momentum investments

# The Macro Research Desk

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# Economic and market snapshot for May 2016

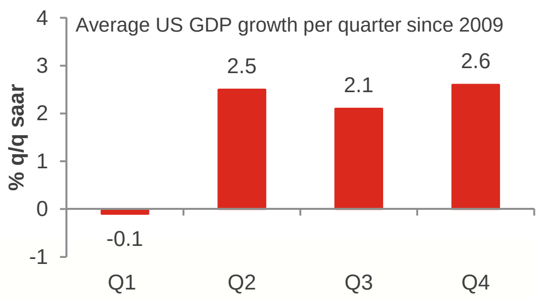
## Global economic developments

United States (US)

*Expectations for an earlier interest rate hike are revived on perceived hawkish Federal Reserve (Fed) meeting minutes*

The Wall Street Journal's Survey of Economists revealed a 20% chance of the US economy falling into a new recession within the next 12-month period, following a paltry 0.5% (upwardly revised to 0.8%) quarterly growth print (seasonally adjusted and annualised) in the first quarter of 2016. However, economic indicators from the past seven years expose a consistent pattern of weaker first-quarter growth, followed by a sharper acceleration in economic activity in the second quarter of the year (see chart 1).

Chart 1: Firmer US growth print expected in the second quarter of 2016




*Source: Bloomberg, Momentum Investments*

This phenomenon has partly been attributed to poor weather conditions in recent years and residual seasonality unaccounted for, particularly in the business investment and government-related categories.

Forward-looking surveys point to a recovery in growth in the second quarter of the year. The US ISM Services Index leapt higher to 55.7 index points in the latest reading for April, indicating renewed strength in the services sector. In addition, solid growth in retail sales (3.0% year on year (y/y) in April 2016) is likely to be supported in upcoming quarters by underlying strength in the US housing and labour markets, positive wealth gains and above-average consumer confidence levels.

Moreover, a c.3.0% year-to-date weakening in the US dollar basket and modest growth in the Eurozone may alleviate the extent of the drag from net exports on US gross domestic product (GDP) growth.

Inflation is likely to head towards the Fed's target of 2% in upcoming quarters in response to strengthening economic data and a tighter labour market, suggesting that the Fed is likely to raise interest rates before the year is up.

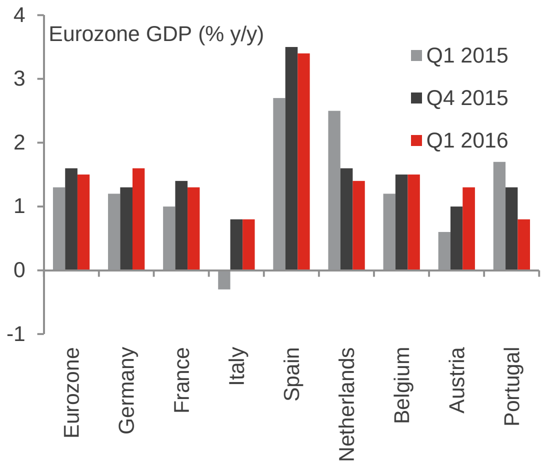
The implied probability for an interest rate increase in June 2016 of 25 basis points based on Fed funds futures rose from a low of 2% in mid-February to 34% in the week following the release of the minutes of the April 2016 Federal Open Market Committee (FOMC) meeting. Policymakers had sounded notably hawkish, noting that "A couple of participants were concerned that further postponement of action to raise the federal funds rate might confuse the public about the economic considerations that influence the Committee's policy decisions and potentially erode the Committee's credibility."

## Eurozone

*Economic headwinds likely to slow pace of growth*

The Eurozone's modest economic recovery continued into the first quarter of the year, helped by easy monetary policy provided by the European Central Bank (ECB) and slightly stimulative fiscal conditions. The 1.5% y/y growth rate (see chart 2) was underpinned by higher GDP growth in the region's largest economy, Germany, which saw a notable acceleration in fixed investment.

Chart 2: Eurozone growth momentum set to slow




*Source: Bloomberg, Momentum Investments*

Though overall real GDP has finally risen to levels last seen in the first quarter of 2008, growth activity remains disparate across the underlying economies. Germany's real GDP level is 5.5% higher than where it was in the first quarter of 2008, followed by the French economy, which is 3.5% larger than it was in the first quarter of 2008. Meanwhile, the Italian and Spanish economies are 8.5% and 4.0% smaller in real terms than they were in the first quarter 2008.

Forward-looking indicators, including the Eurozone Composite Purchasing Managers' Index (PMI), signal a softer growth outlook for the second quarter of the year. The composite PMI reading fell to a 16-month low, largely on the back of a decline in manufacturing conditions, while services sentiment tracked sideways in April 2016.

Accommodative fiscal and monetary policy will likely persist well into 2017 to boost growth and inflation outcomes. The European Commission recently opted not to fine Spain and Portugal for running large fiscal deficits, which acts as yet another indication that austerity has been postponed.

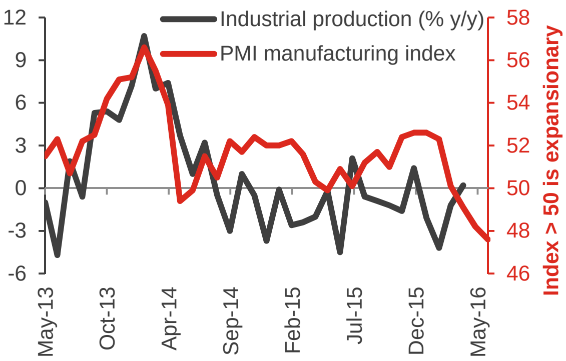
## Japan

*Still experiencing sub-par growth and near deflation*

Despite cutting interest rates into negative territory in late-January, inflation pressures remain dormant, with the headline measure falling well below the Bank of Japan's (BoJ) target. The 10.5% strengthening in the yen against the US dollar in the past 12 months (more recently owing to a flight to safety following global financial turbulence) does not only suggest that inflation will remain quiescent over upcoming months, but it also threatens the outlook for exports.

Lethargic growth in global demand and the lingering effects of two severe earthquakes in Japan's manufacturing hub for automotive parts and semiconductors have further disrupted manufacturing supply chains. The Nikkei Flash Japan Manufacturing PMI fell from 48.2 index points in April to 47.6 points in May (see chart 3), its lowest reading since late 2012. The sub-indices suggest that exports are being hit hard by yen strength, while new sales orders point to a more persistent downturn in industrial activity.

Chart 3: Japan's industrial sector in the doldrums




*Source: Bloomberg, Momentum Investments*

In support of reviving tepid inflation and growth activity, Prime Minister Abe intends to delay the planned sales tax increase for two and a half years (until October 2019). Moreover, with the finance minister recently being instructed to frontload spending for the new fiscal year, it appears as though there is appetite to expand on the so-called second arrow of Abenomics (economic policies based on 1 – monetary easing, 2 – fiscal stimulus and 3 – structural reform). Nevertheless, market-opening reforms, forming part of Prime Minister Abe's third arrow, are still in Momentum Investments' opinion necessary to encourage faster growth activity.

### Emerging markets (EM)

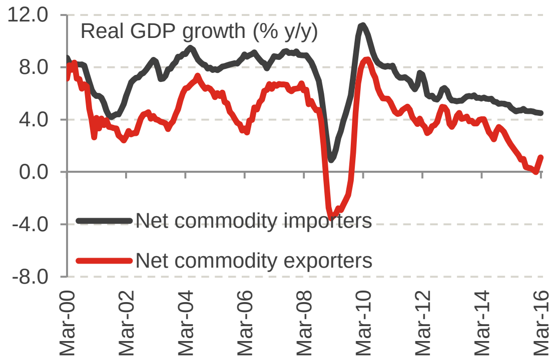
*Growth performance across net commodity exporters improving off a low base*

Weak commodity prices, subdued global trade activity and the possibility of higher US interest rates have been behind significant downgrades to EM real GDP growth forecasts in the past year. The Bloomberg median forecast for 2016's growth outcome has been pared back to 4.3%, from 5.1% a year ago and 4.6% at the start of the year.

The pace of growth downgrades has nonetheless slowed and could bottom out soon. Capital Economics' EM GDP tracker points to a marginal acceleration in growth to 3.2% y/y in March 2016. The uptick can be attributed to an increase in growth in net commodity exporters to 1.1% y/y in March, while growth across net commodity importers held steady at 4.5% y/y (see chart 4).

The turnaround in growth in net-commodity-exporting nations appears to be relatively broad based. Retail sales have stopped falling across net-commodity-exporting nations, while the rate of contraction in export growth in this region has slowed since the start of the year.

Chart 4: Net-commodity exporters growing off a low base




*Source: Bloomberg, Momentum Investments*

Even so, an imminent slowdown in China's industrial-led sectors of the economy and the potential for interest rate increases in the US economy are expected to temper the pace of the EM growth recovery.

## Local economic developments

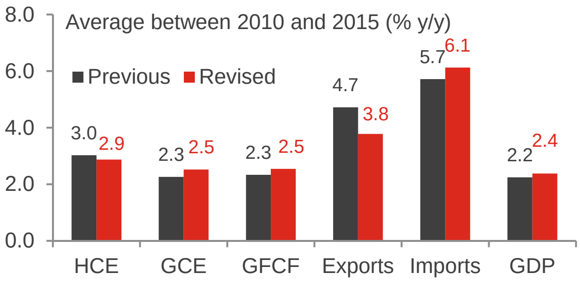
*Revisions leave GDP little changed at the headline level*

Up until recently, Stats SA released the production-side GDP data, while the SA Reserve Bank (SARB) was responsible for the expenditure-side GDP data. To conform with international best practice, Stats SA will now be in exclusive charge of compiling the alternative breakdowns of quarterly GDP.

The new methodologies applied have led to the near-elimination of the residual (unaccounted-for share of GDP), which has been escalating as a share of real GDP growth since the global financial crisis (averaging a negative R26.8 billion for that period in the previous data series), which will bring closer alignment between the production and expenditure-side GDP estimates.

The revisions have left real GDP growth 0.2% (and nominal GDP around 0.1%) higher between 2010 and 2015. Growth in household consumption expenditure (HCE) has been revised slightly lower to 2.9% for the corresponding period, while growth in government consumption expenditure (GCE) and gross fixed capital formation (GFCF) have been revised upwards by 0.2%. Growth in exports saw the largest downward revision to 3.8% while growth in imports experienced the largest upward revision to 6.1% for the same time period (see chart 5).

Chart 5: Minor revisions to weak domestic demand




*Source: Stats SA, Momentum Investments*

The relatively small change to nominal GDP figures suggests a minimal change to the past five-year average budget (negative 4.7% of GDP) and current account (negative 4.5% of GDP) balances.

According to Citi Research, growth in real GDP per capita has been revised slightly higher from a five-year average of 0.7% to 0.8%. The trend in average living standards, however, remains negative and, as such, the GDP revisions are likely to do little to influence S&P's decision on SA's sovereign rating.

## Financial market performance

### Global markets

World equity markets ended the month relatively flat (0.1%), with the outperformance across developed markets largely being offset by losses across emerging markets.

Within the developed market composite, gains were strongest in the Eurostoxx 50 Index (2.9%) and the Nikkei 225 Index (3.4%). Steady gains in the Eurostoxx 50 Index were buoyed by German, French and UK bourses on the back of surprisingly firm economic data in the first quarter of the year and an increase in confidence stemming from another Greek debt deal, while the Nikkei 225 Index was buffered in late May by news of a potential delay in the Japanese sales tax.

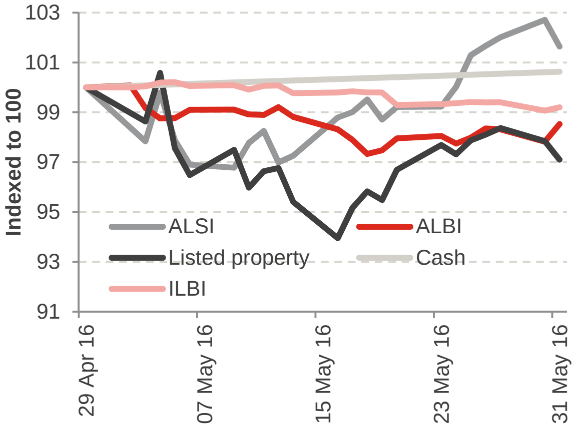
Meanwhile, the MSCI Emerging Markets Index lost 4.0% in May. EMs are likely discounting the possibility of further capital outflows in response to potentially higher interest rates in the US.

Losses were most pronounced in the MSCI Emerging Markets Latin America Index (negative 10.8%) and the MSCI Emerging Markets Europe, Middle East and Africa (EMEA) Index (negative 7.9%), while losses were capped at 1.2% in the MSCI Emerging Markets Asia Index.

### Local markets

Local equities tracked global markets higher in May 2016. The FTSE/JSE ALSI gained 1.8% in May, supported by strong gains in the FTSE/JSE Industrials Index (5.1%), while resource and financial shares had a weaker month. A firmer US dollar and a drop in precious commodity prices left the FTSE/JSE Resources Index 3.8% lower by month-end, while the FTSE/JSE Financials Index declined marginally by 2.0%.

Chart 6: Local asset class returns




*Source: Bloomberg, Momentum Investments*

Small and mid caps underperformed in May. The FTSE/JSE Mid-cap Index ended May 5.7% lower, while the FTSE/JSE Small-caps Index lost 3.6%.

The ALBI lost ground in May (negative 1.5%), as the SA ten-year bond yield sold off by 42 basis points. Listed property returns took a step back, dipping by 6.6% into mid-month, but gains in the second half of the month left the FTSE/JSE Listed Property Index only 3.5% lower by month end. Inflation-linked bonds gave up 0.8% for the same time period, while SA cash continued to deliver a steady 0.6% return for the month, following the SARB's decision to leave interest rates on hold at 7.0% at its May interest-rate-setting meeting.

EM currencies have come under renewed pressure on the back of the repricing of Fed-rate-hike expectations. Though the MSCI Emerging Market Currency Index weakened by c.2.5% since the beginning of the month, the rand has fared worse (losing 9.5% against the US dollar and 6.8% against the euro), highlighting lingering SA-specific risks.

# Indices summary for May 2016

| Equity indices | One month | Three months | One year | Three years | Five years | Ten years |
|---|---|---|---|---|---|---|
| FTSE/JSE All-Share Index (ALSI) | 1.84% | 10.23% | 6.25% | 11.98% | 14.04% | 13.34% |
| FTSE/JSE Shareholder Weighted Index (SWIX) | 1.34% | 11.15% | 6.14% | 13.74% | 15.62% | 14.34% |
| FTSE/JSE All Share Top 40 Index | 3.27% | 10.73% | 6.78% | 11.74% | 13.75% | 12.99% |
| FTSE/JSE Mid Cap Index | -5.69% | 7.04% | 3.54% | 12.67% | 15.02% | 15.30% |
| FTSE/JSE Small Cap Index | -3.56% | 10.65% | 2.52% | 14.89% | 17.47% | 14.74% |
| FTSE/JSE Resources Index | -3.81% | 14.67% | -20.52% | -9.90% | -7.51% | 0.99% |
| FTSE/JSE Financials Index | -1.98% | 8.96% | -1.17% | 15.25% | 18.43% | 13.01% |
| FTSE/JSE Industrials Index | 5.11% | 9.40% | 12.11% | 17.28% | 22.62% | 20.10% |
| FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI) | -3.32% | 10.20% | 0.83% | 8.00% | 10.51% | 12.18% |
| FTSE/JSE Research Affiliates Fundamental Indices All Share Index | -3.83% | 10.48% | -0.64% | 7.50% | 9.98% | 11.53% |
| FTSE/JSE SA Listed Property Index (SAPY) | -3.47% | 7.75% | 9.36% | 15.52% | 18.54% | 16.87% |
| **Interest-bearing indices** | | | | | | |
| BEASSA All Bond Index (ALBI) | -1.49% | 2.99% | 0.96% | 4.36% | 7.08% | 7.55% |
| BEASSA All Bond Index 1-3 years (ALBI) | 0.31% | 2.63% | 6.36% | 6.00% | 6.72% | 7.58% |
| Barclays BEASSA SA Government ILB Index | -0.80% | 3.54% | 7.10% | 5.87% | 9.53% | 9.89% |
| Short-term Fixed Interest Composite Index (SteFI) | 0.61% | 1.77% | 6.76% | 6.11% | 5.87% | 7.32% |
| **Commodities** | | | | | | |
| NewGold Exchange-Traded Fund | 4.15% | -3.02% | 31.23% | 10.41% | 12.13% | 15.54% |
| Gold price (in rands) | 4.50% | -3.33% | 31.78% | 10.46% | 12.62% | 15.94% |
| Platinum Exchange-Traded Fund | 0.87% | 4.54% | 12.40% | 5.41% | | |
| Platinum price (in rands) | 0.16% | 3.81% | 13.85% | 4.38% | -2.44% | 2.19% |
| **Currency movements** | | | | | | |
| Rand/euro movements | 7.85% | 2.17% | 31.35% | 10.36% | 12.29% | 7.40% |
| Rand/dollar movements | 10.94% | -0.28% | 29.49% | 16.09% | 18.14% | 8.95% |
| **Inflation index** | | | | | | |
| Consumer Price Index (CPI) | | | 6.22% | 5.61% | 5.77% | 6.37% |

**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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