MARKET MATTERS

22 OCTOBER – 26 OCTOBER 2018

OLD MUTUAL MULTI-MANAGERS

THE HAUNTING OF RED OCTOBER

Dave Mohr and Izak Odendaal, Old Mutual Multi-Managers

It has been a red October as global equity markets slumped to one of the worst monthly performances in years. The local market has not been spared. US equities erased the gains for the year, while the JSE All Share Index is down 12%.

Commentators can easily come up with reasons after the fact to explain why markets are down, usually blaming a news event, geopolitics or some other macro development. Often though, investors sell because they see prices falling, with the reason for falling prices being less important. This feedback loop works on the way up too.

Risks always simmer in the background, but how much attention investors choose to pay to them shifts over time. For instance, global markets sold off heavily with the Brexit vote in 2016, but since then have shrugged off headlines on the debacle.

GLOBAL GROWTH STILL HEALTHY

Our task is to assess how far prices move from the underlying economic reality. Financial assets are traded on exchanges in real time and therefore exposed to significant fluctuations in price from one minute to the next. A real asset like a house is not traded on an exchange and we therefore don't know or worry about the price changes from day to day. But all financial assets still have a link to the real economy. Bonds are issued by corporates or governments, and backed by the revenues of those entities. Listed property values are determined by the growth rate of the rental income the underlying portfolio of assets generates. And of course shareholders have a claim in perpetuity on the profits generated by the companies they invest in. These profits are distributed as dividends, or reinvested into the business for the benefit of future shareholders.

The underlying rate of global economic growth is thus the one crucial ingredient to investment returns. The other is valuations, the price investors are prepared to pay to reap the cash flow from each asset. This is driven by psychology and emotions. When investors are optimistic, they are prepared to pay more for the same dollar of cash flow than when they are pessimistic.

In terms of the rate of global growth, it is clearly still quite solid, but not as strong as investors thought at the start of the year, particularly in Europe and China. The US economy posted quarterly growth of 3.5% in the third quarter, and is firing on almost all cylinders. Yet inflation in the quarter was lower than expected.

The concerns about slowing Chinese growth are amplified by the uncertainty around the impact of US tariffs, and the rapid increase in private debt in recent years. China is the world's second largest economy and it would be very unreasonable to expect an economy of that size to continue growing more than 7% per year for ever. The Chinese yuan has weakened to the lowest level against the US dollar since January 2017. The 11% decline since the start of the year largely offsets the impact of tariffs, but does not address the uncertainty.

Worries about slowing growth are compounded by rising US interest rates, both the policy interest rate set by the Federal Reserve, and the longer-term rates set by the market (bond yields). In fact, the initial round of equity selling was prompted by rising yields. But this in turn caused yields to fall as investors fled to the perceived safety of bonds. The US 10-year yield hit a seven-year high of 3.22% earlier in the month, but has since pulled back to 3.1% (bond yields and prices move in opposite directions).

Neither the Fed nor the European Central Bank (which held its monetary policy meeting last week) have given any indication that they would stop the process of gradually removing monetary stimulus. In previous episodes of global market volatility over the past few years, the Fed paused. But this time it seems there will be no central bank backstop. This does not mean that monetary policy is restrictive. In real terms, US rates are basically zero and European rates still deeply negative. This should still support economic activity, but does not provide any sugar rush to financial markets.

On top of all this, investors are also questioning the prospects for company profits. The US corporate results season is underway and most companies have reported solid earnings and sales growth numbers. To date, the third quarter earnings are 19% higher than a year ago, and at record high levels. However, investors have harshly punished any company which failed to beat expectations by a sufficient margin. The broader question is whether earnings growth has peaked. The benefit of US corporate tax cuts will fade out of the numbers in the coming quarters, while tariff increases push up costs for some firms and the stronger dollar depresses foreign revenues. A handful of companies have explicitly warned of tougher times ahead. But importantly, the concern at this stage is a slower rate of profit growth, not companies making losses, as would be the case if the economy was in a recession.

BEAR NECESSITIES

It is important to reiterate this: the US market sets the tone for global markets, and wobbles in the US have reverberated globally. This volatility is as a result of markets adjusting interest rate and growth expectations, but not because there is a looming recession. We have no way of knowing when this correction will burn itself out – it normally takes a few weeks – but in the absence of a US recession, a major bear market with deep and sustained losses remains very unlikely.

BUDGET DISAPPOINTMENT

Against this volatile global backdrop, many investors hoped the Medium Term Budget Policy Statement (MTBPS) would provide reasons to be more optimistic about local prospects. This was not to be the case.

Investors were expecting Finance Minister Tito Mboweni to announce a larger budget deficit for the current year than the 3.6% pencilled in in February. However, what the market was not prepared for was that deficits for the next two years would be widening, instead of narrowing. The deficits for the 2019, 2020 and 2021 fiscal years are now expected to be 4%, 4.2% and 4.2% respectively. This means that the debt to GDP ratio will stabilise at 59% instead of 56% and only by 2025. As a result, interest payments will grow by 11% a year over the next three years, faster than any other item in the Budget, even the wage bill which is set to grow at 7.2%.

The reasons for the red ink can be found mostly on the revenue, and not the spending side. Government spending will remain below the self-imposed expenditure ceiling, and will grow around 2% per year in real terms for the next few years. Economic growth has been persistently weaker-than-expected for the past eight years, and a weak economy struggles to generate needed tax revenue. The 2018 economic growth forecast was halved from 1.5% to 0.7%. This has been compounded by operational problems at SARS, notably the R20 billion in accumulated VAT refunds that will be paid out this year.

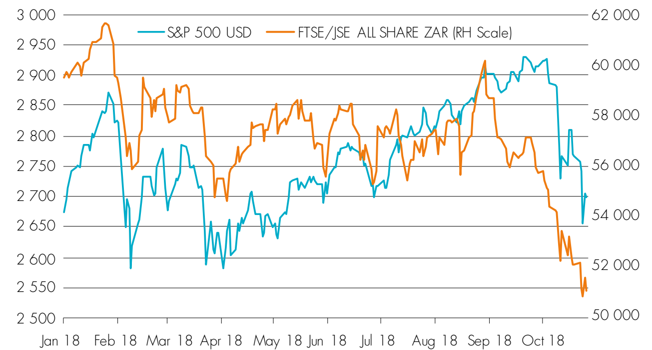
The other disappointment in the MTBPS was that no further bold reforms to stimulate economic growth were announced, even though the tone was honest about what needs to be done. Particularly, the reconfiguring of underperforming and cash-strapped State Owned Enterprises remains a work in progress, and in fact more bail-outs were announced.

The MTBPS was neither bond-friendly nor ratings-positive. Fitch and Moody's have already grumbled, but no immediate downgrades are expected. However, before we get carried away with the negativity, there are a couple of points to remember. Firstly, though debt is rising, it is mostly fixed-rate, long duration and denominated in rand. The risk that government will not be able to fund itself in the coming years, requiring an IMF bail-out, remains small. Secondly, the problems in SARS are now being tackled head-on, and might result in revenue surprises in coming years. Thirdly, though we should avoid ratings downgrades, they are not catastrophic, as last year showed. What matters more is global sentiment towards emerging market debt. Lastly, and crucially, unlike a year ago there is credible leadership at the helm, and fixing the economy – ultimately needed for fiscal sustainability – is at the top of the agenda. Since the government does not have the fiscal space to directly stimulate economic growth, it is being forced to do so through other means. This is likely to include greater participation for the private sector in areas that the government has until now jealously guarded.

THE SUM OF ALL FEARS

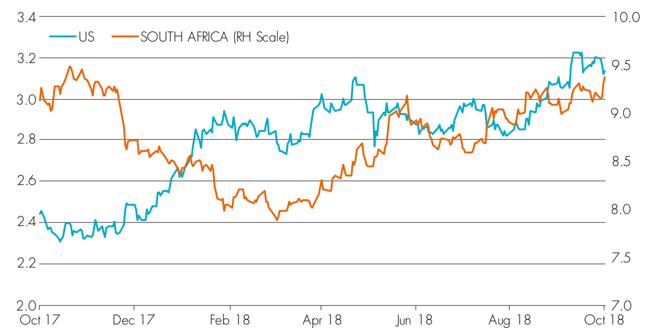
With bonds and equities negative in October, there have been few places to hide for local investors. The rand has weakened somewhat since the start of the month, but not enough to offset the declines in global asset prices. One small silver lining is that oil prices have pulled back along with other risk assets, leading to an over-recovery and potential petrol price cuts. But the reality is that recent returns are poor, even in diversified portfolios, and investors are rightly anxious and frustrated. The question is what to do about it. The biggest temptation is to shift to a fund or asset class that recently outperformed but that is investing through the rear view mirror. Investing through the windscreen requires thinking about what will outperform in the future. There has been no major change in the global or local economic outlook, and as markets have sold off, the valuations and therefore prospective returns have improved. Investors who for whatever reason cannot stomach market volatility should reassess whether they are in the right strategy. But investors who can and who are focused on the appropriate investment horizon will be rewarded accordingly.

CHART 1: US AND SOUTH AFRICAN EQUITIES IN 2018



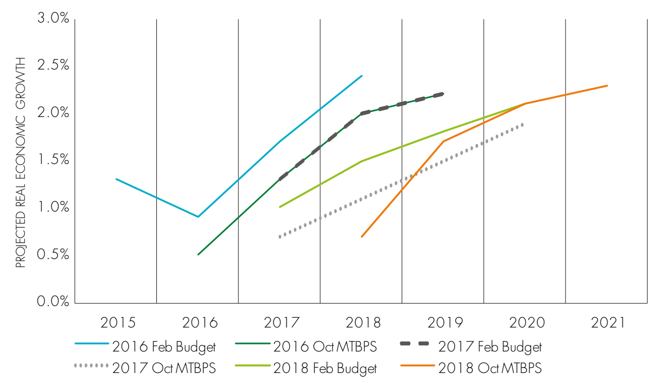
Source: Thomson Reuters Datastream

CHART 2: US AND SOUTH AFRICAN 10-YEAR GOVERNMENT BOND YIELDS, %



Source: Thomson Reuters Datastream

CHART 3: SA ECONOMIC GROWTH FORECASTS IN THE BUDGET



Source: National Treasury

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 006.0	-2.72%	-8.15%	-4.61%	-0.99%
United States	S&P 500	US$	2 659.0	-3.94%	-8.75%	-0.56%	3.87%
Europe	MSCI Europe	US$	1 555.0	-2.69%	-9.01%	-13.47%	-11.70%
Britain	FTSE 100	US$	8 903.0	-3.35%	-9.03%	-14.40%	-9.42%
Germany	DAX	US$	1 205.0	-3.98%	-10.48%	-14.15%	-14.84%
Japan	Nikkei 225	US$	189.4	-5.43%	-10.75%	-6.29%	-1.02%
Emerging Markets	MSCI Emerging Markets	US$	949.0	-2.27%	-9.45%	-18.05%	-14.35%
Brazil	MSCI Brazil	US$	1 969.0	-0.10%	13.88%	-2.67%	-4.42%
China	MSCI China	US$	69.8	-1.15%	-11.51%	-21.08%	-17.35%
India	MSCI India	US$	492.0	-1.83%	-9.90%	-19.48%	-15.90%
South Africa	MSCI South Africa	US$	416.0	-2.12%	-10.34%	-31.24%	-17.62%

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	50 838.0	-2.41%	-8.74%	-14.57%	-13.21%
All Share	All Share (Total Return)	Rand	7 430.0	-2.42%	-8.57%	-12.07%	-10.48%
TOP 40/Large Caps	Top 40	Rand	6 510.0	-2.72%	-9.68%	-12.59%	-12.02%
Mid Caps	Mid Cap	Rand	14 759.0	-0.17%	-1.11%	-13.05%	-5.67%
Small Companies	Small Cap	Rand	18 623.0	-1.36%	-3.91%	-11.41%	-9.68%
Resources	Resource 20	Rand	2 594.7	-3.84%	-8.44%	13.50%	9.57%
Industrials	Industrial 25	Rand	11 893.0	-2.50%	-10.75%	-21.32%	-23.06%
Financials	Financial 15	Rand	8 679.0	-1.31%	-7.11%	-10.59%	5.35%
Listed Property	SA Listed Property	Rand	1 892.6	-1.85%	-1.33%	-23.19%	-17.57%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	917.4	0.00%	-1.48%	-3.24%	-1.87%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	607.1	-0.59%	-1.43%	3.31%	9.59%
Government Bonds	BESA GOVI	Rand	600.7	-0.64%	-1.62%	2.45%	8.70%
Corporate Bonds	SB JSE Credit Indices	Rand	114.3	-0.09%	-1.51%	-9.38%	-13.52%
Inflation Linked Bonds	BESA CILI	Rand	254.2	-0.10%	0.72%	0.63%	1.79%
Cash	STEFI Composite	Rand	405.7	0.13%	0.54%	5.94%	7.26%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	76.6	-4.18%	-7.66%	14.39%	29.90%
Gold	Gold Spot	US$	1 233.0	0.57%	3.44%	-4.93%	-2.68%
Platinum	Platinum Spot	US$	830.0	0.00%	2.09%	-10.75%	-9.59%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14.61	-1.47%	-3.10%	-15.24%	-2.50%
ZAR/Pound	ZAR/GBP	Rand	18.74	0.32%	-1.60%	-10.67%	-0.27%
ZAR/Euro	ZAR/EUR	Rand	16.66	-0.52%	-1.42%	-10.78%	-0.52%
Dollar/Euro	USD/EUR	US$	1.14	0.88%	1.84%	5.35%	1.75%
Dollar/Pound	USD/GBP	US$	1.28	1.85%	1.33%	5.22%	2.10%
Dollar/Yen	USD/JPY	US$	0.01	-0.58%	-1.59%	-0.69%	-1.54%

Source: I-Net, figures as at 26 October 2018

HELPLINE +27 21 524 4430 | **FACSIMILE** +27 21 441 1199 | **EMAIL** ommmclientquery@ommm.co.za | **INTERNET** www.ommultimanagers.co.za

ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Money supply and credit growth
- Trade balance
- Absa Purchasing Managers' Index
- New vehicle sales
- Unemployment rate

US

- Personal income and spending
- Personal consumption inflation rate
- House price index
- ISM manufacturing index
- Non-farm payrolls and unemployment rate

EUROPE

- Eurozone Economic Sentiment indices
- Eurozone inflation

CHINA

- Official Manufacturing Purchasing Managers' index

Whilst every care has been taken in compiling the information in this document, the information is not advice and Old Mutual Multi-Managers and/or its associates, do not give any warranty as to the accuracy or completeness of the information provided and disclaim all liability for any loss or expense, however caused, arising from any use of or reliance upon the information. Please note that there are risks associated with investments in financial products and past performances are not necessarily indicative of future performances.

HELPLINE +27 21 524 4430 | **FACSIMILE** +27 21 441 1199 | **EMAIL** ommmclientquery@ommm.co.za | **INTERNET** www.ommultimanagers.co.za

Old Mutual Multi Managers ("OM m|m") is a business unit of Old Mutual Life Assurance Company (South Africa) Limited ("OMLACSA"), a licenced Financial Services Provider, Reg. No: 1999/004643/06. OM m|m is authorised to provide financial services on the OMLACSA license, FSP 703.