

What to expect from investment markets in 2018

The start of a new year brings with it a fresh mindset with which to consider investment prospects for 2018. Over the course of any given year, and in particular such a politically and economically busy one such as 2017, it is easy to lose track of where we are as we filter the deluge of information hitting us daily.

To recap briefly, over the past 12 months we've needed to consider the tweets of Trump, ongoing uncertainty over the nature of Brexit, European politics being both good (Macron in France) and bad (Catalonian independence), SA politics, a chaotic ANC conference resulting in new ANC leadership, the rand which started at R13.70/\$, moved out to R14.50/\$ then reversed to end at R12.38/\$, three US interest rate hikes and emerging markets ending the year 40% up in Dollar terms. That is without taking into account the individual asset classes which we can consider for investment or any of the numerous fund manager changes over the year.

In the US, the Trump administration has failed on many of their proposals since taking office, but the recent successful tax legislation changes to decrease the corporate tax rate is expected to have positive effects on equity valuations in 2018. The strategy appears to be positive for growth, however we caution that legislation such as this can create bubble valuations as positive sentiment pushes prices higher, even as the US Federal Reserve seems set to raise rates a further three times in 2018. There is also the potential for Trump's brinkmanship with North Korea to materially change how the West deals with the East, causing further market risk and even full-scale war.

The UK continues to operate under extreme uncertainty with no clear outcome to the Brexit negotiations on the horizon. The conservative party enters 2018 weaker on the back of a snap-election called by Theresa May in which the British public showed their displeasure at the course of negotiations to leave the EU. Under May, the UK must navigate both the Brexit process and the threat of higher inflation as they seek to begin rate normalisation in the ilk of the US. The next 12 months will be characterised by further uncertainty as the UK learns what their Brexit fate will be, this leads us to view the investment risk higher than usual for this region.

In Europe, the continent enters 2018 on much firmer footing than in 2017, with the central nations of Germany and France having concluded their elections and market friendly candidates elected. 2018 sees politics come to the fore once more as major elections in Italy take place and the push for independence by Catalonia reaches a conclusion. The question of whether the UK has started a chain reaction in the unravelling of the EU and the common currency still needs to be answered. Voters in these countries may well push against the incumbent politicians as has happened in the US (Trump) and the UK (Brexit). Economic justification will not play a significant role it seems, with votes being won with social messages, particularly given the weak economies and high unemployment rates in Spain and Italy. The consequences of a negative outcome with respect to the EU for either of these elections, leads to higher risks for investments.

Locally we enter a phase of political consolidation as the market watches and waits to see what the tangible outcome of Cyril Ramaphosa emerging as the new president of the ANC will be. The relief rally in December 2017 for the ZAR and all locally biased assets will be tested as questions emerge as to the policy switches that will be enacted by the new ANC leadership. Notwithstanding the more positive political backdrop, South Africa is still faced with a worsening fiscal environment as government debt continues to climb to unsustainable levels and local consumers find themselves under constant budget pressure. South Africa is not out of the woods just yet and the next year will be a testing one for the investment market as the news flow is set to increase in the lead-up to the 2019 national elections.

Apart from these events all having significant impact on currencies, and therefore the fortunes of the local investor, we also need to consider asset classes. If there is one thing we can fall back on when markets are volatile, it's to gain perspective by looking at where we are today relative to history in terms of valuations.

As part of our ongoing investment process we track major markets to ensure we understand the valuation risks inherent in each asset class being considered for investment. We introduced investors last year to two interesting metrics that we look at to determine relative market valuations, these are: the 'CAPE' (or cyclically adjusted PE ratio which acts as a useful guide to valuation levels) as well as the level of corporate earnings.

Globally, valuations rose on the back of a general increase in earnings growth from the beginning of 2017. Europe saw a strong positive trend in real earnings growth emerge, from -11% to +1.9% by the end of 2017. Valuations have run ahead of this trend as markets expect this to continue to move higher. The US has seen valuations push out to seemingly expensive levels, but this is based off earnings expectations from the recent tax cuts. On these valuation metrics, the UK and Europe appear to show relative value, we temper this view with high levels of political risk that are present in both regions.

Locally, corporate earnings have been declining for almost 4 years and have now reached levels last seen during the financial crisis of 2008/09. This has been sector wide, led by commodities and mid-caps but including real estate, financials and industrial shares. The table below highlights the relatively uninspiring equity outlook based on the CAPE valuation as well as the level of corporate earnings, adjusted for inflation:

Market	CAPE – (Long term average PE)	CAPE - (Current PE)	Valuation Premium/Discount	Real Earnings growth long-term Average	Real Earnings Growth Current
South Africa	16.4x	19.2x	+17% expensive	4.2% p.a	-8.42% p.a
United States	22.3x	27.6x	+24% expensive	3.8% p.a	-0.8% p.a
United Kingdom	17.6x	16.5x	-6% cheap	3% p.a	-5.8% p.a
Europe	17.5x	15.67x	-11% cheap	3.1% p.a	+1.9%p.a

Long term earnings and valuation comparison (1973 -). Source: Thomson Reuters

The expansion of global market valuations in 2017 has been a result of improving earnings trends as the world finds itself in a rare period of synchronised global growth with factories struggling to keep up with demand for the first time since 2011. Markets remain exposed to the possibility that an event occurs to derail this period of growth; this could be a spike in inflation, overexuberant central bankers raising interest rates too quickly, political upheaval or even war on the Korean peninsula.

For South African investors, currency plays a major role in the success or failure of any investment planning. In 2017 the strong Rand was a drag on performance while the robust local market performance resulted in a mixed bag for many investors when looking at the performance of their portfolios at the end of the year. Looking forward we monitor the 'purchasing power parity' of the rand relative to other currencies to be able to judge relative value. As we stand today, the rand is expensive (16%) against the Dollar; sterling is 16% cheap relative to the Dollar and the Euro is at fair value to the Dollar. By implication, the euro and sterling are cheap relative to the rand, bearing in mind the high-risk environment in those regions for the meantime.

To summarise: We start 2018 with positive earnings trends across global markets, this positive trend should lead to further expansions in valuation levels. This positive trend can be unwound by the material economic and political risks that remain in the world economy. Valuation levels are generally closer to fair value than they were a year ago and as investors we need to be even more aware of our exposure to the risks that exist within our portfolios.

Locally, the markets need to decide whether the political or economic forces dominate, as the political outlook improves for the first time in a decade even as South Africa's fiscal situation continues to deteriorate. It is a decision between the positive political trajectory and the current negative economic reality that faces us.

31 December 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	7.4%	21.0%	21.0%	9.3%	11.9%	10.7%	11.0%	15.1%
FTSE/JSE SA Listed Property	ZAR	8.3%	17.2%	17.2%	11.7%	13.9%	14.9%	13.1%	15.0%
SA All Bond Index (ALBI)	ZAR	2.2%	10.2%	10.2%	6.9%	6.3%	8.6%	8.1%	7.7%
SA Cash Index (SteFI)	ZAR	1.8%	7.5%	7.5%	7.1%	6.5%	7.1%	0.3%	0.5%
Balanced Benchmark	ZAR	3.9%	15.2%	15.2%	9.2%	11.9%	10.9%	7.2%	7.2%
SA Inflation (1 month lag)	ZAR	0.9%	4.2%	4.6%	5.3%	5.4%	5.8%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	5.5%	22.4%	22.4%	9.3%	11.6%	5.0%	9.9%	16.3%
Emerging Markets Equity (MSCI EM)	USD	7.4%	37.3%	37.3%	9.1%	4.3%	1.7%	14.4%	22.8%
Global Bonds (Barclays Global Bond Index)	USD	1.1%	7.4%	7.4%	2.0%	0.8%	3.1%	4.7%	5.8%
Global Cash	USD	0.3%	1.1%	1.1%	0.6%	0.4%	0.7%	0.1%	0.3%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	7.4%	21.0%	21.0%	9.3%	11.9%	10.7%	11.0%	15.1%
Global Equity (MSCI World)	ZAR	-3.3%	10.8%	10.8%	11.8%	20.4%	11.5%	14.2%	14.3%
Emerging Markets Equity (MSCI EM)	ZAR	-1.5%	24.3%	24.3%	11.6%	12.5%	7.9%	13.0%	15.8%
SA All Bond Index (ALBI)	ZAR	2.2%	10.2%	10.2%	6.9%	6.3%	8.6%	8.1%	7.7%
Global Bonds (Barclays Global Bond Index)	ZAR	-7.3%	-2.8%	-2.8%	4.3%	8.7%	9.4%	12.3%	14.8%
COMMODITIES									
Gold (US Dollars)	USD	0.6%	12.7%	12.7%	1.1%	0.7%	0.3%	10.7%	7.6%
Gold (Rands)	ZAR	-7.9%	2.0%	2.0%	6.3%	3.7%	1.9%	12.6%	8.9%
CURRENCIES									
Rand / Dollar	ZAR	9.2%	10.9%	10.9%	-2.3%	-7.3%	-5.8%	13.8%	16.2%
Rand / GBP Pound	ZAR	8.3%	6.4%	1.2%	2.5%	-3.8%	-2.1%	15.5%	16.0%
Rand / Euro	ZAR	7.2%	-2.8%	-2.8%	-2.1%	-5.6%	-3.9%	13.0%	13.9%
LOCAL UNIT TRUST SECTORS									
SA Equity - General	ZAR	5.5%	12.3%	12.3%	5.6%	9.1%	8.5%	9.3%	12.3%
SA Multi Asset - High Equity	ZAR	2.0%	9.3%	9.3%	6.0%	8.9%	8.2%	6.2%	7.1%
SA Multi Asset - Low equity	ZAR	1.4%	8.0%	8.0%	6.5%	7.8%	7.9%	3.4%	3.6%
SA Real Estate - General	ZAR	5.8%	13.9%	13.9%	10.1%	12.6%	13.2%	11.3%	13.0%
Global Equity - General	USD	5.3%	20.7%	20.7%	7.5%	9.1%	2.4%	9.9%	16.1%
Global Multi Asset - High equity	USD	3.7%	15.5%	15.5%	5.9%	6.8%	3.4%	7.6%	12.2%
Global Real Estate - General	USD	3.8%	10.7%	10.7%	2.1%	4.0%	2.1%	10.8%	21.0%

Spot Rates		1-Jan-18	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US\$	Rand	12.38	12.38	13.68	8.25	6.83	4.87
Rand/GBP	Rand	16.61	16.61	16.88	13.33	13.60	8.01
Rand/EUR	Rand	14.87	14.87	14.42	10.62	9.99	-
RATES							
Libor 6m \$	US\$	1.84	1.84	1.32	0.64	4.60	5.84
Repo Rate	Rand	6.75	6.75	7.00	5.00	11.00	-
Prime	Rand	10.25	10.25	10.50	8.50	14.00	19.25
All Bond Index Yield	Rand	9.35	9.35	9.39	7.10	-	-
COMMODITIES							
Gold (\$/oz)	US\$	1,303.46	1,303.46	1,157.49	1,774.45	836.15	289.15
Platinum	US\$	927.00	927.00	898.00	1,668.00	1,529.00	362.00
Oil (Brent Crude) \$	US\$	66.61	66.61	56.71	112.56	93.82	16.41
INFLATION							
SA Inflation	%	NA	-	6.7	5.5	5.8	9.4

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