FVV CAPITAL

December 2019

# Line of THOUGHT

## ECONOMIC AND MARKET OVERVIEW

### Global

*The latest World Economic Outlook (published by the International Monetary Fund) reports that, after slowing sharply in the last three quarters of 2018, the pace of global economic activity remains weak. Momentum in manufacturing activity, in particular, has weakened substantially to levels not seen since the global financial crisis. Rising trade and geopolitical tensions have increased uncertainty about the future of the global trading system and international cooperation more generally, taking a toll on business confidence, investment decisions, and global trade.*

A notable shift toward increased monetary policy accommodation – through both action and communication – has cushioned the impact of these tensions on financial market sentiment and activity, while a generally resilient service sector has supported employment growth. That said, the outlook remains precarious.

Global economic growth is forecast at 3 percent for 2019, its lowest level since 2008–09 and a 0.3 percentage point downgrade from the April 2019 World Economic Outlook. Growth is projected to pick up to 3.4 percent in 2020, reflecting primarily a projected improvement in economic performance in a number of emerging markets in Latin America, the Middle East, and emerging and developing Europe that are under macroeconomic strain. Yet, with uncertainty about prospects for several of these countries, a projected slowdown in China and the United States, and prominent downside risks, a much more subdued pace of global activity could well materialise.

Having said that, the resilience of the consumer sector bodes well for the economic outlook of the United States. In a recent global macro strategy report, MRB Partners expects the downturn in manufacturing to gradually unwind. This should be supportive of investment returns in global growth assets (equities and property) over the medium term. Current dividend yields on equities remain compelling compared with the extraordinarily low yields available on long-term government bonds. Based on MRB's most recent analysis, returns from dividends for most markets will exceed those from bonds, and will provide the majority of total equity returns over the next decade. Dividends can provide little immediate protection for equities in an economic recession and bear market, but even under conservative growth assumptions, they will provide a solid safety valve for equities over the long haul.

From a pure valuation point of view, emerging market equities look particularly attractive. Concerns about the US-China tariff war, however, seem to hinder an unlocking of this value and it's unlikely that emerging markets will outperform their developed peers before uncertainty about a possible trade deal subsides. Patient investors would, however, do well to consider their investment options in emerging markets as current levels provide a very attractive entry point. Discerning allocations to equities and bonds in developing markets may yet prove to have been a smart move when assessed at the end of the next decade.

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## *South Africa*

*November's news flow around South Africa did little to improve investor confidence. Ratings agency Moody's downgraded the South African sovereign outlook to negative, following the reality check of the medium term budget policy statement (MTBPS) in October.*

Tantalum Capital further reports that the strike at South African Airways and the appointment of Eskom's new group chief executive, kept the perilous state of South Africa's state owned enterprises on the front page. On the bright side, the supportive global risk-on backdrop helped to support the Rand, which traded stronger despite the deteriorating sovereign debt outlook.

The South African bond market remains uneasy about the fragile fiscal outlook, as yields rose towards the end of November. Inflation (3.7% year on year) continued to surprise on the downside, but the South African Reserve Bank's Monetary Policy Committee (MPC) kept rates unchanged at their November meeting. It was not a unanimous decision though, with two of the five votes opting for a 25 basis point cut in rates. The MPC assesses the risks to the growth forecast to be to the downside. Escalation in global trade tensions, geo-political risks, further domestic supply constraints and/or sustained higher oil prices could generate headwinds to growth. Public sector financing needs have risen, raising the prospect of further pressure on the currency and pushing borrowing costs for the broader economy higher. Implementation of prudent macroeconomic policies and structural reforms that lower costs and increase investment potential growth and job creation, remains urgent. The question remains whether the governing party will have the political will to implement these much needed structural reforms and risk alienating themselves from their labour union support base.

*It was **not a unanimous decision** though, with two of the five members opting for a **25 basis point cut** in rates*

Sustained low inflation, high real interest rates and a return of global appetite for yield may support both the local bond and equity market through the next 12 to 18 months. A further sovereign credit downgrade may turn out to be a fleeting dampener to a proper bull market, but should not have a lasting effect as it already seems to be priced in.

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## *Market Performance*

Global financial markets had a mixed month with equities in developed markets (led by the United States) delivering strong returns (+2.5% in USD) while their emerging market peers lagged behind (-0.1%). Developed market bonds however underperformed those from developing markets, although this asset class also did not perform strongly.

Local assets remain under pressure - only listed property (0.8%) performed better than cash (0.6%) in November. Equities performed poorly (-1.8%) with only the healthcare sector recording a positive return. It, however, remains the worst performer among the equity sectors over 12 months.

Over 12 months, the top performing counters among the South African large and mid cap stocks can be found in the resources sector. The top seven stocks (Impala, Sibanye, Northam, Anglo Platinum, Goldfields and AngloGold Ashanti) all benefited from a very low valuation at the start of the year, much improved cash-flow and steady increases in commodity prices.

*In both instances the **returns** on these type of portfolios **beat** the performance of **cash***

Multi-asset portfolios enjoyed a better year as high equity portfolios (on average) delivered 9.1% to investors, at least 5% ahead of the annual inflation number. The mean conservative (low equity) portfolio ended the 12 months to end November 8.8% higher (net of fees). In both instances, the returns on these type of portfolios beat the performance of cash as measured by the Short Term Fixed Interest (STeFI) Composite index which gained 7.3% for the year.

| MARKET INDICES [1] (All returns in Rand) | 30 November 2019 | | |
|---|---|---|---|
| | 3 months | 12 months | 5 years |
| SA equities (JSE All Share Index) | 1.5% | 13.1% | 5.3% |
| SA property (S&P SA Reit Index) | 4.0% | -0.9% | 3.2% |
| SA bonds (SA All Bond Index) | 0.4% | 9.0% | 7.0% |
| SA cash (STeFI) | 1.7% | 7.3% | 7.2% |
| Global developed equities (MSCI World Index) | 4.0% | 21.7% | 14.7% |
| Emerging market equities (MSCI Emerging Market Index) | 2.4% | 13.8% | 9.5% |
| Global bonds (Bloomberg Barclays Global Aggregate) | -4.6% | 14.5% | 8.0% |
| Rand/dollar [2] | -3.5% | 5.7% | 5.8% |
| Rand/sterling | 2.5% | 7.1% | 1.8% |
| Rand/euro | -3.4% | 2.9% | 3.2% |
| Average South African Multi-Asset High Equity Fund | 2.4% | 9.1% | 4.8% |
| Average South African Multi-Asset Low Equity Fund | 1.7% | 8.8% | 6.1% |

1. Source: Factset
2. A negative number means fewer rands are being paid per US dollar, so it implies a strengthening of the rand.

# Line of THOUGHT

## Commentary – Rise of the machines

The Turing test, developed by Alan Turing in 1950, is a test of a machine's ability to exhibit intelligent behaviour equivalent to, or indistinguishable from that of a human. His academic paper, "Computing Machinery and Intelligence", which introduced the concept, opens with the words "I propose to consider the question, 'Can machines think?'"

Nearly 70 years after Turing's ground-breaking work on artificial intelligence, it's clear that machines can think – at least to a certain extent. Take Apple's Siri, Amazon's Alexa or Google Assistant, for instance. They are much more than a convenient tool – they are very real applications of artificial intelligence (AI) that are increasingly integral to our daily life. They rely on natural language generation, processing and machine learning, all forms of artificial intelligence, in order to effectively operate and perform better over time.

*It may **sound** like science fiction, but it's **very real***

Machine learning is the application of artificial intelligence where machines are given access to data and then can learn from it, rather than needing to be programmed by humans as to what to think about and do, with the data. Every time Alexa, Siri or Google Assistant make a mistake when responding to your request, it uses the data it receives based on how it responded to the original query to improve the next time. If an error was made, it takes that data and learns from it. If the response was favourable, the system notes that as well.

The analysis of investment opportunities has been the domain of fund managers for decades. Over time, developments in spreadsheets (e.g. Microsoft Excel), information databases (e.g. Bloomberg) and analysis tools (e.g. Morningstar) has certainly helped to process more information in an increasingly smarter way, but it did not make the final decision on the type, size, and timing of investments. These remained the responsibility of a human being who, at the very least, provided the rules and framework for the calculations done by the machines.

Machine learning allows computers to learn on their own, independent of boundaries, principles and constraints set by humans. It may sound like science fiction, but it's very real and being implemented by hundreds of investment firms around the world.

A recent CFA Institute report examined the trends and practical application of AI and big data technologies in investments. In "AI Pioneers in Investment Management", they pose the question, "Will robots replace human investment managers?"



1 - Edited from the Economist's "World in 2020"

## *Commentary –The rise of the machines (continued)*

The study found that relatively few investment professionals are currently exploiting AI and big data applications in their investment processes. They spoke with a selection of institutions across the globe that are currently using these technologies; these are among the AI pioneers in investment management. Their findings were illuminating, and lead them to ascribe to the power of the "AI + HI" model – artificial intelligence combined with human intelligence.

AI techniques can augment human intelligence to enable investment professionals to reach a higher level of performance, freeing them from routine tasks and enabling smarter decision making that leverages the collective intelligence of machines and humans.

One of the case studies in the report focused on Bloomberg's product, which attempts to gauge investor sentiment towards a security, sector, market and/or currency. They analyse structured data, as well as unstructured data (social media and news flow among others) in order to determine investor biases and interests. The resulting machine learning processes a stream of more than 2 million documents per day. The per story and sentiment data (e.g., for one document mentioning both Google and Microsoft, you may see positive sentiment for Google with 75% probability and negative for Microsoft with 50% probability) can then be used to determine whether other investors are planning to buy or sell these stocks. In short – machine learning can be very beneficial to improve the information behind, and quality of, investment decisions.

Successful investment firms of the future will be those that strategically plan on incorporating AI, machine learning and big data techniques into their investment processes. Successful investment professionals will be those who can understand and best exploit the opportunities brought about by these new technologies. The machines are not taking over (yet), but it's important to acknowledge that we are not the only species (if machines could be classified as such) with the ability to think.

The future is here.

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