momentum investments

The Macro Research Desk

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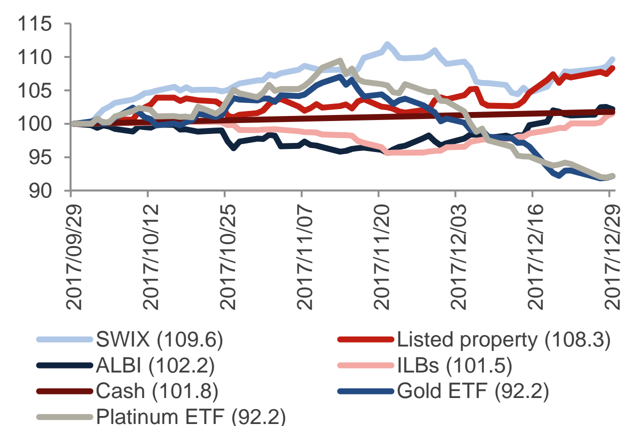
Quarterly market and economic review to end December 2017

Positive South African (SA) political momentum supporting local asset classes

A strong rand rally triggered by the election of Cyril Ramaphosa as the new African National Congress (ANC) president in mid-December 2017 eroded the rand returns produced by global asset classes and commodity exchange-traded funds (ETFs) during the final quarter of 2017, leaving them in negative territory for the period. The combination of a synchronised global recovery, the approval of a tax stimulus package for the United States (US) economy and the continuation of the gradual normalisation of US monetary policy supported strong outperformance of global equities over global bonds in the quarter. Within global equities, emerging market (EM) equity returns outpaced those of developed markets (DM), due to their higher beta to the synchronised global growth recovery, a slightly weaker US dollar and somewhat higher commodity prices.

Among the outperforming local asset classes, the positive sentiment garnered by the ANC leadership change supported listed property and local shares, while the favourable global equity backdrop also contributed to the strong overall SA equity market outperformance for the final quarter of 2017 (see chart 1). While SA bonds also rallied strongly in December on the positive political developments, the damage done to the asset class by the disappointing October mini-budget kept its quarterly returns under wraps.

Chart 1: SA asset class returns in Q4 2017 (indexed)



Source: INET BFA, Momentum Investments

In Momentum Investments' view, a broad-based synchronised global economic growth recovery is likely to persist for most of 2018. Meanwhile, demand-pull inflation is likely to drift up slightly during the year, necessitating some interest rate tightening around the world, but keeping an overall easy policy framework in place, with aggregate central bank balance sheets expected to continue increasing for most of 2018.

This envisaged environment should have positive implications for global revenue and profit momentum (while limiting the downside for equity market ratings) in the year, hence supporting the outlook for global

equities, but does not provide a favourable fundamental backdrop for global fixed-income investments. In addition, relative valuations continue to favour global equities over bonds.

High-beta equity markets in Europe, Japan and EMs should benefit most from the positive profit affect of the most synchronised global growth recovery since 2010 and more supportive monetary policy conditions, while any US dollar strength could provide external sector support for Europe and Japan, but could be problematic for EMs with high levels of external debt.

The election of Ramaphosa as president of the ANC in December 2017 has rekindled hope for sufficient political change and policy reform to propel the SA economy to a higher growth plane over time. Should this hope come to fruition, there could be a significantly positive effect on the locally driven part of the SA equity market, as local and global investor flows erode the political risk premium attached to the local equity market (although the rand-hedge component of the market could come under pressure from rand strength). Such a positive political outcome would also be beneficial to the SA bond market, particularly if the global hunt for more attractive returns continues to support EM debt.

The combination of some improvement in the local growth performance and the possibility for lower bond yields should provide a supportive backdrop for local listed property. In contrast, further declines in local interest rates would increase the reinvestment risk for SA cash and make the asset class less attractive as an investment destination.

Global economy to display resiliency in 2018, but tumultuous politics remain a downside risk

One of the biggest surprise factors for investors in 2017 was the strength and resilience of the global economy. Investors ended 2016 on a gloomy note, expecting the world economy to expand at only 3.1% in 2017. However, by December 2017, expectations for the full year had improved to 3.6%, largely owing to a more robust growth outcome in DMs.

2017 was characterised by a perfect 'Goldilocks' combination of improving global growth, low inflation and accommodative monetary policies, which led to robust returns from risky investments, while volatility remained close to all-time lows.

The stage looks set for a continued, broad-based expansion in the world economy in 2018. Falling unemployment, diminishing output gaps, reduced deleveraging pressures, more supportive fiscal policies and well-behaved inflation are expected to boost many DMs, despite a gradual removal of the monetary stimulus punchbowl, while improving fundamentals and firmer global trade should further contribute to a stabilisation in EMs.

Despite a maturing business cycle in the US, Bloomberg estimates the risk of an imminent recession at only 15%. A further improvement in wealth conditions, favourable growth in real wages and encouraging jobs growth remain supportive of consumption spend, while high capacity utilisation rates should drive up capital expenditure. Goldman Sachs estimates the changes to US fiscal policy (including changes to the tax legislation) to boost growth by 0.4% in 2018 and 2019. Momentum Investments expects real growth in the US to improve to around 2.5% in 2018 from a projected 2.3% in 2017.

A solid expansion is expected in the Eurozone (from an estimated 1.8% in 2017 to around 2.2% in 2018), supported by similar factors boosting conditions in 2017. Lead economic indicators in the Eurozone point to an ongoing recovery, even in those economies, which had to be rescued during the Eurozone debt crisis.

Although Brexit uncertainty lingers and rising inflation continues to squeeze household incomes, the strength of the global economy will likely limit growth weakness in the United Kingdom (UK) to just above 1% in 2018 from a projected 1.5% in 2017.

Japan's growth performance could slow somewhat from an estimated 1.7% in 2017 to around 1.5% in 2018 should the government decide against renewing its

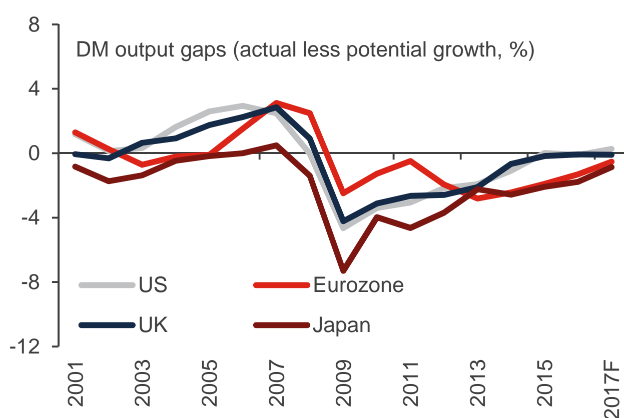
fiscal stimulus. However, resilient private demand, continued exports and infrastructure projects ahead of the 2020 Olympic Games should prevent a sharp slowdown.

Meanwhile, a recovery in EMs is likely to be sustained by a further improvement in fundamentals, a smooth normalisation in DM monetary policy and a 20% increase in the Bloomberg Commodity Price index since January 2016. Nonetheless, countries experiencing political unrest, including the Middle East, parts of Latin America and Sub-Saharan Africa, will continue to lag the global growth performance.

Growth in China is expected to slow in coming years, as policymakers work to prevent financial vulnerabilities from turning into systemic financial risks. Momentum Investments projects growth at around 6% on average in the medium term, with a reasonable likelihood that government will employ macroeconomic stabilisation tools if growth threatens to trend below this level. Ongoing efforts to address structural reforms and cultivate innovation are likely to produce healthy growth returns in the medium to long term.

Global growth has performed better than expected, contributing to closing output gaps (see chart 2), but low inflation prints continue to confound DM policymakers. It is likely it will be a few years until inflation exceeds the 2% target across DM central banks, allowing policymakers to take away the punchbowl slowly without disrupting the party.

Chart 2: Improved growth has led to a narrowing in DM output gaps



Source: Bloomberg, Momentum Investments

Import price weakness, positive shocks to aggregate supply and the effect of lower commodity prices, which all drove inflation lower previously, are nonetheless diminishing. The Global Purchasing Managers' Index readings shows input and selling prices are lifting, and, although the increase in wage growth has been sluggish, impressive employment growth, in the US in particular, suggests wages should further underpin higher inflation.

Pricewaterhouse Coopers dubs this period as the "beginning of the end of easy policy". The US Federal Reserve (Fed), although guided by a new chair, is likely to continue along its path of monetary policy normalisation. Up to three 25-basis-point increases in the Fed funds rate and a further shrinking of the balance sheet are expected to materialise during 2018.

In response to solid growth, the European Central Bank (ECB) is halving its asset purchases to €30 billion a month in 2018, but, given low inflation and the likelihood that price pressures will remain low for most of 2018, the ECB will likely only tighten interest rates in 2019.

Stubbornly low inflation points to lower interest rates for longer in Japan. However, there is a chance the Bank of Japan (BoJ) may choose to reconsider its ten-year target under its yield curve control policy, in reaction to firmer growth.

Contrary to inflation dynamics within the remainder of the DM composite, inflation pressures have increased considerably in the UK, owing to Brexit-induced sterling weakness. Despite a soft growth outlook, the Bank of England (BoE) may be forced to hike interest rates at least once in 2018 to combat rising inflation, which has eaten into consumers' purchasing power.

Similarly, financial conditions are tightening in China. Policymakers have clamped down on shadow financing and credit growth has fallen to its lowest rate in almost a decade. Monetary policy is expected to remain stable in 2018, although Chinese authorities could step in, should growth tumble below 6%.

While Momentum Investments' base case suggests good news is set to continue on the global economics front, politics could create some turbulence, derailing the momentum behind the economic recovery.

Though globalisation, free markets and free trade have persisted for decades, rising populist sentiment increasingly threatens this status quo. With a number of anti-globalists coming into political office in recent times, talks of increasing trade barriers and deporting migrants have increased, threatening the growth outlook for the global economy.

Rising protectionism could raise inflation more sharply through more onerous tariff arrangements, while geopolitical instability could dash consumer and business sentiment, weighing negatively on growth. The standoff between US President Donald Trump and North Korean leader Kim Jong Un could result in further conflict, while power struggles may flare up again in the Middle East.

Moreover, the unpredictability of the direction in government's trade policies increases the downside risk to trade growth, which has resumed in recent months. In the US, Trump clearly favours a more protectionist future. He abrogated the Trans-Pacific Partnership (TPP) agreement in early 2017 and is forcing a renegotiation of the North American Free Trade Agreement (NAFTA), in what he believes is an effort to save US manufacturing jobs. In Europe, the UK still requires a reasonable Brexit deal with the European Union (EU) to preserve trade relations.

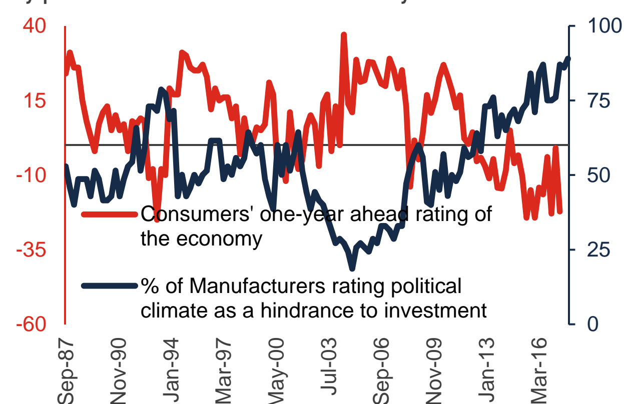
A cross-slate top ANC leadership team could delay structural reform in SA

Ramaphosa's victory in the December 2017 ANC presidential race at the ANC National Conference was widely welcomed by investors. However, a draw for the top-six positions between Ramaphosa's camp and that of opponent Nkosazana Dlamini-Zuma renders an uncertain outcome for the timing and extent of structural reforms necessary to avert a further ratings downgrade.

While the results of the elective conference could resuscitate downtrodden consumer and business sentiment (see chart 3), sustainably higher confidence levels will depend on the ability of the new leadership to rebuild trust between government and the private sector. Higher confidence will further be subject to a commitment to fiscal discipline and the ability to raise fiscal credibility through improving the efficiency of public spending, tackling state capture and addressing the governance and financial problems in SA's state-owned enterprises.

With the party under the control of Ramaphosa and the government under the control of President Jacob Zuma, at the time of writing, the two centres of power could disrupt policy and economic progress, potentially leaving SA in a state of policy paralysis. Potential trade-offs between key policy objectives supported by the two factions could further compromise SA's economic trajectory.

Chart 3: SA consumer and business confidence dashed by political and economic uncertainty



Source: Bloomberg, Momentum Investments, data up until December 2017 (consumer data up until June 2017)

Although SA has the ability to hold free and fair elections, an assault on democracy has come through a violation of public trust in the form of rampant state capture and a deterioration in some of SA's key democratic institutions, including the finance ministry, the state prosecutor, the public protector and the country's tax authorities.

The extent of the anticipated growth recovery in 2018 and the outlook for SA's sovereign ratings will depend on whether or not officials will adopt and enact policies to enhance the country's creditworthiness and restore confidence. Even if fiscal consolidation efforts are announced in the February 2018 national budget, significant fiscal challenges remain. A higher growth path is additionally required to curb SA's

debt-to-gross-domestic-product profile in the medium term and to make inroads into high levels of unemployment and poverty. This suggests the country could remain in sub-investment grade for some time.

Resilient global growth and a modest recovery in commodity prices, underpinned by firm Chinese growth activity, should help real growth in SA reach close to 1.5% from below 1% in 2017 through a lift in exports, whereas the domestic demand trajectory will rely on the extent of the recovery in sentiment. A more convincing pick up in business confidence could provide an upside risk to investment growth, although this is more likely after the 2019 national elections, when policy uncertainty should recede somewhat.

Recent currency strength, in reaction to the ANC election results, should keep inflation comfortably within the target band in upcoming months. Although the SA Reserve Bank already reduced its repurchase rate from a recent 7% peak to 6.75% in July 2017, falling inflation potentially leaves room for additional modest monetary policy easing in 2018. Momentum Investments only sees space for up to 50 basis points worth in interest rate decreases (two cuts of 25 basis points each, at the most), given the medium-term outlook for inflation and political uncertainty, as the 2019 national elections draw near.

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