MARKET MATTERS

3 DECEMBER – 7 DECEMBER 2018

ENDING ON A SOUR NOTE

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Hopes of a pre-Christmas rally on global equity markets were dashed last week. The optimism around a thawing in US-China trade relations following the G20 Summit in Buenos Aires lasted barely a day before it became clear that there was widespread confusion over what exactly the two countries agreed to. US President Trump's message that "I am a tariff man" then set the cat properly among the pigeons. A day later, markets tumbled on the news that a top executive at Chinese telecoms giant Huawei had been arrested for alleged sanctions-busting in its dealings with Iran, a move that added renewed strain in the relationship between China and the US.

It seems very likely that these trade tensions will remain a feature of the investment landscape in 2019. Though it is in the economic interests of both sides to resolve the dispute, political pressures in both countries may make it difficult to back down. And Trump clearly has some strange ideas about how trade works, claiming that tariffs are taxes on foreigners when in fact they are paid by US customers. This reality is one reason why markets have been significantly more volatile this year.

INVERSION AVERSION

Lurking in the background behind the tariff turmoil is the concern that growth is slowing and that interest rates could end up too high. In the US, the difference between yields on long-dated and short-dated bonds – known as the yield curve – fell to the lowest level in a decade. An inverted yield curve – when short rates exceed long rates – has historically been a reliable recession indicator, showing that the market expects the central bank to be forced into rate cuts down the line.

Short-dated yields largely reflect market expectations of where the Federal Reserve will set interest rates, while longer-dated yields also include compensation for the uncertainty that comes with locking up an investment for long periods of time. In normal times, therefore, the yield curve would be quite steep, with long-dated yields much higher than short-dated yields. Short-dated yields have risen in lockstep with the Fed's hiking path, with another hike expected next week, but long-dated yields have fallen in recent weeks. The yield on two-year government bonds was 2.7% last week, but the 10-year yield fell to 2.85%, down from a seven-year high of 3.24% at the start of the month.

But it is important to note that an inverted yield curve does not cause a recession, it merely highlights the risk that it might take place. This distinction appears to have been missed by many investors over the past week, even though the yield curve has not actually inverted.

At any rate, it is not as if there have been new data releases over the past few days that point to a sudden and severe economic slowdown. The JPMorgan Global Purchasing Managers' Index, one of the broadest and timeliest indicators of global activity, rose to a three-month high level in November, consistent with solid global growth. However, underneath the healthy headline numbers there are pockets of weakness. Eurozone growth has slowed quite substantially, and manufacturing in China and other key exporters does appear to be taking strain from tariff interventions.

There is, however, increasing evidence that the cumulative impact of the Fed's past rate hikes (200 basis points in total since December 2015) is starting to squeeze interest rate-sensitive sectors, especially housing. A broad range of activity indicators in the housing market – sales, building permits, new construction – have declined during the course of the year and price growth has slowed. This should give the Fed reason to pause its rate hikes next year. Its preferred measure of price pressures, personal consumption expenditure inflation, was at 2% in October, down from a recent peak of 2.4% in July. Excluding fuel and food prices, the inflation rate dipped to 1.7%. A relatively strong dollar and lower oil prices are expected to put further downward pressure on inflation. Meanwhile, wage inflation, though rising, remains low by historic standards at 3.1% year-on-year in November, especially given how low the unemployment rate is (3.7%).

GOOD AND BAD NEWS

Local markets took their cue from global developments, and the JSE was under severe pressure along with other emerging markets. In terms of the domestic economy, there was good news and bad news.

The good news is that Stats SA data showed that the technical recession ended in the third quarter. The local economy expanded at an annual rate of 2.2% in real terms between the second and third quarters, after two consecutive negative quarters in the first half of the year. Compared to the third quarter of last year, the economy grew by 1.1% in real terms and 7.8% in nominal terms. Real growth rates indicate how living standards are improving (especially when compared to population growth), while nominal growth rates give us a yardstick to measure company revenue growth. Real growth has been stuck around 1% since early 2015 with nominal growth range bound between 6% and 8%.

The local economy is a low-flying aeroplane, vulnerable to turbulence that is merely inconvenient at 40 000 feet but can cause a crash at 10 000 feet. The bad news then is that load shedding, if it persists, can be such

an air pocket. In other words, things aren't getting worse, but there will be bumps along the way. But there is no indication of things getting much better either, especially now that the Reserve Bank is ignoring evidence of the underlying disinflationary pressures in the economy and tightening the screws. The uptick in new vehicle sales, an interest rate-sensitive sector, also appears to be petering out with 47 486 sold in November, 4.6% lower than a year ago. Exports are still looking solid though.

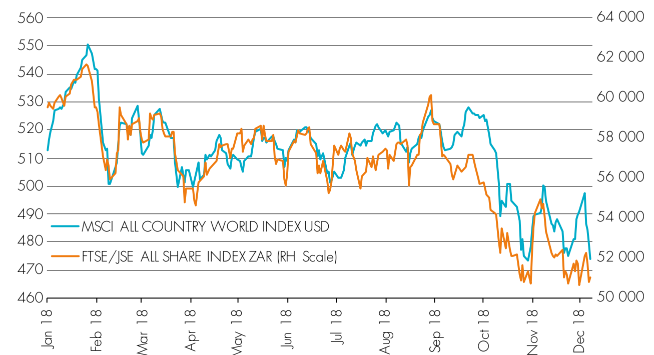
Real household consumption, the economy's main growth engine, is spluttering and was only 1.2% higher in the third quarter compared to a year ago. This is no surprise since the growth in the economy-wide wage bill slowed to 5.4% year-on-year, barely above inflation. Government's generous pay increases means its wage bill grew by 7.5% compared to a year ago, much higher than the private sector.

The Reserve Bank reported that the current account deficit was slightly larger in the third quarter, at R176 billion or 3.5% of GDP. The trade account posted a modest surplus, but the balance on the services, income and transfers account was in deficit, as it basically is on a permanent basis, since it largely reflects the outflows of interest payments to the foreigners who hold around 40% of South African government bonds. While the current account deficit has halved since its worst point in 2013, a 3.5% deficit puts South Africa in the wrong company as far as global investors are concerned, especially given a 4% of GDP budget deficit. This means that there is little scope for fiscal and monetary policy to stimulate the economy.

ENDING ON A SOUR NOTE

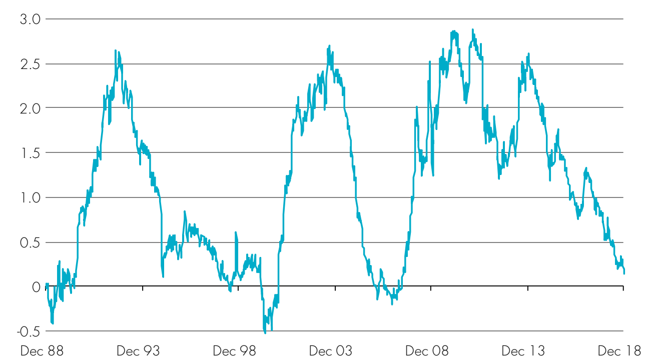
This is our last weekly market commentary for the year and unfortunately it is not ending on a happy note. As things stand, several key equity markets across the global could well end the year in the red. The JSE almost certainly will. Last week the index fell to a level it first reached in July 2014, meaning that the only returns over this four-year period came from dividends. This has been painful for our investors. However, many decades of stock-market history here and abroad suggest that such periods of weak performance are followed by periods of strong performance. We cannot predict when the cycle will turn, but here's to 2019 ushering in such a period.

CHART 1: GLOBAL AND LOCAL EQUITIES IN 2018



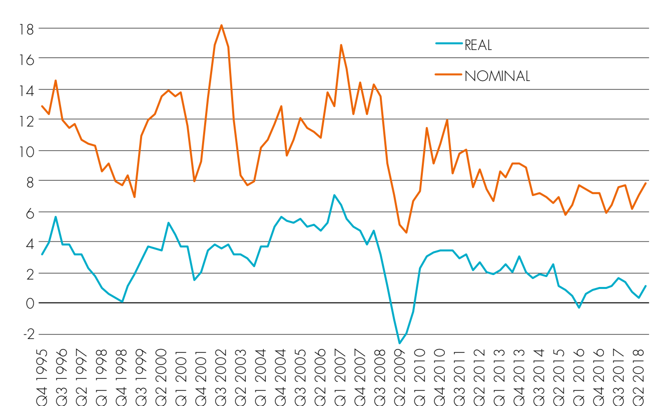
Source: Thomson Reuters Datastream

CHART 2: SPREAD BETWEEN YIELDS ON 10 YEAR AND 2 YEAR US GOVERNMENT BONDS, %



Source: Thomson Reuters Datastream

CHART 3: SOUTH AFRICAN YEAR-ON-YEAR ECONOMIC GROWTH %



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$	1 991.0	-2.45%	-2.45%	-5.33%	-3.54%
United States	S&P 500	US$	2 633.0	-4.60%	-4.60%	-1.53%	-0.15%
Europe	MSCI Europe	US$	1 505.0	-3.53%	-3.53%	-16.25%	-14.10%
Britain	FTSE 100	US$	8 631.0	-3.03%	-3.03%	-17.02%	-12.50%
Germany	DAX	US$	1 161.0	-3.49%	-3.49%	-15.19%	-18.81%
Japan	Nikkei 225	US$	192.3	-2.36%	-2.36%	-4.82%	-2.85%
Emerging Markets	MSCI Emerging Markets	US$	979.0	-1.61%	-1.61%	-15.46%	-11.08%
Brazil	MSCI Brazil	US$	1 957.0	-1.86%	-1.86%	-3.26%	0.67%
China	MSCI China	US$	73.7	-1.71%	-1.71%	-16.74%	-12.54%
India	MSCI India	US$	535.4	-4.16%	-4.22%	-12.37%	-7.68%
South Africa	MSCI South Africa	US$	437.0	-2.46%	-2.46%	-27.77%	-17.23%

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	51 038.0	0.74%	0.74%	-14.23%	-12.02%
All Share	All Share (Total Return)	Rand	7 474.0	0.81%	0.81%	-11.55%	-9.24%
TOP 40/Large Caps	Top 40	Rand	6 573.0	0.83%	0.83%	-11.75%	-10.23%
Mid Caps	Mid Cap	Rand	14 948.0	0.84%	0.84%	-11.94%	-4.90%
Small Companies	Small Cap	Rand	18 245.0	0.75%	0.75%	-13.21%	-8.88%
Resources	Resource 20	Rand	2 492.7	4.24%	4.24%	9.03%	11.57%
Industrials	Industrial 25	Rand	12 151.0	0.55%	0.55%	-19.61%	-20.07%
Financials	Financial 15	Rand	9 001.0	-2.11%	-2.11%	-7.27%	1.10%
Listed Property	SA Listed Property	Rand	1 859.6	-0.08%	-0.08%	-24.53%	-20.73%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	473.5	0.87%	0.87%	-2.31%	-1.76%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY					
All Bond	BESA ALBI	Rand	624.1	-0.80%	-0.80%	6.19%	10.82%
Government Bonds	BESA GOVI	Rand	617.5	-0.83%	-0.83%	5.32%	9.99%
Corporate Bonds	SB JSE Credit Indices	Rand	106.0	-1.75%	-1.75%	-15.98%	-15.16%
Inflation Linked Bonds	BESA CILI	Rand	252.0	0.10%	0.10%	-0.24%	3.46%
Cash	STEFI Composite	Rand	409.0	0.13%	0.13%	6.79%	7.25%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	61.3	3.67%	3.92%	-8.49%	-1.11%
Gold	Gold Spot	US$	1 248.0	2.13%	2.13%	-3.78%	0.08%
Platinum	Platinum Spot	US$	790.0	-1.00%	-1.00%	-15.05%	-11.53%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14.17	-2.12%	-2.15%	-12.64%	-3.11%
ZAR/Pound	ZAR/GBP	Rand	18.04	-2.05%	-2.05%	-7.21%	2.61%
ZAR/Euro	ZAR/EUR	Rand	16.15	-2.83%	-2.83%	-7.97%	0.14%
Dollar/Euro	USD/EUR	US$	1.14	-0.88%	-0.70%	5.35%	3.51%
Dollar/Pound	USD/GBP	US$	1.27	0.14%	0.53%	6.02%	6.02%
Dollar/Yen	USD/JPY	US$	0.01	-0.67%	-0.67%	0.05%	-0.81%

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

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ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Mining and manufacturing production
- Consumer inflation
- Retail sales

US

- Inflation
- Industrial production
- Retail sales

EUROPE

- UK parliament vote on Brexit agreement
- Germany ZEW Economic Sentiment Index
- Eurozone industrial production
- European Central Bank interest rate decision

JAPAN

- Current account balance
- Tankan survey

CHINA

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

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