Diversification is key during market uncertainty

By Reza Hendrickse

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After a quiet start to the third quarter, a familiar script began playing out with President Donald Trump once again proceeding to threaten China with additional tariffs on imports.

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His series of early-August tweets, wherein he also labelled China as “currency manipulators”, made it clear that their trade dispute remains far from resolution, sapping confidence and sending stock markets lower. In a further drain on risk appetite the US yield curve came back into focus, with its inversion, a prominent and often reliable recession indicator, causing widespread concern. After a brief reprieve into mid-September, news of a drone attack on a Saudi Arabian oil field, threatening to disrupt global oil supply, once again rattled markets.

Again, Trump’s unfolding impeachment investigation regarding his communications with Ukraine, as well as the rising possibility of a no-deal Brexit outcome posed further risks, keeping markets on edge.

Local and global market performance

Markets contended with predominantly negative news flow in the quarter. Domestic equities, as measured by the FTSE/ JSE Capped SWIX, ended 5.1% lower overall. The MSCI All Countries World Index on the other hand, as a measure of global equities, churned sideways in dollars. In rand terms though, global stocks delivered a 7.5% gain, given a sizeable depreciation in the local currency in response to the prevailing risk-off sentiment. The weaker rand benefitted all offshore asset classes, boosting global bonds to a third quarter return of 8.4%, and driving global listed real estate up to a solid 13.8%. The offshore exposure was a key driver of portfolio returns for the quarter.

In contrast to strong offshore performance, domestic government bonds returned 0.7%, inflation-linked bonds delivered 0.3%, while domestic listed real estate lost 4.4%. These asset classes all underperformed South African cash this quarter, which returned 1.7%. Year-to-date domestic growth assets have remained hamstrung by the domestic economy, which is virtually at a standstill. The local equity and property markets have delivered paltry returns of around 1%, substantially underperforming inflation. Offshore growth asset classes on the other hand are up between 20% and 30% year-to-date in rands, without much help from the rand, which was 5.4% weaker over the period. Global bonds have done surprisingly well, having gained 12.0% as a result of the global easing cycle tailwind, outperforming SA bonds which have increased to 8.4%.

Global growth

Global growth has stalled to a moderate level, but the key question now is whether economic activity will continue to fade or stimulus efforts around the world will be sufficient to provide stability and impetus for a re-acceleration from here?

The slowdown in growth this year and last year was mostly policy-driven, leading to weakness in the manufacturing sector. The Fed had been tightening policy, China had shifted gears from stimulating their economy to deleveraging, and the trade-war impacted both confidence and global supply chains.

Although growth has slowed, stimulus efforts around the world should be supportive from here and growth should pick up. Global central banks are easing financial conditions, led by the Fed which switched from monetary policy "normalisation" to "pre-emptive easing". Other major central banks are also expanding their balance sheets and gearing up for additional stimulus measures, while the cutting cycle has broadened across several developed and emerging markets.

There is no guarantee that stimulus will ignite growth this time, but historically it has proven helpful in other post global financial crisis (GFC) slowdowns. Encouragingly, there is early evidence of an improvement in certain leading economic indicators for the moment. In addition, China has significant capacity to ramp-up their stimulus efforts further, while the trade war risk is manageable, given that both sides have a strong incentive to keep any fallout contained.

Local growth prospects

South Africa remains on a weak footing. Quarter-on-quarter GDP growth has been erratic, evidenced in the most recent GDP print which saw a sharp second quarter rebound of 3.1%, after the prior quarter's worse than expected 3.1% contraction. Year-on-year, the economy is barely growing in real terms, and the SA Reserve Bank (Sarb) continues to lower its growth expectations at virtually every opportunity. The bank now expects a mere 0.5% in GDP growth for 2019, recovering to 1.4% in 2020 and 1.7% in 2021. Against this backdrop, business confidence has fallen to a new post-GFC low, projecting continued downbeat conditions for the medium term. Importantly, without growth, the current path of fiscal deterioration leaves SA increasingly vulnerable to a sovereign credit rating downgrade, especially given the lack of any meaningful reforms and the recurring bailouts of State-owned enterprises. The market has already priced in the threat of a downgrade, although it now looks like Moody's will not act any time soon.

In July the Monetary Policy Committee (MPC) (like the Fed) lowered the repo rate by 0.25% to 6.5%, seeing inflation risks as balanced but downside risks to growth. There was no follow-through at the MPC September and November meetings, where the committee opted to keep rates steady. Although the US has continued to cut rates, the Sarb has been reluctant to cut its rates aggressively, pointing out that the key drivers of weak domestic growth are less responsive to lower rates than to policy uncertainty. They also remain very focused on keeping inflation near the mid-point of the target range, while keeping inflation expectations anchored lower than they have been historically.

Risk reward trade-off

The investing landscape has proved quite challenging over the past year or two, potentially leaving investors with feelings of uncertainty and trepidation. This is understandable given the array of macro risks we currently face, compounded by mixed signals from the markets. The global bond market, for example, appears to reflect a very pessimistic growth outlook at the moment, while global stocks appear less concerned, with the MSCI ACWI not far from its all-time highs.

While it may not feel like it, times like these often present the greatest opportunities for investors who remain committed to their long-term objectives. For investors with a capital growth objective, we think the risk reward trade-off still favours equity and we do not recommend repositioning more defensively at this juncture. More importantly, we advocate maintaining an appropriate level of diversification in positioning for a variety of potential outcomes that could unfold, while also remaining flexible in processing new information.

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