momentum investments

The Macro Research Desk

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Economic and market snapshot for March 2016

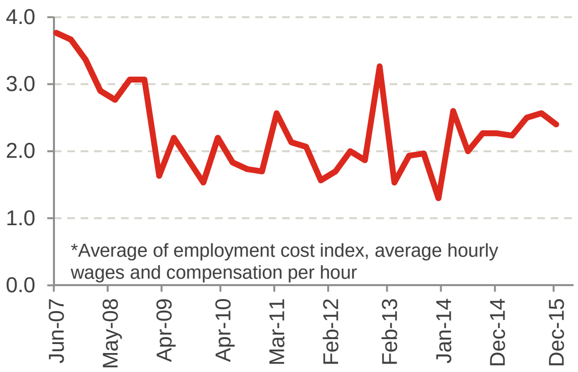
Global economic developments

United States (US)

Conflicting economic outcomes temper interest rate hike expectations

The US Federal Reserve (Fed) left interest rates on hold at the March interest rate-setting meeting, in line with the consensus expectation, at the effective rate of 0.36%. The Fed continues to face conflicting signals in the real economy. While information from the US labour market paints a robust employment picture, growth momentum overall has slowed.

Chart 1: Average US wage inflation inching higher (%)



Source: Bloomberg, Momentum Investments

The Bloomberg consensus has downgraded real GDP growth forecasts for the region down from 2.8% for May 2015 to 2.1% for March 2016 (a tad higher than potential growth of 2%).

Subdued international oil prices have been a major negative contributor to headline inflation in the US. Even if oil prices remain around their current levels, Capital Economics expects energy inflation to rise from its current negative rate to zero during 2017. US headline inflation has also been suppressed by dollar appreciation, but the dollar has more recently weakened by more than 3% on a trade-weighted basis between December 2015 and March 2016, suggesting upward momentum in core prices. Core or underlying inflation (i.e. headline inflation excluding the prices of food and energy) is set to rise further on the back of reasonably firm demand and a steady rise in wage growth (see chart 1).

Although further mention of global growth and financial market concerns by the Fed has left the market implied probability of an interest rate hike (at the June meeting) at only 20%, the expectation of a rising inflation profile and a moderate expansion in GDP likely still supports the view for two interest rate hikes of 25 basis points each during 2016, in line with the Fed's downwardly-revised median expectation.

Eurozone

European Central Bank (ECB) unleashes further stimulus

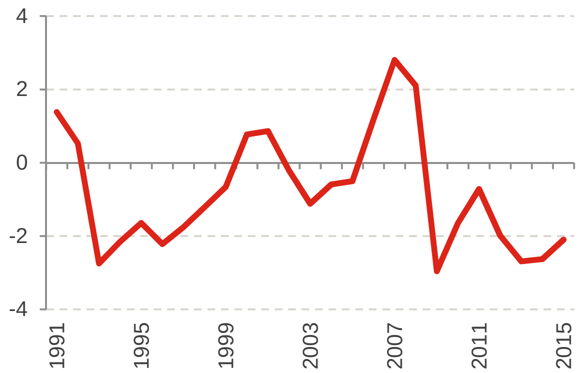
In response to weaker-than-expected growth and subdued inflation, the ECB cut all three of its interest rates and expanded its asset buying programme by a further €20 billion to €80 billion per month, which was above the consensus expectation for an increase to €70 billion.

The ECB continues to view growth risks as being to the downside in light of softer emerging market growth, financial volatility and slow momentum on structural reforms.

The ECB's deposit rate was cut by 10 basis points to negative 0.4%, while the main refinancing rate was reduced to zero from 0.05%. The marginal lending rate (the rate used by commercial banks to borrow from the ECB overnight) fell to 0.25% from 0.3%.

The announcement, which also included news that the ECB will be expanding purchases to corporate bonds and implementing a new Long-term Refinancing Operation (LTRO), initially surprised the market positively. However, the subsequent reaction to ECB President Mario Draghi's comments in the Q&A session that followed the statement was not received favourably. After announcing that "rates will stay low, very low, for a long period of time and well past the horizon of our [ECB] purchases" earlier in the address, he intimated that the ECB did not anticipate the need for a further reduction in interest rates.

Chart 2: Persistently negative output gap (%)



Source: IMF, Momentum Investments

Further growth disappointments could result in the output gap (actual less trend growth) remaining in negative territory for some time (see chart 2), supressing inflation and forcing the ECB to maintain easy monetary policy well into 2017.

Japan

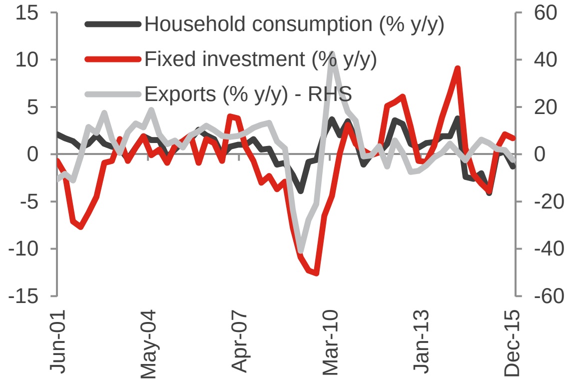
Consumer confidence implodes on negative interest rate announcement

Real GDP growth forecasts have tumbled from an expectation of 1.4% for 2016 in May 2015 to 0.6% ten months later. Household consumption growth remains mild at best, while growth in fixed investment and exports ticked lower into negative territory in the final quarter of 2015 (see chart 3).

Moreover, inflation pressures are largely absent. Consumer price inflation (CPI) data revealed that prices were only 0.3% higher in February 2016 than a year ago, significantly below the Bank of Japan (BoJ) target of 2%.

Asset purchases by the BoJ have seen their balance sheets expand to 77% of GDP in 4Q15 from 21% in 4Q07, while the BoJ has run near-zero interest rates since the early-90s. However, with growth stalling and the BoJ remaining a long way off from its 2% inflation goal, the BoJ turned to decreasing interest rates into negative territory.

Chart 3: Japanese growth momentum slowing



Source: Bloomberg, Momentum Investments

By implementing a tiered system of rates on bank reserves held at the BoJ, authorities expected damage to bank profitability levels to be limited, yet there was a strong negative reaction to the announcement.

Japan's ten-year breakeven inflation rate dipped to a low of close to 0.1% following the announcement (but has since retraced to 0.4%), while consumer confidence fell. The deterioration in consumer sentiment could be the result of Japanese households preferring to hold physical banknotes rather than experience a decline in their bank accounts in nominal terms. Nearly 20% of banknotes (as a share of GDP) are in circulation in Japan relative to 11% in the Eurozone or 2% in Sweden, where central banks have already experimented with negative interest rate policies.

Hopes of higher growth are pinned to Prime Minister Abe's "third arrow" which contains more than 200 pro-market measures, but businesses have been disappointment by the pace of reform resulting in dull future growth prospects.

Emerging markets (EM)

EM growth forecasts pulled to below 2015 levels

EM growth forecasts have been pulled down further to the extent that the market now sees the expansion in real GDP this year slowing from the pace observed during 2015. The gap between the composite PMI readings of developed compared with emerging markets has narrowed, mostly owing to a deterioration in DM prospects rather than a reacceleration in EM (see chart 4).

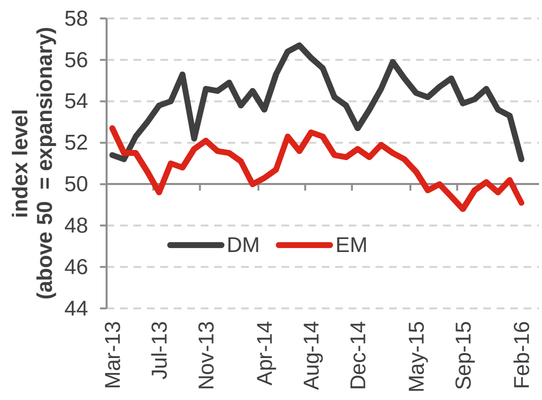
However, the stability in the Chinese currency, relatively stable oil prices and supportive developed market central bank policies could provide some support for growth in the region this year.

Risk appetite in this asset class has improved markedly following the Fed's communication that fewer interest rate hikes and a more protracted interest rate cycle were likely to take place, given growth and financial market stability concerns. Moreover, oil prices look set to drift marginally higher into next year.

Dispersion across EM countries persists. The commodity-exporting bloc is likely to continue facing stagflationary pressures, as currency weakness keeps inflation elevated, while countries within Emerging Asia and Eastern Europe are likely to ease policy rates further on low inflation pressures thanks to subdued oil prices. Net commodity exporters are also facing increasing budgetary constraints leading to lower credit worthiness scores.

In China, Momentum Investments expects slow and steady growth in the household consumption and services sectors of the economy, while heavy industry zones are likely to remain depressed with a limited spill-over onto the rest of the economy. Momentum Investments expects targeted stimulus to maintain growth rates in line with the country's five-year plan, including further fiscal stimulus, lower interest rates to encourage households to borrow more and lower reserve requirement ratios to buoy the property market.

Chart 4: EM PMI remains in unfavourable territory



Source: Bloomberg, Momentum Investments

Local economic developments

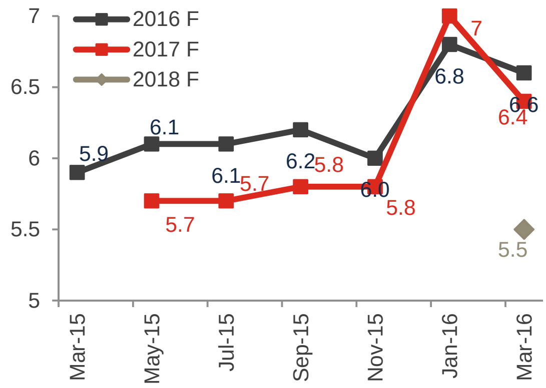
SA Reserve Bank hikes interest rates to 7% to limit economic cost of rising inflation and sticky inflation expectations

Despite a weaker growth outcome, the South African Reserve Bank (SARB) hiked the repo rate by 25 basis points to 7.0% in an effort to abide by its inflation-targeting mandate. This was in line with just under half of the economists polled by Bloomberg.

The SARB noted that EM weakness had pulled global GDP prospects lower. The SARB views geopolitical uncertainties, China's move to a less commodity-dependent growth model and financial market volatility as key risks to growth outlook. Though the SARB downgraded its expectations on real GDP growth from 0.9% for 2016 to 0.8% and from 1.6% to 1.4% for 2017, Momentum Investments still sees scope for further downward revisions. Muted global trade conditions and rising domestic headwinds have led Momentum Investments to downwardly revise its internal real GDP growth forecasts to 0.6% this year and 1.2% for 2017.

The SARB admitted that the inflation forecast had improved moderately (see chart 5) since the January meeting of the Monetary Policy Committee (MPC) due to the higher interest rate assumption (following the 50 basis point hike in January), a slight retracement in the currency, downward revisions to international oil price assumptions and a lower-than-anticipated hike in the electricity tariff.

Chart 5: SARB headline CPI forecast revisions (%)



Source: SARB, Momentum Investments

The SARB continues to emphasise the risks of keeping interest rates at artificially low levels, which could come at the cost of rising inflation and higher future inflation expectations. Moreover, the SARB continues to view the stance of monetary policy as accommodative. As such, Momentum Investments still anticipates a further 50 basis points worth of interest rate hikes in the next 12 months to address inflation risks, which is expected to leave real policy rates at close to 1% for the corresponding period.

Financial market performance

Global markets

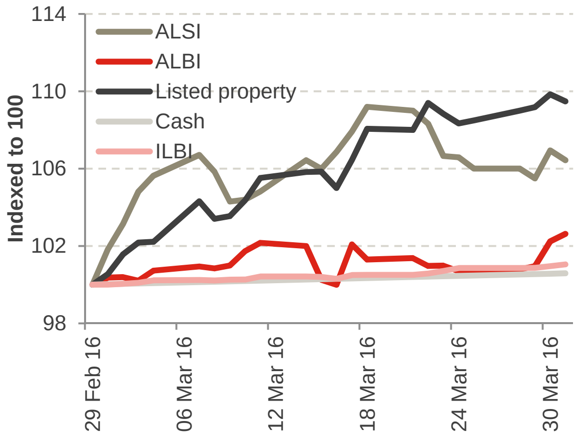
World stock markets rebounded sharply in March 2016, as risk appetite improved. The VIX volatility index fell by seven points, while commodity prices recovered by 4.1% for the corresponding period.

The MSCI All Country World Index (ACWI) surged ahead by 7.6% for the month. Developed markets ended the month 7.1% up, led higher by a 7.0% increase in the S&P 500 Index on the back of comments that the US Fed would "proceed cautiously" in its interest rate hiking cycle, a recovery in oil prices and a bottoming out in negative economic surprises in China.

This was followed by a decent performance in Japanese and European markets. The Nikkei 225 Index increased by 5.4% for March, while the Eurostoxx 50 Index experienced a 2.4% uptick for the corresponding period.

The recovery in commodity prices and an improvement in risk sentiment indicators led to a sharp 12.8% recovery in the MSCI Emerging Markets Index. The best-performing region was Latin America, followed by Europe, Middle East and Africa (EMEA). The MSCI Emerging Markets Latin America Index posted a phenomenal 21% rebound for March, while the MSCI Emerging Markets EMEA Index recorded a robust 14.7% return. The MSCI Emerging Markets Asia Index climbed by a healthy 11% for the same time period.

Chart 6: Local asset class returns



Source: Bloomberg, Momentum Investments, data up to 31 Mar 2016

Local markets

The local market was swept up by the positive mood in world markets. The South African equity market (FTSE/JSE ALSI) ended March 6.4% higher, buoyed by the 11.5% gain in the FTSE/JSE Financials Index. Resource stocks benefited from higher global commodity prices and less negative Chinese sentiment. The FTSE/JSE Resources Index gained 5.1% for March, followed by a 5.0% rise in the FTSE/JSE Industrials Index.

The returns between mid- and small-caps for March were reasonably similar. The FTSE/JSE Mid-cap Index gained 8.5% for March, while the FTSE/JSE Small-caps Index ended the month 8.3% firmer.

The ALBI moved up by a marginal 2.6% for March (SA ten-year yields rallied by 29 basis points). Meanwhile, the listed property sector posted strong gains of 9.5% on the back of the bond yield rally and better-than-expected distribution growth for some of the larger shares. SA cash was the worst-performing asset class for March, earning only 0.6%, followed by a mild 1.1% gain in inflation-linked bonds.

The rand appreciated steadily for the month in line with a firmer Brazilian real, Russian rouble and Colombian peso (among other emerging market currencies), as the US dollar came under pressure on dovish comments made by the US Fed. The rand ended March 6.9% firmer against the US dollar and 2.2% sturdier against the euro.

Indices summary for March 2016

Equity indices	One month	Three months	One year	Three years	Five years	Ten years
FTSE/JSE All-Share Index (ALSI)	6.44%	3.87%	3.17%	12.78%	13.57%	13.11%
FTSE/JSE Shareholder Weighted Index (SWIX)	8.32%	5.88%	2.65%	14.58%	15.43%	13.83%
FTSE/JSE All Share Top 40 Index	6.07%	1.50%	3.29%	12.68%	13.04%	12.76%
FTSE/JSE Mid Cap Index	8.51%	18.83%	2.13%	13.07%	16.08%	15.01%
FTSE/JSE Small Cap Index	8.29%	11.39%	3.75%	14.65%	17.53%	14.12%
FTSE/JSE Resources Index	5.08%	18.13%	-25.45%	-11.89%	-9.61%	1.08%
FTSE/JSE Financials Index	11.51%	6.22%	-0.70%	16.47%	19.75%	12.82%
FTSE/JSE Industrials Index	5.03%	-0.40%	8.75%	19.40%	22.77%	19.11%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	6.69%	10.99%	-1.07%	8.13%	10.04%	11.83%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	6.91%	10.09%	-2.80%	7.44%	9.48%	11.11%
FTSE/JSE SA Listed Property Index (SAPY)	9.48%	10.10%	4.57%	14.35%	19.81%	16.35%
Interest-bearing indices						
BEASSA All Bond Index (ALBI)	2.63%	6.55%	-0.61%	3.97%	7.79%	7.52%
BEASSA All Bond Index 1-3 years (ALBI)	1.28%	3.22%	5.57%	5.69%	6.78%	7.52%
Barclays BEASSA SA Government ILB Index	1.05%	2.19%	5.70%	5.24%	9.62%	9.76%
Short-term Fixed Interest Composite Index (SteFI)	0.58%	1.68%	6.61%	5.99%	5.81%	7.31%
Commodities						
NewGold Exchange-Traded Fund	-7.50%	9.72%	25.68%	6.90%	12.89%	17.06%
Gold price (in rands)	-4.28%	14.84%	30.81%	8.63%	14.12%	18.09%
Platinum Exchange-Traded Fund	-1.59%	5.94%	3.71%	2.79%		
Platinum price (in rands)	-3.22%	3.99%	3.32%	-1.92%	-5.39%	2.28%
Currency movements						
Rand/euro movements	-2.22%	-0.30%	28.88%	12.48%	11.81%	8.43%
Rand/dollar movements	-6.92%	-5.10%	21.33%	16.98%	16.81%	9.08%
Inflation index						
Consumer Price Index (CPI)			7.00%	5.60%	5.75%	6.31%

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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