2019 Market Outlook

Introduction

South African investors face numerous headwinds, from low domestic economic growth, the tightening US monetary policy, an unwinding of the Federal Reserve's balance sheet and escalating trade tensions. What investors need is an active management strategy that is smart, but humble, with potential to generate excess investment returns that are risk-controlled. The 2019 Lima Mbeu Market Outlook provides insights that can help you cultivate the seeds of wealth creation through the consistent application of sound investment principles.

Market overview

Domestic equities delivered a poor return of -9,3% year to date with offshore asset classes, providing stellar returns due to the depreciation of the Rand exchange rate. Year to date, the return of most offshore asset classes in dollar terms has been poor and is indicative of a global low return environment. This performance can be attributed to a number of factors. There have been fears that escalating trade tensions between the US and China will dampen economic growth, particularly in emerging market economies. Country specific issues in Turkey and Argentina have led to general risk aversion towards emerging market economies. This has been exacerbated by weak domestic activity as tax increases, fuel price hikes and a high agricultural production base have led to lower than anticipated economic growth in 2018. The negative sentiment attributable to political uncertainty has continued unabated in 2018, despite the brief respite experienced at the start of the year stemming from a Cyril Ramaphosa victory in the ruling party's elections. Although the current administration is expensing a lot of effort to halt rampant corruption and address the governance issues at state owned entities, the perception remains that not enough is being done owing to the 'unity' objective that is being pursued by the ruling party. This is unlikely to change until after the 2019 general elections. The above-mentioned issues are well known by the market. Dopfel (2010) shows that investors are unlikely to outperform their benchmarks when, after gaining an understanding of the prevailing economic environment, they then extrapolate the same environment into the future (myopic investing). In our research and analysis, we are therefore careful not to get overly carried away by the current negative sentiment. We believe that although history may not recur, it often rhymes. Our 'quantamental' research process uses quantitative strategies to search for historical environments that are similar to what we are experiencing currently, in order to ascertain the nature of investment returns that are to be expected over the medium-term. We analyse sentiment variables and fundamental macro drivers whilst identifying potential risks to our market outlook. This is a multi-asset approach recommended by Clewell, et al (2017) and Froot, et al (2014). Our analysis shows that investors should consider implementing low tracking error strategies, simply because global markets are faced with risks that are of an un-precedented nature, relative to history.

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LimaMbeu
INVESTMENT MANAGERS

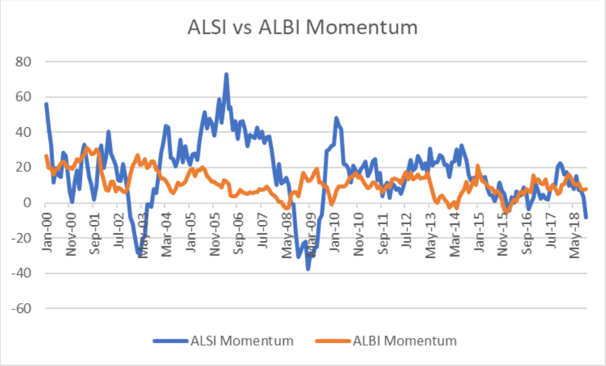
			1 Month	YTD	1 Year
Asset Classes	Domestic	SA Equities	-5,8	-9,3	-8,3
		SA Property	-1,7	-23,5	-18,7
		SA Bonds	-1,7	3,0	7,8
		SA Cash	0,6	6,0	7,3
	Offshore	Global Equities	-3,4	17,0	6,3
		Global Property	0,9	16,3	6,3
		Global Bonds	3,0	15,0	2,2
		US Cash	4,8	21,7	7,0

Asset class return in ZAR, Bloomberg

Sentiment

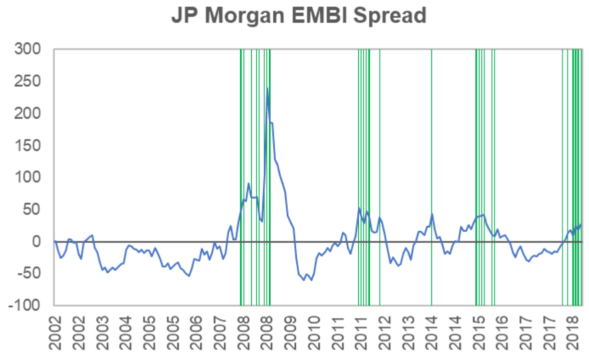
Market sentiment is similar to a heart rate monitor. By merely observing a heartbeat, we can make safe conclusions about a person's activity, that is whether they are exercising, eating or sleeping. We use sentiment in a similar manner to measure the economy's pulse, which is extremely important as most macro variables are often lagging indicators. We match the current environment to periods in history that had similar sentiment. We use the investment returns observed during the subsequent months as an indicator of the returns we can expect in the current environment.

There are two common variables used to describe the sentiment. The measure of **ALSI momentum relative to ALBI momentum** is an indication of the level of risk investors are willing to take within the domestic market.



Source: Bloomberg

The **JP Morgan EMBI spread** (below) gives an indication of the level of risk investors are willing to take within a global context.



Source: Bloomberg

Our estimates indicate that the current environment is one of low ALSI vs. ALBI momentum (domestic equities underperforming domestic bonds) and a high EMBI spread (emerging market bonds underperforming developed market bonds). This means that there is a **general flight to safety**, with investors preferring the safe haven of, firstly developed market bonds, and secondly, in the event that an allocation is made to emerging economies, investors prefer the safe haven of domestic bonds. The table below lists the periods in history that have experienced similar levels of sentiment:

Period	Months	Description
Dec 2007 to Nov 2008	12	Global financial crisis
Sep 2011 to May 2012	9	EU sovereign debt crisis
Jun 2015 to Jan 2016	7	Chinese market crash
Mar 2018 to Oct 2018	8	Current period

Historically, these periods have typically been followed by an appetite for higher risk with domestic equities often outperforming domestic bonds. This points to a key behavioural element of financial markets. Market environments never persist into perpetuity, and more importantly, periods of negative market sentiment often last up to 12 months as reactive measures adopted by policy-makers starts yielding results. Our investment process aims to confirm this conclusion, by conducting a similar historical mapping exercise on economic variables before adopting a conclusive stance for tactical asset allocation.

Fundamental factors

Research shows that the two most important economic variables that drive asset class returns are GDP growth and inflation. The directionality of interest rates is largely driven by the inflation targeting mandates of most monetary policy authorities. The table below provides a description of the expected domestic GDP growth and inflation rates, relative to the past ten years. Although GDP growth is expected to increase form 0,6% in 2018 to 1,5% in 2019, this is still considered a low growth environment relative to history. The 2018 average inflation rate of 4,8% is expected to rise marginally to 5,5% in 2019, which is considered to be in the mid-range relative to history.

Variable	2018	2019	2020	LT average
GDP	0,6%	1,8%	2,1%	2,1%
Inflation	4,9%	5,2%	5,2%	5,9%

Source: Bloomberg

The table below lists the periods in history where we have observed economic environments that are similar to what we have today:

Period	Months	Description
Oct 2009 to Feb 2010	5	Post GFC recovery
Dec 2012 to Dec 2013	13	Domestic labour unrest

The 2009/2010 recovery period was characterised by the impact of sustained fiscal and monetary stimulation on an unprecedented scale. Global inflation remained subdued, partly on account of the deflationary forces arising from exceptionally large output gaps in various economies.

The 2012 period was characterized by significant labour unrest in South Africa, which disrupted economic growth significantly. Unrest from the platinum sector spilled over into the gold and road freight sectors leading to weaker economic growth than anticipated. But more importantly, South Africa's fiscal policy continued to be stimulatory with National treasury forecasting that government's debt to GDP ratio would continue to rise over the next 3 years.

Although the above-mentioned periods have similar characteristics to those observed in today's environment, the one key difference is the fact that it is not realistic to expect accommodative monetary and fiscal policies.

Much like the sentiment variable mapping, similar economic periods in the past have been followed by an increase in investor risk appetite, with domestic equities outperforming domestic bonds. Indicating once again that weak economic environments do not persist into perpetuity.

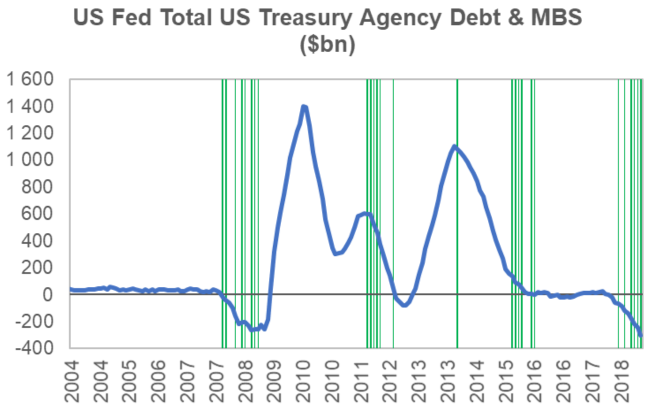
Multi-asset strategy

An analysis of both sentiment and fundamental macro factors indicates that based on history, we should expect increasing investor risk appetite. We hold the offshore asset classes at benchmark weight, as our objective is to provide access to offshore returns, which become increasingly important in an environment where the global economy is outperforming the domestic economy. We follow the method proposed by Qian (2003) and express our tactical asset allocation outlook using pair-wise strategies:

Asset class	Outlook
Domestic equities vs Domestic bonds	positive
Domestic equities vs Domestic cash	positive
Domestic bonds vs Domestic cash	neutral
Domestic property	neutral
Offshore cash	neutral
Offshore equities	neutral
Offshore bonds	neutral

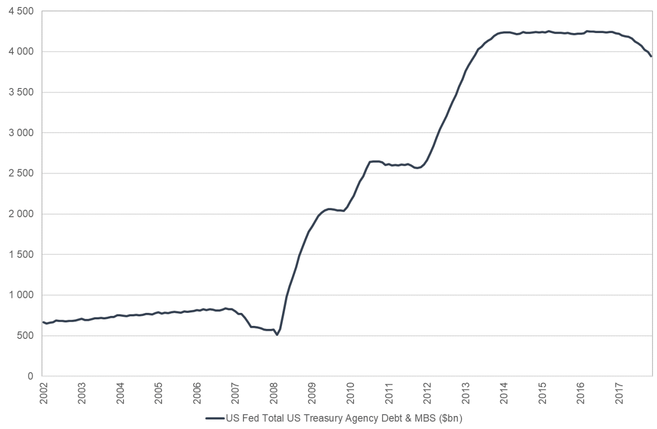
Risk management

Although our outlook is favourable for domestic equities, our evaluation of the risks reveals that we are entering un-chartered waters. Firstly, the poor investment return environment in 2018 can be partly linked to a lack of continued liquidity from the Fed.



US$bn Change in the US Fed Balance Sheet, Bloomberg

From the above figure, the periods identified as being similar to the current market environment (highlighted in green) coincided with an unwinding of the US Fed balance sheet after periods of expansion. In this instance the most similar period is 2008, where the Fed shrunk its balance sheet by +$250bn. More recently the Fed has reduced its balance sheet by +$300bn over a 12-month period. Historically, an unwinding balance sheet has not been good for markets and this presents a major risk to our positive outlook on domestic equities. This is particularly concerning given the extent of surplus liquidity that has been injected into the markets particularly when considering that a minor reduction in liquidity has partly contributed to the very poor investment returns of 2018.



US$bn Total US Treasury Agency Debt, Bloomberg

In their research titled "Five mysteries surrounding low and negative interest rates", Siegel et al point out that quantitative easing has not ignited inflation because M2 is the monetary aggregate that counts for setting inflation (cash and cheque deposits). The Fed has effectively manipulated various monetary aggregates without affecting inflation, which effectively means that the Fed can control the pace of unwinding the balance sheet as inflation is not a concern. However, this still presents an un-comfortable situation for investors where investment returns for some asset classes have the look-and-feel of being manufactured. This remains the single biggest risk to our favourable outlook on domestic equities.

Domestic equities strategy

Our research shows that the disciplined growth strategy that we use should outperform its benchmark during risk-off environments because of the ‘growth’ beta that is being exploited. The ‘value’ beta tends to perform well during an economic recovery or early expansion periods (‘risk-on’) when investors are likely to pay up for risky assets. The ‘growth’ beta performs better during the latter part of economic expansions or during early to mid-slowdowns (‘risk-off’). During these ‘risk-off’ periods investors are more cautious and safer asset such as US treasuries and the US dollar benefit from a flight to safety. This is primarily because the ‘growth’ companies that we invest in often have more flexibility to adapt to bad economic environments, relative to their ‘value’ counterparts.

In an environment when investors are seeking greater risk appetite our disciplined growth strategy should generate lower levels of alpha. Nonetheless, we believe strongly that earnings growth is the key driver of share prices in the long run. We continue to search for companies that have the ability to deliver superior earnings growth relative to peers, regardless of the economic environment. Our focus is on building a growth portfolio where most of the excess return will be driven by stock specific factors. In executing our disciplined growth philosophy, 17% of the fund has been invested in growth stocks whilst 83% of the fund is invested into diversifiers to ensure that the portfolio’s excess return is not sensitive to currency or macro fluctuations.

Key take-aways

1. Previous periods of similar negative sentiment have been followed by periods of increasing risk appetite.

2. Previous periods of similar economic fundamentals have been followed by periods where investors sought more risk with domestic equities outperforming bonds.

3. An accelerated unwinding of the Federal Reserve’s (Fed) balance sheet is a major risk to this outlook.

4. Our disciplined growth strategy for the domestic equities asset class should continue generating alpha, albeit at a reduced rate as excess returns are driven by stock specific factors, irrespective of the macro environment.

Lima Mbeu’s Investment Philosophy

We believe that disciplined growth investing is the best way to build wealth and capital in the long term. Our core investment pillars are:

Active Management
The market is inefficient, and often has significant levels of excess volatility providing enough opportunities for skilled investors to generate alpha. However, the highly competitive nature of markets makes it difficult for investors to generate alpha on a consistent basis. Therefore, we actively manage our investment portfolios with a benchmark-cognizant mindset.

Growth Focus
Earnings growth is the most important driver of share price returns, over the long term. We believe that companies with superior returns and high re-investment rates outperform their peers in the long term. We understand that growth investing comes with higher drawdowns, therefore our preference is to be growth-biased, but within limits.

‘Quantamental’ Investing
Some investment decisions are better handled by a machine and others by a human fund manager. We believe that integrating quantitative techniques with traditional investing reduces cognitive errors and enhances investment returns. We use this disciplined approach across all our investment strategies.

Risk Controlled Strategies
The best way to build wealth is through the compounding of consistent alpha. Investment management is enormously complex, and a comprehensive risk management function is critical to delivering the best outcomes. Risk management is embedded within our investment processes to create portfolios that deliver risk-controlled excess investment returns.

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