momentum
investments

The Macro Research Desk

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Quarterly market and economic review

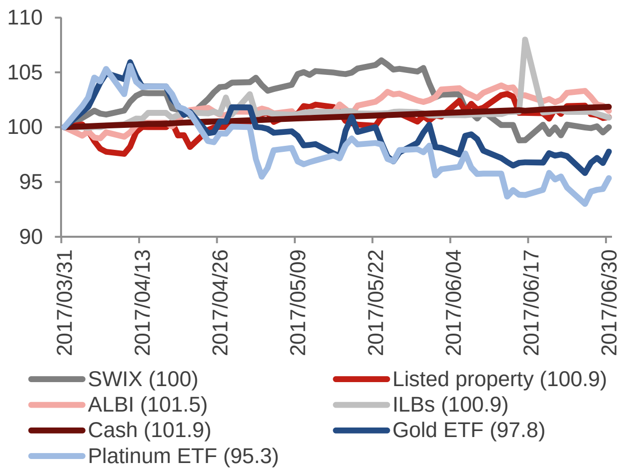
Broadening global recovery buoyed equities in Q2 2017

Increasing signs that the global growth recovery was broadening beyond the United States (US) into the Eurozone and Japan provided fundamental earnings support to the global equity asset class during the second quarter of 2017. A more synchronised global growth return, in tandem with a weakening US dollar trend (the latter driven by US inflation continuing to underperform expectations and early indications by the European Central Bank (ECB) and the Bank of England (BoE) that both were starting to contemplate the advent of monetary tightening policies), supported the strong outperformance by emerging market (EM) equities for the quarter. While fading US economic momentum buoyed global bonds during the first part of the quarter, the tightening noises made by the ECB and BoE caused a European-induced global bond sell-off towards quarter-end.

A weaker US dollar put pressure on commodity prices during the quarter, while simultaneously supporting the rand. This lethal combination made the platinum and gold exchange-traded funds (ETFs) the weakest performers among the South African (SA) asset classes for the quarter (see chart 1). Despite negative ratings action and ongoing political uncertainty, local bonds remained remarkably stable during the quarter, receiving support from the global carry trade and an acceleration in the domestic inflation downtrend.

Local cash provided the highest local returns for the second quarter of 2017. In contrast, a strong rand hurt the return from globally based listed property shares, as well as the foreign earnings bases of SA equities. The latter was also hurt by a weak commodity price environment, an unfavourable Mining Charter announcement by government, as well as recessionary conditions in the local economy and rock-bottom confidence levels.

Chart 1: SA asset class returns in Q2 2017 (indexed)



Source: INET BFA, Momentum Investments

Momentum Investments expects global equities to provide better returns than global bonds, as long as synchronised global economic and profit growth trends, still-stimulatory policy settings and favourable relative valuations remain in place.

Earnings trends and valuations should now favour non-US regions. A decent yield pick-up is available for European equities over fixed income, while fundamental support remains in place for Japanese shares. Meanwhile, a widening positive growth differential between EM and developed markets is likely to underpin EM equity outperformance.

SA nominal bonds are likely to benefit alongside EM bond markets in the current global hunt-for-yield environment. This asset class generally performs well from around the current low levels of business confidence and in the run-up to interest rate cuts.

An anticipated rapid decline in local inflation should further strengthen the case for SA nominal bonds into 2018, but would be fundamentally negative for inflation-linked bonds.

Local cash should continue to deliver decent risk-adjusted returns in a low-return environment, but re-investment rate risk is set to increase in response to a likely peak in the local interest rate cycle.

SA equity valuations have improved meaningfully due to a flat market in the past three years and an expected profit rebound on the back of higher commodity prices and a synchronised global recovery, but a turnaround in confidence is necessary to unlock strong SA equity returns. The latter hinges on political change and/or improved policy certainty. The marked improvement in listed property's relative valuation against nominal bonds (now close to its five-year average) points to strong property returns from the current rating.

Low global inflation: The elephant in the room

Higher economic growth is stretching across developed and EM economies in a synchronised fashion for the first time since 2010. However, the recovery is not without risks. The International Monetary Fund (IMF) warns about threats to the growth trajectory posed by a possible shift towards inward-looking policy platforms, rising protectionism and increased geopolitical tensions. It has been a year since the European Union (EU) referendum in the United Kingdom (UK) triggered a rise in awareness over anti-globalisation sentiment, but political developments still dominate the outlook. The June 2017 Barclays Global Macro Survey shows that investors still consider geopolitics to be the biggest risk facing markets in the next year, despite European election risks being largely behind us.

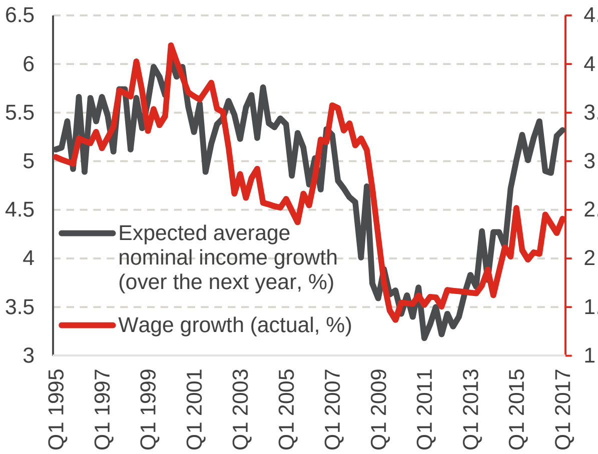
Even though recent developments (including the defeat of Geert Wilders' right-wing party in the March 2017 Dutch election poll, a split in nationalist support in Finland and Emmanuel Macron's victory over Marine Le Pen's far-right political party in France) suggest the protectionist wave may be receding, it is unlikely the forces driving the populist surge in Britain and the US have been exhausted. In its June 2017 Global Economic Outlook, the Organisation for Economic Co-operation and Development points out that better policies are needed to make globalisation work for all. If the economic, social and security issues that boosted populism are not dealt with effectively, political fragmentation may return to Europe.

With political headwinds in Europe appearing to be less vicious than initially feared, the ECB suggests that a newfound support for European cohesion, starting with a friendlier Franco-German relationship, could release pent-up demand and investment in the region, extending the Eurozone's surprise economic recovery that saw all member states experiencing an expansion in early 2017.

Notwithstanding the ECB's improved view of the Eurozone's growth prospects, unemployment and growth output gaps (actual relative to trend) are expected to remain negative for the remainder of this year and next. Persistent slack should continue holding back inflation pressures. Eurozone inflation dynamics have suffered from the after-effects of price shocks in global commodity prices, falling import prices, continuing slack and increased wage flexibility. Moreover, wage formation has become progressively backward looking in key economies (including Italy), increasing the weight of low past inflation. This has led to wage growth in the Eurozone lagging the upward trend in G10 economies (the eleven-largest industrialised nations) for the last three years. The ECB's recent comments that "a very substantial degree of monetary policy accommodation is needed for underlying inflationary pressures to build up" points to an ongoing cautious monetary policy stance. As such, a sustained Eurozone interest rate hiking cycle is still premature in Momentum Investments' view.

In contrast, the headline rate of unemployment has fallen more convincingly in the US, declining from around 10% for December 2009 to 4.3% for June 2017. Typically, a tight labour market leads to upward pressure on wages and inflation, as embodied in the Philips curve. This time around, the transmission mechanism from a tighter labour market into higher inflation has been much weaker, with average US wage growth across a number of measures only increasing from 1.5% to only 2.5% for the corresponding period (see chart 2).

Chart 2: Modest uptick in US wage growth



Source: Deutsche Bank, Momentum Investments

The IMF blames this on financial shocks, which lead to slow recoveries and persistently low inflation. It claims that globalisation has increased the role of international factors and decreased the role of domestic factors in industrial economies. The World Economic Forum speculates that lower wage growth may be the consequence of a decrease in labour market mobility, which has affected both genders, all age groups and various skills levels, equally. During the past two decades, workers have transitioned less frequently across firms and sectors, leading to lower wage growth overall. This phenomenon could be the result of technological advancement lessening the ease of skills transfer and displacing workers towards lower-wage jobs from automated sectors, while more onerous regulations have raised the costs of job hiring and job switching.

An ageing and more educated workforce also implies a lower inclination to move jobs and, hence, a potentially lower natural rate of unemployment. In addition, low labour productivity is capping wage-growth upside.

The Economist proposes that changes to America's unemployment scheme in 2013 (reducing the period for which citizens could draw unemployment benefits) lowered the reservation wage, which is the rate needed to entice people into the labour market. Following this, a large number of jobs were created in lower-wage sectors.

However, Deutsche Bank shows that jobs growth accelerated in higher-skilled areas (and likely higher-wage areas) in the recent expansion. Moreover, a diverse range of labour market indicators (part-time employment, long-term unemployment and the number of discouraged work-seekers) reveal a more widespread recovery in the US labour market, helping to dispel the notion that the natural rate of unemployment may be lower than the current rate.

In Momentum Investments' opinion, the US Federal Reserve (Fed) appears to be nearing its growth and unemployment goals and conditions (including those in the labour market) look set for inflation to move higher. This should allow the Fed to raise interest rates by up to 100 basis points between now and the end of 2018.

The UK has similarly encountered subdued wage growth in the face of falling unemployment. Low productivity, immigration, a squeeze on public wages and gains in low-skilled jobs have likely led to this outcome. Despite low wages, UK core inflation has climbed distinctly above target due to sterling weakness. Nevertheless, the BoE is expected to leave policy settings unchanged well into 2018, given dampened cyclical growth prospects, following a disastrous election outcome, which left Theresa May's Conservative party in the position of a minority government.

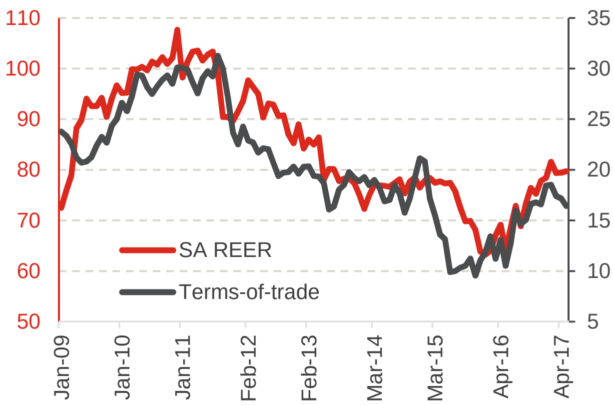
Stagnant Japanese wage growth has puzzled in light of unemployment reaching new lows. HSBC explains that a structural rise in casual worker appointments and the concept of "lifetime employment" (where wages closely track slowing potential growth) may solve the labour market conundrum. With incomes barely rising, in spite of a tight jobs market, highly accommodative monetary policy is expected to persist even though a firm cyclical growth expansion remains intact.

Inflation has also softened in EM, reaching an eight-year low recently. This has allowed net commodity exporters in particular to ease monetary policy further to support growth. Although forecasts have been pared back by around 0.3% relative to a year ago, growth in the region is expected to improve to around 4.5% this year, marginally higher than growth levels recorded in 2016. Though EMs remain exposed to the potential for tighter global liquidity conditions and weaker global growth negatively affecting trade, investor sentiment has remained positive in light of improving macro fundamentals and slowing momentum in sovereign rating downgrades, related to idiosyncratic political and policy risks.

SA on a political knife edge

The rand has surprisingly weathered the domestic political and economic storm. It remains the best-performing currency for a twelve-month rolling basis compared to a basket of EM currencies.
A favourable trend in SA's terms-of-trade (export prices relative to import prices) and the continued global hunt for yield have bid the currency firmer, despite deteriorating macro fundamentals (see chart 3).
While commodity price forecasts should provide support for the currency in the medium term, political willingness to avert an economic slippery slope will likely play a key role in determining the direction of the rand.

Chart 3: Favourable terms-of-trade have benefited the rand



Source: JP Morgan, Citi, Bloomberg, Momentum Investments, REER = real effective exchange rate

A crisis of confidence plagues the economic outlook for SA. While the current cycle is not the worst business confidence cycle in the history of economic downturns in SA, it is highly unusual to experience such a sharp dip in confidence this late into an economic cycle.
Consumers across the income-earning spectrum are equally concerned about the SA economic outlook, holding a similar view to that held in the late 1980s to early 1990s, before democracy.

A poorly performing economy will place further downward pressure on revenue collection, while a downgrade to junk status on SA's foreign currency rating has meant higher borrowing costs for government. This increases the burden on taxes to escalate further and implies less available money for social infrastructure. Ultimately this lowers SA's potential growth, raising the risks of social unrest, as the economy struggles to keep up with the rate of population growth. The rating agencies have warned that a marked increase in the country's debt ratio (including further financial demands by SA's state-owned entities), diminishing independence of SA's institutions, unpredictable policy or delays in economic reform to generate higher levels of growth could trigger further downgrades.

This leaves the currency vulnerable to a bout of foreign portfolio outflows and, as such, the rand still poses the greatest upside threat to the inflation outlook.
Nevertheless, lower food inflation and some currency tailwinds from previous appreciation should lead to a near-term disinflationary trend into the first quarter of 2018. With inflation set to head lower, SA real interest rates stack up favourably against other EMs, giving the SA Reserve Bank (SARB), in Momentum Investments' view, a limited opportunity to cut interest rates by around 50 basis points. However, with the rand likely to remain volatile heading into the African National Congress National Elective Conference in December 2017, the SARB is likely to defer cutting interest rates into early 2018.