momentum investments

The Macro Research Desk

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Economic and market snapshot for December 2017

Highlights

- **United States: The Federal Reserve raised interest rates for the fifth time since the global financial crisis**
- **Eurozone: Italian elections are the next big test for European politics**
- **United Kingdom: Economic conditions are likely to remain challenging in 2018**
- **China: Control of credit growth formed a central focus of the annual Central Economic Work Conference**
- **South Africa: Market-friendly outcome, but a cross-slate top six could compromise a number of issues, which need to be addressed as a matter of urgency to favourably shift SA's macroeconomic fortunes**

Global economic developments

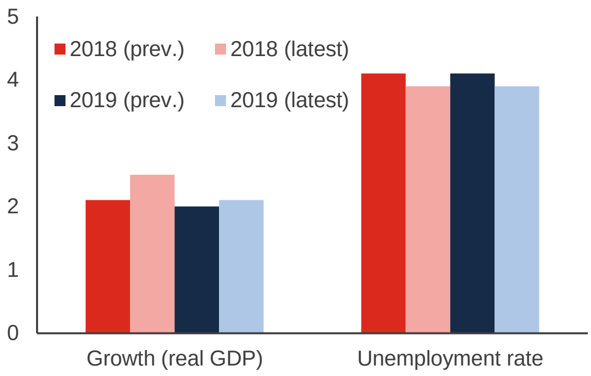
United States (US)

The Federal Reserve (Fed) raised interest rates for the fifth time since the global financial crisis

Global financial markets were little moved by the December 2017 interest rate increase, which left US short-term rates drifting between 1.25% and 1.5%. The timing and extent of future interest rate moves are, however, likely to be less predictable.

Two US Fed officials dissented on the December 2017 interest rate decision, on concerns the Fed should have waited longer to raise interest rates again. This side of the argument intimates a too rapid rise in interest rates could stifle economic growth and bring about renewed debt concerns, should significant asset price falls be triggered. The other side of the argument, however, warns a prolonged period of ultra-easy monetary conditions could allow a build-up of risks in the financial sector, potentially prompting another crisis. This time around, a low interest rate base suggests the Fed will be left with limited room to reduce interest rates to spur a higher level of economic activity.

Chart 1: US Fed economic projections (%)



Source: US Fed, Momentum Investments

your goal is our benchmark

Momentum Investments anticipates the Fed will continue on its interest rate tightening cycle following the improvement in jobs and growth. In its latest quarterly economic projections, the Fed's median forecast for economic growth inched higher to 2.5% (previously 2.4%) for 2017 and to 2.5% for 2018, from a prior estimate of 2.1%, taking into account the effect of tax cuts. The Fed's view on the projected unemployment rate improved further, dropping to 3.9% in 2018 from 4.1% previously (see chart 1).

Even with Governor Jerome Powell replacing Fed Chair Janet Yellen, after her term expires in February 2018, the expectation of solid economic activity and a continued strengthening in the labour market should allow for up to a further three interest rate hikes in 2018. Despite weak inflation, the Fed expects once-off factors (such as mobile phone service costs) to dissipate. Moreover, slowing job creation, in response to the economy nearing full employment, should lead to a further acceleration in wage growth, which could keep inflation expectations comfortably in line with the Fed's official 2% inflation target.

Eurozone

Italian elections are the next big test for European politics

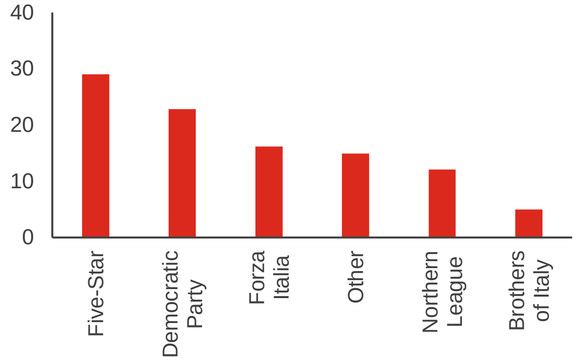
Italy's political landscape has shifted significantly during the past five years. Populist parties have made significant inroads, while traditional centre-left parties have lost support.

Italian President Sergio Mattarella recently dissolved the Parliament and scheduled Italy's first national elections in five years for 4 March 2018. Despite the Democratic Party fulfilling its five-year term, the governing party lost more than 300 lawmakers in the past few months, making reaching a consensus in Parliament ever more challenging.

The Italian Ixe Agency reports the governing Democratic Party's level of support at only 22.8% of the electorate, placing it notably behind the anti-establishment Five-Star Movement, polling at 29% of the survey (see chart 2). As such, the risk of a coalition of right-winged parties remains a significant threat. Investors are also concerned with the prospect of a hung parliament and a rise in political instability, given Five-Star's earlier indication any alliances with other parties had been ruled out.

Investor fears have extended to a possible referendum on Italian membership of the euro area.

Chart 2: Italian polled political support (%)



Source: Ixe Agency, Momentum Investments

A hung parliament bodes ill for hopes of structural reform. Italy's sluggish growth trajectory has been hampered by a large influx of migrants, high and rising debt (currently more than 130% of gross domestic product (GDP)) and elevated bad debt levels in the banking sector.

United Kingdom (UK)

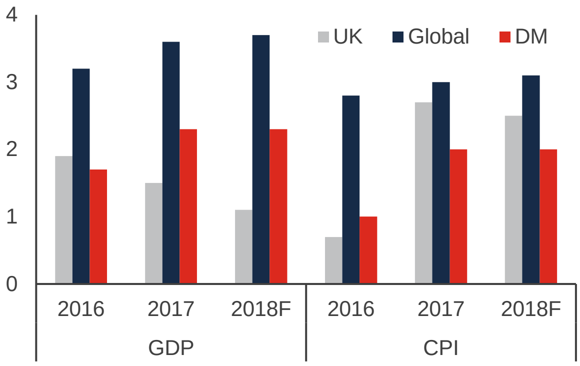
Economic conditions are likely to remain challenging in 2018

Growth in the UK economy slowed from 1.9% in 2016 to 1.5% in 2017, in contrast to a continued economic expansion across developed markets from 1.7% in 2016 to 2.3% in 2017.

The Financial Times estimated the value of Britain's output to be around a percent lower than if British citizens had voted to remain within the European Union. A lack of certainty around Brexit negotiations weakened investment intentions, while a 40% reduction in net migration in the first 12 months after the vote likely shaved off between 0.1% and 0.2% from growth.

According to the Financial Times, the 0.9% cut in growth output implies a £9 billion reduction in fiscal revenue. A sharp depreciation in the sterling has additionally pushed up inflation in the UK. While developed market (DM) inflation inched higher from 1.0% to 2.0% between 2016 and 2017, UK inflation surged to 2.7% in 2017 from 0.7% in 2016 (see chart 3).

Chart 3: UK growth and inflation (%)



Source: Bloomberg, Momentum Investments

A further analysis by the Financial Times shows a continued stagnation in productivity despite an uptick in unit labour costs. This could put pressure on the Bank of England to tighten policy rates in spite of weak economic growth. The Bloomberg consensus anticipates a single 25 basis point interest rate increase in 2018 and a further 25 basis point hike in 2019.

China

Control of credit growth formed a central focus of the annual Central Economic Work Conference (CEWC)

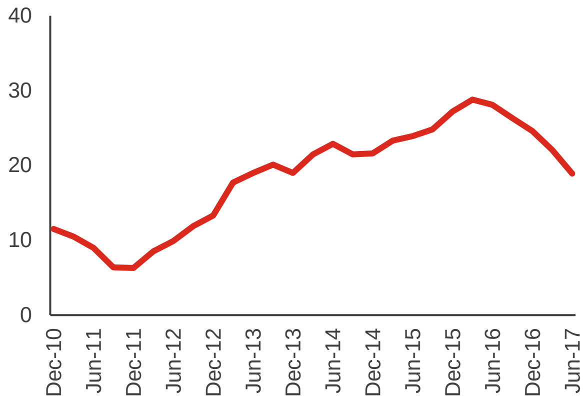
China has embarked on a new five-year political cycle, which will culminate in the 20th Party Congress in 2022. During the past five years, stimulus in the property and infrastructure markets was prioritised to cushion the economic slowdown. Systemic risks in the housing market and an unprecedented rise in local government debt have been an unfortunate consequence.

In response, the 19th Party Congress noted a key change in focus from the quantity of growth to the quality of growth. The CEWC cited the importance of sustainable growth, focusing on curbing tail risks, reducing poverty and protecting the environment, as ways of improving the quality of the economic expansion.

China's debt-to-GDP ratio continued to rise throughout 2017. Although the pace at which it increased has slowed, given faster economic growth and stable total social financing.

The International Monetary Fund (IMF) recommends China intensifies its deleveraging efforts, given strong growth momentum. China's credit gap (credit-to-GDP ratio relative to trend) peaked in 2016, but has started to narrow (see chart 4).

Chart 4: China's credit gap has started to close (%)



Source: Bank for International Settlements, Momentum Investments

Anticipated financial tightening in 2018 should see growth slowing gradually in China. Although the strengthening of the renminbi in 2017 could soften export growth in 2018, growth is likely to remain robust, supported by demand for exported services. In addition, regional development initiatives should keep growth infrastructure investment firm, preventing a so-called 'hard landing'.

Local economic developments

Market-friendly outcome, but a cross-slate top six could compromise SA's macroeconomic fortunes

Cyril Ramaphosa's victory in the December 2017 African National Congress (ANC) presidential race at the ANC National Elective Committee (NEC) meeting was widely welcomed by investors. However, a draw for the top-six positions between Ramaphosa's camp and that of opponent Nkosazana Dlamini-Zuma renders an uncertain outcome for the timing and extent of structural reforms necessary to avert a further ratings downgrade.

While the results of the elective conference could resuscitate downtrodden consumer and business sentiment, sustainably higher confidence levels will depend on the ability of the new leadership to rebuild trust between government and the private sector, commit to fiscal discipline, address the governance and financial problems in SA's state-owned enterprises and tackle state capture.

With the party under the control of Ramaphosa and the government under the control of President Jacob Zuma, the two centres of power could disrupt policy and economic progress, leaving SA in a state of policy paralysis. Potential trade-offs between key policy objectives supported by the two factions could further compromise SA's economic trajectory.

While an early recall of President Zuma before the end of his term would likely be viewed as positive by the market, this would require the consent of the Zuma faction. Moreover, the stakes remain high in the run up to the 2019 national elections, where the ruling party faces threats from opposition parties, including a more populist left led by the Economic Freedom Fighters (EFF).

The extent of the anticipated growth recovery in 2018 and the outlook for SA's sovereign ratings will depend on whether or not officials will adopt and enact policies to enhance the country's creditworthiness. Nevertheless, even if fiscal consolidation efforts are announced in the February 2018 national budget, significant fiscal challenges remain, and a higher growth path is still needed to curb SA's debt-to-GDP profile in the medium term, suggesting the country could remain in sub-investment grade for some time.

The market has reacted positively to the ANC election results of the top leadership, leaving the rand nearly 11% firmer against the US dollar, relative to a year ago. Currency strength should keep inflation comfortably within the target band in upcoming months, potentially leaving room for further modest monetary policy easing in 2018.

Financial market performance

Global markets

Global equity markets gained 1.6% in the final month of 2017, driven by a robust performance in emerging markets (EM). The MSCI EM Index rose 3.6% in December 2017, broadly tracking the Bloomberg Commodity Price Index, which experienced a 3.0% increase during the same period, as investors grew more optimistic over the growth outlook for the Chinese economy. The MSCI EMEA (Europe, Middle East and Africa) Index surged ahead, posting a 7.0% gain in December 2017, followed by a 4.4% rise in the MSCI Latin America Index. Meanwhile, Asian stocks ended the month only 2.8% higher.

The MSCI Developed Markets Index inched 1.4% higher in December 2017, led by a 1.1% uptick in the US S&P 500 Index. Changes to US tax legislation acted as the biggest catalyst for the performance across US bourses, while robust corporate profits and improved growth prospects further supported US equity market gains. Moreover, a partial government shutdown was averted with the House and Senate voting in favour to extend US government funding until 19 January. A poor US consumer sentiment print, however, tempered gains in the S&P 500 Index later in the month.

The Japanese Nikkei 225 edged up 0.3% in December 2017, but extended its annual rising streak for the sixth year in a row, making it the longest bull run since the early 1990s. The index's full-year return is likely explained by solid corporate earnings and optimistic expectations for Japanese Prime Minister Shinzo Abe's economic policies.

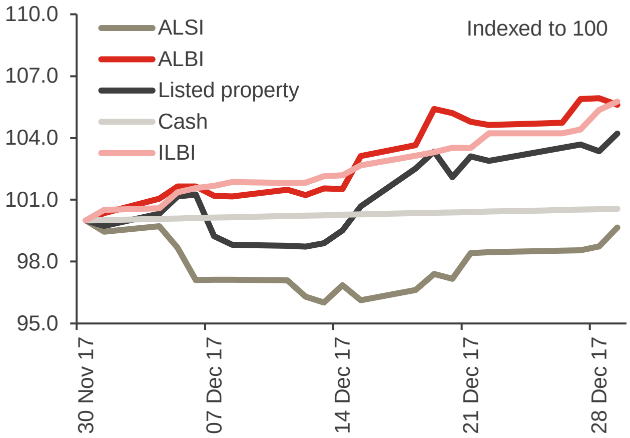
European stocks lagged the return in developed markets. The Eurostoxx 50 dipped 1.7% in December 2017, with losses partly attributable to a narrow victory declared by pro-independence parties in the Catalan election, which reignited tensions between the region and Madrid.

Local markets

The local equity market shifted lower in the first half of the month. An accounting scandal engulfing one of the biggest shares on the exchange soured market sentiment, leading to the market plunging 4% by mid-December 2017.

The market, however, resumed its upward trend in the second half of the month in response to the outcome of the NEC meeting. Financial, retail and property stocks rallied on the news of a Ramaphosa victory, who was widely considered by investors as the most market-friendly candidate. Despite a firmer second half of the month, the FTSE/JSE All-Share Index closed down slightly (negative 0.3%, see chart 5). A firmer rand, on improved sentiment, hurt rand-hedge shares and commodity-based sectors late in the month.

Chart 5: Local asset class returns (%)



Source: INET BFA, Momentum Investments, data up to 29 December 2017

FTSE/JSE Financial shares soared 11.6% from a mid-month trough, while FTSE/JSE Industrial shares drifted broadly sideways in the second half of the month after diving 6.7% in the first half. The FTSE/JSE Resources Index had a volatile performance, but ended the month only 0.5% in the red.

The FTSE/JSE Mid-cap and Small-cap indices fared well, climbing between 4% and 5% higher in the same period.

Listed property and the fixed income markets were the star performers in December 2017. The FTSE/JSE Listed Property Index closed 4.2% higher, while the Inflation-linked Bond Index (ILBI) outperformed at 5.8%.

The SA ten-year government bond yield rallied close to 70 basis points in December 2017. However, gains were tempered late in the month, as the market digested the outcome of the NEC meeting and started looking towards the likely extent and speed of the economic recovery the new leadership is expected to usher in. SA cash posted a more modest return (0.6%) in the same period.

Gains in the rand were bolstered by a revival in sentiment, as investors responded positively to the election of Ramaphosa as the new ANC president. Rand strength was further supported by an uptick in commodity prices and a weaker dollar. Despite the US Fed triggering its third interest rate increase for 2017 in December, investors focused on a muted US inflation outlook and the Fed´s relatively low long-run federal funds rate forecast of 2.75%, ultimately weighing negatively on the US dollar.

The rand was one of the best-performing currencies from a basket of EM peers in the past three-month period. However, currencies in the Eastern European bloc generally outperformed the rand for the year. The rand ended the month 10.4% firmer against the US dollar, 10% stronger against the pound and 8.9% steadier against the euro.

Indices summary for December 2017

	One month	Three months	One year	Three years	Four years	Five years	Six years	Seven years	Ten years
Equity indices									
FTSE/JSE All-Share Index (ALSI)	-0.34%	7.44%	20.95%	9.28%	9.68%	11.93%	14.27%	12.52%	10.67%
FTSE/JSE Shareholder Weighted Index (SWIX)	-0.16%	9.63%	21.21%	9.36%	10.84%	12.75%	15.32%	13.67%	11.67%
FTSE/JSE Capped SWIX All Share index	0.91%	8.44%	16.49%	7.98%	9.80%	11.90%	14.59%		
FTSE/JSE All Share Top 40 Index	-1.31%	6.71%	23.07%	9.20%	9.19%	11.78%	14.05%	12.28%	10.25%
FTSE/JSE Mid Cap Index	4.74%	11.58%	7.36%	7.99%	10.79%	11.23%	14.08%	12.69%	12.74%
FTSE/JSE Small Cap Index	3.86%	3.60%	2.95%	6.14%	9.58%	12.74%	15.29%	13.15%	10.08%
FTSE/JSE Resources Index	-0.45%	4.86%	17.90%	-0.09%	-3.97%	-2.93%	-1.95%	-2.61%	-0.99%
FTSE/JSE Financials Index	8.40%	15.98%	20.61%	9.73%	13.88%	14.91%	18.48%	16.82%	12.59%
FTSE/JSE Industrials Index	-4.08%	4.67%	22.50%	9.70%	11.42%	15.78%	19.61%	18.06%	16.13%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	1.02%	7.28%	17.64%	9.21%	8.68%	10.36%	12.58%	11.15%	10.66%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	1.75%	7.84%	17.41%	8.90%	8.52%	10.12%	12.43%	10.71%	10.07%
FTSE/JSE SA Listed Property Index (SAPY)	4.21%	8.32%	17.15%	11.71%	15.27%	13.86%	17.27%	16.04%	14.87%
Interest-bearing indices									
BEASSA All Bond Index (ALBI)	5.66%	2.22%	10.22%	6.92%	7.72%	6.27%	7.83%	7.97%	8.58%
BEASSA All Bond Index 1-3 years (ALBI)	2.20%	2.02%	9.61%	7.90%	7.48%	6.86%	7.10%	7.35%	8.07%
Barclays BEASSA SA Government ILB Index	5.76%	1.52%	2.93%	4.28%	5.96%	4.90%	7.19%	8.01%	8.81%
Short-term Fixed Interest Composite Index (SteFI)	0.56%	1.78%	7.50%	7.12%	6.82%	6.49%	6.33%	6.24%	7.13%
Commodities									
NewGold Exchange-Traded Fund	-8.19%	-7.83%	-0.07%	4.47%	5.55%	1.97%	3.40%	7.39%	10.24%
Gold price (in rands)	-8.27%	-7.44%	0.98%	4.98%	6.22%	2.56%	4.33%	8.07%	10.91%
Platinum Exchange-Traded Fund	-10.88%	-7.80%	-9.03%	-6.82%	-5.93%				
Platinum price (in rands)	-10.38%	-6.88%	-6.92%	-5.98%	-5.13%	-7.36%	-5.34%	-6.24%	-4.08%
Currency movements									
Rand/euro movements	-8.58%	-6.89%	2.94%	2.04%	0.71%	5.85%	6.00%	7.63%	4.04%
Rand/dollar movements	-9.25%	-8.32%	-9.54%	2.30%	4.25%	7.84%	7.41%	9.31%	6.09%
Inflation index									
Consumer Price Index (CPI)			4.62%	5.33%	5.45%	5.43%	5.46%	5.55%	5.88%
Global indices									
MSCI World Index (All Countries)	-7.33%	-3.58%	11.70%	11.23%	12.48%	19.38%	19.86%	18.63%	10.04%
MSCI Developed Markets Index	-8.02%	-3.27%	10.61%	11.78%	12.76%	20.39%	20.65%	19.78%	11.43%
MSCI Emerging Markets Index	-8.07%	-1.05%	24.21%	11.53%	10.58%	12.44%	14.43%		
Global Property Research (GPR) 250 REIT Index	-16.61%	-13.31%	-12.50%	10.03%	18.92%	25.28%	27.09%	30.50%	18.34%
MSCI Africa Index	-2.00%	9.22%	19.17%	4.98%	6.56%	8.30%	10.64%	8.78%	6.47%
Citigroup World Government Bond Index	-9.14%	-7.46%	-2.89%	3.90%	5.41%	7.85%	7.87%	10.76%	8.66%
Three-month US dollar LIBOR rate	-9.12%	-7.96%	-8.37%	3.12%	4.92%	8.46%	8.01%	9.94%	6.94%
Three-month Euro LIBOR rate	-8.61%	-6.98%	2.56%	1.80%	0.60%	5.79%	6.01%		

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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