

Cabinet Changes and the increase in offshore allowance within Regulation 28

The past week has seen some significant structural changes within our investment market, with two further significant events to factor into portfolio positioning. We discuss the implications of these below.

Cabinet changes

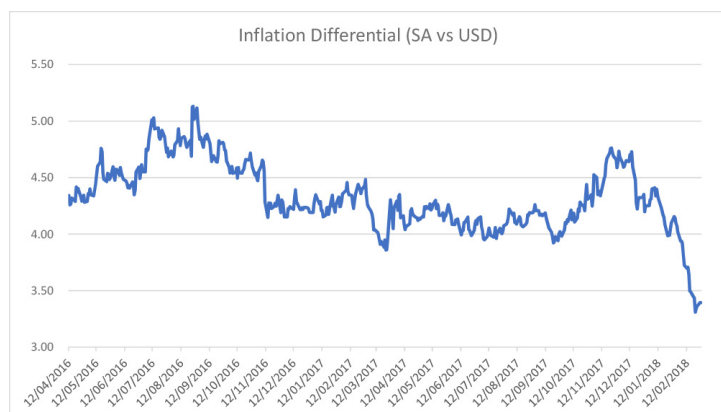
Prior to the ANC elective conference in December 2017 the decision-making power was evenly balanced between the pro-Zuma camp and the pro-Ramaphosa camp. The results of this conference have been widely covered, with the narrowest of margins deciding the outcome in the end. What this did highlight was the increasing divergence of the various voting constituents which underpin ANC voting support, and pointed towards a less decisive future going forward, albeit with the 'pro-business' leadership of Ramaphosa. Markets duly responded, with strengthening domestic assets and a general pickup in consumer and business confidence. This has driven a self-fulfilling cycle of optimism, which despite being genuine and a welcome respite from the past administration, is glossing over the structural weaknesses which remain.

The divided ANC poses the largest near-term risk to our local economy and therefore investor returns. With the key decision-making forums evenly split between the competing factions (the NEC and the Top 6), progress is likely to be slower in making the reforms necessary with the knock-on consequences to the local economy. This is the position we now find ourselves in, where the potential for the 'new dawn' has not been fully realised, and the real balance of power has been shown. It remains, for the time being, a transition period.

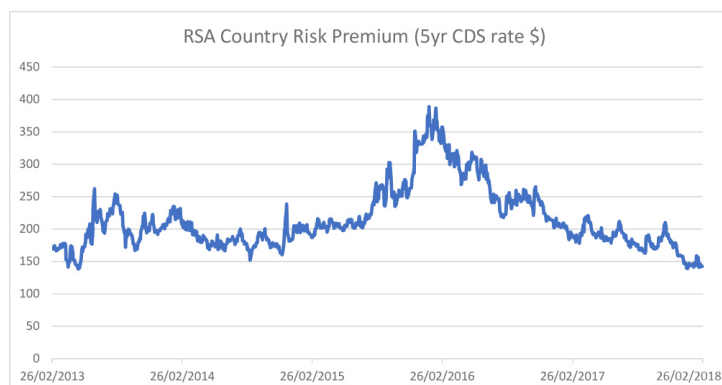
Importantly, several of the priority cabinet posts have been filled with business-friendly ministers: Pravin Gordhan in charge of Public Enterprises and Nhlanhla Nene returning as Minister of Finance. This will go a long way to staving off the credit rating downgrade, and course-correcting the poor financial state of the state-owned enterprises. Gwede Mantashe has been appointed as the Minister in charge of Mineral Resources, an important economic driver and one which has been under a huge amount of scrutiny given the redistribution policies being put forward, seemingly without industry consultation. This is likely to bode well for this sector which also acts as a significant employer.

Overall, our outlook has not changed with respect to the prospects for local assets. The medium to longer term horizon is positive and the country is coming off a relatively low base across most asset classes. In the shorter term, during the transition period, there will be elevated risk levels as the new administration grows into its role, hopefully in a measured way as seems to be the case.

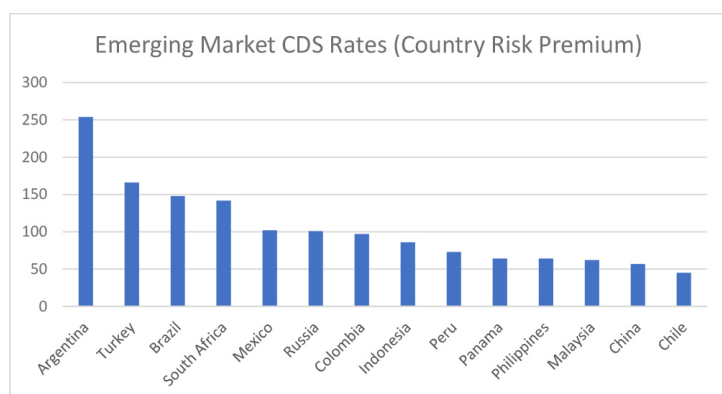
The main question we need to gauge is what is priced into markets? A brief run through some of the indicators below:



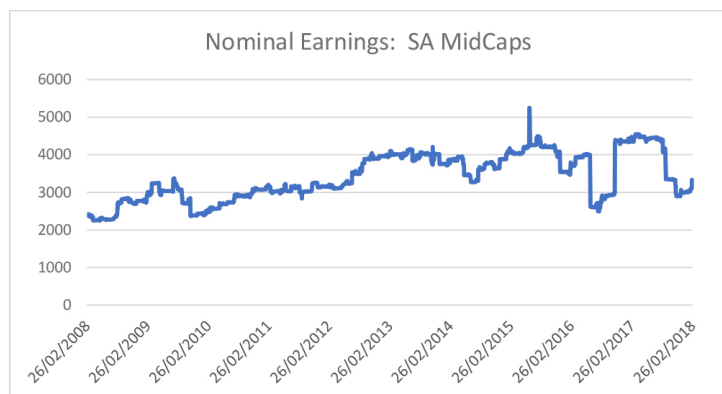
With rising US and global inflation, and local inflation at relatively low levels and within the inflation band, the expected premium for holding local assets is lower, reflected through a lower depreciation expectation. For the status quo to remain, the currency needs to remain relatively strong.



The Credit Default Swap (CDS) can be used as a proxy for our country specific risk premium. 2015 saw its highpoint (Nenagate) at almost 4%, being the premium over and above a 'risk free' asset such as US treasuries. It has subsequently moved stronger and is heading back towards its strongest levels, although it remains in the upper reaches of its EM peers.



Compared with other Emerging Markets, we still trade at a higher risk premium when compared using the CDS rate as a proxy. Russia for example has just been raised to investment grade and trades at 100bp; despite our CDS rate strengthening from historical lows, this does indicate the upside risk potential posed by a sustained recovery in SA.



Local mid-caps tend to be highly correlated with prospects for the local economy. There has been a large rerating of late, alongside the earnings cycle which is relatively depressed. These are moderate conditions for local equity and require a sustained growth recovery to justify the lofty valuations (not dissimilar to global markets). SA is still playing catchup in this respect.

Overall, the outlook remains one which is more evenly balanced between local and offshore assets, and between equity and fixed income, than it has in the past – and one would generally expect a reversion towards more balanced investment views within funds. We do see the early evidence of this, however there is still likely to be an extended normalisation period as both our local and offshore investment environments tend back towards their respective long-term average levels.

Changes to prudential investment guidelines: Offshore allocation limit increase

With the recent budget announcement in February 2018, the Finance Minister communicated a continued relaxing of the offshore limitation for retirement funds. The new levels are:

- 25% to 30% for offshore assets ex Africa
- 5% to 10% for Africa ex South Africa.

There has been no change in the asset class limits (equity, bonds and cash), where equity is still required to remain below 75%, and total equity plus property no higher than 90%.

This presents an opportunity for investors to further diversify their retirement portfolios, however the decision is not straightforward for the following reasons:

1. Increasing your offshore also increases your dependency on the currency as a source of return. Ideally, investor returns are earned through real assets such as equity and property and diversified through bonds and cash. Local investors have come to expect the rand to add a significant additional return over time, and while this has been the case in certain periods, the quantum it adds, relative to the risk it adds, does not support a large currency specific position within a retirement fund. As an example, the expected return from the rand over time approximates its expected depreciation relative to 'hard currencies' such as the US Dollar. We could take the outlook currently as 5% to 5.5% local inflation, minus US inflation of 2% to 2.5% currently. This equates to a 3% expected depreciation and therefore a 3% expected return (leaving aside cash rates for now). This comes at a risk level in line, or greater than, equities! Not a great risk/return trade off.
2. The second aspect to consider is what you buy with your extra offshore allocation, and then what do you sell to fund it? With a local market seemingly in recovery mode, and an offshore market which has experienced a solid bull run since 2009, it is not obvious that one should make this broad level adjustment, particularly for more risk sensitive investors.
3. The argument for additional diversification is a good one, particularly in SA which has a concentrated share market meaning the reliance on a handful of shares to deliver investment outcomes for the broad population has been immense (and fortuitous! Naspers, SAB, mining, et al). So it is more likely in our opinion that local managers make a more refined adjustment within funds, adding additional offshore holdings in place of local listed rand hedge shares, with minimal risk impact on the overall portfolio.
4. Lastly, it is easy to get caught up in our own local market, however a number of significant drivers outside of our control also require attention – for instance the demand for high yield and emerging market bonds which has provided massive support for our bond market and currency over the past few years. The pressure is building with rising hard currency yields weakening the case to hold the higher risk bonds in emerging markets such as SA, which supports a higher offshore allocation.

With ASISA still to conclude on timing for the offshore limit changes it is still too early to tell how individual managers will respond. It is likely that those with bearish local views will take advantage quickly, while those managers with more of a pro-SA slant will hang back. Given the recent shift in SA politics and the majority of managers favoring a more balanced view than in the past, we expect the take-up to be more gradual.

On a case by case basis we are currently reviewing the local Regulation 28 compliant strategies to assess each with respect to the changes given the current opportunities and risks across asset classes.