momentum investments

in the moment

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Market and economic outlook: October 2019

Highlights

Markets

- Several political factors, including soured trade relations between the United States (US) and China, created a tumultuous backdrop for global markets during the third quarter of 2019.
- The return on global equity markets disappointed, more so for emerging market (EM) equities than developed market (DM) equities, with political events powering investor angst during the quarter.
- Global uncertainty and a rise in precious commodity prices drove investments into gold and platinum exchange-traded funds (ETFs) during the quarter. The South African (SA) equity market remained sensitive to negative trade war rhetoric and underperformed EM equities in the third quarter of the year. It was a poor quarter for listed property shares, while nominal and inflation-linked bond (ILB) indices tracked broadly sideways.
- The risk of a recession is rising, making a case for de-risking portfolios. Although sharp equity drawdowns are typical around recessions, global equities can still move higher in the interim. US equities tend to act as a defensive play in a slowdown and often outperform equity markets in non-US regions.
- The vast majority of SA shares are trading considerably below their highs after underperforming in the last five years. However, historical data underpins prospective SA equity returns from the current low five-year trailing return level.
- The global hunt for yield has become even more pertinent as the global stock of negative-yielding debt continues to rise. SA's real bond yields continue to look attractive relative to other EM peers.
- Good returns are expected from the low base created in SA listed property in 2018, even at an unchanged relative rating to bonds and below-consensus real distribution growth of negative 5%.

Economics

- Unfavourable demographics, rising debt levels and high global uncertainty will ensure lower potential growth in a majority of developed economies in the next five years. The pace of adoption of structural reforms has been too sporadic and too slow to promise a return to pre-crisis growth norms.
- Monetary policy is likely to adopt an increasingly unconventional role as some central banks have already breached or are close to breaking below the zero lower bound on short-term interest rates.
- The Organisation for Economic Co-operation and Development (OECD) advocates co-ordinated growth-enhancing measures to provide a timely counterweight to any negative global growth surprises. A combined policy mix, including higher levels of public infrastructure spend and structural reforms, could limit financial distortions in the economy and enhance long-term growth and living standards.
- This could prove beneficial in reducing the growth impact of rising trade protectionism and potentially turbulent financial markets, amid protracted uncertainty.

- In SA, some progress has been made on reforming the struggling economy, but big business is growing impatient with President Cyril Ramaphosa's trickle-through approach to reform and government's discernible inertia on critical reforms at state entities.
- The social cost of postponing these crucial reforms is rising at an accelerating rate and citizens are demanding a more assertive response to alleviating pressing economic and institutional ills.
- The outlook for SA growth remains tepid and is expected to rise from 0.6% in 2019 to 1.5% by 2021, on a marginal positive adjustment in confidence as incremental reforms and more concrete restructuring plans are unveiled for energy utility Eskom.
- Absent demand-pull inflation and benign underlying price pressures should keep headline inflation below 5% for the next three years, creating space for the SA Reserve Bank (Sarb) to cut interest rates by at least 25 basis points more.

Enflamed trade relations and geopolitical concerns tested markets in the third quarter

Soured trade relations between the US and China created a tumultuous backdrop for global markets during the third quarter of 2019. The CBOE Volatility Index (Vix) or fear gauge ended the quarter at 17 points, several notches higher than two years ago, when the index dipped to nine points amid complacent markets. Several political factors added to negative trade developments, keeping markets on edge. The nature of the United Kingdom's (UK) pending exit from the European Union (EU) became more uncertain after UK courts ruled that Prime Minister, Boris Johnson, acted illegally by suspending parliament. The US faced its political challenges in the third quarter when impeachment proceedings were formally initiated against President Donald Trump. Socio-political upheaval meanwhile continued in Hong Kong, while the threat of war in the Middle East continued to loom following an attack on oil fields in Saudi Arabia.

As a result, the return on global equity markets disappointed at negative 0.2%, with the above events powering investor angst during the quarter. EM equities were the biggest losers for the third quarter of 2019, while the MSCI DM Index inched higher. The MSCI DM Index rose 0.3% in the quarter driven higher by shares on Japanese and European bourses. The Nikkei 225 Index surged ahead by 5.8% in September, helping the quarter finish 3.1% in the black. Even though the Bank of Japan (BoJ) stayed pat in September, it signalled its readiness to expand stimulus, which raised optimism for further monetary policy easing in the coming months. The rising prospect of new elections in Italy and a string of poor manufacturing data in Germany weighed on the Eurostoxx 50 Index earlier in the quarter, but an announced resumption of the European Central Bank's (ECB) quantitative easing programme supplemented a quarterly gain of 3.1% in the index.

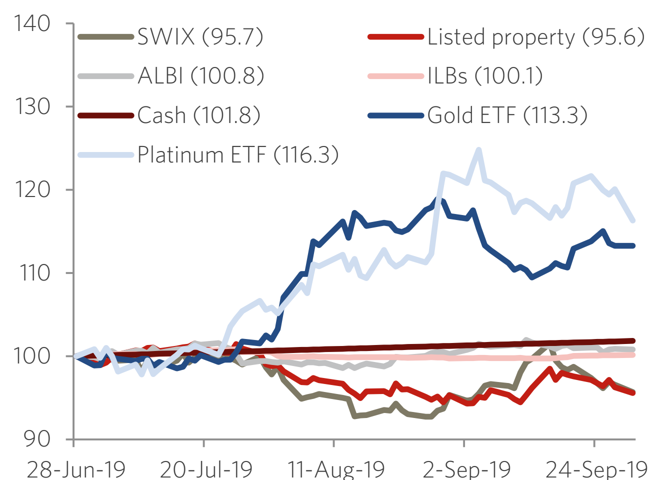
Despite two cuts of 25 basis points each in the benchmark interest rate in the US during the third quarter of 2019, investors remained underwhelmed and continued to price in a greater extent of easing relative to the median expectation of the Federal Reserve's (Fed) dot plot (a chart with dots reflecting what each Fed official thinks would be an appropriate target range for the Fed funds rate at the end of each calendar year), which denoted a shift to an unchanged stance.

The share of investors, surveyed in the Bank of America Merrill Lynch Fund Manager Survey for September 2019, expecting a recession (two consecutive quarters of negative growth in the next 12 months) spiked to its highest level since August 2009 at 38%. Although the value of global negative-yielding bonds shrank by around US$3 trillion during September 2019, the Bank for International Settlements suggests negative interest rates are still more pervasive than they have been in periods of previous market jitters. Though the yields on the US and German 10-year government bond yields drifted higher in September 2019, these yields were still 33 and 24 basis points lower, respectively, relative to the start of the quarter.

The MSCI EM Index slumped 4.2% in the quarter ended September 2019, in accordance with a two-point rise in the Vix and a 1.8% fall in the Bloomberg Commodity Price Index, the latter dented by continued strength in the US dollar. During the quarter, the dollar price of gold

spiked to its highest level since April 2013 on amplified anxiety over geopolitical threats and a dovish monetary policy stance from major DM central banks.

Chart 1: SA asset class returns in Q3 2019 (indexed)



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

The SA equity market remained sensitive to negative trade war rhetoric and underperformed EM equities in the third quarter of the year at negative 4.6% (see chart 1). The FTSE/JSE Financials Index was the worst performer for the third quarter of the year, ending 6.8% in the red, weakening in line with a further deterioration in the local currency. Resource shares followed suit and finished the quarter 6.4% weaker, while losses were limited to 2.5% for the FTSE/JSE Industrials Index, partly countered by a better performance in rand-hedged shares. SA listed property had a poor quarter, shedding 4.4%, while the JSE Assa All-bond Index (Albi) staged a mild improvement of 0.8%. The JSE Assa Government ILB Index (Ilbi) moved broadly sideways during the third quarter of 2019.

Although the gold price started to lose its shine towards the end of September 2019, global uncertainty drove large inflows into gold exchange-traded funds (ETFs) which climbed 13.3% in the quarter. Platinum ETFs performed even better, gaining 16.3% in the quarter, alongside an 8.4% improvement in the dollar price of platinum.

The probability of a global recession is rising, making a case for de-risking portfolios. Equity market volatility has risen on the back of Trump's market-moving comments on social media platforms. In Momentum Investments' opinion, volatility could shift higher still in relation to a flatter yield curve and heightened global uncertainty.

Although sharp equity drawdowns are typical around recessions, global equities can still move higher in the interim. US equities tend to act as a defensive play in a global slowdown and often outperform equity markets in non-US regions. Additionally, DM equities typically outperform EM equities in a risk-off environment like the current one, where trade disputes between the US and China are playing up global economic policy uncertainty.

European equities are not as cheap as they appear, especially once accounting for sector differences. Equities tend to have a more muted response to interest rate cuts once policy has moved beyond the zero lower bound. This is likely partly due to the adverse impact of negative interest rates on the profitability of European banks, which constitute around 20% of the European equity market. While EM equities look fairly valued against DM equities, trade wars and a strong US dollar are hurting earnings in emerging equity markets.

Although global equities still appear cheap relative to bonds, the defensive characteristics of the latter increase their fundamental attractiveness in a risk-off environment. While global government bonds are already priced for a recessionary outcome, equities and credit are not. As global bond yields have to fall significantly to offset even a 10% equity drawdown, Morgan Stanley has shown that this asset class on its own will likely be an insufficient overall portfolio hedge against equity downside, necessitating alternative hedging strategies to protect portfolios against equity downside risk.

The vast majority of SA shares are trading considerably below their highs after underperforming in the last five years. However, historical data underpins prospective SA 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, while forward multiples are trading below historical averages.

The global hunt for yield has become even more pertinent as the global stock of negative-yielding debt continues to rise. SA's real bond yields continue to look attractive relative to other EM peers. At the time of writing, ex-ante real yields were trading half a standard deviation above their average since inflation targeting. Moreover, the yield spread premium between SA and the US is currently one-and-a-half standard deviations higher than the average since inflation targeting.

The expected upward trend in local inflation into early 2020 should benefit SA ILBs, however, the one-year expected return on nominal bonds looks more appealing. Current ex-ante real cash yields have fallen close to their average recorded since inflation targeting and are now fairly valued, but provides attractive relative risk-adjusted returns.

Listed property is trading at its cheapest relative rating in a decade against SA government bonds, with a lot of bad news already in the price. Good property returns are expected from the low base created in 2018, even at an unchanged relative rating to bonds and below-consensus real distribution growth of negative 5%.

The global economy continues to be characterised by the new (ab)normal

The world economy is slowing. The International Monetary Fund (IMF) confirmed that global economic activity peaked at 3.8% in 2017 before rolling down to 3.6% in 2018. The IMF estimates a further slowdown in global growth to 3.3% in 2019 and predicts that 55% of the 194 countries monitored will experience a moderation in growth rates in 2020, highlighting an ongoing synchronised downswing in the global economy.

Unfavourable demographics, the rising burden of public and private debt and various risk factors keeping global uncertainty high will likely ensure lower potential growth in the new (ab)normal in a majority of developed economies in the next five years relative to historical long-term averages. Technological advances have failed to translate into higher levels of productivity overall, while anaemic investment rates have responded to the rise in global economic policy uncertainty indices, which have become a new permanent feature of the global economy. Aggregate investment growth slowed abruptly in the world's 20-largest economies (G20) from an annual rate of 5% in 2018 to just 1% for the first half of 2019. Moreover, the pace of adoption of structural reforms has been too sporadic and too slow to promise a return to pre-crisis growth norms.

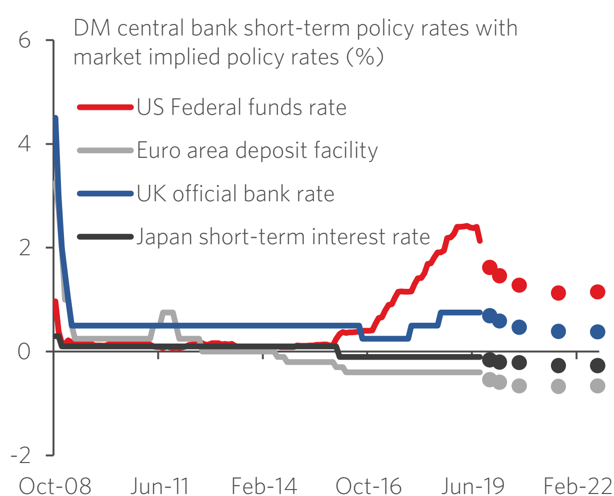
Limited money policy room exists to weather any worse-than-expected outcomes on growth in the near future. Aside from the US Fed, few central banks in developed economies were able to amass monetary policy ammunition in the aftermath of the global financial crisis, as interest rates were kept low in the hope of spurring growth. More than a decade on and central banks will likely have to revert to verbal hints and signals to set expectations about the future path of interest rate policy in response to sluggish growth and disappointing inflation outcomes.

Monetary policy is likely to adopt an increasingly unconventional role as some central banks (the ECB, the BoJ, the Swiss National Bank, the Swedish Riksbank and the central bank of the Netherlands) have already breached or are close to breaking below the zero lower bound at the short end of the yield curve. In some countries, even long rates have fallen. German, Danish and Swiss yield curves are now entirely below zero. The stock of negative-yielding government debt peaked at US$16.8 trillion before sliding lower to US$14.9 trillion at the end of September 2019. There is little incentive for investors to lend to governments at a negative nominal yield for longer time horizons when they could instead hold cash to at least earn a zero yield.

Already, the ECB has returned to quantitative easing, with fewer monetary policy options left at its disposal, given the harmful effect of negative interest rate policy on bank profitability. The ECB announced a

commitment to restart its quantitative easing programme in November 2019 and it intends to conduct asset purchases until inflation has recovered to its target of below, but close to, 2%. In essence, this amounts to open-ended easing. Though the US Fed has already cut its benchmark interest rate twice in the third quarter of 2019 by 50 basis points in total from a peak of a range between 2.25% and 2.5%, the market is greedy for further monetary policy easing. The market-implied policy rate points to a further 100 basis points worth of cuts by the third quarter of 2021 (see chart 2), despite the median expectation of the Federal Open Market Committee members seeing a stable interest rate trajectory. Similarly, even with acute Brexit-related uncertainty in the UK weighing on the sterling, the market is projecting 35 basis points worth of easing from the Bank of England before the third quarter of 2021. This is in spite of the prospect of a no-deal Brexit, which could leave inflation higher on the back of a further sell-off in the sterling in reaction to fresh uncertainty.

Chart 2: The market is greedy for further easing



Source: Bloomberg, Momentum Investments, forecasts up to end of 2022

The OECD argues that the effectiveness of accommodative monetary policy "could be enhanced if accompanied by stronger fiscal and structural policy support". The OECD upholds the view that fiscal policy, such as stronger investments in infrastructure, should be used to lift growth by taking advantage of low interest rates. Oxford Economics and the Global Infrastructure Hub estimate the infrastructure investment gap to be as wide as US$3.8 trillion in the US, US$148 billion in the United Kingdom, US$373 billion in Italy and US$57 billion in Spain.

The OECD further advocates co-ordinated growth-enhancing measures to provide a timely counterweight to any negative growth surprises. It emphasises the dangers associated with burdening monetary policy with the full macroeconomic adjustment and notes a combined policy mix, including higher levels of public infrastructure spending and structural reforms (to strengthen competition and improve skills and education), could limit financial distortions in the economy and enhance long-term growth and living standards.

This could prove beneficial in reducing the growth impact of rising trade protectionism and potentially turbulent financial markets, amid protracted uncertainty. Efforts by President Trump to revitalise fairer trade with China is likely masking grievances regarding the alleged theft of intellectual property, excessive subsidisation and unfair investment practices. As such, the risk of the Sino-American trade war is biased towards spiralling into stronger confrontation beyond trade issues and is unlikely to end anytime soon.

Global manufacturing's struggles are likely to continue as the world's two economic giants continue to face off. The escalating trade war has dented manufacturing sentiment, slowed exports and further threatens to distort global supply chains. However, data from the US-China Business Council maintains that 87% of US firms surveyed are not planning to move operations out of China. Irrespective of the trade war, HSBC reasons that labour-intensive sectors (including furniture, textiles and apparel) had already started relocating their factories to Vietnam, the Philippines and Bangladesh, where average factory wage costs are nearly half China's and as such, these factory relocations should not be viewed as a consequence to higher tariffs. With the US importing more products from Vietnam, India, Mexico, Japan, South Korea and the EU, rather than China, and with China increasing its trade with other economies in the Association of Southeast Asian Nations (Asean), global trade volumes have not suffered as much as sentiment indicators would have

suggested. Global trade has been sheltered by trade diversion with volumes only falling by 1.7% in June 2019, before recovering to negative 0.9% in July 2019. In comparison, global trade volumes plunged 18.9% in February 2009 in reaction to ailing demand during the global financial crisis.

The negative effect on higher value-add sectors (electronics and electrical equipment) could be limited due to China's superior logistics support according to all measures of the World Bank Logistics Performance Index and favourable procurement sources, which could outweigh rising costs due to more punitive US tariffs. Moreover, China is accelerating reform and enriching its attractiveness as an investment destination, through reducing corporate taxes, strengthening protection for intellectual property and creating an environment of competitive neutrality with China's state-owned firms.

China's efforts to expand domestic demand has, in addition, decreased the trade intensity of China's manufacturing sector. According to HSBC, China is also moving up the manufacturing value chain and placing increased emphasis on manufacturing services, including research and development, automation of production and testing. China has also partly offset its retaliatory measures with the US by lowering tariffs on all other World Trade Organisation members.

Nevertheless, outright export bans could be more disruptive to growth in China's supply chain development. While China has so far resisted relaxing policy too aggressively, in an attempt to rein in the financial system and the property market, under those circumstances, the stance of the Chinese government may have to become more interventionist should risks cause growth to slow more significantly. Particularly so if progress on reform is not moving quick enough to take up the growth slack.

Stifling policy paralysis is sabotaging SA's future

In his inaugural weekly newsletter, SA President Cyril Ramaphosa acknowledged "Much of the confidence that the country had 20 months ago has dissipated as the reality of the problems we face became clearer. This confidence was born out of the hope that we would quickly undo the damage that was done over a number of years. Implementing change does take time." While government's capacity for meaningful economic change and a resolution to continuing financial and operational hardship at the country's state entities appear to be lacking, the president has been more successful in shoring up support within the ruling party and has made notable progress on confronting corruption and re-establishing institutional credibility across a number of anti-corruption bodies and governance institutions.

The apparent shift in political power is evidenced by the ruling party's selection of its premier candidates (particularly in deeply contested provinces), the resignations of senior African National Congress (ANC) MPs from parliament since the May 2019 national elections, parliamentary officials chosen as well the selection of a non-trivial majority of cabinet ministers who are backers of Ramaphosa. Even so, internal opposition within the ruling party seeks to undermine Ramaphosa's authority. According to Standard Bank Group Securities, several prominent roles within various portfolio committees (including transport, cooperative governance and traditional affairs, home affairs, appropriations and police) in parliament were awarded to compromised ministers, who served during former President Jacob Zuma's tenure. Similarly, power dynamics are shifting disparagingly at the ANC's Luthuli House headquarters. Moreover, investigations by Public Protector, Busisiwe Mkhwebane, have stalled the president's reform efforts by providing fodder for President Ramaphosa's detractors. Nevertheless, a string of high-profile court losses are stacking up for Mkhwebane. That said, a wider political backing for her removal may still be some way off given the timeline of the judicial reviews still to be concluded.

Although the wheels of justice appear to be turning slowly, Ramaphosa's efforts have placed the plundered state on the road to recovery. According to Standard Bank Group Securities, the Hawks' (a Directorate for

Priority Crime Investigation) National Clean Audit Task Team have arrested 14 politicians, officials and businesspeople in KwaZulu-Natal and the Free State on corruption-related charges, while 1 800 completed corruption cases were handed to the National Prosecuting Authority (NPA) in May and June 2019 alone. Under Ramaphosa's endeavours to rebuild a state that can deliver, the restoration of SA's Revenue Services is advancing under the new commissioner, Edward Kieswetter. Moreover, the appointment of National Director of Public Prosecutions, Shamila Batohi, has instilled confidence, although the NPA remains hamstrung by financial constraints and there are strong societal calls for expediting prosecutions for those implicated in state capture.

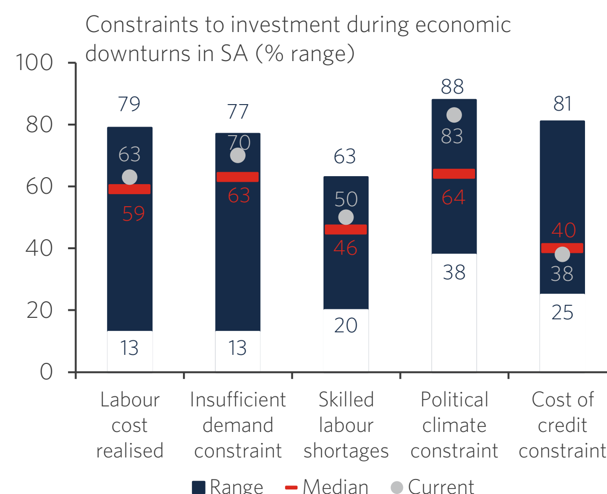
Some progress has been made on reforming the struggling economy, but big business is growing impatient with Ramaphosa's trickle-through approach to reform and government's discernible inertia on critical reforms at state-owned enterprises (SoEs). The publication of a revised mining charter, the establishment of a directive on the release of spectrum, some progress made to the country's visa regime (including lowering the turnaround time for critical work skills visas, expanding visa-free access, piloting e-visas and simplifying visa requirements for key tourism markets like China and India), the formation of an Infrastructure Fund and a One-stop Shop approach for potential investors hold significant promise in rehabilitating a languid economy, but corporates are hungry for a stronger focus on economic growth from the ANC government and have reflected this in glum surveyed sentiment.

Despite a lull in business and consumer confidence, the president remains popular. In the Citizen Survey conducted in the second quarter of 2019, President Ramaphosa secured a strong popularity rating of 62%. According to the Daily Maverick, sitting presidents of more established democracies would be considered fortunate to have a favourability rating above 50%.

Notwithstanding his high popularity securing a mandate for reform, the president's vague responses on contentious matters, including land expropriation without compensation, the national health insurance, prescribed assets and the necessary sale of ill-functioning state entities are a function of ideological tensions, which are likely to elicit a polarised response from within the ruling party's structures. Factional debates arising from these widely disputed reforms could feed positional jockeying in the run up to the ANC's National General Council in June 2020 and could also influence the outcome of the elective conferences for new leadership of the ANC Youth League and ANC Women's League in 2020. The political alignment of these key power bases plays an important role in garnering broader support for Ramaphosa, going into the 2022 ANC National Elective Conference.

The social cost of postponing crucial reforms is rising at an accelerating rate and citizens are demanding a bolder response to alleviating pressing economic and institutional ills. Muted demand and policy uncertainty are exacerbating SA's longest-evereconomic downturn. An in-depth look at the Bureau of Economic Research's (BER) Business Confidence Index during historic economic downturns in SA suggests these two factors are weighing on investment even more than usual in the current downturn (see chart 3).

Chart 3: Policy certainty and a revival in demand are needed to yank SA out of its low growth quagmire



Source: BER, Momentum Investments

Fixed investment by the private sector has grown by a paltry 0.9% (inflation-adjusted) on average in the past

five years, in comparison to growth of 4.4% historically. Similarly, growth in household spend on discretionary items (proxied by spend on durable and semi-durable goods including cars, furniture and clothing), collapsed to 1.9% on average in the past five years, relative to heartier growth of 4.7% historically.

The local economy recovered in the second quarter of the year after experiencing the most negative output gap since 1993 in the first quarter of the year. But the outlook for growth remains tepid, likely rising from 0.6% in 2019 to 1.2% in 2020 and 1.5% by 2021. Momentum Investments' expects a marginal positive adjustment in confidence into 2020 as incremental reforms and more concrete restructuring plans and managerial capacity for energy utility Eskom surface. The medium-term budget on 30 October 2019 will likely acknowledge prevailing growth and fiscal challenges, but it presents an opportunity for government to commit to enhanced policy responses that were outlined in Finance Minister Tito Mboweni's economic policy paper. As we head into the second Investment Conference in early November 2019, Mboweni is likely to give an update of the amount of investment secured at the inaugural conference in 2018. BusinessTech reported that of R300 billion commitments that were pledged by local and international companies last year, around R250 billion are already in implementation phase.

Although the October 2019 budget figures are likely to disappoint relative to Treasury's February 2019 iteration, the market and rating agencies have already factored in a meaningful deterioration in the fiscal deficit on the back of disappointing revenue growth. Moody's methodology is still likely to produce an investment grade outcome for SA's sovereign rating on 1 November 2019, but there is a higher-than-even chance, in Momentum Investments' view, for a lowering of the outlook to negative to flag rising fiscal and debt risks. SA's credit default swap spread has traded higher than Brazil's for the past year despite the latter's sovereign rating ranking one notch lower than SA on Standard and Poor's methodology and two notches below SA on Moody's ratings tiers, suggesting a deterioration in the country's sovereign rating may already, in any case, be partly priced in.

Low or negative returns on perceived global safe assets could continue to prompt a search for yield. Continued global central bank easing may accommodate lower real interest rates in SA, particularly in an environment where trend growth is inching below 2%, in Momentum Investments' opinion.

Absent demand-pull inflation and benign underlying price pressures are expected to keep headline inflation below 5% for the next three years, creating space for the Sarb to cut interest rates by at least 25 basis points more. In its October 2019 Monetary Policy Review, the Sarb noted its inflation fan chart calculations show an implied probability, of inflation tracking above the upper bound of the 3% to 6% target range, of just 6%, which lowers the inflation risk of cutting rates again.

Nonetheless, this is unlikely to be an aggressive easing cycle given fiscal dominance reducing the space for significantly easier monetary policy, the lower sensitivity of demand to interest rates cuts and the elevated risk premium, which constrains monetary policy by raising the interest rate needed to stabilise inflation.

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