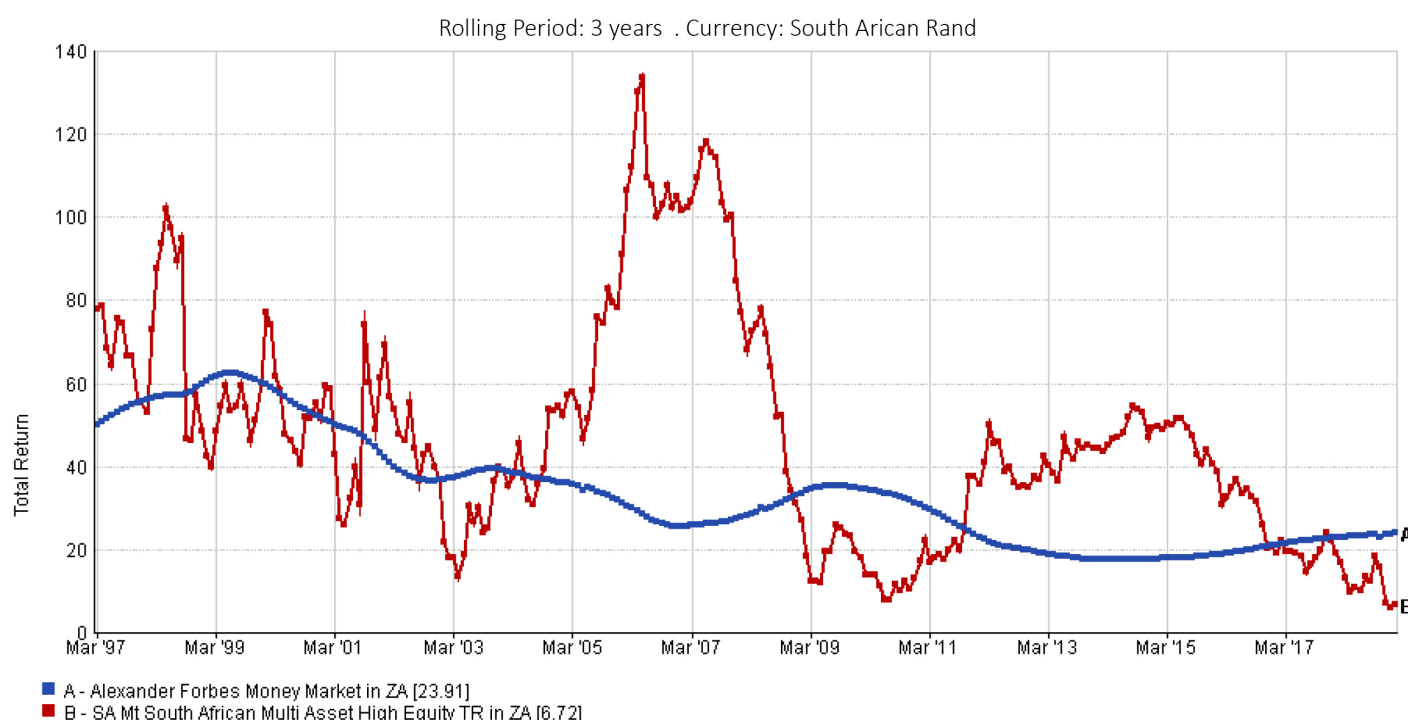


Investment Outlook 2019

For some time now most local and global asset class valuations have been trending towards their long-term averages from historical starting points which have been quite expensive. While this is a painful experience as asset classes de-rate, it is a necessary part of the investment journey and has been illustrated consistently over many investment cycles. Investors often call this 'mean reversion', simply meaning that cheap assets should go up in price, and expensive assets should go down in price.

2018 was a rather rude reminder as to how quickly this mean reversion can impact investment returns. This is shown clearly in the medium to longer term, where the average investor in a local balanced fund has lagged money market since 2016 over a three-year horizon, and has recently dipped below money market over a five-year horizon. To add insult to injury, many investors are questioning the merit of long term investing and are voting with their feet, moving to money market or avoiding investment altogether.



28/02/1997 - 31/12/2018 Data from FE 2019

Chart 1: Local Balanced funds have underperformed money market over 3yrs since 2016

It will be little comfort then to point out that because asset classes have fallen, the future should be brighter! It also won't help to highlight that through the course of history, we have had worse times. In fact, over the past 100 years there have been nine instances where investors have been worse off than they are today – relative to cash.

It is interesting however to note that in all prior nine instances, we had experienced a significant market event – a crash, bubble or even a war:

Instances where balanced funds lagged cash investments over 3 years	Explanation
1930s	Great Crash followed by the Great Depression – a Wall Street bubble
1970s	Energy Crisis
1990	Gulf War
1992-1993	Japanese equity bubble and UK currency issues
1997	Asian Crises
1998	Emerging Market Crisis
1999-2000	Dot.com bubble collapse
2003-2004	Strengthening rand post 2001 blowout and a weak local economy
2009-2011	Global Financial Crisis

What is noticeable with current low levels of return is the absence of any crash, bubble or war. Markets may be ‘noisier’ than ever, but we have not been subjected to any significant event which in itself would cause significant negative returns. Instead, we have had a somewhat bumpy ride, but one in which most asset classes have lagged that of cash over the past few years without any single event taking place. The following points detail why asset classes have been persistent poor performers of late, showing three year annualized returns:

- Local cash investments: 7.4% per year over the past three years.
- Local equities: (+4.3% per year) Due to a weak domestic economy and weak earnings from companies; stock specific issues (Steinhoff, MTN, Resilient) and the rand headwind.
- Local property (-1.2%): insatiable demand for property led to an overpriced sector where the underlying economics were not sustainable, none more clearly evidenced than with the Resilient problems but also seen more broadly across the sector.
- Rand effect: (-2.9%). In 2015 we experienced ‘Nenegate’, where the rand sold off to excessively low levels. In the subsequent three years to 2018 we have had a ‘mean reversion’ in the rand back towards its stronger expected value – causing a headwind to offshore linked returns which comprise a material part of local portfolios.
- Offshore equities (4.3%) have been volatile, and the impact of QE, Brexit and the rise of the technology sector has created a complex environment in which to make global equity decisions. The strong rand has also reduced offshore returns.
- Local bonds (+11.1%) have been the standout performer, for no other reason than during Nenegate they were aggressively sold down on declining confidence in fiscal South Africa creating a low base from which to earn returns. To compound matters, fund managers were largely uninvested in local bonds, forgoing this opportunity for investors.

The resulting outcome being a poor return for the average balanced fund investor over the past few years. So where does this leave us? To inform our outlook for 2019 and beyond, we evaluate each of the asset classes relative to their long term average valuations. This helps us determine which asset class is due a positive mean reversion, and which is not.

Looking back exactly 12 months to January 2018, the starting valuation levels were in aggregate high – with a balanced fund strategy¹ starting the year with a 6% premium relative to fair value. At current levels, balanced funds are now on the cheaper side of fair value, reflecting a discount of 4.3%. This bodes well for future returns relative to history.

In a global context, 12-month prior levels were also expensive, reflecting a premium for a balanced fund investor of 2.1% one year ago (equities in aggregate were on the cheaper side despite the US being expensive), whereas at today's value's there is a 5.3% discount – also a positive sign for future returns.

Looking at each asset class on this basis we can identify where the relative value in markets exists:

% from the asset class long term average or fair value

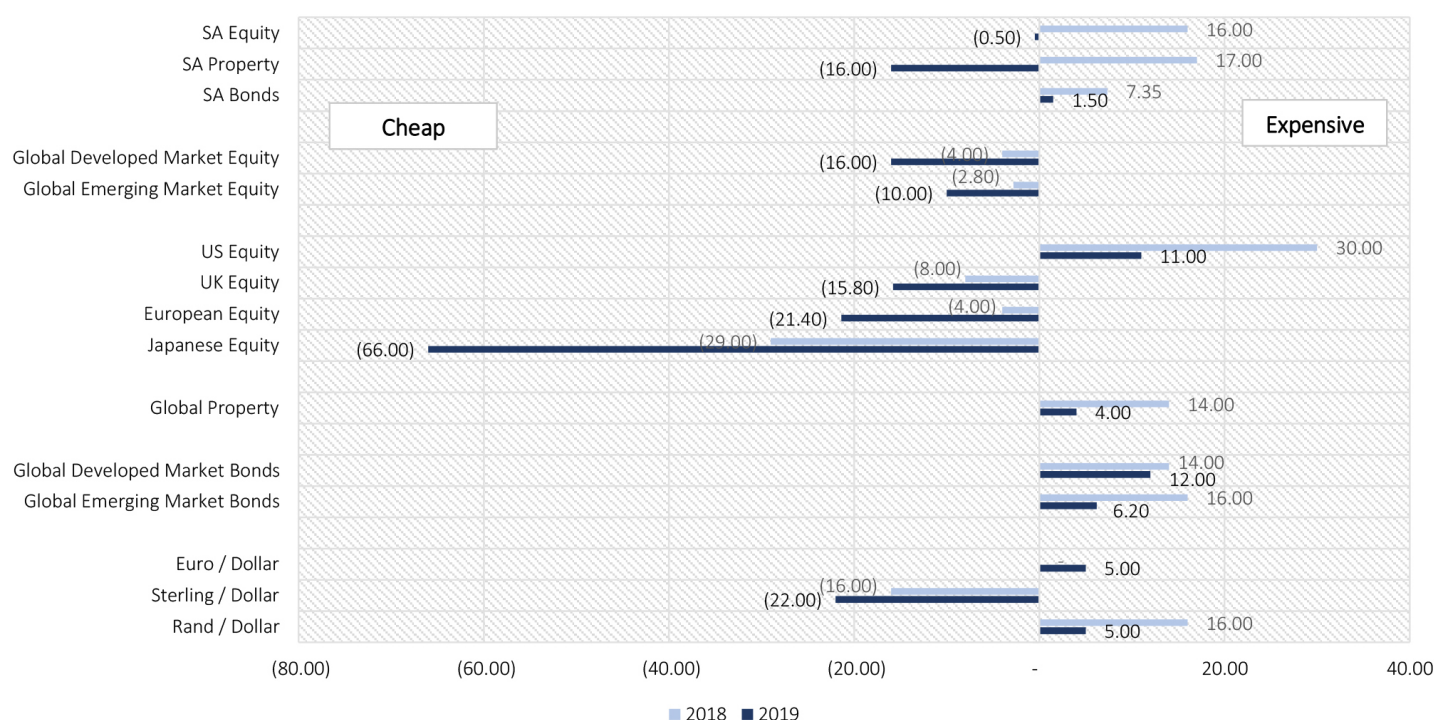


Chart 2: Relative value of asset classes vs long term history

The table below provides a summary of where each asset class is currently positioned from a relative value perspective:

Asset class	Context	Outlook
ASSET CLASSES AT A DISCOUNT		
SA Property	The unwind in property valuations has come about through stock specifics (Resilient et al) as well as a fundamentally weak local economy. This has led to earnings and distribution disappointment, and because the accounting has a lag (lease horizons for example), there is potentially more bad news to come.	Poor
Global Equity	UK: Brexit risks are escalating again, and the 'old world' UK equity market which is quite	Mixed

(UK, EU, Japan)	commodity heavy is taking strain; EU has not yet managed to shrug off the lasting impact of the GFC, and the high levels of debt will curb future growth. Japanese valuation multiples have declined sharply, but due to a sharp rise in underlying earnings for the first time in many years.	
EM Equity	Strong EM currencies elevated returns in 2017, and much of this unwound in 2018; with EM increasingly focused on China and Technology, the selloff in growth-oriented equities impacted EM negatively, as did the Trump induced trade wars. Commodities remain a significant component of EM, and with their recovery cycle quite mature, the future prospects look weaker.	Reasonable
Sterling	Sterling retains a significant discount due to Brexit risks.	High risk

ASSET CLASSES AT A PREMIUM

US Equity	Both the 'quality' and 'technology/growth-oriented' sectors have been trading at exceptionally high valuations. However, with high levels of risk and low prevailing yields, quality equities have been favoured; and with the technology platform 'landgrab' continuing unabated through the likes of the FAANGS, with real cash earnings this time, the appetite for growth has been high. Much of the market has been oversold or ignored so there is opportunity, but with a lower quality caveat.	Mixed
Developed Market bonds	Aggregate bond yields remain at low levels relative to history, with US treasuries leading the way and breaching 3%, they are now back below due to cautious comments by the Fed	Poor
EM Bonds	Despite EM yields selling off and their discount to developed bonds normalising, global income markets remain highly priced post QE. However, in a world where yield is sought after we may see persistent demand and support for prices.	Mixed
Euro	A function of the weaker dollar of late, we don't expect this to move materially away from fair value unless there is a significant event	Mixed
Rand	With the rand somewhat stronger than PPP models suggest, there is potential upside, albeit limited. Strong rand factors include the global search for yield and the more conservative Fed stance, as well as an improving economic and political environment in SA. Headwinds include a poor fiscal state, risks around a credit downgrade resurfacing, and sustained weak economic growth.	Positive

ASSET CLASSES AT FAIR VALUE

SA Equities	Having sold off during 2018, local equities are low in their earning cycle and are showing reasonable value on average. However, they do not fully reflect, in aggregate, how poor much of the economic environment is. Ideally, starting valuations would be lower, and the prospect of a strong local economy good, with a supporting global economy. Any significant global slowdown would likely impact future returns negatively.	Average
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SA Bonds	Real yields remain high on the 10-year bond (+4%), however risks remain quite elevated (fiscal, SOE's, election and the credit downgrade).	Average
Global Property	In line with yield-based assets globally, property was highly valued, but the 2018 selloff has resulted in a better entry point and provided the global economy stays on track, property returns remain reasonable.	Average

Within global equities we are faced with a conundrum in that in a high risk economic environment such as the one we are faced with, the favoured sectors are growth-oriented shares demonstrating strong earnings, and those which are resilient and able to protect their business models and survive any downturn, while paying high levels of dividends. The problem we face is that both of these tend to be quite highly priced at present, so entry points are not that attractive. On the flip side, lower quality cyclicals and emerging markets (which tend to be held by the value managers at this stage in the cycle), rely on a positive forward looking global growth outcome, so are vulnerable to any material event or slowdown. There is no easy route to global equity investing in 2019, and it pays to be diversified.

While much of the noise we see and hear in global markets is just that, there are a few items to take note of which could escalate in 2019:

- Global debt: The single largest risk we see globally is that of aggregate debt levels, both in governments as well as within corporates. In terms of issuance it must surely fall into bubble territory. High debt levels may be sustainable if countries and companies have strong balance sheets and healthy economies, but they are extremely vulnerable to any inflation or rates shock. The consequences of this would be extreme.
- Brexit: the UK is relatively small in global terms, however Brexit does have the ability to impact Europe and the general risk mindset of investors. A hard Brexit and potentially a change in leadership would not bode well.
- A slowing Chinese economy: GDP continues to trend down, and the US led trade wars may also impact prospects. China is fully integrated with developed and emerging economies and any significant adverse event would hold back investment returns.

We have changed our outlook view (as per Table 1 below) on the following asset classes:

- Core/passive SA equity: from (-2) to (-1) given the more attractive valuation entry point
- Global Value equities: from (3) to (2) as valuations have declined in aggregate to below fair value, the relative appeal of other equity options is higher and the case for Value weaker.

Date	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Note
ASSET CLASSES										
SOUTH AFRICA										
EQUITY	-3	-3	-3	-2	-2	-2	-2	-1	-1	Valuations now broadly at long term average, and earnings cycle is low.
PROPERTY	-3	-3	-3	-3	-3	-2	-2	-2	-2	Valuations have derated, but risks remain high with weak economy
BONDS	-2	-2	-2	-2	-2	-1	-1	-1	-1	EM linked selloff means bonds are showing better value and high real yields
CASH	2	2	2	2	2	2	2	2	2	Real yields are high as CPI remains low, but risks are increasing (fiscal)
GLOBAL										
DEVELOPED EQUITY	2	2	2	2	2	1	0	0	0	Valuations now broadly at long term average, but earnings cycle is near cyclical high.
EMERGING EQUITY	3	3	3	3	2	1	0	0	0	Weakness driven by trade wars and currency derating to US\$
DEVELOPED VANILLA BONDS	-3	-3	-3	-3	-2	-2	-2	-2	-2	Valuations moved further away from fair value. Not an attractive entrypoint.
FLEXIBLE/EMERGING BONDS	1	1	1	1	-1	-1	-1	-1	-1	Spreads have widened in 2018, coming close to long term average. However risks are elevated.
GLOBAL PROPERTY	-2	-1	-1	-1	-1	-1	-1	-1	-1	Stronger performance in 2018, but inflation and rates headwinds
GLOBAL CASH	-3	-3	-3	-3	-1	-1	-1	-1	-1	Yields climbing, \$ cash is now in line with US CPI
US EQUITY	0	0	0	0	-1	-1	-1	-1	-1	Has lead the growth recovery, but valuations high at top line level
CURRENCIES										
USDZAR	-2	-2	-2	-2	-2	-1	-1	-1	-1	Recent strength leaves the rand slightly expensive
USDEUR	-1	-1	0	0	0	0	0	0	0	Trading around parity with the USD
USDGBP	2	2	2	2	1	0	-1	-1	-1	Sterling is cheap, but Brexit risks are escalating again
FUND RISK ALLOCATIONS										
SA EQUITY										
CORE/PASSIVE	-2	-3	-3	-3	-3	-3	-2	-2	-1	Headline indices relative expensive and concentrated
VALUE	3	3	3	3	3	2	2	2	2	Stock picking favours value investing in SA
GROWTH	-2	-2	-2	-2	-2	-2	-2	-2	-2	Little sign of growth recovery in SA
DEFENSIVE	1	-1	-1	-1	-1	-1	-1	-1	-1	Relative lack of opportunities in SA
PROPERTY	-2	-3	-3	-3	-3	-2	-1	-1	-1	Sell off means property is closer to a buy
MIDCAP	0	0	0	0	2	2	2	2	2	Weakness in SA smaller shares = value opportunity; Requires SA recovery
SA DIVERSIFIERS										
VANILLA BONDS	-2	-2	-2	-2	-1	-1	-1	-1	-1	EM linked selloff means bonds are showing better value and high real yields
ALTERNATIVE	0	0	0	0	0	0	0	0	0	Few opportunities exist in this asset class
INCOME	3	3	3	3	3	3	3	3	3	Real yields are high as CPI remains low, but risks are increasing (fiscal)
GLOBAL EQUITY										
CORE	-2	-2	-2	-2	-2	-2	-2	-2	-1	Headline indices globally are above their long term means
VALUE	3	3	3	3	3	3	3	3	2	High levels of dispersion means value presents significant opportunities globally
GROWTH	0	0	0	0	0	-1	-1	-1	-1	Growth cycle has been strong, but priced in now
DEFENSIVE/QUALITY	-2	-2	-2	-2	-2	-1	-1	-1	-1	Quality shares have been broadly overpriced with search for yield; favour managers with a valuation focus
MIDCAP/SMALLER	1	1	1	1	1	1	1	1	1	Stock pickers market
PROPERTY	-2	-1	-1	-1	-1	-1	-1	-1	-1	Stronger performance in 2018, but inflation and rates headwinds
EM	3	3	3	3	2	1	0	0	0	Valuation gap has closed, risks have escalated
GLOBAL DIVERSIFIERS										
VANILLA BONDS	-3	-3	-3	-3	-2	-2	-2	-2	-2	Valuations moved further away from fair value. Not an attractive entrypoint.
FLEXIBLE BONDS	1	1	1	1	0	-1	0	0	0	Have been impacted by widening spreads, more value now though
ALTERNATIVE	2	2	2	2	2	2	1	1	1	Remains attractive while bon and cash yields are low
INCOME	-1	-1	-1	-1	-1	-1	-1	-1	-1	Improving, but not there yet.

-3	Strong underweight
-2	Moderate Underweight
-1	Slight underweight
0	Neutral
1	Slight overweight
2	Moderate overweight
3	Strong overweight

Table 1: Fundhouse Investment Outlook – January 2019

In conclusion, the good news is that the pain of the prior years can also be the pleasure of future years. Lower aggregate valuations bode well for returns. The mean reversion cycle is something which tends to repeat, and what we hope for in 2019 is that the global economy provides a chance to achieve that for investors.

[1] Represented by a passive set of constituents where we build the aggregate portfolio up and overlay the relative premium or discount for each asset class to arrive at a total value.