What to expect from investment markets in 2017

The start of a new year brings with it a fresh mindset with which to consider investment prospects for 2017. Over the course of any given year, and in particular an economically busy one such as 2016, it is easy to lose track of where we are as we attempt to digest the reams of information hitting us on a daily basis.

To recap briefly, over the past 12 months we've needed to consider the implications of Brexit, Trump, Chinese debt and shadow banking, SA politics, the rand which started at R16/$ and ended at R13.70/$, a significant US rates hike, an emerging market crash and recovery, and OPEC cutting oil production and causing the price of oil to double to $56/barrel. That is without considering the individual asset classes which we can consider for investment or any of the numerous fund manager changes over the year.

Unfortunately, the world is no more normal than it was 12 or 24 months prior to today, and is unlikely to be in the near future. The policy implications from a Trump administration appear positive for growth (and therefore investment prospects), however this comes with a fairly strong health warning as the US is a repeat offender in creating bubble valuations without the necessary fundamental underpin. There is also the potential for Trump to materially change how the west deals with the east in terms of trade between the economies, causing further market risk.

The UK will be a case study for years to come, with the power of the voter acting at odds with economic stability. Under Theresa May, the way in which the UK renegotiates its way out of the EU will be felt by investors. Neither of these two significant events are set in stone as to how they may turn out over the next 12 months or even longer, which also makes investment risk higher than usual.

In Europe, there are a few major elections (France, Germany and Holland) to watch in 2017 and the question of whether the UK has started a chain reaction in the unravelling of the EU and the common currency will still need to be answered. Voters in these countries may well push against their administrators as has happened in the US and the UK. Economic justification will not play a significant role it seems, with votes being won with social messages, particularly given the weak economies and high unemployment rates in certain parts. The consequences of a negative outcome with respect to the EU are extremely complex to consider, which again leads to higher risks for investments.

Locally we will be going through a transition phase as potential suitors come forward for the ANC presidency and quite probably the South African presidency come 2019. Depending on which faction takes the lead here, we could either find the base for an economic recovery, or potentially find ourselves in a worsening position driven by political uncertainty – the outcomes are far apart and equally likely. In addition, the credit downgrade risk remains.

Apart from these events all having significant impact on currencies, and therefore the fortunes of the local investor, we also need to consider asset classes. If there is one thing we can fall back on when markets are volatile, it's to gain perspective by looking at where we are today relative to history in terms of valuations.

As part of our ongoing investment process we track major markets to ensure we understand the valuation risks inherent in each asset class being considered for investment. Two interesting items we look at are the 'CAPE' (or cyclically adjusted PE ratio which acts as a useful guide to valuation levels) as well as the level of corporate earnings. For example, the aggregate value of earnings by global companies today is the same, in nominal terms, as it was in 2007. Global profits have gone sideways for 10 years! It's no surprise global equity returns have been poor (3.8% per annum for 10 years, of which 2.6% was dividends).

Locally, corporate earnings have been declining for almost 3 years to levels last seen in 2014. This has been sector wide, led by commodities but including real estate, financials and industrial shares. The table below highlights the relatively uninspiring equity outlook based on the CAPE valuation as well as the level of corporate earnings, adjusted for inflation:

MARKET	CAPE - (Long term average PE)	CAPE (Current PE)	Valuation Premium/Discount	Real Earnings growth Average	Real Earnings Growth
South Africa	16.3x	16.7x	+3% expensive	4.5% p.a	-4% p.a
United States	22.1x	23.8x	+8% expensive	3.9% p.a	+2% p.a
United Kingdom	17.7x	14.5x	-15% cheap	3.3% p.a	-8.5% p.a
Europe	17.6x	12.2x	-30% cheap	3.3% p.a	-11% p.a

Long term earnings and valuation comparison (1973 -). Source: Thomson Reuters

Market valuations have continued to expand on declining earnings in most regions, creating quite a dangerous environment for investors unless earnings recover. In the case of global risks coming to the fore, markets are vulnerable when earnings support is as weak as we have it today.

For South African investors, currency plays a major role in the success or failure of any investment planning. In 2016 we had the double edged sword of a strong rand, where its relative appreciation is negative for investment returns held offshore, further reducing what are already quite pedestrian local returns. On the plus side, this strengthening helps keep inflation under control which is key to having a stable economic environment which includes interest rates. We monitor the ‘purchasing power parity’ of the rand relative to other currencies to be able to judge relative value. As we stand today, the rand is roughly fair against the dollar; sterling is almost 20% cheap relative to the dollar and the Euro is around 12-13% cheap relative to the dollar. By implication, the euro and sterling are cheap relative to the rand, bearing in mind the high risk environment in those regions for the meantime.

To summarise: major economic and political risks remain, valuation levels generally unattractive across asset classes but increasing levels of diversity within which does present viable investment opportunities.

Fortunately for investors, economic strife is often distantly related to investment returns so the potential for a positive 2017 is still there despite the relatively weak position we find ourselves in at the start of the year.

Despite the economic events characterising global markets, not much has changed over the past 12 months at an asset class level so we would expect any portfolio changes to be relatively limited for the time being. Investors will be well served to ride it out, but be aware to any opportunities which may arise if any of the major local or global risks play out.

31 December 2016

Sector		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol[1]	10yr Vol[1]
LOCAL MARKET INDICES (In Rands)									
FTSE/JSE All Share Index (ALSI)	ZAR	-2.1%	2.6%	2.6%	6.2%	13.0%	10.5%	10.5%	15.1%
FTSE/JSE SA Listed Property	ZAR	1.3%	10.2%	10.2%	14.7%	17.3%	15.8%	14.4%	15.6%
SA All Bond Index (ALBI)	ZAR	0.3%	15.4%	15.4%	6.9%	7.4%	8.0%	7.9%	7.5%
SA Cash Index (SteFI)	ZAR	1.9%	7.4%	7.4%	6.6%	6.1%	7.3%	0.2%	0.6%
Balanced Benchmark [2]	ZAR	-1.3%	3.5%	3.5%	8.1%	13.2%	10.9%	6.2%	6.2%
SA Inflation (1 month lag)	ZAR	1.0%	6.3%	6.6%	5.7%	5.6%	6.2%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	1.9%	7.5%	7.5%	3.8%	10.4%	3.8%	11.2%	16.5%
Emerging Markets Equity (MSCI EM)	USD	-4.2%	11.2%	11.2%	-2.6%	1.3%	1.8%	16.2%	23.4%
Global Bonds (Barclays Global Bond Index)	USD	-7.1%	2.1%	2.1%	-0.2%	0.2%	3.3%	4.6%	5.9%
Global Cash	USD	0.2%	0.6%	0.6%	0.3%	0.3%	1.1%	0.1%	0.5%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-2.1%	2.6%	2.6%	6.2%	13.0%	10.5%	10.5%	15.1%
Global Equity (MSCI World)	ZAR	1.3%	-5.1%	-5.1%	13.4%	22.7%	10.9%	13.3%	13.9%
Emerging Markets Equity (MSCI EM)	ZAR	-4.7%	-1.9%	-1.9%	6.5%	12.5%	8.8%	12.2%	15.7%
SA All Bond Index (ALBI)	ZAR	0.3%	15.4%	15.4%	6.9%	7.4%	8.0%	7.9%	7.5%
Global Bonds (Barclays Global Bond Index)	ZAR	-7.6%	-9.9%	-9.9%	9.1%	11.3%	10.4%	12.7%	14.6%
COMMODITIES									
Gold (US Dollars)	USD	-12.5%	10.3%	10.3%	-1.1%	-6.0%	6.3%	17.7%	19.4%
Gold (Rands)	ZAR	-13.0%	-2.7%	-2.7%	8.1%	4.5%	13.5%	18.8%	21.8%
Currencies (positive return = Rand weakening)									
Rand / Dollar	ZAR	0.0%	-11.2%	-11.2%	9.4%	11.2%	6.9%	14.3%	16.5%
Rand / GBP Pound	ZAR	-4.9%	-25.7%	-25.7%	-0.8%	6.2%	2.1%	14.2%	15.2%
Rand / Euro	ZAR	-6.1%	-13.8%	-13.8%	0.1%	6.7%	4.5%	12.8%	13.7%

Spot Rates

31-Dec-16		8-Jan-17	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Rand/US$	Rand	13.69	13.72	13.82	8.09	7.74	4.54
Rand/GBP	Rand	16.70	17.59	20.93	12.60	14.51	7.08
Rand/EUR	Rand	14.44	15.42	15.46	10.83	9.84	5.39
Rand/Aus $	Rand	9.89	10.51	9.68	7.82	5.79	3.60
Libor 6m $	US$	1.32	1.24	0.53	0.56	5.37	N/a
Prime	Rand	10.50	10.50	9.50	9.00	11.50	19.50
Repo Rate	Rand	7.00	7.00	6.00	5.50	8.00	N/a
All Bond Index Yield	Rand	8.98	8.79	8.54	8.62	10.00	14.03
Gold ($/oz)	US$	1,150.60	1,312.00	1,115.05	1,624.40	598.30	378.40
Palladium	US$	676.00	722.00	661.00	614.00	315.00	118.75
Platinum	US$	903.00	1,026.50	906.50	1,525.50	1,140.50	382.50
Oil (Brent Crude) $	US$	56.82	50.00	48.54	105.94	60.76	23.36
SA Inflation	Rand	6.60	6.10	4.60	5.70	5.30	8.40

data provided by Profile Data Analytics and INET BFA