



Herman van Papendorp
Head of Investment
Research & Asset
Allocation



Sanisha Packirisamy
Economist

The Macro Research Desk

Economic and market outlook

July 2018

Highlights

Market outlook

- Momentum Investments expects global equities to still outperform global government bonds as long as the global expansion continues. Meanwhile, government bond market fundamentals remain negative (with rising inflation and some fiscal deterioration), while the wide bond valuation premium with equities still persists.
- The future path of the United States (US) dollar is likely to be a major determinant of relative regional global equity returns. During weaker US dollar periods, local currency returns in the US and emerging market (EM) equity markets typically outpace those in Europe and Japan, and vice versa.
- Recent rand weakness has driven significant South African (SA) corporate earnings upgrades, particularly for the resource sector shares and Naspers - the enhanced earnings outlook has improved the return prospects of SA equities as an asset class.
- The anticipated uptick in local inflation in the coming year seems to already have been captured in local bond yields. Although breakevens are expected to expand in line with a rising local inflation trajectory, SA nominal bonds are favoured to real bonds due to significantly higher expected returns for the former.
- In the absence of additional negative share-specific news from the listed property sector, good property returns should be expected from the current valuation, even without assuming any positive rerating compared to bonds.
- Local cash is expected to deliver lower absolute returns than nominal local bonds, but scope for interest rate hikes in 2019 and beyond should bolster returns from this asset class in due course.

Economic outlook

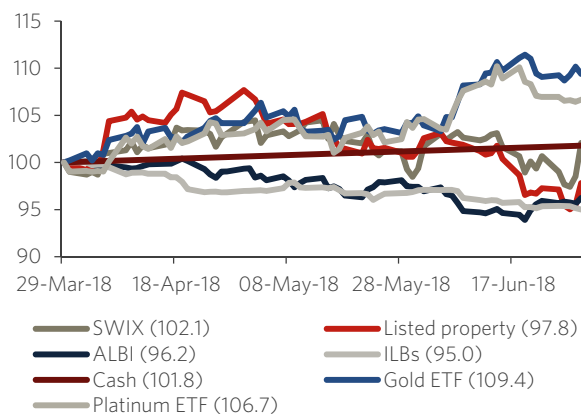
- Fiscal easing and loose monetary policy continue to support economic activity, but momentum in global growth has likely peaked.
- Tell-tale signs of an imminent recession are still largely absent. However, escalating trade-war risks and geopolitical headwinds could push the world to the brink of a recession sooner than 2020, when the fiscal impulse is expected to turn growth negative.
- The pace of US jobs growth, still positive growth surprises and resilient inflation reinforced a more hawkish stance by the US Federal Reserve (Fed) in June 2018. In contrast, the European Central Bank (ECB) adopted a more cautious stance, taking its direction from negative surprises in European growth activity, little upward movement in muted longer-dated inflation expectations and renewed political uncertainty.
- The strength of the US dollar and an escalation in trade disputes were the main challenges to EMs in the first half of the year. Despite a sell-off in EM, Momentum Investments views the fundamentals of the EM asset class as solid in the medium term.
- China's ongoing de-risking process has the potential to turn the slowdown in its moderate growth into a sharp and sudden growth deterioration, but authorities are likely to have sufficient policy room to keep the economy on a steady path.
- In SA, the president's Herculean task to address deep inequities has the potential to be achieved through his ten-point growth plan, but the land reform debate and a delay in the new mining charter are inhibiting sentiment.
- Although government's fiscal actions are likely to stave off a further sovereign ratings downgrade, a migration of the debt of state-owned enterprises (SoE) to government's balance sheet or populist political posturing could trigger negative ratings action.
- Tepid growth and confidence are likely to delay the first interest rate increase into the first quarter of 2019, despite renewed upside risks to inflation and a widening external imbalance in an environment of tightening global financial conditions.

Global equities to outperform government bonds as long as the global expansion continues

A build up of global trade tensions between the US and its major trading partners supported a flight to safety of global financial flows to the US dollar during the second quarter of 2018. Together with a change in market expectations of the future relative trends in US and European monetary policies, this culminated in a 5% rise in the value of the greenback against a basket of global currencies in the quarter. With the Fed's preferred inflation measure, core personal consumption expenditure (PCE) inflation, finally reaching the 2% inflation target level in May 2018, financial market participants started discounting a more aggressive US tightening cycle for 2018/2019, while a simultaneous slowdown in European growth and the absence of inflationary pressures in the region motivated the ECB to indicate a more dovish pace of monetary tightening, in terms of quantitative easing (QE) tapering and a postponement of the eventual interest-rate-hiking cycle to the latter part of 2019.

As a result, the strong greenback eroded the US dollar-denominated returns from non-US global asset classes during the past quarter, with global equities outperforming global bonds and cash. The main casualties from this risk-off environment were EM investments, including currencies, debt and equities, with developed market (DM) equity returns, hence, strongly outperforming EM equities in the quarter. The SA rand fell by almost 14% in the quarter, akin to the Brazilian real and Turkish lira. It should thus be no surprise that rand-hedge investments provided the best returns among local asset classes in SA during the second quarter of 2018 (see chart 1), with commodity exchange-traded fund returns the highest, while SA equities and cash still provided positive returns. In contrast, SA real and nominal bonds, as well as listed property, registered negative returns in the quarter.

Chart 1: SA asset class returns in Q2 2018 (indexed)



Source: IRESS, Momentum Investments

Although lower global equity returns and rising volatility are typical for late-bull cycle phases of the global business cycle, when policy tightens and the yield curve flattens during the transition from a 'goldilocks' period for equities (strong growth and low inflation) to a deflation period (strong growth and rising inflation), Momentum Investments expects global equities to still outperform global government bonds as long as global expansion continues. With the leading indicators of an imminent US recession still absent and only pointing to a rising likelihood for US recession by 2020, historical precedent would see global equities still doing well into 2019. In addition, government bond market fundamentals remain negative (with rising inflation and some fiscal deterioration), while the wide bond valuation premium with equities still persists.

The future path of the US dollar is likely to be a major determining factor for relative regional global equity returns. During weaker US dollar periods, local currency returns in the US and EM equity markets typically outpace those in Europe and Japan, and vice versa. EM fundamentals are better than during the 2013 US Taper Tantrum (with higher real policy rates and smaller current account deficits), while strong EM growth in the absence of a global trade war should be supportive for equities.

Recent rand weakness has driven significant SA corporate earnings upgrades, particularly for the resource sector shares and Naspers. While the enhanced earnings outlook has improved the return prospects of SA equities as an asset class, valuations are only more attractive once the Naspers effect is accounted for. Notwithstanding a meaningfully positive real yield available to international investors in the SA bond market, a disproportionate outflow from SA bonds was observed during the EM bond market sell-off in the second quarter of 2018. This proves SA is still seen as a liquid EM proxy for global investors. With SA ex-ante real bond yields trading around 90 basis points (bps) above their average recorded during the inflation targeting period and the SA/US yield spread premium around 70 bps higher than its average for the same period, the anticipated uptick in local inflation in the coming year seems to already have been captured in local bond yields. Although breakevens are expected to expand in line with a rising local inflation trajectory, SA nominal bonds are favoured to real bonds, due to significantly higher expected returns for the former.

After the big Resilient-driven property sector sell-off in the early parts of 2018, the SA listed property sector is trading at

its cheapest relative rating to local bonds in five years, with its relative rating cheaper than the 10-year average and in line with the 15-year average. In the absence of additional negative share-specific news from the sector, good property returns should be expected from the current valuation, even without

assuming any positive rerating compared to bonds.

Local cash is expected to deliver lower absolute returns than nominal local bonds, but scope for interest rate hikes in 2019 and beyond should bolster returns from this asset class in due course.

Global recession talks are premature, but trade wars are a risk

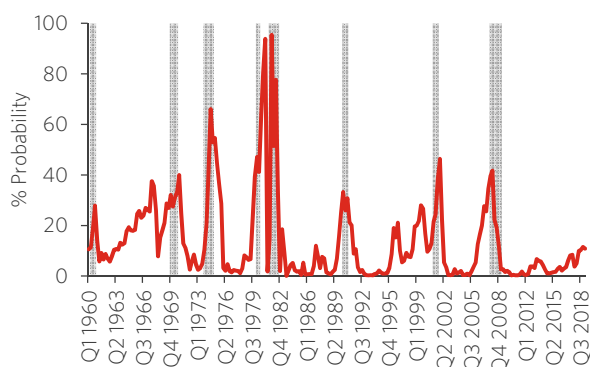
Although activity in the global economy remains robust, momentum has likely peaked. Elevated international oil prices have tapered strong consumption growth, while a moderation in business sentiment, a fading boost from a recovery in commodity prices and a further tightening in financial conditions have softened growth in global capital expenditure. Nevertheless, fiscal easing and loose monetary policy in a number of economies continue to support economic activity. More than 80% of the Organisation for Economic Co-operation and Development (OECD) countries have undertaken fiscal easing in the first half of 2018. This is expected to decrease to around 30% of countries in 2019, before the fiscal impulse turns growth negative in 2020, raising the chances of a global economic downturn.

At 108 months, the upswing in the US ranks as the second-longest in post-war history. However, generous business and consumer tax cuts and an expected infusion of additional government spending should continue to support US growth above its potential in 2018 and most of 2019. Tell-tale signs of an imminent recession are still largely absent. The US lead indicator is still on the rise, while the US yield curve (the spread between the short-term borrowing rate set by the Fed and interest rates on longer-term Treasury notes) remains positive, despite dipping to its lowest point since the 2008 global financial crisis. The National Bureau of Economic Research (NBER) translated the gap into a reasonably low 11% chance of a recession transpiring in the next nine months (see chart 2).

Escalating trade war risks, geopolitical headwinds and political vulnerabilities could nevertheless push the world to the brink of a recession sooner. The OECD claims a negative shock to trade would inflict more pain on the global economy today than in the past. The trade share of global gross domestic product (GDP) accounted for only 15% of GDP in 1990, but has since doubled to 30%. Since peaking at a seven-year high in January 2018, world trade momentum, as published by the Dutch Bureau for Economic Policy Analysis, slowed in April 2018 to its weakest level since 2015, in line with a doubling of the number of newly implemented trade-restrictive measures in the previous six-month period.

US President Donald Trump recently widened the rift with America's closest allies by imposing tariffs on steel and aluminium from Canada, Mexico and the European Union, which have hit back with retaliatory tariffs on farm goods, food and metals. While the direct macroeconomic effect of the existing measures, including those imposed on China, will likely be small, Goldman Sachs suggests more draconian tariff measures, under a multilateral trade-war scenario, would knock 0.4% off from global growth. Secondary effects from injured confidence and possibly tighter monetary policy, to counter a rise in inflation, could further hurt global growth in this setting. Though China does not import as much from the US economy, Deutsche Bank highlights a number of alternative ways in which China could retaliate. These include raising tariff rates to 25%, restricting US firms' sales in China (through local subsidiaries), allowing the renminbi to depreciate or selling a portion of its US Treasury holdings.

Chart 2: The probability of a US recession before March 2019 remains low



Source: NBER, Momentum Investments

Though Momentum Investments has not factored in a multi-lateral trade war into its forecasts, the company acknowledges the World Bank's warning of mounting trade protectionist sentiment and the possibility of disorderly volatility of financial markets.

With politics taking a more central role in influencing the outlook for global trade and output, the shift away from ultra-accommodative monetary policy towards more normalised interest rates may be met with higher levels of volatility and could raise the risk of short-circuiting the economic recovery, particularly in the absence of higher levels of productivity and far-reaching structural reforms.

Raising interest rates too slowly could similarly prove problematic, given that reducing interest rates remains the main recession-fighting tool. As such, global central banks may need to raise interest rates to a sufficiently high level before the next economic downturn, so the subsequent interest-rate-cutting cycle can provide a meaningful boost to the economy.

Increasingly, there are signs of inflation beginning to stir in key DM economies. Steep energy costs have pushed inflation outcomes higher, while labour market shortages in the US, Germany and Japan have ignited wage growth, urging core measures of inflation (excluding the effect of food and fuel prices) higher. Moreover, large fiscal expansion programmes have contributed to rising inflation, particular in economies, which are experiencing extended expansions.

Although economic activity slowed across DMs in the first quarter of the year, the pace of US jobs growth, still-positive growth surprises and resilient inflation prints reinforced a more hawkish stance by the Fed at its June 2018 interest-rate-setting meeting. In contrast, the ECB adopted a more cautious stance, taking its direction from negative surprises in activity in European growth, little upward movement in muted longer-dated inflation expectations and renewed political uncertainty. Ongoing disagreement in Germany over the treatment of asylum seekers, a rising risk of a snap election in Spain (due to a lack of a solid majority supporting the new socialist leader), the exit of two high-profile pro-Brexit ministers from United Kingdom (UK) Prime Minister Theresa May's parliament and a populist coalition's ascent to power in Italy have all contributed to a higher level of policy uncertainty in Europe relative to the US. Differentials between the US and Eurozone based on growth, monetary policy and political risk have kept the dollar strong against the euro, despite US dollar sentiment indicators flashing overbought signals and the dollar's overvaluation in real effective trade-weighted terms.

US dollar strength and an escalation in trade disputes were the main challenges to EMs in the first half of the year.

SA is at the right place, at the wrong time

The SA economy missed out on a generous growth opportunity during the last decade, in which the world was awash with cheap capital. SA's growth diverged more markedly from the rest of the world after reaching a peak in its terms-of-trade (an index measuring the country's export prices relative to its import prices) in 2011. Since 2011, growth

This was reflected in a 10% setback in the JP Morgan EM currency index since the peak in February 2018. In addition, EM equities, from the first week in July 2018, suffered its longest streak of withdrawals since 2016, notwithstanding an improvement in economic fundamentals. Skittish global investors have also lowered their allocation to EM fixed income portfolios for the 11th week in a row, as sentiment towards the asset class soured on angst over rising protectionist trends.

Despite a sell-off in EM, Momentum Investments views the fundamentals of the EM asset class as solid in the medium term. EMs are anticipated to grow more than twice as fast as DMs in 2018 and 2019. The Bloomberg July 2018 consensus estimate for DM growth points to a moderation in growth outcomes from 2.4% in 2018 to 2.1% in 2019, while EM growth is expected to improve marginally from 4.9% in 2018 to 5.1% in 2019. Unlike previous episodes of US dollar strength, EM current account deficits are on average narrower, inflation milder, foreign exchange reserves higher and a greater proportion of EMs now operate under a floating exchange rate regime.

China's economy is reasonably stable, but its ongoing de-risking process has the potential to turn its envisioned soft landing (a moderate growth slowdown) into a hard landing (a sharp and sudden growth deterioration). In its April 2018 Global Financial Stability Report press briefing, the International Monetary fund (IMF) welcomed decisive steps by the Chinese regulators to tighten the regulatory environment and focus on financial stability as a top priority. In response to government's deleveraging campaign, growth in total social financing has slowed from a peak of 35% in 2009 to 10% in June 2018, as authorities continued to squeeze off-balance sheet financing. While this has resulted in a collapse in infrastructure growth since the fourth quarter of 2017, growth in fixed asset investment outside of infrastructure remained firm. Moreover, the highest consumer confidence print on record since 1996 should fuel China's need to rebalance growth away from investment and exports to consumption, without incurring a hard landing.

in SA's GDP underperformed the globe by an average 1.8%, and EMs by a greater 3.2%, per year. Despite SA's terms-of-trade recovering from a bottom reached in 2014 to levels higher than the 2011 peak in the final quarter of 2017, weak consumer demand, disappointing private sector fixed investment, a prolonged drought and heightened political uncertainty continued to weigh on growth activity.

SA's political fortunes, however, shifted favourably at the December 2017 African National Congress (ANC) National Elective Conference. The election of a new and well-received leadership caused a positive knee-jerk response in investor, business and consumer sentiment, but confidence levels have since re-adjusted to less euphoric levels. Since succeeding Jacob Zuma, as president in February 2018, Cyril Ramaphosa has increased efforts to convince investors of his unwavering commitment to reverse poor growth outcomes, reduce political uncertainty and address rampant corruption and state capture in the ANC and the state.

In an effort to strengthen the cohesion of the ruling party and bring about organisational renewal, the ANC made 11 changes in the formation of the new national working committee (the party's highest decision-making body) at the start of the year. With a majority of members of the National Worker Committee backing Ramaphosa, this could help alleviate potential stalemates in the wider National Executive Committee, which is more evenly balanced in terms of Ramaphosa and Zuma supporters. In his first 100 days in the presidency, Ramaphosa also appointed a strong, independent economic adviser and announced two summits, on jobs and investment, to buffer investor confidence in his ability to turn around a moribund economy.

Encouraging changes in the finance, public enterprises, mineral resources and energy portfolios in a wide-sweeping cabinet reshuffle, calling for an inquiry into state capture projects (including the suspension of the SA Revenue Services commissioner and the removal of the head of the SA Police Service Crime Intelligence unit), a re-institution of charges of corruption against the former president and a broad governance clean up at board and senior management level of the country's key SoEs are further evidence of a new trajectory in SA.

Ramaphosa's Herculean task to address SA's deep inequities has the potential to be achieved through his ten-point growth plan (focusing on creating jobs, lifting growth through increasing investment, accelerating transfer of ownership and control over the economy to black citizens, widening economic participation, ensuring economic sovereignty through avoiding an unsustainable debt trap, improving access to quality education, expanding manufacturing capacity, boosting spend on critical infrastructure, restoring SoEs as drivers of growth and social development as well as confronting corruption), but the land reform and policy

restitution discourse underway and a delay in the finalisation and implementation of the new mining charter are hindering the president's attempts to uphold positive sentiment.

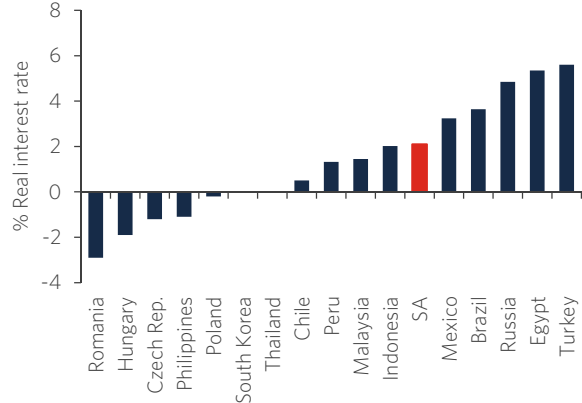
A more stable political environment, domestically, could regrettably be overshadowed by bigger factors trending in the global economy. The world is fast approaching the point at which net global liquidity additions will be turning negative. EMs will soon be forced to adjust to a withdrawal of liquidity and increasing global interest rates. Alongside tighter financial conditions, the effect of the fourth industrial revolution on lower-skilled workers, a surge in populism and growing anti-globalisation sentiment could limit the risk appetite global investors have for EMs and for a continuation in the carry trade (borrowing at lower rates in DMs and investing in EM currencies with a higher interest rate).

SA's economy is expected to expand by 1.7% in 2018 and 2.1% in 2019 against a positively changed political environment supporting increased business and consumer confidence, but for growth to strengthen in the longer term, the OECD advises SA to improve education access and quality, reduce energy costs, develop transport infrastructure, deepen region integration, enforce sanctions for breaches of the Public Financial Management Act, reduce regulatory red tape and develop apprenticeship and internship programmes to increase youth employment. A higher medium-term growth trajectory, tax reforms and expenditure cuts have created space for more investment in higher education, while still allowing for fiscal consolidation in the medium term. Although still higher than the average BB-median-rated country, SA debt levels are expected to stabilise against GDP in the medium term. The three major credit rating agencies have acknowledged the country's fiscal efforts, but warn a fiscal deterioration (through higher expenditure or lower growth), a migration of SoE debt to government's balance sheet or populist political posturing (which interrupts policy making) could trigger negative ratings action.

SA inflation is expected to climb from its April 2018 low, but is still seen to remain within the target band in the medium term. With rand and oil prices posing significant upside threats and inflation expectations still a way from the midpoint of the target band, the next move in interest rates is likely higher. While tepid growth and confidence are likely to delay the first interest rate increase into the first quarter of 2019, heated trade war rhetoric, tightening global financial

conditions and a widening external imbalance have raised the importance of maintaining a healthy real interest profile (see chart 3).

Chart 3: Attractive real interest rates needed, given diminishing global liquidity additions



Source: Bloomberg, Momentum Investments

