The Macro Research Desk

Herman van Papendorp
(Head of Investment Research and Asset Allocation)

Sanisha Packirisamy
(Economist)

Economic and market snapshot for November 2017

Highlights

- **United States: Republicans are making headway on tax reform, but the final bill has yet to be signed**
- **Eurozone: Political headwinds in Germany are unlikely to detract from growth prospects, but they could pose a risk to economic integration in the longer run**
- **Japan: Despite healthy economic activity, subdued inflation expectations suggest the Bank of Japan is likely to retain a steady hand on interest rates**
- **Emerging markets: Rising food and oil prices, together with a build-up of core pressures, point to inflation drifting higher in upcoming months**
- **South Africa: Moody's rating agency has placed the country on review for downgrade, which could trigger the country's exclusion from key world bond indices, if a downgrade were to materialise**

Global economic developments

United States (US)

The Senate Budget Committee has approved the Republican tax bill, but the vote still needs to be passed by the full chamber

Although the Republicans have made meaningful progress on introducing their tax bill, there are still a number of issues that could slow down the momentum or halt the plan altogether.

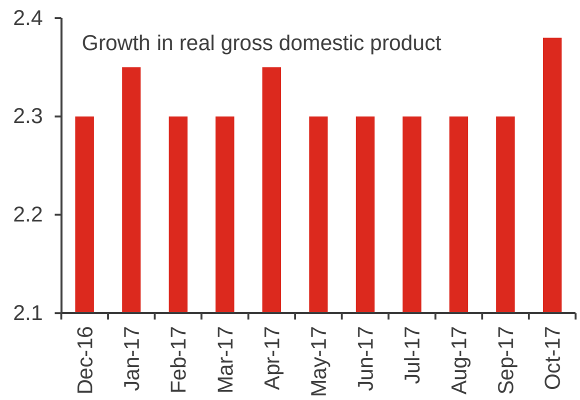
While the Senate has been successful in moving its version of the Tax Cuts and Jobs Act out of the Finance Committee, after a week of being introduced, the biggest challenge will be when both chambers have to agree on the details of the final bill, before obtaining final sign off from President Donald Trump. Adding to the challenges are a number of Republicans, which have concerns on some of the aspects of their own proposed bill.

Key differences between the two proposed bills include the number of tax brackets (the House proposes four relative to the Senate bill, which maintains seven brackets) and the timing of the cut to corporate taxes from 35% to 20% (the Senate bill suggests implementation by only 2019).

The market has responded strongly to the acceleration in tax reform momentum. The Bloomberg US Gross Domestic Product (GDP) forecast for 2018 increased to 2.5% from 2.3% on the back of the latest news (see chart 1). This is largely in line with

Momentum Investments' expectation and supports the firm's view for up to three interest rate hikes by the US Federal Reserve in 2018.

Chart 1: Consensus upgraded the 2018 forecast (%)



Source: Bloomberg, Momentum Investments

Eurozone

Political headwinds in Germany are unlikely to detract from growth prospects

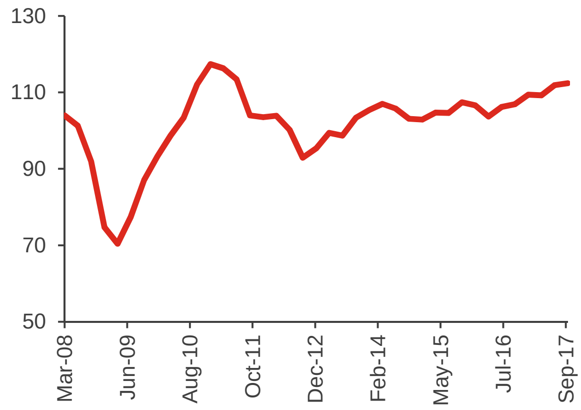
After four years of governing together with the Christian Democratic Union of Germany and the Christian Social Union in Bavaria (CDU/CSU), the Social Democratic Party (SPD) rejected a coalition with German Chancellor Angela Merkel's conservatives. After suffering its worst election outcome in history, the SPD declared it would go into opposition.

Moreover, exploratory talks between the CDU/CSU, the pro-business Free Democratic Party (FDP) and the environmentalist Green Party collapsed, primarily due to a disagreement over the number of refugees allowed into the country.

Political uncertainty and the threat of a fresh round of elections pressured the SPD into reversing its earlier stance and it has now agreed to engage with Merkel. This has raised the prospect of a new 'grand coalition'.

A coalition with either the FDP or SPD is unlikely to be detrimental for German growth, given the likely outcome for tax cuts. The European Commission's Economic Sentiment Indicator for Germany has continued to rise (see chart 2), despite an uncertain political outlook. The index gained more than ten points since the second quarter of 2016, signalling firm German growth prospects in the near term.

Chart 2: Rise in German economic sentiment index



Source: Bloomberg, Momentum Investments

The coalition outcome could, however, have an effect on European policy, depending on whether the SPD or FDP are involved. With support for the Alternative for Germany (AfD) constituent and the FDP accounting for more than 20% of the voter base, progress towards a fiscal or banking union could be stymied, threatening Eurozone integration in the event the FDP governs with the CDU/CSU.

Japan

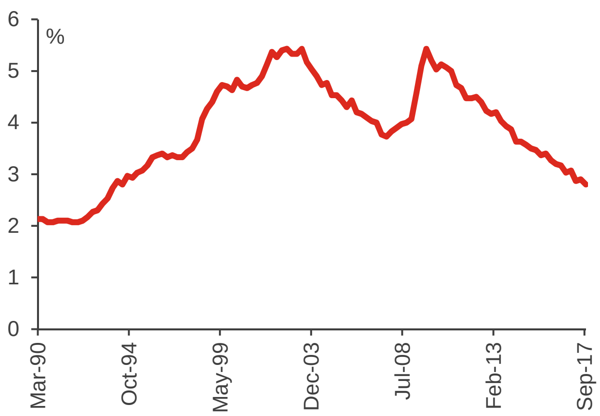
Economy grows for the seventh consecutive quarter, but Bank of Japan (BoJ) is likely to stay the course

Real economic activity increased by 0.3% in quarter-on-quarter terms (seasonally adjusted) in the third quarter of 2017, representing the longest growth streak in 16 years. Growth was supported by a strong rebound in exports (predominantly capital goods), while domestic demand dipped slightly after posting a strong performance in the second quarter of the year.

The market expects real GDP to grow at 1.2% in 2018, from 1.5% in 2017, which remains marginally above trend in Momentum Investments' view. Strong support for Prime Minister Shinzo Abe at the October 2017 snap elections suggests he is likely to secure a third three-year term as the leader of the Liberal Democratic Party (LPD) and push through additional reforms. Despite the growth performance improving since 2012, under his governance, productivity in the services sector remains weak and significant wage increases are largely absent, highlighting the need for labour market reforms.

With growth in wages remaining stagnant, the BoJ has failed to achieve its price stability target of 2%. Japanese labour market conditions remain tight, with the headline rate of unemployment tracking at lows last observed in 1994 (see chart 3). However, wage growth remains structurally low, owing to the number of part-time workers in the labour force earning lower wages. As such, Momentum Investments expects the BoJ to maintain a steady monetary policy stance for the foreseeable future, as a premature tightening in interest rates could hurt growth (through currency adjustments, in particular) and curb inflation expectations.

Chart 3: Japanese unemployment rate trickles lower



Source: Bloomberg, Momentum Investments

Emerging markets (EM)

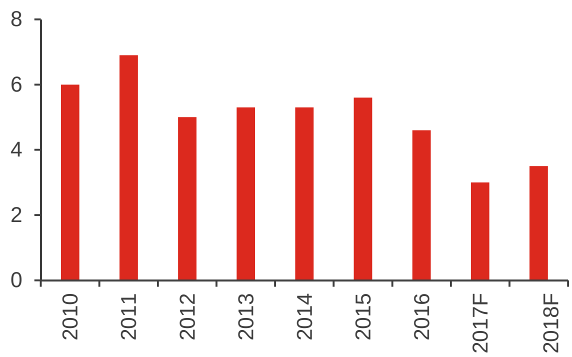
Rising food and oil prices, accompanied by a build-up in core price pressures, point to inflation drifting higher in upcoming months

According to Capital Economics, aggregate EM inflation bottomed at an eight-year low of 3.0% in July 2017. Since then, oil prices have ticked up, boosting overall inflation across EM. Nevertheless, even if oil prices are unlikely to rise substantially from current levels (given the increase in production of shale gas in the US), Capital Economics forecasts fuel price inflation at between 10% and 15% in 2018.

Moreover, food prices have most likely troughed in the EM composite and are likely to rise from current levels. Although spare capacity is likely to cap the rise in core or underlying inflation measures, Capital Economics notes the likes of China, India and Central and Eastern Europe, which are beginning to push against capacity constraints. This could urge headline inflation measures higher across EM.

In aggregate, Capital Economics anticipates EM inflation to edge higher to 3.5% in 2018. This suggests inflation is likely to continue tracking below central bank inflation targets in many countries, allowing for further easing in monetary policy to support growth.

Chart 4: Aggregate EM inflation (% y/y)



Source: RMBMS, Momentum Investments

Local economic developments

No ratings bargains for South Africa (SA) on Black Friday

SA's ratings outlook could take on a more positive bias, should the new leadership ushered in at the December 2017 elective conference boost confidence by implementing structural reforms needed to halt the rot at SA's state-owned enterprises, improve competitiveness and boost growth. However, if structural reforms are not forthcoming and if offsetting fiscal measures in the February 2018 national budget do not stabilise, SA's fiscal and debt outlook, further negative ratings action is more than likely by Fitch and Moody's in particular. According to RMB Morgan Stanley, SA's sovereign bonds will now be excluded from the Barclays Global Aggregate Bond Index. It estimates up to US$1.5 billion in passive outflows, based on Turkey's experience and the size of the SA bond market.

For now, SA remains in the Citi World Government Bond Index (Citi WGBI). RMB Morgan Stanley projects a potential US$5 billion in outflows should SA be excluded from this index. An exclusion from the Citi WGBI would be triggered by Moody's dropping its rating by one notch, so that the local currency rating for S&P and Moody's are rated as sub-investment grade (see table 1).

Table 1: SA's sovereign ratings

Long-term rating	S&P	Fitch	Moody's
Investment grade	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1
	BB	BB	Ba2
Outlook	Stable	Stable	Negative

Local currency rating
Foreign currency rating

Source: Fitch, Moody's, S&P, Momentum Investments

Citi notes that, while buying into the index inclusion might have been staggered, the exit door could be crowded. Re-entry into the index will be difficult to achieve.
The Citi WGBI requires a minimum credit quality of A- by S&P and A3 by Moody's for the country's local currency rating (four notches above junk status).

Financial market performance

Global markets

Global equity markets experienced a month of two halves. International bourses tracked largely sideways during the first half of the month, but extended its gains in the second half, as political optimism returned in Germany and US retail activity picked up strongly in response to promotional sales related to Black Friday and Cyber Monday.

The MSCI Developed Markets Index increased 2.2% in November 2017, supported by gains in US and Japanese stocks. The S&P 500 Index experienced a jump towards month end, ending November 2017 3.1% higher, in response to the Senate Budget Committee approving President Trump's tax bill. Renewed optimism over potential growth-enhancing tax reforms in the US was enough to overshadow a rise in geopolitical tensions caused by North Korea's announcement that a powerful new intercontinental ballistic missile could place the US mainland within range.

The Japanese Nikkei echoed the global rally, climbing 3.3% in the month on improved global growth prospects. In contrast, the Eurostoxx 50 had shed 3.4% by mid-month, as political uncertainty set in after coalition talks failed in Germany. With the SPD reversing its earlier decision to not engage with Chancellor Merkel, the equity market clawed back some of its earlier losses towards month end.

The MSCI EM Index moved broadly sideways in November 2017, in line with little movement in the Bloomberg commodity price index. A robust 3.4% gain in the MSCI EMEA (Europe, Middle East and Africa) Index led EM equities higher in the month. Asian stocks followed, recording a marginal 0.1% increase for the corresponding period. For a second consecutive month, returns from the MSCI Latin America Index lagged, losing 3.0% in November 2017.

Local markets

The local equity market took its direction from global markets, increasing by 1.5% in November 2017. During the first half of the month, the FTSE/JSE All-Share Index struggled to find direction ahead of the sovereign ratings reviews. Approaching the ratings reviews, SA equities gained ground on the back of a weaker currency, but retraced marginally towards month end as a stronger domestic currency defied negative ratings news.

The largest gains were evident in the FTSE/JSE Financials Index, which strengthened 4.4% in November 2017, followed by a 1.4% increase in the FTSE/JSE Industrials Index. Despite gaining nearly 3% in the first half of the month, the FTSE/JSE Resources Index dipped 1.6% by month end on currency gains.

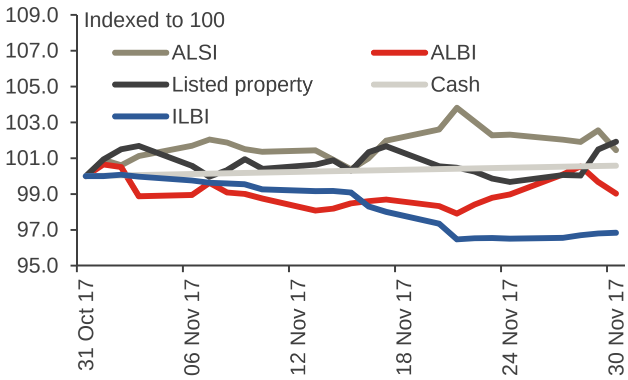
The returns between mid- and small-caps diverged in November 2017. The FTSE/JSE Mid-cap Index ticked 2.3% higher, while the FTSE/JSE Small-cap Index dived 2.7%.

SA ten-year government bond yields sold off 36 basis points in the run up to the ratings reviews, but this move was largely reversed soon after, suggesting the negative move in ratings by S&P was largely anticipated by the market.

The Inflation-linked Bond Index (ILBI) weakened 3.2% in the month, while the FTSE/JSE Listed Property Index ended November 2017 1.9% up. SA cash increased 0.6% in the same period.

At its worst point in the month, the rand lost 2.3% against the US dollar before the ratings announcement. Despite the ratings blow from S&P, the demand for local bonds strengthened, supporting the local unit. The rand ended the month 3.4% firmer against the US dollar and 1.7% stronger against the euro.

Chart 6: Local asset class returns



Source: Bloomberg, INET BFA, Momentum Investments

The rand's depreciation against the British pound in November 2017 was limited, as uncertainty surrounding Brexit negotiations hindered the pound's recovery. Only late in the month did reports suggest a breakthrough in the deadlock between British and European Union negotiators on the Brexit bill, indicating the final Brexit bill will range between €45 billion and €55 billion.

Indices summary for November 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)	1.46%	6.87%	22.54%	9.33%	10.58%	12.71%	13.86%	13.54%	10.21%
FTSE/JSE Shareholder Weighted Index (SWIX)	3.09%	7.90%	23.81%	9.52%	11.84%	13.75%	15.09%	14.71%	11.29%
FTSE/JSE Capped SWIX All Share index	2.46%	5.40%	18.16%	7.76%	10.49%	12.65%	14.16%		
FTSE/JSE All Share Top 40 Index	1.43%	7.70%	25.36%	9.50%	10.46%	12.70%	13.68%	13.54%	9.84%
FTSE/JSE Mid Cap Index	2.31%	1.10%	6.63%	6.75%	9.85%	11.30%	13.44%	12.43%	12.16%
FTSE/JSE Small Cap Index	-2.74%	-0.17%	0.70%	5.44%	8.73%	12.72%	15.28%	13.26%	9.54%
FTSE/JSE Resources Index	-1.60%	4.21%	14.17%	-1.52%	-3.47%	-2.27%	-2.80%	-1.51%	-1.57%
FTSE/JSE Financials Index	4.42%	4.93%	15.10%	7.12%	12.28%	14.25%	17.27%	16.25%	11.12%
FTSE/JSE Industrials Index	1.41%	8.78%	30.06%	11.60%	13.65%	17.29%	20.09%	19.66%	16.39%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	1.30%	5.07%	17.66%	8.57%	9.21%	11.02%	12.10%	12.02%	10.12%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	1.05%	4.48%	15.40%	8.00%	8.73%	10.65%	11.74%	11.40%	9.48%
FTSE/JSE SA Listed Property Index (SAPY)	1.92%	5.18%	17.18%	10.59%	14.37%	13.01%	16.87%	15.72%	14.20%
Interest-bearing indices									
BEASSA All Bond Index (ALBI)	-0.97%	-2.18%	5.95%	4.44%	6.54%	5.58%	6.97%	7.39%	8.07%
BEASSA All Bond Index 1-3 years (ALBI)	0.00%	0.40%	8.09%	6.95%	7.04%	6.56%	6.82%	7.12%	7.95%
Barclays BEASSA SA Government ILB Index	-3.16%	-3.07%	-2.96%	2.31%	4.76%	4.35%	6.55%	7.20%	8.29%
Short-term Fixed Interest Composite Index (SteFI)	0.58%	1.79%	7.57%	7.12%	6.78%	6.46%	6.31%	6.23%	7.16%
Commodities									
NewGold Exchange-Traded Fund	-3.28%	1.42%	4.73%	9.71%	7.69%	2.25%	3.41%	8.05%	12.02%
Gold price (in rands)	-2.42%	2.21%	5.94%	10.22%	8.37%	2.74%	3.22%	8.55%	12.65%
Platinum Exchange-Traded Fund	-1.14%	-0.60%	-0.82%	-1.70%	-2.60%				
Platinum price (in rands)	-1.22%	-1.19%	-0.09%	-1.09%	-1.83%	-3.71%	-1.49%	-4.59%	-1.79%
Currency movements									
Rand/euro movements	-1.32%	5.22%	9.21%	5.71%	4.11%	7.08%	6.89%	8.43%	4.98%
Rand/dollar movements	-3.54%	4.92%	-2.75%	7.30%	7.63%	8.96%	9.08%	9.80%	7.22%
Inflation index									
Consumer Price Index (CPI)			4.86%	5.29%	5.45%	5.46%	5.48%	5.56%	5.91%

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.
5. FTSE/JSE disclaimer: www.jse.co.za
6. The information reproduced in this document has been compiled by or arrived at by Momentum Investments (Pty) Ltd from sources believed to be reliable.
7. Although reasonable steps have been taken to ensure the validity and accuracy of the information in this document, Momentum Investments (Pty) Ltd does not accept any responsibility for any claim, damages, loss or expense, howsoever arising, out of or in connection with the information in this document, whether by a client, investor or intermediary.
8. The content of this document is confidential and remain the property of Momentum Investments (Pty) Ltd and may not be reproduced without written permission.