MERGENCE
INVESTMENT MANAGERS

Macro and Multi-Asset

October 2021, Mergence Investment Managers

This note summarises our macro asset allocation views and positioning. We include a research piece which details the current outputs of our tactical asset allocation process.

Current Views

Underweight Risk Assets	Overweight SA Equity vs Global Equity	Overweight SA Fixed Income	Underweight Global Fixed Income	Neutral USDZAR

Asset Allocation Views

Asset Class	Underweight	Neutral	Overweight
SA Equity			Overweight
SA Property		Neutral	
SA Fixed Bonds			Overweight
SA Inflation Linked Bonds		Neutral	
Emerging Market Equity	Underweight		
Developed Market Equity	Underweight		
US Large Cap	Underweight		
US Mid Cap Value		Neutral	
UK Equity			Overweight
European Equity		Neutral	
Japanese Equity			Overweight
Global Bonds	Underweight		
USD Cash	Underweight		

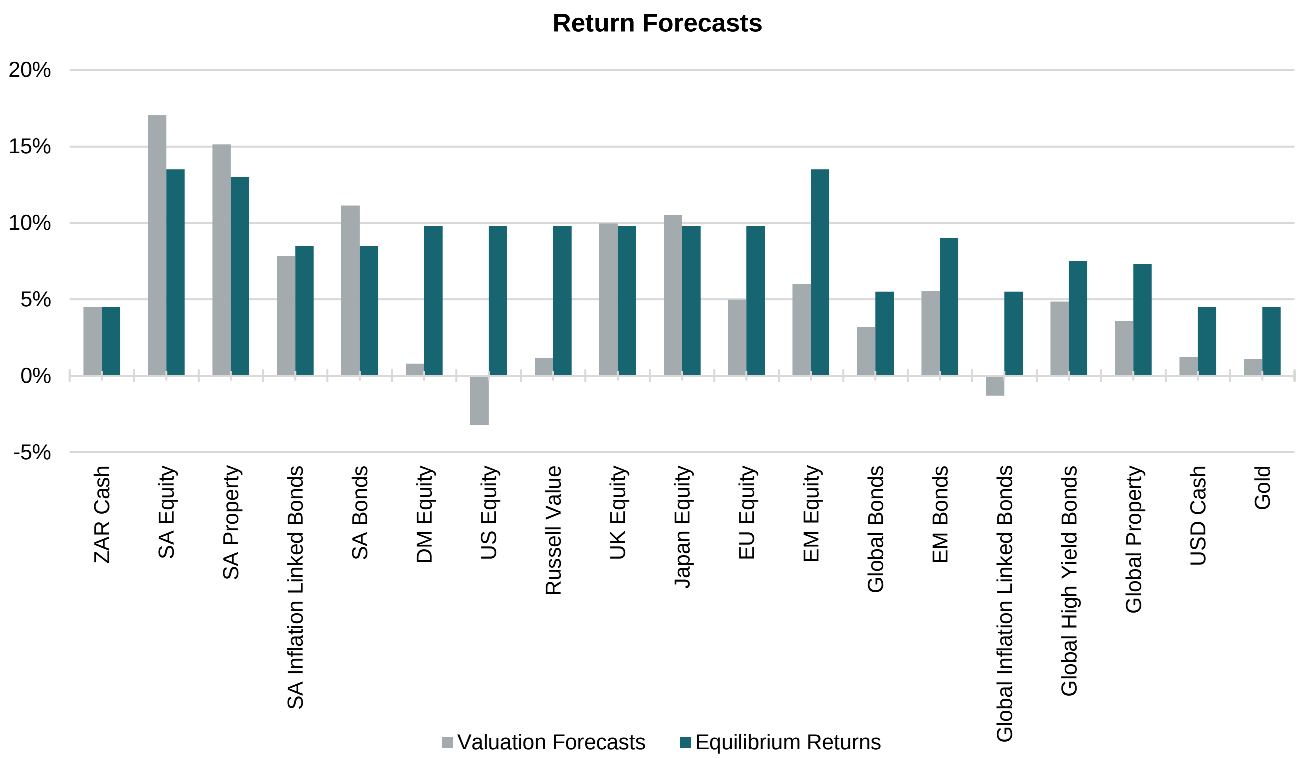
Source: Mergence Calculation. All forecasts in ZAR

An update on our Tactical Asset Allocation views

Our tactical asset allocation process focusses primarily on the relative value of global asset classes, and secondly tries to understand where we are in the global macro cycle and what that may mean for asset class returns.

Valuation

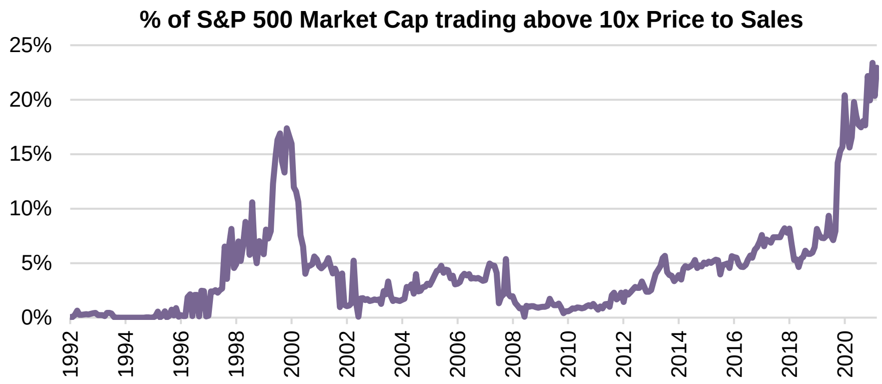
The chart below summarises our valuation views. For each asset class in our universe, we estimate a three year forward return based on current valuations. In each case we compare this forward return forecast to the long-run equilibrium return we expect from that asset class. This is effectively our hurdle rate for owning that asset given its risk. All forecasts are in ZAR. Offshore assets are forecast in their base currency and converted at our three-year currency forecast.



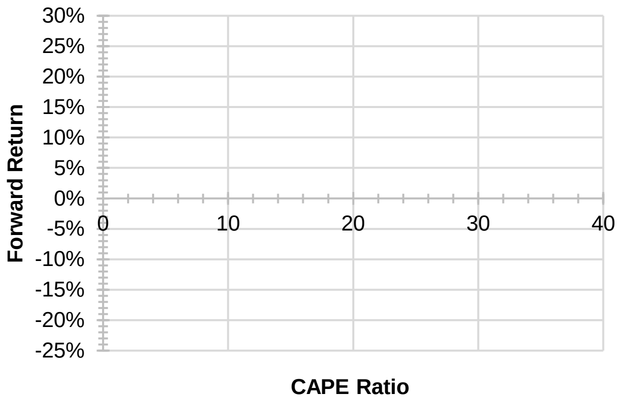
US equities are expensive and the largest component of global developed market indices; as a result, we find global equity expensive. One of the most striking illustrations of this is the percentage of the market cap of the S&P500 index that is trading at above 10 times price to sales.

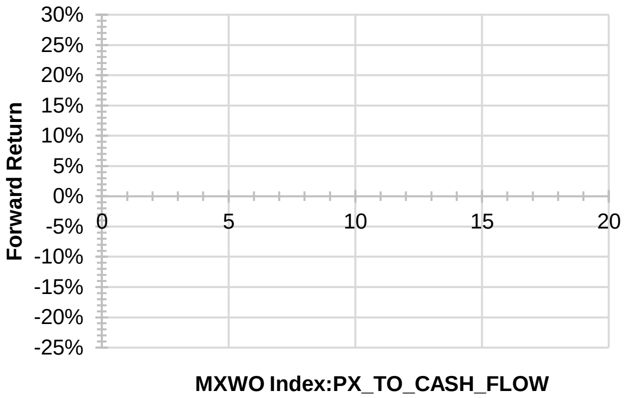
In our view this is a clear measure of over-optimistic sentiment in the equity market and this measure has now risen to a higher level than that at the peak of the dotcom bubble.

Historically, buying equity above a 10 times price to sales ratio has not led to good long-term results and we would be surprised if this time is different.



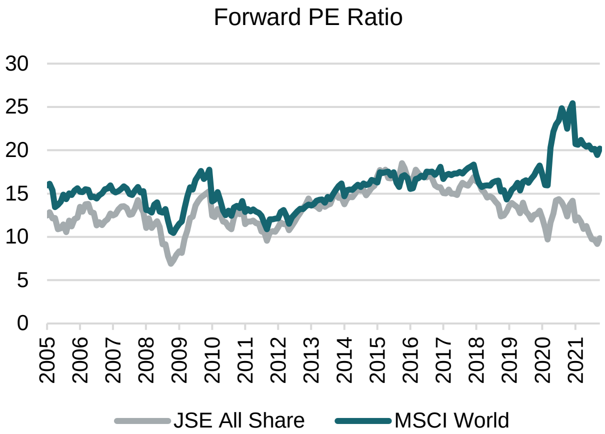
Each of the charts below show the history of a valuation measure for the MSCI world index and the subsequent three returns that holders of that index earned had they bought at that valuation measure. The green point illustrates the current valuation and the forward return that could be expected if the historic relationship between valuation and return holds. On average, buying global equities at current valuations has led to flat total returns over the next three years and generally buying any more expensive than current valuations has led to negative forward returns.

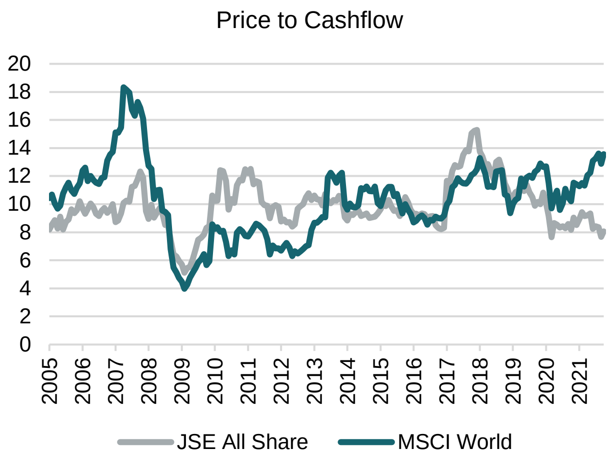




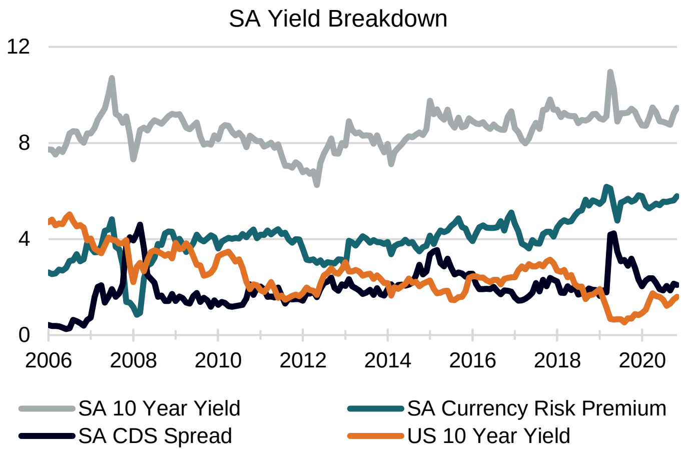
SA equity remains relatively attractive

On an absolute basis versus history, we would argue that SA equities are positioned to earn forward returns above our cost of equity assumption. There are a few risks to this view, most notably spot commodity prices that are elevated above their cost of production, but on aggregate SA equity looks attractively priced. On a relative valuation basis this is even more pronounced. Below we compare the forward PE ratio and price to cash flow of the JSE All Share vs the MSCI World index, showing just how much of a valuation gap has opened up between SA listed and global equities.



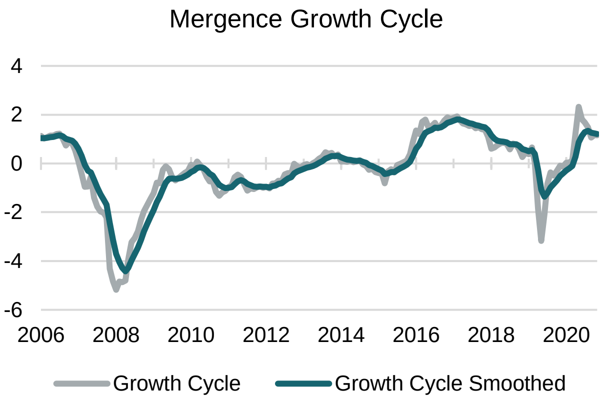


SA bonds

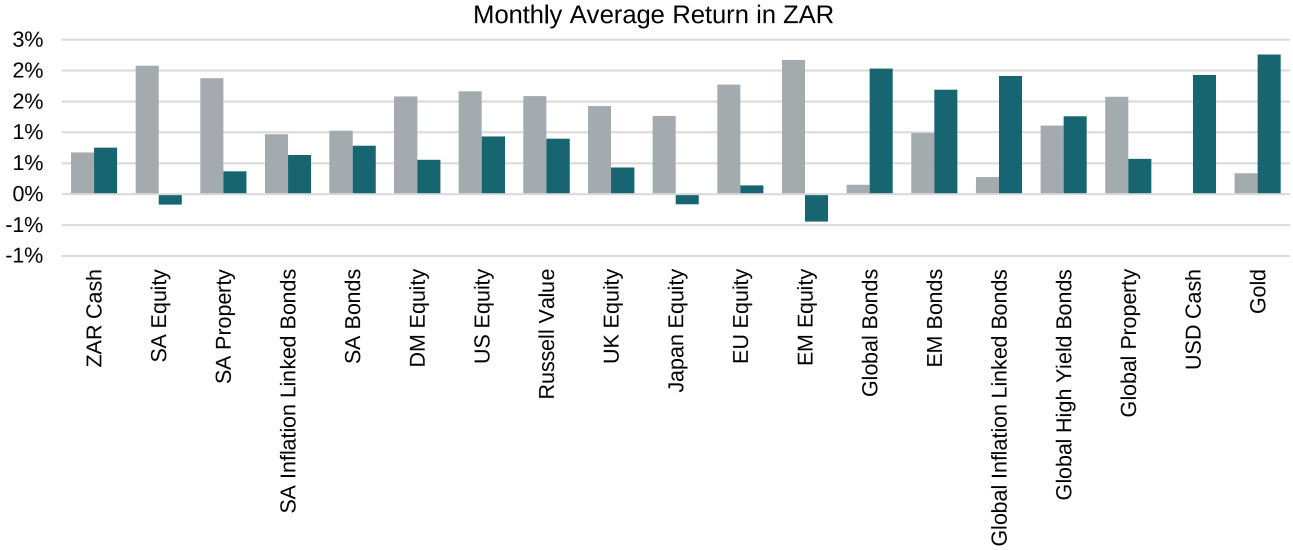


The decomposition of bond yields below compares the yield on the ALBI to the US ten year plus the price of a five-year South African CDS. This splits the SA bond yield into the effect from global yields, the South Africa sovereign credit risk and the risk of currency depreciation over the life of the bond. After spiking higher in March 2020 South African Sovereign credit risk has declined back to its average level of the past decade. Despite this, bond yields have remained elevated, resulting in a higher currency risk premium implied by SA government bond yields. We would argue that this elevated currency risk premium presents an opportunity for investors. Our long-term hurdle rate for South African bonds is a 3% real return. With yields above 9%, as long as long-run inflation stays within the SARB's target range of 3% to 6%, then current yields are offering value.

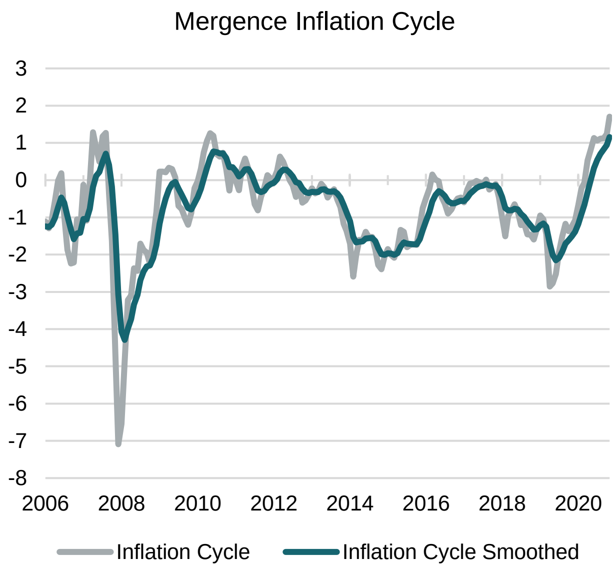
Global cycle



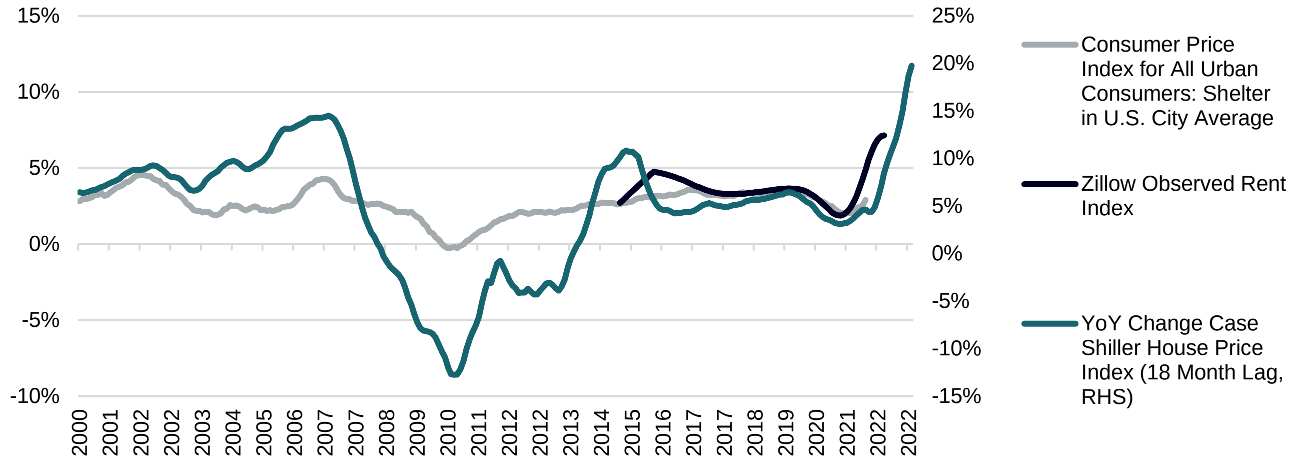
Historically the direction of global growth has been the strongest driver of relative asset class performance over the medium term that we have found. Since July 2020 global growth has been increasing strongly but with base effects rolling out and initial pandemic related stimulus fading this growth rate has now peaked and rolled over. We measure this effect using the Mergence Global Growth Cycle, a composite indicator of coincident growth measures. We have used this indicator to divide history into periods of rising and falling, with the chart below showing how these regimes drive the performance of asset classes.



While growth slows, inflation continues to climb. Our Mergence Inflation Cycle indicator is a combination of official inflation rates as well as market expectations in the form of break-even rates. This measure remains in a clear uptrend and is at its highest level since 2005.



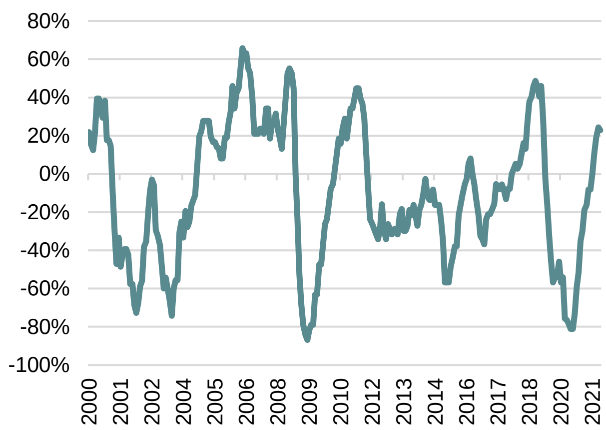
We believe it is likely that inflation will stay above the Fed's 2% target into 2022. Multiple drivers of the current inflation surge are reopening, driven as global supply chain issues lead to share price rises from used vehicles to energy prices. These prices may subside into next year as supply chains normalise. On the other hand, housing's impact on CPI is bound to be felt for a longer period. Given the construction and measurement of the Shelter component of CPI, the current high housing prices and rental levels should filter into the official CPI numbers over the next 18 months, leading this component higher. This is especially relevant as shelter accounts for almost 60% of Core CPI and over 40% of headline CPI. The recent sharp rise in US house prices as well as data on current market rentals suggests that this large component of CPI is heading higher.



Policy tightening

While much focus is placed on the Federal Reserve's future policy trajectory, the rest of the globe is well into a policy tightening cycle. Our research shows that risk assets perform worse during tightening regimes, although the direction of global growth is more important, especially for cyclical assets. The result is that typically tightening policy cycles have led to risk assets underperforming globally and EM currencies weakening, but SA equities have on average performed better in Rands during tightening phases. Our interpretation of this data is that the early stages of a tightening cycle, while inflation is still rising, and growth remains strong, typically remains supportive of 'late cycle' exposures including cyclical equity.

Percentage of central banks raising rates



In summary, we prefer SA assets to global assets from a valuation perspective. The global macro cycle is deteriorating for risk assets. While growth remains strong, the rate of change of growth is declining. Inflation continues to increase and for the first time since the global financial crisis is a real policy consideration. The Fed has clearly stated their intention to taper QE and globally central banks have begun tightening policy.

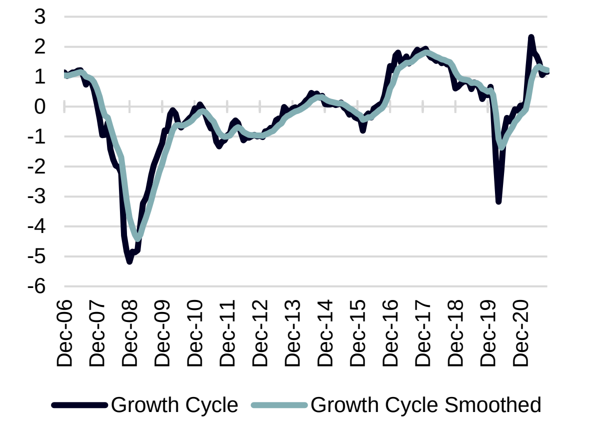
We have shifted our exposure to underweight risk on an overall portfolio position but with a preference for SA assets over global risk assets.

Key Indicator Forecasts

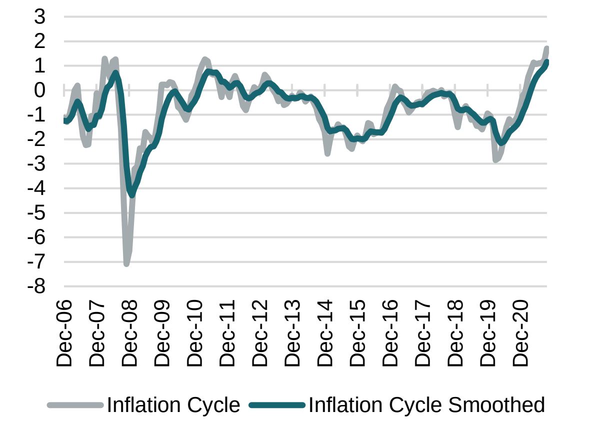
Indicator	Current	1 Year	3 Year	5 Year
USDZAR	15.4	14.6	15.5	16.4
SA 10 Year Yield	9.6%	9.0%	9.0%	9.0%
SA Inflation	5.0%	4.2%	4.5%	5.0%
US Inflation	5.4%	2.5%	2.2%	2.0%
US 10 Year Yield	1.55%	2.0%	2.4%	2.75%
Fed Funds Rate	0.13%	0.38%	1.25%	2.5%
SA Repo Rate	3.5%	4.5%	5.5%	6.0%

Key charts

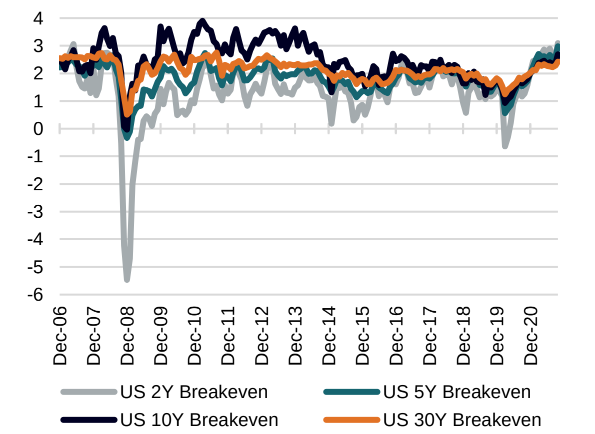
Mergence Growth Cycle



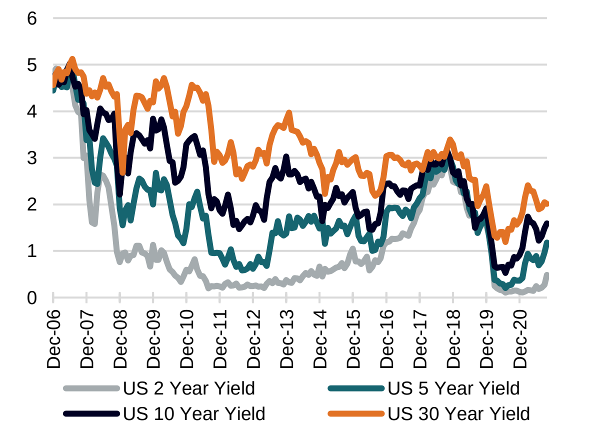
Mergence Inflation Cycle



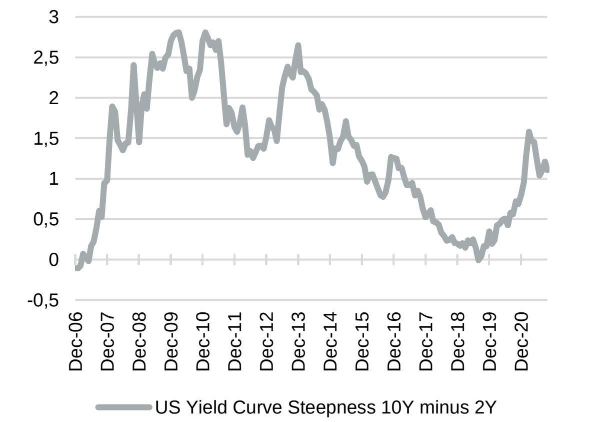
US breakeven rates



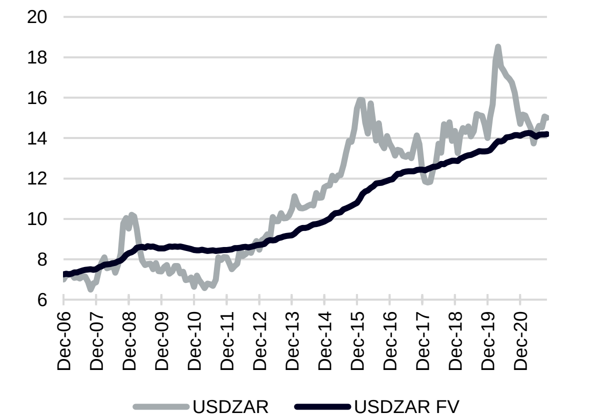
US bond yields



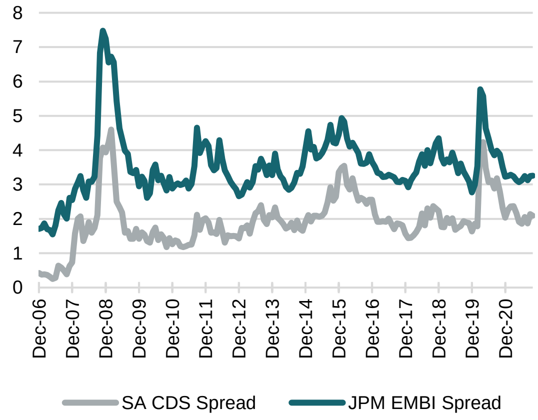
US yield curve

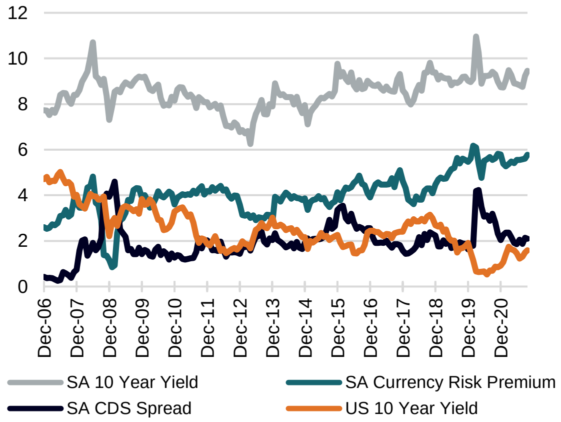


USDZAR

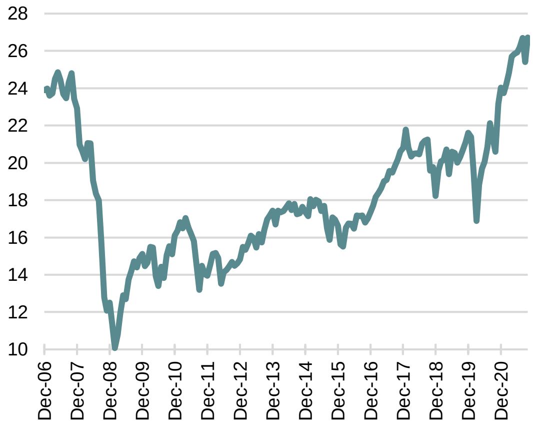


SA CDS





MSCI World CAPE



JSE All Share CAPE

SAPY price to book

SAPY yield gap

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