Q3 | October 2019

STAND POINT

FROM OUR STANDPOINT
A note from our professional.

INSIGHTS FOR IMPACT
Some key messages from our investment team.

THE MARKET AT A GLANCE
Our Multi-strategy team take a look at some of the fund impacts.

SPOTLIGHT ON...
Featured funds.

STANLIB

From our STANDPOINT

2019 is proving to be yet another challenging and uncertain year for financial markets.

We're grappling with downward revisions to economic growth forecasts and weak or volatile returns from riskier traditional asset classes in our local market. In theory these provide the much needed growth element to a well-balanced long term portfolio. Low risk local Fixed Income funds as well as rand denominated Offshore unit trusts stand out as the top performers over the short to medium term, while in developed markets fixed income assets merely provide a safe haven as interest rates for longer dated instruments have sunk so low, investors are effectively paying to invest their money. Sylvestor Kobo, our fixed income portfolio manager, provides additional insight into the current market anomaly of an inverted US yield curve and what this could mean for South African investors

Designed to boost business activity and economic growth, this reduction of interest rates by Central Banks in developed markets over 2019 has also led to some interesting and perhaps unintended consequences as the search for yield has seen capital allocators funding the elusive "unicorns". Warren Buhai, Multi-asset portfolio manager, unpacks some interesting dynamics in offshore equity markets having us question the sustainability of companies like Uber and We work.

Whilst the ongoing market uncertainty driven by the likes of the trade wars between the US and China, Brexit and other key events drive choppy markets across the globe we recognise that our own tough economic environment in South Africa has continued to result in challenging conversations for yourselves with your clients.

> "..developed markets over 2019 has also led to some interesting and perhaps unintended consequences."

From our STANDPOINT

Kevin Lings provides a sobering account of government finances ahead of the Medium Term Budget Speech at the end of October, and while the challenges he outlines are great, I hope you join me in feeling hopeful that as a nation the foundations of a turnaround are becoming clearer, and we are able to enter the new year a few steps further forward.

At the time of writing I am encouraged by the camaraderie experienced in our community around the Rugby World Cup. I have no doubt the Springboks will do us proud and I sincerely hope you have managed to escape the daily routine to watch a few games and feel “proudly South African”. It’s a good reminder of the spirit, tenacity and teamwork required in our jobs to stand tall and tackle tough and unpredictable market conditions.

I also want to thank you for your ongoing support of our business and propositions, we appreciate and respect the important role which you as advisers play with your clients in general and specifically within the current environment. We look forward to continuing to build on our partnerships with yourselves over the balance of the year and into 2020.

Enjoy the read.
Regards,
Alan

Alan Ehret
Head of Retail Distribution

From STANLIB's viewpoint

It's said that change is the only inevitability. Derrick Msibi, CEO of STANLIB, has found this to be true in his first two years at the helm.

The Challenge

We started off with a healthy reality check! We found ourselves in a less than ideal position despite great group support and a legacy of over 150 years. We were due for a turnaround. But how to make it happen?

The challenge was clear: the industry landscape was changing. To remain competitive, we'd need to modernise, up our game and change with it. Simple perhaps, but not necessarily easy. The first few months were spent in learning and reflection: finding the gaps that needed filling and developing a deliberate, targeted strategic response.

Delivering change

Effective, consistent leadership is always the first step: to this end, Giles Heeger (Executive Asset Management) and I worked together to deliver a credible investment philosophy and process.

Having an experienced global head of investments onboard helped us spot those gaps in institutional quality, and develop a roadmap towards remediating them. This also meant embedding a performance and risk analytics platform that supported strong oversight and governance and solidifying our tactical asset allocation capabilities. Underpinning all of this with high calibre investment professionals working on delivering the best outcomes for our clients.

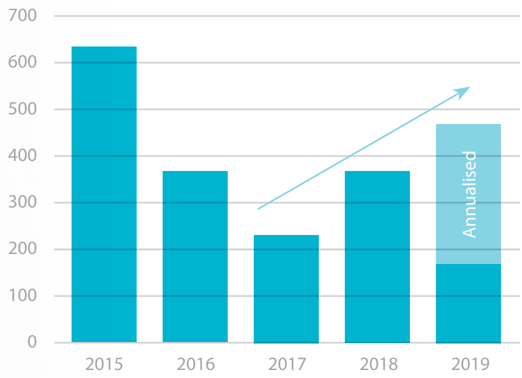
We also focused on evolving our service proposition. Delivering service excellence to our clients starts with having the right people in place with a deliberate focus on the right technology, alongside adoption of industry best practices across the board.

From STANLIB's viewpoint

Derrick Msibi
CEO of STANLIB

The proof is in the pudding

These past two years have seen a concerted push towards delivery on these areas, and results for the first half of 2019, as well as investment performance have shown that we're getting there! Our equity and multi-asset capabilities have delivered strong investment performance over the short term – we've come a long way since that sobering dose of reality in 2017.



Core retail funds - quartile performance

	1H19		1H18		1H17	
Fund name	1 year	3 years	1 year	3 years	1 year	3 years
STANLIB Equity	2	2	2	2	4	3
STANLIB Balanced	1	2	2	3	4	4
STANLIB Income	1	1	2	1	1	2

Where to from here?

As a business we will always strive for progress, but we remain acutely aware of the external pressures facing the industry at large. Fee compression, the emergence of lower margin products, digital disruption and increased regulation all remain top of mind.

We're not about to rest on our laurels – we've seen progress, but still have a long road ahead.

The right people, the right technology, the right philosophy – we continue to evolve these pillars of our business, and we remain inspired by our commitment to delivering the best possible investment outcomes for our clients.

2020 beckons, and we're ready to continue the challenge.

Insights for IMPACT

Unicorns: a warning sign for modern-day markets

Warren Buhai
Senior Portfolio Manager

My fascination with financial markets has recently peaked to a level I last experienced around the late 1990's "dot-com" craze.

The Global Financial Crisis ("GFC") in 2008 resulted in central banks printing money (better known as quantitative easing or "QE") and reducing interest rates down to zero without fear of any long-term consequences provided asset classes kept producing positive returns.

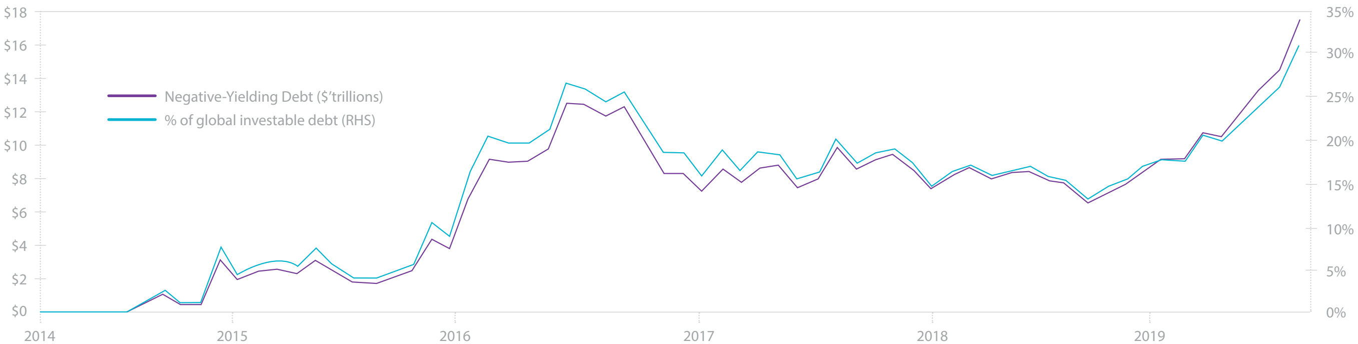
Then around five years ago, certain government bonds began trading with negative yields, effectively meaning a guaranteed loss for an investor if held to maturity! As global recession fears have risen, so this level of negative-yielding debt has increased to a hard-to-fathom $16 trillion, circa 30% of the world's investable bond universe. Some Danish banks now even offer negative interest rate mortgage bonds meaning they pay you interest every month on your home loan!

So where do the unicorns fit in?

The unintended consequence of "free" or rather "ultra-cheap" money has incentivised the wrong behaviour from both corporates and investors. For large listed corporates, it's become beneficial to borrow "cheap" and use debt funding to buy-back shares at ever higher prices. Instead of investing in growing their businesses and/or improving productivity, these companies are opting for a more "guaranteed" and less risky way to generate improved short-term earnings per share growth in an uncertain environment. It is therefore unsurprising that US corporate debt is at its highest levels as a percentage of GDP ever.

Chart 1: The growth of negative yielding debt

Data source: Bloomberg



Top Points

Five years ago, we began to see certain government bonds trading with negative yields.

Negative-yielding debt has increased to a hard-to-fathom $16 trillion. This amounts to circa 30% of the world's investable bond universe!

"Unicorn" was a term coined in 2013 to describe an unlisted company that has a valuation of at least $1 billion.

Unicorns: a warning sign for modern-day markets

From an investor's perspective, there have been a host of consequences. Let's focus on the impact to the unlisted or private asset markets, home to the elusive unicorns. "Unicorn" was a term coined in 2013 to describe an unlisted company that has a valuation of at least $1 billion.

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but thanks to significant amounts of ultra-cheap money to finance their growth, there are now 404 unicorns globally with a total valuation of $1.3 trillion([1]).

Thorough interest rate reductions, central banks in developed markets have intentionally incentivised investors to take risk to generate real wealth, in the hope that this in turn will spur more consumer spending. Many investors take the bait simply because money sitting in the bank or in government bonds would give them a return below the inflation rate.

Over the past five years, we have seen a significant increase in investment money (circa $4.4 trillion) flowing into unlisted assets, such as venture capital and private equity, where illiquidity and opaque corporate governance risks are multiple times higher than the listed environment. The flight of investors cash to these riskier assets has allowed start-up unicorns to create business models that can make seemingly endless losses, provided they grow revenue aggressively. A good example of this phenomenon is Uber, recently listed and previously the most highly valued unicorn. recently listed Uber has been generating very high revenue growth through large spend on advertising, driver incentives and passenger discounts and has attracted investors due to the sheer amount of capital looking for a home in the venture capital space.

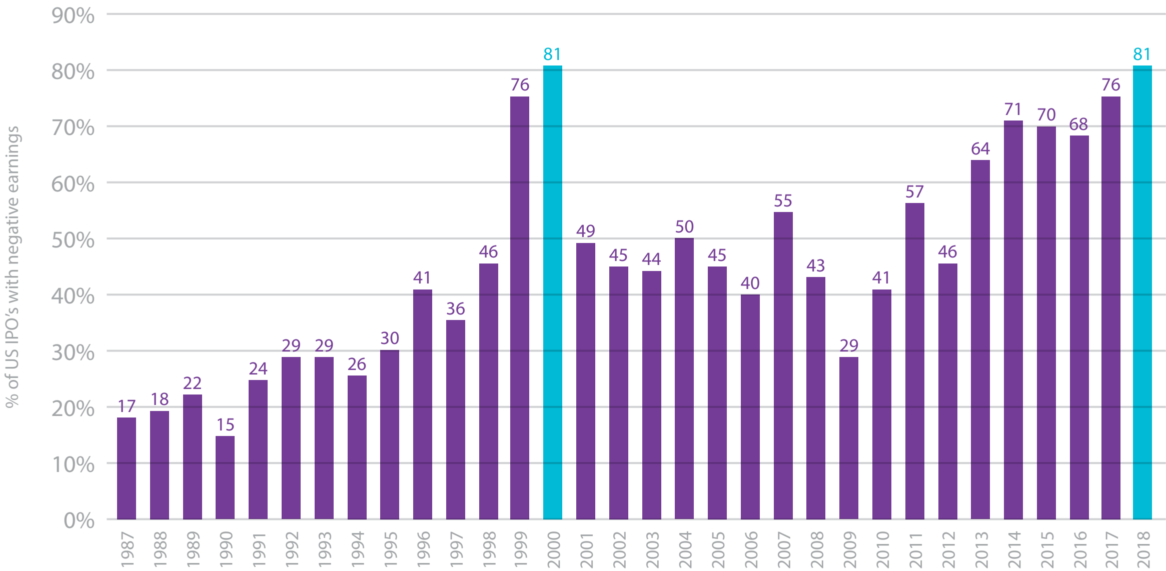
The ultimate question: when do we think this endless support of zombie-like companies will end? Looking at prior cycles can provide a clue as to when we may expect the bubble to burst. An initial indicator is the percentage of new companies listing in the US with negative earnings (refer chart below). The latest level matches the peak last seen at the height of the dot-com bubble in 2000.

This would not be a concern if these unprofitable companies had successful listings. Secondly, the performance of these new listings is another warning sign. For example, Uber's share value is down over 25% since listing in May this year, with a market capitalisation circa $50 billion.

"The flight of investors cash to these riskier assets has allowed start-up unicorns to create business models that can make seemingly endless losses, provided they grow revenue aggressively."

Chart 2: % initial public offerings (IPO's) in the US with negative earnings

Data source: Professor Jay R. Ritter, University of Florida



([1]) data from research house CB Insights.

Unicorns: a warning sign for modern-day markets

Warren Buhai
Senior Portfolio Manager
BCompt(Hons), CA(SA), CFA

Warren has 19 years industry experience, with a strong focus on research and portfolio management of multi-asset funds. Most recently he has transitioned to a senior portfolio management role in the Multi-Asset franchise.

While some unicorn listings have been successful, generally we've see a similar pattern over the past two years, where aggregate US IPO's are underperforming the S&P500 index, as well as their private market counterparts. This is similar to market behaviour ahead of the peaks of the prior two equity bull markets in 2000 and 2007. Similarly, in China, the second biggest unicorn market after the US, IPO performance is even worse and venture capital funding has collapsed 77% year-on-year.

Valuation multiples for unlisted companies are potentially a third indicator, reaching levels not seen since the late 1990's dot-com bubble. Certain of the recent successful unicorn listings currently trade at price to sales multiples of over 30 times.

Scott McNeely, CEO of dot-com darling Sun Microsystems, in response to assumptions made by investors to justify the 10 times price to sales multiple when the share price peaked at $64, famously said: "Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"

His share price was $5 three years after that peak. Today, there are currently 36 S&P500 companies that have price to sales multiples of over 10 times compared to 29 such companies at the peak of the dot-com bubble!

While no two cycles are the same, investors' behaviour often follows a similar path, the longer a cycle continues. There are currently many warning signs like the ones seen in prior periods of irrational exuberance. What makes this current cycle unique is the sheer amount of capital clamouring for ever more expensive, ever more leveraged private market investments, which by their very nature are illiquid and opaque. Ironically, when this cycle of seemingly endless ultra-cheap money inevitably ends, the pain may first be felt within public markets because investors who need to raise capital quickly to repay debt, will inevitably sell the most liquid assets first regardless of relative valuation levels.

However, there's never before been this amount of money sitting complacently in the private market space. How will it all end? It's a difficult call to make, given this cycle's unique features. It's clear though that investors who have flocked to private markets on the assumption that they have uncorrelated and low volatility exposure relative to public asset markets, may be in for a rude awakening when this cycle comes to an end.

"There are currently many warning signs like the ones seen in prior periods of irrational exuberance."

Insights for IMPACT

The possible re-introduction of prescribed assets in South Africa – a view from STANLIB

In 2019 the election manifesto of the African National Congress (ANC) expressly stated that the party will “investigate the introduction of prescribed assets on financial institutions’ funds to unlock resources for investments in social and economic development”.

Understandably, this together with various prior statements from high ranking ANC officials, including the Minister of Trade, Industry and Development, regarding the implementation of prescribed assets, has led to increased concern by a wide range of investors both locally and internationally. In particular, stakeholders are concerned that at some point in the future the South African government will force domestic pension and provident funds, as well as other retirement savings, to divert a significant portion of their assets into funding the public sector’s large and rapidly growing debt burden. This would, most likely, include the forced funding of fragile State Owned Enterprises (SOEs) such as Eskom.

A substantial deterioration of government’s key fiscal parameters in recent years has led to a swift increase in public sector debt, successive credit rating downgrades, and a growing concern that the government could start to experience some difficulties in raising sufficient funds in the domestic bond market. Already, most SOEs are unable to raise sufficient finance directly in the bond market, and have become reliant on government transfers. A further key risk to South Africa’s ongoing fiscal stability is the increase in state debt cost which is now consistently one of the fastest growing components of government expenditure.

Introducing prescribed assets: a threat?

The support for presecribed assets within the ANC is largely premised on the perception that private investment does not currently support South Africa’s fixed investment activity and needs to be redirected. As the monitoring of the ANC Conference resolutions gathers pace, it is expected that work on prescribed should start - possibly towards the end of the year. What the ANC will need to consider is the fact that the fund management industry has a fiduciary obligation to manage client’s money in a prudent and responsible manner. The preamble to Regulation 28 states that “funds must act in the best interests of its members”. It would therefore be extremely difficult to align a policy of prescribed assets with the responsibilities placed on pension fund trustees under current Regulation 28 limiting the the ability of government to implement prescribed assets without first amending Regulation 28.

Looking back - we don’t have a good track record. During the apartheid era, the South African government introduced a policy of prescribed assets, which was implemented through the Pension Funds Act and lasted around three decades from 1956 until 1989. Prescribed asset policy at this time may have been successful in re-directing capital from the private sector into the public sector, but it had a number of severe and un-intended consequences meaning pension fund trustees were persistently unable to act in the best interests of their members.

The possible re-introduction of prescribed assets in South Africa – a view from STANLIB

An extension of the prescribed assets requirement to other forms of retirement savings as well as unit trusts, would potentially makethe asset allocation to public sector debt lot more substantial.

The re-introduction of a policy that simply prescribes a specific percentage of public sector investment in South Africa could have a profound effect on ordinary South Africans, inflicting damage that goes far beyond just the obvious impact on retirement outcomes. In general, it would undermine domestic and international investor confidence, encourage foreign capital outflows, discourage discretionary savings, weaken South Africa's international credit rating, and undermine the country's ability to raise foreign finance.

Can we limit the damage?

Limiting the damage is possible. In our view government would need to consider implementing the following key guidelines:

- A broad and well defined category of prescribed assets
- The prescribed asset ratio to be as small as possible to prevent concentration of risk, lack of diversification and over-exposure to sovereign risk. The ratio should also be a target range as opposed to a preceise percentage with pension funds having longer periods to reach requirements
- Funds from prescribed assets are used for investment in infrastructure development projects or similar and not consumption . This creates less chance of eroding pension fund wealth and is truly developmental in nature.
- There should be strict rules as to how the prescribed asset policy is implemented, especially rules that limit the ability of government to arbitrarily increase the ratio..

Or is this an opportunity?

There are a few far more elegant ways to achieve similar results including public-private partnerships (PPPs). History shows that there is in fact private sector appetite for well-conceived public investment programmes. The country already has some examples of successful programmes, such as the Renewable Energy Independent Power Producer Procurement Programme.

A further short term solution for government would be to sell non-strategic assets such as property, shareholdings in listed entities, non-strategic shareholdings in SOEs and surplus cash balances in public entities.

Conclusion

It is clear from a very broad range of research that when government crowds out the private sector, fixed investment activity tends to languish and economic growth slows, especially if it accompanied by policy uncertainty. The implementation of prescribed assets would have similar consequences, especially since South Africa has a substantial savings shortfall and has become highly reliant on foreign investment.

Very few countries have made use of prescribed assets successfully, while the major multinational organisations (IMF, OECD, BIS) would, in general, argue against the use of prescribed assets.

Imposing prescribed assets would have far reaching consequences that go well beyond the distortion of asset class returns and measures of risk. In particular, it would undermine business and consumer confidence leading to increased capital outflows, while also weakening South Africa's credit rating score. Instead, there are many more attractive alternatives to the imposition of prescribed assets that would achieve a similar outcome but without the unintended negative consequences.

Economics Team
STANLIB

Insights for IMPACT

Yield curve inversion explained

Sylvester Kobo
Portfolio Manager

Global growth has been slowing throughout most of 2019.

Although the US economy has achieved full employment and consumer-related data is still robust, fears of this economy slowing below potential growth have been increasing across financial markets, largely attributed to trade tensions between the US and China. Europe has its own housekeeping issues and continues to face persistently low growth and inflation, which during 2019 nudged the European Central Bank to reintroduce a more open-ended quantitative easing programme and cut deposit rates further into negative territory. As a result, we now have approximately US$15 trillion of bonds globally with a negative yield and some markets (like the US) with an inverted yield curve.

The inversion of the US yield curve has recently sparked debate across the investment industry of a looming recession. History has shown us that recessions post World War II were preceded or signalled by a yield curve inversion.

About the yield curve

The yield curve is a graphical representation of prevailing market interest rates (yields) for bonds of different maturities, usually government bonds. Shorter-dated bonds tend to reflect government's current monetary policy stance, while longer maturity bonds tend to reflect market expectations of future inflation and the resulting path of interest rates.

Yield curve inversion prior to recession?

To illustrate why the yield curve usually inverts before recession, let's consider the example of the yield curve representing monetary policy expectations. If market participants expect growth to slow down in the near future, they start pricing in higher probabilities of This results in long-dated bond yields decreasing by a higher margin than short-dated bonds. i.e. the yield curve flattens.

The quantum of the reduction in future interest is a function of the length and severity of economic slowdown expected by market participants. In the case of expectations of a recession, participants would price in more pronounced interest rate cuts by central bankers as they employ countercyclical monetary policy to stimulate the economy – in other words cut interest rates to encourage investors and businesses to borrow for growth. In this case long maturity bond yields can decrease by such big magnitudes that they fall below short maturity bonds, the phenomenon called yield curve inversion.

Historically, an inverted yield curve successfully signalled a recession 6 to 18 months before it happened, justifying recent debates around whether a recession in the US is looming. US 10-year bonds (the longer dated government bonds) are trading at [xx] as at 30 September.

Typically the yield curve is upward-sloping as investors expect to receive higher interest returns for longer dated investments (those with a longer maturity) , given the increasing uncertainty around the path of inflation and interest rates further into the future.

Yield curve inversion explained

How does this impact local investors?

Whether or not a recession unfolds in the short term, recession fears in global markets present a rise in volatility levels. Volatility leads to risk aversion, causing investors to sell off risk assets such as equities and emerging market currencies and debt. Volatility also leads to a flight to quality as investors reallocate capital to safe haven assets such as developed market government bonds. This explains the rally we recently experienced in these assets, where some of these government bond yields decreased (prices increased) to an extent that even the longest dated 30 year government bond yields were negative. This means the investor in these negative-yielding bonds holding them to maturity, is effectively paying the government to invest money instead of the other way around.

Investors do however tend to balance this need for safety with a search for positive yield elsewhere. Emerging market bonds tend to offer attractive positive yields, and so the extent of any sell-off of these assets as recession fears mount is limited. Instead we may experience capital flows into these markets.

As an emerging market, South Africa offers compelling bond yields, with nominal 30-year bond yields hovering around 10% or a real return of 5.5% (considering current inflation rates). Given the SARB's credibility and the markets view that our central bank will keep longer term inflation around the 4.5% level, these real rates and investment opportunity stands out compared to SA's emerging peers and the low to negative developed market bond yields.

There are local risks pertaining to the strained fiscus and persistently low growth which could lead ratings downgrades (although our view is that this is unlikely) and a potential sell-off in bond yields, however we believe the accommodative global monetary environment and relative valuation of SA bonds providing a cushion against a major sell-off in our market.

Sylvester Kobo
Portfolio Manager
MM (Finace and Investments)(Cum laude)

Sylvester is a Fixed Income Portfolio Manager, with ten year's industry experience. He's currently looking after Bond & Income Funds after being on the Money Market desk for 6 years.

Insights for IMPACT

Deteriorated government finances

Kevin Lings
Chief Economist

The October 2019 MTBPS will be especially challenging for the Minister of Finance, as National Treasury needs to address several critical issues.

In particular, the Minister will have to articulate the extent of the current tax revenue shortfall as well as explain how government intends to improve tax collection to fund this shortfall. The Minister is expected to demonstrate that government is willing to significantly curtail expenditure over the next 3 years given the recent surge in public sector debt as well as the looming increase in the fiscal deficit.

> The Minister is expected to demonstrate that government is willing to significantly curtail expenditure over the next 3 years

It would also be extremely helpful if the Minister of Finance was able to clarify some key policy issues. For example, to what extent will government be looking to implement National Treasury's recently released policy document, how much will the introduction of National Health Insurance (NHI) cost the state and how will the NHI be funded. Other key focus areas include government's willingness to reallocate funds away from consumption expenditure into infrastructural investment, as well as government's ability to further improve the efficiency of spending through the reduction of "irregular, fruitless and wasteful" expenditure. The inefficiency of government spending together with the ongoing lack of policy certainty has clearly undermined private sector investment, leading to lacklustre economic growth and employment.

The South African government's fiscal position has deteriorated substantially in the last decade and remains under significant pressure. These pressures can be divided into three main constraints.

Tax revenue behind budget

First, tax revenue is well behind budget. Data from the National Treasury's monthly statement of revenue, expenditure and borrowing indicates that in the first five months of the financial year, the state of government finances remains weak. South Africa's fiscal deficit year-to-date amounted to R189.4 billion, compared to R131.4 billion during the same period last year. The higher deficit stems mostly from the gross tax revenue side. According to the February 2019 National Budget, government expects to collect R1.42 trillion in gross tax revenues in 2019/20, which is an overly optimistic growth of around 10%. This increase is expected to be driven by a double-digit increase in personal income tax and VAT.

Top Points

The South African government's fiscal position has deteriorated substantially.

The higher deficit stems mostly from the gross tax revenue side.

The value of government guarantees to SOEs amounted to R372.4 billion at the end of the 2018/19 fiscal year.

In the current fiscal year (2019/2020) government expenditure is running well behind budget.

Deteriorated government finances

Since the beginning of the financial year, gross tax revenue has been coming in below the budgeted growth estimate. At this stage of the fiscal year, government should have collected around 41% of the budget estimate in order to keep up with required growth rate. So far, however, government has collected only around 36% of budget.

Based on current trends,

the government's tax revenue shortfall is estimated at around R60 billion

to R65 billion in 2019/2020, with evidence of weakness across most areas of tax collection - although a lot can change, both positively and negatively over the coming months. It is clear that without a sustained increase in economic growth accompanied by an increase in employment, as well as an improvement in revenue collection and tax morality, the South African government is going to continue to struggle to meet its revenue targets, right through to 2022. In each of the past five years, tax revenue has meaningfully under-performed budget. Without higher economic growth, tax collection will continue to dwindle.

Guarantees for State-Owned Enterprises

The second constraint is that the government has had to provide many of the State-Owned Enterprises (SOEs) with significant additional finance. The value of government guarantees to SOEs amounted to R372.4 billion at the end of the 2018/19 fiscal year, which represents an increase of 15.9% compared with the previous year and is up 28.2% compared with 2016/2017.

These guarantees remain a major concern for National Treasury as well as the international credit rating agencies. Furthermore, government is under pressure to provide further financial support to many of the SOE, which limits the government's ability to implement meaningful fiscal consolidation.

For example, in the February 2019 National Budget the Minister of Finance indicated that government would transfer an additional R23 billion to Eskom each year for the next ten years to support their balance sheet. Shortly after the National Budget was released, the authorities acknowledged that Eskom would require much more than R23 billion in 2019/2020. Consequently, government decided to allocate an additional R26 billion to Eskom in 2019 and a further R33 billion in 2020. They also indicated that plans to restructure/unbundle Eskom would be announced before the end of 2019. We are still awaiting these details. Clearly there is a real risk that the SOEs will require additional funding in the years ahead.

The good news is that government is looking to implement a series of structural reforms at the various SOEs. According to the National Treasury, these reforms will adjust business models in response to changed economic conditions, restore good governance, bolster operational efficiency, and strengthen financial controls and planning. Hopefully, these reforms can be implemented effectively and without placing further strain on the already fragile government finances. It is critical that the National Treasury is able to stop the damage that SOEs have inflicted on the government's fiscal position and systematically improve their balance sheet.

Inefficient government spending

The third constraint is the need for fiscal discipline, most especially an improvement in the efficiency of government spending. A few years ago, National Treasury introduced an Expenditure Ceiling, attempting effort to control government spending and restore fiscal discipline over the medium term. In general, the results of this initiative have been encouraging. For example, in the 2017 budget review, government set its expenditure ceiling at R1.323 trillion for 2018/2019. In the 2017 MTBPS this ceiling was lowered to R1.316 trillion, then dropped to R1.315 trillion in the 2018 budget review, R1.314 trillion in the 2018 MTBPS and finally in the 2019 budget review expenditure for 2018/2019 was recorded at R1.310 trillion. Similarly, in the current fiscal year (2019/2020) government expenditure is running well behind budget.

Unfortunately, while there has been an attempt to restore fiscal discipline, the split between consumption and capital expenditure remains problematic. Over the past ten years, government has tended to increase consumption expenditure at the expense of capital projects.

This clearly undermines economic growth over the longer term,

and is leading to the deterioration of many vital areas of service

Deteriorated government finances

delivery, including water, healthcare and education. Furthermore, the efficiency of spending has deteriorated significantly, with the Auditor General reporting a significant increase in wasteful and unauthorised expenditure in recent years. This, coupled with high levels of corruption, undermines the effectiveness of government services, negatively impacting confidence. Lastly, government has raised expectations regarding the implementation of severalambitious projects, for example National Health Insurance. Achieving these ambitious goals is going to become increasingly problematic unless there is a substantial increase in tax revenue, and an improvement in the efficiency of government expenditure.

As a result of these constraints government debt has risen from a low of 26% of GDP in 2009 (at the time Moody's had assigned South Africa and 'A' credit rating), to an estimated 58.5% of GDP in 2019/2020 and is expected to rise to well over 60% of GDP within the next three years. In value terms, this means that since 2009 government debt has increased by more than R2.5 trillion, equating to an average annual increase of a staggering 16%. This is especially damming when you consider what has been achieved with this increased debt – sustained low economic growth, record high unemployment, a record low savings rate, systematic downward revisions to the credit rating, regular electricity outages, a fragile water supply, the deterioration in public sector health, and poor education outcomes.

The situation is made worse by the fact that this debt excludes all of the SOE debt, which equates to over 10% of GDP. (Eskom's total debt represents between 8.5% and 9% of South Africa's GDP).

Fortunately, only around 12% of South Africa's government debt is in foreign currency, which is especially low by international standards. This substantially reduces the risk of default, especially if the current were to weaken significantly. Nevertheless, foreign investors own 37% of the government's debt through the South African bond market, which highlights that government's financial position is still vulnerable to changes in foreign investor sentiment towards the country. In the past 18 months foreign holdings of SA government bonds have systematically decreased from a high of 42.8% of total government debt as recently as March 2018, highlighting the loss in foreign investor confidence in South Africa.

While it is unrealistic to expect the upcoming MTBPS to deal with all of these challenges, it is critical that government starts to urgently relieve these fiscal constraints, before the government's funding requirement and debt level becomes unbearable within South Africa's fragile economic system.

Kevin Lings
Chief Economist
BCompt(Hons), CA(SA), CFA

Kevin joined then-Liberty Asset Management as an economic analyst in 2001. As STANLIB's chief economist, he is responsible for domestic and global economic research and forecasts. Kevin also provides input into STANLIB's asset allocation processes and provides relevant economic research for our Fixed Income, Property and Equity teams.

ViewPOINT

Podcasts

TALKING TRADE WARS:
Kevin Lings & Marius Oberholzer talk global trade wars and the effect on currency exposure.

Listen now

CREDIT ALTERNATIVES:
Kevin Lings & Johan Marnewick talk alternative credit as an asset class in the current landscape.

Listen now

PROPERTY GROWTH:
Kevin Lings & Keillen Ndlovu on the growth outlook in the SA property sector.

Listen now

The market at a GLANCE

Monthly performance and fund insights from of our asset managers

STANLIB Fund Performance

		1 Month		Q3		YTD		1 Year		3 Years		5 Years		10 Years	
	FUND	Return %	Quartile Ranking	Return %	Quartile Ranking	Return %	Quartile Ranking	Return %	Quartile Ranking	Return %	Quartile Ranking	Return %	Quartile Ranking	Return %	Quartile Ranking
Equity & Multi-Asset	STANLIB Equity	0.20	3	-1.43	1	8.30	1	1.18	1	3.27	2	3.62	2	11.34	1
	STANLIB Balanced	0.11	4	0.17	2	9.38	1	4.47	1	4.32	2	4.47	3	10.02	2
	STANLIB Balanced Cautious	0.13	4	1.25	3	9.20	1	6.91	1	5.09	3	5.97	3	8.70	1
Absolute Return	STANLIB Absolute Plus	0.50	3	1.61	1	6.71	3	5.51	1	5.73	1	6.42	1	--	--
Listed Property	STANLIB Property Income	2.30	1	-2.47	1	0.96	1	-3.75	3	-5.22	4	2.48	3	10.56	2
	STANLIB Global Property (ZAR)	1.17	4	12.84	2	25.46	3	21.19	2	6.75	3	11.44	2	15.50	1
Fixed Income	STANLIB Extra Income	0.60	3	1.97	3	5.86	4	7.84	4	8.07	4	7.71	4	6.99	3
	STANLIB Income	0.59	4	2.11	1	6.50	1	8.87	1	8.75	1	8.32	1	7.81	1
	STANLIB Bond	0.38	3	0.92	2	8.07	2	10.92	2	9.03	1	8.47	1	9.18	1
	STANLIB Flexible Income	0.46	4	1.83	3	7.57	1	9.02	2	6.92	4	7.10	4	7.74	2
Offshore (CTN) (ZAR)	STANLIB Global Equity	-0.58	4	7.03	2	28.61	1	10.72	1	13.64	1	13.17	1	15.07	2
	STANLIB Global Balanced	-0.54	4	7.86	2	23.33	1	12.38	1	10.80	1	11.17	1	12.71	1
	STANLIB Global Balanced Cautious	-0.80	4	7.86	2	17.26	1	12.92	1	7.31	1	8.42	2	9.45	3

The market at a GLANCE

Market Indicator Performance

Table of market indicator performance in % for the period to 30 Sept 2019

	Q3 2019	YTD	1 Year	3 Years (p.a.)	5 Years (p.a.)	10 Years (p.a.)
SA markets						
All share (J203T)	-4.6	7.1	1.9	5.1	5.3	11.5
Top 40 (J200T)	-5.2	7.5	1.9	5.6	5.1	11.3
SWIX (J403T)	-4.3	4.3	0.2	2.6	4.6	11.5
Financial 15	-7.7	-1.6	-2.0	6.6	6.3	12.9
Industrial 25	-2.3	11.1	3.5	2.7	5.8	16.0
Resource 10	-7.3	10.5	4.9	14.5	0.0	3.2
Property (J253T)	-4.4	1.3	-2.7	-3.5	3.2	11.2
Inflation (CPI)	1.0	3.2	4.3	4.7	4.9	5.1
All bond index (ALBI)	0.7	8.4	11.4	8.9	8.3	8.8
Cash (STeFI)	1.8	5.5	7.3	7.4	7.1	6.5
Offshore markets (Base currency)						
MSCI AC World	0.1	16.7	1.9	10.3	7.2	8.9
Dow Jones US	1.8	17.5	4.2	16.4	12.3	--
S&P 500 US	1.7	20.6	4.3	13.4	10.8	13.2
CAC 40	0.1	16.4	-0.6	5.9	6.4	8.8
FTSE 100 UK	1.0	14.3	3.2	6.8	6.5	7.7
Nikkei 225	3.1	10.8	-7.8	12.0	8.2	10.0
3 month LIBOR (ZAR)	8.0	7.0	9.3	4.7	6.9	7.5
3 month LIBOR (USD)	0.4	1.5	2.0	1.4	0.8	0.3
Commodities						
Platinum ($)	11.7	17.3	14.5	-3.2	-6.5	-3.3
Brent Crude ($)	-5.6	11.6	-26.7	6.7	-8.5	-0.9
Gold ($)	5.8	16.3	25.0	4.3	4.3	4.0
Currencies						
GBPZAR	-4.0	-1.5	-0.9	-1.9	-0.4	-4.5
USDZAR	-7.4	-5.5	-6.9	-3.3	-6.1	-7.3
EURZAR	-3.0	-0.2	-0.5	-2.3	-3.0	-4.1
EURUSD	-4.2	-4.9	-6.1	-1.0	-2.9	-2.9
USDJPY	-0.2	1.4	4.9	-2.2	0.3	-1.9

Source: Morningstar, IRESS

Commentary: interesting developments for the quarter (can be bullets)

- SA markets
- US markets
- UK / EUR markets
- Asia markets

10 year bond yields	Yield % (as at 30 Sept)	Qtr. change in bps	1 year change in bps
R186	8.3	20	-70
German	-0.6	-30	-110
US	1.7	-30	-140

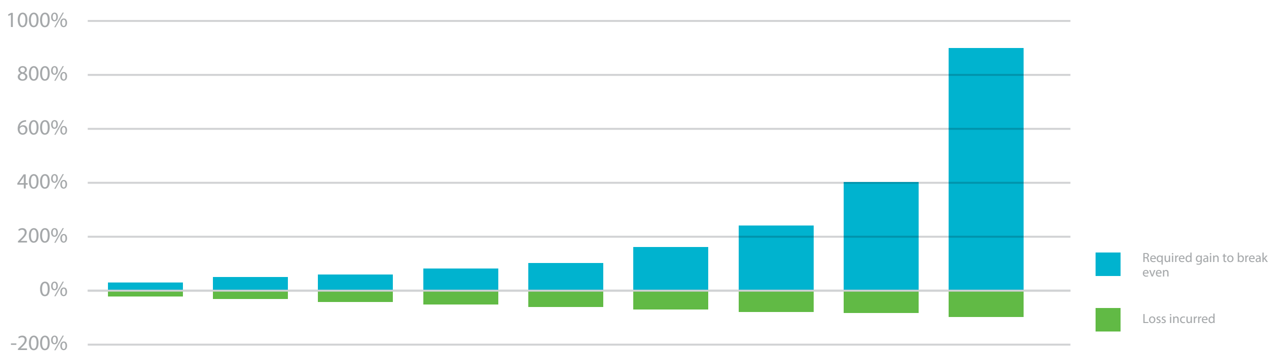
Source: IRESS

Spotlight On: STANLIB Absolute Plus Fund

The STANLIB Absolute Plus fund aims to deliver clients inflation beating returns over time periods of at least three years whilst managing the risk of capital loss and avoiding large drawdowns, enabling the investment team to harness the power of compounding. This fund is suitable for any market environment but is designed to perform better in volatile markets.

Power of compounding

Siegel's Paradox: loss incurred vs required return to break even What to expect in the medium term – optimal portfolio outcome. The greatest risk to any investor is capital loss.



“The perception of how to prepare for retirement changes on a global level”

Marius Oberholzer
Head of Absolute Return

Fund features:

Authentic absolute
The fund aims to provide high quality risk-adjusted returns over any 12-month period, while consistently growing investors' capital over time.

Embrace flexibility
We follow an unconstrained asset llocation framework while being style agnostic and opportunistic. We embrace active, passive and hybrid investment styles.

Risk management philosophy
The fund has a lower maximum drawdown and standard deviation over five years than its major competitors.

Keep things simple and nimble
A whole universe of asset classes and instruments are available to this strategy. We prefer to use indices with a high degree of liquidity to remain nimble. Our flexibility allows us to seek out better risk-adjusted returns.

Uncorrelated outcome
The fund provides a suitably uncorrelated outcome when blended into a portfolio, due to our unique management style.

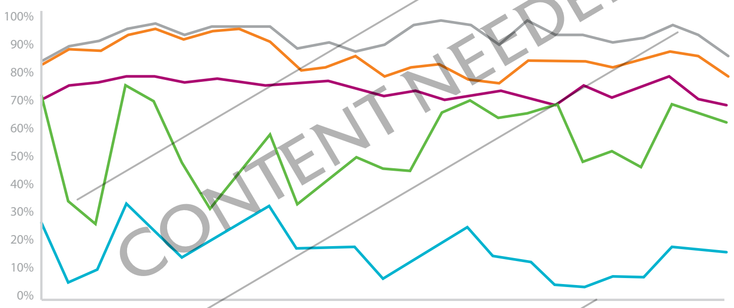
Risk management focus
The fund benefits from market volatility and is opportunistic in how this is implemented. This approach favours investing the way markets are and not the way we would like them to be.

Volatility bias
The fund is suitable for any market environment but is designed to perform better in more volatile markets.

Spotlight On:

STANLIB Absolute Plus Fund

Absolute Plus asset allocation over time



Risk/return scatter plot - 3 years

The fund has demonstrated the ability to achieve high returns with a lower risk profile than multi-asset, medium- and high equity sectors.

Quartile ranking

The STANLIB Absolute Plus Fund stacks up well versus multi-asset low-, medium- and high equity sectors.

	1 YEAR		3 YEARS		5 YEARS	
	Return %	Quartile Ranking	Return %	Quartile Ranking	Return %	Quartile Ranking
STANLIB Absolute Plus	5.51	1	5.51	1	5.51	1

Marius Oberholzer

Head of Absolute Return

BSc(Hons)(Advanced Mathematics of Finance)

Industry experience – 22 years

Possessing a very strong academic record and a passion for financial markets, Marius joined the Beta Quants team in 2012. As a quantitative analyst, he specialises in asset allocation, portfolio construction, investment risk management and multi-factor risk modelling.

He is currently head of absolute return at STANLIB Index Investments responsible for the management of R 22 billion across quantitative enhanced index funds, smart beta funds, completion strategies and index tracking fund across a number of asset classes.

FUND AIMS:

Avoid losing capital over any one-year period

Deliver CPI + 4% net of fees over time periods of more than three years

FUND DETAILS:

Inception: Dec 2005
Size: R 7.56 billion
Class: B1
Risk: Moderate

Beside the POINT

Time for your daily dose of fascinating trivia. With a Rugby World Cup taking place in Japan, we thought we'd take a moment behind the scenes at how the country has prepared for the tournament.

Introducing Japan to the (rugby) world

RUGBY WORLD CUP™ JAPAN日本2019

Although the Brave Blossoms have endured mixed results over the years, Japan's place in rugby royalty rose thanks that astonishing victory over the Boks in the 2015 Rugby World Cup that was widely considered one of the biggest shockers in the history of the game.

Fast forward four years and it's estimated that over 600 000 foreign fans descended onto the island for the ninth staging of Rugby World Cup. Japan was chosen as 2019 host in July 2009, when World Rugby looked to the future of the game by exploring a new market.

In the decade since, interest in rugby has increased from close to 100 000 people enjoying the game, to 21% of the Japanese population supporting the game, much less than the 70% in South Africa and 63% in New Zealand, but nevertheless translating to a significant fan base of 11 million Japanese people.

So far, players and visitors alike have spoken highly about the country playing host - and for good reason: it's set to change the way Rugby world Cups are held in the future.

Read on to find out how:

Arigato

The hospitality industry relaxed their stance on the taboo against tattoos being shown (which normally are banned for their association with the Yakuza gang), and the country welcomed each team in their own unique way.

No sides taken

There are 13 000 volunteers that have helped run the tournament across the 12 hosting cities. They are known as Team No Sided and can be spotted in their brightly coloured uniforms featuring blue and yellow stripes said to symbolise unity, smiles and memories. The oldest volunteer is 88-year old Toshio Yasuda.

It's always beer time

What's a rugby match without a cold one? To keep up with the expected increased demand during this year's RWC, Heineken, the tournament's official beer sponsor, upped its Japanese brewery production by 80%.

Warding off evil

Japan is known for its seamless cultural blend of old and new – and this year's mascots do just that. The mythical creatures are known as Shishi, and bring happiness wherever they go, warding off evil. Yes, it's those two mascots that were swinging their hair in circles at the opening ceremony – which is a sign that they are happy and are about to break out into dance!

Don't smile for the camera

Instead of being issued official passes or badges to gain entry into events, Japan is trialling new technology for its Tokyo stadiums that allow journalists to gain entry via facial recognition with the hope to continue using it for next year's Olympics.

Corporate teams become professional

Unlike South Africa, where many of our players have been born from school stardom, in Japan, it's the Top League that supplies most of its international players, comprised of corporate teams specifically from the iron, steel and auto-making industries across the country. Rugby's core values of commitment, loyalty and inclusivity fit hand-in-glove with Japanese corporate history, making it the ideal after-work exercise.

No matter which team you support, there's no doubt that Japan is putting on a show to be proud of and has successfully earned their place on the World Rugby stage.