The Macro Research Desk

From left to right: Herman van Papendorp (Head of Macro Research and Asset Allocation), Sanisha Packirisamy (Economist)

Economic and market snapshot for July 2016

Global economic developments

United States (US)

Data painting a muddled picture for the interest rate outlook in the second half of 2016

The Federal Open Market Committee (FOMC) confirmed that the US labour market had strengthened since the last interest rate-setting meeting in June 2016. It noted that economic activity continues to expand at a moderate pace and assessed near-term risks to the economic outlook as having diminished relative to the previous meeting.

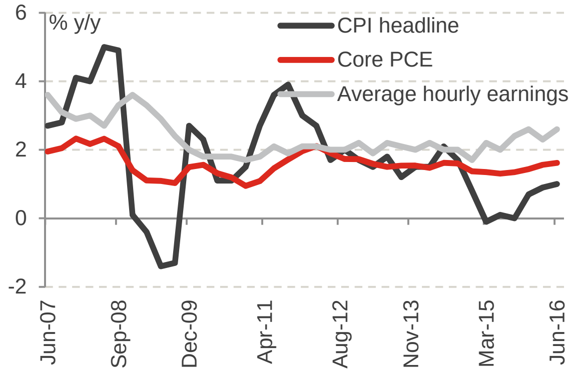
While there is likely to be further easing from central banks in the European Union (EU) and Japan, in particular, in upcoming months, following the 23 June Brexit vote, a series of better-than-expected consumer and services-related economic prints in the US have pushed up expectations for an interest rate hike.
Fed futures have repriced the probability of an interest rate increase in September 2016 (December 2016) from 0% (26.4%) in the immediate aftermath of the Brexit decision to 26.4% (45.2%) following the July 2016 FOMC meeting. However, interest rate expectations were scaled back late in the month to an 18% probability of a hike in September and a 35.7% probability for December, following a poorer-than-expected gross domestic product (GDP) print.

The first estimate of US GDP growth for the second quarter of the year disappointed markets, increasing by 1.2% in quarterly annualised terms. The Atlanta Fed Nowcast (an indicator measuring high-frequency data releases) projected real GDP growth of 1.8% for the same period.

Encouragingly, consumption growth surged ahead at 4.2% in quarterly annualised terms, reaffirming the statement by Fed officials describing household consumption as "growing strongly" in response to firm retail sales data.

The FOMC nonetheless indicated in its statement that it "expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate". As such, Momentum Investments anticipates a measured approach to interest rate tightening, as global economic and financial developments continue to be monitored closely, with some reasons for optimism still allowing for a more-than-even chance of an interest rate increase later this year.

Chart 1: Steady rise in US inflation



Source: Bloomberg, Momentum Investments

Net exports contributed positively (0.2%) to growth in the second quarter, while recent dollar moves should remain supportive for export growth in upcoming quarters.

Moreover, the drag from mining-related fixed investment in 2Q16 is further expected to reverse during the remainder of the year. Inventories, which have detracted from GDP for the past five quarters, could also see a reversal.

Additionally, various measures of inflation have been drifting higher during the past year. The Consumer Price Index (excluding food and energy) rose to 1.0% for June 2016 from 0.1% a year ago, while the core personal consumption expenditure measure of inflation, which is more closely watched by the Fed, increased from 1.3% to 1.6% for the corresponding period. Wage inflation stepped up in response to a tightening labour market with the average hourly earnings measure increasing by 2.4% y/y for June 2016 (see chart 1).

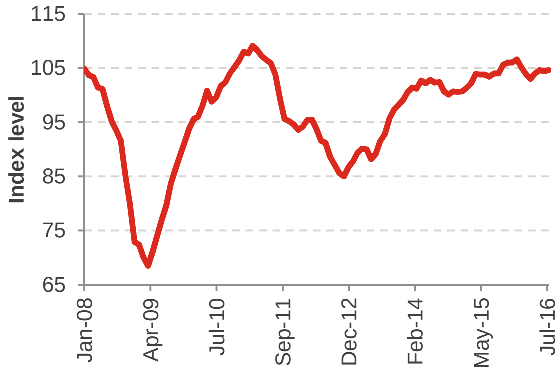
Eurozone

Political risk poses a threat to the region's recovery

Growth in the euro area surprised to the upside in the first quarter of the year at 1.7% y/y, driven by strong domestic demand, including a 2.9% y/y growth performance in fixed investment.

Although the Eurozone's Economic Sentiment indicator rose for July from 104.4 to 104.6 points (see chart 2), suggesting that businesses and consumers have shrugged off any potentially negative ramifications of the Brexit vote, political uncertainty could weigh negatively on future prints. The International Monetary Fund (IMF) has lowered its real GDP forecast by 0.2% to 1.4% for 2017, reflecting high levels of political uncertainty.

Chart 2: Eurozone sentiment firm post Brexit



Source: Bloomberg, Momentum Investments

Though investors had feared European political contagion from Britain's recent decision to leave the EU, Spain actually saw a worse-than-expected showing from the radical left party following Brexit. In France, opinion polls suggest the 'remain' vote is still firmly in the lead, while the far-right presidential candidate in Austria and the Eurosceptic Five Star movement in Italy have publicly supported a 'remain' position in recent weeks.

However, the political calendar includes a high-risk Italian Senate referendum in 4Q16, which could lead to an end of the current government, inducing a period of heightened uncertainty. This is to be followed by presidential/general elections in Austria (a re-run) in October 2016, the Netherlands in 1Q17, France in May 2017 and Germany in late 3Q17/early 4Q17. Moreover, the migrant crisis could re-emerge as a key downside risk to growth in the year ahead.

United Kingdom (UK)

Speculation of vote reversal rises

Following Britain's decision to leave the EU, voters who were unhappy with the referendum result have sought to reverse the decision. More than four million citizens signed a petition to implement a rule that states if the 'remain' (or 'leave') vote accounts for less than 60% of the total vote, based on a turnout less than 75%, another referendum should be held.

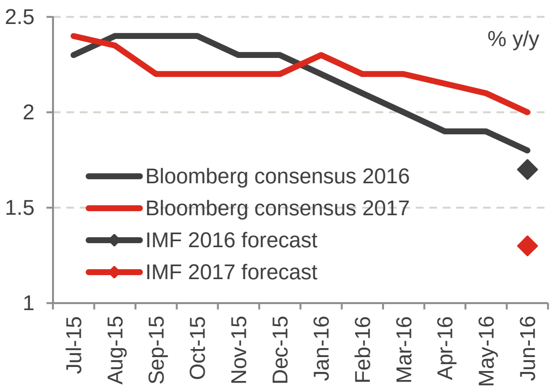
According to Deutsche Bank, a reversal of this decision could occur if the new administration requests a second opinion based on the number of regret voters or if the prime minister refuses to trigger Article 50, which could lead to a new general election.

However, with EU leaders taking the stance that the UK must stand by its decision, Momentum Investments' base case remains for the UK to leave the EU despite speculation of a reversal of the vote.

UK Prime Minister May has stated an intention to delay invoking Article 50 until a clear strategy has been agreed upon, suggesting this may only be triggered later in 2017. Article 50, once triggered, allows for two years of negotiation of post-exit terms after which the UK's relationship with the EU defaults to World Trade Organisation (WTO) rules. The two-year negotiation period may only be extended in the event that all remaining member states agree on an extension unanimously.

Meanwhile, growth forecasts have been pared back. The Bloomberg consensus has revised UK real GDP growth (for 2016 and 2017) lower by around 0.5% relative to a year ago, while the IMF have pencilled in more damaging repercussions following the Brexit decision (see chart 3).

Chart 3: UK GDP prospects have been downgraded



Source: Bloomberg, IMF, Momentum Investments

Japan

Record stimulus package announced to boost economy, as Brexit-induced yen strength poses a risk to growth

Britain's decision to leave the EU has led to a bid for the Japanese yen, as investors attempted to find a safe haven for their cash. However, a firmer Japanese yen bodes ill for already-weak real GDP growth, as currency strength hurts export growth.

In an attempt to shore up growth prospects, Prime Minister Abe announced a ¥28 trillion economic stimulus package (exceeding market expectations of ¥20 trillion), including a range of tax and spending measures. Given the size of the package, fiscal measures may extend over a number of years.

Working together with the government to boost flagging growth and dismal inflation prints, the Bank of Japan (BoJ) announced further stimulus. The BoJ signalled that further action was possible at its next meeting in September, but announced a decision to double its annual purchases of equity funds to ¥6 trillion at the July meeting. The BoJ kept its bond purchases unchanged at ¥80 trillion a year and left interest rates on hold at negative 0.1%. The size of the overall move disappointed markets and led to a further surge in the yen.

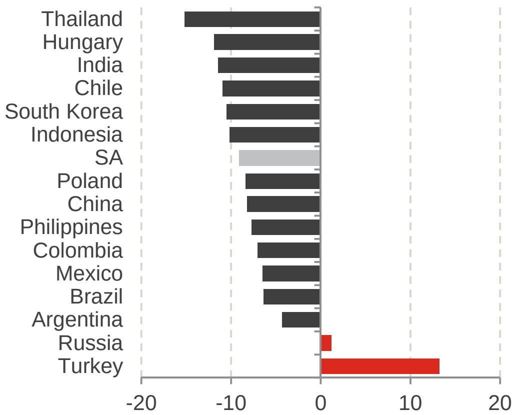
Emerging markets (EM)

EM resilience as the region shakes off Brexit

Supportive conditions, including low-for-longer developed market interest rates and a stabilisation in commodity prices, have boosted risk appetite for EM financial assets (see chart 4), with performance only temporarily dented by the UK's decision to leave the EU.

Strong capital inflows have followed the Brexit vote, as investors anticipated further monetary policy accommodation by major central banks. Moreover, trade and financial linkages between the UK and EM are relatively limited and have not resulted in a further downgrade to EM growth assumptions in the IMF's latest July 2016 World Economic Outlook update.

Chart 4: Percentage change in EM CDS* spreads since Brexit



Source: Bloomberg, Momentum Investments
**CDS = credit default swap*

Growth across the EM aggregate is expected to track largely sideways at 4.1% for 2016 before picking up to 4.6% for 2017. The growth improvement is expected to be driven by a moderation in Brazil's downturn (following a recovery in consumer and business sentiment), a stabilisation in Russia (thanks to a rebound in oil prices off their previous lows) and an uptick in economic activity in Sub-Saharan Africa, where a severe drought and low commodity prices had previously damaged growth.

Nevertheless, growth risks remain to the downside. Political changes and the threat of rising protectionism could derail EM growth momentum in the current cycle.

Local economic developments

Methodological changes drive Fitch's South African (SA) local currency rating lower

Fitch Ratings has revised its sovereign criteria of the notching relationship between sovereign long-term local currency and long-term foreign currency ratings.

There are now only two scenarios under which a local long-term currency rating can rank higher than the foreign currency rating. These include a situation in which public finance fundamentals remain strong relative to external finance fundaments and/or if there is any evidence that suggests that local-currency creditors will receive preferential treatment relative to foreign-currency creditors.

In its review, Fitch concluded that neither of these factors was supportive of the gap between local and foreign currency ratings across 23 sovereigns, including SA, resulting in SA's long-term local currency rating being downgraded from BBB to BBB- to align it to SA's foreign currency rating (see chart 5).

Treasury responded by acknowledging that even though the local rating downgrade represented an alignment as a result of an updated methodology, the rating action "serves as a timely reminder of the risks of a downgrade that lie ahead and the urgency of actions required to reinvigorate the economy".

There continues to be a more-than-even chance of a foreign currency rating downgrade by S&P rating agency in the next year, given the slow progress made on structural reform, battered confidence and a subdued growth environment. Moreover, the current two-notch gap between S&P's local and foreign currency debt rating looks particularly vulnerable.
In its June 2016 review, S&P warned that a reduction in fiscal flexibility could lead to a narrowing of the rating gap.

Chart 5: SA's sovereign rating

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
Outlook	Negative	Stable	Negative

Local currency rating
Foreign currency rating

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

Financial market performance

Global markets

The second half of July 2016 saw a rebound in global equity markets, as investors digested the outcome of Britain's referendum and the potential repercussions thereof. Global equity markets ended the month 4.3% higher, reflecting gains in the developed and emerging market indices.

The 4.2% monthly gain in the MSCI Developed Markets Index was primarily driven by robust gains in the Nikkei 225 (6.4%) and the Eurostoxx 50 (4.5%) indices. The S&P 500 Index logged a modest increase of 3.7% for the corresponding period, supported by encouraging economic data in the US.

Despite the unexpected win by the 'leave' campaign in Britain, the Chicago Board Options Exchange (CBOE) VIX (volatility index) continued to hover near a low 12 points.

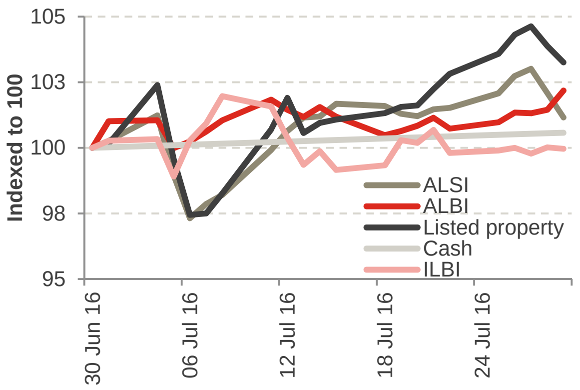
The Brexit referendum on 23 June has boosted investors' expectations of further stimulus by key central banks to avert a deeper economic downturn. The growth premium offered by EM, particularly as developed market growth prospects have been revised lower yet again, has led to a strong return (5.0%) from the MSCI Emerging Markets Index for July 2016.

Within EM, gains were strongest in the MSCI Emerging Markets Europe, Middle East and Africa (EMEA) (5.5%) and MSCI Emerging Markets Latin America (5.5%) indices, followed by a 4.8% increase in the MSCI Emerging Markets Asia Index.

Local markets

Local equities took their cue from firmer global markets. The FTSE/JSE All-Share Index rose 1.2% for July 2016 (see chart 6), with gains concentrated in the FTSE/JSE Resources Index (4.3%). Although commodity prices declined for July 2016 in aggregate, platinum prices increased by more than 12%, with gold prices ticking marginally higher by around 1%.
Despite weaker European growth (following Brexit) weighing negatively on platinum demand (Europe's car manufacturers are the top consumers of the metal where diesel constitutes nearly half of the market), wage negotiations underway in the platinum mining industry are likely triggering a higher dollar platinum price.

Chart 6: Local asset class returns



Source: Bloomberg, Momentum Investments

The FTSE/JSE Financials Index ended the month 2.8% higher, while the FTSE/JSE Industrials Index dipped 0.4%. Mid-caps outperformed small-caps for July 2016 by a large margin. The FTSE/JSE Mid-cap Index ended the month 8.1% higher, while the FTSE/JSE Small-caps Index gained 2.5% for the same time period.

Listed property was the best-performing local asset class for the month, following a dismal June 2016 performance. The FTSE/JSE Listed Property Index increased by 3.3% for July 2016, while gains in the BEASSA All Bond Index were limited to 2.2% (the SA ten-year bond yield rallied by around 17 basis points). The poorest-performing asset classes included SA cash and the Inflation-linked Bond Index (ILBI). SA cash gained 0.6% for the month, with the ILBI remaining flat.

The SA rand posted the largest monthly gain against the US dollar among a basket of key EM currencies. The rand gained 4.9% against the US dollar and 4.6% against the euro for July 2016, while other key EM currencies suffered losses for the same period.
The Brazilian real (central bank intervention), Mexican peso (potentially related to the US presidential race), Turkish lira (a violent coup attempt) and Russian rouble (lower oil prices) weakened between 1% and 4% for the month.

Indices summary for July 2016

Equity indices	One month	Three months	One year	Three years	Five years	Ten years
FTSE/JSE All-Share Index (ALSI)	1.16%	-0.09%	4.49%	11.85%	14.53%	12.92%
FTSE/JSE Shareholder Weighted Index (SWIX)	1.88%	1.93%	6.24%	14.29%	16.45%	14.33%
FTSE/JSE All Share Top 40 Index	-0.08%	-1.06%	1.60%	10.87%	13.89%	12.20%
FTSE/JSE Mid Cap Index	8.14%	5.30%	22.29%	16.87%	17.52%	17.08%
FTSE/JSE Small Cap Index	2.54%	-1.02%	7.92%	15.07%	18.13%	15.49%
FTSE/JSE Resources Index	4.33%	-2.12%	-4.94%	-7.58%	-5.74%	0.70%
FTSE/JSE Financials Index	2.83%	-1.32%	-3.73%	15.90%	19.44%	13.21%
FTSE/JSE Industrials Index	-0.39%	1.01%	5.79%	15.56%	21.89%	19.59%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	3.11%	-1.15%	6.59%	9.85%	12.08%	12.24%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	3.47%	-1.14%	5.73%	9.35%	11.58%	11.76%
FTSE/JSE SA Listed Property Index (SAPY)	3.26%	0.85%	9.05%	17.21%	18.93%	19.35%
Interest-bearing indices						
BEASSA All Bond Index (ALBI)	2.23%	4.77%	6.48%	7.31%	8.06%	8.54%
BEASSA All Bond Index 1-3 years (ALBI)	0.79%	2.63%	7.83%	6.67%	6.86%	7.88%
Barclays BEASSA SA Government ILB Index	-0.04%	1.30%	6.76%	7.96%	9.60%	10.08%
Short-term Fixed Interest Composite Index (SteFI)	0.62%	1.83%	6.94%	6.24%	5.93%	7.32%
Commodities						
NewGold Exchange-Traded Fund	-3.30%	1.91%	34.81%	12.67%	10.98%	15.14%
Gold price (in rands)	-3.73%	2.97%	35.02%	13.16%	11.42%	15.76%
Platinum Exchange-Traded Fund	8.00%	5.21%	27.87%	1.10%		
Platinum price (in rands)	5.90%	3.81%	27.93%	1.28%	-3.06%	2.44%
Currency movements						
Rand/euro movements	-4.63%	-4.54%	11.27%	5.62%	9.97%	5.77%
Rand/dollar movements	-5.27%	-2.28%	10.09%	11.88%	15.69%	7.17%
Inflation index						
Consumer Price Index (CPI)			6.27%	5.87%	5.73%	6.30%

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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