The Macro Research Desk

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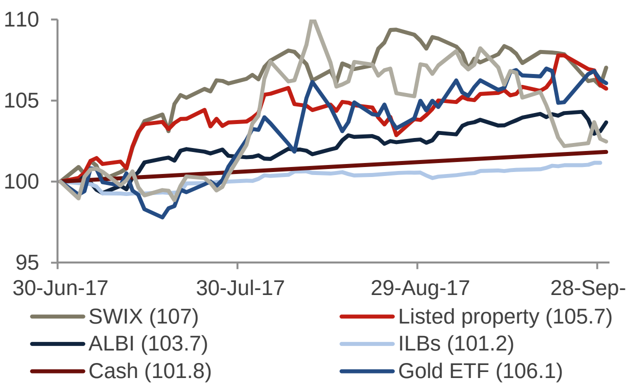
Quarterly market and economic review

Growth investments benefiting from synchronous global recovery

Ongoing confirmation that the global economy enjoys the first period of synchronous global recovery since 2010, with Europe and Japan having joined the United States (US) in expansion mode, supported strong returns from growth investments during the third quarter of 2017. Global equities benefited from the resultant strong earnings momentum, with emerging markets (EMs) the outperforming equity region for the quarter, also buoyed by US dollar weakness, supportive commodity prices and stabilising inflation. In the same vein, South African (SA) equities gave strong returns during the quarter (see chart 1), with the resources sector of the market benefiting from higher metal prices, a weaker rand and the suspended implementation of the Mining Charter, while the rate-sensitive sectors enjoyed the advent of a domestic rate-cutting cycle, made possible by rapidly falling inflation.

Chart 1: SA asset class returns in Q3 2017 (indexed)



Source: INET BFA, Momentum Investments, data to 29 September 2017

SA bond returns received support from the global hunt for yield and a rapidly falling domestic inflation trajectory during the third quarter of 2017. In contrast, indications by the US and European central banks, that they are on the verge of starting to shrink their balance sheets as part of a broader process of monetary policy normalisation, put pressure on developed market bonds in the quarter. Lower SA bond yields, solid Eastern-European growth and rand weakness underpinned SA listed property returns, but falling inflation eroded SA inflation-linked bond (ILB) returns.

The gold exchange-traded fund (ETF) benefited from a stronger gold price (in response to a weaker US dollar and the metal's safe-haven characteristics during the escalation of US-North Korea tensions) and a weaker rand during the quarter. However, worries about the future of diesel engine technology against the backdrop of global emission scandals put pressure on the platinum price during the quarter.

Momentum Investments expects 'Goldilocks' conditions (synchronised global growth coupled with mild inflation, hence keeping policy tightening moderate) to provide fundamental earnings support for global equity markets going forward. In contrast, global bonds are constrained by euphoric flows, rising net issuance, an imminent rebound in inflation and market complacency around US interest rate hike expectations. Moreover, valuations continue to favour global equities over global bonds, with a higher equity risk premium providing better protection for investors than fixed income risk premia, in Momentum Investments' view.

Fundamentally, European and Japanese equity markets are favoured over the US market, where relative returns and valuations are at historical extremes. Rising relative earnings growth, falling inflation and depressed valuations remain supportive of EM equities, but any US dollar recovery will be a risk.

With moderate developed market policy normalisation likely prolonging the EM carry trade, SA nominal bonds should continue benefiting alongside EM bond markets from the global hunt-for-yield environment, while the expected decline in SA inflation into early 2018 should provide a major bond underpin. Although SA bonds are attractive relative to other EM bonds on a risk/return basis, domestic politics and ratings actions pose threats. With breakevens expected to compress further in line with falling inflation, Momentum Investments continues to favour nominal bonds over ILBs. Although SA cash is expected to deliver decent risk-adjusted returns in a low-return environment, re-investment risk is set to increase in response to further reductions in local interest rates.

SA equity valuations have improved meaningfully, due to a flat market in recent years and an earnings rebound from a low base. Nevertheless, political tensions have shattered domestic confidence, which remains negative for locally produced earnings. The marked improvement in listed property's relative valuation against nominal bonds (now close to its five-year average) points to good property returns from the current rating.

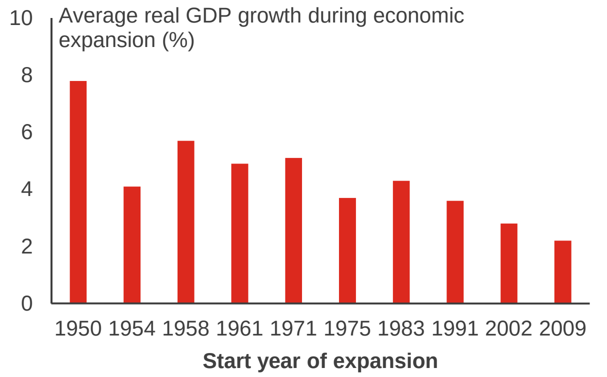
Global economy not too hot, not too cold

The global economy is in better shape than it has been in years. International Monetary Fund (IMF) chief economist, Maurice Obstfeld recently acknowledged that "recent data point to the broadest synchronised upswing the world economy has experienced in the last decade".

Admittedly, US fiscal policy looks less likely to provide a meaningful boost to the economy and the eventual effect of Brexit on the United Kingdom is still far from clear. However, 2017 growth projections for the Eurozone and Japan have been raised on a better-than-expected return so far this year. Higher global trade activity has trumped fears of protectionism and has supported growth in EMs. Resilient growth in China defied earlier worries of a sharper slowdown as authorities shifted away from a credit-fuelled economic strategy. Solid growth activity, here, has also helped to sustain the economies of commodity exporters.

Optimal growth and inflation conditions have created a 'Goldilocks' environment in the US economy. Growth is running at a rate that is hot enough to spur business and consumer optimism, but cool enough to keep the US Federal Reserve (Fed) from strongly applying the monetary brakes. US inflation is rising at a moderate pace and looks likely to take much longer than historically to become a meaningful threat to the central bank. Although the current upswing underway in the US is already quite mature (this being the third-longest upturn in post-war history), it does not imply the cycle cannot be longer still. With little danger of the economy overheating at this stage (growth in the current upswing has averaged a tepid rate of 2.2%, which looks considerably weaker when compared to the 4.7% average growth rate recorded in previous economic upswings, see chart 2), the US is likely less susceptible to pronounced boom-bust activity this time around.

Chart 2: Shallowest US recovery on record



Source: Deutsche Bank, Momentum Investments

Despite this 'Goldilocks' world of continual expansion and tame inflation, a number of bears are prowling. Firstly, there have been a number of nuclear tests and a major increase in missile range by the North Koreans in the past two years. Disagreements within President Donald Trump's administration on how to diffuse the North Korean situation leave the spectre of nuclear conflict as a serious threat. Setbacks to globalisation pose a second key threat to the 'Goldilocks' environment, given the risk of protectionist tariffs or quotas, which could destabilise the ongoing global economic recovery. Thirdly, even though the latest continuing resolution and debt ceiling suspension expiration have been delayed to 8 December 2017, a spending impasse could lead to a government shutdown, while a failure to raise the debt ceiling could cause a government default. While cash management measures could extend the need for a debt ceiling increase until the second quarter of 2018, addressing the issue earlier might benefit the Republicans to avoid voting on it closer to midterm elections, which could complicate matters for finalising tax reform.

In Momentum Investments' view, significantly higher inflation accompanying higher growth is unlikely to materialise as a fourth threat. Current weakness in US inflation may not be due to idiosyncratic or once-off factors.

Technological advancement, low levels of productivity capping wage growth, EM disinflation and falling inflation expectations may be, in part, playing a structural role in keeping inflation lower.

Global economy not too hot, not too cold

Although tame US inflation limits the likelihood of a faster-than-expected rise in interest rates, which could lead to US dollar strength and disturb the recovery in EMs, a more hawkish Fed still poses a threat to the upswing in EMs. EMs also remain at risk from adverse US trade policy changes and geopolitical risk factors, which could trigger a 'risk-off' episode.

Robust underlying economic conditions have seen EM countries extending their 2016 recovery. Reduced currency volatility led to a stabilisation in inflation and has allowed EM central banks to ease policy further to support growth. A firm positive growth impulse in developed markets has further fuelled growth through higher trade activity.

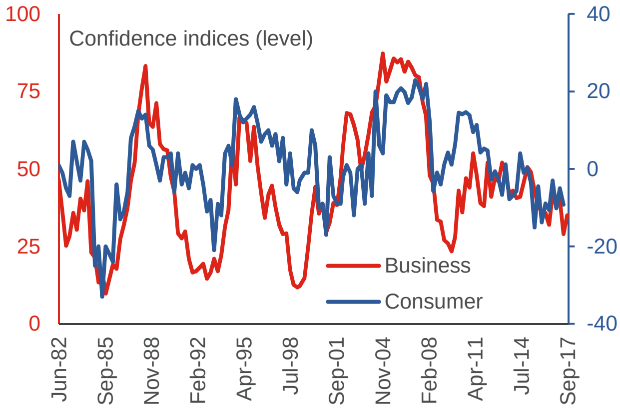
Going forward, EM growth will need to increase its reliance on domestic demand, by implementing structural reforms to drive sentiment among a burgeoning consumer population.

SA at risk of falling further behind

A study by the World Bank shows SA's productivity diverging from global trends. It calculates that productivity losses have cost the economy 0.7% in forgone gross domestic product (GDP) growth annually since 2008. With private investment in research and development declining 40% in SA during the same period, the World Bank worries growth will be insufficient to restore positive per-capita GDP growth in the medium term.

Coinciding with a decline in global commodity prices, real SA GDP growth slowed to an average of 1.6% (from 3.1% historically) between 2012 and 2016. While a rebound in commodity prices should foster higher export growth, low business and consumer confidence (see chart 3), associated with rising uncertainty regarding the direction of economic policies, will likely cap the performance in domestic demand.

Chart 3: SA sentiment remains in the doldrums



Source: Global Insight, BER, Momentum Investments

The IMF warns SA's vulnerabilities have become more pronounced in recent years and is set to increase further, unless growth accelerates. The scope for monetary and fiscal policy to bail out poor growth in the economy remains limited.
With insufficient reforms (namely legislative uncertainty in land and mining, a lack of competition in product markets and low value-add tradable content), SA is unlikely to make a dent in longstanding unemployment and rising inequality. Even if a market-friendly outcome materialises at the African National Congress elective conference in December 2017, the pace of economic reform may only pick up appreciably after the national elections in 2019, which suggests SA could remain stuck in a low-growth environment in the medium term.

Anaemic growth has taken its toll on the state of SA's public finances. Spending inefficiencies and a failure to impose more rigorous penalties for breaches of the Public Finance Management Act at SA's state-owned enterprises (SOEs) have exacerbated the problem. Although Cabinet adopted a new governance framework for SA's SOEs, in November 2016, momentum behind this initiative stalled after a damaging cabinet reshuffle in March 2017.

In Momentum Investments' opinion, there is a more-than-even chance of the rating agencies acting on SA's weak growth, worsening fiscal outlook and sizeable contingent liabilities in SA's SOEs by June 2018.

Although the rand has remained resilient in the face of sovereign ratings and political risks, it remains vulnerable to an adverse change in EM risk sentiment. Reigniting investor confidence and improving governance will play a crucial role in attracting a more stable source of foreign direct investment. For now, SA remains vulnerable to more fickle portfolio flows to cover its current account deficit and, as such, the need to maintain a healthy real interest rate differential with developed markets still exists.

Despite the likelihood of food disinflation and recent currency appreciation dragging inflation lower in the next two quarters, the SA Reserve Bank likely only has a limited window of opportunity in which to ease interest rates further. Momentum Investments expects up to two further interest rate cuts of 25 basis points each before the end of the first quarter of 2018.