QUARTERLY INVESTMENT UPDATE

Q3 2021

NEDBANK PRIVATE WEALTH
SINCE 1834

GLOBAL AND SOUTH AFRICAN CONTEXT AT THE END OF Q3 2021

- Volatility affected global markets during the quarter due to tension between the pandemic and the uncertainty about whether governments and central banks would withdraw policy support or not.
- The three themes that led to flat or negative markets for many risk assets (especially equities) were the following:
  - Peak global growth.
  - Regulatory and credit tightening in China.
  - Inflationary pressure against a policy trajectory of lower liquidity.
- The massive declines in all Chinese asset prices and the Chinese state affected developed and emerging markets because of its material contribution to the global economy.
- The low base from which the global recovery started and which gave us some high numbers ('base effects') are now behind us.
- After a strong first two quarters of the year, the above factors, the ongoing energy crisis, increased demand and supply chain disruptions have led to inflationary headwinds for the global economy and moderating growth expectations.

- South African markets echoed the global trend over the first and second quarters, and despite lockdowns and lower levels of vaccination, consumers were surprisingly resilient. This, combined with a manufacturing sector that bounced back each time lockdowns eased, the broader global recovery and the commodity cycle, led to higher growth than would have otherwise been the case. Some of these tailwinds are dissipating and the biggest impact from this cyclical boost looks to be behind us.
- Despite possibly having seen the peak, our purchasing manager index figures are still above the 50% mark, which indicates expansion.
- The economy recorded quarterly GDP growth of 1,2% (not annualised), exceeding market expectations again. Activity data released over the month confirmed the negative impact of the unrest in July on the economy and confidence, but forward-looking measures also suggest that a recovery is underway, as businesses get back to operation.
- The rand weakened by around 1,7% against the US dollar in September.
- The South African Reserve Bank (SARB) kept interest rates unchanged but highlighted increased risks to near term inflation.

OUR VIEWS

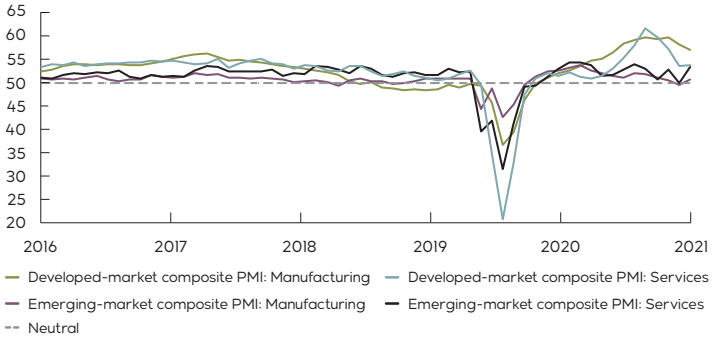
We take a long-term view, remain diversified and focus on valuations.

As long-term investors, we do not tend to chop and change our portfolio allocations in response to the latest headline news. Instead, we strip out the 'noise'. While we keep a close eye on gradually evolving global themes and the long-term risks and opportunities that may arise, we focus on what we think are key long-term valuations and long-term expected returns and prospects, both for asset classes and underlying shares and instruments.

LOOKING BACK

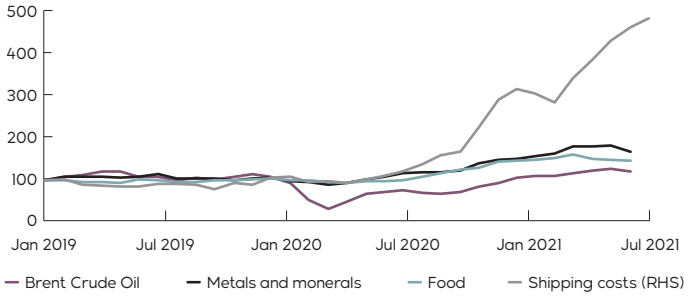
- **The FTSE/JSE All Share Index** returned -0,8% for the quarter. Notable contributions to this outcome were the following:
  - **Industrials**, which returned -5,3%.
  - **Resources**, which returned -3,8% due to another poor quarter for precious metals.
  - **Financials**, which returned 12,7%.
  - **Domestically exposed small-cap shares returned** 11, 7% and **mid-cap shares** returned 7,2%, both again doing better than their large-cap counterparts. The **Capped SWIX** 40 and **SWIX 40** indices returned 3,3% and -0,5%, respectively.
  - **South African preference shares** were the top performers for the quarter, returning 16,7%, followed by the **South African property** sector, which finished the quarter with a return of 5,9%.
- **Inflation-linked bonds** returned 2,0%, **South African cash** returned 1,0%, and the **BEASSA All-Bond Index** returned 0,4%.

The growth outlook is still constructive, but facing more headwinds.
There is stronger momentum in developed economies; manufacturing is still strong but dealing with supply bottlenecks.



Source: Refinitiv, Markit IHS, data as September 2021

Trade and supply disruptions present a more enduring risk: input pricing pressures in context.



Source: Refinitiv, data to end September 2021, Shanghai Containerised Freight Index (SCFI), OECD Economic Outlook Interim Report September 2021.

LOOKING AHEAD

- Globally, countries are moving back to trend growth. While the outlook is still constructive, the unwinding of initial base effects is likely to mean that expectations may need to be moderated.
- Chinese growth is facing multiple headwinds and may therefore be disappointing. This could continue to have a knock-on impact on related economies, as we have seen this past quarter.
- The global earnings recovery was better than expected and expectations have now moderated but are overall still positive.
- Headline valuations have moderated, but are still elevated in many places.
- Lower global liquidity is bound to cause market volatility, but broader policy is still supportive. Labour markets are key to the timing and progression of interest rate hikes.

OUR WEALTH ADVISORY AND INVESTMENT APPROACH REMAINS CONSISTENT

VALUATIONS

Investment returns are a function of what you get (value) for the price you pay, adjusted for risk. There are certain investments that we want to own in the long term and certain investments that we do not.

DIVERSIFICATION

We recognise the benefits of diversifying across countries, currencies, asset classes, business sectors and counterparties to ensure that we make the most of your wealth at the lowest risk throughout market cycles.

LONG-TERM VIEW

Investing in financial markets offers the best results over the long term (five years or longer).

OUR ASSET ALLOCATION AND PORTFOLIO POSITIONING

Asset class	Previous positioning	Current positioning					Our current views
		UW		Neutral		OW	
Global	Overweight (OW)						**The global asset allocation is tilted to provide capital protection and income.** We have a preference for risk assets although we are conscious of the fact that economic growth is starting to peak in some developed countries. Equity valuations are no doubt stretched, however, there are pockets of opportunity. Currently, the macro outlook appears to favour value and small caps. The investment case for emerging markets is becoming more appealing and one we are monitoring. Real assets appear attractive as an alternative to fixed income and with some inflation protection. Alternative strategies are preferable in the current environment to provide a credible diversifier within portfolios. Cash holds little attraction as do fixed-income assets with the exception of higher yields where a supportive default environment should mitigate risk. Overall, we are overweight risk assets (equity, real assets and alternatives), underweight fixed income and underweight cash.
South African equities	Neutral						**We leveraged the weakness over the quarter to add to our equity allocation, but stock selection remains key.** • Headline index levels have retraced as index bellwethers, Naspers and Prosus lost ground, while resource counters were hit hard as commodity prices retraced from historic highs. Local sectors have shown more resilience with company earnings exceeding expectations. Idiosyncratic risk and corporate restructuring have offered diversification to portfolios. Certain sectors and companies still offer opportunity for long-term investors. • South African corporates are likely to face an improved, but still challenging, economic backdrop over the coming year, but this is highly dependent on the progression of vaccine rollouts, load-shedding and sector-specific trends. Companies with high debt levels remain vulnerable in this environment, although many have successfully prioritised and improved balance sheets. • Stock selection remains key and should help differentiate between and within sectors. **For now:** We have added to equites on extreme valuations and on maturing hedges, leveraging the weakness over of the quarter. Portfolios are modestly overweight equities.
Alternatives	Overweight (OW)						**We continue to recalibrate portfolios and maintain a balanced risk profile.** Portfolios have a modest overweight exposure to equity-linked notes to provide some protection from equity market falls.
South African property	Underweight (UW)						**We have been cautious on property for the last few years, tactically entering stock-specific trades on extreme valuation opportunities.** • Return expectations have been revised to allow for a reintroduction of distributions, base effects, improvements in balance sheets and trends in reversions. • Structural changes continue to play out globally and locally, which may not be fully captured in a structural asset and rental value correction yet. • Domestic property valuations offer a margin of safety but require a consistent improvement in economic conditions to address demand-supply imbalances. • The accommodative monetary policy backdrop and a slow, modest interest rate hiking cycle should present a benign environment. This could become a modest headwind as interest rates start rising. If inflationary pressures persist and the interest rate hiking cycle becomes more aggressive, it could increase the risk. • The cost of the recent protest action is significant for the sector, but the exposure varies. **For now:** We have retained some exposure to capitalise on attractive entry points, but caution that a focus on quality is essential.
South African preference shares	Underweight (UW)						**Preference shares continue to offer attractive after-tax returns relative to cash, but returns have moderated after a strong rerating of bank capital values.** • SARB prefers a gradual path to interest rate hikes but have raised concerns about inflationary pressures. • Capital values should be more stable with upside from here on a medium-to long-term view. • Corporate activity has led to rerating in several instances but also decreases the opportunity set. Nedbank has indicated that they intend to make an offer to all non-redeemable, non-cumulative preference shareholders. Bank preference shares rerated on the news. • Floating-rate instruments will become more attractive as a standalone opportunity and diversifier, as interest rates rise. **For now:** • This is a reasonable hold in our portfolios providing an annuity-like income stream and diversification. • The sector could be vulnerable if there is a credit ratings downgrade and forced selling, given the low liquidity.

South African bonds	Overweight (OW)						**Nominal bonds are still attractive, but fiscal risks remain elevated with high execution risk.** • Cyclical tailwinds have benefited the fiscus with revenues surprising to the upside, while expenditure remains broadly within budget although spending pressures continue to emerge. Riots have been a setback and the pace of vaccinations and further lockdowns continue to present some downside risk to the growth outlook. Increased spending on Covid-19 and unrest relief will largely be funded by overruns in revenues and detracts from potential improvements to fiscal numbers. Additional requirements from Sasria and other state-owned enterprises remain a risk. • Food inflation, increases in electricity tariffs, a higher oil price and base effects will result in an inflation increase. Supply-side pressures aside, we expect inflation to remain broadly contained, close to the South African Reserve Bank midpoint in the medium term. Input pricing pressure remains a risk in the near term and is worth monitoring. • Global central banks are likely to remain broadly accommodative but broadening inflationary pressure and the withdrawal of liquidity are likely to be the cause of more volatility in the year. South African bonds are vulnerable in these conditions, despite the additional compensation they offer, and we are therefore watching these conditions closely. • Fiscal metrics presented at the Medium-term Budget Statement are likely to be better than those presented earlier in the year, not least so because of the restated gross domestic product. The trend, however, remains the same and policymakers will need to stay disciplined to convince investors of further fiscal consolidation in the face of increasing expenditure needs such as wages and the possible extension of grants. • Public sector wages have been agreed for one year, and though reasonable, still require budget reallocation. A multi-year agreement remains outstanding. **For now:** Given the starting valuations in our local bond market, we believe nominal bonds are still attractive on an absolute and relative basis, even when allowing for a variety of scenarios for global bond yields and local inflationary dynamics. Fiscal risks, however, remain elevated with high execution risk. Directionally we see merit in taking profits, as and when valuation allows.
Cash	Underweight (UW)						Cash is a stabilising factor and provides us with the optionality to deploy this, when appropriate opportunities arise.

HOW WE IMPLEMENT OUR INVESTMENT APPROACH

A proven asset allocation framework

Successful tactical asset allocation

Good stock selection

LONG-TERM THEMES THAT WE ARE WATCHING, GLOBALLY AND LOCALLY.

GLOBALLY THE REBOUND IS BEHIND US, AND AN UNEVEN BACKDROP REMAINS.

We have seen peak growth and the Delta variant of the virus caused an unsurprising slowdown in third-quarter activity. The growth outlook is still constructive but facing headwinds. Increased demand, weather-related disruptions and supply discipline have resulted in the oil price rising to a multi-year high. This, combined with increased input prices for metals and minerals, food, shipping and supply-side shocks, has caused inflation to increase more than expected, putting policymakers between a rock and a hard place. As commented by Andrew Bailey, the Bank of England Governor, 'Monetary policy will not increase the supply of semiconductor chips ...'. Employment is still below prepandemic levels, but average wage growth has increased, despite the underlying data revealing a great dispersion between sectors and different workers. Although house price increases will ultimately impact rentals and inflation, the equally important consideration is increased household credit against a backdrop of rising interest rates. Markets are starting to worry about stagflation.

POLICYMAKERS ARE IN A TRICKY POSITION IF INFLATION INCREASES, ECONOMIC GROWTH SLOWS, AND UNEMPLOYMENT REMAINS HIGH.

This is stagflationary and is a dilemma because actions designed to lower inflation may raise unemployment, and policies designed to decrease unemployment can worsen inflation. Inflation expectations are higher than the Federal Reserve's average target but are still fairly contained – real yields are still accommodative but artificially low.

UNTIL EVERYONE IS SAFE, NOBODY IS SAFE AND WITH COUNTRY-SPECIFIC CHALLENGES REMAINING, A CONCERTED GLOBAL VACCINATION EFFORT IS REQUIRED.

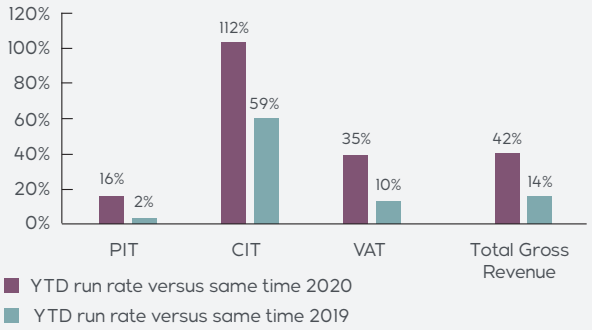
While the spread of the Delta variant of the virus has largely subsided, the Federal Drug Authority in the US approved the Pfizer vaccine, and there has been encouraging news about antiviral medicines from Merck, it has not been smooth sailing. There has been a slower-than-expected vaccine roll-out in many emerging markets.

IN TERMS OF SOUTH AFRICA'S' POTENTIAL, CYCLICAL TAILWINDS ARE TURNING A CORNER AND THE CIVIL UNREST WAS A SETBACK, BUT STRUCTURAL REFORMS HAVE THE POTENTIAL TO CREATE HIGHER PRODUCTIVITY AND TREND GROWTH.

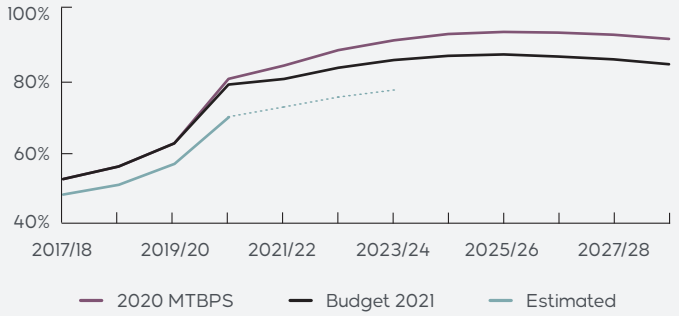
South Africa should benefit from a positive, albeit moderating, global growth backdrop and improved emerging market sentiment, as vaccination roll-outs improve. The local civil unrest has been a major setback to growth recovery and employment. But local reforms and investment offer upside potential if implemented. While the country has fewer vulnerabilities than in 2013, reforms remain the only way of sustainably lifting economic growth and long-term earnings prospects.

IMPROVED METRICS

Improved revenues.



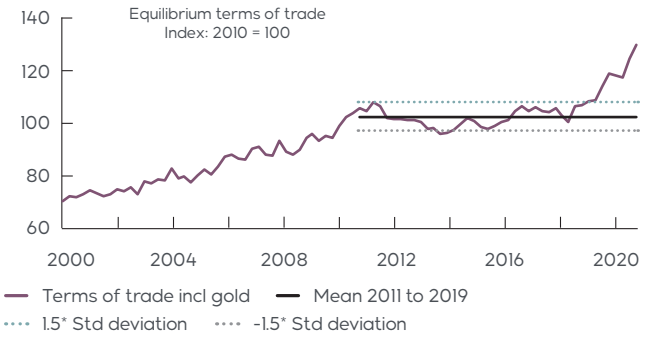
Impact of restatement of GDP provides an improved starting point, even if trend remains.



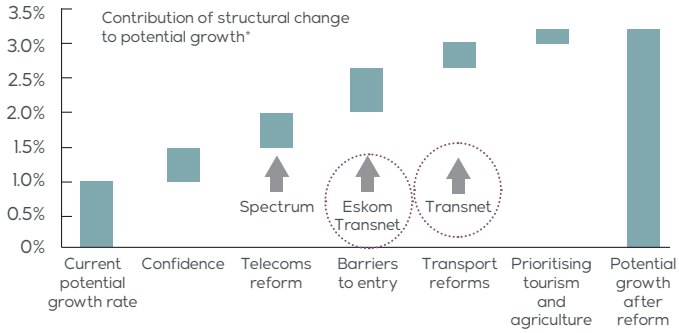
Source: Refinitiv. Stats SA. National Treasury – preliminary revenue figures to end August 2021

SOUTH AFRICA'S POTENTIAL

Cyclical tailwinds turning a corner and civil unrest was a setback.



Reforms have the potential to create higher productivity and trend growth. Not to be overstated, but also not underestimated.



Source: SARB Monetary Policy Review, September 2021, Refinitiv, First Rand Annual Results Presentation, National Treasury

OUR DEPTH AND BREADTH OF RESOURCES, PEOPLE AND INSTITUTIONAL EXPERTISE GIVE US THE EDGE

A DEDICATED WEALTH MANAGER WHO WILL HELP YOU MAKE THE MOST OF OUR SERVICES.	With personalised advice from a single point of contact, you can take advantage of exclusive access to portfolio managers as well as fiduciary, insurance, philanthropy and specialised-lending experts.
AN ACCESSIBLE INTERNATIONAL TEAM OF SPECIALISTS.	We can meet your global-investment and banking needs in an integrated way.
A SOCIALLY RESPONSIBLE APPROACH TO WEALTH MANAGEMENT.	We are committed to applying our collective expertise and wealth management insights to offer you smart choices that have a positive long-term social impact and make your wealth count.
A RICH HISTORY AND HERITAGE THAT DATES BACK TO 1834.	We have been helping wealthy clients structure and plan their wealth successfully for nearly 200 years. This, combined with Nedbank's financial strength, resources and footprint, gives you institutional depth and breadth of insights and experience.

nedbankprivatewealth.co.za