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Economic outlook for 2019: Activity in the global economy is set to cool in the face of mounting headwinds

Highlights

- World growth is expected to slow, but the recovery remains firm. The global economy is, however, becoming less synchronised, with a smaller share of economies expected to experience an uptick in growth in 2019.
- While growth in emerging markets (EMs) should broadly retain its pace in 2019, activity is expected to moderate in a number of advanced economies.
- The global expansion is expected to have run its course by 2020 and conditions will be more conducive for a global economic downturn. Reduced fiscal stimulus should temper business and consumer confidence, while the effect of restrictive trade tariffs could further trim growth prospects in the United States (US) to below trend in 2020.
- Political risks are likely to feature prominently in 2019, as fringe parties continue to make inroads. Crippling debt levels and joblessness in a number of economies in the European Union (EU) should keep the euro membership debate alive in the longer term.
- Although a normalisation in monetary policy is well underway in the US and United Kingdom (UK), spare capacity and muted inflation expectations have suppressed the outlook for inflation in Japan and the Eurozone, preventing a faster unwind of accommodative monetary policy.
- Growth in EMs was spurred by a prolonged period of ultra-accommodative monetary conditions, but EMs are now vulnerable to a rise in borrowing costs and a potential reversal in capital flows.
- Although EMs face reduced macro fragilities relative to previous crises, a rebalancing of policy buffers and an acceleration in reforms are required to increase the resilience of EMs against capital flows and negative exchange rate shocks.
- Deep damage done by the previous administration has led to four consecutive years in which living standards have declined in South Africa (SA). A tepid growth outlook, further impaired by the rising threat of persistent electricity outages, point to little progress in eradicating poverty in the medium term.
- The political realities of a fractious ruling party have stymied the pace of progress in SA. While government is working to fix some challenges, policy uncertainty in a number of areas has suppressed a recovery in confidence.
- Momentum Investments expects a mild interest rate response from the SA Reserve Bank, given a weak growth environment, despite it emphasising the need to draw inflation expectations away from the upper edge of the target band.
- The risk of a downgrade remains, should trend growth deteriorate, if parastatal debt migrated to government's balance sheet, if tensions in the ruling party derail policy making or if the rule of law weakens.

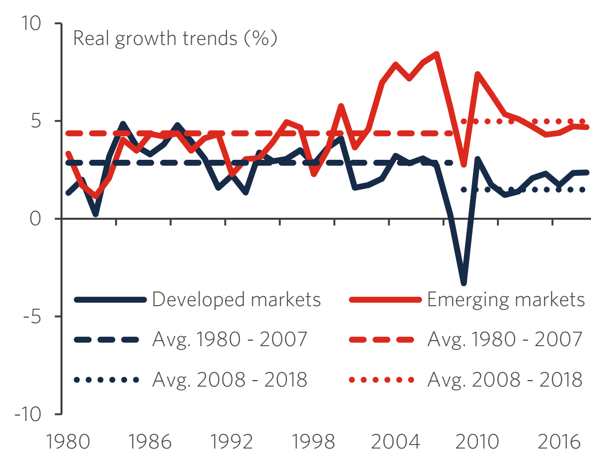
Global expansion set to cool, but growth remains firm

2018 marked a decade since the collapse of Bear Stearns and Lehman Brothers, which triggered the global financial crisis (GFC) that peaked in 2008. Growth in developed markets (DMs) has trended lower since the GFC, averaging 1.3% since 2008, which is less than half its longer-term average of 2.8% (see chart 1). The International Monetary Fund (IMF) attributed the downward trend to an ageing workforce, a decline in productivity growth, fewer highly productive start-up firms available to replace older less productive ones and less competition in a more highly concentrated market. In contrast, growth in EMs improved from 4.4% to 5.0% during the corresponding period. Stronger macroeconomic

frameworks, more flexible exchange rate regimes and favourable global funding conditions were generally supportive for this region when DM monetary policies grew more accommodative in the aftermath of the GFC.

More recently, however, tighter global financing conditions and US dollar appreciation highlighted vulnerabilities in countries with large external fragilities, while the EM composite as a whole has sustained its growth momentum. Though growth in EM should broadly retain its pace in 2019 from levels experienced in 2018, activity is expected to moderate in a number of advanced economies.

Chart 1: Growth patterns before and after the GFC

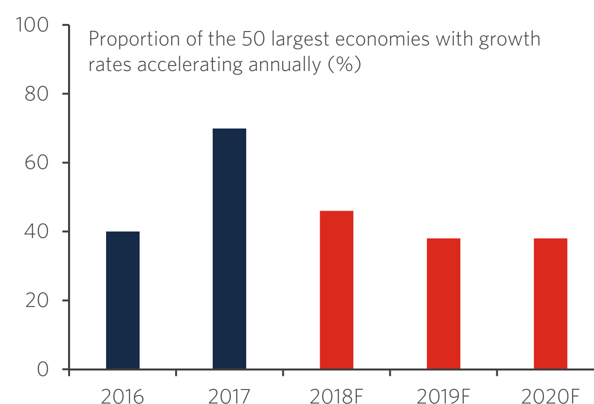


Source: IMF, Momentum Investments, data up to 2018

Even though world growth is expected to slow, the recovery remains convincing. The global expansion is likely to have peaked at 3.8% for 2018, but consensus growth forecasts for the world remain healthy at 3.6% for 2019.

Nevertheless, the global expansion is becoming less synchronised. The IMF reported that 58% of countries, globally, which accounted for 75% of world gross domestic product (GDP) in purchasing-power-parity terms, experienced an uptick in growth rates in 2017. This share declined to 47% of world GDP represented by 52% of economies in 2018 and should dip further to 32% of global GDP (54% of economies) in 2019 (see chart 2).

Chart 2: Shifting to a more uneven global recovery



Source: IMF, SARB, Momentum Investments

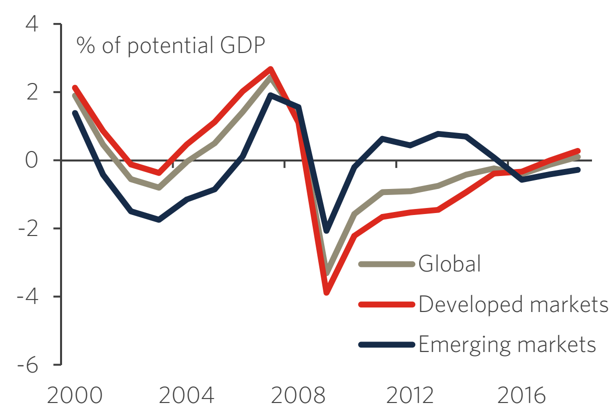
By 2020, the current global expansion is expected to have run its course and conditions will be more conducive for a global economic downturn. Fiscal stimulus, which has propelled growth in the US economy to beyond its potential, is forecasted to turn into a fiscal drag of 0.3% by 2020. Reduced stimulus should temper consumer and business confidence, while the effect of restrictive trade tariffs could further trim US growth prospects to below trend in 2020.

An ongoing normalisation in global monetary policy

The World Bank predicted that 2018 would be the first year since the GFC where the output gap (the difference between actual and potential growth) would be closed. It further expects the global economy to continue operating above full capacity in 2019 (see chart 3).

While firm growth and tighter labour markets have contributed to a cyclical upturn in price pressures, a resurgence in inflation is less likely on a structural basis given an elevated number of discouraged work seekers, an increase in automation and intertwined global value chains, the latter evidenced by an increased co-movement of inflation across countries.

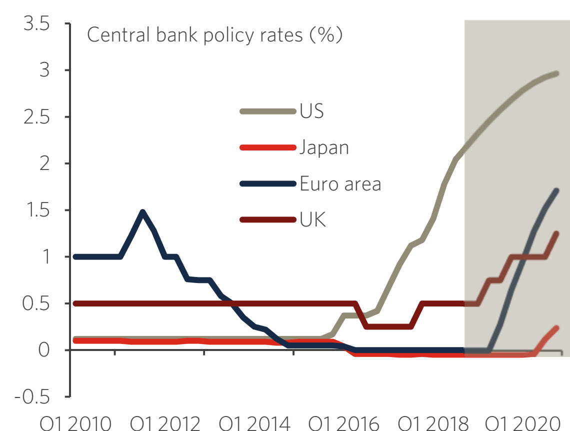
Chart 3: Output gaps are closing around the world



Source: World Bank, Momentum Investments, data up to 2018

Although a normalisation in monetary policy is well underway in the US and United Kingdom (UK), spare capacity and muted inflation expectations have suppressed the outlook for inflation in Japan and the Eurozone.

Chart 4: Gradual unwind of accommodative monetary policy



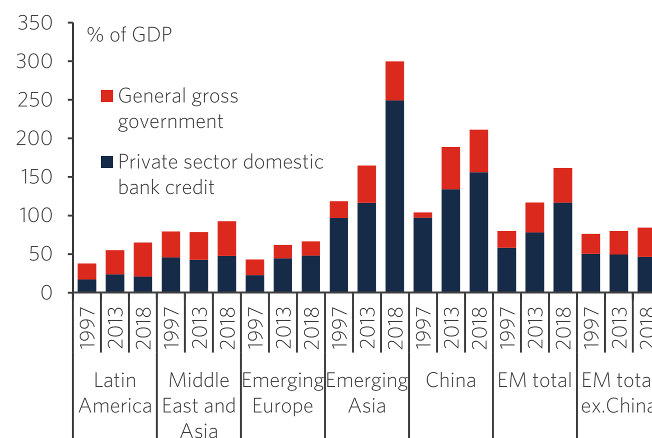
Source: SARB, BoE, Momentum Investments, data up to Q4 2020

The Bloomberg consensus expects the US Federal Reserve (Fed) to increase interest rates to a peak of between 3% and 3.25% by the end of 2019, but forecasts a more gradual tightening of interest rate policy in the Eurozone.
The European Central Bank (ECB) has signalled an end to its bond purchase scheme by the end of 2018, but concerns of a persistence in the recent slip in economic activity and below-target inflation should delay the start to a gradual interest rate hiking cycle to the final quarter of 2019, at the earliest. Likewise, the Bank of Japan (BoJ) is not expected to exit its extensive monetary policy easing programme anytime soon, given its failure to revive inflation to its 2% goal.

A gradual and shallow normalisation in monetary policy in DMs, until now, have left markets complacent about the risk of a sudden and sharp tightening in financial conditions. While there is a fairly strong likelihood that global rates will continue to only rise slowly, a faster-than-expected tightening of global financial conditions, in the face of shrinking central bank liquidity, remains a risk to EM.

Growth in EMs was spurred by a prolonged period of ultra-accommodative monetary policy in DMs since the major central banks responded to the GFC. During this period, private and public debt levels mushroomed in a number of EM economies, particularly China, leaving them vulnerable to a rise in borrowing costs and a potential reversal in capital flows (see chart 5).

Chart 5: China has been a significant contributor to the rise in EM debt, as a share of GDP



Source: JP Morgan, Momentum Investments

While it is true that the EM composite faces reduced macro fragilities relative to previous crises (including sound policy frameworks, higher foreign exchange reserves, healthier current account positions, fewer currency pegs, lower inflation), a rebalancing of policy buffers and an acceleration in reforms are required to increase the resilience of EMs against capital flows and negative exchange rate shocks in the longer run.

Trade protectionist fears are possibly overblown

Inward-looking economic policies and trade disputes have sprouted in a climate of uneven growth in the global economy, consequently leading to a rise in inequality since the GFC.

Recent country-specific events in Argentina, Venezuela and Turkey have soured sentiment towards the broader EM composite, even dragging countries, which have implemented reforms (namely India and Indonesia) into the wider EM turmoil.

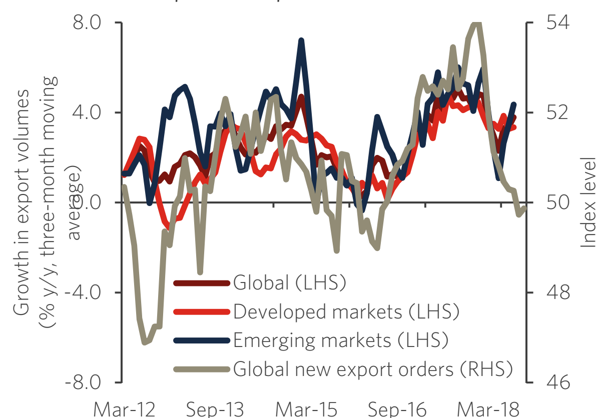
An intensification in trade tensions has further dampened sentiment in EMs, but in Momentum Investments' opinion, fears of a return to a 1930s-style trade protectionist era are overblown, as reflected by trade volumes (see chart 6).

The World Economic Forum argues that, unlike the 1930s, the interests of workers and capitalists are no longer aligned, given the prominence of multinational firms. Policies intended to hurt the Chinese economy are likely to backfire on firms in the US and Europe that have made huge investments

into China. In addition, many firms today act as part of a global value chain and, as such, tariffs are likely to hit imported components.

A new era of protectionism has further been waived by a number of economies moving in the opposite direction, namely that of free trade. The European Union (EU) has entered an accord with Japan and has finalised the Comprehensive Economic and Trade Agreement with Canada, while Japan has entered into an economic partnership agreement with Australia. Moreover, China and the EU have sought to make progress on increasing trade and defending the multilateral trading system.

Chart 6: Trade volumes have held up despite a fall in confidence in expected export orders



Source: IMF, SARB, Momentum Investments, data up to Q3 2018

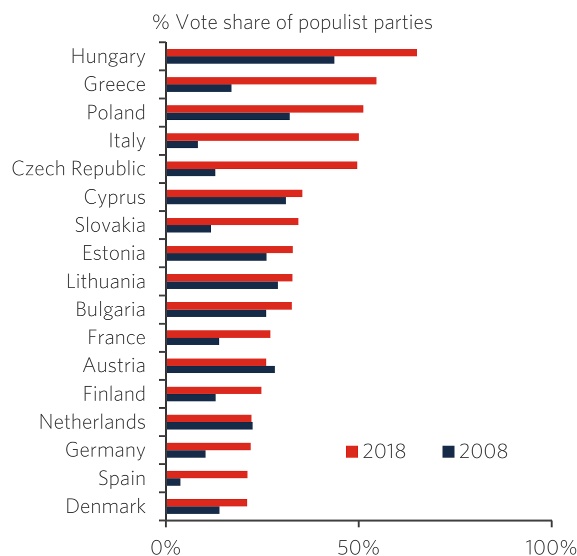
Another high political risk year

Aside from a continuation of trade protectionism, 2019 is likely to be inundated with political risks, with elections set to take place in Asia (India, Indonesia, the Philippines and Thailand), Africa (SA and Nigeria) and Europe (Greece, Poland and Ukraine).

Although the election of French President Emmanuel Macron and the fourth-term victory of German Chancellor Angela Merkel backed the rising anti-EU trend, populists are expected to keep the EU on the political knife-edge in 2019 (see chart 7. Popular support for Macron fell to 23% in December 2018 from 45% a year ago, while fringe political parties made major inroads in a key regional election in Germany in October 2018. Meanwhile, Italy's anti-establishment government has promised to increase spending, directly challenging European fiscal rules, which risks higher borrowing costs, EU sanctions and the potential for spillover to broader EM financial markets.

Crippling debt levels and joblessness in a number of EU economies will keep the debate around euro membership alive in the longer term in Momentum Investments' view, forcing mainstream parties to adapt to retain their voter base.

Chart 7: Populist tide in the EU



Source: IMF, Momentum Investments, data up to 2018

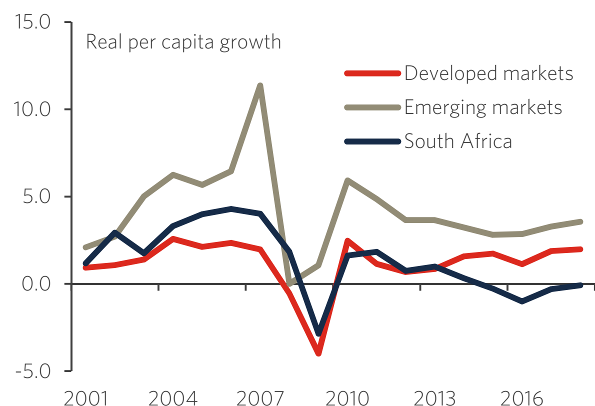
The honeymoon is over

In its September 2017 economic update, the World Bank noted President Cyril Ramaphosa's smooth transition to presidential power and the authorities' recommitment to good governance and fiscal consolidation breathed a sense of optimism into SA's political and economic future. However, the honeymoon is over. A year has passed since Ramaphosa's slim win at the African National Congress's (ANC) leadership battle in December 2017, but little recovery has been observed in growth and jobs since. Deep damage done by the previous administration has led to four consecutive years in which real growth has been unable to outstrip the growth in the country's population, resulting in a decline in living standards overall (see chart 8).

Based on Momentum Investments' expectation for growth in the economy to gather pace from an estimated 0.7% in 2018

to around 1.5% in 2019 and close to 2.0% in 2020, real growth per capita should only begin to trend more meaningfully into positive territory by the outer year.

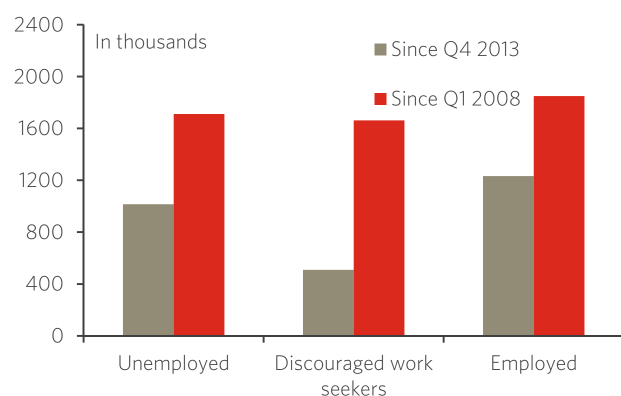
Chart 8: SA has diverged from global trends since 2014



Source: IMF, Momentum Investments, data up to 2018

During this period, few bold decisions were taken to break the cycle of low growth and high inequality. An additional 1.1 million people lost their jobs since the end of 2013 (see chart 9), leaving the number of unemployed persons and discouraged work seekers (those who have given up looking for work) at 9 million.

Chart 9: A million more became unemployed since the end of 2013



Source: Statistics SA, Momentum Investments

Though the World Bank acknowledges SA's success since the advent of democracy, it concedes that resolving SA's socio-economic fragilities will take time. The political realities of a fractious ruling party have stymied the pace of progress in SA.

Nonetheless, the measures implemented thus far by the new administration, have been effective in Momentum Investments' opinion. A restoration of good governance at the country's state-owned enterprises (SoEs) aims to restore public confidence in pivotal institutions to fulfil their constitutional mandate. Moreover, an inquiry into state capture and the affairs at the SA Revenue Services (SARS) as well as the appointment of a new National Director of Public Prosecutions have attempted to remove the stain of corruption, which has been a significant detractor of growth and has suffocated innovation in SA for a number of years.

Ramaphosa has further provided a platform for investors to seek out opportunities in SA at the October 2018 Investment Conference and a number of measures were outlined at the September 2018 Jobs Summit to tackle joblessness.

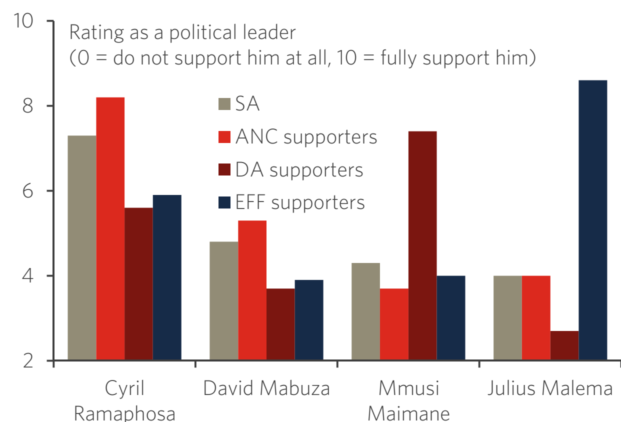
Additionally, a framework for increased public-private co-operation is beginning to take shape, as evidenced by the recent reforms in the labour market and a finalisation of the third Mining Charter. While government is working to fix some challenges, policy uncertainty in a number of areas has suppressed a recovery in confidence. SA has not been immune to rising global populist sentiment. The World Bank concludes the legacy of exclusion in land, labour, capital and the product markets has led to glaring inequality, has provided fertile ground for support for populist policies and has fuelled the contestation over resources. Discontentment erupted in the #FeesMustFAll movement in October 2015, while the expropriation of land without compensation debate (property rights) and a socialised model for healthcare remain on the political agenda.

While it is likely the ANC will retain power in the national elections in SA in 2019, a slow pace of economic transformation may eat into support for the ruling party. The IPSOS Pulse of the People poll conducted between May and June 2018 showed strong support (7.3 out of 10) for Ramaphosa, despite the uncertainty expressed about the ANC's future as the ruling party of SA (see chart 10).

SA's corporates have struggled in the low growth environment. Real growth in operating surplus has averaged a measly 1.2% in the past two years, while real growth in the uptake of corporate credit remained slow at 0.2% in the first ten months of 2018. Moreover, spend on private fixed investment has lagged at negative 1.8% in the past three years. Momentum Investments expects the private sector's contribution to fixed investment to only gather momentum after the national elections take place and a greater sense of policy certainty and consistency is achieved. In the firm's opinion, breaking the cycle between a stagnant economic performance and elevated poverty will require a stronger social contract between business, labour and civil society. However, for the private sector to pay a more active role in shaping the economy and creating jobs, government

must pursue efforts to improve the ease of doing business. In the likely absence of another commodity or credit boom, reinvigorating confidence will be an important driver for growth.

Chart 10: Strong support for Ramaphosa, even from outside the ruling party



Source: Ipsos, Momentum Investments

Consumers, on the other hand, may be past the peak point of vulnerability. Households have actively delevered to 71.3% as a share of disposable income since the 85.7% peak in 2008. A further rise in debt-servicing costs is anticipated, but within-target inflation and a modest growth outlook warrants a shallow interest rate response. Although the near-term risks to the inflation outlook have subsided, the SA Reserve Bank (SARB) expressed its concerns over upside threats to inflation in the longer term. Tighter global financial conditions and SA's relatively poor macro fundamentals highlight the need to maintain an attractive real interest rate profile, but a muted growth outlook will likely prevent a sharper acceleration in interest rates. Accordingly, Momentum Investments expects only a mild tightening in monetary policy from 6.75% to 7.25% by the end of 2020.

The SARB's Household Economic Stress Index and UNISA's Consumer Financial Vulnerability Index pointed to an improvement in consumer vulnerability since the second quarter of 2018. Moreover, a controlled rise in inflation from an expected 4.6% in 2018 to 5.2% in 2019 and 5.7% in 2020 (based on lagged currency depreciation, above-inflation wage increases and electricity tariffs) suggests growth in disposable income will continue to outstrip inflation, remaining supportive for household spend. Moreover, consumers' ability to spend should lift marginally on reduced fiscal drag adjustments and an improvement in the household credit impulse.

Employment gains are, however. expected to remain constrained in the near term, particularly given the pressure on government to downsize its burgeoning wage bill, which stood at 35% of non-interest expenditure in FY2017/18. In light of poor growth, government has chosen to allow some fiscal slippage to avoid further damage to the economy.

Despite the unexpected deterioration in SA's fiscal deficit and debt ratios projected in the October 2018 medium-term budget, government has maintained the expenditure ceiling and remains committed to fiscal consolidation, forecasting a primary deficit of close to zero by FY2021/22.

With Moody's only looking for a stabilisation in debt in the medium term and not expecting a quick turnaround in growth, Momentum Investments expects Moody's to leave the country's sovereign rating unchanged in the near term. Nonetheless, the risk of a downgrade remains, should trend growth deteriorate (particularly in light of the renewed threat of persistent electricity outages), if SoE debt migrated to government's balance sheet, if tensions in the ruling party derail policy making or if the rule of law weakens.

A recommencement of load shedding could detract further from growth estimates for 2019. Research by Standard Bank noted a 5% electricity shortfall during the 2008 electricity load shedding reduced economic growth by around 0.3% to 0.5%. However, scheduled interruptions and alternative arrangements by firms to cater with electricity outages should reduce the negative effect of load shedding on growth to between 0.15% and 0.3%. Aside from the growth risks posed by the operational underperformance by the country's energy utility, its financial underperformance poses a risk to additional government support and, thus, sovereign ratings.

A downgrade of Moody's sovereign rating of SA into sub-investment grade would trigger an exclusion from the Citi World Government Bond Index (Citi WGBI) and a forced selling of local government bonds. This, together with poor macro fundamentals, leaves the rand vulnerable to a shakier global environment and a deterioration in sentiment towards perceived-riskier EMs. Momentum Investments anticipates a brief strengthening in the rand in reaction to an expected market-friendly outcome in the national elections in SA in May 2019. Nevertheless, the rand should experience a mild deterioration in the medium term in response to a weakening in the country's terms of trade (export prices relative to import prices) and its slow economic progress in alleviating the country's employment and poverty challenges.

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