Investment News
2018 Outlook

Background

Retirement funds have been on the receiving end of volatile markets for the past two years. This volatility has caused much anxiety for retirement fund trustees and members, especially those contemplating retirement in the near future.

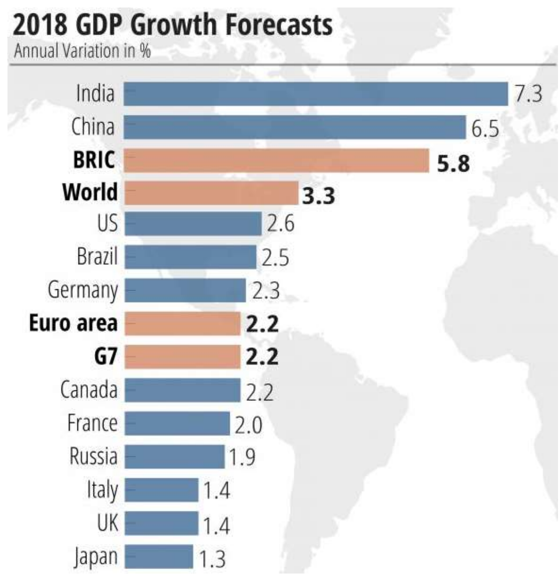
Whilst much of the past 2 years' volatility in our domestic markets centered around political issues and the credit rating of our sovereign debt, investors were also faced with other unusual events that increased the market volatility, such as the 2017 ANC elective conference, the spectacular collapse of JSE-listed Steinhoff, the fall and rise of commodity prices, the election of Donald Trump as president of the USA and the decision of British voters to exit the European Union.

We have seen how many experienced asset managers struggle to make sense of "the new normal" during these uncertain times. It is therefore unsurprising that many retirement fund trustees have commented that they are ill-at-ease with the mammoth responsibility of setting, implementing and monitoring an appropriate investment policy for their funds.

In this edition of "Investment News", we try to unpack some of the key issues we believe will impact global and domestic market behaviour in 2018 to help retirement fund trustees navigate these uncertain times.

Global Economic Outlook

Global economic growth has been buoyant in 2017 and we believe that this will continue throughout 2018. The growth is most likely to come from China, United States and the European Union (EU), on the back of ongoing expansionary fiscal policy (China and the EU via increasing money supply and the US via income tax reduction), the improvement in employment statistics in these economies and the resultant increase in consumer spending.



Source: FocusEconomics

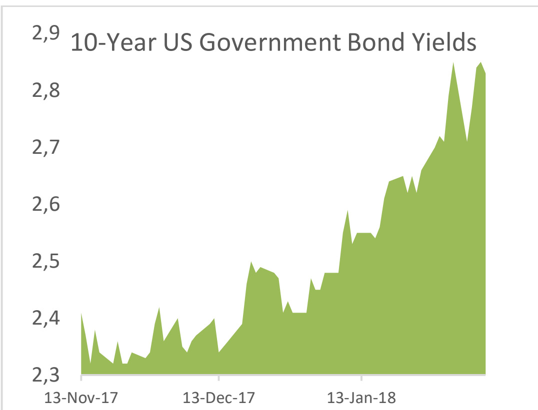
Economic growth in the United Kingdom is likely to be subdued as a result of increased inflation, the reduction in consumer spending and the uncertainty around Brexit negotiations. This was also evidenced in the decline in the business confidence indicator from 15 to -11 from quarter 1 to quarter 4 in 2017.

The unemployment rate is at a low level in most developed markets. Whilst this bodes well for an ongoing increase in consumer spending in those markets, it does increase the risk of increased inflation in line with wage increases.

Inflation risks identified by the monetary authorities in developed markets are high, due to record-low unemployment, low interest rates and depreciating currencies (Pound Sterling and US Dollar). If these price pressures are sustained, then tightening of the monetary policy will be more aggressive. This is likely to affect emerging markets like South Africa negatively as the capital inflows experienced in the last decade could be reversed.

It is uncertain, how Mr. Trumps' Tax Amendment Bill in the US will affect the rest of the world. Particularly, the incentive of reduced corporate taxes for repatriation of profits by US companies in foreign countries.

The 10-year US government bond yields have increased by more than 0.4% since the beginning of 2018. This signals that the market is at least pricing in two interest rate hikes by the Federal Reserve (see chart below).



Emerging markets have, to date, ignored these developments. However, in the event of aggressive monetary policy tightening, capital is likely to flow out of emerging markets, which will result in depreciation in emerging market currencies and induce inflation leading to increase in interest rates by monetary authorities.

As the monetary policy normalises, the stock market is likely to benefit positively as an alternative asset.

Research by many investment houses seem to suggest that the equities are near or at fair value valuations. However, the risk of capital losses as the interest rate increase might be positive for the global stock market.

Domestic Outlook

Markets entered 2018 buoyed on the back of the election of Cyril Ramaphosa as president of the ANC at its 54th National Conference in December 2017.

This result was well received by domestic markets and the business community at large and it is likely to increase domestic business confidence and improve investment spending in support for economic growth. Local companies have an estimate R1.3 trillion in reserves that could be released as companies look at expanding on the back of improving market sentiment.

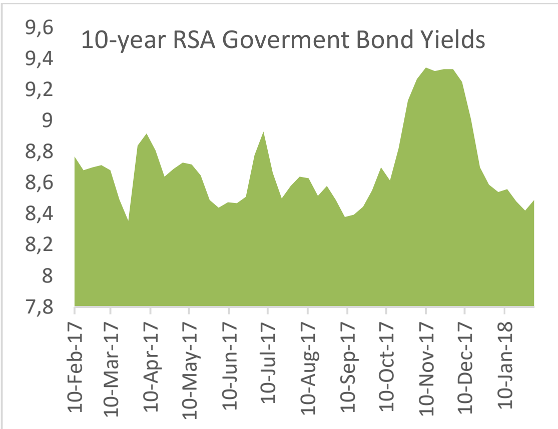
Domestic economic growth has been low compared to the past. At the center of this low growth was the "structural bottle neck" resulting from a lack of adequate skills, lack of investment, political uncertainty and a fiscal consolidation program.

The Reserve Bank has forecast the economy to grow at about 1.4% and 1.6% for 2018 and 2019 respectively.

Despite the positive sentiment, the risk of another downgrade of our sovereign debt remains. The deciding issue for ratings agencies is the significant challenge government is facing with regards to its own fiscal consolidation (i.e. low revenue collection and higher government expenditure). Added to this are the dual challenges of low economic growth and pressure on inflation.

The inflation rate for December 2017 was 4.7% compared to 4.6%, which is within the Reserve Bank target range of 3.0% - 6.0%. The Reserve Bank forecasts inflation to remain within the target band for both 2018 and 2019. The Reserve Bank has evaluated the risk to the inflation to be balanced and as a result decided to keep the interest rates unchanged to date.

The outlook for the bond market is dependent on the developments in the developed markets, particularly the US and UK with regards to monetary policy tightening. If this is performed aggressively, it is likely to have a negative impact on our domestic bond market.

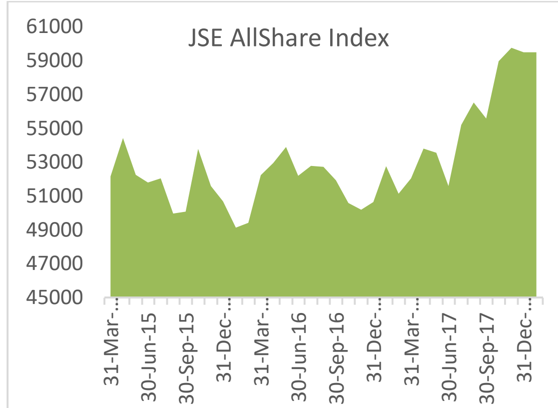


It is surprising that the South African bond market is not pricing in any risk relating to the tightening of the monetary policy in the developed market, albeit the fact that the US labour market is strengthening further.

The explanation for this phenomenon might either be that the positive news of election of Cyril Ramaphosa might be over-priced in our market, relative to the risk outlined above or in the alternative, the market is playing a wait-and-see game. If it is the latter, the budget speech will provide extra clues on the direction of the market.

The Johannesburg Stock Exchange (JSE) will be volatile for most of the year. The volatility will be sparked by both local and offshore economic and political developments.

The JSE All Share Index has lost approximately 6.0% since the beginning of 2018. We view these losses to be largely as a result of profit-taking by investors after the domestic equity market performed well in the calendar year 2017, with the AllShare Index returning a handsome 17.5% for the 12 months to 31 December 2017.



Equities have a better chance of being the best performing asset class, provided that the monetary policy tightening in the US and UK does not surprise on the upside. If we see a faster than expected monetary policy normalisation, the market might be jittery and heighten irrational exuberance.

Conclusion

Retirement fund trustees have an unenviable task of navigating through a myriad of complex issues in managing their funds' investments.

Aside from "market behaviour", they also have to deal with the added complexity of understanding the position of their selected asset managers relative to other managers and be able to explain to members why their selected managers were (or were not) exposed to a specific market segment or stock.

It is at volatile times like these that the robustness of investment policy statements as well as the conviction of retirement fund trustees on the suitability of the strategy they implemented to achieve their risk and return objective are severely tested.

We often hear trustees suggest that during volatile times they need to "tweak" their retirement fund's investments in order to "*be seen doing something by their members*".

Other trustees implement complex "tactical asset allocation" maneuvers aimed at anticipating market movements or events to gain a few basis points in returns.

We remain of the view that market timing as a strategy generally reduces investment returns as opposed to its intent of enhancing it. There are numerous studies and examples proving this.

Experience has proven that a sound long-term strategic asset allocation strategy is key to ensuring consistent long-term investment performance. Whilst it is important to regularly review your investment strategy, we caution investors against investment strategies driven by sentiment, momentum or market noise.

There is always going to be noise and lots of it. Knowing which noise to listen to remains a very difficult task. The recent case of Capitec is an excellent example of how easily investors react to "untested noise".

Retirement fund trustees must ensure that they seek proper advice to help them navigate the murky waters of investment decision making they are forced to deal with.

Ensimini Financial Services

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Our team of experienced investment professionals have succeeded in developing robust investment policies and strategies that have consistently achieved the risk and return objectives of our clients.

We are advisors to retirement funds with a total combined asset base in excess of R2.5 billion.

Feel free to contact our investment consulting team to discuss your needs or if you require more information.

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