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Economic and market snapshot for May 2019

Highlights

- United States (US): The decline in inflation expectations rattled investors and has caused the market to price in interest rate cuts a lot sooner and to a larger extent than what is being indicated by the dot plot.
- Euro area: The two-largest centrist parties have lost their absolute majorities for the first time since 1979. This is a strong indication European voters want change.
- United Kingdom (UK): The electorate is becoming polarised over Brexit and support is shifting to the main 'leave' and 'remain' parties. The new prime minister will have until 31 October 2019 to resolve the Brexit impasse.
- Emerging markets (EMs): A resurgence in the trade war between the US and China has triggered a bout of outflows from EM bonds and equities.
- South Africa (SA): Standard and Poor's Global Ratings (S&P) could lower the country's sovereign rating if the economy weakened structurally, if property rights were fundamentally undermined or if further fiscal deterioration occurred through higher expenditure pressures or a crystallisation of contingent liabilities.

Global economic developments

US

A decline in inflation expectations rattled investors and has caused the market to price in interest rate cuts a lot sooner

Even with a tight labour market and the unemployment rate at a 49-year low, inflation is struggling to sustainably meet the US Federal Reserve's (Fed) target of 2%. Consumer price inflation ticked higher to 2.0% in April 2019, driven by petrol and accommodation costs, but remained below the recent peak of 2.9% in July 2018. Core inflation remained above 2% at 2.1% in April, but was lower than the 2.4% peak reached in July 2018.

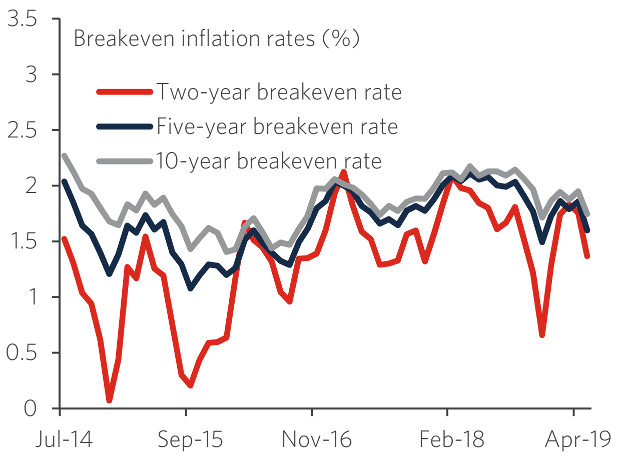
The US Fed tends to follow the personal consumption expenditure (PCE) deflator measure of inflation more closely. The headline PCE measure dropped to 1.5% in March 2019 from 2.4% in June 2018, while the targeted PCE core measure dropped to 1.6% from 2% in June 2018.

The Fed Chair Jerome Powell attributed the decline in the core measure of inflation to transitory factors, including the change in the methodology used for clothing prices and weakness in financial services prices. However, Capital Economics shows core PCE inflation excluding clothing and financial services also declined to just above 1.7% in the latest print, suggestive of further weakness in pricing pressures.

Measures of inflation expectations have also fallen in recent months. The benchmark 10-year breakeven rate (derived from inflation-protected US government securities) dropped below 1.8% in May 2019 (see chart 1).

Household measures of inflation expectations were mixed. Three-year ahead inflation expectations measured by the New York Fed dropped from 3% in mid-2018 to below 2.7% in April 2019, which is the lowest rate since late 2017.

Chart 1: Drop in US breakeven inflation expectations



Source: Bloomberg, Momentum Investments, data up to May 2019

The transcript of Powell's press conference on 1 May 2019 indicated inflation is somewhat weaker than what the Fed originally anticipated. However, Powell noted the Federal Open Market Committee (FOMC) would be more concerned if inflation ran persistently below its target and would take that into account when setting policy. He mentioned the Dallas trimmed mean measure of inflation (which strips out items, which experienced large negative or positive moves in inflation) did not decline as much and remained close to 2%.

The market is forecasting interest rate cuts a lot sooner and to a larger extent than what is being indicated by the median FOMC member interest rate expectation (dot plot). The Fed fund futures implied rate moved to 2% for December 2019 and 1.6% by December 2021 in comparison to the dot plot, which highlights no interest rate cuts for 2019 and one further hike in 2020, before remaining steady into 2021. Momentum Investments expects no further interest rate cuts by the Fed, but only anticipates the first interest cut in 2020, when growth is likely to weaken more substantially on the back of a negative fiscal impulse.

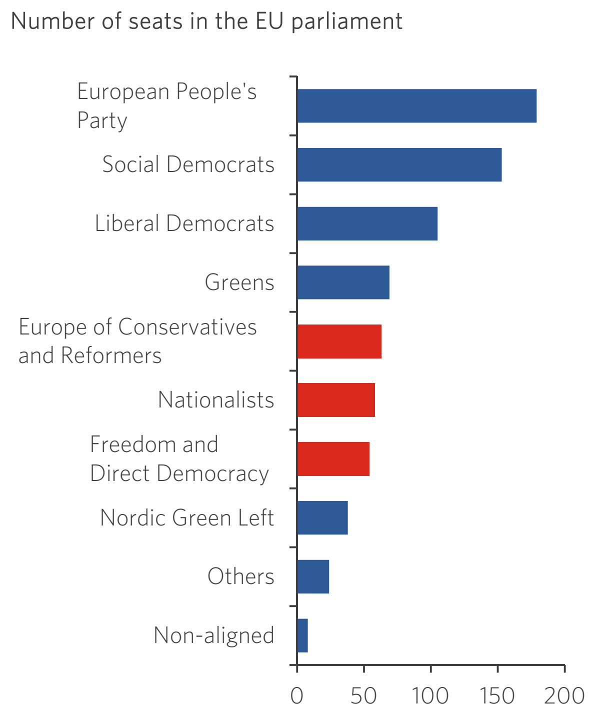
Euro area

The pro-European Union (EU) centre is not depleted, but populist parties have become a bigger player in the EU's political landscape

The European parliament is a directly elected EU legislature, which decides how public money is used in the EU's common budget and how the European Single Market is regulated. It can also influence trade agreements, environmental policies and economic regulations, which becomes more challenging the more fractured parliament is.

The turnout for the European parliamentary elections has historically been low. However, this time around, 51% of EU citizens turned out to cast their vote from 42.6% in 2014. Turnout was the highest in Belgium (88.5%), where voting is compulsory, and Luxembourg (84.1%), but lowest for Slovenia (28.3%) and Croatia (29.9%).

Chart 2: Pro-EU stance holds, but populists are becoming more important to the political landscape



*Source: The Guardian, Momentum Investments, *parties in red have a more populist stance*

The election outcome reinforced the trend of traditional political constituencies losing support. The two-largest centrist parties have lost their absolute majorities for the first time since European parliamentary elections were held (1979), while smaller parties made gains. Although the centre-right European People's Party (EPP) and the centre-left Progressive Alliance of Socialists and Democrats (S&D) lost support, the pro-EU centre was buffered by support for the Greens, liberals and other smaller centrist parties. For the centre-right and centre-left parties to get their agendas passed in parliament, they will require support from these smaller parties, which have started to cut into support for the mainstream parties.

The far-right populist parties increased their share of seats in the European parliament from 20% to 25% (see chart 2). While they have not conquered Europe, they have become more important to the European political landscape.

UK

The electorate is becoming polarised over Brexit and support is shifting to the main leave and remain parties

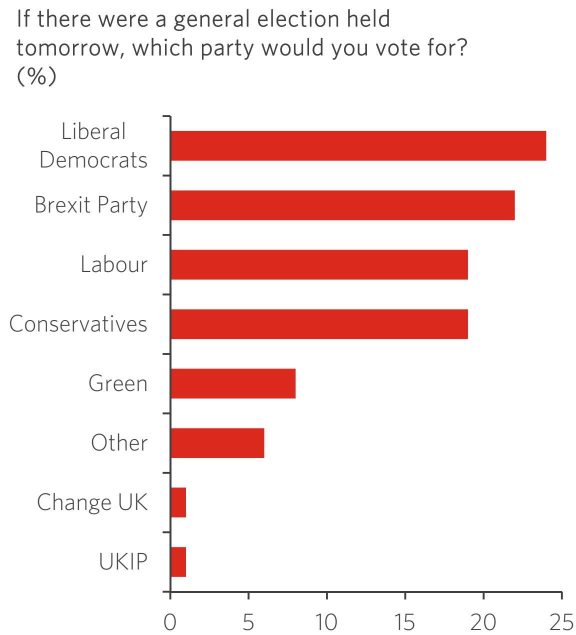
According to the Fixed-term Parliaments Act, the next UK general election should take place on 5 May 2022. However, a general election could be called earlier if it is approved by a supermajority (two thirds) of the ministers in Parliament. Similarly, a general election could be triggered by a vote of no confidence in government.

In the latest YouGov poll for The Times, 24% of those surveyed suggested they would vote for the Liberal Democrats in a general election (see chart 3). In second place was Nigel Farage's Brexit Party (formed only six months ago) at 22% of the vote. The Conservatives and the Labour parties registered at 19% of the surveyed vote, with the Greens at 8%.

The last time the Liberal Democrats led in a survey of this kind was back in 2010. The results of the survey indicate voters are looking for parties that represent their views on Brexit and have a clear pro-EU (Liberal Democrats) or anti-EU (Brexit Party) stance. Meanwhile, support has dropped for the ruling Conservative Party and the opposition Labour Party, which have been making a number of compromises.

The European election results were disappointing for the Conservative Party, which suffered the biggest blow a government ever has in a European election. The party won only four seats, while the Brexit Party won 29 seats in first place, followed by the Liberal Democrats, which won 16 seats. The Labour Party came in third at 10 seats.

Chart 3: UK voter support is shifting to the main 'leave' and 'remain' parties



Source: YouGov, Momentum Investments

Prime Minister Theresa May agreed to step down as the leader of the Conservative Party by 7 June 2019. Twelve Conservatives have announced their candidacy for the leadership of the party. Whoever succeeds May will need to steer Britain through the Brexit impasse and will have until 31 October 2019 to find a solution in spite of the parliamentary deadlock and division they will likely face, as did May.

EMs

A resurgence in the trade war between the US and China has triggered a bout of risk-off sentiment

US President Donald Trump increased tariffs on US$200 billion worth of Chinese imports from 10% to 25% in May 2019. Chinese authorities have retaliated by imposing tariffs of up to 25% on US$60 billion of imports from the US. These tariffs will apply to meat, alcohol, frozen foods, oil seeds and fruits.
Moreover, in response to some US firms cutting supplies to and blocking Chinese companies, China announced plans to blacklist US firms that have engaged in discriminatory action against Chinese entities or pose a threat to national security.

Although China only imported US$120 billion worth of goods from the US in 2018, thereby limiting the effect of the increased tariffs on gross domestic product (GDP) in the US, falling investment from China in the US could have an additional negative effect on economic growth in the US. A report by the US-China Investment Project noted foreign direct investment from China into the US plunged more than 80% in 2018 (to US$5 billion), while flows from the US into China dipped 7% to US$13 billion. US firms are primarily investing in Chinese start-ups and distressed assets in the property market.

The Chinese government has indicated it is looking to halt rare earth mineral exports to the US.
However, being a key component of the global manufacturing supply chain, blocked supplies of rare earth minerals could hurt other trading partners including Japan and South Korea.

The escalation in the trade war between the US and China roiled markets in May 2019 and triggered outflows from EM bond and equity markets.
According to the Institute of International Finance, EM equities have suffered the largest outflow since the June 2013 'Taper Tantrum' in response to a resurgence in trade conflict between the US and China.

Towards the end of the month, Trump turned his attention to Mexico and announced on social media that a 5% tariff would be imposed on all goods coming into the country from Mexico. He warned the tariff would gradually increase until the illegal immigration problem was resolved.

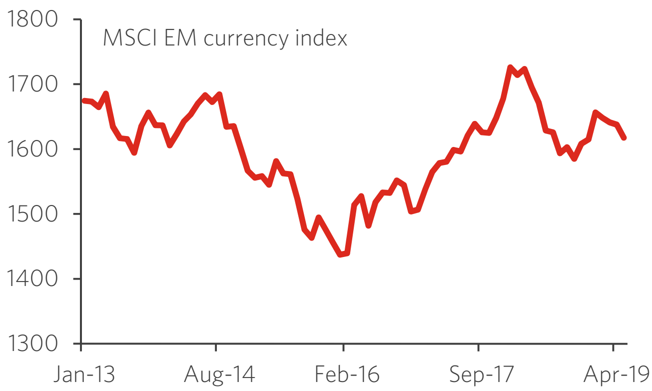
Moreover, Trump is still considering putting tariffs on Japanese auto imports unless the US can gain greater access to the Japanese market for American farmers. Nonetheless, a deal is only likely to occur after the July 2019 Japanese elections.

The US has also delayed imposing tariffs of 25% on auto imports from Europe and has agreed upon a six-month period to negotiate a trade deal with Europe that refused to allow more American agricultural products into Europe.

Canada has also been caught in the crossfire of the trade war between the US and China.
The North American trade deal included a clause disallowing any free-trade deal between China and Canada.

EM currencies reacted poorly to the likelihood that the long-drawn-out trade dispute may not be resolved soon. The MSCI EM currency index fell in May 2019 (see chart 4)

Chart 4: EM currencies hit in latest bout of risk-off sentiment



Source: Bloomberg, Momentum Investments

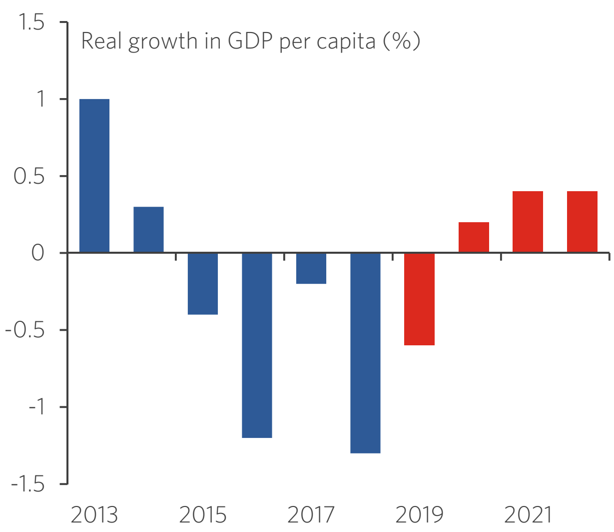
Local economic developments

The country's sovereign rating is constrained by weak per-capita growth and a rising debt burden

In its May 2019 review, S&P kept the foreign currency sovereign rating on South Africa (SA) unchanged at BB on a stable outlook. The rating agency expects some reform to follow the outcome of the 2019 national elections to improve economic growth and fiscal outcomes.

S&P predicts growth in SA will average 1.0% in 2019, 1.8% in 2020 and 2.0% in 2021. This implies real growth on a per-capita basis will remain negative in 2019 for a fifth consecutive year before improving in 2020 (see chart 5).

Chart 5: Living standards have deteriorated in SA for five years in a row



Source: Bloomberg, Momentum Investments, forecasts to 2022

S&P forecasts the country's primary fiscal balance to enter positive territory by 2020, while government's fiscal balance is expected to narrow from 4.5% in 2019 to 4.0% in 2022. This is based on S&P's assumption of an improvement in government revenues in line with an anticipated improvement in growth and better control over expenditures.

S&P acknowledged SA's debt trajectory would take longer to stabilise than previously assumed and interest payments would exceed 13% of revenue in the forecasted horizon. Nevertheless, S&P partly countered this by saying only 12% of SA's government debt was denominated in foreign currency and that shields SA from shocks in the exchange rate.

Eskom warned contingent liabilities remain sizeable in SA and could require further government support than is provisioned for. S&P recognises fixing the financial position of ailing state-owned enterprises "may only deliver results over time".

S&P warned it could lower ratings if further fiscal deterioration occurred through higher expenditure pressures or a crystallisation of contingent liabilities. A deterioration in ratings could also result if the economic performance weakened structurally or external financing pressures grew. If property rights were fundamentally undermined, S&P would also consider lowering the country's rating.

In contrast, S&P suggested the country's rating could improve if economic growth and fiscal outcomes strengthen significantly and on a sustainable basis.

Financial market performance

Global markets

It was an ugly month for global equities, which sank on the trade spat between the US and China.
This outweighed a more dovish rhetoric by major central banks in developed markets (DMs), which had benefited global equity markets in earlier months.
The MSCI All Country World Index plunged 5.9% in May 2019, driven weaker by a fallout in developed and emerging equity markets.

The CBOE Volatility index rose to nearly 19 points from 13 at the end of April 2019, reflecting increased fears over negative trade developments, Brexit and the re-emergence of geopolitical conflict involving Iran.

The MSCI DM Index finished the month 5.8% in the red, with equity markets in Japan and the US leading the index lower. The Nikkei 225 Index suffered a 7.5% knock in May 2019 in line with heightened trade conflict between the world's two-largest economies and a firmer yen, which gained on increased risk aversion.

This was followed by a 6.4% dip in the S&P 500 Index. Bloomberg noted this was the worst monthly return for May in seven years and the second-worst return since the 1960s. Negative trade developments between the US and China and Mexico hurt the return from US shares in the month and stirred volatility in global equity markets.

Global developments had a bigger effect on European shares than the European Parliamentary elections, with trade talks moving in a negative direction.
The Eurostoxx 50 Index lost 5.1% in May 2019, with automakers and banks especially hard hit. Ten-year German bond yields also fell to a new low of negative 0.2% by the end of the month. Although the sell-off made European shares cheaper than previously, European equity funds continued to experience outflows in May 2019.

EM equities underperformed DM equities in May 2019, dragging the global equity index lower. The MSCI EM Index plummeted 7.3%, driven by losses in Asian markets. The MSCI Asia sank 8.8% in May 2019 on negative trade news. Moreover, the official purchasing managers index (PMI) for China, which measures sentiment in the manufacturing sector, tipped below neutral for May. The PMI dropped to 49.4 index points from 50.1 previously and came in below the market consensus of 49.9 points, indicating near-term data out of the manufacturing sector could still be soft in China.

Losses were softer in the MSCI Europe, Middle East and African (EMEA) Index, which fell 3.7% in the month. The MSCI Latin American Index performed better on a relative basis, losing only 2.0% in May 2019. Fears over the imposition of tariffs on goods from Mexico prevented a better outcome for equity markets in the month.

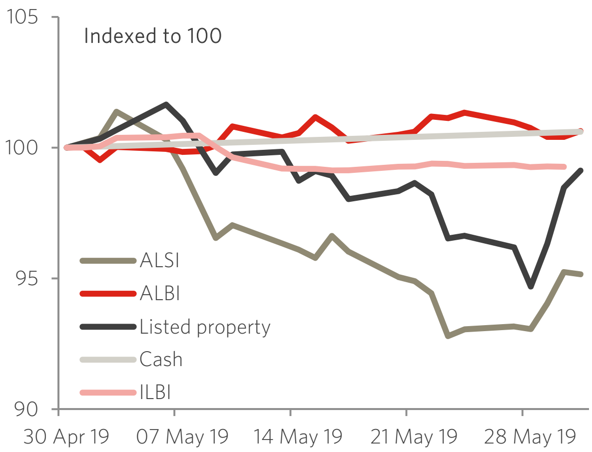
Sentiment soured towards EMs in May 2019.
The JP Morgan EM Bond Index (EMBI) spread picked up seven points in the month. Spreads for China (45 basis points), Malaysia (35 points) and Chile (32 points) deteriorated the most in the month.
The largest improvement in spreads was observed in Romania (8 basis points lower).

In line with a slight widening in the EMBI spread, the JPMorgan EM Currency Index weakened by 1.5% in the same period. Notable losses were made in the Chilean peso (negative 4.7%), Colombian peso (negative 4.3%) and Mexican peso (negative 3.4%), while the Turkish lira (2.2%) and Thai baht (0.9%) strengthened.

Local markets

SA equities followed global markets down in May 2019, as the trade war between the US and China continued to rattle markets. The FTSE/JSE All-Share Index slipped 4.8% in the month (see chart 6), dragged lower by resource and industrial shares. This was the worst return in seven months and followed five consecutive months of gains.

Chart 6: Returns from local asset classes (%)



Source: IRESS, Momentum Investments, data up to 31 May 2019

The FTSE/JSE Industrials Index dove 6.0% in May 2019. Retailers performed well in the last week of the month on a broadly positive reconfiguration of cabinet. This was followed by a 5.1% decline in the FTSE/JSE Resources Index. Although the US dollar price of gold ended the month 1.7% higher, the price of platinum sank 10.6%.

Meanwhile, losses were capped at 2.3% in the FTSE/JSE Financial Index for May 2019. Bank shares reacted favourably to the announcement of the new cabinet.

The SA 10-year government bond yield traded within a narrow range during May 2019 and ended the month at 9.0%. The JSE ASSA All Bond Index lifted 0.6% higher in the month, while the JSE ASSA Government Inflation-linked Bond Index (ILBI) and the FTSE/JSE SA Listed Property Index underperformed and ended the month 0.7% and 0.9% lower, respectively. SA cash gained 0.6% in the same period.

The SA rand traded broadly sideways for the first half of the month, before depreciating into the end of the month on higher uncertainty in global markets. The rand weakened by 1.9% against the US dollar, 1.6% against the euro and 1.2% against the sterling by the end of May 2019. SA's five-year corporate default swap (CDS) spread similarly widened by 14 points in the month.

Indices summary for May 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)	-4.75%	-0.17%	-1.08%	1.40%	2.38%	4.31%	7.26%	10.08%	
FTSE/JSE Shareholder Weighted Index (SWIX)	-5.09%	1.19%	2.80%	4.10%	4.76%	5.16%	7.85%	11.09%	12.31%
FTSE/JSE Capped SWIX All Share index	-3.53%	-2.78%	0.47%	2.20%	2.54%	5.45%	7.31%	9.04%	13.22%
FTSE/JSE All Share Top 40 Index	-2.68%	-0.76%	-13.70%	-2.73%	-1.44%	1.79%	5.72%	8.83%	11.94%
FTSE/JSE Mid Cap Index	-5.09%	-2.70%	16.59%	15.83%	5.42%	-0.43%	2.16%	2.85%	3.37%
FTSE/JSE Small Cap Index	-2.31%	-0.11%	1.32%	5.03%	3.44%	7.32%	10.02%	12.52%	15.37%
FTSE/JSE Resources Index	-5.95%	3.11%	-3.30%	-0.68%	2.37%	5.01%	7.92%	12.89%	16.46%
FTSE/JSE Financials Index	-4.33%	-0.89%	4.16%	8.20%	6.31%	5.63%	8.10%	10.44%	12.47%
FTSE/JSE Industrials Index	-4.28%	-0.72%	3.71%	8.04%	5.80%	5.40%	7.77%	10.15%	12.12%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	-0.87%	0.77%	-4.78%	-2.60%	0.26%	5.89%	6.07%	8.84%	12.55%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	-4.75%	-0.17%	-1.08%	1.40%	2.38%	4.31%	7.26%	10.08%	
FTSE/JSE SA Listed Property Index (SAPY)	-5.09%	1.19%	2.80%	4.10%	4.76%	5.16%	7.85%	11.09%	12.31%
Interest-bearing indices									
JSE ASSA All Bond Index (ALBI)	0.64%	2.74%	7.75%	10.49%	8.03%	8.31%	7.38%	7.96%	8.75%
JSE ASSA All Bond Index 1-3 years (ALBI)	0.88%	2.51%	10.24%	9.27%	8.53%	8.14%	7.62%	7.39%	7.71%
JSE ASSA SA Government ILB Index	-0.97%	1.58%	1.52%	2.30%	3.45%	4.01%	4.06%	6.00%	7.08%
Short-term Fixed Interest Composite Index (SteFI)	0.61%	1.82%	7.29%	7.44%	7.27%	7.07%	6.78%	6.57%	6.56%
Commodities									
NewGold Exchange-Traded Fund	3.47%	2.77%	14.82%	-0.57%	6.57%	7.20%	4.78%	4.67%	8.77%
Gold price (in rands)	2.98%	2.42%	14.30%	-0.26%	6.93%	7.58%	4.96%	5.20%	9.28%
Platinum Exchange-Traded Fund	-8.93%	-5.03%	0.47%	-9.19%	-4.22%	-5.83%	-2.16%		
Platinum price (in rands)	-10.10%	-6.01%	-0.40%	-9.09%	-3.83%	-5.53%	-2.59%	-3.29%	-0.27%
Currency movements									
Rand/euro movements	0.98%	1.35%	9.71%	-2.53%	5.01%	2.36%	3.71%	6.28%	3.61%
Rand/dollar movements	1.55%	3.56%	14.93%	-2.56%	4.62%	6.59%	6.36%	7.87%	6.11%
Inflation index									
Consumer Price Index (CPI)			4.39%	4.75%	5.11%	4.99%	5.18%	5.28%	5.21%

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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