SQUARING THE CIRCLE

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Expectations of global economic growth are being cut, but equity markets both here and abroad have zoomed ahead this year. How does this circle get squared?

GLOBAL SLOWDOWN

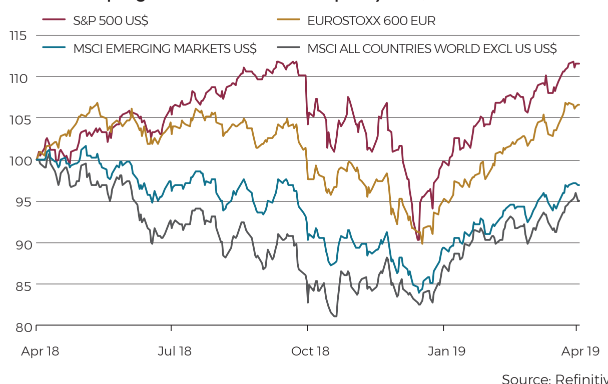
The International Monetary Fund (IMF) cut its forecast for 2019 global economic growth from 3.5% to 3.3%. If realised, this would be the slowest growth rate since 2009. In contrast to the much-heralded synchronised global upswing of 2017, the IMF warned of a synchronised slowdown with the forecasts of all major economies lowered (China is the notable exception). The IMF does expect global growth to rebound to 3.6% next year.

Moreover, profit growth is also expected to slow substantially this year. US companies will start reporting on first quarter earnings this week and the consensus expectation is that there will be a decline. For 2019 as a whole, consensus S&P 500 earnings growth is down to 3.5% compared to 24% for 2018, although last year was an outlier, with profits boosted by corporate tax cuts. The earnings growth expectation for next year rises to 11%. Outside the US, earnings growth for the MSCI All Countries ex US Index is expected to decline from 6.6% in 2018 to 5.5% in 2019, before rising to 9.5% next year.

EQUITIES UP STRONGLY

And yet, the FTSE/JSE All Share Index has returned 10% year to date, closing above 58 000 points for the first time since August last year. The US benchmark S&P 500 has delivered 15% with the tech-heavy Nasdaq gaining 19%. Even in struggling Europe the benchmark indices are up around 14% in euros. With the rand slightly stronger against major currencies year-to-date, local investors have mostly benefited from the gains on local and global markets this year. However, it must be noted that none of the major local or global indices have surpassed previous peaks, indicating the severity of the late-2018 sell-off.

Chart 1: Major global indices over the past year (total returns, rebased to 100)



Source: Refinitiv

Clearly then, the market is looking beyond the recent slowdown in global growth and company profits, and pricing in an improvement later this year. A big reason is that trade talks between the US and China seem to be progressing well, with the announcement of a comprehensive agreement expected in the coming weeks. Meanwhile, attempts by Chinese authorities to lift growth in the world's largest economy appear to be gaining traction. However, the US is now considering tariffs on European aerospace imports, claiming unfair state assistance to Airbus, the main competitor of US-based Boeing. This is a reminder that trade concerns will likely remain elevated for the duration of the Trump administration, even if deals are signed along the way.

The other major factor is that the risk of central banks hiking interest rates too quickly has all but disappeared and the market is now pricing in cuts, even in the US. Overall recession risk in the US, still the world's largest economy with an outsized impact on global markets, remains low. March jobs data showed a strong bounce after February's disappointment. Wage growth is still muted around 3% despite an unemployment rate close to record lows at 3.8%. Inflation is also still low. Years of zero interest rates and bond buying by the Federal Reserve has only resulted in core consumer inflation of 2% in March.

INVERSION AVERSION

The dreaded inversion of yield curve, a traditional US recession warning sign, has also not lasted. The yield curve is the difference between short and long-dated bond yields, and after briefly turning negative, has turned positive, meaning longer-dated yields have risen relative to shorter-dated yields. Long bond yields reflect expectations of future growth, inflation and interest rates, while shorter-date bond yields reflect near-term interest rate moves by the central bank.

The bottom line is that while many investors and commentators have obsessed about the slope of the yield curve, longer-term rates have declined compared to six months ago. This should support economic activity by reducing the cost of servicing debt (or rolling over debt) for existing borrowers and making debt cheaper for new borrowers. For instance, in the US, the interest rate on home loans is linked to long-bond yields and not short-term central bank interest rates, as is the case in South Africa. Therefore, home loan rates in the US have declined by almost a fifth since November from 5% to 4% and home loan applications have shot up.

In the case of the Eurozone, there is less conviction that no recession looms. The European Central Bank maintained its policy stance last week, pledging that zero to negative interest rates will prevail for the remainder of the year, while it will continue to reinvest maturing bonds in its portfolio. It also claims to stand ready to act should the growth outlook worsen, but in truth there is not much it can do. Deeply unconventional stimulus policies have only seen core consumer inflation at around 1%. Most borrowing in Europe is done through the banking system (in the US more companies issue bonds) and European banks are still in bad shape, constraining the flow of credit despite record low interest rates. European households are in decent health, with good job and wage growth and low inflation. However, consumer spending is a smaller share of the Eurozone economy than of the US, with manufacturing and exports more important, particularly in Germany.

One seemingly positive development has been an agreement between the UK and European Union to shift the Brexit deadline to 31 October. While it does prolong some of the uncertainty associated with Brexit, it also decreases the likelihood of a damaging no-deal withdrawal.

OIL RISK

The rising oil price also poses a risk. Oil prices rose steadily through the course of 2017 and 2018, peaking at $85 per barrel and contributed to the slowdown in global growth. The oil price then slumped sharply. Renewed conflict in Libya, sanctions on Venezuelan and Iran and Saudi cutbacks have now all conspired to push Brent crude above $70 per barrel. With US production still near record levels of 12 million barrels per day (more than any other country) and demand clearly under pressure amid the global slowdown, it seems unlikely that oil will stay at these levels. But as long as it does, it can cause some damage.

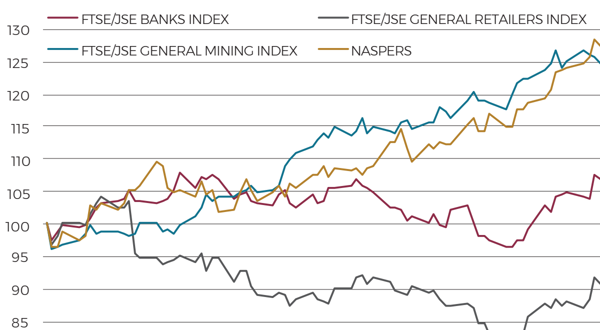
Chart 2: Brent crude oil, dollars per barrel

Source: Refinitiv

LOCAL GROWTH STUCK IN A LOW GEAR

In the case of South Africa, it is easier to understand the apparent disconnect between rising share prices and a gloomy economic outlook. The JSE has been led this year by its mining and global consumer companies, in particular heavyweights Naspers, Anglo American, BHP and British American Tobacco. On the contrary, firms that primarily sell goods and services locally, such as banks and retailers, have seen their share prices languish (or worse).

Chart 3: Divergent performance on the JSE



Source: Refinitiv

The IMF cut its outlook for 2019 local economic growth to 1.2% from 1.4% and to 1.5% for 2020, citing persistent policy uncertainty. Last week's dismal mining and manufacturing output numbers show a weakening trend in activity even before March's stage four load-shedding. Given the lower economic growth outlook and higher government borrowing announced in the February Budget, it came as a surprise to many that Moody's did not downgrade South Africa's last investment grade rating. In fact Moody's did not issue a ratings decision at all, but rather just published a review note. Moody's argue that their rating already reflects many of the most pertinent issues such as slow growth, rising government debt and Eskom's dire finances. For instance, it started the year with a growth forecast of 1.3% that was already lower than the consensus. Moody's once again highlighted South Africa's institutional strength, particularly the independence of the Reserve Bank, as a factor supporting its current rating, but clearly it too wants to see to what extent policy reforms are implemented after the election.

In any event, much like the IMF's growth forecasts, credit ratings agencies tend to tell the market what it already knows and therefore what it has already priced in. Emerging market government bonds have rallied and the gap (or spread) between these yields and safe-haven US yields have narrowed since the Fed pivoted to a patient interest rate stance (Argentina and Turkey are notable exceptions). South Africa's spreads are, however, still very much in line with other junk status economies, reflecting all the known risks about the government's creditworthiness. Meanwhile bonds have delivered solid returns so far this year, ahead of cash and inflation. Local fixed income yields remain attractively high, in stark contrast to developed markets.

TIME, NOT TIMING

The equity market rally so far this year might seem too much too fast, but then markets don't move in a neat straight line. Rather, what looks like a fairly smooth upward trajectory over time is in fact made up of several jerks higher, interspersed by periods of sideways and downward movement (in contrast to the upward trajectory of company profits and dividend pay-outs, which are in fact rather gradual). Missing out on such upward surges greatly limits the returns investors earn from equities over time. To put it differently, the JSE All Share has delivered more than a year's worth of money market returns in the first 16 weeks of 2019 and global markets even more. While the market slump late last year clearly presented a buying opportunity, no one could've predicted how rapidly markets would snap back. Hence the old adage, it's about time in the markets, not timing the markets.

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 159,0	0,42%	2,42%	14,60%	3,25%
United States	S&P 500	US$	2 907,0	0,48%	2,58%	15,96%	9,12%
Europe	MSCI Europe	US$	1 684,0	0,66%	3,00%	13,32%	-6,03%
Britain	FTSE 100	US$	9 722,0	0,14%	2,47%	13,24%	-5,85%
Germany	DAX	US$	1 275,0	0,95%	4,85%	4,87%	-11,70%
Japan	Nikkei 225	US$	195,3	0,06%	2,10%	0,94%	-3,22%
Emerging Markets	MSCI Emerging Markets	US$	1 089,0	0,37%	2,93%	12,73%	-7,48%
Brazil	MSCI Brazil	US$	2 037,0	-4,50%	-2,11%	4,78%	-7,62%
China	MSCI China	US$	86,0	0,69%	3,79%	22,14%	-5,91%
India	MSCI India	US$	598,9	-0,06%	0,48%	7,32%	2,19%
South Africa	MSCI South Africa	US$	503,0	2,86%	8,87%	13,03%	-12,98%

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	58 405,0	1,09%	3,44%	10,75%	3,41%
All Share	All Share (Total Return)	Rand	8 678,0	1,41%	3,98%	12,26%	6,94%
TOP 40/Large Caps	Top 40	Rand	7 725,0	1,59%	4,29%	13,12%	8,10%
Mid Caps	Mid Cap	Rand	16 143,0	1,01%	2,51%	5,34%	-1,02%
Small Companies	Small Cap	Rand	17 436,0	-0,11%	0,54%	-2,89%	-16,43%
Resources	Resource 20	Rand	3 208,7	-0,03%	2,58%	19,18%	40,39%
Industrials	Industrial 25	Rand	14 112,0	2,45%	4,47%	13,67%	-0,49%
Financials	Financial 15	Rand	9 821,0	1,50%	5,96%	5,50%	1,26%
Listed Property	SA Listed Property	Rand	1 903,7	1,02%	1,91%	3,41%	-8,34%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	487,9	0,16%	-0,32%	1,88%	-0,55%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	664,4	0,12%	1,13%	4,93%	5,04%
Government Bonds	BESA GOVI	Rand	658,0	0,11%	1,15%	5,01%	4,61%
Corporate Bonds	SB JSE Credit Indices	Rand	97,8	0,19%	0,57%	-4,03%	-19,30%
Inflation Linked Bonds	BESA CILI	Rand	256,0	0,22%	0,49%	0,99%	-2,05%
Cash	STEFI Composite	Rand	419,1	0,14%	0,27%	2,01%	7,27%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	71,5	1,49%	5,12%	32,37%	-0,72%
Gold	Gold Spot	US$	1 291,0	0,00%	-0,08%	0,78%	-4,30%
Platinum	Platinum Spot	US$	888,0	-1,11%	4,96%	11,98%	-4,21%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	13,96	0,97%	3,85%	2,83%	-13,58%
ZAR/Pound	ZAR/GBP	Rand	18,25	0,66%	3,56%	0,38%	-5,97%
ZAR/Euro	ZAR/EUR	Rand	15,77	0,19%	3,11%	4,44%	-5,71%
Dollar/Euro	USD/EUR	US$	1,13	-0,88%	-0,71%	1,50%	8,85%
Dollar/Pound	USD/GBP	US$	1,31	-0,27%	-0,55%	-2,08%	8,63%
Dollar/Yen	USD/JPY	US$	0,01	0,22%	1,01%	2,17%	4,32%

Source: I-Net, figures as at 12 April 2019

ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Inflation
- Retail sales

US

- Industrial production
- Retail sales
- Flash Markit Purchasing Managers' indices
- Leading indicator
- Housing starts and building permits

EUROPE

- Germany ZEW Economic Sentiment Index
- Eurozone Flash Markit Purchasing Managers' indices

CHINA

- First quarter GDP growth
- Industrial production
- Fixed asset investment
- Retail sales

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