momentum
investments

The Macro Research Desk

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Economic and market snapshot for the quarter ended September 2016

Global 'hunt for yield' driving asset class returns

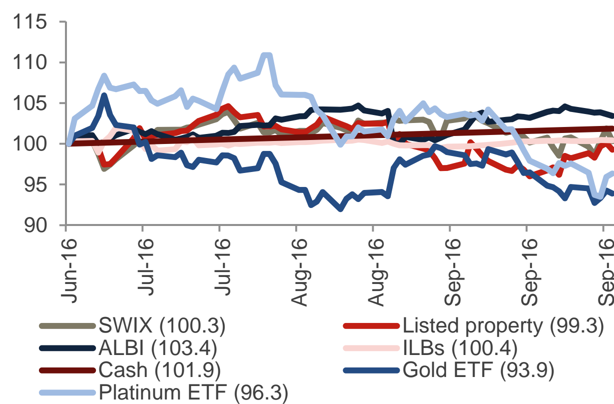
Against the backdrop of diminishing returns available from global developed market (DM) fixed-interest investments (close to 40% of DM sovereign bonds are now negative yielding), investors have been forced to scour the globe for better-yielding investments. As such, prices of global equities, as the superior income-producing investment, have been bid up vis-à-vis global bonds. Similarly, higher emerging market (EM) bond yields have attracted significant foreign interest during 3Q16, culminating in stronger EM currencies. SA bonds also received fundamental support from indications that local interest rates are close to their peak in anticipation of lower local inflation during 2017.

During the quarter, global equities strongly outperformed global bonds and cash, while a 7% stronger rand eroded returns from all rand-sensitive asset class returns, including global asset classes and the gold and platinum exchange-traded funds (ETFs). SA bonds were the strongest local asset class performer, with local cash providing decent low-risk returns in 3Q16.

Not only do global equities still provide investors with favourable growth prospects over time, they also provide much better near-term income flows than the traditional income-producing asset classes like bonds and cash, in Momentum Investments' view. Furthermore, equities also have the added advantage of much more attractive valuations than the latter, further enhancing potential future relative returns from equities. Indications that policy makers might soon be forced to use fiscal stimulus levers would be fundamentally negative for global bonds. As such, Momentum Investments has a strong preference for global equities over global bonds and cash in its portfolios. Some expected rand weakness in the next 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 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 local 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 inflation-linked bonds in its portfolios.

Chart 1: SA asset class returns in 3Q16 (indexed)



Source: INET BFA, Momentum Investments

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

Reforms vital for global growth to structurally shift gears

The share of the global population experiencing flat or falling incomes has surged in advanced economies. McKinsey's Global Institute report, 'Poorer than their parents', outlines that the positive (global) trend in income has ended. As recently as between 1993 and 2005, 98% of advanced economies (sample of 25 countries) saw real incomes rise.

However, real market incomes (comprising wages and income from capital) for over two-thirds of households in those same economies were either flat or deteriorated in the decade that followed.

Though a reduction in taxes and increased government transfers were aimed at protecting household incomes, lower investment returns, a smaller share of GDP ending up in the hands of workers, a demographic shift towards fewer working-age adults and sluggish growth in output and demand have negatively affected median household incomes.

The study found that less-educated workers, especially younger ones, have been hit the hardest.
The International Labour Organisation (ILO) calculates that 37% of the global unemployed in 2014 were youth (aged 15 to 24) with the rate of global youth unemployment settling at 13% between 2012 and 2014. The ILO warns that there "could be lingering harm accruing to the cohorts who experienced long-term unemployment spells", which may result in economic and social disruption further down the line.

Recent government regimes have failed to remedy the protracted period of real income stagnation suffered by the majority, which has given rise to far-right, anti-establishment and populist parties. Anti-immigration and anti-globalisation movements have also gained support in line with shifting global cultural trends. Global Trade Alert points out that world export volumes plateaued in January 2015. Policy initiatives harming foreign commercial interests in 2015 outnumbered

trade liberalisation three-to-one, revealing a rise in protectionist political rhetoric.

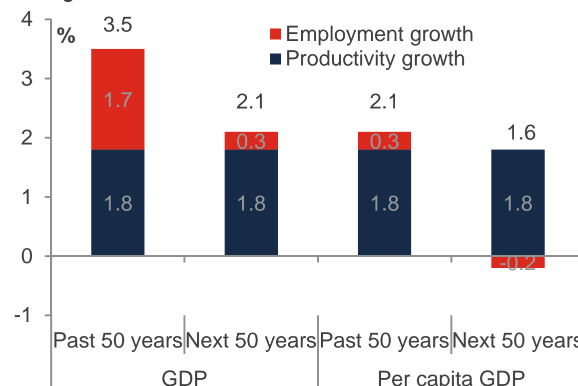
With economic prosperity slipping globally, free-market capitalism has come under fire. Support for previously unthinkable ideologies has mushroomed, as few mainstream political movements are deemed to provide an attractive alternative to a disgruntled electorate who has become frustrated with the current leadership holding political office. As a result, with political uncertainty climbing, a populist, anti-establishment Trump victory in the US presidential election cannot be ruled out.

Moody's Analytics warns that Trump's proposed changes to immigration and trade policies would result in a more isolated United States (US) economy. They conclude that the implementation of Trump's economic policies would diminish the nation's growth prospects (2.4% decline from peak to trough), resulting in higher unemployment (3.5 million fewer jobs than under current economic policies). Government deficits are likely to widen (close to 10% of gross domestic product (GDP)) under a Trump presidency, worsening the country's debt burden (climbing to 95% of GDP), while his tax proposals would likely see no improvement in living standards for the average American family.

International Monetary Fund (IMF) managing director, Christine Lagarde, recently warned that further reductions in global growth potential and more obstacles to the free movement of goods and capital would prove detrimental to all. She urged G20 leaders (representing countries that account for 85% of global GDP and 75% of global trade) to make a stronger case for the benefits of trade and suggested that those "harmed by trade and innovation need to be helped by policies to allow them to retrain and acquire new skills and job mobility".

Global potential growth faces additional headwinds. McKinsey reasons that productivity growth would have to accelerate by 80% from its historical rate to fully compensate for weakening labour growth (a function of declining population growth). If productivity growth remains at 1.8% (the average pace over the past 50 years), the rate of GDP growth is set to be 40% lower than the 3.5% average recorded over the past 50 years (see chart 2).

Chart 2: Demographic headwinds impede global GDP growth



Source: McKinsey, Momentum Investments

Maintaining the long-term growth rate in productivity may prove to be challenging given that productivity growth has slid across advanced economies for the past decade. Although there is an argument to be made that the rise in the digital economy has not been adequately accounted for, regulatory barriers, rising protectionism, little growth in innovation and slowing investment (as a result of a misallocation of capital) have dragged productivity growth lower.

McKinsey proposes encouraging business expansion, labour market reform and upskilling the labour force to rekindle economic activity and support job creation. Innovation has also proven to be key in advancing social mobility through the creation of new firms and additional employment opportunities.
US Federal Reserve (Fed) Chair, Janet Yellen, has echoed these sentiments, calling for more investment, education, training and entrepreneurship to reverse the slowing trend in productivity growth.

Meanwhile, entrepreneurship has waned in key economies. The percentage of young (under five years) firms as a share of total firms in the US has dwindled from c.50% in 1980 to 37% in the latest available data for 2011, accounting for a quarter of total employment from a third previously. This could be partly blamed on the lack of adequate fiscal action by politicians, forcing central banks to pump excessive stimulus into the global economy. The response from the financial industry has been a change in focus from lending to speculation in a low interest rate environment, evident in the price of real investments plunging to its lowest level on record relative to financial investments.

McKinsey argues that it is possible to counter waning demographic tailwinds to safeguard living standards. Removing barriers to competition, increasing efficiency in regulated sectors, incentivising research and development, investing in digital and physical infrastructure, promoting labour market flexibility and opening up economies are some of the ways the global economy can reinvigorate growth.

EM looking more attractive on a cyclical basis

Market forecasts are generally predicting an era of much lower investment returns during the next decade. According to the Financial Times, more than 30% of global government debt offers yields of less than zero. As such, the search for higher yields has forced more conservative investors into riskier asset classes. Between March and September 2016, total portfolio inflows into EM netted R117 billion, relative to R6.5 billion for the same period the year before. Meanwhile, fundamentals are looking better across EM. The growth differential between EM and DM peaked in 2009 at 6.4%, but has since narrowed to 2.1% in 2015. Plunging commodity prices, since topping out in early 2011, partly drove the declining gap between growth outcomes in EM compared with DM as net commodity-exporting countries suffered from depreciating currencies, rising inflation, low revenue growth and weak global trade activity.

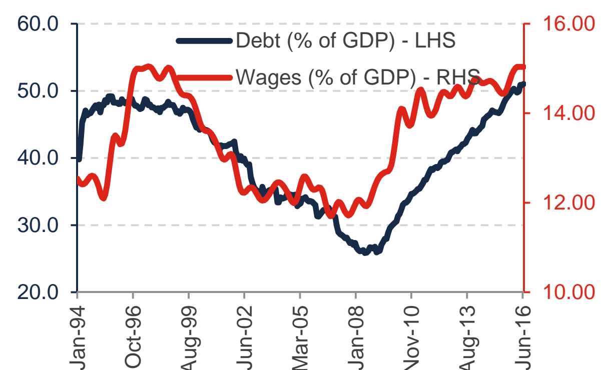
However, economic prospects for net commodity-exporters appear to be bottoming out in response to firmer currencies since the beginning of the year, coinciding with a 9% uplift in commodity prices for the same period. Growth in retail sales in the worst-performing regions (Latin America and Emerging Europe) is back in positive territory for the first time in a year. Similarly, the deceleration in growth in EM exports has slowed from a trough of 29.7% in August 2015 to 13.5% in June 2016.

With minor negative post-Brexit revisions to growth in EMs and cuts being concentrated in DM, Momentum Investments expects the differential in GDP growth outcomes between EM and DM to widen in 2017. Nevertheless, rising protectionist measures, slow progress on reforms and financial vulnerabilities continue to weigh negatively on longer-term EM growth prospects. World Bank President, Jim Yong Kim, has emphasised the need for fiscal and structural reforms to sustain long-run growth and inclusive development in developing nations.

Urgent structural policy initiatives still unresolved in SA
The relationship between political instability, governance and economic outcomes has become increasingly tangled globally, with SA being no exception. Policy incoherence and a lack of policy implementation threaten the country's ability to achieve growth higher than 1.5% to 2% over the longer term.

A significant welfare burden that aims to alleviate poverty by providing free basic services and employment is not the only challenge facing fiscal consolidation. The public sector wage bill has swelled from 11.7% of GDP in late 2007 to 15% in March 2016. This has contributed to a weakening in government finances from a 0.7% surplus in the government budget balance as a share of GDP in late 2007 to a 5.5% deficit in the third quarter of 2010, only partly reversing to a 3.4% deficit by mid-2016. Net government debt as a share of GDP has climbed from a mid-2008 low of 25.6% to just below 50% in June 2016 (see chart 3). Once adding provisions, guarantees and contingent liabilities, SA's public debt burden rises to just below 70% of GDP.

Chart 3: Ballooning wage bill is a risk to SA's debt burden.



Source: National Treasury, MRB Partners, Momentum Investments

In 2014, the IMF recommended that SA's net debt-to-GDP ratio should be kept below 40% to be able to absorb shocks that increase the fiscal borrowing requirement. Achieving fiscal consolidation through

revenue and expenditure measures is likely to have a negative effect on output. The IMF proposes more growth-friendly fiscal consolidation through a reorientation of spending toward investment or implementing reforms that can boost potential growth.

Securing greater flexibility in SA's labour markets should be a high priority on government's reform agenda. Discussions regarding a national minimum wage, a secret strike ballot, the banning of dangerous weapons during strikes and compulsory advisory arbitration have been underway for some time now. Credit rating agencies, including Standard and Poor's (S&P), that rate SA on the lowest investment grade rung with a negative outlook, are looking for an imminent conclusion to negotiations between government, the private sector and labour in this regard.

S&P has also warned against "periodic disputes between key government institutions and within the ruling party". To the extent that political interference affects government's policy framework, a downgrade to sub-investment grade could become a reality sooner rather than later.

A low growth environment and a burgeoning civil servant wage bill have reduced fiscal flexibility in Momentum Investments' view, which is expected to lead to a narrowing of the two-notch gap between S&P's local and foreign currency ratings.

With the implementation of economic reforms dragging out and preventing a sharper rebound in domestic business and external investor confidence, SA's longer-term growth potential suggests little improvement in per capita GDP. As such, Momentum Investments still believes a rating downgrade to junk status is likely by the middle of 2017.

That said, the company does not expect a negative ratings spiral. Momentum Investments expects government to react with tighter fiscal policy to offset revenue slippage and improve debt metrics.
SA has enjoyed the benefit of being an investment-grade rated economy since 2000 and authorities are likely to respond strongly to negative ratings action. Citi research shows that countries (including Slovenia, Latvia and Thailand), which have spent a longer period in investment grade before being downgraded to junk, were able to get upgraded again within an average of 2.5 years rather than 12.5 years of those countries that were in investment grade for a shorter period before the downgrade (like Colombia, Uruguay and Turkey).

While the rand remains vulnerable to negative political shocks and sovereign downgrade risks in the next year, the medium-term outlook remains more favourable on higher EM growth and a rebalancing in the current oversupply of commodities. This is likely to aid a further deceleration in inflation in addition to lower food prices as better planting conditions are forecasted. Though the SA Reserve Bank has started to signal that SA is approaching the end of the current interest rate hiking cycle, the hurdle for interest rate cuts remains high in the near term, given stubbornly high inflation expectations, limited space for unfavourable shocks and elevated underlying measures of inflation.

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Indices summary for September 2016

Equity indices	One month	Three months	One year	Three years	Five years	Ten years
FTSE/JSE All-Share Index (ALSI)	-0.94%	0.48%	6.59%	8.84%	15.29%	11.98%
FTSE/JSE Shareholder Weighted Index (SWIX)	-0.89%	0.31%	9.04%	10.92%	16.77%	13.35%
FTSE/JSE All Share Top 40 Index	-1.25%	-0.16%	3.99%	7.92%	14.86%	11.34%
FTSE/JSE Mid Cap Index	0.93%	3.79%	22.51%	13.65%	17.08%	15.73%
FTSE/JSE Small Cap Index	1.23%	5.52%	14.78%	13.10%	19.35%	15.00%
FTSE/JSE Resources Index	4.48%	8.07%	9.77%	-9.32%	-3.94%	0.48%
FTSE/JSE Financials Index	1.35%	0.85%	-0.91%	13.16%	19.36%	12.05%
FTSE/JSE Industrials Index	-3.51%	-2.05%	4.49%	12.10%	22.31%	18.26%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	2.35%	3.19%	12.73%	7.03%	13.09%	11.58%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	2.59%	3.85%	12.22%	6.64%	12.91%	11.16%
FTSE/JSE SA Listed Property Index (SAPY)	1.09%	-0.73%	3.76%	14.55%	17.86%	17.65%
Interest-bearing indices						
BEASSA All Bond Index (ALBI)	2.98%	3.42%	7.65%	6.82%	8.02%	8.52%
BEASSA All Bond Index 1-3 years (ALBI)	1.35%	2.21%	7.98%	6.79%	6.76%	7.92%
Barclays BEASSA SA Government ILB Index	0.92%	0.42%	8.38%	8.36%	9.24%	9.84%
Short-term Fixed Interest Composite Index (SteFI)	0.63%	1.88%	7.15%	6.39%	6.00%	7.33%
Commodities						
NewGold Exchange-Traded Fund	-5.83%	-6.11%	17.31%	10.24%	7.06%	14.11%
Gold price (in rands)	-3.78%	-6.03%	18.66%	11.13%	7.06%	14.80%
Platinum Exchange-Traded Fund	-7.66%	-3.65%	12.88%	-0.39%		
Platinum price (in rands)	-8.94%	-6.38%	12.35%	-1.25%	-2.66%	2.60%
Currency movements						
Rand/euro movements	-5.68%	-4.89%	0.23%	4.32%	7.47%	4.63%
Rand/dollar movements	-6.62%	-6.20%	-0.71%	10.89%	11.37%	5.88%
Inflation index						
Consumer Price Index (CPI)			5.94%	5.65%	5.67%	6.19%

Important notes

1. Sources: Momentum Investments (Pty) Ltd, 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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