momentum investments

The Macro Research Desk

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Economic and market snapshot for February 2018

Highlights

- **United States: Measures of inflation and inflation expectations are edging higher, but a measured approach to raising interest rates is still expected for 2018**
- **Eurozone: The recent slowdown in domestic demand is likely to be short lived, upholding growth in 2018**
- **United Kingdom: The economy continues to feel the strain of unresolved Brexit negotiations**
- **China: Economic resiliency has prevented a full-blown debt crisis**
- **South Africa: The appointment of a few key reformists in the latest Cabinet reshuffle bodes well for structural change in specific areas of the economy in the medium term**

Global economic developments

United States (US)

Measures of inflation and inflation expectations are edging higher

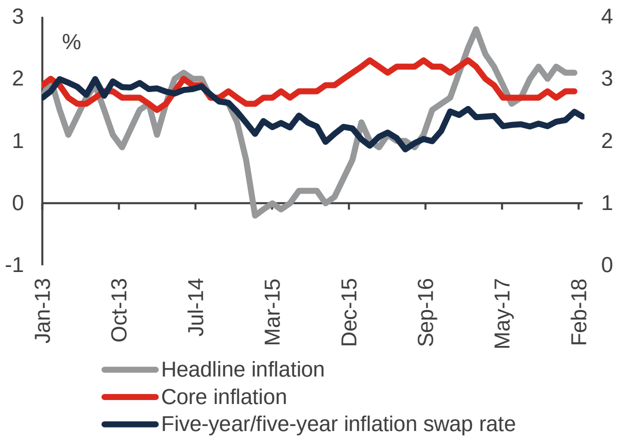
Core inflation, which excludes volatile food and energy prices, rose marginally above consensus to 1.8% in January 2018, relative to the same month a year ago. Similarly, headline inflation increased to 2.1%, ahead of expectations for a 1.9% rise. The monthly uptick in core inflation was the fastest increase in nearly a year, while the three-month annualised rate hit a six-year high in January 2018.

Other measures of inflation are additionally pointing to an uptick in price pressures. The Underlying Inflation Gauge, developed by the New York Federal Reserve, estimated underlying (or persistent) inflation at 3% in January 2018. This measure includes consumer price index (CPI) components as well as a wide range of nominal, real and financial variables.

On a forward-looking basis, the US Institute for Supply Management (ISM) Purchasing Managers' Index (PMI) showed price pressures in the manufacturing sector intensified in February 2018, with the price sub-index climbing to 72.7 points from 68.3 points in the previous month.

Inflation expectations have correspondingly edged higher. The University of Michigan Inflation Expectations Survey (surveying consumers' median expected price change for the next 12 months) inched higher to 2.7% in December 2017. The break-even rate for inflation (which looks at the gap between yields on nominal and inflation-linked treasury securities of comparable maturities) increased to 2.1% in February 2018, while forward inflation expectations based on the five-year/ five-year inflation swap climbed to 2.3% in early February 2018, from a low of 1.6% in June 2016 (see chart 1).

Chart 1: Various inflation measures inching higher



Source: Bloomberg, Momentum Investments

Momentum Investments anticipates headline inflation in the US to increase moderately to 2.2% in 2018, from 2.1% in 2017. Although pressures on wage prices, which are building on the back of diminishing slack in the labour market, and previous US dollar weakness (relative to the euro) should feed into higher rates of inflation, technological advances (including automation) and structurally higher rates of underutilisation in select sectors are likely to cap price pressures overall.

Solid growth, coupled with low inflation, has allowed the US Federal Reserve (Fed) to keep monetary policy highly accommodative, with interest rates rising at a gradual pace during the past few quarters.

Momentum Investments expects the Fed to continue using a measured approach to raising interest rates. Accordingly, the firm expects up to three interest rate increases in 2018.

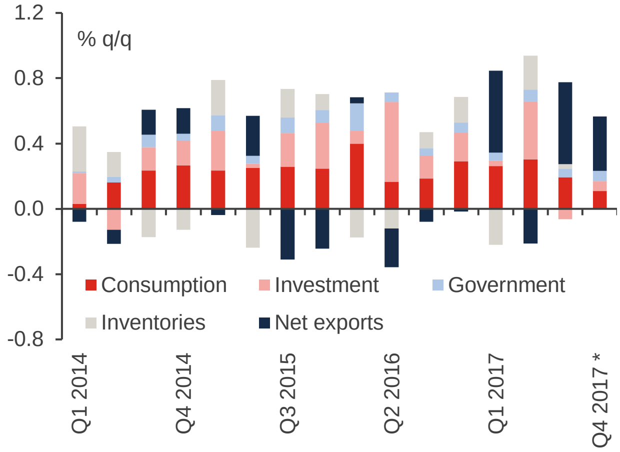
Eurozone

The recent slowdown in domestic demand is likely to be short lived

Growth in the Eurozone ended 2017 on a high note. Real gross domestic product (GDP) increased by 0.6% (in quarterly terms) in the final quarter of 2017, leaving full-year growth at a healthy rate of 2.5%.

Based on the available national breakdowns, Capital Economics estimates net trade contributed a significant 0.3% to the quarterly growth rate in the fourth quarter of 2017 (see chart 2). However, the euro's recent appreciation is expected to weigh negatively on net exports, suggesting a smaller growth contribution in upcoming quarters.

Chart 2: Contribution to quarterly Eurozone GDP growth (%)



*Source: Capital Economics, Momentum Investments, * forecast*

As such, growth prospects rely heavily on a recovery in domestic demand. Growth in this component, however, likely halved to 0.2% in the final quarter of 2017, according to Capital Economics, given a sharp slowdown in spend on household energy and clothing. In essence, warmer-than-expected weather undermined spend in these consumer-related categories, implying weakness in household spend is likely temporary. With consumer confidence having reached a 16-year high in January 2018, the outlook for household consumption remains bright. In addition, easy monetary conditions remain supportive of economic growth. Growth in private-sector lending increased to 3.3% in January 2018, relative to the same month a year ago, from negative 2.5% in January 2014.

Moreover, investment growth is likely to underpin domestic demand in upcoming quarters. An overhang of spare capacity led to a decline in the investment share of GDP from about 23% in 2008 to a trough of 19.5% in 2013. This ratio has risen to 20.5% in 2017, in response to re-emergence of capacity constraints.

Momentum Investments expects a recovery in business confidence and rising home prices to promote construction spend further in the near to medium term. While the firm anticipates growth to remain above trend, it expects growth to slow marginally to 2.2% in 2018, from 2.5% in 2017.

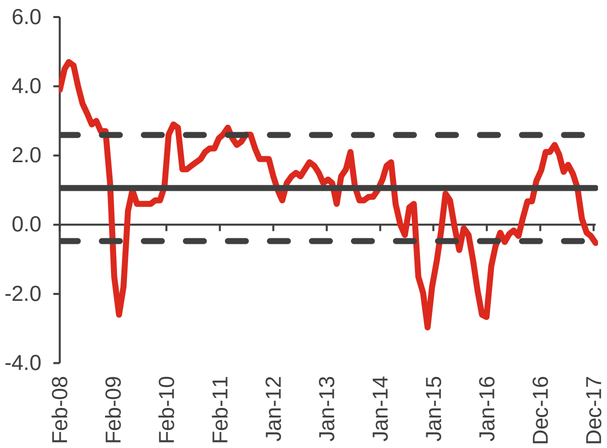
United Kingdom (UK)

The economy continues to feel the strain of unresolved Brexit negotiations

The recent growth revisions show the first half of the year underperformed more significantly than what initial estimates showed, leaving full-year growth in the economy the weakest within the G7 (the seven-largest advanced economies) composite.

Inflation pressures have squeezed consumers' purchasing power throughout most of 2017 and have acted as a drag on household spend. In December 2017, headline inflation of 3% outstripped nominal wage gains of 2.5%, leaving real growth in compensation in negative territory (see chart 3).

Chart 3: UK real wage growth is under pressure (%)



Source: Bloomberg, Momentum Investments

Rising inflation pressures stirred monetary policy intervention by the Bank of England (BoE). The BoE increased interest rates by 25 basis points in November 2017 – the first increase since July 2007.

While Brexit uncertainty has been to the detriment of the consumer, the Brexit-related depreciation in the sterling boosted GDP growth by 0.4% in 2017. UK manufacturers are enjoying the longest run of uninterrupted growth since 1997, due to sterling weakness and an economic upturn in the euro area, which buys almost half of British exports.

Regrettably, trade with the European Union will revert to World Trade Organisation (WTO) rules after 29 March 2019, unless Prime Minister Theresa May is able to secure a new trade deal before then. Calculations by Bloomberg Economics show a Canada-style trade agreement would be better than no deal, though it would still leave the economy smaller than if the UK stayed in the bloc. Worse yet, under WTO rules, the pound would depreciate and currency effects and tariffs would push inflation to 3.6% by the end of the year, according to the analysis done by Bloomberg Economics.

In Momentum Investments' opinion, Britain is forecast to join Italy at the bottom of the G7 growth league in 2018, with GDP growth expected to slow to 1.2% from 1.7% in 2017.

China

China's economic resiliency has prevented a full-blown debt crisis

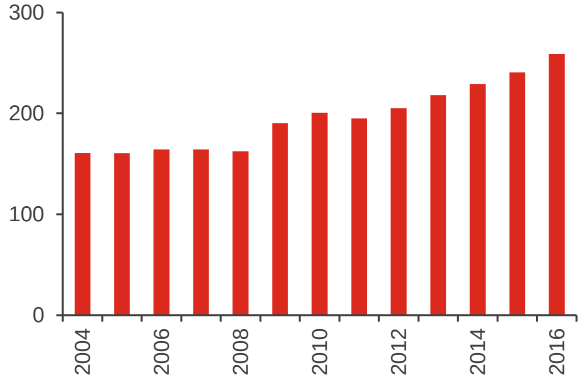
Growth in China slowed consistently from 9.5% in 2011 to 6.9% in 2017. Momentum Investments expects a managed slowdown to continue in 2018 and 2019, given the tightening in financial sector regulations and the negative effect it will have on the property market.

JP Morgan estimates growth in real estate investment to cool from an estimated 11% in 2018 to 9% in 2019. Momentum Investments still sees space to ease monetary policy further, to stimulate the economy, should the slowdown in the property sector accelerate beyond projections. China's reserve requirement ratio was cut to 17% in March 2016, but this remains above the longer-term average of 12.9% and is significantly higher than the 6% trough reached between 2000 and 2003.

China's high debt-to-GDP ratio continues to fuel the expectation for a downturn. Total debt surged from 158% to 259% between 2008 and 2016 (see chart 4), suggesting growth in credit outstripped growth in nominal GDP, on average, for this period.

Nevertheless, a deleveraging exercise is under way. China's credit-to-GDP gap, as calculated by the Bank for

Chart 4: Rising debt-to-GDP ratio in China



Source: Bloomberg, Momentum Investments

International Settlements has rolled over from an extreme level of 28.1% in the second quarter of 2016 to 18.9% by mid-2017. Authorities have issued a number of measures to encourage deleveraging, including swapping state-owned enterprise (SoE) debt for equity, providing policy loans to encourage SoEs to merge and streamline and increasing scrutiny over speculative financial activities.

In Momentum Investments' view, a debt crisis is unlikely to affect China's growth trajectory in the next five years. China's debt is backed by high household and corporate savings and the commercial banking structure is, ultimately, backstopped by government. The country holds around US$3.2 trillion in foreign currency reserves and it boasts a current account surplus of US$172 billion, increasing its resiliency to debt pressures.

Local economic developments

The appointment of a few key reformists in the latest Cabinet reshuffle bodes well for structural change in specific areas

President Cyril Ramaphosa made significant changes to Cabinet in February 2018 (see table 1), but noted an ongoing review into the number of departments and ministers would be finalised at a later date.

Table 1: Changes to Cabinet

Ministry	Previous minister	New minister
Communications	Mmamoloko Kubayi-Ngubane	Nomvula Mokonyane
Cooperative Governance and Traditional Affairs	Des van Rooyen	Zweli Mkhize
Energy	David Mahlobo	Jeff Radebe
Finance	Malusi Gigaba	Nhlanhla Nene
Higher Education	Hlengiwe Mkhize	Naledi Pandor
Home Affairs	Ayanda Dlodlo	Malusi Gigaba
Human Settlements	Lindiwe Sisulu	Nomaindia Mfeketo
International Relations and Cooperation	Maite Nkoana-Mashabane	Lindiwe Sisulu
Mineral Resources	Mosebenzi Zwane	Gwede Mantashe
Police	Fikile Mbalula	Bheki Cele
Public Enterprises	Lynne Brown	Pravin Gordhan
Public Service and Administration	Faith Muthambi	Ayanda Dlodlo
Public Works	Nathi Nhleko	Thulas Nxesi
Rural Developments and Land Reform	Gugile Nkwinti	Maite Nkoana-Mashabane
Science and Technology	Naledi Pandor	Mmamoloko Kubayi-Ngubane
Social Development	Bathabile Dlamini	Susan Shabangu
Sport and Recreation	Thulas Nxesi	Tokozile Xasa
State Security	Bongani Bongo	Dipuo Letsatsi-Duba
Minister in the Presidency	Jeff Radebe	Nkosazana Dlamini-Zuma
Tourism	Tokozile Xasa	Derek Hanekom
Transport	Joe Maswanganyi	Blade Nzimande
Water and Sanitation	Nomvula Mokonyane	Gugile Nkwinti
Women in the Presidency	Susan Shabangu	Bathabile Dlamini

Source: EWN, Momentum Investments

Departments where no changes were made included Arts and Culture, Basic Education, Defence and Military Veterans, Economic Development, Environmental Affairs, Health, Justice and Correctional Services, Labour, Telecommunications and Postal Services and Trade and Industry.

While the removal of underperforming ministers (including Des van Rooyen, Fikile Mbalula, Lynne Brown, Faith Muthambi, Hlengiwe Mkhize, Mosebenzie Zwane and David Mahlobo) will be received positively by the market, a number of compromised ministers were redeployed into other ministries.

It is widely speculated Bathabile Dlamini retained a position in Cabinet, despite her role in the social grants debacle, given her involvement in the African National Congress (ANC) Women's League. However, it should be noted this ministry is vulnerable to being cut in the awaited downsizing exercise for Cabinet.
Moreover, Malusi Gigaba has returned to the Home Affairs ministry, where it is suspected he had favoured the patronage networks previously.
Similarly, Nomvula Mokonyane, who has been accused of mismanagement of money in her previous role as Minister of Water and Sanitation, has been shifted to the all-important communications portfolio.

In Momentum Investments' opinion, the president's prerogative to reshuffle Cabinet is complicated by the fractious nature of the ruling party. That said, key changes in the Finance (Nhlanhla Nene and Mondli Gungubele), Public Enterprises (Pravin Gordhan), Mineral Resources (Gwede Mantashe), Energy (Jeff Radebe) and Social Development (Susan Shabangu) portfolios should assist government in pushing through the new administration's reform agenda.

While this bodes well for the short to medium term, concerns have arisen over the appointment of David Mabuza as deputy president and his ability to propel positive economic change in the longer term should he succeed Ramaphosa as president of the ANC.

Financial market performance

Global markets

Global equity markets tumbled 7.5% by the second week of February 2018 on concerns that higher-than-expected inflation would lead to a more rapid tightening of interest rates in the US. Market stresses were reflected in a jump in the Chicago Board Options Exchange (CBOE) volatility index (VIX), which spiked at an intra-month high of 37 points. Investor anxiety subsided in the second half of the month, as investors thought monetary policy tightening would be unlikely to derail the bull run in the equity market, leading to a partial rebound. Despite gains in the latter half of the month, the MSCI All World Index still ended February 2018 3.1% in the red.

The MSCI Developed Markets Index dipped 3.1% in the month, with losses extending in the European and Japanese equity markets. The Eurostoxx 50 finished the month 4.5% lower. Gains in the second half of the month were unable to fully offset the worse sell off in two years, experienced in the second week of February 2018.
The Nikkei 225 plunged 7.4% in the second week of February 2018, but staged a partial recovery in the second half of the month, in line with a rise in US stocks and an arrest in yen appreciation. The Nikkei 225 ended the month 4.4% down.

Emerging market (EM) equities fared equally poorly in February 2018. The MSCI EM Index dropped 3.3% in the month, led lower by Asian stocks (negative 4.2%).
Losses were capped at 1.8% in the MSCI Latin America Index, while the MSCI EMEA (Europe, Middle East and Africa) Index was flat for the same period.

Local markets

The local equity market followed international equity markets lower in the first half of the month, with positive local developments driving gains in the latter half of February 2018.

The FTSE/JSE All-Share Index slid 2.0% in February 2018, dragged lower by a 4.8% collapse in the FTSE/JSE Resources Index. Resource shares were hurt by rand appreciation in the month, related to increased optimism that South Africa's (SA) economic trajectory was likely to improve under the new administration.

A number of positive political developments lowered expectations for a sovereign ratings downgrade by Moody's rating agency, scheduled to release its review on 23 March 2018. The swearing in of Rampahosa, as the new president of SA, a well-received national budget and the appointment of a few key reformists in the latest Cabinet reshuffle buoyed financial shares. The FTSE/JSE Financial Index lifted 2.6% by the end of the month.

A firmer currency weighed negatively on rand-hedge shares, leaving the FTSE/JSE Industrial Index 3.0% lower by the end of the month.

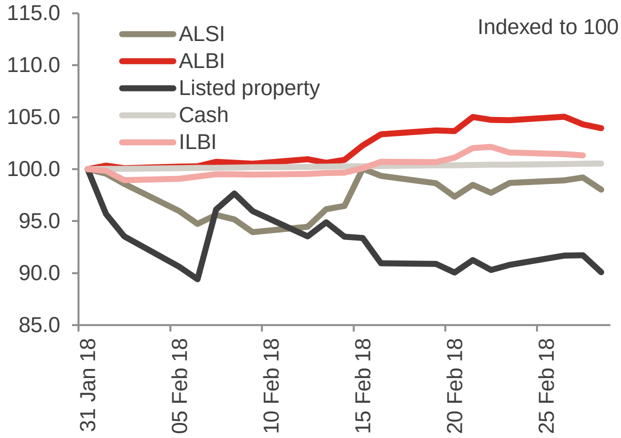
The FTSE/JSE Small-cap Index edged 0.3% higher in February 2018, while the FTSE/JSE Mid-cap Index traded broadly sideways.

The FTSE/JSE Listed Property Index slumped nearly 10% in February 2018, over allegations levelled at Resilient and its associate companies. Meanwhile, the Inflation-linked Bond Index (ILBI) fared well, increasing by 1.3% in the same period.

The SA ten-year government bond yield rallied 35 basis points in February 2018 to 8.3%, on positive political and economic momentum, while SA cash posted a pedestrian 0.5% return in the corresponding period.

Good news stories on the political and economic fronts drove an appreciation in the rand, but gains in the local unit were eroded late in the month on a motion by parliament to move ahead with land expropriation without compensation. The rand ended February 2018 only 0.7% firmer against the US dollar and 2.8% steadier against the euro. Gains were strongest against the sterling at 4.1%.

Chart 5: Local asset class returns (%)



Source: INET BFA, Momentum Investments, data up to 28 February 2018

Indices summary for February 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)	-1.97%	-2.20%	17.44%	6.08%	8.51%	11.23%	12.54%	12.12%	9.80%
FTSE/JSE Shareholder Weighted Index (SWIX)	-1.18%	-2.01%	17.75%	6.37%	9.94%	12.24%	13.59%	13.59%	11.12%
FTSE/JSE Capped SWIX All Share index	-0.79%	-0.33%	14.16%	5.26%	9.08%	11.54%	13.00%		
FTSE/JSE All Share Top 40 Index	-2.32%	-3.41%	19.77%	5.90%	7.77%	11.01%	12.27%	11.69%	9.15%
FTSE/JSE Mid Cap Index	-0.13%	4.51%	5.79%	5.32%	11.30%	11.12%	12.68%	13.43%	13.49%
FTSE/JSE Small Cap Index	0.34%	3.92%	-1.30%	4.30%	9.13%	11.72%	14.00%	13.90%	10.85%
FTSE/JSE Resources Index	-4.82%	-2.23%	16.07%	-3.69%	-6.79%	-2.60%	-3.16%	-3.51%	-3.08%
FTSE/JSE Financials Index	2.58%	7.89%	20.54%	6.78%	13.81%	14.18%	16.45%	17.07%	13.32%
FTSE/JSE Industrials Index	-3.02%	-6.58%	16.57%	6.57%	10.81%	14.39%	17.62%	18.01%	16.48%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	-1.14%	2.14%	20.36%	7.16%	8.11%	10.25%	11.31%	11.04%	10.21%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	-1.22%	2.23%	17.98%	6.59%	7.94%	9.87%	11.04%	10.59%	9.64%
FTSE/JSE SA Listed Property Index (SAPY)	-9.90%	-15.41%	-6.09%	0.71%	10.20%	8.01%	12.20%	13.52%	13.35%
Interest-bearing indices									
BEASSA All Bond Index (ALBI)	3.93%	11.85%	14.33%	7.72%	9.51%	7.33%	8.46%	9.17%	9.35%
BEASSA All Bond Index 1-3 years (ALBI)	1.13%	4.42%	9.91%	8.10%	8.14%	7.12%	7.22%	7.58%	8.19%
Barclays BEASSA SA Government ILB Index	1.30%	4.82%	0.66%	4.09%	5.97%	4.66%	6.75%	7.77%	8.44%
Short-term Fixed Interest Composite Index (SteFI)	0.54%	1.76%	7.48%	7.20%	6.91%	6.57%	6.38%	6.28%	7.07%
Commodities									
NewGold Exchange-Traded Fund	-2.75%	-11.03%	-5.97%	2.59%	1.82%	1.32%	2.28%	6.27%	7.04%
Gold price (in rands)	-3.31%	-11.35%	-5.41%	3.27%	2.17%	1.79%	2.70%	6.70%	7.60%
Platinum Exchange-Traded Fund	-3.09%	-10.03%	-14.29%	-6.24%	-7.70%				
Platinum price (in rands)	-2.94%	-9.99%	-13.96%	-5.88%	-7.15%	-6.09%	-5.77%	-5.98%	-5.39%
Currency movements									
Rand/euro movements	-2.64%	-11.43%	3.55%	3.27%	-0.74%	4.18%	6.33%	5.99%	2.02%
Rand/dollar movements	-0.69%	-13.53%	-9.87%	0.40%	2.36%	5.62%	7.95%	7.87%	4.25%
Inflation index									
Consumer Price Index (CPI)			4.37%	5.72%	5.40%	5.48%	5.46%	5.57%	5.75%
Global indices									
MSCI World Index (All Countries)	-4.30%	-9.85%	7.49%	8.76%	10.79%	16.43%	18.51%	16.76%	8.96%
MSCI Developed Markets Index	-4.80%	-11.56%	5.62%	8.63%	10.67%	16.92%	19.50%	17.40%	10.54%
MSCI Emerging Markets Index	-3.38%	-7.81%	18.81%	9.80%	11.00%	11.40%	12.95%		
Global Property Research (GPR) 250 REIT Index	-7.72%	-30.70%	-23.02%	1.58%	10.12%	17.10%	25.05%	24.23%	13.78%
MSCI Africa Index	-1.02%	-4.14%	17.12%	2.65%	5.88%	7.99%	8.99%	8.87%	5.40%
Citigroup World Government Bond Index	-1.30%	-12.45%	-3.58%	2.91%	3.14%	6.41%	8.37%	8.96%	6.43%
Three-month US dollar LIBOR rate	-0.53%	-13.14%	-8.57%	1.29%	3.09%	6.27%	8.58%	8.19%	5.05%
Three-month Euro LIBOR rate	-2.67%	-11.52%	3.16%	3.01%	-0.88%	4.10%	6.31%		

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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