momentum

Smooth Bonus Report

Third Quarter 2016

With us the safest distance between two points is also the smoothest

Dear valued investors

Looking back over the past quarter

Global markets continue to provide excitement. In the last quarter the talk was all about whether Britain was going to leave the European Union (EU), dubbed Brexit, and any global contagion that may result. Brexit materialized and we saw a sharp decline in global markets with a subsequent recovery. In Britain, a number of monetary stimulus measures were implemented and together with a weakened pound has caused growth to surprise on the upside. However, the true impact will only be known over the medium to long term and it is still uncertain as to whether Britain leaves on easy or hard terms. EU leaders are increasingly taking a firm stance on Brexit, raising the risks of a so-called hard Brexit event.

Meanwhile in the EU, authorities have implemented the 'Junker Plan', which aims to double investment by stimulating infrastructure spending and boosting growth in small & medium enterprises in an effort to underpin growth. Over in the US there have been solid job gains and the labour market is showing signs of nearing full employment. As such, the chances of an interest rate increase by the US Federal Reserve in December have strengthened.

In South Africa (SA), there has been growing public unrest in response to headlines alluding to political interference. Consequently, markets have reacted to negative news stories, including the Public Protector's investigation into state capture, the #FeesMustFall debate, rising factionalism within the ANC and the National Prosecuting Authority's investigation into Finance Minister Pravin Gordhan, to name but a few. The ratings agencies are waiting in the wings deciding on whether to downgrade SA's sovereign rating. Over the last quarter, we had the local government elections with the ANC going into them with 62% of the total vote and control over 7 of the 8 major metros. They emerged from the elections with only 53.9% of the total vote and control over just 3 of the 8 major metros.

Nevertheless, SA's economy is very much driven by global sentiment. The rand, along with other emerging market asset classes, has benefited from global capital flows chasing higher yields.

Over the last quarter both global and local markets have been flat with the rand appreciating against the US dollar. There has been a marginal rise in market performance over the last year.

Herman van Papendorp and Sanisha Packirisamy from Momentum Investments provide further market and economic commentary on page 12.

Smooth Bonus Portfolios

Our smooth bonus portfolio range is positively funded. Members benefit from exposure to growth assets while receiving protection on benefit payments at a time where continued volatility and uncertainty in the economy is expected. The range continues to provide exposure to growth assets for members, while protecting downside risk.

Most of our portfolio solutions are exceeding their performance benchmarks. This is as a result of positive performance over the long term and the effective use of our risk management measures. While all the solutions are positively funded, funding levels have reduced to be closer to 100% and in the short term, volatile and uncertain asset returns may dampen the outlook for bonuses, i.e., in the short term bonuses may fall below the long term average. In markets where returns are potentially low and volatile, the focus shifts more to managing the protection provided to policyholder benefits.

At the end of July the Momentum Capital Plus portfolio was closed down and is no longer featured in this quarterly report.

Warm regards

Steed Duncan-Smith

Client Relationship Manager
MMI Corporate and Public Sector

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MTBPS 2016: Additional taxes and spending cuts used to negate weaker growth impact on fiscus

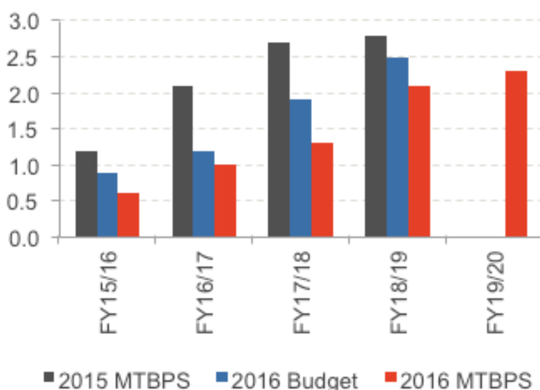
by Herman van Papendorp and Sanisha Packirisamy

Sharper focus needed on structural impediments holding back the SA economy

In its 2016 Medium-Term Budget Policy Statement (MTBPS), South Africa's National Treasury unsurprisingly revised its estimates of real GDP growth lower to around 1.5% p.a. between the current fiscal year (FY2016/17) and FY2018/19, from 1.9% projected at the tabling of the February 2016 National Budget (see chart 1). The downward revisions to growth were largely attributable to domestic structural constraints and persistently low confidence levels related to elevated political risk clouding the direction of economic policy. In addition, excessive debt levels, a less commodity-intensive growth model in China and a rise in non-mainstream political parties have translated into an uncertain outlook on global economic growth. As such, muted commodity prices and stagnant global trade activity stemming from a tepid global backdrop are constraining the outlook for economic activity in SA.

Although Treasury's estimates of growth in real economic activity in SA are only marginally higher than our own, we see further downside risks to growth in nominal terms (and hence fiscal revenues) given our more bullish view on inflation. Treasury anticipates an average headline inflation rate of 6.1% between 2016 and 2018. Our embedded forecasts, that incorporate relative currency strength over the corresponding time horizon (due to an expected mild uptick in commodity prices) and lower food inflation (in 2017, in particular), point to potential downside inflation risk of around 0.5%.

Chart 1: Treasury downwardly revises real GDP growth forecasts (%)



Source: National Treasury, Momentum Investments, MTBPS = medium-term budget policy statement

However, Treasury did allude to the potential bottoming out in cyclical GDP growth. It noted that additional sources of energy supply, a recovery in agricultural production following the drought (an additional R533.3 million has been provided for drought relief), an acceleration in exports and tourism receipts, as well as a reduction in strike action, all point to a recovery in GDP momentum. That said, Treasury acknowledges obstacles to achieving a higher rate of trend growth, which it notes has likely fallen from above 4% in 2012 to below 2%. Infrastructure bottlenecks, a lack of competition in key markets, a volatile labour relations environment, regulatory constraints, inefficiencies at state-owned enterprises (SOEs) and policy uncertainty were cited as the main stumbling blocks to achieving a higher growth trajectory. Treasury warns that a stable debt path will be difficult to sustain at the current level of expenditure, even if no new policy initiatives are taken, should real GDP growth remain stuck below 2% over the longer term.

Although Treasury acknowledged the importance of improving the policy environment, particularly in the fields of mining, immigration and communications, unfortunately no new detail around labour reform or the Mineral and Petroleum Resources Development Amendment Bill was revealed.

Disappointing growth results in fiscal slippage

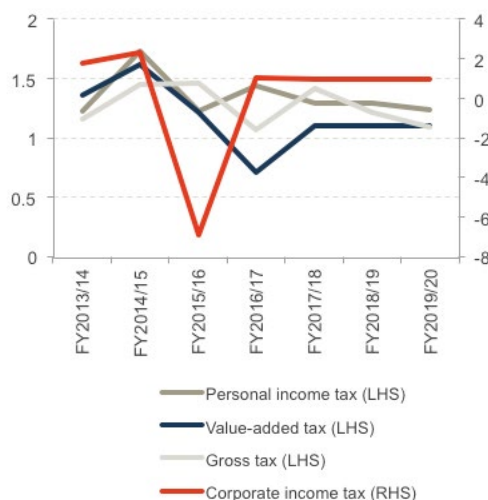
Subdued economic activity has resulted in a widening of the FY2016/17 budget deficit from 3.2% of GDP estimated in February to a revised 3.4%. Further out, the deficit is expected to be 0.3% wider than the previously anticipated 2.4% share of GDP in FY2018/19. An increase in the revenue share of GDP from 29.7% in FY2016/17 to 30.4% by FY2018/19, accompanied by a stable expenditure share of GDP at around 33% over the same time period, ensures a narrowing of the fiscal deficit and a stabilisation in the debt profile over the medium-term horizon.

Sluggish growth has led to a shortfall in revenue collection for the first half of the current fiscal year, leading Treasury to cut its FY2016/17 tax revenue assumption by R22.8 billion. Personal income tax revenue was revised down by R12.5 billion, while projected value-added tax (VAT) receipts were cut by R7.9 billion. This is a reflection of increased consumer vulnerability on the back of elevated household debt burdens, rising food costs eroding real wages, muted credit growth and a depressed jobs market. In contrast, corporate income

tax has performed better than expected thanks to higher provisional tax from the mining sector (no doubt related to rebounding commodity prices), resulting in a R2.5 billion upward revision by Treasury for FY2016/17.

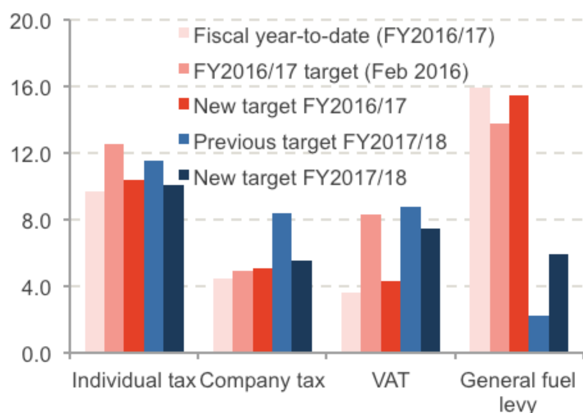
Tax revenue buoyancy, which describes the relationship between tax collection and economic growth, has averaged 1.25 since FY2010/11, implying that for every 10% growth in nominal GDP, 12.5% growth in revenue collection could be achieved. However, with moderate average wage settlements, declining wealth gains, anaemic employment growth, a rising likelihood of less tax relief being granted, weak import demand and the probability of rand strength, there is a risk that personal income tax and VAT buoyancy rates could decline by more than Treasury's assumptions over the medium term (see chart 2). Lower nominal growth assumptions (7.5% over the medium-term framework versus 8.2% estimated in the February 2016 National Budget) and a reduction in tax buoyancy ratios have led Treasury to downwardly revise its revenue growth targets for the three largest revenue sources, namely personal income tax, company tax and VAT (see chart 3).

Chart 2: Tax buoyancy ratios (actual and projected)



Source: National Treasury, Momentum Investments

Chart 3: Revenue targets adjusted lower (%)



Source: National Treasury, Momentum Investments

In an effort to avoid a low-growth trap, Treasury proposes a balanced solution to fiscal consolidation, including a number of additional tax policy measures (R28 billion in FY2017/18 and R15 billion in FY2018/19, including the proposals announced in the National Budget earlier this year), as well as a further cut in the expenditure ceiling (R20 billion in FY2017/18 and R31 billion in FY2018/19, including the proposals announced in the National Budget earlier this year). In our preview of the 2016 MTBPS, we outlined a number of possible additional tax measures that could be announced in the February 2017 National Budget to bolster revenue growth. These include:

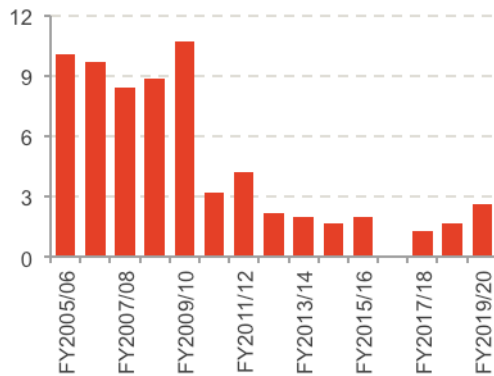
- An increase in wealth-related taxes (Macquarie estimates a doubling of the estate duty tax and an increase in the dividend tax rate from 15% to 20% could generate an additional R2.3 billion and R9.1 billion a year, respectively, while PwC estimates that a new band taxing those earning above R1 million at a rate of 45% could add an additional R5 billion to revenues).
- A 1% tax increase across the board, but sheltering low-income earning brackets (PwC estimates this could add an additional R10 billion to revenues).
- An additional general fuel levy (particularly given that fuel prices are currently around 7.5% lower than levels two years ago).
- Limiting relief for fiscal drag (countering the effects of inflation on personal income tax) – government generated an additional R6.6 billion in revenues in the February 2016 national budget by only providing relief (including medical tax credits) to lower income brackets.
- Tax on sugar-sweetened beverages expected to come into effect in 2017 (Treasury's deputy director general estimates a R4 billion in additional revenues).
- An environmental tax on emissions of carbon dioxide – Treasury intends to implement this tax in 2017, initially in a revenue-neutral manner (i.e. shifting rather than increasing the tax burden potentially to sectors that are already under pressure).

Expenditure ceiling lowered to mitigate fiscal risk

Government's self-imposed expenditure ceiling has been reduced by a further R51 billion, including the proposals outlined in the February 2016 National Budget. Non-interest expenditure is set to grow at an average real rate of 1.4% between FY2016/17 and FY2019/20 (see chart 4). In an effort to adhere to the expenditure ceiling, government has reprioritised spend and accommodated expenditure deviations via the contingency reserve (unallocated funds used to accommodate changes to the economic environment or to meet unforeseen spending pressures).

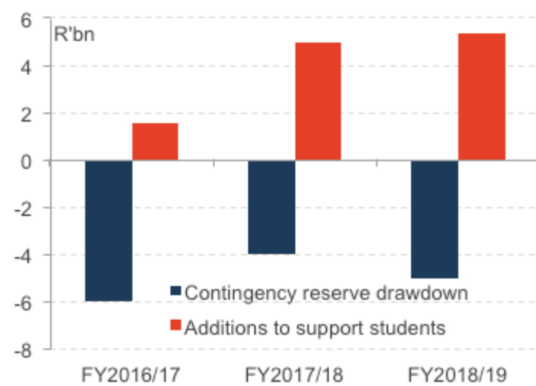
This time around, the contingency reserve drawdown (R6 billion in FY16/17, R4 billion in FY2017/18 and R5 billion in FY2018/19) was partly used to fund the revenue shortfall experienced in the current fiscal year, as well as to supplement an increase in subsidies for university students over the medium-term framework (see chart 5).

Chart 4: Real growth in non-interest expenditure (% y/y)



Source: National Treasury, Momentum Investments

Chart 5: Drawdown in contingency reserve funds



Source: National Treasury, Momentum Investments

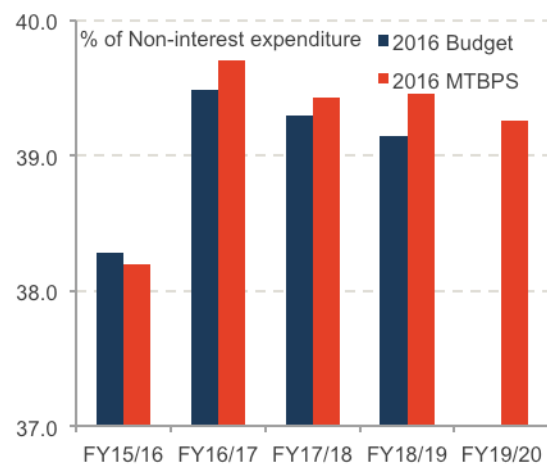
Government announced that it will fund the increase in tertiary fees (up to 8%) for the 2017 academic year. This includes a R9.2 billion allocation to the National Student Financial Aid Scheme, R7.8 billion in support for students from households earning less than R600 000 per year and additional funds (R0.5 billion) for technical and vocational education and training colleges. Treasury noted in its fiscal risk statement that a zero percent university fee increase in 2018 would likely result in a shift of resources from other priorities towards higher education.

Treasury has reiterated that any unforeseen spending pressures would result in the composition of spending changing, rather than an upward revision of the expenditure ceiling. Similarly, wage bill pressures are likely to be funded from non-core goods and services or from capital budgets. However, the reduction in capital budgets may not necessarily be growth-negative, given that infrastructure underspending has amounted to 5% of published infrastructure budgets in FY2015/16 on a national government level and 19% at the local government level.

Despite a cumulative R7.8 billion cut in the government wage bill between FY2016/17 and FY2018/19, employee compensation (as a share of non-interest expenditure) inched higher relative to estimates in the February 2016 National Budget (see chart 6). The current multi-year wage civil servant agreement expires in March 2018. If a CPI-related deal is concluded between government and public-sector workers, the clamp down on public sector hiring may be eased, allowing for an increase in resources.

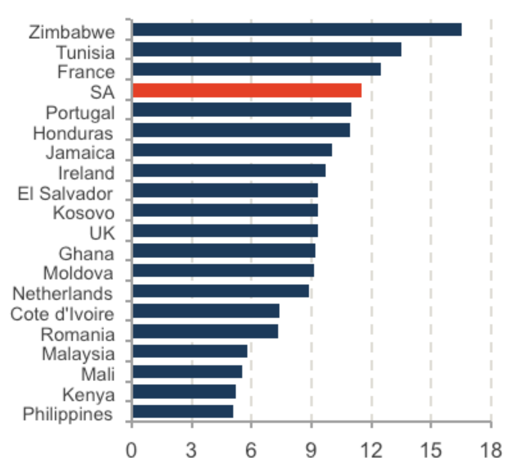
Nevertheless, judging from the consistent underestimation of the public sector wage bill, against a setting of solid public sector unionisation and a proposal for a national minimum wage, we expect that the public sector headcount with have to continue being monitored closely.

Chart 6: Government wage bill



Source: National Treasury, Momentum Investments

Chart 7: Government wage bill (% of GDP)



Source: IMF, Momentum Investments

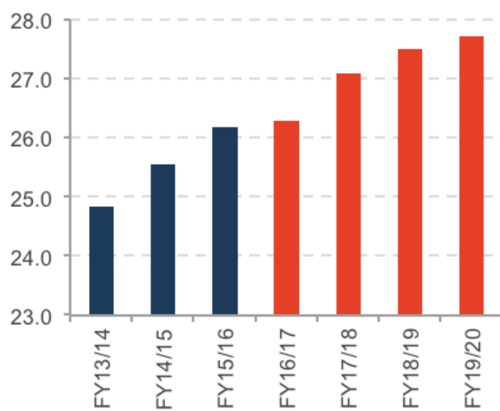
SA's tax burden set to climb

In the absence of growth-enhancing structural reforms, SA will struggle to exceed or even return to its historical trend growth rate of 3.1%. A low-growth environment poses a threat to fiscal consolidation and debt stabilisation, particularly

given the sticky nature of SA's expenditure. The number of social grant recipients has ballooned from 2.5 million in 1998 to nearly 17 million today and is set to grow further to 18.1 million by FY2018/19. Similarly, wage demands still account for a sizeable share of the non-interest expenditure bill. At 11.5% of GDP, SA's bloated civil servant wage bill ranks as the fourth largest (behind only Zimbabwe, Tunisia and France) in an International Monetary Fund (IMF) case study on managing government compensation and employment (see chart 7). The IMF warns that the level of wage settlements in SA's public sector ranks above the median country, while the size of the public sector work force is slightly smaller than that of the median country in the study. As such, SA's bloated public sector wage bill is attributable to excessive wage settlements rather than the number of people employed. Both of these spending pressures are tough to reverse in a struggling growth environment. As such, additional tax measures are inevitable, in our view.

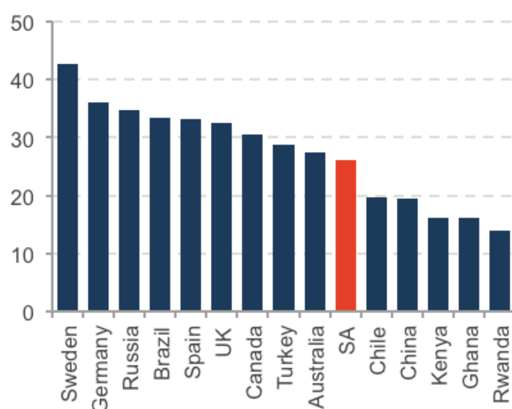
SA's tax burden is set to climb from 26.2% currently to 27.7% by FY2019/20 and could likely rise over the longer term as government struggles to meet fiscal consolidation and debt targets. Relative to other economies, government views SA's tax burden as being roughly between that of developed and emerging countries (see chart 9).

Chart 8: Tax-to-GDP ratio edging higher (%)



Source: National Treasury, Momentum Investments

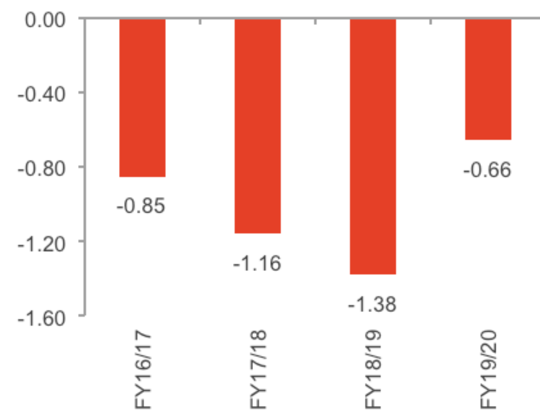
Chart 9: Tax burden in selected countries (%)



Source: National Treasury, Momentum Investments

The rising tax burden accompanying fiscal consolidation implies that the budget is removing spending power from the economy on a net basis between FY2016/17 and FY2019/20 and as such can be construed as contractionary for the economy. Furthermore, the fact that spending growth (averaging 7.1% p.a. between FY2016/17 and FY2019/20) is expected to lag revenue growth (averaging 8.2% p.a. over the corresponding period) also implies a net drain on economic activity (see chart 10) over the medium term.

Chart 10: Revenue growth expected to outstrip expenditure growth over the medium term (%)

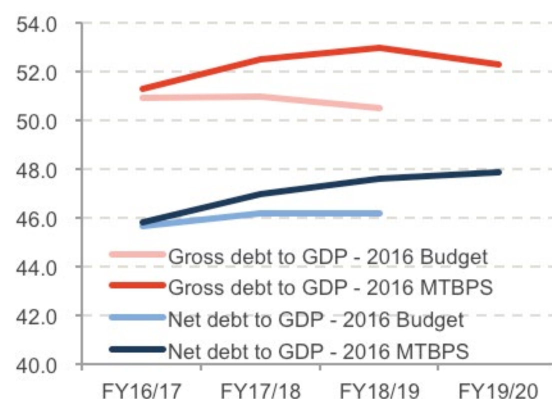


Source: National Treasury, Momentum Investments

Onerous debt costs crowd out more preferable forms of expenditure

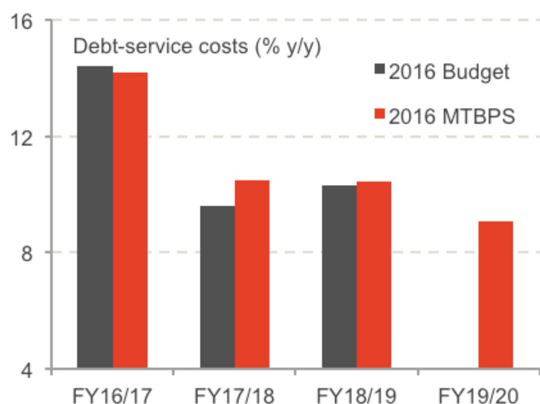
Nearly 12 cents of every rand of state revenue goes towards debt-servicing costs. Due to the increase in government borrowing (see chart 11), debt-servicing costs are expected to remain the fastest-growing expenditure item between FY2016/17 and FY2019/20, increasing at an average rate of 11.0% y/y p.a. (see chart 12). The rapid rise in debt-servicing costs is crowding out other (social and growth-enhancing) spending priorities and has been raised as a key concern by the rating agencies in the past.

Chart 11: Deterioration in government debt profile (%)



Source: National Treasury, Momentum Investments

Chart 12: Fastest growing spending category



Source: National Treasury, Momentum Investments

Borrowing requirement revised slightly higher in FY2016/17

The borrowing requirement has increased by R8.6 billion in FY2016/17. Government expects to increase net issuance of short-term loans from R25 billion to R40 billion to finance the higher budget deficit in the current fiscal year. The increase takes short-term debt as a share of total domestic debt to 11.2%, relative to a strategic benchmark of 15%, implying that short-term refinancing risk remains reasonably low. Although the share of long-term debt as percentage of fixed-rate and inflation-linked bonds (at 14.9%) remains low relative to a 25% benchmark, government remains committed to their bond-switch programme that aims to exchange short-term for longer-term debt. Government raised an additional USD2.3 billion in (new) foreign loans in September, which takes the foreign debt share of total government debt to 9.3%, well short of the 15% benchmark.

No update on longer-term spending projects

Little new detail on longer-term projects, including the National Health Insurance (NHI) plan and nuclear energy, was disclosed, except to confirm that an additional R9 million would be allocated to the NHI grant and that while the nuclear power initiative will be led by Eskom, every effort would be made to ensure that procurement arrangements are transparent. Although Eskom's revised projections show that cash reserves are likely to exceed R150 billion in ten years' time, there is still a significant risk, in our view, that the need for government support may increase, raising fiscal risks in the long term.

New national procurement legislation bodes well for the fight against corruption

The Office of the Chief Procurement Officer (CPO) aims to improve efficiency of spend and eliminate opportunities for corruption. The introduction of a Public Procurement Bill in April 2017 could empower the CPO to review transactions across the public sector and conduct audits. The CPO has also driven an initiative to renegotiate contracts with airlines, hotels, software suppliers and property owners in an effort to curb wasteful expenditure amounting to an expected (but slightly ambitious, in our opinion) R25 billion saving per year by FY2018/19.

Cost-containment measures have seen some success since their implementation in December 2013. In real terms, government spend on non-essential goods and services has fallen by 7.7%, including a 12.6% cut in consultant fees, a 5.1% drop in travel and subsistence costs and a 5.0% decline in catering and venue expenditure.

Sovereign foreign currency rating downgrade may be delayed until June 2017 in the absence of any further political shocks

While a commitment to the expenditure ceiling and achieving a primary budget surplus (excludes interest costs) could stave off a foreign currency rating downgrade in December by Standard and Poors Global Ratings (S&P), reduced fiscal flexibility will more likely than not lead to a narrowing of the current two-notch gap between SA's local and foreign currency ratings by the next review (2 December 2016). This would still leave SA's local currency debt rating at two notches above junk status. Exclusion criteria for the Citibank World Government Bond Index require SA to lose its investment grade status on its local debt by both S&P and Moody's (which currently rank local and foreign debt at two notches above the investment grade threshold).

S&P has previously warned that a downgrade of the foreign currency rating could materialise as a result of weaker than expected growth, a further decline in wealth levels (in US$ terms), a weakening of institutions and a delay in structural reforms (in the labour, mining and SOE sectors) as a result of political interference or a further rise in SA's net debt and guarantees ratio to GDP above 60% over the next three years.

Even though the medium-term budget showed a commitment to fiscal austerity, lukewarm economic growth prospects (in the absence of structural reform or another commodity price boom) over the medium to longer term will likely struggle to keep up with population growth, leading to a minimal recovery in overall living standards and social inequality. As such, we still see a reasonably high likelihood of SA downgraded to sub-investment grade by S&P over the next nine months as sluggish GDP growth poses a risk to fiscal consolidation and debt stabilisation in the medium term.

Although a kneejerk reaction by the currency is likely in the event of a downgrade to junk, JPMorgan suggests that rising country risk has a smaller impact on SA equities. Investec research implies that SA's five-year corporate default swap spreads (which gauge country risk) are more than fully discounting a downgrade to below investment grade, while ten-year government bond yields suggest that a downgrade has been fully priced in by the fixed-income market. That said, it is unlikely that markets are pricing in much more than a one-notch downgrade at this stage, although we assume a downgrade to sub-investment grade to trigger a strong response from government to prevent a negative debt and credit ratings spiral.

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Retirement Reform

By Yusraa Gamiet

According to the National Treasury, Retirement reform is a process whereby government, through policies, seeks to:

- Encourage employees to save and provide adequately for retirement. This is to ensure that they retire comfortably and have income that lasts throughout their retirement years;
- Encourage employers to provide retirement saving plans for their employees as part of the employment contract;
- Enable employees to receive good value for money in respect of their retirement savings;
- Ensure that employees are treated fairly, and that their savings are prudently and diligently managed; and
- Improve standards of retirement fund governance, which include trustee knowledge, conduct, and the protection of members' interests.

In this article we feature frequently ask questions, to assist stakeholders in understanding how the retirement reform will impact them.

Frequently Asked Questions

How will the retirement reform benefit workers?

Workers will be encouraged to save through retirement funds, and will be able to provide for their own retirement. In essence this should limit or reduce old-age poverty, seeking financial assistance from relatives and the dependency on the Older Person's Grant.

What are the economic implications of retirement reform?

The National Development Plan acknowledges the importance of higher savings and investments in promoting economic growth in the country. At an individual level, retirees will increase their chances of a financially better life in retirement.

Proposals on pre-retirement preservation

What is preservation?

Preservation is when money saved for retirement through pension, provident and preservation funds remain in those funds until the person retires, or is rolled over into another similar retirement savings vehicle without incurring taxes or penalties on withdrawal due to resignation or retrenchment.

What is Government's proposal on preservation?

Government is proposing partial preservation only in respect of new contributions that come into the retirement system after new legislation comes into effect. Limited withdrawals will be allowed and accumulated savings on the date of implementation of legislation will not be affected.

Why is Government encouraging preservation?

People tend to change jobs a number of times in their working lives. Every time an employee changes employment, they cash in their accumulated retirement savings, thereby retiring with insufficient retirement benefits. Cashing in before retirement also prematurely erodes security in old age, undermines the alleviation of chronic poverty and increases reliance on others.

Will preservation affect all retirement funds?

Yes. Preservation will apply to all provident and pension funds, with accumulated savings not being subject to restricted withdrawal rules. Retirement annuity funds already have a preservation element in that policyholders cannot withdraw from the fund until they are 55 years old.

When will preservation come into effect?

No date has been set for when the preservation regulation will come into effect. There are still outstanding policy decisions on the exact and final nature on the preservation rules. At this stage preservation is still a proposal which is open for public comment and debate. Before any form of preservation comes into effect, a white paper will be made available for public comment before being passed into law.

Alignment of provident and pension funds

Which reforms are related to provident funds?

Government is aligning the benefits of provident funds to those of pension and retirement annuity funds at retirement. This means that provident fund members will be required to convert at least two thirds of their retirement savings into an annuity or pension when they reach retirement, instead of a once-off large sum of cash. Furthermore, members of provident funds will also enjoy the same tax deduction on their own contributions as currently applied to contributions by pension fund members, enabling them to potentially take home a slightly higher monthly salary. Similar to a pension and retirement annuity funds, tax will apply on the income received in retirement. This delay before tax is paid on savings will be positive for the investment growth.

How will I be affected by the new legislation on provident funds?

The effect of the alignment between provident and pension funds will not affect provident fund members who are currently close to retirement. The conversion of a portion of the retirement money into income at retirement will only apply to new contributions made by those who are younger than 55 when the new rules come into effect. This means that members who are 55 years and older, when the new rules come into effect, will not be affected. They will therefore still be able to take new contributions made after the new rules as a cash lump sum in retirement. Furthermore, workers who are below 55 years, when the new regulations come into effect, will not be asked to annuitise or take a pension on the portion of new contributions if the total of those new contributions is less than the R150 000 threshold when they reach retirement. Irrespective of age, whatever a member has accumulated in the provident fund as at implementation date of the regulation, will be available to them as a cash lump sum when the person retires.

What happens if I am a member of a provident fund and want to access my money upon resigning?

Provident fund members will be able to take all their retirement savings as a cash lump sum upon resignation before implementation date with tax implications, or to preserve it with a financial institution, or old or new employer. Preservation of the savings will have no immediate tax implications.

Why is Government aligning provident fund benefits with those received from pension and retirement annuity funds?

To help retirees from provident funds to better manage longevity risk (i.e. the risk of outliving your retirement savings when in retirement) and prevent them from spending their retirement assets too quickly and becoming excessively reliant on the Government or their families for support.

Will I be affected by the alignment if I am contributing to a pension fund?

No. There will not be any changes for those retiring from pension funds. The pension fund status quo will remain in terms of the annuitisation requirement (i.e. drawing an income when one retires). Whenever a member resigns from a company, before the normal retirement date, any accumulated balances up to when the preservation reforms come into effect will not be affected and can be withdrawn as per current rules.

Is Government going to take away or deny me access to my money?

No. There is no intention by Government to nationalise workers' pension/provident funds, or to prevent them from accessing their money. Instead, Government is proposing important measures to encourage workers to keep their savings until retirement, and to convert some of these funds into income at retirement. Workers should therefore not panic and resign to access their pension savings.

How do the reforms affect me if I take early retirement or get disabled or deceased?

If a member takes on an early retirement, becomes disabled or dies the respective benefit will be paid out in accordance with the rules of the fund.

Where can I find information about the retirement reform?

Information can be obtained from the National Treasury website:

http://www.treasury.gov.za/publications/RetirementReform/

Retirement reform is an ongoing process. There is still a long way to go before we see its full effect, however the primary themes of promoting preservation and saving more for retirement are a step in the right direction.

Yusraa Gamiet

Actuarial Specialist
ISCoE: Structured Solutions

Momentum Investments market commentary for the quarter ending Sept 2016

by Herman van Papendorp and
Sanisha Packirisamy

Global 'hunt for yield' driving asset class returns

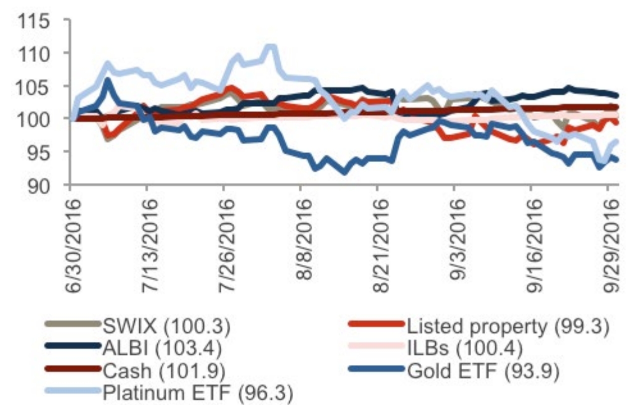
Against the backdrop of diminishing returns available from global developed market (DM) fixed-interest investments (close to 40% of DM sovereign bonds are now negative yielding), investors have been forced to scour the globe for better-yielding investments. As such, prices of global equities, as the superior income-producing investment, have been bid up vis-à-vis global bonds. Similarly, higher emerging market (EM) bond yields have attracted significant foreign interest during 3Q16, culminating in stronger EM currencies. SA bonds also received fundamental support from indications that localc interest rates are close to their peak in anticipation of lower local inflation during 2017.

During the quarter, global equities strongly outperformed global bonds and cash, while a 7% stronger rand eroded returns from all rand-sensitive asset class returns, including global asset classes and the gold and platinum exchange-traded funds (ETFs). SA bonds were the strongest local asset class performer, with local cash providing decent low-risk returns in 3Q16.

Not only do global equities still provide investors with favourable growth prospects over time, they also provide much better near-term income flows than the traditional income-producing asset classes like bonds and cash, in Momentum Investments' view. Furthermore, equities also have the added advantage of much more attractive valuations than the latter, further enhancing potential future relative returns from equities. Indications that policy makers might soon be forced to use fiscal stimulus levers would be fundamentally negative for global bonds. As such, Momentum Investments has a strong preference for global equities over global bonds and cash in its portfolios. Some expected rand weakness in the next year in response to political and sovereign rating downgrade risk should add to the returns on global asset classes for SA investors.

Although the local equity market's earnings recovery is very much dependent on the sustainability of the commodity price rally, less expensive valuations now point to decent future returns, in Momentum Investments' view. The company considers local bonds to have an attractive risk/return profile against the backdrop of the ongoing global carry trade and an improving envisaged local inflation and policy rate profile. Momentum Investments' view that the inflation risk premium currently discounted by inflation-linked bonds remains too high makes the company still favour vanilla bonds over inflation-linked bonds in its portfolios.

Chart 1: SA asset class returns in 3Q16 (indexed)



Source: INET BFA, Momentum Investments

Recent underperformance from listed property has meaningfully improved its future return prospects, in Momentum Investments opinion, particularly against the backdrop of an improved local bond market outlook. Although risk-adjusted local cash returns currently still look decent in a low-return environment, re-investment risk should increase going forward, as the local rate cycle peaks.

Reforms vital for global growth to structurally shift gears

The share of the global population experiencing flat or falling incomes has surged in advanced economies. McKinsey's Global Institute report, 'Poorer than their parents', outlines that the positive (global) trend in income has ended. As recently as between 1993 and 2005, 98% of advanced economies (sample of 25 countries) saw real incomes rise.

However, real market incomes (comprising wages and income from capital) for over two-thirds of households in those same economies were either flat or deteriorated in the decade that followed.

Though a reduction in taxes and increased government transfers were aimed at protecting household incomes, lower investment returns, a smaller share of GDP ending up in the hands of workers, a demographic shift towards fewer working-age adults and sluggish growth in output and demand have negatively affected median household incomes.

The study found that less-educated workers, especially younger ones, have been hit the hardest. The International Labour Organisation (ILO) calculates that 37% of the global unemployed in 2014 were youth (aged 15 to 24) with the rate of global youth unemployment settling at 13% between 2012 and 2014. The ILO warns that there "could be lingering harm accruing to the cohorts who experienced long-term unemployment spells", which may result in economic and social disruption further down the line.

Recent government regimes have failed to remedy the protracted period of real income stagnation suffered by the majority, which has given rise to far-right, anti-establishment and populist parties. Anti-immigration and anti-globalisation movements have also gained support in line with shifting global cultural trends. Global Trade Alert points out that world export volumes plateaued in January 2015. Policy initiatives harming foreign commercial interests in 2015 outnumbered trade liberalisation three-to-one, revealing a rise in protectionist political rhetoric.

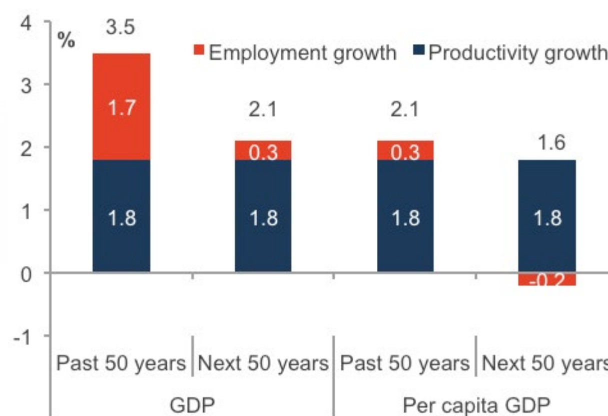
With economic prosperity slipping globally, free-market capitalism has come under fire. Support for previously unthinkable ideologies has mushroomed, as few mainstream political movements are deemed to provide an attractive alternative to a disgruntled electorate who has become frustrated with the current leadership holding political office. As a result, with political uncertainty climbing, a populist, anti-establishment Trump victory in the US presidential election cannot be ruled out.

Moody's Analytics warns that Trump's proposed changes to immigration and trade policies would result in a more isolated United States (US) economy. They conclude that the implementation of Trump's economic policies would diminish the nation's growth prospects (2.4% decline from peak to trough), resulting in higher unemployment (3.5 million fewer jobs than under current economic policies). Government deficits are likely to widen (close to 10% of gross domestic product (GDP)) under a Trump presidency, worsening the country's debt burden (climbing to 95% of GDP), while his tax proposals would likely see no improvement in living standards for the average American family.

International Monetary Fund (IMF) managing director, Christine Lagarde, recently warned that further reductions in global growth potential and more obstacles to the free movement of goods and capital would prove detrimental to all. She urged G20 leaders (representing countries that account for 85% of global GDP and 75% of global trade) to make a stronger case for the benefits of trade and suggested that those "harmed by trade and innovation need to be helped by policies to allow them to retrain and acquire new skills and job mobility".

Global potential growth faces additional headwinds. McKinsey reasons that productivity growth would have to accelerate by 80% from its historical rate to fully compensate for weakening labour growth (a function of declining population growth). If productivity growth remains at 1.8% (the average pace over the past 50 years), the rate of GDP growth is set to be 40% lower than the 3.5% average recorded over the past 50 years (see chart 2).

Chart 2: Demographic headwinds impede global GDP growth



Source: McKinsey, Momentum Investments

Maintaining the long-term growth rate in productivity may prove to be challenging given that productivity growth has slid across advanced economies for the past decade. Although there is an argument to be made that the rise in the digital economy has not been adequately accounted for, regulatory barriers, rising protectionism, little growth in innovation and slowing investment (as a result of a misallocation of capital) have dragged productivity growth lower.

McKinsey proposes encouraging business expansion, labour market reform and upskilling the labour force to rekindle economic activity and support job creation. Innovation has also proven to be key in advancing social mobility through the creation of new firms and additional employment opportunities.

US Federal Reserve (Fed) Chair, Jane Yellen, has echoed these sentiments, calling for more investment, education, training and entrepreneurship to reverse the slowing trend in productivity growth.

Meanwhile, entrepreneurship has waned in key economies. The percentage of young (under five years) firms as a share of total firms in the US has dwindled from c.50% in 1980 to 37% in the latest available data for 2011, accounting for a quarter of total employment from a third previously. This could be partly

blamed on the lack of adequate fiscal action by politicians, forcing central banks to pump excessive stimulus into the global economy. The response from the financial industry has been a change in focus from lending to speculation in a low interest rate environment, evident in the price of real investments plunging to its lowest level on record relative to financial investments.

McKinsey argues that it is possible to counter waning demographic tailwinds to safeguard living standards. Removing barriers to competition, increasing efficiency in regulated sectors, incentivising research and development, investing in digital and physical infrastructure, promoting labour market flexibility and opening up economies are some of the ways the global economy can reinvigorate growth.

EM looking more attractive on a cyclical basis

Market forecasts are generally predicting an era of much lower investment returns during the next decade. According to the Financial Times, more than 30% of global government debt offers yields of less than zero. As such, the search for higher yields has forced more conservative investors into riskier asset classes. Between March and September 2016, total portfolio inflows into EM netted R117 billion, relative to R6.5 billion for the same period the year before.

Meanwhile, fundamentals are looking better across EM. The growth differential between EM and DM peaked in 2009 at 6.4%, but has since narrowed to 2.1% in 2015. Plunging commodity prices, since topping out in early 2011, partly drove the declining gap between growth outcomes in EM compared with DM as net commodity-exporting countries suffered from depreciating currencies, rising inflation, low revenue growth and weak global trade activity.

However, economic prospects for net commodity-exporters appear to be bottoming out in response to firmer currencies since the beginning of the year, coinciding with a 9% uplift in commodity prices for the same period. Growth in retail sales in the worst-performing regions (Latin America and Emerging Europe) is back in positive territory for the first time in a year. Similarly, the deceleration in growth in EM exports has slowed from a trough of 29.7% in August 2015 to 13.5% in June 2016.

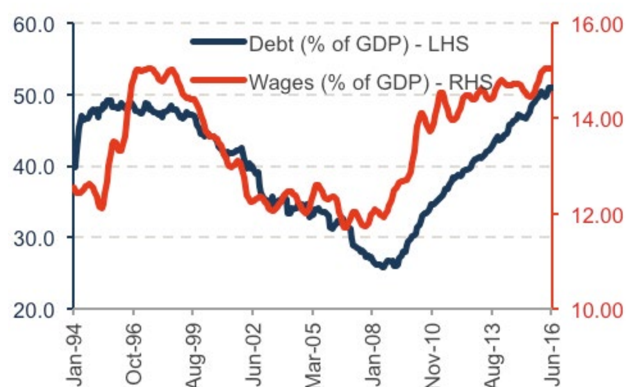
With minor negative post-Brexit revisions to growth in EMs and cuts being concentrated in DM, Momentum Investments expects the differential in GDP growth outcomes between EM and DM to widen in 2017. Nevertheless, rising protectionist measures, slow progress on reforms and financial vulnerabilities continue to weigh negatively on longer-term EM growth prospects. World Bank President, Jim Yong Kim, has emphasised the need for fiscal and structural reforms to sustain long-run growth and inclusive development in developing nations.

Urgent structural policy initiatives still unresolved in SA

The relationship between political instability, governance and economic outcomes has become increasingly tangled globally, with SA being no exception. Policy incoherence and a lack of policy implementation threaten the country's ability to achieve growth higher than 1.5% to 2% over the longer term.

A significant welfare burden that aims to alleviate poverty by providing free basic services and employment is not the only challenge facing fiscal consolidation. The public sector wage bill has swelled from 11.7% of GDP in late 2007 to 15% in March 2016. This has contributed to a weakening in government finances from a 0.7% surplus in the government budget balance as a share of GDP in late 2007 to a 5.5% deficit in the third quarter of 2010, only partly reversing to a 3.4% deficit by mid-2016. Net government debt as a share of GDP has climbed from a mid-2008 low of 25.6% to just below 50% in June 2016 (see chart 3). Once adding provisions, guarantees and contingent liabilities, SA's public debt burden rises to just below 70% of GDP.

Chart 3: Ballooning wage bill is a risk to SA's debt burden



Source: National Treasury, MRB Partners, Momentum Investments

In 2014, the IMF recommended that SA's net debt-to-GDP ratio should be kept below 40% to be able to absorb shocks that increase the fiscal borrowing requirement. Achieving fiscal consolidation through revenue and expenditure measures is likely to have a negative effeact on output. The IMF proposes more growth-friendly fiscal consolidation through a reorientation of spending toward investment or implementing reforms that can boost potential growth.

Securing greater flexibility in SA's labour markets should be a high priority on government's reform agenda. Discussions regarding a national minimum wage, a secret strike ballot, the banning of dangerous weapons during strikes and compulsory advisory arbitration have been underway for some time now. Credit rating agencies, including Standard and Poor's (S&P), that rate SA on the lowest investment grade rung with a negative outlook, are looking for an imminent conclusion to negotiations between government, the private sector and labour in this regard.

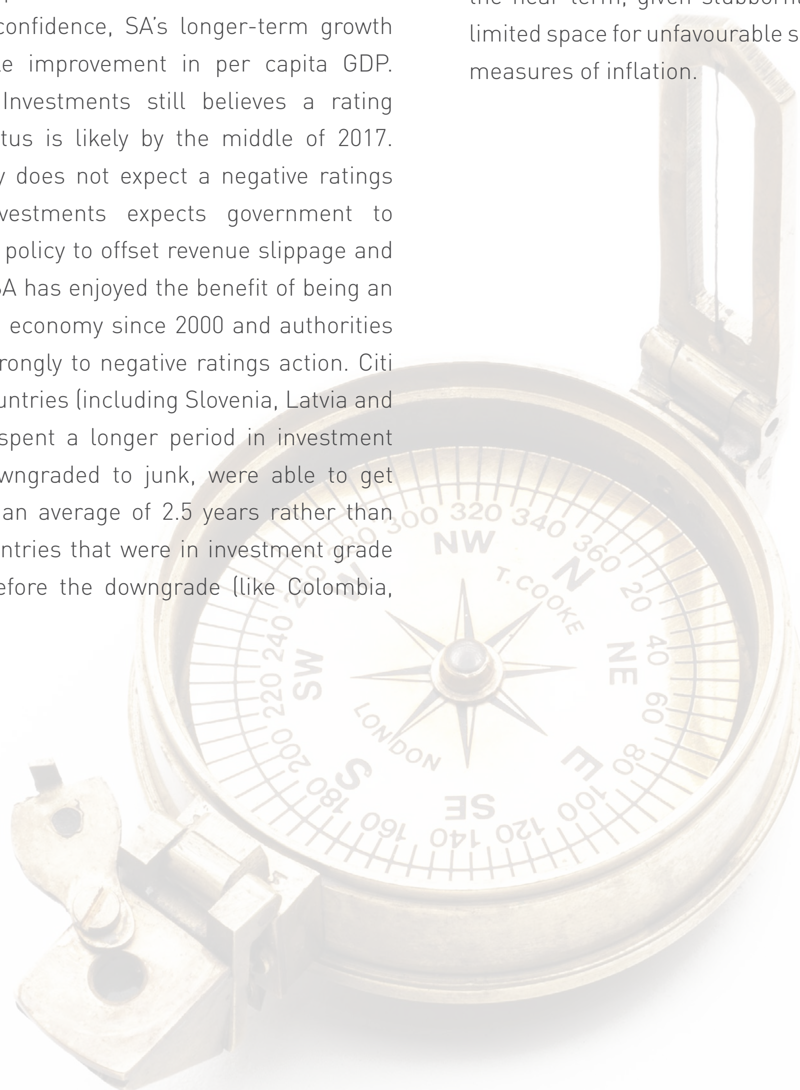
S&P has also warned against "periodic disputes between key government institutions and within the ruling party". To the

extent that political interference affects government's policy framework, a downgrade to sub-investment grade could become a reality sooner rather than later.

A low growth environment and a burgeoning civil servant wage bill have reduced fiscal flexibility in Momentum Investments' view, which is expected to lead to a narrowing of the two-notch gap between S&P's local and foreign currency ratings.

With the implementation of economic reforms dragging out and preventing a sharper rebound in domestic business and external investor confidence, SA's longer-term growth potential suggests little improvement in per capita GDP. As such, Momentum Investments still believes a rating downgrade to junk status is likely by the middle of 2017. That said, the company does not expect a negative ratings spiral. Momentum Investments expects government to react with tighter fiscal policy to offset revenue slippage and improve debt metrics. SA has enjoyed the benefit of being an investment-grade rated economy since 2000 and authorities are likely to respond strongly to negative ratings action. Citi research shows that countries (including Slovenia, Latvia and Thailand), which have spent a longer period in investment grade before being downgraded to junk, were able to get upgraded again within an average of 2.5 years rather than 12.5 years of those countries that were in investment grade for a shorter period before the downgrade (like Colombia, Uruguay and Turkey).

While the rand remains vulnerable to negative political shocks and sovereign downgrade risks in the next year, the medium-term outlook remains more favourable on higher EM growth and a rebalancing in the current oversupply of commodities. This is likely to aid a further deceleration in inflation in addition to lower food prices as better planting conditions are forecasted. Though the SA Reserve Bank has started to signal that SA is approaching the end of the current interest rate hiking cycle, the hurdle for interest rate cuts remains high in the near term, given stubbornly-high inflation expectations, limited space for unfavourable shocks and elevated underlying measures of inflation.



Herman van Papendorp

Head: Macro Research and Asset Allocation
Momentum Investments

Sanisha Packirisamy

Economist
Momentum Investments

Partially Vesting Smooth Bonus Range

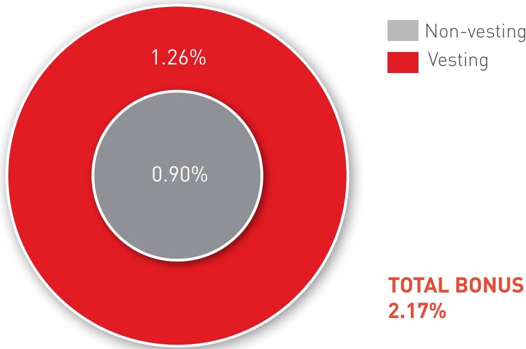
Multi-Manager Smooth Growth Fund Global

Fund Snap Shot

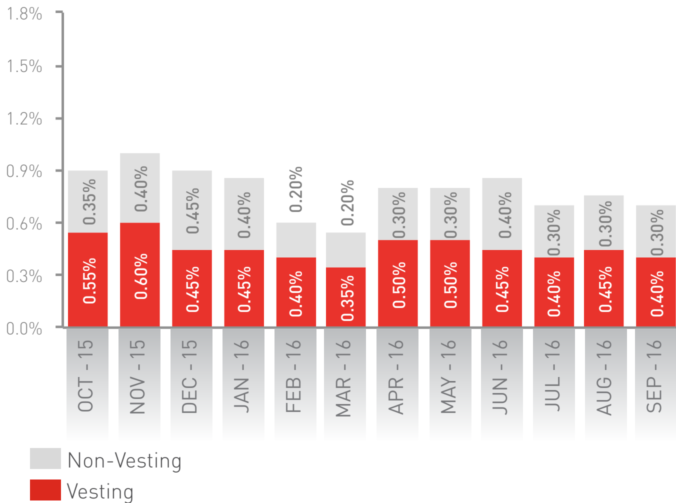
INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN
Jan 2004	100% - 105%	R12.2bn	1.33%	16.12%

Performance

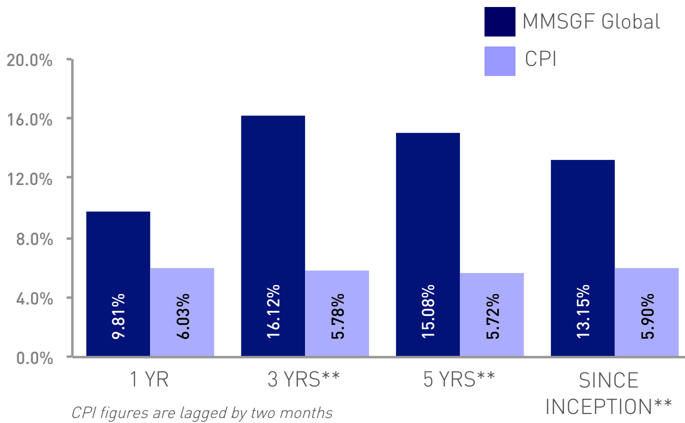
The total bonus* for the past quarter on the Multi-Manager Smooth Growth Fund Global is shown below.



The chart below shows the monthly bonuses* for the past 12 months



The chart below shows the long term bonus* performance of the Multi-Manager Smooth Growth Fund Global against CPI

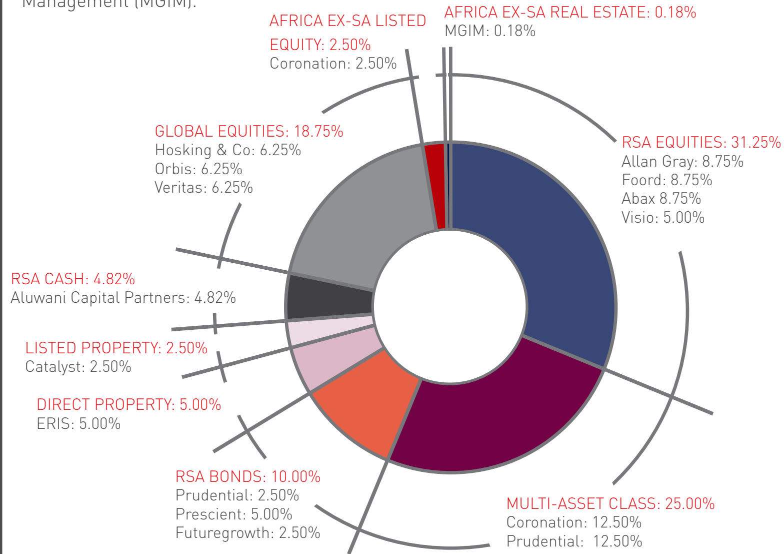


CPI figures are lagged by two months

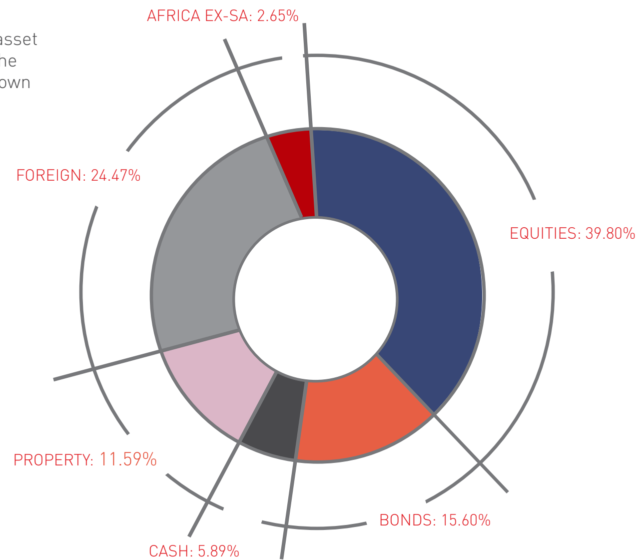
* Bonuses are net of underlying asset charges but are gross of the policy fee
** Annualised

Asset Allocation

The strategic asset allocation of the portfolio is shown alongside.
The Africa ex-SA Real Estate allocation is expected to increase gradually over the next 5 years to a total of 2.50%, in line with drawdown notices from Momentum Global Investment Management (MGIM).



The effective asset allocation of the portfolio is shown alongside.



From the fifteenth century, **mariners' astrolabes** were used to determine the latitude of a ship at sea. Designed for use on boats in rough water and heavy winds, the astrolabe could locate and predict the positions of the sun, moon, stars and planets, determining local time given local latitude and vice-versa. Less than one hundred are known to have survived from antiquity.

In the new world, Trustees, Professional Financial Advisors and members need clear directions to stay on track within the turbulent retirement fund environment. Our best-of-breed multi-manager smooth bonus products with independent governance provide just that.

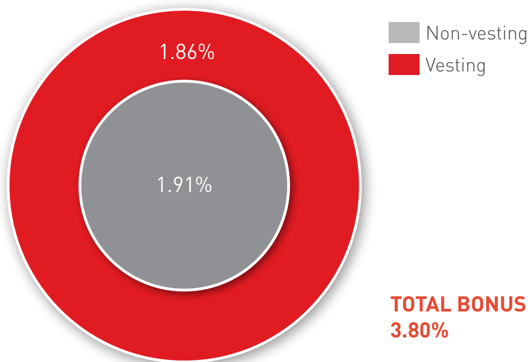
Partially Vesting Smooth Bonus Range
Multi-Manager Smooth Growth Fund Local

Fund Snap Shot

INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN
Jan 2004	110% - 115%	R 239.5m	1.43%	25.70%

Performance

The total bonus* for the past quarter on the Multi-Manager Smooth Growth Fund Local is shown below.



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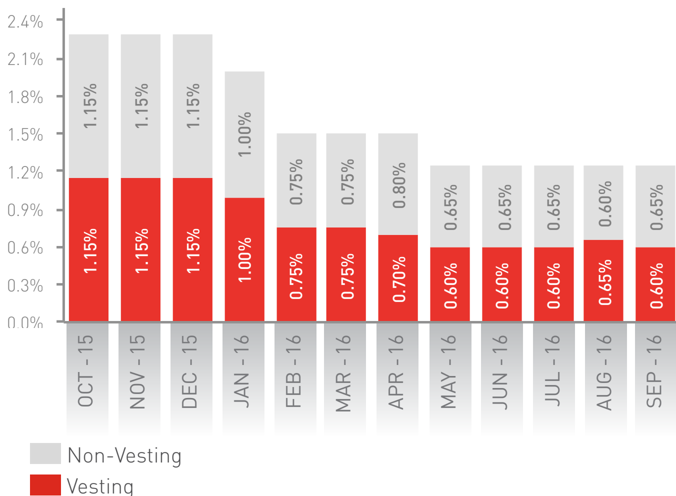
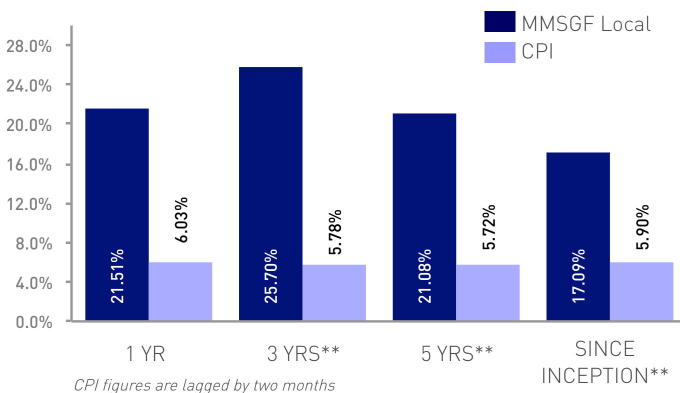


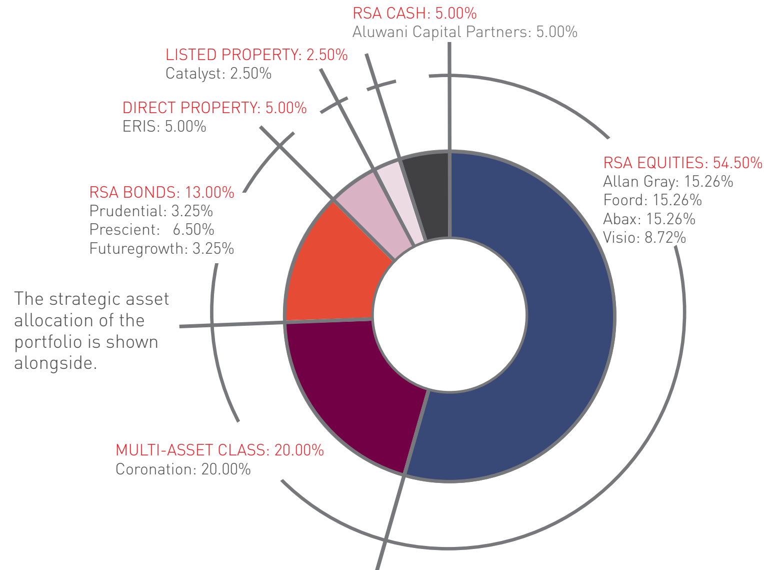
The chart below shows the long term bonus* performance of the Multi-Manager Smooth Growth Fund Local against CPI

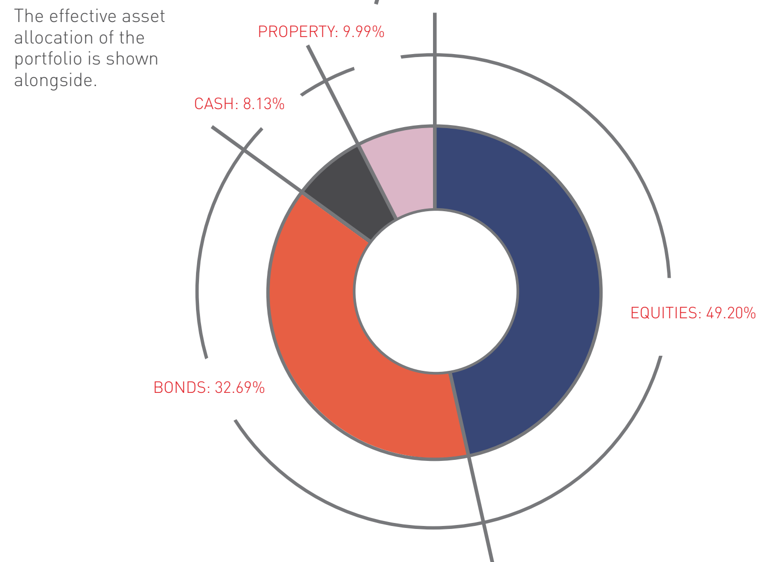


CPI figures are lagged by two months

* Bonuses are net of underlying asset charges but are gross of the policy fee
** Annualised

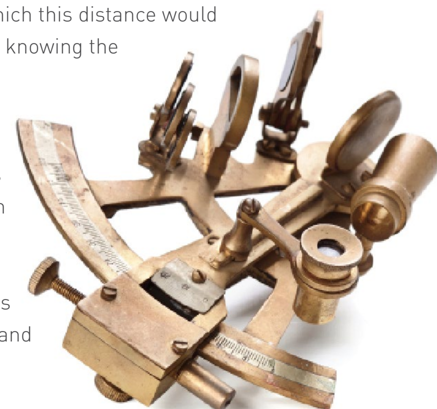
Asset Allocation





From as early as 150 B.C navigators could find their latitude, but ships were lost in shipwrecks because it was impossible to determine longitude. Thanks to **the 17th century sextant**, the navigator could measure the angle between the moon and a celestial body, calculating the exact time at which this distance would occur. Knowing the time meant knowing the longitude.

In the new world, Trustees, Professional Financial Advisors and members need certainty on their journey to financial wellness. Expert guidance from the thought leaders means knowing where you're heading and how to get there.



Partially Vesting Smooth Bonus Range

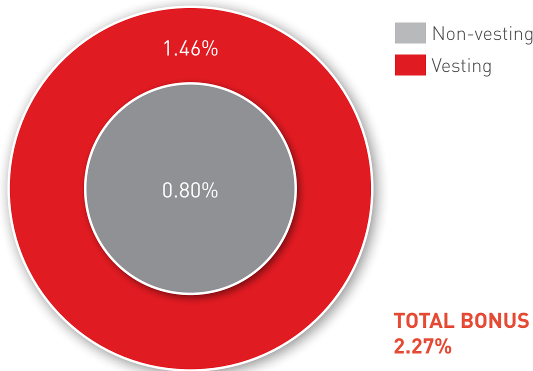
Smooth Growth Fund Global

Fund Snap Shot

INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN
Jan 1989	100% - 105%	R 2.5bn	1.64%	18.08%

Performance

The total bonus* for the past quarter on the Smooth Growth Fund Global is shown below.



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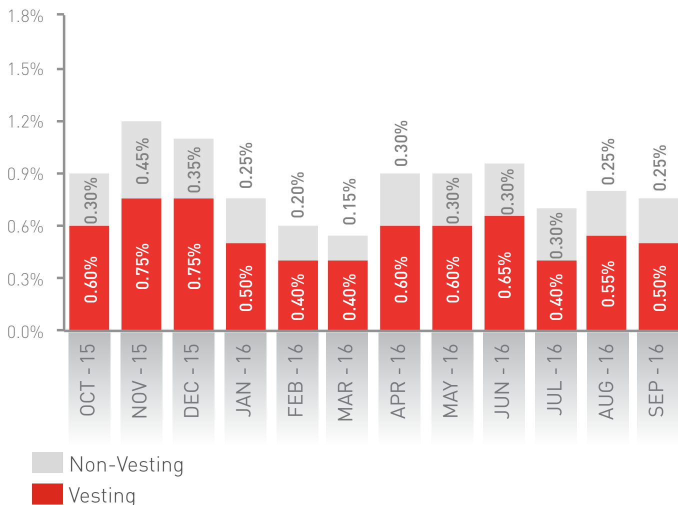
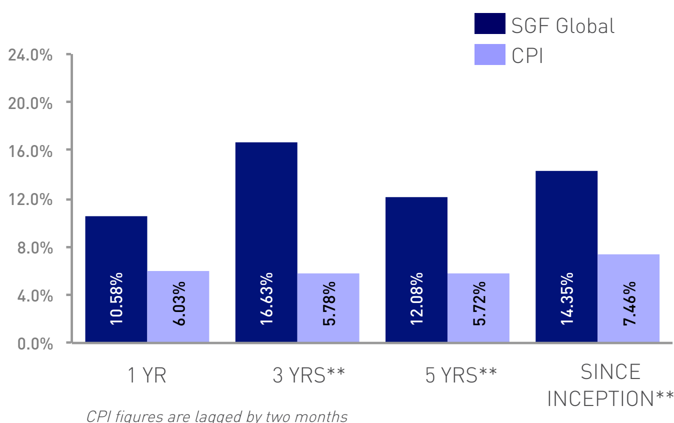


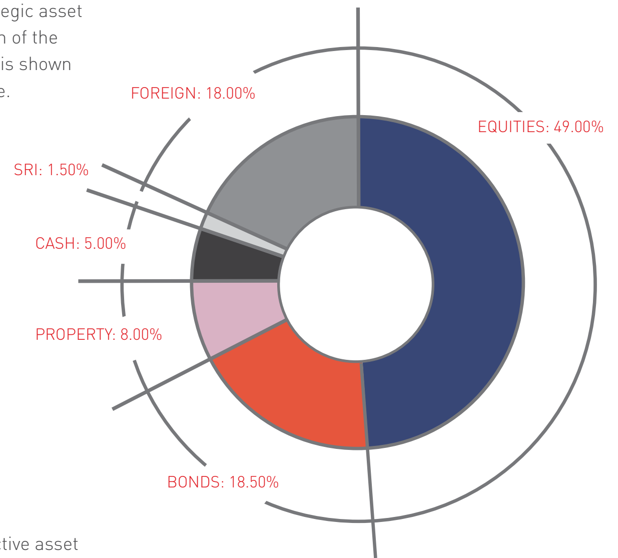
The chart below shows the long term bonus* performance of the Smooth Growth Fund Global against CPI.



CPI figures are lagged by two months

Asset Allocation

The strategic asset allocation of the portfolio is shown alongside.



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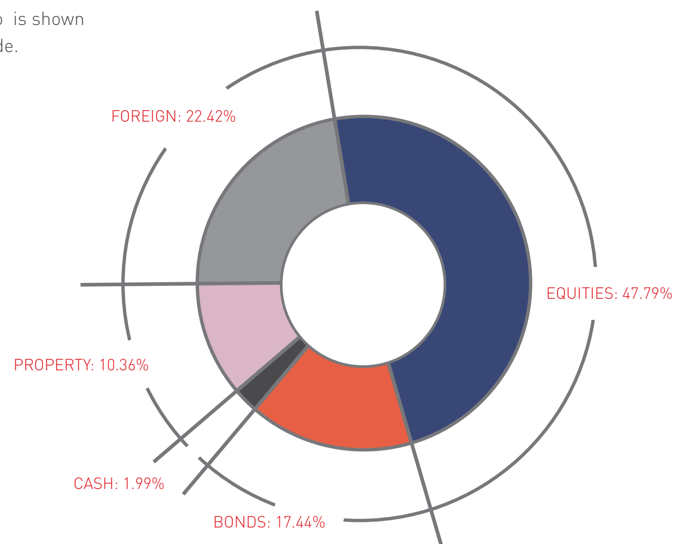


The engine order telegraph is used by the pilot on the bridge to instruct the engine room below to power the vessel at the right speed. By moving the handle to a different position on the dial, a bell would ring in the engine room and move their pointer to the same position - a fast and very handy way of powering the vessel away from trouble.

In a world where Trustees, Professional Financial Advisors and employees are looking for greater certainty, Momentum's continuous capital guarantee on benefit payments and smooth inflation-beating returns will result in plain sailing.

* Bonuses are net of underlying asset charges but are gross of the policy fee
** Annualised

Fully Vesting Smooth Bonus Range

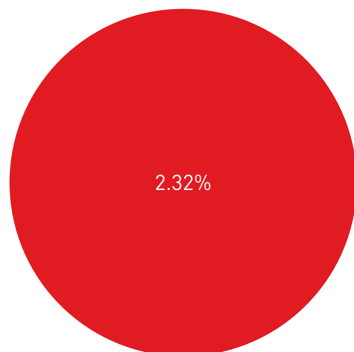
Multi-Manager Secure Growth Fund

Fund Snap Shot

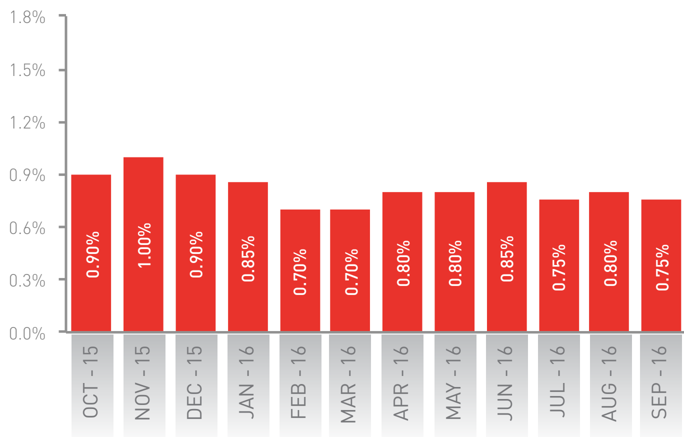
INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN
Nov 2007	105% - 110%	R 47.6m	1.01%	14.83%

Performance

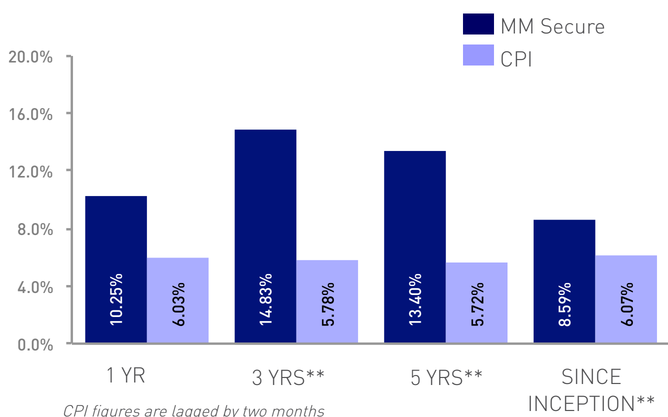
The total bonus* for the past quarter on the Multi-Manager Secure Growth Fund is shown below.



The chart below shows the monthly bonuses* for the past 12 months.



The chart below shows the long term bonus* performance of the Multi -Manager Secure Growth Fund against CPI



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** Annualised

Asset Allocation

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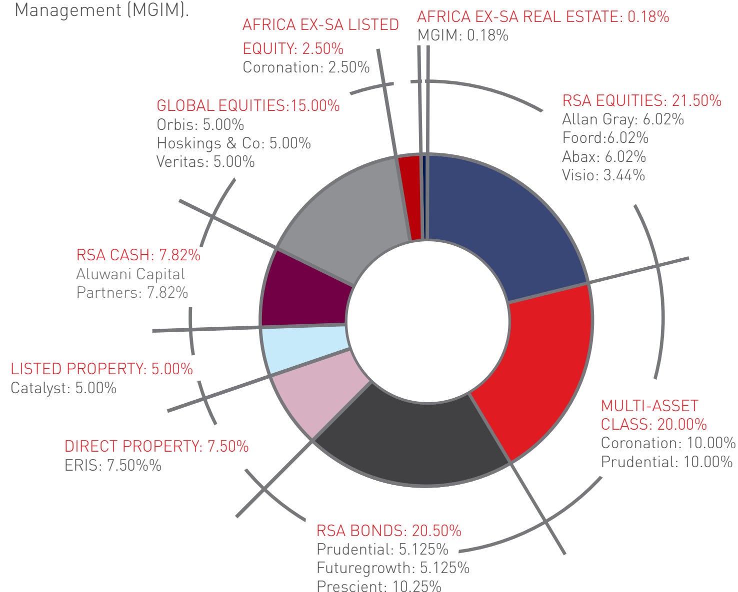

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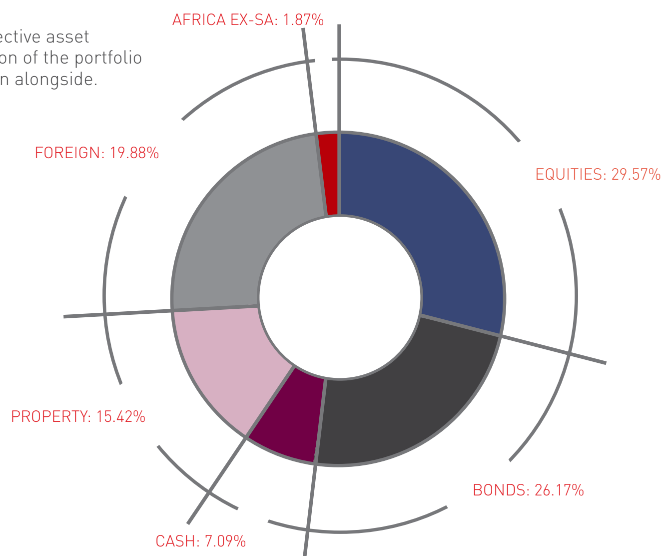


The first known **practical telescope** was invented in the Netherlands at the beginning of the 17th century. A telescope aids in the observation of remote objects by collecting electromagnetic radiation (including visible light), using glass lenses to increase the apparent size and brightness of distant objects.

Clarity is a key need of Trustees, Professional Financial Advisors and employees.
Our transparent approach to bonus declarations and capital guarantees provide peace of mind on the journey to financial wellness.

Fully Vesting Smooth Bonus Range

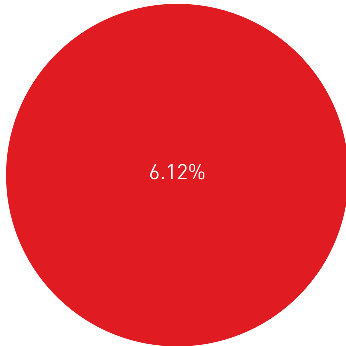
Multi Manager Secure Growth Fund Bonus Series 2013

Fund Snap Shot

INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN
Jun 2013	> 120%	R 60.2m	26.82%

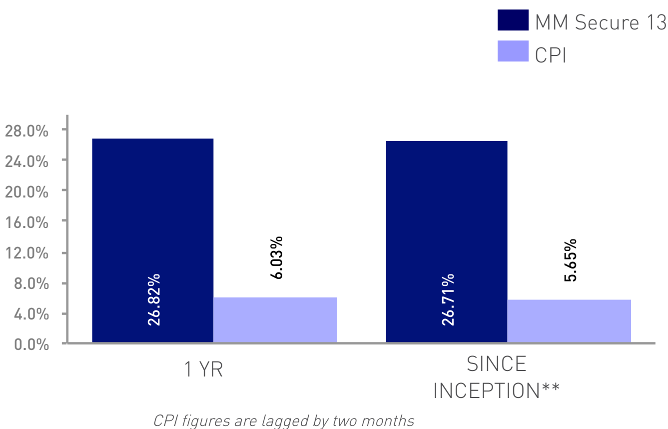
Performance

The total bonus* for the past quarter on the Multi Manager Secure Growth Fund Series 2013 is shown below.



The chart below shows the monthly bonuses* for the past 12 months.

The chart below shows the long term bonus* performance of the Multi -Manager Secure Growth Fund Bonus Series 2013 against CPI



CPI figures are lagged by two months

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** Annualised

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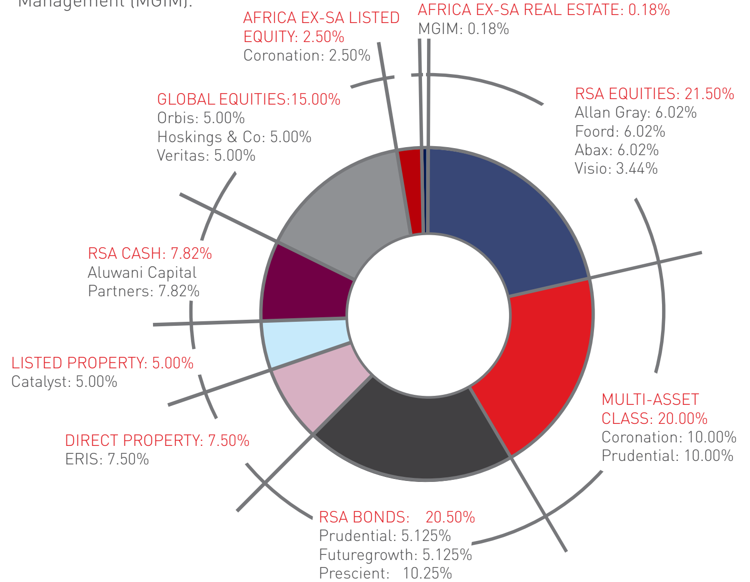

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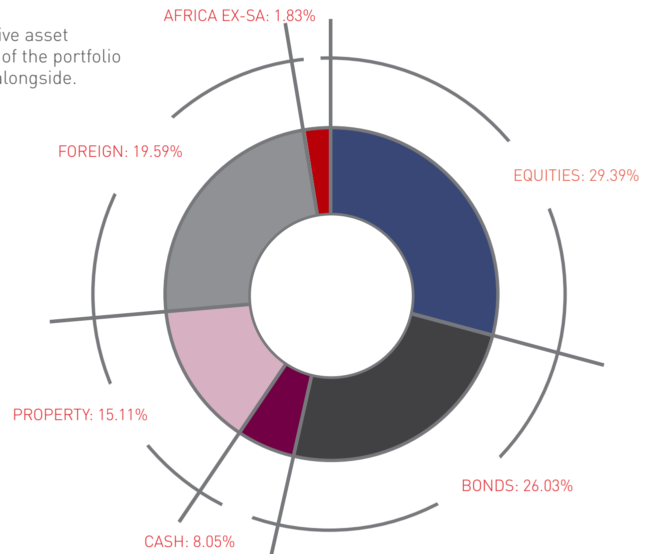


Following the invention of the telescope in the 17th century, the advantages of mounting two of them side by side for binocular vision became obvious. Developed by Italian optician, Ignazio Porro in 1854 and made popular by the Carl Zeiss Company in the 1890s, **Binoculars** give users a three-dimensional image, presented to each of the viewer's eyes from slightly different viewpoints. This merged view provides a greater impression of depth.

We recognise that in the new world, nothing less than 100% certainty will do. As a result, our rigorous portfolio construction inspires investor confidence in the prospective investment performance of the Fund.

Fully Vesting Smooth Bonus Range

Smart Guarantee + 3 Fund

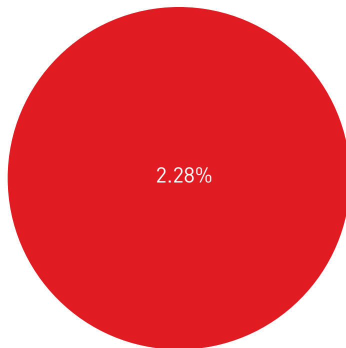
Fund Snap Shot

INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN OF BONUS GENERATING PORTFOLIO
Oct 2013	95% - 100%	R 177m	1.07%[1]	10.98%

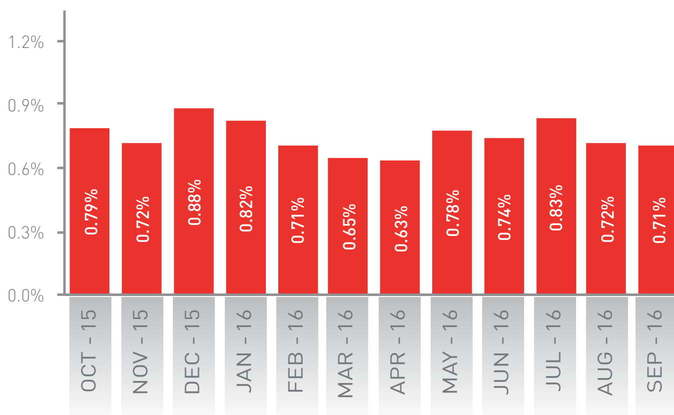
[1] Figures are based on back-tested (not actual) bonuses.

Performance

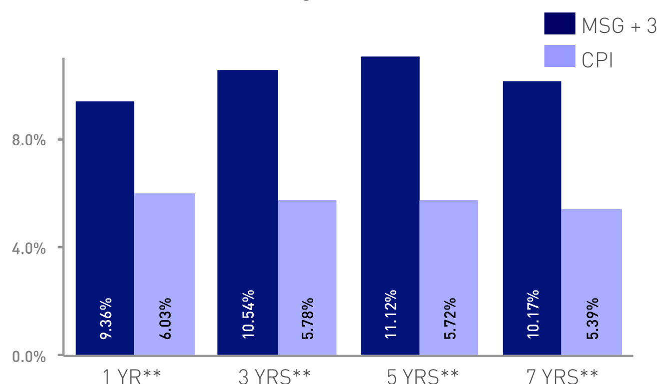
The total bonus* for the past quarter on the Smart Guarantee + 3 Fund is shown below.



The chart below shows the actual monthly bonuses* for the past 12 months, together with the actual one year performance* against the benchmark of CPI.



The chart below shows the long term bonus* performance of the Smart Guarantee +3 Fund against CPI.



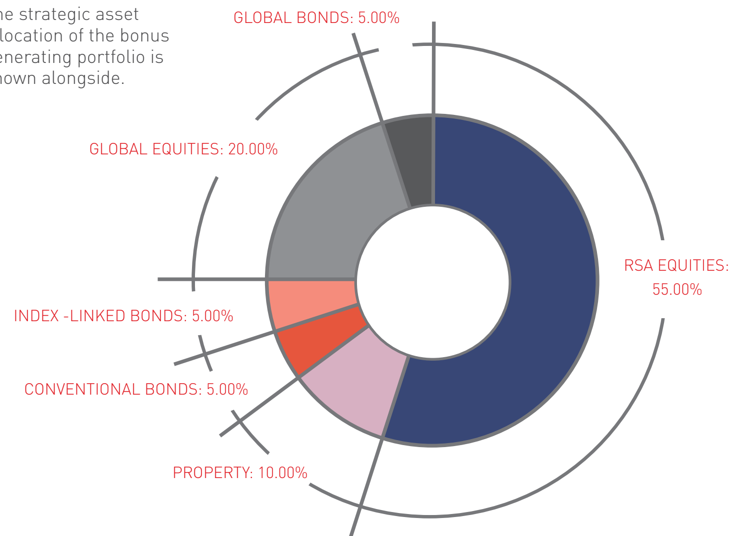
CPI figures are lagged by two months
1 year performance is at 30 September 2016
3, 5 and 7 year returns are back-tested performance numbers as at 31 August 2016

* Bonuses are net of underlying asset charges but are gross of the investment management fee

** Annualised

Asset Allocation

The strategic asset allocation of the bonus generating portfolio is shown alongside.



For more information on the bonus generating portfolio, Momentum MoM Enhanced Factor 7, please refer to our website: https://www.momentum.co.za/for/business/products/funds-at-work/fund-fact-sheets

For bonus declarations, 80% of the underlying assets returns of the bonus generating portfolio are smoothed over a three-year period as per the smoothing formula. The liability driven investment strategy includes a dynamic protection overlay to secure the guarantee.

As a result, for disinvestments other than guaranteed benefit payments the underlying assets value is sensitive to both asset values and interest rates and the effective asset allocation will reflect both the bonus generating portfolio and the dynamic protection overlay.

Bonuses to be declared

Given that the monthly bonuses are based on the weighted average of the previous 36 months' returns of the bonus generating portfolio, it is possible to calculate the future bonuses that will be declared under various future investment return assumptions. Assuming zero returns over the following 34 months (there is a two month lag), around 7.55% of bonuses will still be declared.

Prior to the introduction of **the compass**, position, destination, and direction at sea were primarily determined by the sighting of landmarks, supplemented with the observation of the position of celestial bodies. On cloudy days, even the Vikings were at a loss for which way to go.

Because the compass is used for calculating heading, it provides a much improved navigational capability. And on our compass, security is the number one moral imperative.

Smooth Bonus Products
Key Features

Vesting	Fund	Fund Return Objective	Manager	Mandate Type	Guarantee on Benefit Payments[1]	Market Value Adjustment on Voluntary Exits[2]	Capital Charge	Policy Fee	Inception Date
Partially Vesting	Multi-Manager Smooth Growth Fund Global	CPI + 4% pa, net of the policy fee and underlying asset charges over a 5 year time horizon	Multi-Manager	Moderate Balanced	100% of net capital invested and vested bonus declared (net of the Policy fee)	Yes	1.00% pa	0.35% of the first R50m, 0.25% of the excess above R50m[3]	January 2004
Partially Vesting	Multi-Manager Smooth Growth Fund Local	CPI + 4% pa, net of the policy fee and underlying asset charges over a 5 year time horizon	Multi-Manager	Moderate Balanced	100% of net capital invested and vested bonus declared (net of the Policy fee)	Yes	1.00% pa	0.35% of the first R50m, 0.25% of the excess above R50m[3]	January 2004
Partially Vesting	Smooth Growth Fund Global	CPI + 4% pa, net of the policy fee and underlying asset charges over the long to medium term	Momentum Asset Managers	Moderate Balanced	100% of capital invested and vested bonus declared	Yes	1.00% pa	0.45% of the first R10m, 0.35% of the next R40m, 0.25% of the excess above R50m[3]	January 1989
Fully Vesting	Multi-Manager Secure Growth Fund	CPI + 2% pa, net of the policy fee and underlying asset charges over a 5 year time horizon	Multi-Manager	Moderate Conservative Balanced	100% of net capital invested and total bonus declared (net of the Policy fee)	Yes	1.50% pa	0.35% of the first R50m, 0.25% of the excess above R50m[3]	November 2007
Fully Vesting	Multi-Manager Secure Growth Fund Bonus Series 2013	CPI + 2% pa, net of the policy fee and underlying asset charges over a 5 year time horizon	Multi-Manager	Moderate Conservative Balanced	100% of net capital invested and total bonus declared (net of the Policy fee)	Yes	1.50% pa	0.35% of the first R50m, 0.25% of the excess above R50m[3]	June 2013
Fully Vesting	Smart Guarantee +3 Fund	CPI + 3% pa, net of the policy fee and underlying asset charges over a 7 year time horizon	Liability Driven Investment by Structured Solutions	Moderate Balanced	100% of net capital invested and total bonus declared (net of the Policy fee)	Yes	0.50% pa	0.90% pa[3]	October 2013

1. Benefit payments generally refer to resignation, retirement, death, disability and retrenchment. Specific benefit payments and terms and conditions are specified in client policy contracts
2. Market value adjustments are applied on member switches out and terminations if a client is underfunded
3. Depending on the underlying mandates that are negotiated with asset managers, net unit priced fees are and performance fees may deducted from the underlying assets

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