ASSESSING POLICY ERROR RISKS

Dave Mohr and Izak Odendaal, Old Mutual Multi-Managers

It was another messy week on world equity markets. If 2018 feels like a particularly volatile year for global markets, it is partly because 2017 was so quiet. The S&P500 had only eight daily gains or losses of more than 1% last year. This year, there have been more than 50, which according to a Financial Times report, is more or less in line with its longer term average.

THE APPLE FALLS FAR

But for the local market, it has been more than just volatility. The FTSE/All Share Index has lost 12% this year, compared to last year's 20% gain. Naspers, which accounts for a fifth of the JSE All Share's value, lost a fifth of its value this year as global technology stocks came under pressure, contributing 4% points of the 12% year-to-date loss. The fabled FAANGs (Facebook, Apple, Amazon, Netflix and Google) delivered almost double the return of the broader US market in the three years to end June. Since then, the FAANG index is down 22%, against 4% for the broader market.

The stronger dollar, which has gained almost 10% on a trade-weighted basis since April, hurts US multinationals like Apple that generate most of their revenue outside America.

But the bigger concern is that global economic growth is cooling and has become more divergent. At the start of the year, 'synchronised global growth' was the dominant narrative among investors and commenters. Now the US is still humming along, but growth in China and Europe has been disappointing. Even in the US, the fiscal boost from tax cuts will fade in 2019 and the cumulative impact of rate increases is becoming a drag. Not to mention the potential disruption if trade policies remain in place.

The Organisation for Economic Co-operation and Development (OECD), a club of developed economies, cut its global growth forecast for 2019 from 3.7% to 3.5%. As recently as May this year, it was expecting global growth to accelerate next year and the year thereafter. 3.5% is still a fairly healthy growth rate, but the fact that a major forecasting body is cutting its outlook is notable. The US forecast is unchanged, but still reflects a cooling in the current heady 3% growth rate in the next two years towards 2%.

If central banks continue to push ahead with monetary tightening, they risk making a policy error that won't be immediately apparent since interest rates impact the real economy with a lag. The Fed seems to appreciate this, and has emphasised the importance of making decisions 'data-dependent'. Certainly the market has in the last few days changed its expectation of where Fed rates will settle, leading to declining bond yields and a softer dollar. This is partly because the lower oil price dampens expected inflation over the medium term, but also because expectations of interest rate hikes are being scaled back. A number of key Fed officials have also noted over the past two weeks that the central bank might need to reassess its hiking path.

For the European Central Bank (ECB), problems range from political to practical. Germany's Bundesbank, the dominant central bank in the Eurozone, has been critical of the ECB's quantitative easing. Italy, in contrast, has called for the programme to continue. In practical terms, the ECB is running out of bonds to buy, since it only buys bonds with a high credit quality. The minutes of its October monetary policy meeting, released last week, showed a determination to put up a brave face while removing stimulus. "Regarding communication, it was important to emphasise that the incoming information, while somewhat weaker than expected, remained overall consistent with an ongoing broad-based expansion of the euro-area economy and gradually rising inflation."

WHEN DOVES CRY

However, the central bank most at risk of making a policy error is perhaps our own SA Reserve Bank. The surprise interest rate hike, which took the repo rate to 6.75%, comes against the backdrop of an improving inflation outlook and a lower economic growth forecast. A notable change at the monetary policy committee (MPC) is the retiring of a 'dove', shifting its balance. (In central bank speak, hawks favour hikes and doves focus on the economy.) The Reserve Bank's growth forecast for this year was cut to 0.6% from an already anaemic 0.7%, while the inflation forecast was cut to 5.4% from 5.7%. The forecasts for 2019 and 2020 were unchanged. These circumstances would normally lead to an interest rate cut.

Consumer inflation rose from 4.9% to 5.1% in October, as expected. The petrol price hit an all-time high in October and was responsible for 1.5% points of total annual consumer inflation. Core inflation, excluding volatile food and fuel prices, remained steady at 4.2%. Excluding administered prices, inflation was 3.8%. This is effectively the inflation rate for those prices that are set in competitive markets. Record petrol price hikes, the April VAT increase and a 6% depreciation of the rand in the year to end October are all in the numbers now, and inflation is still within the SARB's 3% to 6% target range. More recently, inflation drivers improved. A petrol price cut of up to R1.60 per litre is on the cards in December, while the rand is now stronger than the dollar compared to a year ago.

Meanwhile, the local economy remains weak, and companies lack pricing power. They might also lack electrical power, with Eskom's coal supplies running low. It has now been 10 years since the term "load shedding" became part of day-to-day conversation in South Africa. The fact that a stable electricity supply is still lacking despite the fact that electricity tariffs have more than doubled is a sad indictment of the management of State Owned Enterprises.

4.5% IS THE NEW 6%

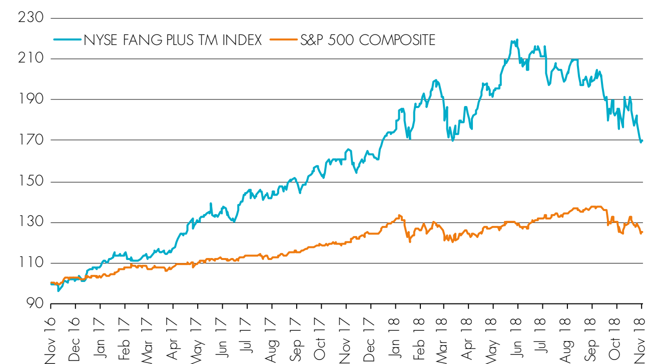
So why the cut if growth is weak and inflation well behaved and within the target range? Because the SARB has changed its de facto target to 4.5%, the midpoint of the range, and both actual and expected inflation is above this range. Rather than using the benign backdrop to cut rates and support the economy, the Reserve Bank is using the weak economy as an opportunity to force longer-term expectations down to 4.5%. In its statement the MPC noted it had to decide whether to act "now or later" and that delaying hikes could cause inflation expectations to "become entrenched at higher levels". This might be a good thing over the long term, but in the short term it will hurt the economy and might be a price too high to pay.

GOOD FOR BONDS, BAD FOR SHARES

The investment implications of this are good for fixed income and bad for domestically-focused shares. With tightening monetary policy and fiscal policies weighing on economic growth, local companies are forced to cut costs to maintain profit growth, instead of relying on robust revenue growth, but this only takes you so far. For shorter-date fixed income, high rates mean a more attractive low-risk investment. The Reserve Bank's determination to drive down long-term inflation is good for longer-dated bonds, and indeed bonds rallied on the hike. If inflation averages around 4.5% over the next ten years, the current yield of 8.9% on the 10-year bond promises an attractive real return.

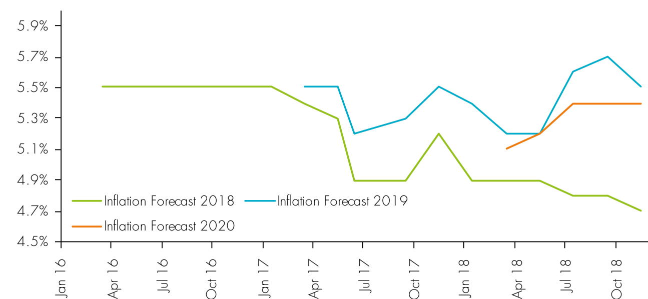
But don't write the struggling SA stock market off completely. A tough economy is one part of the equation, but the other part is the valuation, i.e. how much of the bad news is priced in already. Most measures suggest that it is offering the best value in years. Consumers stood in long queues for Black Friday bargains, but investors often run away when the stock market is on sale.

CHART 1: TECHNOLOGY SHARES AND THE US S&P 500



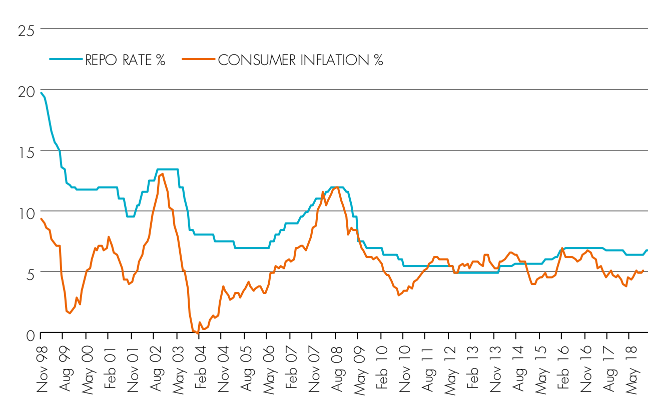
Source: Thomson Reuters Datastream

CHART 2: SA RESERVE BANK INFLATION FORECASTS, %



Source: Thomson Reuters Datastream

CHART 3: SA REPO RATE AND CONSUMER INFLATION, %



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$	1 984.0	-2.36%	-1.88%	-5.66%	-3.36%
United States	S&P 500	US$	2 633.0	-3.76%	-2.91%	-1.53%	1.39%
Europe	MSCI Europe	US$	1 550.0	-1.34%	-1.71%	-13.75%	-11.98%
Britain	FTSE 100	US$	8 909.0	-1.03%	-2.11%	-14.34%	-9.73%
Germany	DAX	US$	1 197.0	-2.29%	-2.37%	-12.51%	-16.59%
Japan	Nikkei 225	US$	191.6	-0.28%	-1.24%	-5.17%	-5.47%
Emerging Markets	MSCI Emerging Markets	US$	976.0	-1.01%	2.09%	-15.72%	-15.28%
Brazil	MSCI Brazil	US$	1 981.0	-2.99%	-2.75%	-2.08%	-2.80%
China	MSCI China	US$	72.8	-0.94%	4.25%	-17.71%	-19.38%
India	MSCI India	US$	532.9	-0.39%	5.11%	-12.78%	-9.37%
South Africa	MSCI South Africa	US$	451.0	1.35%	9.47%	-25.45%	-17.10%

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	50 698.0	-2.68%	-3.23%	-14.80%	-15.92%
All Share	All Share (Total Return)	Rand	7 413.0	-2.68%	-3.20%	-12.27%	-13.27%
TOP 40/Large Caps	Top 40	Rand	6 495.0	-2.87%	-3.45%	-12.80%	-15.03%
Mid Caps	Mid Cap	Rand	15 006.0	-0.10%	-0.19%	-11.60%	-5.63%
Small Companies	Small Cap	Rand	18 180.0	-3.38%	-2.89%	-13.52%	-8.13%
Resources	Resource 20	Rand	2 437.6	-6.42%	-10.18%	6.62%	1.52%
Industrials	Industrial 25	Rand	12 003.0	-1.04%	-1.63%	-20.59%	-25.14%
Financials	Financial 15	Rand	9 033.0	-2.62%	0.78%	-6.94%	3.79%
Listed Property	SA Listed Property	Rand	1 878.2	-0.34%	-0.36%	-23.77%	-18.94%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	Index Value	Week	Month-to-date	Year-to-date	1 Year
All Bond	BESA ALBI	Rand	628.7	1.34%	3.80%	6.98%	13.25%
Government Bonds	BESA GOVI	Rand	622.4	1.37%	3.88%	6.15%	12.44%
Corporate Bonds	SB JSE Credit Indices	Rand	107.7	-6.75%	-6.01%	-14.64%	-15.83%
Inflation Linked Bonds	BESA CILI	Rand	251.0	-0.25%	-1.38%	-0.65%	4.87%
Cash	STEFI Composite	Rand	407.9	0.13%	0.44%	6.51%	7.25%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	58.8	-12.25%	-21.60%	-12.24%	-6.67%
Gold	Gold Spot	US$	1 223.0	0.16%	0.66%	-5.71%	-5.12%
Platinum	Platinum Spot	US$	840.0	-0.24%	0.84%	-9.68%	-10.16%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	13.85	0.88%	6.69%	-10.60%	0.31%
ZAR/Pound	ZAR/GBP	Rand	17.75	1.07%	6.31%	-5.69%	4.06%
ZAR/Euro	ZAR/EUR	Rand	15.71	1.58%	6.35%	-5.42%	4.70%
Dollar/Euro	USD/EUR	US$	1.13	0.88%	0.09%	6.28%	5.31%
Dollar/Pound	USD/GBP	US$	1.28	0.16%	-0.11%	5.35%	3.79%
Dollar/Yen	USD/JPY	US$	0.01	0.12%	-0.01%	0.27%	1.67%

Source: I-Net, figures as at 23 November 2018

ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- RMB/BER Business Confidence Index
- FNB/BER Consumer Confidence Index
- Credit growth
- Producer inflation
- Trade balance

US

- House price index
- New home sales
- Personal income and spending
- Personal consumption inflation
- Minutes from previous FOMC meeting

EUROPE

- Eurozone loan growth
- Eurozone economic sentiment indices
- Eurozone inflation

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.