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Market and economic outlook

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Highlights

Markets

- In Momentum Investments' view, the rand is more likely to detract than add to the returns from global asset classes.
- Although some global equity caution is warranted during late-cycle bull markets when contracting global liquidity becomes less asset-price friendly and bear market signals start to emerge, global bonds typically only outperform equities closer to the onset of recession. In this regard, a recession in the United States (US) only looks likely by 2020.
- The dualistic nature of the South African (SA) equity market provides built-in rand diversification for investors. One of the idiosyncrasies of the SA equity market is that market-dominant Naspers inflates the valuation of the SA equity market to trade like a more expensive developed market (DM); without Naspers, it trades in line with cheaper emerging market (EM) valuations.
- Due to Turkey contagion, current SA ex-ante real bond yields are at attractive levels. Momentum Investments favours local nominal bonds over inflation-linked bonds, due to more favourable implied real yields for nominal beyond the front end of the curve.
- Although good property returns can be expected from the current valuation on macro grounds, company-specific risks need to be monitored closely to avoid another Resilient-like drawdown.
- The relative risk-adjusted returns from local cash are attractive, with the scope for interest rate hikes to bolster returns from this asset class in due course.

Economics

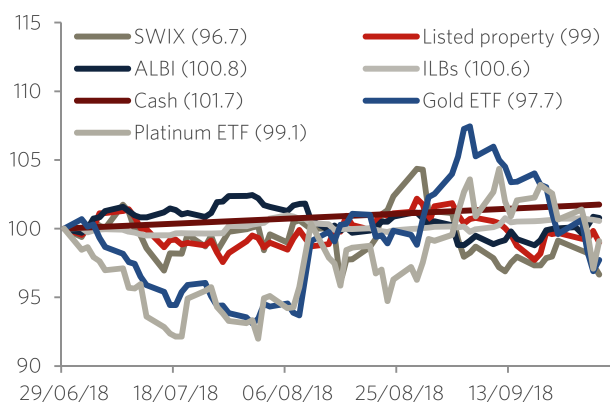
- An escalation in international trade tensions, a gradual erosion of democratic standards in Europe, rising world debt levels, tighter global financial conditions and geopolitically driven oil price shocks have dampened optimism around global economic prospects.
- The timing, degree and effect of previous fiscal and monetary interventions by the major central banks and varying progress in fiscal and monetary exit strategies have given rise to a desynchronisation in global growth.
- Tell-tale signs of a late cycle phase are emerging in the US. The fading effect of the fiscal boost, higher expected interest rates and onerous tariffs are likely to trigger a downswing in 2020.
- Punitive trade measures could compound the negative growth effect of previous targeted deleveraging efforts in China. However, supportive measures from the Chinese government should prevent a hard landing in its late-cycle growth phase.
- Internal politics threaten Europe's growth outlook, as it transitions from mid to late cycle. If the newly formed anti-establishment coalition government in Italy fails to cooperate with European authorities, contagion effects could ripple throughout the bloc.
- Protectionist policies, higher oil prices and tighter global financial conditions have generated uncertainty in EMs. However, EMs are in general far better positioned today to withstand external shocks.
- Although SA has been unfairly categorised within the latest EM grouping in terms of economic mismanagement, the country does exhibit some vulnerabilities, which stack up relatively poorly on an EM comparison.
- Disappointing growth in local economic activity is likely to lead to some fiscal slippage in the medium term, which could delay a recovery in SA's elevated debt ratio.
- Unless there is a significant fiscal disappointment or further unconditional guarantees allocated to state-owned enterprises (SoEs), sovereign ratings are likely to remain steady into the end of the year.
- A tepid near-term growth environment and a non-threatening inflation trajectory in SA point to the start of a shallow interest rate hiking cycle in due course.

Until US recession becomes imminent, global equities to continue outperforming bonds

While global equities were supported by better-than-expected growth indicators out of the US during the third quarter of 2018, the combination of the improved growth environment and a widespread rise in US inflation gauges undermined the returns from global government bonds in the quarter. Although DM equities provided strong positive returns in the period, EM equities were buffeted by severe headwinds during the quarter.
These included the trade wars between the US and China (with a number of rounds of tariffs and retaliatory counter-tariffs imposed by the two countries on each other's exports), EM contagion fears in response to the escalation of political and trade tensions between the US and Turkey and a questioning of the latter's economic policy credibility, a further rate increase in the US and its implication for the relative attractiveness of EM investments, as well as the inflationary effect of a supply-driven significant increase in the oil price.

Among the local asset classes, cash was the stand-out performer during the third quarter, with nominal and real bonds also providing positive returns (see chart 1). All the other main asset classes provided negative returns in the quarter, with SA equities the clear laggard, as index-heavyweight, Naspers, buckled under negative regulatory issues affecting China's Tencent.

Chart 1: SA asset class returns in Q3 2018 (indexed)



Source: IRESS, Momentum Investments, data to 28 September 2018

In Momentum Investments' view, recent rand weakness has reflected contagion fears stemming from idiosyncratic risks in a handful of EMs and, thus, has been overdone relative to the country's own macro fundamentals. An assessment of the real effective exchange rate points to some retracement in the currency in the coming months – as such, the currency is more likely to detract than add to global asset class returns from current levels. This is particularly pertinent for global cash returns, as global interest rates are still tracking close to historical lows even though interest rates have been rising steadily in the US.

Although some global equity caution is warranted during late-cycle bull markets, when contracting global liquidity becomes less asset-price friendly and Bear market signals start to emerge, bonds typically only outperform equities closer to the onset of recession. In this regard, a recession in the US only looks likely by 2020 as high-yield spreads, lending standards and default rates are not rising yet and real policy rates are still too low. Moreover, firm growth, broad US inflation pressure and rising net bond supply should put upward pressure on bond yields, while valuations still favour global equities over global bonds for now.

The dualistic nature of the SA equity market provides built-in rand diversification for investors. As such, significant rand weakness in 2018 initiated earnings per share upgrades.
One of the idiosyncrasies of the SA equity market is that market-dominant Naspers inflates the valuation of the SA equity market to trade like a more expensive DM; without Naspers, it trades in line with cheaper EM valuations.

In contrast to DMs, there are meaningfully positive real bond yields available in EM, with EM real yield differentials tracking close to recent historical highs. As the SA bond market suffered from Turkey contagion in the third quarter of 2019 due to SA's twin deficits (but ignoring the country's relatively more favourable net foreign asset position and inflation targeting credibility), current SA ex-ante real yields are trading at an attractive 105 basis points above the post inflation-targeting average. Although break-evens are expected to expand in line with a rising inflation trajectory into 2019, Momentum Investments favours nominal bonds over inflation-linked bonds on the back of more favourable implied real yields for the former beyond the front end of the curve.

With listed property now trading at its cheapest relative rating to local bonds in five years, good property returns can be expected from the current valuation on macro grounds, even if the yield relative to bonds is derated to its 15-year average. However, company-specific risks need to be monitored closely to avoid another Resilient-like drawdown. The relative risk-adjusted returns from local cash are attractive, with the scope for interest rate hikes to bolster returns from this asset class in due course.

Intensifying trade conflict starting to bite

The year started with a general sense of optimism around prospects for the global economy. In a January 2018 World Economic Outlook update, entitled 'Brighter Prospects, Optimistic Markets, Challenges Ahead', the International Monetary Fund (IMF) upwardly revised its global growth forecasts by 0.2% to 3.9% for 2018 and 2019. The market consensus echoed an expected improvement in global growth momentum, reflective of positive growth surprises in Europe and Asia at the time.

Since then, an escalation in international trade tensions, a gradual erosion of democratic standards in Europe, rising world debt levels, tighter global financial conditions and oil price shocks (the latter partly a consequence of geopolitical spill-overs) have dampened optimism.

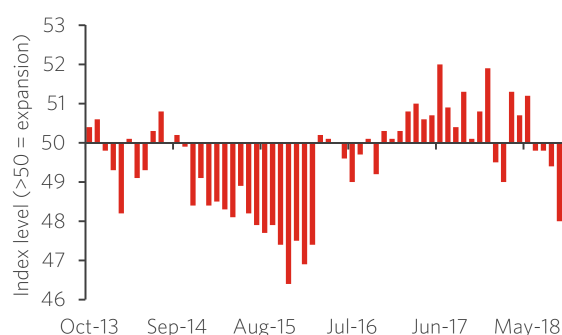
The timing and degree of previous fiscal and monetary interventions, an asymmetrical reaction by consumers and businesses across countries and the progress in fiscal and monetary exit strategies have given rise to a desynchronisation in the position of major countries in the global business cycle.

Tell-tale signs of a late cycle phase are emerging in the US. Growth is anticipated to slow in 2019 (and more aggressively in 2020), while inflation is likely nearing a peak. The Federal Reserve (Fed) has responded typically by positioning its communication to tighten interest rates further.
With unemployment tracking near all-time lows, the economy is not in obvious need of stimulus. However, fiscal policy has been eased through generous consumer and business tax cuts. Nonetheless, should the Democratic Party be successful in winning a majority in the House of Representatives, at the upcoming mid-term elections scheduled for 6 November 2018, additional tax cuts would likely be off the table. In Momentum Investments' view, the fading effect of the fiscal boost and lagged effect from cumulative monetary tightening should trigger a downturn in 2020. Deutsche Bank estimates mild fiscal drag to shave 0.3% off growth in 2020. Higher expected interest rates (the market anticipates a peak of 2.9% by 2020 compared to the Fed's 3.4%) will make it more difficult and expensive to borrow money, causing US households and businesses to spend less in 2020. Moreover, onerous tariffs threaten to undermine growth in the US further out.
As such, Momentum Investments projects growth in the US to slip below its potential during 2020.

More than 45% of the surveyed respondents in the latest Barclays Global Macro Survey signalled that market risks presented by an economic confrontation between the US and China are likely to rise in 2019. Barometers, indicating the state of global trade, have already turned less positive.
The Baltic Dry Index, which reflects shipping activity, plunged in August 2018 and has not yet fully recovered.
The International Air Transport Association showed that growth in airfreight traffic stood at 2.3% in August, compared to 4% during the first eight months of the year.
The deterioration in global trade politics has in addition dented export orders in a number of economies.

China's new export orders tumbled at its fastest rate in more than two years in September 2018, in response to an intensifying trade spat with the US (see chart 2). Attempts at fresh negotiations between the two have faltered and resulted in US President Donald Trump imposing a 10% tariff (expected to rise to 25%, if no trade deal is reached by the end of the year) on US$200 billion additional Chinese imports. This is on top of a 25% tariff, which was imposed during August 2018 on US$50 billion worth of Chinese imports. Trump noted, if China took retaliatory action, the third phase of tariffs (25% on an additional US$250 billion worth of imports) would be pursued.

Chart 2: Negative trade developments have hit China's new export orders index



Source: Bloomberg, Momentum Investments, data up to September 2018

The full effect of the punitive trade measures could compound the negative growth effect of previous targeted deleveraging efforts in China. However, supportive measures from the Chinese government should keep growth close to 6% in 2019, preventing a hard landing in its late cycle phase.
Indirect measures to stimulate domestic demand, including tax cuts and the provision of finance for private firms, are being deliberated aside from subsidies and tariff cuts on

consumer goods and key firm inputs. Many Chinese firms are, in addition, considering moving some of their operations to other Asian markets to avoid the extra costs.

Not all recent trade developments have been negative. The United States-Mexico-Canada trade deal was little changed from the original North American Free Trade Agreement. Secondly, Europe recently reached a deal with Japan after four years and 18 rounds of negotiations. The deal ratified cuts to Japan's tariffs on imports of European meat, wine and dairy products, while Europe's import duties on Japanese cars were slashed. Thirdly, a fifth round of tariff cuts under the Japan-Australia Economic Partnership Agreement came into effect in April this year. Fourthly, the Comprehensive Economic and Trade Agreement between the European Union (EU) and Canada sought to remove duties on 98% of goods traded with Canada. Finally, China and the EU are seeking to ensure the future relevance of the multilateral trading system.

While trade tensions with the US are expected to dampen confidence in Europe, the most pressing challenge the region faces, as it transitions from mid to late cycle, is internal politics. Support for populist parties has increased in all, but five, EU member states in the past decade. While the surge in Euroscepticism has been popular in the smaller EU members, major countries including Germany, Spain, France and Italy have also been affected. If the newly formed anti-establishment coalition government in Italy fails to cooperate with European authorities, contagion effects could ripple throughout the bloc.

Italy could face downgrades in the event of a collapse in consumer and investor confidence, which would preclude Italian bonds as a form of collateral accepted by the European Central Bank. Similarly, the Emergency Support Programme would be disregarded as a funding option, as it is conditional on a fiscal adjustment. Italy's interconnectedness and relative size of the economy would likely put the region under stress. Nonetheless, this remains a risk rather than a base-case scenario for now, given the Italian government backed down in recent budget negotiations and signalled its intention to reverse the deficit from 2020.

SA caught up in the throes of another EM sell-off

In addition to stepped-up protectionist policies, higher oil prices and a normalisation in global financial conditions have generated uncertainty in EMs and have cast the spotlight on countries with external vulnerabilities. While major policy errors in Turkey and Argentina warranted the recent sell-off in assets in those countries, EMs are in general far better positioned today to withstand external shocks.

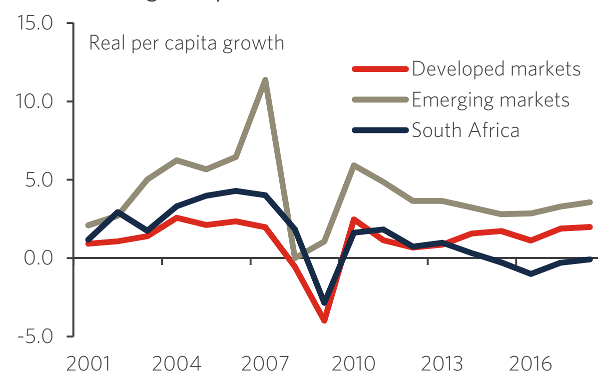
In Momentum Investments' opinion, many countries (including SA) were unfairly punished in the latest EM sell-off. Due to the depth and liquidity of SA's markets, SA assets are often traded as a proxy for general EM investor sentiment.

Unlike Turkey, SA has a smaller external imbalance, a healthy net foreign asset position and a lower exposure to foreign-currency-denominated debt. Although SA has been unfairly categorised within the latest EM grouping in terms of economic mismanagement, the country does exhibit some vulnerabilities, which stack up relatively poorly compared to other EMs.

Downward phases of business cycles in SA have had an average duration of 20 months since 1945. However, the current downward phase calculated by the SA Reserve Bank reached 58 months in September 2018, which exceeds the longest confirmed downward phase of 51 months, which stretched across the early 1990s in the period preceding democracy.

Data from the IMF confirms the average yearly increase in real growth per capita in SA has been lower than that of EM since 2001 (see chart 3). Real per capita growth in SA outperformed that of DMs by an average of 1.4% between 2001 and 2009, but has significantly underperformed more robust global trends in the past five years.

Chart 3: Weak domestic growth trend diverging from more robust global patterns



Source: IMF, Momentum Investments, data up to 2018

Disappointing growth in economic activity is likely to lead to some fiscal slippage in the medium term, which could delay a recovery in SA's elevated debt ratio. Rating agencies have noted they are not expecting a quick turnaround in structural reforms, but instead take a longer-term view on expected growth and fiscal outcomes. Unless there is a significant fiscal disappointment or further unconditional guarantees allocated to state-owned enterprises (SoEs), sovereign ratings are likely to remain steady into the end of the year.

Since Cyril Ramaphosa's victory at the African National Congress (ANC) National Elective Conference in December 2017, he has managed to restore confidence in government, effected a leadership change within the SoEs, implemented labour market reforms to reduce prolonged strike activity and reinstated government's commitment to fiscal consolidation.

A new Mining Charter, which reflected substantial engagement between key stakeholders and a bridging of the trust deficit between government and the private sector, as well as the scrapping of the Minerals and Petroleum Resources Development Amendment Bill, could help to lift constraints on investment in the mining sector. Government further intends to unveil its infrastructure plans at the upcoming Investment Summit in October 2018, which is likely to focus on how to unblock investments, which have been trapped as a result of high levels of policy and regulatory uncertainty. Secured inward investment into SA (US$10 billion each from the United Arab Emirates and Saudi Arabia and US$15 billion from China) is likely to be focused towards renewable energy, tourism, agriculture, exports and beneficiation.

Announced measures to release broadband spectrum, revisit the requirements for highly skilled foreigners and review administrative costs for power, ports and rail tariffs should help to lower the costs of doing business.

While some of the low-hanging fruit have already been addressed under the new administration, reforms to build a strong foundation for longer-term economic prosperity will take time to implement, particularly as the ruling party remains in conflict over a number of issues. Land reform has been one such issue, in which the ANC's approach to addressing policy uncertainty has failed to calm nervous investors.

In Momentum Investments' opinion, real growth in SA is likely to average 1.3% between 2018 and 2019, before rising in line with its potential at 2.3% in 2020, as fixed investment recovers in a clearer policy and regulatory environment.

As such, demand-pull inflation pressures are likely to remain absent. Exogenous factors (including the rand and international oil prices) and administrative costs (electricity) remain the biggest upside threats to the inflation outlook, which is expected to remain within the 3% to 6% target band in the medium term. A tepid near-term growth environment and a non-threatening inflation trajectory point to the start of a shallow interest rate hiking cycle in due course.

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