MARKET MATTERS

14 JANUARY – 18 JANUARY 2019

OLD MUTUAL MULTI-MANAGERS

NO HIKE, BUT NO RELIEF EITHER

Dave Mohr and Izak Odendaal, Old Mutual Multi-Managers

The Monetary Policy Committee (MPC) of the SA Reserve Bank (SARB) left the repo rate unchanged at 6.75%, as widely expected. The decision was unanimous among MPC members. Even though the most recent inflation numbers (for November) showed a slight acceleration in the broad consumer price index to 5.2% year-on-year, the inflation outlook has improved since the late November. The MPC's statement also struck a more neutral tone, compared to the hawkish stance in November when it hiked by 0.25%. More specifically, the forecast model that the MPC uses as a guideline now projects only one more hike instead of four over the next two years.

INFLATION OUTLOOK SUBDUED

The Bank cut its inflation forecast to 4.8% in 2019 (down from 5.5%), and to 5.3% in 2020 (down from 5.4%). The change in forecast is largely due to a lower assumed oil price of $63 per barrel by year-end, instead of $73. The oil price has firmed up after its fourth quarter sell-off to breach $60 per barrel last week, but in rand terms it's still 3% lower than on the eve of the November meeting. And while Saudi Arabia and Russia have made noises about cutting output to raise the price, US oil production continues to surge higher, hitting a record 11.7 million barrels per day.

The rand depreciated during the global market sell-off in December, but since the start of the year has recouped those losses. Between the November and January MPC meetings, it appreciated 0.5% on a trade weighted basis.

Crucially, the US Federal Reserve (Fed) has signalled a more gradual pace of rate increases, which the market has broadly interpreted as the end of the hiking cycle. Though the MPC doesn't follow the Fed explicitly, it keeps a close eye on what the 'world's central bank' does. It has long worried that the Fed would hike aggressively, triggering capital flight from emerging markets and a sell-off in the rand, which could place upward pressure on inflation.

The low inflation environment was also visible in the post-festive season trading updates of local retailers. The Foschini Group reported product inflation of -1% in its local operations in the last quarter of 2018, while Woolworths reported 1.7% apparel inflation (according to Avior). Product inflation at Truworths was -1.5%. Mr Price reported slightly higher inflation for its basket of 5.8% in the three months to end December.

Looking at official retail sales numbers from StatsSA, which lag by two months, total growth in sales was 3.1% in real terms in November compared to a year ago and 5.5% in nominal terms, implying inflation in retail sales of around 2%. It appears that consumers are increasingly bringing forward Christmas spending from December to November to capitalise on Black Friday sales, indicative of the broad need to save money in tough times.

Total consumer inflation covers a broader basket of goods and services than what is available at retailers, including insurance, leisure, fuel and cars. It also includes electricity tariffs and municipal rates, which are not subject to market competition. The bottom line is that those prices that are set in a competitive market – such as retail – are under pressure. The sluggish local economy means companies are reluctant to raise prices, even when their input costs rise, because they worry about losing business.

The SARB expects real economic growth of 1.7% this year, rising to 2% next year. South Africa continues to lag global growth, which is expected to be 3.3% this year (down slightly from 3.5%), and if this forecast materialises, it is nowhere near fast enough to address unemployment. But it would represent a doubling of 2018's growth rate, which was probably 0.7%.

FALLING INFLATION EXPECTATIONS

It also appears that soft inflation is starting to alter expectations of future inflation. Inflation expectations as surveyed quarterly by the Bureau for Economic Research continue to decline, which is what the MPC wants. Its theoretical underpin is that as consumers and businesses anchor their expectations of the future, it changes their price-setting behaviour, which leads to lower and more stable inflation. On average, households, businesses, unions and analysts now expect inflation of 5.3% over the next five years. That is below the 6% upper-range of the inflation target, but above the mid-point, which is the MPC's de facto new target.

FOOD AND ELECTRICITY RISKS

There are some risks to the benign inflation outlook. There has been a substantial increase in maize prices over the past two months as large parts of the country received below-average rainfall during the planting season. Maize futures prices are up 32% year-on-year. However, food prices in the shop are never as volatile as at the farm gate. In January 2016, the maize price doubled from a year ago amidst the worst drought in a century, but the consumer inflation rate for bread and cereals peaked at 17% a few months later. High, but not nearly as severe.

According to the SARB, food price inflation, which was 2.7% in November, has bottomed, but is rising slower than expected. It expects global food prices to remain in deflation this year, which puts downward pressure on local prices.

The other wild card is Eskom's application for 15% per year tariff increases for the next three years to stave off effective bankruptcy.

Although it is unlikely that the National Energy Regulator (NERSA) will grant the full increase, given Eskom's well-documented inefficiencies, above-inflation tariff increases are likely, and the SARB has included a 10% increase per year assumption in its forecast.

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GETTING POLITICAL

At the press conference following the statement, most of the questions from journalists were around politics, not monetary policy. The ANC's election manifesto called for the nationalisation of the SARB, and for a more explicit focus on employment. The SARB is one of the few central banks in private hands, but that has never impacted its monetary policy decision-making. The Governor and his deputies are appointed by the President and the inflation target is set by National Treasury (and it already includes balanced and sustainable growth as part of the mandate). The independence of its monetary policy decision-making is also enshrined in the constitution and will not be impacted by nationalisation. This was reaffirmed by President Ramaphosa.

HIGH RATES GOOD FOR INVESTORS, BAD FOR ECONOMY

That is not to say that the SARB has always been correct in setting rates. It still views its monetary policy stance as 'broadly accommodative' even as the country has some of the highest real interest rates among major economies. However, the sluggish pace of credit growth and subdued household spending suggests it is not so accommodative.

Part of the reason is that the MPC views the country's growth problems as structural, not cyclical. In other words, problems like infrastructure bottlenecks, unnecessary red tape and skills shortages hold back the pace at which the economy can sustainably grow over time, rather than a lack of demand, which is cyclical. But it ignores the fact that the long term is made up of lots of short terms, and the 'structure' of the economy comprises successive cycles that each add to its overall productive capacity. Particularly, the low potential growth rate (estimated by the SARB at between 1% and 1.5%) is largely due to under-investment. This in turn is partly due to persistent weak demand, which is suppressed by high real interest rates.

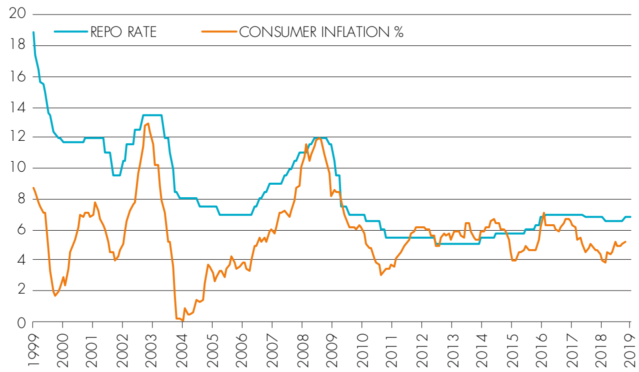
There are of course limits to this argument. Global markets will punish a loss of central bank credibility as we saw with Turkey and Argentina last year. So we are talking about changes of policy at the margin. However, the SARB's stance appears too tight at the margin.

Be that as it may, the Reserve Bank's stance is good for fixed income assets, where yields are already attractive. Long-term inflation should trend lower and the risk of short-term rate hikes has diminished. One of the questions that we'll address in coming weeks is whether we've entered 'a low-return environment' following last year's market rout. Certainly for bonds and fixed income more broadly, that is not the case.

CHART 1: RAND-DOLLAR EXCHANGE RATE

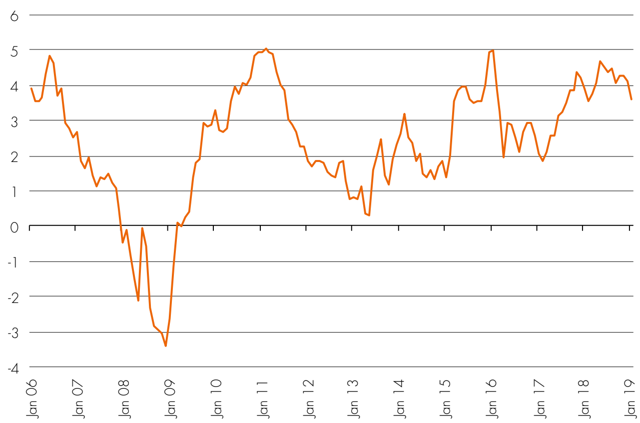
Source: Thomson Reuters Datastream

CHART 2: REPO RATE AND CONSUMER INFLATION, %



Source: Thomson Reuters Datastream

CHART 3: SOUTH AFRICAN REAL 10-YEAR GOVERNMENT BOND YIELD, %



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$	2 001.0	2.25%	6.21%	6.21%	-8.92%
United States	S&P 500	US$	2 671.0	2.89%	6.54%	6.54%	-4.54%
Europe	MSCI Europe	US$	1 560.0	1.17%	4.98%	4.98%	-16.84%
Britain	FTSE 100	US$	8 971.0	0.99%	4.50%	4.50%	-16.08%
Germany	DAX	US$	1 201.0	1.87%	5.72%	5.75%	-21.40%
Japan	Nikkei 225	US$	188.3	0.38%	3.09%	3.09%	-12.11%
Emerging Markets	MSCI Emerging Markets	US$	1 018.0	1.70%	5.38%	5.38%	-17.10%
Brazil	MSCI Brazil	US$	2 200.0	1.71%	13.17%	13.17%	-0.81%
China	MSCI China	US$	75.2	2.55%	6.85%	6.85%	-21.82%
India	MSCI India	US$	549.3	0.27%	-1.55%	-1.55%	-12.11%
South Africa	MSCI South Africa	US$	476.0	0.63%	6.97%	6.97%	-24.20%

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	53 731.0	0.15%	1.88%	1.88%	-11.81%
All Share	All Share (Total Return)	Rand	7 882.0	0.17%	1.97%	1.97%	-8.96%
TOP 40/Large Caps	Top 40	Rand	6 959.0	0.20%	1.90%	1.90%	-9.16%
Mid Caps	Mid Cap	Rand	15 517.0	-0.81%	1.26%	1.26%	-8.77%
Small Companies	Small Cap	Rand	18 448.0	-0.05%	2.75%	2.75%	-12.54%
Resources	Resource 20	Rand	2 695.4	-0.23%	0.11%	0.11%	10.69%
Industrials	Industrial 25	Rand	12 705.0	0.32%	2.34%	2.34%	-18.20%
Financials	Financial 15	Rand	9 626.0	0.50%	3.41%	3.41%	-0.69%
Listed Property	SA Listed Property	Rand	1 911.0	1.94%	3.80%	3.80%	-17.13%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	479.5	-0.46%	0.12%	0.12%	-1.57%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY					
All Bond	BESA ALBI	Rand	635.9	-0.87%	0.44%	0.44%	6.89%
Government Bonds	BESA GOVI	Rand	629.5	-0.89%	0.45%	0.45%	6.03%
Corporate Bonds	SB JSE Credit Indices	Rand	102.2	-0.07%	0.30%	0.30%	-20.97%
Inflation Linked Bonds	BESA CILI	Rand	257.4	0.83%	1.57%	1.57%	2.47%
Cash	STEFI Composite	Rand	412.3	0.14%	0.35%	0.35%	7.25%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	62.7	3.31%	16.02%	16.02%	-9.20%
Gold	Gold Spot	US$	1 281.0	-0.47%	0.00%	0.00%	-3.54%
Platinum	Platinum Spot	US$	795.0	-1.61%	0.25%	0.25%	-20.34%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	13.84	-0.10%	3.68%	3.66%	-12.16%
ZAR/Pound	ZAR/GBP	Rand	17.83	-0.34%	2.75%	2.75%	-5.33%
ZAR/Euro	ZAR/EUR	Rand	15.73	0.81%	4.69%	4.69%	-5.42%
Dollar/Euro	USD/EUR	US$	1.14	0.88%	0.61%	0.61%	7.02%
Dollar/Pound	USD/GBP	US$	1.29	-0.26%	-0.57%	-0.57%	7.97%
Dollar/Yen	USD/JPY	US$	0.01	1.12%	0.16%	0.16%	-1.04%

Source: I-Net, figures as at 18 January 2019

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

- Consumer inflation

US

- Existing home sales
- Flash manufacturing purchasing managers' index

EUROPE

- European Central Bank interest rate decision
- ZEW Germany sentiment index
- Eurozone consumer confidence
- Flash manufacturing purchasing managers' index

CHINA

- Q4 GDP growth
- Retail sales
- Industrial production

JAPAN

- Trade balance
- Tokyo consumer inflation
- Flash manufacturing purchasing managers' index

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