PRUDENTIAL **INSIGHTS**

PRUDENTIAL
INVESTMENT MANAGERS

Michael Moyle
Head of Multi-Asset

NOVEMBER 2018

Asset valuations signal stronger returns ahead

Investors have been experiencing low returns over the last several years, and 2018 has been notably weak across most local asset classes, while the rand has been exceptionally volatile. As a consequence, we've seen how investors, especially retirees who need a steady income, are struggling to cope. Yet we would urge patience rather than moving to cash: Prudential's valuation-based analysis indicates that returns are likely to be much improved over the next three to five years. Patient investors will be rewarded.

Large buffer against bad news built into equity valuations

In particular, key valuation measures indicate that SA equity is priced to deliver healthy prospective returns over the longer term. At current valuation levels, we believe a large buffer against bad news has already been deeply embedded into our market. If current proposed reforms can even modestly lift our GDP growth from its current very low base, then the potential is genuinely there for equities to produce very good returns going forward.

- The market's price-to-book value ratio (P/B) relative to history is currently cheap at 1.7x. Historically when the equity market P/B has been 1.7x, it has subsequently produced a five-year nominal return of 19.4% p.a.
- The two most important components of equity returns – dividend yield and real earnings growth – currently have five-year consensus forecasts of 2.9% p.a. and 4.2% p.a. respectively. This amounts to a real return forecast of 7.1% p.a. (or around 12% to 13% on a nominal basis), ignoring any possible market re-rating that would enhance this.
- Prudential's current valuation of the SA equity market points to a real return from equity of 7.6% p.a. over the next five years.

Listed property indiscriminately de-rated

At the same time, investors have indiscriminately de-rated the listed property sector across the board, largely as a result of the well-publicised issues surrounding the Resilient group of property companies. Approximately 80% of listed property companies are now trading at a discount to their net asset value (NAV), in other words, below the book value of the properties they own. And with approximately 40% of sector earnings coming from offshore, it offers a well-diversified income stream.

According to our valuation based on long-term fair value, listed property is cheap relative to its history and is priced to deliver a real return of 8.1% p.a. over the next five years. Such a decent real return is unlikely to be forthcoming from either cash or bonds over the next five years. Improving growth should provide a supportive backdrop for the sector, although we are very mindful of the headwinds it currently faces given the slow growth environment.

Nominal bond yields compensate for the risk

Meanwhile, South African government bonds have been exceptionally volatile in the past few years, hit by "Nenegate", global risk-averse sentiment and concerns over further sovereign credit rating downgrades, among other issues. At this point we believe these risks are priced into the market and yields on longer-dated bonds in particular – at over 10% (nominal) – are offering ample compensation for the risks involved. According to our long-term fair value analysis they are priced to deliver an attractive real return of around 3.3% p.a. over the next five years, which is well above the historic norm.

Inflation-linked bonds offering highest real yields in 10 years

Inflation-linked bonds (ILBs) have produced consistently negative real returns for several years in a row, a very disappointing performance, mainly due to the negative impact of lower-than-expected inflation. Now these assets are offering their highest real yields - and therefore the cheapest valuation – in the past 10 years. Combined with the evidence that our inflation trough has now passed, and that the consensus inflation forecast is 5.0%-5.5% over the next two years, we would only need a modest fall in real yields for ILBs to post good returns going forward. Currently they are valued to deliver a real return of around 2.9% p.a. over the next five years, considerably more than their long-term fair value.

Cash returns likely to deteriorate

Cash is the only local asset whose real returns are likely to deteriorate going forward. Having delivered relatively high real returns through the downturn, we believe they will fall to less attractive levels relative to other assets – to around 2.1% p.a. – over the next five years as the business cycle improves.
In conclusion, while we can’t predict the future, such as when the economy will start to deliver the conditions necessary for asset returns to recover, we do have the utmost faith in our valuation-based investment process, which currently indicates that most local asset classes are likely to produce attractive returns in the next three to five years. This process has delivered consistent longer-term outperformance since 2001. We do know it is very difficult for investors to be patient in the face of extended poor performance, but they need to stay invested in order to reap the rewards of the improved returns that are likely as any economic recovery takes hold.

To learn more about our valuation-based investment process, contact our Client Services Team on **0860 105 775** or email query@prudential.co.za.