momentum
investments

The Macro Research Desk

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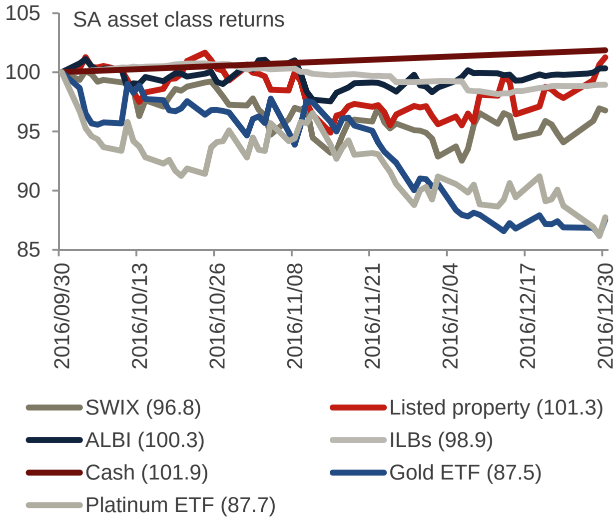
Quarterly economic and market review for the quarter ended 31 December 2016

Global stimulus baton passed from monetary to fiscal policy

There is increasing evidence that the global economy is in the process of transitioning from an era of deflation to reflation and that the global stimulus baton is being passed from monetary to fiscal policy in the developed world. Personified by Britain's decision to leave the European Union (Brexit) and Donald Trump's victory in the United States (US) presidential election, disgruntled developed world voters have intensified pressures on politicians to improve their economic circumstances. In essence, electorates are now demanding a direct positive stimulus to all income levels, rather than the previous stimulus aimed at the wealth levels of only a selected few via the support of asset prices through quantitative easing (QE) policies. In response to this anti-establishment sentiment, there has been a renewed political focus on fiscal transfers, either through higher public spending or cutting tax burdens, as a means to improve the livelihoods of voter constituencies. This has tilted the fundamental dial in favour of global equities as an asset class vis-à-vis global government bonds, as already reflected in a strong outperformance of global equities over global bonds in the fourth quarter of 2016, with equities providing positive returns counter to the significant losses experienced by bonds.

During the final quarter of 2016, the perceived fiscally induced growth-enhancing effect of the Trump victory has increased US policy rate expectations, combining to drive the US dollar stronger against developed and emerging market (EM) currencies, with a resultant negative effect on commodity prices. As a result, the gold and platinum exchange-traded funds (ETFs) were the worst performers by far among the South African (SA) asset classes during the quarter (see chart 1). Although the rand was basically unchanged for the quarter, this belies the fact that the currency strengthened on improving domestic political sentiment during the first half of the quarter, only to falter in the aftermath of the US election results. Cash, listed property and bonds, in that order, were the domestic asset class winners in the quarter, with the latter two supported by an improving SA inflation and interest rate outlook.

Chart 1: SA asset class returns for 4Q16 (indexed)



Source: INET BFA, Momentum Investments

Although elevated volatility levels should be expected in financial markets during 2017, due to the known unknowns of (1) the uncertainty associated with the eventual policy measures undertaken by new US president Trump, (2) the unclear outcomes of a multitude of European elections upcoming in 2017 and (3) the advent of the Brexit process, fundamentals and valuations should favour global equities over global bonds in 2017.

Momentum Investments expects global equities to benefit fundamentally from reflation policies during 2017, not only providing investors with superior asset growth, but also delivering much better income flows than the traditional income-producing asset classes like global bonds and cash. In contrast, rising inflation and negative supply/demand dynamics from concomitant fiscal expansion and QE tapering would be fundamentally negative for global bonds.

In addition, equities also have the added advantage of much more attractive valuations than fixed income, thus further enhancing potential future relative returns from the equity asset class. As such, Momentum Investments has a strong preference for global equities over global bonds and cash in its portfolios entering 2017.

Some expected rand weakness during the year in response to political and sovereign rating downgrade risk should add to the returns on global asset classes for SA investors.

Although the local equity market's earnings recovery is very much dependent on the sustainability of the commodity price rally, less expensive valuations now point to relatively decent future returns, in Momentum Investments' view. The company considers local bonds to have an attractive risk/return profile against the backdrop of the ongoing global carry trade and an improving envisaged domestic inflation and policy rate profile. Momentum Investments' view that the inflation risk premium currently discounted by inflation-linked bonds remains too high makes the company still favour vanilla bonds over linkers in its portfolios.

Recent underperformance from listed property has meaningfully improved its future return prospects, in Momentum Investments' opinion, particularly against the backdrop of an improved domestic bond market outlook and a better-than-expected domestic growth return. Although risk-adjusted domestic cash returns still look decent in a low-return environment, reinvestment risk should increase going forward, as the local interest rate cycle peaks.

Political uncertainty dominates the economic outlook

The global economy has undergone a prolonged period of disappointing growth following the worst financial crisis since the Great Depression in the 1930s. Several structural factors, including ageing populations, over-indebtedness and weak productivity, have stifled the uneven economic recovery, following the 2008/2009 global financial crisis.

Government responses to the crisis, in which near-zero interest rates and QE-generated inflated asset prices, favoured the rich. Large parts of the population have been excluded from the increase in prosperity, resulting in a rise in voter frustration, which has splintered electoral landscapes in western economies. The electorate is in search of an alternative to monetary policy, which acted as a single stimulus engine to anaemic growth in recent years, but is now facing diminishing returns.

Long-term, growth-enhancing reform agendas will be crucial in navigating the expected global economic expansion through choppy political waters.

Although the global economy appeared to have shrugged off earlier unimagined political outcomes (namely Brexit and Trump's election victory) through further stimulus and a swift response by central banks, the world economy is hardly in peak condition. While less austere budgets could temporarily boost growth, an increase in borrowing today by the public and private sectors risks narrowing growth prospects in the future.

Momentum Investments expects a modest growth trajectory in developed economies in the medium term, with the United Kingdom (UK) and Japan remaining the laggards, while improving fundamentals and continued policy support should underpin relatively firmer economic activity in the US and Eurozone, respectively.

Together with strengthening macro-fundamentals in emerging economies (including smaller external balances and sturdier growth prospects), risks to the consensus global growth outlook of around 3% in 2017 appear more balanced this time around.

However, given the high dispersion around possible economic outcomes in a politically fraught environment, the anticipated modest recovery in global growth is not without risks. While a rising fiscal tide in the US could lift all global boats, a more inward-looking US is a key threat to EMs, which have relied on an export-led growth strategy to catch up to their richer counterparts. A sharp move towards trade protectionism could trigger reactive tariff wars and a collapse of global trade (see chart 2) – a scenario under which all players lose.

Chart 2: Global trade activity has peaked

Source: World Bank, Momentum Investments

Trump is now faced with the challenge of bridging the chasm between the rich and poor at a time when the US debt-to-GDP (gross domestic product) ratio is closer to 100%, limiting fiscal headroom.

Anticipated Trump stimulus could lengthen the current (already-extended) business cycle, reducing the probability of a near-term recession. While tax and regulatory changes could boost confidence and rekindle investment, there is great uncertainty attached to how much of Trump's agenda will become a reality. At this stage, it is unknown whether the proposed economic stimulus will outweigh the economic drag posed by higher trade barriers and dollar strength. If it does, this could result in an overheating of the US. A faster pace of interest rate tightening would likely follow, bringing forward the prospect of a sharper downturn as early as 2018. Depending on the timing of proposed changes to US immigration and anti-trade policies, higher labour and imported input costs could lead to a growth offset and a higher inflation outcome, necessitating a reaction from the US Federal Reserve (Fed).

The likelihood of increased fiscal stimulus should also see the Fed raising interest rates more aggressively. Initially, Momentum Investments expects the Fed to continue to err on the side of caution and push through a further two interest rate hikes by the end of 2017. However, the pace of interest rate hikes could accelerate thereafter in response to higher inflation triggered by additional fiscal stimulus at full employment levels.

A downside risk scenario cannot be ruled out. Should Trump initiate major trade conflicts with key trading partners, the US economy could be faced with onerous countermeasures, which could weigh negatively on growth. A disruption in trade between the US and China, in particular, could have dire consequences for the rest of the world.

Populism could alter Europe's economic future

Eurosceptic populism is likely to remain a significant theme in 2017, in response to the decline in living standards and stubbornly high unemployment levels (amid a migrant crisis) plaguing the region. The main challenge facing mainstream political parties is boosting growth and employment, while preserving the Eurozone's balance sheet. Limited fiscal room could cap trend growth in the Eurozone, while the potential for a rise in trade protectionism poses a further headwind to growth.

In Momentum Investments' opinion, it is difficult to see where growth will come from in the absence of broad-based structural reforms. The European Central Bank's decision to extend asset purchases to the end of 2017, albeit at a slower pace, is likely to keep real GDP growth in positive territory in 2017, but the pace is expected to soften relative to 2016 levels. Tailwinds to domestic demand should lessen in response to moderately rising inflation, while likely volatile Brexit negotiations are expected to shave off another few basis points from growth.

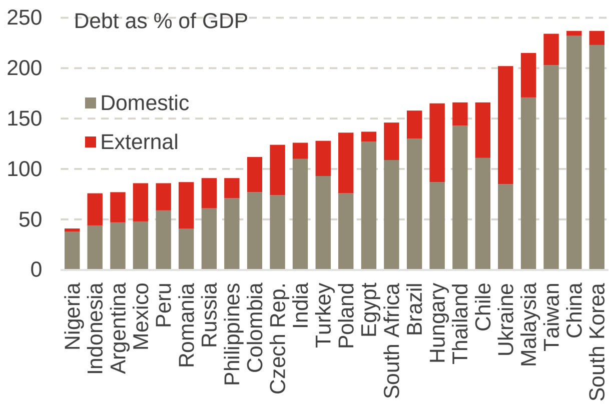
A series of important elections and referenda are lined up for 2017, creating a disruptive political backdrop for growth in the Eurozone. Although the political centre held in Austria in the December 2016 presidential election, polls have shown strong support for Norbery Hofer's far-right Freedom party. Meanwhile, the likelihood of political instability has risen in Italy, with Prime Minister Renzi's wide-margin defeat in a referendum vote in December 2016 ending hopes for an acceleration in reforms. Opinion polling in the run up to the March 2017 Dutch general election shows dwindling support for the far-right Party for Freedom, while rising support for the Alternative for Germany is unlikely to unseat the current leadership in the federal election to be held in the second half of 2017. Meanwhile, cracks are beginning to show in France's National Front party ahead of the April/May 2017 presidential election. However, the general feeling of disenfranchisement with current politicians should not be overlooked. A 'Frexit' (France exiting the European Union), in an effort to retain monetary, legislative, territorial and budget sovereignty, while not the base case, could trigger a widespread crisis.

Anti-globalisation sentiment a longer-term threat to EM

On the surface, a Trump presidential victory is clearly negative for the EM composite. Growth is vulnerable to increased trade protectionism, anti-immigration measures and an uncertain outlook on foreign policy. Nevertheless, it is likely that 2016 marked the bottom of the EM growth cycle as a further stabilisation in commodity prices (avoiding balance-of-payments struggles and fiscal deterioration) and an improvement in growth in recession-hit Brazil and Russia provide an underpin for growth in 2017.

Nonetheless, the region remains highly sensitive to policy changes in the US. EMs reliant on trade could face the backlash of anti-globalisation sentiment, while the prospect of rising US yields is a risk to emerging economies with a high level of dollar-denominated debt (see chart 3).

Chart 3: External risks facing a handful of EMs



Source: Capital Economics, Momentum Investments

Although industrial overcapacity, unfavourable demographics and slowing productivity gains point to softer trend growth rates, a sharp near-term downturn in Chinese economic activity is unlikely to be a key risk to EM growth. Chinese authorities appear to remain supportive of growth in the run up to the 19th Party Congress in November 2017. Weaker support for infrastructure funding and a correction in the property market could see growth slipping marginally in 2017 from 2016 levels, but growth is unlikely to significantly undershoot China's Five-Year Plan of 6.5%. While the debt can is likely to be kicked further down the road, greater near-term risks, in Momentum Investments' view, involve trade disputes with the US and capital flight if the currency falls too sharply.

Mild growth improvement expected in SA

Growth in SA is set to improve marginally in 2017. Agricultural output is estimated to recover thanks to higher rainfall, while exports are likely to piggyback off slightly better global economic activity and a modest revival in commodity prices. Restocking in response to higher growth expectations could lift growth to above 1% in 2017. Nonetheless, growth is likely to remain sluggish, as political uncertainty ahead of the ruling party's elective conference in December 2017 deters fixed investment and purchases of big-ticket consumer goods.

Though lower food inflation and a probable shift to looser monetary policy in the latter half of 2017 should provide some relief to consumers, households remain exposed to a bleak jobs outlook, high levels of indebtedness and the potential for higher taxes. Based on Momentum Investments' forecasts for headline inflation to drop more meaningfully on a two-year outlook, the company expects further interest rate cuts in 2018 to benefit consumption spend further out. With SA corporates still voicing concerns over muted domestic demand and uncertainty regarding economic policy, employment growth is only likely to improve meaningfully beyond 2017, becoming a larger contributor to household consumption in 2018. In addition, the phasing in of the national minimum wage should have a larger positive effect on consumption in a medium- rather than near-term view.

Despite government identifying necessary reforms and supply-side bottlenecks, the ratings agencies share the view that more needs to be done to instil confidence in SA's growth trajectory. They have warned that recent politically motivated events have detracted from the progress on growth-enhancing reform implementation and could further negatively affect the direction of government policy, damaging growth prospects and constricting fiscal room to manoeuvre.

A tumultuous year in domestic politics has elicited a show of democracy. Business leaders are at long last taking a more assertive stance on SA politics to ensure a more business-friendly climate. Big business, in collaboration with government, are tackling the debilitating issue of unemployment through a small business fund and a youth employment programme.

Some progress has been made in providing a more stable labour environment. A recognition of strike balloting (to limit strike-related intimidation) and the empowerment of the Commission for Conciliation, Mediation and Arbitration (CCMA) to intervene in protracted or violent strikes should lower the barriers to hiring.

That said, labour has pushed back against the idea of a second strike ballot (a way to gauge whether workers want to return to work during a lengthy strike) and could oppose the national minimum wage level proposed. This, together with upcoming wage agreements in the coal, steel and engineering sectors, could spark labour unrest by the middle of 2017.

Although SA scores higher than its peers on the World Bank Governance Indicator, the ratings agencies warn that rising perceptions of political interference in key spheres of government institutions threaten SA's macroeconomic performance, public finances and, consequently, the ratings outlook. The capturing of key state-owned enterprises and failure to comply with global regulations are risks to attracting necessary foreign capital flows, considering SA's low domestic savings rate.

Together with political challenges to domestic policy implementation, negative developments in US-China trade relations and its effect on commodity prices act as key downside risks to SA's potential growth profile. As such, Momentum Investments sees a strong chance of a foreign rating downgrade by S&P to sub-investment grade by June 2017. During this timeframe, Fitch is likely to maintain its negative outlook, while there is a high probability that Moody's could downgrade its more-optimistic Baa2 rating by one notch.

Treasury has warned that a sub-investment grade status could translate into higher interest payments, a weaker rand, a higher cost of living, reduced fiscal space to address escalating spending pressures and subdued confidence, ultimately translating into low investment and weak job creation. Nonetheless, unlike the unfavourable fiscal response triggered in Brazil, following a rating downgrade to junk, which led to a downgrade spiral, Momentum Investments expects a downgrade of the foreign rating into junk status to induce an appropriate response from the SA authorities. Government is likely to adhere to fiscal consolidation and trigger vital structural reforms to reverse a potential sub-investment grade rating within the next five-year horizon.