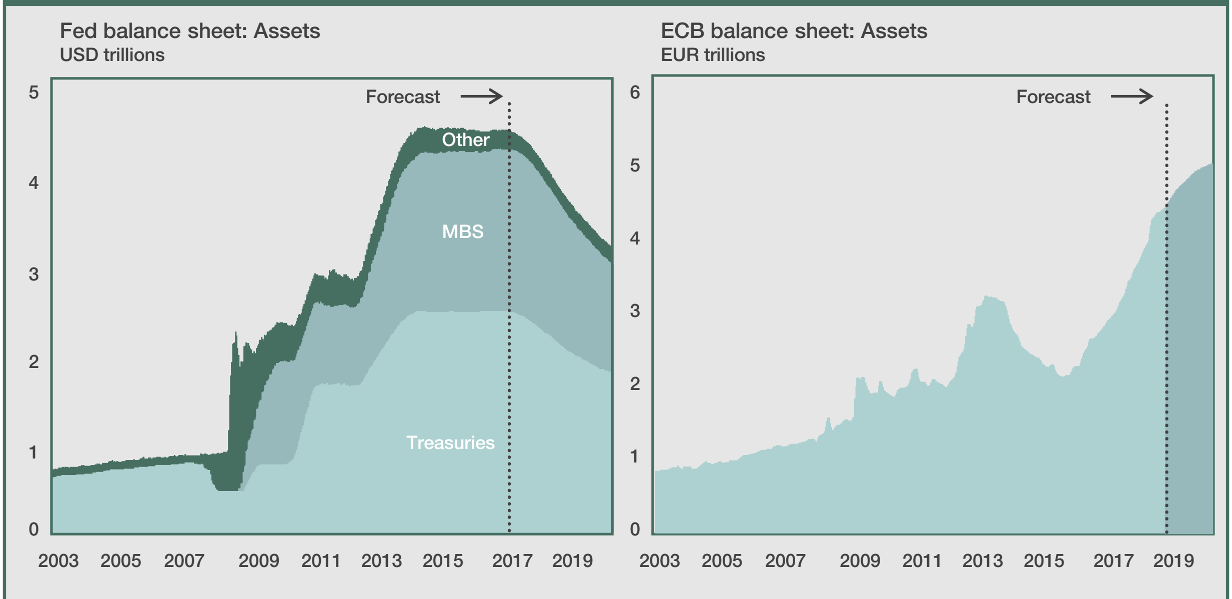
The consequence of declaring victory over deflationary forces is, however, that central banks in the US and Europe will move further to withdraw the extraordinary stimulus that has been in place since the Global Financial Crisis (GFC). Even if we assume that the policy transition is managed adroitly, there is no roadmap for this operation – the transition risk referred to above. Inflation data is becoming a key variable which financial markets will use to second guess their success. Real economic variables (interest rates and foreign exchange rates), will by definition become increasingly "unsuppressed" and volatile.

Figure 2: Central Bank purchases
(USD billions, rolling 12 month flows)



Source: Iress and Investec Wealth & Investment

Figure 3: Central Bank policies
Global economy



Source: Iress and Investec Wealth & Investment

> The propensity for President Donald Trump to spring surprises (North Korea is a challenge that he looks unwilling to let lie) sits uncomfortably with an extended risk position.

Valuation concerns are overdone

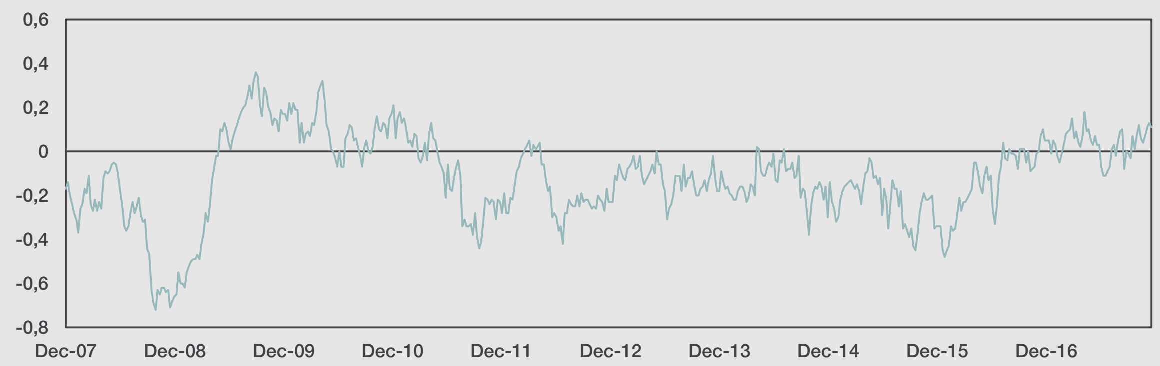
Earnings declines cause bear markets, not high valuations. High valuations simply magnify the effect of any earnings declines in stock prices, so valuations need to be monitored for downside risk. Some segments of markets are seeing speculative bubbles (bitcoin / cryptocurrencies, some technology) and others are certainly fully-discounting low interest rates (bond proxies, European junk bonds). Using our own valuation touchstone that monitors dividends relative to 10-year government bond yields, we judge that stock markets are currently "fair value" in both developed and emerging markets. Another way of looking at this assertion is that, since we also believe that systemic risk is low (the financial system is well capitalised and the emergency rescue procedure is both proven & recently rehearsed) even our worst case outlook (unexpected recession) sees no more than average equity bear-market risk (20-30%) – not the 50% decline seen in 2000 & 2007/8.

> Another interpretation is that "Xi Jinping thought" is a more market-friendly version of "socialism with Chinese characteristics" – the previous guiding doctrine.

Anticipating choppier waters, not storm conditions

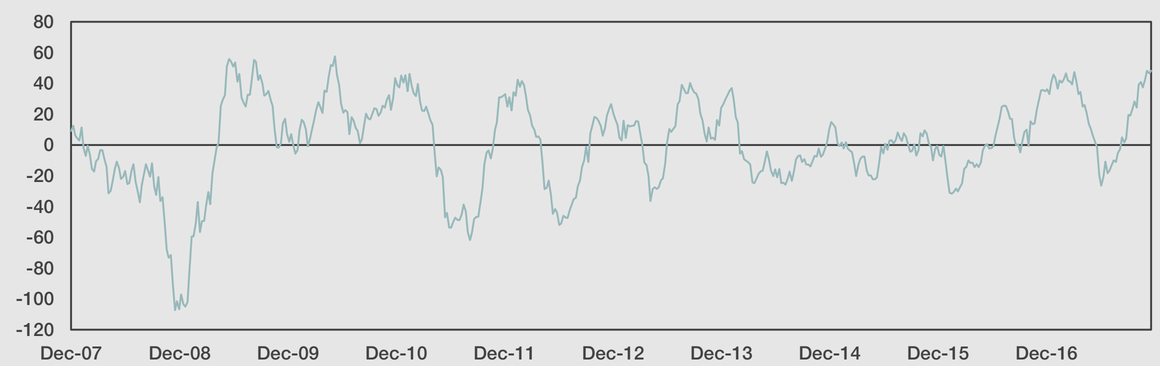
Increased volatility in interest rates and exchange rates will certainly transmit themselves back into share prices. However, we retain the view that the conditions for a substantial and prolonged equity retreat (a bear market) do not exist. As indicated already, we see these as always caused by falls in corporate earnings, which, with the "net" global policy environment (fiscal and monetary) remaining supportive, we see as unlikely in our investment horizon.

Figure 4: Citi Global Earnings Revisions Index



Source: Iress and Investec Wealth & Investment

Figure 5: Citi Economic Surprise Index (G10)



Source: Iress and Investec Wealth & Investment

Recognising our limitations

We must also allow for the way that this cycle is different from previous cycles. In particular, the normalisation of interest rates after an unusually long period of low rates will certainly find out those who have overused leverage. The private equity industry has been booming and junk bond yield premiums are low, so we must expect that at some point our assertion of financial system robustness will be challenged in the court of live markets. Similarly, we have never before had a cycle where China was a maker, rather than a taker of the global (rather than local) growth impetus. We are implicitly assuming benign monetary policy trajectories in the US, Europe and China in our central case outlook. Finally, the propensity for President Donald Trump to spring surprises (North Korea is a challenge that he looks unwilling to let lie) sits uncomfortably with an extended risk position.

… but blue sky potential cannot be ruled out

Faced with repeated systemic and cyclical challenges over the past decade, investors have been unwilling to believe in "blue sky" upside. Hence a risk-appetite capitulation could occur, where we see what is known as a "melt up" (the opposite of a "meltdown") in the markets. The drivers of such a move would be earnings growth combined with increased confidence in the economic cycle being extended, compounded by aggressive corporate behaviour (merger and acquisition activity). This has become a genuine possibility as the passage of US tax legislation makes it possible for acquisitive companies to do their maths with greater certainty.

In addition, there are anecdotal reports that, encouraged by a lighter regulatory touch in the US, financial institutions are rebuilding their share trading inventory – if this is the case, then this would provide additional fuel for share prices beyond earnings growth. Were China to also confound the sceptics and deliver solid growth, with no negative surprises over the coming 12 months, then the bulls would own the stage.

New issues since the last meeting (positive or negative impact in brackets)

China political direction confirmed (a positive, we believe)

The 19th Chinese Communist National Party Congress reshuffled its leadership, as expected, and enshrined "Xi Jinping thought" in Chinese Communist Party core values. To some, this is a dangerously authoritarian development – hinting at Maoist tendencies and dynastic ambitions. Another interpretation is that "Xi Jinping thought" is a more market-friendly version of "socialism with Chinese characteristics" – the previous guiding doctrine.

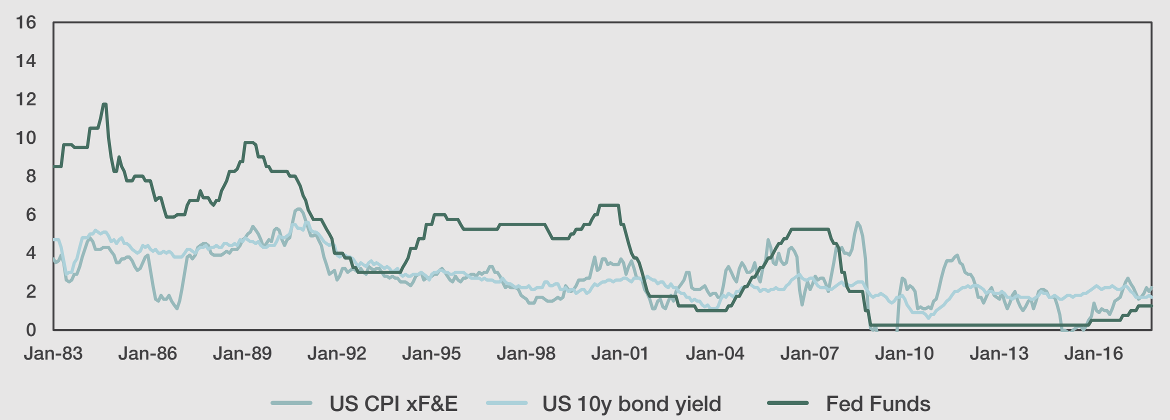
What is certain is that to China's neighbours, the growth opportunity that is being offered through programmes such as "One Belt, One Road" (in many ways similar to the Marshall Plan in post-World War 2 Europe) contrasts sharply with Donald Trump's increasingly uncertain hand of friendship. This could be a good thing, because a new austerity drive is not expected (or needed) and Xi seems intent on promoting China as a stable regional partner – which also suggests it will be a stable influence on financial markets.

Faced with repeated systemic and cyclical challenges over the past decade, investors have been unwilling to believe in "blue sky" upside. Hence a risk-appetite capitulation could occur, where we see what is known as a "melt up" (the opposite of a "meltdown") in the markets.

Tax reform in the US (good short term, uncertain longer term)

After a number of attempts, Donald Trump has succeeded in passing legislation to overhaul the US tax system. The tax framework calls for a cut in the headline corporate tax rate from 35% to 20%. The effect will be very simulative since, absent heroic assumptions, the budget deficit will widen substantially.

Figure 6: US inflation v Fed Funds & Bond Yields



Source: Iress and Investec Wealth & Investment

European politics (mostly negative)

German post-election political uncertainty is unresolved (negative)

After an inconclusive election, Chancellor Angela Merkel has been unable to form a coalition government. A new election is increasingly possible.

Catalan independence flares up & subsides (negative)

Catalan politicians provoked the Spanish central authorities by holding an illegal referendum and subsequently, de facto, declaring independence. The Spanish leadership regained its poise after initial missteps and, having taken back control of the region, gambled by scheduling fresh regional elections – a gamble that failed after separatists took the majority of seats.

Brexit momentum (positive)

The UK's decision to leave the EU has, at least initially, brought the EU closer together. A recently agreed two-year transition period for the UK should also allow for the impact to be managed – although the majority will inevitably fall on the UK.

> Consensus forecasts of around 3% for US 10-year yields in 12 months' time do not threaten equity valuations.

New Fed governor chosen (neutral)

Jerome Powell has been named as Trump's choice to succeed Janet Yellen in February, when her term expires. Policy is expected to be consistent and Janet Yellen remains a governor until 2014.

Global tensions with North Korea still elevated (negative – unchanged)

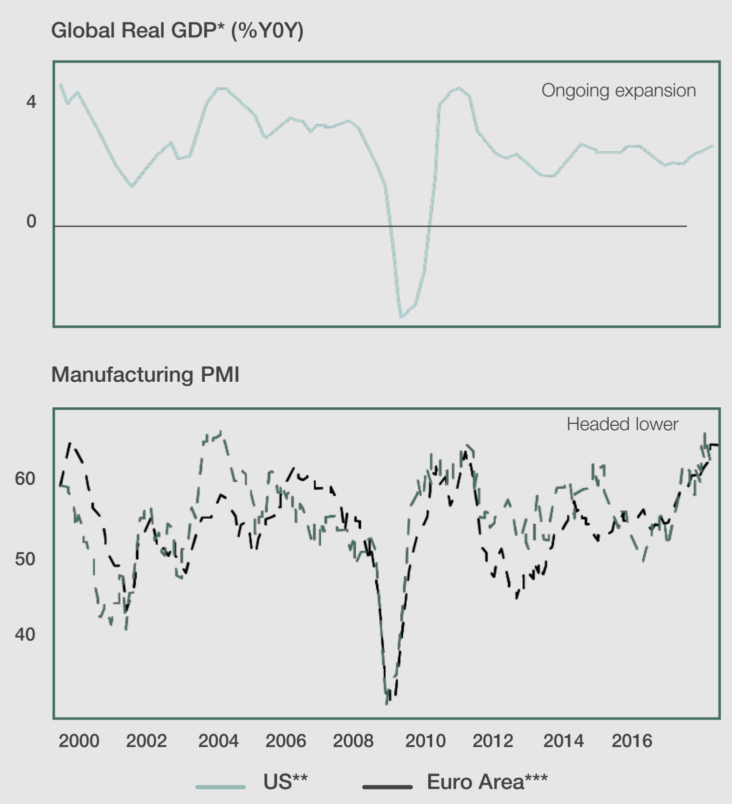
At the end of November, North Korea tested a long range ICBM that could reach the US. The US's rhetoric in response was more muted than in the past. Investment markets continue to take the view that the likelihood of a war between North Korea and the West is very low.

Other comments and clarifications

Global growth expectations

Estimates for global GDP growth rates continue to improve, with the consensus expecting another year of just under 4% in 2018 – a level projected to be sustained through 2019 and 2020. Growth improvement is driven by emerging markets, which should grow close to 6%, over two and a half times faster than developed markets (2.2%). This supports double digit corporate earnings growth forecasts next year – evenly spread between developed and emerging markets.

Figure 7: Global growth will be good, but not better next year



Source: Iress and Investec Wealth & Investment

Inflation

Global inflation over the next three years is not forecast to exceed 3%: deflationary global supply-side forces (technology-driven) are balanced against the positive impact on prices from higher demand. This assumption is clearly an important pre-condition for bond yields to remain anchored in ranges that do not threaten equity valuations.

US 10-year Treasury yield expectations

Consensus forecasts of around 3% for US 10-year yields in 12 months' time do not threaten equity valuations. Re-establishing the historical premium versus inflation could see a ceiling of 4% - a level that would almost certainly retard growth.

> In other words, a badly executed withdrawal of monetary policy stimulus, probably catalysed by an over-reaction to inflation data.

Icebergs revisited – No new icebergs and the existing ones are less threatening

The top risk factor identified by the strategy team is "developed market cyclical policy risk". In other words, a badly executed withdrawal of monetary policy stimulus, probably catalysed by an over-reaction to inflation data.

It is notable that the icebergs highlighted in our previous editions have receded, namely:

European systemic risk – low and receding further:

- Financial system recapitalisation is complete.
- Electoral challenges are largely behind US (populism repelled and Brexit withstood – but notwithstanding developments in Spain / Catalonia)
- Cyclical risk is also low.
- The key risk factor is monetary policy normalisation / QE tapering ahead.

China – systemic risk low, cyclical risk increasing

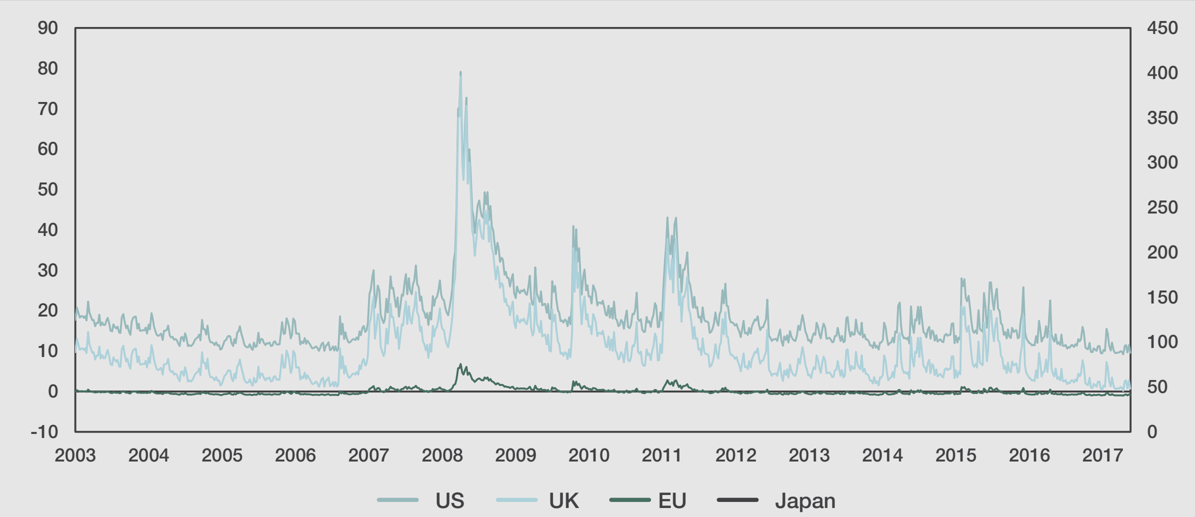
Systemic factors

- Integration with the global economy has passed the first major test (a dirty float of the yuan).
- Economic rebalancing is progressing well
- Debt accumulation has peaked. Furthermore, although debt levels are high, debt is self-funded.
- Politics is very stable.

Cyclical issues

- Cyclical risk is more debatable, but the last sharp slowdown was in 2015/6 – there is no reason to expect another self-engineered, broad-based retrenchment in the near term.
- However, it is likely that heat in the housing market will be cooled by the authorities (probably through macro-prudential measures). One should point out that outside observers are always prone to "shoot first and ask questions later" where China is concerned!

Figure 8: Equity, Currency & Fixed Income Volatility



Source: Iress and Investec Wealth & Investment

2018 scheduled political calendar - low risk

- German elections – a possible event, but the result is unlikely to be worse than the current impasse.
- An Italian election is required by May. Anti-EU parties, including the Five Star Movement, Northern League and Forza Italia, could win more than 50% of the vote, but a process of withdrawal from Europe unlikely to be triggered.
- US mid-term elections – a low-risk event from a financial markets perspective.

Geopolitics

- Key conflict flashpoints – tensions appear to be lower everywhere except North Korea.
- Donald Trump – an unknowable source of either positive or negative surprises.

Reading the share market – beyond market timing

By Professor Brian Kantor, chief economist and strategist, Investec Wealth & Investment

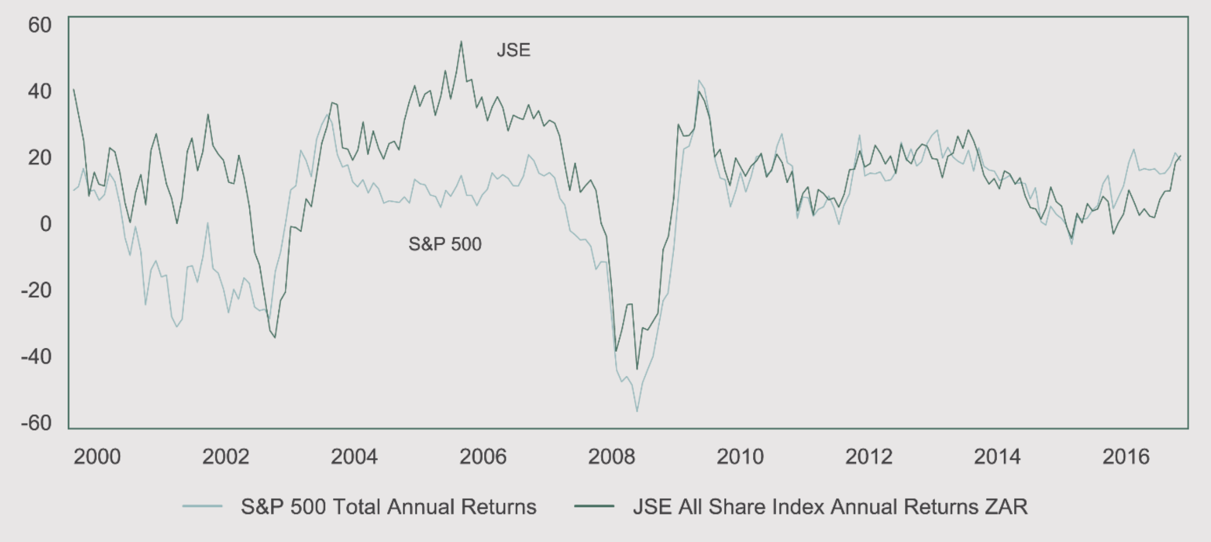
Every well traded market offers opportunity and danger. The opportunity is to buy low and sell high. The grave danger is that the investor/speculator does the opposite- sells at the bottom and buys at the top. The history of returns from equity markets reveals just how tempting it is to try and get the timing of entry into and exit from the market right; or, to put it more modestly, why it is important not to get the timing badly wrong.

The irregular pattern of past returns from equities

In figure 1 we show that since January 2000, the ups and downs of the S&P 500 Index of the largest companies listed on the New York Stock Exchange and the JSE All Share Index. With the benefit of hindsight, we can see that getting out of the New York market in early 2000 and re-entering in 2002, would have been very good for wealth creation. For investors on the JSE, timing would have called for even greater agility. It would have been best to have sold off somewhat later, in 2002, and then to have re-entered in 2003, so benefiting from the excellent returns available until the Global Financial Crisis (GFC) of 2008 caused so much damage to all equity markets.

Despite all the understandable gloom and doom of that unhappy episode in the history of capitalism, the GFC was followed by a period of strong and sustained value gains that continue to the present day (late 2017). It has been a rising equity tide that only briefly faltered in 2014. Those with strong beliefs in the essential strength of the global economic system and, more important, with faith in the capabilities of central bankers to come to the rescue, did well not to sell out in 2008 at what proved to be a deep bottom to share prices.

Figure 1: Annual returns on the S&P 500 Index (USD) and the JSE All Share Index (ZAR)



Source: Iress and Investec Wealth & Investment

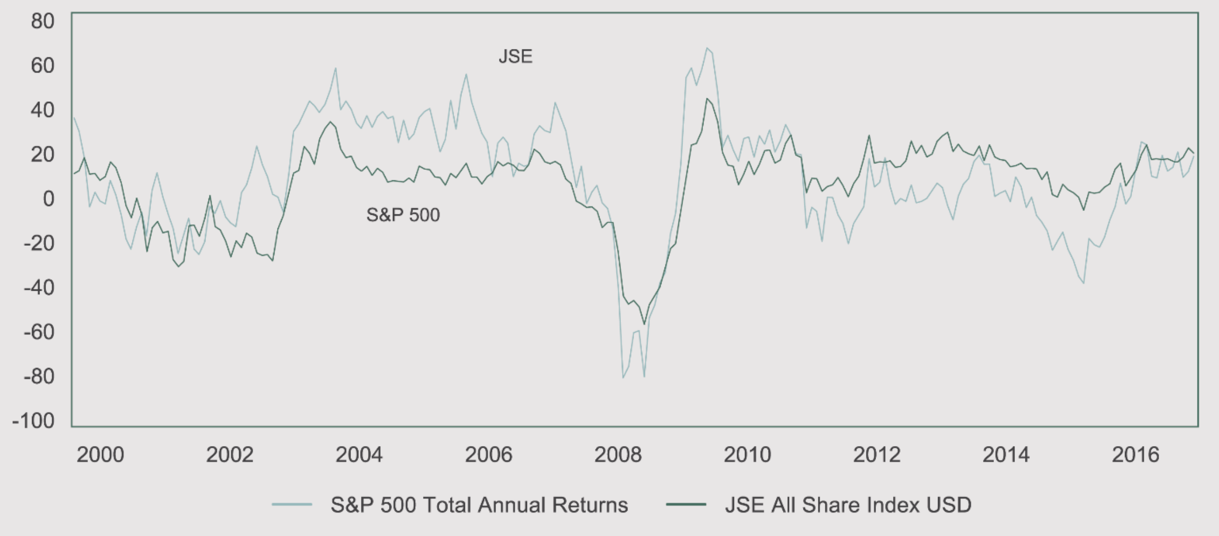
While perfectly timing market entry or exit is not a task given to ordinary mortals, we can draw some helpful inferences about the condition of the market place, given this sense of what has driven past performance.

These total share market returns (price changes and dividends received) have been calculated as gains or losses realised over the previous 12 months and calculated each month. The average annual return on the S&P 500 between January 2000 and November 2017, in US dollars, was 5.3% compared to 14.4% in rands generated on the JSE. The worst month for both markets was in late 2008, when both markets were down over 50% on the year before. The best year-on-year return on the S&P 500 over this period was 43%, realised in the 12 months to Februarion 2010, while the best months for investors on the JSE were in late 2005 when annual returns peaked at over 50%. Adjusted for inflation in the US and SA, the S&P Index has provided about a real average 3% p.a return and the JSE an impressive 8% p.a. in real rands.

When measured in US dollars, the JSE also outperformed, having delivered close to 7.5 % p.a on average compared to the 5.3% p.a earned on the S&P 500. It may be seen in figure 2 below that the JSE provided superior US dollar returns between 2003 and 2007, but offered markedly inferior returns (in US dollars) compared to the S&P 500 since 2012. These high average returns over an extended period of time surely indicate the advantage of maintaining consistently high exposure to equities over the long run.

> Despite all the understandable gloom and doom of that unhappy episode in the history of capitalism, the GFC was followed by a period of strong and sustained value gains.

Figure 2: Annual US dollar returns – S&P 500 Index and the JSE All Share Index



Source: Iress and Investec Wealth & Investment

While timing which market to favour over another – the JSE before 2008 and the S&P 500 after 2014 – can make an important difference to investment outcomes, it should also be noted that the returns on the S&P 500 and the JSE are quite highly correlated on average (close to 70%) in all the ways to measure performance.

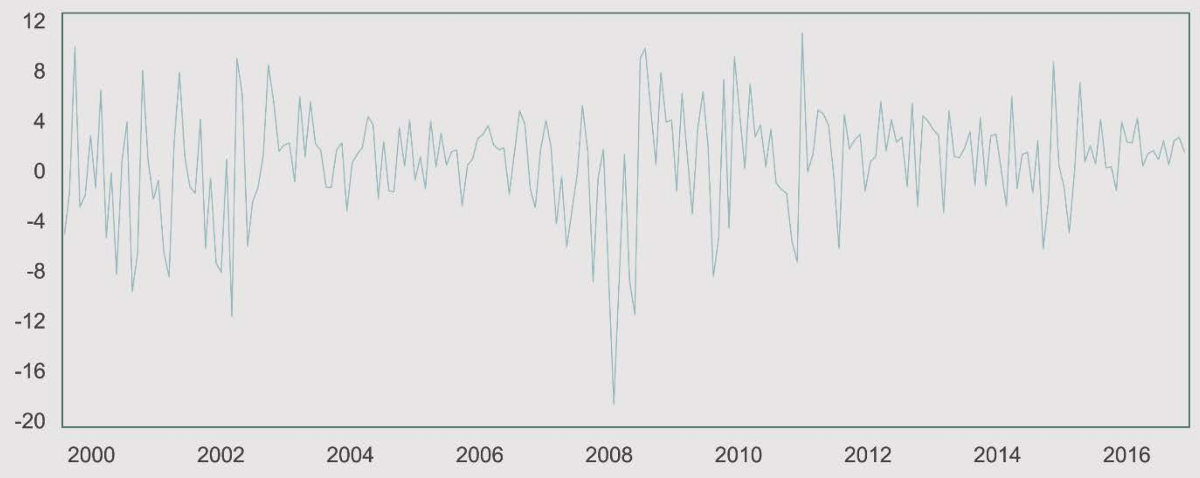
The forces common to all equity markets around the world will often be directed from the US economy and its asset markets to the rest of the world – rather than the other way round – making an analysis of the state of the S&P 500 a very good starting point for analysing any equity market.

The essential question then arises. Is it possible to undertake value-adding or loss-avoiding equity market timing decisions with any degree of analytical conviction? Such market timing decisions are unavoidable for any fund manager or investment strategist with responsibilities for funds that are not all-equity funds. Any fund required by its investors to hold a balance in their portfolios of cash, fixed interest investments of various kinds as well as the many alternative asset classes that might feature in portfolios, would have to exercise judgements about the risk inherent in equity markets at any point in time.

The risk that the equity markets might, as they have in the past, melt down or even melt up – only then perhaps to melt down again – must therefore be uppermost in the minds of all fund managers having to decide on an appropriate allocation of assets. Even those running all equity funds have to decide how to time turning newly entrusted cash into equities and, more important still, which particular equities to buy and sell.

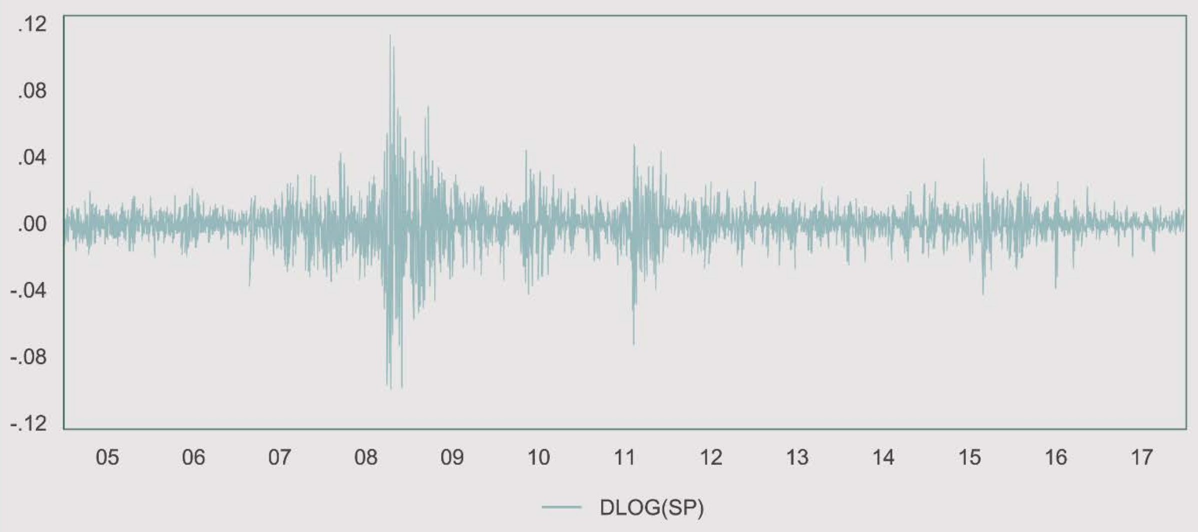
The broad direction of the equity or any other market can only be known after the event. From day to day, month to month or quarter to quarter, market prices and values are about as likely to go up as they are to go down. These short-term price moves therefore appear to observers as largely random, as the figure of monthly changes and daily moves in the S&P 500 Index shown below demonstrate. Note the still random (down/up, up/ down in no predictable order or magnitude) but very wide daily moves in the S&P 500 during 2008-2009 and during the euro bond crisis of 2011.

Figure 3: S&P 500 monthly returns (percent)



Source: Iress and Investec Wealth & Investment

Figure 4: S&P 500 daily returns (2005-2017)



Source: Iress and Investec Wealth & Investment

But these daily or monthly movements may reveal a broad drift in either direction, more up than down, or the other way round, measured over longer period of time. So when daily and monthly moves are converted into annual changes, observers will get the drift (after the event) and a persistent statistically smoothed trend in returns, that peaks and troughs in some more regular way, will be registered, as shown in figures one and two above. These phases, from top to bottom in annual returns, are defined as either a bull or bear market or something in between, depending on the depth or height of the following trough or peak, but can only be identified with hindsight.

Understanding how assets are valued

This does not mean that nothing meaningful can ever be said about the state of a market after it has moved higher or lower. With observation of the past we can understand the forces that have driven the value of any company higher or lower and so the average of them represented by a stock market index and therefore recognise the forces that might drive them higher or lower in the future, if past performance can be relied upon.

Successful, more profitable companies – those that earn a high return on the capital shareholders provide their managers – after all command higher values than less successful ones. And part of their success or failure will also have to do with the environment in which they operate. The laws and regulations, including the taxes their shareholders are subject to, will influence their ability to generate revenues and reduce costs, as will fiscal and monetary policies. The more certainty about these forces in the future, the less (more) risk to be discounted in the prices paid and the more (less) valuable will be the future flows of revenues and costs in which owners will share.

These market-wide forces that determine the value of a share market index are in principle not difficult to identify. In practice they raise many unresolved issues about how best to give effect to the underlying theory.

> It will take less SA risk, which comes with an improved political dispensation, to focus global attention on the potential value in SA equities, particularly the companies heavily exposed to the SA economy.

The economic caravan always moves on making it impossible to prove the superiority of one valuation approach over another. Holding other things equal is only possible in the laboratory, not in the economy.

The market can be thought of as conducting a continuous net present value (NPV) calculation, estimating a flow of benefits from share ownership over time, the numerator of the equation. That can be calculated as earnings (profits) or dividends or net (free after-capital expenditure) cash flow expected. The calculations of these are highly correlated when measured for an aggregate of all the firms that make up the Index. This expected performance of the market is then assumed to be discounted by a rate that reflects the required risk-adjusted rate of return set by the market.

The cost of owning shares rather than other assets, is given effect in the applied discount rate. It represents the opportunity foregone to own other assets, for example government or private bonds or cash, that offer pre-determined interest rate rewards with less default risk. In addition shareholders will, it is assumed, expect some additional reward, described as an equity risk premium (ERP) for the extra risks incurred in share ownership that offer no predetermined income. Hence a higher discount rate when the ERP is added to benchmark, default risk free fixed interest rates as provided by securities issued by a government. Such risks can be measured by the variability of the value of the share index from day to day, as shown above, a process of price determination that makes share prices more variable and less predictable than those of almost all other relevant asset classes.

These share prices will go up or down as the discount rate rises or falls with changes in interest rates. And with circumstances that cause investors to attach more uncertainty to the flow of benefits they expect from share ownership. The price of the shares goes lower or higher to compensate for these extra or reduced risks to the outlook for the economy and the companies who contribute to it.

The numerator of the NPV equation that summarises the expected flow of benefits to owners may be regarded (for reasons of simplicity) as (relatively) stable. A lower (higher) share price reconciles this given outlook with the required risk adjusted return that makes owning a share seem worthwhile. So when discount rates go up (down) – valuations (share prices) move in the opposite direction to improve (reduce) the expected returns from share ownership. Lower prices, other things being equal including expectations of profits to come, mean higher expected returns and vice versa.

Understanding and taking issue with the market consensus

One of the essential questions with which to interrogate the market, is to judge whether current market-determined interest rates are likely to move higher or lower or if the environment that companies will operate in is going to become more or less helpful to their profitability. By definition, what surprises the market moves in interest rates or tax rates or risk premiums, will move valuations in the opposite direction. You may believe that the marketplace has misread the true state of affairs, such as the outlook for interest rates and risk premiums, and so has mispriced the share market, overvaluing or undervaluing it enough to encourage additional selling or buying.

The market consensus (revealed by the current level of the Index) will also have incorporated its expectations of performance to come by the companies represented in the Index. This consensus may also prove fallible. Earnings may be about to accelerate or decelerate in surprising ways. Operating profit margins may stay higher or lower for longer than expected. The economy itself may be about to enter an extended period of well-above past growth rates. If so, and you will have your own reasons for believing so, this would provide good reason to reduce or increase exposure.

Such contrarian opinions, if acted upon will add to or reduce exposure to equities. The market consensus is determined by its participants, all with the same incentive to understand it better, as you have, and is studied by many with great analytical skills and vast experience. Consensus has every reason to be the consensus. And when the consensus changes – as we have shown it so often changes – it will do so for good and well-informed reasons. Beating the market – that is getting market timing right – is a formidable task, so humility is advised.

While perfectly timing market entry or exit is not a task given to ordinary mortals, we can draw some helpful inferences about the condition of the market place, given this sense of what has driven past performance. We are in a position to judge how appropriately valued a market is at a point in time and therefore what would be required of the wider economic forces at work to take the market higher- or prevent it from going lower. We will attempt to recognise what is being assumed of the equity market – what assumptions are reflected in the prices paid for shares – and whether or not you can agree or differ from what is at all times the market consensus.

Our valuation exercises

We judge whether the equity market is demandingly or un-demandingly valued in the following way. We determine how current valuations are more or less demanding of additional dividends. Why dividends? Because they have the same meaning today as always: cash paid out to shareholders rather than retained by the enterprise. They are not subject to changing accounting conventions, such as the nature of capital expenditure and research and development expenditure that may or may not be fully expensed to reduce earnings. What may appear as an overvalued market would need a strong flow of dividends to justify current values and expectations. An undervalued market would be pricing in a slow-down in dividend payments. Good or poor dividend flows can take the market higher or lower.

Furthermore, we judge whether the market is more or less complacent about the discount rates that will be attached to these dividends to come. In this we are also aware that the interest rates we observe and that the market expects, as revealed by the level of long term interest rates and the slope of the yield curve, may be abnormally low or high – but might normalise to some degree in the near future.

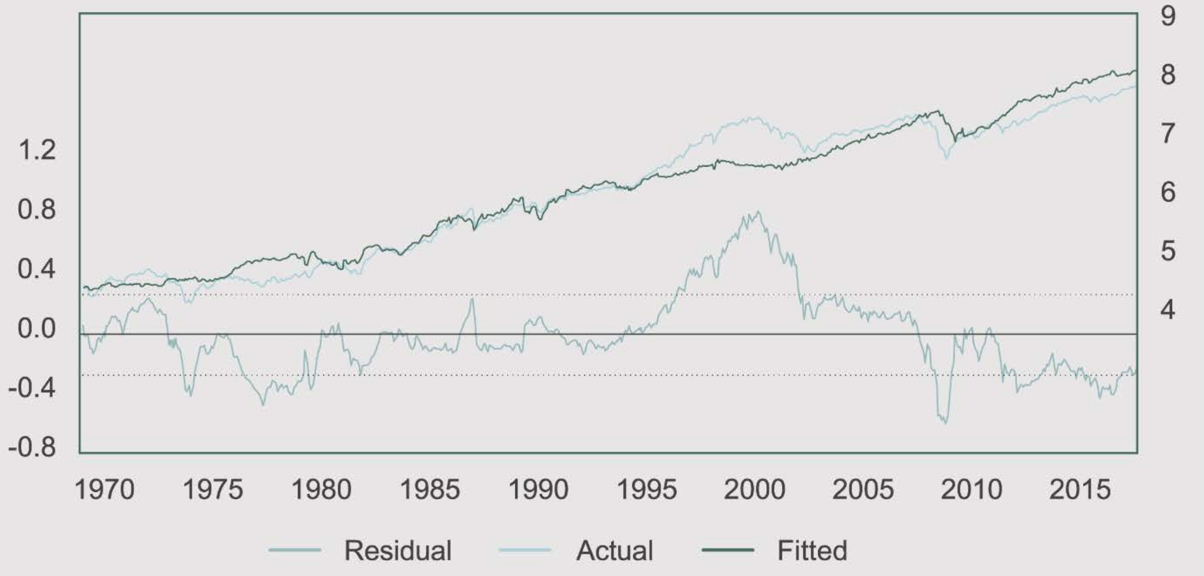
We utilise regression equations that compare the current level of the leading equity index, the S&P 500, to the level predicted by trailing dividends and long-term interest rates. The results of such an exercise are shown below. The model equation predicts a significantly higher S&P 500 than is the case today, some 40% higher. By this standard the S&P is currently undervalued.

The model provides a very good fit and both explanatory variables easily pass the test for statistical significance and accord well with economic theory. It explains past market behaviour well.

We can back test the model. If the model was run with data only up to November 2014 when the S&P began its new upward momentum we would have received a very helpful signal that the S&P was in fact very undervalued at that time. This signal would have encouraged investors at that point in time to have maintained high equity weight in portfolios- or what is described as a risk-on position.

Similarly had we applied the model in early 2000, just before the so called Dot.com bubble burst, the model would have registered that the S&P 500 Index was then greatly overvalued for prevailing dividend flows and interest rates Reducing exposure to equities at that point in time would have been very much the right approach to have taken – as we soon came to find out.

Figure 5: Regression model* of the S&P 500
(1970-2017)



Source: Iress and Investec Wealth & Investment
*Representation: LOG(SP) = -1.80463655704 + 1.18059721064*LOG (SPDIV) - 0.0727779346562*USGB10

We should add however that the model would also have registered a high degree of overvaluation as many as three years before the market fell away from its high peak. Even irrational exuberance, as Alan Greenspan memorably described it in 1997, perhaps relying on a similar approach to value determination, or its reverse undue pessimism, can persist for an extended period of time, making our model or any such valuation exercise based on historical performance unhelpful as a short-term trading model, but still valuable as a basis with which to interrogate market consensus.

In our models we regard the value of the S&P 500 as representing the present value of a flow of dividends (the performance measure) discounted by its opportunity cost, represented by the interest rate (the expected return) on offer from a 10-year US bond yield. An alternative approach would be to compare the value of the Index to the expected economic performance of the companies included in the Index, and then to infer the discount rate that could equalise price and expected performance in the NPV equation.

The Holt system[1]undertakes this calculation. It estimates the free cash flow return on capital realised by and expected from all listed companies (CFROI) real cash flow return on real cash invested using the same algorithms applied to all the companies covered by the system and its data base. This analysis can be used to derive a market discount rate for any Index that equalises the value of an Index, for example the S&P 500, to the cash flows expected from it.

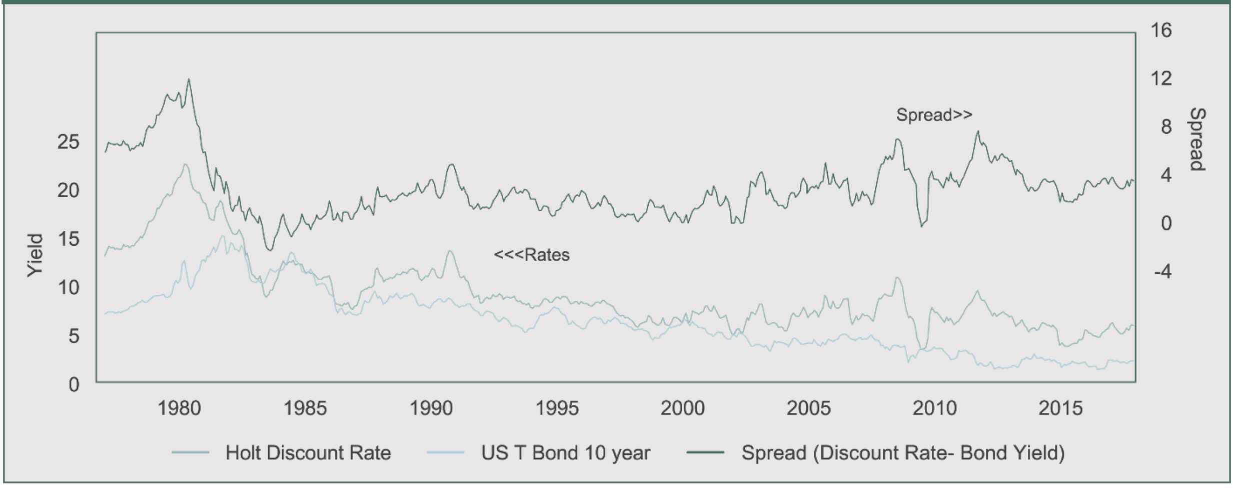
In the figure on the next page, we compare this nominal Holt discount rate for the S&P 500 to US long term interest rates. These discount rates have receded with long-term interest rates, as theory would predict. Note also that both interest and the Holt discount rate are at very low levels, implying higher share prices for any given flow of dividends.

Of greater importance perhaps for share prices than discount and interest rates is the spread between them. This spread, the extra risk premium for holding equities rather than bonds, has widened in recent years. While the discount rate may have declined, it has maintained and even increased the distance between it and interest rates, so encouraging demand for equities.

1. Credit-suisse.com/holtmethodolgy
   "HOLT derives a market-implied discount rate by equating firm enterprise value to the net present value of free cash flow (FCFF). HOLTs FCFF is generated by a systematic process based on consensus earnings estimates, a growth forecast, and Fade. This process is similar to calculating a yield-to-maturity on a bond" See Holt Notes November 2012.
2. In order to undertake the analysis over an extended period of time we added US inflation to the real Holt discount rate for the US sample to establish a nominal discount rate to be compared with nominal interest rate. An equivalent series of US real interest rates (Tips) is only available from 1997.

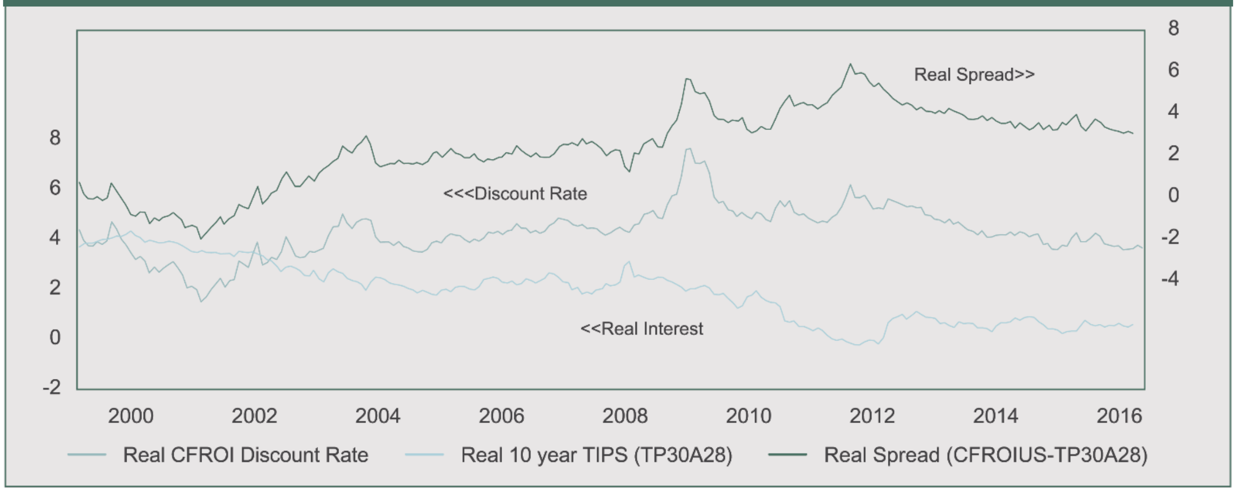
When we replace interest rates with this risk premium in our dividend discount model we get a very similar signal of a currently undervalued S&P 500 (see below).

Figure 6: US Holt discount rates (nominal) US long bond yields (10 year) and risk spread



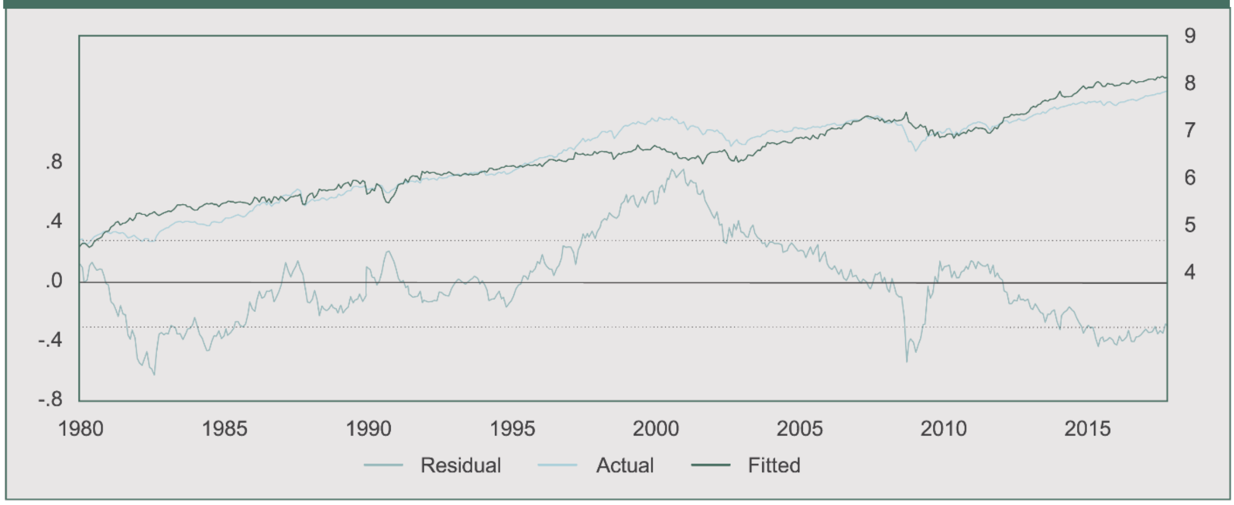
Source: Credit Suisse Holt, Iress and Investec Wealth & Investment

Figure 7: Real Holt discount rates and real interest rates and real risk spread



Source: Credit Suisse Holt, Iress and Investec Wealth & Investment

Figure 8: A model of the S&P 500 (explanatory variables, dividends and spread between discount rate and long term interest rates)*



Source: Credit Suisse Holt, Iress and Investec Wealth & Investment

*Representation of the equation:

LOG(SP) = -4.59846533561 + 1.51940769795*LOG(SPDIV) - 0.0501430590849*(CFROINOM-USGB10)

> Successful, more profitable companies – those that earn a high return on the capital shareholders provide their managers – after all command higher values than less successful ones.

Therefore we conclude that the S&P 500, despite its recent strong upward momentum, is undervalued for current dividends and interest rates or the risk spread. However some caution about the level of the S&P Index is called for by a sense that long-term interest rates are now very low and may well normalise. A further reason to be cautious about the current level of the S&P 500 is that the day-to-day volatility of the Index has been very low by comparison with the past.

This indicates an unusual degree of comfort with the current state of the US share market. Were volatility to normalise, share prices would probably be under pressure.

Hence our asset allocation advice has been to retain a neutral exposure to equities for now, with the next 18 months in mind. On a shorter term view (less than six months) however, we are of the view that upside strength is at least as likely as any move lower.

When we review the JSE applying a similar method of analysis, the rand values of the All Share Index appears as fairly valued for trailing dividends and US Interest rates. It also appears fairly valued when all the variables of the model are converted into US dollars. However when the (high) level of the S&P is included as an explanation of the USD value of the JSE in place of US interest rates the JSE appears as now attractively undervalued.

The S&P 500 is normally a rising tide that lifts all boats. But in the case of the JSE this has not been the recent case. Not only the JSE but emerging market equity indexes generally also lagged behind the S&P 500 after 2014 and until mid-2016. It will take less SA risk, which comes with an improved political dispensation, to focus global attention on the potential value in SA equities, particularly the companies heavily exposed to the SA economy. The SA political news has improved and the case for SA equities exposed to a potentially stronger SA economy, has also improved, making the case for a somewhat overweight exposure to this sector of the JSE.

Figure 9: A model of the US dollar value of the JSE with dividends and US interest rates*

Source: Credit Suisse Holt, Iress and Investec Wealth & Investment
*Representation of the equation:
LOG(JSE USD) = 1.3925529347 + 0.776827626347*LOG(DIVIDENDS USD) - 0.127168505553*US 10 Y Bond Yields

SA market view and asset allocation – A window of opportunity

By Paul McKeaveney, chairman of the asset allocation committee, Investec Wealth & Investment SA

The ANC elective conference presents a window of opportunity for some positive self-help, to take advantage of the positive emerging market environment. We await evidence of a follow through on this however, so the SA team maintains its broadly neutral stance, with a positive bias.

Market overview

2017 was a draining year for South African investors but when we consider the returns across the major asset classes, things have turned out quite well. The All Share Index returned 21%, the All Bond Index 11%, Property Index 17% and cash 7%. A simple 60:40 equity/bond balanced portfolio would have returned 17%. Digging a little deeper, most of the returns came in the second half of the year, so investors who stayed the course amidst the doom and gloom ended up being well rewarded. With the benefit of hindsight, the right stock to have owned on the All Share Index was Naspers, which accounted for almost 10% of the 21% (i.e almost half of the market return), while the one to have avoided was Steinhoff, which knocked 3% off the annual return. These returns need to be viewed in context of a very strong year for risk assets, i.e assets like equities in general, commodities, emerging markets and so on. The MSCI World Index returned 23% and the MSCI Emerging Market Index 39% (both in US dollars). 2017 was the best year for emerging markets versus developed markets since 2009.

Cautiously optimistic

Looking at South African asset allocation positioning moving into 2018, the phrase that comes to mind is cautiously optimistic.

"Cautiously" because global markets will, to a large extent, drive performance of the South African market and, even more so, emerging markets. As one will have read in the Global Investment View above, our risk appetite has slipped below zero (indicating an underweight risk position) as we "move closer to the door", which is an analogy for the maturing and lengthy bull market we have been in and the fact that we are looking to take some money off the table.

"Optimistic" because the new president of the ANC, Cyril Ramaphosa, has an opportunity to set the country on a new course after a long period of stagnation. Global risk appetite for emerging markets has acted as a shock absorber for South Africa recently and we have a window now to administer some self-help while the going is good. Setting the new course will not be straightforward given the various entrenched interests in the ruling party. However there is a good chance that Ramaphosa can get things going in the right direction, although we aren't getting too excited just yet.

Lot of water still to flow under the bridge

In light of the above, the asset allocation moves reflect this cautious optimism for South African assets. The ANC elective conference in December was a closely run affair and we believe that our neutral equity allocation and overweight cash position at the expense of the bonds and property was the right call even though we did get a positive political outcome. We think we may well be on a new path and that moving back to a neutral bonds and property position at the expense of cash makes sense. The reason we are not moving to an overweight position in any of the major asset classes is that it is still very early days and there is a lot of water yet to flow under the bridge. We still have to navigate February's Budget speech (government finances are under increasing pressure), we are teetering on the brink of exiting major bond indices, the composition of ANC top six is problematic and the global bull market looks stretched.

Looking at South African asset allocation positioning moving into 2018, the phrase that comes to mind is cautiously optimistic.

Too much negativity priced in

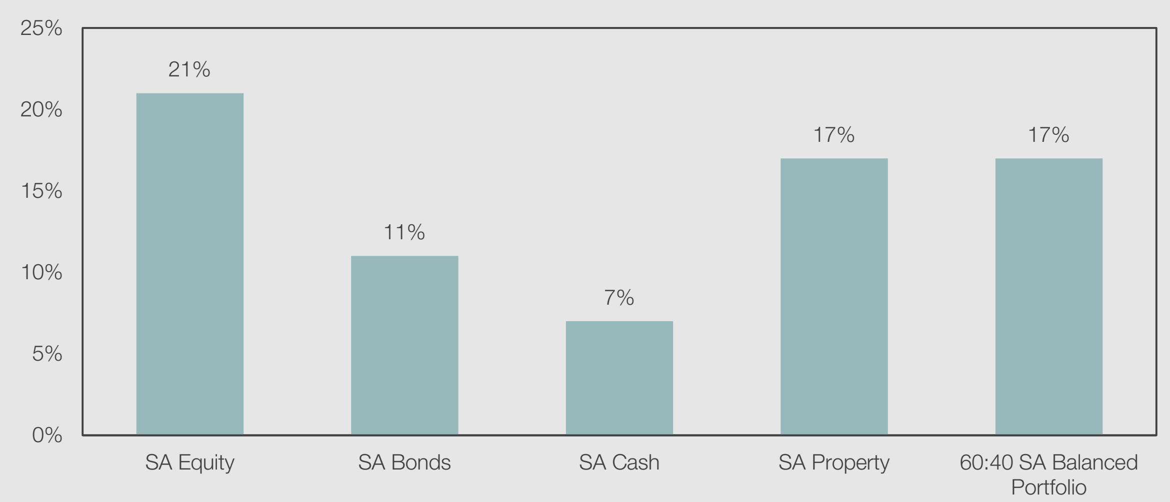
That all said, what can drive South African asset performance is the fact that there has been so much negativity priced into our asset prices. This has meant that investors (foreign and domestic) are very underweight SA assets and the JSE (adjusted for Naspers) is now the fourth cheapest emerging market globally (having traded at a premium for a long period of time). There is now scope for improvement on the economic and political front. Markets are forward looking and we think that improvements in our prospects off a very low base could lead to strong performance. On top of the wins that would be earned by addressing corruption and the misallocation of state resources, a virtuous circle could take hold: lower inflation, on the back of a stronger rand, would allow the MPC of the Reserve Bank to cut interest rates, providing relief for consumers and help to stimulate the economy, in turn improving our growth rates which will attract more investment as well as instilling more confidence.

Positively neutral

Accordingly, we have maintained our neutral exposure to equity, but are moving to a neutral position for fixed income and property, using the cash on hand. The crucial message is that while we are looking to move to an overweight position in domestic risk assets, we need to see the politicians deliver against the positive backdrop. We hold some physical gold but, given the relationship between gold and US real interest rates (which we think are going up – all things being equal this would be bad for gold), this means that this position is becoming a lower conviction hold.

Markets are forward looking and we think that improvements in our prospects off a very low base could lead to strong performance.

Figure 1: Returns by asset class



Source: Bloomberg

The ANC elective conference in December was a closely run affair and we believe that our neutral equity allocation and overweight cash position at the expense of the bonds and property was the right call.

Asset allocation positioning:

The metrics below show our asset allocation positioning for global, domestic and by theme.

Global Asset Allocation	Q1 2018	Q4 2017	Comments
Offshore Equity	▼	N	Moving underweight global equities. Given where we are in the cycle we would like to "move closer to the door".
Offshore Fixed Income	▼	▼	Low expected total returns from these starting yield levels. Risk spreads across fixed income asset classes are expensive.
Offshore Cash	▲	▲	Adding to cash. Provides optionality to increase risk should we see an opportunity.
Offshore Property	N	N	Valuations reasonable relative to long term averages
Offshore Alternatives	▲▲	▲▲	Offers attractive risk-adjusted returns relative to traditional long only assets classes. Variations include return enhanced, capital protected and low correlation products.
SA Asset Allocation	**Q1 2018**	**Q4 2017**	**Comments**
SA Equity	N	N	Much more optimistic on outlook for SA assets but cognisant that a) we are reducing risk globally and b) there is a lot of work ahead for the new leadership.
SA Fixed Income	N	▼	Concentrated in "belly" of the yield curve. Inflation trajectory should support attractive total returns. Expect to see cuts to Repo rate in 2018.
SA Cash	N	▲	Using cash to increase fixed income and property. Still providing an attractive real return.
SA Listed Property	N	▼	Moving back to neutral. In risk-on SA environment, coupled with lower bond yields, property stocks could perform well.
Preference Shares	▲	▲	Attractive yield advantage over taxable yields assets with possible repurchase underpin. Focus on the bank preference shares.
$/R (+ for Rand strength)	N	N	ZAR is currently at fair value - expect to be rangebound and driven by political news flow in the near term.
Sectoral / Thematic Positioning	**Q1 2018**	**Q4 2017**	**Comments**
Global Plays	▲	▲	We have reduced our exposure to global plays.
Commodities	▲	▲	Overweight commodity plays although upweight in quality and lower beta. Prefer diversified miners versus single commodity producers.
Gold Plays	▼▼	▼▼	Currently do not own any gold producers given poor fundamentals. Continue to own physical gold in balanced portfolios as a geopolitical hedge.
Interest Rate Plays	▲	▲	Adding to our interest rate play exposure on the back of the positive SA fundamental outlook. Investors are underweight.
SA Industrials	▼	▼	Valuations at interesting levels, especially in mid and small cap area of the market.

▼▼	▼	N	▲	▲▲
Underweight	Moderately underweight	Neutral	Moderately overweight	Overweight

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