The Macro Research Desk

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Market and economic outlook

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Highlights

Markets

- Valuations and the late-cycle global fundamentals of positive growth momentum, rising inflation, fiscal stimulus and increasing net bond supply should continue to favour global equities over bonds.
- There are, as yet, few signs of the imminence of a global equity bear market, although a move from a 'goldilocks' environment (strong growth and low inflation) to reflation (strong growth and rising inflation) during the last phase of the equity bull market should be less positive for equities and will likely correspond with higher volatility.
- The global hunt for yield continues to underpin emerging market (EM) debt markets, but with South African (SA) inflation bottoming, there should be limited further inflation support for the SA bond market during the remainder of 2018, while bond valuations look full.
- The combination of a large Ramaphosa-driven bond market rally since November last year and the big Resilient-driven property sector sell-off since then has caused the SA listed property sector to now trade at the cheapest relative rating to local bonds in five years.
- The expected positive 'Ramaphoria' effect on corporate sales and margins should support the profit growth of domestically orientated companies in SA, while expected moderate rand weakness should enhance globally generated profits. Although globalisation and the Naspers effect have caused the overall SA equity market to trade in line with elevated developed market (DM) valuations, the median SA share trades in line with more attractive EM valuations, providing investors with better return prospects.

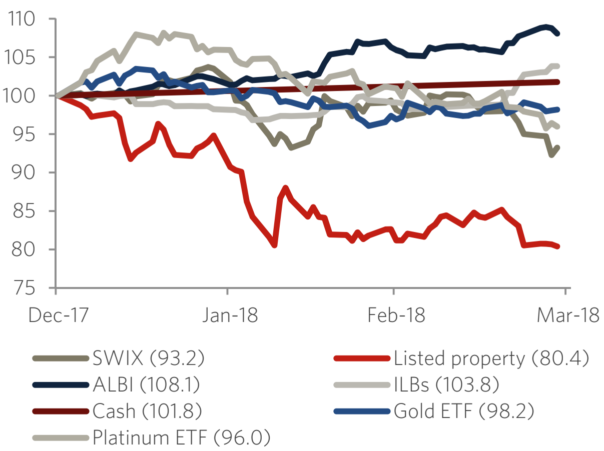
Economics

- A closing output gap and rising inflation should allow for additional interest rate hikes to beyond a neutral monetary policy stance in upcoming quarters in the United States (US).
- Monetary policy is expected to remain expansionary in the Eurozone, although it is expected to gradually shift away from an easing bias, in response to firm growth and a modest uptick in inflation.
- Actions by the Bank of Japan should lag that of the European Central Bank, given ongoing weakness in inflation expectations.
- Trade frictions and the potential for a faster pace of monetary policy tightening in DMs pose downside risks to the economic recovery underway in EMs.
- In SA, the new administration will require time to improve economic growth and stabilise the fiscal position, given the country's structural weaknesses. As such, Momentum Investments still views trend growth at around 2%.
- The fragile financial state of many of SA's parastatals pose a material risk to government's balance sheet.
- Despite the expectation of a mildly depreciating rand and rising inflation trend, Momentum Investments expects SA inflation to remain well within the target band in 2018 and 2019.
- A further interest rate cut of 25 basis points in SA by the second half of 2018 is plausible, but this would likely require inflation expectations to shift closer to the mid-point of the inflation target.

Move from 'goldilocks' to reflation should induce more volatility into global markets

During the first quarter of 2018, asset class returns for SA investors were strongly influenced by the ongoing positive domestic political momentum initially ignited by the election of Cyril Ramaphosa as the new African National Congress (ANC) president in mid-December 2017, followed by Ramaphosa'a elevation to president of the country and a cabinet renewal in February this year. As a result, the rand appreciated by almost 5% during the quarter, providing strong support for the outperformance of local bonds (see chart 1), but hurting the return from global asset classes, commodity exchange-traded funds and the globally orientated part of the SA equity market. SA bonds also benefited from a stern, but credible budget in February and a sovereign ratings reprieve from Moody's in March. Unfortunately, the strong return from local bonds could not negate the negative sentiment around the Resilient group of companies in the listed property asset class, which caused the sector to lose 20% of its value during the quarter. Concerns about Resilient related to valuation premiums, cross-shareholdings, the structure of its Siyakha education trust, as well as accusations about trading activity by related companies that inflated share prices.

Chart 1: SA asset class returns in Q1 2018 (indexed)



Source: INET BFA, Momentum Investments

Indications that the US Federal Reserve (Fed) might have to raise interest rates more aggressively than previously thought and negative headlines in the technology space put pressure on global growth stocks during the quarter, while worries about trade wars between the US on the one side and China and Europe on the other have caused a sell-off in global equities as a more risky asset class.

Although the global equity pullback seen in the first quarter can be regarded as long overdue, following the longest post-war period without a 3% drawdown, Momentum Investments argues that the extent of the sell-off discounts a too-negative growth outlook, as it seems to imply a 30% to 50% probability of a recession ensuing against the backdrop of ongoing broad-based earnings support. There are, as yet, few signs of the imminence of an equity bear market, although a move from a 'goldilocks' environment for equities (strong growth and low inflation) to reflation (strong growth and rising inflation) during the last phase of the equity bull market should be less positive for equities and will likely correspond with higher volatility. The late-cycle fundamentals of positive growth momentum, rising inflation, fiscal stimulus and increasing net bond supply should continue to favour equities over bonds. In addition, global bond valuations remain expensive, with the valuation gap between bonds and equities still wide.

With the highest profit betas to global growth being outside the US, the equity markets of Japan and EMs should be the biggest beneficiaries of the synchronised global growth recovery, although they will also be more at risk from rising trade protectionism. As the EM equity market is becoming more of a technology and less of a commodity play, it should be less cyclical than in the past, with a resultant falling correlation with commodity prices, the US dollar and US bond yields. While US equities look expensive, equity valuations outside the US seem more attractive. Japan and EM look cheap, with the latter benefitting from any US dollar weakness.

With the 'Ramaphoria' effect continuing to underpin positive consumer, business and investor sentiment, it is not a surprise that SA's leading economic growth indicators are pointing upwards. The resultant expected corporate sales and margin recovery should support the profit growth of domestically oriented companies in SA, while expected moderate rand weakness should enhance globally generated profits. Although globalisation and the Naspers effect have caused the overall SA equity market to trade in line with elevated DM valuations, the median SA share trades in line with more attractive EM valuations, providing investors with better return prospects.

The global hunt for yield continues to underpin EM debt markets – unlike in DMs, meaningfully positive real yields are available in EMs for global investors. Unfortunately, with SA inflation bottoming, there should be limited further inflation support for the SA bond market during the remainder of 2018. In addition, ex-ante real yields and the SA/US yield spread premium have now fallen to around historical averages, likely

limiting future capital returns for local bonds.
With break-evens likely to expand with rising inflation, the fundamental underpin for SA inflation-linked bonds should improve going forward.

The combination of a large Ramaphosa-driven bond market rally since November last year (yields down 125 basis points) and the big Resilient-driven property sector sell-off since then have caused the listed property sector to now trade at the cheapest relative rating to local bonds in five years. To put this into context, the 39% relative derating of listed property to bonds in the four months since November 2017 has surpassed the 30% relative derating seen in the four months to December 2008 during the global financial crisis.

'Goldilocks' conditions persist, but the acceleration in global growth is likely nearing a peak

The 'goldilocks' environment acted as a tailwind for the global economy and financial markets for the past year and is projected to persist in 2018. However, the likelihood of the global expansion strengthening from current levels is less certain. Economic surprises have rolled back into negative territory for DMs, while surprises are off their recent highs in EMs.

Although growth in the global economy is likely drawing nearer to a peak, the risk of the world economy overheating has been lowered substantially, with different economies operating in different stages of the business cycle.
However, maturing business cycles, in certain areas of the DM composite, could cause global growth to soften from current levels.

Economic activity in the US is typified by late-cycle conditions. Nevertheless, fiscal policy, which traditionally has a counter-cyclical role, is further fuelling growth, even as the US economy closes in on full employment. An environment where fiscal policy acts in a pro-cyclical manner (an expanding deficit when unemployment is already low), could cause volatility to rise from benign levels. As such, the market may increase its focus on data that could be surprising relative to consensus expectations.

A closing US output gap, driven by solid momentum in economic activity greater than potential growth, and a rebound in international oil prices are likely to drive inflation higher, which should allow for additional interest rate hikes to beyond a neutral monetary policy stance in upcoming quarters.

Central bank policy is decidedly less hawkish outside the US. In the Eurozone, where activity is characterised by mid-cycle conditions, monetary policy is expected to remain expansionary, although gradually shifting away from an easing bias.

Monetary policy is also expected to remain expansionary in Japan, where mid-cycle economic conditions persist.
While the Bank of Japan should similarly move away from an ultra-loose monetary policy stance, it is expected to lag the actions of the European Central Bank. Even though the eighth consecutive quarter of growth into the final quarter of 2017 has meant Japan has enjoyed its longest growth streak since 1989, economic activity has not been robust enough to stir inflation, which, excluding volatile food and energy prices, rose to just 0.5% in February 2018, from a year earlier, despite a tight labour market and wage increases.

Even without China, EMs are playing an increasingly important role in driving the global economic cycle.
According to the International Monetary Fund, emerging countries accounted for 41% of global gross domestic product (GDP) in 2017, weighted on the basis of purchasing power parity. Economic growth surprises for this region rolled over from their recent March 2018 peak, but remain well within positive territory. Net commodity exporters, in this region, are operating under early-cycle conditions.
Muted inflation has allowed central banks to pursue a more accommodative monetary policy stance to promote higher rates of growth.

Nevertheless, this region is not immune to developments in the rest of the world. Continued concerns over international trade and the potential for a faster pace of monetary policy tightening in the US have increased the downside risks to the EM economic recovery. While Momentum Investments is not of the opinion the introduction of new limited tariffs (including a number of exemptions) will trigger a broad-based trade war and derail the recovery, the risk of an escalation in trade tensions cannot be discounted altogether.

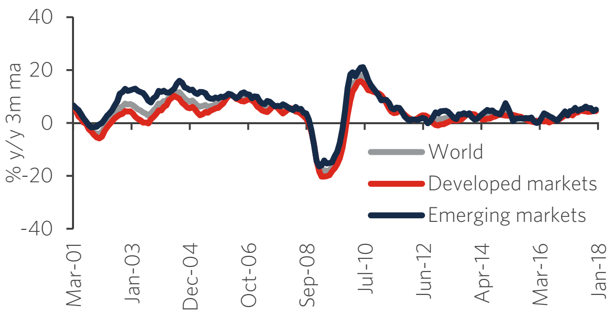
A protectionist Donald Trump administration in the US has pushed anti-China tariffs to the top of its international policy agenda, threatening the most serious breakdown in Sino-American relations since the Tiananmen Square Incident in 1989, which resulted in the US imposing trade sanctions on the emerging giant.

This time around, the largest threat to US and Chinese (and by implication, global) growth would be an aggressive use of Section 301 under the Trade Act of 1974, which allows the US President to take action against any measures that are deemed detrimental to US business. Morgan Stanley estimates a 20% broad-based tariff hike across Chinese-manufactured goods and a commensurate response from China could lower base case growth estimates by 1% after four quarters in the US and China, after considering the spillover on investment, employment and consumption. Morgan Stanley argues the effect would be amplified by global value chains and, together with tighter financial conditions, would result in a material drag on global growth.

In 2016, the Financial Times argued international stability hung in the balance, with a number of economies going down the road of mixing democracy with an autocratic reality. The rise of Russia's Vladimir Putin, the US' Trump, Turkey's Recep Erdogan, Hungary's Viktor Orban and, recently, China's Xi Jinping (in a disappointing governance setback involving the removal of the two-term presidential limit) have all expressed a tendency to favour more inward-looking policies. This is a blow to globalisation efforts, which have brought about a larger and cheaper range of goods and services, higher economic growth and a rise in living standards.

Admittedly, global trade is not growing at the double-digit growth rates, which prevailed in in the late 1990s and early 2000s, but the Netherlands Bureau for Economic Policy Analysis calculated growth in 2017 global trade rose to its strongest pace since 2011 (see chart 2).

Chart 2: Rise in global trade activity



Source: CBS, Momentum Investments

Global Trade Alert shows a rise in the number of protectionist measures since the global financial crisis. With protectionism slowly ratcheting higher, long-run growth (globally) faces the threat of less innovation, higher costs and lower economic activity, in Momentum Investments' opinion.

The United Kingdom's (UK) vote to leave the European Union (EU) demonstrated that rising populism in Europe was driven by disgruntled voters, who felt alienated from the benefits of globalisation. For the past year, the British government and the EU have been negotiating a framework for the UK's exit. With the UK wanting out of the customs union and the single market, a comprehensive free-trade agreement must be negotiated, but, so far, the EU has made no compromises. While the economic ramifications of the proposed Brexit have been relatively modest, finding a path to a softer Brexit (involving a more cooperative approach) may be necessary to improve longer-term political and economic prospects for both parties.

Growing populist angst over migration and a weak economy has also led to an outperformance of fringe parties in the Italian elections, but a lack of visibility on the future government could persist for weeks, undermining growth in the Eurozone's third-largest economy. Moreover, the election results suggest it is clear Italy will not be a positive force for European reform in the coming years. This creates problems for German Chancellor Angela Merkel and French President Emmanuel Macron, who have admitted migration and the aftermath of the European debt crisis were driving political polarisation across Europe and have pledged to drive European reform and advance EU integration.

As such, even though the short-term economic outlook is positive, global leaders and policymakers must ensure geopolitical and protectionist threats do not undermine economic potential in the longer run.

Bringing SA back from the brink

Under the Jacob Zuma administration, political accountability was destroyed. Many critical state institutions faltered and corruption undermined SA's democracy, leading to a destruction of the economy, a mismanagement of state resources and higher levels of poverty and inequality. The State Capacity Research Project, entitled '*Betrayal of the Promise: How South Africa is being Stolen*', highlighted how a power elite captured a number of key state institutions and repurposed them for its own benefit in ways which subverted the legal and constitutional framework, rendering them incapable of executing their societal responsibilities.

Nevertheless, the Centre for Development and Enterprise argues SA remains one of a handful of countries in Africa that can be considered a true 'liberal democracy', boasting a "strong free press, an independent judiciary and a tradition of civil society activism to hold leaders to account".

Since the market-favourable outcome of the ANC National Conference in December 2017, a renewed focus on national issues instead of party politics has been observed. However, as much as the traditionalist faction of the ANC is associated with corruption and state capture, it still represents a strong ideological undercurrent that could lead to a splintering of the ruling party along factional fault lines and hurt the party's showing in the 2019 national elections. The party that Cyril Ramaphosa has inherited still reflects the legacy of the Zuma era and it is not unfounded that certain segments may try to block his progress in broadening the policy debate from the myopic politics of the ruling party itself. A tightly contested race for party president resulted in a narrow victory for Ramaphosa and a mixed slate leadership, forcing him to tread the path for economic renewal carefully.

Since December 2017, Ramaphosa has started to shift the narrative and has ushered in an era of greater cooperation between government, business, labour and civil society, to cultivate greater inclusivity in SA's policy-making environment. A more market-friendly approach and a change in attitude to corruption and maladministration has comforted consumers, businesses and investors alike. In December 2017, Ramaphosa concluded that "a restoration of confidence is the quickest and cheapest form of stimulus available, especially in light of our fiscal constraints".

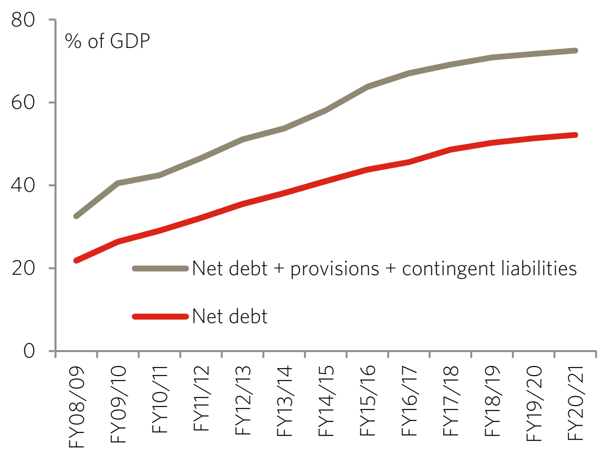
In a recent review, Moody's Investors Service kept SA's sovereign credit rating at the lowest investment grade rung, but changed its outlook for the country from negative to stable, seeing "significant growth potential for the country". Together with Standard and Poor's Ratings, the agencies noted the new administration will require time to improve economic growth and stabilise the fiscal position, given the country's structural weaknesses.

SA growth forecasts, as surveyed by the Reuters Econometer, shows GDP is expected to increase from 1.6% in 2018 (previously forecasted at 1.2% in October 2017) to 1.9% in 2019 and 2.3% in 2020. It is yet to be seen whether or not Ramaphosa will be able to resolve the different views within the ANC on how to reignite growth in the long run and foster social cohesion (through deep-seated reform and market-friendly policies). As such, Momentum Investments still sees trend growth at around 2%.

Improving the governance and financial standing of state-owned enterprises (SoEs) and placing the country on a more sustainable fiscal path is a top priority for the new administration. The ratings agencies have noted the change in political leadership has arrested the degradation of SA's institutions, including the National Treasury, the SA Revenue Service and key SoEs. However, the fragile financial state of many SoEs, in particular public-energy-utility Eskom (accounting for R350 billion of the R466 billion in guarantees government has extended to public institutions), pose a material risk to government's balance sheet, through the potential realisation of government's contingent liabilities.

In February 2018, Treasury outlined a number of front-end-loaded fiscal adjustment plans (including significant cuts to expenditure amounting to R80 billion over the medium-term expenditure framework and an increase in the value-added tax rate from 14% to 15%) to stabilise SA's government debt ratio at 52.2% of GDP by fiscal year (FY) 2020/21, while still allowing for funding for fee-free higher education (see chart 3).

Chart 3: Contingent liabilities pose a threat to government's balance sheet



Source: National Treasury, Momentum Investments

This is one example where Ramaphosa has been forced to juggle populist demands with fiscal pragmatism. Ramaphosa's follow through on his declaration of support behind land expropriation without compensation will likely be his toughest test yet, given the balance required between addressing racial disparities in land ownership, the need to protect property rights and to ensure food security and a tenable environment for agricultural investment.

Positive domestic political momentum and global risk-on sentiment underpinned rand strength early in the year. A confidence-instilling Cabinet reshuffle and revived fiscal consolidation efforts further bolstered the currency. However, Parliament's passing of the motion to review the country's land laws and a renewed focus on global factors, rather than local politics, have tempered the rand's recent gains.

Nonetheless, even after factoring in a mildly depreciating currency in the medium term (4.5%, on average, in 2019 relative to 2018 and 3.5% in 2020 relative to 2019), Momentum Investments anticipates inflation to remain well within the target band for the foreseeable future at 5.2% on average in the next three years. Inflation expectations have further surprised positively. The Bureau for Economic Research's (BER) Inflation Expectation Survey suggested the average inflation expectation for the next five years had dropped to its lowest level on record, 5.3%, in the first quarter of 2018. But the SA Reserve Bank has reiterated its preference for inflation expectations to trend closer to the mid-point of the inflation target band (4.5%).

While another interest rate cut of 25 basis points by the second half of 2018 is plausible, particularly if inflation expectations remain well anchored closer to 4.5%, more aggressive easing in monetary policy is unlikely given the medium-term outlook for inflation and political uncertainty, as the national elections draw near.