momentum investments

# The Macro Research Desk

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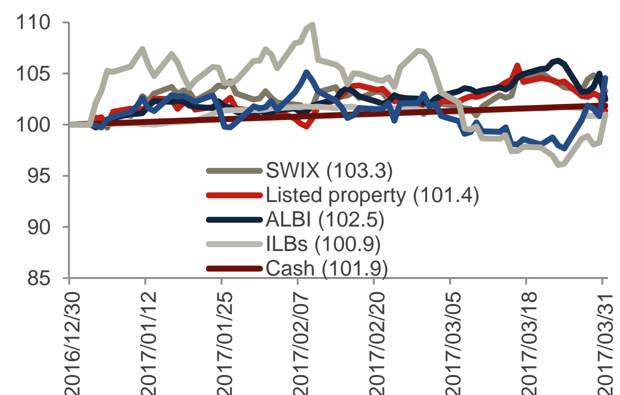
# Quarterly market and economic review

## Ongoing reflationary boost to risky investments in 1Q17

The combination of an ongoing global economic recovery and rising inflation has continued to support the revenue bases of global corporates during the first quarter of 2017, while preventing global bond yields from declining. It is thus unsurprising that global bond returns have lagged during this period, while global equities have been the outperforming asset class, with a particularly strong showing from emerging market (EM) equities that outperformed developed market equities and South African (SA) equities in the first quarter. United States (US) dollar weakness during the quarter supported EM equities and the gold price and was driven by lower expectations of the magnitude of US Federal Reserve (Fed) tightening in the coming year, as well as a lower perceived probability that the European Central Bank (ECB) would be tapering its quantitative easing programme from late this year. The blend of US dollar weakness and stable global real rates underpinned a rally in the dollar gold price during the quarter and made the gold exchange-traded fund (ETF) the star performer among the SA asset classes (see chart 1).

A weaker US dollar and stable global bond yields supported the rand and SA bonds for most of the first quarter of 2017, before political machinations around the fear and eventual reality of an SA cabinet reshuffle that included the axing of the well-regarded Finance and Deputy Finance Ministers unsettled the rand and the local bond market in the last week of the quarter (subsequently exacerbated by sovereign ratings downgrades in early April).

Chart 1: SA asset class returns in 1Q17 (indexed)




*Source: INET BFA, Momentum Investments*

Momentum Investments expects a firmer US dollar associated with global reflation, a rising US interest rate cycle and favourable relative valuations to cause global equities to outperform global bonds. On a regional basis, we see strong earnings and valuation

support for Eurozone and Japanese equities, while US margins appear to be at risk from a tightening labour market. A widening growth differential between emerging and developed markets should be positive for relative EM returns, but higher US interest rates, a strong US dollar and trade protectionism pose risks. SA nominal bonds should be fundamentally supported by a strong anticipated domestic disinflationary trend, while attractive valuations are underlined by historically-high real rates, as well as an historically-elevated risk spread premium to US bonds. In contrast, inflation-linked bonds (ILBs) still seem to be discounting a too-high inflation premium, while a dwindling inflation carry in coming months should be a fundamental headwind. Domestic cash is expected to deliver decent risk-adjusted returns in a low-return environment, but re-investment risk is set to increase later this year in response to a likely peak in the local interest rate cycle.

SA equity valuations have improved meaningfully after a flat market in the past two-and-a-half years and amidst a significant expected profit rebound from a low base, driven by higher commodity prices and some domestic growth recovery.

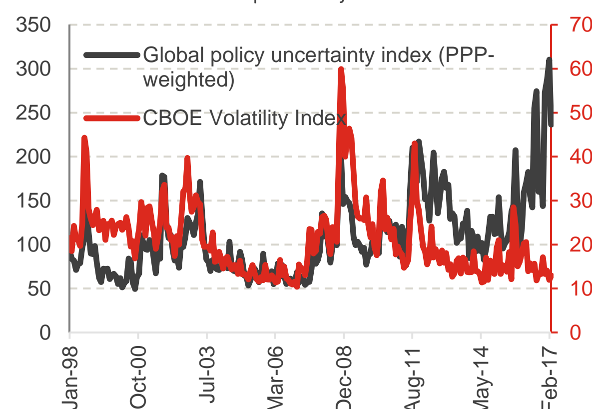
Listed property's relative valuation against nominal bonds has improved meaningfully since 2015 and is now close to its five-year average, pointing to potentially strong property returns from its current rating.

## Geopolitics reshaping the world economy

Major underlying shifts have occurred in the geopolitical landscape, marking the current period the most politically volatile environment in post-war history. Arguably these trends started emerging in the Middle East in a series of anti-government protests in early 2011, but the rise in populism accelerated in 2016, with the Britons voting for the United Kingdom (UK) to exit the European Union (EU), Italians rejecting reforms with the 'no' vote on the referendum and the emergence of Donald Trump as the next president of the US. Europe's political order is likely to be a source of investor anxiety this year and next. The outcome of Brexit negotiations are far from certain, while pivotal elections are lined up for France (April and May 2017), Germany (September 2017) and Italy (by February 2018 at the latest). Moreover, much remains uncertain about President Trump's policy intentions and implications. For instance, the cost of increasingly protectionist policies could spark retaliation and further damage growth in world trade.

Surprisingly, against this backdrop of considerable political uncertainty, equity investors seemingly have a pretty sanguine view of risks (see chart 2). The US volatility index (a measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices) remains marginally off the lows experienced in mid-2014. A perceived robust economy could potentially explain this discrepancy. Global data surprises, which are tracking close to six-year highs, are likely acting as a near-term driver of investor complacency.

Chart 2: Investor complacency




*Source: Economic Policy Uncertainty, Bloomberg, Momentum Investments*

However, this may be as good as it gets. Trump made a variety of lofty promises during his election campaign, but it remains to be seen whether he will be able to follow through on all his plans. Optimism over tax cuts and deregulation are currently outweighing concerns regarding trade and immigration and have spurred on confidence in US firms and middle-income households, in particular. But are expectations running too far ahead of the economic reality?

Firstly, Trump's $1 trillion plan to rebuild America's roads, bridges, airports and other vital infrastructure

relies heavily on private investment. However, private investors are likely to only back investments on which they will realise a strong return. Consequently, state and local governments will have to provide funding for the missing links in critical development areas, but public finances remain on shaky ground. Secondly, Trump's ambitious proposal to cut the non-defence share of the discretionary budget (including education, housing and parks) by 10% per year (to provide an additional 0.3% to the defence budget) is unlikely to be supported by Democrats and a number of Republicans. As such, it remains to be seen whether tax reform including slashing corporate taxes can in fact be funded. Currently, there is no consensus on the tax reform bill and some house members are opposed to the border tax plan.

Thirdly, Trump's pro-growth agenda may be overshadowed by a focus on protectionism, led by the newly created National Trade Council. Increasing tariffs on goods arriving from key trading partners (including China and Mexico) could make purchases of consumer goods more expensive for the average American household. Together with the proposed personal tax cuts, that favour higher-income earners, inequality in the US could increase further. Punitive tariffs on China could also trigger retaliatory efforts by one of the world's major superpowers, sending shockwaves through the global economy. Lastly, the repatriation of overseas cash by US multinationals (estimated to be around USD2.5 trillion) is likely to find its way into share buybacks or dividends, rather than manifesting in increased activity in capital spend or hiring in the real economy.

That said, the underlying economy had started to recover even prior to the US presidential election in November 2016. As such, any positive momentum on tax cuts, deregulation or increased infrastructure spend (the latter more likely a 2018 story), would provide further tailwinds to an expected c.2.3% recovery in real US economic activity in 2017 from 1.6% in 2016. An improvement in real growth prospects in the short term, together with evidence of broader-based inflationary pressures, suggest that the US Fed will unlikely need to raise rates by more than the so-called 'dot plot' (the interest rate projections of the Federal Open Market Committee members) advocates in the next two years.

Staying with politics, a stable, but lacklustre, growth performance in Europe could be undermined should anti-euro populist candidates gain significant ground.

Elections across Europe have the scope to shock markets once again, but unlike a Grexit-style (Greece exiting the European Union) risk, negative outcomes from events this time around could reverberate through the global economy on a much larger scale.

Aside from the crowded political calendar, troubles also surround Europe's banking sector, where non-performing loans in Southern Europe remain elevated.

Despite Momentum Investments' tepid growth expectation in the Eurozone this year, there should be some support from previous euro depreciation, which should bolster export volumes, while a reduction in spare capacity hints at a further uptick in fixed investment. Unprecedented monetary policy easing and less austere fiscal policy have supported the consumer in the past, but sticky unemployment and a drop-off in real wage growth (thanks to higher inflation) flag concerns over the sustainability of household consumption spend going forward. Although higher inflation readings in the past few months may add pressure on the ECB to start tapering quantitative easing (QE) policies earlier, Momentum Investments thinks it is too early for the ECB to declare a victory on the inflation front. Core inflation (headline inflation excluding food and fuel) has barely budged in the past three years, trading in a narrow band marginally below 1%. Moreover, tightening policy too early could have negative ramifications for the fiscal figures given that a significant share of the improvement in the budget deficit since 2013 has come from the interest portion.

Although British consumers initially brushed off the Brexit vote, cracks in the outlook for consumer spend are beginning to emerge. Retail sales growth plummeted to 1.5% in January 2017, while consumer confidence is waning under the pressure of weak employment prospects and a slide in real wage growth. Jitters around uncertain terms of the exit from the EU poses a challenge for new business investment spend, which already tumbled into negative territory in the first quarter of 2016. Though export orders are benefiting from a weaker

sterling, the UK faces huge uncertainties in the future concerning its terms of trade with key trading partners. While still tracking at 5% in year-on-year terms, government receipts may also begin to falter thanks to slowing growth, exerting pressure on already-high government debt levels, currently at around 90% of GDP.

Meanwhile, easy monetary policy, government fiscal stimulus and an uptick in growth elsewhere has buoyed economic growth prospects in Japan. A tight labour market pushing wages higher and a recovery in private loan growth are supporting domestic demand, while a weaker yen has translated into higher export volumes. However, despite an improved growth setting, the Bank of Japan is unlikely to withdraw monetary stimulus while inflation remains stuck near 0%.

Momentum Investments expects policymakers to tolerate a modest slowdown in China. Should growth dip significantly below their five-year growth target of 6.5%, policymakers are likely to react by propping up growth through increased infrastructure spend. While Chinese authorities have the firepower to kick the debt can down the road, bilateral relations with the US pose a major downside risk to growth. So far, President Trump has proved to be an unpredictable trading partner. According to HSBC, should the US implement a 45% tariff on all inward-bound Chinese products, China's exports to the US could halve, shaving off more than 1.5% from annual growth.

Trump's anti-trade rhetoric could strike a destabilising blow across EM more generally. EM also faces the risk of tighter global financial conditions should the US Fed raise rates at a faster-than-expected pace.

Nevertheless, EM is in a healthier condition relative to the Taper Tantrum of 2013, when investors stressed about the potential for the US Fed to wind back its stimulus programme. This time around, economic activity is on healthier footing, current account deficits have narrowed, thanks to a rise in commodity prices, currencies are in a firmer position, higher real policy rates provide better buffers and valuations have improved. Momentum Investments' is particularly optimistic on EMs, which rely more heavily on domestic demand rather than external trade. Those with improving macro fundamentals and an appetite for reform are expected to outperform.

## Political developments eclipse SA's economic outlook

After more than two decades of democracy in SA, many remain economically disempowered. Little has changed in the structure of the economy and patterns of wealth accumulation remain in the hands of very few. In attempting to tackle these inequalities, government continues to lay the ground work to accelerate the pace of economic transformation.

While some view President Jacob Zuma's 'radical economic transformation' mantra as an attempt to control public resources and accelerate patronage gains, others are of the opinion that the spirited drive behind this narrative is in response to the electoral pressure that the African National Congress (ANC) is facing from the Economic Freedom Fighters (EFF) in particular. By embarking on this strategy, they hope to divert attention away from rising internal party factionalism and government failures.

With the rising prospect of the ANC potentially losing its dominance by the 2019 national elections, it is likely that this theme could carry through beyond the current government leadership.

Following a series of political setbacks, it is likely that Zuma implemented the third cabinet reshuffle in his eight-year tenure in late March 2017 from a weakened position, as calls for his immediate resignation have intensified. The latest sweeping changes have arguably freed access to state resources, which were previously carefully guarded by former Finance Minister Pravin Gordhan and Deputy Finance Minister Mcebisi Jonas.

Although Gordhan agreed with the need for radical economic transformation, he redefined what pro-poor distribution means in the February 2017 budget speech,

emphasising that "sound public finances, the health of our financial institutions, investment-grade credit ratings and competitive public procurement processes are valued elements in the sustainability and integrity of our transformation path". He stressed that "without transformation, growth will reinforce inequality; without growth, transformation will be distorted by patronage".

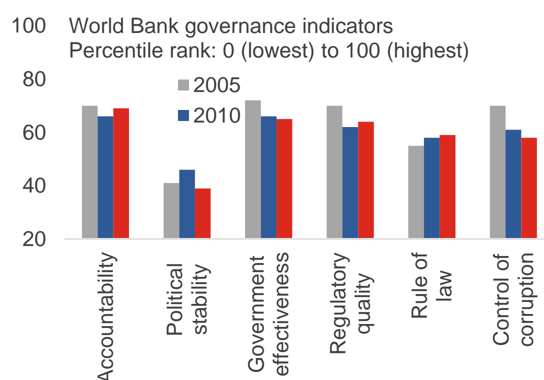
By securing some of his strongest loyalists in the Energy and Treasury portfolios in particular, Zuma has compromised SA's institutional credibility and put SA's sovereign ratings at risk. Uncertainty around policy continuity triggered a foreign currency rating downgrade to junk status by Standard and Poor's Global Ratings (S&P) on 3 April 2017. Moody's is scheduled to release its review on 7 April 2017. It is more likely than not that it will shift SA's foreign and local currency ratings one notch lower (but remaining in investment grade). While Fitch has not specified a review date, it is expected that it will lower SA's foreign and local currency rating to sub-investment grade in due course.

According to the World Bank's governance indicators, SA has slipped down the 'political stability', 'government effectiveness' and 'control of corruption' rankings between 2010 and 2015 (see chart 3). Recent political developments have arguably accelerated this decline.

Moreover, the ratings agencies have voiced their concern over the precipitous increase in contingent liabilities, most notably those by public electricity utility Eskom. The recent change in the Energy portfolio could signal a push for the nuclear deal, raising concerns over further fiscal support for SA's state-owned enterprises. Without any meaningful retort from the factions aligning themselves against the President, the odds will tilt towards further negative ratings action. Should this materialise, the rand could suffer an additional blow.

A likely weaker rand path under this scenario would limit the expected relief in inflation if sustained at these or more depreciated levels, partly offsetting the expected drop in food inflation owing to higher agricultural output following severe drought conditions in 2016. Reduced downside for inflation suggests weaker prospects for lower interest rates.

Chart 3: SA's governance rankings have been slipping




*Source: World Bank, Momentum Investments*

In its latest March 2017 Monetary Policy Committee meeting, the SA Reserve Bank noted that the high degree of exchange rate uncertainty leaves the risk to its inflation outlook to be moderately to the upside, while increased political uncertainty could negatively affect its latest growth assessment. Given that 79% of respondents surveyed in the Bureau of Economic Research's manufacturing survey highlighted the political climate as a key constraint to investment, the recent political tumult is likely to dampen private fixed investment intentions, posing downside risks to Momentum Investments' view of real economic growth of around 1% this year.

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