momentum investments

The Macro Research Desk

Herman van Papendorp
(Head of Investment Research and Asset Allocation)

Sanisha Packirisamy
(Economist)

Economic and market snapshot for January 2018

Highlights

- **United States: The economic expansion is long in the tooth, but it could still have a way to go**
- **Eurozone: Economic growth is firing on all cylinders, but political risks could weigh on growth in the medium to long term**
- **United Kingdom: A no-deal Brexit will be a costly affair**
- **Emerging markets: A 'Goldilocks' environment can persist, bar any political or economic shocks**
- **South Africa: A favourable inflation trajectory potentially leaves room for modest monetary policy easing in upcoming months**

Global economic developments

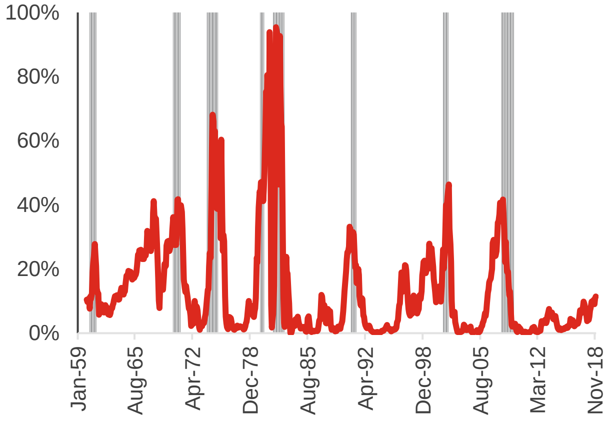
United States (US)

The economic expansion is long in the tooth, but it could still have a way to go

The economic expansion has been running for 103 months. This is just 17 months short of the longest economic upswing experienced in the US between 1991 and 2001.

Although the business cycle is becoming increasingly mature, there is reason to believe the risk of an imminent recession remains low. The New York Federal Reserve's recession model using the US yield curve (long-term less short-term yields) signals less than a 12% chance of a recession within the next 12 months (see chart 1).

Chart 1: Probability of a US recession (percentage, based on the yield curve)



Source: Deutsche Bank, Momentum Investments (grey bars = recessions)

your goal is our benchmark

In Momentum Investments' view, a still accommodative monetary policy stance (notwithstanding expected interest rate increases), easier fiscal policy and a lack of clear economic distortions suggest growth in the economy and could pick up close to 2.5% in 2018 from 2.3% in 2017.

The household net wealth ratio relative to disposable income reached a new high of 673% in the third quarter of 2017, pointing to a robust consumer. US consumers have effectively deleveraged (household debt-to-disposable income ratio) from a peak of 132% in the first quarter of 2008 to 104% in mid-2017, placing them in a healthier financial state. Capital expenditure should further bolster growth this year, with growth in equipment investment touching a five-year high in the third quarter of 2017.

Moreover, fiscal policy is set to become a little more supportive in 2018 and 2019. Morgan Stanley estimates the changes to tax legislation should boost growth by 0.3% in 2018 and 0.2% in 2019.

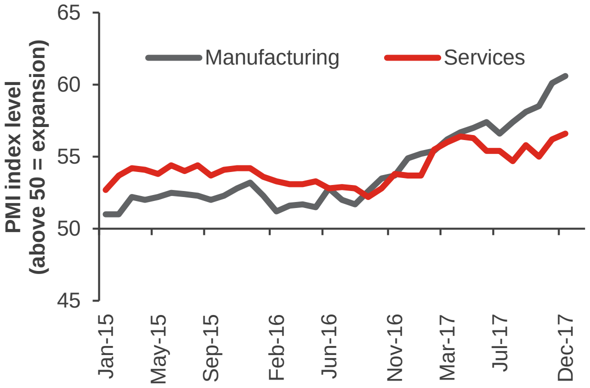
In Momentum Investments' opinion, a firm growth environment and a continued modest rise in inflation should allow for up to three interest rate increases this year.

Eurozone

Economic growth is firing on all cylinders, but political risks could weigh on growth in the medium to long term

The Eurozone experienced a strong start to the year, with manufacturing and services sentiment levels improving further (see chart 2), indicating a broad-based economic recovery.

Chart 2: Robust Eurozone manufacturing and services sentiment (%)



Source: Bloomberg, Momentum Investments

This time around, not only are the core economies experiencing an uptick in growth, but peripheral countries are also undergoing an improvement in growth. The European Commission's economic sentiment indicator improved from 76 points in August 2015, in Greece, to 101 points in December 2017. The sentiment index for Germany was nearly 25 points higher in December 2017, compared to its previous low in October 2012.

With the economy firing on all cylinders, investors' expectations for one of the countries in the euro area to leave within the next 12 months dropped to only 8% in December 2017, a far cry from the 73% registered in July 2012, following concerns in Greece.

Although the lower risk of a euro breakup could indicate populist forces have dimmed somewhat, the risk of rising populist support has not been extinguished, in Momentum Investments' view. Support for populist parties today is the highest it's been in three decades. With citizens rating immigration and terrorism as the two main concerns facing the European Union, it is no wonder support for non-mainstream parties has strengthened.

Although a smaller percentage of the Eurozone population will be going to the polls in 2018, relative to the busy election calendar in 2017, the result of Italy's elections could have significant economic and political repercussions for the European Union.

United Kingdom (UK)

A no-deal Brexit will be a costly affair

Mark carney, the governor of the Bank of England, noted the UK economy had gone from being one of the fastest-growing economies in the G7 (the seven-largest advanced economies in the world) to the one of the slowest, due to Brexit uncertainty, which has tainted economic-growth prospects.

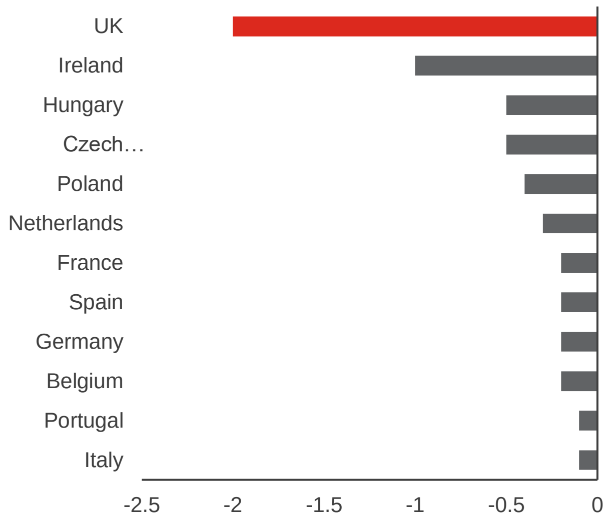
In the absence of a deal, to either replace or extend the UK's membership of the European Union, trade conditions between the UK and the European Union would revert to World Trade Organisation (WTO) rules, which are less favourable for the UK, given that more punitive tariffs would likely be implemented across many sectors of the UK economy.

In particular, a 30% to 40% tariff on agricultural goods could potentially be imposed on UK farmers, which would curb export growth.

Similarly, UK banks would be affected. These banks have 'passporting rights', which allow the UK bank to conduct business in the European Union, without having to physically relocate or set up a subsidiary.

Eurasia Group predicts UK gross domestic product (GDP) could be a significant 2% weaker relative to its baseline growth forecast, by 2020, in a scenario where trade reverts to WTO rules (see chart 3).

Chart 3: Change in GDP relative to baseline forecast by 2020 (%)



Source: Eurasia Group, Momentum Investments

While Momentum Investments expects growth in the UK to slow from 1.6% in 2017, the economy could still post a growth rate above 1% in 2018, buoyed by resilient global growth.

Emerging markets (EMs)

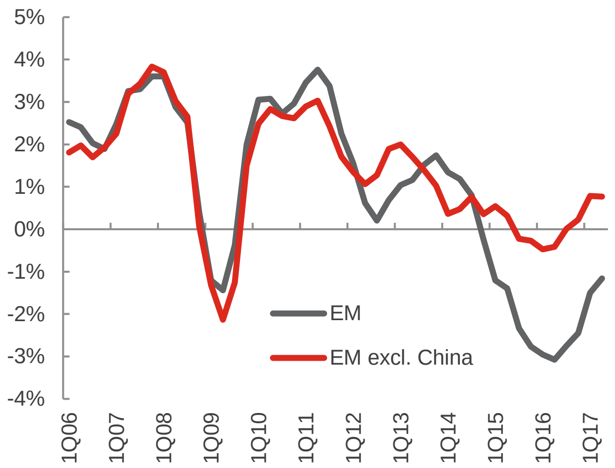
A 'Goldilocks' environment can persist, bar any political or economic shocks

Ongoing progress in meaningful economic and political reforms is likely to boost Ems' growth advantage over developed markets (DMs) in the near term. Moreover, the traditional vulnerabilities plaguing EMs (ranging from extended current account deficits to inadequate foreign exchange levels and pegged currencies) are no longer an issue for many countries.

Nonetheless, despite a favourable growth outlook for 2018, EMs continue to face downside risks. Firstly, a faster-than-expected increase in interest rates in DMs could lead to a sharper reversal in capital flows. Capital inflows into EMs (excluding China) reached 0.8% in mid-2017 (see chart 4). This level was high enough to support growth, without threatening a potential collapse in economic activity (should there be a sudden-stop event, where capital dries up). While the interest rate differential between EMs and developed markets should start to narrow in upcoming months, it is likely to remain supportive for capital flows into EMsin 2018.

Secondly, a rise in global protectionism remains a risk to trade activity. Shifting away from an open global trade regime could derail the economic recovery underway in EMs.

Chart 4: Capital inflows as a percentage of GDP



Source: Citigroup, Momentum Investments, data up to 2Q17

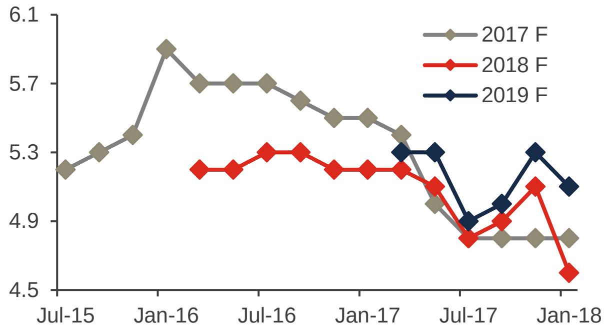
Local economic developments

A favourable inflation trajectory potentially leaves room for modest monetary policy easing in upcoming months

In light of lingering sovereign rating downgrade risks and a recent sharp uptick in international oil prices, the South African Reserve Bank (SARB) prudently decided to leave local interest rates unchanged at 6.75% at its January 2018 Monetary Policy Committee (MPC) meeting.

Although the SARB admitted to an improvement in the inflation outlook since its November 2017 interest rate-setting meeting (see chart 5), it continued to view upside risks to its forecast (although to a lesser degree, given stronger exchange rate assumptions and a lower-than-expected electricity tariff increase).

Chart 5: SARB's core inflation forecasts (%)



Source: SARB, Momentum Investments

The MPC's growth forecasts reflect a mild expansion off a low base, while its risk assessment improved somewhat. In its November 2017 meeting, the MPC noted it "assesses the risks to the revised growth forecast to be slightly on the downside", whereas this time around risks to the growth forecast were seen to be "more or less balanced".

Even after factoring in a mildly depreciating currency trajectory from current levels, inflation should still remain comfortably within the target band in upcoming months. Although the SARB maintained interest rates at 6.75% at the January 2018 meeting, citing the potential for a sovereign ratings downgrade and higher international oil prices as risks, falling inflation potentially leaves room for further modest monetary policy easing in 2018.

Momentum Investments expects only one 25 basis point cut (with a potential for two cuts should conditions remain favourable) given the medium-term outlook for inflation and political uncertainty, as the 2019 national elections draw near.

Financial market performance

Global markets

Global equity markets had a stellar start to the year. The MSCI All World Index gained 5.6% by the end of January 2018, supported by a robust performance in DMs and EMs.

The MSCI DM Index climbed 5.3%, buoyed by a 5.7% gain in the S&P 500 Index. Investors' return expectations have improved on a weak dollar, changes to tax legislation and a vibrant global economy.

The Eurostoxx 50 gained 4.7% by the third week of January 2018, but gains were partly reversed in the final week of the month as concerns arose over a paring back of asset purchases by the European Central Bank.

The Japanese Nikkei 225 brought up the rear, edging higher by 1.5% for the same period.

The MSCI EM Index soared 7.7% higher in January 2018, driven by a robust 12.2% gain in the MSCI Latin America Index. Brazilian shares, in particular, soared in response to the appeals court upholding a corruption conviction for former President Lula da Silva, implying an easier path for current President Michel Temer to be re-elected.

Asian stocks ended the month 7.5% higher, while the MSCI EMEA (Europe, Middle East and Africa) Index rose 5.5%.

Local markets

The local equity market moved broadly sideways for the month. The FTSE/ALSI All Share Index inched 0.1% higher in January, while the returns from the market's underlying constituents varied considerably.

The FTSE/ALSI Resources Index increased by 3.2% in the month, in line with a rise in commodity prices. The FTSE/ALSI Financials Index, on the other hand, collapsed 3%, with losses extending in the final week of January 2018 in reaction to a negative report released on Capitec, by Viceroy Research.

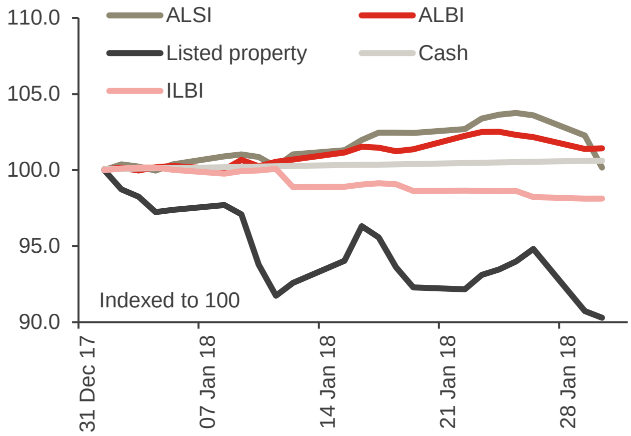
The FTSE/ALSI Industrials Index treaded water in January 2018, ending the month only 0.4% higher. Rand-hedge shares suffered on the back of further gains in the local unit.

The FTSE/JSE Mid-cap Index dipped 0.1% in January, while the FTSE/JSE Small-cap Index tracked lost 0.3% for the month.

Listed property plunged sharply in January 2018 (negative 9.9%) on speculation that companies in the Resilient property stable would be mentioned in an unfavourable corporate governance report by Viceroy Research.

The SA ten-year government bond yield rallied 23 points by the third week of January 2018, but yields ticked higher into month end. The Inflation-Linked Bond Index fell 2.2% in the month, while SA cash rose by a pedestrian 0.6%.

Chart 5: Local asset class returns (%)



Source: INET BFA, Momentum Investments

The rand gained nearly 3.5% against the US dollar during the month on rising sentiment. Cyril Ramaphosa's commitment to rooting out corruption (through forging ahead with the inquiry into state capture), a firm stance on the unaffordability of nuclear energy and an overhaul of Eskom's board have rekindled hopes for structural reform, necessary to lift the country to a higher growth plane in the medium term. Ramaphosa further noted the importance of providing regulatory certainty and reining in government's budget deficit.

Gains were muted against the euro (0.2%), which strengthened against the US dollar in January 2018. The rand weakened against the British pound by 0.8% in the same period.

Indices summary for January 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)	-0.44%	2.94%	13.38%	6.44%	10.61%	11.46%	13.67%		
FTSE/JSE Shareholder Weighted Index (SWIX)	0.20%	0.30%	17.82%	8.33%	9.84%	11.00%	12.99%	12.59%	10.76%
FTSE/JSE Capped SWIX All Share index	-0.09%	7.06%	5.51%	6.02%	11.89%	11.22%	13.26%	13.47%	14.50%
FTSE/JSE All Share Top 40 Index	-0.28%	0.73%	0.24%	4.45%	9.89%	11.80%	14.43%	13.70%	11.46%
FTSE/JSE Mid Cap Index	3.18%	1.07%	9.85%	0.57%	-4.60%	-2.95%	-2.71%	-2.11%	-1.00%
FTSE/JSE Small Cap Index	-2.98%	9.82%	17.79%	7.05%	15.07%	13.51%	16.73%	16.57%	13.79%
FTSE/JSE Resources Index	0.43%	-2.32%	18.32%	8.71%	12.86%	15.14%	18.97%	18.84%	17.73%
FTSE/JSE Financials Index	2.27%	4.65%	15.81%	8.96%	9.70%	10.12%	11.87%	11.71%	11.57%
FTSE/JSE Industrials Index	1.71%	4.58%	12.89%	8.30%	9.44%	9.83%	11.52%	11.17%	11.04%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	-9.91%	-4.31%	3.85%	5.37%	14.40%	11.29%	14.36%	15.02%	15.04%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	-0.44%	2.94%	13.38%	6.44%	10.61%	11.46%	13.67%		
FTSE/JSE SA Listed Property Index (SAPY)	0.20%	0.30%	17.82%	8.33%	9.84%	11.00%	12.99%	12.59%	10.76%
Interest-bearing indices									
BEASSA All Bond Index (ALBI)	1.86%	6.57%	10.79%	5.35%	9.11%	6.64%	7.79%	8.59%	8.84%
BEASSA All Bond Index 1-3 years (ALBI)	1.04%	3.26%	9.87%	7.59%	8.09%	6.99%	7.11%	7.61%	8.09%
Barclays BEASSA SA Government ILB Index	-2.16%	0.20%	-0.70%	3.53%	6.45%	4.54%	6.63%	7.73%	8.42%
Short-term Fixed Interest Composite Index (SteFI)	0.60%	1.80%	7.51%	7.17%	6.87%	6.53%	6.36%	6.26%	7.10%
Commodities									
NewGold Exchange-Traded Fund	-0.36%	-11.51%	-1.99%	2.48%	2.66%	0.95%	2.27%	7.17%	8.18%
Gold price (in rands)	-0.04%	-10.53%	-1.98%	3.09%	3.39%	1.36%	2.76%	7.73%	8.88%
Platinum Exchange-Traded Fund	4.17%	-8.22%	-10.80%	-6.00%	-6.72%				
Platinum price (in rands)	3.48%	-8.39%	-11.14%	-6.24%	-6.09%	-5.69%	-5.69%	-5.90%	-5.85%
Currency movements									
Rand/euro movements	-0.49%	-10.22%	1.54%	4.03%	-0.45%	4.05%	6.37%	5.99%	2.90%
Rand/dollar movements	-4.06%	-16.01%	-11.87%	0.75%	1.57%	5.86%	7.26%	7.46%	4.72%
Inflation index									
Consumer Price Index (CPI)			4.70%	5.56%	5.50%	5.48%	5.51%	5.60%	5.84%
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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