The Macro Research Desk

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Market and economic outlook

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Highlights

Market outlook

- Global equity markets rebounded in the first quarter of 2019 from a weak end to 2018, as more accommodative monetary policy stances by the major central banks and a temporary ceasefire in the Sino-United States (US) trade dispute fuelled gains.
- In global fixed income markets, growing caution among investors over faltering economic growth led to a 30-basis point drop in US and German 10-year government bond yields, while concerns sprouted over whether the current economic expansion was nearing an end upon 10-year treasury yields dropping below three-month treasury bill rates in the US in March 2019.
- Notwithstanding the global rally in risky asset classes, the South African (SA) equity market lagged emerging market (EM) equities in the first quarter of the year in view of a continued disappointment in local economic activity, amid rising electricity supply concerns.
- A rethink in the US Federal Reserve's (Fed) monetary policy stance could support good US equity returns for some time, after the inversion of the yield curve, but higher levels of equity volatility are likely to prevail in the coming years. US equities look slightly cheap relative to bonds on a valuation basis.
- In the SA market, historical data support prospective equity returns from the current low five-year trailing return level. The trailing price-to-earnings (p:e) ratio excluding Naspers remains on the cheap side of fair value.
- Listed property is trading at its cheapest rating against SA government bonds in ten years. As such, good property returns are expected from the low base created in 2018, even with conservative assumptions on distribution growth and relative ratings.
- Real bond yields in SA appear very attractive relative to the country's investment grade peer group and relative to its post-inflation targeting history. SA's yield spread premium with the US has moved even higher in recent months.

Economic outlook

- The world economy continues to expand, but there are increasing signs that momentum in growth appears to be fading relative to the peak experienced in the first quarter of 2018.
- The global expansion is set to slow further in 2020 on the grounds that high levels of public debt limit the ability of major advanced economies to counteract a slowdown with fiscal stimulus. A negative fiscal impulse could be accompanied by a capex-led slowdown in the US, considering the worrying rise in corporate debt, which has resulted in a number of firms curbing their fixed investment plans.
- Regardless of firm macro fundamentals, the US Fed pivoted towards a more dovish stance in the past quarter, with its reaction function placing more emphasis on elevated global political and economic risks, which could harm growth in the US economy.

- The recent coordinated dovish U-turn in monetary policy in major advanced economies, expected near-term dollar weakness and a pause in trade war rhetoric should lead to an improvement in sentiment towards EMs, but a rise in anti-globalisation politics, the reduced pace of growth in global liquidity and elevated debt-servicing costs for EM corporates continue to pose downside risks.
- The damaging effects of electricity constraints on confidence and output has prompted a downward adjustment to Momentum Investments' forecast for real growth in SA to 1.0% for 2019. A modest improvement is expected in the medium term to 2.1% by 2021 on the back of some regulatory and governance reform.
- The positive downward trajectory in inflation expectations and weaker-than-expected growth outcomes likely lower the pressure on the SA Reserve Bank (SARB) to maintain a tightening bias. Nonetheless, in the firm's view, the hurdle to interest rate cuts remains high given the SARB's intention to drive inflation expectations closer to the midpoint of the target band, while looser fiscal policy further encumbers the SARB's ability to run a more accommodative stance on monetary policy.

A dovish monetary policy U-turn and a still-growing global economy is supportive of risky asset classes

A slowdown in the world economy and a spike in economic policy uncertainty led to a dovish pivot in global monetary policy in the past quarter. The US Fed unexpectedly pledged its patience on the future path of interest rate policy after raising its benchmark rate four times in 2018. Monetary authorities in Europe and Japan complied with the Fed's rhetoric and indicated that policy in their respective economies would remain easy for some time. Moreover, China has loosened credit conditions and has stepped up fiscal spending to ensure its revised growth targets will be met for 2019.

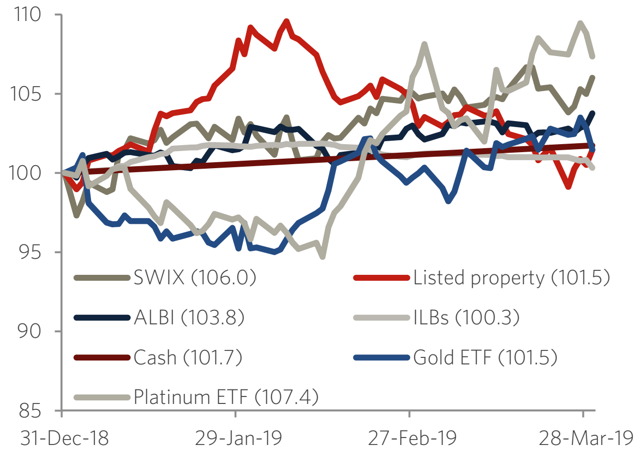
Global equity markets rebounded in the first quarter of 2019 from a weak end to 2018, as more accommodative monetary policy stances by the major central banks and a temporary ceasefire in the Sino-US trade dispute fuelled gains. Despite growth worries, developed equity markets rose 12.5% in the first quarter of the year. The rally was driven by strong returns of 13.6% in the S&P 500 Index and a 12.3% gain in the Eurostoxx 50 Index, while the Japanese Nikkei 225 Index lagged at 6.9%.

In global fixed income markets, growing caution among investors over faltering economic growth led to a 30-basis-point drop in US and German 10-year government bond yields. Concerns sprouted over whether the current economic expansion was nearing an end when the 10-year US treasury yield dropped below the three-month treasury bill in March 2019.

Notwithstanding the rally in risky asset classes, the SA equity market lagged (6.1%) EM equities (9.9%) in the first quarter of the year in response to disappointing economic activity in the local economy, amid rising electricity supply concerns. SA equities outperformed nominal bonds (3.8%) and listed property (1.5%), but trailed the quarterly rand return of 7.4% in platinum exchange-traded funds (ETFs), the latter buoyed by currency weakness, which was triggered by downgrades to local growth expectations and the increased incidence of stage four loadshedding (see chart 1).

Looking ahead, a rethink in the US Fed's monetary policy stance could support good equity returns in the US for some time after the inversion of the yield curve. Traditionally, the US equity market peaks around 13 months after the yield curve inverts and an eventual recession has typically followed the inversion by 18 months. Although equities are expected to continue performing well in the run-up to the expected US downturn, Momentum Investments remains cautious of increased levels of volatility in the global equity market in the coming years.

Chart 1: SA asset class returns in Q1 2019 (indexed)



Source: IRESS, Momentum Investments, data to 29 March 2019

On a valuation basis, global equities appear cheap relative to bonds. As the balance of probabilities starts pointing to the onset of an economic downturn sometime from 2020, the outlook for global equities will likely deteriorate as 2019 progresses. Historically, bonds have tended to outperform equities under recessionary conditions. However, the typical canaries in the recession coal mine (credit spreads and bank lending standards) are still silent and the long lead time between curve inversion and the peak in the equity market are indicative of ongoing supportive for global equities in the coming months.

On a regional allocation, relative valuations favour non-US markets. Expected US dollar weakness in the near term could benefit equity markets in the US and EMs, while Japanese and European markets perform better in a strong dollar environment.

In SA, most shares are trading significantly below their highs after performing poorly for the past five years. However, historical data support prospective SA equity returns from the current low five-year trailing return level. The trailing p:e ratio for the SA market (excluding Naspers) continues to trade on the cheap side of fair value.

In fixed income markets, SA boasts the highest real yield of its global investment grade peer group, illustrating the relative attractiveness of the asset class. In addition, SA ex-ante real yields are 95 basis points above the post-inflation-targeting average and the SA/US yield spread premium is 81 basis points higher than the average since inflation targeting. While SA inflation-linked bonds (ILBs) should benefit in 2019 from a general uptrend in expected local inflation, the one-year expected return on nominal bonds looks more attractive. Although expected SA real cash returns for the next year 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 on a risk-adjusted basis.

Listed property is trading at its cheapest rating against SA government bonds in ten years. Unless there has been some additional undetected questionable financial engineering among the main companies in the listed property sector, good returns are expected from the low base created in 2018, even at an unchanged relative rating to bonds and after taking into account real distribution growth of negative 2%.

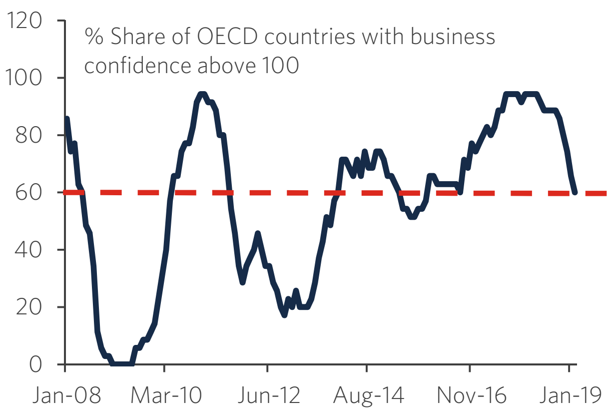
Shakier global activity complicates central banks' plans to normalise policy

After peaking in the first quarter of 2018, the world economy continued to expand. However, there are increasing signs that momentum in growth in all parts of the world economy appears to be fading. In the past weeks, forecasters have been negatively surprised by sentiment indicators and economic data across developed and emerging economies, in what appears to be a synchronised slowdown.

Although the share of Organisation for Economic Co-operation and Development (OECD) countries registering above-neutral business and consumer sentiment fell sharply between October 2018 and February 2019, around 60% of these countries are still experiencing positive readings for business and consumer confidence (see chart 2). Likewise, the slowdown has been concentrated in the manufacturing and tradeable goods sectors (the consequence of more onerous trade arrangements), while sentiment in the services sectors has largely ignored the ongoing trade disputes.

In Momentum Investments' opinion, the global expansion is set to slow further in 2020, as high levels of public debt limit the ability of major advanced economies to counteract a slowdown with additional fiscal stimulus. The primary government budget balances for advanced and emerging economies are projected to swing from a position of fiscal expansion in 2019 to a position of consolidation in 2020.
This negative fiscal impulse could be accompanied by a capex-led slowdown in the US, considering the worrying rise in corporate debt, which has resulted in a number of firms curbing their fixed investment plans. Given that investment contributes towards a smaller share of the US economy, the expected downturn in 2020 is likely to be shallow, unlike the financial and consumption-led crisis that roiled markets in 2008/09.

Chart 2: Global economy shifting down a gear



Source: OECD, Momentum Investments, data up to February 2019

This time around, consumer metrics remain firm. US consumer confidence remained upbeat at 97.8 points in March 2019 (notably above its long-term average of 86.2 points), partly owing to robust net wealth metrics. Labour-market dynamics additionally remain supportive of household spend, with growth in average hourly earnings tracking above 3% and average payrolls having stabilised at 192 000 in the first quarter of the year.

Regardless of firm domestic macro fundamentals, the US Fed pulled back from earlier tightening plans for interest rates and pivoted to a more dovish stance on monetary policy. Its reaction function has shifted its emphasis to elevated global political and economic risks, which could spill back negatively into the US economy. This marked change in rhetoric led to an orchestrated central bank retreat from policy tightening. The Fed dot plot (measuring median Fed member expectations) removed its two projected interest rate hikes for 2019, while the European Central Bank announced a fresh round of stimulus in light of policymakers' gloomy prognosis for the economy, the latter based on geopolitical risk factors, the threat of more aggressive protectionist policies and vulnerability in select EM export destinations. With Japan's inflation target remaining remarkably elusive, the Bank of Japan vowed to continue 'powerful' easing until its 2% inflation target is achieved.

The Bank of England could pursue a similar extension of its accommodative monetary policy stance, particularly if a no-deal Brexit left the economy on the verge of recession. To date, a chaotic political stalemate has dragged business sentiment lower in the United Kingdom and has resulted in private investment falling 18% short of previous economic cycles on a cumulative basis.

'Slowbalisation' to cap EM growth, but Chinese stimulus will prevent a dramatic slowdown

Globalisation gathered steam during the 1990s, with the creation of the single market in the European Union and China's admission into the World Trade Organisation in 2001. However, since then, near-sourcing (bringing factories back home), an increased desire for self-sufficiency in technologies, which could risk national security, and a populist drive for the return of borders have worsened international relations and reversed globalisation trends. This has resulted in what the Economist publication refers to as 'slowbalisation', where regional deals and spheres of influence are asserting more control over trade and investment, while cross-border investment, trade, finance and supply chains have been shrinking as a share of world gross domestic product (GDP).

For EMs, the expansion in trade between 1990 and 2010 raised growth and productivity in the region. However, increased integration at a regional (rather than global) level may make it more difficult, in future, for emerging nations to close the gap with richer nations. Moreover, while trade patterns become less linked across the globe, US interest rates will continue to govern the global financial system, cultivating more financial turbulence and volatility down the line. The International Monetary Fund revised its growth forecast for EMs slightly lower from 4.5% and 4.9% to 4.4% and 4.8% in 2019 and 2020, respectively, but noted the slowdown in advanced economies and trade tensions pose headwinds to the outlook, while regional differences in growth are likely to remain apparent. Although the coordinated dovish U-turn in monetary policy in major advanced economies, expected near-term recent dollar weakness and a pause in trade war rhetoric should lead to an improvement in sentiment towards EMs, a rise in anti-globalisation politics, the reduced pace of growth in global liquidity, the continual slide in EM sovereign ratings and elevated debt-servicing costs for corporates continue to pose downside risks to the outlook for EMs.

That said, mounting concerns over slowing growth in China, which contributed 32% of GDP in the EM composite in 2018, are overdone in Momentum Investments' view. Admittedly, China's deleveraging campaign has weighed down business and property investment and the manufacturing sector has dipped on a deterioration in the global trade cycle. However, the transformation and upgrading of the economy have continued to open new drivers for growth. China has notably shifted its reliance towards services (constituting around 60% of the economy in 2018) and its consumer base (household consumption contributed 76% towards GDP growth in 2018). The Purchasing Managers' Index for the services sector registered at an average 54 points for the past year in China, implying the sector has shrugged off the ongoing trade dispute with the US. Similarly, Chinese household confidence at an all-time high bodes well for household consumption, as consumer willingness to spend improved further in February 2019. China has also stepped up the pace of monetary and fiscal easing, targeted at consumers and small businesses, which should result in a soft growth landing in the economy at an average of around 6.0% between 2019 and 2020 from 6.6% in 2018.

Loadshedding and lingering policy uncertainty threaten a modest recovery in SA

SA's challenges, against the backdrop of slowing momentum in the global economy, are exacerbated by heightened concerns over the sustainability of energy supply, which has dampened confidence and weakened the fiscal outlook.

Earlier in the year, energy utility, Eskom, was confronted with more than 13 000 megawatts (MW) of unplanned electricity outages (due to unforeseen boiler tube leaks and a loss in imports from Cahora Bassa as a result of cyclone Idai) against its earlier assumption of 8 000 MW. This escalated into stage four loadshedding, which requires 4 000 MW to be rotationally shed on a national basis to prevent a total collapse of the system. In a briefing in April 2019, the minister of public enterprises and the Eskom chair suggested a winter free of loadshedding under the base-case scenario, with a maximum of stage one loadshedding for 26 days in the alternative-risk scenario, in the event unplanned outages rise above 9 500 MW. While planned maintenance should reduce during winter and additional generating units are expected to come back online, the peak level of demand is generally higher during the colder months. As such, unplanned outages could result in further mismatches between demand and supply.

The damaging effects of electricity constraints on confidence and output in the economy has lowered Momentum Investments' forecast for real growth in GDP to 1.0% for 2019. Higher taxes and tariffs, muted employment prospects and a deterioration in the growth rate of net wealth should dampen consumer spend, while a lack of demand and ongoing regulatory and economic uncertainty should further delay private investment spend. A modest improvement is expected in the medium term, with growth anticipated to recover to 2.1% by 2021 on the back of some regulatory and governance reform.

The increased frequency of loadshedding and its negative effects on sentiment could challenge the African National Congress' (ANC) performance at the national election polls on 8 May 2019.
Moreover, mounting allegations that Bosasa had paid large bribes, on a regular basis, to senior ANC officials for a number of years in exchange for lucrative state contracts could negatively shape electoral support for the ruling party.

Survey results from the Institute of Race Relations (IRR), polled in the second half of February, show a decline in the level of support for the ANC from 60% in December 2018 to 55%, on the assumption voter turnout dips to 71% from 73.5% in 2014 (based on the reduced number of new voter registrations). Support for the Democratic Alliance (DA) improved between these survey dates from 20% to 24%, while the outcome for the Economic Freedom Fighters (EFF) remained stagnant at 11%. The IRR poll indicated the ANC will struggle to maintain its majority vote in Gauteng (at a polled 47% relative to 53.6% in 2014), risking the need for a coalition government (likely with the minority parties if the margin of loss is small) and could subsequently result in President Cyril Ramaphosa coming under increased internal party pressure. Meanwhile, the DA's majority in the Western Cape could dip (the polls point to a fall to 54% from the 2014 election outcome of 59.4%), as support defects to the Good Party or the Freedom Front Plus.

Efforts by Ramaphosa during the past year have reinforced his commitment to governance and regulatory reform and this has been reflected in his reputational advantage over other party leaders, including the DA's Mmusi Maimane and the EFF's Julius Malema. Ramaphosa scored a 43% net favourability rating in the February 2019 IRR poll, compared to weaker ratings of negative 2 and negative 12 for Maimane and Malema, respectively.

In Momentum Investments' opinion, Ramaphosa has made a concerted effort to reinstate credibility at state institutions, which were compromised during former President Jacob Zuma's tenure. In furthering his campaign to fight corruption, Ramaphosa signed a proclamation in March 2019 to establish a new anti-corruption unit in the office of the new National Director of Public Prosecutions, Shamila Batohi, raising hopes of increased accountability and potential prosecutions against those implicated in corrupt activities.

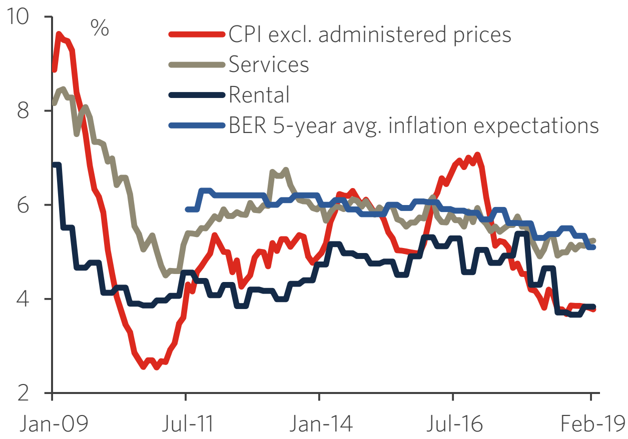
Edward Kieswetter, the recently appointed new SA Revenue Services Commissioner, has further pledged to handle high-profile cases of tax evasion, which could, in time, restore tax morality more broadly. Alongside a stabilisation of the tax agency, more sustainable economic growth is required to boost tax buoyancy. With few revenue avenues left to tap, the curbing of government's wage bill was a welcome move at the February 2019 national budget announcement. Although government's revised projections indicate a breach of its self-imposed expenditure ceiling by a total of R16 billion for the next three fiscal years, rating agency Moody's acknowledged government's efforts to trim expenditure elsewhere. While the risk of Eskom requiring money over and above the R150 billion provision for the next five years remains elevated, Moody's has noted a further allocation to Eskom would be measured against the use of the money as well as government's ability to offset the additional injection. Moody's further acknowledged, while a functional separation of Eskom into three subsidiaries could occur relatively quickly, the legal separation may take time.

Moody's methodology allows for a further deterioration in SA's growth and fiscal metrics. However, if the rating agency is underwhelmed by the progress made on Eskom's turnaround strategy by the next scheduled rating review in November 2019, this could lead to a higher risk rating for SA's contingent liabilities, triggering a change in the stable outlook to negative or even a ratings downgrade to junk status in the longer term.

Sizeable net foreign bond outflows of R68 billion recorded by the JSE for 2018 intimates that additional outflows could be limited if SA was ejected from the Citi World Government Bond Index (WGBI) in the event of a Moody's downgrade. That said, the local currency could still experience a knee-jerk reaction if the event is actualised.

Recent currency movements have nevertheless had a muted effect on underlying inflation, as pass-through has been capped in an effort to sustain growth in retailer volumes. With 80% of the (weighted) categories in the inflation basket registering inflation of below 6% in February 2019, the main risk to the inflation outlook remains administered prices. Positive trends in services inflation and other measures of underlying inflation have led to an eventual downward adjustment in inflation expectations of businesses and labour, which resulted in average five-year ahead inflation expectations edging to its lowest level on record (since 2011) at 5.1% (see chart 3).

Chart 3: Encouraging downward trend in expected and underlying measures of inflation



Source: BER, SARB, Momentum Investments

In Momentum Investments' opinion, the positive downward trajectory in inflation expectations and weaker-than-expected growth outcomes likely lower the pressure on the SARB to maintain a tightening bias. Nonetheless, in the firm's view, the hurdle to interest rate cuts remains high, given the SARB's intention to drive inflation expectations closer to the midpoint of the target band on a sustainable basis to allow for more room to manoeuvre in the event of external shocks. Moreover, looser fiscal policy is inhibiting the SARB's ability to run more accommodative policy and should contribute to a steady stance on monetary policy in the coming quarters.