March 2021

Fundhouse Investment Outlook Q1 2021

A significant change has taken place in global markets over the past few months where US and global bond yields have started to build in expectations for higher inflation. This indicates a higher confidence level in a global recovery, with the result that inflation trends higher as demand starts to catch up and overtake supply across the globe.

Where interest rates and inflation expectations were heading towards zero only a few months ago, the US 10 year bond – the benchmark for global interest rates – is now hovering at around 1.7% after having reached a low point of 0.50% in 2020. Chart 1 below shows this interest rate cycle over the past decade:

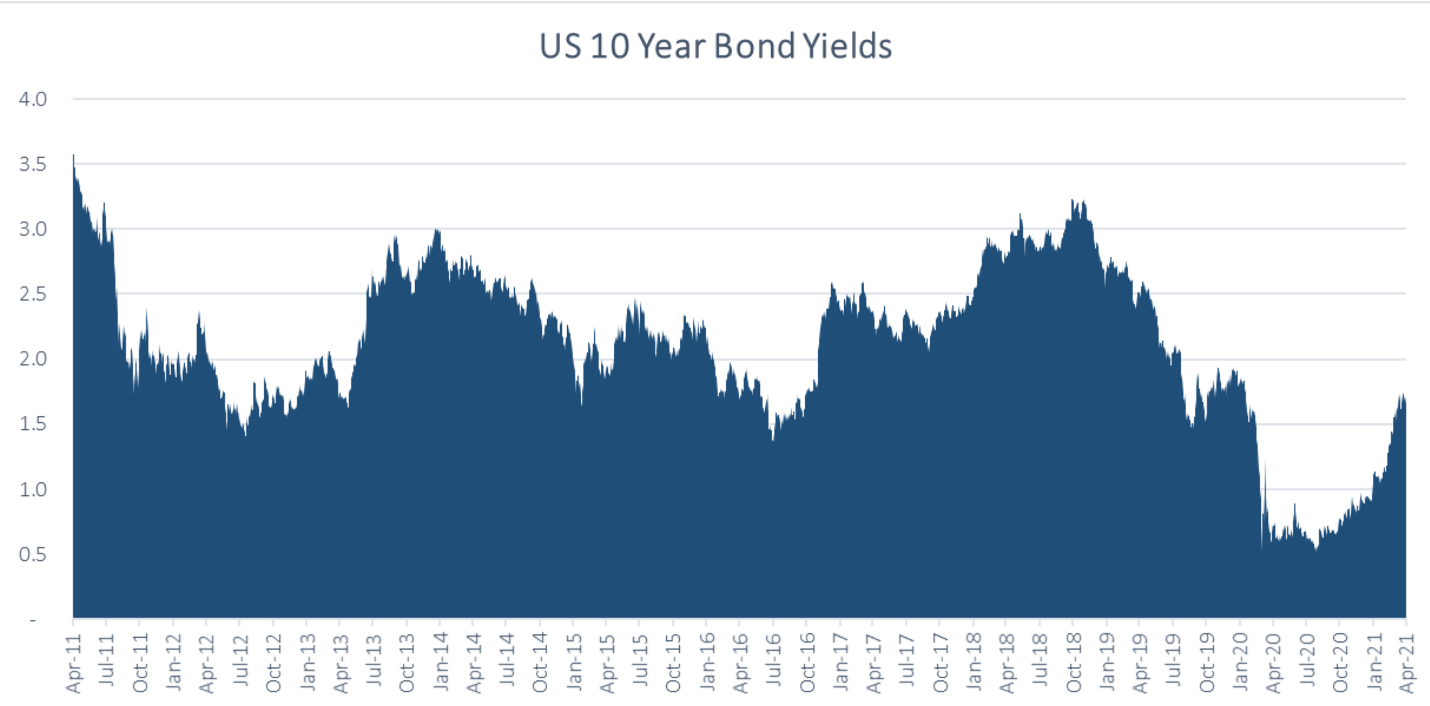

Chart 1: US Benchmark 10 Year bonds since 2011. Source: Refinitiv

Why is this important? To start with, over the past 10 years this bond yield has averaged around 2.1%, well below the long-term average of around 4%. This 'risk free' interest rate, backed by the worlds reserve currency and largest economy, has set the baseline for the global cost of capital. This was mostly driven by the response to the GFC in 2008 as a way to defend and support a vulnerable global economy. This lower cost of capital had a number of consequences for investments, some of them unintended:

- It pushed up prices for high growth companies, as the low cost of capital meant that long term, future dated earnings were worth more in today's terms.
- It pushed up prices for high quality, stable, dividend paying companies as they offered a yield (via dividends) where bond yields were no longer as attractive.
- With the US Fed being the main enabler of lower interest rates through its QE programme[1], bond prices kept moving up, bond yields kept falling, given that there was a permanent and sustained buyer in the market.
- A whole host of other asset classes benefited by association: any form of income producing investment (corporate bonds for example) being sought after as a replacement for the declining yields on government bonds.

At the same time, companies with a greater reliance on a strong global economy and higher interest rates in general, such as banks, were discarded in favour of the high quality/high growth darlings. This drove a huge valuation dislocation between these so called 'value' and 'quality/growth' shares, to the point where an average value share was trading at around one third of the price of a

Fiscal Private Client Services (PTY) Ltd
Phone: 021 671 3175
Email: info@fiscal.co.za
Website: www.fiscal.co.za
FUNDHOUSE
investment clarity

higher quality share with a similar earnings growth rate.

Since early November 2020, the mood of the market has shifted in their outlook for inflation, and as a result, bond yields have started to rise. We have subsequently seen very sharp performance differentials since that point as the ‘value’ or ‘reflation’ trade has found favour, and investors have started to reposition towards assets which provide growth within this new expected outlook. The chart below highlights this period. While short, the differences are meaningful:

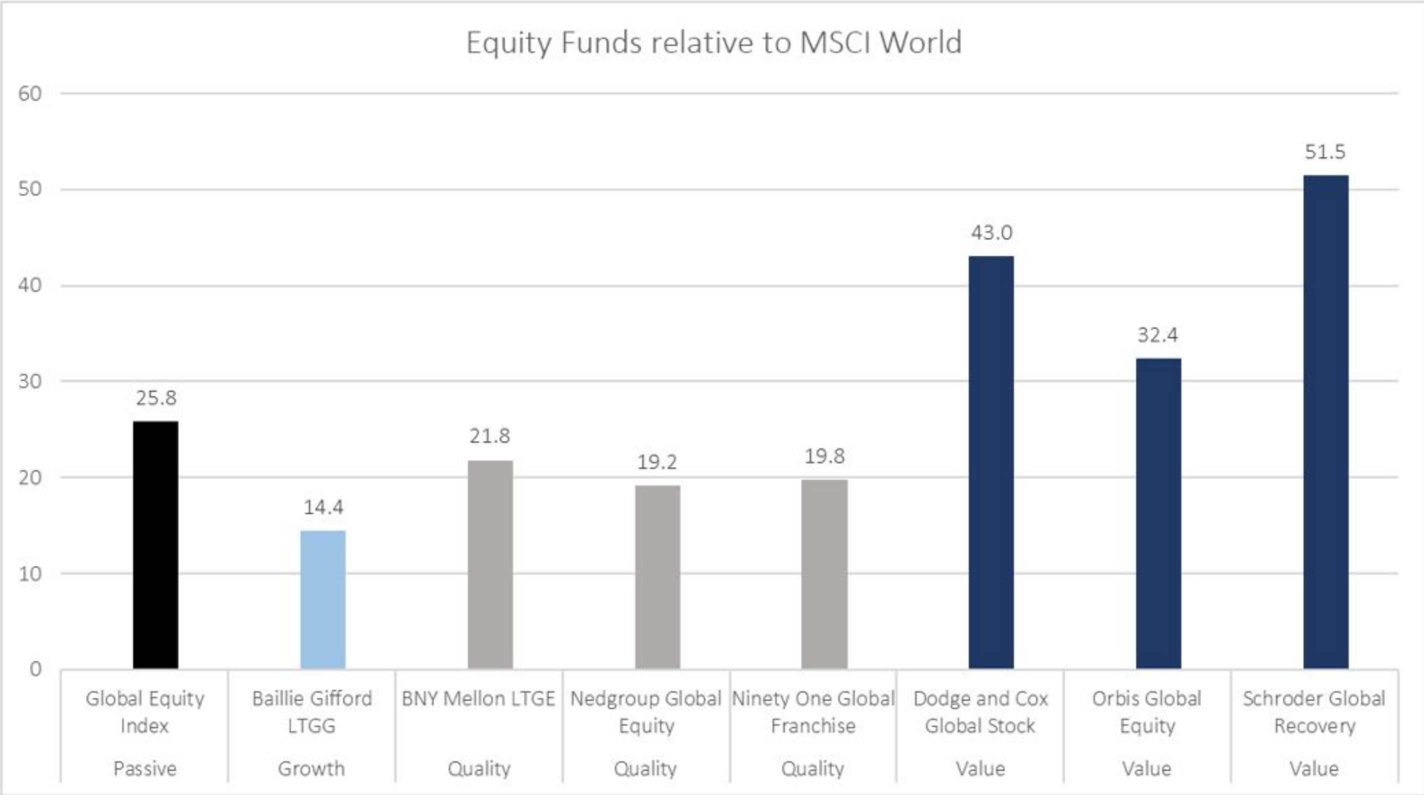

Chart 2: Performance of selected Value, Quality and Growth funds relative to

MSCI World 01/11/2020 to 06/04/2021. Source: FE Analytics

The implications for portfolios today are twofold (and this is what makes investing hard!):

- It is preferable to hold a higher allocation to value-oriented assets should the environment of higher future inflation persist.
- However, if the global economy has a setback – really of any nature – then we are back to square one where the more exposed value shares will likely be discarded once again.

Fiscal Private Client Services (PTY) Ltd
Phone: 021 671 3175
Email: info@fiscal.co.za
Website: www.fiscal.co.za

Instances like this are quite common in investing, but critically the potential to add value or impair capital is most significant when the relative price differences to start are as wide as they are today. Be too careful through favouring highly priced quality shares, and you could be in for a real shock should rates rise back towards their 4% average. Be too aggressive by favouring the higher risk assets offering value, and you could take a knock if we have a setback. It really is quite binary at the moment, and in these instances the sensible decision is to firstly be diversified, but secondly, to make sure you are not overexposing yourself to overpriced assets. Rather than a 'value trap', today we have a 'quality trap'.

By value we would expect the majority of investor portfolios worldwide to be at risk in this higher inflation scenario. The asset flows into the FAANGs, the make up of global index funds, the way the average share portfolio is invested – all speaks to a one-way outcome dependent on a lower cost of capital. At this point, we may have had an early warning and there is still time to adjust, but the risks do worth bearing in mind of not taking appropriate action while you still have the chance.

Locally, the JSE has continued to rocket north with the recovery in a number of the laggard sectors, including property. While commodities remain the key driver of returns, we have seen more broad-based support for the more domestically reliant equities which have borne the brunt of a weak economy for the past few years. Table 1 below shows the returns over the past 6 months, in line with the general upswing in higher risk, value-based assets worldwide:

Company	Sector	Return
Arrowhead	Property	135.4%
Attacq	Property	106.7%
Murray and Roberts	Construction	102.8%
Motus	Vehicles	102.5%
Hyprop	Property	98.1%
Impala Platinum	Resources / Platinum	95.3%
Vukile Property	Property	94.4%
Fortress B	Property	93.3%
Hammerson	Property	93.2%
Cartrack	Vehicles	93.0%
Tsogo Sun Gaming	Hospitality	89.5%
Anglo American Platinum	Resources / Platinum	88.1%
Reunert	Industrials	85.1%
EPP NV	Property	85.0%
HCI	Hospitality	84.1%
SA Corporate Real Estate	Property	79.2%
Textainer	Industrials	75.1%
Massmart	Retail	74.3%
Sappi	Resources - paper and plastics	73.2%
KAP Industrial	Industrials	68.6%

Table 1: local equity returns: Top 20 from 01.10.2020 to 31/03/2021

Fiscal Private Client Services (PTY) Ltd
Phone: 021 671 3175
Email: info@fiscal.co.za
Website: www.fiscal.co.za

Local bonds have moved slightly weaker as US rates have risen as well (a key underpin to local bond pricing). While the expected real return on local bonds remains very high, this could be offset somewhat should US rates continue to rise. SA Cash remains a relatively poor prospect as the Reserve Bank retains a low interest rate policy for the foreseeable future to assist in the recovery post COVID.

The substantial returns in both local and offshore assets of late does require some thought: take profits, derisk your portfolio and preserve capital?; or hope that the economic recovery continues and pushes through into company earnings and higher equity returns? The risks are quite evenly balanced in this regard, and so we revert to the basics to guide portfolio construction:

- Sensible diversification across top tier fund managers
- Aim to avoid assets which have a high potential for permanent capital loss
- Aim for areas where valuations are not excessive
- Let compounding, diversification and time do the rest

Asset Classes

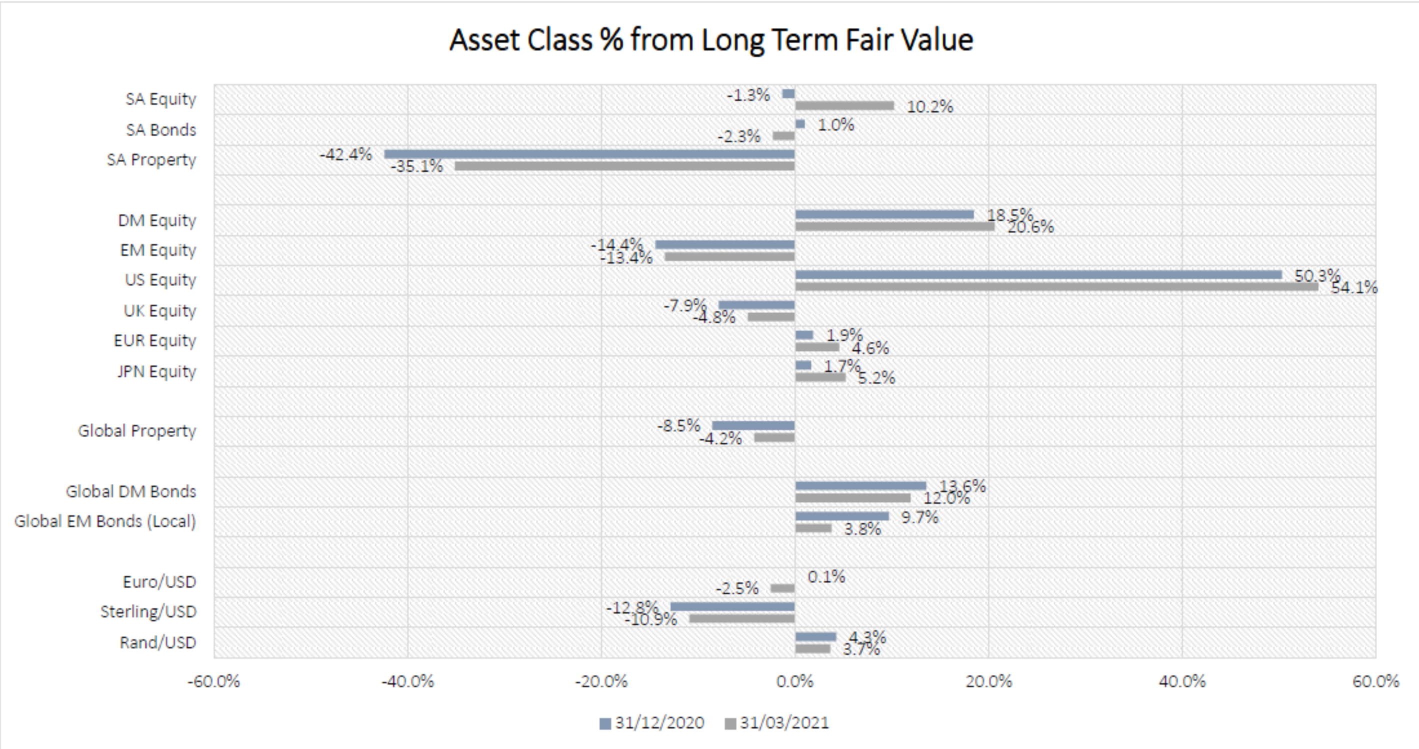

Chart 1: Relative value of asset classes vs long term history. Source: Fundhouse

Fiscal Private Client Services (PTY) Ltd
Phone: 021 671 3175
Email: info@fiscal.co.za
Website: www.fiscal.co.za

The table below provides a summary of where each asset class is currently positioned from a relative value perspective:

Asset class	Context	Outlook
Asset classes at a Discount		
SA Property	Property remains cheap as concerns around potential equity dilution, REIT status and distribution payments weigh on risk levels. There has been somewhat of a recovery though, driven by a general uplift in sentiment, and rescue plans being implemented for companies in distress.	Negative
Emerging Market Equity	EM equities remain attractive, but less so as scrutiny increases on the large tech shares like Alibaba and Tencent.	Positive
Global Property	Property was trading in synchronized fashion with global bonds as a beneficiary of the yield trade, however as COVID-19 drives people away from retail property in particular, the selling has been extreme. This has opened up a decent value opportunity for the survivors, but there are likely to be casualties.	Neutral
UK Equity	The UK market has recovered strongly as it has high exposure to cyclical shares like banks and oil producers.	Positive
GBP/USD	Sterling remains weak as the implications from Brexit become clear, but the gap to USD has closed by half given the US currency weakness.	Positive
Asset classes at a Premium		
Developed Market Equity	Spot multiples look expensive (at 30x PE), yet forward expectations are more average at around 20x. This remains quite high, and is not in the bag.	Negative
US Equity	Remains very expensive in aggregate, with multiple areas exposed to rising rates, higher taxes and regulator scrutiny. Forward multiple is 23x PE. Buyer beware.	Negative
Developed Market bonds	Yields have moved sharply upwards, but have levelled off now at around 1.7%. should higher inflation be realized, we would expect the Fed to let it run for some time before stepping in to raise shorter term rates. Non-US sovereign bonds remain very weak from a return perspective.	Negative
Global Emerging Market Bonds	EM bond spreads have continued to strengthen as risk appetite returns.	Negative
Asset classes at or near Fair Value		
SA Equity	Recent strong performance broadly led by Commodities still appear to have tailwinds, while local equities dependent on policy direction still. It does appear to be a case of "less worse" than expected, and share prices are reacting strongly as a result.	Neutral
European Equity	European Equity has rerated in line with the reflation trade.	Neutral
Japanese Equity	Japanese shares trading more in line with global peers, after decades of premium valuations.	Neutral
US Dollar/ZAR	The US$ has been weaker of late as risks around debt and inflation mount. SA ZAR supported by higher than expected tax receipts, high commodity demand, and lower levels of imports.	Neutral
SA Bonds	Good real yields remain, but the debt load is high and economy weak. Risks have increased around rising US rates.	Neutral

Fiscal Private Client Services (PTY) Ltd
Phone: 021 671 3175
Email: info@fiscal.co.za
Website: www.fiscal.co.za

Outlook changes since 31.12.2020

- **SA Cash:** downgraded from (0) to (-1). With base effects coming through into likely higher inflation, low cash yields are unlikely to compensate over the short to medium term.
- **Emerging Markets Debt**: rising risk appetites have meant yield spreads have declined to a lower point. As such we have downgraded EM Debt from (-1) to (-2).

Summary Outlook per asset class

Date	30-06-18	30-09-18	31-12-18	31-03-19	30-06-19	30-09-19	31-12-19	17-03-20	31-03-20	15-05-20	23-06-20	03-07-20	07-10-20	20-11-20	12-01-21	31-03-21	*
ASSET CLASSES																	
SOUTH AFRICA																	
EQUITY	-2	-1	-1	-1	-1	0	0	1	1	1	0	0	0	0	0	0	
PROPERTY	-2	-2	-2	-2	-2	-2	-2	-1	-1	-1	-2	-2	-2	-2	-2	-2	
BONDS	-1	-1	-1	-1	-1	-1	-1	1	1	0	0	0	0	0	0	0	
CASH	2	2	2	2	2	2	2	2	2	2	1	0	0	0	0	-1	*
GLOBAL																	
DEVELOPED EQUITY	0	0	0	-1	-1	-1	-2	0	-1	-1	-2	-2	-2	-2	-2	-2	
EMERGING EQUITY	0	0	0	1	1	1	1	2	2	2	2	2	2	2	1	1	
US EQUITY	-1	-1	-1	-1	-2	-3	-3	-1	-2	-2	-3	-3	-3	-3	-3	-3	
DM DURATION BONDS	-2	-2	-2	-2	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	
EM DURATION BONDS	0	0	0	0	-1	-1	-1	-1	1	1	0	0	0	0	-1	-2	*
GLOBAL PROPERTY	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	
GLOBAL CASH	-1	-1	-1	0	0	0	-1	-1	-2	-2	-2	-2	-2	-2	-3	-3	
CURRENCIES																	
USDZAR	-1	-1	-1	-1	-1	-1	-1	1	1	1	1	1	1	0	0	0	
USDEUR	0	0	0	0	1	1	1	1	1	1	1	1	0	0	0	0	
USDGBP	-1	-1	-1	-1	1	1	1	1	1	1	1	2	2	2	2	2	

Table 1: Fundhouse Asset Class Outlook: Q1 2021

---

[1] QE is Quantitative Easing – a form of central bank support where debt is bought from the market to help increase economic activity through increasing the supply of money in an economy.

Fiscal Private Client Services (PTY) Ltd
Phone: 021 671 3175
Email: info@fiscal.co.za
Website: www.fiscal.co.za