The Macro Research Desk

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Economic and market snapshot for October 2018

Highlights

- United States: The trade balance for goods expanded to its widest deficit on record, despite a number of trade initiatives.
- Eurozone: The German electoral landscape is becoming increasingly fragmented, as fringe political parties, including the Greens and Alternative for Germany, made inroads in a key regional election.
- United Kingdom: The government budget revealed a modest uplift to spending and few major tax increases, while borrowing levels were little changed.
- China: Authorities are providing additional support to the economy to partly offset the negative effect of tariffs.
- South Africa: Tough balancing act between fiscal discipline and growth protection.

Global economic developments

United States (US)

Trade balance for goods expanded to its widest deficit on record

A number of trade initiatives have been introduced by US President Donald Trump in recent months, endeavouring to reduce the country's reliance on external trade partners. In spite of these trade initiatives, the US trade balance for goods widened for a fourth consecutive month in September 2018 to the largest deficit on record.

According to the US Census Bureau, the trade deficit for goods (the difference between exports and imports) widened to US$76 billion, after exports increased by 1.8% in year-on-year (y/y) terms between August and September 2018 and imports expanded by 1.5% y/y in the same period.

During 2017, the largest US export categories measured by the Commerce Department included food/beverages, petroleum products, commercial aircraft, automobiles and automobile parts. The largest import categories included automobiles, crude oil, phone devices, computers and automobile parts. During this period, the US ran the largest trade deficits with China, Canada, Mexico, Japan and Germany.

Table 1: Trade initiatives between the US and China to date

Date effective	Amount of trade affected	Tariff
6 July 2018	US$34 billion (aircraft parts, batteries, televisions, medical devices)	25%
6 July 2018	US$34 billion (soybeans, pork, fish, orange juice, whiskey)	25%
23 August 2018	US$16 billion (motorcycles, steam turbines, railway cars)	25%
23 August 2018	US$16 billion (medical equipment, fuels, fish meal, wood waste, paper, metal scraps, cars and bicycles)	25%
24 Sept. 2018	US$200 billion (33% related to consumer goods)	10%
24 Sept. 2018	US$60 billion	10%

Source: RMB Morgan Stanley, Momentum Investments, black font = US tariffs on Chinese imports, blue font = Chinese tariffs on US imports

The Trump administration developed a number of anti-China protectionist tariffs, which have been met with retaliatory measures (see table 1).

The US aims to lower its trade deficit with China and restore lost jobs. However, increasing trade protectionism could result in lower growth and higher inflation in Momentum Investments' view.

According to RMB Morgan Stanley, a full blown escalation of the trade war (which would include a 25% tariff on all Chinese imports into the US and a 100% tariff on all US imports into China) could result in 0.4% being shaved off growth in global gross domestic product (GDP), after taking account of financial market effects. Growth in the US would likely be 0.4% weaker and 0.7% weaker in China under this scenario.

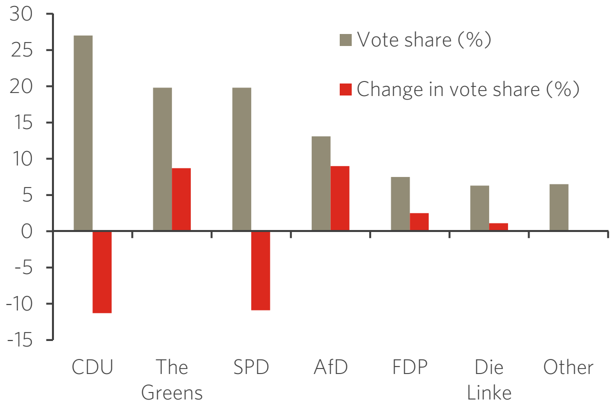
Eurozone

German electoral landscape becoming increasingly fragmented

Both parties belonging to the German governing coalition faced a setback in the elections held in the central region of Hesse (one of the most important regional elections) in October 2018. This threatens German Chancellor Angela Merkel's grand coalition between the Christian Democratic Union (CDU) and the Social Democratic Party (SPD).

Support for the major centrist parties has waned since Germany's 2013 federal elections, while the Alternative for Germany (AfD) party and the environmentalist political grouping, the Greens, advanced their following in the same period (see chart 1).

Chart 1: Results of the 2018 state elections in Hesse and change relative to 2013



Source: https://statistik-hessen.de/l_2018/html/landesergebnis

After following a series of tough electoral setbacks, Merkel announced she would not seek another term, as the head of the CDU party, which she led for nearly two decades. Although Merkel's current term only expires in 2021, the succession fight may begin earlier with the CDU set to hold party elections in December 2018.

In an environment where the far-right AfD is gaining ground, a new leader of the CDU may want to evolve rightwards to defend its share of the voter base. This could potentially mean a shift for Germany's political stance, which had taken on a centrist approach during Merkel's tenure. This raises the possibility that Germany's role in supporting the European Union (EU) project may weaken in time.

More immediate is the risk that the poor showing for the SPD results in the party pulling out of the alliance, bringing down the already-fragile government and triggering a national election in Germany.

United Kingdom (UK)

Budget reveals a modest uplift in spending and few major tax increases

Chancellor Phillip Hammond announced a more rapid narrowing in the UK budget deficit relative to the March 2018 statement. Investec calculated the fiscal stimulus amounts to £2.3 billion in the current fiscal year and £15.1 billion in the next and it is expected to grow to £30.6 billion in fiscal year (FY) 2023/24.

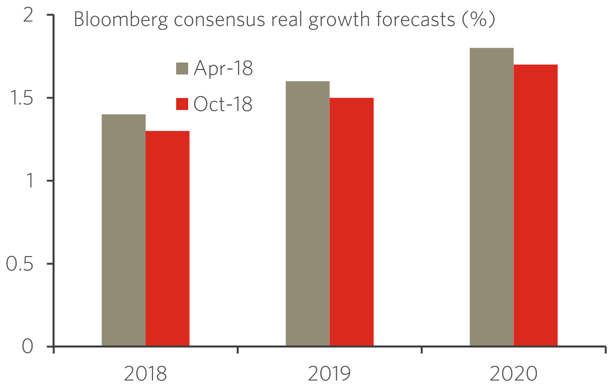
The budget revealed an increase in funding for the National Health Scheme, relief on personal income taxes and increases in business taxes, while borrowing levels were little changed. Debt, as a share of national income, is therefore still expected to decline from 83.7% in FY2017/18 to 74.1% by FY2023/24. Outside of spending on the NHS (which is anticipated to grow at 3.4% in real terms every year for the next five years), increases in funding for other public services will be capped at inflation, after being cut for eight consecutive years.

Hammond noted a soft Brexit deal could lead to a further upgrade in growth and revenue forecasts, while a 'no-deal' Brexit could lead to an emergency budget being announced to reset the fiscal course.

The UK is nearing the date at which is it scheduled to leave the currency bloc (29 March 2019), but the precise course of action on the planned date and final negotiations have yet to be decided upon. The last European Council meeting for the year is set to take place between 13 and 14 December and is seen as the last practical date for a Brexit deal to be reached. For a deal to be reached, the Withdrawal Treaty (essentially, conclusions of the negotiations in phase one of the Brexit timeline) needs to be supported by at least 20 of the 27 EU countries and 65% of their population.

The Withdrawal Treaty and the outline for future relations between the UK and the EU will then require approval from the House of Commons by early January 2019. If ratified, the EU Withdrawal Agreement Bill can be legislated by early February 2019, before the UK's exit from the EU by 29 March 2019.

Chart 2: Consensus continues to downgrade UK growth



Source: Bloomberg, Momentum Investments

The Bloomberg consensus expects growth to average 1.3% in 2018 before rising to 1.5% in 2019 (see chart 2), but the National Institute of Economic and Social Research warns growth could drop to 0.3% in 2019 if Britain leaves the EU without an agreement.

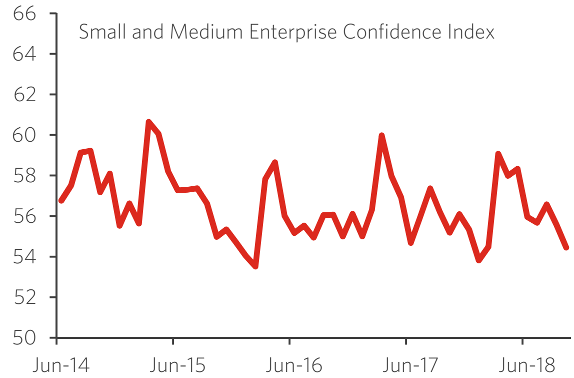
China

Authorities providing additional support to the economy

Fitch rating agency warned sentiment within the Chinese residential property market was souring. This is expected to lead to a weakening in growth in real estate fixed investment, which has displayed firm growth for the first three quarters of 2018.

Trade conflict with the US has stepped up in recent months, leading to a slowdown in a number of economic measures. The Citigroup Economic Surprise Index for Chinese economic activity has tracked in negative territory since June 2018. Similarly, the Li Keqiang index, which calibrates the change in bank lending, rail freight and electricity, slowed to 8.9% in September 2018 from a year-to-date (YTD) average of 9.4%. Moreover, the Small and Medium Enterprise Confidence Index produced by Standard Chartered, which is a survey-based diffusion index gauging sentiment at more than 500 small and medium enterprises nationwide, dipped for a second consecutive month in October 2018 (see chart 3).

Chart 3: Low confidence among small and medium Chinese enterprises



Source: Bloomberg, Momentum Investments, data up to October 2018

Nevertheless, measures, which focus on large enterprises, including sentiment in the manufacturing and services industries, remained above the neutral 50 mark in October 2018.

Chinese authorities have introduced a range of measures to support sentiment to partly counter the negative shock of US-imposed tariffs on Chinese exports. These include a reduction in the ratio reserves banks are required to hold against deposits, a large increase in local government bond issuance, additional tax deductions for households and support for exporters through a reduction in costs.

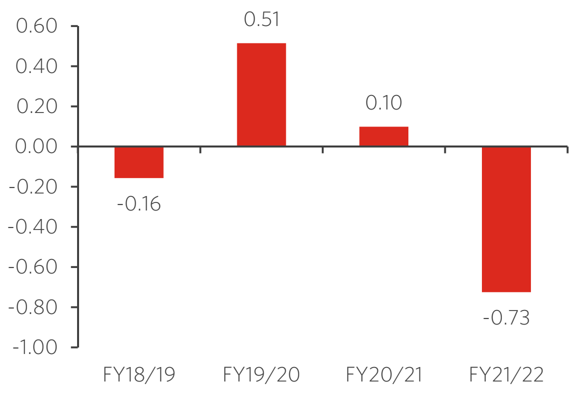
The tax deductions for households are expected to ensure this round of stimulus supports consumption spend and not just investment spending, as it has in the past. Despite these measures, the full effect of the negative trade dynamics and a slowdown in the property sector are likely to see growth in China slow into 2019. The Bloomberg consensus is looking for a slowdown in growth from 6.6% in 2018 to 6.2% in 2019.

Local economic developments

Tough balancing act between fiscal discipline and growth protection

The market responded negatively to a wider-than-anticipated budget deficit projection for the next three fiscal years. A rising budget deficit and spending growth that outstrips revenue growth in the next two years point to a slightly expansionary budget (see chart 4), which is marginally positive for the economy, somewhat profit-positive for companies, which are linked to the local economy, but detrimental to the South African (SA) bond market.

Chart 4: Excess expenditure growth over revenue growth (%)



Source: Treasury, Momentum Investments

Treasury downwardly revised its growth assumption in response to the poor economic performance in the first half of the year. As such, robust tax collections YTD are expected to deteriorate in line with downward revisions to the growth outlook as well as an expected acceleration in refunds of value added tax (VAT).

A tepid growth environment leaves fewer obvious additional revenue streams available to be tapped into, but Momentum Investments expects limited compensation for bracket creep and a further rise in sin taxes to be announced in the February 2019 budget.

Above-inflation social grants, a generous three-year civil-servant wage deal, limited retrenchments in the public sector workforce, an extension of VAT-exempt products and promises made at the Jobs Summit should limit the negative consumer effect of potential bracket creep and higher sin taxes in next year's budget.

Despite the poor financial standing of some of the country's key parastatals still posing a risk to the overall debt trajectory, rating agencies are likely to give SA the benefit of the doubt for now, given the ongoing commitment to fiscal consolidation in the medium term and an effort to maintain the expenditure ceiling, through reprioritising spend within the existing framework. Nevertheless, rating downgrades could materialise if prospects to revive growth falter and if government's debt burden and contingent liabilities fail to stabilise in the medium term.

Financial market performance

Global markets

It was a turbulent month for global equity markets. The MSCI All World Index plunged 7.5% in October 2018, recording the worst month for global equities in more than six years. Investor jitters were reflected in the biggest monthly rise in the CBOE volatility index (VIX) since March 2018. The VIX ended the month at 21 points, as the market extrapolated the likelihood of more unsettled markets and major central banks added less monetary stimulus to the global economy.

Losses were broad based with emerging market (EM) and developed market (DM) equities experiencing significant losses in the month. The MSCI DM Index lost 7.3% of its value in October 2018, led weaker by Japanese equities. The Nikkei 225 Index sank 9%, partly due to concerns about higher US interest rates and trade protectionism. In its October 2018 interest rate-setting meeting, the Bank of Japan (BoJ) left its monetary stimulus unchanged and kept its ten-year bond yield target intact. The BoJ trimmed its inflation forecasts, further lowering the probability that its inflation target would be met in the medium term.

The US equity market ignored a robust growth print, which showed the economy growing at 3.5% in annualised terms in the third quarter of the year. A total of 231 firms in the S&P 500 Index reported third-quarter sales figures in October 2018. From the 231 firms, 138 reported figures that were better than expected, while the rest fell short of expectations. Despite the generally positive sales results, discouraging forecasts from big technology groups proved to be more important for investor sentiment.
The technology-heavy Nasdaq Index experienced its worst month since the global financial crisis, while the S&P 500 Index experienced losses in the materials, energy, consumer discretionary goods, industrial and information technology sectors.

The Eurostoxx 50 Index dipped 5.8% in October 2018, as the European Central Bank (ECB) chief Mario Draghi affirmed asset purchases would soon cease. The equity market also fell on news that the third-quarter growth print disappointed at 0.2% relative to analysts' expectations of 0.4%.
Economic woes were compounded by political troubles in the Eurozone in October 2018. Standard and Poor's Global Ratings downgraded Italy's sovereign rating outlook to negative, although kept the rating steady at BBB.
Moreover, Germany faced rising domestic political uncertainty in the month in an unexpected outcome at a key regional election, which showed deteriorating support for centrist parties.

EM equities fared worse than their DM counterparts in the month. The dismal performance in EM equity markets coincided with a spate of growth downgrades to region by the International Monetary Fund (0.2% and 0.4% lower in 2018 and 2019, respectively), continued uncertainty about trade policy, a 2.2% decline in the Bloomberg Commodity Price Index and a potential peak being reached in US growth.

The MSCI EM Index plummeted 10.6% in October 2018, led lower by Asian stocks. The MSCI Asia Index collapsed 10.9% in the same period, followed by a 6.8% drop in the MSCI Europe Middle East and Africa (EMEA) Index. The MSCI Latin America Index bucked the trend and rose 3.5% in the month. A clear victory for free-market proponent Jair Bolsonaro, in the Brazilian presidential elections (where he won 55.2% of the votes in a run off with left-wing rival Fernando Haddad), spurred confidence that fiscal reforms would be prioritised given his strong political capital and mandate to implement structural reforms.

The JPMorgan EM Bond Index (EMBI) spread sold off by 31 points in the month, while the JPMorgan EM Currency Index depreciated by 0.9%. Corporate default swap (CDS) spreads mostly deteriorated across the EM composite in the month, except for in Brazil and Hungary, where spreads narrowed by 23 and 2 points, respectively. Mexico and China experienced the worst widening in spreads (around 30 points) in the same period.

In the international currency markets, pressure continued to build towards the Latin American currencies. The Mexican peso depreciated by 7.9% against the US dollar, followed by a 7.0% depreciation in the Colombian peso and a 5.7% depreciation in the Chilean peso. However, the Argentine peso and the Brazilian real staged a recovery of 10% and 8%, respectively.

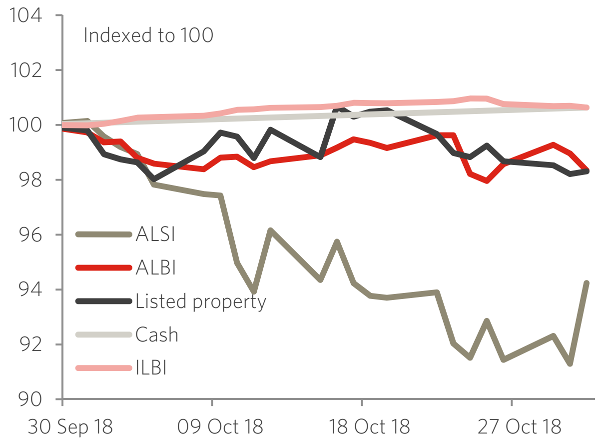
Local markets

SA equities suffered a similar fate to the global equity market in October 2018, despite government's efforts to prop up local confidence in the Jobs Summit and Investment Conference, which were held during the month. The FTSE/JSE All-Share Index ended the month 5.8% in the red, dragged lower by industrial and resource shares (see chart 5).

The FTSE/JSE Industrials Index lost 8% of its value in the month, despite a firmer rand, which ordinarily supports returns in dual-listed industrial shares. Losses were also observed among financial shares. The FTSE/JSE Financials Index ended the month 3.1% lower. Financial shares held onto gains made in the final week of the month despite weakening into the budget.

The FTSE/JSE Mid-cap Index increased 0.7% in the month, while the FTSE/JSE Small-cap Index experienced losses of 3.4%.

Chart 5: Returns on local asset classes (%)



Source: IRESS, Momentum Investments, data up to 31 October 2018

Listed property shares edged 1.7% lower in October 2018, while the ten-year local government bond yield sold off by 41 basis points, after the announcement of a wider-than-expected government budget deficit profile in the medium term. The ten-year local government bond yield retraced around 10 basis points by the end of the month.

The JSE ASSA All Bond Index slipped 1.7% in October 2018, while the JSE ASSA Government Inflation-linked Bond Index (ILBI) inched 0.6% higher in the same period. SA cash posted a 0.6% gain.

The SA rand was the fourth-worst-performing currency for the month, depreciating by 4.2% against the US dollar and 1.7% against the euro. The rand tracked largely sideways against the British pound in the corresponding period. In line with a weaker local currency, SA's five-year CDS spread widened by 34 points in the month, almost fully reversing the narrowing in the spread in the previous month. The spread is 51 basis points wider than at the start of the year...

Indices summary for October 2018

	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)	-5.76%	-7.58%	-8.37%	2.06%	4.37%	5.96%	9.09%	10.40%	12.83%
FTSE/JSE Shareholder Weighted Index (SWIX)	-6.12%	-9.35%	-11.10%	0.99%	3.32%	5.83%	9.00%	10.74%	13.20%
FTSE/JSE Capped SWIX All Share index	-4.61%	-7.52%	-8.69%	0.59%	2.92%	5.50%	8.71%	10.49%	
FTSE/JSE All Share Top 40 Index	-6.67%	-8.90%	-9.59%	1.29%	3.95%	5.58%	8.86%	10.04%	12.36%
FTSE/JSE Mid Cap Index	0.74%	-1.53%	-5.09%	3.45%	4.42%	5.98%	8.35%	10.54%	14.51%
FTSE/JSE Small Cap Index	-3.39%	-3.86%	-10.04%	0.22%	2.29%	5.11%	9.80%	11.87%	13.32%
FTSE/JSE Resources Index	-3.96%	2.47%	13.85%	11.95%	0.94%	-0.36%	0.21%	-0.05%	4.41%
FTSE/JSE Financials Index	-3.19%	-4.90%	2.11%	1.23%	5.49%	8.66%	11.83%	14.40%	15.21%
FTSE/JSE Industrials Index	-8.00%	-13.47%	-21.10%	-2.92%	2.51%	5.34%	10.50%	13.11%	15.76%
FTSE/JSE Research Affiliates Fundamental Indices 40 Index (RAFI)	-4.15%	-5.52%	-0.96%	7.12%	5.69%	6.51%	9.01%	10.15%	13.08%
FTSE/JSE Research Affiliates Fundamental Indices All Share Index	-4.03%	-4.71%	-1.05%	6.73%	5.40%	6.13%	8.73%	9.84%	12.52%
FTSE/JSE SA Listed Property Index (SAPY)	-1.69%	-2.19%	-18.72%	-2.64%	2.63%	5.78%	7.79%	10.51%	14.04%
Interest-bearing indices									
JSE ASSA All Bond Index (ALBI)	-1.71%	-3.25%	7.79%	6.58%	6.15%	6.71%	6.28%	7.24%	8.42%
JSE ASSA All Bond Index 1-3 years (ALBI)	1.29%	2.23%	8.50%	8.07%	7.66%	7.34%	6.94%	7.09%	7.95%
JSE ASSA SA Government ILB Index	0.64%	0.91%	2.40%	2.66%	3.40%	5.03%	4.77%	6.81%	7.42%
Short-term Fixed Interest Composite Index (SteFI)	0.63%	1.77%	7.26%	7.36%	7.12%	6.84%	6.56%	6.43%	6.78%
Commodities									
NewGold Exchange-Traded Fund	7.02%	12.33%	-0.24%	4.01%	8.31%	5.83%	2.69%	3.76%	8.99%
Gold price (in rands)	6.25%	11.08%	-0.14%	4.21%	8.82%	6.22%	3.09%	4.09%	9.41%
Platinum Exchange-Traded Fund	6.59%	13.15%	-4.72%	-3.47%	-2.46%	-2.34%			
Platinum price (in rands)	7.02%	12.35%	-5.32%	-3.26%	-2.07%	-2.16%	-4.44%	-3.42%	3.32%
Currency movements									
Rand/euro movements	1.82%	9.14%	1.56%	3.14%	4.85%	4.22%	6.80%	6.16%	2.94%
Rand/dollar movements	4.40%	12.69%	4.42%	2.28%	7.52%	8.09%	9.21%	9.35%	4.13%
Inflation index									
Consumer Price Index (CPI)			4.91%	5.36%	5.17%	5.32%	5.43%	5.43%	5.18%

Important notes

1. Sources: Momentum Investments, 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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