momentum investments

in the moment

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Economic and market snapshot for June 2019

Highlights

- United States (US): Markets are gaining confidence that looser monetary policy is on the horizon, but volatility could spike if the US Federal Reserve (Fed) fails to deliver on interest rate cuts in the near term.
- Euro area: The European Central Bank (ECB) signalled it stood ready to use its available monetary policy tools should inflation expectations and actual inflation outcomes remain significantly below target.
- Japan: Growth surprised sharply to the upside for the first quarter of the year, but the growth backdrop looks less supportive going forward.
- Emerging markets (EMs): Global growth concerns have led to a lowering of interest rates in a number of EMs.
- South Africa (SA): Macroeconomic stimulus cannot alone resolve the country's problem of low trend growth. Microeconomic reforms are needed to boost the country's growth potential.

Global economic developments

US

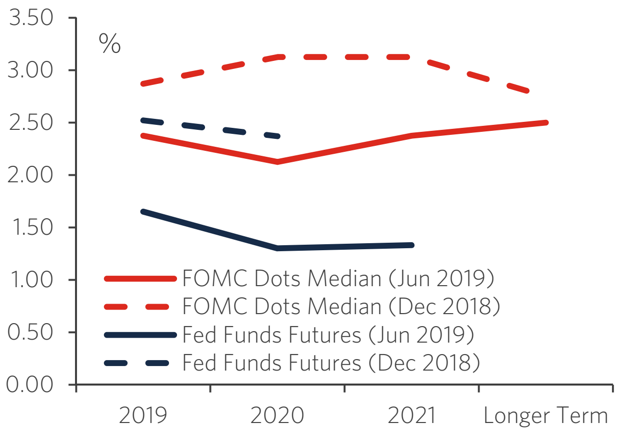
Markets are gaining confidence that looser monetary policy is on the horizon

The language around the strength of the economic recovery became less favourable in the June 2019 statement of the Federal Open Market Committee (FOMC) meeting. Previously, the FOMC noted growth was rising at a "solid" rate, but this was downgraded to "moderate" in June. The committee warned uncertainties about the economic outlook had increased and, consequently, removed the wording about being "patient" in determining its future adjustments in the interest rate.

The voting action at the June 2019 meeting was not unanimous, with one member preferring to lower the target range for the Fed funds rate by 25 basis points from the current range of between 2.25% and 2.5%. At the end of each quarter, FOMC policymakers put forward their projections of where short-term interest rates should head. Accumulated, these views are presented in the Fed's dot plot. Although the median expectation for the benchmark interest rate was unchanged for 2019, eight members indicated they were in favour of interest rate easing in 2019. Nine members indicated they expect the Fed funds rate to approach 2.1% by the end of 2020, in comparison to the previous outlook of 2.6%.

At the end of June 2019, the market was pricing in a 75% chance of an interest rate cut of 25 basis points at the July 2019 interest-rate-setting meeting and a 25% probability of a 50 basis point cut. Despite St. Louis Fed President James Bullard proposing it was a good time for an "insurance cut" (to cushion the economy against weakness and uncertainty), he also admitted that a 50 basis point cut in interest rates in July 2019 would be "overdone".

Chart 1: Shift in US interest rate expectations



Source: Bloomberg, Momentum Investments

Despite firm economic data (the Bloomberg consensus forecast for growth in 2019 has increased by 0.1% in the past year to 2.5% and only dropped by 0.1% during the same period to 1.8% for 2020), markets have priced in looser monetary policy (see chart 1). If the Fed fails to deliver on interest rate cuts in the near term, in relation to elevated downside risks posed by a slowing global economy, financial markets are likely to be negatively affected.

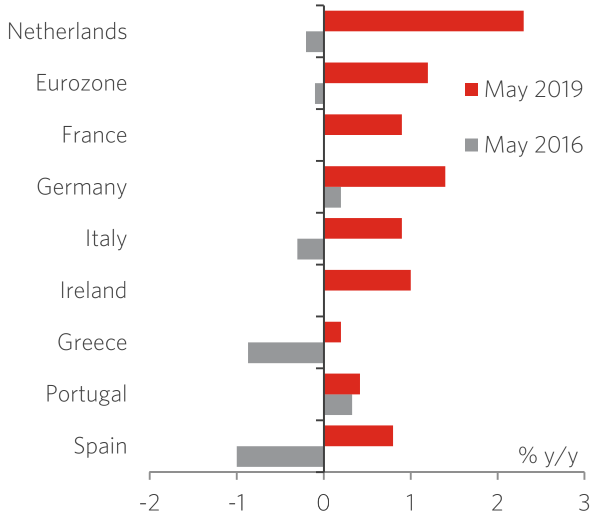
Euro area

ECB signalled further stimulus is on the horizon if inflation expectations and actual inflation outcomes remain low

Growth in the Euro area surprised to the upside for the first quarter of the year, increasing by 0.4% relative to the previous three-month period and was 1.2% higher in comparison to a year ago. Household consumption was the largest driver of growth in the first quarter, in line with the rate of unemployment falling to a 10-year low and real wage growth continuing to support spend. Growth in investment remained robust and net exports made a minor positive contribution, while a dip in inventories detracted from the overall rate of growth.

Nevertheless, an expected slowdown in wage growth and slower employment gains could weigh on household spend in the coming quarters, while weak global growth is expected to undermine growth in exports.

Chart 2: Headline inflation across the Eurozone



Source: Bloomberg, Momentum Investments

Inflation in the region has been below the ECB's 2% target for most of the past six years. Although inflation for the Eurozone climbed from negative 1.2% three years ago to 2.3% in October 2018, the headline rate drifted lower to 1.2% in May 2019, leaving the past three-year average at 1.3%. Inflation in Germany registered at 1.4% in May 2019, while inflation in the periphery continued to lag behind (see chart 2).

Meanwhile, core or underlying inflation (which excludes the effect of volatile food and energy prices) has disappointed at an average of below 1% in the past three years. The average five-year expectation for inflation in five years' time (measured by inflation swaps) dropped sharply from 1.7% in July 2018 (and from 2.2% six years ago) to 1.2% in June 2019, possibly in reaction to more shakier global growth expectations.

In light of heightened uncertainty (relating to the Brexit negotiations, global trade volumes and vulnerabilities in select emerging economies), the ECB announced an extension in its expectations for interest rates to remain steady to the end of the first half of 2020. In its question and answer session at the June 2019 interest-rate-setting meeting, ECB President Mario Draghi denied any threats to a de-anchoring of inflation expectations, but admitted the slide in inflation expectations, unlike in the Euro area, has started from higher levels elsewhere in the world. Draghi also added that survey-based expectations (in comparison to market-based expectations) were still anchored around 1.6% to 1.7% in the long term.

Draghi stated further policy space existed to cut interest rates "if adverse contingencies were to materialise" and left the door open to further prospects for quantitative easing. He clarified conditions are not comparable with those which emerged seven years ago and that had led to the "whatever it takes" speech, given tighter labour markets and rising wage growth this time around, but he suggested the ECB stood ready to use any monetary policy tools at its disposal.

Japan

Surprisingly firm growth in the first quarter of the year unlikely to last

Real growth in economic activity increased by more than expected at an upwardly revised 2.2% in the first quarter of the year, relative to the consensus expecting a small contraction in the same period. Numbers were revised higher from 2.1%, due to improvements in capital spending.

Nevertheless, momentum in growth is expected to slow into the next quarter's reading. Real consumption activity dropped markedly towards the end of the first quarter, suggesting a weaker trend in consumption spend is likely to follow. Subdued consumer sentiment corroborates the view of slowing consumption spend. Japan's consumer confidence index dropped below consensus to 39.4 points in May 2019, remaining below the long-term average reading of 42.2 points for the fifth consecutive reading.

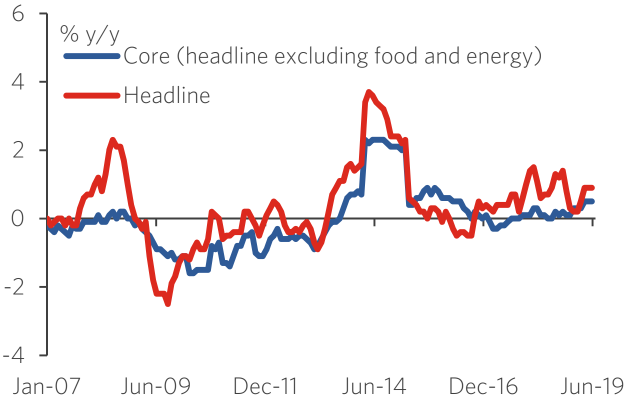
In addition, inventories, which have contributed positively to growth in the past three quarters, should reverse course and detract from growth in the second quarter of the year.

Moreover, the robust contribution from net exports is unlikely to be repeated for the second quarter of the year. During the first quarter of 2019, a larger fall in imports relative to exports boosted the overall contribution from net exports. The Macquarie Group, however, warns Japan's economy remains highly leveraged to the global cycle and should the trade war between the US and China escalate, medium-term prospects for the Japanese economy are likely to be dented.

Although Prime Minister Shinzo Abe has twice pushed back the planned hike in the consumption tax from 8% to 10%, government has maintained it will go ahead with its plan to raise the rate in October 2019, unless the economy faces a shock on the scale of the global financial crisis. Government previously increased the rate from 5% to 8% in 2014, which led to a recessionary outcome. Notwithstanding a better-than-expected growth print, speculation of a delay in the tax hike has remained high, in line with weakness in the economy, prompted by a slowdown in exports to its largest trading partner, China.

Meanwhile, inflation at a headline level remains well below the Bank of Japan's (BoJ) 2% target at 0.9% for June 2019 (see chart 3). The ten-year breakeven rate of inflation dipped to 0.2% in June 2019 reinforcing weak inflation expectations. As such, Momentum Investments expects monetary policy conditions to remain highly accommodative for an extended period.

Chart 3: Subdued inflation pressures in Japan



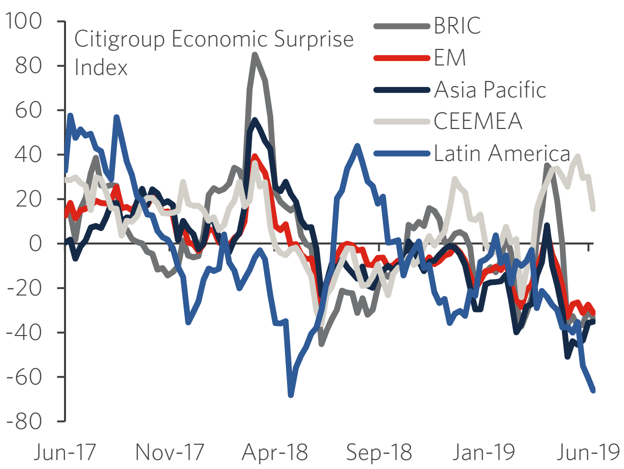
Source: Bloomberg, Momentum Investments

EMs

Global growth concerns have led to a lowering of interest rates in a number of EMs

Growth data disappointed in the EM composite for the past quarter (see chart 4). Discouraging activity data out of Brazil drove a further deterioration in the economic surprise index for the Latin American region.

Chart 4: Growth data disappointed in EMs



Source: Bloomberg, Momentum Investments, BRIC = Brazil, Russia, India and China, CEEMEA = Central and Eastern Europe, Middle East and Africa

A growth tracker run by Capital Economics suggests growth in EMs slowed to 3.3% in year-on-year (y/y) terms in the first quarter of 2019, which is the weakest pace in three years. Data from Capital Economics showed a slide in growth in retail sales for Latin America and Emerging Europe to 0% and 2% for the latest three-month period ending April 2019, while retail sales volumes grew by 6% for the same period in Emerging Asia. Growth in industrial production volumes was highest in Emerging Asia, at 4% for the corresponding period, but lower at 2% for Emerging Europe and negative 2% for Latin America.

An intensification of the trade war between the US and China has led to negative spillovers for EMs. Growth in aggregate EM exports in US dollar terms sank to 0% from 15% in January 2018. Export volumes contracted mildly in Latin America and Emerging Asia in the first quarter of the year, but growth was positive at 5% for Emerging Europe.

The Bloomberg consensus has downward adjusted its expectation for growth in EMs in 2019 from 5.1% a year ago to 4.7% in June 2019. Similarly, forecasts have been pruned for 2020 from 5.2% a year ago to 4.9% in June 2019.

Capital Economics' measure of aggregate EM headline inflation lifted to a seven-month high of 3.8% y/y in May 2019. Nevertheless, subdued fuel inflation suggests a softer inflation outlook for the region. The Bloomberg consensus forecasts a dip in EM inflation from 3.7% in 2019 to 3.5% in 2020.

In the past six years, more EM central banks have cut interest rates than those that have raised interest rates. In June 2019, Russia, Chile, India and Sri Lanka lowered interest rates. Russia cut interest rates by 0.25% to 7.5%, citing easing inflation and milder growth, and signalled further cuts for the year. Meanwhile, Chile cut interest rates by a larger 50 basis points to 2.5% on the back of rising global trade tensions, which could negatively affect Chinese copper demand from the country. India cut interest rates for a third time this year by 25 basis points to 5.75% in response to growth in the economy falling to its lowest level in five years. The Reserve Bank of India signalled the possibility of additional easing should growth disappoint further.

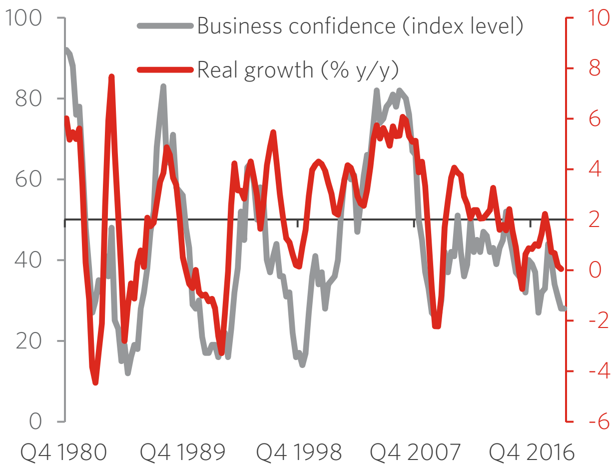
Local economic developments

Macroeconomic stimulus cannot alone resolve the country's problem of low trend growth

In a recent speech by the adviser to the governors of the South African Reserve Bank (Sarb), Fundi Tshazibana warned struggling commodity prices, a slowing in global growth momentum and risks to a further escalation in global trade tensions would result in less supportive global conditions for SA's growth profile in the medium term.

Moreover, the speech highlighted concerns around the sharp broad-based contraction in local growth in the first quarter of the year. In addition, depressed business confidence (which stagnated at 28 index points in the second quarter reading, significantly below the neutral level of 50 according to the Bureau of Economic Research, see chart 5), the potential for further shortages in electricity supply and lofty debt levels at a number of key state-owned enterprises remain downside risks to the outlook for growth locally.

Chart 5: Growth and the Business Confidence Index



Source: Bloomberg, Momentum Investments, data up to Q2 2019 for business confidence and up to Q1 2019 for growth

The Sarb noted monetary policy has been accommodative, but acknowledged the degree of accommodation has declined in the past 10 months in particular. The Sarb attributes this decline to lower-than-expected inflation (due to declining nominal wage growth, lower imported inflation and a drop in meat prices), which has allowed real interest rates to rise.

Should interest rates drop in the near term, Momentum Investments anticipates the cutting cycle to be shallow, given the structural nature of SA's projected low growth profile. The Sarb recognises inflation in SA remains elevated relative to its trading partners and ascribes this to pricing practises, market structure and supply-side rigidities that need to be addressed through the implementation of structural reforms.

The Sarb is of the view macroeconomic stimulus could cause higher inflation, further currency depreciation and higher interest rates, rather than growth in investment and employment. Where structural constraints are prominent, the Sarb sees the effectiveness of monetary policy being impeded. As such, the Sarb believes monetary policy space needs to be created by microeconomic reforms, which raise potential growth.

Financial market performance

Global markets

Global equity markets recovered strongly in June 2019 with the MSCI All Country World Index up 6.5% in the month, after plummeting 5.9% in May 2019, on hopes for a positive breakthrough in the ongoing trade negotiations between the US and China at the G20 Summit in Osaka, Japan.

US President Donald Trump agreed to hold off on new tariffs and allowed Huawei to once again purchase US products. Increased concern over global risks lifted expectations for further monetary policy easing by major central banks, which boosted risk appetite further. With intra-quarter volatility, the index was only up 2.4% for the second quarter of the year.

Developed market (DM) equities outperformed EM equities for the quarter ended June 2019. The MSCI DM Index climbed 2.8% for the quarter, while the MSCI EM Index slid 0.6% in the same period. During the month, however, the two indices performed similarly, springing 6.6% and 6.2% higher, respectively.

Higher returns on the MSCI EM Index were corroborated by a 4-point reprieve in the CBOE Volatility index (Vix) in June 2019 and a 2.7% rise in the Bloomberg Commodity Price Index.

The MSCI DM Index benefitted from stronger returns in the US and European equity markets, while Japanese markets brought up the rear. The S&P 500 Index rallied 7.0% in June 2019 after a significant 6.4% dip in May, leaving the quarterly return at 3.1%.

Despite poor data for US durable goods hinting at a negative hit from unfavourable trade tariffs, optimism over a favourable outcome for the negotiations between the US and China boosted US shares. President Trump had previously indicated the failure of reaching a deal with China would result in the application of tariffs on another US$300 billion worth of Chinese goods. Earlier in the month, Mexico reached a deal with the US to curb migration, thereby avoiding tariffs on Mexican goods exported to the US. Moreover, a more dovish outlook on monetary policy provided optimism in the US equity market.

The Eurostoxx 50 Index rose 6.0% in the month, recouping losses of 5.1% made in May 2019. European shares were buoyed in June 2019 on comments made by Draghi that the €2.6 trillion quantitative easing programme could be revived, if the inflation trajectory did not improve. Headline inflation averaged 1.8% in the Euro area for the past year, but dropped to an average of 1.4% for the last three months. Meanwhile, core inflation remained stubbornly low at 1% on a three-month and one-year average. Moreover, Draghi warned about “lingering softness” in growth in the economy, further raising expectations for an easier monetary policy stance in the Euro area. Quarterly returns in the Eurostoxx 50 Index outperformed US and Japanese equities (negative 0.8%) at 4.7%.

The Nikkei 225 Index lagged the DM composite and finished the month only 3.5% higher on yen strength, which hurt exporters. The BoJ left interest rates unchanged at the latest meeting, but BoJ Governor Haruhiko Kuroda hinted at “additional monetary easing steps” if “the momentum for achieving our price target is lost”.

Ten-year government bond yields in the US dipped to their lowest level since 2016 during June 2019, as weaker global growth fears triggered expectations of lower global central bank rates. In its June 2019 statement, the US Fed scrapped its reference to “patient” in describing its stance of future interest rate moves, downgraded its assessment of economic activity from “solid” to “moderate” and forecasted a bigger miss on its 2% inflation target for 2019.

In Germany, 10-year government bond yields slipped to their lowest level on record in the month, as shaky economic data drove investors into safe asset classes.

Meanwhile, Bitcoin made a comeback on news that tech giant, Facebook, would be launching its own cryptocurrency, the Libra. This vote of confidence boosted expectations for future demand of Bitcoin, causing a rally from US$4 400 at the start of April 2019 to a peak of US$12 893 during the final week of June 2019.

EM equities were slightly down in the quarter (negative 0.6%), in line with a 2.1% dip in commodity prices, but the MSCI EM Index partly offset losses of 7.3% in May 2019, by increasing by 6.2% in June 2019. During the quarter ended June 2019, returns were firmest in MSCI Europe, Middle East and the African (EMEA) region at 5.1%, followed by gains in the MSCI Latin American Index of 3.9%, while the MSCI Asian Index lost 2.4%. Returns for these three regions were closer in line for the month, with the MSCI Latin American Index up 6.2%, while the MSCI Asia and MSCI EMEA indices posted gains of 6.4% and 5.8%, respectively.

Sentiment improved towards EMs in June 2019. The JP Morgan EM Bond Index (EMBI) spread dropped seven points in the month, reversing a similar rise the month before. The EMBI spread was stable for the quarter, with the largest quarterly deterioration observed for Argentina (22 points), while Romania staged the biggest improvement (23 points).

The JPMorgan EM Currency Index weakened by 0.5% in the quarter. Notable gains for the quarter were made in the Argentine peso (17.4%), Russian ruble (5.9%) and SA rand (4.7%), while the South Korean won weakened by 1.4%. A similar picture emerged for the month, with the biggest gains being made in the Argentine peso (10.4%), Colombian peso (5.6%) and Chilean peso (4.9%), while the rand was the fifth-best-performing EM currency at 4%.

Local markets

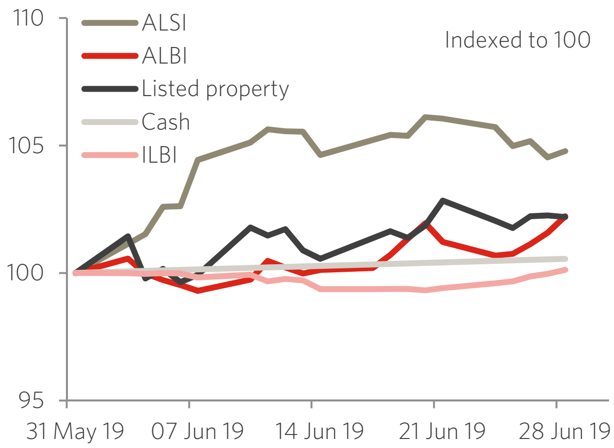
The FTSE/JSE All-Share Index rose 3.9% in the quarter, supported by returns on financial (5.4%) and industrial shares (4.0%). In June 2019, SA equity markets followed global markets higher and ended the month 4.8% up (see chart 6). Resources were the largest contributor to returns in the month. The FTSE/JSE Resources Index soared 10.2% in the month on higher gold prices. The dollar price of gold increased by 7.9% in the month, responding to investors seeking protection against rising uncertainty. The dollar price of platinum picked up 2.5% in the same period.

Oil prices also rose during the month (2.8%), on tensions between the US and Iran. Media reports intimated the US had prepared for strikes on Iranian military targets after Tehran shot down a surveillance drone belonging to the US. In addition, the US Senate has blocked further military deals with Saudi Arabia, stoking further geopolitical tensions.

The FTSE/JSE Industrials Index gained 3.8% in June 2019. Retailers were up by a lesser 0.8% in the month. Gains in the FTSE/JSE Financial Index were more muted for June 2019 at 1.3%. Bank shares were up 0.5% in the corresponding period.

The SA 10-year government bond yield rallied 30 basis points in June 2019 and ended the month at 8.7%. The JSE ASSA All Bond Index lifted 2.2% in the month, while the JSE ASSA Government Inflation-linked Bond Index (ILBI) underperformed at negative 0.1%. Meanwhile, the FTSE/JSE SA Listed Property Index increased by 2.2% in June 2019.

Chart 6: Returns from local asset classes (%)



Source: IRESS, Momentum Investments, data up to 30 June 2019

The SA rand traded firmer in the second half of the month, as dovish DM central bank rhetoric and hopes of positive trade talks between the US and China supported the local currency. The rand strengthened by 1.6% against the euro and 3.0% against the sterling by the end of June 2019. SA's five-year corporate default swap (CDS) spread similarly narrowed by 34 points in the month.

Indices summary for June 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)	4.78%	3.92%	4.42%	6.89%	6.12%	5.85%	9.92%	11.44%	13.47%
FTSE/JSE Shareholder Weighted Index (SWIX)	3.12%	2.86%	1.20%	4.26%	4.23%	5.40%	9.41%	10.97%	13.48%
FTSE/JSE Capped SWIX All Share index	2.88%	2.90%	1.11%	2.77%	2.98%	4.35%	8.50%	10.18%	
FTSE/JSE All Share Top 40 Index	5.39%	4.61%	4.57%	7.43%	6.21%	5.64%	10.07%	11.68%	13.34%
FTSE/JSE Mid Cap Index	2.46%	1.45%	5.19%	1.94%	4.15%	5.61%	7.82%	8.92%	13.38%
FTSE/JSE Small Cap Index	-0.16%	1.84%	-10.89%	-2.81%	-1.01%	1.77%	5.88%	8.37%	11.81%
FTSE/JSE Resources Index	10.16%	2.41%	21.22%	20.63%	10.00%	0.83%	6.38%	4.13%	5.37%
FTSE/JSE Financials Index	1.29%	5.44%	5.66%	6.22%	3.89%	7.09%	10.70%	12.25%	15.06%
FTSE/JSE Industrials Index	3.76%	4.01%	-3.69%	1.75%	3.17%	5.25%	9.10%	13.18%	16.82%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	4.76%	3.82%	7.81%	10.20%	7.98%	6.09%	10.34%	10.97%	13.19%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	4.34%	3.55%	7.16%	9.82%	7.44%	5.81%	9.78%	10.56%	12.82%
FTSE/JSE SA Listed Property Index (SAPY)	2.20%	4.52%	0.79%	-2.27%	0.90%	5.64%	5.70%	8.14%	13.00%
Interest-bearing indices									
JSE ASSA All Bond Index (ALBI)	2.27%	3.70%	11.50%	9.86%	8.69%	8.59%	8.06%	7.80%	9.02%
JSE ASSA All Bond Index 1-3 years (ALBI)	0.93%	2.66%	10.92%	9.06%	8.67%	8.24%	7.80%	7.32%	7.80%
JSE ASSA SA Government ILB Index	0.40%	2.80%	4.06%	1.77%	3.46%	3.78%	5.09%	5.91%	7.10%
Short-term Fixed Interest Composite Index (SteFI)	0.55%	1.80%	7.29%	7.43%	7.28%	7.08%	6.80%	6.58%	6.55%
Commodities									
NewGold Exchange-Traded Fund	4.61%	5.91%	15.17%	0.53%	8.31%	6.79%	8.25%	5.14%	10.28%
Gold price (in rands)	5.25%	6.10%	14.68%	0.66%	8.67%	7.39%	9.04%	6.02%	10.66%
Platinum Exchange-Traded Fund	0.88%	-4.71%	-0.64%	-7.86%	-3.21%	-6.27%	-3.17%		
Platinum price (in rands)	1.73%	-4.16%	0.61%	-7.91%	-2.73%	-5.77%	-3.42%	-2.73%	-0.39%
Currency movements									
Rand/euro movements	-0.97%	-0.85%	0.34%	-0.40%	4.37%	1.98%	3.72%	6.44%	4.01%
Rand/dollar movements	-3.09%	-2.24%	2.89%	-1.21%	3.83%	5.82%	6.07%	8.11%	6.19%
Inflation index									
Consumer Price Index (CPI)			4.48%	4.78%	5.11%	5.01%	5.27%	5.31%	5.20%

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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