May 2018

Monthly Investment Overview

Investment Environment

Domestic equity markets followed global markets higher as trade tensions between the US and China eased somewhat and investors' attention shifted towards a robust Q1 earnings reporting cycle abroad. The US Dollar strengthened on the back of higher interest rate expectations and weaker European data. This resulted in a lower rand and higher SA bond yields.

Jerome O'Regan

Chief Investment Officer

Bernard Drotschie

Deputy Chief
Investment Officer

Market Performance %

April 2018

EQUITY	APRIL	QTR	12M
All Share Index	5.4	-0.9	11.4
Resources	8.7	4.5	20.0
Financials	3.2	-0.4	17.2
Industrials	5.2	-3.2	5.7
All Bond index	-0.7	7.3	13.8
MSCI US	5.8	0.6	5.6
MSCI UK	10.4	1.6	7.3
MSCI Emerging	4.9	1.9	13.9
MSCI AC World	6.4	1.0	7.0

US DOLLAR RETURNS	APRIL	QTR	12M
MSCI US	0.4	-0.2	13.3
MSCI UK	4.8	0.8	15.0
MSCI Japan	0.7	1.7	19.6
MSCI Emerging	-0.4	1.0	22.1
MSCI AC World	1.0	0.2	14.8
Citigroup WGB Index	-1.8	0.1	2.9
Currency vs. US Dollar			
Rand	-5.1	-0.8	7.2
Euro	-1.8	0.6	11.0
Yen	-2.8	2.9	1.9
Sterling	-1.8	1.8	6.5

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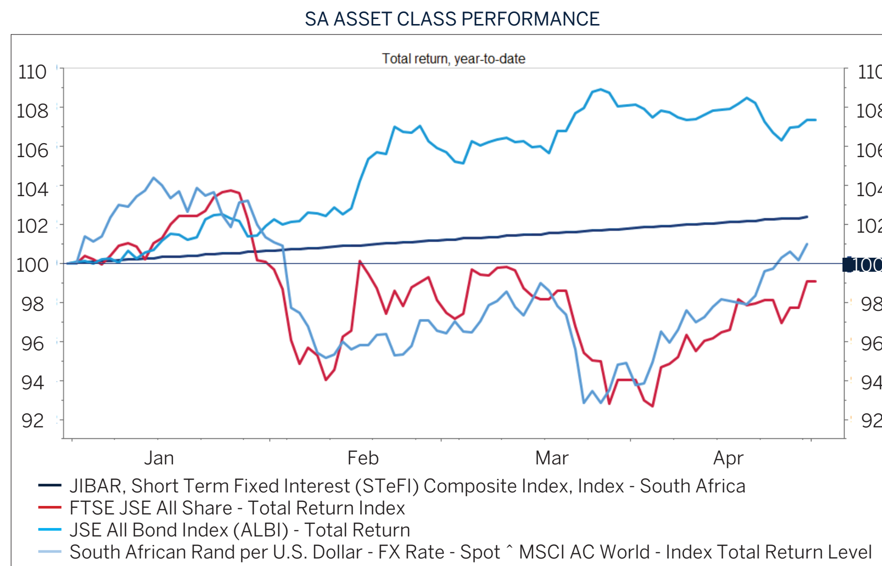
"Market euphoria over South Africa's leadership transition has abated as the year has progressed."

SA ASSET CLASS PERFORMANCE



Source: Factset Research System

The domestic equity market benefited from a weaker rand and a sharp rebound in mining shares as the High Court granted a declaratory order on "once empowered always empowered" thereby removing uncertainty on the ownership of existing mining rights. The spike in the oil price due to increased geopolitical tensions in the Middle East, strong underlying demand and disciplined output from OPEC and Russia further supported the performance of the sector during the month. But it wasn't just the JSE Resources sector that performed well. Even though headline inflation in South Africa fell further due mainly to lower food prices, domestic bond yields moved much higher in sympathy with higher developed market yields where inflationary pressures are mounting.

Market euphoria over South Africa's leadership transition has abated as the year has progressed. Although policy uncertainty with regards to land ownership and the Mining Charter remains, investors should not lose sight of the recent positive changes implemented by president Ramaphosa. In addition to the High Court's declaratory order relating to ownership of existing mining rights (which will be challenged by government), several other actions were taken during the month, including the appointment of a new Chairperson and Interim board at Denel and the appointment of an Economic Advisory Council with an investment team to help raise over $100bn over the next five years. Furthermore, minister Radebe signed a R56bn contract with renewable energy producers.

The steps taken so far to stabilise state-owned enterprises (SOEs), with the objective of returning them to financial sustainability, are starting to yield positive outcomes. A few months ago, capital markets were completely shut to the SOEs, but now funders have become more comfortable and SOEs have been able to refinance maturing debt. This is critical not only for the certainty of medium-term service delivery, but also for the reduction of the immediate threat to government finances. The task ahead is still enormous for Public Enterprises Minister Pravin Gordhan, but some success spells good news for industries supplying the various SOEs as well as those consuming their services.

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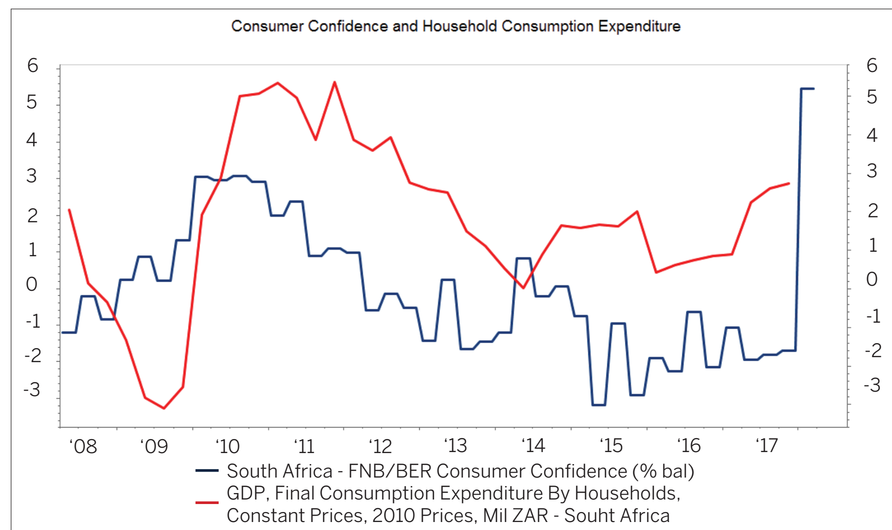
> "While the global economy continues to grow and much-needed structural reforms are implemented domestically, the cyclical recovery of South Africa's economy will likely be sustained."

Consumer and Business confidence has returned, which bodes well for an acceleration in economic activity towards the latter part of this year as companies start the process of rebuilding depleted inventory from an improvement in final demand. The latest confidence survey compiled by the Bureau for Economic Research (BER) highlighted that one of the inputs in measuring confidence, the "Political Constraints to Business" index, has fallen to a two-year low. At the same time, there has been a sharp recovery in intended investment in machinery and equipment, which provides further evidence that the economy is one step closer to the start of the next investment spending cycle.

Household consumer expenditure may not expand as much as in previous growth cycles due to the fiscal constraints from higher taxes, but real growth in income levels combined with healthy balance sheets will still support an improvement. The impact of inflation and wage settlement outcomes is less certain than previously was the case because of the Reserve Bank's determination to achieve a permanently lower inflation path, which involves higher real interest rates.



Source: Factset Research System

The improvement in final demand combined with an inventory restocking cycle will add impetus to South Africa's manufacturing sector. Recent survey data suggests that the sector is finally gaining some traction, and that new sales orders are behind the improvement. The manufacturing sector has declined in size relative to the services sector over a prolonged period. While this trend is not unique to SA, the manufacturing sector's importance to the rest of the economy should not be underestimated. Research indicates that the manufacturing sector's potential to drive growth is the highest of all sectors as it has the largest output multiplier in the economy. Deutsche Bank calculates that for "every R1m additional demand for manufactured goods, R9.9m of intermediate demand is generated in the sector." Given the sector's linkages to other sectors, manufacturing contributes significantly to employment growth in other parts of the economy as well as confidence levels in general. Much of the expected improvement in demand will naturally also depend on the external environment. While the global economy continues to grow and much-needed structural reforms are implemented domestically, the cyclical recovery of South Africa's economy will likely be sustained.

Conclusion

South Africa is well positioned for an improvement in growth momentum, which will attract foreign investment, and improved delivery by SOEs and reduced policy uncertainty under the new leadership of President Ramaphosa. Inflation is well contained and the Reserve Bank is determined to lower inflation expectations to the mid-point of the 3-6% target band. So, although real interest rates will remain high, there is scope for further monetary easing which will be positive for both fixed income and equity investors.

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Global

Equity markets rebounded and outperformed other asset classes in April, as robust corporate earnings overpowered the various geopolitical and trade headlines. Inflation is on the rise and so are bond yields – an important challenge for bond investors and the US fiscus, given the unusual timing of fiscal expansion, via tax reforms, so late in the economic cycle.

After a very uncertain start to the month, trade war tensions have eased somewhat with a renegotiated NAFTA looking more likely and China showing some increased flexibility in trade policy and willingness to negotiate. Chinese President Xi Jinping reinforced that China will enter a new phase of opening-up the economy to foreign investors with sectors such as financial services and auto-manufacturing looking to benefit. Uncertainty remains, but negotiations are at least a step in the right direction to avoid a full-blown trade war that would cause considerable market disruption.

The US Q1 earnings season has been promising thus far, with profits growing almost 25% year-over-year and running well ahead of market expectations and the previous quarter's 15.2%. Top line growth has also been very encouraging, at 10%, as pricing power for companies has improved, enabling them to expand operating profit margins in the face of higher costs associated with strong growth in wages and higher commodity prices. Increased operating costs remain a challenge for companies to contend with and the effects on margins will be closely followed, especially when sales growth starts to stabilise at more normalised levels. Certain manufacturing companies are already pointing to inflated input costs emanating from the tariffs imposed on steel and aluminium imports. However, it is not just higher operating costs that will weigh on future profitability. The inflationary effects of a tightening labour market and the recent spike in commodity prices, with specific reference to the oil price, looks set to drive interest rates upwards as the year progresses. Companies will suffer from the resulting increase in their cost of capital in time as the median US company has doubled its net debt, relative to operating profits, since the financial crisis, when low interest rates enticed management teams to refinance at lower rates.

OIL PRICE MOVEMENT (BRENT CRUDE)

Source: Bloomberg

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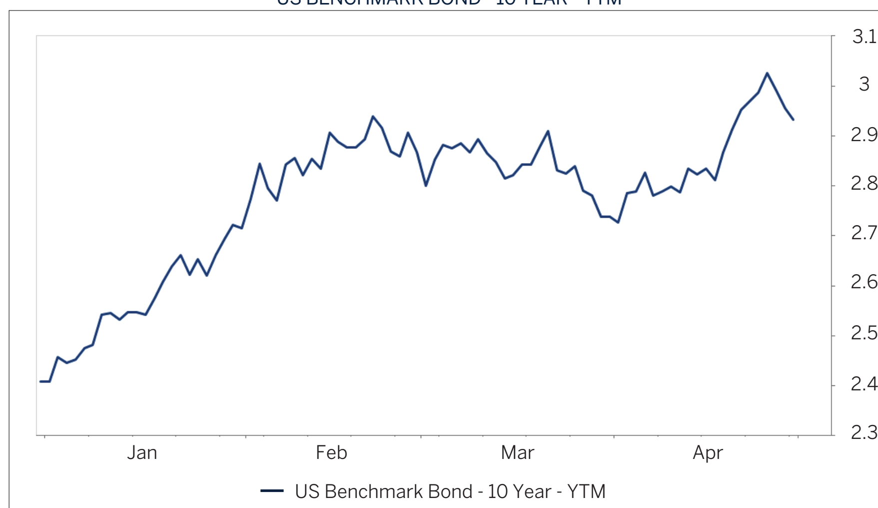
"The question of how US authorities intend to provide the necessary stimulus during the next economic downturn or financial shock, given the deteriorating fiscal position, remains to be answered."

The Congressional Budget Office (CBO) recently released its latest projection for the US budget deficit, their first estimate since the tax cuts were approved and signed into law by President Trump. The budget deficit is expected to exceed $1trn by 2020, two years earlier than previously expected. Nearer term, the deficit is expected to be $804bn in fiscal 2018 (vs. $563bn previous) and $981bn in fiscal 2019 (vs. $689bn previous). The CBO expects that the Federal debt held by the public will rise to 96% of GDP by 2028 from 76% of GDP last year, which would be a record level of indebtedness for the US government since 1946 and more than twice the average level recorded over the last fifty years. In effect, their estimates indicate that the annual fiscal deficit will increase to approximately 5% of GDP by 2022, vs. 3.5% at the end of 2017.

Indeed, the timing and magnitude of the US fiscal expansion are very unusual given the trends of fiscal consolidation expected from the G20 economies over the same period and during an environment of strong economic momentum and rising inflation in the US. Fiscal accommodation of this magnitude is usually deployed to combat periods of serious recession, such as the Global Financial Crisis of 2008 - 2009. The question of how US authorities intend to provide the necessary stimulus during the next economic downturn or financial shock, given the deteriorating fiscal position, remains to be answered. When the US previously deployed a similar pro-cyclical fiscal policy in the 1960s inflation edged higher, a key risk that will be closely monitored by the Federal Reserve, especially given that Core CPI is already above the Fed's target rate of 2% and is expected to be higher in the coming months. Rising inflationary pressure will lend further support to the view expressed by a growing number of FOMC participants, that the appropriate path for the Federal Fund rate over the next few years would likely be steeper than what they had previously expected.

US BENCHMARK BOND - 10 YEAR - YTM



Source: Factset Research System

"A period of abnormally low interest rates is coming to an end and investment markets have started to adjust for this reality."

It is not only the risk of inflation emanating from tax cuts at this point of the business cycle that could push interest rates upwards. The CBO report also highlighted that it is reasonable to expect an increase of fiscal crises in the US given growing levels of government debt, which ultimately should result in investors demanding enhanced (interest) rates of return to finance the government's increasing borrowing requirements; an impediment to future government spending and economic growth in general. Additionally, the challenges and risks associated with the funding of an ever-increasing debt burden at a time when the Fed is shrinking its balance sheet and foreign purchases of US government bonds will fall as quantitative easing comes to an end in Europe, look set to become more apparent. It is difficult to envisage that this will be achieved smoothly and without increased volatility in most asset classes around the world.

Conclusion

The outlook for the global economy remains positive for the remainder of this year, even though the first quarter showed some signs of a slowdown compared to the very strong growth trajectory experienced towards the end of last year. Geopolitical risks and trade tensions appear to have eased for now as the dialogue between the various economic powerhouses has become more conciliatory. This will however remain a risk for policy makers to contend with.

A period of abnormally low interest rates is coming to an end and investment markets have started to adjust for this reality. Although the lower taxes in the US will provide some underpin for near term growth, the longer-term outlook for growth, inflation and returns is less certain.

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Melville Douglas

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