MARKET MATTERS

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OLD MUTUAL MULTI-MANAGERS

IN THE EYE OF A STORM

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In stark contrast to the optimism prevailing at the start of the year, the South African economy suddenly finds itself battered from three sides.

EMERGING MARKETS BATTERED

Firstly, the emerging market turmoil of recent weeks escalated in the last few days with accelerated depreciation of the rand and other emerging market currencies. As a result, the rand closed above R15 to the dollar for the first time since June 2016. The rand has lost 20% of its value since the start of the year. This is in line with the performance of our peers, but Turkey and Argentina remain far ahead in terms of currency weakness.

Among financial commentators, there are increasing references to "contagion" and a "full-blown emerging market crisis". What has resulted in the past is that something breaks: either there is a debt default (which South Africa did in 1985), or the currency is forced off a dollar peg (as was the case during the East Asia crisis), or domestic demand has to shrink to rebalance (Greece after 2010), or all three (as was the case with Argentina in 2001). What protects South Africa is that we have a fully flexible exchange rate that adjusts in real time to shifts in global risk appetite, benefiting the sectors of the economy exposed to global demand, and that we do not have significant dollar denominated debt.

A decline of 20% to 30% is in line with previous emerging market sell-offs, such as the 2013/14 'Taper Tantrum' and 'Fragile Five' episodes, as well as the 2015 fears around a Chinese hard landing. This doesn't mean that the selling is over – that is impossible to predict – but just that the worst of the selling is probably behind us.

One of the reasons why South Africa is a vulnerable emerging market is because of our large current account deficit, though our economy is not nearly as unbalanced as Turkey's or as dollar-starved as Argentina. There was some good news on this score when the Reserve Bank announced that the current account deficit had shrunk from an annualised R219 billion to R164 billion in the second quarter. This equates to 3.3% of gross domestic product (GDP), down from 4.6% in the first quarter. A rebound in export volumes and prices in the second quarter saw the trade balance – the volatile component of the current account balance – swing into surplus.

One consequence of the rand's slump is that rather than support the weak economy with interest rate cuts, the risk of the SA Reserve Bank hiking interest rates has increased. The Reserve Bank does not respond to currency movements directly, but to whether it results in higher inflation. Recent experience suggests that the pass-through from exchange rate movements to inflation is much lower than in the past. It will ultimately depend on the extent to which companies can increase selling prices in response to higher input prices. In the current tough competitive environment, they might not be able to.

RECESSION REARS ITS UGLY HEAD

Secondly, data from Stats SA last week showed that the economy is in a technical recession, having surprisingly contracted by 0.7% in the second quarter, following a 2.6% decline in the first quarter. A technical recession, defined as two consecutive negative quarters, is not a very useful way of looking at the economy's performance, but does add to the prevailing negative sentiment. A better way of thinking about a recession is that it is a deep and prolonged decline in economic activity across a widespread range of sectors. Using this definition, the economy was clearly in recession in 2009, but the current slowdown would not necessarily qualify.

Quarterly growth numbers can be volatile and the 0.7% decline is a seasonally-adjusted and annualised rate, which means that the actual decline in activity was small. Remember that a similar technical recession in 2017 was subsequently revised away. But clearly the economy is weak, and enjoying neither external support nor much internal policy direction. Most forecasters, including the ratings agencies, have cut 2018 growth numbers to below 1%. The time for government to implement growth-enhancing reforms is now and the upcoming Medium Term Budget will be closely watched. There have been promising announcements on three fronts in the past few weeks – freeing up broadcast spectrum, abandoning changes to the Minerals Act and a mooted 'complete overhaul' of the visa regime – but without firm deadlines. The clean-up of governance in the State Owned Enterprises (SOEs) also continues, but will not have any immediate impact on economic growth.

The growth disappointment could place further downward pressure on the government's credit rating. However, the events of the past few months confirm how little ratings matter for foreign bond purchases. Foreigners will buy our high-yielding bonds when they have sufficient risk appetite and sell when their risk appetite recedes. They have been selling aggressively since April.

AGRICULTURE, THE CULPRIT

The second quarter decline was largely due to a 29% contraction in the volatile agricultural sector. The delayed impact from the drought conditions in the Western Cape, which have fortunately eased substantially, are largely to blame. Unlike for other sectors, Stats SA does not publish detailed advance data on agriculture, therefore it is always a bit of a wild card in the GDP release. Although agriculture is only 2% of GDP, the size of the decline shaved off 0.8% points from overall second quarter growth. The trade sector (wholesale, retail, vehicles, accommodation and catering) and transport sector (transport, logistics and communications) were also negative. Finance, real estate and business services, the largest sector, was positive in the quarter, as was mining.

Looking at the demand side of the economy, household spending declined in the quarter for the first time since the first quarter of 2016. But on a year-on-year basis, growth is still positive. The economy's wage bill grew by 6.5% compared to a year ago, ahead of inflation. Fixed investment spending, which is highly sensitive to confidence levels, was also negative.

ADDING FUEL TO THE FIRE

The third headwind is that oil prices have increased substantially this year, even as other commodity prices have tumbled. For instance, despite much global uncertainty, gold has not benefited from "safe haven" buying. Brent crude oil almost touched $80 per barrel last week on supply concerns

ahead of sanctions on Iran taking effect and a storm in the Gulf of Mexico. Combined with the rand slump, a petrol price hike of more than R1 per litre is possible in October. The Department of Energy's decision to not pass through the full hike in September only postpones the pain, and sets a bad precedent. The only way to reduce the petrol price would be to cut the various levies and this would entail hiking taxes elsewhere (the fuel levy is budgeted to contribute R77 billion to the fiscus this year). Until such time as electric vehicles become widespread, this is the reality we need to live with.

The higher oil price doesn't only harm motorists and eat into corporate profit margins, but it could also result in the current account deficit widening again as the import bill rises. In fact, several emerging markets (including Turkey, India and Thailand) are oil importers and face pressure.

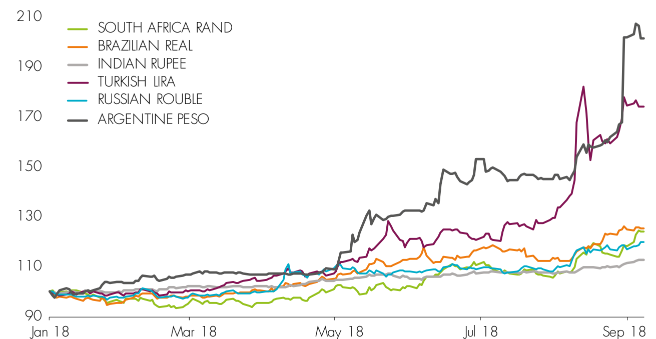
SO WHAT NOW?

As taxpayers, citizens, workers and businesspeople, we clearly need to be concerned about the persistent weakness in the economy. Irrespective of which recession definition you prefer, last week's numbers confirm that the economy is under pressure. This news is not new though, and the weakness has long been reflected in financial markets.

As investors, we fortunately have the benefit of being able to spread risk beyond South Africa's borders, even in traditional pension vehicles where regulations now allow 30% offshore exposure. As the rand bears the brunt of negative sentiment towards South Africa, the value of foreign assets increases. Global equities (MSCI All Countries World Index) have delivered 26% in rand terms over the past year. The make-up of the JSE is very different to GDP. For instance, banking is 5% of GDP but 14% of the JSE. Government and SOEs are 20% of GDP but with no representation on the JSE. And of course there is also considerable global exposure within locally listed companies, which is not reflected in GDP at all. The JSE does benefit from a weak rand over time.

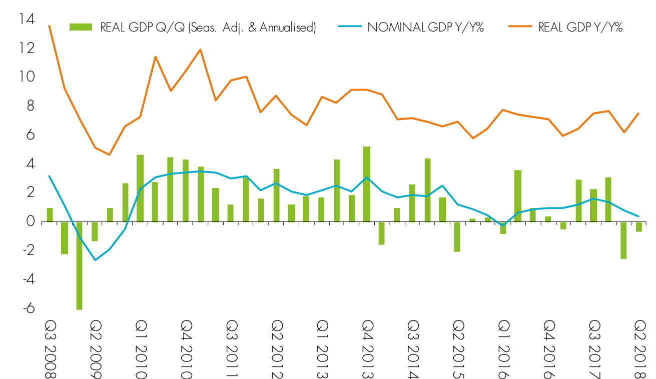
Investors understandably get tired of being told to "be patient" and "invest for the long term", when returns have been disappointing for a while now, but it is very important to keep three things in mind: One, the flip side of disappointing recent returns is that valuations and therefore prospective returns have improved. Secondly, being appropriately diversified remains the best defence against negative surprises. Lastly, while the economy has contracted, there has been substantial growth in scary headlines and depressing commentary. Don't get carried away and make emotional investment decisions such as selling out of long-term investments or a knee-jerk switch out of local into global assets. The rand horse has probably bolted already, and at the current exchange rate, doing so could do more harm than good.

CHART 1: EMERGING MARKET CURRENCIES AGAINST THE US DOLLAR, REBASED TO 100



Source: Thomson Reuters Datastream

CHART 2: SA REAL GROSS DOMESTIC PRODUCT GROWTH



Source: Thomson Reuters Datastream

CHART 3: GLOBAL EQUITIES IN RAND TERMS

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$	2 144.0	-1.43%	-1.43%	1.95%	9.11%
United States	S&P 500	US$	2 872.0	-1.03%	-1.03%	7.40%	16.51%
Europe	MSCI Europe	US$	1 665.0	-2.35%	-2.35%	-7.35%	-3.76%
Britain	FTSE 100	US$	9 402.0	-2.39%	-2.39%	-9.60%	-3.00%
Germany	DAX	US$	1 323.0	-3.64%	-3.64%	-5.72%	-3.50%
Japan	Nikkei 225	US$	200.8	-2.41%	-2.41%	-0.61%	12.54%
Emerging Markets	MSCI Emerging Markets	US$	1 018.0	-3.60%	-3.60%	-12.09%	-6.61%
Brazil	MSCI Brazil	US$	1 602.0	-1.05%	-1.05%	-20.81%	-23.68%
China	MSCI China	US$	76.5	-4.74%	-4.74%	-13.60%	-5.77%
India	MSCI India	US$	583.5	-2.83%	-2.75%	-4.50%	2.19%
South Africa	MSCI South Africa	US$	435.0	-8.81%	-8.81%	-28.10%	-18.39%

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	-2.73%	-2.73%	-4.10%	2.13%	3.90%
All Share	All Share (Total Return)	Rand	-2.37%	-2.37%	-2.02%	5.18%	6.95%
TOP 40/Large Caps	Top 40	Rand	-2.70%	-2.70%	-1.18%	5.81%	8.23%
Mid Caps	Mid Cap	Rand	-1.26%	-1.26%	-9.87%	-3.04%	-3.95%
Small Companies	Small Cap	Rand	-0.07%	-0.07%	-6.28%	-2.98%	-1.83%
Resources	Resource 20	Rand	-1.58%	-1.58%	21.59%	23.89%	25.08%
Industrials	Industrial 25	Rand	-3.34%	-3.34%	-7.30%	-1.94%	2.40%
Financials	Financial 15	Rand	-2.24%	-2.24%	-4.03%	13.55%	11.46%
Listed Property	SA Listed Property	Rand	-0.83%	-0.83%	-20.75%	-13.56%	-12.42%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	932.6	-0.43%	-0.43%	-1.63%	-2.63%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	608.0	-1.05%	-1.05%	3.45%	5.72%
Government Bonds	BESA GOVI	Rand	602.4	-1.14%	-1.14%	2.74%	4.96%
Corporate Bonds	SB JSE Credit Indices	Rand	115.1	-0.32%	-0.32%	-8.79%	-16.46%
Inflation Linked Bonds	BESA CILI	Rand	-	-100.00%	-100.00%	-100.00%	-100.00%
Cash	STEFI Composite	Rand	401.9	0.13%	0.13%	4.95%	7.28%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	76.4	-1.71%	-2.05%	14.03%	41.48%
Gold	Gold Spot	US$	1 197.0	-0.42%	-0.42%	-7.71%	-11.00%
Platinum	Platinum Spot	US$	782.0	-0.38%	-0.38%	-15.91%	-23.18%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	15.23	-3.64%	-3.60%	-18.73%	-15.91%
ZAR/Pound	ZAR/GBP	Rand	19.70	-3.40%	-3.40%	-15.03%	-14.92%
ZAR/Euro	ZAR/EUR	Rand	17.60	-3.21%	-3.21%	-15.59%	-12.52%
Dollar/Euro	USD/EUR	US$	1.16	0.00%	0.00%	3.53%	3.45%
Dollar/Pound	USD/GBP	US$	1.29	0.31%	0.63%	4.50%	1.40%
Dollar/Yen	USD/JPY	US$	0.01	-0.03%	-0.03%	-1.41%	2.19%

Source: I-Net, figures as at 7 September 2018

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ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Manufacturing production
- Retail sales
- Mining production

US

- Small business optimism
- Job openings and labour turnover
- Inflation rate
- Retail sales
- Industrial production

EUROPE

- European Central Bank interest rate decision
- Germany ZEW Economic Sentiment Index
- Eurozone industrial production

CHINA

- Inflation
- Loan growth
- Retail sales
- Industrial production
- Fixed asset investment

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