COMMENT ON
MTBPS and market volatility

By David Knee, Chief Investment Officer **26 October 2018**

Medium-Term Budget Policy Statement (MTBPS)
The MTBPS unveiled by new Finance Minister Tito Mboweni on Wednesday revealed somewhat worse-than-expected details on the state of government finances, pointing to higher government borrowing requirements and prompting the rand and government bonds to weaken.

While Mboweni's downward revision to the 2018 GDP growth forecast to only 0.7% was largely expected (mirroring the SARB's earlier projection), the 2018/19 budget deficit is now set to be significantly higher, at 4.0% of GDP from 3.6% in January, rising to 4.2% next year before falling back to 4.0% by 2022. This means overall government debt is set to reach 59% of GDP by the end of 2022, and government's long-dated bond issuance is now expected to rise by 33% over the next three years, news that pushed government bond yields higher. The yield on the benchmark R186 bond rose from 9.15% to 9.32% after market close.

While the news of higher government debt levels was expected given the previously known factors of weaker GDP growth, tax revenue shortfalls and the weaker rand, the new MTBPS debt trajectory arguably brings South Africa closer to a downgrade to sub-investment grade status by Moody's. At the same time, it was not all bad news; there were no further tax increases - which would have hit the consumer again - and also the government was successful in containing pressures on the expenditure side of its balance sheet, forcing departments to absorb higher wage increases from their general budgets and re-allocating expenditure to support certain state-owned enterprises (SOEs). Much now will depend on what growth-enhancing initiatives might be put in place in the February budget, as the key to an improved fiscal trajectory will be revenue improvement led by rising economic activity. The market will need to wait to see how Moody's view the facts and forecasts, but there is enough leeway for them to take a view either way - and a downgrade is by no means a foregone conclusion. They have demonstrated a propensity to wait and see, and with much government work at improving things going on behind the scenes - as well as an election next year - we suspect they will continue in this mode.

Nevertheless, there can be no denying risks have increased, for bonds at least. Investors need to decide, as ever, if markets have priced the risk environment appropriately. With long-dated bond yields above 10%, Prudential's analysis would suggest this offers a real yield of at least 4.5%, a

substantial prospective return for those able to take a medium-term investment view. Prudential regards current yields on longer-dated bonds as attractive, and already held an overweight position in long-dated government bonds in our house view portfolios prior to the MTBPS. We have maintained that position following the MTBPS as we believe bondholders are being well compensated for the downgrade risk involved.

Market volatility
So far this year South African equities and bonds have come under pressure from a number of factors, the first being broad emerging market weakness caused generally by rising US interest rates. With interest-bearing securities finally becoming relatively more attractive in the US after years of depressed interest rates in the US (and other developed markets), investors are switching their funds out of relatively riskier emerging markets, starting to reverse the decade-long trend market commentators have generally described as "the search for yield".

A second factor weighing on South African equities and bonds more recently has been the sell-off in US equities. This is widely regarded as a correction from expensive levels following a record equity bull market that began in 2008 after the global financial crisis. While no one can say whether the 10-year bull market is at an end, US economic growth is widely expected to remain robust for the foreseeable future, and corporate earnings growth relatively strong. However, there had been very little room for disappointment built into US equity valuations before the current sell-off and more weakness could follow. At Prudential we have viewed US equities as being expensive for some time now – and therefore been underweight these assets in our house view portfolios versus more attractive equity markets like Germany and Japan, as well as certain emerging markets such as Korea and Indonesia. As with all downturns, we see this as a possible opportunity to acquire stocks at more attractive levels.

Another factor weighing on South African equities and bonds has been more idiosyncratic emerging market contagion from domestic events in Turkey and Argentina, among other countries this year, which have added to uncertainty and risk aversion. **See the recent podcast** by our Head of Equity, Johny Lambridis, explaining the emerging market impact on our equity market. Also important has been disappointing domestic news, which has been well-publicised and includes macroeconomic factors such as slow growth and historically poor governance in the government and state-owned enterprises. Company-specific concerns have equally weighed on the JSE as well, most notably at Naspers, which has dragged our equity indices significantly lower this year.

Outlook
Currently, most asset classes in South Africa – including equities, listed property, nominal bonds and inflation-linked bonds are cheap compared to their long-term averages and, based on our estimates, should deliver attractive returns over the next five years. Unlike 2008 when equity earnings were far above their long-term trend and the price-to-book multiple on the

market was very elevated, all valuation measures currently confirm that the market is attractively priced. Equities and listed property, in particular, are priced to produce double-digit returns (on a nominal basis) as are long-dated bonds, while cash returns are likely to remain in the 7-8% range as the Reserve Bank keeps rates unchanged despite weaker economic growth, in order to ensure inflation expectations gradually anchor themselves lower. Investors therefore need to be patient and not sell their growth assets amid the volatility.

While the bad news has dominated headlines, we are encouraged by recent developments under Cyril Ramaphosa's administration - we have seen progress in government reform, fighting corruption, improving governance, appointing qualified ministers, directors and other management, uncovering maladministration and taking steps to accelerate growth and job creation. While this will certainly take much more time, the country is moving in the right direction and the MTBPS has been honest in its acknowledgement and assessment of our position.

Looking ahead, we can expect more short-term market volatility given the elevated state of uncertainty in global financial markets, as well as concerns regarding a possible waning in global growth, trade tensions and geopolitical factors. However, we will continue to take advantage of opportunities to add well-priced assets to our portfolios to benefit our clients' returns. With actual market returns at low levels, the value we can add from active management becomes even more important.