The darkest hour is just before the dawn[1]

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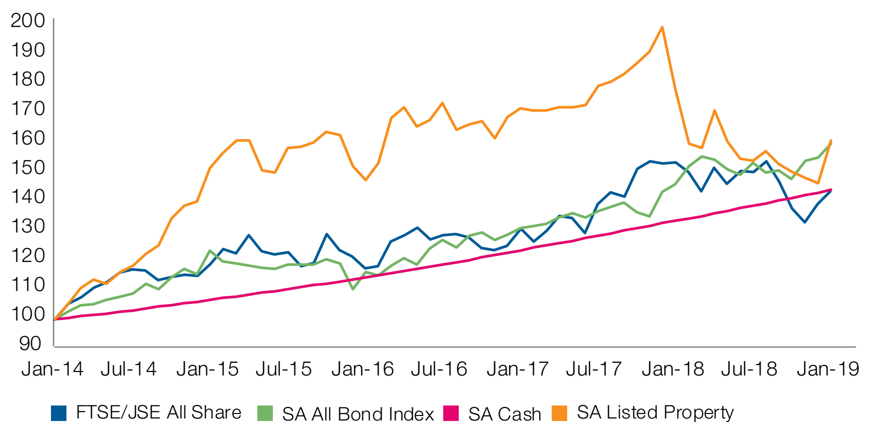
Investors are questioning why they should not simply switch to cash.

Following five years of disappointing returns from listed property and equities, as evidenced in the following performance graph, many investors are questioning why they should not simply cut their losses and switch to cash. Investor anxiety was further exacerbated following the worst December for US equities (down more than 9%) since the Great Depression!

Figure 1: SA asset class cumulative returns for the 5 years to 31 December 2018



Source: Bloomberg

Factors contributing to these disappointing market returns included:

- Rising US interest rates, resulting in both reduced liquidity and a higher discount rate, thereby reducing the present value of a company's future cash flows.
- A policy shift from globalization to protectionism, with President Trump seemingly intent on sparking a trade war.
- In South Africa, while we got a new president, a mild recession dampened the Ramaphoria-rally.
- Domestic interest rates were cut in March 2018 only to be raised again in November.
- Several unfortunate corporate events: the Steinhoff aftermath, MTN's troubles with the Nigerian authorities, the Resilient group of companies shaking the foundation of the property market, Tencent dragging Naspers down, Tiger Brands and its polony-induced crisis, and tobacco stocks going up in smoke.

[1] The English theologian and historian Thomas Fuller appears to be the first person to commit the notion that 'the darkest hour is just before the dawn' to print. His religious travelogue *A Pisgah-Sight of Palestine And the Confines Thereof*, 1650, contains this view.

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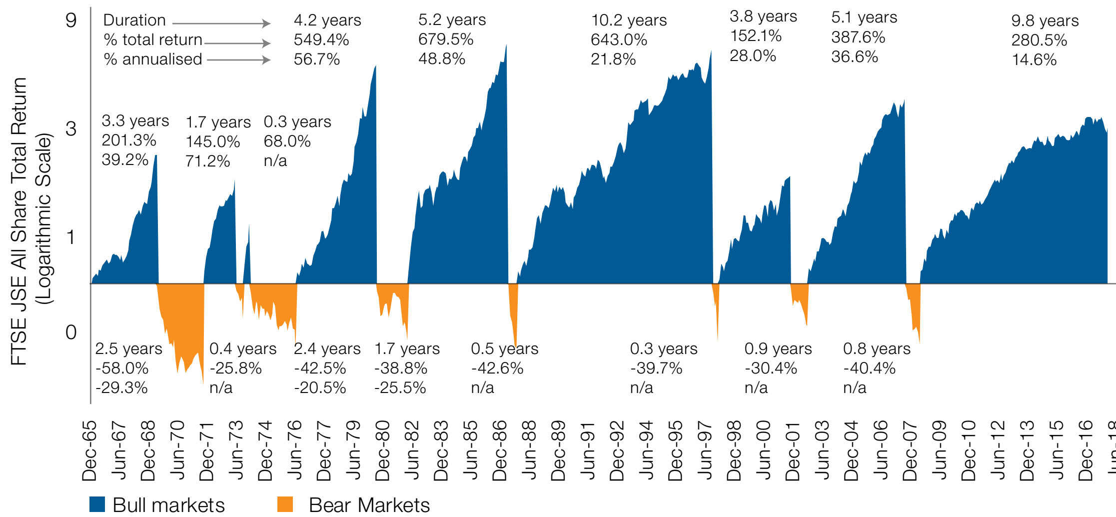
So, while commentators may inform us that we are only four months away from South Africa's longest equity bull market, it certainly doesn't feel like it.

The following slide shows the history of South Africa's bear and bull markets since 1965.

Figure 2: History of SA bear and bull markets since 1965



Bull

From the lowest close reached after the market has fallen 20% or more, to the next market high

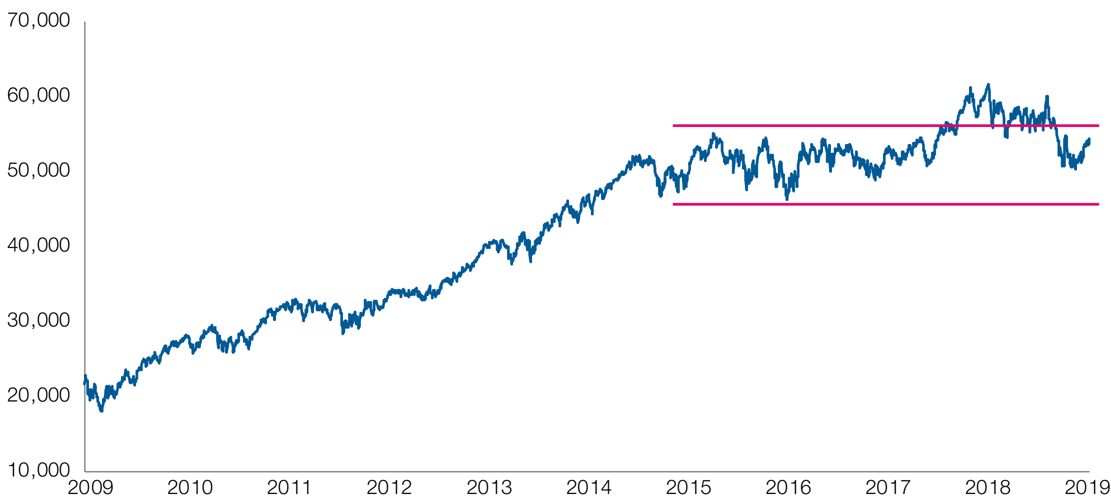
Bear

From when the index closes at least 20% down from its previous high close, through the lowest close reached after it has fallen 20% or more

Source: Bloomberg, Deutche Bank and Investec Asset Management as at 31.12.18

It is clear that the almost ten years' annualised return of 14.6% is far more tepid than previous bull markets, with much of this return front-end loaded. In fact, South African equities have mostly drifted sideways over the past five years, which is clear below:

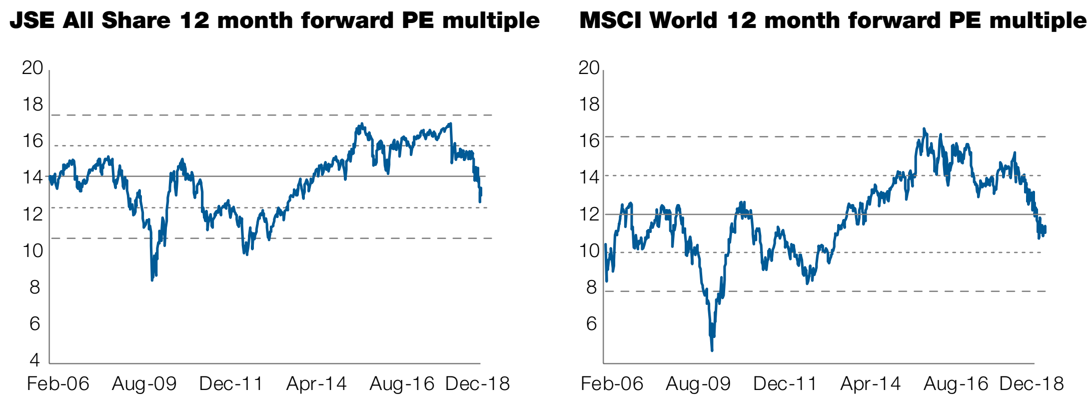
Figure 3: SA equities have been rangebound for almost 5 years



Source: Bloomberg to 31.01.19

Importantly though, last year's -8.5% SA equity market performance, coupled with positive earnings growth from many companies has made our equity market (and global markets for that matter) more reasonably priced, as is evident in figure 4.

Figure 4: Equity valuations are reasonable



Source: Bloomberg, Investec Asset Management, 04.01.19

Remembering that "the return you get depends on the price you pay", today's lower prices mean that the probability of inflation-beating returns from SA equities has risen.

Other than valuations, what else has changed?

- The US Federal Reserve appears to have backed off from its interest rate hiking cycle, having previously telegraphed several 25 basis points rate hikes in 2019, and reset expectations to zero. This has halted the strong march of the US dollar and reinvigorated emerging market assets.
- Donald Trump has toned down his trade war rhetoric (perhaps with an eye on the upcoming US elections and his desire to serve a second term) and hinted at a reconciliation with China.
- In South Africa, upward inflation pressure appears non-existent, suggesting that the November 2018 rate hike is likely to be the only hike in this rising interest rate cycle, the obvious risks to this view being a depreciating rand and a rising oil price.
- As an aside, our relatively low inflation rate is likely to be positive for South African bonds, which are currently yielding a real return of approximately 4%, making them an attractive asset within multi-asset and inflation-plus portfolios, particularly as there is scope for interest rates to fall.

However, investors cannot be ignorant of potential risks, which include slowing global growth, rising recession risk in the US, a hard Brexit (and Corbyn-led UK government), populist policies and, closer to home, Eskom and government finances. Importantly though, these risks are broadly understood by most market participants and more fully reflected in asset prices.

Where to from here?

So, while cash has been the best place to hide over the past three years, in a stable or even falling interest rate environment it is unlikely to deliver the after-tax real returns required by most investors to meet their financial planning goals. Therefore, most investors' needs may be best served by a broad-based multi-asset fund such as the Investec Opportunity Fund, where the fund manager can exploit all the levers available to him to deliver inflation-beating returns over the long-term.

In fact, in a recent interview in Taking Stock[2], Clyde Rossouw, portfolio manager of the Investec Opportunity Fund, encourages long-term investors not to become despondent. He goes on to say: "I know we have had three years of very muted returns and investors may be tempted to turn to cash. We believe it is a good time to sow the seeds for future returns from growth assets."

[2] Sowing the seeds for future growth, Taking Stock Summer 2019

"What's encouraging for us is that the investment environment has become more favourable to pursue attractive real returns over the long term. To summarise: we still like SA bonds; we're seeing much better value in local equities; and we expect continued growth opportunities offshore. So, from an asset allocation perspective, we have identified several drivers of returns that should help us to deliver inflation-beating returns over the long term."

Following several years of disappointing negative real returns from most growth asset classes we are closer to the dawn. While it may not quite be 5am, it is clearly no longer 8pm!

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P20190212_3507398T