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in the moment

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Economic and market snapshot for July 2019

Highlights

- United States (US): Two-year debt ceiling and budget deals were struck between the White House and Congress, but waning fiscal restraint is a concern.
- Euro area: Downside risks to growth and subdued inflation should result in further monetary accommodation. However, given limited monetary policy room to manoeuvre, unconventional monetary policy tools may have to be considered in conjunction with fiscal stimulus and coordinated structural reforms.
- United Kingdom (UK): Many possible outcomes from the ongoing Brexit negotiations still exist, even as the 31 October 2019 deadline draws nearer.
- China: While China's dependence on the rest of the world has declined, the rest of the world's dependence on China has increased. As such, a more significant dent in Chinese domestic demand could have a meaningful effect on global growth.
- South Africa (SA): Fitch revised the outlook on the country's sovereign rating to negative to reflect weakening trend growth and rising fiscal and debt pressures.

Global economic developments

US

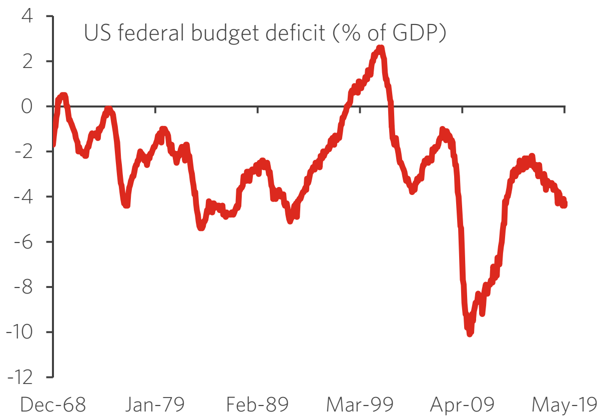
Two-year debt ceiling and budget deals were struck between the White House and Congress

President Donald Trump struck a deal with Congress to increase spending by US$320 billion (relative to the original planned capped level), which will be spread over two years. Relative to 2019, the cap will increase by a smaller US$50 billion in 2020 and is expected to remain relatively steady into 2021.

This budget deal helps to prevent a debt ceiling (the maximum amount of money set by Congress that government can borrow to pay its bills) crisis in September and spending cuts across the board that would have been triggered in October 2019. The debt ceiling has been raised until the middle of June 2021, suggesting that concerns over defaulting on debt will arise again only after the next presidential election.

Although it is positive that the debt ceiling was addressed, fiscal restraint is waning. The US federal budget deficit is expected to exceed US$1 trillion in 2020, which is wider than the Congressional Budget Office estimate of US$892 billion (or 4% of gross domestic product [GDP]) in 2020 (see chart 1). The US budget deficit has risen sharply on the back of generous tax cuts in 2017 and the failure to cut back on popular spending programmes.

Chart 1: The US fiscal deficit is widening



Source: Bloomberg, Momentum Investments

Debt in the US exceeds GDP. Overall debt has either equalled or exceeded GDP since 2012, which had not been the case since the Second World War. Moreover, debt interest costs are once again on the rise. Net interest payments on debt account for 8.7% of all expenditure outlays. This ratio peaked close to 16% in the early 1990s. Part of the decline since the 1990s arose from an increase in outlays while lower interest rates also played a role.

Ultimately, higher debt-servicing costs redirect spending away from more useful forms of social and economic expenditure.

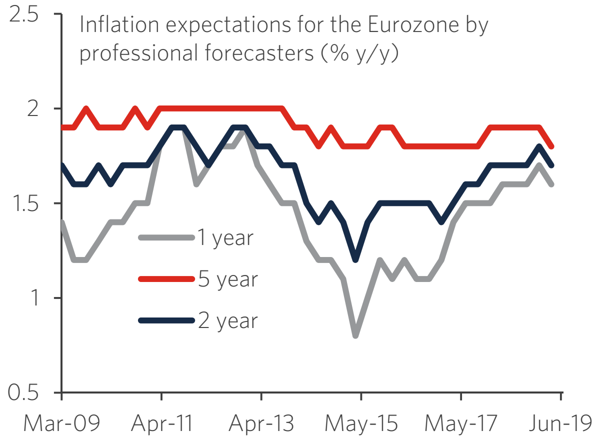
Euro area

Downside risks to growth and subdued inflation should result in further monetary accommodation

Economic surprises shifted further into negative territory in July 2019 while headline and core measures of inflation remained subdued. Headline inflation was 1.2% in June 2019 (lower than the 1.4% average for the past three years) while the underlying or core measure of inflation rose marginally to 1.1% from its previous three-year average of 1%.

Although current rates of inflation remain subdued, the inflation forecasts of the European Central Bank's (ECB) Survey of Professional Forecasters remain closer to the ECB's inflation target of 2%. While these inflation estimates for the next one-, two- and five-year periods have dipped slightly in the latest quarterly reading, the extent of the decline was far shallower than what was experienced during 2015 and 2016 (see chart 2).

Chart 2: Dip in Eurozone inflation expectations not as severe as in 2015 and 2016



Source: Bloomberg, Momentum Investments

Nonetheless, subdued inflation readings and concerns over downside risks to growth imply the ECB will likely cut interest rates by 25 basis points before the end of the year. Given that the ECB has limited monetary policy room to manoeuvre, a wider range of policy options could be contemplated. However, each of these can have drawbacks.

Additional asset purchases could be considered, but this may not be sufficient to encourage private sector investment, and central bank balance sheets are already swollen. There may be space for an additional interest rate cut, but negative short-term interest rates could spur cash hoarding and weaken bank profitability.
In time, the ECB may be forced to consider yield curve control, but this could induce excess borrowing by government. To issue a Eurobond is not likely to be as good a deal for stronger nations, as risk pooling aims to help struggling economies. The ECB could also expand its range of assets held, including exchange-traded funds, but this raises the risk of asset price bubbles. Lastly, the ECB could consider price-level targeting or nominal growth targeting, but both these options could disrupt inflation expectations.

The International Monetary Fund and the Organisation for Economic Cooperation and Development (OECD) have highlighted the urgency for a coordinated government stimulus response to revive growth and inflation.

UK

Many possible outcomes still exist despite the looming deadline

The new UK prime minister, Boris Johnson, stated his intention to renegotiate the Brexit deal agreed with the European Union (EU) by his predecessor Theresa May. She stepped down after failing to rally sufficient parliamentary support for her negotiated deal on the terms of Britain's withdrawal from the EU.

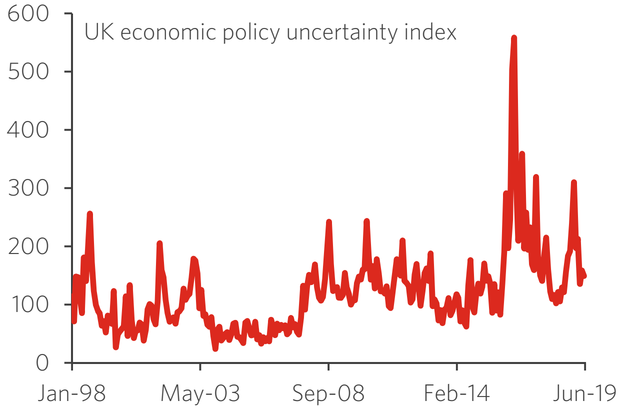
Johnson seeks to negotiate with the EU to remove the Northern Ireland backstop (a proposal to keep Northern Ireland in some aspects of the EU Customs Union and the European Single Market to prevent a hard border) from the withdrawal agreement. He further seeks changes to the political declaration, which deals with the long-term future relationship of the UK and EU. While the EU may consider changes to the political declaration, it is not prepared to reopen negotiations on the withdrawal agreement.

At this stage, all options remain on the table. If minor changes are made to the Brexit deal, Parliament could agree to or reject Brexit on the newly adjusted deal. If no new deal is formulated, MPs could block a no-deal option. If the deadline of 31 October 2019 is not delayed, Britain could leave the EU without any deal in place, or they could cancel Brexit. If the two parties, however, agree on a delay, a vote of no confidence in government, a general election or a second referendum could be possible.

There is also rising speculation that Johnson may prorogue parliament, which effectively shuts down parliament and prevents it from voting and opposing a no-deal Brexit.

The previous vote of no confidence against May's government resulted in a win of 325 to 306 votes. Though the next UK general elections are only scheduled for 2022, the Labour Party could table a vote of no confidence at any time. If the incumbent government doesn't survive the vote, a general election could be held. If fewer than two-thirds of MPs approve a general election, Brexit could be cancelled, Britain could leave with no deal, a further delay could be agreed on or another referendum could be held.

Chart 3: UK policy uncertainty has retraced, despite being no closer to an outcome



Source: Economic Policy Uncertainty, Momentum Investments

With Brexit negotiations lingering, Brexit fatigue appears to be setting in. The policy uncertainty index (based on newspaper articles about policy uncertainty) for the UK has dropped in the recent month (see chart 3). Less than 3% of investment managers in the Bank of America Merrill Lynch Fund Manager Survey in July 2019 indicated that Brexit was the largest risk to financial markets.

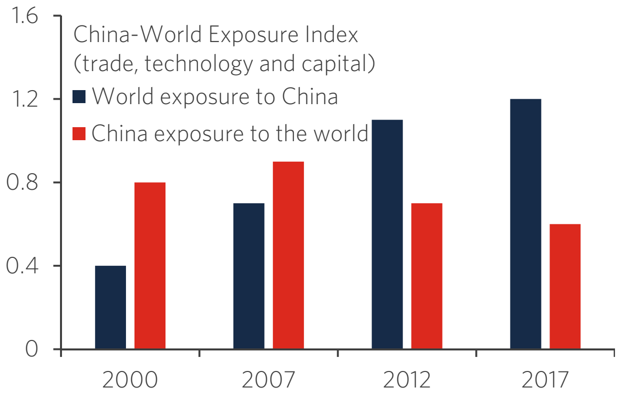
China

The rest of the world's dependence on China leaves it vulnerable to a sharper drop in Chinese domestic demand

Since the global financial crisis, China has reduced its reliance on trade, technology and capital from the rest of the world (see chart 4). Meanwhile, the rest of the world has increased its dependence on China during the same period.

Consequently, the ongoing trade war between the US and China can have significant ramifications for global growth as a whole, given the rising trade and financial linkages China has with the rest of the world. The OECD simulated the effect of a two-year decline of 2% per year in domestic demand in China on the rest of the world.

Chart 4: The world has been increasing its exposure to China

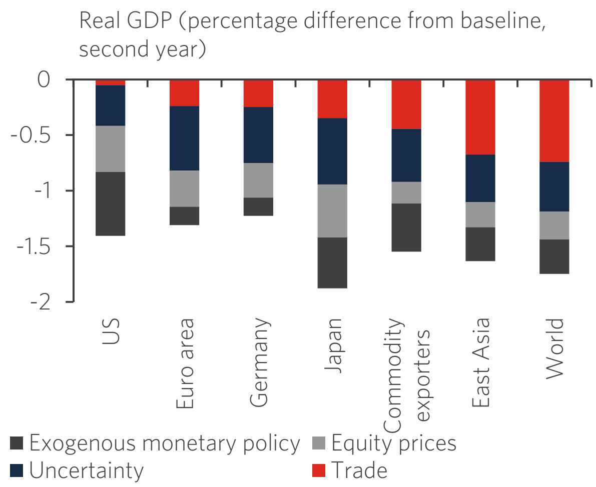


Source: McKinsey, Momentum Investments

The exercise considered that a sharper slowdown in China would raise investment risk premia on corporate and emerging market bond spreads by 50 basis points and trigger a 10% decline in equity prices in all economies.

Greater uncertainty would add to the trade costs of a slowdown that is sharper than expected in China, while higher-risk premia would add to the cost of capital for economies. Moreover, a dip in equity prices would further raise the cost of capital and negatively affect consumer spend. A steeper slowdown in China could have a larger effect on other economies, should monetary policymakers have limited room to manoeuvre and be unable to react. The combined shocks would result in 1.75% weaker real growth in the world economy in a two-year period, with the largest negative effect likely in Japan, East Asia and in commodity-exporting nations (see chart 5).

Chart 5: If China sneezes, we all catch a cold



Source: McKinsey, Momentum Investments

Local economic developments

Fitch revised the outlook on SA's sovereign rating to negative on rising growth and fiscal risks

In a largely unanticipated move, Fitch ratings agency lowered the outlook on SA's BB+ rating from stable to negative (see table 1). Fitch attributed the downgrade in the outlook to persistently weaker growth and heightened "difficulty of stabilising (the) debt-to-GDP (ratio) over the medium term".

Fitch's ratings methodology placed SA on a BBB rating. It took a more pessimistic subjective view on the country by lowering this rating by one notch to account for weaker growth prospects and by another notch to signal its discomfort with SA's substantial contingent liability risks, leaving the rating at BB+.

Fitch noted the latest downward revisions to growth in 2019 raised concerns over SA's growth potential. The agency further warned that the "social context of exceptionally high inequality will constrain government's policy response to these challenges".

Weaker growth outcomes have led to government revenues underperforming and with Fitch's trend growth estimated at just 1.7%, the medium-term fiscal trajectory is unlikely to show significant signs of improvement. Fitch's SA trend growth estimate compared poorly with growth of 3.4% for the median country in the BB ratings bucket. While the agency acknowledged government's efforts around the initiative to accelerate infrastructure spend, government's intention to reduce the cost of logistics and the aim to change immigration rules to attract tourism, it worried that the slow pace of implementation of these reforms would continue to hold back growth.

Table 1: Sovereign ratings matrix

Long-term rating	S&P	Fitch	Moody's
Investment grade	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1
	BB	BB	Ba2
Outlook	Stable	Negative	Stable

Local currency rating
Foreign currency rating
Both ratings

Source: Moody's, S&P, Fitch, Momentum Investments

Fitch expects the government budget deficit to expand from 4.2% in the previous fiscal year to 6.3% of GDP in the fiscal year 2019-'20, which is markedly higher than Treasury's February 2019 estimate of 4.5%. The government debt ratio is set to rise to 68% of GDP by the fiscal year 2021-'22, with no stabilisation in view, from 57.3% in the fiscal year 2018-'19. This is comparatively high when looking at the median country in the BB category, which has a debt ratio of 44.6%. Debt of state-owned enterprises (SoEs) adds 14.3% to the overall debt ratio. Fitch maintains a cautious view on the restructuring of the energy utility, Eskom, which contributes 9.1% of GDP towards debt. The agency recognised significant job cuts would be difficult to achieve in the light of pressure by the trade unions.

Credit strengths, such as the credibility of the South African Reserve Bank (Sarb), a well-regulated and healthy banking sector and a large non-bank financial sector, were highlighted in the statement released. Fitch suggested a strengthening of trend growth, an improvement in SoE finances or a narrowing of the budget deficit could result in a stabilisation of the outlook. A failure to stabilise the debt ratio, a further dip in potential growth or heightened vulnerability from external financing needs could lead to a downgrade in time. In relation to political risks, the agency was concerned about political in-fighting, which could detract from policymaking. However, Fitch believes government will tackle land reform (including measures to allow for expropriation without compensation) in a manner that does not harm growth or the fiscus.

Financial market performance

Global markets

Gains were tempered in global equity markets in July 2019 as investors remained cautious on trade talks between US and Chinese officials late in the month. The MSCI All Country World Index inched 0.3% higher in the month, after surging 6.5% in the previous month.

Developed markets (DMs) performed better than EMs during July 2019. US shares contributed the most to the 0.5% increase in the MSCI DM Index, followed by Japanese shares, while European shares lagged the composite.

Expectations for an interest rate cut by the US Federal Reserve (Fed) and better-than-expected second quarter earnings drove the S&P 500 Index higher by 1.4%.

Economic activity for the first quarter of the year surprised positively in the US. The second estimate of GDP growth recorded at 2.1%, while the market was anticipating a figure below 2%. Strong consumer spend continued to buoy growth in spite of a slowdown in the business investment. 20% of Polled economists in the final week of the month expected an interest rate cut by the US Fed of 50 basis points, which dropped from 40% a week earlier. This decline followed comments from the New York Fed that dovish statements made by its president, John Williams, should not be taken as a guide to the future direction of monetary policy.

The Nikkei 225 Index gained 1.2% in the month. Towards month end, the Bank of Japan struck a similar note to other DM central banks suggesting it had no plans to raise interest rates for another year.

Market expectations are for interest rates to remain flat in Japan for the foreseeable future.

The Eurostoxx 50 Index ended the month barely unchanged, tracking 0.1% weaker. Data from Germany's manufacturing sector highlighted strain resulting from negative swings in trade sentiment. The ECB disappointed markets by not cutting interest rates, but signalled it would be looking into a range of options to support the economy, leaving the door open to further bond-buying and a potential cut in interest rates. European markets dipped in the third week of July 2019 as fears of a snap election arose in Italy. The far-right League Party threatened to abandon its fractious political coalition with the anti-establishment Five-Star Movement, stirring uncertainty in Italy.

Ten-year government bond yields in the US drifted higher by 4 basis points. In contrast, ten-year government bond yields rallied by nearly 8 basis points in Germany on the prospect of additional stimulus. Elevated global uncertainty also drove yields lower, emphasising the safe-haven status of German bunds.

The MSCI EM Index underperformed in July 2019, losing 1.2%. This was in line with a 0.7% drop in the Bloomberg Commodity Price Index. Asian stocks slipped 1.6% notwithstanding a landslide victory by Prime Minister Narendra Modi in the general elections in India. Modi's win underscores the stability of the Indian government and has raised expectations of a follow through on policy reform. Chinese data disappointed in the month, with growth in the second quarter falling to its lowest level in 27 years at 6.2% from 6.4% in the previous quarter.

The MSCI Europe, Middle East and the Africa (EMEA) Index tracked 0.6% lower in July 2019. Russian equity markets performed well on fading fears of further sanctions as well as a stable oil price. Russia's largest gas producer and the country's biggest bank have had stellar gains on a year-to-date basis, underpinning the performance of the Russian equity market.

Sentiment improved towards EM bonds in July 2019. The JP Morgan EM Bond Index (EMBI) spread dropped 9 points in the month (30 points in the last three months). The largest monthly improvements in credit default swap spreads were in India (down 20 points), Brazil (down 16 points) and Indonesia (down 14 points), while spreads widened marginally for Mexico and SA.

The JPMorgan EM Currency Index strengthened slightly by 0.8% in the month. Notable losses were recorded for the Polish zloty (3.5% weaker), Hungarian forint (3.4% weaker) and Czech koruna (3.4% weaker) in July 2019, while the Turkish lira (5.7% firmer), Argentine peso (1.8% firmer) and Brazilian real (1.4% firmer) appreciated against the US dollar.

Local markets

The FTSE/JSE All-Share Index had a lacklustre performance in July 2019. SA shares were lifted during the third week of the month on an interest rate cut of 25 basis points by the Sarb, but slipped 2.4% by the end of the month partly on a downgrade of the sovereign outlook from stable to negative by Fitch (see chart 6).

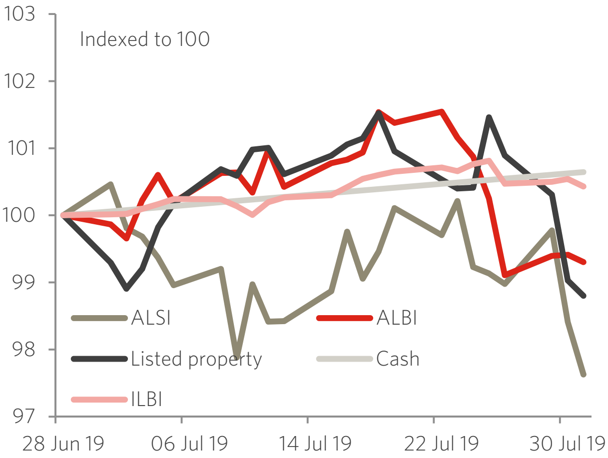
Industrial shares pulled the overall index higher, while resource and financial shares lagged. The FTSE/JSE Industrials Index ended the month 1.2% higher despite a 4.2% drop in retail shares, while the FTSE/JSE Resources Index slid 5.2% lower and financial shares shed 6.4%. Losses in the FTSE/JSE Financial Index were driven by bank shares, which plunged 8.7% in the month.

Despite an increase in the dollar price of gold and platinum, local resource shares underperformed early in the month on disappointing data in local mining production. The dollar price of gold reached a six-year high during the month on expectations of an interest rate cut by the US Fed and raised fears over economic growth. The dollar price of platinum shot up 3.6% in the month. Platinum miners in SA kicked off wage talks in the previous month demanding a hike of 48% for its workers. The price of Brent crude oil ended the month 2.1% lower despite Iran seizing a British tanker in the Strait of Hormuz and notwithstanding sabotaged production in Libya earlier in the month.

The SA 10-year government bond yield sold off 17 basis points late in the month on the back of the negative news by Fitch and ended the month at 8.8%. The JSE

ASSA All Bond Index edged 0.7% lower in the month, while the JSE ASSA Government Inflation-linked Bond Index (ILBI) ticked 0.4% higher. The FTSE/JSE SA Listed Property Index had a subdued session in July 2019, decreasing by 1.2%.

Chart 6: Returns from local asset classes (%)



Source: Iress, Momentum Investments, data up to 31 July 2019

The SA rand traded weaker towards month end on the change in Fitch's sovereign rating outlook on the country from stable to negative. The rand ended the month 1.7% weaker against the US dollar, but 0.9% firmer against the euro. The rand strengthened by 2.5% against the sterling, as the sterling tumbled to a two-year low on UK Prime Minister Johnson holding talks over a no-deal Brexit.

SA's five-year credit default swap spread widened by 6 points in the month, but narrowed by 16 points in the past three months.

Indices summary for July 2019

	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)	-2.37%	-2.66%	2.19%	5.63%	5.34%	5.15%	8.70%	10.63%	12.12%
FTSE/JSE Shareholder Weighted Index (SWIX)	-2.21%	-4.85%	-1.14%	2.85%	3.69%	4.64%	8.42%	10.12%	12.26%
FTSE/JSE Capped SWIX All Share index	-3.13%	-5.07%	-3.45%	0.92%	2.15%	3.41%	7.35%	9.19%	
FTSE/JSE All Share Top 40 Index	-2.63%	-2.60%	2.16%	6.51%	5.26%	4.96%	8.67%	10.85%	11.93%
FTSE/JSE Mid Cap Index	-1.99%	-3.12%	2.56%	-1.35%	4.10%	4.53%	7.38%	8.04%	12.14%
FTSE/JSE Small Cap Index	0.51%	-2.34%	-8.84%	-3.46%	-0.73%	1.67%	5.40%	8.15%	11.19%
FTSE/JSE Resources Index	-5.24%	-0.92%	16.50%	16.83%	10.96%	-1.17%	3.91%	3.60%	3.83%
FTSE/JSE Financials Index	-6.44%	-7.42%	-5.55%	2.93%	1.22%	5.43%	9.22%	10.60%	13.19%
FTSE/JSE Industrials Index	1.23%	-1.21%	-0.52%	2.30%	3.17%	5.71%	8.73%	12.56%	15.81%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	-3.81%	-3.60%	1.49%	7.68%	7.41%	4.98%	8.76%	10.08%	11.50%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	-3.63%	-3.76%	1.62%	7.25%	6.86%	4.67%	8.29%	9.66%	11.15%
FTSE/JSE SA Listed Property Index (SAPY)	-1.20%	0.09%	0.08%	-3.70%	-0.66%	4.99%	6.24%	6.69%	12.02%
Interest-bearing indices									
JSE ASSA All Bond Index (ALBI)	-0.74%	2.16%	8.06%	8.79%	8.20%	8.21%	8.04%	7.09%	8.80%
JSE ASSA All Bond Index 1-3 years (ALBI)	0.05%	1.87%	9.97%	8.79%	8.55%	8.13%	7.73%	7.22%	7.79%
JSE ASSA SA Government ILB Index	-0.04%	-0.62%	3.75%	1.72%	2.93%	3.80%	4.75%	5.19%	6.97%
Short-term Fixed Interest Composite Index (SteFI)	0.61%	1.82%	7.37%	7.45%	7.32%	7.12%	6.85%	6.61%	6.55%
Commodities									
NewGold Exchange-Traded Fund	1.98%	10.38%	26.15%	2.33%	9.63%	7.58%	7.38%	5.68%	10.15%
Gold price (in rands)	2.06%	10.62%	26.34%	2.64%	9.93%	8.13%	7.77%	6.20%	10.79%
Platinum Exchange-Traded Fund	5.82%	-2.78%	12.64%	-8.48%	-0.50%	-5.03%	-3.81%		
Platinum price (in rands)	6.62%	-2.49%	14.32%	-7.70%	0.15%	-4.33%	-3.32%	-3.00%	0.03%
Currency movements									
Rand/euro movements	-1.75%	-1.76%	2.96%	0.59%	3.16%	1.94%	3.07%	6.56%	3.57%
Rand/dollar movements	0.48%	-1.12%	8.21%	0.76%	3.01%	5.76%	6.17%	8.12%	6.17%
Inflation index									
Consumer Price Index (CPI)			4.46%	4.71%	5.09%	5.02%	5.29%	5.33%	5.20%

Important notes

1. Sources: Momentum Investments, IRESS, 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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