Communiqué

Monthly

South Africa

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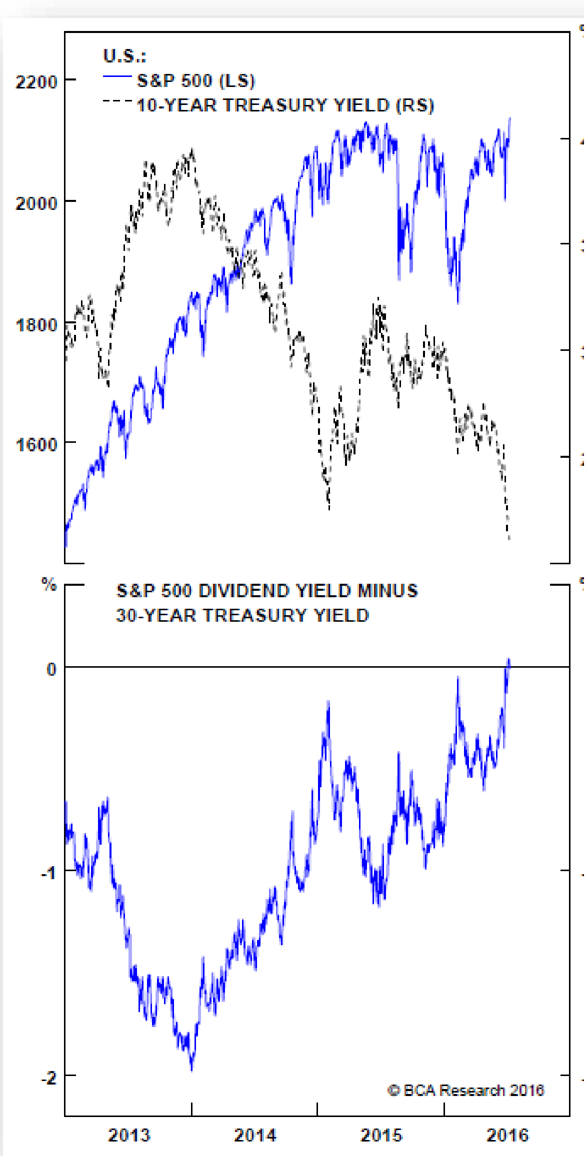
Stuck in a rut!

Abroad

Economic growth in all the major economies remains disappointing accompanied by weak growth in median family incomes in most countries. Following Brexit, the main risk to medium term growth projections is the rise of populism which will present a hostile environment for businesses and consumers alike. Companies will likely not embark on meaningful investment which could negatively impact employment and ultimately private consumption. This together with a weak credit environment will likely cause global interest rates to remain low for a protracted period. Growing voter dissatisfaction regarding the economic status quo will likely put pressure on governments to lower fiscal austerity which will put a floor under bond yields which are trading at record lows and negative in real terms across Europe.

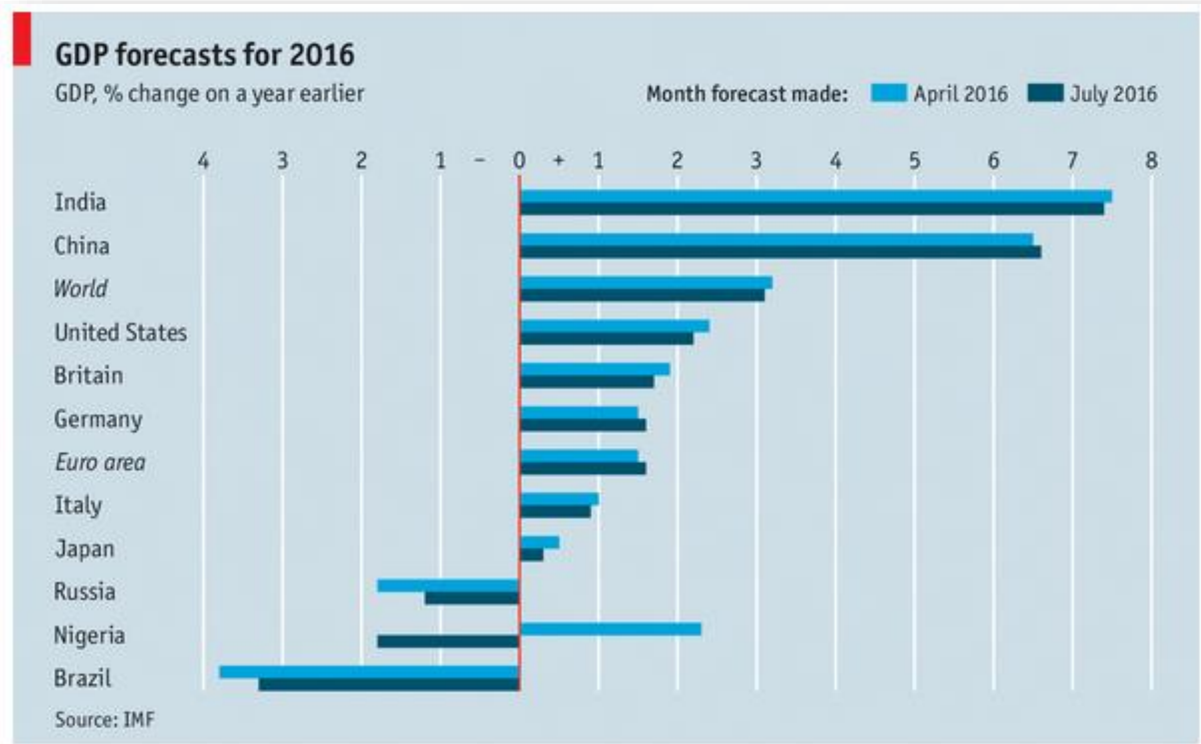
Record low bond yields and high equity markets are interpreting things very differently. Bond yields are suggesting no economic growth accompanied by deflation whereas equity markets are suggesting better economic prospects with rising inflation. According to research done by BCA (See chart) the dividend yield on the S&P 500 is on par with the yield on 30 year bonds. This compares to an average negative yield gap of 380 basis points over the past 50 years. So which market is right?



Source: BCA July 12

A contributing factor that drove down bond yields undoubtedly has been the large amounts of monetary stimulus by central banks but nevertheless, bonds yields at current levels are consistent with a low economic growth and therefor low inflationary environment.

If the economic outlook is rather poor, then why are equities in the US at record levels? The answer to this is more than likely that until the end of last year, corporate earnings were growing strongly despite a sluggish economy due to record operating margins as companies were not employing that much and also due to the fact that general wage increases were very subdued. The average wage of a blue collar worker in the US is at the same level currently as it was in 2008! This together with low interest rates underpinned the equity market as global investors favoured the US (read strong dollar) as growth there compared to Europe was and is much better. Furthermore, the search for yield should continue to support equities due to the low yields on bonds. So, low bond yields are in effect supporting equity valuations! At current levels, the US equity market appears expensive but where else can investors get a better yield compared to bonds? Monetary conditions in the US remain accommodative and a recession does not appear likely. One could therefore argue that stock prices are in fact not indicative of a better economic outlook but they are where they are because of the yields they offer and the likelihood that the FED will remain accommodative for some time still. Let's hope that fundamental factors (growth and earnings) improve in due course to support the heady valuations. We are also still hoping that further stimulus both there and in Europe will eventually lead to better economic growth.



Source: Economist, July 16

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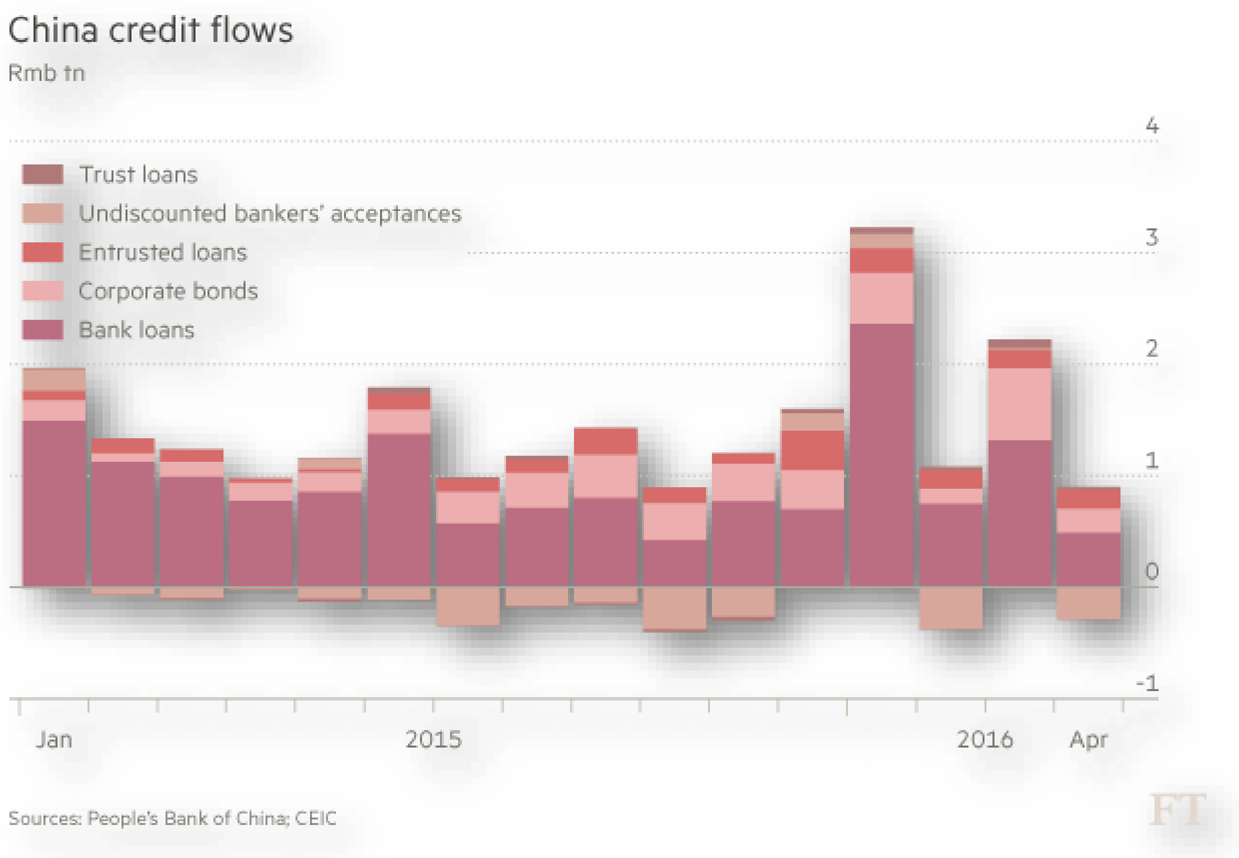
Given the above, one can argue that from a risk point of view, capital preservation rather than capital appreciation might be a central theme going forward, hence bond yields will likely remain firm or stable at least.

The hunt for yield is having a positive impact on emerging markets as witnessed by the recent strong inflows into both bond and equity markets. The continues derating in equities has led to far more attractive valuations in these markets compared to some developed markets.

There are mounting concerns that the Chinese economy is due for a hard landing but we don't think that will be the case. Chinese authorities have been walking a fine line between dealing with excess capacity and supporting economic growth. For a while now, authorities have viewed the slowdown in growth as an acceptable cost for rebalancing the economy but it now appears that there is a renewed focus to ensure faster economic growth. The government has embarked on fiscal stimulus and has backed off on attempts to curtail credit growth which is growing at a steady pace.



Source: Financial Times July 2016

Usually a credit-fuelled boom in real estate ends in economic turmoil. The difference with China however is that the banking system is under state control and not the free market. It's expected, that if need be, the banking system will be recapitalised by the public sector with bad loans written off. Given that government debt only amounts to 43% of GDP, there appears to be ample scope to stabilise the banking system if needed.

It is difficult to reduce debt burdens in a slow economic growth environment, so financial repression in the form of low interest rates is the only viable solution. Global growth will likely remain weak over the medium term so it's very much a theme of "stuck in a rut".

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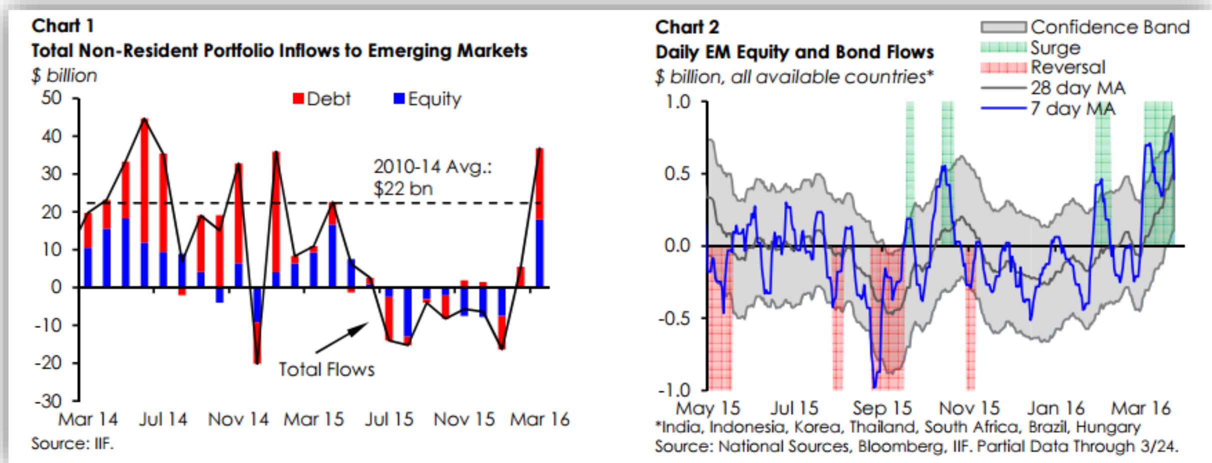
In South Africa

Supportive conditions including a more benign interest rate outlook and a stabilisation in commodity prices have boosted appetite for emerging markets. Strong capital flows have been experienced into our financial markets following the Brexit vote as investors are expecting further monetary accommodation by global central banks.



Source: CNBC

Despite local growth being downgraded to only +0.1% for 2016 (IMF), South Africa is experiencing a couple of favourable tailwinds. Declining global yield curves have resulted in emerging markets being viewed as a safe haven (who would have thought). Our financial markets have experienced a 6-month comeback so far accompanied by a fairly strong rand exchange rate. This together with, in our view, a sustained low oil price, will likely results in less inflationary expectations which could well result in no further rate hikes by the SARB.

MSCI Emerging Market Index

Source: FT.com

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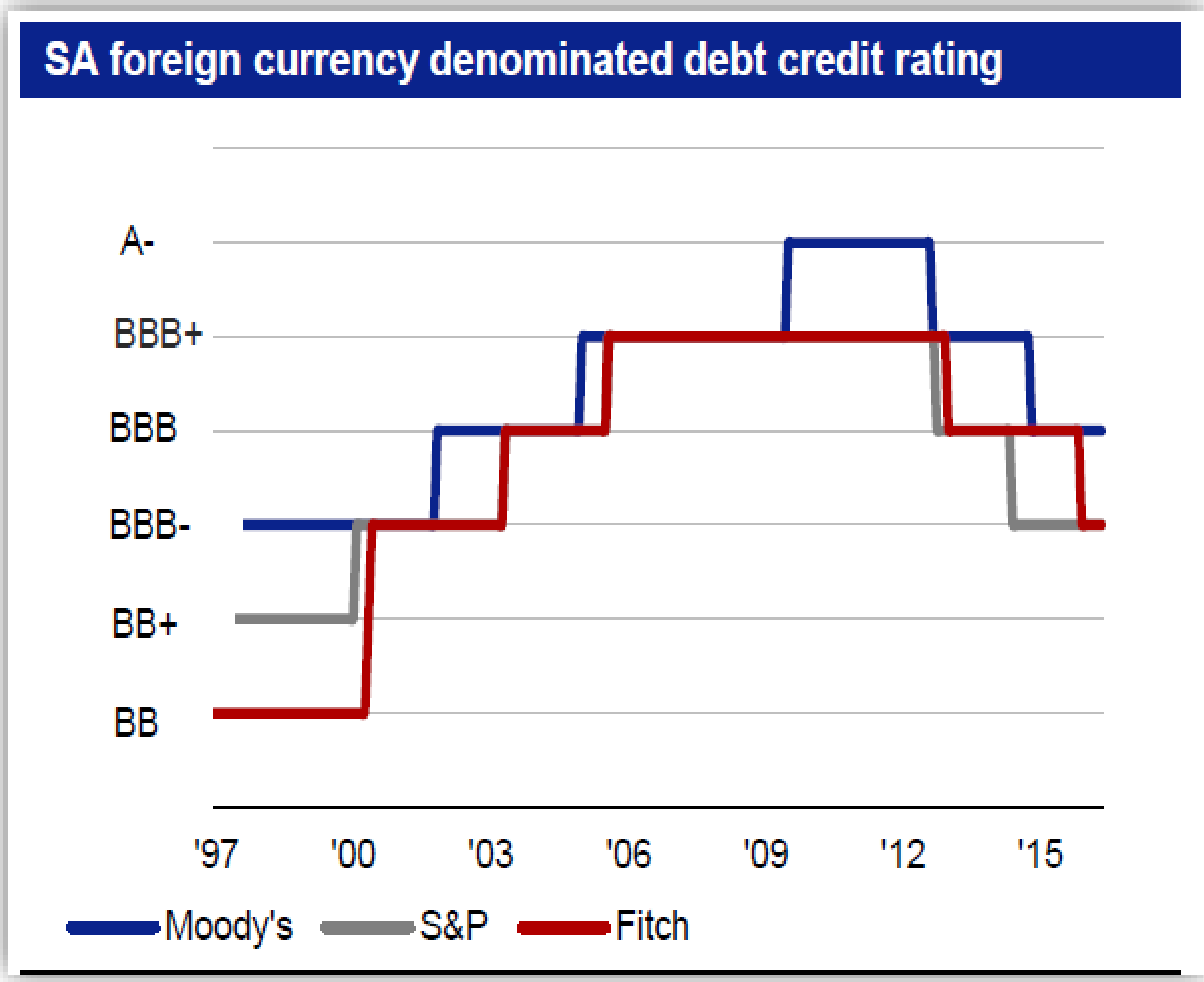
Further positive news is that the major ratings agencies have so far followed the official view that growth prospects locally are improving due to the end of the drought as well as easing electricity shortfalls. The rating agencies may well be persuaded to maintain our ratings for a little longer while the search for yield continues to support our financial accounts. This could have a positive impact on business and consumer confidence.



Source: Avior Capital Markets

For now, the favourable inflows (carry trade) will likely support the rand and our financial markets in the near term, but one needs to keep in mind that the carry mechanism is an inherently unstable one and is currently a reflection of uncertain global trade-offs.

To conclude:

- The weak credit environment will likely cause global interest rates to remain low for a protracted period
- Record low bond yields and high equity markets are interpreting things very differently. Bond yields are suggesting no economic growth accompanied by deflation whereas equity markets are suggesting better economic prospects with rising inflation
- Low bond yields are in effect supporting equity valuations. At current levels, the US equity market appears expensive but where else can investors get a better yield compared to bonds?
- The hunt for yield is having a positive impact on emerging markets as witnessed by the recent strong inflows into both bond and equity markets
- Our financial markets have experienced a 6-month comeback so far accompanied by a fairly strong rand exchange rate. This together with, in our view, a sustained low oil price, will likely results in less inflationary expectations which could well result in no further rate hikes by the SARB.
- In SA, our financial markets have experienced a 6-month comeback so far accompanied by a fairly strong rand exchange rate. This together with, in our view, a sustained low oil price, will likely results in less inflationary expectations which could well result in no further rate hikes by the SARB.
- Major ratings agencies have so far followed the official view that growth prospects locally are improving due to the end of the drought as well as easing electricity shortfalls. The rating agencies may well be persuaded to maintain our ratings for a little longer
- Local bond and equity markets are being supported by the carry trade due to the search for yield. How long it will last?

Sincerely

Chris

Chris Botha

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