The Macro Research Desk

Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

Economic and market snapshot for May 2018

Highlights

- United States: Additional interest rate tightening is justified in the context of rising inflation, firm growth and a tight labour market.
- Eurozone: Winter storms have pulled first-quarter growth lower, but momentum in economic activity is expected to continue.
- United Kingdom: The Bank of England showed a commitment to tightening plans, despite keeping interest rates steady at the May 2018 interest-rate-setting meeting.
- China: A moderate growth slowdown is threatened by trade friction with the United States.
- South Africa: Fulfilling its commitment to economic revitalisation is crucial for the ruling party to ensure a comfortable win in the next elections.

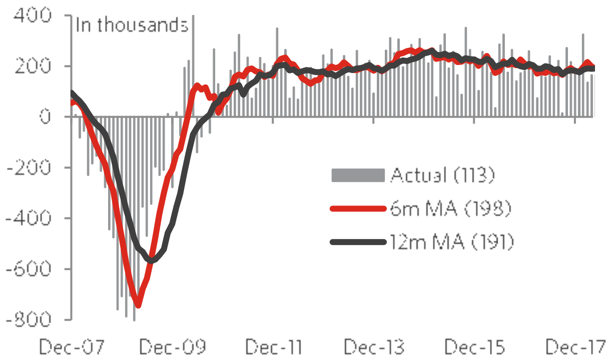
Global economic developments

United States (US)

Additional interest rate tightening is justified in the context of rising inflation, firm growth and a tight labour market

Unemployment in the US reached an 18-year low of 3.9% in April 2018, despite a below-consensus gain of 164 000 in non-farm payrolls in the same month. During the past six months, non-farm payrolls averaged 198 000, suggesting the momentum in jobs growth remained firm despite a lower-than-expected April print (see chart 1).

Chart 1: Solid US jobs momentum



Source: Deutsche Bank, Bloomberg, Momentum Investments

Deutsche Bank noted the April employment-to-unemployment ratio nudged higher to levels exceeding the 2006 high, further highlighting labour-market tightness. Total US employment, at 148 million jobs, ranked at an all-time high in April 2018, with only one unemployed worker per job opening, as opposed to six in 2009.

Moreover, small businesses are increasingly becoming concerned about the tightness of the labour market. The National Federation of Independent Business (NFIB) Small Business Survey pointed to the highest share of small businesses on record reporting the quality of labour as the single most important problem facing small and medium enterprises in April 2018 in the US. More than 50% of respondents reported few or no qualified applicants for the job.

Deutsche Bank has shown that total labour income (the product of payrolls, wages and hours worked) is a key indicator of consumer spending. With growth in total labour income remaining comfortably above 4% in year-on-year (y/y) terms, consumption spend is likely to continue supporting overall growth in economic activity.

Despite a moderation in growth in average hourly earnings, a broad-based rise in wages is in the pipeline. The percentage of small businesses planning to raise worker compensation remains close to pre-crisis levels, while growth in the employment cost index (including wages/salaries and benefits) continued to rise to 2.9% y/y in March 2018.

In addition, a further rise in unit labour costs, to around 2% in the same period, points to an increase in core inflation measures in upcoming months.

Momentum Investments expects the US Federal Reserve to shift monetary policy beyond a neutral stance in upcoming quarters, in response to robust growth, a tight labour market and signs of a further uptick in inflation.

Eurozone

Winter storms have pulled first-quarter growth lower, but momentum in economic activity is expected to continue

The recent moderation in growth in the Eurozone to 0.4% in the first quarter of 2018 was acknowledged by one of the members of the executive board of the European Central Bank (ECB) in a May 2018 speech. The ECB nevertheless voiced confidence in the underlying strength of the economy.

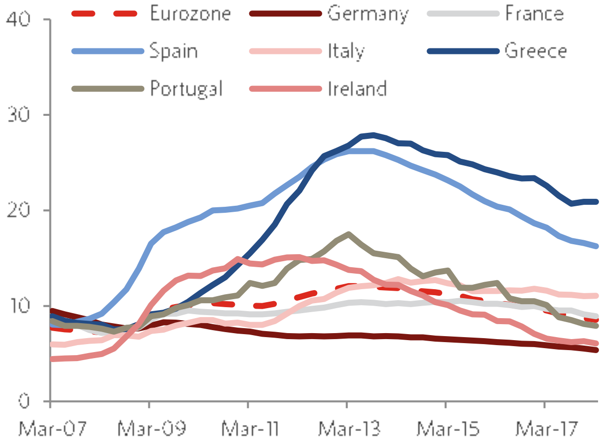
The ECB attributed the growth slowdown to unusually cold weather conditions, influenza, the timing of the Easter holidays and industrial strikes in some countries. It surmised elevated concerns about trade protectionism, which may have dampened business sentiment further.

Nonetheless, the ECB claimed there is no evidence of the first-quarter dip extending into the remainder of the year. Though sentiment indicators have surprised negatively in recent months, most remain well above their long-term averages. The ECB noted underlying momentum remained supported by "favourable financing conditions, a robust labour market and steady income and profit growth".

Solid employment gains have driven the unemployment rate down to its lowest level since December 2008, despite an increase in the labour force of nearly 2% (see chart 2). Together with firm growth in household disposable income, higher jobs growth has facilitated steady growth in consumption spend. Moreover, favourable financing conditions and a need to modernise infrastructure have led to a strong increase in investment spend.

Domestic demand should remain a key driver of growth, despite a potential tapering off in the contribution from net exports, as further euro strength is anticipated (given ongoing net quantitative easing in the Eurozone compared to the net quantitative tightening stance adopted by the US).

Chart 2: Consistent fall in Eurozone unemployment (%)



Source: Bloomberg, Momentum Investments

Negative price shocks in energy markets and a shift in the Philips curve, due to a potential de-anchoring of inflation expectations, suggest price pressures will take time to gradually shift higher. As such, Momentum Investments expects stable policy rates to extend well past the end of the ECB's net asset purchases.

United Kingdom (UK)

The Bank of England (BoE) showed a commitment to tightening plans, despite keeping interest rates steady at the May meeting

The BoE Monetary Policy Committee (MPC) decided to leave interest rates unchanged at 0.5% at its May 2018 interest-rate-setting meeting. It was unanimously decided to leave the targeted quantitative easing total at £435 billion and the corporate bond purchase programme at £10 billion.

Although the MPC's language shifted notably more dovish relative to its February 2018 meeting, the communication suggested the BoE's plans to tighten interest rates remains at play. Two members of the MPC continued to favour an interest rate hike.

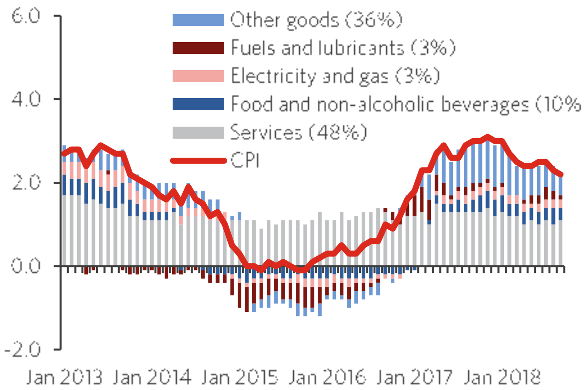
Growth in the UK softened to 0.1% in the first quarter of 2018, due to poor weather conditions (0.3% lower than expected by the BoE in February 2018), which had similarly affected the Eurozone. The MPC may be waiting for confirmation that growth momentum remains intact despite this temporary blip. It has broadly maintained its growth forecasts since its last meeting, despite a lower-than-expected first-quarter print. In its May 2018 Inflation Report, the MPC notes the UK economy has a very limited degree of slack and suggested growth will continue to be supported by strong global demand and accommodative financial conditions, even though investment is still being restrained by Brexit-related uncertainties.

According to the MPC, the effect of the past depreciation of the sterling on consumer price inflation (CPI) remains significant, but is expected to fade slightly faster than previously anticipated, reaching the BoE's 2% target in two years' time.

However, as outlined by the BoE minutes, this prediction was premised on three interest rate rises within the next three years. BoE Governor Mark Carney stressed interest rate increases would be limited and gradual in the coming years and would depend on the ability of the UK economy to recover from weak first-quarter growth.

Momentum Investments continues to expect an interest rate increase in the UK in the second half of 2018, given above-target inflation (see chart 3) and a likely recovery in growth in the second quarter of the year.

Chart 3: Breakdown of UK CPI (%)



Source: BoE forecasts, Momentum Investments

China

A moderate growth slowdown is threatened by trade friction with the US

Economic activity increased by 6.8% in the first quarter of 2018, surpassing expectations for a steeper slowdown in growth.

Early indications of second-quarter growth point to a normalisation in growth, following a temporary dip in March 2018, caused by the shift in timing of the Lunar New Year.

Although a previous tightening in the credit cycle signals a slowdown in property investment, private consumption and investment should remain supportive, partly offsetting the slowdown in the property market. Credit growth has slowed to around 12% in the first quarter of 2018, but it is likely the bulk of tightening has already been done.

A breakthrough deal did not result from the first round of trade talks between the US and China in the first week of May 2018. However, it does allow for further negotiation to bring about a less disruptive trade relationship, which limits the effect on growth.

Morgan Stanley estimated tariffs on US$50 billion worth of goods from China could shave off around 0.1% from China's growth and proposed China could offset this through fine-tuning of credit tightening and fiscal support for social housing.

Meanwhile, the Donald Trump administration in the US recently drew a hard line with China on trade talks, given the trade imbalance between China and the US (see chart 4). It has demanded a US$200 billion cut in China's trade surplus with the US by 2020, significantly lower tariffs (China's car tariff is 25% compared to the US's of 2.5%) and advanced technology subsidies.

Chart 4: China's exports to the US dwarfs imports from China into the US

Source: Statista, Momentum Investments

While Momentum Investments expects a more moderate and gradual change to US/China trade relations, disagreements between the US and China's delegations remain large, leaving a non-negligible risk of a damaging trade war.

However, risks in the medium term are tilted to the downside. An escalation in Trump's trade policy poses a considerable downside risk to the emerging market (EM) growth outlook through the direct effect of a potential financial market fallout or the indirect effect through supply chains.

Moreover, a handful of EMs (exhibiting either an extended current account deficit, an elevated level of external debt or a substantial foreign holding of their government bonds) are highly exposed to a more rapid tightening in global financial conditions than anticipated, including a faster-than-expected rise in interest rates by the US Fed or a faster removal of policy accommodation by the ECB.

Local economic developments

Revitalising the economy is crucial to ensure a comfortable win for the ruling party in the next elections

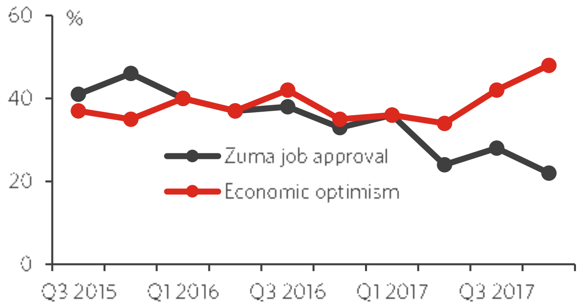
In contrast to other surveys pointing to resilient approval ratings for former president Jacob Zuma of between 60% and 70%, the December 2017 South African (SA) Citizen Survey (surveying 3 900 respondents) demonstrated the opposite.

The survey uses a measure called partisan identification, which has proven to be an accurate predictor of voter turnout and voter choice. In the December 2017 results, only 32% of those surveyed said they "felt close" to the African National Congress (ANC), which was the worst recorded result in 17 years. A decline in ANC support was further evident in a question posed to respondents gauging how much they "like or dislike" each major political party. In mid-2015, 61% of respondents held a favourable view of the ruling party, but this dropped to only 43% in December 2017.

Since 1994, the decline in popular support for the ANC, as surveyed by the Citizen, has taken its direction from the degree of economic optimism (measured by the proportion of respondents who expect the economy to improve in the next year). However, in the latter half of 2017 (following numerous votes of no confidence, the capture of key state institutions, personal scandals and poor political decisions), it was evident voter support became tied to respondents' views of Zuma, rather than their outlook on the economy (see chart 5).

Consequently, the incumbent ANC leader and SA president, Cyril Ramaphosa, faces an enormous challenge of rebuilding a positive connection between the president and the voter base and will be required to restore a more favourable image of the ruling party.

Chart 5: ANC support dipped on Zuma's performance



Source: SA Citizen Survey, Momentum investments
Economic optimism = Net balance expecting economy to improve within the next 12 months

The Citizen Survey results for February 2018 have already shown an improvement in the public perception of the ANC government. Ramaphosa's rating came in close to 60%, compared to Zuma's 22% in late 2017 and may well resuscitate the chances of an outright majority win for the ANC in the 2019 national elections. The Daily Maverick warns, however, 'Ramaphoria' ("citizens' thankfulness for the end of the Zuma season" or "the reward for just not being Zuma") may wear off before the national elections and support for the opposition parties may grow, despite not showing notable growth in public support since 2016.

While the Citizen warns optimism may become muted if Ramaphosa fails to act decisively on issues, such as corruption, Standard Bank argues more than just stabilisation initiatives are required to sustain a political calm in SA. The economic and political damage Zuma exerted on the economy in his nine years in power and ongoing ideological battles within the ruling party create a challenging background against which Ramaphosa must show his commitment to a new dawn in a tangible manner to ensure a comfortable win in the next national elections.

Financial market performance

Global markets

Global equity markets were unfazed by the continued flow of geopolitical headlines in the first half of the month. Trade talks between the US and China late in the month resulted in China agreeing to buy more goods form the US to reduce its trade surplus with the US. The MSCI All World Index increased 2.3% by mid-month, but shifted gradually lower in the second half of the month. The positive political development between China and the US was, however, offset by Trump's cancellation of planned talks with North Korea scheduled for June 2018. Despite the collapse in US/North Korea summit talks, risk sentiment steadied, with the CBOE Volatility Index (VIX) dropping by nearly three points by mid-month.

The MSCI Developed Markets Index rose 1.0% in May 2018. This was mainly a function of strong gains in the US, while more pedestrian gains were recorded by the European and Japanese equity markets in the same period. The S&P 500 Index rose steadily in the first half of the month, before tracking sideways. While a confirmation in the US Fed minutes that a gradual approach to interest rate hikes would be followed despite higher inflation, benefited the S&P 500 Index in the final week of the month, a relatively muted and diplomatic response from North Korea to Trump's cancellation of talks further supported the index.

Political chaos in Italy rocked European bond and equity markets late in the month. Despite rising more than 2.5% in the first three weeks of May 2018, the Eurostoxx 50 ended the month 2.1% lower. Italian President Sergio Mattarella vetoed the choice for economy minister going against the wishes of the anti-establishment Five Star Movement (M5S) and the far-right League as well as disrupting their plans for a coalition. This decision resulted in Mattarella facing impeachment calls and has raised the risk of fresh Italian elections, potentially as early as August 2018.

The Japanese Nikkei 225 lagged the return from the developed market. The index ended the month 1.2% down, after slipping markedly in the last week of the month, tracking lower on political concerns in Europe. A firmer yen further hurt the index's return.

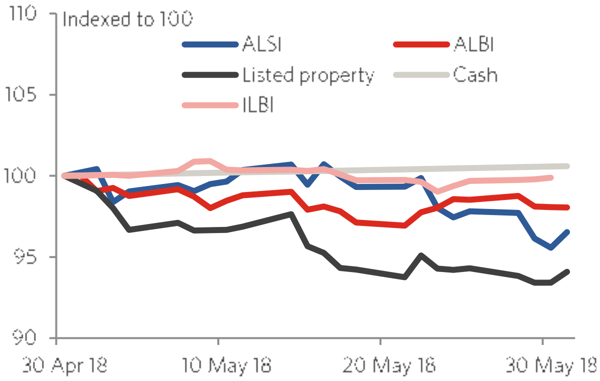
The MSCI EM Index ended the month 4.2% lower, dragged into the red by a 13.9% plunge in the MSCI Latin America Index. Investor sentiment soured towards the Brazilian market, following a trucker's strike, which affected fuel and gas stations and rippled over into supermarket shortages of perishables and low raw material supplies for businesses.

Losses were more muted in the MSCI Asia Index. The index finished the month only 2.4% lower, despite earlier concerns that talks would not be held between North Korea and the US. The MSCI EMEA (Europe, Middle East and Africa) Index underperformed, losing 5.6% by the end of the month on rising European political risks.

Local markets

SA equities ended lower in May 2018, tracking weaker global equity markets and following bleak corporate earnings reports. The FTSE/JSE All Share Index fell 3.5% in May 2018, led weaker by a collapse in financial and retail shares in the second half of the month.

Chart 6: Local asset class returns (%)



Source: INET BFA, Momentum Investments, data up to 31 May 2018

The FTSE/JSE Financials Index sank 6.3% in May 2018, as a weaker rand drove losses in the banks. The FTSE/JSE Industrials Index ended the month 5.1% lower, with retailers being similarly affected by rand weakness. In contrast, the FTSE/JSE Resources Index increased by 4.0% in the same period.

The FTSE/JSE Mid-cap Index dived 8.4% in May 2018, while losses were more muted in the FTSE/JSE Small-cap Index at 2.4%.

Listed property shares had an unpleasant month, falling 5.9% in May 2018, in line with a sell-off in bond yields. The SA ten-year government bond yield sold off more than 35 basis points in the month, as developments in Turkey and Argentina sparked angst across EM bond markets. Interest rates were hiked by 300 basis points in Turkey to tackle elevated inflation of close to 10%, while interest rates jumped by 675 basis points to 40% in Argentina, following a sudden run on the Argentinian peso.

The JSE ASSA All Bond Index shed 2.0% in May 2018, followed by a 0.1% loss in the JSE ASSA SA Government Inflation-linked Bond Index (ILBI). SA cash posted modest gains of 0.6% in the corresponding period. The rand ended the month 1.9% weaker against the US dollar, but 1.3% firmer against the euro and 1.6% stronger against the sterling. The rand displayed a middle-of-the-range performance against major currencies, when compared to its EM peer group. Losses were far greater in the Brazilian real (5.8% weaker against the US dollar), the Turkish Lira (10.3% weaker against the US dollar) and the Argentinian peso (17.8% weaker against the US dollar) in May 2018.

Indices summary for May 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)	-3.50%	-2.54%	8.00%	5.45%	6.21%	9.16%	12.48%	11.39%	9.01%
FTSE/JSE Shareholder Weighted Index (SWIX)	-4.76%	-5.61%	4.54%	4.54%	6.48%	9.63%	12.59%	12.09%	10.13%
FTSE/JSE Capped SWIX All Share index	-5.32%	-5.28%	3.66%	3.58%	5.72%	9.01%	12.06%		
FTSE/JSE All Share Top 40 Index	-3.10%	-1.91%	8.63%	5.42%	5.76%	8.89%	12.53%	11.11%	8.25%
FTSE/JSE Mid Cap Index	-8.37%	-8.37%	2.18%	3.23%	6.74%	8.73%	10.54%	11.47%	13.40%
FTSE/JSE Small Cap Index	-2.44%	-2.55%	1.17%	3.02%	6.08%	10.09%	13.12%	13.23%	11.67%
FTSE/JSE Resources Index	3.88%	10.55%	30.02%	1.94%	-4.29%	-0.50%	0.73%	-1.46%	-2.87%
FTSE/JSE Financials Index	-6.26%	-6.23%	11.37%	4.16%	8.88%	11.85%	14.50%	15.02%	13.94%
FTSE/JSE Industrials Index	-5.14%	-5.73%	-1.12%	4.33%	7.20%	10.32%	15.85%	15.90%	14.94%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	-3.57%	-2.03%	14.14%	7.04%	6.00%	8.91%	11.53%	10.44%	9.80%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	-3.83%	-2.05%	13.57%	6.51%	5.82%	8.60%	11.26%	10.06%	9.36%
FTSE/JSE SA Listed Property Index (SAPY)	-5.92%	0.34%	-6.45%	2.00%	8.73%	8.39%	11.29%	12.43%	15.31%
Interest-bearing indices									
JSE ASSA All Bond Index (ALBI)	-1.95%	-0.63%	10.44%	8.12%	8.45%	7.31%	8.00%	8.43%	9.70%
JSE ASSA All Bond Index 1-3 years (ALBI)	-0.03%	0.40%	7.77%	7.97%	7.63%	7.11%	6.92%	7.31%	8.38%
JSE ASSA SA Government ILB Index	0.08%	1.83%	3.49%	4.13%	4.63%	4.58%	6.76%	7.53%	8.19%
Short-term Fixed Interest Composite Index (SteFI)	0.59%	1.79%	7.39%	7.27%	7.01%	6.67%	6.45%	6.34%	6.98%
Commodities									
NewGold Exchange-Traded Fund	0.70%	6.29%	-1.77%	3.95%	5.37%	2.88%	3.07%	6.14%	8.81%
Gold price (in rands)	1.14%	6.94%	-0.39%	4.58%	5.97%	3.19%	3.76%	6.68%	9.46%
Platinum Exchange-Traded Fund	1.44%	-0.59%	-8.04%	-5.73%	-7.34%	-2.68%			
Platinum price (in rands)	2.64%	0.29%	-6.54%	-4.95%	-6.77%	-3.02%	-3.77%	-5.62%	-5.70%
Currency movements									
Rand/euro movements	-1.95%	2.69%	-0.29%	3.49%	0.59%	2.55%	5.72%	6.03%	2.22%
Rand/dollar movements	1.48%	7.41%	-3.93%	1.39%	4.60%	4.72%	6.74%	9.21%	5.20%
Inflation index									
Consumer Price Index (CPI)			4.49%	5.35%	5.14%	5.33%	5.43%	5.53%	5.56%
Global indices									
MSCI World Index (All Countries)	1.78%	5.65%	7.33%	8.73%	11.79%	13.40%	18.77%	17.72%	9.48%
MSCI Developed Markets Index	2.11%	6.95%	7.18%	8.90%	12.08%	14.57%	19.83%	18.60%	10.87%
MSCI Emerging Markets Index	-2.14%	-0.92%	8.07%	7.20%	8.91%	9.15%	13.05%		
Global Property Research (GPR) 250 REIT Index	5.27%	23.19%	-5.07%	7.37%	15.01%	16.29%	23.45%	27.49%	16.04%
MSCI Africa Index	-5.56%	-7.63%	0.81%	0.46%	2.45%	5.33%	7.73%	7.43%	4.39%
Citigroup World Government Bond Index	-0.19%	5.47%	-1.99%	4.13%	4.47%	5.66%	6.95%	9.63%	7.13%
Three-month US dollar LIBOR rate	1.67%	8.04%	-2.27%	2.47%	5.47%	5.48%	7.44%	9.75%	6.00%
Three-month Euro LIBOR rate	-1.98%	2.60%	-0.67%	3.20%	0.42%	2.45%	5.66%	6.15%	

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.
5. FTSE/JSE disclaimer: www.jse.co.za
6. The information reproduced in this document has been compiled by or arrived at by Investments from sources believed to be reliable.
7. Reasonable steps have been taken to ensure the validity and accuracy of the information in this document. However, Momentum Investments does not accept any responsibility for any claim, damages, loss or expense, howsoever arising out of or in connection with the information in this document, whether by a client, investor or intermediary.
8. The content used in this document is sourced from various media publications, the Internet and Momentum Investments. For further information, please visit us at www.momentuminv.co.za.
9. Momentum Investments is a division of MMI Group Limited, which is an authorised financial services and credit provider.