momentum
investments

The Macro Research Desk

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Economic and market snapshot for July 2017

Global economic developments

United States (US)

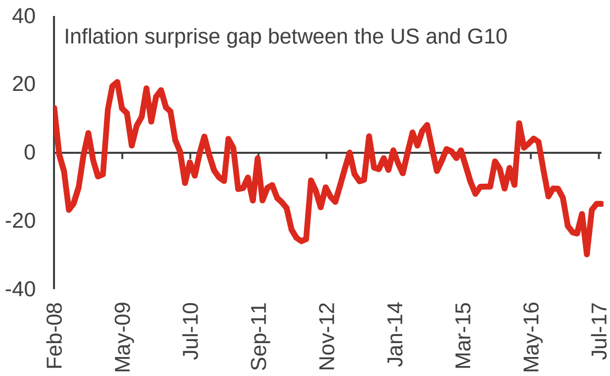
Debate over whether inflation undershoot will trigger a change in interest rate policy

Inflation in the US has remained below the US Federal Reserve's (Fed) inflation target of 2% for four years in a row. Stubbornly sluggish inflation prints for the year to date suggest the same will likely be true for 2017.

The recent fall in the Fed's preferred measure of US core inflation from 1.8% in February 2017 to 1.4% in May 2017 can be attributed to a drop off in core services inflation, which partly reflects transitory factors. In part, the Fed attributes the fall in core services inflation to price movements in prescription drugs and the quality-adjusted price of wireless telephone services, which fell sharply in response to a price war (based on the introduction of unlimited data plans) between providers.

The Fed, however, views these factors as temporary and still expects a sustained return to its 2% inflation target. In its July 2017 monetary policy statement, the Fed noted survey-based measures of longer-term inflation expectations were little changed. Nonetheless, current inflation prints are still surprising to the downside. The relative inflation surprise (actual less expected) gap between the US and the rest of its G10 (the largest-11 industrialised countries) peers reached an all-time high in April 2017 (see chart 1).

Chart 1: US inflation undershooting expectations



Source: Bloomberg, Momentum Investments

While Momentum Investments acknowledges a continuation of low inflation could become a constraint to further interest rate tightening in the near term, decent growth activity, a further strengthening in the US labour market and a moderately increasing inflation trajectory (on dollar weakness and a gradual uptick in wage growth) should keep the Fed on the path of interest rate normalisation.

In a recent Financial Times article, Mohamed El-Erian (chief economic adviser to Allianz) suggested the Fed is becoming "less data dependent and more emboldened to normalise monetary policy". He argues the Fed may be more willing to look through weak growth and inflation data, in an effort to normalise its interest rate structure and address excessive risk taking by investors.

Momentum Investments expects the Fed to begin its balance sheet reduction towards the end of the third quarter of 2017, while the next interest rate hike is expected to follow late in the fourth quarter of the year.

Eurozone

Hinting at a 2018 taper

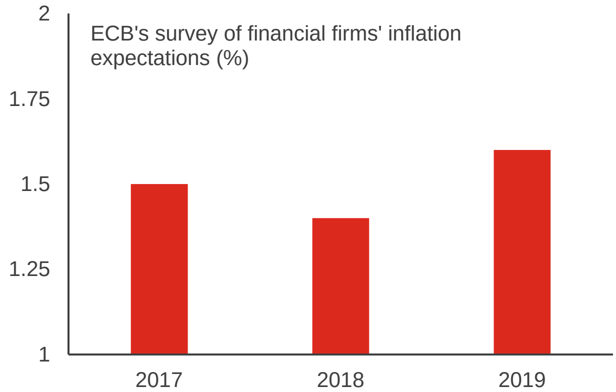
At its July 2017 rate-setting meeting, the European Central Bank (ECB) affirmed that the incoming information points to a strengthening of the economic expansion in the euro area. The ECB noted growth is broadening across sectors and regions and risks to the outlook are viewed as being broadly balanced.

Nonetheless, inflation pressures are still largely absent. Despite his comments made in a speech in June 2017 on reflationary forces in the region, ECB president Mario Draghi clarified his view on inflation in the July 2017 rate-setting meeting by stating inflation remains subdued, owing to weak underlying price pressures.

Under its current forward guidance, the ECB is buying €60 billion a month in (mostly) government bonds until at least December 2017. Draghi's relatively bullish comments on the Eurozone recovery and an admission to an end of deflation threats may, however, lead to a more hawkish change in the Governing Council's language around the trajectory of asset purchases at the September 2017 rate-setting meeting.

With Eurozone inflation likely to fall short of the ECB's 2% target for the next two years (see chart 2), Momentum Investments expects only a gradual removal of asset purchases. Interest rate hikes, in the company's view, are likely still some way off.

Chart 2: Eurozone inflation struggling to meet the 2% target



Source: Financial Times, Momentum Investments

United Kingdom (UK)

Brexit blues

It has been more than a year since the Britons voted to leave the European Union (EU), but it is becoming increasingly apparent that Britain triggered exit talks before working out the details. Britain's position on key trade deals is being analysed by a civil service whose headcount (according to The Economist) has fallen by nearly a quarter in the past decade.

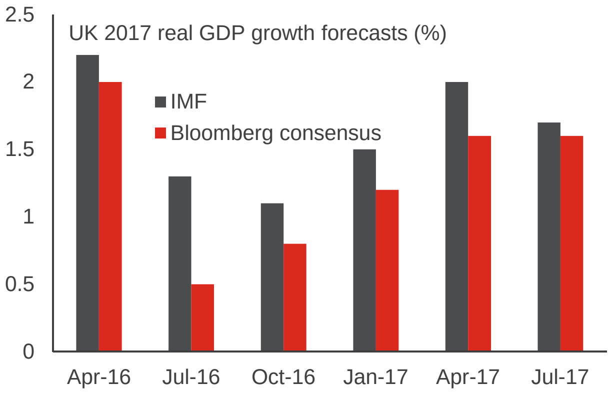
Prime Minister Theresa May's decision to hold an early election has resulted in her government losing its grip on a so-called 'hard' Brexit. There is rising disagreement between cabinet ministers on what form Brexit should take.

While The Economist calculates that a 'hard' exit may cut trade by 40% in ten years and slash annual income per capita by 2.6%, none of the roads to Britain's eventual exit, in Momentum Investments' view, are free from drawbacks. The more it wishes to control its borders and laws, the more difficult it will be for the UK to conduct business with the EU. If the UK aims to preserve a friendlier economic relationship with the EU, more EU rules have to be followed.

Though some Remainers (those who wished to remain within the EU) have rekindled talks of holding a second referendum, an exit from Brexit may be equally as messy. Article 50 of the Treaty on the EU, which sets the procedure for a member state to withdraw from the EU, does not provide for unilateral withdrawal of notification, and even if the other 27 EU leaders agree on a reversal, it would presumably come with a number of conditions. The UK would also have to reapply for EU membership from scratch.

In Momentum Investments' opinion, elevated uncertainty during the transition period is likely to damage growth prospects in the short to medium term (see chart 3) and should defer any interest rate policy decisions, despite inflation tracking above the Bank of England's 2% target.

Chart 3: UK growth prospects peaked and now rolling over



Source: Bloomberg, Momentum Investments

Emerging markets (EMs)

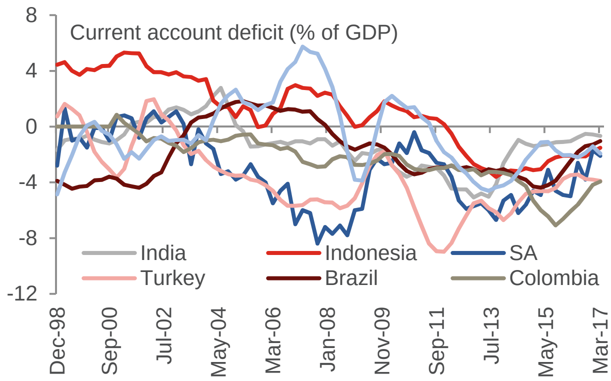
Capital flows to EMs have held up well, but developed market (DM) central banks are turning more hawkish

According to the Institute of International Finance, EM has managed to attract around US$160 billion in foreign portfolio inflows during the first half of 2017. However, DM central banks are switching their rhetoric towards a more 'hawkish' stance. Monetary conditions are expected to tighten across DMs, with the US Fed looking set to announce the start of its balance sheet reduction by September this year, while the ECB is also likely to signal a tapering in its asset purchases in September 2017.

A relatively high real interest rate (nominal interest rates less inflation) differential between EM and DM, a favourable commodity price underpin and generally low global risk aversion could prevent a large unwind in these flows, particular if central bank moves are well signalled in advance. EMs also appear to be more financially resilient this time around compared to the May 2013 'Taper Tantrum', when investors panicked in reaction to the Fed's indication of forthcoming tapering of asset purchases.

Financing gaps across EM have fallen, while external deficits have improved (see chart 4). Measures of short-term debt relative to foreign exchange reserves, in addition, look healthy.

Chart 4: Improvement in EM external position



Source: Bloomberg, Momentum Investments

Moreover, the growth differential between EM and DM should improve in the medium term. This should help to offset a tightening in DM monetary policy, in the absence of a negative shock in volatility or a faster unwind in policy than predicted.

Local economic developments

Interest rates cut sooner than anticipated

The July 2017 South African Reserve Bank's (SARB) interest rate decision was not in line with the Reuters consensus poll, in which 24 out of the 27 analysts surveyed predicted the SA repo rate would remain steady at 7.0%.

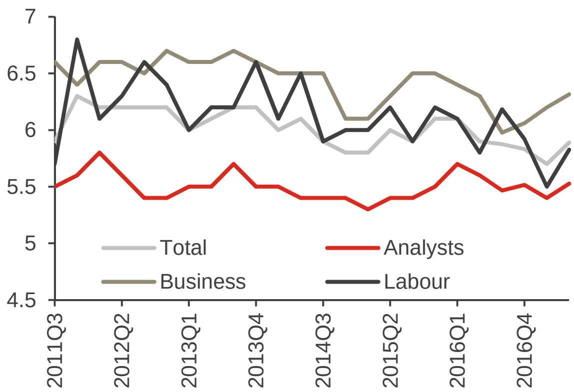
The SARB noted a significant move lower in its inflation forecasts for this year and next. It now expects headline inflation to average 5.3% in 2017 (previously 5.7%) and 4.9% in 2018 (previously 5.3%). These revised forecasts relative to the May 2017 rate-setting meeting have moved closer in line to Momentum Investments' view, although the company sees notable upside risks to the SARB's

2019 forecast of 5.2%. A lower base on inflation, a downward adjustment to international oil price assumptions, lower domestic electricity tariffs, a wider output gap and an adjustment to the real effective exchange rate were noted as key reasons underlining the downward revision in inflation assumptions.

The SARB clearly stated the move to cut interest rates by 25 basis points to 6.75% was made in reaction to its improved outlook on inflation and in response to the deteriorated view on domestic growth. Should inflation continue to track lower in line with expectations and remain well within the target band for the foreseeable future, it is likely the SARB will respond by cutting interest rates further by at least an additional 25 basis points in the near future. Momentum Investments agrees with the SARB's sentiments that SA's growth problems are not cyclical in nature, but are tied to the elevated level of policy uncertainty, which has been extremely damaging to consumer and business confidence. Nevertheless, easier monetary policy should, at the margin, help indebted households.

Momentum Investments still expects the current interest rate cutting cycle to be comparatively shallow relative to previous cycles, given the lingering risk of further ratings downgrades (which could negatively affect the currency and inflation expectations), ongoing political uncertainty, potential negative swings in EM sentiment and uncomfortably high domestic inflation expectations (see chart 5).

Chart 5: Expected inflation in the next five years (%)



Source: BER, Momentum Investments

Financial market performance

Global markets

Global stock markets ended July 2017 2.8% firmer, with EM leading the performance. The MSCI DM Index finished 2.4% higher, boosted by gains in the US and Europe (to a lesser extent), while Japan lost 0.5%.

The S&P 500 Index rose 2.1% in July 2017, riding the stronger earnings wave (more than 80% of the S&P 500 companies reporting earnings delivered higher-than-expected profit), while the Fed rate-setting meeting had little effect on the US equity market.

A weaker start to the earnings season held back gains across European markets. Less than 50% of the companies reporting, at the time of writing, were higher than expectations, with industrials being the main driver behind the earnings misses. Nevertheless, the Eurostoxx 50 Index increased 0.3% for the corresponding period, as macro surprises remained positive, despite rolling over from recent peak levels.

The MSCI EM Index delivered a robust 6.0% gain in July 2017, pulled higher by a surge in the MSCI Latin America Index (8.3%). The MSCI EMEA (Europe, Middle East and Africa) Index traded 5.9% higher in the same period, followed by a 5.6% uptick in the MSCI Asia Index.

Local markets

The local equity market staged a recovery during July 2017. The FTSE/JSE All Share Index rallied 7.0% in the month (see chart 6), underpinned by a stellar return from resource shares. In particular, higher precious metal prices underpinned a notable return from gold shares.

In response to the backlash following Mineral Resource Minister Mosebenzi Zwane's third edition of the new Mining Charter in mid-June 2017, the minister was forced to suspend the implementation of the Charter. Confidence in the industry was knocked further on 9 July, when the minister announced a proposal to restrict the granting of new mining and prospecting rights and the transfer of mineral rights between companies. The Chamber of Mines (representing 90% of industry players) has since moved to interdict the blanket ban on new mining and prospecting licenses.

The FTSE/JSE Resources Index rose 13.3% towards the last week of the month, but gains were pared back marginally in the final days of July 2017 on rand strength.

The FTSE/JSE Industrials Index ended July 2017 5.7% higher. Industrial shares rose in a risk-on trade, with the SARB's 25 basis point cut in interest rates further supporting momentum in the retail shares.

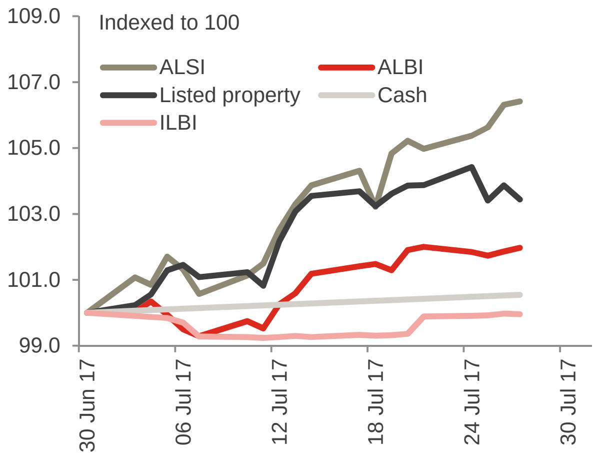
The unexpected cut in interest rates also helped the return from bank shares. The FTSE/JSE Financials Index rose 5.0% in July 2017. The FTSE/JSE Mid-cap Index climbed 4.7%, while the FTSE/JSE Small-cap Index ticked 0.8% higher in July 2017.

SA ten-year government bonds rallied 14 basis points in July 2017, with gains accelerating after the US interest rate policy announcement, which prompted US dollar weakness in reaction to the Fed sounding less confident on inflation.

The Inflation-linked Bond Index (ILBI) was flat in July 2017, while more robust gains of 3.7% were reported for the FTSE/JSE Listed Property Index. SA cash ticked 0.6% higher in the same period.

The rand ended the month 0.8% weaker against the US dollar and 4.2% weaker against the euro. The US dollar was placed on the back foot following dovish comments by the US Fed at its July 2017 rate-setting meeting. The rand weakened marginally against the British pound (2.4%) in the same time period.

Chart 6: Local asset class returns



Source: Bloomberg, Momentum Investments, data up to 31 July 2017

Indices summary for July 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)	7.03%	2.86%	7.59%	5.47%	10.77%	13.12%	13.34%	13.30%	9.96%
FTSE/JSE Shareholder Weighted Index (SWIX)	6.34%	2.20%	4.68%	6.48%	11.81%	13.57%	14.40%	14.21%	10.95%
FTSE/JSE All Share Top 40 Index	7.65%	4.00%	9.42%	4.87%	10.51%	13.25%	13.13%	13.15%	9.59%
FTSE/JSE Mid Cap Index	4.69%	-3.29%	-5.95%	6.93%	10.69%	10.98%	13.23%	12.96%	11.73%
FTSE/JSE Small Cap Index	0.76%	-4.58%	0.60%	6.70%	11.27%	14.11%	15.01%	15.05%	9.90%
FTSE/JSE Resources Index	13.32%	5.32%	10.67%	-13.19%	-3.32%	-2.32%	-3.19%	-1.54%	-1.49%
FTSE/JSE Financials Index	5.04%	1.42%	4.84%	7.79%	13.03%	14.25%	16.87%	15.02%	10.58%
FTSE/JSE Industrials Index	5.65%	2.67%	7.92%	9.99%	13.60%	18.21%	19.44%	19.71%	15.88%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	8.10%	2.49%	9.10%	3.67%	9.66%	11.35%	11.58%	11.60%	9.84%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	7.93%	2.22%	9.03%	3.55%	9.27%	11.01%	11.15%	11.27%	9.25%
FTSE/JSE SA Listed Property Index (SAPY)	3.70%	4.12%	3.27%	13.84%	13.56%	12.72%	16.16%	15.95%	14.56%
Interest-bearing indices									
BEASSA All Bond Index (ALBI)	1.50%	1.53%	7.16%	7.29%	7.27%	6.10%	7.91%	7.99%	8.53%
BEASSA All Bond Index 1-3 years (ALBI)	1.23%	2.23%	8.99%	7.76%	7.25%	6.64%	7.21%	7.31%	8.08%
Barclays BEASSA SA Government ILB Index	0.05%	-0.23%	-0.38%	4.52%	5.81%	6.20%	7.87%	8.32%	9.20%
Short-term Fixed Interest Composite Index (SteFI)	0.62%	1.87%	7.67%	6.97%	6.60%	6.32%	6.21%	6.19%	7.24%
Commodities									
NewGold Exchange-Traded Fund	2.58%	-1.50%	-10.88%	6.21%	6.25%	4.13%	6.99%	9.43%	12.90%
Gold price (in rands)	2.72%	-1.12%	-11.36%	6.61%	6.46%	4.55%	7.26%	9.99%	13.44%
Platinum Exchange-Traded Fund	2.26%	-2.54%	-22.92%	-8.08%	-5.53%				
Platinum price (in rands)	2.32%	-1.81%	-22.24%	-7.46%	-5.20%	-4.39%	-6.56%	-3.03%	-0.31%
Currency movements									
Rand/euro movements	4.15%	6.76%	0.37%	2.78%	4.28%	9.00%	8.31%	7.28%	4.81%
Rand/dollar movements	0.74%	-1.39%	-4.77%	7.20%	7.46%	9.97%	12.00%	8.82%	6.39%
Inflation index									
Consumer Price Index (CPI)			5.09%	5.36%	5.67%	5.65%	5.62%	5.54%	6.11%

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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