

ECONOMIC TRENDS AND PROSPECTS FOR FINANCIAL MARKETS IN 2019

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Good morning. I think the cellar is probably quite an appropriate place this morning. After the events of 2018, I think many investors might have felt they were struggling with a hangover! Let's just revisit a few trends that unfolded during 2018. I think if we look at investment performance, it is true to say that it was a very tough year for investors, not only in South Africa but across the world. If you analyse the performance of the various asset classes, all the asset classes except cash gave a negative return. Global equities in dollar terms lost about 8% of their value. Bonds lost 3%. If you look at the performance of high-yield corporate bonds, they lost about 3% of their value.

So there was in fact no place to hide. If you look at South Africa, cash gave a decent return in rand terms, but the South African equity market unfortunately lost about 8.5% of its value over the year. What is perhaps a bit more concerning if you look at the performance of South African equities, is that it's the fourth consecutive year where we had a really pedestrian or negative performance for the South African market.

I think it is true to say if you look at the performance of asset classes in South Africa over the last four years – investors unfortunately have not been rewarded for the risks that they've taken to invest in risky asset classes. By risky asset classes, I mean equities and property. Listed property last year gave a negative return of 25% and over the last three years returned a negative 1.2%.

The problem with these numbers is that many investors now question the normal financial laws. Those laws would normally dictate that given higher risk, investors are entitled to expect a higher return. This truism is now being questioned by many investors, and the risk is that they are taking their risky investments out of the market and investing in non-risk investments that will ultimately not give them the returns that they deserve over the longer term.

Looking at the prospects of financial markets in 2019 and for this particular investment cycle, I think it is important that we just revisit some of the major economic trends that we think will dictate the behaviour of investors. Some of these trends have already started in 2018. In 2018 it was quite clear to us that if you look at global economic growth, the momentum is slowly but surely starting to come off, in terms of economic growth. Many commentators might argue that a recession is quite imminent. We tend to differ from that view. We don't argue that activity will slow down, but we think that a number of indicators would suggest that it is unlikely for the global economy to go into recession in 2019.

There are a number of factors that would give us that indication. Firstly, if you look at inflation, there are very few signs that inflation will go out of control. If inflation stays within the 2% or 2.5% levels, it is unlikely for monetary authorities to act aggressively to try and cut inflation. Therefore we think that monetary authorities will remain quite cautious when they decide to hike interest rates in this global cycle. So that is quite important.

If you look at the employment market, we've seen the lowest unemployment rates in history in the United States, so the consumer in the States is likely to remain quite upbeat. And because it's such an important part of that cycle, it is unlikely that the consumer will suddenly disappear and allow the economy to drop into recession. Of course, the market is concerned about a few, what we call tail risks – those risks that, on the periphery, are likely to cause a recession.



Those risks are very well documented. The first thing is the problems we have with global trade, and in particular the trade war between the United States and China. At the moment, the two sets of authorities are in conversation with each other to try and come with a solution. We don't think that that will necessarily put the world into recession. Secondly, we have Brexit, and as we speak, negotiations are happening around Brexit and how the Brits are likely to take themselves out of the European Union. Of course it will have economic implications. And finally, there are also some problems within Europe, where an economy like Italy can easily go into recession and cause some financial problems on the rest of the continent. Those are risks that we will continue to monitor, but our base case view is that those risks will ultimately not result in a recession.

However, what we can say is that the economic upcycle has now been ongoing for about 10 years and it is just natural to expect the activity to slow, and therefore it is likely to have an impact on the strength of the profit cycle, not only in the US but in the rest of the world.

So let's talk about the financial markets. As I said, I think the risk is starting to build in terms of economic activity and therefore investors are likely to take that on board when they decide on how they're going to invest in markets. We've had a 10-year bull market for American equities in particular, and for the world. It was correct to have an aggressive position there, we think now is not the time to be aggressive – that is beyond us.

Why do we say that? Firstly, profits are likely to slow. Secondly, and very importantly, the valuation of these shares reflect a lot of good news. We are by no means saying that the market is in bubble territory, in other words, that we expect a major collapse in financial shares across the world. We are simply saying that we've got to recalibrate in terms of our performance expectations, and the very good performance that we've experienced over this particular 10-year cycle is unlikely to repeat itself for global equities over the next three years.

If you look at global bonds, those bond yields in America are currently trading around 3.8%. Because inflation is not really a threat, it is hard to expect those bond yields to kick up significantly. On the other hand, the market is probably correctly priced, so if we think the market is correctly priced, it will be probable to get a return of around 3% in dollar terms in this particular asset class.

Let's talk about South Africa. It would be true to say that South Africa was a major disappointment, not only in terms of the performance that was generated across a wide range of assets but also in terms of the economic performance. The strong structural performance that we saw in the period from 2003 to 2008 was not repeated. We've actually gone backwards, and over the last two to three years, we were certainly caught in a low growth trap.

It's very hard to see what will get us out of this very pedestrian growth cycle. Given the elections that are just around the corner and will probably happen in the second quarter of this year, it is unlikely for entrepreneurs in South Africa to make major investment decisions. So I think it would just be logical to expect more of the same in terms of the growth rate in South Africa. If we need to add a number to it, we think that the local economy can in 2019 grow at a rate of about 1.2% to about 1.7%.

The next thing is, what does it mean for the performance of fixed interest, of property and of equities? Let's start with fixed interest. Cash will probably give you about 7.5% to 8% this year. That brings us to government bonds. Although the bond yield is quite attractive at about 9% if you buy a 10-year government bond, my major concern is that the fiscal situation in South Africa has deteriorated significantly over the last 10 years, so the risk associated with that quite attractive yield is very high for us. So despite the high yield, we would be unlikely to take an aggressive positive position on government bonds, as the risks are still pretty high.

That brings us to equity. Equities are always close to our heart because we still have the view that over the longer term, if you want to grow your wealth in real terms, that is the asset class that you should look at. However, investors were materially disappointed with very poor performance over the last four, four-and-a-half years, and it would probably be true to say that you can understand why they think they should find another alternative to produce inflation-beating returns over the longer term.

Our experience and analysis would indicate that to lose patience right at the wrong time is probably the worst decision that investors can take. So despite the pedestrian outlook for economic growth, it is true to say that if you analyse the valuation of the South African equity market, many of the shares that we look at are now trading at very low valuation levels. In other words, to put it in simple English, when you buy many South African shares at the moment, you buy a cheap asset, and cheap assets are probably the most important ingredient in the recipe to generate decent returns over the longer term. So despite the very pedestrian outlook in this investment cycle, we think that South African equities might well reward investors for the risk that they take to expose themselves to a volatile asset class.

For us, if I compare it to three, four years ago, it is quite easy for us from a bottom-up perspective. In other words, if you look at individual counters, to find shares that we would be likely to buy. So what we would suggest to clients is that now is the last moment that you should think of reducing your exposure to equities. In fact, should the market go down further, we would view this as a very good buying opportunity for equities on longer term considerations.

Quite often people ask us, what is your view for the next 12 months? I can give you an answer. Unfortunately in the short term and over a 12-month period, short-term investor sentiment can change significantly and that of course will dictate the performance. What we can say with far more certainty is that in this investment cycle (and now we talk three to five years), we think that the prospects are quite good.

When we look at our normal prospective return matrix – a matrix that we designed for ourselves where we look at the prospective investment performance based on the earnings we think could be generated by South African companies, and of course the rating that you associate with these companies – we think that equities can easily do 13% per annum over the next five years, if we sit with an inflation rate of round about 5%. And by the way, the Reserve Bank seems to now target 4.5%. That gives you a significant real return, in other words, a significant return in excess of the inflation rate. It simply means that we think that in this particular investment cycle, equity should grow your wealth in real terms and ultimately provide the outcome that you deserve to sustain yourself at a period when you need these funds.



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