The Macro Research Desk

From left to right: Herman van Papendorp (Head of Investment Research and Asset Allocation), Sanisha Packirisamy (Economist)

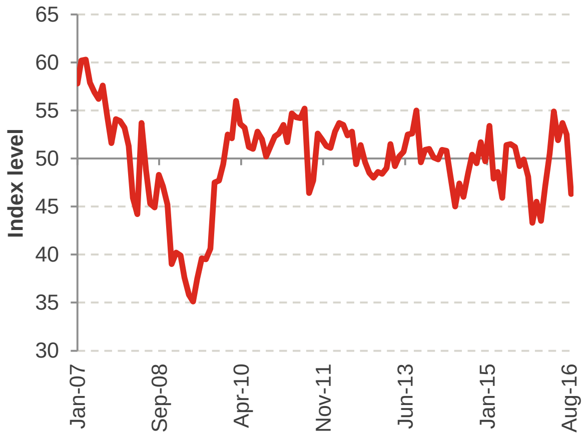
August PMI sinks below 50

Manufacturing sentiment falters after printing in positive territory for five consecutive months

The Barclays/Bureau of Economic Research (BER) Purchasing Managers' Index (PMI) plunged 6.2 points to 46.3 points in August 2016, signalling tougher conditions in SA's manufacturing sector. Over the past few months a rise in commodity prices, buoyed by an upswing in Chinese housing data, filtered into positive sentiment in the manufacturing sector. However, we expect softer data to emerge in the Chinese housing market towards year end which could pose a headwind to SA's mining and manufacturing industries, despite these sectors likely making a meaningful contribution to second quarter GDP growth (expected to be released next week).

Both the business activity index (measuring current conditions) and the new sales orders index (an indicator of future demand levels) shifted well below the neutral 50-mark. The business activity index slowed to 44.8 points in August 2016 from 54.3 points two months ago, while the new sales orders index reversed the upward trend experienced over the past three months, crashing nearly 12 points lower to 42.5 points in August 2016.

Chart 1: Headline PMI sinks below neutral reading



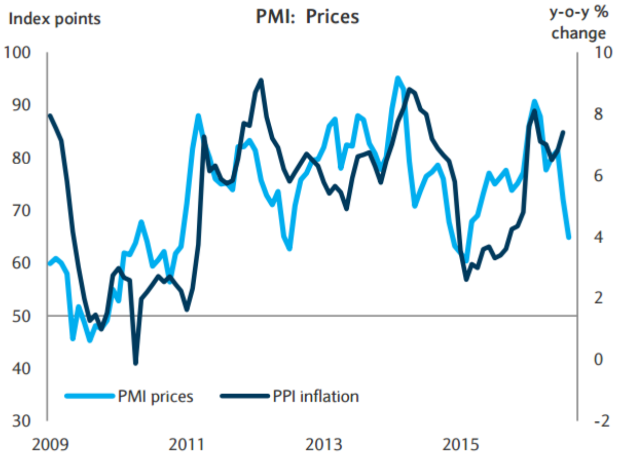
Source: Global Insight, Momentum Investments

According to the BER, the decline in new sales orders reflected a fragile domestic demand environment as well as slower growth in export orders during August, despite the latter having supported overall new sales orders in previous months. This could be owing to the initial strengthening in the local currency in the first half of the month. Currency strength across emerging markets followed on from robust inflows into emerging market asset classes, in response to statements suggesting a delay in the next interest rate hike in the United States (US). This trend, however, reversed towards month end following perceived hawkish comments by senior Federal Reserve officials. The local unit was hammered further by ongoing domestic political tussles, which left the rand nearly 6% weaker against the US dollar and c.5.5% weaker against the euro.

Recent weakening in the exchange rate poses a threat to manufacturing costs

The survey responses were largely captured over the first half of the month when the domestic currency was on a strengthening path. As such, manufacturers recorded a significant alleviation in cost pressures (see chart 2), easing some of the downward pressure on profitability levels. However, elevated political tensions could lead to sustained rand weakness, reversing the positive trend observed in the PMI price index.

Chart 2: Reprieve in cost pressures vulnerable to a sustained rand reversal



Source: Barclays/BER

Employment index relatively steady

Despite the collapse in the headline index, the employment reading remained in positive territory for the third consecutive month. The employment index dipped to 50.6 points, but remained above the all-important 50-mark suggesting that manufacturers intended to keep employment levels steady over upcoming months. Nevertheless, we remain cautious on employment gains in the manufacturing sector as a lack of labour reform (the large gap between management offers and union demands persists, uncertainty over the minimum wage lingers and a solution for protracted, violent strikes has not yet been decided upon), above-inflation increases in nominal wage settlements and anaemic growth in demand provide a challenging backdrop for hiring and accelerating fixed investment in the sector.

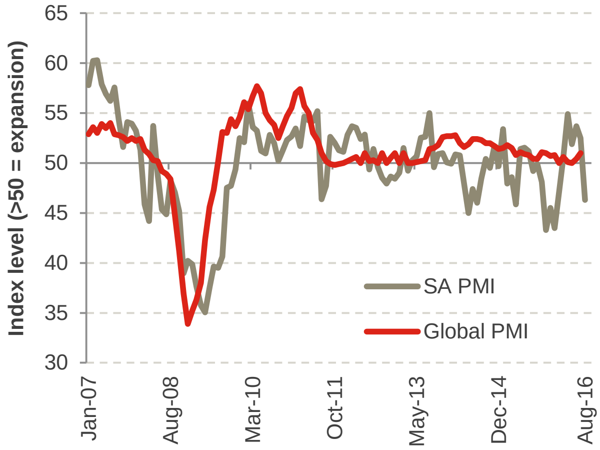
SA underperforming global trends

Manufacturing growth likely slowed in the Eurozone in August 2016 given that the Markit manufacturing PMI flagged wavering performance in key countries. New sales orders dropped to a one-and-a-half year low, potentially as the impact of the UK's decision to leave the European Union takes hold. Although printing above the neutral 50-mark, the headline index dipped to 51.7 points in August 2016 from 52 points a month ago, with sentiment in Germany, the Netherlands and Austria printing firmly in positive territory. Meanwhile, activity remained soft in France and Italy and dipped to mid-2013 lows in Spain and Ireland.

Manufacturing sentiment surprised to the upside in the United Kingdom (UK) in August 2016, rebounding to 53.3 points from 48.3 points in July and exceeding market expectations for a modest rise to 49 points. Though UK manufacturers have shown resilience (in spite of the uncertainty surrounding the Brexit vote), helped by a stronger performance by exporters taking advantage of the weaker sterling, input costs are likely to rise and could squeeze profit margins going forward.

Over in emerging markets, the official manufacturing PMI in China (tracking large state-owned enterprises) rose to 50.4 points in August 2016, which was the highest reading since October 2014. The survey results indicated an improvement in light manufacturing, while heavy manufacturing remained in contraction. That said, we expect sequential momentum to slow in the economy as officials are unlikely to provide the same quantum of monetary stimulus as they did in 2015.

Chart 3: After a brief period of outperforming global trends, the SA PMI dipped below the global reading



Source: Bloomberg, Global Insight, Momentum Investments

Second-quarter rebound in growth unlikely to be repeated in the third quarter

The rebound in mining and manufacturing production volumes in the second quarter of the year is expected to underpin a firmer real GDP growth rate, likely ruling out a technical recession in the first half of the year. Manufacturing production volumes increased by 8% in q/q seasonally adjusted annualised (saar) terms in 2Q16, while mining rebounded sharply from a negative 1% q/q saar in 1Q16 to 17% q/q saar in 2Q16. Nevertheless, the steep decline in the PMI business activity and new sales orders indices suggest that risks to the outlook for the third quarter of the year remain to the downside. We expect growth to average 0.3% for the full year, increasing to 1% in 2017.