momentum investments

The Macro Research Desk

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Economic and market snapshot for August 2016

Global economic developments

United States (US)

Debating the neutral rate of interest, as estimates of potential growth decline

Despite meaningful progress being made in the labour market (total employment has risen to 152 million from the pre-crisis peak of 147 million in late 2007), real economic activity has only expanded at an average rate of 1.8% since the global financial crisis, considerably lower than the long-term average of 3.2%. For Okun's Law (a macroeconomic relationship, which demonstrates that the unemployment rate tends to fall when output is growing faster than its potential) to hold today, it would mean that growth in potential output has been lower than originally thought.

Former US Federal Reserve (Fed) Chair, Ben Bernanke, argues that a reduction in potential growth has lowered the neutral level of the Fed funds rate. He points out that "with a shorter distance to travel to get to a neutral level of the (Fed) funds rate, rate hikes are seen as less urgent even by those participants inclined to be hawkish".

He goes on to state that the Fed's projected potential output has fallen by 0.5% cumulatively in the past four years, thanks to low levels of productivity. This translates into a loss of US$1.1 trillion in gross domestic product (GDP) in 2016 currency terms over a ten-year period. In addition, the Fed's estimated unemployment rate in a steady state has dropped by 0.75% and its median forecast of the neutral rate of interest has declined notably by 1.25% (see table 1).

As a result, concerns have arisen over central banks' room to cut interest rates in response to a growth slowdown in an environment of low neutral interest rates. The minutes of the Fed meetings have increasingly contained indications that a consensus to raise interest rates is slowly building. Recent media comments by Fed members Dudley, Lockhart and Williams indicate that fears over inflated financial asset prices and the need to provide a 'cushion' above the zero lower bound suggest that an interest rate hike before year end is deemed necessary.

Table 1: Fed long-run projections

Year	Potential output*	Unemployment rate (in a steady state)*	Neutral rate*
2012	2.3 to 2.5	5.2 to 6.0	4.25
2013	2.3 to 2.5	5.2 to 6.0	4.00
2014	2.1 to 2.3	5.2 to 5.5	3.75
2015	2.0 to 2.3	5.0 to 5.2	3.75
2016	1.8 to 2.0	4.7 to 5.0	3.00

Source: Brookings blog post by Ben Bernanke
*Central tendencies for growth and unemployment and Fed committee median for neutral rate

Moreover, Fed Chair, Janet Yellen, also intimated that a near-term hike was likely. She noted in her Jackson Hole statement that she believes "the case for an increase in the federal funds rate has strengthened in recent months" in light of the "continued solid performance of the labor market and our (committee) outlook for economic activity and inflation".

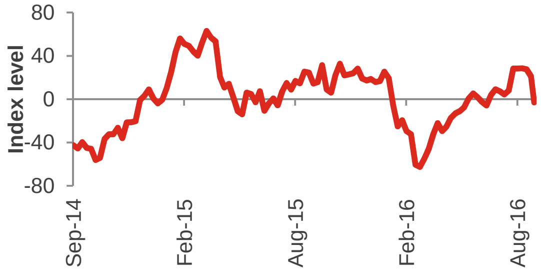
Momentum Investments expect a measured rise in interest rates to 1% by the end of 2017, peaking no higher than 2.25% in 2019, markedly lower than the Fed's current expected peak of 3%.

Eurozone

Key survey outcomes raising caution over future prospects in a post-Brexit world

Economic activity data surprises turned negative in late August according to the Citi Economic Surprise Index (see chart 1), potentially factoring in the implications of the United Kingdom's (UK) referendum to leave the European Union (EU).

Chart 1: Eurozone economic surprises turned negative



Source: Bloomberg, Momentum Investments

Forward-looking indicators, including the new sales orders subcomponent of the Eurozone manufacturing Purchasing Managers' Index (PMI), which fell to an 18-month low in August, have also signalled growth concerns further down the line.

Additionally, German business confidence (as reflected in the German Ifo Business Climate Index) collapsed at its fastest pace since the Eurozone debt crisis in 2012. While the index points to a deceleration in growth in the third quarter of the year, the country is still expected to grow at around 1% (year on year (y/y)) in 3Q16 based on Capital Economics' regression results.

Further monetary accommodation by the European Central Bank (including an extension of the current asset purchase programme) is nonetheless expected in response to softer growth and stagnant inflation.

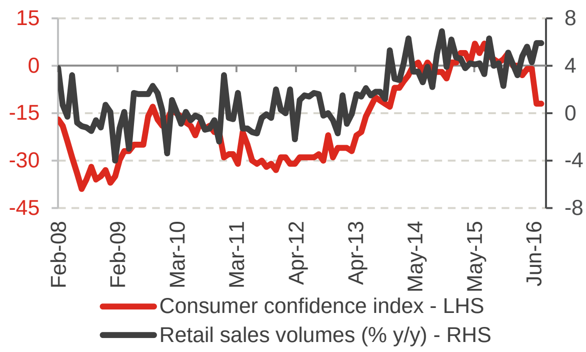
UK

Steep fall in the pound attracts tourists

Retail sales volumes (including fuel) increased by 5.9% y/y in July, exceeding the market's expectations for a more modest rise in light of a sharp deterioration in the consumer confidence index from 4 index points a year ago to negative 12 index points in July 2016 (see chart 2).

In monthly terms, retail sales volumes climbed 1.4%, with clothing and footwear retailers among the best performers. Specialist retailers (including jewellers) also reported a good month (16.6% y/y increase in sales). Tax-free shopping firms have indicated that a fall in the pound since the referendum has made holidaying in the UK much more affordable for overseas visitors and, as such, helped drive the bounce in retail sales growth in July 2016.

Chart 2: Weak pound benefiting tourism-related sales



Source: Bloomberg, Momentum Investments

While a fall in the pound could have a positive effect on growth from increased tourism and higher export volumes, the Brexit-related hit to confidence is expected to drag consumption and investment spending lower in the short to medium term.

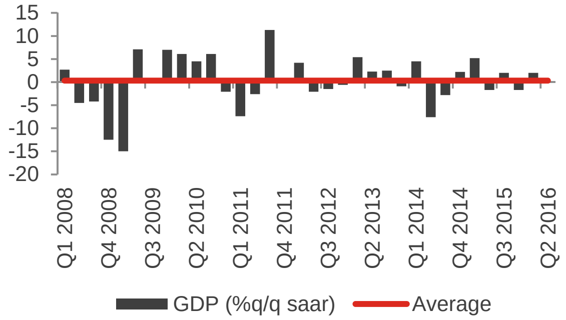
Despite an anticipated uptick in inflation in response to recent movements in the exchange rate, the Monetary Policy Committee (MPC) introduced a package of measures designed to provide additional support to growth. The package included a 25 basis point cut in the bank rate to 0.25%, a new Term Funding Scheme to limit the effect of bank profitability, the purchase of £10 billion of UK corporate bonds and an expansion of the asset purchase scheme for UK government bonds of £60 billion (taking the total stock of asset purchases to £435 billion).
The committee has signalled the likelihood of a further interest rate cut before year end.

Japan

Dramatic slowdown in GDP acceleration 2Q16

On an annualised basis, real GDP expanded at 0.2% in the second quarter of 2016, slowing sharply from the 2.0% increase in the first quarter of the year (see chart 3). This was markedly lower than the 0.7% print expected by the market. The full-year estimate based on the Bloomberg median consensus figure still stands at 0.5%, but this is likely to be revised lower given the disappointing second-quarter print.

Chart 3: Economic activity stagnating in Japan



Source: Bloomberg, Momentum Investments

Further yen strength (following Britain's decision to exit the EU, which pushed the value of safe-haven assets higher), an increase in international oil prices and prevailing economic uncertainty suggest further growth weakness.

The Japanese government has responded by unveiling a fiscal stimulus package worth US$278 billion to reinvigorate economic growth, but the jury is out on whether this will be sufficient to aid flagging economic activity.

Bank of Japan Governor, Haruhiko Kuroda, said that the Bank would "not hesitate to boost monetary stimulus if needed" and that "there is no doubt that there is ample space for additional easing in each of the three dimensions", here referring to asset buying, monetary-based guidance and negative interest rates.

Emerging markets (EM)

EMs back in vogue for now

Despite earlier concerns about the riskiness of developing regions, including depressed commodity prices and heightened political tensions, investors piled back into EM investments in recent months.

Real growth in economic activity has declined steadily every year since 2010, from 7.8% to an estimated 3.9% (Bloomberg median estimate) for 2016. A more pronounced rebound is expected in 2017, as economic fundamentals improve for the region.

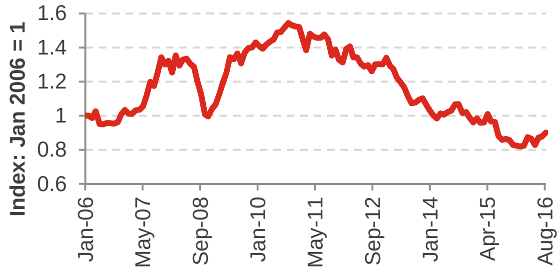
Commodity prices have staged a modest recovery, moving c.17% higher since their low point in January 2016, after collapsing 58% from their April 2011 peak. This has led to a reversal in the steep rate of decline in EM export growth (in value terms) from negative 16% y/y in mid-2015 to negative 5% y/y more recently, while volumes are now growing firmly in positive territory at 5% y/y.

Though the lagged effects of previous currency falls are still keeping headline rates of inflation stubbornly high in some geographies (including Latin America), recent currency strength should see price pressures abate in upcoming quarters, allowing for a more accommodative monetary policy stance.

While the Bloomberg consensus EM growth forecast of 4.9% for 2017 is slightly higher than this year's, the International Monetary Fund is a bit more cautious, leaving their estimate unchanged in the July 2016 forecast update at 4.6%. Likewise, Momentum Investments is of the view that growth risks remain to the downside. Political changes and the threat of rising protectionism could derail EM growth momentum in the current cycle.

With cash rates remaining at close to zero (or below) in many developed countries, investors are willing to take more risk and are searching for higher returns elsewhere. The MSCI EM Equity Index has climbed 13% since the start of the year, with its relative return against the MSCI World Index reversing course (see chart 4).

Chart 4: MSCI EM Index relative to MSCI World Index



Source: The Economist, Bloomberg, Momentum Investments

The Bank of America Merrill Lynch (BoAML) Global Fund Manager survey suggests that the portfolio allocation to EM equities improved to its highest level since September 2014, but remains below its long-term average. With geopolitical and protectionist risks still being viewed as the largest threats to financial market stability, EM investments remain vulnerable to a change in risk aversion among global investors.

Local economic developments

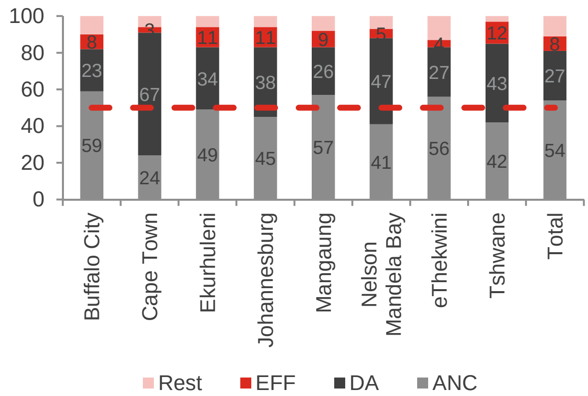
Growing public restlessness

The current ruling party lost support against a fragile economic backdrop in response to soaring unemployment rates and public perceptions of rising corruption. The African National Congress (ANC) experienced their worst electoral performance since democracy, entering the local government polls with a 62% national majority and control over seven of the country's key eight metropolitan municipalities (metros), but emerging from the local government election with only 53.9% over the national vote and fully controlling only three of the eight metros (see chart 5).

According to Standard Bank, this implies that the ANC now has sole control over 40% of the R233 billion budget across the eight metros, a sharp decline from 83% before the election.

The August 2016 local government election results have indicated that growing public restlessness with the status quo will result in SA politics being more contested and, as a result, more uncertain. Coalition and minority governments have become a more prominent feature of SA's political scene. While having a tendency to be unstable (given that enough members of the council need to support passing the budget or proceeding with legislation), this is still seen as a step towards encouraging multiparty democracy, potentially strengthening SA's political infrastructure.

Chart 5: Final vote in the key metros



Source: RMBMS, Momentum Investments

Nevertheless, pressure on the Presidency has led to the rating agencies voicing concerns about the rising threat to fiscal consolidation. In response to ANC Secretary General Gwede Mantashe's comments that "the national budget should be reprioritised to focus on key economic and social policies", Standard and Poor's

(S&P) and Fitch rating agencies have warned about a sovereign downgrade should institutions weaken due to "political interference affecting the government's policy framework".
As such, expectations for a cabinet reshuffle (following a vacancy for a deputy minister in the Department of Trade and Industry and speculation that former African Union Commission Chairperson, Nkosazana Dlamini-Zuma. will get a post in cabinet) have left political risk at elevated levels. A standoff between the finance minister and the president have further led to SA's credit default swap (CDS) spread and currency underperforming those of key EMs during the second half of August 2016.

Financial market performance

Global markets

It was a dull month in global markets. Global equities ended the month 0.3% higher, mostly reflecting a robust performance in EM, while developed markets inched marginally higher for the month.

The MSCI Developed Markets Index increased by 0.1% for August 2016, driven by gains in the Nikkei 225 (2.0%), while the Eurostoxx 50 and S&P 500 Index rose slightly by 1.2% and 0.1%, respectively, for the same period.

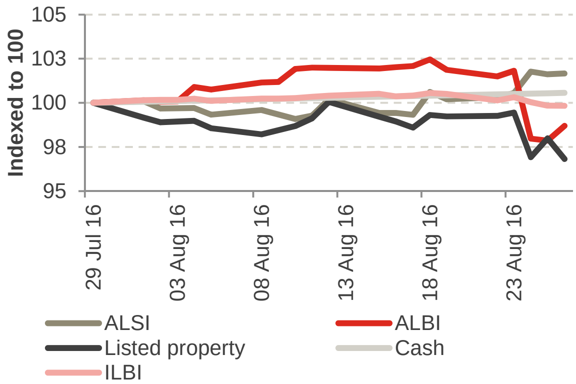
Although commodity prices lost 1.8% for August, the MSCI EM Index surged nearly 5% in the first half of the month, as investors became more sanguine about the prospect of interest rate hikes in the US. However, gains were pared back in the latter half of the month, following on from perceived hawkish comments from senior Fed members raising expectations of a near-term hike. The MSCI EM Index ended the month 2.5% higher, with the MSCI EM Asia Index posting the largest gains (4.0%), followed by a 0.7% increase in the MSCI EM Latin America Index, while the MSCI EM Europe, Middle East and Africa (EMEA) Index shed 2.6% for the corresponding period.

Local markets

Local asset classes were affected by heightened political risk triggered by a number of events, including the Hawks and the National Prosecuting Authority's (NPA) investigation into Finance Minister, Pravin Gordhan and four of his former colleagues at the South African Revenue Service (SARS).
Similarly, calls for hosting an earlier National Executive Committee meeting by the ANC Youth League and the SA Communist Party's concerns over the president's motives behind a potential cabinet reshuffle have increased political attention. The Food and Allied Workers Union's (FAWU) exit from the Congress of SA Trade Unions (Cosatu) has additionally raised risks in SA's labour and political setting.

The FTSE/JSE All-Share Index rose 0.3% in August 2016 (see chart 6), largely thanks to gains in rand-sensitive industrials. The FTSE/JSE Industrials Index increased by 1.9%, while the FTSE/JSE Financials Index and the FTSE/JSE Resources Index lost 3.2% and 0.9%, respectively, for the same time period.

Chart 6: Local asset class returns



Source: Bloomberg, Momentum Investments

The FTSE/JSE Mid-cap Index plummeted 4.9%, while the FTSE/JSE Small-caps Index gained 1.7% for August 2016. Mounting political tensions led to a 0.39% sell off in the BEASSA All Bond Index, while pressure in the bond market also weighed negatively on property shares. The FTSE/JSE Listed Property Index ended the month 4.9% in the red. Losses were limited in inflation-linked bonds with the Inflation-linked Bond Index (ILBI) losing 0.5% for the month. Meanwhile, SA cash ended the month 0.6% higher.

The SA rand underperformed key EM currencies in August, particularly in the second half of the month, as SA politics increasingly dominated news flow. The rand sold off by 5.8% against the US dollar and 5.5% against the euro. The US dollar initially weakened against the euro in early August, but strengthened towards month end in response to perceived hawkish comments by key Fed officials.

Indices summary for August 2016

Equity indices	One month	Three months	One year	Three years	Five years	Ten years
FTSE/JSE All-Share Index (ALSI)	0.27%	-1.63%	8.63%	11.00%	14.66%	12.35%
FTSE/JSE Shareholder Weighted Index (SWIX)	-0.66%	-0.08%	8.92%	13.28%	16.19%	13.69%
FTSE/JSE All Share Top 40 Index	1.19%	-3.05%	7.38%	10.18%	14.22%	11.75%
FTSE/JSE Mid Cap Index	-4.91%	6.17%	15.80%	15.13%	16.43%	15.82%
FTSE/JSE Small Cap Index	1.66%	4.34%	11.12%	14.93%	18.97%	15.09%
FTSE/JSE Resources Index	-0.85%	0.89%	-5.39%	-10.05%	-5.66%	0.07%
FTSE/JSE Financials Index	-3.23%	-2.57%	-3.93%	14.98%	18.34%	12.35%
FTSE/JSE Industrials Index	1.92%	-2.05%	12.75%	15.76%	22.41%	19.13%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	-2.22%	-0.03%	8.07%	7.79%	11.64%	11.53%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	-2.17%	0.57%	6.77%	7.39%	11.31%	11.06%
FTSE/JSE SA Listed Property Index (SAPY)	-4.89%	-0.65%	3.49%	16.63%	17.10%	17.34%
Interest-bearing indices						
BEASSA All Bond Index (ALBI)	-1.77%	4.48%	4.46%	7.14%	6.94%	8.35%
BEASSA All Bond Index 1-3 years (ALBI)	0.06%	2.38%	7.24%	6.70%	6.41%	7.84%
Barclays BEASSA SA Government ILB Index	-0.46%	1.65%	7.06%	9.07%	8.77%	9.87%
Short-term Fixed Interest Composite Index (SteFI)	0.62%	1.84%	7.03%	6.32%	5.96%	7.32%
Commodities						
NewGold Exchange-Traded Fund	3.11%	0.89%	27.79%	9.98%	8.22%	15.15%
Gold price (in rands)	1.45%	-0.03%	27.02%	10.00%	8.42%	15.69%
Platinum Exchange-Traded Fund	-3.39%	0.77%	14.42%	3.05%		
Platinum price (in rands)	-2.91%	0.63%	15.39%	3.00%	0.12%	3.01%
Currency movements						
Rand/euro movements	5.73%	-6.42%	10.26%	6.69%	10.30%	5.91%
Rand/dollar movements	6.04%	-6.60%	10.74%	12.80%	16.01%	7.38%
Inflation index						
Consumer Price Index (CPI)			6.03%	5.78%	5.72%	6.29%

Important notes

1. Sources: Momentum Investments (Pty) Ltd, INET BFA, www.msci.com, www.yieldbook.com, www.ft.com.
2. Returns for periods exceeding one year are annualised.
3. The return for Consumer Price Index (CPI) is to the end of the previous month. Due to the reweighting of the CPI from January 2009, this number reflects a compound of month-on-month CPI returns. The historical numbers used are the official month-on-month numbers based on a composite of the previous inflation series (calculations before January 2009) and the revised inflation series (calculations after January 2009).
4. The MSCI World index (All Countries) returns are adjusted to correspond with global investment prices received.
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