The Macro Research Desk

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Economic and market snapshot for December 2018

Highlights

- United States (US): Inflation averaging above the 2% target and a continuation in above-trend growth should allow for a further gradual tightening in monetary policy.
- Eurozone: Slow upward progress across inflation measures, an end to monetary stimulus and headwinds from global trade should see growth slow further in 2019 from 2018 levels.
- United Kingdom (UK): Political and economic uncertainties related to the Brexit negotiations and international trade tensions should hold back growth prospects in 2019.
- China: Policymakers have committed to slower, but more sustainable, growth. Any sharp backsliding in economic activity could result in a further rise in financial risks, as authorities attempt to shore up growth in the economy.
- South Africa (SA): Fragile growth reflects policy uncertainty and slow progress on structural reforms to improve the ease of doing business in the country.

Global economic developments

US

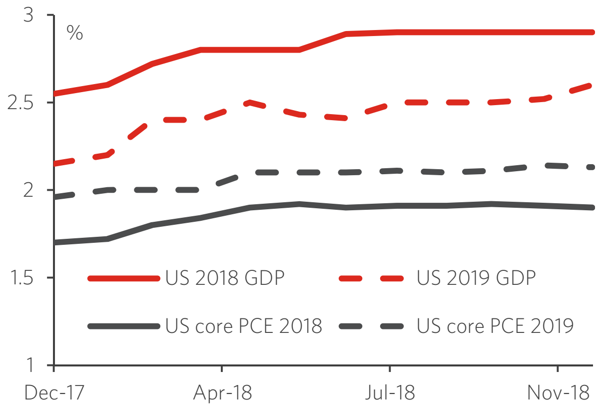
Above-trend growth and inflation pressures should allow for a further gradual tightening in monetary policy

The Federal Open Market Committee (FOMC) forecasted longer-run growth in the US at 1.9% (previously 1.8% in September 2018) in its updated December 2018 economic projections. The Bloomberg consensus estimate for growth in gross domestic product (GDP) in the US for 2018 started the year at 2.6%, but was revised higher during the course of the year to 2.9% (see chart 1). In Momentum Investments' opinion, growth in economic activity is set to exceed the FOMC's estimated level of trend growth for a second consecutive year in 2019.

The Republican package of tax cuts signed into law by US President Donald Trump in December 2017 delivered a significant boost to confidence for business and consumers and aided the recovery in the economy in 2018.
The University of Michigan Consumer Sentiment Index averaged 99 points in 2018, which was significantly higher than the long-term average of 86.1 points since 1978.

Despite signs of labour market tightness, more than 200 000 jobs were created on average per month in 2018, further supporting growth in consumer spend. Similarly, household net wealth, as a share of disposable income, charged higher towards 700% by the end of 2018 and contributed to a more upbeat consumer.

Chart 1: US growth is expected to remain above trend and core inflation should edge higher in 2019



Source: Bloomberg, Momentum Investments

Significant tax savings by US firms, in part, drove business confidence higher. The NFIB Small Business Optimism Index recorded an average of 106 points in 2018, relative to its longer-term average of 98.2 points since 1984.

Although the consensus estimate for growth in 2019 has lifted throughout the year to 2.6%, growth is expected to slow relative to 2018 levels. Punitive tariffs, less fiscal support and tighter monetary policy will likely mean more restraint on economic activity in 2019.

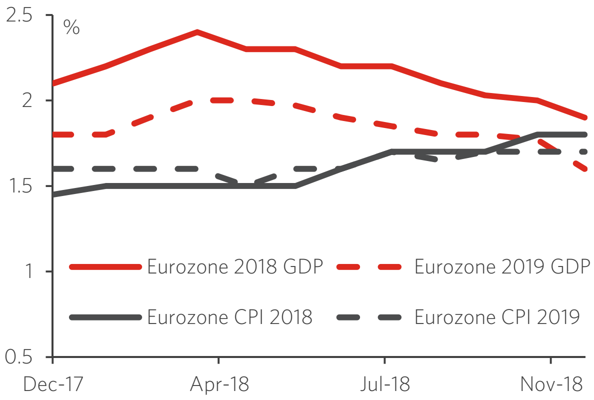
The Federal Reserve's preferred inflation measure, the core personal consumption expenditure (PCE) deflator, surprised to the upside in 2018, substantiating the four interest rate hikes experienced in the year. Momentum Investments expects a further gradual tightening in interest rates of between two and three additional hikes in the US in 2019.

Eurozone

Stuttering growth in the second half of 2018 to continue facing headwinds from global trade in 2019

The Eurozone's growth prospects for 2018 were chopped from a peak of 2.4% in March 2018 to below 2% by the end of the year (see chart 2). The Citigroup Economic Surprise Index (CESI), which compares actual data with forecasted data, has languished in negative territory since March 2018.

Chart 2: Softer growth and little upward progress in inflation expected in the Eurozone in 2019



Source: Bloomberg, Momentum Investments

GDP data for the third quarter of 2018 showed a smaller contribution from investment, government spend and household consumption, while net exports detracted from overall growth. This suggests the slowdown in growth was broader than the disruption to car production in the third quarter of the year.

Net trade contributions to growth in the Eurozone have waned, while those from domestic demand have increased. Stronger employment, higher wages, supportive growth in credit and still accommodative monetary policy should prevent a sharper slowdown in 2019, but risks are still firmly tilted to the downside. The International Monetary Fund (IMF) warned the global environment had become less supportive for growth, given slowing global demand and mounting trade tensions. In addition to the risk from global trade tensions, a firmer euro, particularly in the second half of 2019, could further detract from growth in trade.

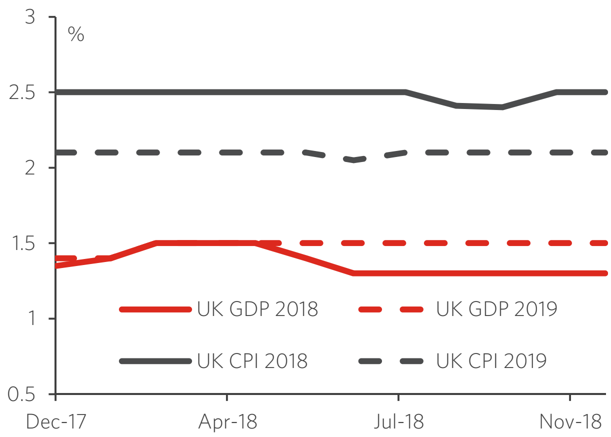
As the economy shifted its reliance away from external trade towards domestic demand in 2018, the disinflationary bias started to lift. While higher oil prices buoyed headline inflation, core measures of inflation stayed stubbornly low. In Momentum Investments' opinion, a closing output gap and rising wage growth should lead to a gradual uptick in core inflation, but price pressures are likely to remain below the 2% inflation target throughout the European Central Bank's forecast horizon. As such, the ECB is likely to delay the first hike in interest rates to the end of 2019, at the earliest.

UK

Modest growth outlook expected under a soft Brexit scenario

The Bloomberg consensus forecasts growth in the UK to remain steady at around 1.5% in 2019 (see chart 3), which inherently assumes a smooth exit from the European Union (EU). Political and economic uncertainty related to Brexit negotiations is expected to linger nonetheless and should draw down on investment intentions until a clearer outlook emerges, once the transition period is in place.

Chart 3: Brexit uncertainty and international trade tensions to weigh on UK growth prospects in 2019



Source: Bloomberg, Momentum Investments

Sturdy real wage growth and strong job creation held up consumer spending in 2018, but the pace of employment growth is expected to slow in 2019. Continued government spending and short-term tax cuts announced in the Budget should prevent a collapse in growth, but downside risks from international trade tensions to the growth outlook remain.

While the EU is happy with the negotiated deal, the UK needs to accept these terms by parliamentary approval. This may require the EU to move on its position to make the deal more politically palatable to the UK parliament. The UK is scheduled to leave the EU by 29 March 2019, but the UK could request an extension to the Article 50 period to hold a referendum or general election. That would, however, require all countries belonging to the EU to ratify that decision.

Inflation spiked above the Bank of England's (BoE) target of 2% in 2018 on higher international oil prices and the feed-through from a weaker pound into import prices, but inflation is expected to gradually drop closer to the 2% target in 2019.

Inflation pressures prompted the BoE to raise interest rates by 0.25% to 0.75% in August 2018, but the committee signalled a slow interest rate hiking cycle. Hikes are likely to be dependent on how the Brexit negotiations evolve and how they affect economic data. In Momentum Investments' view, the BoE is only likely to raise interest rates once in 2019, in the second half of the year.

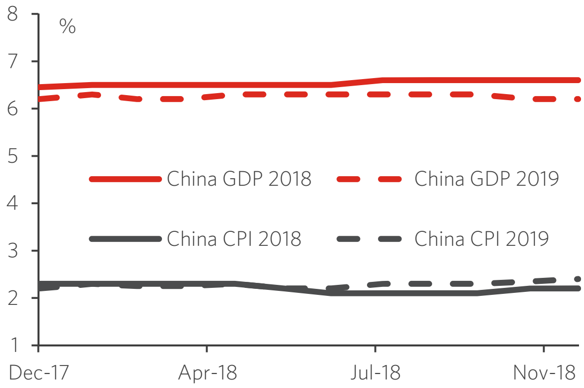
China

Policymakers continue to face the challenge of balancing China's elevated debt burden with moderating growth prospects

Growth in China has slowed in the past six years to an average of 7.1% from an average of 9.8% between 1990 and 2012. Growth in economic activity is expected to slow further in 2019 to 6.2% (see chart 4 for the Bloomberg consensus forecasts), as China settles into a more sustainable growth trajectory.

The IMF has pointed to authorities' focus on shifting the economy away from high-speed growth towards high-quality growth. It notes that government's main focus areas include reining in credit growth, accelerating efforts behind rebalancing the economy away from the more traditional growth drivers towards internally led demand, increasing the role of market openness, encouraging a more open economy and modernising policy frameworks.

Chart 4: Escalating trade tensions with the US pose a downside risk to gradually moderating growth in China



Source: Bloomberg, Momentum Investments

Although credit growth has slowed in China, it remains too high. Corporate debt levels relative to GDP have stabilised above 135%, but government and household debt levels have continued to climb to 62% and 50%, respectively. Although government has committed to slower, but more sustainable growth, a faster-than-anticipated slowdown in the economy (potentially triggered by an escalation in trade tensions with the US) could lead to a new wave of loans in China to prop up growth. This could derail recent trends in containing credit growth and risk overall financial stability in the country.

Local economic developments

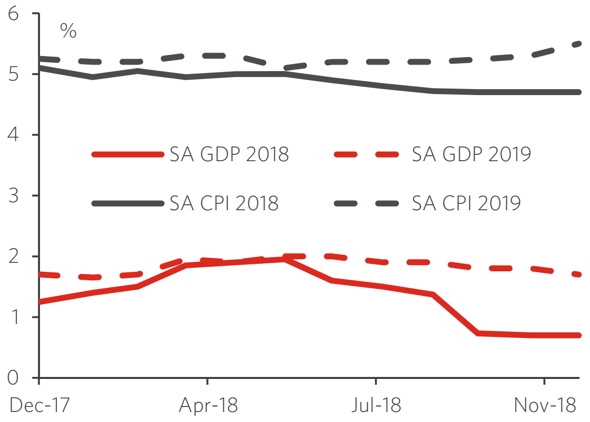
Fragile growth reflects policy uncertainty and slow progress on structural reforms to improve the ease of doing business

Bloomberg consensus growth forecasts for 2018 faded from 2% in April 2018 to 0.7% by the end of the year (see chart 5). While the global economy posted a solid performance, local growth drivers disappointed. Low consumer and business confidence dampened consumption and investment spend, while companies continued to run down inventory levels. Consequently, growth contracted in SA during the first two quarters of the year and led to a surprise technical recession and a swath of downgrades to full-year growth estimates in the third quarter of 2018.

The IMF attributed low growth to labour rigidities, a lack of sufficient competition in product markets, corruption, policy uncertainty and higher input prices (arising from inefficiencies at state-owned enterprises (SoEs)).

The IMF acknowledged that recent reforms announced to tackle corruption, strengthen procurement and eliminate wasteful expenditure were welcome, but it warned that reforms were needed to reduce policy uncertainty, improve efficiency levels at SoEs, enhance labour market flexibility and improve the level of basic education.

Chart 5: Subdued SA growth prospects are reflective of policy uncertainty and slow progress in structural reforms



Source: SARB, Momentum Investments

In line with softer growth prospects, the SA Reserve Bank (SARB) revised its negative output gap estimates (the gap between actual and potential growth) at the November 2018 interest-rate-setting meeting to reflect a marginally wider negative gap, for longer. Although demand-side inflation pressures have been largely absent in an environment where growth has remained below trend, the SARB warned longer-term inflation risks posed by exogenous factors could push inflation above the 3% to 6% inflation target band for an extended period and warrant a more aggressive interest-rate-hiking cycle.

As such, the SARB hiked interest rates pre-emptively in November 2018 by 25 basis points.
In Momentum Investments' view, in the absence of a faster-than-anticipated normalisation of monetary policy in developed markets (DMs) or broad-based negative sentiment towards EMs, lower growth and in-target inflation should allow for a shallow interest-rate-hiking cycle of two further interest rate hikes during 2019 and 2020.

Financial market performance

Global markets

Most of the risky investments recorded negative returns for 2018, while safe-haven investments rallied. The CBOE volatility index (VIX), or fear gauge, rose to 25 points by the end of 2018, a meaningful jump from the past five-year average of 15 points.

A strengthening global economy provided a supportive backdrop for a stellar return (up 24%) from global equity markets in 2017. However, global equity markets tanked 9.4% in 2018 (down 7.0% for December 2018) in reaction to an escalation in global trade tensions, slowing growth in China, news of oil supply cuts, Brexit uncertainty and tough negotiations around budget restructuring between Italy and the EU.

The MSCI DM Index lost 8.7% in 2018 (7.6% weaker for December 2018), driven weaker by losses in European stocks. The Eurostoxx 50 Index suffered an 11.3% blow during the year (but down only 5.2% for December 2018 relative to the previous month) as German, Spanish and Italian markets tanked for the year as a whole. The Nikkei 225 Index fell 10.3% in 2018 (and underwent an identical 10.3% monthly drop in December 2018) on growing investor concerns over corporate earnings in the technology and chemical sectors as well as a further slowdown in the Chinese economy.
The S&P 500 Index fared better and ended the year only 4.4% in the red, despite dipping by 9.0% in the final month of 2018. US stocks were primarily weighed down by anxiety over damaging trade policies, geopolitical tensions and a potential government shutdown.

In the DM composite, the spread between ten-year government bond yields in the US and Germany increased between 2017 and 2018 from 198 to 245 basis points. That was largely due to a 29 basis point move higher in US ten-year government bonds, while German ten-year government bond yields rallied by 18 points in the same period.

Even though developed equity markets lost ground in 2018, emerging equity markets were the biggest losers during the year. The MSCI EM Index plunged 15% in 2018 (and a milder 2.7% in the final month of 2018) in the face of rising trade protectionism, a further increase in interest rates, signs of a slowdown in global economic activity, lingering geopolitical pressures and downward pressure on commodity prices. The latter was reflected in an 11.3% dip in the Bloomberg Commodity Price Index in 2018, which was partly led lower by a 20% collapse in international oil prices on an annual basis.

Risk in the EM composite increased throughout the year, with the JP Morgan EM Bond Index (EMBI) spread rising by 124 basis points for 2018. Argentina (244 points), Turkey (118 points) and Malaysia (89 points) experienced the largest widening in-country risk (corporate default swap (CDS)) spreads during 2018, while spreads narrowed for South Korea (27 points), Bulgaria (19 points) and Thailand (1 point).

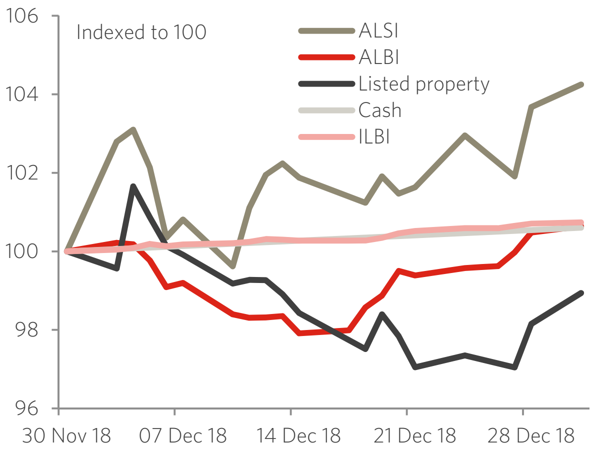
A deterioration in sentiment towards EMs was more evident in the poor returns from shares in the Europe, Middle East and Africa (EMEA) region. The MSCI EMEA Index tumbled 16.1% during 2018 (and 1.6% in December 2018), but was closely followed by a 15.5% drop (down 3.2% in the final month of the year) in the MSCI Asia Index.

EM currencies stabilised towards the end of 2018, but are still much weaker than where they started the year. The JPMorgan EM Currency Index sank 10.6% in 2018 in response to tightening global financial conditions, a strong US dollar and worries over changes to trade policies. Losses were severe for countries, which were punished for economic mismanagement. These included a 50.6% collapse in the Argentine peso and a 28.2% drop in the Turkish Lira.

Local markets

After a strong run in 2017 (up 21%), the SA equity market gave back 8.5% in 2018. Nonetheless, the FTSE/JSE All-Share Index ended the year on a high note, posting gains of 4.3% for the final month of the year (see chart 6). From the constituent sectors, resource shares displayed the strongest return, while industrial shares were hammered.

Chart 6: Returns on local asset classes (%)



Source: IRESS, Momentum Investments, data up to 31 December 2018

The run in the FTSE/JSE Resources Index continued in 2018, with the index climbing 15.5% in 2018, after a 17.9% gain in 2017. Resource shares had a firm December, showing robust gains of 12.3% in the final month of 2018.
The FTSE/JSE Industrials Index performed poorly and slumped 17.5% in 2018, after increasing by 22.5% in 2017. A 2.4% gain was, however, noted in the index in the final month of the year. The FTSE/JSE Financials Index lost ground in 2018 (down 8.8%) despite increasing by 0.6% in December 2018.

Small-cap shares underperformed relative to mid-cap shares in 2018. The FTSE/JSE Mid-cap Index decreased by 9.7% in 2018, while the FTSE/JSE Small-cap Index sank by a larger 14.6%.

Listed property shares had a dismal year, after allegations of share price manipulation and insider trading were made against the Resilient stable of property firms. Losses in the property sector extended to more than a quarter of the value of the index in 2018. Losses, however, slowed towards the end of the year, with the index only losing 1.1% in December 2018.

The SA ten-year government bond yield sold off by more than 40 basis points in 2018 (and remained steady in December 2018). Gains in the JSE ASSA All Bond Index slowed in 2018 relative to the previous year. The index rose 7.7% in 2018, relative to a 10.2% increase in 2017. In contrast, the JSE ASSA Government Inflation-linked Bond Index (ILBI) slipped 0.4% in 2018 (but increased by 0.7% in the final month of the year). SA cash posted a 7.2% gain in the same period.

The SA rand was the fifth-worst-performing currency against the US dollar in 2018 (13.8% weaker). The rand depreciated by 9.7% against the euro and 8.6% against the British pound in the corresponding period. In line with a weaker local currency, SA's five-year CDS spread widened by 66 points during the year.

Indices summary for December 2018

	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)	4.25%	-4.88%	-8.53%	4.33%	4.53%	5.77%	8.23%	10.69%	12.62%
FTSE/JSE Shareholder Weighted Index (SWIX)	2.90%	-3.98%	-11.67%	3.69%	3.67%	5.92%	8.26%	11.01%	13.02%
FTSE/JSE Capped SWIX All Share index	2.59%	-3.79%	-10.94%	2.95%	2.91%	5.30%	7.72%	10.54%	
FTSE/JSE All Share Top 40 Index	4.76%	-5.25%	-8.31%	3.55%	4.53%	5.44%	8.15%	10.55%	12.28%
FTSE/JSE Mid Cap Index	3.37%	2.68%	-9.73%	7.14%	3.26%	6.34%	7.42%	10.33%	13.93%
FTSE/JSE Small Cap Index	-0.85%	-7.35%	-14.59%	2.06%	0.53%	4.25%	7.64%	10.46%	12.48%
FTSE/JSE Resources Index	12.33%	-4.52%	15.55%	22.29%	3.61%	-0.35%	-0.07%	0.37%	3.85%
FTSE/JSE Financials Index	0.62%	-2.09%	-8.76%	5.08%	4.78%	8.94%	10.57%	14.14%	14.99%
FTSE/JSE Industrials Index	2.35%	-6.49%	-17.55%	-1.91%	2.14%	4.91%	9.41%	13.42%	15.92%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	5.71%	-4.07%	-3.13%	10.89%	5.98%	6.21%	7.99%	10.19%	12.69%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	5.44%	-4.25%	-4.00%	10.51%	5.52%	5.89%	7.63%	9.92%	12.07%
FTSE/JSE SA Listed Property Index (SAPY)	-1.06%	-3.99%	-25.26%	-1.19%	1.03%	5.70%	6.15%	9.96%	12.09%
Interest-bearing indices									
JSE ASSA All Bond Index (ALBI)	0.64%	2.74%	7.69%	11.07%	7.11%	7.71%	6.50%	7.81%	7.68%
JSE ASSA All Bond Index 1-3 years (ALBI)	1.02%	4.14%	9.14%	9.61%	8.21%	7.81%	7.23%	7.39%	7.71%
JSE ASSA SA Government ILB Index	0.73%	0.23%	-0.43%	2.89%	3.09%	4.65%	4.00%	6.06%	7.39%
Short-term Fixed Interest Composite Index (SteFI)	0.60%	1.78%	7.25%	7.40%	7.16%	6.91%	6.62%	6.47%	6.70%
Commodities									
NewGold Exchange-Traded Fund	10.17%	9.65%	15.10%	3.24%	7.03%	7.39%	4.05%	4.99%	8.05%
Gold price (in rands)	9.93%	9.69%	15.18%	3.91%	7.44%	7.95%	4.57%	5.82%	8.51%
Platinum Exchange-Traded Fund	3.13%	-1.99%	-0.57%	-5.98%	-5.30%	-4.88%			
Platinum price (in rands)	2.90%	-0.97%	-1.03%	-6.15%	-4.77%	-4.32%	-6.33%	-4.74%	1.35%
Currency movements									
Rand/euro movements	4.63%	-0.02%	10.54%	-0.78%	4.10%	2.61%	6.62%	6.64%	2.49%
Rand/dollar movements	3.59%	1.54%	16.01%	-2.47%	5.57%	6.50%	9.16%	8.60%	4.66%
Inflation index									
Consumer Price Index (CPI)			5.18%	5.47%	5.29%	5.39%	5.39%	5.42%	5.24%

Important notes

1. Sources: Momentum Investments, 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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