

Politics and Portfolio Positioning

In December, delegates will come together for the 54th ANC National Conference during which new officials will be elected to lead the party for the next five years. This is a contentious issue, because the president of the ANC will almost certainly become the next president of the nation in 2019, or earlier. Although there are several comrades battling it out for the seat at the head of the table, this is really a race between Cyril Ramaphosa and Nkosazana Dlamini-Zuma.

The elective conference concerns investors for three primary reasons: Firstly, this election is a break from tradition. The deputy president of the ANC is generally expected to become the president, as has been the case in the past. Given Dlamini-Zuma's support from various senior leaders in the ANC, this is no longer guaranteed. Secondly, the market impact of the outcome is binary – it's one or the other. There are two broad factions in the ANC at the moment: the modernists and the traditionalists, where Ramaphosa is representative of the former and Dlamini-Zuma of the latter. The modernists are generally viewed by the market as more progressive, moderate and business friendly. In contrast, the traditionalists are less favoured by the market because of their perceived preference to maintain the status quo. The two outcomes appear to have little overlap, which makes it binary. Thirdly, following Brexit and Trump's presidential win last year, it's become clear that unexpected outcomes can't be ignored, and that the probability and impact of each should be carefully considered. Here, the probability of either is frustratingly opaque.

So, how do we look at portfolio positioning when the market faces a major political event with a binary, yet highly disparate outcome?

1. Face the realities

While a market friendly political dispensation might buy us some time, weak economic indicators have increased the likelihood of a downgrade to the extent that we consider it the base case scenario – regardless of the outcome in December. Just two weeks ago, Finance Minister Malusi Gigaba released his first Medium Term Budget Policy Statement (MTBPS), which painted a refreshingly honest, yet depressing picture of the country's finances: Economic growth projections (which government revenue is dependent on) for the next few years were effectively halved, while government expenditure is expected to increase by over 7% per year over the next three years. Consequently, the revenue shortfall is expected to rise to R90 billion by 2020/21 (from R50 billion in 2017), pushing government debt to GDP out to 61%, from 50% in 2017. Ratings agencies have, understandably, responded negatively to the statement.

Fund managers differ on the degree to which a downgrade is priced into the market, with some even arguing that it's fully priced in. Since the MTBPS, bond yields have risen from 8.6% to over 9.3% and the Rand weakened to over 14.30 to the US Dollar, from 13.30 ten days before the statement. The All Share Index has never been higher, as the Rand hedge stocks responded well to the weakening Rand. If a downgrade in our debt ratings is only partially reflected in bond prices given what's happened after the MTBPS, we should expect yields to rise and the Rand to depreciate further if our debt is officially downgraded.

2. Assess the probability of outcomes

Both Ramaphosa and Dlamini-Zuma are part of the same institution (the ANC), so the elective outcome therefore has less to do with the individuals themselves and more to do with the broader groups they represent. Suppose then the following two scenarios: Scenario 1 sees the Ramaphosa-led modernists take over in December. Scenario 2 is where the Dlamini-Zuma traditionalist camp wins. Our assessment is that there is strong support for both candidates but that it's unclear at this stage who will take over the reins in December. Therefore, a prudent way to look at this is probably to meet somewhere in the middle, so to assign a 50/50 probability to either scenario.

3. Measure the magnitude of outcomes

We would expect the outcome of the election to have the largest impact on bond yields and the currency. Bond yields are driven by the trust investors place in the ability of the bond issuer to repay the outstanding debt. If the risk of default rises, investors demand higher yields in compensation. Importantly, bond yields and prices are inversely related, so as yields increase, bond prices fall. The value of the Rand is determined by the supply and demand interaction in relation to another currency. Financial flows out of the country for example increases the supply of Rands relative to say US Dollars, causing depreciation.

So, let's consider the market impact of our best-case and worst-case scenarios. In Scenario 1, the market reacts positively to a Ramaphosa win and to the expectation that things will improve. We would expect bond yields to decline, the currency to strengthen (resulting in Rand-hedged equities declining) and domestically exposed equities rally. While this would be good for economic growth over the longer term, the short-term impact on portfolios is likely to be negative, given the Rand strength impact on offshore assets and Rand-hedged equities.

In Scenario 2, the markets are expected to react poorly to a Dlamini-Zuma win, because of the expectation that there will be less positive change, and more of the same. This results in higher yields, a weaker currency (boosting offshore holdings and Rand-hedge equities), and less support for domestic equities. Again, while this would be seen as negative for economic growth over time, we would expect it to be positive for portfolios in the short term as the weakening rand results in offshore assets and the Rand-hedged equities running.

While we have assumed that both scenarios are equally likely and that the typical market reaction will be different directionally, we don't expect the impact of either scenario to necessarily be equal in magnitude. Consider bonds for example. Bond prices in South Africa have been artificially propped up by foreign investors this year, as part of a broader search for higher yields in emerging markets, given the low yields prevailing in developed markets. This pushed bond prices into mildly expensive territory. Post the MTBPS, yields rose resulting in a fall in bond prices closer to fair value. If Nenegate is anything to go by, markets react more to bad news than it does to good news. The big question is how much of the downgrade is priced in when considering the impact of either scenario on bond prices.

The argument for equities is slightly different. Equities have been relatively expensive for a while now, but in contrast to the bond markets, it has rallied since the MTBPS, with the index reaching an all-time high of 60,000 on November 6th. Most of this performance was carried by the Rand-hedge industrial stocks and the commodity producers that earn revenue offshore, and therefore benefitted from the currency depreciation. These share prices will likely be supported by continued Rand depreciation. Shares that are inextricably linked to the South African economy for their earnings - think banks, retailers and most property counters - will feel continued pressure if the current economic situation continues or deteriorates.

4. Incorporate views into portfolio positioning

Although the probability of either scenario is equally likely, the risks remain to the downside in our opinion. Portfolios are therefore positioned as though Scenario 2 is more likely to occur. In a low growth environment, with high systemic risks and an asymmetric payoff profile biased to the downside, our portfolios are positioned to protect against capital loss, instead of allocating to growth assets (like equity and property) where they provide less compensation for the risk taken.

Practically, this is implemented by maintaining a well-diversified portfolio, with an overweight exposure to offshore assets (to protect against Rand depreciation), an underweight exposure to bonds (to protect against capital losses as yields rise) and an underweight position to local growth assets like property and equity.

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OCT INVESTMENT 2017 REVIEW

31 October 2017

data provided by Profile Data Analytics, Reuters and Datastream

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol	10yr Vol
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	8.1%	19.6%	20.1%	9.0%	13.0%	9.7%	11.0%	15.3%
FTSE/JSE SA Listed Property	ZAR	4.0%	10.3%	11.1%	10.9%	14.1%	13.6%	13.3%	15.0%
SA All Bond Index (ALBI)	ZAR	-0.2%	5.4%	5.0%	5.6%	6.0%	8.0%	7.7%	7.5%
SA Cash Index (SteFI)	ZAR	1.8%	6.3%	7.6%	7.1%	6.4%	7.2%	0.3%	0.5%
Balanced Benchmark	ZAR	6.6%	15.6%	16.4%	9.9%	12.8%	10.5%	7.1%	7.1%
SA Inflation (1 month lag)	ZAR	0.9%	3.8%	5.1%	5.3%	5.5%	5.9%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	4.3%	18.2%	22.8%	8.1%	11.6%	4.1%	9.8%	16.4%
Emerging Markets Equity (MSCI EM)	USD	5.4%	32.3%	26.5%	5.7%	4.8%	0.6%	14.5%	22.9%
Global Bonds (Barclays Global Bond Index)	USD	-0.3%	5.8%	1.2%	1.2%	0.4%	3.1%	4.6%	5.8%
Global Cash	USD	0.3%	0.9%	1.0%	0.5%	0.4%	0.7%	0.1%	0.3%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	8.1%	19.6%	20.1%	9.0%	13.0%	9.7%	11.0%	15.3%
Global Equity (MSCI World)	ZAR	11.8%	22.2%	28.8%	17.4%	22.9%	12.4%	13.6%	14.0%
Emerging Markets Equity (MSCI EM)	ZAR	13.0%	36.8%	32.6%	14.8%	15.5%	8.7%	12.5%	15.7%
SA All Bond Index (ALBI)	ZAR	-0.2%	5.4%	5.0%	5.6%	6.0%	8.0%	7.7%	7.5%
Global Bonds (Barclays Global Bond Index)	ZAR	6.9%	9.5%	6.1%	9.8%	10.7%	11.4%	11.7%	14.5%
COMMODITIES									
Gold (US Dollars)	USD	0.2%	10.8%	-0.1%	0.6%	0.3%	0.2%	10.7%	7.6%
Gold (Rands)	ZAR	7.4%	14.8%	4.7%	10.6%	6.2%	3.1%	11.9%	8.4%
CURRENCIES									
Rand / Dollar	ZAR	-6.5%	-2.9%	-4.1%	-7.9%	-9.2%	-7.4%	12.9%	15.8%
Rand / GBP Pound	ZAR	-7.0%	-5.0%	-11.6%	-2.0%	-5.7%	-3.2%	14.8%	15.7%
Rand / Euro	ZAR	-5.2%	-12.0%	-9.7%	-5.7%	-7.3%	-5.4%	12.3%	13.7%
LOCAL UNIT TRUST SECTORS									
SA Equity - General	ZAR	6.0%	11.9%	12.8%	5.9%	10.0%	7.7%	9.3%	12.4%
SA Multi Asset - High Equity	ZAR	5.4%	11.2%	12.0%	7.4%	9.9%	8.0%	6.1%	7.1%
SA Multi Asset - Low equity	ZAR	3.8%	8.8%	9.8%	7.4%	8.5%	7.9%	3.4%	3.6%
SA Real Estate - General	ZAR	3.5%	9.2%	10.2%	10.1%	13.0%	12.3%	11.6%	13.1%
Global Equity - General	USD	3.4%	16.3%	18.8%	6.5%	8.9%	1.5%	9.9%	16.2%
Global Multi Asset - High equity	USD	1.9%	12.3%	13.2%	5.0%	6.6%	2.5%	7.6%	12.3%
Global Real Estate - General	USD	-1.0%	6.6%	5.9%	1.7%	4.0%	0.3%	10.8%	21.3%

Spot Rates		31-Oct-17	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US\$	Rand	14.14	13.50	13.75	8.25	6.90	4.66
Rand/GBP	Rand	18.78	18.11	17.87	13.33	14.05	7.53
Rand/EUR	Rand	16.47	15.96	15.45	10.62	9.81	-
RATES							
Libor 6m \$	US\$	1.58	1.51	1.24	0.64	5.13	5.84
Repo Rate	Rand	6.75	6.75	7.00	5.00	10.00	-
Prime	Rand	10.25	10.25	10.50	8.50	13.00	20.25
All Bond Index Yield	Rand	9.75	9.32	9.12	7.10	-	-
COMMODITIES							
Gold (\$/oz)	US\$	1,269.46	1,283.83	1,321.51	1,774.45	743.50	333.05
Platinum	US\$	915.00	920.00	1,034.00	1,668.00	1,377.00	434.25
Oil (Brent Crude) \$	US\$	61.12	57.57	48.97	112.56	80.84	19.84
INFLATION							
SA Inflation	%	NA	5.1	6.1	5.5	5.8	9.4

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