momentum investments

The Macro Research Desk

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Economic and market snapshot for June 2017

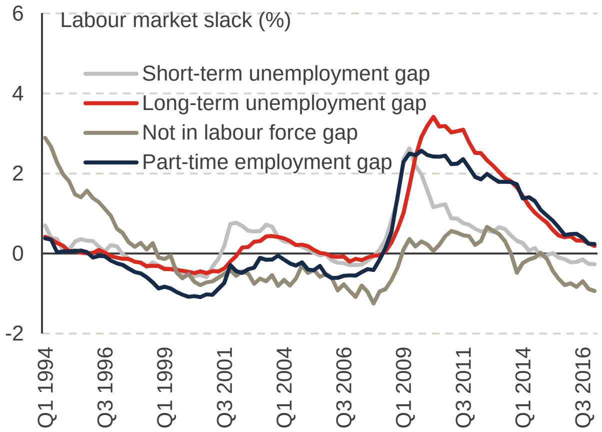
Global economic developments

United States (US)

Continued strength across various labour market indicators allows for further interest rate normalisation

The headline rate of unemployment in the US eased further to a 16-year low of 4.3% for June 2017. Although jobs growth figures appeared weak in the latest employment report at a headline level, the average number of employees hired in the past three months (120 000) remains more than the estimated 75 000 to 100 000 jobs needed to keep pace with growth in the working-age population.

Chart 1: Shrinking labour market slack in the US



Source: Deutsche Bank, Momentum Investments, data up to Q1 2017

In addition to the improvement in the headline measure of unemployment, slack in other labour market measures has declined (see chart 1). The gaps in current short-term unemployment and part-time employment (preferable to full-time employment under poor growth conditions), relative to their respective long-term trends, have closed. Further labour market improvements are evident in estimates of long-term (longer than a year) unemployment and the number of people who are not in the labour force.

The number of discouraged work-seekers (those who have given up looking for work after four weeks) dropped to 355 000 in May 2017, leaving the measure back at levels last seen in late 2007.

Although the transmission mechanism from a tighter labour market into higher inflation has been much weaker this time around (technological progress, a larger number of pension-age workers in the workforce, public sector pay cuts and increasingly flexible regulations are partly to blame), wage inflation has ticked up in the current economic upswing. Wage inflation lifted from 1.3% for the fourth quarter of 2013 to around 2.5% for the second quarter of 2017, taking the average of the employment cost index, average hourly earnings and compensation per hour measures.

Household expectations of wage growth indicate further upside in upcoming quarters. Providing oil prices do not lurch significantly lower in 2018, Momentum Investments expects a broader-based recovery in targeted inflation towards the US Federal Reserve's (Fed) 2% goal within the next 12 months. This should allow the Fed to continue raising interest rates by an additional percent by the end of 2018.

Eurozone

Notwithstanding a cyclical improvement in growth, absent inflationary pressures point to a cautious monetary policy stance

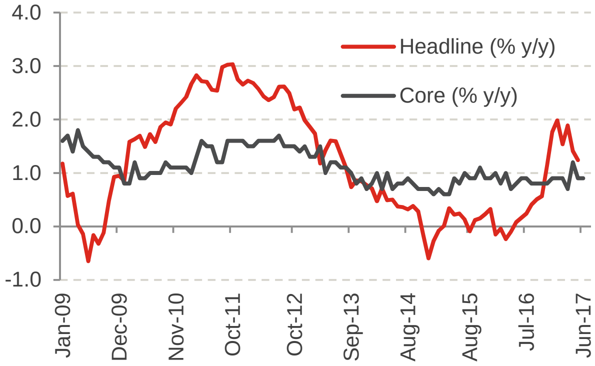
A recent uptick in the Eurozone's consumer sentiment index flags a further potential increase in household spending growth in the second quarter of 2017. Additionally, positive prints in the forward-looking export orders' index signals higher volume growth for the corresponding period.

Although evidence of a cyclical improvement in Eurozone growth has become more apparent, officials at the European Central Bank (ECB) see the output gap (the difference between actual and trend growth) remaining negative for the remainder of this year and next.

Despite headline unemployment having retraced from its near-12% peak for 2013 to 9.4% for the first quarter of 2017, the amount of slack in the Eurozone labour market remains sizeable. Consequently, wage growth remains muted. Wage growth has averaged around 1.3% since 2013, bucking the rising trend in wages in the G10 economies (referring to the largest-eleven industrialised countries in the world).

With wage growth remaining subdued, there has been scant evidence of a convincing rise in domestic cost pressures (see chart 2). As such, even with an improvement in cyclical economic growth activity, the ECB is likely to remain wary of weak inflation.
In Momentum Investments' view, this pushes out the prospects of interest rate increases to the back end of 2018, at the earliest.

Chart 2: Soft Eurozone inflation prints



Source: Bloomberg, Momentum Investments

United Kingdom (UK)

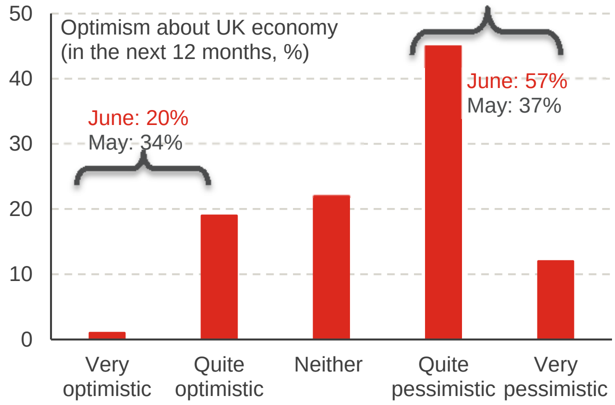
A weaker negotiating stance could lead to a softer British exit from the European Union (Brexit)

Prime Minister Theresa May's snap election gamble on 8 June 2017 backfired, creating further uncertainty in the UK. The Conservatives emerged as the biggest party, but fell short of an overall majority, resulting in a hung parliament. The uncertain election outcome raised doubts over May's future as prime minister and whether a 'hard-Brexit' strategy could still be pursued.

More recently, May's minority government secured the support of the Democratic Unionist Party (DUP), which could promote a higher level of stability, as the UK government embarks on its Brexit process. The deal between the Conservatives and Northern Ireland's DUP should give May enough votes in the House of Commons to pass legislation and the recent negotiations may just be enough to secure May's tenure as prime minister.

The recent deal could at the margin temper heightened concerns over the outlook for the UK economy. A survey by the Institute of Directors (IoD) revealed a dramatic drop in UK business confidence between May and June 2017. While 34% of businesses surveyed suggested they were either very or quite optimistic about the UK's economic prospects in the next 12 months for May 2017, this figure plunged to 20% for the June 2017 survey results, following the recent uncertain election outcome (see chart 3).

Chart 3: UK business sentiment dips following election



Source: IoD, Momentum Investments

The household savings ratio in the UK slumped to 3% recently (from 6% a year ago), highlighting stress at the household level and placing domestic demand under additional pressure. Although the value of exports climbed on sterling weakness, around 295 bilateral trade deals have to be renegotiated in the Brexit process, which could place pressure on exports going forward.

Despite core inflation (headline excluding food and fuel) jumping well above the official 2% target in recent months, reduced growth prospects (highlighted by downtrodden confidence) should keep monetary policy at ultra-accommodative levels for now.

Emerging markets (EMs)

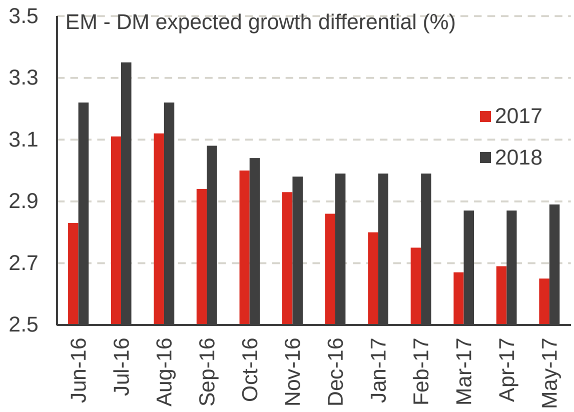
EM is experiencing its first synchronised recovery with developed markets (DM) since 2010

Though the Bloomberg consensus has scaled back its expectations on EM real growth prospects in the gross domestic product (from 5.2% a year ago to 4.9% for 2017 and from 4.9% a year ago to 4.6% for 2018), the growth gap between EM and DM is expected to remain in EM's favour (see chart 4).

The near-term growth outlook in EM is likely to be supported by the recent upswing in export volumes and a convincing turnaround in household consumption growth.

While parts of EM are still exposed to idiosyncratic policy and political risks, Morgan Stanley shows the sovereign ratings drift (net upgrades to downgrades as a share of the total EMs covered) has swung positive for the region as a whole.

Chart 4: Expected growth differential has narrowed



Source: Bloomberg, Momentum Investments

In line with supportive macro fundamentals and a likely less negative risk backdrop, sentiment towards EM remained positive on a year-to-date basis. Cumulative net inflows into EM portfolios reached 3% of assets under management by May 2017 (since the beginning of the year), relative to a net outflow of 1.5% for the same period a year ago.

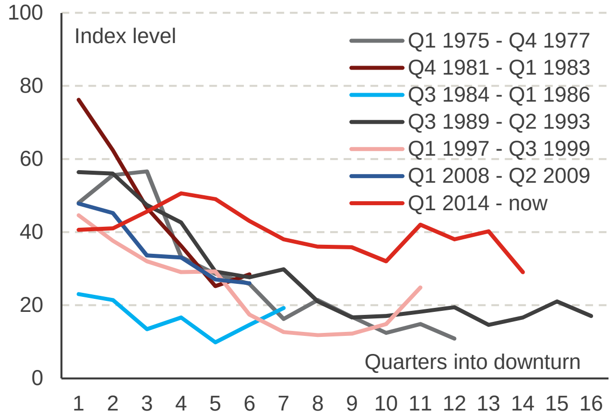
Local economic developments

South African (SA) firms are as despondent as they were during the initial years following the global financial crisis.

Business sentiment, as surveyed by the Bureau of Economic Research (BER), tanked to 29 index points for the second quarter of 2017 from 40 points a quarter before.

Not only does this signal that fewer than 30% of the respondents are satisfied with prevailing business conditions, but business confidence has not been this low since the final quarter of 2009.

Chart 5: Business confidence cycles during downturns



Source: BER, Momentum Investments

Even though this is not the worst business confidence cycle in SA's history of official economic downturns (calibrated by the SA Reserve Bank), it is rare for confidence to slip so markedly at this late stage in an economic cycle (see chart 5).

From the contributing sectors, sentiment remained in the doldrums for manufacturing (16 points) and new vehicle dealerships (11 points). Confidence in these indices slipped by 12 and 19 index points, respectively, relative to the first quarter reading. Fewer building contractors are satisfied with current business conditions (36 index points from 42 previously), while retailer confidence dropped by a larger 10 points, from 45 points to 35 for the second quarter of 2017.

Persistently fragile business confidence prints suggest little scope for a recovery in fixed investment in the private sector in the near term. This reduction in capital bodes ill for potential growth in SA, which has likely fallen below 2% in Momentum Investments' view.

Financial market performance

Global markets

Global stock markets nudged 0.5% higher for June 2017, with DM underperforming EM. The MSCI DM Index drifted 0.4% higher for the month, boosted by gains in Japan, while stocks in the US and Europe lagged.

The Nikkei 225 rose 2.1%, with gains accelerating mid-month in response to the Bank of Japan's (BoJ) decision to keep ten-year bond yields at zero percent and maintain its current level of bond purchases at ¥80 trillion per year. The BoJ remained upbeat on expectations for domestic demand and export growth, but noted the monetary base would continue to expand until inflation stabilised above the 2% target.

The S&P 500 Index traded within a narrow band in June 2017, changing little in reaction to the widely anticipated 25 basis point interest rate hike by the US Fed in the second week of the month. The US Senate's delay of a vote on a bill to overhaul the Affordable Care Act (Obamacare) to July 2017 has raised further questions about President Donald Trump's ability to proceed with tax cuts, deregulation and infrastructure spending plans. This likely led to a further tempering of growth prospects and gains being pared back accordingly in the US equity market.

The Eurostoxx 50 tracked largely sideways for most of June 2017, but ended the month 2.9% lower as markets over-interpreted ECB President Mario Draghi's comments. The index jumped higher mid-month, positively reacting to a short-term compromise between the European Union and the International Monetary Fund, allowing Greece to avoid a near-term payment default on debt owed to European creditors. A solid victory by French President Emmanuel Macron's party En Marche! in the National Assembly further buoyed European markets during mid-June.

A 1.0% gain in the MSCI EM Index for June 2017 was supported by firm gains in Asia (1.7%) and a pedestrian 0.7% increase in the MSCI Latin America Index, while the MSCI EMEA (Europe, Middle East and Africa) Index lost ground (negative 2.5%) for the corresponding period.

Local markets

The local equity market bucked the sideways trend in global markets for June 2017. The FTSE/JSE All Share Index collapsed more than 5% by the end of the first two weeks of the month, partly driven lower by weak domestic economic data and a damaging, redrafted Mining Charter.

The Mining Charter aims to increase permanent black ownership targets of all mines to 30% (previously 26%), implying previous empowerment would not be recognised. Onerous procurement requirements (70% of all mining goods and 80% of all services in the mining industry must be procured from Black Economic Empowerment entities) will likely significantly raise operating costs for mining houses, further harming prospects for SA's mining industry.

The FTSE/JSE Resources Index sank 6.2% following the announcement, but stabilised slightly thereafter on the news that mining companies have applied to the high court to block the controversial Charter.

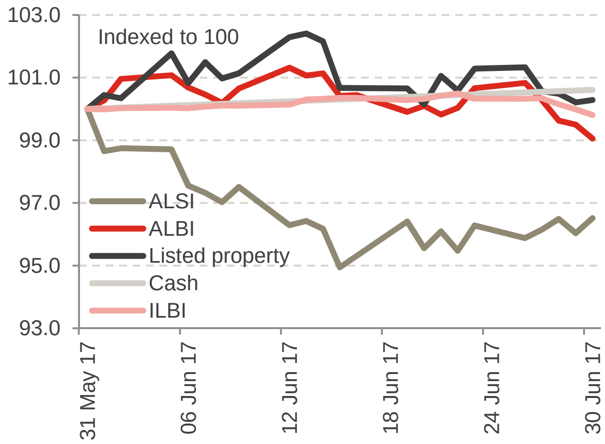
The FTSE/JSE Industrials Index did not fare much better for June 2017. The index fell 4.2%, followed by a 2.1% decline in the FTSE/JSE Financials Index for the corresponding period.

The FTSE/JSE Mid-cap Index lost 3.5% for May 2017, while the FTSE/JSE Small-cap Index decreased by a lesser 2.8%.

SA ten-year government bonds rallied by around 18 basis points by mid-June, but sold off by around 40 basis points in the second half of the month. The Inflation-linked Bond Index (ILBI) recorded a 0.2% loss for June 2017, with marginal gains (0.3%) recorded in the FTSE/JSE Listed Property Index. SA cash ticked 0.6% higher for the same period.

The rand experienced mild gains against the majors, relative to other EM currencies for June 2017. The rand ended the month only 0.1% firmer against the US dollar, but 1.5% weaker against the euro. The rand strengthened by 4.6% against the British pound, following the election results, but this was reversed by month-end, following the deal in the UK between the Conservatives and Northern Ireland's DUP.

Chart 6: Local asset class returns



Source: Bloomberg, Momentum Investments

Indices summary for June 2017

	One month	Three months	One year	Three years	Four years	Five years	Six years	Seven years	Ten years
Equity indices									
FTSE/JSE All-Share Index (ALSI)	-3.49%	-0.39%	1.69%	3.43%	10.08%	12.19%	11.69%	13.46%	9.32%
FTSE/JSE Shareholder Weighted Index (SWIX)	-3.83%	0.00%	0.28%	4.79%	10.99%	12.89%	12.96%	14.52%	10.32%
FTSE/JSE All Share Top 40 Index	-3.59%	0.94%	1.56%	2.53%	9.86%	12.15%	11.30%	13.24%	8.92%
FTSE/JSE Mid Cap Index	-3.54%	-8.37%	-2.85%	6.41%	9.55%	10.77%	12.42%	13.35%	11.14%
FTSE/JSE Small Cap Index	-2.78%	-7.72%	2.38%	6.78%	11.97%	14.38%	14.86%	15.41%	9.66%
FTSE/JSE Resources Index	-3.08%	-7.05%	1.89%	-15.43%	-4.23%	-5.08%	-5.90%	-2.48%	-2.59%
FTSE/JSE Financials Index	-2.13%	-0.01%	2.63%	6.44%	12.04%	13.98%	15.61%	15.86%	10.12%
FTSE/JSE Industrials Index	-4.18%	2.21%	1.74%	7.65%	12.96%	18.10%	18.37%	20.23%	15.34%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	-3.17%	-2.59%	4.06%	1.47%	8.84%	10.01%	9.67%	11.73%	9.05%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	-3.01%	-3.07%	4.53%	1.53%	8.42%	9.76%	9.28%	11.41%	8.44%
FTSE/JSE SA Listed Property Index (SAPY)	0.29%	0.91%	2.82%	13.18%	11.33%	13.76%	15.76%	16.42%	14.30%
Interest-bearing indices									
BEASSA All Bond Index (ALBI)	-0.95%	1.49%	7.93%	7.12%	6.69%	6.61%	7.90%	8.38%	8.40%
BEASSA All Bond Index 1-3 years (ALBI)	0.31%	2.03%	8.52%	7.52%	7.05%	6.53%	7.19%	7.28%	8.01%
Barclays BEASSA SA Government ILB Index	-0.19%	-0.70%	-0.47%	4.46%	6.29%	7.19%	8.02%	8.42%	9.24%
Short-term Fixed Interest Composite Index (SteFI)	0.61%	1.85%	7.66%	6.93%	6.55%	6.29%	6.19%	6.19%	7.25%
Commodities									
NewGold Exchange-Traded Fund	-2.45%	-2.23%	-15.99%	4.71%	7.39%	3.27%	7.64%	7.57%	13.01%
Gold price (in rands)	-2.42%	-0.61%	-16.93%	5.17%	8.16%	4.17%	8.04%	7.95%	13.46%
Platinum Exchange-Traded Fund	-3.01%	-4.65%	-18.59%	-9.03%	-3.76%				
Platinum price (in rands)	-2.40%	-4.80%	-19.52%	-8.52%	-4.38%	-3.22%	-6.35%	-3.78%	-0.72%
Currency movements									
Rand/euro movements	0.77%	4.10%	-8.09%	0.87%	3.73%	7.57%	7.24%	6.87%	4.61%
Rand/dollar movements	-0.64%	-2.29%	-10.46%	7.21%	7.24%	9.89%	11.62%	7.95%	6.39%
Inflation index									
Consumer Price Index (CPI)			5.49%	5.39%	5.70%	5.66%	5.66%	5.51%	6.18%

Important notes

1. Sources: Momentum Investments (Pty) Ltd, INET BFA, www.msci.com, www.yieldbook.com, www.ft.com.
2. Returns for periods exceeding one year are annualised.
3. The return for Consumer Price Index (CPI) is to the end of the previous month. Due to the reweighting of the CPI from January 2009, this number reflects a compound of month-on-month CPI returns. The historical numbers used are the official month-on-month numbers based on a composite of the previous inflation series (calculations before January 2009) and the revised inflation series (calculations after January 2009).
4. The MSCI World index (All Countries) returns are adjusted to correspond with global investment prices received.
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