

OLDMUTUAL

LONG-TERM PERSPECTIVES 2020



INVESTMENT GROUP
MACROSOLUTIONS

INVEST WITH PERSPECTIVE

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THE PROFESSIONAL STANDARD



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FOREWORD

2019 marked the end of a decade that started with a bang for markets, as central bankers threw everything but the kitchen sink at their economies in an attempt to minimise the consequences of the Global Financial Crisis of 2008/09. Despite this, the decade ended with a whimper as valuations became extended and the liquidity taps started to close.

To better understand the major factors that influenced global and local markets in the 2010s, we have included an article reviewing some of the most memorable events and what they potentially tell investors about the decade ahead.

The premise behind the LONG-TERM PERSPECTIVES yearbook, now in its seventh edition, is to unpack the drivers behind the returns of the different asset classes and to highlight the importance of both diversification and time in the market. Using 90 years of data, consider that the frequency of a negative return from the SA equity market diminished from 20% over a one-year investment term to 0% over five years and longer. After time, diversification is the second most valuable tool you can employ to manage risk.

This yearbook is specifically designed to help investors look beyond the daily and even monthly volatility and uncertainty. We scrutinise the long-term performance and behaviour of a range of asset classes. These asset classes are used to create the MacroSolutions Balanced Index – a diversified portfolio that is a proxy for an average balanced fund (the main savings solution in South Africa).

We also retain a strong focus on the “silent assassin”, inflation, throughout the publication. We primarily use inflation-adjusted, or REAL, returns in our analyses, as this better reflects the actual growth in your and my wealth.

I hope you find LONG-TERM PERSPECTIVES informative and that it helps you make the right decisions to grow your wealth in the 2020s and beyond.

Yours sincerely

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Portfolio Manager

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EXECUTIVE SUMMARY

With the primary objective of investors being to save for long-term goals, the aim of this report is to draw attention to the long-term behaviour of asset classes and, in so doing, provide perspective on the shorter-term volatility.

8 lessons guide an investment plan

In analysing long-term data, we uncovered profound lessons to help build a resilient investment plan. These lessons shape the key principles of our investment philosophy (see page 12).

When R10 000 becomes R5 584

The first of our lessons is on an investor's worst enemy: inflation. A 6% inflation rate will almost halve the value of your money over 10 years (see Chart 11).

86 years to double your money

Another risk to our future wealth is investing in cash. While there is minimal risk of losing money, it takes a lifetime to double the real value of your money, as opposed to 10 years in equities.

SA's top asset class 42 out of 90 years

To counter the effects of inflation and low-return investments, you need the higher growth potential of equities – SA's winning local asset class for 47% of the time (see Chart 6).

Diversification is the one free lunch

While equities are often the winning asset class, it still pays to diversify. Diversification is invaluable in managing risk. The article on page 16 talks about the benefit of blending different asset classes, while on page 19 you can see the consistent, above-average returns of the MacroSolutions Balanced Index.

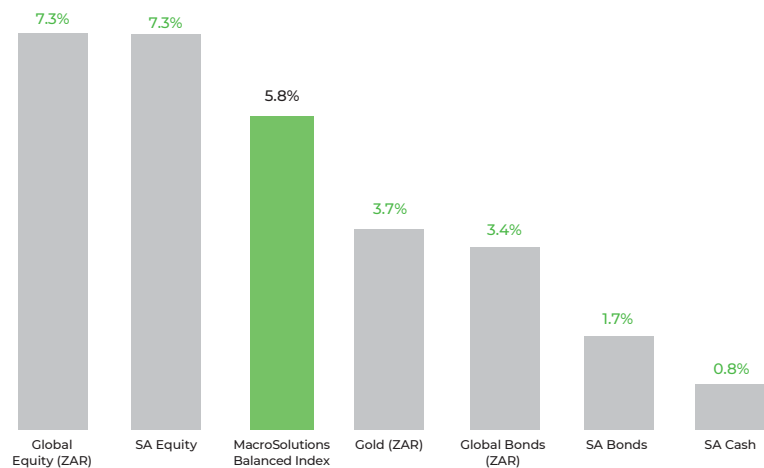
Active asset allocation can improve returns

The range between the highest and lowest annual asset class return (see page 19) has averaged 33.5% over the past 10 years. The freedom to actively favour exposure to particular asset classes over others from time to time enables managers to potentially improve returns for less risk.

Despite domestic politics and slowing global growth, the MacroSolutions Balanced Index delivered a real return of 7% in 2019. SA Equity, on the other hand, returned a poor 2.6% after inflation. Looking forward, we expect the MacroSolutions Balanced Index to deliver a real return of 4.9% annualised over the next five years (see page 43), up from the current 2.6% a year over the past five years and lower than the average 5.8% a year real return achieved since 1930.

CHART 1: GROWTH ASSETS REWARD OVER TIME

Annualised real returns in rand terms (December 1929 – December 2019)



THE 2010S IN PERSPECTIVE

Taking a long, hard look in the rearview mirror tells us something about the decade ahead



URVESH DESAI
Portfolio Manager



GRAHAM TUCKER
Portfolio Manager

As every parking payment machine attests, change is possible. Some changes are dramatic and obvious, while others are more creeping and harder to notice. This is why it can be insightful to stop and take stock of the past 10 years. For instance, we work with colleagues on a daily basis, but definitely do not notice the extent of the change in them over 10 years (or in ourselves, for that matter).

THE DECADE IN THE REARVIEW MIRROR

The decade of 2010 started with the global economy trying to rise from the ashes of the Global Financial Crisis. Central banks were taking unprecedented actions to revive the global economy. This saw several hundred interest rate cuts and the use of extraordinary monetary policy, which resulted in the purchase of government bonds and, in some instances, even equity. This resulted in one of the longest, but also one of the shallowest, economic recoveries on record. Inflation also remained well below most targeted levels – a somewhat surprising achievement given the size of the stimulus packages.

THE 2010S WILL BE REMEMBERED FOR:



Ultra-low interest rates, quantitative easing and negative bond yields



A stealth bull market, driven by growth and quality, not value



Innovation: Uber, AirBnB, Amazon, AI (Watson, AlphaGo)



Cracks revealed: China, EM and EU (PIIGS nations)

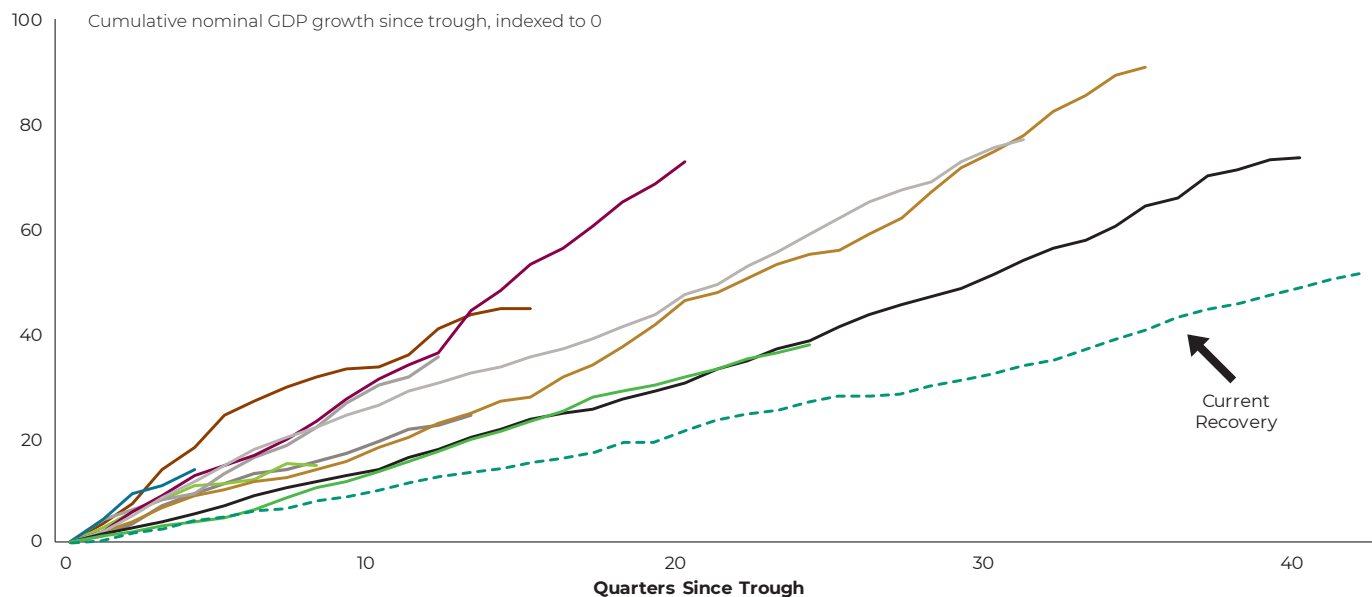


Rise of nationalism: Trump, Brexit, tariff wars



Widespread corruption allegations rock SA

CHART 2: A HISTORY OF US ECONOMIC RECOVERIES: CURRENTLY THE LONGEST, BUT SHALLOWEST, ON RECORD (1949 – 2019)



Sources: BEA, NBER, ISM, Haver Analytics®, Credit Suisse

This bumpy and brittle recovery resulted in a search for yield, but, more importantly, a premium was placed on growth and quality. If high or sustainable earnings growth is rare, it is quite valuable when you can find it. This meant growth and quality companies persistently outperformed attractively valued companies across the world. The biggest growth story of the decade was certainly the internet finally delivering on its promise during the tech boom of the 1990s. Companies that were already household names entering the decade – Apple, Facebook and Amazon – went on to become some of the biggest companies in the world. These, and new, innovative companies like Uber, Airbnb and Tesla, changed the way we live, shop and do business. From a quality perspective, Denmark and pharmaceuticals outperformed emerging markets and cyclicals, large companies beat small companies, and certainty surpassed vulnerability by a hefty margin over the decade.

THE RICH GOT RICHER, THE POOR GOT DISGRUNTLED

The nature of this economic expansion and the policies employed also meant the owners of capital/assets benefited disproportionately more than labour or the working person. Income inequality has grown and labour has enjoyed less of the profits generated by economies. The significant impact was felt in the world of politics as populism and nationalism became mainstream globally. The European “experiment” (aka the European Union) was severely tested early in the decade, with Portugal, Ireland, Italy, Greece and Spain (PIIGS) looking to exit perceived repressive policy. This was followed by Brexit dominating news headlines over the last three years of the decade. Across the Atlantic, the US elected Donald Trump (not many would have seen that coming in 2010) as its 45th President of the United States.

A NEW DAWN LATE IN RISING

Locally, South Africa was not without its own challenges – political or otherwise. We entered the 2010s on a high, with the hosting of the 2010 FIFA World Cup. The rest of the decade was largely downhill – Chinese growth slowed, the commodity boom ended, state-owned enterprise (SOE) problems came to the surface and corruption appeared to permeate most spheres of government. On the positive side, though, the role of the media, the independence of the courts, the integrity of the Public Protector for much of the decade, and the independence of the South African Reserve Bank offered rays of hope. This culminated in a change of political leadership and, according to initial indications, the beginning of the change needed – the “New Dawn” as now President Cyril Ramaphosa put it.

Over the decade, we saw the rand nearly halve in value relative to the US dollar. Our article on page 34 explains why the rand has such a profound impact on investment returns. As a result of the weakening rand, the local equity market was buoyed by locally listed, globally diversified companies. These global companies comprised roughly 12% of the market cap of our stock market at the start of the decade. This had increased to a massive 30% by the end of 2019. A great 10 years for global names, but a dismal decade for local-facing companies. Property initially continued its bull run, but had a torrid final few years of the decade. The bond market entered the FTSE World Government Bond Index (WGBI) in 2012. Recent years have seen South Africa on the brink of losing that place in the WGBI as two of the three key ratings agencies downgraded SA to a sub-investment grade credit rating. Despite this, the bond market held up well, often delivering returns in line with or ahead of the equity market.

LOOKING THROUGH THE WINDSCREEN INTO THE 2020S

The pace of innovation is likely to radically alter our world in the decade ahead. Artificial intelligence (AI) advancement seems inevitable, self-driving cars could become the norm (and, with any luck, result in a significant reduction in traffic jams), and sustainability will gain in prominence.

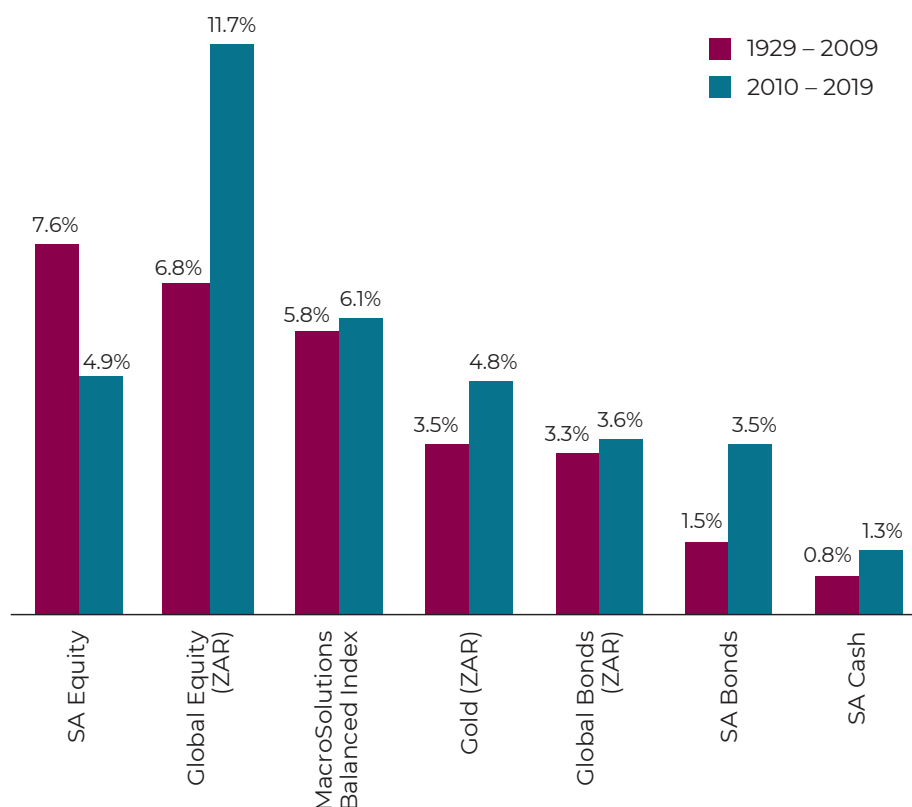
You could argue that choosing to look at a 10-year window now may not make sense. After all, the change from one year to the next is just a random point in the earth's orbit. However, regardless of the point you chose, when looking over periods as long as 10 years, the idea of mean reversion does start to play a role.

Using this lens, we can say it would be extraordinarily surprising if the US stock market and the tech sector were again the best performing areas for the next decade. Developed market government bonds seem to have limited potential for significant capital returns over the coming 10 years. However, the timing of these reversals will prove important. Of course, every rule has its exceptions... Just look at what happened to Japan and the print media industry, for instance.

Thinking of Japan, one cannot help but reflect on demographics. The developed world as a whole is ageing, making demographics a key differentiator. Africa has one of the few positive demographics stories. Will this see Africa improve its position on the world stage? And where will South Africa fit into that potential growth story? We need to continue walking the reform path, even though it will likely be painful at first.

We believe SA will walk that painful path and, given starting valuations, we see greater opportunities for returns in local assets than in global assets.

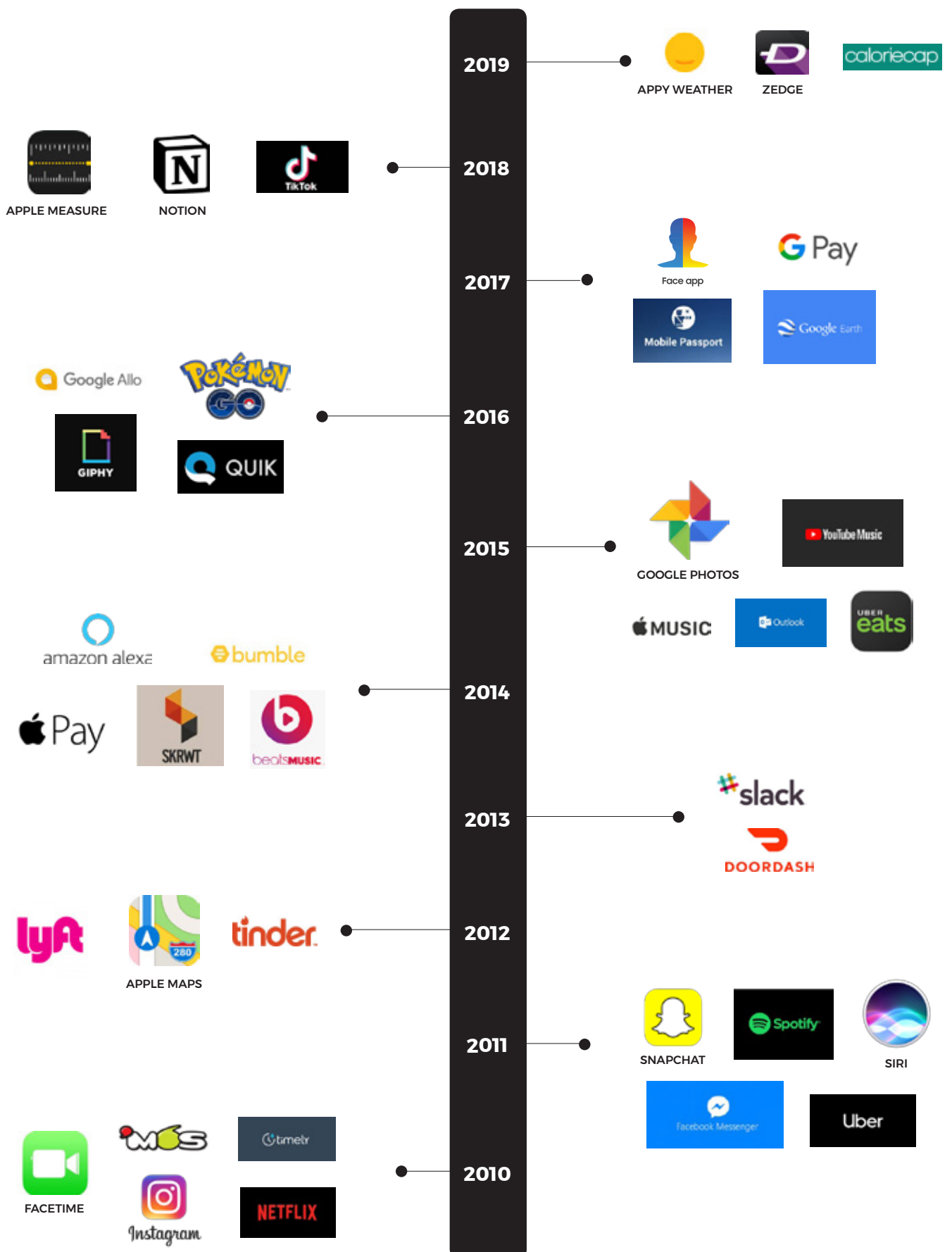
CHART 3: A DIFFICULT DECADE FOR SA EQUITY
Annualised real returns in rand terms (December 1929 – December 2019)



As we look from the rearview mirror into the future, all we now need is to find a way for AI to make us look young again...



APPS OF THE DECADE



THE MACROSOLUTIONS BALANCED INDEX

A long-term picture of multi-asset class performance

CURRENT WEIGHTING OF BALANCED INDEX

SA EQUITY	47.5%
GLOBAL EQUITY	22.5%
SA BONDS	15%
GLOBAL BONDS	7.5%
SA CASH	5%
GOLD	2.5%

LONG-TERM RETURNS OF THE MACROSOLUTIONS BALANCED INDEX (SINCE 1930)

12.1%

NOMINAL ANNUAL RETURNS

5.8%

REAL ANNUAL RETURNS

Multi-asset class portfolios, such as balanced funds, account for a significant portion of total flows into the unit trust industry.

Investors favour these funds because they:

1. Provide excellent real (above-inflation) returns
2. Offer diversified, risk-managed solutions
3. Comply with Regulation 28 of the Pension Funds Act
4. Qualify for a tax incentive for retirement savings.

Therefore, the average SA investor's returns are best measured by how a typical balanced fund has performed, and for that reason we developed our proprietary MacroSolutions Balanced Index.

THE MACROSOLUTIONS BALANCED INDEX OVER 90 YEARS

The MacroSolutions Balanced Index dates back to 1930 and provides a long-term total return series for an SA balanced fund.

The Index has been fine-tuned over the years to reflect changes in the local investable universe (see History in the bottom left corner).

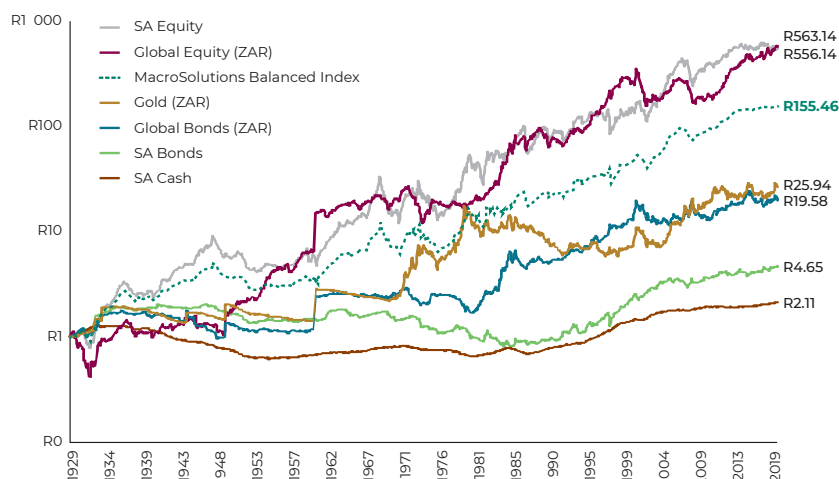
This index is a valuable tool in that it provides insight into long-term structural investment trends in SA.

THE HISTORY OF THE MACROSOLUTIONS BALANCED INDEX

The Index was initially a simple equity (65%), bonds (25%) and cash (10%) allocation. Over time, the weights adjusted to reflect changes in the investable universe and regulatory environment – for instance, gold was included in 1967 and global assets were introduced in 1995. The current weighting of the Index is 70% equity (including listed property), 22.5% bonds, 5% cash and 2.5% gold.

CHART 4: MACROSOLUTIONS BALANCED INDEX PROVIDES CONSISTENT LONG-TERM RETURNS

Growth of R1 over 90 years in real terms (December 1929 – December 2019)



MULTI-ASSET CLASS GROWTH OVER 90 YEARS: THE POWER OF COMPOUNDING

**R1 INVESTED
FOR 90
YEARS...**

MACROSOLUTIONS
BALANCED INDEX
12.1% a year

R29 851

In real terms,
investors' money
increased

155 TIMES

INFLATION RATE
6% a year

R184

in the MacroSolutions
Balanced Index.

EXPANDING THE INVESTMENT UNIVERSE

Investors have an increasing array of investment opportunities available for inclusion in their portfolios. This creates a greater opportunity set for managers to add value through actively managing portfolios across asset classes.

To illustrate this, we look at the impact of including different assets on a now globally diversified MacroSolutions Balanced Index relative to an SA-only index (70% SA equity, 20% SA bonds, 10% SA cash).

CHART 5: MORE OPTIONS, MORE OPPORTUNITIES

MacroSolutions Balanced Index relative to an SA-only balanced index (December 1950 – December 2019)

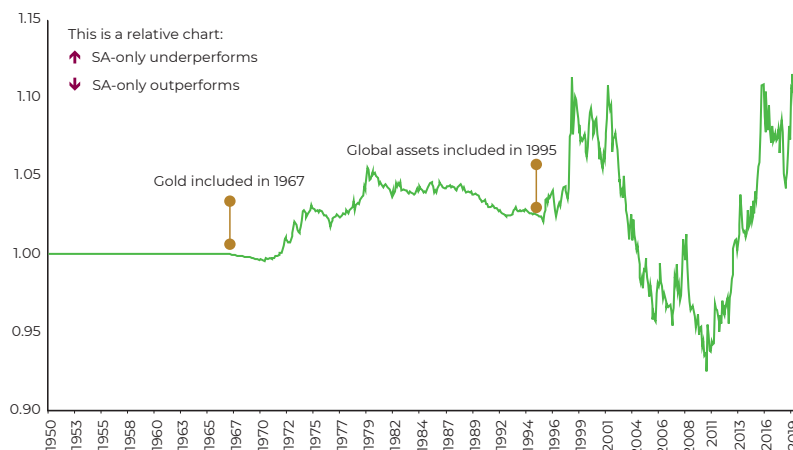
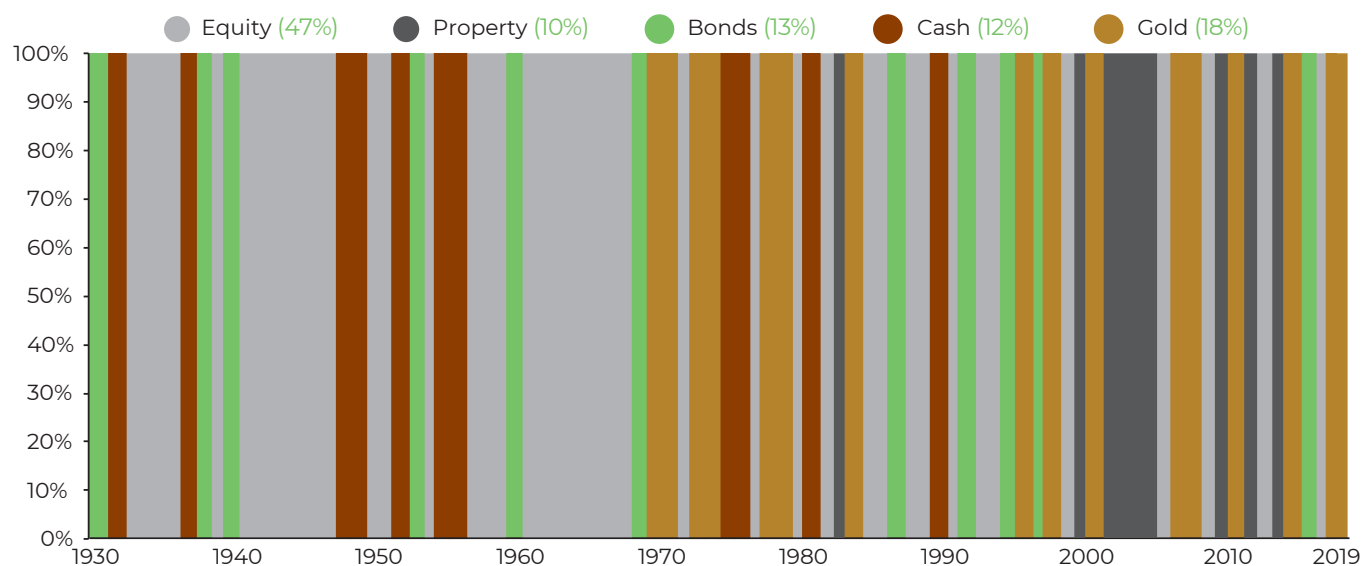


Chart 5 shows that simply including offshore exposure into a balanced fund's portfolio as exchange controls relax is far from a one-way advantage. An expanding investment universe creates opportunity for active asset allocation to add value on a risk-adjusted basis. Chart 6 shows why...

CHART 6: A MIXED PERFORMANCE PICTURE

Each year's best performing local asset class (1930 – 2019)

The figure in brackets denotes the percentage of time it's the top performing asset class for the year



LOSER: CASH... BUT THE BEST PERFORMER FOR 12% OF THE 90 YEARS.

WINNER: EQUITIES... BUT ONLY FOR 47% OF THE TIME.

LONG-TERM LESSONS

Building an informed solution

Analysing long-term data is crucial to our investment process and it also teaches us some profound lessons. Understanding these lessons will help you build the right investment solution to achieve your goals.

LESSON 1

INFLATION IS YOUR ENEMY

REALITY:

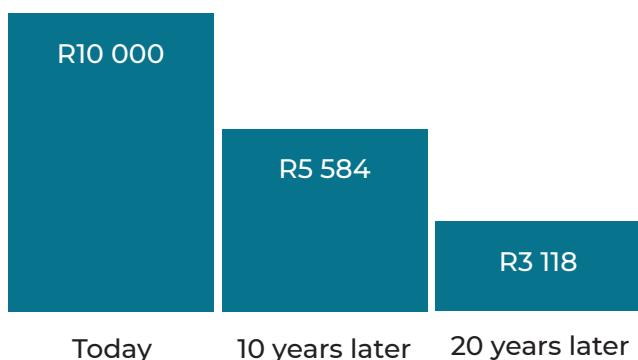
Many investors suffer from “inflation illusion” as they don’t notice how destructive inflation can be over time (see INFLATION research on page 20).

LESSON:

We need to look at long-term investment returns in “real” terms, stripping out the impact of inflation.

INFLATION ERODES SPENDING POWER

Take a look at what a 6% inflation rate effectively does to your money.



“Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man.”

Ronald Reagan

LESSON 2

TIME IS YOUR FRIEND

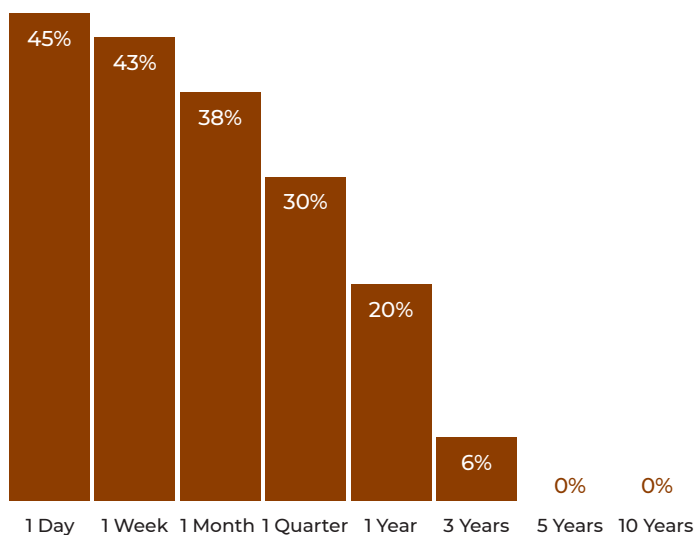
REALITY:

The main reason investors prefer cash to equities is the fear of losing money.

LESSON:

The best way to manage the risk of losing money is to remain invested in equities for longer. As soon as you extend your holding period for more than three years, SA equity past performance shows that the chance of losing money becomes negligible. Take what happened in 2008: after a negative 30% real return, the market rebounded to deliver 14% a year over the following five years (see Chart 14).

FREQUENCY OF NEGATIVE EQUITY RETURNS OVER DIFFERENT TIME PERIODS



1 day and 1 week: Rolling total returns for SA equity, June 1995 – December 2019

1 month to 10 years: Rolling returns for SA equity, January 1960 – December 2019

The old ADAGE holds true:

“ It's time in the market, not timing the market, that counts. ”

LESSON 3 YOU NEED EQUITIES

REALITY:

Many investors will not retire with enough money.

LESSON:

We need the higher long-term returns from equities to grow our wealth. This is particularly important in a world where people are living longer. Using average returns over the past 90 years, the graphic below shows how long it takes to double the real (after-inflation) value of your money.

LESSON 4 CASH IS TRASH

REALITY:

A bank deposit exposes you to minimal risk, but there's a price to be paid for that security.

LESSON:

Cash does not significantly increase your real wealth over time. Over 90 years, cash has an after-inflation return of less than 1% a year. It is better to own shares in the bank than to leave your money there.

TIME NEEDED TO DOUBLE YOUR MONEY

Using each asset class's long-term average returns, this is how long it will take to double your REAL investment value.

SA EQUITIES



10 YEARS

SA BONDS



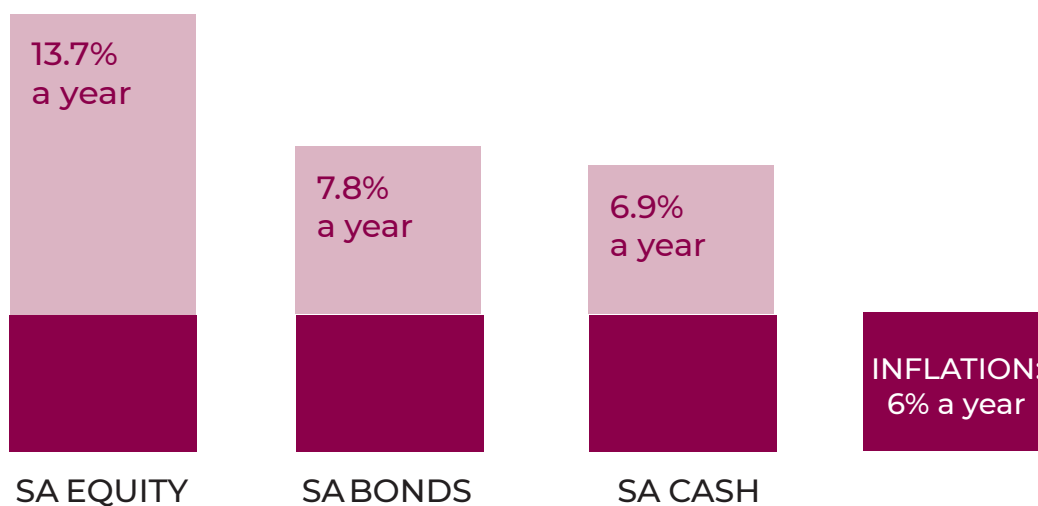
42 YEARS

SA CASH



86 YEARS

PERFORMANCE OVER 90 YEARS (nominal returns)



Compounding simply means making money on your original investment as well as on the gains made in previous years (i.e. growth on growth over time).

LESSON 5

COMPOUNDING IS A POWERFUL WEALTH GENERATOR

REALITY:


Money needs time to benefit from the full potential of compounding growth.

LESSON:

Start saving as soon as you can, leave it for as long as you can, and let compounding do the work for you. And tick the dividend reinvest box on your investment application form to maximise your growth.

GROWING YOUR WEALTH OVER TIME

Using the long-term nominal average return of 13.7% a year, look at what happens when a lump sum is invested in SA equities over time.

TODAY	10 YEARS LATER	20 YEARS LATER
		
R1 000	R3 611	R13 038

LESSON 6

HIGH PRICE OF MISSING OUT

REALITY:

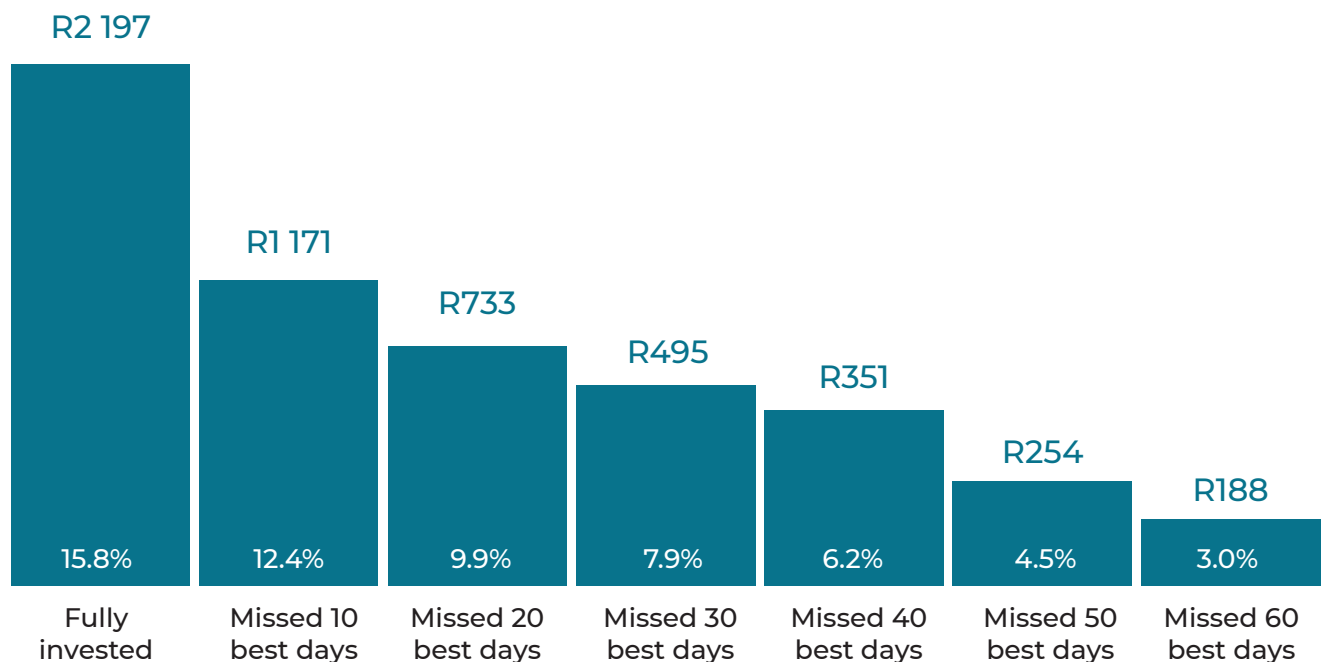
Short-term volatility can often lead to investors selling their investments at the worst time – as almost all of the 10 best days on the JSE occurred after bad news or during uncertain times.

LESSON:

Sitting on the sidelines and missing those good days can be detrimental to your savings. The only thing you can control is to have a well-considered plan and to stick to that plan. It is the best way of ensuring you have a secure retirement.

THE HIGH PRICE OF MISSING OUT

The performance of R100 invested in the FTSE/JSE All Share Index (January 1999 to December 2019)



LESSON 7

DON'T PUT ALL YOUR EGGS IN ONE BASKET

REALITY:

Equities may have been the best performing asset class since 1930, but cash was the best performer for 11 of those 90 years and listed property for nine years...

LESSON:

Diversification is the one free lunch in investments; use it. That is because it pays to invest across different asset classes. The article on page 16 talks about why it pays to diversify, while on page 19 you can see the consistent, above-average returns of the diversified MacroSolutions Balanced Index over time relative to other individual asset classes.

PERCENTAGE OF TIME AS THE YEAR'S BEST PERFORMING LOCAL ASSET CLASS (1930 – 2019)

47% SA Equity

18% SA Gold*

13% SA Bonds

12% SA Cash

10% SA Property**

* since 1967

** since 1980

LESSON 8

ACTIVE ALLOCATION ADDS VALUE

REALITY:

Asset classes have distinct secular or long-term periods of under- and outperformance.

LESSON:

Active asset allocation is a vital tool in delivering superior returns.

UNDERSTAND THAT MARKETS MOVE IN CYCLES



LISTED PROPERTY

went nowhere for 15 years, before becoming the best performing asset class for the next 20.



SA BONDS

delivered a negative real return for 40 years, before delivering a great return over the last 30 years.

SO WHAT?

We incorporate these lessons into the way we build our solutions:

- They all have real return targets.
- They all invest in growth assets.
- They are all well diversified.
- They all employ active asset allocation strategies.
- We recommend a minimum holding period for each solution – the more exposure a fund has to equities, the longer the recommended investment time.
- We hardcode long-term thinking into our investment process.

These principles also form the basis of Old Mutual Wealth's investment philosophy, enabling them to deliver to client objectives.

DIVERSIFICATION

Don't put all your eggs in one basket

VOLATILITY

Volatility is the variability of an asset's returns. The higher volatility for equity means that it has a wider range of possible returns than bonds (both positive and negative).

EQUITY VOLATILITY

17.8%

BOND VOLATILITY

7.1%

(The above figures are based on the volatility of monthly returns since 1925.)

ASSET CLASS CORRELATIONS

Correlation is the extent of co-movement between the returns of two asset classes. A high correlation reflects a positive relationship between asset classes, which means their returns move up or down in parallel. A low correlation means that asset classes move relatively independently of each other. Lower correlations help in improving the diversification of the portfolio. Combining SA Equity with Global Bonds is more effective in improving diversification than adding Global Bonds and Global Equity together.

HIGH

Global Equity correlation with Global Bonds

MEDIUM

SA Equity correlation with Global Equity

LOW

SA Equity correlation with Global Bonds

After **time** in the market, **diversification** is the second most valuable tool you can employ to manage risk, as it reduces the impact that a single poorly performing asset has on your overall portfolio.

Investors tend to have a low tolerance for pain, with the fear of losing money outweighing the greed for gains. Not only is losing money difficult to accept, but the cumulative impact of this can be a significant setback to an investor's financial outcome, particularly compared with a smoother return experience.

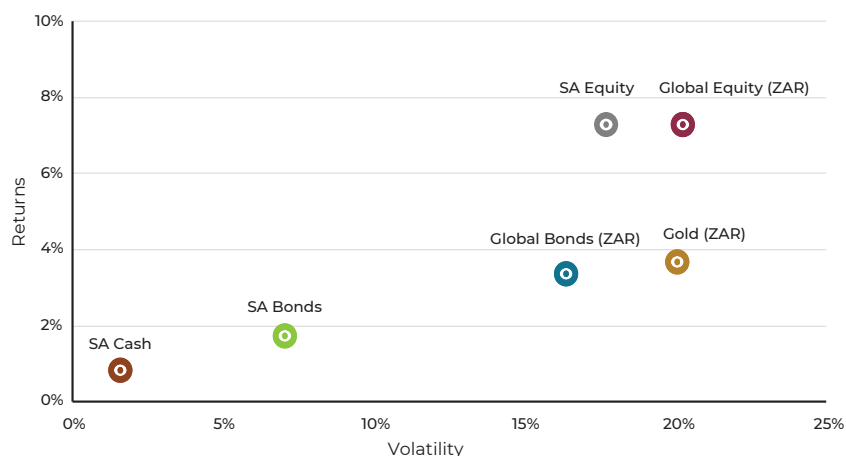
To this end, it is vitally important to ensure your portfolio has the optimal blend of diversifying asset classes to reduce the chance of large drawdowns and, ultimately, lower the portfolio's overall volatility.

WHAT MAKES A GREAT DIVERSIFYING ASSET CLASS?

1. Low volatility. Asset classes with low volatility, like cash, improve diversification in the portfolio and assist to limit large drawdowns. However, low volatility can also be costly as you sacrifice long-term returns by not having exposure to higher-risk growth assets, like equities. The article on SA CASH (page 31) further explains how the absence of risk can, in itself, be a risk to the long-term growth of your investments.

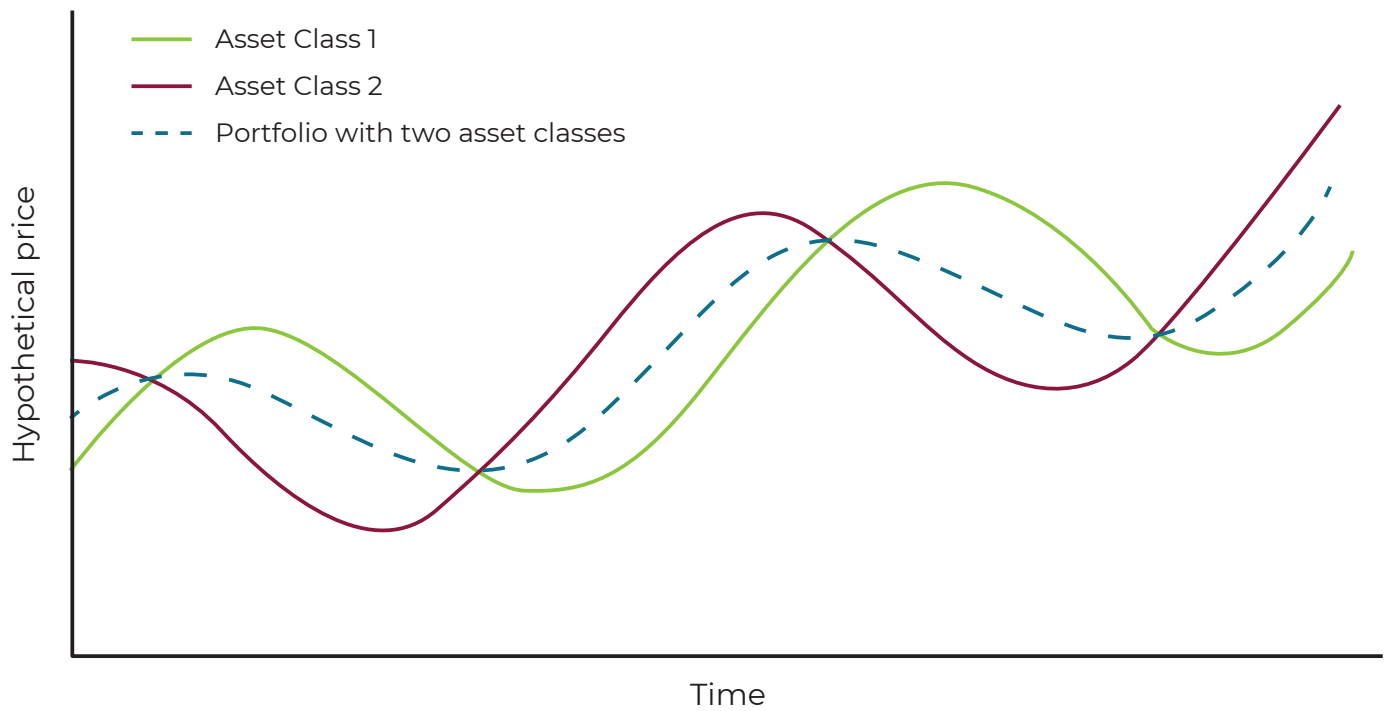
CHART 7: A BALANCING ACT BETWEEN RISK AND RETURN

Annualised real returns versus volatility of nominal returns (December 1929 - December 2019)



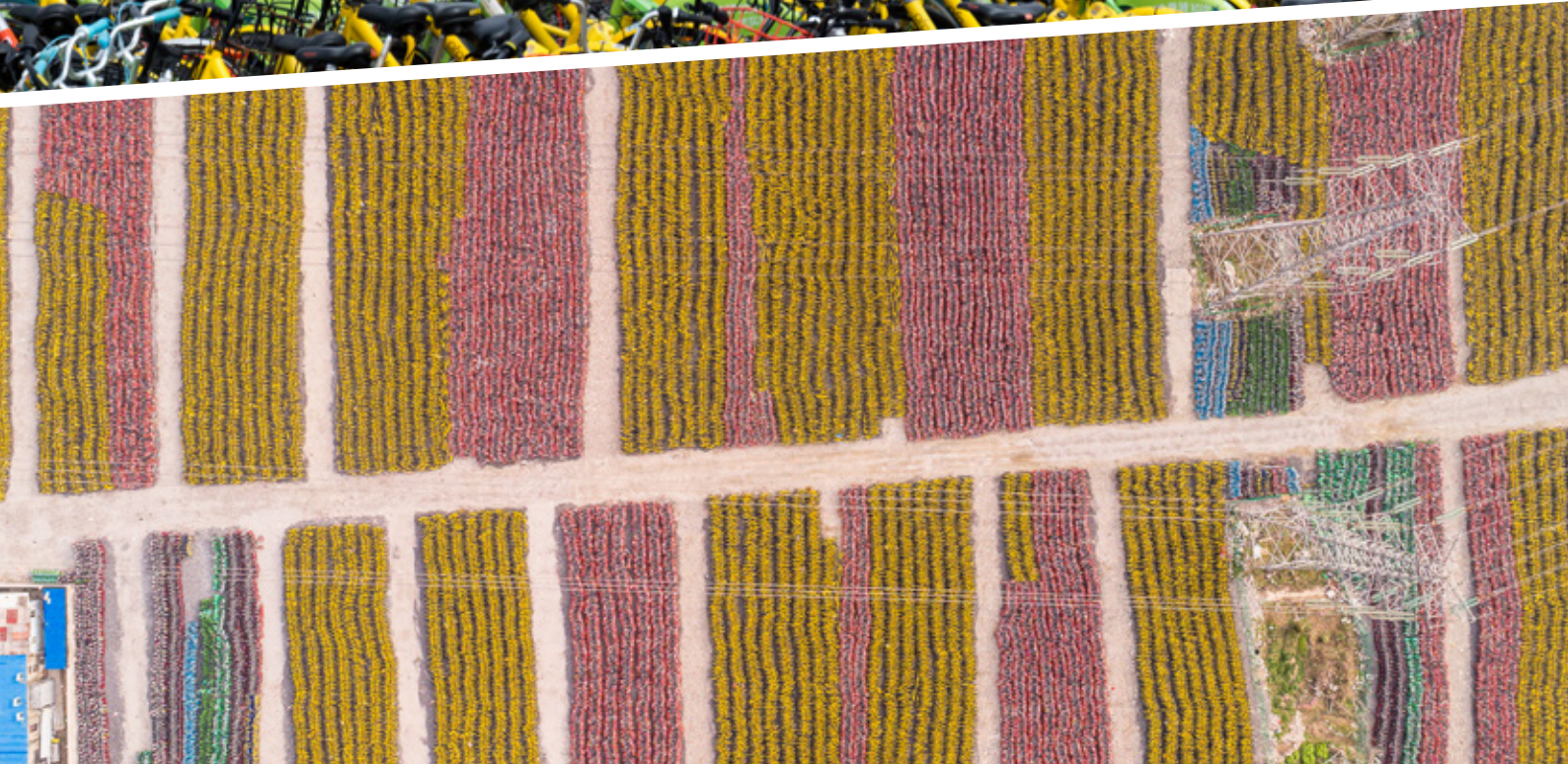
2. Low correlation. Asset classes with similar returns, but with low (or preferably negative) correlations to each other are a more effective means of improving diversification. Simply put, low correlated assets have different drivers of returns and so will outperform/underperform under different market conditions. Low correlated asset classes provide "offsetting" returns that improve the portfolio's drawdown profile and smooth the bumps in the investor's journey without compromising the long-term return prospects of the portfolio.

CHART 8: LOW CORRELATED ASSETS BENEFIT THE NET RESULT



It is thus key for a balanced fund to consider combining those asset classes with different characteristics to build a diversified, multi-asset portfolio. While you cannot eliminate volatility, spreading market risk across different asset classes reduces unnecessary volatility.

As shown in our “smartie box” on page 19, the performance of the MacroSolutions Balanced Index from year to year is not without volatility, yet it has a more stable return path than many of the riskier asset classes. The Index is also giving you returns well in excess of inflation over longer time periods.



DIVERSIFICATION

Our "smartie box" shows the performance of the different asset classes ranked over various time periods. The last 10 columns show just how variable the relative performance of asset classes can be from one year to the next. There are three key points arising from the table below that are discussed in LONG-TERM LESSONS (page 12).

1. Diversification: The MacroSolutions Balanced Index represents a typical balanced portfolio and illustrates that diversification works. The past five years saw incredible swings in the rankings. For instance, Global Equity went from topping the returns table in 2015 to being negative the following year, only to take the lead again in 2019. A similar scenario plays out in other asset classes. However, over these periods the diversified Index reduces some of the volatility you find in many individual asset classes.
2. Active asset allocation: The range of returns shown in the last line demonstrates just how important it is to have the ability and agility to move between asset classes. The wide ranges show the significant opportunity set for adding value with active allocation.
3. Equities for the long term: Although equities do go through periods of underperformance, investors are rewarded for this risk over the long term, as equities outperform inflation and "less risky" asset classes such as cash and bonds.

Annual nominal returns in rands

	50 Years	25 Years	20 Years	15 Years	10 Years	5 Years	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
HIGHEST RETURN	Global Equity 16.4%	Global Equity 14.0%	SA Property 16.8%	Gold 15.4%	Global Equity 17.4%	Global Equity 13.6%	SA Property 29.6%	Gold 32.9%	SA Property 35.9%	Global Equity 57.2%	SA Property 26.6%	Global Equity 33.5%	SA Bonds 15.4%	SA Equity 21.0%	Global Bonds 15.4%	Global Equity 24.8%
	SA Equity 16.3%	SA Property 13.5%	Gold 13.2%	SA Property 14.3%	Macro-Solutions Balanced Index 11.6%	Gold 8.7%	SA Equity 19.0%	Global Bonds 30.8%	SA Equity 26.7%	Macro-Solutions Balanced Index 23.3%	Global Equity 16.5%	Global Bonds 30.4%	SA Property 10.2%	SA Property 17.2%	Gold 15.1%	Gold 15.1%
	Macro-Solutions Balanced Index 15.3%	Macro-Solutions Balanced Index 13.0%	SA Equity 13.0%	Global Equity 14.2%	SA Property 10.8%	Macro-Solutions Balanced Index 7.8%	Global Equity 15.9%	Global Equity 15.9%	Global Equity 22.5%	SA Equity 21.4%	Macro-Solutions Balanced Index 11.5%	Gold 17.7%	SA Cash 7.4%	Macro-Solutions Balanced Index 14.7%	SA Bonds 7.7%	Macro-Solutions Balanced Index 11.3%
	Gold 14.4%	SA Equity 12.5%	Macro-Solutions Balanced Index 12.6%	SA Equity 13.5%	SA Equity 10.2%	SA Bonds 7.7%	SA Property 8.9%	SA Property 8.9%	Macro-Solutions Balanced Index 21.3%	Global Bonds 17.9%	Global Bonds 11.2%	Macro-Solutions Balanced Index 11.1%	SA CPI 6.7%	Global Equity 11.4%	SA Cash 7.3%	SA Bonds 10.3%
	Global Bonds 13.7%	SA Bonds 12.2%	SA Bonds 10.5%	Macro-Solutions Balanced Index 13.1%	Gold 10.2%	SA Cash 7.2%	SA Bonds 8.8%	SA Bonds 8.8%	SA Bonds 16.0%	SA Property 8.4%	SA Equity 10.9%	SA Property 8.0%	Macro-Solutions Balanced Index 2.6%	SA Bonds 10.2%	Global Equity 6.7%	SA Cash 7.3%
	SA Bonds 11.1%	Gold 11.6%	Global Equity 9.4%	Global Bonds 9.4%	Global Bonds 8.9%	Global Bonds 6.1%	SA Cash 6.9%	Macro-Solutions Balanced Index 8.6%	Gold 13.8%	SA CPI 5.4%	Gold 10.6%	SA Cash 6.5%	SA Equity 2.6%	SA Cash 7.5%	SA CPI 4.5%	SA Equity 6.8%
	SA Cash 11.1%	Global Bonds 10.8%	Global Bonds 8.8%	SA Bonds 8.3%	SA Bonds 8.9%	SA CPI 5.0%	SA CPI 3.5%	SA CPI 6.2%	Global Bonds 6.5%	SA Cash 5.2%	SA Bonds 10.1%	SA CPI 5.3%	Global Equity -4.6%	SA CPI 4.7%	Macro-Solutions Balanced Index -0.1%	SA CPI 4.0%
	SA CPI 8.9%	SA Cash 9.7%	SA Cash 8.1%	SA Cash 7.3%	SA Cash 6.5%	SA Equity 5.0%	Global Equity 0.9%	SA Cash 5.7%	SA CPI 5.7%	SA Bonds 0.6%	SA Cash 5.9%	SA Equity 5.1%	Gold -4.6%	Gold 2.0%	SA Equity -8.5%	Global Bonds 3.1%
		SA CPI 5.9%	SA CPI 5.6%	SA CPI 5.7%	SA CPI 5.1%	SA Property 1.2%	Global Bonds -4.4%	SA Equity 2.6%	SA Cash 5.6%	Gold -10.3%	SA CPI 5.3%	SA Bonds -3.9%	Global Bonds -10.4%	Global Bonds -3.3%	SA Property -25.3%	SA Property 1.9%
LOWEST RETURN		8.2%	11.1%	9.7%	12.3%	12.4%	34.0%	30.4%	30.3%	67.5%	21.3%	37.4%	25.8%	24.2%	40.7%	22.9%
RANGE BETWEEN HIGHEST AND LOWEST RETURN	7.5%															

SA INFLATION

Public enemy #1

Inflation was remarkably contained over the past decade, despite the rand almost halving in value against the US dollar over that time. During 2019 alone, inflation eased from 5.2% in late 2018 to 4% at the end of 2019. The weak economy meant that a very deflationary environment prevailed during the year. Cost increases in areas such as electricity and petrol actually lowered price pressures elsewhere as weak demand limited pass-through of these price pressures.

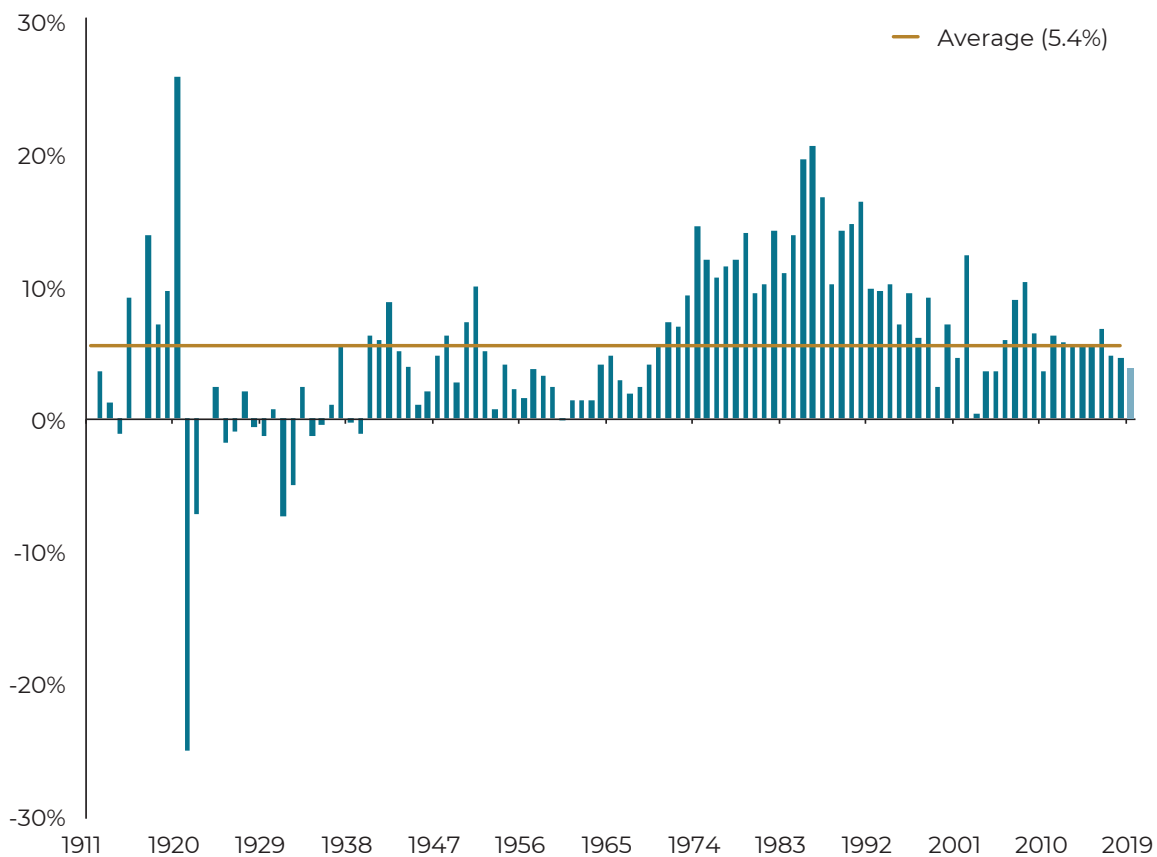
However, inflation is still the biggest enemy of savers as it erodes their spending power. This is why we look at our long-term investment returns in real terms (stripping out the impact of inflation). In SA, this is particularly pertinent as inflation has averaged 5.4% over the past 108 years (see Chart 9). This compares unfavourably to the average 4.3% in the UK and 3.8% in the US.

SA's inflation followed the rest of the world higher during the 1970s, on the back of the first oil crisis, while local factors kept our inflation rate high during the 1980s. These included rocketing wage growth, as remuneration per worker topped growth of 20% in the 1970s and early 1980s, and the negative impact of economic isolation during the sanction years of the mid-1980s.

Nearly a decade after US Federal Reserve Board (Fed) Chairman Paul Volcker broke the back of US inflation, Dr Chris Stals played a similar role after becoming Governor of the South African Reserve Bank (SARB) in 1989. A combination of high real interest rates, a lengthy recession and the opening of the economy in 1994 led to lower inflation. The introduction of inflation targets also played a big role in anchoring inflation expectations. The result is that inflation has averaged 5.1% over the last decade.

CHART 9: INFLATION TARGET ANCHORS EXPECTATIONS

SA inflation as measured by the consumer price index (CPI) (December 1911 – December 2019)



Source: Stats SA

THE IMPACT OF INFLATION ON OUR EVERYDAY LIVES

1. WHAT WILL IT COST?

The variability of inflation is a challenge for budgeting. Even though SA's inflation measurement and calculation is among the best in the world, it is an average of all the consumers in the country. If your expenditure is more skewed towards components in the basket of goods with very high inflation rates (for instance, education and healthcare), you will experience a much higher personal inflation rate than the country average. In this case you will need to save more for future expenses.



Mid-size family sedan (1600cc engine) at 4.7% vehicle inflation rate (average since 2009)



One year's tuition and boarding at a private school at 6.9% education inflation rate (average since 2009).

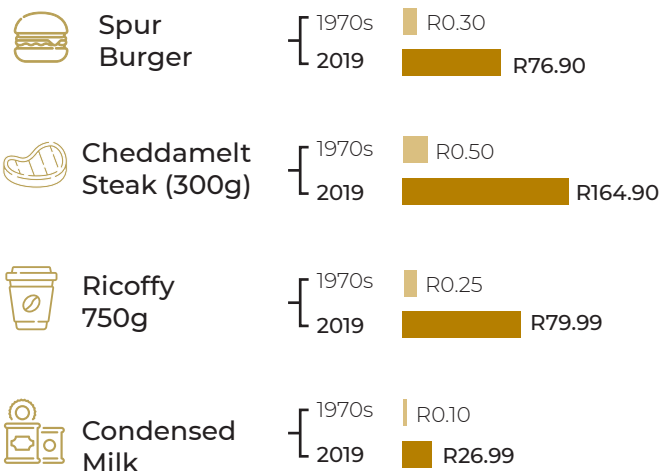


Private hospital kidney dialysis costs for a year at 5.6% medical inflation rate (average since 2009).



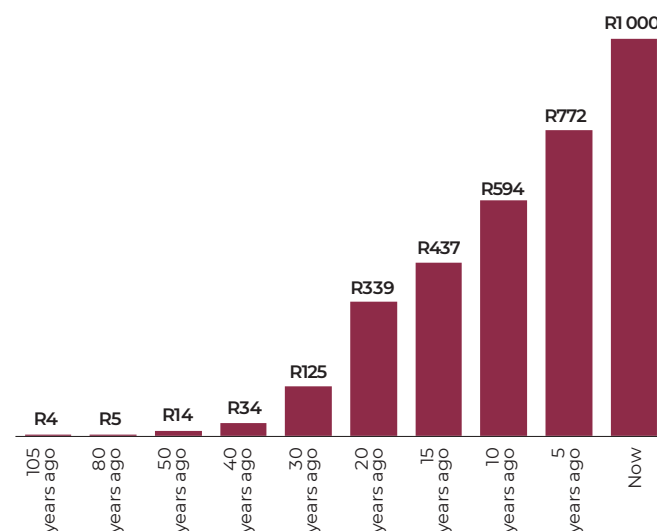
2. HOW MUCH HAVE PRICES GONE UP?

We can look back in time to see how much some South African favourites cost compared with today's prices.



Similarly, 10 years ago you would have paid just under 60% of what it costs today for a basket of consumer goods. Twenty years ago it would have cost around one third of what you would pay today to fill your trolley.

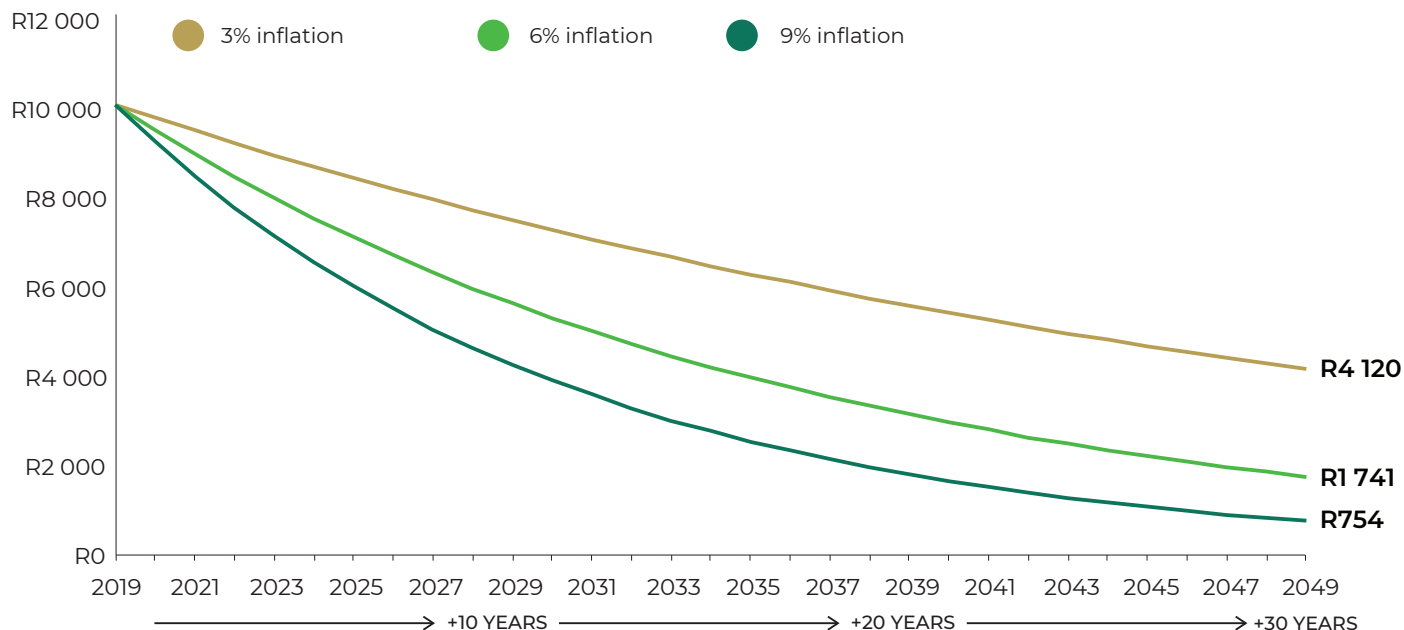
CHART 10: VALUE OF BASKET OF GOODS THAT COSTS R1 000 TODAY



3. DID I SAVE ENOUGH?

If your retirement income does not at least grow in line with inflation, you will either experience a decline in your standard of living or you will run out of money. At a 6% inflation rate, a fixed monthly retirement income of R10 000 a month today will decline in real terms to about R1 700 a month after 30 years. Chart 11 shows your purchasing power is even worse at a higher inflation rate. This highlights how important it is to plan carefully and ensure that you invest to achieve inflation-beating returns in the long run.

CHART 11: IMPACT OF INFLATION ON RETIREMENT INCOME OF R10 000 OVER TIME



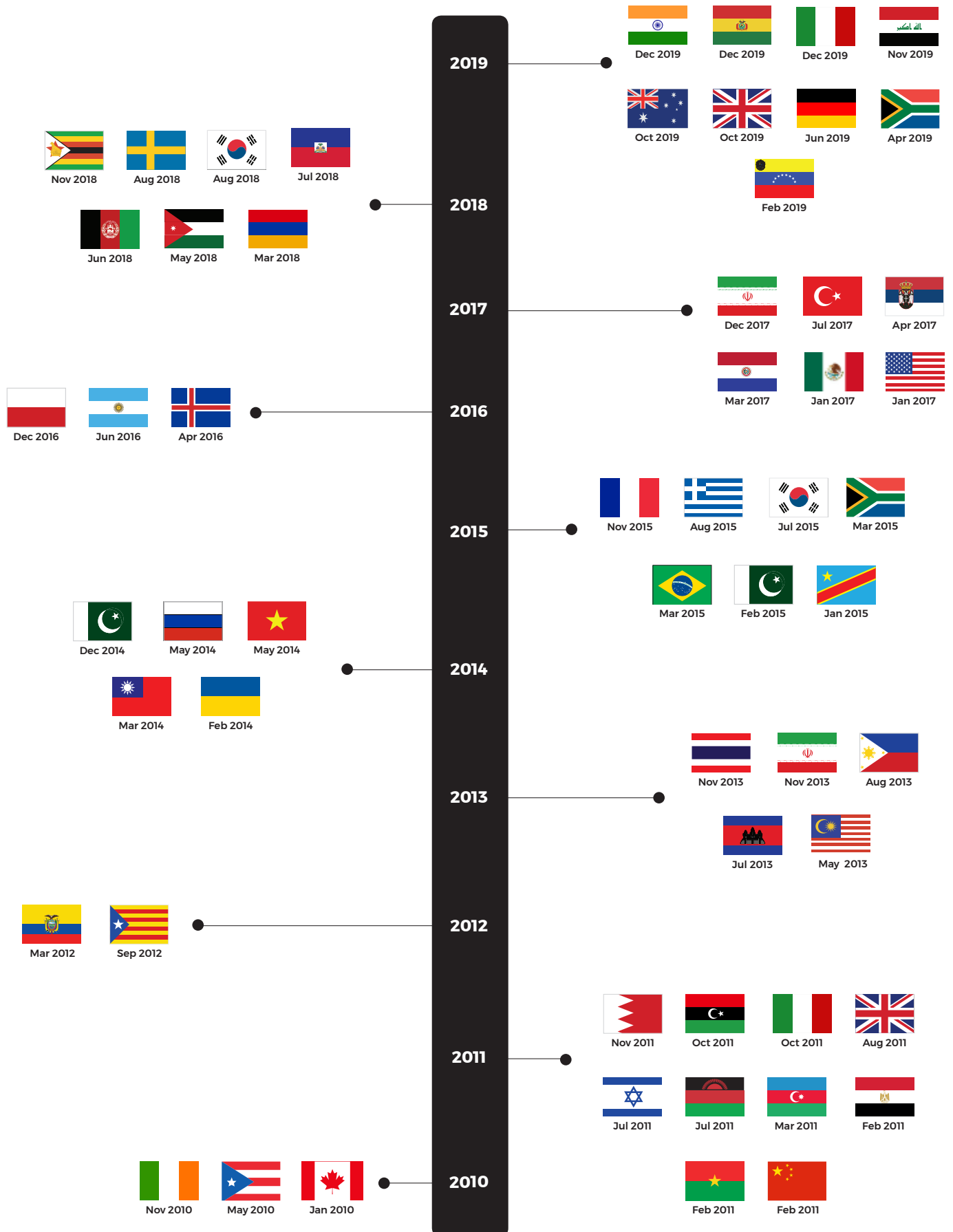
2020

The deflationary environment of 2019 – where cost increases limit the spending ability of the consumer and thus ease price pressures in other areas – will likely continue for most of 2020. Some cyclical growth improvement is expected later in 2020 and, combined with an anticipated uptrend in food inflation, will likely mean less downside inflation surprises. While inflation will probably stay very comfortably within the 3% to 6% target range and mostly in a tight 4% to 5% band, some updrift is foreseen as the very low price pressures of 2019 are unlikely to be repeated. Also, with any sign of improved economic growth, some pent-up price pressures might be passed on to consumers. Average CPI inflation in 2020 of 4.5% is thus expected, slightly higher than the 4.1% recorded in 2019.

LONGER TERM

We expect inflation to average 4.5% to 5.0% over the next five years, which is within the SARB's target range of 3% to 6%. The risk, though, remains to the upside. As we are a small and an open economy, SA inflation will always be subject to big global cycles as the currency and, consequently, food and petrol prices play havoc with price changes. Exchange rate risk remains particularly high, given how exposed SA is during this period of heightened political and credit ratings risk.

A DECADE OF PROTESTS AROUND THE WORLD





SA EQUITY

Valuations determine subsequent returns

The local equity market once again came under pressure in 2019 as the dire state of our economy continued to weigh heavily on companies. The platinum and gold sectors were the stand-out performers, while a large portion of the SA-facing names languished. While extremely disheartening for investors, it helps to look at the past year's stock market returns in context of the longer-term trend. Over the past 95 years, the SA equity market has swung between cheap and expensive relative to trend (as per the trend line in Chart 12). This movement from low to high and vice versa is known as **reflexivity**.

REAL RETURNS

+7.7% a year since 1925

NOMINAL RETURNS

+13.8% a year since 1925

+93.7% HIGHEST
annual return (1979)

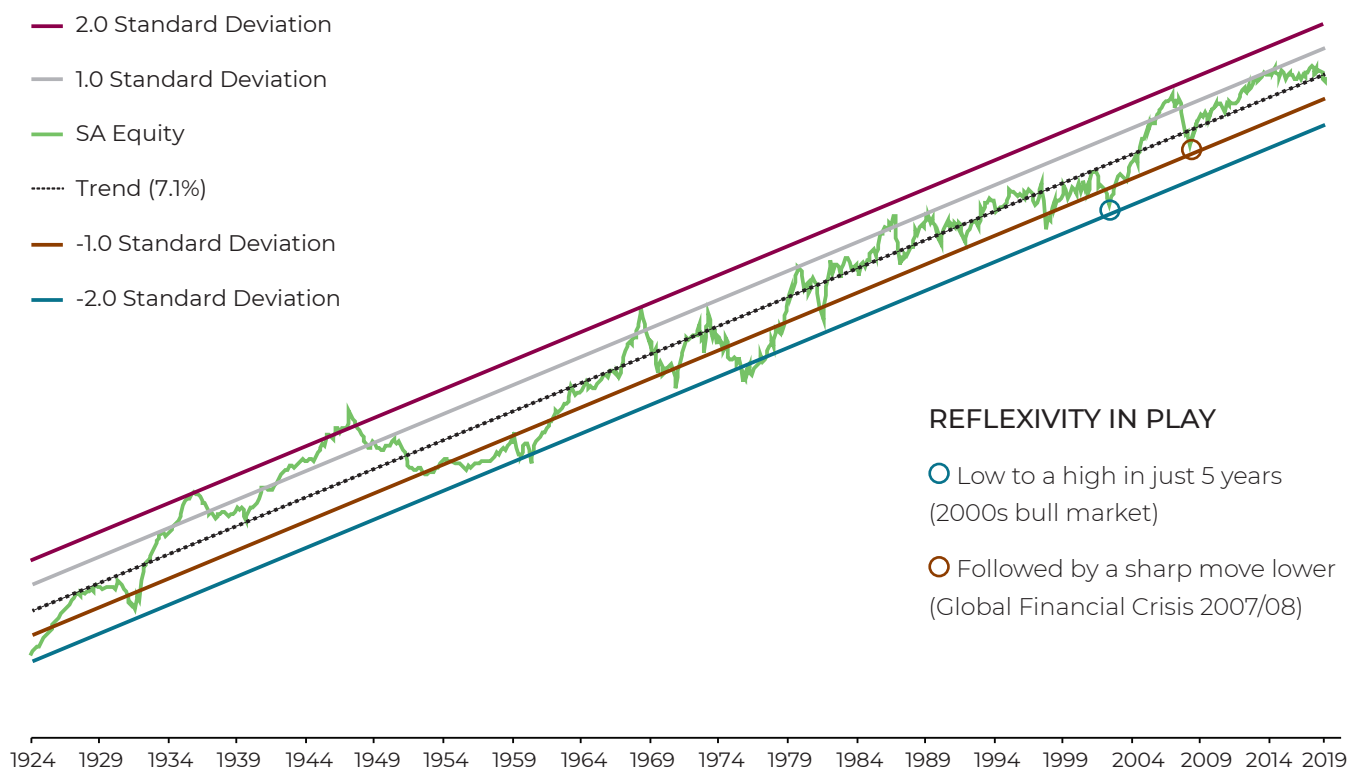
-26.4% LOWEST
annual return (1970)

THE ROLE OF VALUATIONS

While Chart 12 shows the real price of the equity market relative to its history, to determine if a market offers value, an important consideration is the price one is paying relative to the profits the company is generating, that is, the price-to-earnings ratio (PE ratio).

Chart 13 on the following page plots the annualised five-year real return for the equity market based on the PE ratio quintile at the beginning of that period. When viewed in this way, there is a clear relationship between the attractiveness of the market from a valuation perspective and the subsequent returns.

CHART 12: UPWARD TREND, DESPITE VOLATILITY
SA equities in real terms (December 1924 – December 2019)

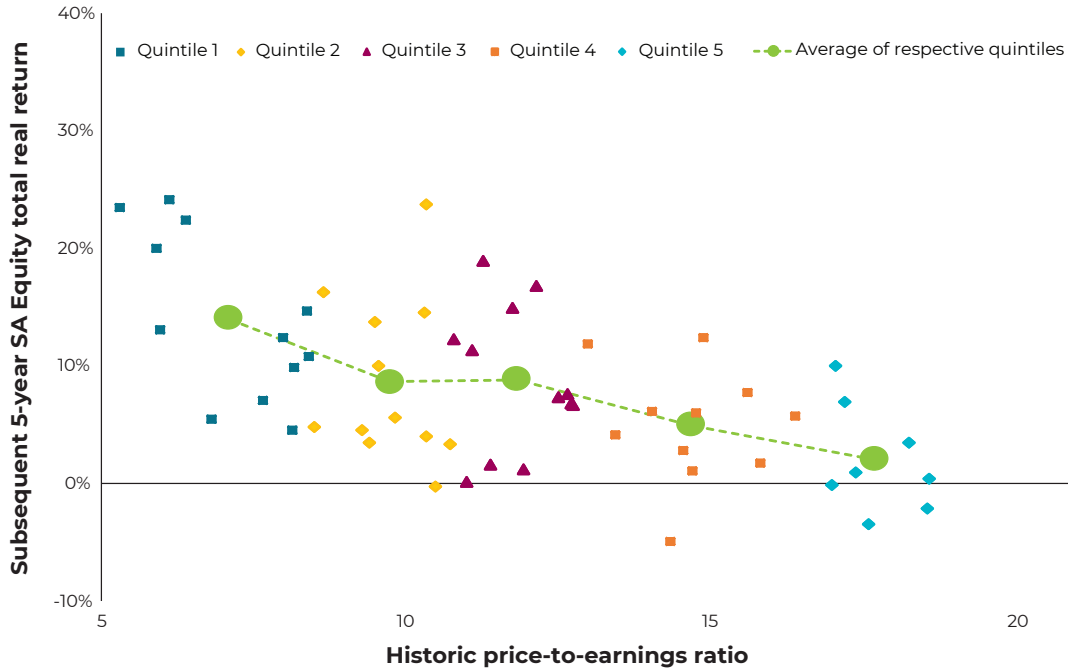


THE MARKET IS LESS EXPENSIVE

The more expensive the market (i.e. higher historic PE ratio), the lower the subsequent five-year return, and vice versa. In recent years, the PE ratio for the local equity market has been elevated and in the top quintile, indicating low future real returns. Given the recent market movements, the PE ratio has fallen somewhat to the fourth quintile. This means that some value has returned to the market and, accordingly, we would expect slightly better real returns going forward.

CHART 13: IS THE MARKET EXPENSIVE OR OFFERING VALUE?

Historic PE ratio of JSE vs subsequent five-year real return (1960 – 2019)



TAKING A POSITIVE VIEW ON NEGATIVE RETURNS

Although the long-term equity market trend is up, in nearly one out of every three years investors have lost money in real terms. While painful, periods of significant negative returns can be opportunities, as can be seen in Chart 14, which shows the “Sandton skyline” of annual real returns for the local equity market.

CHART 14: OPPORTUNITIES IN TIMES OF CRISIS

SA equities' real return (December 1924 – December 2019)

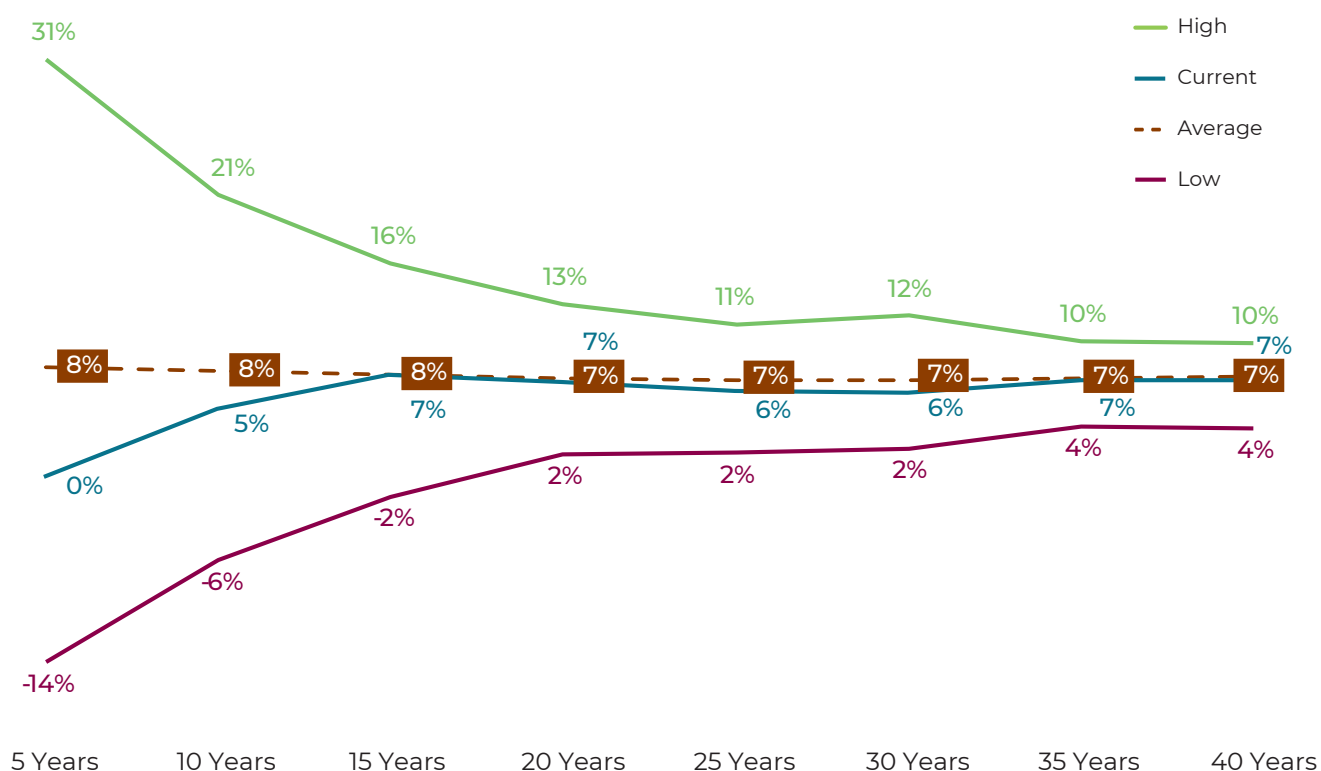


While Chart 14 shows that there are years in which equities have lost a significant portion of their value, it is important to remember that investing is a long-term endeavour, and Chart 15 demonstrates the benefits of being patient. This time funnel shows the range of the annualised real returns investors would have achieved over various periods (listed on the horizontal axis). The funnel narrows from both the top and bottom as you increase the length of time invested, showing that time softens the impact of large positive or negative periods.

Although losses can be experienced over shorter periods, history shows that long-term investors have been rewarded with positive real returns. This will have contributed significantly to meeting their investment objectives, but only if they had the patience required to unlock that risk premium.

CHART 15: OVER TIME RETURNS BECOME LESS VOLATILE

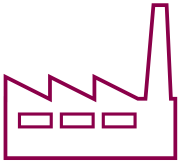
Range of annualised real returns from SA equities (December 1924 – December 2019)



OUTLOOK

History tells us that real trend growth for the SA equity market is 7.1% a year, while the average five-year real return is 8% a year. In our view, the market has become cheaper, but is not cheap. We expect earnings growth will remain somewhat hindered by low economic growth. Consequently, our five-year expected annualised real return is only 6.5%. However, given the diverse nature of our market, there will be opportunities to enhance these returns. A potential upside risk to these returns would be the ability of Government to implement growth-enhancing reforms.

It has been a difficult period of late for equity investors. Returns have been well below the long-term experience. The primary drivers of these sub-par returns have been expensive valuations and poor local economic growth. The recent below-average returns from the equity market have refreshed valuations somewhat and we believe South Africa is on an upward trajectory, given the political developments in 2018 and 2019. As such, we believe the next five years should result in better returns for equity investors, with stock and industry selection key to the outcome.



SA LISTED PROPERTY

The once-tiny sector is an important asset class today

REAL RETURNS

+3.5% a year since 1980

NOMINAL RETURNS

+12.3% a year since 1980

+53.2% HIGHEST
annual return (1999)

-26.3% LOWEST
annual return (1998)

At MacroSolutions, we have long considered this once-tiny sector an important and a distinct asset class in its own right. The past few years have been challenging for the sector. A weak local economy, excess supply and a hangover from past aggressiveness have taken their toll.

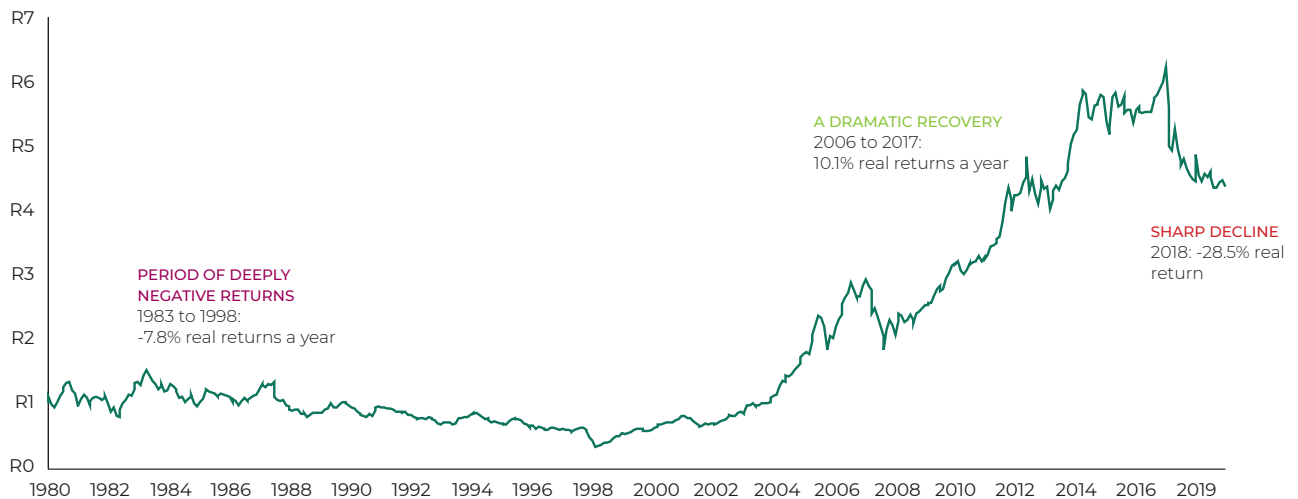
THE LURE OF HIGH YIELDS

Listed property is essentially a hybrid of equities and bonds, offering both capital growth and a stable and growing rental income component.

Following difficult conditions in the 1980s and 1990s, property fundamentals started to recover in the early 2000s. For instance, office vacancies peaked at 24%. It improved later as the voids were filled when a buoyant SA consumer boosted shopping centres. This allowed for growth in dividends, which have more than doubled since 2002.

CHART 16: LISTED PROPERTY TURNAROUND

R1 invested in SA Property Index in real terms (January 1980 – December 2019)



The weak economy has put pressure on tenants and rental markets, lowering earnings and valuation expectations. This has had a detrimental impact on sector pricing, which has fallen sharply. Over the next five years, we expect property to deliver a 7.5% a year real return. This is based on the current double-digit forward yield of the sector and flat earnings growth. The extremely attractive yields are tempered by the tough trading conditions and questionable capital allocation in the sector.



SA BONDS

Real returns in a world without inflation

REAL RETURNS

+1.9% a year since 1925

NOMINAL RETURNS

+7.7% a year since 1925

+36% HIGHEST

annual return (1986)

-9% LOWEST

annual return (1994)

Through a domestic lens, SA bonds delivered a good return in 2019, with 10.3% in nominal terms translating into a healthy 6.1% after adjusting for inflation. This was ahead of other major domestic asset classes and in line with our expectations. However, when viewed through the eyes of a global investor, SA bonds failed to benefit from the tailwinds of falling global yields. While emerging market bonds, in aggregate, ended the year 13.5% up in US dollar terms, SA bonds scraped ahead of their developed market counterparts, despite starting the year with yields 7.4% higher.

Bond market returns are particularly sensitive to event and policy risk and can be broken up into distinct periods driven by structural macroeconomic and socio-political forces. Seeing the impact of these forces on returns reinforces why a long-term macro perspective is so critical.

1980s: THE LOST DECADE

While the US bond bull market began in the early 1980s (see GLOBAL BONDS on page 40), SA bonds continued to suffer from a combination of a weakening currency, structurally high inflation and political and economic isolation. The broad strength of the US dollar, along with a weak gold price (SA's primary export at the time), exacerbated the financial pressures exerted on the economy by international sanctions. The consequences of trade restrictions increased as the strong external reserves position deteriorated and eventually led to a group of foreign creditors refusing to refinance their loans to domestic South African banks. This ultimately ended in the SA government imposing a moratorium on private sector debt. While national debt was unaffected, the rand weakened against foreign currencies, entrenching higher and less stable inflation, and with it higher bond yields and poor real bond returns.

CHART 17: BOND MARKET REACTION TO ECONOMIC AND POLITICAL EVENTS

SA bonds in real terms (December 1924 – December 2019)



7.7%
real return

1995 – 2009: SA FINDS ITS FOOTING

The decade-and-a-half that followed the change of government in SA saw many of the aforementioned pressures reverse: the US dollar peaked and was followed by a period of falling US interest rates and easier global financial conditions, while SA's political and economic transition enabled the domestic bond market to re-sync with falling global bond yields at a time when inflation had begun its almost three-decade-long structural decline. At the same time, the strength of domestic institutions' actions added stability and reduced vulnerabilities in the SA economy, while Government's tax revenues benefited from a booming global commodity cycle.

SA bonds benefited from both global and domestic forces:

- The signing of the Plaza Accord in 1985 paved the way for a period of a weaker US dollar and lower global interest rates.
- A more credible monetary policy was established as the SARB adopted inflation targeting in 2000 and began accumulating more foreign exchange reserves.
- With the aid of a strong economy, National Treasury reduced public debt to below 30% of GDP by 2008.

3.6%
real return

2010 – CURRENT: POST GLOBAL FINANCIAL CRISIS (GFC)

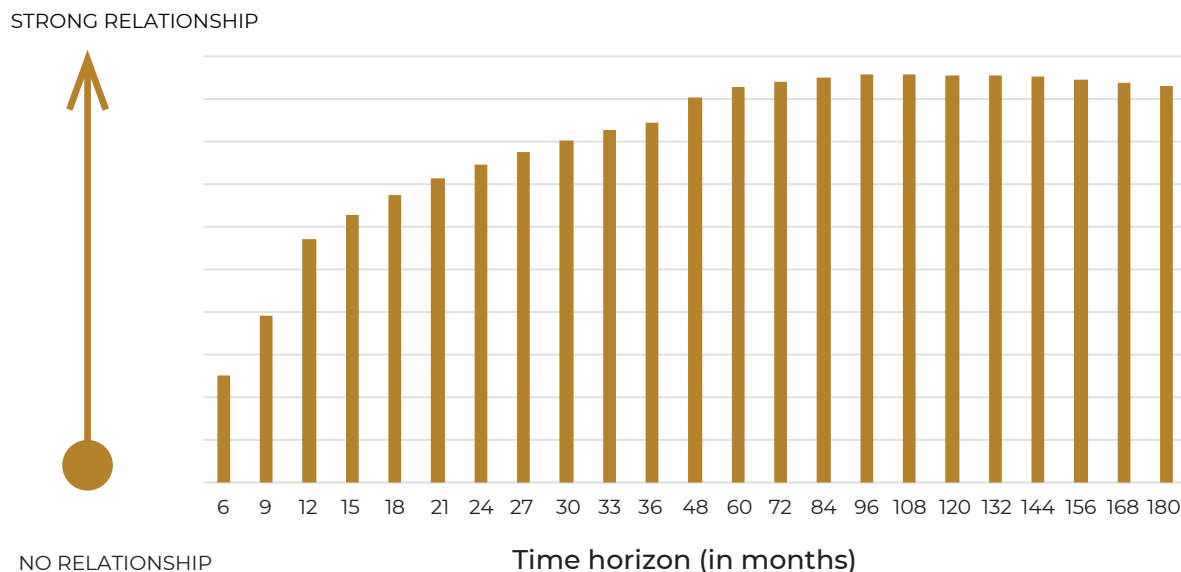
Over the most recent decade, South Africa has suffered from an extended period of low growth along with a decline in fiscal discipline and weakening institutions. With government debt, including contingencies to state-owned entities (SOEs), at record highs, the risk of falling into a "debt trap" rises disproportionately. While at lower levels of debt, a country (or company) can navigate periods where revenues grow more slowly than their interest burden; when debt levels are high, the margin for error decreases. At the end of 2019, South Africa's benchmark 10-year bond yield was 9% – this is almost 4% higher than nominal GDP growth over the past three years.

While there is no magic number at which this dynamic becomes unsustainable, South Africa's current arithmetic is at a point where we require a combination of a cyclical growth recovery, tighter fiscal policy and at least a partial resolution to burgeoning SOE debt. This is particularly necessary as we continue to run an aggregate savings shortfall, leaving Government reliant on accessing global liquidity.

Despite the clear deterioration in domestic fundamentals, South Africa's bond yields have broadly remained unchanged since the beginning of the decade. The South African 10-year bond currently yields 9%, having started the decade at 9.1%; while the JSE All Bond Index has returned an average of 8.9% a year over the period, comfortably above both cash (6.5%) and inflation (5.1%). While far from the stellar real returns experienced during the Great Bond Bull Market, these are above the average real return of 1.9% since 1925, and more than respectable in a period defined by low growth and returns across countries and asset classes. This, too, when the currency has almost halved in value against the US dollar.

CHART 18: BOND YIELDS ARE THE BEST PREDICTOR OF FUTURE RETURNS

SA 10-year bond yield versus subsequent nominal returns



YIELDS PROVIDE A CRYSTAL BALL

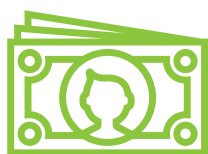
While market volatility influences the performance of bonds in the short run, as we expand our horizon we see that yield proves to be the best predictor of nominal returns. Chart 18 shows the relationship between any given level of yield and returns, over different time horizons. As your time horizon lengthens, your starting bond yield is increasingly better at telling you what your returns could be.

OUTLOOK

On the one hand, weak domestic growth and poor fiscal dynamics justify high bond yields at home. Through a domestic lens, risks appear stacked for further deterioration unless action is taken to meaningfully cut public expenditure and “crowd in” private investment to boost growth.

However, we expect the global environment to continue to bail out South Africa’s bond yields. With global growth remaining broadly anaemic, inflation absent and global bond yields near record lows, South Africa stands out as cheap and rating risks priced. With domestic inflation remaining benign, reflecting weak local growth, South African bonds remain our favoured asset class.

From starting yields of 9%, we expect SA 10-year bonds to deliver a real return of 4% a year over the next five years. Inflation-linked bonds will likely deliver a 3.5% real return a year – not far off the average that investors have received since the 1920s.



SA CASH

You get what you pay for... not much

REAL RETURNS

+0.9% a year since 1925

NOMINAL RETURNS

+6.7% a year since 1925

+21.7% HIGHEST
annual return (1985)

0% LOWEST
annual return (1938)

Over the past five years, cash has outperformed local equities. The temptation is to extrapolate this experience into the future and switch from growth assets to cash. However, the lesson from history is clear: Cash is a poor long-term investment. The reason being that you cannot expect a high return from a short-term, risk-free loan. Investors in cash get what they pay for – limited return for limited risk. So, while cash is sometimes a good parking bay, it is not optimal to grow long-term savings by making short-term investments.

VICTIM TO INFLATION AND POLICY

Today's holders of cash may be lulled into a false sense of security by its recent good returns. However, the lesson from history is that inflation is a real threat to cash, eroding its purchasing power over time. Central banks control interest rates and, consequently, cash returns can be negatively affected by central bank policy actions. For instance, over the last decade, global central banks have pegged interest rates at close to zero, resulting in negative real returns for investors. In South Africa, the long-term real return from cash of 0.8% a year masks long periods of negative real returns. Cash delivered a negative real return for 23 years from 1932 and for another 16 years from 1972, highlighting how monetary policy can adversely impact savers. This was reversed by the very high real yields under the Stals/Mboweni regime to crush inflation. While cash has, more recently, outperformed growth assets like equities and property, investors should remember the lesson of time – cash is a long-term loser that often does not keep pace with inflation.

WHEN CASH IS KING

The primary benefit of cash is opportunity value – it preserves its nominal value while other asset prices are falling, enabling investors to buy those assets at a cheaper price. Cash has been the best performing asset class for 11 years out of the past 90 years. In 100% of these instances, the JSE was actually down, including the 1932 Great Depression, the 1948-1949 post-WWII bear market and the 1998 emerging market crisis. That said, it is important to remember that cash is not a long-term investment. Over all 10-year time periods, cash has been the worst performer 35% of the time, and never the best performer.

IT PAYS TO TAKE RISK

In a global context, cash has been trash over the long term. The average real return on global cash has been just 0.8%¹ a year (1900 - 2018). More recently, however, real returns from global cash have been negative, at -0.5% a year between 2000 and 2018. Over the long term, investors have harvested a considerable premium by holding longer-dated bonds or equities. The term premium² for government bonds is 1.1% a year, while the equity risk premium³ is 4.2% a year (data from 1900 to 2018). While there are inter-country differences, the global experience is mirrored within most countries. The lesson globally is that it pays to take risk.

The lesson is clear: Cash offers protection against downside risk in growth assets, but is not a viable long-term investment option.

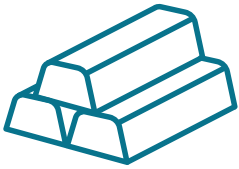
OUTLOOK

In 2019, cash returned 7.3% compared to 6.8% from equities and 10.3% from bonds. Over the past five years, cash has outperformed equities with a real return of 2% a year versus 0.1% for equities. Despite very low inflation and a weak economy, the central bank has been reluctant to cut interest rates significantly. It remains focused on risks to the inflation outlook – mostly stemming from concerns about currency weakness in response to potential further downgrades to South Africa's credit rating. However, the sustained downward surprise in inflation and the extremely depressed local economy mean there is a growing risk that the central bank will end up cutting interest rates more than markets expect. This would be a catalyst for local bonds and equities outperforming cash, given the significant risk premium built into these assets.

¹ Credit Suisse Global Investment Returns Yearbook 2019.

² Term premium – the extra annual return the market demands for buying a bond that matures further in the future.

³ Equity risk premium – the extra annual return the market demands for investing in more risky equity rather than less risky bonds.



GOLD

Low correlation to other asset classes

REAL RETURNS

+4.6% a year since 1967

NOMINAL RETURNS

+13.5% a year since 1967

+122% HIGHEST
annual return (1979)

-19% LOWEST
annual return (1997)

GOLD PRODUCTION AND THE SA ECONOMY



Source: Stats SA

Despite its dwindled significance in SA's economy, gold has remained a useful investment alternative with significant returns recorded in periods, especially in times of elevated uncertainty.

During 2019, the US Federal Reserve softened its monetary policy stance and began cutting interest rates. The lower opportunity cost of holding gold as a hedge in an increasingly uncertain environment, and the expectation that the US dollar may begin to weaken, saw the gold price rise by around 15% in both US dollar and rand terms.

GOLD AS AN INVESTMENT

Gold has been part of the global financial system for centuries, having been adopted as a peg for currencies such as the UK pound since 1717. The end of the Bretton Woods system of fixed exchange rates in 1971 saw the move to broadly floating exchange rates.

Gold's value has been seen as a hedge against inflation and protection against economic turmoil. The investment case cited against gold is that the metal has virtually no fundamental intrinsic value and does not produce cash flows. South African investors, in particular, have a long history of investing in gold, no doubt influenced by the historical importance of gold in the South African economy.

Investors who find the ability to own physical gold appealing have been able to invest in Krugerrand coins since 1967. We added gold to the MacroSolutions Balanced Index at a 2.5% weight, and it has delivered a return of 13.5% a year since 1967. A large component of this return has been driven by currency weakness, as the annual US dollar return has been 6.1% a year. This is clearly shown in Chart 19 where the gold price has gone from R25/oz to R21 181/oz, while in US dollars it has gone from US\$36/oz to US\$1 514/oz.

CHART 19: RAND DEPRECIATION AUGMENTS THE US DOLLAR GOLD PRICE

Nominal gold price/oz in rands and US dollars (1967 – 2019)

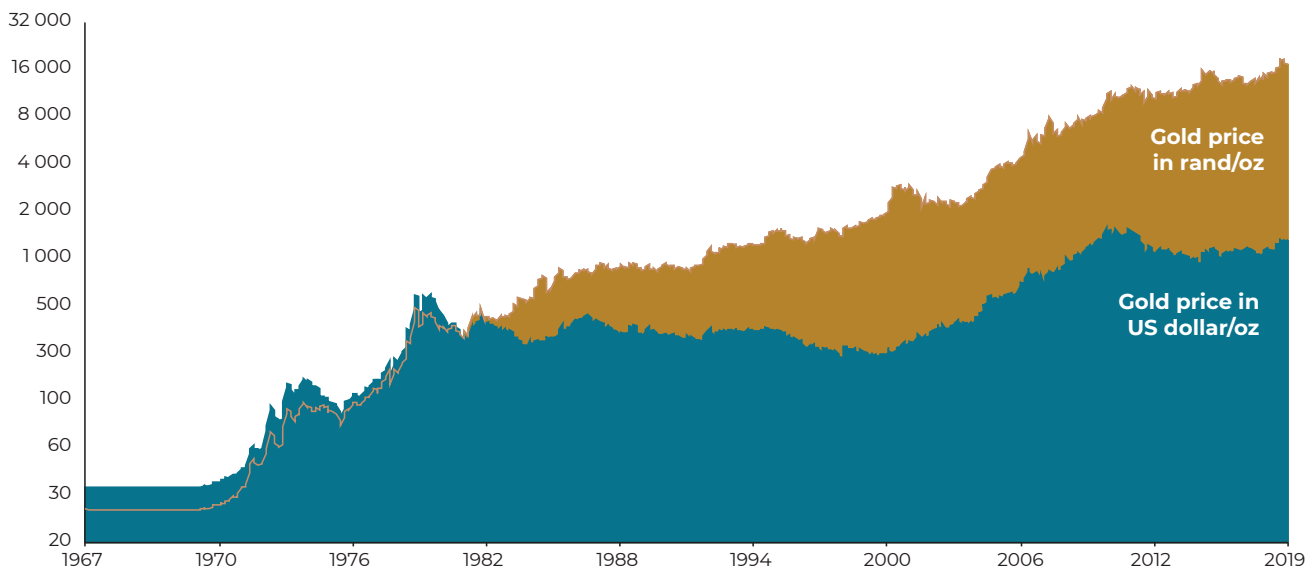


CHART 20: US DOLLAR CONTRIBUTES MATERIALLY TO GOLD'S PERFORMANCE

Nominal gold price/oz in US dollars and the trade weighted US dollar index (December 1992 – December 2019)



GOLD'S ROLE IN A DIVERSIFIED PORTFOLIO

Our optimisation work shows that, historically, the price of gold has a low correlation to the various mainstream asset classes. The tendency for gold to move independently from other markets helps to smooth out the overall volatility of a diversified investment portfolio. From 2004, gold became even easier to access, especially for retirement funds, via the popular NewGold Exchange Traded Fund (ETF). Some R13.6 billion of this ETF had been issued by the end of 2019.

CHART 21: GOLD REMAINS PRECIOUS

Inflation-adjusted gold price in US dollars (1967 – 2019)



The price of gold remains fairly elevated in real terms compared with its long-term history. It is accordingly difficult to motivate good returns for this asset class over the next few years off this relatively high base. Having said that, a major reason for holding gold in a portfolio is to diversify risk and the level of uncertainty on, inter alia, the global geopolitical front has clearly increased in recent times. There will almost inevitably be times when holding gold will be beneficial to investment portfolios over the coming years.

THE RAND

A critically important driver of your investment returns

The rand exchange rate to the US dollar was essentially flat during 2019. This is incredible given all the news flow during the year that, at times, severely impacted the currency. Nevertheless, it went from R14.39/US\$ at the beginning of the year to end 2019 at R13.98/US\$. This flat exchange rate masked the volatility that came from trade wars, worries about the Chinese economy, global recession fears, US dollar strength and local woes of no economic growth, Eskom debt, load shedding, fiscal risks around the deficit and debt ratios, and the lack of confidence in economic reforms. The strongest point during 2019 was R13.27/US\$ recorded at the end of January, while the weakest was R15.42/US\$ in mid-August. As the year progressed and the market accepted that, at some point in 2020, the most likely move from Moody's will be a downgrade in South Africa's credit rating from investment grade to sub-investment grade, markets (including the rand) priced this in.

The exchange rate has a profound effect on investors, given its impact on inflation and that it is used to translate the returns of global assets into local currency returns. Local companies with offshore businesses also have a significant impact on the JSE's earnings.

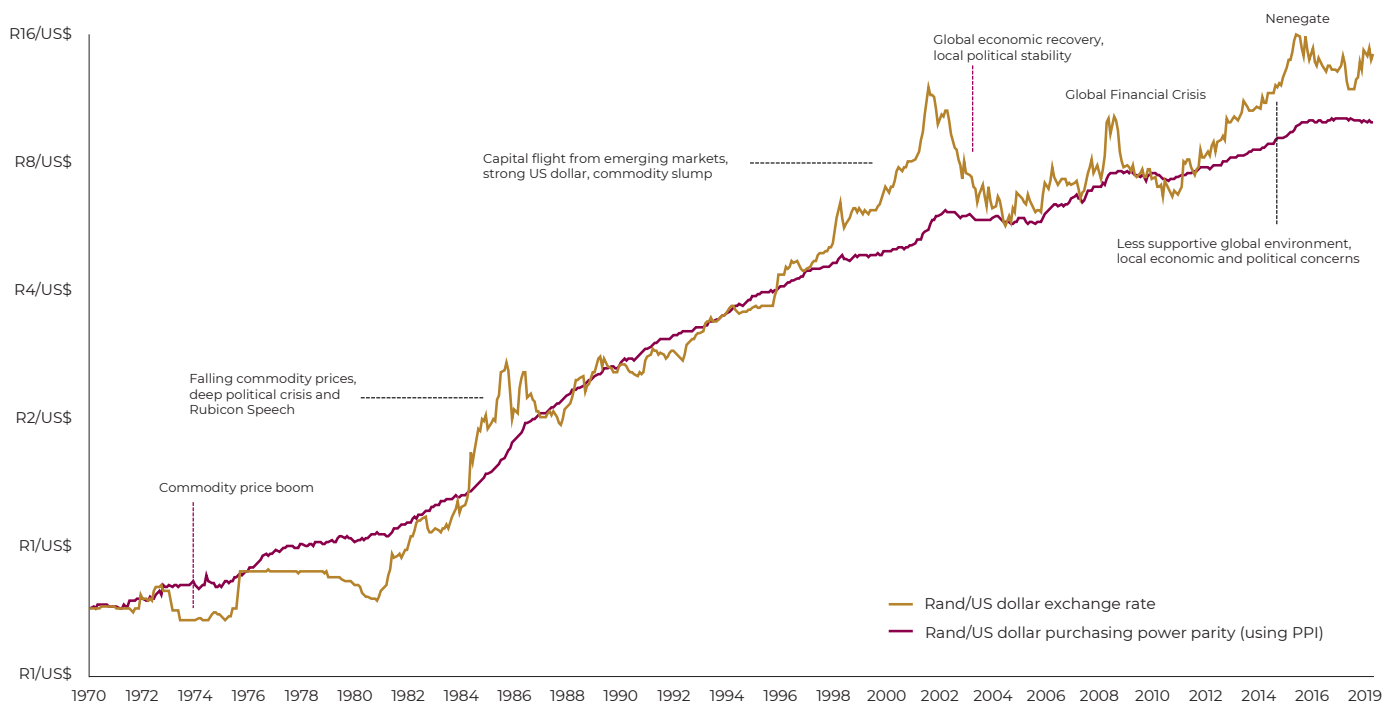
DRIVERS OF THE RAND

The most important fundamental long-term driver of any currency is inflation – and, more specifically, inflation differentials. Structurally higher inflation in one country versus that of its trading partner means that, over time, the currency must weaken to reflect that inflation difference. This difference in inflation rates, or the inflation differential line, is also termed the purchasing power parity (PPP) line. In other words, the exchange rates between two countries are assumed to be equal to the ratio of the currencies' respective purchasing power. The reasoning is simple: relatively higher inflation drives up prices of locally produced goods, making them less competitive globally. So, unless local inflation is brought under control, the currency must weaken for exporters to remain globally competitive.

Chart 22 plots this inflation difference between SA and the US (or the theoretical exchange rate) versus the actual rand/US dollar exchange rate. The PPP line displays the practical impact on the structural weakening trend of the rand, of SA's consistently higher rate of inflation compared with the US.

CHART 22: THE RAND BUFFETED BY A DIVERSITY OF FACTORS

December 1970 – December 2019



The chart also highlights that while the rand follows the broad PPP line trend over time, it can deviate significantly from it, often for extended periods.

Essentially, three things drive these deviations: commodity prices, global capital flows and local issues (often related to local economic and political considerations). It is therefore interesting to note that all the major deviations can be related to any, or a combination, of these three factors.

NOTABLE EVENTS THAT IMPACTED THE RAND

 1985 RUBICON SPEECH	 2008/2009 GLOBAL FINANCIAL CRISIS	 2015 NENEGATE
<p>In August 1985, then President PW Botha was widely expected to announce the unbanning of the African National Congress (ANC). Instead, he failed to “cross the Rubicon” – pledging his commitment to the apartheid system. This caused an already softening rand to plummet.</p>	<p>The Global Financial Crisis (GFC) plunged the world into recession, drying up demand for commodities and causing a flight of capital to US Treasury bonds. The rand lost nearly 40% of its value as it fell from R6.83/US\$ at the end of 2007 to its weakest point of R11.03/US\$ in October 2008.</p>	<p>The rand was already under some pressure from weaker commodities when well-respected Finance Minister Nhlanhla Nene was suddenly removed in December 2015. In just one day the rand weakened 10% as local and global investor confidence declined.</p>

THE BOTTOM LINE

The rand has many influencing forces, of which inflation and global conditions remain the dominant ones. While local economic and political considerations are important, too, they typically tend to accentuate or blunt the driving forces coming from abroad.

For investors, the rand remains a key consideration and, while difficult to predict with accuracy (given the diverse influencing forces), rand views remain a key input in any investment decision.

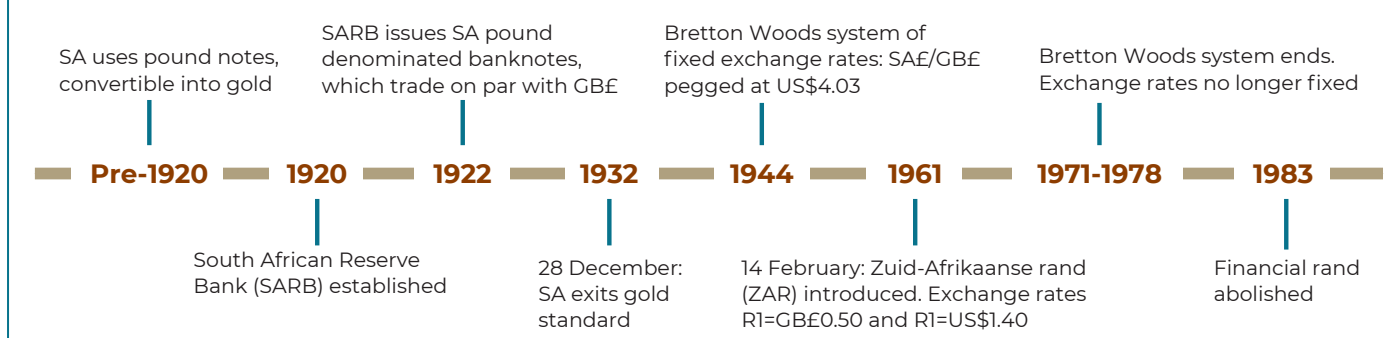
OUTLOOK

From fears during the latter half of 2019 of a global recession coming in 2020, de-escalation of trade war fears and central bank policy support have lifted business sentiment to the extent that not only have recession fears eased, but a mild growth rebound is now expected in the global economy. This, combined with a better emerging market outlook and an expected weaker US dollar during 2020, will bring some support for the rand in 2020.

The rand seems to have priced in all the negatives mentioned above – and some strengthening late

in 2019 probably reflected the somewhat improved global outlook. While the expected Moody's downgrade has likely been fully priced, some short-term knee-jerk reaction is still possible. Combined with the expected confidence-boosting “Winds of Change” environment in South Africa and further fiscal and state-owned enterprise reforms, the rand could potentially be much more stable over the next year or two. This could even include significant strength over the short term. However, the PPP discussion above indicates that over the medium to longer term, the rand will continue on a weakening path as SA inflation will remain higher than that of the US.

A BRIEF HISTORY OF THE RAND





BREXIT



CHINA



USA

GLOBAL ASSETS

Expanding investment opportunities



Global assets remain a key component to your investment solution. However, if these assets become too expensive or the rand becomes too cheap (that is, too weak), then the outlook for good global market returns could shift in favour of local assets.

Global equity has been a preferred asset class for many years. In the past two years, we have become more concerned about the outlook for this asset class – in particular, the US. Valuations are demanding and the fundamentals appear stretched. Global bond yields remain too low in our view. However, it is important that portfolios have the ability to alter the allocation to global assets quickly and efficiently, as required – this is a key advantage of investing via a broad-balanced fund that includes global assets.

2019 was a good year for global assets, as global equity rose sharply and global bond yields moved lower. Several of the major 10-year bond yields dipped into negative territory again.

Given the characteristics of our local market, global assets play two vital roles within a diversified balanced fund: providing exposure to other sources of returns and offering additional protection against volatility.

Fortunately for investors, in 1995 exchange controls were relaxed to initially allow for some exposure (5%) to global assets. Over time, this has increased to 30% (effective February 2018) for retirement funds, with an additional 10% permitted for African investments.

EXPOSURE TO OTHER MARKETS

The South African equity market has developed significantly over time. A mere 30 years ago the equity market was dominated by resources companies and gold miners, in particular. With time, the market has developed, industries have risen and fallen, and companies have come and gone, merged and unbundled. Many local equity names have expanded into other emerging markets or invested in developed markets, such as Europe and Australia. This has meant that their earnings are increasingly impacted by the broader global cycle. Despite these developments, there remains a fair degree of concentration within our equity market and fairly limited choice in some industries. Global investments provide additional avenues for generating returns, as investors are able to access a larger universe of shares, industries, geographies and currencies.

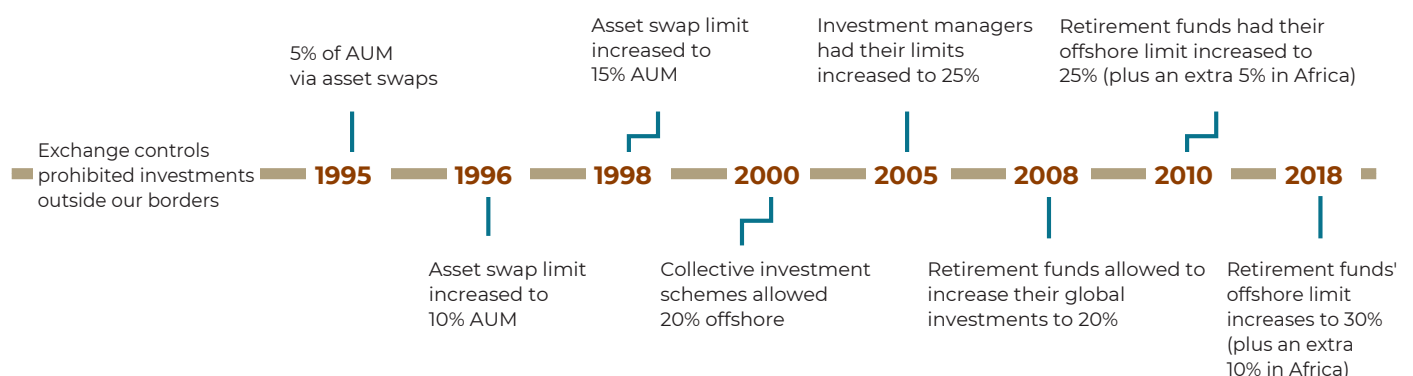
ENHANCED RISK DIVERSIFICATION

Our bond market is still largely driven by our local inflation rate, which in turn is subject to the global cycle via the rand, oil and food prices. Therefore, in times of heightened risk, local bonds offer little protection and may even exacerbate the anxiety already felt in riskier assets.

Due to the nature of some global assets (for instance, US Treasuries) and the behaviour of the rand, global exposure often acts as a more effective diversifier in times of turmoil.

In the subsequent sections we will unpack the two primary asset classes, namely global equity and global bonds, in more detail.

A BRIEF HISTORY OF THE RELAXATION OF EXCHANGE CONTROLS





GLOBAL EQUITY

Alternative source of growth to more risky SA equity

RETURNS IN US DOLLARS (and using US inflation)

REAL RETURNS
+5.8% a year since 1925

NOMINAL RETURNS
+8.9% a year since 1925

+73% **HIGHEST**
annual return (1933)

-40% **LOWEST**
annual return (2008)

RETURNS IN RANDS (and using SA inflation)

REAL RETURNS
+7.7% a year since 1925

NOMINAL RETURNS
+13.9% a year since 1925

+155% **HIGHEST**
annual return (1961)

-49% **LOWEST**
annual return (2002)

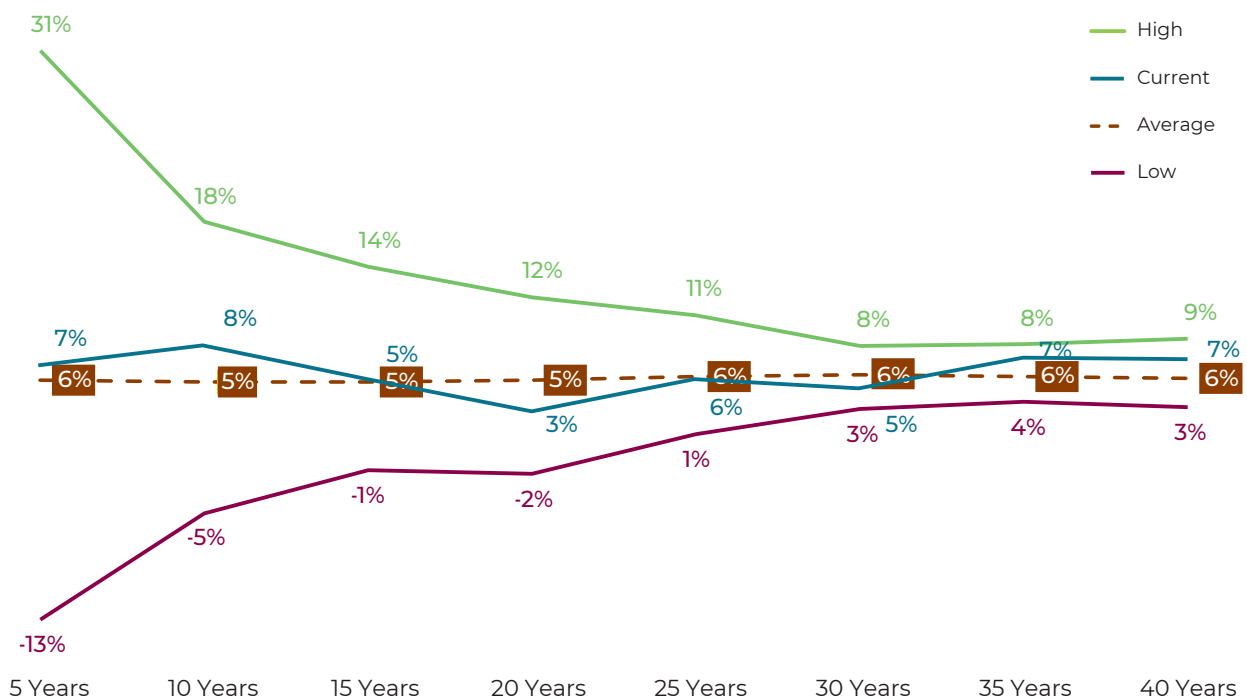
2019 mirrored the past decade as both were a roller coaster of sentiment, political upheaval and market volatility. Three rate cuts from the US Federal Reserve in 2019 turned the tide on negative sentiment and global equity rebounded to end the year with a phenomenal 27% return in US dollar terms. Worth noting is the resurgence of US equity. This comes in stark contrast to the previous decade, which saw the emergence of China as the driver of global returns.

Over the past 95 years, global equities have delivered inflation-adjusted returns of 5.8% a year in US dollar terms and 7.7% a year in rand terms. After a number of years of disappointing returns, the SA equity market has now dropped to also delivering a real return of 7.7% a year over the same period. Prior to this drop, independent studies confirmed the SA equity market to be one of the best investments since 1900.

As with SA EQUITY (page 24), time is your friend when investing in global equity. When compared to the SA market (Chart 15), global equity has almost identical ranges between high and low across all periods. Note that this graph is in real terms. Nominal returns would look much better, as inflation provides a cushion to returns.

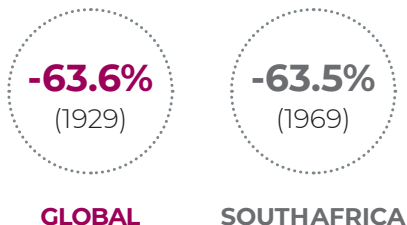
CHART 23: OVER TIME RETURNS BECOME LESS VOLATILE

Range of annualised US dollar real returns from global equities (December 1924 – December 2019)



The market drawdowns in Chart 25 show how important it is to have a global perspective when managing assets and, particularly, understanding risk.

WORST DRAWDOWNS



Comparing global equity to local equity in Chart 25, you can see some major differences in drawdowns:

- The 1929 Wall Street Crash and the resultant Great Depression affected global markets more than the SA market.
- WWII was good for export industries and SA was generally more insulated from the conflict.
- In the aftermath that saw a building boom and recovery in Germany and Japan, SA entered a major bear market.

Investing globally remains a powerful source of diversification and risk reduction.

CHART 24: GLOBAL EQUITY LONG-TERM TREND

Global equities in real US dollar terms (January 1925 – December 2019)

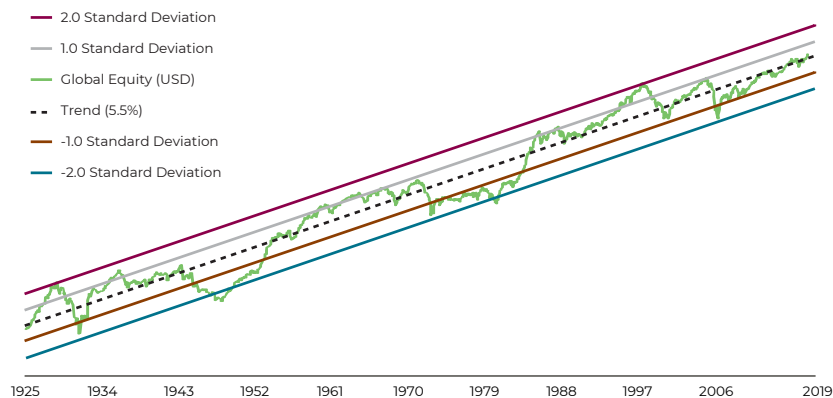
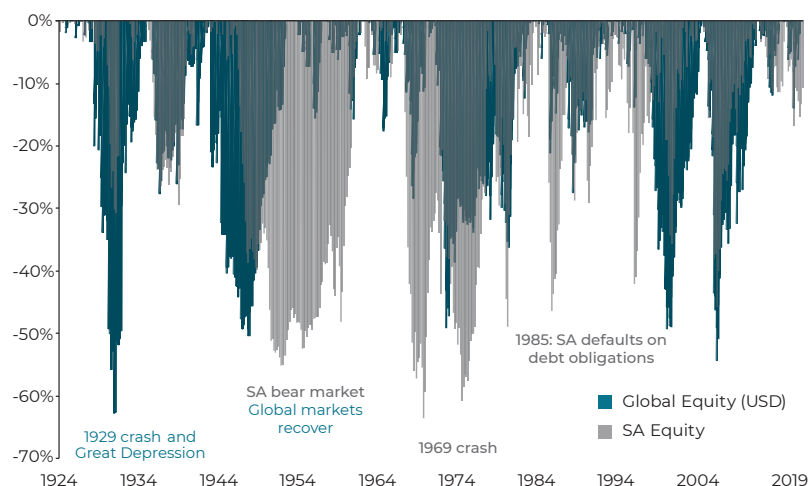


CHART 25: DRAWDOWNS OF GLOBAL EQUITY (US\$) AND SA EQUITY (RANDS)

December 1924 – December 2019



OUTLOOK

For a significant portion of the last decade, the world economy has laboured under the weight of an imbalance between a stronger US economy and a slowing in the rest of the world. The resultant strong US dollar caused financial conditions around the world to tighten.

On the positive side, the “external” shock to the world economy caused by the trade war resulted in global monetary policy being eased. We are also now at a fairly low base, from which it is very likely that manufacturing and trade will rebound, especially as US President Trump looks to do a deal with China to boost his chances of getting re-elected in 2020.

While monetary policy is reaching the limits of its effectiveness around the developed world, it looks as if developed markets may finally achieve some growth and inflation through fiscal stimulus. Looser US monetary policy and better ex-US growth should mean a weaker US dollar going forward, which will give emerging markets some breathing room. While the world should, at least for the first half of 2020, be conducive to equities outperforming, it is unlikely to be anything close to the level experienced in 2019, due to relatively high valuations, particularly in the US.



GLOBAL BONDS

Low correlation to equities enhances global diversification

After peaking in November 2018, developed market bond yields fell during most of 2019, buoyed by a slowdown in global industrial growth and a broad wave of central bank stimulus. Having started 2019 with a yield of 2%, the Barclays Global Aggregate Bond Index ended the year at 1.45%. This was within striking distance of the lows set in 2016. Within major markets, European bond yields are at all-time lows, with Germany overtaking Japan as the torchbearer for negative yields. This drop in yields meant capital appreciation drove returns, delivering nominal returns of 6% for the year. This was well ahead of an inflation rate of 2% in developed markets.

RETURNS IN US DOLLARS (and using US inflation)

REAL RETURNS

+1.4% a year since 1930

NOMINAL RETURNS

+4.5% a year since 1930

+35.9% HIGHEST
annual return (1933)

-24.9% LOWEST
annual return (1945)

RETURNS IN RANDS (and using SA inflation)

REAL RETURNS

+3.4% a year since 1930

NOMINAL RETURNS

+9.6% a year since 1930

+109.5% HIGHEST
annual return (1961)

-24.9% LOWEST
annual return (1945)

Given their diversification benefits relative to equity risk, developed market government bonds are an important asset class. Their correlation to SA equities in calendar year returns (in rands) is effectively 0%, while their correlation to global equities (in US dollars) is 34%.

CURRENCY ENHANCES RETURNS MORE THAN INFLATION

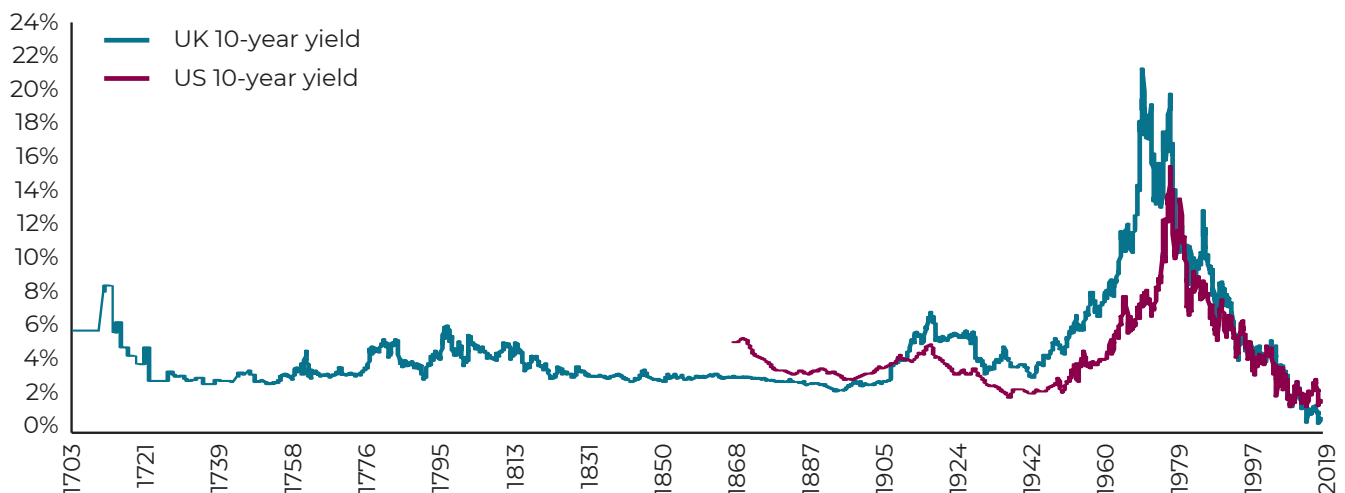
In line with economic theory, most of the difference in US dollar and SA rand returns can be explained by the real depreciation of the currency over and above the inflation differential.

As with SA bonds, the returns on global bonds have gone through very long cycles. The secular pattern of the global bond market can easily be seen by looking at Chart 26, which shows the benchmark UK and US 10-year government bond yields since 1703 and 1871, respectively. These cycles tend to reflect extended periods of high (often war-time) and low inflation, and with it respective monetary and fiscal regimes.

At the time of the peak in the US 10-year bond yield, the federal funds rate came close to 20%, as Chairman Paul Volcker sought to end the decade-long stagflation (high inflation and low growth/high unemployment) that the US had experienced following the post-WWII boom of the 1950s and 1960s. This arguably sowed the seeds for the phenomenal returns delivered by global bonds over the next 30 years, as inflation dropped and interest rates followed –

CHART 26: SECULAR CYCLES OF DEVELOPED MARKET BOND YIELDS

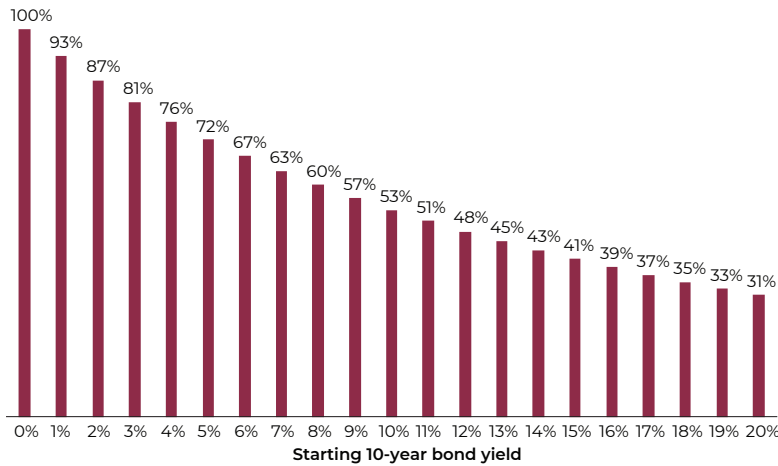
UK & US 10-year government bond yields (1703 – 2019)



allowing global bonds to benefit from cheap starting valuations as well as good capital returns. Similarly, arguments have been made that the actions of the respective US Federal Reserve Chairs after Volcker – Alan Greenspan, Ben Bernanke and Janet Yellen – laid the ground for the next 30-year bond bear market.

CHART 27: CAPITAL CONTRIBUTION TO TOTAL RETURNS FOR DIFFERENT STARTING BOND YIELDS

Percentage of total returns from capital (1925 – 2019)



LOW YIELDS = “RETURN-LESS” RISK

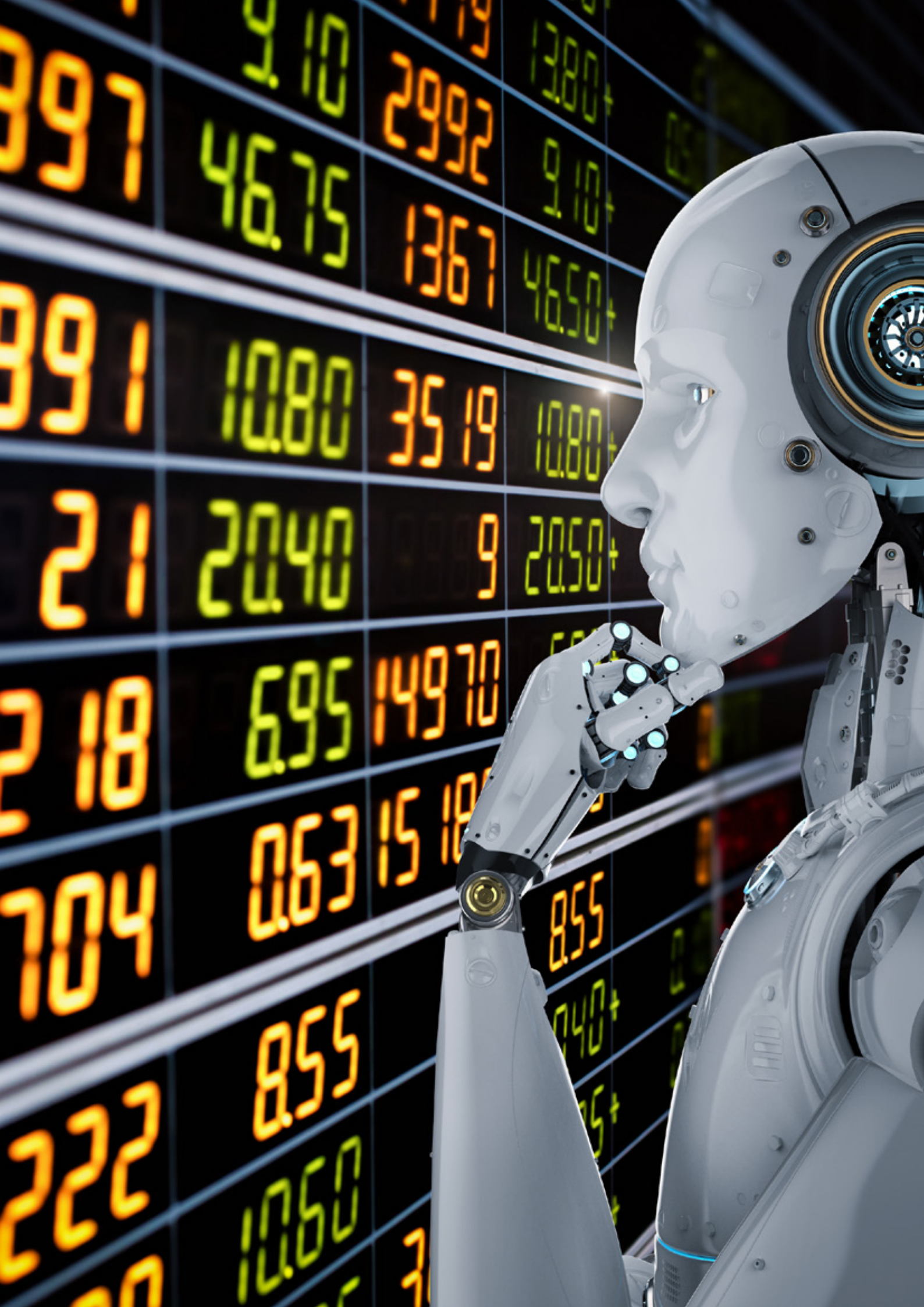
One feature of bonds as an asset class is that, for a given bond, the nature of returns changes materially depending on the starting level of yields. This can be illustrated by looking at what percentage of total bond return comes from capital vs income for a fixed change in yield over a one-year investment period. At extremely low yields, as we stand currently, we can see that upwards of 85% of total returns are likely to come from capital return, or yield curve changes! Combined with a directional bias towards high rather than lower yields (and thus lower prices), it is clear how global bonds at current yields present a good example of “return-less” risk.

The Barclays Global Aggregate Bond Index, our benchmark for global bonds as an asset class, comprises more than just government bonds. The index increasingly includes other significant asset classes, such as global corporate bonds, high-yield debt and emerging market debt. Over the past 10 years, global government bonds have returned 2.1% a year in US dollar terms. Comparatively, global corporate bonds have only offered a small premium to this for, at times, significantly more risk. The greatest beneficiaries of the low interest rate environment have been high-yield debt and emerging market local currency debt, as low developed market sovereign rates have pushed investors further out on the risk spectrum in search of yield. Over the past 10 years, high-yield debt has returned in excess of 7.3% a year and emerging market local currency debt has returned 2.7% a year. Although the latter might seem meagre, it hides what have been distinct periods of material out- and underperformance – indicative of the volatility and currency risk that come with these instruments.

 **OUTLOOK**

Starting from a lower yield than last year, we continue to view the future return prospects of global bonds as bleak. As more bonds move towards and below the 0% level, the reason for owning bonds shifts even further towards capital return investing as opposed to yield. This doesn't mean investors can't achieve positive real returns (imagine a world where prices are deflationary,

that is, falling). However, zero and negative yields on bonds increase the attractiveness of alternative assets that provide similar protection from deflation or diversification, but without the punitive cost. We have thus maintained our longer-term expectations for global bonds to a -1.0% real return a year over the next five years (in US dollars).



LONG-TERM REAL RETURNS (OUTLOOK)

Our asset allocation decisions are partly informed by the macro themes we see playing out over the medium term. Two key themes are likely to dominate local and global asset class performance going forward: The longest expansion cycle in US history is showing signs of slowing and global investors' search for yield will drive them into emerging markets.

While it has been a great decade for the US economy, as reflected in their low unemployment rate, we expect US markets to underperform relative to the rest of the world. As US growth slows, and wages continue to go up, corporate earnings will come under pressure. With US earnings growth likely to remain sluggish in 2020, we are now seeing more value in global equities outside of the US and in SA equities.

The search for returns, and specifically yield, will remain a dominant theme going forward. Almost 20% of the world's total government bond market currently

trades at negative yields and many corporates are issuing negative-yielding bonds. With ultra-low or negative interest rates in developed markets, investors are turning to the higher-risk emerging markets, in search of positive real yields. While a downgrade to junk status is almost guaranteed, South African markets have already priced this in and we expect SA bonds to garner support from global investors' search for yield.

A big factor behind this view is the much higher real return expectations from South African assets. Over the past couple of years, South Africa has been shunned, causing assets to underperform and boosting future returns. Some of these returns are the most attractive we have seen in many years, especially in light of the much lower inflation locally. On the other side of the coin, the strong returns from global assets have reduced future returns.

FIVE-YEAR ASSET CLASS OUTLOOK AS AT 31 DECEMBER 2019 (real returns)

	REAL RETURN (P.A.)	HISTORIC REAL RETURNS SINCE 1930 (P.A.)	VIEW	COMMENT
South Africa			+	South Africa starting to improve
Equity	6.5%	7.2%	Neutral +	Getting cheaper, more opportunities
Property	7.5%	4.7%**	Neutral	Very cheap, but negative theme
Bonds	4.0%	1.7%	+	Good real return even for "junk"
Cash	2.0%	0.8%	Neutral -	Better options elsewhere in South Africa
Global*			-	Still maintain some diversification
Equity	4.5%	5.3%	Neutral -	Pricing in good news = risky
Bonds	-1.0%	1.4%	-	Rewardless risk
Cash	-1.0%	0.8%	-	Rate cuts still to come
MacroSolutions Balanced Index	4.9%	5.8%		

Source: Old Mutual Investment Group | NB: These are long-term, real returns expected over the next five years, as at 31 December 2019

* The international return expectations above are in US dollar terms; any rand depreciation will add to returns in rands.

** Since 1980



ASSET CLASS RETURNS (LONG-TERM OVERVIEW)

REAL RETURNS IN RANDS	YEARLY RETURNS					LONG-TERM RETURNS (P.A.)										RETURNS BY DECADE (P.A.)									
	2019	2018	2017	2016	2015	Last 5 years	Last 10 years	Last 20 years	Last 50 years	Last 90 years	2000-2010	1990-2000	1980-1990	1970-1980	1960-1970	1950-1960	1940-1950	1930-1940							
	2.6%	-12.5%	15.5%	-3.8%	-0.1%	0.1%	4.9%	6.9%	6.8%	7.3%	11.3%	5.9%	5.0%	12.5%	9.3%	0.3%	7.9%	10.1%							
SA Equity	-2.0%	3.1%	5.2%	8.2%	-8.7%	-3.6%	5.4%	10.5%	-	-	16.7%	-1.9%	-3.3%	-	-	-	-	-							
SA Property	6.1%	2.7%	2.7%	0.6%	1.1%	2.6%	3.6%	4.6%	2.0%	1.7%	5.5%	8.5%	-0.8%	-3.9%	0.3%	-1.0%	-1.4%	6.1%							
SA Bonds	3.1%	2.7%	2.7%	0.6%	1.1%	2.0%	1.3%	2.3%	2.0%	0.8%	3.3%	6.0%	1.9%	-2.1%	1.8%	-0.7%	-4.5%	0.9%							
Global Equity	20.0%	2.1%	6.4%	-10.6%	26.8%	8.1%	11.7%	3.6%	6.9%	7.3%	-4.1%	15.5%	13.8%	-0.3%	11.4%	13.1%	5.4%	3.6%							
Global Bonds	-0.9%	10.5%	-7.6%	-16.0%	23.9%	1.0%	3.6%	3.0%	4.4%	3.4%	-0.1%	9.7%	11.8%	-3.9%	7.8%	-0.7%	-2.5%	4.3%							
Gold	10.7%	10.2%	-2.6%	-10.6%	11.8%	3.5%	4.9%	7.1%	5.0%	3.7%	9.8%	-0.8%	-5.1%	19.2%	4.9%	-3.0%	1.3%	5.2%							
MacroSolutions Balanced Index	7.0%	-4.4%	9.6%	-3.8%	5.6%	2.6%	6.1%	6.6%	5.9%	5.8%	8.0%	7.5%	3.4%	8.1%	6.6%	0.0%	4.4%	8.7%							

NOMINAL RETURNS IN RANDS	YEARLY RETURNS					LONG-TERM RETURNS (P.A.)										RETURNS BY DECADE (P.A.)									
	2019	2018	2017	2016	2015	Last 5 years	Last 10 years	Last 20 years	Last 50 years	Last 90 years	2000-2010	1990-2000	1980-1990	1970-1980	1960-1970	1950-1960	1940-1950	1930-1940							
	6.8%	-8.5%	21.0%	2.6%	5.1%	5.0%	10.2%	13.0%	16.3%	13.7%	17.8%	14.9%	20.1%	24.5%	12.5%	3.6%	12.9%	10.0%							
SA Equity	1.9%	-25.3%	17.2%	10.2%	8.0%	1.2%	10.8%	16.8%	-	-	23.5%	6.5%	10.6%	-	-	-	-	-							
SA Property	10.3%	7.7%	10.2%	15.4%	-3.9%	7.7%	8.9%	10.5%	11.1%	7.8%	11.7%	17.8%	13.4%	6.4%	3.3%	2.2%	3.2%	6.0%							
SA Bonds	7.3%	7.3%	7.5%	7.4%	6.5%	7.2%	6.5%	8.1%	11.1%	6.9%	9.4%	15.1%	16.4%	8.4%	4.7%	2.5%	0.0%	0.7%							
Global Equity	24.8%	6.7%	11.4%	-4.6%	33.5%	13.6%	17.4%	9.4%	16.4%	13.7%	1.4%	25.3%	30.0%	10.3%	14.7%	16.8%	10.4%	3.4%							
Global Bonds	3.1%	15.4%	-3.3%	-10.4%	30.4%	6.1%	8.9%	8.8%	13.7%	9.6%	5.7%	19.1%	27.8%	6.4%	11.0%	2.5%	2.1%	4.2%							
Gold	15.1%	15.1%	2.0%	-4.6%	17.7%	8.7%	10.2%	13.2%	14.4%	9.9%	16.2%	7.7%	8.5%	31.9%	8.0%	0.2%	6.0%	5.1%							
MacroSolutions Balanced Index	11.3%	-0.1%	14.7%	2.6%	11.1%	7.8%	11.6%	12.6%	15.3%	12.1%	14.3%	16.7%	18.2%	19.6%	9.8%	3.2%	9.3%	8.5%							

REGULATORY INFORMATION

Sources: Except where an alternative source is referenced on a specific graph, all graphs have been produced by MacroSolutions, acknowledging the following sources of external data: FactSet, I-Net Bridge, Colin Firer, Bloomberg, BNP Paribas Cadiz Securities, Bank of America Merrill Lynch, Credit Suisse, JPMorgan, Citigroup, Barclays and Deutsche Securities.

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