momentum
investments

The Macro Research Desk

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Economic and market snapshot for December 2016

Global economic developments

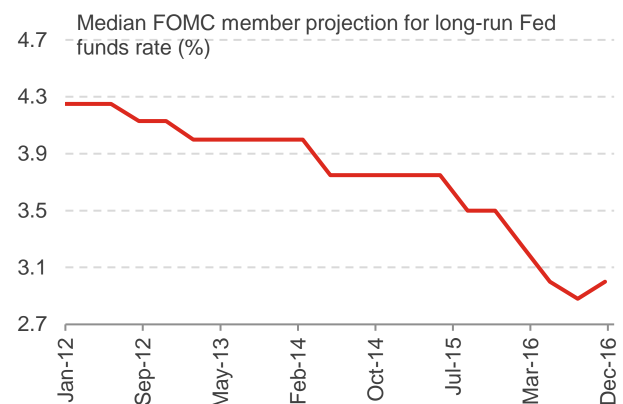
United States (US)

Realised and expected labour market conditions and inflation enable US Federal Reserve (Fed) to hike interest rates

The Federal Open Market Committee (FOMC) raised interest rates by 25 basis points at its December 2016 interest rate-setting meeting, citing a moderate growth expansion since mid-2016 and acknowledging a further strengthening in the US labour market.

Bucking the recent trend of consistently moderating the timing and extent of its expected interest rate hikes, the Fed has finally boosted its interest rate forecasts. Based on the median interest rate expectation, the Fed forecasts now show that the committee could raise the Fed funds rate by three times this year, instead of the two increases (of 25 basis points each) previously forecasted. Moreover, the committee indicated that forecasts have also now increased to three hikes in 2018 and 2019. The median estimate now pitches the long-run Fed funds rate at 3%, up from 2.9% in September 2016 (see chart 1).

Chart 1: Long-run interest rate expectation kicks higher



Source: US Fed, Momentum Investments

In the Q&A session following the meeting, Fed Chair Janet Yellen admitted that some of the Fed officials had considered the president-elect's fiscal policy proposals in their projections, but later explained the diversity in views on the committee by adding that the Fed is "operating under a cloud of uncertainty at the moment".

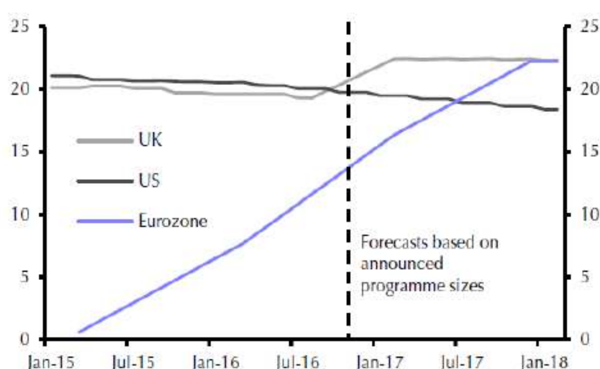
In Momentum Investments' view, anticipated fiscal stimulus could lengthen the current (already-extended) business cycle, reducing the probability of a near-term recession. Potential tax and regulatory changes could also boost confidence and rekindle investment. Nevertheless, president-elect Donald Trump still has to get the fiscal hawks in Congress on his side to turn his policy proposals into concrete plans. Moreover, potential trade conflicts with key trading partners could weigh negatively on US growth in the medium term. The Fed is likely, in Momentum Investments' opinion, to err on the side of caution initially while navigating an uncertain political transition. Momentum Investments expects a further two interest rate hikes during 2017, with the potential for an acceleration in the pace of interest rate hikes thereafter in response to higher inflation, triggered by additional fiscal stimulus at full employment levels.

Eurozone

European Central Bank (ECB) extends asset purchase programme for an additional nine months

The ECB left interest rates on the marginal lending facility and the deposit facility unchanged, but decided to continue its asset purchases to December 2017, or beyond if deemed necessary. The rate of purchases is expected to slow from the current level of €80 billion per month to €60 billion per month between April and December 2017. The extension in purchases suggests that the programme will match the relative size of quantitative easing (QE) in the United Kingdom (UK), as seen in chart 2.

Chart 2: Central bank asset purchases (% of GDP)



Source: Capital Economics

The Governing Council left the door open to increasing the programme in terms of size and/or duration should the growth outlook become less favourable or inflation disappoint.

In Momentum Investments' view, it is difficult to see where growth will come from in the absence of broad-based structural reforms, particularly as tailwinds to domestic demand are expected to lessen in response to moderately rising inflation. Limited fiscal room could cap trend growth in the Eurozone, while the potential for a rise in trade protectionism poses a further headwind to growth. Moreover, a series of important elections and referenda are lined up for 2017, creating a disruptive political backdrop for growth in the Eurozone.

UK

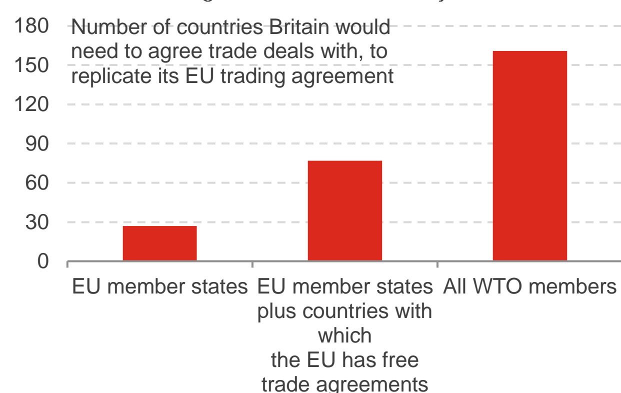
British Parliament backs UK voters' Brexit decision

Ministers in the British Parliament were asked to vote on whether or not they supported Britain's decision to leave the European Union (EU), expressed by UK voters in a referendum vote on 23 June 2016. An overwhelming majority of 461 ministers endorsed the Brexit vote, while 89 ministers voted against it.

Prime Minister Theresa May has set 31 March 2017 as the deadline for invoking Article 50 (rules for exiting the EU), implying that Britain's exit from the EU will be made official no later than April 2019. However, in Momentum Investments' view, agreeing on new trading relationships, establishing tariff agreements and negotiating barriers to entry will likely require more time (see chart 3). A transitional phase could limit the negative effect on growth.

Though further stimulus, higher exports and increased tourism are likely to rule out a recession in 2017, Momentum Investments does anticipate some fallout from the Brexit vote, as firms' concerns over disrupted relations with the EU delay investment and a prolonged period of uncertainty dampens consumer confidence.

Chart 3: Trade negotiations could take years



Source: Financial Times, Momentum Investments

Emerging markets (EMs)

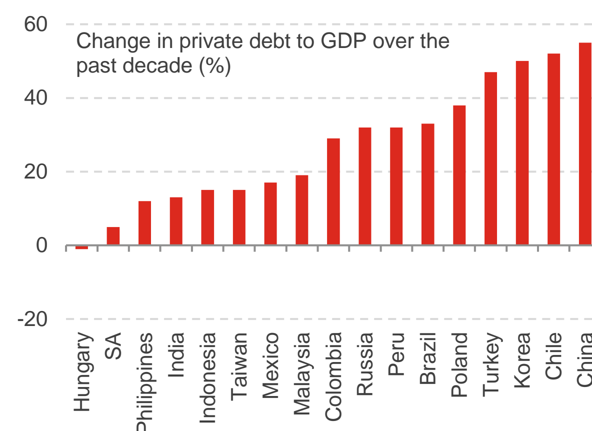
Vulnerabilities to Fed tightening and a strong US dollar put select emerging countries at risk

Overall, (domestic and external) financial risks across EMs remain low, as measured by the Capital Economics Risk Indicator. The indicator is based on five sub-indices, respectively measuring changes in real equity prices, private sector credit, real exchange rate movements, short-term external debt and trade balances.

According to the indicator, financial risks are currently tracking at a 13-year low for the EM composite. However, risks vary across the different regions. Based on the results, Latin America appears to be the most vulnerable region, while risks have abated considerably in Emerging Europe since the beginning of 2013.

On a country basis, China ranks as one of the most vulnerable among the larger EMs, primarily owing to a rapid acceleration in domestic private debt, which has risen from around 120% of gross domestic product (GDP) to 176% of GDP within a decade (see chart 4).

Chart 4: China's build-up of private debt a medium-term risk



Source: Capital Economics, Momentum Investments

While Momentum Investments expects the debt can to be kicked further down the road, greater near-term risks to the growth outlook for China involves potential trade disputes with the US and capital flight if the currency falls too sharply.

Nevertheless, Chinese authorities appear to remain supportive of growth in the run up to the 19th Party Congress in November 2017. Weaker support for infrastructure funding and a correction in the property market could see growth slipping marginally in 2017 from 2016 levels, but it is unlikely to significantly undershoot China's Five-Year Plan of 6.5%.

Local economic developments

Consumers still unwilling to spend on big-ticket items

Although the Bureau of Economic Research's (BER) Consumer Confidence Index (CCI) remained below its long-term average (since 1982) of one index point in the third quarter of 2016, for the eighth consecutive quarter, it improved eight points from a reading of negative 11 in the previous quarter.

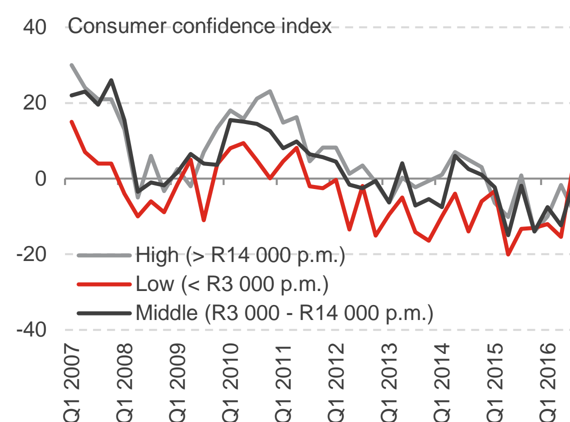
From the three underlying sub-indices contributing to the headline confidence index, a less pessimistic view on the economy in a year's time drove the improvement in the third-quarter reading. In line with consumers anticipating a better outlook for the economy, households' expectations of their personal financial position a year from now improved markedly.

The largest drag on the headline index was the unwillingness of consumers to purchase big-ticket items such as furniture, appliances and electronic goods. The BER attributes the weak uptake of durable goods to subdued sentiment, rising interest rates, moribund credit growth and more expensive imported durable goods, thanks to previously sustained rand weakness.

Notably, high-income earners (classified as earning above R14 000 per month) expressed more reluctance to buy durable goods in the third quarter of the year, supressing the high-income earners' sentiment levels overall.

Though confidence levels surged for low-income consumers in the third quarter reading (see chart 5), Momentum Investments remains cautious on the near-term outlook for spending in this category. Elevated food prices have eroded real wage gains for low-income consumers, while financial institutions have tightened credit-lending conditions at this end of the market. Moreover, a bleak jobs outlook has persisted in an environment in which businesses have deferred spend on capital and labour in response to elevated political uncertainty and muted domestic demand.

Chart 5: Recovery in low-income earners' confidence



Source: BER, Momentum Investments, data up to 3Q16

Nevertheless, higher rainfall points to a sharp fall in food prices during 2017, which should alleviate pressure on the low-income segment of the market further down the line. More clarity on the future political leadership in SA after the African National Congress (ANC) National Executive Committee (NEC) elective conference in December 2017 and further expected interest rate cuts in 2018 should provide a more encouraging backdrop for consumer spend in the medium term.

Financial market performance

Global markets

Global equities ended the month 2.2% in the black, supported by a 2.4% uptick in developed market (DM) equities, while US dollar strength and a 25 basis point interest rate increase by the US Fed left EM equity returns flat (0.2%) in December 2016.

European and Japanese bourses were the outperformers within DM equities. The Eurostoxx 50 jumped nearly 5% higher in the first week of December on an announcement by the ECB that it would extend its bond-buying programme. Meanwhile, investors have been increasing their Japanese equity allocation. The Bank of America Merrill Lynch monthly fund manager survey (surveying 173 investors with US$473 billion assets under management) showed the largest swing on record in favour of Japanese equities.

By month end, the Eurostoxx 50 and Nikkei 225 indices were 7.9% and 4.5% higher, respectively. The S&P 500 Index rallied by an additional 2.0% for December 2016, following a firm 3.7% gain in the post-election rally in November.

Even though the December 2016 US interest rate hike was not a surprise, EM equities took a hit.

EM assets sold off in response to the market's hawkish interpretation of the US central bank's signal of three more hikes in 2017, rather than only two, as suggested at its September 2016 monetary policy meeting.

The MSCI Latin America Index tumbled 3.7% by the third week of December 2016, but recovered in the final week to end the month 0.9% higher. The MSCI Europe, Middle East and Africa (EMEA) Index benefited from the extension of ECB QE, rising 7.2% for the corresponding period, while a 1.4% loss was recorded in the MSCI Asia Index.

Local markets

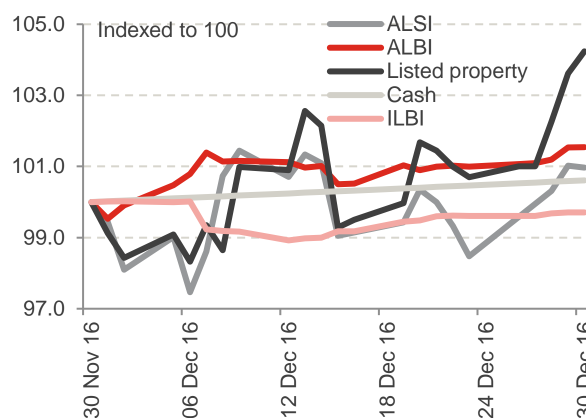
The initial market reaction to the US Fed interest rate rise was a broad-based sell off across all major indices on the JSE. However, by month end, the FTSE/JSE Financials Index clawed back earlier losses, ending the month 3.5% higher. This was followed by a 1.8% gain in the FTSE/JSE Industrials Index. Meanwhile, the FTSE/JSE Resources Index suffered a 3.6% blow for December 2016.

The FTSE/JSE Mid-cap Index surged 4% for the same period, while the FTSE/JSE Small-cap Index rose by a marginal 1.6%.

SA ten-year government bonds rallied 18 points into mid-month, but ended December 2016 nearly 10 points higher. The Inflation-linked Bond Index (ILBI) declined marginally by 0.3% for December, while the FTSE/JSE Listed Property Index staged a remarkable recovery in the second half of the month, leaving the index 4.2% higher by month end. SA cash gained 0.6% for the same period.

Despite a more hawkish US Fed rhetoric, the rand ended the month 2.9% firmer against the US dollar. The rand made further gains against the euro, strengthening by 3.3% for December 2016.

Chart 6: Local asset class returns



Source: Bloomberg, Momentum Investments

Indices summary for December 2016

Equity indices	One month	Three months	One year	Three years	Five years	Ten years
FTSE/JSE All-Share Index (ALSI)	0.97%	-2.09%	2.63%	6.16%	12.97%	10.50%
FTSE/JSE Shareholder Weighted Index (SWIX)	1.98%	-3.22%	4.13%	7.59%	14.18%	11.38%
FTSE/JSE All Share Top 40 Index	0.53%	-3.00%	-1.60%	4.92%	12.33%	9.88%
FTSE/JSE Mid Cap Index	4.03%	1.02%	26.89%	11.96%	15.48%	13.78%
FTSE/JSE Small Cap Index	1.59%	0.58%	20.90%	11.88%	17.93%	13.02%
FTSE/JSE Resources Index	-3.60%	-1.20%	34.24%	-10.32%	-5.50%	-0.09%
FTSE/JSE Financials Index	3.45%	2.89%	5.44%	11.72%	18.06%	10.83%
FTSE/JSE Industrials Index	1.84%	-4.69%	-6.55%	7.96%	19.04%	15.67%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	1.03%	2.00%	19.66%	5.85%	11.59%	10.73%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	0.01%	2.00%	19.72%	5.71%	11.45%	10.17%
FTSE/JSE SA Listed Property Index (SAPY)	4.24%	1.26%	10.20%	14.65%	17.29%	15.76%
Interest-bearing indices						
BEASSA All Bond Index (ALBI)	1.57%	0.35%	15.45%	6.90%	7.36%	7.97%
BEASSA All Bond Index 1-3 years (ALBI)	0.78%	1.44%	10.08%	6.78%	6.60%	7.82%
Barclays BEASSA SA Government ILB Index	-0.29%	-1.07%	6.27%	6.99%	8.06%	9.45%
Short-term Fixed Interest Composite Index (SteFI)	0.63%	1.88%	7.42%	6.59%	6.10%	7.31%
Commodities						
NewGold Exchange-Traded Fund	-3.78%	-12.46%	-4.32%	7.49%	4.11%	13.11%
Gold price (in rands)	-3.77%	-13.54%	-3.55%	8.02%	5.01%	13.56%
Platinum Exchange-Traded Fund	-2.83%	-12.25%	-8.11%	-4.88%		
Platinum price (in rands)	-3.81%	-12.20%	-10.26%	-4.52%	-5.02%	0.39%
Currency movements						
Rand/euro movements	-3.01%	-6.65%	-14.16%	-0.02%	6.62%	4.50%
Rand/dollar movements	-2.44%	-0.31%	-11.60%	9.30%	11.17%	6.86%
Inflation index						
Consumer Price Index (CPI)			6.61%	5.72%	5.62%	6.26%
Global indices						
MSCI World Index (All Countries)	-0.43%	1.05%	-6.04%	12.74%	21.56%	9.33%
MSCI Developed Markets Index	-0.19%	1.99%	-4.86%	13.48%	22.77%	10.96%
MSCI Emerging Markets Index	-2.15%	-5.92%	-1.81%	6.37%	12.57%	
Global Property Research (GPR) 250 REIT Index	-0.86%	-6.27%	-16.92%	31.72%	36.94%	17.71%
MSCI Africa Index	2.64%	-4.84%	-1.09%	2.66%	9.00%	
Citigroup World Government Bond Index	-3.27%	-8.98%	-10.40%	8.33%	10.16%	9.75%
Three-month US dollar LIBOR rate	-2.36%	-0.07%	-10.92%	9.76%	11.62%	8.16%
Three-month Euro LIBOR rate	-3.04%	-6.72%	-14.40%	-0.05%	6.72%	

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.
5. FTSE/JSE disclaimer: www.jse.co.za
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