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Market and economic outlook: January 2020

Highlights

Markets

- The majority of risky asset classes entered the year on poor footing following an extensive sell-off at the end of 2018. However, a complete about turn in the global monetary policy stance supported robust returns in 2019.
- A more accommodative monetary policy stance adopted by the major developed market (DM) central banks fuelled DM equity markets by 27.7% in 2019, sending them higher relative to emerging market (EM) bourses (up 18.4%).
- The South African (SA) equity market trailed global equity markets in 2019 at 12% partly due to weak economic conditions. Resource shares were the clear winner for 2019, while financial shares barely eked out a gain for the year.
- The JSE Assa All Bond Index (Albi) managed a 10.3% increase in 2019, while inflation-linked bonds (ILBs) edged up only 2.3%. Listed property ended the year 1.9% in the black after a dismal 25.3% contraction in 2018.
- While a soft landing in the global economy is expected, we acknowledge the meaningful risk for a deeper recession. It is, therefore, prudent to use exposure to defensive asset classes as part of our diversified portfolio mix while also providing some protection for portfolios where appropriate.
- From a valuation perspective, none of the primary global asset classes look cheap compared to the past. However, on a relative basis, equities look cheaper than credit and particularly government bonds.
- In SA, attractive valuations provide some margin of safety for equities against a weak growth environment.
- In a yield-deprived global environment, SA fixed income investments continue to offer very attractive real risk-adjusted returns to more than adequately compensate investors for investment risk.
- While the operating environment for listed property shares remains tough against the backdrop of a weak local economy, low valuations show that this is already well discounted, leaving the risk-return profile for listed property with more upside than downside.

Economics

- Trade friction, geopolitical threats and debt accumulation could further disrupt global economic activity and derail its tepid recovery since the global financial crisis. In our view, global growth is likely to move sideways from here.
- Growing business angst over the duration of the current economic upswing has raised questions over how long today's global economic expansion can last, but many traditional indicators of recession are not flashing red yet.
- Having played most of their cards, central banks are now faced with diminishing marginal returns on their monetary policy endeavours. This makes a strong case for governments to step up fiscal policy and reform efforts.

- The growth gap between DMs and EMs is likely to widen on weaker growth in the former and imperceptibly higher growth in the latter as the poor EM performers of 2019 go from bad to better.
- Global synchronised easing and a search for yield should help to sustain portfolio flows into EMs, but protectionism and lacklustre global growth will likely continue to create trade frustrations for EMs.
- Anaemic sentiment heralds a tepid growth recovery in SA from less than 0.5% in 2019 to under 1% in 2020, as confidence edges higher on the execution of easy-to-reach reforms where there is broad agreement.
- Even with a probable sovereign downgrade by Moody's in 2020, we expect the rand to end 2020 only marginally weaker, boding well for inflation, which is expected to increase from an average of 4.2% in 2019 to 4.6% in 2020.
- Additional monetary policy easing at the margin will depend on government's ability to plot a credible path towards fiscal consolidation as well as a downward revision in the SA Reserve Bank's (Sarb) growth and inflation forecasts.

Global hard or soft landing will be the determining factor of financial markets in 2020

The majority of risky asset classes entered the year on poor footing following an extensive sell-off at the end of 2018. However, a complete about turn in the global monetary policy stance has supported robust returns in global equity markets in 2019. Market returns were further supported late in the year on an easing in trade disputes between the United States (US) and China and a majority win by the Conservative Party in the United Kingdom (UK), suggesting a clearer path towards Brexit. These positive political developments contributed to a reduction in the CBOE Volatility Index (Vix) from 25 index points at the end of 2018 to nearly 14 index points by the end of 2019.

Global equity markets had their best year since 2009, when markets soared 34.6%. The MSCI All Country World Index ended the year 26.6% higher after collapsing 9.4% in 2018. A more accommodative monetary policy stance adopted by the major DM central banks fuelled DM equity markets in 2019, sending them higher relative to EM bourses. Returns in the MSCI DM Index more than made up for an 8.7% dip in 2018 and powered ahead at 27.7% in 2019. This left 2019 as the best performing year since 2009 when the MSCI DM Index climbed nearly 30%. Easier monetary policy and above-trend growth aided robust returns in US equity markets. The US equity market was the star performer in the DM composite, with the S&P 500 Index rushing ahead by 31.5% in 2019, which was the highest return since the index printed 32.4% in 2013.

DM government bond yields rallied further in 2019. The US 10-year government bond yield declined nearly 77 basis points to 1.9% in 2019, while the German 10-year government bond yield rallied a further 43 basis points to negative 0.2% at the end of 2019. The German 10-year government bond yield reached a new low of negative 0.7% in 2019 during August.

The MSCI EM Index unwound the 14.6% fall it experienced in 2018, but underperformed its DM equity counterpart at 18.4% for 2019. Firmer commodity prices in 2019 also provided an impetus for growth in EMs. The Bloomberg Commodity Price Index rose 7.7% in 2019, previously down 11.3% in 2018.

Risk appetite towards EMs improved in 2019. The JPMorgan EM Bond Index (Embi) spread recovered 157 points in 2019 after deteriorating 123 points in 2018. The biggest deterioration in sovereign credit quality was observed in Argentina, where the credit default swap (CDS) spread blew up 312% in 2019. The most substantial improvements were seen in Malaysia (down 68%) and Russia (64% lower). The JPMorgan EM Currency Index staged a smaller reaction and only appreciated by 0.9% in 2019. The steepest depreciation against the US dollar was in the Argentine peso (37.1%), followed by the Turkish lira (11.1%). At the same time, the most significant currency appreciations were in the Russian rouble (12.5%) and Thai baht (8.6%).

The local equity market trailed global equity markets in 2019, partly due to weak local economic conditions. The FTSE/JSE All-Share Index gained 12% in 2019 after losing 8.5% in 2018. Resource shares were the clear winner for 2019, while financial shares barely eked out a gain for the year.

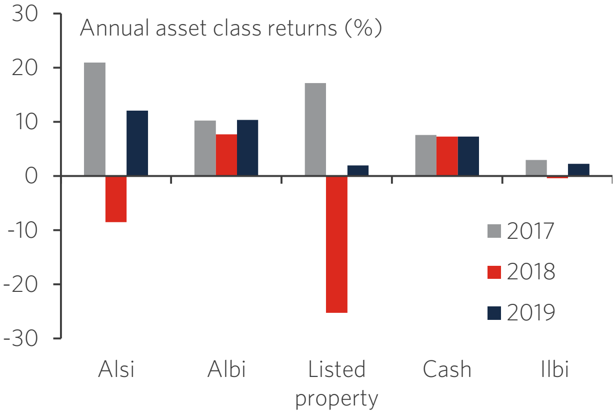
The FTSE/JSE Resources Index shot 28.5% higher in 2019, posting its fourth consecutive annual increase in returns. Gold and platinum prices were up 18.3% and 21.5% for the year following contractions of 1.6% and 14.3% in 2018, respectively. Although consumer demand for jewellery was knocked by weaker confidence in India and China, gold had a strong year supported by central bank purchases in Turkey, Russia and China. Palladium rocketed 54% higher during the year, further lifting several mining stocks.

Financial shares had a dismal year linked to the poor performance of the domestic economy, with the FTSE/JSE Financials Index only up 0.6% for 2019 after sinking 8.8% in 2018. Pedestrian returns of 8.9% were recorded in the FTSE/JSE Industrials Index for 2019, following a plunge in the index of 17.5% in 2018. The general retail sector fell around 20% in 2019 on continued consumer pressure, while construction stocks underperformed on poor building activity, a drying up of contracts and thin margins.

The SA 10-year government bond yield rallied 26 basis points in 2019 after selling off 40 basis points in the year before. The Albi managed a 10.3% gain for 2019, following a 7.7% rise in 2018, while the JSE Assa Government Inflation-linked Bond Index (Ilbi) edged up only 2.3% higher in 2019 following a 0.4% dip in 2018. Meanwhile, the FTSE/JSE SA Listed Property Index managed to end the year in the black at 1.9% after plummeting 25.3% in 2018 (see chart 1).

A rise in global trade optimism left the rand firmer in December 2019. The rand strengthened by 2.5% against the US dollar in 2019 after depreciating by 13.8% in 2018. The rand was 4.9% firmer against the euro at the end of 2019 after depreciating by 9.7% against the euro in 2018, while the rand extended losses against the pound in 2019 by a further 1.3% following 8.6% the year before. SA's five-year CDS spread narrowed by 27% during 2019 despite a rising risk of further sovereign rating downgrades to reflect a worsening in SA trend growth and a deterioration in government finances.

Chart 1: Returns from local asset classes (%)



Source: Iress, Momentum Investments

The expected determining factor for the outcome of global financial markets in 2020 is whether the global economy will experience a hard or soft landing. This will primarily be shaped by the interplay between the negative effect of trade tariff increases and the positive growth effect of policy stimulus measures.

Whereas growth assets like equities, credit and property are likely to experience meaningful drawdowns in case of a hard landing for the global economy, defensive assets such as government bonds and gold are likely to flourish in absolute and particularly relative terms in such an outcome. In contrast, if policy makers are successful in engineering a soft landing for the global economy through their combined policy efforts, the more risky asset classes are likely to perform better.

While either the hard or soft landing scenarios unfold in 2020, financial market volatility is likely to rise in line with the ebb and flow of market sentiment across the asset classes. This could be enhanced by additional uncertainties typically associated with events in a US election year.

From a valuation perspective, none of the primary global asset classes look cheap compared to the past. However, on a relative basis, equities look cheaper than credit and particularly government bonds. While a soft landing in the global economy is expected, we acknowledge the meaningful risk for a deeper recession. It is thus prudent to use exposure to defensive asset classes as part of our diversified portfolio mix, while also providing some protection for portfolios where appropriate.

History shows that the recent (lack of) returns from SA equities may be a good indicator of better future returns and that the state of the SA economy had little bearing in the past on the returns from the SA equity market. This is a testament to the global nature of the SA equity market. Attractive valuations also provide some margin of safety for SA equities against a weak local growth environment. The main near-term risk for local equities is a hard landing for the global economy, as the SA equity market typically performs poorly around the onset of a US recession.

In a yield-deprived global environment, SA fixed income investments continue to offer very attractive real risk-adjusted returns to more than adequately compensate investors for investment risk. Vanilla bonds offer real yields of 4% to 5%, ILBs have yields of around 3.75% and cash yields a real return of around 2.75%.

While the operating environment for listed property shares remains tough against the backdrop of a weak local economy, low valuations show that this is already well discounted. As a result, the risk-return profile for listed property is now asymmetric, with more upside than downside.

Unpredictable politics presages a tricky path ahead for the global economy

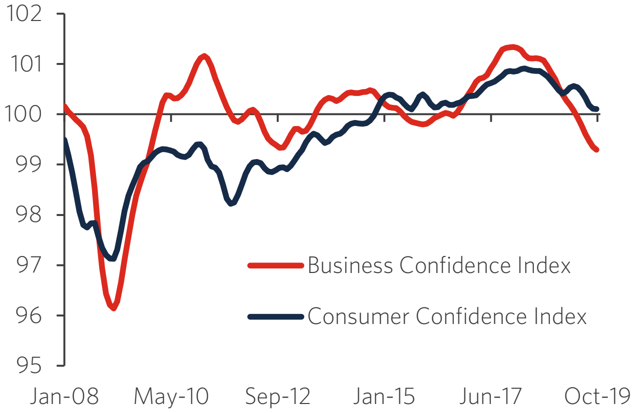
It is not easy to be optimistic about the world economy, given several downside risks that could further disrupt global economic activity and derail its tepid recovery since the global financial crisis.
Trade friction, geopolitical threats and debt accumulation have, in particular, raised prospects for another global recession and pose a downside threat to the International Monetary Fund's (IMF) global growth forecast of 3.4% in 2020 from 3.1% in 2019. In our view, it is more likely that global growth moves sideways from here.

In contrast to extremely weak global manufacturing and trade data, the world economy's services sector has continued to hold up. This has so far sustained a buoyant labour market, rising wage growth and healthy consumer spending in many advanced economies. Growing business angst over the duration of the current upswing in economic activity has raised questions over how long today's global economic expansion can last.

A few traditional US recession indicators have already signalled stress, including an inversion of the yield curve, when the two-year Treasury tops the 10-year. The distortive effect of quantitative easing on lowering longer-term yields, however, renders this indicator less reliable this time around. Moreover, other indicators of recession (including building permits and initial jobless claims) are not flashing red as yet.

Although the Organisation for Economic Co-operation and Development (OECD) Consumer Confidence Index continues to track in positive territory, it has nudged lower and equally reflects that consumers may be feeling less confident about economic conditions (see chart 2).

Chart 2: Global business confidence is slumping



Source: OECD, Momentum Investments

Rising wage inflation and more constrained corporate pricing power have squeezed firms' profit margins and could trigger a pullback in hiring in 2020, leading to a softening in consumer-related activity. With consumer spending constituting nearly 70% of gross domestic product (GDP) in the US, we expect growth to slow from 2.3% in 2019 to below trend at 1.7% in 2020.

The most significant downside risk to our growth view stems from an escalation in global trade wars and higher global economic policy uncertainty. A bigger negative shift in private sector confidence could create its own negative reality, preventing a recovery in capital expenditure and leading to a breakdown in consumer confidence, which would see the economy slipping into a deeper growth slumber.

Despite the recent trade détente, more profound issues, such as threats to the US's near monopoly in the digital and technology space, remain unresolved between the US and China. Even with a rollback in tariffs, a comprehensive Sino-American trade deal looks unlikely during the remainder of the current US administration's term in our view. The World Economic Forum (WEF) highlights the risks associated with the world entering a bipolar state, strongly dominated by the US and China. The WEF warns this holds important implications to revive multilateralism and global cooperation on issues such as poverty, climate change and artificial intelligence, which need to be addressed on an international level.

Although the IMF suggests without decisive and timely central bank easing in 2019, global growth would have been 0.5% lower in 2019 and 2020, global central banks have shouldered the burden of trying to revive the economy. Having played most of their cards, central banks are now faced with diminishing marginal returns on their monetary policy actions.

The Royal Institute of International Affairs, one of the world's leading institutes for the analysis of international issues, proposes minimal benefit to come from further monetary policy easing. The Institute warns that a return to unconventional monetary policies will exacerbate social and political woes already vexing Western democracies, due to the benefits of such policies predominantly accruing to wealthier households. In our view, there is a strong case to be made for fiscal policy and structural reform efforts to be stepped up to douse the flames of social unrest, which have consequently flared up across the globe and have led to an ascendancy of populism and nationalism.

The Bank for International Settlements (BIS) Annual Economic Report notes the importance of firing up all four growth engines including monetary policy, macro-prudential policy, fiscal policy and structural policy to reinvigorate economic activity.
While tumbling interest rates are now ubiquitous, policymakers have become aware of approaching the 'reversal rate'. This is the point beyond which the Financial Times warns that further cuts in the interest rate, typically into negative territory, may inflict harm on the economy through undercutting bank profitability, destroying the stability of retirement and insurance funds and allowing a build-up of low quality debt.

Unlike in 2009, when the G20 (an international forum for governments and central bank governors from 19 countries and the European Union) responded to the financial crisis with a co-ordinated stimulus plan, fiscal policies are likely to be uncoordinated and more focused on localised complexities this time around.

In light of negative interest rate policy in several countries, the OECD notes there is scope to strengthen automatic stabilisers (fiscal policy instruments, which help to counter swings in the business cycle) to uphold household income and consumer spending.

Though consumption and investment data confirm that the sensitivity of demand to lower interest rates has weakened, we still see a chance for one more interest rate cut in the US of 25 basis points. More aggressive cuts, coupled with unconventional policy tools, would, however, be necessary in the alternate scenario, where US growth falls by more than anticipated. While additional fiscal stimulus would be ideal to cope with the supply-side shocks the global economy is facing, the 2020 presidential election lowers the chances of bipartisan consensus for major additional fiscal spending.

At the September 2019 European Central Bank Council meeting, the Bank strengthened its call on government to abandon years of cautious fiscal policy to boost aggregate demand. With limited remaining monetary ammunition, further support to the Eurozone will have to be deployed by government in the form of additional fiscal stimulus or specific structural reforms that focus on longer-term growth enhancing measures rather than actions, which only turbo-charge short-term growth. More recently, Japanese Prime Minister, Shinzo Abe, appears to be embracing the need for fiscal stimulus to offset Japan's recent consumption tax hike which could send growth to below 0.5% in 2020. The UK is similarly looking for fiscal stimulus options amid all the chaos caused by Brexit to support growth, which is likely to track largely sideways from an expected 1.2% in 2019 to 1.1% in 2020.

Healthy global liquidity and arrest in global trade contraction not enough to lift all EM boats

Global synchronised easing and the search for yield should help to sustain portfolio flows into EMs, but protectionism and lacklustre global growth will likely continue to create trade headwinds for the composite. Although the growth gap between DMs and EMs is likely to widen in 2020, this is mainly due to a deceleration in DM growth. Growth in EMs, in our opinion, is likely to track only marginally higher from an expected 4.4% in 2019.

Ageing populations, new technology, excess global savings, high leverage and competition from China have pushed inflation lower in several EMs, which opened up substantial space for monetary easing in 2019. Although we expect a greater degree of stability in EM currencies in 2020 on a largely unchanged US dollar, a still antagonistic trade environment and elevated global uncertainty could slow the pace of easing in EMs going forward to maintain central bank credibility and shelter their respective currencies against the potential for any major capital outflows.

After growing at an average pace of nearly 10.5% in the three decades up to 2013, Chinese growth has tapered off in the last seven years to below 7% and is expected to fall further to 5.8% in 2020. Should growth threaten to dip significantly below 6% on a sustainable basis, Chinese authorities are likely standing ready to launch additional fiscal and monetary stimulus to offset the growth slowdown triggered by weaker external demand.

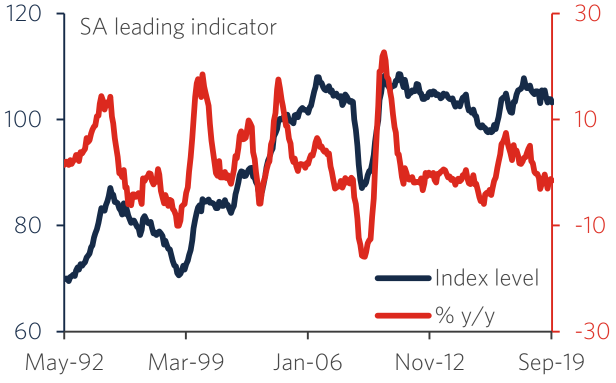
SA on a difficult path, but moving slowly in the right direction

Growth in SA's leading indicator, which provides foresight into where the economy is headed, has contracted for the past year, confirming downbeat consumer and business sentiment and heralding a tepid growth outlook (see chart 3).

The local economy slipped into its 73rd month of the economic downswing in December 2019 with little to suggest a growth surge is on the horizon. We believe growth in SA is likely to struggle to reach 1% in 2020 on reform efforts, which are too slow to suddenly reinvigorate sentiment, accelerate consumer purchases of bigger-ticket items or encourage the outlay of big capital investment projects just yet.

While SA President Cyril Ramaphosa has effected a number of structural reforms already, the IMF has proven that reform is more politically challenging under weak economic conditions, and the effects of these reforms may be watered down against a brittle growth setting.

Chart 3: Leading indicator flagging ongoing weakness in SA's economy



Source: Iress, Momentum Investments

The need for a social compact in SA, where all stakeholders concede to enduring some of the short-term pain has never been more urgent since the dawn of our democracy. Without this, kick-starting growth and moving our growth potential from around 1.5% currently assumed to the historic average of closer to 3% will be tough.

Weaker nominal GDP and lower tax compliance have led to another year of disappointment in government revenue collections. Efforts being made at the SA Revenue Services (Sars) to prosecute cases of misconduct and to close loopholes in base erosion and profit shifting are critical in addressing taxpayer compliance.

While efforts by Sars to bolster revenue growth may take time, there is pressure to reduce government expenditure, in particular the wage bill, where for every R1 of government expenditure, 35 cents is earmarked for civil servant salaries. Early retirement without penalties did not achieve the savings government hoped for, while curbing bonuses is unlikely to be enough. This leaves Treasury with the option of below-inflation pay-progression and salary increases or outright wage freezes.

Government's interest bill remains a drag on the fiscus. With nominal growth in debt-service costs averaging 13.7% a year in the medium term, the interest bill will exceed spending in health and economic development by fiscal year 2022/23.

Ailing state-owned enterprises (SoEs) pose an additional threat to fiscal consolidation. While government's commitment to SA Airways is only 0.5% of GDP, its obligation to Eskom is much larger at 9% of GDP. Allowing private generators to feed electricity directly into the grid could help to reduce the electricity supply constraint on growth and could lower costs for consumers. Struggling consumers can ill afford another steep increase in electricity prices, while government's vested interests may prohibit it from cutting staff or salaries. Similarly, the broad-based empowerment nature of the coal supply contracts may complicate coal price renegotiations. In a speech in March 2019, the Sarb Governor, Lesetja Kganyago, raised the importance of avoiding fiscal dominance, which he stated is "the need for monetary policy to prevent the sovereign from going bankrupt because of excessive spending on current consumption". In a global context, the Head of the Monetary and Economic Department of the BIS, Claudio Borio, expressed the need for safeguarding the autonomy of central banks and avoiding fiscal dominance. Borio noted to "protect the monetary policy room for manoeuvre and safeguard central banks' autonomy…i.e. avoid fiscal dominance, having very large government debt in relation to GDP is not the way to go".

As such, further interest rate easing in the local economy will likely be dependent on government's ability to plot a credible path towards fiscal consolidation and debt stabilisation. In our view, there is likely an opportunity to cut interest rates in SA by 25 basis points in the first half of 2020, but this will require more meaningful downgrades to the Sarb's growth and inflation forecasts. In its November 2019 economic assumptions, the Sarb forecasted growth of 1.4% for 2020 (above our forecast of below 1%) and expected inflation of 5.1% relative to our forecast of 4.6% in 2020 from an anticipated 4.2% in 2019.

Core or underlying inflation has averaged 4.3% for the past two years in comparison to its long-term history of 5% since 2009, while services inflation has averaged 5% for the past two years relative to 5.8% for the full history since 2009. This suggests downside surprises in inflation were broader than just food. Muted inflation appears to be broad based with a weighted average of 77% of items in the consumer inflation basket registering inflation below 6% in the past two years, in comparison to 61% for the longer-term history.

We expect the rand to end 2020 marginally weaker on lower domestic political event risk relative to the past few years and a short-term reprieve in the trade war between the US and China. An expected sovereign downgrade by Moody's rating agency to junk status in 2020, based on elevated SoE risks and difficulties in curbing the wage bill, could temporarily weaken the rand, but we believe this move is already largely priced in by markets.

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