October 2019

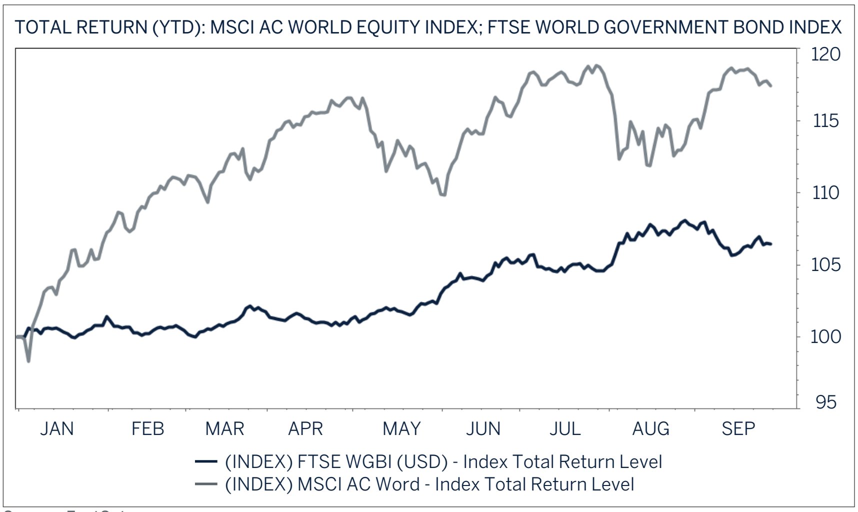
Quarterly Commentary

MelvilleDouglas
A Member of Standard Bank Group

Bernard Drotschie
/ Chief Investment Officer

Slower growth and inflated valuations = lower expected returns

Investment returns from all major asset classes have held up exceptionally well this year considering the current uncertain geopolitical and macro backdrop. Last year's interest rate hikes in the US in an attempt to "normalise" interest rates, combined with the fading benefits from lower taxes and a period of deleveraging in China has resulted in a cyclical slowdown globally. Furthermore, with President Trump on a mission to make "America great again", heightened trade tensions between the US and the rest of the world have amplified the pace of slowdown as the private sector has pulled back investment spending plans resulting in the contraction of global trade-and-manufacturing activities. Global central banks are aware of these economic dangers and have been coming to the rescue (again) by injecting monetary stimulus through interest rate cuts. **Pressure is mounting, especially within Europe, for governments to do more through fiscal measures** such as committing more capital to infrastructure projects and/or reducing taxes in an effort to lift investment. Lower interest rates have played an important role in supporting asset prices this year, but without an improvement in the outlook for growth, investors should expect lower returns accompanied by higher levels of volatility going forward.



Source: FactSet

Quarterly Commentary

Which has it right: Equities or Bonds?

This year's rally in global bonds has reduced yields to historic lows, signalling little in the way of inflationary risks and very weak nominal economic growth which traditionally has been a headwind for equity investors. However, risk assets such as equity valuations have also rallied despite a sharp slowdown in economic growth and corporate earnings.

Clearly the "market" is aware that the slowdown in economic activity has been centred around global industrial production and manufacturing, not (consumer) services which is by far the largest contributor to the global economy and equity bourses, particularly in the US where 74% of the US gross value added is in services. As such, revenues in consumer sectors have thus far been resilient and it is not apparent that consumer spending has been overly influenced by the slowdown in global trade. Additionally, investors are expecting that a combination of lower interest rates and fiscal stimulus will support global economic growth in 2020 and in-turn provide for a pick-up in earnings growth for corporates in the year ahead. Earnings growth for listed equities is forecast to be in the region of 10% next year which although not impossible is certainly not a foregone conclusion. Unemployment levels and interest rates are already extremely low (compared to history), wage growth elevated and consumer spending robust. Equity markets would therefore appear to be already largely discounting better times ahead and therefore future returns are reliant on the delivery of more favourable economic data.

"Investors are expecting that a combination of lower interest rates and fiscal stimulus will support global economic growth in 2020."

Source: FactSet

Bond valuations are very sensitive to the outlook for inflation and central banks response to changes in prices. Inflation in developed economies has consistently tracked below the levels targeted by central banks, hence the abnormally low level of policy interest rates. Additionally, the trade war has impacted goods sectors such as Materials, Industrials and Energy more than other sectors and has had a significant influence on inflation expectations, the future path of interest rates and ultimately bond yields. We appreciate why government bond yields are low but with large parts of the global economy still looking healthy and resilient we find current bond valuations unattractive and do not believe that it makes sense to allocate significant capital to an asset class with income yields well below inflation and in many cases negative in absolute terms.

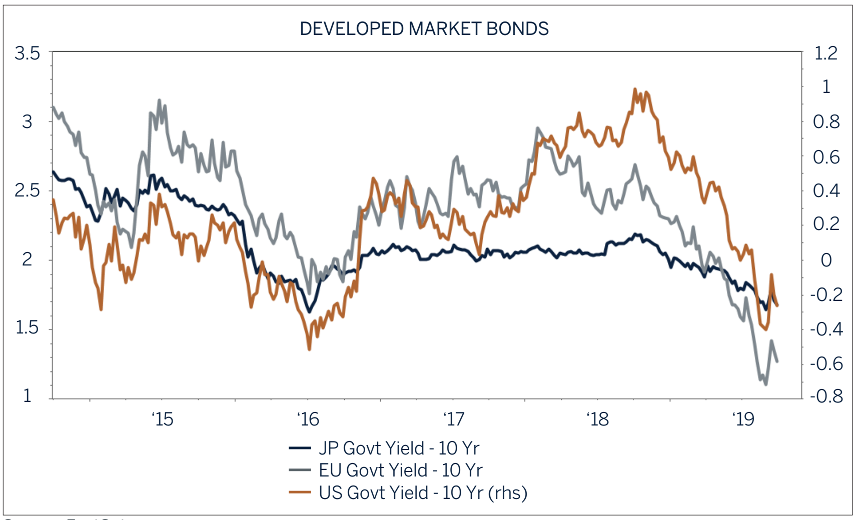
Fiscal stimulus to the rescue?

During July, the White House and Democratic party leaders in Congress reached a deal on the US debt ceiling which allows for stronger federal spending. It also means that there will be no big budgetary stand-off until after next year's presidential election which is an important development in terms of supporting the growth momentum through 2020. The UK administration is also ready to provide fiscal support if needed. Boris Johnson has promised GBP30bn of tax cuts and government spending initiatives.

In Europe after an extended period of fiscal austerity, the French have lowered taxes and pressure is mounting for Germany, whose economy has probably already entered a technical recession, to follow suit. In Holland, the Dutch announced that they are looking to spend more on infrastructure projects and lower taxes, a tonic designed to lift the economy - encouraging news for the periphery. National debt levels have improved to such an extent that these governments are better able to deal with economic setbacks.

> "It has become clear that monetary policy alone has not been enough to provide the necessary impetus to economic growth."

It has become clear that monetary policy alone will not be enough to provide the necessary impetus to economic growth for many economies against the backdrop of heightened trade uncertainty and a slump in global manufacturing.



Source: FactSet

Although pressure is mounting to do more, it is unlikely that a significant shift in fiscal policy from Western Europe's largest economies is on the cards, particularly while monetary policy remains so accommodative, but at the margin, there appears to be some traction and the markets may force them to do more in the coming months.

Brexit – "are we there yet?"

Brexit has again taken the headlines as the UK Supreme Court made the unprecedented and unanimous decision that the Prime Minister acted unlawfully to prorogue (suspend) Parliament for five weeks in preparation for a Queen's speech. Whilst shaking the UK constitution to the core it did little to influence financial markets other than to temporarily strengthen Sterling in the belief that a delay or no Brexit at all is now marginally more likely. Little has really changed as the leaving date stays at 31 October 2019 and unless there is a fresh 'divorce' agreement agreed with the European Union (EU) and passed through Parliament, the UK government must request a three-month extension to 31 January 2020.

"The UK Prime Minister acted unlawfully to prorogue Parliament."

Political issues remain uppermost whilst the domestic population and the EU become more and more frustrated at the lack of progress in executing the leave decision. The government now has no majority, is basically powerless to drive any change and cannot even pass a vote for a General Election as the opposition parties refuse to go along with this until it is crystal clear that the UK will not leave the EU without a deal.

To speculate on future events in this saga is fraught with difficulties. What we do know is the Prime Minister will attempt to negotiate a new agreement that can be placed before and ratified by the EU Council of Ministers on 17/18 October. Even if we get this far there is no guarantee that it will be passed by Parliament as the Prime Minister has hardly made friends with opposition parties or indeed some of his backbench members. The EU are only too aware of this given the history of three failed attempts by the previous Prime Minister. Should there be no agreement the EU will probably accept the extension request which will be a signal for the opposition parties to allow a General Election in early December.

From an investment perspective, within our UK equity weightings we continue with our policy of concentrating on companies that have global reach and only modest exposure to UK economic activity, which continues to be dampened down by the uncertainties of Brexit. This strategy has delivered very favourable relative returns. Given the uncertain nature of what transpires in terms of both the UK political backdrop and whether the UK is leaving or not leaving the EU, the pound looks set to remain vulnerable to marked moves in the period ahead. This ongoing uncertainty has scared many international investors away from UK assets and they are unlikely to return until the Brexit and political positions are clearer.

Conclusion

The global economy has entered a period of below trend growth. The slowdown in global economic activity and corporate profits makes the whole financial system more vulnerable to an unexpected and exogenous shock which would likely result in a global recession. This risk is well understood by many central banks who have sanctioned a wave of interest rate cuts. In addition, fiscal easing looks increasingly likely in many parts of the world in the year ahead which, if seen, could provide some much-needed support for investment spending.

Going forward, investment returns will very much depend on the path of global growth. The geopolitical backdrop has become increasingly uncertain and remains the single largest risk to the future pace of economic expansion, something that investors do not have much control over. The key to successful investing during these more challenging times is to focus on fundamentals, ensure that portfolios are adequately diversified, and that asset allocation is in line with long term investment objectives.

"The global economy has entered a period of below tend growth."

Quarterly Commentary

Market Performance %

as at 30 September 2019

Equities	Q3	YTD	12M
Global			
FTSE All World TR Net **(Sterling)**	3.33%	19.94%	7.19%
FTSE All World TR Net **(US dollar)**	0.05%	16.05%	1.29%
UK			
FTSE All-Share TR	1.27%	14.41%	2.68%
US			
S&P 500 TR	1.70%	20.55%	4.25%
Europe			
Dow Jones EuroSTOXX TR	2.47%	19.71%	4.20%
Fixed Income			
Bloomberg Barclays Series -E **UK Govt 1-10 Yr Bond Index**	1.73%	3.61%	5.02%
Bloomberg Barclays Series -E **US Govt 1-10 Yr Bond Index**	1.18%	5.22%	7.58%
JP Morgan **Global Government Bond (Sterling)**	4.46%	10.15%	15.05%
JP Morgan **Global Government Bond (US dollar)**	1.14%	6.58%	8.72%
Iboxx **Sterling Corporates** Total Return Index	3.72%	11.24%	10.98%
Iboxx **US Dollar Corporates** Total Return Index	2.83%	12.64%	12.70%
Currency vs. Sterling			
US Dollar	3.29%	3.70%	6.10%
Euro	-0.85%	-1.26%	-0.38%
Yen	3.01%	5.14%	11.35%
Currency vs. US dollar			
Euro	-4.01%	-4.79%	-6.12%
Yen	-0.24%	1.40%	4.95%

Investment Performance

Global markets continue to be supported by ongoing confidence that central banks will lower interest rates further and governments will sanction fiscal stimulus to keep the global economy from falling into recession. This has led to further, albeit more modest, advances in the world's major asset classes during the period and strong year-to-date returns. Client portfolio results continue to please with returns ahead of, or in-line with, benchmarks except for lower risk and fixed income mandates which have lagged due to our prudent capital preservation defensive short duration strategy. Portfolio results also compare very favourably when viewed against peer group with 1,3 and 5-year relative returns highlighting continued outperformance.

Quarterly Commentary

Asset Classes

Equities	Neutral
Fixed Income	Underweight
Cash Plus	Overweight

Bernard Drotschie
/ Chief Investment Officer

- After one of the strongest and broadest rallies across every major asset during the first half of the year, asset class returns have been more modest during the third quarter of 2019. **Leading economic indicators have deteriorated as the trade war between the US and China escalated whilst business and consumer confidence, albeit still at elevated levels, has turned down sharply.** The outlook is not expected to change much in the near term as the current economic expansion appears decisively late cycle. The good news is that global central banks are on alert to inject additional liquidity and fiscal support could be on offer again. At the same time, non-manufacturing activity and consumer spending remain robust and should continue to benefit from a combination of low levels of unemployment, positive real disposable income growth and loose monetary policy.
- **We remain neutral to global equities.** Valuation multiples have rerated and the near-term outlook for earnings growth is not expected to improve much from current levels. The gap between valuations and earnings has widened as investors position themselves for an improved outlook, but this could easily narrow again if growth disappoints. Government bond yields have declined sharply which has proven to be an important underpin to equity valuations. Although we are cognisant that interest rates are on a downward trajectory, **we believe bonds are expensive and provide investors with little margin of safety at current yields. Hence our preference for cash and short dated money market instruments over longer dated bonds.**

Equities

Consumer Discretionary	Overweight
Consumer Staples	Neutral
Energy	Underweight
Financials	Neutral
Healthcare	Overweight
Industrials	Neutral
Information Technology	Overweight
Materials	Underweight
Communications Services	Neutral
Utilities	Underweight
Real Estate	Underweight

Justin Maloney
/ Global Equity Fund Manager

- If the past year is a guide, holiday seasons seldom succeed in "chillaxing" investors. The sharp pre-Christmas sell off last December was followed by the August slump. The multiple rationales blamed for both downturns have been markedly similar, i.e. trade wars, weak economic data, more hawkish-than-expected Fed policy and lower trading volumes.
- Some of these concerns are here to stay. We expect the US and China to remain at loggerheads for many years to come as both superpowers vie for supremacy. Markets will continue to be roiled and then temporarily relieved by the US-China rolling war of words and trade tariffs. As the deadline for the November 2020 presidential election looms, President Trump may be tempted to strike a deal to boost the markets and therefore his chances of re-election.
- Longer term prospects are more reliant on whether the economy drops into recession. **We maintain a weather eye on the consumer and their employment status to ensure portfolios are positioned on the right side of events.** A further underpinning is our philosophy and process, which focuses on investing in businesses (rather than trading in stocks) that can reliably deliver compound earnings growth through business cycles.
- **HDFC Bank,** India's largest private sector lender, is a new investment idea. The Indian banking sector is a sizeable opportunity given a vast segment of individuals and small businesses are unbanked or underbanked. HDFC Bank has garnered clients and taken market share from state banks by rolling out branches as well as actively promoting phone-based banking to shops and to individuals in smaller cities and villages. The bank is expected to maintain strong loan growth, averaging around 20% annually over the past decade, underpinned by an expansion of its deposit base at nearly the same pace.

Quarterly Commentary

Fixed Income

G7 Government	Underweight
Index-Linked (US Government)	Overweight
Investment Grade – Supranational	Overweight
Investment Grade – Corporate	Overweight

Karl Holden
/ Head of International Fixed Interest and Currency Strategy

- Approximately 25% of the global bond market now offers investors a yield, before inflation, of less than zero – a situation that will either be dubbed crazy or the new norm in years to come – for now we are inclined towards the former. A consequence of this dramatic decline in yields is a sharp rise in the embedded risk of global bond markets. **Put simply, low yields equal potential high volatility and this is particularly evident in longer dated bonds where any retracement back to higher yields will be met with significant capital downside.** As long-term investors focussing on the preservation of capital, we are reluctant to join the party when it may be approaching midnight, as such our defensive positioning remains in situ.
- The US Federal Reserve sanctioned two interest rate cuts in the quarter. We view these policy moves as a safeguard against a further escalation in trade wars and the negative consequences to global growth. Although the manufacturing indicators are disappointing, the broader US economy led by consumer services remains relatively buoyant, supported by a strong employment market, muted inflationary pressures and now, easier monetary conditions. With US government bond yields having fallen in the quarter, bond investors are acutely at risk of a reversal if the US and China talks progress positively. We cannot predict the outcome, only attempt to evaluate how much negativity is priced into the bond market and on many measures, it appears extreme.
- The Bank of England sorely want to lift interest rates, but the fate of upcoming monetary policy remains firmly in the hands of BREXIT. The market is forecasting a very dim view of the BREXIT outcome, evident in the meagre 0.30% yield on three to five-year UK gilts. Of course, all options remain in play, but the last three years has been a lesson in the futility of attempting to second guess political outcomes. **Even in the event of a 'no deal' we struggle to find yields at current severely depressed levels a compelling medium to long term investment** and have not materially extended the maturity profiles of Sterling based portfolios.

Currencies / Interest Rates

RECOMMENDATION - INTEREST RATES			
		CURRENT	**DIRECTION**
US Dollar	Overweight	2.00%	→ ↓
Sterling	Neutral	0.75%	→ ↑
Euro	Underweight	0.00%	→ ↑

- Our high conviction and long held bias to the **US Dollar** continues to add value with the currency gaining, in general terms, over 3% in the quarter. Whilst much of this upside can be attributed to the relative strength of the US economy and subsequent favourable yield and interest rate differentials, more recently, it has also benefited from its reserve currency status given the ongoing disruptions from trade war uncertainty. Weaker growth conditions in the Eurozone and the continuous BREXIT saga have only added to the allure of the US Dollar as both are delaying any prospect of monetary tightening this side of the Atlantic. We remain cognisant that on many measures the currency remains overvalued but given the myriad of global economic and political issues currently at play, much to the frustration of President Trump, it can remain expensive for some time yet and as such, we remain overweight.
- Although the UK economy is holding up better than many had forecast thanks to a buoyant employment market an interest rate hike appears a distant prospect. As such **Sterling** still cannot break from the shackles of BREXIT where the sheer level of uncertainty is keeping the currency under pressure. A positive resolution to this saga would certainly lift sentiment, potentially kick-start some hawkish rhetoric from the Bank of England and Sterling would rally – we just need to get there first! Whilst undoubtedly undervalued, it would be remis not to hold some foreign currency exposure in our Sterling International portfolios as a hedge in the event of a 'no deal'.

Quarterly Commentary

Melville Douglas

Melville Douglas is a subsidiary of Standard Bank Group Limited. Melville Douglas Investment Management (Pty) Ltd. (Reg. No. 1962/000738/06) is an authorised Financial Services Provider. (FSP number 595)

Disclaimer

2019-182