momentum investments

Quarterly Market and Economic Review

Quarter ended 30 June 2016

From left to right:
Herman van Papendorp (Head of Investment Research and Asset Allocation),
Sanisha Packirisamy (Economist)

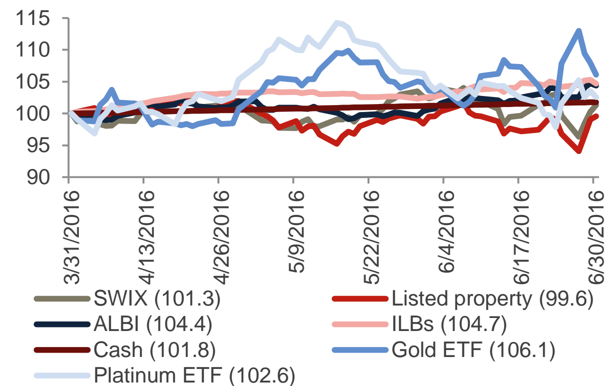
Brexit triggers renewed financial market instability

British voters' decision towards the end of 2Q16 to leave the European Union (EU) provides further evidence that anti-establishment attitudes are gaining momentum globally. This has resulted in increased political and economic uncertainty among investors, businesses and consumers.

The reality that dampened sentiment will likely have negative consequences for both global growth (as companies postpone investment and hiring) and the flow of global capital around the world has directly impacted the performance of global asset classes since Brexit. Up to June 23rd, global equity markets were decently up, with global bond yields relatively unchanged. However, in the last week of the quarter, the risk-off sentiment induced by Brexit caused a sell-off in global equities and supported a meaningful decline in global bond yields. For 2Q16 as a whole, perceived safe-haven assets were the clear outperformers, viz. gold and fixed income, while more risky assets like global and local equities were basically flat over the quarter.

With global policymakers likely to lean towards more monetary and fiscal accommodation in response to the renewed financial market instability and global growth risks, there should be ongoing support for financial assets going forward. Some expected rand weakness over the next year in response to sovereign rating downgrade risk should add to the returns on global assets for SA investors. Our preference for global equities over bonds are premised on the high likelihood that equities will produce both superior capital and income returns against the backdrop of very attractive relative valuations. While a flat local equity market over the past two years has increased its absolute return prospects, its risk-adjusted returns are still estimated to be below that of domestic cash, which remains an attractive asset class in a low-return environment in the interim.

Chart 1: SA asset class performance in 2Q16 (indexed)



Source: INET BFA, Momentum Investments

While there should be global carry trade support for the local bond market, prospective risk-adjusted cash returns also look preferable to bonds. Our view that the inflation risk premium currently discounted by inflation-linked bonds is too high makes us favour vanilla bonds over linkers in our portfolios. Listed property remains an expensive asset class at current levels, in our opinion.

Global anti-establishment rebellion awakens

The tepid global economic recovery over the last eight years has been very unbalanced as authorities' attempts to shore up growth led to a rise in the cost of living and a fall in living standards for all but the world's wealthiest groups. Instead of central banks making more funds available via the commercial banking sector to enable individuals and businesses to boost economic activity, quantitative easing (large-scale asset purchases) has largely benefited those who own assets through the creation of asset price inflation.

Credit Suisse's 2015 Global Wealth Report shows that the rise in financial asset prices has led to the world's top percentile of wealth holders owning half of the world's wealth and the richest decile 87.7%.

Central bank balance sheets have already peaked as a share of GDP in the United States (US) and United Kingdom (UK), at 26% in 4Q14 and 25% in 4Q12 respectively, whereas the European Central Bank (32% of GDP) and Bank of Japan (85% of GDP) are increasingly trying unconventional and untested variations of monetary easing to reinvigorate growth. Meanwhile, quantitative easing and record-low interest rates have fuelled financial inequality, providing an environment in which support for populist political leanings has emerged more strongly. Rising public dissatisfaction with the present state of affairs and the responses of incumbent governments to the status quo have led to a loss in faith in mainstream parties and a rise in popularity of more extremist political views.

As anxiety over immigration, globalisation and technological advances (leading to a displacement of labour) has grown, anti-establishment sentiment has drawn increasing support across the Western world. This has ranged from support for Donald Trump in the US to voters increasingly embracing France's right-wing National Front, Germany's far-right AfD (Alternative for Germany), Italy's Eurosceptic party Lega Nord and anti-austerity left-wing alliances in Greece (Syriza) and Spain (Podemos). More recently, the UK's victorious "leave" vote left financial markets stunned and has stirred fears of a domino effect rippling through Europe.

With more than a million migrants and refugees crossing into Europe in 2015, further division has been sowed over how to manage the influx of displaced people. The European Central Bank (ECB) cautioned in their May 2016 Financial Stability Review that "increasing support for political forces which are seen to be less reform-oriented may potentially lead to the delay of much-needed fiscal and structural reforms." A delay or insufficient progress on reforms, particularly in the context of sluggish growth, will likely weaken the outlook for sovereign debt sustainability. As such, the ECB warned that "renewed pressure on more vulnerable sovereigns (could) potentially contribute to contagion and re-fragmentation in the euro area."

Though financial panic following Britain's vote to leave the EU has not reached the levels experienced during the collapse of financial services firm Lehman Brothers in 2008 or the Greek debt restructuring in 2012, new risks surrounding the global economic outlook have emerged. Rising sovereignty and nationalism sentiment are displacing economics as a key driver of voter attitudes. Less than a quarter of respondents surveyed in the European Commission Eurobarometer are optimistic on growth prospects in the Netherlands if the country were to exit the EU. Yet, Capital Economics notes that opinion polls suggest that if an election were held now Eurosceptic parties in the Netherlands would capture a larger 57% of the vote.

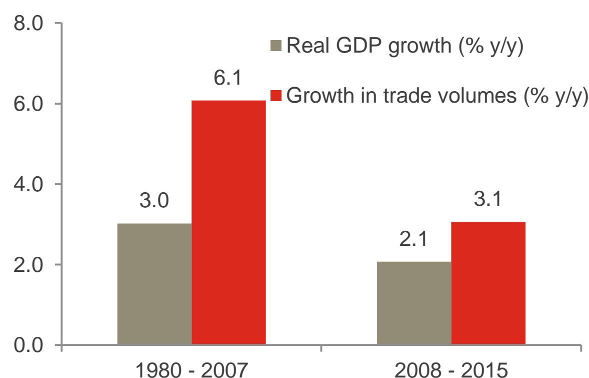
Globalisation trend loses momentum

The number of protectionist measures and trade restrictions across G20 countries (a group including some of the world's largest economies) touched a new high against the backdrop of increasing scepticism towards free markets and free trade. The Bank of Canada attributes the post-crisis slowdown in global trade to diminished incentives to expand trade, a change in the composition of global demand and increased protectionism.

Between 1980 and 2007, world trade volumes on average increased at twice the rate of real global GDP growth. However, as politics continues to tilt towards less openness in favour of a retreat from globalisation, the ease with which capital and labour move from one jurisdiction to another will likely be compromised. Lower policy predictability will also probably lead to a further deterioration in the business environment, capping long-term growth prospects.

Growth in global GDP has slowed from an average of 3% between 1980 and 2007 to 2.1% in the last eight years (see chart 2). The International Monetary Fund (IMF) has previously shown that potential growth in advanced economies has been negatively impacted by an ageing demographic, low investment spend and a slowdown in total productivity.

Chart 2: Sluggish global trade activity



Source: IMF, Momentum Investments

In addition to lower labour force growth and infrastructure bottlenecks, the IMF postulates that less favourable external financing conditions and softer commodity price growth will curb trend growth prospects in the emerging world. Reviving global economic activity will be a difficult task while world trade growth is struggling to gain traction. As such, we expect only a gradual acceleration in global growth toward a mediocre growth path, with downside risks stemming from increased financial market volatility, limited policy space and geopolitical risk factors.

Risks posed by ultra-accommodative global monetary policy

Despite anaemic growth keeping near-term inflation low, the Bank of International Settlements (BIS) has cautioned against the risk of mounting macro-economic dislocations resulting from "overly accommodative aggregate monetary conditions for the global economy". They argue that although authorities have little incentive to tighten policies as long as inflation remains low and stable, monetary policy regimes focusing on near-term inflation control could provide less resistance to the build-up of financial imbalances.

The BIS goes on to say that the recent financial boom had been fuelled by excessive risk taking as asset values surged and incentives to take on risk grew. Ample liquidity and aggressive risk taking has resulted in outsized financial cycles, stretching government balance sheets and papering over the cracks in the real economy.

The BIS study further shows that financial cycles can last for far longer (16 to 20 years) than a traditional business cycle (up to 8 years) and can lead to deeper and more permanent output losses, generating weaker growth recoveries. The institution recommends that alongside establishing a number of macro-prudential policy buffers, authorities should limit the degree and length of monetary policy accommodation to prevent the unwanted build-up of imbalances. Fiscal space also needs to be created to support the repair of private sector balance sheets without triggering a sovereign crisis given the typical overestimation of potential growth in the latter half of a protracted financial cycle and the impact that slow growth has on contingent liabilities.

In addition to leaning against the build-up of financial imbalances and creating policy room to manoeuvre in the next economic downturn, a stabilisation in US growth (buoyed by consumption and services spend) and a gradual strengthening in inflation further point to the need for further interest rate hikes. However, we expect the US Federal Reserve to maintain a cautious stance on the pace and extent of rate tightening in response to rising external risks. Meanwhile, renewed market instability as a result of Brexit argues for further monetary and fiscal accommodation in the Eurozone and Japan, where growth and inflation outcomes remain more downbeat. However, given that each successive round of monetary policy easing by the ECB and the Bank of Japan has resulted in diminishing returns to their respective economies, a faster implementation of structural reforms, in our view, would be of greater benefit.

Diverse EM outcomes

Arguably a low interest rate environment in advanced economies has encouraged robust growth in US dollar-denominated debt in EMs. Meanwhile, commodity prices have plummeted and capital outflows were recorded in EM during the past two years. Aside from capital flows, diverse growth outcomes across EMs have also been driven by relative sensitivities to a muted commodity price environment, the pace of structural reform momentum, the level of foreign debt and the availability of policy buffers.

A negative terms-of-trade (export prices relative to import prices) shock has driven a sharp slowdown in domestic demand in net commodity-exporting EMs, while commodity-importing EMs have been far more resilient. Weaker growth in the former has led to larger external imbalances, an extension of government budget deficits and elevated debt burdens. This has left an increasing number of net commodity-exporting nations in a poorer credit standing and with limited policy buffers to protect growth.

Although the initial shock of the Brexit vote has triggered a flight to safety, we expect the dust to eventually settle in EM. Growth in retail sales and exports in the weaker-performing regions appear to be bottoming out, while expectations of better weather conditions and a stabilisation in commodity prices are expected to support a mild recovery in 2017.

Low growth remains a threat to SA's credit worthiness

As with many other commodity producers with large external imbalances, the SA economy remains vulnerable. Between a slowing Chinese economy, soft commodity prices and the US Fed's well-telegraphed intent to gradually normalise monetary policy, SA's growth outlook is set to remain fragile in the medium term.

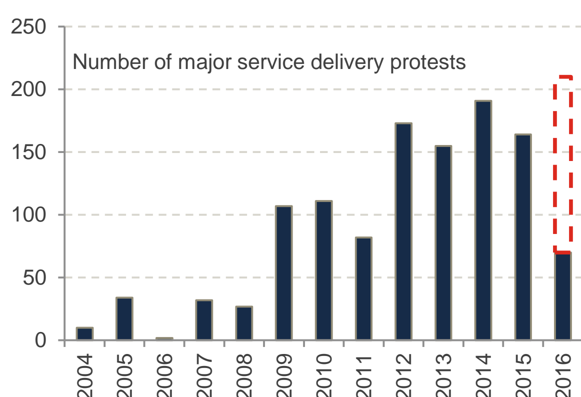
The severity of the drought in late 2015 compounded SA's (largely structural) growth challenges. The expectation of better weather conditions, as the El Nino weather phase transitions to a La Nina cycle (characterised by higher rainfall), and a stabilisation in commodity prices should help growth recover on a cyclical basis, while follow-through on the engagement between business and labour remains crucial in rebuilding SA's structural growth potential.

Though the key rating agencies have commended SA on the strength of its institutions in a tough economic climate and have acknowledged government's commitment to the expenditure ceiling and the stabilisation of SA's debt ratio, fiscal risks have risen against the backdrop of low growth. Between Standard and Poor's (S&P), Moody's and Fitch, four key areas of concern were highlighted in their latest sovereign rating reviews.

Firstly, they emphasize the need to reinvigorate growth through securing a healthier investment climate and enhancing relative competitiveness. Alleviating infrastructural bottlenecks, including a reliable source of energy supply, remain key in improving investor sentiment, while key upcoming political events and shaky labour relations still pose risks. Moreover, SA needs to establish legislative/regulatory clarity in key areas where the outlook has become murky. This includes finalising reforms in the labour and mining sector in particular.

Secondly, the rating agencies note that SA's fiscal and debt consolidation timelines are jeopardised by a bloated public sector wage bill. With the average return on equity for SA's state-owned enterprises having declined by 3% in FY14/15, higher funding demands pose a further threat to stabilising government's debt levels over the medium term.

Chart 3: Rising social tensions



Source: Municipal IQ, Momentum Investments

Inequality and rising social tensions are an additional factor worrying rating agencies. Although Stats SA's 2016 Community Survey boasts a further rollout of basic services and a steady decline in poverty since 1994, data collected by Municipal IQ shows a rise in dissatisfaction. If one extrapolates the number of service delivery protests observed in the first four months to the full year, 2016 could register the highest number of protests on record (see chart 3). Any threat to weakening support for the current ruling party could increase the urgency to ramp up expenditure. Against a subdued growth backdrop, achieving higher levels of expenditure will be challenging and could threaten government's commitment to its self-imposed expenditure ceiling.

Lastly, the rating agencies have highlighted SA's institutional credibility. Although the rating agencies praised the independence of SA's key institutions (particularly the response of SA's Public Protector and the Judiciary more recently), they warned that political tensions have risen since Nenegate in December 2015.

The credit default swap (CDS) market (a measure of overall country risk) continues to price SA at a notch below investment grade. This is in line with our view that a low growth environment will ultimately lead to rising fiscal vulnerabilities, resulting in a high probability that SA will lose its investment grade status over the next year. With the risk of a rating downgrade looming and commodity prices remaining soft in the near term, the currency is likely to trade with a weakening bias over the next year.

Previous unfavourable movements in the currency and food inflation are expected to propel headline inflation higher over the course of the next two quarters, before staging a recovery in 2017 as better weather conditions drive food inflation lower. While lacklustre growth and the expectation of a decelerating inflation trajectory suggest a narrowing window for further interest rate increases, SA's sizeable twin deficits and stubbornly-high inflation expectations point to the likelihood of a further rate rise before the year is up.

Disclaimer:
Reasonable steps have been taken to ensure the validity and accuracy of the information in this document. However, Momentum Investments (Pty) Ltd 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. The content used in this document is sourced from various media publications, the Internet and Momentum Investments (Pty) Ltd. For further information, please visit us at www.momentuminv.co.za.