The Macro Research Desk

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Market and economic outlook

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Highlights

Market outlook

- For the first time since the global financial crisis (GFC), investors are likely to experience a transition from a period where global equities were the obvious superior asset class to own, to a period where other asset classes look like viable alternatives. Such a shift in the relative appeal of asset classes typically coincides with a pick-up in return volatility.
- As a result of the removal of accommodative policy measures in developed markets (DMs) and a more stimulatory policy framework remaining in place in emerging markets (EMs), a positive (economic and profit) growth divergence in favour of EMs is likely to become evident, as 2019 unfolds. In the absence of a global risk-off environment taking hold, this should fundamentally benefit the relative returns from EM equities, particularly in conjunction with a weaker US dollar and cheap EM valuations.
- While improved valuation metrics for the South African (SA) equity market are evident, improving fundamentals are needed to supplement cheaper valuations to build an investment case for SA equities. If the global equity market could avoid a significant sell-off during 2019, improving fundamentals could provide investors with decent available returns from current attractive valuation levels.
- SA nominal bond yields look about 1% cheap compared to US yields, illustrating the relative attractiveness of the asset class. While SA inflation-linked bonds (ILBs) should benefit in 2019 from a general uptrend in expected local inflation, the 4% real yield available on nominal bonds looks more attractive than the comparable 3.25% yields in ILBs.
- Unless there has been additional undetected financial engineering among the main companies in the listed property sector, the sector's positive valuation underpin and some macro improvement in the SA economy point to strong return prospects, even with conservative assumptions on barely positive real distribution growth in the period and no rerating expected against bonds.

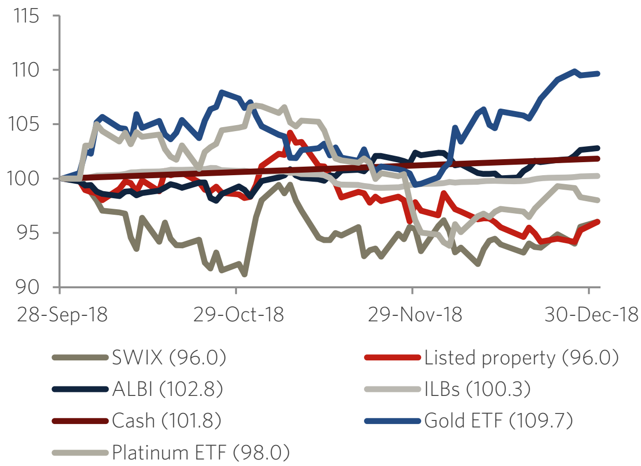
Economic outlook

- World growth is expected to slow, but the recovery remains firm. The global economy is, however, becoming less synchronised, with a smaller share of economies expected to experience an uptick in growth in 2019.
- The global expansion is expected to have run its course by 2020 and conditions will be more conducive for a global economic downturn. Reduced fiscal stimulus should temper business and consumer confidence, while the effect of restrictive trade tariffs could further trim growth prospects in the US to below trend in 2020.
- Although a normalisation in monetary policy is well underway in the US and United Kingdom (UK), spare capacity and muted inflation expectations have suppressed the outlook for inflation in Japan and the Eurozone, preventing a faster unwind of accommodative monetary policy.
- Growth in EMs was spurred by a prolonged period of ultra-accommodative monetary conditions, but EMs are now vulnerable to a rise in borrowing costs and a potential reversal in capital flows.
- Deep damage done by the previous administration has led to four consecutive years in which living standards have declined in South Africa (SA). A tepid growth outlook, further impaired by the rising threat of persistent electricity outages, point to little progress in eradicating poverty in the medium term.
- Momentum Investments expects a mild interest rate response from the SA Reserve Bank (SARB), given a weak growth environment, despite it emphasising the need to draw inflation expectations away from the upper edge of the target band.
- The risk of a downgrade remains, should trend growth deteriorate, if parastatal debt migrated to government's balance sheet, if tensions in the ruling party derail policy making or if the rule of law weakens.

Macro transition to cause significant shifts in relative global asset class appeal

Rapidly escalating worries about the future global growth prognosis resulted in a meaningful global sell-off in more risky asset classes and a concomitant fleeing to perceived safe-haven investments in the final quarter of 2018. As a result, gold, as well as global and SA government bonds were the standout performers in the quarter, with global and SA equities, as well as local listed property and platinum, recording negative returns (see chart 1).

Chart 1: SA asset class returns in Q4 2018 (indexed)



Source: IRESS, Momentum Investments, data to 31 December 2018

Looking ahead, as long as the probability for imminent US recession remains low, as is indicated by a plethora of leading indicators, the early part of 2019 could still experience moderately positive equity returns and an outperformance of global equities over bonds, if history repeats itself. However, as the balance of probabilities start pointing to the onset of a recession sometime from 2020, the outlook for global equities will likely deteriorate as 2019 progresses.

For the first time since the GFC, investors are likely to experience a transition from a period where global equities were the obvious superior asset class to own, to a period where other asset classes look like viable alternatives. Such a shift in relative asset class appeal typically coincides with a pick-up in return volatility. As a result of the removal of accommodative policy measures in DMs and a more stimulatory policy framework remaining in place in EMs, a positive (economic and profit) growth divergence in favour of EMs is likely to become evident as 2019 unfolds. In the absence of a global risk-off environment sustainably taking hold, this should fundamentally benefit the relative returns from EM equities, particularly in conjunction with a weaker US dollar and cheap EM valuations.

While the improved valuation metrics for the SA equity market are evident, improving fundamentals are needed to supplement cheaper valuations to build a positive investment case for SA equities. Local equity value could be unlocked by some cyclical acceleration in economic growth in 2019 and enhanced investor confidence, should tangible local policy reforms be forthcoming after the 2019 elections. If the global equity market could avoid a significant sell-off during 2019, improving SA equity fundamentals could provide investors with decent available returns from current attractive valuation levels.

SA nominal bond yields look about 1% cheap compared to US yields, while the forward-looking real SA bond yield of around 4% is also about 1% higher than the historical average real yield available to investors in the last 16 years, illustrating the relative attractiveness of the asset class. While SA ILBs should benefit in 2019 from a general uptrend in expected local inflation, the 4% real yield available on nominal bonds looks more attractive than the comparable 3.25% ILB yields. Although expected SA real cash returns look similar to those from inflation-linked bonds and lower than those anticipated from nominal bonds, real cash returns are compelling relative to their own history, as well as to nominal and real bonds on a risk-adjusted basis.

Unless there has been some additional undetected questionable financial engineering among the main companies in the listed property sector, it is Momentum Investments' view that the sector's positive valuation underpin and some macro improvement in the SA economy point to strong return prospects in the coming years, even with conservative assumptions on barely positive real distribution growth in the period and no rerating expected against bonds.

Global expansion set to cool in the face of mounting headwinds

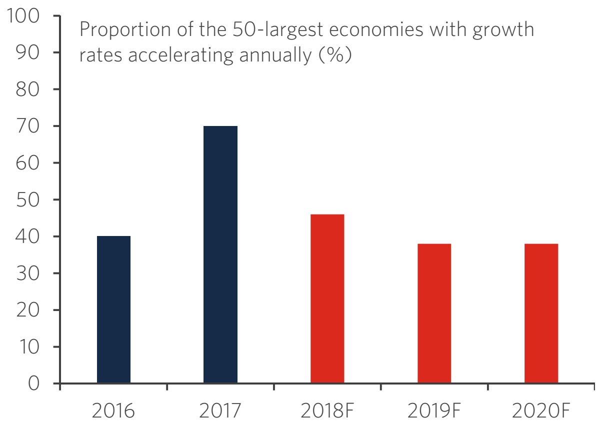
2018 marked a decade since the collapse of Bear Stearns and Lehman Brothers, which triggered the GFC that peaked in 2008. Growth in DMs has trended lower since the GFC, averaging 1.3% since 2008, which is less than half its longer-term average of 2.8%. The International Monetary Fund (IMF) attributed the downward trend to an ageing workforce, a decline in productivity growth, fewer highly productive start-up firms available to replace older, less productive ones and less competition in a more highly concentrated market.

In contrast, growth in EMs improved from 4.4% to 5.0% during the corresponding period. Stronger macroeconomic frameworks, more flexible exchange rate regimes and favourable global funding conditions were generally supportive for this region, when DM monetary policies grew more accommodative in the aftermath of the GFC.

More recently, however, tighter global financing conditions and US dollar appreciation highlighted vulnerabilities in countries with large external fragilities, while the EM composite as a whole has sustained its growth momentum. Though growth in EMs should broadly retain its pace in 2019 from levels experienced in 2018, activity is expected to moderate in a number of advanced economies. World growth is expected to slow, but the recovery remains convincing. The global expansion is likely to have peaked at 3.8% for 2018, but consensus growth forecasts for the world remain healthy at 3.6% for 2019.

Nevertheless, the global expansion is becoming less synchronised. The IMF reported that 58% of countries, globally, which accounted for 75% of world gross domestic product (GDP) in purchasing-power-parity terms, experienced an uptick in growth rates in 2017. This share declined to 47% of world GDP represented by 52% of economies in 2018 and should dip further to 32% of global GDP (54% of economies) in 2019 (see chart 2).

Chart 2: Shifting to a more uneven global recovery



Source: IMF, SARB, Momentum Investments

By 2020, the current global expansion is expected to have run its course and conditions will be more conducive for a global economic downturn. Fiscal stimulus, which has propelled growth in the US economy to beyond its potential, is forecasted to turn into a fiscal drag of 0.3% by 2020. Reduced stimulus should temper consumer and business confidence, while the effect of restrictive trade tariffs could further trim US growth prospects to below trend in 2020.

Further measured rise in global interest rates

The World Bank predicted that 2018 would be the first year since the GFC where the output gap (the difference between actual and potential growth) would be closed. It further expects the global economy to continue operating above full capacity in 2019.

While firm growth and tighter labour markets have contributed to a cyclical upturn in price pressures, a resurgence in inflation is less likely on a structural basis, given an elevated number of discouraged work seekers, an increase in automation and intertwined global value chains, the latter evidenced by an increased co-movement of inflation across countries.

Although a normalisation in monetary policy is well underway in the US and UK, spare capacity and muted inflation expectations have suppressed the outlook for inflation in Japan and the Eurozone.

The Bloomberg consensus expects the US Federal Reserve (Fed) to increase interest rates to a peak of around 3% by the end of 2019, but forecasts a more gradual tightening of interest rate policy in the Eurozone. The European Central Bank (ECB) ended its bond purchase scheme at the end of 2018, but concerns of persistence in the recent slip in economic activity and below-target inflation should delay the start to a gradual interest rate hiking cycle to the final quarter of 2019, at the earliest. Likewise, the Bank of Japan (BoJ) is not expected to exit its extensive monetary policy easing programme anytime soon, given its failure to revive inflation to its 2% goal.

A gradual and shallow normalisation in monetary policy in DMs, until now, has left markets complacent about the risk of a sudden and sharp tightening in financial conditions. While there is a fairly strong likelihood that global rates will continue to only rise slowly, a faster-than-expected tightening of global financial conditions, in the face of shrinking central bank liquidity, remains a risk to EMs through a rise in borrowing costs and a potential reversal in capital flows.

While it is true that the EM composite faces reduced macro fragilities relative to previous crises, a rebalancing of policy buffers and acceleration in reforms are required to increase the resilience of EMs against capital flows and negative exchange rate shocks in the longer run.

Bold decisions needed to break the cycle of low growth and high inequality in SA

In its September 2018 economic update, the World Bank noted President Cyril Ramaphosa's smooth transition to presidential power and the authorities' recommitment to good governance and fiscal consolidation breathed a sense of optimism into SA's political and economic future.

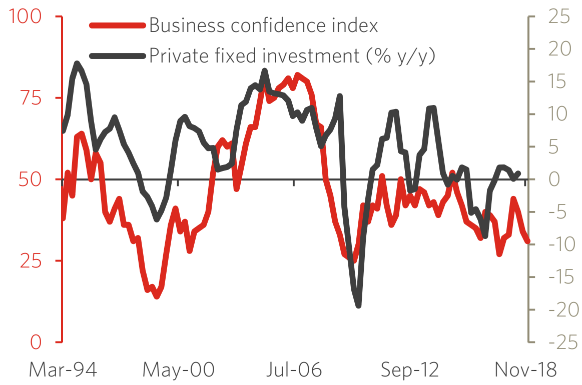
However, the honeymoon is over. A year has passed since Ramaphosa's slim win at the African National Congress's (ANC) leadership battle in December 2017 and little recovery has been observed in growth and jobs since. Deep damage done by the previous administration has led to four consecutive years in which real growth has been unable to outstrip the growth in the country's population, resulting in a decline in living standards overall. Based on Momentum Investments' expectation is for growth in the economy to gather pace from an estimated 0.7% in 2018 to around 1.5% in 2019 and close to 2.0% in 2020. However, real growth per capita should only begin to trend more meaningfully into positive territory by 2020. A recommencement of load shedding could detract further from growth estimates for 2019. Research by Standard Bank noted a 5% cut in electricity supply could shave between 0.15% and 0.3% off growth.

The World Bank acknowledges SA's success since the advent of democracy, but it concedes resolving SA's socio-economic fragilities will take time. Though the political realities of a fractious ruling party have stymied the pace of progress in SA, the measures implemented thus far by the new administration, have been effective in Momentum Investments' opinion.

While government is working to fix some challenges, policy uncertainty in a number of areas has suppressed a recovery in confidence. SA has not been immune to rising global populist sentiment. The World Bank concludes the legacy of exclusion in land, labour, capital and the product markets has led to glaring inequality. This has provided fertile ground for support for populist policies and has fuelled the contestation over resources, which manifested in the #FeesMustFall movement in October 2015, while the debate over property rights and a socialised model for healthcare remain on the political agenda.

SA's corporates have struggled in the low growth environment. Spend on private fixed investment has lagged at negative 1.8% in the past three years and is only expected to gather momentum after the national elections take place and a greater sense of policy certainty and consistency is achieved. In Momentum Investments' opinion, breaking the cycle between a stagnant economic performance and elevated poverty will require a stronger social contract between business, labour and civil society. However, for the private sector to pay a more active role in shaping the economy and creating jobs, government must pursue efforts to improve the ease of doing business. In the likely absence of another commodity or credit boom, reinvigorating confidence will be an important driver for growth.

Chart 3: Private fixed investment has lagged on weaker confidence



Source: BER, SARB, Momentum Investments

A controlled rise in inflation from an expected 4.6% in 2018 to 5.2% in 2019 and 5.7% in 2020 (based on lagged currency depreciation, above-inflation wage increases and electricity tariffs) suggests growth in disposable income will continue to outstrip inflation, remaining supportive for household spend. Moreover, consumers' ability to spend should lift marginally on reduced fiscal drag adjustments and an improvement in the household credit impulse. Households have actively delevered to 71.3% as a share of disposable income since the 85.7% peak in 2008. A further rise in debt-servicing costs is anticipated, but within-target inflation and a modest growth outlook warrants a shallow interest rate response.

Although the near-term risks to the inflation outlook have subsided, the SARB expressed its concerns over upside threats to inflation in the longer term. Tighter global financial conditions and SA's relatively poor macro fundamentals highlight the need to maintain an attractive real interest rate profile, but a muted growth outlook will likely prevent a sharper acceleration in interest rates. Accordingly, Momentum Investments expects only a mild tightening in monetary policy from 6.75% to 7.25% by the end of 2020.

Despite the unexpected deterioration in SA's fiscal deficit and debt ratios projected in the October 2018 medium-term budget, government has maintained the expenditure ceiling and remains committed to fiscal consolidation, forecasting a primary deficit of close to zero by FY2021/22.

With Moody's only looking for a stabilisation in debt in the medium term and not expecting a quick turnaround in growth, Momentum Investments expects Moody's to leave the country's sovereign rating unchanged in the near term. Nonetheless, the risk of a downgrade remains, should trend growth deteriorate (particularly in light of the renewed threat of persistent electricity outages), if state-owned enterprise debt migrated to government's balance sheet, if tensions in the ruling party derail policy making or if the rule of law weakens.

A downgrade of Moody's sovereign rating of SA into sub-investment grade would trigger an exclusion from the Citi World Government Bond Index (Citi WGBI) and a forced selling of local government bonds. This, together with poor macro fundamentals, leaves the rand vulnerable to a shakier global environment and a deterioration in sentiment towards perceived-riskier EMs. Momentum Investments anticipates a brief strengthening in the rand in reaction to an expected market-friendly outcome in the national elections in SA in May 2019. Nevertheless, the rand should experience a mild deterioration in the medium term in response to a weakening in the country's terms of trade (export prices relative to import prices) and its slow economic progress in alleviating the country's employment and poverty challenges.