momentum investments

in the moment


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Market and economic outlook: July 2019

Highlights

Markets

- The geopolitical backdrop remained unsettling for global investors in the second quarter of the year as trade talks between the world's two largest economies, the United States (US) and China, continued to ebb and flow.
- Global equities rose 3.6% during the second quarter as weaker growth indicators and rising uncertainty spurred on expectations of additional monetary accommodation by major central banks. Meanwhile, softening growth and subdued inflation outcomes placed continued downward pressure on global bond yields in the same period.
- Emerging market equities underperformed their developed market counterparts. Rising expectations that major central banks remained poised to potentially ease policy helped emerging equity markets in the second quarter, but strained trade negotiations between the US and China and weaker commodity prices pared back gains.
- The South African equity market outperformed emerging market equities in the second quarter of the year, buttressed by rand hedges and safe-haven gold shares.
- Global bonds have traditionally tended to outperform equities in a weaker growth environment, but the long lead time between yield curve inversion and the peak in the equity market suggests ongoing support for global equities in the interim.
- South African shares are trading considerably below their highs after disappointing in the last five years. However, historical data underpins prospective South African equity returns from the current low five-year trailing return level.
- South Africa flaunts the highest real bond yield among its global investment grade peers, highlighting the relative attractiveness of local fixed income. Listed property has been trading cheaply against South African government bonds for the last ten years. Good returns are expected, from the low base in 2018, even taking into account negative real distribution growth.

Economics

- Renewed growth risks and tepid inflation have caused most developed market central banks to walk away from their mantra of policy normalisation. However, global central bank balance sheets are close to historic highs and interest rates in a number of economies remain close to record lows, which limits the scope and magnitude of monetary policy measures to resuscitate growth. Moreover, high levels of public debt will constrain support from fiscal stimulus.
- By front-loading its interest rate response to subdued inflation and rising growth risks starting in the third quarter of 2019, the US Federal Reserve is likely to sustain the current economic expansion and prevent a sharp dip in growth.

Other major central banks have joined the dovish chorus and could ease monetary policy further in the coming quarters.

- Although macroeconomic fundamentals remain sound across the emerging market composite, weaker growth expectations in advanced economies, sluggish growth in investment and a re-escalation of confrontational trade negotiations will weigh on growth.
- China has felt some pain on the back of rising trade barriers, but has managed to cushion the blow to growth through targeted stimulus measures. Integrated global value chains, however, raise growth stakes more broadly across the globe.
- With the pace of reform likely to only be gradual in the near term, the outlook for growth in South Africa is expected to remain sluggish at around 0.5% in 2019 and will likely struggle to achieve a rate higher than 1.5% in 2020.
- A weaker-than-expected growth trajectory will add to concerns over government revenue. The front-loading of financial support to the energy utility Eskom could bring about more precarious government's finances.
- In Momentum Investments' view, there is a significant risk that Moody's will change its outlook on South Africa's sovereign rating from stable to negative in 2019. This will be to flag the inability of government to stabilise debt and achieve speedier fiscal consolidation in an environment of low growth hampered by political constraints.
- Should interest rates drop in the near term in response to subdued inflation, we anticipate the cutting cycle to be shallow, given the structural nature of South Africa's low-growth quandary.

Markets celebrate chances of easier monetary policy in light of rising growth pessimism

The geopolitical backdrop remained unsettling for global investors in the second quarter of the year as trade talks between the world's two largest economies, the US and China, continued to ebb and flow between a market-friendly result involving a strategic partnership and a less favourable outcome comprising a more aggressive push from the US to hit back at China's technological advances.

Global equity markets nevertheless rose 3.6% during the second quarter as weaker growth indicators and rising uncertainty spurred on expectations of additional monetary accommodation by major central banks to stimulate their respective economies. At the time of writing, traders were pricing in a 100% chance of a cut of 25 basis points, at least, by the US Federal Reserve (Fed) in July and a 36% chance of a larger cut of 50 basis points. European Central Bank President Mario Draghi and Bank of Japan Governor Haruhiko Kuroda joined the dovish chorus and signalled that they stood ready to fire off more stimulus should their respective economies take a turn for the worse. While the European Central Bank initially indicated interest rates would not increase until the end of 2019, it more recently guided this to extend into the middle of 2020. However, markets are forecasting a more aggressive easing stance. Market-implied pricing for monetary policy paths in the Euro area and Japan are projecting two interest rate cuts of 25 basis points each by the European Central Bank before the end of the year and a cut of 25 basis points by the Bank of Japan by the end of March 2020.

Despite the Citigroup Economic Surprise Index highlighting a continuation of negative growth surprises in the world's ten-largest developed market economies, the MSCI DM Index advanced 4% during the second quarter of the year, buoyed by strong returns of 6.1% in the Eurostoxx 50 Index and 4.3% in the S&P 500 Index. Meanwhile, the Japanese Nikkei 225 underperformed the developed market composite index at 0.6% in the same period alongside a further strengthening in the yen.

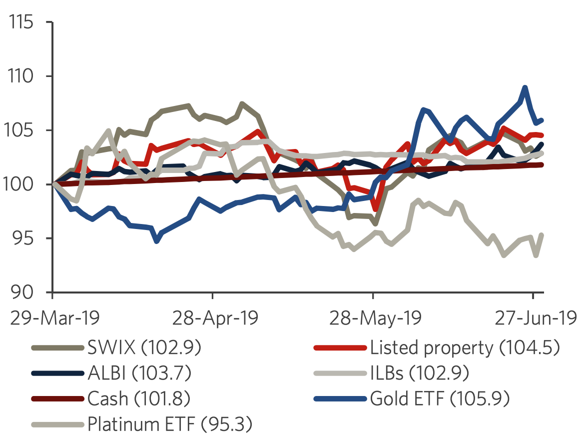
Softening growth and subdued realised inflation outcomes have placed continued downward pressure on global bond yields in the second quarter of the year. The yield on the US 10-year government bond dropped 40 basis points in the second quarter of the year to below the current Fed funds rate, while the German 10-year government bond yield hit a new record low, after falling 26 basis points in the corresponding period.

Goldman Sachs notes a record high US$13 trillion in global debt traded at sub-zero yields at the end of the second quarter of 2019, which surpassed the previous peak reached in 2016.

Emerging market equities eked out gains of 0.6% in the quarter, but underperformed their developed market counterparts. Rising expectations that major central banks remained poised to potentially ease policy helped emerging market equity markets, but strained trade negotiations between the US and China and weaker commodity prices pared back gains. The MSCI Europe, Middle East and Africa (EMEA) rose 7.2% in the quarter, supported by a robust performance in Russian energy shares. This was followed by a firm 4.4% gain in the MSCI Latin American Index. By contrast, the MSCI Asian Index retreated 1.3% on poor equity returns in China and South Korea, which were negatively affected by global trade uncertainty.

The South African equity market (up 2.9%) outperformed emerging market equities in the second quarter of the year buttressed by rand hedges and the safe haven of gold shares. Gold exchange-traded funds (ETFs) soared 5.9% during the quarter, while platinum ETFs sank 4.7% in the same period (see chart 1). Domestic equity lagged during the quarter as policy uncertainty and weak growth outcomes continued to weigh.

Chart 1: SA asset class returns in Q2 2019 (indexed)



Source: Iress, Momentum Investments, data to 30 June 2019

The FTSE/JSE Financials Index led South African equities higher and rose 5.4% in the quarter. Industrial shares firmed 4.0%, while resource shares trailed at 2.4%. South African bonds had a positive quarter. The JSE Assa All-bond Index (Albi) performed in line with South African equities at 3.7% for the quarter, while the JSE Assa Government Inflation-linked Bond Index (Ilbi) moved 2.9% higher.

Going into the second half of 2019, a recalibration in the US Fed's monetary policy position could enhance equity returns for the US for some time despite the inversion of the yield curve. The US equity market usually peaks approximately 13 months after the yield curve inverts and inevitably a recession follows the inversion by 18 months. Momentum Investments remains cautious of increased levels of volatility in the global equity market in the medium term, despite the expectation that equities will continue to perform well in the run-up to softer growth expectations in the US.

Regarding value global equities still appear cheap relative to bonds. More likely than not, expected returns for global equities will likely worsen towards the close of 2019 as the US heads into a softer growth patch in 2020. Bonds have traditionally tended to outperform equities in a weaker growth environment. However, the typical screaming sirens in the recession coal mine (credit spreads and bank lending standards) are still quiet and the long lead time between yield curve inversion and the peak in the equity market suggests ongoing supportive for global equities in the interim.

Relative valuations favour non-US markets on a regional allocation. US equity markets could benefit from US dollar weakness in the near term, triggered by an increasingly dovish Fed, while Japanese and European markets find more support in a strong dollar environment. Most South African shares are trading considerably below their highs after underperforming in the last five years. However, historical data underpins prospective South African equity returns from the current low five-year trailing return level.

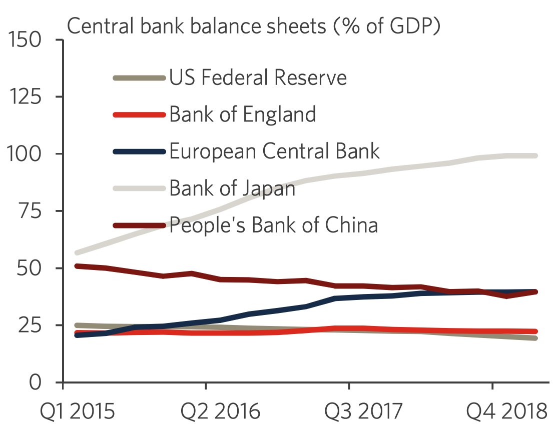
The country flaunts the highest real bond yield among its global investment grade peers, highlighting the relative attractiveness of the local fixed-income asset class. Also, at the time of writing, South Africa's ex-ante real yields were significantly above the post-inflation targeting average and the SA/US yield spread premium was more than 100 basis points higher than the average since inflation targeting. In the coming quarters, the general upward trend in expected local inflation should benefit South African inflation-linked bonds (ILBs), however the one-year expected return on nominal bonds looks more lucrative. Although expected South African real cash returns for the next year look similar to those from ILBs and lower than those anticipated from nominal bonds, real cash returns look attractive on a risk-adjusted basis.

Listed property has been trading cheaply against South African government bonds for the last ten years. Good returns are expected from the low base set in 2018, even taking into account negative real distribution growth, unless further unforeseen, questionable financial engineering are uncovered among the main companies in the listed property sector.

Low inflation and weak growth push major central banks back onto the easing path

Renewed growth risks and tepid inflation outcomes have caused most developed market central banks to walk away from their mantra of policy normalisation. Recent promises by central banks to keep interest rate policy lower for longer should assist in capping longer-term rates and ought to encourage current spending by consumers and businesses, thereby eventually lifting economic growth. However, this time around, the size of global central bank balance sheets are close to historic highs and interest rates in a number of economies remain close to record lows (see chart 2). High levels of public debt further constrain additional growth support from fiscal stimulus.

Chart 2: Bloated global central bank balance sheets



Source: Capital Economics, Momentum Investments, data up to Q1 2019

The consequence of swollen central bank balance sheets and a low interest rate environment suggest central bankers will soon find themselves constrained by the zero lower bound in interest rates. When interest rates fall below zero, people have the option of holding cash (which accrues zero interest), rather than negative-yielding assets. This limits the scope and magnitude of monetary policy measures to resuscitate growth. Moving beyond this lower bound could further impose unwanted economic effects. In response to the constraints faced by the Band of Japan, Kuroda warned against the "reversal rate", which refers to the possibility of too low interest rates causing a decline in net interest margins in the banking sector and resulting in capital constraints. This impairs the ability of financial institutions from acting as intermediaries and initiates a reversal of the effects of monetary easing, which is contractionary.

Economic scholars have proposed a number of solutions to overcome the zero lower bound in interest rates. In the paper "Monetary policy in a new era" published in October 2017, the former chair of the US Fed, Ben Bernanke, put forward the concept of temporary price-level targeting. This method involves central banks committing to not increasing interest rates until the rate of inflation (since the point at which the zero lower bound was reached) averages in line with the respective central bank's target. With suppressed levels of inflation likely in the initial period, the target can likely only be achieved with inflation overshooting in the latter years.

As is the case with many of the proposed solutions in surmounting the zero-lower-bound challenge, there are potential pitfalls associated with the temporary price-level targeting approach. During the period in which inflation overshoots the target, the central bank can lose credibility. This could result in a de-anchoring of inflation expectations, giving rise to even higher inflation outcomes.

Despite the former chief economist of the World Bank, Lawrence Summers, proving central bank independence was associated with better control over inflation in his paper "Central bank independence and macroeconomic performance: Some comparative evidence" in 1993, a number of central banks are feeling political heat today. US President Donald Trump continues to speculate over the firing of Fed Chair Jerome Powell, even after the failure of his nomination of market-unfriendly appointees to the Fed, Stephen Moore and Herman Cain. Trump has criticised the Fed for not slashing interest rates. With the market pricing in a greater likelihood and magnitude of interest rate cuts in the near term, the Fed may have backed itself into a corner and runs the risk of destabilising markets by not following through with easier monetary policy. By front-loading its interest rate response to subdued inflation and rising growth risks starting in the third quarter of 2019, the Fed is likely to sustain the current economic expansion and prevent a sharp dip in growth.

Managing Director of the International Monetary Fund (IMF) Christine Lagarde is set to replace incumbent European Central Bank Chair Mario Draghi after an eight-year tenure. She faces a herculean task of propping up inflation and supporting growth with reduced firepower given interest rates that are low already. Draghi previously complained about attacks on central bank independence, after Germany and the Netherlands disapproved of his ultra-accommodative monetary stance, while Italy frowned on his comments on the country's national budget. The European Central Bank is likely to respond to further disappointing inflation prints and muted inflation expectations, persistent political uncertainty associated with Brexit negotiations, Italy's debt challenges and global trade friction by cutting the interest rate at least once before the end of the year. It may also consider restarting its asset purchase programme in 2020 to shore up growth. Even Bank of England Governor Mark Carney has faced accusations from disgruntled Brexit politicians. The Bank has also made a dovish shift more recently as the probability of a "no deal" outcome in the UK grows with Boris Johnson being the favoured candidate to replace Prime Minister Theresa May. With limited room to manoeuvre in Japan, the Bank of Japan may in time turn to expanding its purchases of exchange-traded funds.

The momentum in global growth is fading and the expansion is becoming more vulnerable to downside risks. In Momentum Investments' opinion, monetary policy alone cannot sustain a recovery in global growth, but additional certainty is needed on the trade and political environment, which has kept the Global Economic Policy Uncertainty index close to all-time highs. Although the increased reliance on services across the world contains the risk of a global recession, in Momentum Investment's view, the threat of increased trade barriers could hinder growth prospects, particularly for small, open emerging markets that are highly dependent on global value chains.

Although macroeconomic fundamentals remain sound across the emerging market composite, the IMF projects growth in emerging markets to fall to its lowest level in four years, pressured by weaker growth expectations in advanced economies, sluggish growth in investment and a re-escalation of confrontational trade negotiations. Notwithstanding the confluence of political and macroeconomic risks facing emerging markets, the IMF still predicts the growth premium in emerging markets relative to developed markets to widen to 2.6% in 2019 from 2.3% in 2018. This gap is forecasted to further increase to 3.1% in 2020 and to 3.3% by 2024, suggesting emerging markets will likely remain a key driver of global growth in the medium term.

The eventual outcome of the current trade stand-off between the US and China is far from clear. Nobel Prize Laureate Paul Krugman said in a*New York Times* article in July 2019 that "China is an economic superpower in its own right." Following 40 years of economic reform, the economic superpower has integrated into the world economy. China's banking, securities and bond markets put it among the world's top three according to size, but China has managed to keep foreign entities' participation at under 6%. The article noted that less than one-fifth of the revenue earned from China's 110 Global Fortune 500 companies is earned overseas in comparison to 44% of the S&P 500 firms. With China placing more emphasis on domestic consumption- and services-led growth, its exposure to the rest of the world is dropping, while the rest of the world's exposure to China has been on the rise.

Although China has felt some pain on the back of rising trade barriers, it has managed to cushion the blow to growth through targeted stimulus measures. Though fiscal stimulus (including tax exemptions for those sectors hit by tariffs and financing for infrastructure) has been a critical pillar of support for growth in China, there is growing speculation that the People's Bank of China could cut the benchmark interest rate after holding it steady at 4.35% since the third quarter of 2015.

Krugman warns, "Almost every manufactured good is the product of a global value chain that crosses multiple national borders." A rise in trade conflict thus raises growth stakes more broadly across the globe. Emerging market central banks are following the same script as those in developed markets given continued downside risks to growth and generally well-behaved inflation.

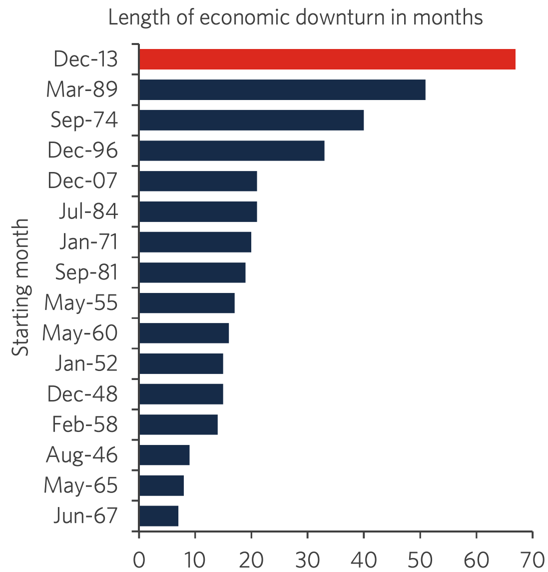
In contrast to Trump's tweet claiming "...trade wars are good, and easy to win", a souring in international relations could affect collaborative efforts involving global issues such as climate change and the eradication of poverty negatively. Moreover, stress on trade relationships will affect the free flow of technology advances and innovation, further impinging growth in productivity. With fewer foreign players in operation in various economies, competition would drop. In a more extreme scenario, investor choice could reduce if the system of integrated financial markets is threatened.

Efforts to reform are becoming more pressing

Average growth in South Africa fell to 1.8% during the Jacob Zuma administration from 4.2% during the Thabo Mbeki era. A lower economic trajectory manifested in further job losses with the headline rate of unemployment ratcheting higher during this period from 23% to 27%. The social compact between business, labour and government fragmented further during Zuma's almost nine-year tenure. This has caused depressed business confidence levels, which on average languished at 10 points below neutral. Downbeat sentiment has in turn held back infrastructure investment and more robust hiring by the private sector.

Economic growth for the first quarter of the year disappointed by an alarming margin and highlighted the urgent need for the incumbent administration to address structural weaknesses facing the economy. Even without the effect of the worst electricity supply disruptions experienced since 2008, uninspiring confidence levels among consumers and business capped growth in domestic demand at the beginning of the year. High levels of joblessness, the rising cost of utilities, steep fuel prices and pressure from escalating taxes have constrained consumer spending across the board. Moreover, lingering economic and regulatory policy uncertainty has stifled investment growth and curbed prospects for the year ahead.

Chart 3: Longest SA downturn in post-war history



Source: Sarb, Momentum Investments

High-frequency data for the early part of the second quarter of the year has soothed fears of a technical recession (or two consecutive quarters of negative growth), but an additional month of data will be necessary to assess this further. Nevertheless, in its latest Quarterly Bulletin for June 2019, the South African Reserve Bank (Sarb) reported the current economic downswing as the longest in history at 67 months up until the end of June 2019. The second-longest economic downturn in the country occurred between 1989 and 1993 in the turbulent period leading up to the first democratic elections. Incidentally, the share of corporates rating policy uncertainty as a constraint to investment in the Bureau of Economic Research's (BER) Manufacturing survey for the second quarter of 2019 is as high as it was in 1993.

Economic policy and regulatory uncertainty have played a role in setting back the country on the World Bank's Ease of Doing Business survey. In the past decade, a number of developing economies have overtaken South Africa, which has shifted from 32nd position to 82nd position (out of 192 countries) in 2018. A country like Rwanda (with a gross domestic product per capita equating to an eighth of South Africa's) has made remarkable gains during this time, improving from 143rd to 29th position in the same period. According to the report, it takes only four days to set up a business in Rwanda, while it requires a staggering 40 days in South Africa. Similarly, the Economic Freedom of the World report, published annually by the Fraser Institute, highlights that South Africa reached its highest score on economic freedom in 2003 (50th out of 127 countries) under the Mbeki regime, but has since fallen in line with stagnating growth to 110th out of 162 countries. The index takes into account the size of government, taxes, property rights, freedom to trade and regulation. Meanwhile, Rwanda has surpassed South Africa and moved from 91stout of 127 countries in 2003 to 40th place out of 162 countries in the latest results for 2016.

The 2019 national elections shaped up to be a referendum on President Cyril Ramaphosa's ability to take the country forward on the path of the "New Dawn" he envisions for the country. The African National Congress (ANC) walked away with a victory of 57.5% and managed to secure the province of Gauteng, which is pivotal to tax collection, job creation and growth. With Ramaphosa polling at a more favourable rating than the ruling party (a phenomenon that only occurred in the Nelson Mandela era in post-democratic history), it is likely that his popularity helped limit the ruling party's losses. While this is expected to give Ramaphosa the mandate to enact some regulatory and economic reforms at a gradual pace in the medium term, there are still members of Cabinet and the ANC national executive committee who are less enthusiastic about Ramaphosa's proposed reform agenda. As such, Momentum Investments doesn't expect a quick resolution to politically contested areas of reform, including a significant scaling back of the public sector workforce, the full implementation of the national health insurance or more rapid progress on the redistribution of land to combat inequality and poverty effectively.

That said, Ramaphosa has managed to carry through competent leadership at a number of the country's Chapter Nine institutions, which uphold democracy. Moreover, he reaffirmed the constitutional mandate of the Sarb and announced urgent work was being done on reducing the cost of compliance, streamlining regulatory processes automating permits and cutting port tariffs to improve the relative ease of doing business. In Momentum Investments' view, garnering positive sentiment requires political will, a reduction in political and policy uncertainty and the implementation of growth-enhancing reforms. The president's plan to accelerate the country's growth trajectory still relies heavily on the ability of the top leadership to carry out the economic plans put forward.

With the pace of reform likely to be gradual in the near term, the outlook for growth in South Africa is expected to remain sluggish at around 0.5% in 2019 and will likely struggle to even achieve a rate of 1.5% in 2020.

A weaker-than-expected growth trajectory will add to concerns over government revenue. The front-loading of financial support to Eskom could bring about more precarious governments finances. Notwithstanding a likely sizeable disappointment in government's fiscal deficit and debt ratios at the medium-term budget announcement in October 2019, Momentum Investments expects Moody's investment-grade rating for South Africa to remain unchanged in 2019 based on room for further fiscal disappointment already factored into its ratings assessment. Nevertheless, the company sees a significant risk of a change in the outlook from stable to negative to flag the inability of government to stabilise debt and achieve speedier fiscal consolidation in an environment of low growth and hampered by political constraints.

Demand-pull inflationary pressures have remained largely absent in South Africa in the context of an output gap that is still negative, which is the difference between actual and potential growth. After excluding sticky administered prices (fuel and electricity prices have accounted for more than half the rise in these costs), inflation has averaged 3.8% for the past year. Further confirmation of subdued measures of underlying and services inflation should further prompt an interest rate cut by the Sarb in the near term. In the Bureau of Economic Research's latest Inflation Expectations survey for the first quarter of 2019, the average inflation projection for the next five-year period dropped to 5.1%, which was the lowest on record, since 2011. The sustained drop in services inflation in the past quarters bodes well for a further reduction in inflation expectations closer to the midpoint of the 3% to 6% target band.

Should interest rates drop in the near term, Momentum Investments anticipates the cutting cycle to be shallow, given the structural nature of South Africa's low-growth quandary. The Sarb noted that monetary policy has a limited effect on pricing practises, market structure and supply-side rigidities, which require the implementation of microeconomic reforms.