August downturn makes SA equities even cheaper – The South African 12 September 2019

With a -2.4% return in August from the FTSE/JSE All Share Index (ALSI), South African equities are now even cheaper and more attractive for investor portfolios.

August's drop was due largely to external factors, such as further investor concerns over global growth due to an escalation in the US-China trade war and growing signs of slowdowns in the EU and China.

At the same time, we saw some local developments also weighing on market sentiment and the rand. These included worries over the government's growing National Budget deficit on the back of both a larger revenue shortfall than expected and higher spending on bailing out Eskom and other SOEs, as well as longer-term spending on the new National Health Insurance (NHI) plan.

The likelihood of a Moody's sovereign credit rating downgrade also rose. SA equities have performed poorly for some five years now, recording a return of only 4.7% per year for the five years to the end of August 2019 (ALSI). This compares to the historic annual average of around 13%, or 7% above inflation.

And while this has put significant pressure on investors wanting solid capital growth above inflation, it also means that our equity market is currently very cheap: investors should take advantage of the good value on offer.

Using a 12-month forward price-earnings (PE) valuation measure, for example, at 30 August 2019 the FTSE/JSE Capped SWIX Index was trading at only 11X including Naspers, or 10X excluding Naspers. It was last at such a low level in early 2009 as the market was recovering from the Global Financial Crisis.

Meanwhile, the overall market's dividend yield as of the end of August was approximately 5%, attractively high compared to history. Should all things remain the same with no increase in the PE, based on our analysis, Prudential estimates equities are priced to deliver a return of around 9% above inflation over the next three to five years.

However, if the market PE rises back to its historic long-term average and company earnings growth doesn't disappoint, then it could offer an even higher return over the longer term.

Of course we don't know how or when these prospective returns will materialise, only that, based on its past performance over decades, the equity market should offer excellent returns from these current valuation levels over the long term.

It's important for investors not to be dissuaded by the negative sentiment currently prevailing; they should instead increase their exposure to equities where their risk profile allows.

This would be especially true for those who switched to cash from growth assets earlier in the current downturn. Some investment options for those with a lower-to-medium level of risk tolerance would include low-equity multi-asset unit trusts like the Prudential Inflation Plus Fund, which has a 40% exposure limit to equities.
For those with medium-to-high risk tolerance, the Prudential Balanced Fund with up to 75% in equities could be appropriate.
As an active investment manager, we have been taking advantage of the downturn to buy well-valued stocks (and other assets) for these funds, making them well positioned to take advantage of any improvement in equity markets, both in South Africa and offshore.

If you aren't already investing with us, contact your financial adviser or our Client Services Team on 0860 105 775 or at query@prudential.co.za.