THE RIGHT RESERVE BANK DEBATE

Dave Mohr and Izak Odendaal, Old Mutual Multi-Managers

President Ramaphosa's announcement that the government intends to push ahead with nationalising the SA Reserve Bank ruffled feathers recently. The Reserve Bank is one of a handful of privately owned central banks in the world, but its leadership is appointed by the government. Importantly, its operational independence – how it sets interest rates and regulates banks - is written into the Constitution, and a change from private to public ownership won't change this. Moreover, the President already appoints the Governor, and the inflation target is set by National Treasury. This is low on the list of things investors should worry about now. Rather, the nationalisation issue is a distraction from a more important debate: what is the appropriate level of interest rates for South Africa?

This is, of course, a question that is asked around the world, and a number of central banks have shifted their views in the past two months. Most prominently has been the Federal Reserve (the Fed), central bank of the US. Since all financial markets directly or indirectly price off US interest rates, the Fed is effectively also the central bank for the rest of the world. After hiking interest rates gradually between December 2015 and December 2018 and reversing its bond buying programme (QE), the Fed is now pausing to assess the impact of this removal of stimulus. Fed chair Jerome Powell has been vocal in reiterating this newfound patience in speeches and interviews to the extent that the market no longer prices in any rate hikes. Particularly notable is that Powell does not believe rising wages will result in rising inflation, and will therefore welcome the fact that wage growth is at the fastest pace so far in this expansion. This in turn should support consumer spending, the biggest part of the US economy.

As long as inflation remains muted (US inflation dipped to a 30-month low of 1.5% in February) and global growth risks tilted to the downside, this is probably correct. The Fed's monetary policy meeting this week will be key in giving markets further guidance, particularly in the form of the quarterly 'dot plot', the summary of Fed officials' individual views.

The Bank of Japan (BoJ) kept its policy interest rate at negative levels, while noting the risks of further economic weakness. Along with other countries, Japanese exports and industrial production have slowed substantially in recent months. Against this backdrop, the BoJ is even less likely to meet its ever-elusive 2% inflation goal. It might have to find new ways of stimulating the economy, but has limited options.

A few other central banks that were in hiking mode, notably those of Australia and Canada, are also pausing. The most recent shift has taken place at the European Central Bank (ECB). Prior to this month, it was still planning on commencing with interest rate hikes later this year. This has been pushed back to next year after a substantial cut in the growth forecast for the Eurozone from 1.7% to 1.1%, while the inflation forecast has been cut from 1.6% to 1.2% (compared to targeted inflation of just below 2%).

The ECB also announced a new round of cheap funding for banks. It must be said that the ECB's track record is not fantastic. It prematurely hiked rates in 2011, and was forced to reverse course. It was also late to the party in launching a quantitative easing programme of its own. But its task is also much more complex than that of other central banks in that it has to set interest rates for a number of very different countries, where there are also divergent views on the ultimate role of a central bank. The German 'hard money' view is that inflation has to be fought at all costs, while the Southern European tradition has always favoured growth over price stability.

Since early 2018, the Eurozone has experienced the sharpest slowdown of all the major economies, though from a surprisingly strong base in 2017. The Eurozone is particularly exposed to global growth and exports make up a much larger part of its economy than is the case in the US, China or Japan. As such, European, particularly German, businesses are vulnerable to a slowdown in global trade as well as the uncertainty caused by US President Trump's trade wars and the UK's shambolic departure from the European Union. (The UK parliament may have voted to extend the Brexit deadline, but this just prolongs the uncertainty; and we are no closer to knowing whether Brexit will be hard or soft, or not happen at all.)

Another reason behind slowing global growth is simply the impact of rising borrowing costs (and tightening financial conditions in general) across the developed world over the past year or two as central banks aimed to return interest rates to something approximating normal and markets tried to price in how this plays out over time. That drain on growth has now halted and is being reversed somewhat and should support economic activity in the coming months. Central banks are reversing course just in time.

China's central bank is not independent, but then all institutions in China are subservient to the Communist Party. This arrangement does have some advantages. When Beijing changes policy, implementation tends to be swift. It has cut the growth target to 6-6.5% from "around" 6.5% last year. These growth targets have shifted lower over the years as China's economy has matured. 2018 saw growth of 6.6%, the slowest pace since 1990. Whether the growth numbers are accurate is not the point here. The new target suggests the authorities do not want a sharp deceleration and will take further steps to prop up growth.

WEAK GROWTH, MUTED OUTLOOK

Which brings us back to South Africa, and the right level of interest rates. Although the economy posted positive growth in the fourth quarter, with real gross domestic product rising by 1.4% on an annualised basis in the fourth quarter of last year, it remains anaemic. Growth in 2018 was 0.8%, but it was a year of two halves, with annualised growth of -1.6% in the first two quarters and 2% in the final two. Growth should improve in 2019 – indeed, it should almost double from a low base if the consensus expectation of 1.5% is met – but getting to a measly 2% real growth will feel like a real achievement. And if there is further sustained load shedding, 1.5% will also seem out of reach.

Other recent data releases add weight to this view. Mining production contracted by 3.3% year-on-year in January, though economists expected a slightly worse outcome. Manufacturing output posted positive growth, but

only barely. The 0.3% year-on-year growth in January was behind the consensus expectation of 1.2%. With economic activity stumbling along, sentiment also remains weak. The RMB/BER Business Confidence Index, which has tracked sentiment in bellwether sectors since the 1970s, is a reliable leading indicator of fixed investment spending. Unfortunately, it declined from 31 to 28 index points in the first quarter. A cocktail of negative factors, including load shedding (which came back with a vengeance last week), strikes and political uncertainty ahead of the May general elections (including noise around land reform and the nationalisation of the Reserve Bank), have all weighed on business confidence. But the biggest factor is probably simply that firms are not seeing much demand for their products and services, but still face rising input costs.

Nominal economic growth, adding back inflation, was 4.5% in the fourth quarter from a year ago. This is the total growth in rand income that is available to SARS to tax, and for company and household income. But government's 10-year borrowing cost is 9% and the borrowing cost for households, the prime overdraft rate, is 10.25%, more than twice nominal national income growth. Interest rates are therefore squeezing the economy. There is also little support from fiscal policy, as the government has to tighten its belt to reduce debt growth, but also to bail out struggling state-owned enterprises, particularly Eskom.

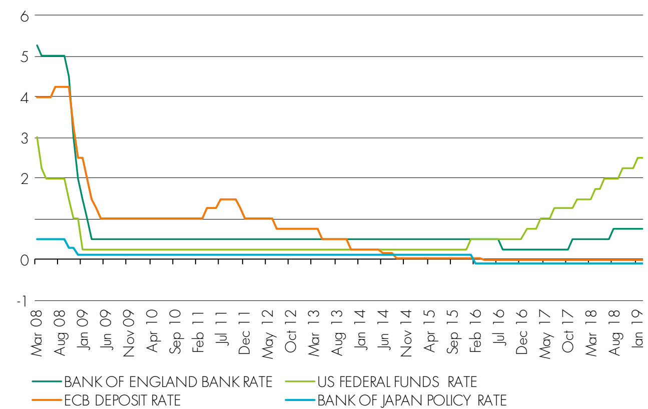
Indeed, Eskom faces additional pressure after the energy regulator Nersa granted far lower tariff increases than it applied for. However, from the consumer's point of view, the tariff increases are steep. Including the claw-back of certain past revenue under-recoveries, the effective tariff increases will be in the region of 13%, 8% and 5% over the next three years. This will add to headline inflation, but is generally in line with most forecasts, including the SARB's assumptions. It is notable that inflationary pressures in South Africa largely stem from quasi-taxes such as electricity tariffs that are not subject to competition or influenced by consumer demand. Where there is choice and competition, price increases are certainly not above the Reserve Bank's 4.5% target. Moreover, as with the big petrol price hike this month, the ability of firms to pass on rising input costs is restricted, so second round inflationary pressures are unlikely. Taking a longer view, these administered price increases can in fact be considered deflationary, in the sense that consumers have little choice and have to pay them, leaving less money for other purchases.

BETTER A LENDER THAN A BORROWER BE

Global central banks are leaning away from tighter monetary policy towards a neutral or even loosening stance, since inflation remains low and growth is sliding. Locally, we have similar conditions of weak growth and muted inflation, but the Reserve Bank has hinted at further hikes. Perhaps next week's meeting will see a shift in tone.

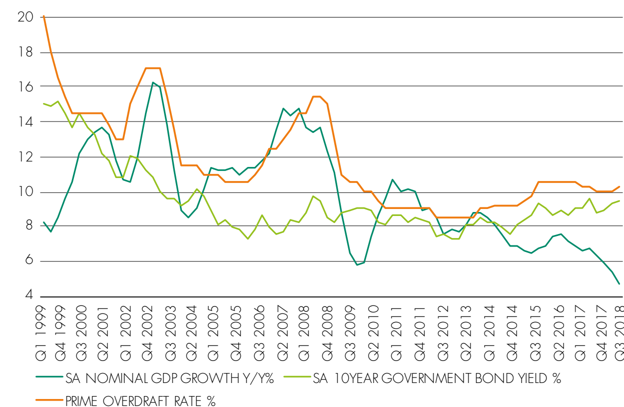
But in the meantime, with high real interest rates, it is better to be a lender than a borrower. In other words, investing in fixed interest is attractive, including longer-dated government bonds that offer substantial real yields. Although there is a risk of South Africa losing its final investment grade rating (from Moody's), the elevated yield suggests we are very much priced as junk status.

CHART 1: POLICY INTEREST RATES IN MAJOR DEVELOPED MARKETS%



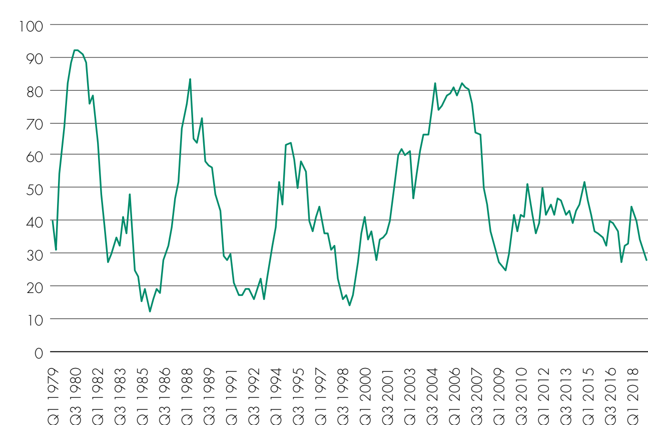
Source: Refinitiv

CHART 2: PRIME OVERDRAFT RATE AND ANNUAL NOMINAL ECONOMIC GROWTH%



Source: Refinitiv

CHART 3: BER/RMB BUSINESS CONFIDENCE INDEX



Source: Refinitiv

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 109.0	2.83%	1.10%	11.94%	-1.13%
United States	S&P 500	US$	2 822.0	2.88%	1.36%	12.56%	2.73%
Europe	MSCI Europe	US$	1 659.0	3.69%	1.65%	11.64%	-6.80%
Britain	FTSE 100	US$	9 609.0	3.93%	2.41%	11.93%	-3.44%
Germany	DAX	US$	1 246.0	2.89%	1.14%	1.17%	-13.29%
Japan	Nikkei 225	US$	192.4	1.74%	0.21%	-1.39%	-6.15%
Emerging Markets	MSCI Emerging Markets	US$	1 057.0	2.62%	0.57%	9.42%	-13.08%
Brazil	MSCI Brazil	US$	2 205.0	5.10%	1.75%	13.43%	-2.52%
China	MSCI China	US$	82.2	3.06%	1.66%	16.79%	-15.11%
India	MSCI India	US$	587.8	4.20%	7.66%	5.34%	0.83%
South Africa	MSCI South Africa	US$	460.0	1.10%	-2.54%	3.37%	-25.57%

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	56 040.0	0.99%	0.07%	6.26%	-3.72%
All Share	All Share (Total Return)	Rand	8 261.0	1.20%	0.52%	6.87%	-0.60%
TOP 40/Large Caps	Top 40	Rand	7 302.0	1.12%	0.51%	6.93%	-0.73%
Mid Caps	Mid Cap	Rand	16 074.0	1.43%	0.22%	4.89%	-1.95%
Small Companies	Small Cap	Rand	17 685.0	0.28%	-0.79%	-1.50%	-13.82%
Resources	Resource 20	Rand	3 040.0	1.99%	1.67%	12.91%	35.16%
Industrials	Industrial 25	Rand	13 262.0	1.34%	1.61%	6.82%	-10.01%
Financials	Financial 15	Rand	9 433.0	-0.17%	-3.09%	1.33%	-5.98%
Listed Property	SA Listed Property	Rand	1 886.8	-1.62%	-0.49%	2.49%	-9.11%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	485.5	0.43%	0.43%	1.37%	-0.83%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	Index Value	Week	Month-to-date	Year-to-date	1 Year
All Bond	BESA ALBI	Rand	653.0	0.01%	0.67%	3.14%	4.85%
Government Bonds	BESA GOVI	Rand	646.6	0.00%	0.69%	3.19%	4.23%
Corporate Bonds	SB JSE Credit Indices	Rand	102.9	0.11%	0.01%	0.94%	-20.11%
Inflation Linked Bonds	BESA CILI	Rand	256.1	-0.16%	-0.22%	1.05%	2.00%
Cash	STEFI Composite	Rand	416.8	0.14%	0.29%	1.45%	7.26%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	67.0	1.96%	1.50%	24.06%	3.06%
Gold	Gold Spot	US$	1 302.0	0.31%	-1.66%	1.64%	-1.74%
Platinum	Platinum Spot	US$	829.0	1.59%	-4.93%	4.54%	-13.74%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14.39	0.37%	-2.10%	-0.26%	-17.29%
ZAR/Pound	ZAR/GBP	Rand	19.15	-1.88%	-2.45%	-4.33%	-13.42%
ZAR/Euro	ZAR/EUR	Rand	16.31	-0.57%	-1.79%	0.96%	-10.25%
Dollar/Euro	USD/EUR	US$	1.13	-0.88%	0.62%	1.50%	8.85%
Dollar/Pound	USD/GBP	US$	1.33	-2.09%	0.05%	-3.71%	4.57%
Dollar/Yen	USD/JPY	US$	0.01	0.28%	0.09%	1.72%	4.83%

Source: I-Net, figures as at 15 March 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

- Inflation
- Retail sales

US

- Federal Reserve interest rate decision
- Factory orders
- Flash Markit Purchasing Managers' Index

EUROPE

- Eurozone trade balance
- Eurozone wage growth
- Germany ZEW Economic Sentiment Index
- UK inflation
- Bank of England interest rate decision
- Flash Markit Purchasing Managers' Index

JAPAN

- Trade Balance
- Inflation
- Flash Markit Purchasing Managers' Index

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