Smooth Bonus Report

First Quarter 2018

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

momentum

>

Looking back over the past quarter

Dear valued investors

It has been pleasing to see another quarter of strong growth on local and global markets as well as low volatility. In the current investment cycle, it is expected for investment returns from growth asset classes to be lower than before. To maximise returns, the selection of the correct investment styles and flexibility in asset classes is needed to achieve desired returns.

During the last quarter, the political landscape stabilised with the relatively smooth transfer of the South African Presidency from Jacob Zuma to Cyril Ramaphosa. Our new president has appointed a cabinet he feels is necessary to take South Africa forward and to deal with the many challenges faced. He has also not wasted any time in replacing various heads of state-owned enterprises and their board members. Many of the changes made have been well received by the ratings agencies and the markets.

Herman van Papendorp and Sanisha Packirisamy from Momentum Investments provide further market and economic commentary on page 6.

Smooth bonus portfolios

In the last quarter's Budget Speech, a change in the investment limitations of Regulation 28 of the Pension Funds Act was announced, with the global investment allowance increasing from 25% to 30%. To maximise the diversification within our Momentum Mutli-Manager Smooth Bonus Fund Global (MMSGF Global), our investment management committee decided to increase the portfolio's exposure to the new maximum, although leaving Africa (excluding South Africa) exposure at 5%. In our multi-manager smooth bonus range (MMSGF Global, MMSGF Local and Momentum Multi-Manager Secure Growth Fund Global), we have started to implement a change within the local equity building block by replacing Foord with two smaller investment managers, namely Steyn Capital and Fairtree Capital. On a risk adjusted basis, we expect to receive more potential outperformance from these changes.

In our dealings with clients, we are still receiving many questions on Steinhoff International. On Friday, 20 April 2018, Steinhoff International had a board meeting but the company was still not able to provide investors with further clarity on the report and accounts. It is important to remember that our portfolios are well diversified in the underlying shares they are invested in and they only had small exposures to Steinhoff.

In the following quarter, we are expecting much of the same of continued growth in the markets and the economy.

Warm regards

Steeed Duncan-Smith

Client Relationship Manager
Momentum Corporate

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The end of provident funds

by : Darryl Gounden

Pension and provident funds are two retirement fund options available to employees. The differences in their definitions make them suitable for different employees in different industries. The proposed change in the definition of a provident fund, which will equate it to a pension fund, aims to create a standard retirement fund, which will aid social security reform. This change may have adverse effects on retiring provident fund members. However, their best interest is upheld by trade unions.

Overview of pension and provident funds

The aim of pension and provident funds is to provide its members with a source of income when they are no longer employed. The income at retirement depends on the fund the member is invested in and can be taken as a lump sum, used to purchase an annuity or a combination of both. Pension and provident funds help a member to maintain an acceptable standard of living in retirement as well as a certain level of independence. In terms of the ultimate purpose of both funds, they are the same.

The differences between pension and provident funds

The main difference between a pension and provident fund is the form of the income on retirement of members. When retiring from a pension fund, members can choose to receive a maximum of one third of their benefit as a lump sum and the remaining portion must be annuitised. The caveat to this rule is a benefit of less than R247 500 may be paid entirely as a lump sum. This was increased from R75 000, effective 1 March 2016. When retiring from a provident fund, members have the option to receive their entire benefit in the form of a lump sum.

Before 1 March 2016, another significant difference was the tax treatment of member contributions. In a pension fund, the monthly member contributions were (and still are) tax deductible. However, in a provident fund, monthly member contributions were not tax deductible. This meant, all other things being equal, a pension fund member would have had a higher disposable income than a provident fund member. Employer contributions were tax deductible for pension and provident funds.

Recent changes to retirement funds

In 2015, National Treasury proposed many changes to the structure of retirement funds and the laws relating to them. These formed part of the changes made to ensure comprehensive social security for South Africans. The changes proposed by National Treasury would effectively change the definition of a provident fund to a pension fund.

In the first quarter of 2016, The Taxation Laws Amendment Act was signed by former President Jacob Zuma to create a set of tax laws that would be applicable to retirement funds from 1 March 2016. One of the major changes was member contributions to provident funds would be tax deductible. This change would have resulted in an increase in disposable income for provident fund members. In addition to this, the total tax deduction would be capped at 27.50% across all retirement fund contributions and would be determined using the higher of remuneration before deductions or taxable income. Previously, it was based on approved remuneration for pension funds or pensionable income for provident funds. An annual deduction cap of R350 000 was also introduced.

National Treasury stated that government made these changes to benefit members in their retirement, but also highlighted the need to protect the principles of the tax system. This meant the new tax relief given to provident fund members would come at a cost – provident fund members would have to annuitise at least two thirds of their benefit at retirement.

The aim of this proposal was to harmonise the tax treatment of retirement funds and, as a result, equate a provident fund to a pension fund. However, following strong opposition from the Congress of South African Trade Unions (COSATU), former President Jacob Zuma signed The Revenue Laws Amendment Act that postponed the compulsory annuitisation requirement of provident funds by two years to March 2018.

COSATU opposed the annuitisation requirement for provident funds and threatened to withdraw support for the African National Congress (ANC) in the 2016 provincial elections. COSATU believes pension funds include rules that limit members' accessibility to their money during their time of need, which is against COSATU's mandate. The National Union of Mineworkers (NUM) stated that the majority of their members are in the lowest-earning income class in the country. Their members are not able to benefit from the 27.50% tax deduction cap because they only contribute 6% to 10% of their total salary (including employer's contribution) to their provident fund.

In August 2017, National Treasury stated the implementation of the compulsory annuitisation requirement of provident funds will be further postponed from March 2018 to March 2019. The postponement is needed for the National Economic Development and Labour Council (Nedlac) to continue discussions on the Social Security Reform Paper. COSATU requires the results of the paper to better understand why the compulsory annuitisation of provident funds fits into the social security reform package. By March 2019, if the compulsory annuitisation requirement of provident funds is scrapped, National Treasury is sure to revisit the tax deductibility of member contributions to provident funds.

The effect on existing retirement fund members

The inclusion of taxable income in determining the tax deduction will allow members who earn an income in addition to their normal remuneration (such as rental income) to claim a deduction against such income. Due to the introduction of the annual deduction cap of R350 000 per year, any retirement fund member contributing more than the cap will face a lower disposable income.

Provident fund members' deduction cap effectively will increase from 20.0% of pensionable income (previously allowed on employer contributions) to 27.5% of the larger of remuneration before deductions or taxable income. This increased percentage, along with the inclusion of taxable income in the definition of the deduction cap, will result in a larger disposable income for provident fund members. If the compulsory annuitisation of provident funds is implemented in March 2019, retiring provident fund members will be significantly affected. It is believed the lump sum benefit was the reason why most provident fund members stayed in the fund, even though tax deductions were more lenient for pension funds.

Pension fund members will be the least affected by the changes since the intended standard retirement fund will be based on a pension fund, with slight adjustments. Member contributions to a retirement annuity fund were previously allowed a deduction cap of 15% of non-pensionable income. Retirement annuity fund members will benefit from the same deduction cap as pension and provident funds. The form of the benefit for pension and retirement annuity fund members will not change. Members were always required to annuitise at least two thirds of their fund on retirement.

In terms of the deduction cap and form of benefits on retirement, pension, provident and retirement annuity funds will have the same rules once the compulsory annuitisation for provident funds is introduced (1 March 2019). This will effectively result in a standard retirement fund.

The definition of a provident fund includes all the tax changes mentioned previously. However, retiring members still have the option of receiving their entire benefit in the form of a lump sum. The Minister of Finance is consulting with Nedlac regarding the annuitisation requirements of provident funds. The implementation date of the compulsory annuitisation of provident funds is, for now, 1 March 2019. If implemented, this would effectively mean the end of provident funds as we have known them. However, given the strong opposition from trade unions, there is always a possibility that this could be delayed further or even abolished altogether.

Darryl Gounden

Product Specialist

Structured Solutions

Momentum Investments market commentary for the quarter ending March 2018

by Sanisha Packirisamy and Herman van Papendorp

Markets

- Valuations and the late-cycle global fundamentals of positive growth momentum, rising inflation, fiscal stimulus and increasing net bond supply should continue to favour global equities over bonds.
- There are, as yet, few signs of the imminence of a global equity bear market, although a move from a 'goldilocks' environment (strong growth and low inflation) to reflation (strong growth and rising inflation) during the last phase of the equity bull market should be less positive for equities and will likely correspond with higher volatility.
- The global hunt for yield continues to underpin emerging market (EM) debt markets, but with South African (SA) inflation bottoming, there should be limited further inflation support for the SA bond market during the remainder of 2018, while bond valuations look full.
- The combination of a large Ramaphosa-driven bond market rally since November last year and the big Resilient-driven property sector sell-off since then has caused the SA listed property sector to now trade at the cheapest relative rating to local bonds in five years.
- The expected positive 'Ramaphoria' effect on corporate sales and margins should support the profit growth of domestically orientated companies in SA, while expected moderate rand weakness should enhance globally generated profits. Although globalisation and the Naspers effect have caused the overall SA equity market to trade in line with elevated developed market (DM) valuations, the median SA share trades in line with more attractive EM valuations, providing investors with better return prospects.

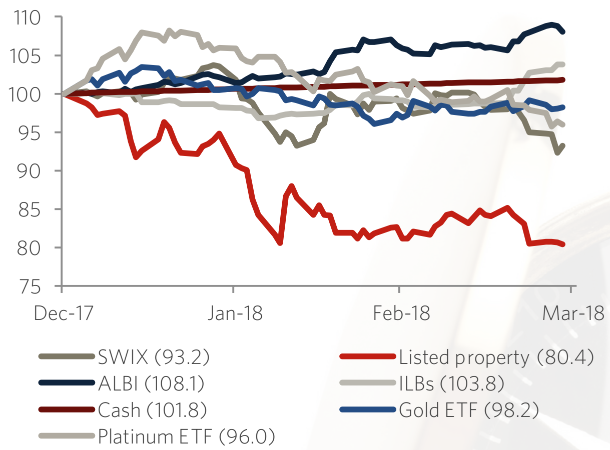
Economics

- A closing output gap and rising inflation should allow for additional interest rate hikes to beyond a neutral monetary policy stance in upcoming quarters in the United States (US).
- Monetary policy is expected to remain expansionary in the Eurozone, although it is expected to gradually shift away from an easing bias, in response to firm growth and a modest uptick in inflation.
- Actions by the Bank of Japan should lag that of the European Central Bank, given ongoing weakness in inflation expectations.
- Trade frictions and the potential for a faster pace of monetary policy tightening in DMs pose downside risks to the economic recovery underway in EMs.
- In SA, the new administration will require time to improve economic growth and stabilise the fiscal position, given the country's structural weaknesses. As such, Momentum Investments still views trend growth at around 2%.
- The fragile financial state of many of SA's parastatals pose a material risk to government's balance sheet.
- Despite the expectation of a mildly depreciating rand and rising inflation trend, Momentum Investments expects SA inflation to remain well within the target band in 2018 and 2019.
- A further interest rate cut of 25 basis points in SA by the second half of 2018 is plausible, but this would likely require inflation expectations to shift closer to the mid-point of the inflation target.

Move from 'goldilocks' to reflation should induce more volatility into global markets

During the first quarter of 2018, asset class returns for SA investors were strongly influenced by the ongoing positive domestic political momentum initially ignited by the election of Cyril Ramaphosa as the new African National Congress (ANC) president in mid-December 2017, followed by Ramaphosa'a elevation to president of the country and a cabinet renewal in February this year. As a result, the rand appreciated by almost 5% during the quarter, providing strong support for the outperformance of local bonds (see chart 1), but hurting the return from global asset classes, commodity exchange-traded funds and the globally orientated part of the SA equity market. SA bonds also benefited from a stern, but credible budget in February and a sovereign ratings reprieve from Moody's in March. Unfortunately, the strong return from local bonds could not negate the negative sentiment around the Resilient group of companies in the listed property asset class, which caused the sector to lose 20% of its value during the quarter. Concerns about Resilient related to valuation premiums, cross-shareholdings, the structure of its Siyakha education trust, as well as accusations about trading activity by related companies that inflated share prices.

Chart 1: SA asset class returns in Q1 2018 (indexed)



Source: INET BFA, Momentum Investments

Indications that the US Federal Reserve (Fed) might have to raise interest rates more aggressively than previously thought and negative headlines in the technology space put pressure on global growth stocks during the quarter, while worries about trade wars between the US on the one side and China and Europe on the other have caused a sell-off in global equities as a more risky asset class.

Although the global equity pullback seen in the first quarter can be regarded as long overdue, following the longest post-war period without a 3% drawdown, Momentum Investments argues that the extent of the sell-off discounts a too-negative growth outlook, as it seems to imply a 30% to 50% probability of a recession ensuing against the backdrop of ongoing broad-based earnings support. There are, as yet, few signs of the imminence of an equity bear market, although a move from a 'goldilocks' environment for equities (strong growth and low inflation) to reflation (strong growth and rising inflation) during the last phase of the equity bull market should be less positive for equities and will likely correspond with higher volatility. The late-cycle fundamentals of positive growth momentum, rising inflation, fiscal stimulus and increasing net bond supply should continue to favour equities over bonds. In addition, global bond valuations remain expensive, with the valuation gap between bonds and equities still wide.

With the highest profit betas to global growth being outside the US, the equity markets of Japan and EMs should be the biggest beneficiaries of the synchronised global growth recovery, although they will also be more at risk from rising trade protectionism. As the EM equity market is becoming more of a technology and less of a commodity play, it should be less cyclical than in the past, with a resultant falling correlation with commodity prices, the US dollar and US bond yields. While US equities look expensive, equity valuations outside the US seem more attractive. Japan and EM look cheap, with the latter benefitting from any US dollar weakness.

With the 'Ramaphoria' effect continuing to underpin positive consumer, business and investor sentiment, it is not a surprise that SA's leading economic growth indicators are pointing upwards. The resultant expected corporate sales and margin recovery should support the profit growth of domestically oriented companies in SA, while expected moderate rand weakness should enhance globally generated profits. Although globalisation and the Naspers effect have caused the overall SA equity market to trade in line with elevated DM valuations, the median SA share trades in line with more attractive EM valuations, providing investors with better return prospects.

The global hunt for yield continues to underpin EM debt markets – unlike in DMs, meaningfully positive real yields are available in EMs for global investors. Unfortunately, with SA inflation bottoming, there should be limited further inflation support for the SA bond market during the remainder of 2018. In addition, ex-ante real yields and the SA/US yield spread premium have now fallen to around historical averages, likely limiting future capital returns for local bonds.

With break-evens likely to expand with rising inflation, the fundamental underpin for SA inflation-linked bonds should improve going forward.

The combination of a large Ramaphosa-driven bond market rally since November last year (yields down 125 basis points) and the big Resilient-driven property sector sell-off since then have caused the listed property sector to now trade at the cheapest relative rating to local bonds in five years. To put this into context, the 39% relative derating of listed property to bonds in the four months since November 2017 has surpassed the 30% relative derating seen in the four months to December 2008 during the global financial crisis.

Goldilocks' conditions persist, but the acceleration in global growth is likely nearing a peak

The 'goldilocks' environment acted as a tailwind for the global economy and financial markets for the past year and is projected to persist in 2018. However, the likelihood of the global expansion strengthening from current levels is less certain. Economic surprises have rolled back into negative territory for DMs, while surprises are off their recent highs in EMs.

Although growth in the global economy is likely drawing nearer to a peak, the risk of the world economy overheating has been lowered substantially, with different economies operating in different stages of the business cycle.

However, maturing business cycles, in certain areas of the DM composite, could cause global growth to soften from current levels.

Economic activity in the US is typified by late-cycle conditions. Nevertheless, fiscal policy, which traditionally has a counter-cyclical role, is further fuelling growth, even as the US economy closes in on full employment. An environment where fiscal policy acts in a pro-cyclical manner (an expanding deficit when unemployment is already low), could cause volatility to rise from benign levels.

As such, the market may increase its focus on data that could be surprising relative to consensus expectations.

A closing US output gap, driven by solid momentum in economic activity greater than potential growth, and a rebound in international oil prices are likely to drive inflation higher, which should allow for additional interest rate hikes to beyond a neutral monetary policy stance in upcoming quarters.

Central bank policy is decidedly less hawkish outside the US. In the Eurozone, where activity is characterised by mid-cycle conditions, monetary policy is expected to remain expansionary, although gradually shifting away from an easing bias.

Monetary policy is also expected to remain expansionary in Japan, where mid-cycle economic conditions persist.

While the Bank of Japan should similarly move away from an ultra-loose monetary policy stance, it is expected to lag the actions of the European Central Bank. Even though the eighth consecutive quarter of growth into the final quarter of 2017 has meant Japan has enjoyed its longest growth streak since 1989, economic activity has not been robust enough to stir inflation, which, excluding volatile food and energy prices, rose to just 0.5% in February 2018, from a year earlier, despite a tight labour market and wage increases.

Even without China, EMs are playing an increasingly important role in driving the global economic cycle.

According to the International Monetary Fund, emerging countries accounted for 41% of global gross domestic product (GDP) in 2017, weighted on the basis of purchasing power parity. Economic growth surprises for this region rolled over from their recent March 2018 peak, but remain well within positive territory. Net commodity exporters, in this region, are operating under early-cycle conditions.

Muted inflation has allowed central banks to pursue a more accommodative monetary policy stance to promote higher rates of growth.

Nevertheless, this region is not immune to developments in the rest of the world. Continued concerns over international trade and the potential for a faster pace of monetary policy tightening in the US have increased the downside risks to the EM economic recovery. While Momentum Investments is not of the opinion the introduction of new limited tariffs (including a number of exemptions) will trigger a broad-based trade war and derail the recovery, the risk of an escalation in trade tensions cannot be discounted altogether.

A protectionist Donald Trump administration in the US has pushed anti-China tariffs to the top of its international policy agenda, threatening the most serious breakdown in Sino-American relations since the Tiananmen Square Incident in 1989, which resulted in the US imposing trade sanctions on the emerging giant.

This time around, the largest threat to US and Chinese (and by implication, global) growth would be an aggressive use of Section 301 under the Trade Act of 1974, which allows the US President to take action against any measures that are deemed detrimental to US business. Morgan Stanley estimates a 20% broad-based tariff hike across

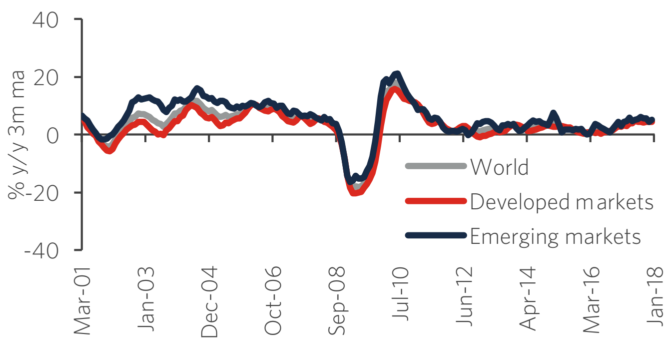
Chinese-manufactured goods and a commensurate response from China could lower base case growth estimates by 1% after four quarters in the US and China, after considering the spillover on investment, employment and consumption. Morgan Stanley argues the effect would be amplified by global value chains and, together with tighter financial conditions, would result in a material drag on global growth.

In 2016, the Financial Times argued international stability hung in the balance, with a number of economies going down the road of mixing democracy with an autocratic reality.

The rise of Russia's Vladimir Putin, the US' Trump, Turkey's Recep Erdogan, Hungary's Viktor Orban and, recently, China's Xi Jinping (in a disappointing governance setback involving the removal of the two-term presidential limit) have all expressed a tendency to favour more inward-looking policies. This is a blow to globalisation efforts, which have brought about a larger and cheaper range of goods and services, higher economic growth and a rise in living standards.

Admittedly, global trade is not growing at the double-digit growth rates, which prevailed in in the late 1990s and early 2000s, but the Netherlands Bureau for Economic Policy Analysis calculated growth in 2017 global trade rose to its strongest pace since 2011 (see chart 2).

Chart 2: Rise in global trade activity



Source: CBS, Momentum Investments

Global Trade Alert shows a rise in the number of protectionist measures since the global financial crisis. With protectionism slowly ratcheting higher, long-run growth (globally) faces the threat of less innovation, higher costs and lower economic activity, in Momentum Investments' opinion.

The United Kingdom's (UK) vote to leave the European Union (EU) demonstrated that rising populism in Europe was driven by disgruntled voters, who felt alienated from the benefits of globalisation.

For the past year, the British government and the EU have been negotiating a framework for the UK's exit. With the UK wanting out of the customs union and the single market, a comprehensive free-trade agreement must be negotiated, but, so far, the EU has made no compromises. While the economic ramifications of the proposed Brexit have been relatively modest, finding a path to a softer Brexit (involving a more cooperative approach) may be necessary to improve longer-term political and economic prospects for both parties.

Growing populist angst over migration and a weak economy has also led to an outperformance of fringe parties in the Italian elections, but a lack of visibility on the future government could persist for weeks, undermining growth in the Eurozone's third-largest economy. Moreover, the election results suggest it is clear Italy will not be a positive force for European reform in the coming years. This creates problems for German Chancellor Angela Merkel and French President Emmanuel Macron, who have admitted migration and the aftermath of the European debt crisis were driving political polarisation across Europe and have pledged to drive European reform and advance EU integration.

As such, even though the short-term economic outlook is positive, global leaders and policymakers must ensure geopolitical and protectionist threats do not undermine economic potential in the longer run.

Bringing SA back from the brink

Under the Jacob Zuma administration, political accountability was destroyed. Many critical state institutions faltered and corruption undermined SA's democracy, leading to a destruction of the economy, a mismanagement of state resources and higher levels of poverty and inequality.

The State Capacity Research Project, entitled 'Betrayal of the Promise: How South Africa is being Stolen', highlighted how a power elite captured a number of key state institutions and repurposed them for its own benefit in ways which subverted the legal and constitutional framework, rendering them incapable of executing their societal responsibilities.

Nevertheless, the Centre for Development and Enterprise argues SA remains one of a handful of countries in Africa that can be considered a true 'liberal democracy', boasting a "strong free press, an independent judiciary and a tradition of civil society activism to hold leaders to account".

Since the market-favourable outcome of the ANC National Conference in December 2017, a renewed focus on national issues instead of party politics has been observed.

However, as much as the traditionalist faction of the ANC is associated with corruption and state capture, it still represents a strong ideological undercurrent that could lead to a splintering of the ruling party along factional fault lines and hurt the party's showing in the 2019 national elections.

The party that Cyril Ramaphosa has inherited still reflects the legacy of the Zuma era and it is not unfounded that certain segments may try to block his progress in broadening the policy debate from the myopic politics of the ruling party itself. A tightly contested race for party president resulted in a narrow victory for Ramaphosa and a mixed slate leadership, forcing him to tread the path for economic renewal carefully.

Since December 2017, Ramaphosa has started to shift the narrative and has ushered in an era of greater cooperation between government, business, labour and civil society, to cultivate greater inclusivity in SA's policy-making environment. A more market-friendly approach and a change in attitude to corruption and maladministration has comforted consumers, businesses and investors alike. In December 2017, Ramaphosa concluded that "a restoration of confidence is the quickest and cheapest form of stimulus available, especially in light of our fiscal constraints".

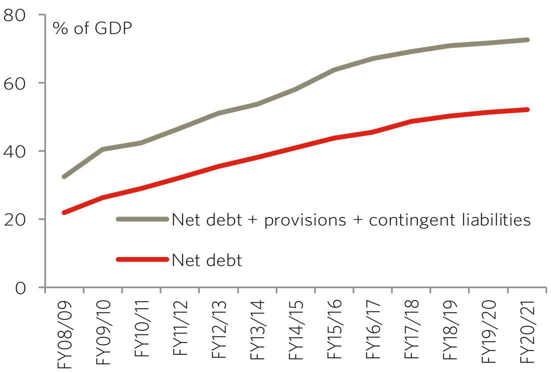
In a recent review, Moody's Investors Service kept SA's sovereign credit rating at the lowest investment grade rung, but changed its outlook for the country from negative to stable, seeing "significant growth potential for the country". Together with Standard and Poor's Ratings, the agencies noted the new administration will require time to improve economic growth and stabilise the fiscal position, given the country's structural weaknesses.

SA growth forecasts, as surveyed by the Reuters Econometer, shows GDP is expected to increase from 1.6% in 2018 (previously forecasted at 1.2% in October 2017) to 1.9% in 2019 and 2.3% in 2020. It is yet to be seen whether or not Ramaphosa will be able to resolve the different views within the ANC on how to reignite growth in the long run and foster social cohesion (through deep-seated reform and market-friendly policies). As such, Momentum Investments still sees trend growth at around 2%.

Improving the governance and financial standing of state-owned enterprises (SoEs) and placing the country on a more sustainable fiscal path is a top priority for the new administration. The ratings agencies have noted the change in political leadership has arrested the degradation of SA's institutions, including the National Treasury, the SA Revenue Service and key SoEs. However, the fragile financial state of many SoEs, in particular public-energy-utility Eskom (accounting for R350 billion of the R466 billion in guarantees government has extended to public institutions), pose a material risk to government's balance sheet, through the potential realisation of government's contingent liabilities.

In February 2018, Treasury outlined a number of front-end-loaded fiscal adjustment plans (including significant cuts to expenditure amounting to R80 billion over the medium-term expenditure framework and an increase in the value-added tax rate from 14% to 15%) to stabilise SA's government debt ratio at 52.2% of GDP by fiscal year (FY) 2020/21, while still allowing for funding for fee-free higher education (see chart 3).

Chart 3: Contingent liabilities pose a threat to government's balance sheet



Source: National Treasury, Momentum Investments

This is one example where Ramaphosa has been forced to juggle populist demands with fiscal pragmatism.

Ramaphosa's follow through on his declaration of support behind land expropriation without compensation will likely be his toughest test yet, given the balance required between addressing racial disparities in land ownership, the need to protect property rights and to ensure food security and a tenable environment for agricultural investment.

Positive domestic political momentum and global risk-on sentiment underpinned rand strength early in the year.

A confidence-instilling Cabinet reshuffle and revived fiscal consolidation efforts further bolstered the currency.

However, Parliament's passing of the motion to review the country's land laws and a renewed focus on global factors, rather than local politics, have tempered the rand's recent gains.

Nonetheless, even after factoring in a mildly depreciating currency in the medium term (4.5%, on average, in 2019 relative to 2018 and 3.5% in 2020 relative to 2019), Momentum Investments anticipates inflation to remain well within the target band for the foreseeable future at 5.2% on average in the next three years. Inflation expectations have further surprised positively. The Bureau for Economic Research's (BER) Inflation Expectation Survey suggested the average inflation expectation for the next five years had dropped to its lowest level on record, 5.3%, in the first quarter of 2018. But the SA Reserve Bank has reiterated its preference for inflation expectations to trend closer to the mid-point of the inflation target band (4.5%).

While another interest rate cut of 25 basis points by the second half of 2018 is plausible, particularly if inflation expectations remain well anchored closer to 4.5%, more aggressive easing in monetary policy is unlikely given the medium-term outlook for inflation and political uncertainty, as the national elections draw near.

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Moody's favourably reverses South Africa's credit rating outlook from negative to stable

by Sanisha Packirisamy and
Herman van Papendorp

Highlights

- Moody's kept South Africa's (SA) foreign and local currency rating unchanged at Baa3, in line with expectations, which left the country eligible for inclusion in the Citigroup World Government Bond Index (Citi WGBI).
- The favourable credit rating outlook reversal from negative to stable was unlikely fully priced in by markets.
- A likely return to a more transparent and predictable policy-making environment was cited as the main reason behind Moody's rating decision.
- The stable outlook reflected a balance of risks (opportunities and challenges) faced by the new administration.
- A resolution to the mining charter debate and a balanced approach to land restitution will test the new administration's ability to address conflicting political priorities.
- Addressing institutional problems and successfully implementing structural reforms could lead to a ratings upgrade.
- A faltering commitment to revived growth and debt stabilisation could lead to SA's credit rating outlook being dropped to negative again.

A more predictable policy-making environment allowed Moody's to keep its rating unchanged

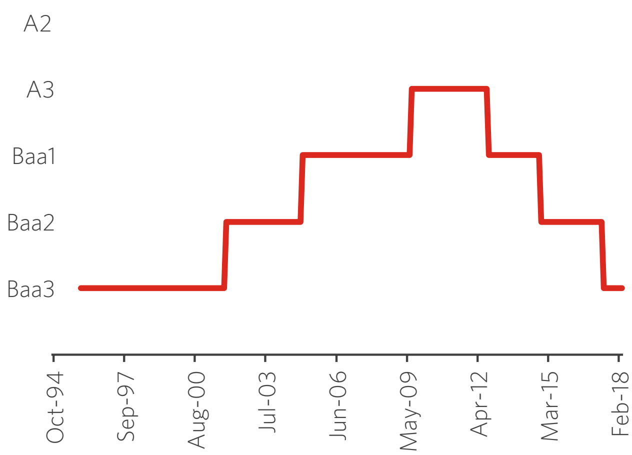
In its June 2017 review, Moody's downgraded SA's sovereign credit rating to Baa3 on fiscal sustainability and economic concerns (see chart 1). Following the release of

National Treasury's sombre medium-term budget policy statement in October 2017, Moody's decided to place SA on review for downgrade in its 24 November 2017 review, citing a volatile political scenario, poor economic growth and a lack of a clear direction in policy as key concerns underlying its earlier decision.

Since then, Moody's noted economic and fiscal challenges have become less pronounced, arresting a further deterioration in the country's creditworthiness. Moreover, the new administration has attempted to begin to restore institutional credibility at some of SA's key institutions, through an ongoing investigation into state capture.

Moody's noted the country was likely to return to a more transparent and predictable policy-making environment.

Chart 1: Moody's SA sovereign credit rating over time



Source: Moody's, Bloomberg, Momentum Investments, data up to March 2018

Political challenges remain a risk to economic success

Moody's noted its decision to reverse the sovereign's credit rating outlook, from negative to stable, reflected the balance of risks faced by the new administration. While the new administration faces the prospect of higher economic growth, rising social cohesion and greater fiscal consolidation, the practical and political challenges of meeting these goals (while appeasing all constituents) remain a challenge.

Moody's recognised the broad nature of the policy agenda and noted certain elements of the agenda have the "potential to create tensions within the administration and society". In the run up to the 2019 national elections, voter perception of economic and socio-political success will remain key and, as such, Momentum Investments expects the debate on land reform to remain a fundamental risk to investor and business sentiment. With respect to land restitution, the rating agency acknowledged the intricate balance between sustaining confidence in the short term with addressing poverty and inequality in the long term, all while ensuring agricultural production and food security.

Moody's argued a successful resolution to the mining charter debate will further be a test of the ruling party's ability to reach compromises to push through reform in the mining sector.

A halt in the deterioration of institutional credibility and some rebuilding highlighted

Moody's drew attention to the ongoing strength of SA's media, civil society, the SA Reserve Bank (SARB) and the judiciary, and noted a number of institutions had embarked on a journey to restore their institutional strength.

Positive changes in governance, key institutions (namely National Treasury and the SA Revenue Service (SARS)) and some state-owned enterprises (SoEs) were taken note of.

As such, the effectiveness of critical policy-making institutions and economic confidence around policy making are expected to favourably reverse towards its former standing.

The rating agency pointed out the speed at which the new president moved to replace the leadership in vital ministries and institutions (namely finance, mineral resources, public enterprises and SARS) illustrated a resolve to shift the country to a new, positive path.

Nonetheless, Moody's acknowledged SA's deep economic, fiscal and social challenges by suggesting the reform agenda, set out in the president's State of the Nation Address (SONA), was ambitious.

An improvement in economic activity and firmer growth prospects were further highlighted as reasons behind Moody's rating decision. The SARB's recent growth revisions suggested the country did not enter a technical recession recently and, instead, actual growth was higher than initially expected. Moody's suggested higher expected growth this year would award government with additional fiscal and political space to pursue economic reforms.

Although the sharp recovery in confidence was pointed out as being positive, Moody's emphasised the need to sustain higher levels of confidence through a continued implementation of structural reforms. The reforms, according to Moody's, must include progress in mining, energy, SoEs and competition.

In addition, Moody's noted the February 2018 national budget outlined a clear strategy to reduce fiscal pressures and adjusted its projections to reflect an expected stabilisation in government's debt-to-GDP (gross domestic product) ratio at 55% between 2018 and 2020. Together, higher economic growth, a restraint on expenditure, a broader revenue base and an improvement in SARS' collection capacity (likely driven by a change in leadership and an improvement in tax morality, in line with government's increased efforts to curb corruption) are expected to drive a stabilisation (and ultimate reversal) in SA's debt ratio.

The rating agency was comforted by the material cuts made to government's expenditures (outside of the additional spending allocated to free higher education) and government's willingness to make a front-loaded fiscal adjustment. Moreover, Moody's mentioned the increase in value-added taxes signalled "a marked, and credit positive, policy shift".

That said, Moody's raised concerns over government's ability to make inter-departmental expenditure cuts, particularly with regards to civil servant wages. It also remained concerned over material risk arising from government's contingent liabilities, specifically noting the "fragile state" of public energy utility, Eskom.

Positive ratings action needs institutional problems addressed and reform implementation

According to Moody's, a ratings upgrade would require government to effectively address institutional problems and implement its reform agenda. Through reform, potential growth could rise, alleviating fiscal pressure. A rebuilding of SA's fiscal buffers and a reduction in contingent liabilities are possible in a higher growth environment, where revenue potential is boosted.

Moody's further requires progress on long-standing structural issues, in mining and agriculture, in particular, to consider a ratings upgrade.

Negative ratings action could be triggered by a faltering commitment to revived growth and debt stabilisation

Should government's commitment to revived growth and debt stabilisation falter, Moody's would likely react by dropping SA's sovereign rating outlook back to negative, from stable. The delivery of structural reforms between now and the 2019 national elections and its consequent effect on investor and business confidence will continue to weigh on SA's rating, given the implications for near-term and potential growth.

Moody's continued to highlight negative fiscal developments as a trigger for an outlook reversal to negative.

These included SoE risks materialising, which would place a larger burden on SA's debt trajectory.

SA dodges an expulsion from the Citi WGBI

Although investor confidence has been lifted by a better-than-expected growth outcome for 2017 and a number of positive political and fiscal developments since the

market-favourable outcome of the African National Congress (ANC) National Conference in December 2017 (including the appointment of credible ministers in key ministries, leadership issues being addressed at SARS, an ongoing investigation into state capture and a brighter, but still credible, fiscal outlook announced in the February 2018 national budget), there is still a non-negligible risk of a change in Moody's outlook on SA from stable back to negative on 12 October 2018.

The sustainability of business and consumer confidence will be dependent on the new administration's ability to keep the momentum behind the implementation of structural economic and political reforms, to usher in an era of higher growth.

Investors will be seeking clarity on the adoption of land reform without expropriation as a policy of the ruling party and will remain vigilant of signs that the rule of law has been reinstated in the country, through the conviction of a number of individuals involved in high-profile corruption cases.

Despite governance issues having been addressed at key parastatals, a more sustainable funding solution for ailing SoEs needs to be finalised to lower the risks to Treasury's contingent liabilities being absorbed onto government's balance sheet.

A downgrade in SA's local currency rating to junk status by Moody's would have triggered SA's exclusion from the Citi WGBI, which could have prompted significant capital outflows from the SA government bond market. Estimates of potential outflows ranged anywhere between R85 billion and R130 billion.

Citi noted that, while SA bond buying by foreign investors in the run up to the 2012 index inclusion might have been staggered, the rush for the exit door could have been crowded. Furthermore, re-entry into the index, once being excluded, is difficult to achieve. The Citi WGBI requires a minimum credit quality of A- by S&P and A3 by Moody's for the country's local currency rating (four notches above junk status).

Standard & Poor's (S&P) is expected to review SA on 25 May 2018, while Fitch Ratings has not released its review dates for SA. While under its base case scenario, Momentum Investments does not expect further negative ratings action from S&P in its upcoming review, a ratings outlook upgrade will remain dependent on S&P's growth forecasts and progress on growth in GDP per capita trends.

Table 1: SA sovereign ratings matrix

Long-term rating	S&P	Fitch	Moody's
Investment grade	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1
	BB	BB	Ba2
Outlook	Stable	Stable	Stable

Local currency rating
Foreign currency rating
Both ratings

Source: S&P, Moody's, Fitch, Momentum Investments

Sanisha Packirisamy
Economist
Momentum Investments

Herman van Papendorp
Head: Macro Research and Asset Allocation
Momentum Investments

Partially Vesting Smooth Bonus Range

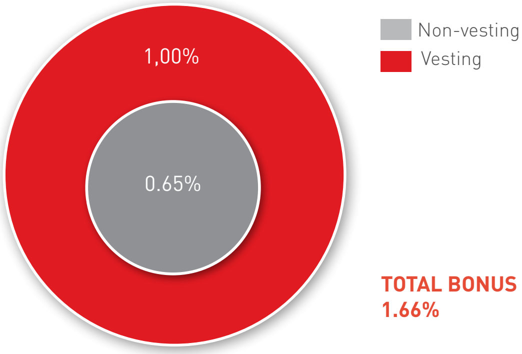
Multi-Manager Smooth Growth Fund Global

Fund Snap Shot

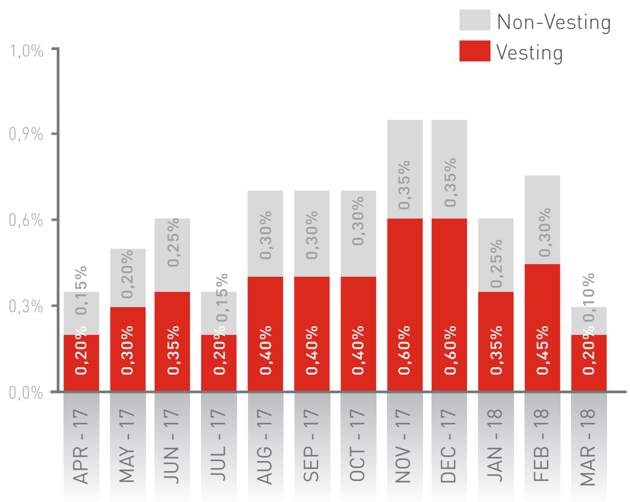
INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN
Jan 2004	95% - 105%	R12.6bn	1.10%	4,91%

Performance

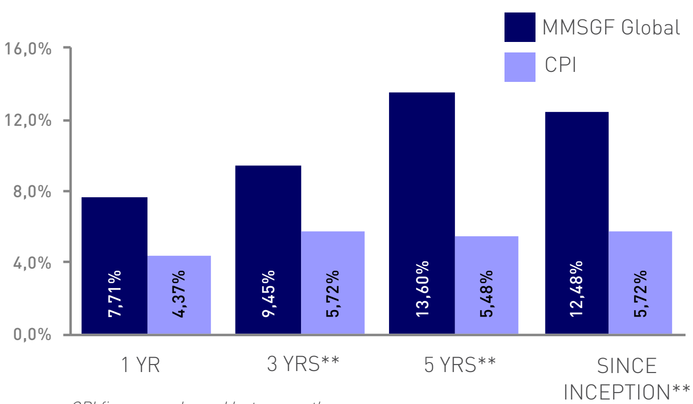
The total bonus* for the past quarter on the Multi-Manager Smooth Growth Fund Global is shown below.



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



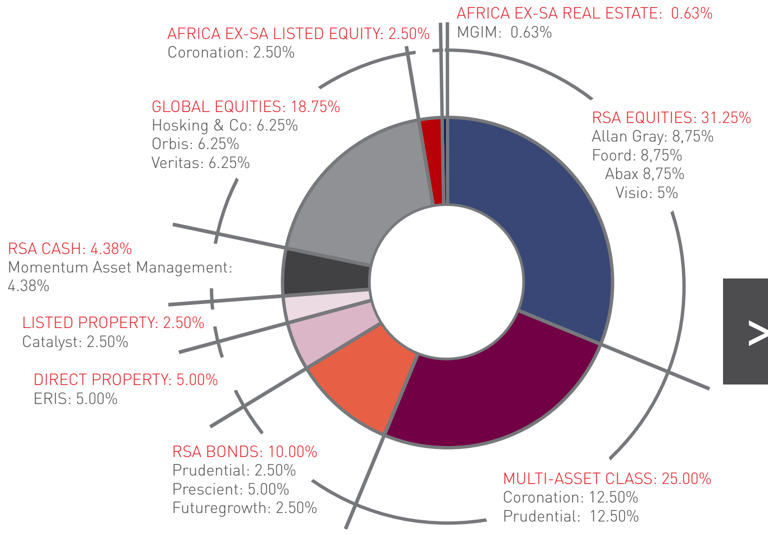
The chart below shows the long term bonus* performance of the Multi-Manager Smooth Growth Fund Global against CPI



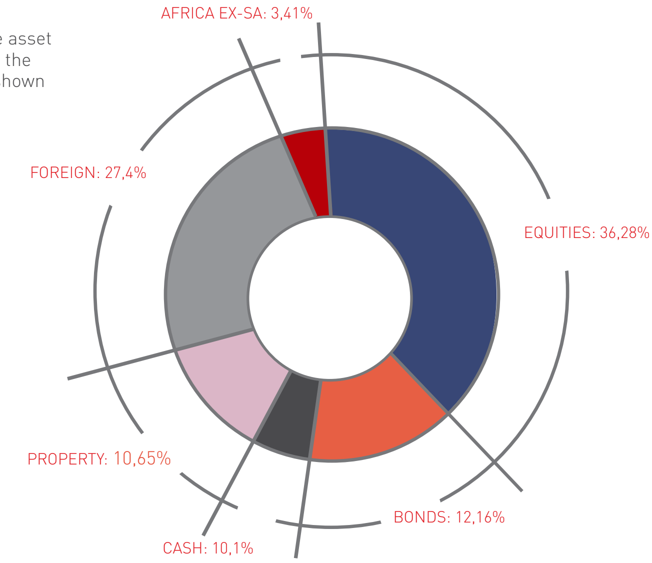
CPI figures are lagged by two months

Asset Allocation

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.



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.

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

Partially Vesting Smooth Bonus Range

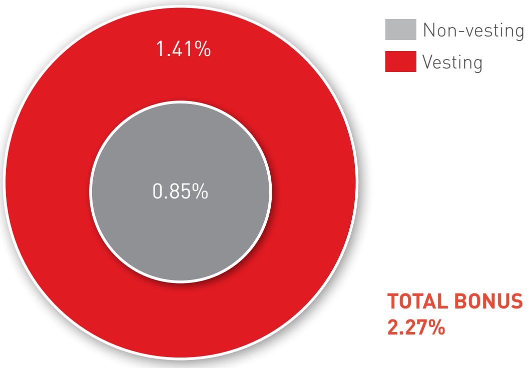
Multi-Manager Smooth Growth Fund Local

Fund Snap Shot

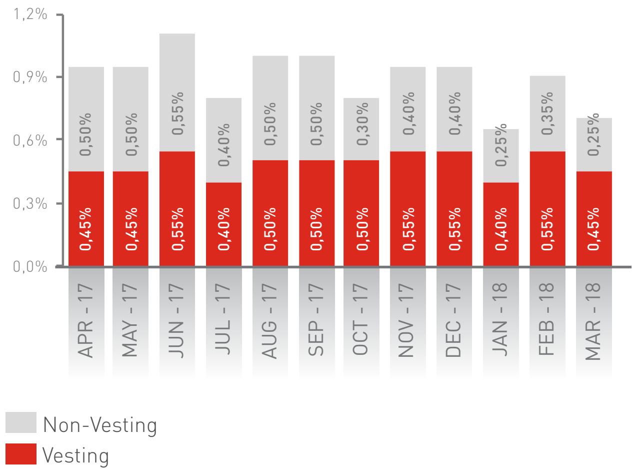
INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN
Jan 2004	100% - 105%	R247.6m	1,99%	4,09%

Performance

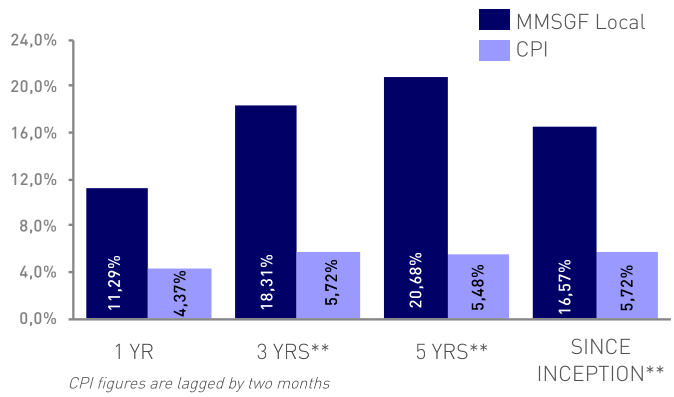
The total bonus* for the past quarter on the Multi-Manager Smooth Growth Fund Local is shown below.



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 Local against CPI

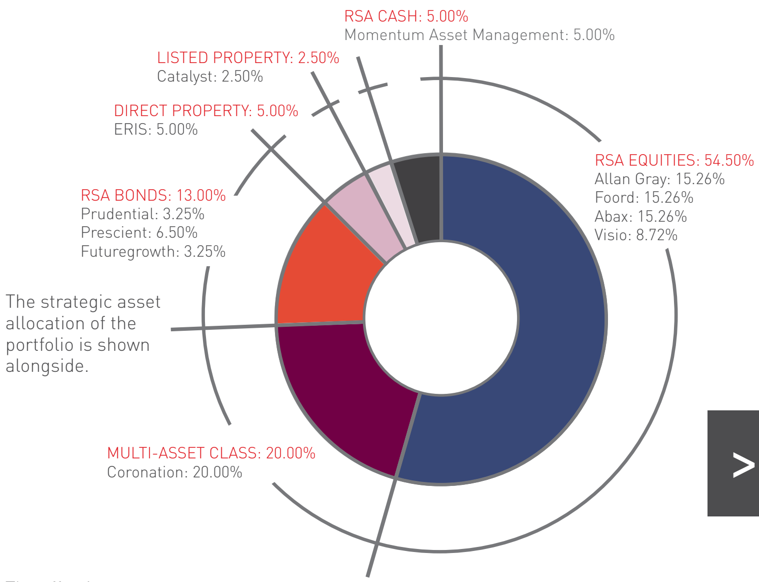


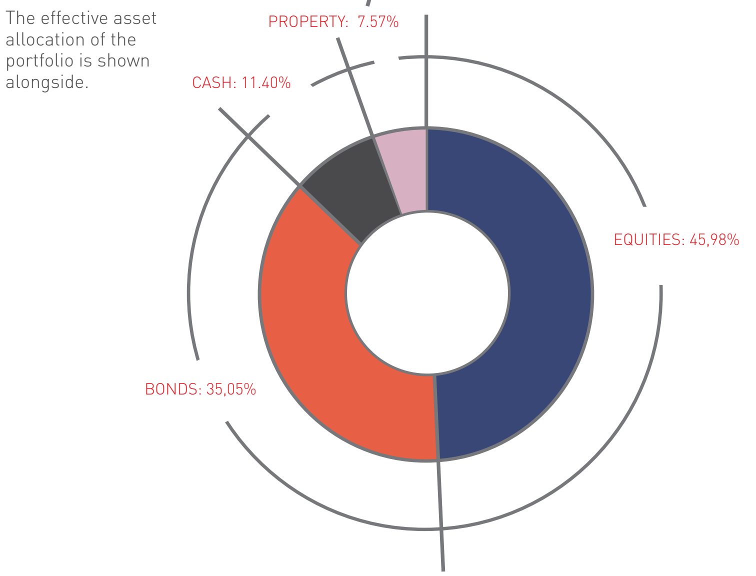
CPI figures are lagged by two months

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

** Annualised

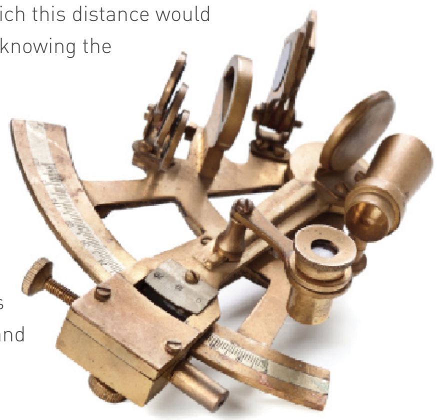
Asset Allocation





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.



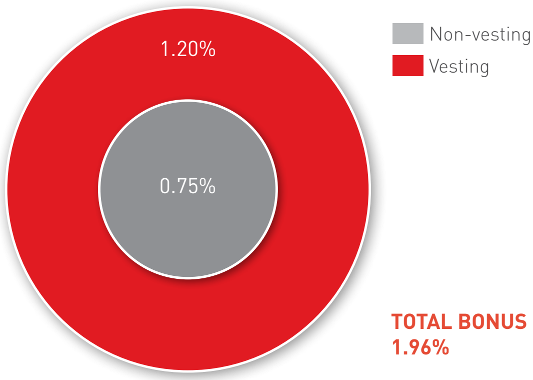
Partially Vesting Smooth Bonus Range
Smooth Growth Fund Global

Fund Snap Shot

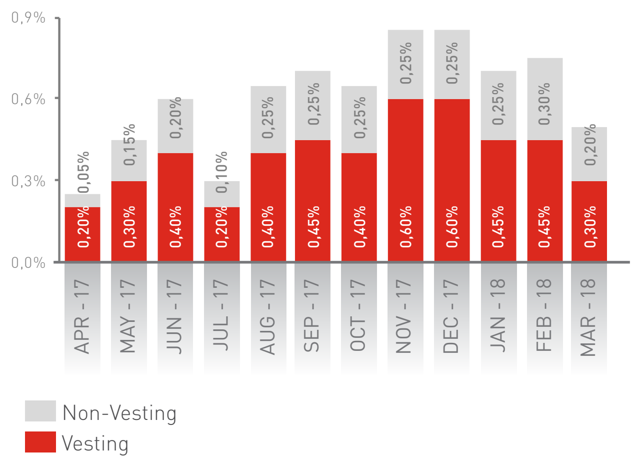
INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN
Jan 1989	95% - 100%	R2.3bn	1.20%	4,33%

Performance

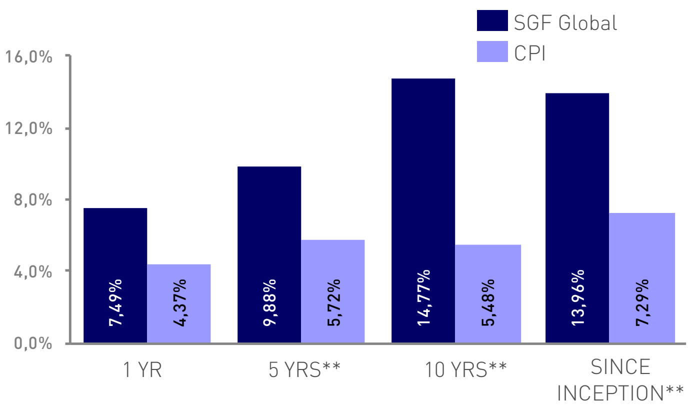
The total bonus* for the past quarter on the Smooth Growth Fund Global is shown below.



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



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

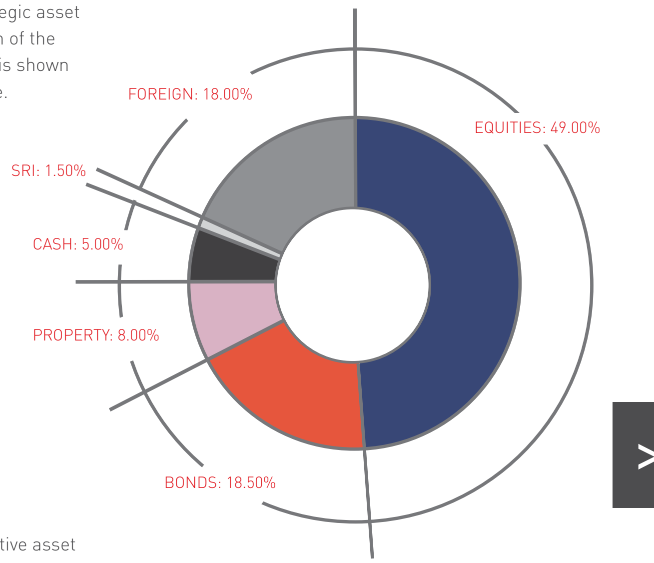


CPI figures are lagged by two months

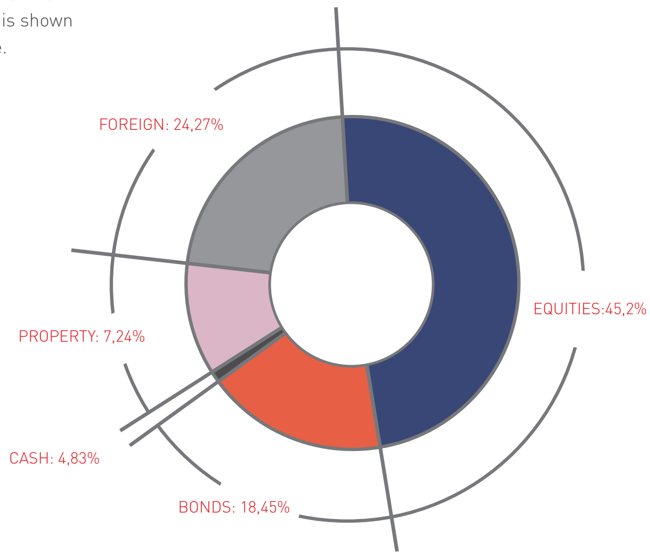
* Bonuses are net of underlying asset charges but are gross of the policy fee
** Annualised

Asset Allocation

The strategic asset allocation of the portfolio is shown alongside.



The effective asset allocation of the portfolio is shown alongside.



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.

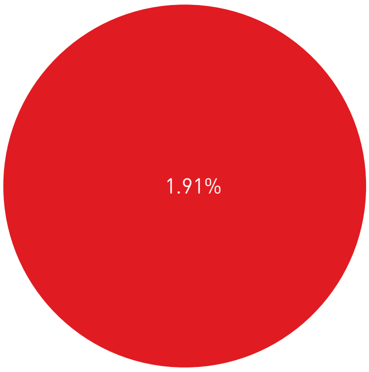
Fully Vesting Smooth Bonus Range
Multi-Manager Secure Growth Fund

Fund Snap Shot

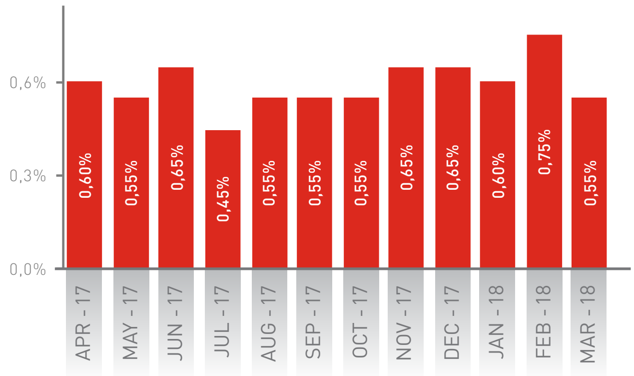
INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN
Nov 2007	100% - 105%	R47.0m	0,85%	4,95%

Performance

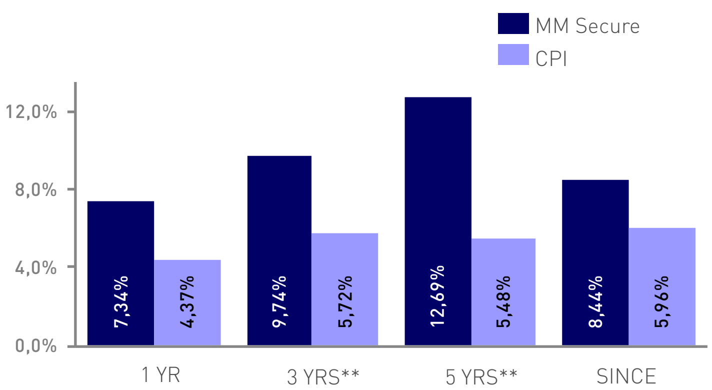
The total bonus* for the past quarter on the Multi-Manager Secure Growth Fund is shown below.



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

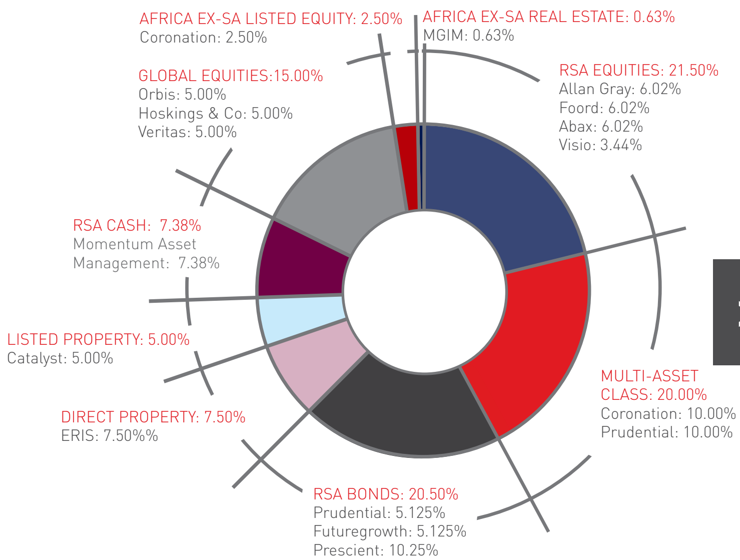


CPI figures are lagged by two months

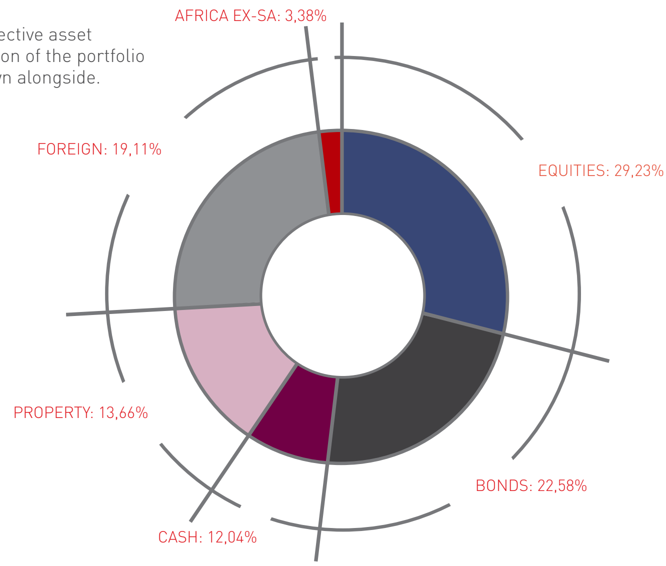
* Bonuses are net of underlying asset charges but are gross of the policy fee
** Annualised

Asset Allocation

The 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.



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

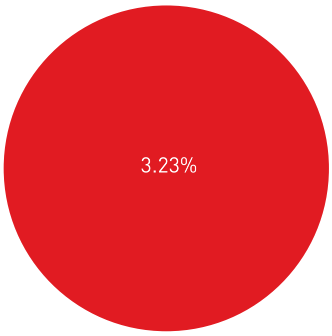
Multi Manager Secure Growth Fund Bonus Series 2013

Fund Snap Shot

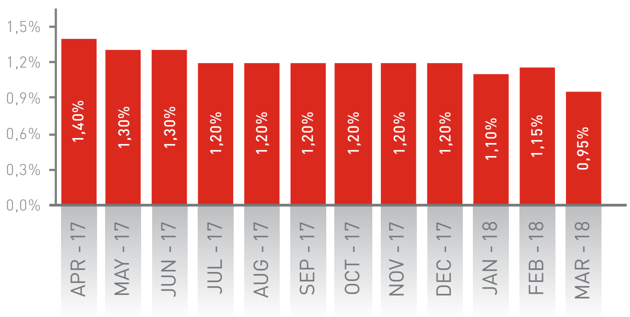
INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN
Jun 2013	105% - 110%	R65.1m	1,33%	4,91%

Performance

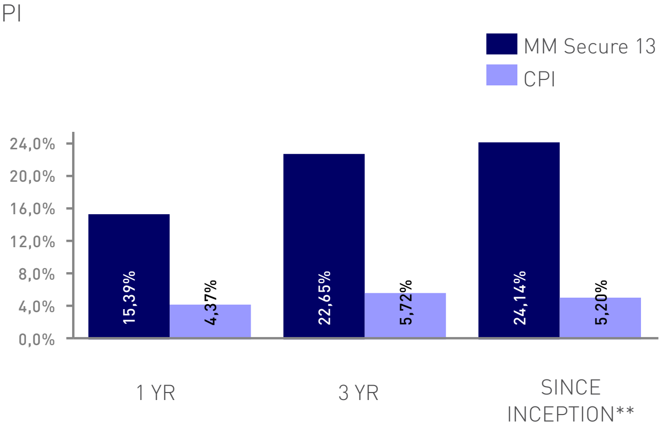
The total bonus* for the past quarter on the Multi Manager Secure Growth Fund Series 2013 is shown below.



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



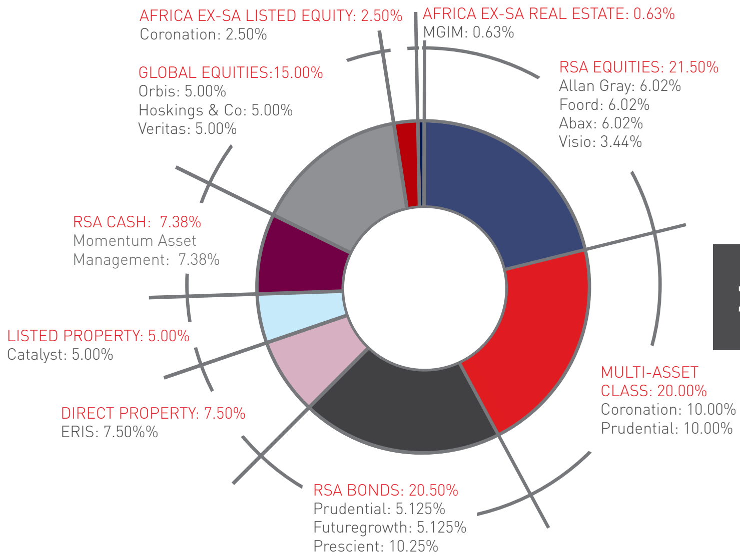
CPI figures are lagged by two months

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

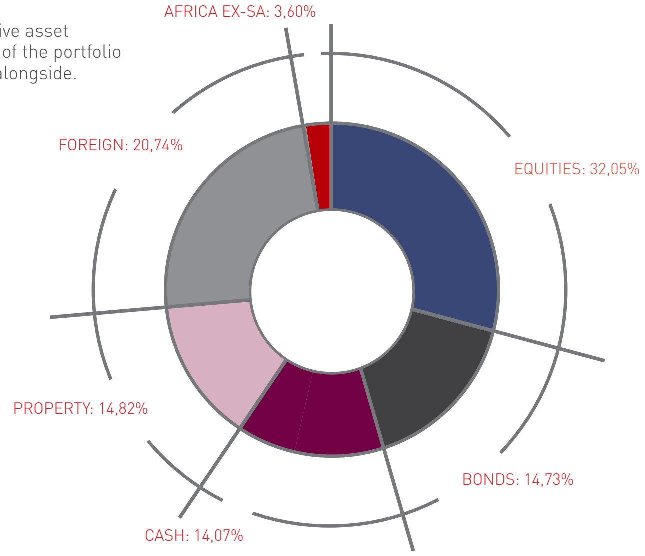
** Annualised

Asset Allocation

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.



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

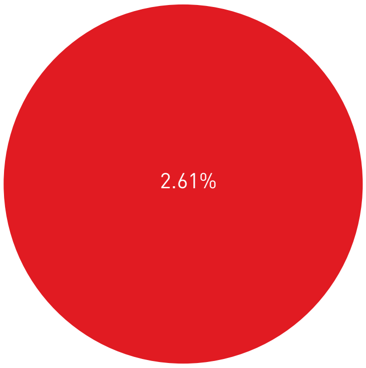
Smart Guarantee + 3 Fund

Fund Snap Shot

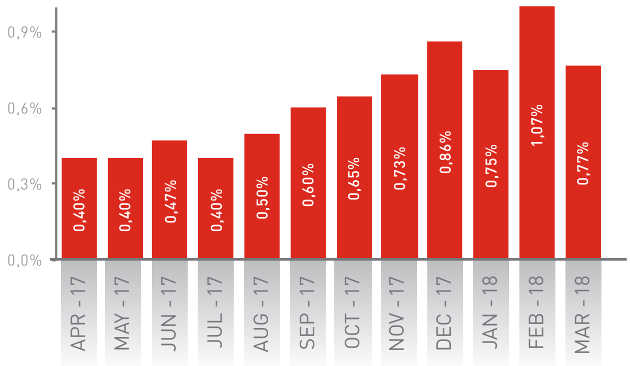
INCEPTION DATE	FUNDING LEVEL RANGE	FUND SIZE	ANNUALISED 3-YEAR VOLATILITY OF BONUSES	ANNUALISED 3-YEAR UNDERLYING ASSET RETURN OF BONUS GENERATING PORTFOLIO
Oct 2013	95% - 100%	R275.7m	0.61%	4,34%

Performance

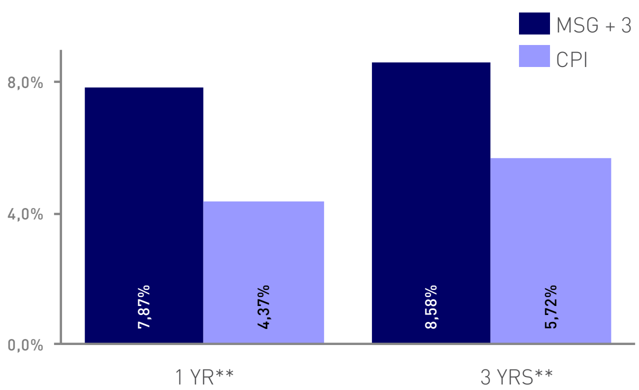
The total bonus* for the past quarter on the Smart Guarantee + 3 Fund is shown below.



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



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



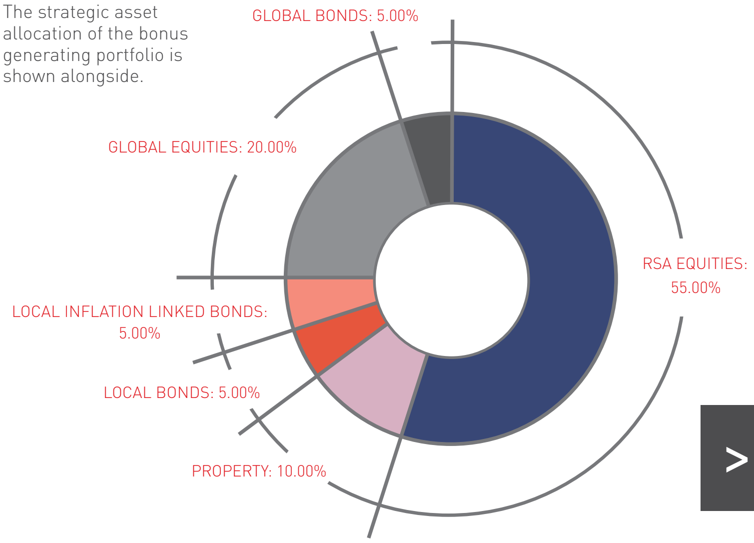
CPI figures are lagged by two months

* 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, 85% 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 2 month lag), around **2.80%** 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

		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 Momentum Investments	Moderate Balanced	100% of net capital invested and total bonus declared (net of the Policy fee)	Yes	0.50% pa	0.75% pa[3]	October 2013

KEY:
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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