Morningstar Investment Management, South Africa
Quarterly Market Commentary

Morningstar Investment Management
South Africa
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For Financial Advisers and
their clients using Morningstar Portfolios

Markets in review: what happened in the second quarter of 2018?

It's undoubtedly been a white-knuckle ride for South Africans in 2018, with markets eliciting a range of emotional and behavioural reactions from investors. The second quarter saw Rhama-phoria turn into Rhama-phobia on the back of intensified discussions around land expropriation, disappointing trade numbers, a weakening rand and the poor GDP growth data. The greater force, however, was the sustained revival of global market volatility on the back of rising geopolitical tensions and US borrowing costs, which saw emerging markets come under significant pressure as capital outflows persisted. In fact, foreign investors sold R33.7 billion of their South Africa bond holdings in June 2018 – the largest monthly net sale on record. This risk aversion and exodus of foreign investors in local bonds caused the rand to weaken materially over the quarter.

The effect of the risk off trade was mixed for South African investors. A significantly weaker rand resulted in strong positive returns from dual listed market heavy weights, such as BHP Billition (+32%). The swelling portion of locally listed companies geared to the global economy in terms of earnings saw the local equity market buck the trend of emerging markets. Symbolic of the reversal in the second quarter was the 21% gain in the share price of index behemoth Naspers which was down -16% in the first quarter.

These shifting tides in the first half of the year sum up what a difficult time it has been for investors to extract any sustained and meaningful returns from the market.

Does the economic and political chaos matter?

We reiterate our previous message that it's incredibly hard to know how the economic and political events around the world will play out. As South Africans, we are often guilty of extrapolating recent political noise into the future, expecting the worst and translating our views into portfolio expectations. Our team at Morningstar has no skill in forecasting the outcomes of events and the impact this will have on asset prices and so we spend little time guessing what will transpire. Instead we focus our time and energy on seeking out assets that are undervalued and out of favour. We tend to see the best opportunities when most investors are selling, either because they must sell or because they cannot deal with the psychological pain of losses. It leaves us, somewhat perversely, looking forward to downturns in sentiment that take prices away from intrinsic values.

Are there any pockets of opportunity on our radar?

On a long-term basis, we see opportunities in selected assets geared to the local economy, with clouds of negative sentiment currently hanging over the prices of these assets. Within equities, the fall in price of certain SA Inc shares has increased our conviction in this segment of the local equity market. Our holding in PSG reflects our exposure to this undervalued sector in the market.

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With a most recently published inflation number of 4.5% and a 10-year SA government bond yield of approximately 8.8%, we believe the real yield of just over 4% is an attractive investment. In addition to this, government bonds provide portfolio protection against a strengthening rand. While the rand has weakened dramatically over the past quarter, we believe it is now looking slightly oversold.

What impact does this have in the bigger picture?

While negative performance is never comfortable, it does open the door to future opportunity. We therefore seek to avoid market noise and mitigate emotional responses during these periods, as these are prime moments for us to deliver the greatest value for investors.

Bringing this together, we believe the market conditions are challenging although not incomprehensible. Achieving positive portfolio outcomes continues to be our long-term focus, which is driven by a willingness to be different from others and in applying a disciplined investment approach.

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