momentum
investments

The Macro Research Desk

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Economic and market snapshot for September 2017

Global economic developments

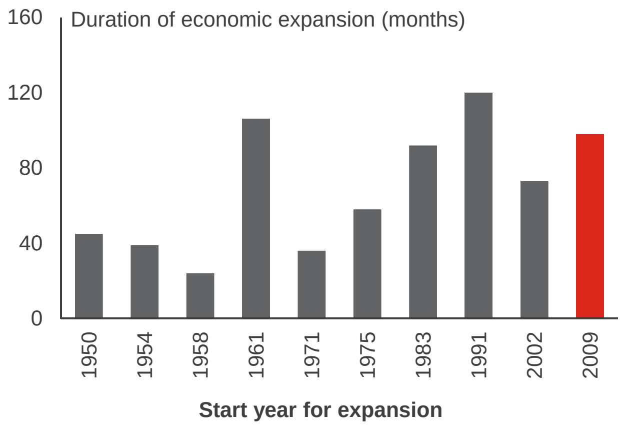
United States (US)

'Goldilocks' economy likely to persist in upcoming quarters

At a press conference in December 2016, US Federal Reserve (Fed) Chair Janet Yellen declared "it's a myth that expansions die of old age". Although the economic expansion underway in the US is the third-longest on record in post-war history (see chart 1), it is also one of the shallowest. Growth in economic activity has averaged 2.2% in the current recovery, which looks considerably weaker, when compared to the average growth rates recorded in previous economic upswings (4.7%). With little danger of the economy overheating at this stage, the US is likely less susceptible to pronounced boom-bust activity this time around.

US households are still in a healthy net wealth position and are likely to continue supporting the growth upswing. Although hurricane activity and a looming government shutdown (deferred to December 2017) threaten to derail the economic recovery, economic-related weather damages are likely to be modest and a high price of failure related to a potential debt ceiling impasse as well as a budget standoff should force a compromise from the Republicans, avoiding an upset to growth.

Chart 1: Third-longest expansion in US post-war history



Source: Bloomberg, Momentum Investments

Ticking along at slightly above-trend rates, growth activity has been insufficient to rear significant demand-pull inflationary pressures. With inflation weakness being, in part, structural in nature (due to technological advances, falling inflation expectations, weak productivity and overcapacity), Momentum Investments expects only a modest rise in inflation. As such, central banks are likely to tighten financial conditions, but at an undemanding pace, leaving the economy in a 'goldilocks' state (decent growth accompanied by modest inflation) in upcoming quarters.

Eurozone

Germany's exit polls highlight significant losses for the two leading political parties

Germany's September 2017 election outcome resulted in Angela Merkel securing a fourth term as German chancellor. Although Chancellor Merkel's Christian Democrat-led bloc (including CDU and CSU) emerged as the largest party, it suffered its worst-ever polling results. Only 33% of the total votes were won by CDU/CSU, nearly 9% lower than its support recorded in 2013. The Social Democrats (SPD), which ruled together with the CDU/CSU as a partner to the grand coalition, also lost a significant share of votes. The SPD won only 20.5% of the total vote in September 2017, nearly 5% lower than that recorded in 2013.

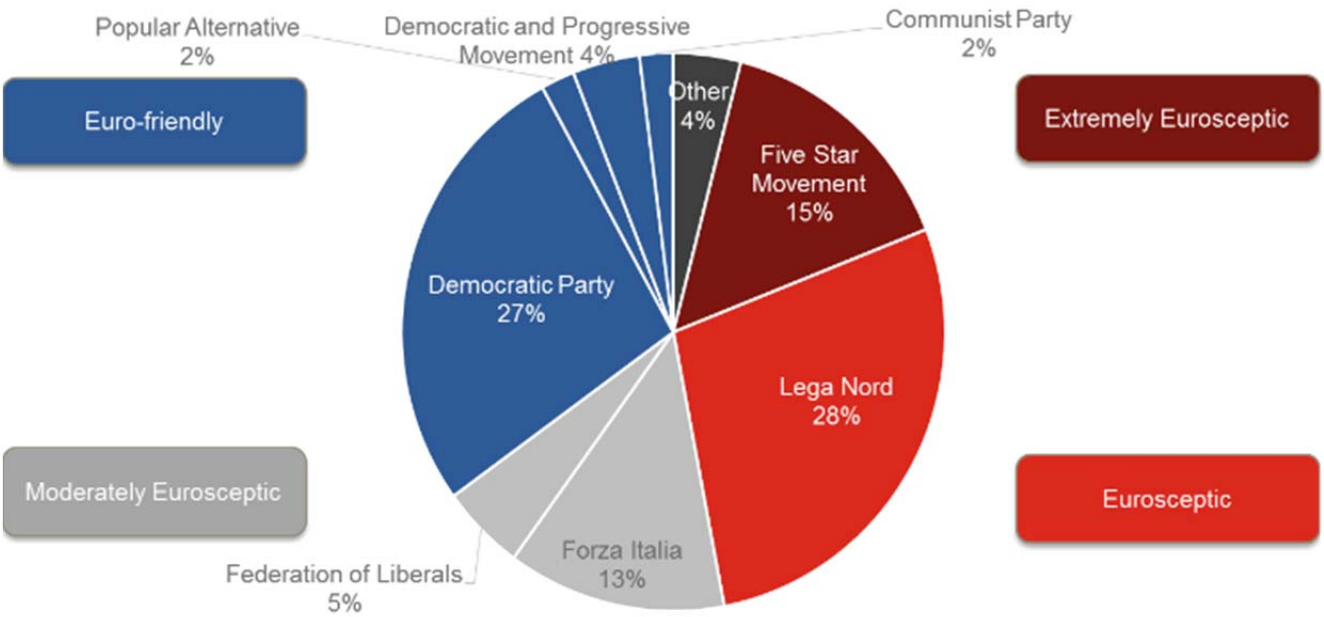
The far-right Alternative for Germany Party (AfD) and the Free Democratic Party (FDP) were the largest beneficiaries of the votes, which swung away from the largest parties.

Despite AfD winning an impressive 12.6% of the vote (making it the third-largest party in the Bundestag), its co-leader, Frauke Petry, announced she would be stepping down from the party. This could lead to new risks for the emergent populist political grouping. Chancellor Merkel faces a period of coalition negotiations, with the SPD announcing it would not participate in a renewed grand coalition. A 'Jamaica' coalition (CDU/CSU, Greens and the FDP) now seems most likely.

Although the FDP could help spur lower tax rates and business-friendly policies, its proposed political programme could be viewed as negative for the euro, given that its proposals tend to oppose the notion of stronger fiscal integration of the Eurozone. Stark policy differences on numerous issues with the Greens could also mean protracted coalition negotiations.

German elections have passed, but political risk is still likely to feature in Europe's investor landscape, as the Italian elections draw near (March 2018). Lagging growth in the Eurozone's third-largest economy has left political tensions running high. In Momentum Investments' view, with nearly 45% of the voter base supporting Eurosceptic parties (see chart 2), populism will remain a long-term threat to the European Union (EU).

Chart 2: Fractured political support in Italy



Source: Commerzbank, Momentum Investments

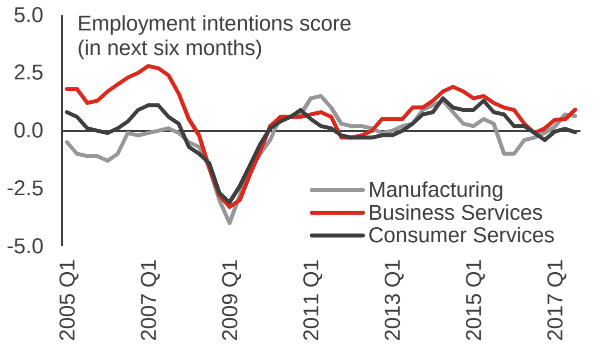
United Kingdom (UK)

Bank of England (BoE) takes a more hawkish stance

Declining real wages and stalling business investment in firms exposed to consumer demand or trade with the EU remains a drag on the UK, but easy monetary policy and healthy global demand should cushion the expected slowdown.

The UK jobs market continues to strengthen (see chart 3). The headline rate of unemployment tumbled to a 42-year low in July 2017, partly owing to pre-emptive hiring to counter dwindling new labour from Continental Europe. However, this has been accompanied by unexpectedly low pay rises.

Chart 3: UK jobs not falling in a heap just yet



Source: Bank of England, Momentum Investments

Notwithstanding low wage growth, UK consumer price inflation ticked up to 2.9% in year-on-year terms in August 2017, putting pressure on the BoE to raise interest rates from an ultra-low base.

In its September 2017 statement, the BoE noted "inflation remains likely to overshoot the 2% target over the next three years" and "monetary policy could need to be tightened by a somewhat greater extent over the forecast period than current market expectations". The BoE further stated "some withdrawal of monetary stimulus is likely to be appropriate over the coming months in order to return inflation sustainably to target".

In Momentum Investments' opinion, the BoE is likely addressing the market's under-pricing of the future path of UK interest rates through its increasingly hawkish tone. However, the BoE remains aware of ongoing Brexit uncertainties and may defer actual interest rate hikes into 2018.

Emerging markets (EMs)

Robust underlying conditions

Steady commodity prices, reduced currency volatility and stabilising inflation (allowing central banks to ease interest rates further) have fuelled an upturn in EM.

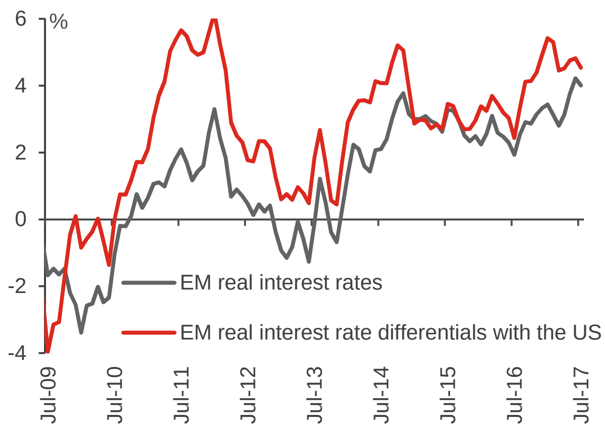
Nevertheless, EM sovereign debt worries have not disappeared. In its latest quarterly report, the Bank for International Settlements reported EM sovereign debt doubling between 2007 and 2016 to US$11.7 trillion. Still, Capital Economics argues the ability of EMs to service higher debt loads has improved. Around three quarters of EM government debt is now issued in local currency, while average maturities have lengthened.

Moreover, the flow of income available to service government debt has also increased, given significant EM growth in the past 15 years.

While select EMs have seen an increase in foreign currency debt (including Argentina), in composite the burden of foreign currency debt has fallen. As such, government balance sheets (overall) are less vulnerable to further US dollar strength (EM currency weakness).

EMs are also in a less vulnerable real interest rate position than during the May 2013 'Taper Tantrum', when the US Fed announced a tapering of one of its quantitative easing programmes (see chart 4). As such, EMs are likely to display more resilience, as the US unwinds ultra-easy monetary policy.

Chart 4: Healthy real interest rate buffer in EM



Source: RMBMS, Momentum Investments

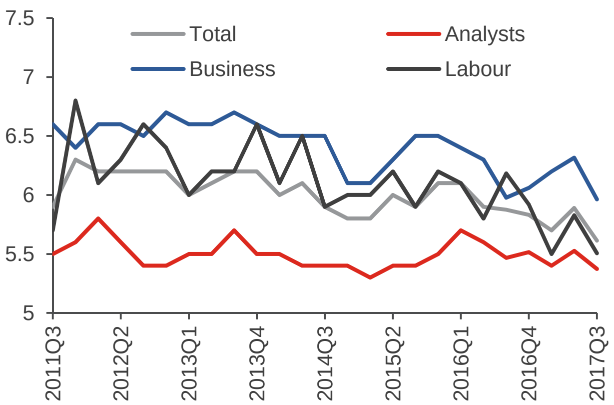
Local economic developments

Interest rates kept on hold at 6.75% due to heightened uncertainties

Momentum Investments, together with the majority of the economists polled by the Reuters survey, expected a 25 basis point cut in interest rates at the September 2017 meeting, based on the expectation of a favourable

inflation trajectory, soft business and consumer confidence and limited negative currency movements, despite lingering domestic political and sovereign ratings risks. However, the South African Reserve Bank (SARB) decided to keep the benchmark interest rate at 6.75%, citing a marginal increase in its inflation forecast and warning against "increased uncertainty regarding a number of the main (inflation) drivers".

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



Source: Stats SA, Global Insight, Momentum Investments

The SARB Monetary Policy Committee's (MPC) forecasts on growth and inflation were little changed at the September 2017 meeting, relative to its forecasts announced in July 2017, but the MPC's assessment of the balance of risks to the inflation outlook changed from being "broadly balanced" to being "somewhat on the upside". This was in spite of the Bureau of Economic Research's (BER) Inflation Expectations survey, which pointed to average five-year inflation expectations falling to its lowest level on record since long-term expectations were first surveyed in 2011.

In Momentum Investments' view, a steadily recovering global macro backdrop, an improvement in the inflation trajectory, a meaningful shift lower in inflation expectations and still muted domestic confidence justifies further monetary policy easing in the current interest rate cycle. Momentum Investments expects up to 50 basis points of easing (two interest rate cuts of 25 basis points each) before the end of the first quarter in 2018.

With the SARB choosing to stay put at its September 2017 meeting, the timing of further expected monetary policy easing will depend on the outcome of a number of high risk events, including potential material fiscal slippage announced in the October 2017 Medium Term Budget Policy Statement, the ratings agencies' November 2017 reviews and the political outcome of the African National Congress elective conference in December 2017.

Financial market performance

Global markets

Global stock markets traded flat in the first week of the month on unconstructive rhetoric regarding North Korea's plans to prepare another missile launch and the threat of Hurricane Irma, which resulted in Florida announcing a state of emergency in the US.

In the week that followed, markets ignored ongoing geopolitical tensions, following the adoption of the United Nations Security Council's agreement on sanctions against North Korea. Global stocks ended September 1.9% higher, largely owing to gains in developed markets.

The MSCI Developed Markets Index rose 2.2%, supported by strong gains in European and Japanese markets, while US equity markets lagged.

Gains in the S&P 500 Index dwindled, following the US Fed's announcement it will begin to roll off its US$4.5 trillion balance sheet in October 2017, while still indicating (via the Fed dot plot) that one more interest rate hike is likely this year. The S&P 500 Index ended September 2017 2.1% in the black, tracking broadly sideways in the final week, in response to a fresh flare up in tensions between the US and North Korea and a sharp dip in technology shares.

European markets were little moved following the European Central Bank (ECB) monetary policy meeting, in which ECB Chief Mario Draghi intimated that although the ECB is getting ready to slow its stimulus programme, it is not in a rush to do so. The Eurostoxx 50 finished the month 5.2% up, reversing some of its earlier gains in the first half of the final week in reaction to Chancellor Merkel's less-than-convincing win in the German September 2017 elections.

Investors drew confidence from a weaker yen in September 2017. The Nikkei 225 rose 4.3% by month end, additionally spurred on by rising expectations of a snap election. Prime Minister Shinzo Abe called an early election, taking advantage of his improved approval ratings, following a cabinet reshuffle in August 2017 and heightened concerns over a volatile North Korea. Investors are likely to view a victory of the incumbent ruling party as a strengthening of the foundations of a once-weak government base.

The MSCI EM Index tumbled 1.8% towards month end, from its intra-month peak, on an escalation in geopolitical concerns. The MSCI EMEA (Europe, Middle East and Africa) Index performed poorly in the second half of the month, ending September 2017 3.9% weaker, partly owing to fears of drawn-out coalition negotiations in Germany. Asian stocks traded flat, while the MSCI Latin America Index jumped 1.6% in the same period.

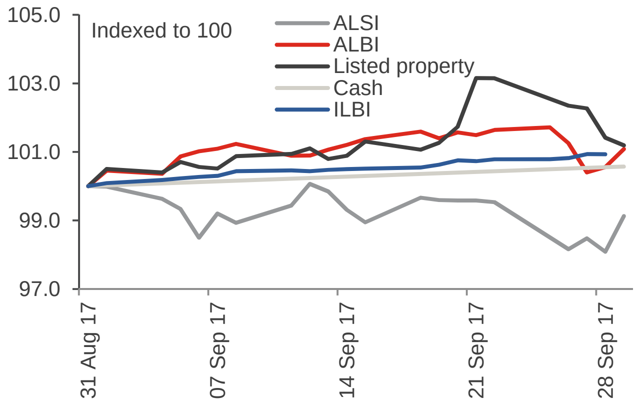
Local markets

It was a difficult trading month for the SA equity market. After choppy trade in the first half of the month, the local bourse stumbled following a hawkish US Fed interest-rate setting meeting. Losses extended into month end as geopolitical tensions spiked.

The FTSE/JSE All Share Index closed 0.9% lower in September 2017 (see chart 6), driven weaker by losses in resource shares.

The FTSE/JSE Resources Index shed 1.1% by month end, despite a slightly softer rand and stable commodity prices. A weaker currency and the SARB's decision to keep interest rates on hold weighed negatively on financial and retail stocks. The FTSE/JSE Financials and Industrials indices ended the month 1.9% and 0.3% lower, respectively.

Chart 6: Local asset class returns



Source: Bloomberg, Momentum Investments, data up to 29 September 2017

The FTSE/JSE Mid-cap Index eroded earlier gains, slumping 5.1% in September 2017, while the FTSE/JSE Small-cap Index traded broadly sideways (negative 0.1%).

SA ten-year government bond yields rallied 17 points in the first week of the month, but yields edged higher towards month end.

The Inflation-linked Bond Index (ILBI) ticked up 0.9% in September 2017, while the FTSE/JSE Listed Property Index outperformed on a relative basis by 1.2%. SA cash increased 0.6% in the same period.

The rand weakened 4.0% against the US dollar in the month as renewed threats of a conflict between North Korea and the US triggered a flight-to-safety bid among investors. The recent underperformance in the rand leaves the currency weaker against its EM peers on a twelve-month rolling basis.

The rand traded 3.3% weaker against the euro. The euro lost ground relative to the US dollar late in the month, as investors expressed their concerns over possible difficulties in cobbling together a coalition government in Germany. The rand weakened 6.9% against the British pound in September 2017 on more hawkish rhetoric from the BoE, which brought market expectations for interest rate hikes forward, despite mixed economic data in the UK.

Indices summary for September 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)	-0.87%	8.91%	10.22%	7.18%	9.19%	12.53%	14.43%	12.82%	9.54%
FTSE/JSE Shareholder Weighted Index (SWIX)	-1.73%	7.03%	7.00%	7.37%	9.93%	12.84%	15.08%	13.45%	10.61%
FTSE/JSE All Share Top 40 Index	-0.39%	9.98%	11.87%	6.86%	8.90%	12.64%	14.36%	12.75%	9.16%
FTSE/JSE Mid Cap Index	-5.10%	3.84%	-2.80%	7.10%	9.30%	10.44%	13.51%	11.96%	11.49%
FTSE/JSE Small Cap Index	0.08%	3.01%	-0.05%	7.15%	9.66%	13.68%	15.87%	14.31%	9.76%
FTSE/JSE Resources Index	-1.07%	17.82%	11.08%	-8.45%	-4.60%	-2.47%	-1.58%	-1.14%	-2.23%
FTSE/JSE Financials Index	-1.93%	5.13%	6.99%	8.09%	11.58%	13.68%	17.20%	14.36%	10.85%
FTSE/JSE Industrials Index	-0.32%	7.38%	11.54%	10.49%	11.96%	17.43%	20.45%	18.55%	15.79%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	-1.06%	10.92%	11.86%	6.09%	8.21%	11.01%	12.88%	11.26%	9.63%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	-1.42%	10.33%	11.06%	5.82%	7.72%	10.59%	12.60%	10.96%	8.99%
FTSE/JSE SA Listed Property Index (SAPY)	1.19%	5.73%	9.51%	12.65%	13.27%	12.67%	16.42%	15.23%	13.91%
Interest-bearing indices									
BEASSA All Bond Index (ALBI)	1.11%	3.68%	8.20%	7.63%	7.17%	6.34%	8.05%	7.75%	8.44%
BEASSA All Bond Index 1-3 years (ALBI)	0.58%	2.66%	8.99%	8.05%	7.34%	6.72%	7.13%	7.33%	8.00%
Barclays BEASSA SA Government ILB Index	0.98%	1.21%	0.31%	4.53%	6.29%	5.72%	7.70%	7.91%	9.22%
Short-term Fixed Interest Composite Index (SteFI)	0.57%	1.82%	7.60%	7.04%	6.69%	6.39%	6.26%	6.21%	7.20%
Commodities									
NewGold Exchange-Traded Fund	1.03%	6.07%	-5.09%	7.71%	6.19%	2.76%	4.93%	9.09%	12.33%
Gold price (in rands)	1.29%	6.70%	-5.67%	8.02%	6.67%	3.35%	4.82%	9.61%	12.99%
Platinum Exchange-Traded Fund	-3.91%	2.47%	-13.42%	-5.99%	-3.82%				
Platinum price (in rands)	-4.91%	2.09%	-12.24%	-5.59%	-4.12%	-4.82%	-4.33%	-4.62%	-1.65%
Currency movements									
Rand/euro movements	3.30%	6.81%	3.21%	3.80%	4.04%	8.50%	6.75%	7.66%	4.99%
Rand/dollar movements	3.85%	3.04%	-1.64%	6.13%	7.62%	10.35%	9.08%	9.85%	6.96%
Inflation index									
Consumer Price Index (CPI)			4.73%	5.09%	5.42%	5.61%	5.51%	5.49%	6.00%

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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