June 2018

Monthly Investment Overview

MelvilleDouglas
A Member of Standard Bank Group

Global

A number of factors have created headwinds for markets: US dollar strength, rising interest rates and lower growth outside the US among them. Emerging markets felt the worst of it as vulnerabilities facing countries such as Turkey and Argentina lie exposed, given their overreliance on dollar-denominated debt. Political developments in Italy have renewed concerns about regional growth and the sustainability of the European Union in its current form.

Jerome O'Regan

Chief Investment Officer

Bernard Drotschie

Deputy Chief
Investment Officer

Market Performance %

May 2018

EQUITY	MAY	QTR	12M
All Share Index	-3.5	-2.5	8.0
Resources	4.0	10.6	30.0
Financials	-6.3	-6.2	11.4
Industrials	-5.1	-5.7	-1.1
All Bond index	-2.0	-0.6	10.4
MSCI US	3.9	7.7	9.9
MSCI UK	0.6	11.2	4.7
MSCI Emerging	-2.1	1.2	9.9
MSCI AC World	1.7	6.4	8.0

US DOLLAR RETURNS	MAY	QTR	12M
MSCI US	2.4	0.3	14.5
MSCI UK	-0.8	3.6	9.0
MSCI Japan	-1.0	-2.3	15.0
MSCI Emerging	-3.5	-5.7	14.4
MSCI AC World	0.2	-0.9	12.4
Citigroup WGB Index	0.1	-0.5	1.7
Currency vs. US dollar			
Rand	-1.4	-6.8	4.1
Euro	-3.4	-4.3	3.8
Yen	0.7	-1.8	1.8
Sterling	-3.4	-3.4	3.1

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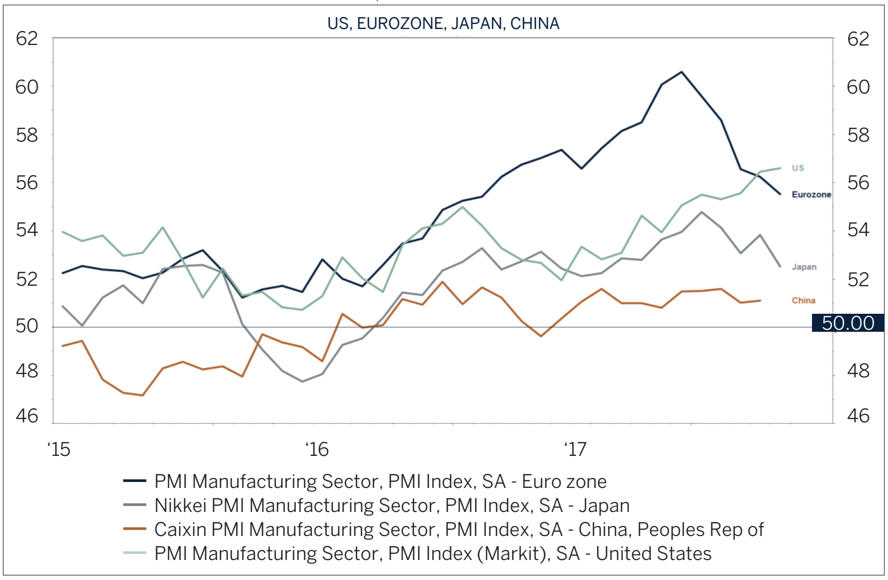
> "The powerful engine that was the synchronised global growth of 2017 is now struggling against the steeper gradient of reduced central bank accommodation and a stronger US dollar."

The powerful engine that was the synchronised global growth of 2017 is now struggling against the steeper gradient of reduced central bank accommodation and a stronger US dollar. The US economy is holding up, but manufacturing data and retail sales highlight the divergence between the US and other developed markets. Some leading indicators have turned down and manufacturing data outside the US have continued to disappoint. Europe should rebound from a disappointing first quarter which was partly explained by poor weather and the timing of Easter. But the political crisis in Italy has cast some doubt over this because the crisis has implications that could embroil the European Central Bank and other major Eurozone countries.

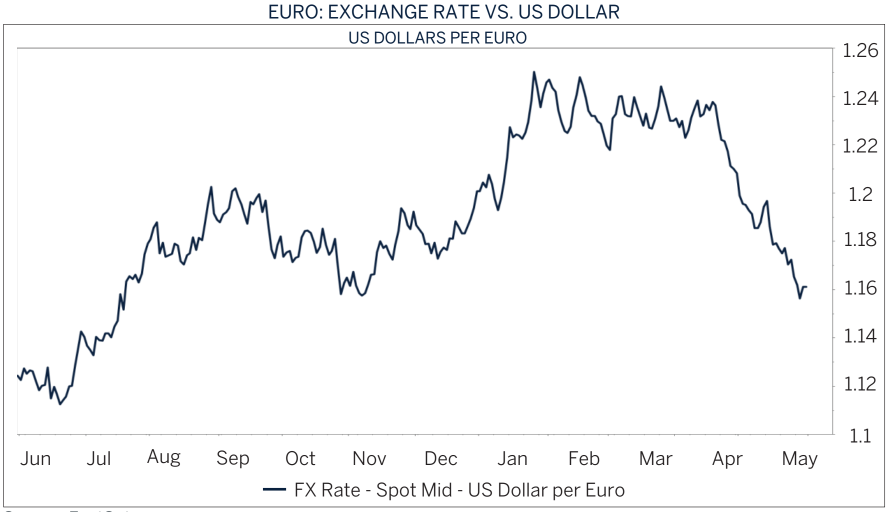
PMI INDICES, MANUFACTURING SECTOR



Source: FactSet

The US dollar has been the primary beneficiary from these developments. Strong relative growth supported by tax cuts and infrastructure spend, and the widening of interest rate differentials between itself and other developed markets have been important contributors to the strength in the currency. The political turmoil in Italy could very well provide additional support to the USD as investors assess the potential spillover effects to the rest of Europe and the global economy in general.

EURO: EXCHANGE RATE VS. US DOLLAR



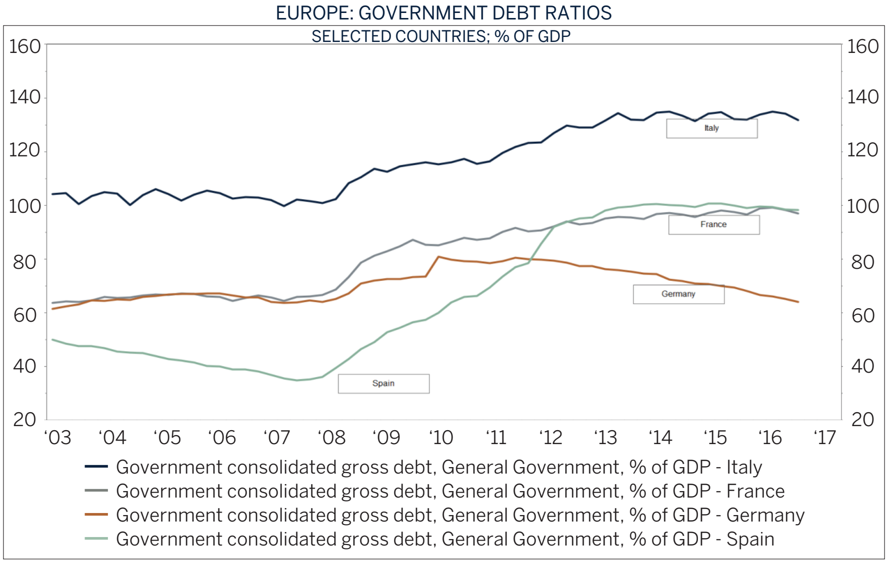
Source: FactSet

> "The backdrop to the political situation is that the country has not been able to recover economically along with the rest of the Eurozone since the financial crisis."

> "This imposes a significant limitation on what the government can achieve by fiscal means – it has no flexibility."

Italy's problems pose a significant risk. The backdrop to the political situation is that Italy has not been able to recover economically along with the rest of the Eurozone since the financial crisis. In terms of GDP per head, it remains well below where it was in 2007, the peak of the previous upcycle. But other major European economies (including Spain) are ahead of where they were then. The result is a dissatisfied electorate, searching for competence and solutions. The economic problem is manifold, but for a start there is too much government debt (over 130% of GDP – see chart below). This imposes a significant limitation on what the government can achieve by fiscal means – it has no flexibility. The new coalition has a loud Eurosceptic component, and its attempt to appoint a longstanding Eurosceptic academic to the post of finance minister is what caused the trouble: the Italian president rejected the appointment. He has asked a new prime minister to appoint a cabinet, but the coalition resisted. A few days later the Italian coalition managed to get a cabinet past the President, with Giuseppe Conte as prime minister and the newly appointed (moderate) minister of economics/finance, who is "in favour" of Italy's continued membership of the single currency. Markets responded positively to the announcements. Savona, the academic who caused all the trouble the first time around, was appointed as minister of "European affairs".

In addition, the coalition of the far-right League and the "non-ideological" Five-Star movement has promised that it will demand that the European Central Bank renegotiates debt terms. There are other impractical ideas, such as issuing a separate "fiscal" currency while keeping the Euro somehow. The attempt to shift the political stress from Italy to the ECB is what has markets worried as it raises the spectre of some kind of default, as it did with Greece. The problem is that Italy is much larger than Greece, and the systemic impact if markets start to close to the Italian government could be severe.



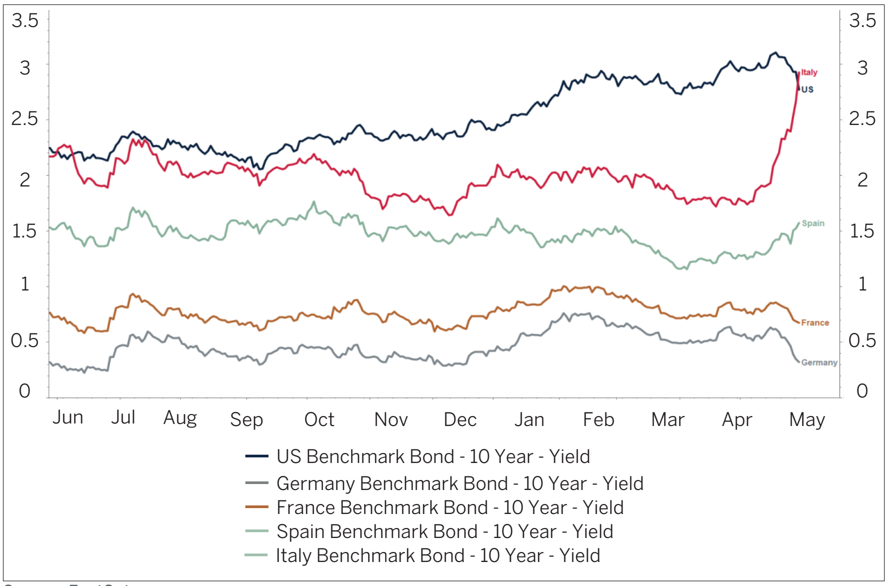
Source: FactSet

"the ECB for now continues to behave as if nothing has changed, thus raising the risk of a clumsy outcome."

One way to understand it is that Italy's new government is attempting to switch a slow internal deleveraging to a swift external one – i.e. shifting the cost to the ECB (essentially asking Germany and France to take the cost). Markets predictably think this is politically unsaleable to the other members of the Eurozone, so the risk of a sudden disruption is higher. Even if it is workable, the basic impulse would be disinflationary at best in the short run. Without significant liquidity support from the central bank, asset prices would find it hard to hold current levels. That is exactly what has already happened to Italian government debt prices: bond yields have jumped sharply.

As the chart below shows, the fallout into other bond yields has been limited, more of a safe-haven retreat – but still implying a higher risk of disinflation. This is why continuing comments from the ECB that they will stick to the current monetary path (probably announcing the end of quantitative easing measures before the end of the year) are not helpful – the ECB for now continues to behave as if nothing has changed, thus raising the risk of a clumsy outcome.

EUROZONE: 10 YEAR BOND YIELDS VS US



Source: FactSet

The Italian problem is not new and not unmanageable (Italy runs a budget surplus before debt service costs), but it is politically less tractable than before. As one strategist put it this week, "the challenge is that the public wants the Euro but is unwilling to pay the price of being part of the club... Italians and Greeks trust their own elites even less than they trust Euro bureaucrats, and hence keeping the Euro is the equivalent of better governance. However, at the same time, structural reforms (labour and product markets) are unacceptable." The structural reforms are what would make the maintenance of the Euro as a domestic currency sustainable.

We can't predict the outcome, but it does make us more cautious of the outlook for Europe as a whole, which was already going through a soft economic patch. In addition, the higher risk will undermine not only growth projections, but also the outlook for the currency.

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"...more could and should be done to stimulate growth in SA. GDP growth per capita is among the lowest in the world and a turnaround should be the number one priority for policy makers."

South Africa

Global events overshadowed domestic fundamentals as equities, bonds and the rand corrected in sympathy with the volatility in international markets. Emerging markets felt the brunt of the correction as investors opted to shift money back to safe-haven assets such as US treasuries on renewed growth and geopolitical concerns.

One hundred days have passed since Mr Ramaphosa's inauguration as South Africa's newly elected president and although a lot has been achieved in a relatively short period, investors have little to show for it and economic follow through has thus far been disappointing, with growth in final demand and household credit extension pedestrian. But, then Rome wasn't built in a day and investors will have to be patient. Consumer and business confidence have improved from very low levels during the Zuma era and there is evidence of some improvement in certain leading indicators such as vehicle sales and home buying confidence. A pick-up in inventory is expected to be a key driver of growth for the economy this year as companies replenish low levels of stock as demand improves.

The President has been successful in focusing on the most pertinent issues that prevented the economy from growing at the rate required to deal with the country's many socioeconomic challenges, including high levels of unemployment and inequality. Some challenges remain however, such as the implementation of land reform, reaching agreement on a workable Mining Charter and finding a sustainable solution to the funding crisis at state owned enterprises. Removing some of these obstacles to economic growth are essential to attract foreign investment capital and support future investment spending.

Yet, more could and should be done to stimulate growth in SA. GDP growth per capita is among the lowest in the world and a turnaround should be the number one priority for policy makers. The credit rating agency Standard & Poor's, one of the first to downgrade SA's sovereign credit rating to non-investment grade, recently kept the country's "stable" rating outlook unchanged in spite of political improvement. The agency stressed that the rating is constrained by weak per capita economic growth, a large fiscal debt burden and sizeable contingent liabilities. S&P said that the credit rating could be upgraded should either growth or the fiscal outcomes improve to a sustainable level above its current projection.

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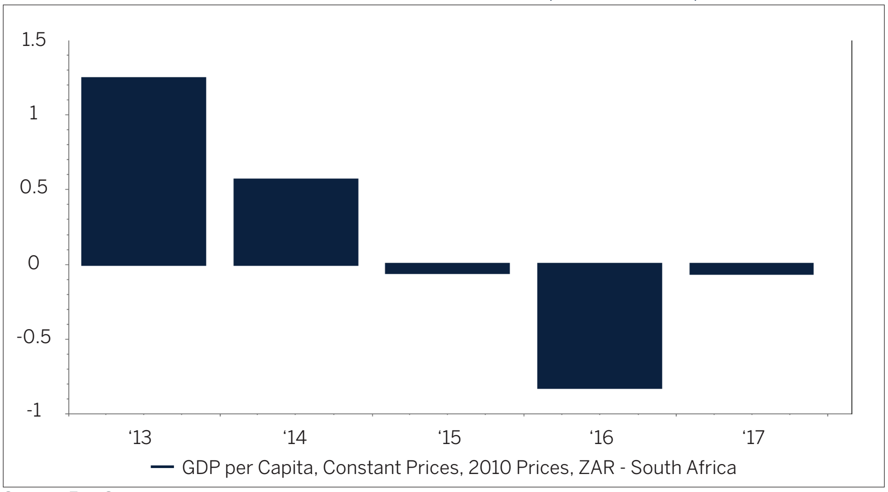
> "Real interest rates are currently higher than at any point since the global financial crisis, and are deliberately set in order to dampen domestic demand and bring the inflation level down."

SOUTH AFRICA - REAL GDP PER CAPITA (% CHANGE YOY)

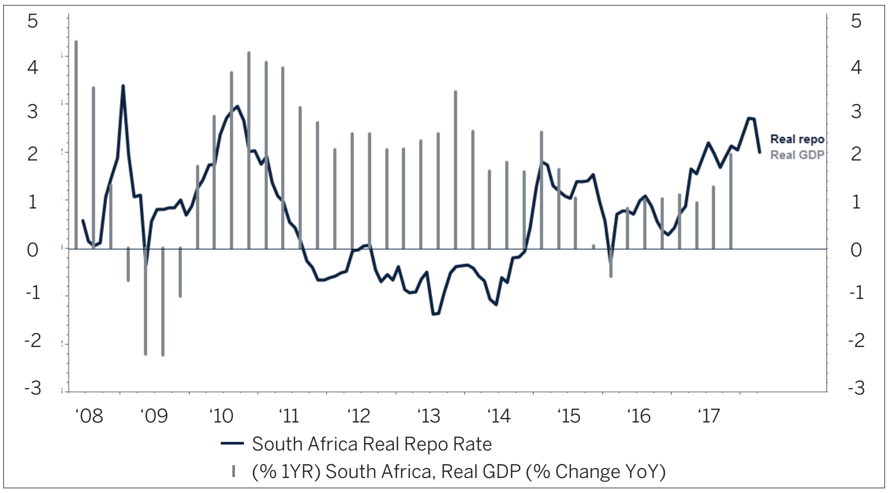


Source: FactSet

Political and economic reforms are required to ensure that confidence levels remain elevated and the path for economic growth higher and sustainable. Monetary policy also counts. Price stability coupled with low levels of inflation lower the cost of doing business and reduce the cost of capital for companies and government. Monetary policy can also be used to trigger or boost a cyclical recovery. The Reserve Bank (SARB) was a key stabilising force through the Zuma era and defended its independence vigorously.

Now, the SARB's commitment to a lower inflation target is very evident. Although it assesses the inflation outlook as stable and expected to remain inside the target range of 3 to 6 percent until at least 2020, it expects interest rates to rise. That's because it is on a mission to anchor inflation expectations at the mid-point of the target range (4.5%), whereas historically expectations have been stuck around 6%. This amounts to a revised target, and to achieve it, requires higher real interest rates for longer. While the SARB believes its current settings are "accommodative", that is only true relative to its desired target: it is completely the opposite relative to history. Real interest rates are currently higher than at any point since the global financial crisis, and are deliberately set in order to dampen domestic demand and bring the inflation level down. Arguably, in a mostly disinflationary world, the goal could be achieved with lower real rates and a less contractionary impact.

REAL GDP VS REAL REPO RATE



Source: Factset Research System

The recent increase in volatility emanating from an appreciating USD, higher US long bond yields and weakening growth now has the political uncertainty in Italy to deal with as well. This increases the likelihood that domestic interest rates will be left unchanged this year to combat portfolio outflows. Some of these factors are temporary, however, and some stabilisation in the global economy may provide an environment for the Reserve Bank to reconsider its policy stance. Lower interest rates accompanied with structural reforms would lend further support to consumer and business sentiment, and trigger a credit cycle and higher economic growth.

Summary

The near-term outlook for global growth remains good. But political developments in Italy have the potential to derail the expected growth path, and should give the ECB pause. The Federal Reserve will continue to normalise rates given the strong US economic backdrop and higher inflation. Other central banks such as the European Central Bank and the Bank of Japan need be in no rush to follow, but the risk of a policy error has risen. For now, we do not so much change our outlook but recognise that there are additional hurdles that will probably defer a return to full strength in Europe.

Other risks have not gone away. US-China trade negotiations have started; the US's exit from the Iran nuclear deal and renewed sanctions have already raised tension; North Korea's on-again off-again denuclearisation runs on; and risks to the survival of the Euro have re-emerged.

Investors should not place extreme bets on the outcome of uncertain political events. Fundamentals matter most in the long run and the best route is to ensure that portfolios are aligned with long-term investment objectives, while at the same time making sure that portfolios are adequately diversified to cater for these unexpected events.

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