THREE'S A CROWD

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They say three's a crowd, but the worry for many investors is that more than three is a stampede. The yield on the benchmark 10-year US government (Treasury) bond broke decisively above 3% for the first time since 2011.

A NICE **ROUND NUMBER**

People tend to like nice round numbers and see them as "psychologically important levels" (such as Brent crude oil breaking above $80 per barrel), hence the hoo-ha over the yield crossing 3%. But the reality is that investors have been selling US bonds – with rising yields - since September last year. The last time yields came close to 3% was the 2013 "taper tantrum" when investors panicked after then Federal Reserve (Fed) Chair Ben Bernanke mused that a tapering of Fed bond purchases might loom. Since then, the Fed has been extremely careful to avoid surprising the market with its policy changes. The current rising bond yields come against the backdrop of continued gradual Fed interest rate hikes, while the higher oil price is likely to put further upward pressure on inflation. However, the last four inflation readings in the US - average wages, producer prices, consumer prices and imported prices - all came in below expectations. Therefore, inflation is rising supported by the low base formed a year ago, but it's not running away.

In really simple terms, there are three types of interest rates or borrowing costs in an economy. One set is determined by the central bank with a view to managing inflation in the economy. These policy rates are typically short-term in nature, often overnight. The second type is set by banks when they make loans. Since banks often turn to the central bank for last minute funding, bank rates will be based on the central bank's policy rate, plus some margin, and an adjustment for the creditworthiness of the borrower. In South Africa's case, the Reserve Bank sets the repo rate at which it lends to banks, and banks lend out at the prime rate, plus or minus a few basis points depending on the borrower. The third category of borrowing costs are determined by the market in real time, not by a monetary policy committee or a bank lending officer. Though government and corporate bonds tend to pay out a fixed interest rate (the coupon) which is determined at issuance, the bond's price will change in reflecting expectations of future inflation and policy interest rates once they start trading in the market. The yield of the bond is simply the interest payment (which is usually fixed) divided by the price (which fluctuates), meaning that prices and yields move in opposite directions. From the point of view of an investor, the purchasing power of those fixed coupon payments is very vulnerable to inflation and inflation is the one variable that moves bond markets more than any other.

WILL THERE **BE A STAMPEDE?**

So why do some fear a stampede beyond 3% in equity markets? There are three concerns: Firstly, as described above, higher yields mean higher borrowing costs throughout the US economy since all private sector interest rates effectively price off the rate the government pays. Higher borrowing costs can hurt company profits by both suppressing top-line revenue growth and raising interest costs. But since the rest of the world prices off US markets, higher borrowing costs there ripple out far and wide, especially on the trillions of dollars of dollar-denominated debt outside the US. Emerging markets that borrow in dollars or require dollar inflows to fund current account deficits are especially vulnerable. Secondly, since investors have to choose between asset classes, one becomes more attractive (at higher yields) when the other becomes less attractive. With bond yields historically low across the world in recent years, equities were relatively attractive. More specifically, defensive shares with stable cash flows that resemble a bond have risen and fallen with the bond market. At one point last year, the dividend yield on equities was higher than the government bond yield, even though dividends grow over time while interest payments from bonds don't. The other argument is a bit more technical. Share prices should reflect the discounted value of future cash flows. The higher the discount rate, the lower the present value of those future cash flows and vice versa. Therefore in a low interest rate environment (i.e. low discount rates) shares should be more valuable. But for now interest rates are rising.

However, there is no certainty what the threshold Treasury yield is that will cause a wholesale switch out of equities into bonds. After all, even 3% Treasury yields are barely positive in real terms, compared to a 50-year average real yield of 2.3%. Also, if yields are rising, bond prices are falling and bond investors are making losses. Investors who focus on valuations like asset classes that have sold-off, but investors who follow a momentum approach don't.

CHEAP MONEY **ERA IS ENDING**

There is no doubt though that the era of ultra-easy money is ending. The question is just how orderly this unwind will be. It also means that the easy returns have probably been made. It is highly unlikely that stock price: earnings multiples will expand from this point onwards. Equity returns will therefore have to be driven by earnings growth. Fortunately, the picture is still healthy on this score, partly due to the recent corporate tax cuts. Companies are also buying back shares at a record pace, and although some have complained that it amounts to financial engineering, it does raise earnings attributable to each outstanding share.

At any rate, the major stock markets weren't particularly spooked last week and most are still up strongly for the month of May. Energy shares in particular have rallied on the surging oil price, while tech shares have also had a strong month. While the oil price has rallied on geopolitical concerns (sanctions on Iran and the collapse of Venezuelan output), it is also increasingly clear that the oil glut of recent years is over as demand has increased faster than supply. This is important, as oil demand tells us the world economy is still doing fine. US shale output has surged, but has done so faster than the supporting infrastructure and many of those "frackers" are struggling to physically transport their production to the market place.

THE IMPACT **DOWN SOUTH**

How does all this impact South Africa? As always, we are vulnerable to massive capital flight from emerging markets if rising US yields draw capital from outside the rest of the world. Argentina and Turkey have been hard hit, but largely because of domestic vulnerabilities. The rand is the barometer

for how global risk appetite and liquidity conditions impact South Africa. Although it took a knock on Friday, it has so far held up quite well, unlike in 2013 when the rand lost 20% during taper tantrum (it lost another 13% in 2014 and 30% in 2015). South Africa's fundamentals have certainly improved since 2013 and the outlook remains positive.

Retail sales grew by 4% year-on-year in real terms in March, which is pretty solid. However, because of a surge in spending in November's Black Friday event, the first quarter is lower compared to the fourth quarter of 2017. Along with quarterly contractions in wholesale sales, buildings completed, mining and manufacturing output, the first quarter GDP growth could well be negative on a quarter-on-quarter basis. This could certainly dent the "New Dawn" narrative, but should not be blown out of proportion. Year-on-year growth should accelerate and the outlook for the remainder of the year looks fairly bright due to a combination of low inflation supporting spending (retail inflation was only 1.7% in April) and a healthy global economy that should support our export and tourism sectors. If President Ramaphosa can deliver economic reforms it will be a further shot in the arm.

RISK OF **AN OIL SPILL**

The oil price is also a potential risk, especially if it coincides with a further weakening of the rand. This will put some upward pressure on inflation, but is unlikely to result in the Reserve Bank hiking interest rates immediately. It does however mean that the next move in the repo rate could be higher. The higher oil price will also lead to a larger import bill, putting pressure on the current account deficit. Higher fuel prices will also increase transport costs for companies and households. However, adjusting for growth in household income over time, the rand oil price is still below its five-year average. In other words, as much as investors like round numbers, $80 oil does not have the same impact today as it did when it crossed that threshold for the first time in September 2007 and then again in late 2010.

For local investors, the best protection against the risks described above is to have significant rand-hedge exposure in their portfolios. This includes offshore equities, but also JSE-listed shares with global reach. However, as always, we caution against making one-way bets. In such an uncertain environment, appropriate diversification is important. Our Strategy funds are always well diversified and have more rand hedge exposure than commonly realised.

CHART 1: REAL TRADE-WEIGHTED US DOLLAR INDEX (HIGHER VALUES INDICATE STRONGER DOLLAR)

Source: Thomson Reuters Datastream

CHART 2: EMERGING MARKET CURRENCIES INDEXED AGAINST THE US DOLLAR (HIGHER VALUES INDICATE STRONGER DOLLAR)

Source: Thomson Reuters Datastream

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 121.0	-0.52%	1.63%	0.86%	12.76%
United States	S&P 500	US$	2 713.0	-0.55%	2.45%	1.46%	14.67%
Europe	MSCI Europe	US$	1 786.0	-0.78%	-0.17%	-0.61%	7.27%
Britain	FTSE 100	US$	10 478.0	0.16%	1.36%	0.74%	8.77%
Germany	DAX	US$	1 450.0	-0.82%	1.05%	-0.75%	13.37%
Japan	Nikkei 225	US$	207.0	-0.50%	0.74%	2.46%	17.65%
Emerging Markets	MSCI Emerging Markets	US$	1 138.0	-2.23%	-2.23%	-1.73%	15.18%
Brazil	MSCI Brazil	US$	1 941.0	-6.77%	-9.97%	-4.05%	16.86%
China	MSCI China	US$	92.6	0.00%	2.85%	4.67%	33.00%
India	MSCI India	US$	558.6	-3.51%	-5.32%	-8.57%	5.20%
South Africa	MSCI South Africa	US$	541.0	-6.56%	-4.59%	-10.58%	7.55%

EQUITIES - SOUTH AFRICA (TR UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	57 804.0	-1.06%	-0.74%	-2.86%	6.66%
All Share	All Share (Total Return)	Rand	8 315.0	-1.05%	-0.68%	-1.60%	9.87%
TOP 40/Large Caps	Top 40	Rand	7 365.0	-1.02%	-0.16%	-1.11%	10.49%
Mid Caps	Mid Cap	Rand	15 901.0	-2.93%	-6.12%	-6.33%	3.55%
Small Companies	Small Cap	Rand	20 822.0	-0.10%	-0.90%	-0.95%	2.61%
Resources	Resource 20	Rand	2 638.7	4.77%	8.55%	15.42%	30.91%
Industrials	Industrial 25	Rand	14 379.0	-1.60%	-1.47%	-4.88%	2.87%
Financials	Financial 15	Rand	9 258.0	-5.55%	-6.40%	-4.63%	17.22%
Listed Property	SA Listed Property	Rand	2 009.6	-2.73%	-5.78%	-18.44%	-6.05%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	938.3	0.00%	-1.76%	-1.03%	2.21%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	612.8	-1.70%	-2.87%	4.27%	10.79%
Government Bonds	BESA GOVI	Rand	608.7	-1.81%	-2.99%	3.81%	10.38%
Corporate Bonds	SB JSE Credit Indices	Rand	119.0	-0.31%	-0.31%	-5.73%	-16.22%
Inflation Linked Bonds	BESA CILI	Rand	256.0	-0.39%	-0.06%	1.33%	3.33%
Cash	STEFI Composite	Rand	393.4	0.13%	0.35%	2.74%	7.40%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	79.1	2.74%	5.44%	18.03%	49.21%
Gold	Gold Spot	US$	1 294.0	-1.90%	-1.75%	-0.23%	3.77%
Platinum	Platinum Spot	US$	885.0	-4.22%	-2.32%	-4.84%	-5.14%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	12.77	-3.87%	-2.45%	-3.09%	4.98%
ZAR/Pound	ZAR/GBP	Rand	17.20	-3.43%	-0.29%	-2.67%	0.99%
ZAR/Euro	ZAR/EUR	Rand	15.04	-2.56%	0.10%	-1.17%	-0.97%
Dollar/Euro	USD/EUR	US$	1.18	0.85%	2.37%	1.78%	-5.93%
Dollar/Pound	USD/GBP	US$	1.35	0.53%	2.45%	0.22%	-3.49%
Dollar/Yen	USD/JPY	US$	0.01	1.26%	1.31%	-1.69%	-0.32%

Source: I-Net, figures as at 18 May 2018

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ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Consumer inflation
- SA Reserve Bank Monetary Policy Committee meeting
- S&P Global ratings decision

US

- Flash Markit Purchasing Managers' Index
- Minutes from previous Fed interest rate meeting released
- Existing home sales
- Durable goods orders

EUROPE

- Eurozone flash Markit Purchasing Managers' Index
- Eurozone consumer confidence
- UK inflation

JAPAN

- Trade balance
- Flash Markit Purchasing Managers' Index

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