IMARA
Asset Management SA

Communiqué

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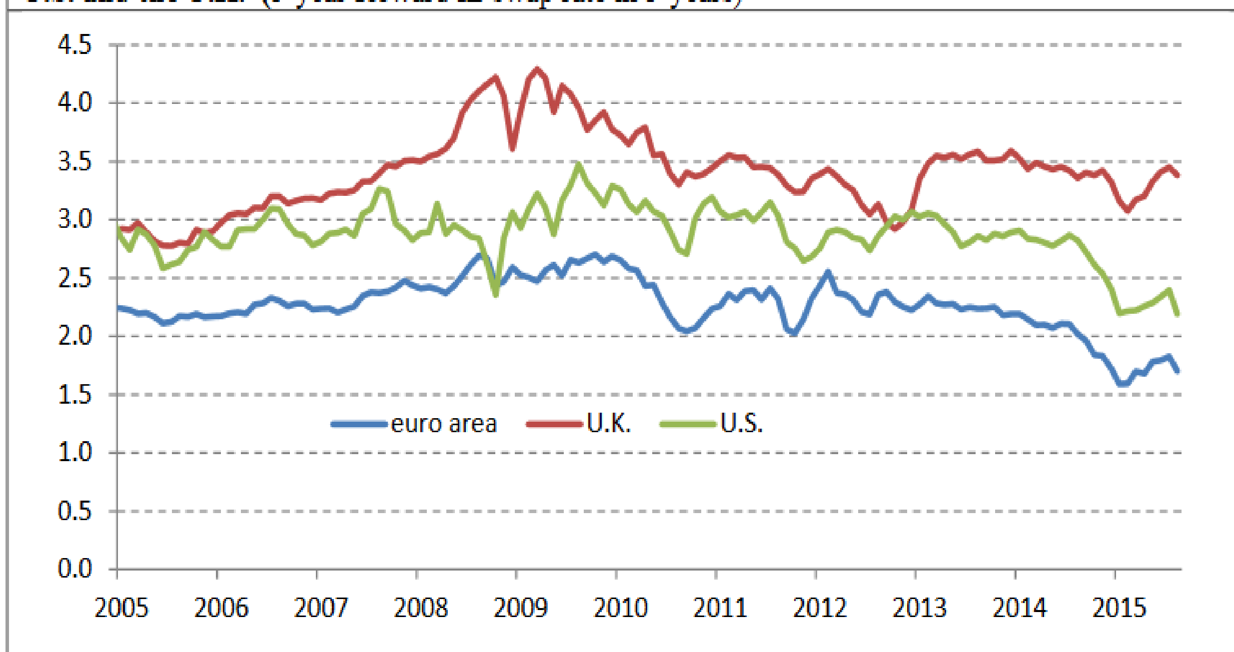
Is inflation too low?

Abroad

Policy makers and central bankers are frustrated. Despite driving down interest rates to zero and below in certain cases the global economy is staging its slowest recovery ever seen since the Second World War. Possible reasons for this are too much debt, too much saving amongst consumers and corporates as well as hardly any investment activity amongst corporates and governments. In their defence though, their speedy response by aggressively lowering rates has prevented a global depression.



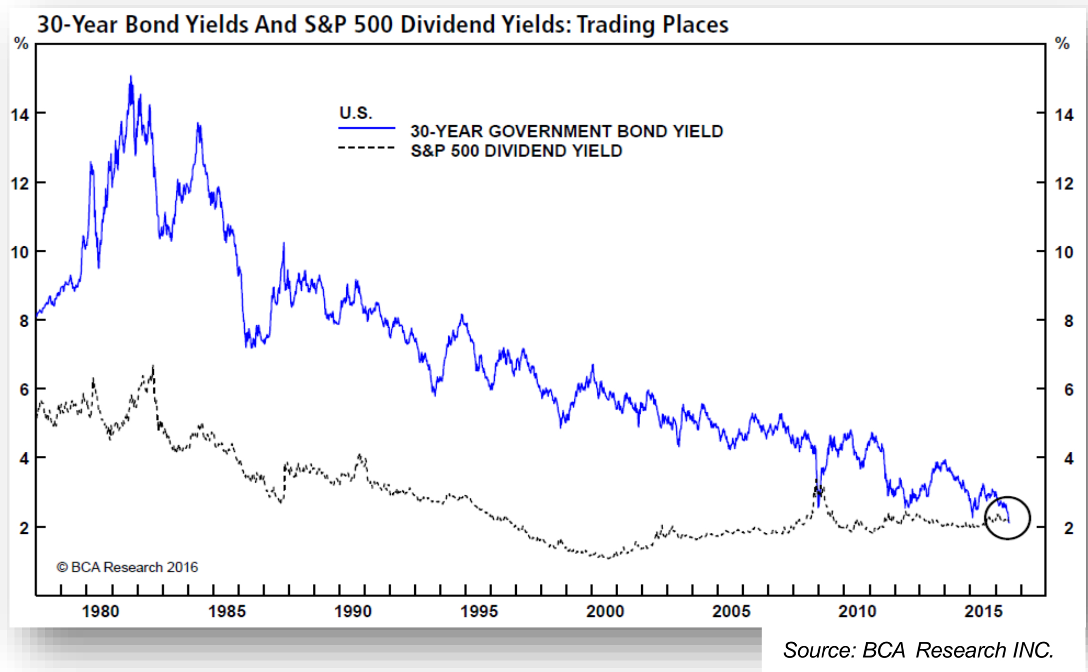
Source: ECB

Following this emergence of cheap debt, companies and consumers alike went on a splurge. The problem is that the debt was not used to finance productive assets but was used to finance consumption activity to a point where the debt burden got just too high and hence had a negative impact on GDP and productivity growth.

Recent comments by leading economists are suggesting that inflation is too low and that central bankers need to adjust their inflationary expectations upwards which will increase inflationary expectations amongst investors and consumers. This should in theory lead to a decline in real interest rates which will then likely support more consumer expenditure and cause currencies to weaken making exports more competitive. The resulting boom will eventually lead economies to overheat which will then legitimise the high inflation expectations. But this theory needs buy-in from the public. Given high debt levels and political uncertainty in both the US and Europe following Brexit, it's a fairly big ask.

In any event, the latest G7 core inflation rate was published as 1.7%, not that far off from the 2% target rate of most central bankers. In the US, the latest University of Michigan Consumer Survey showed that inflation expectations are 2.5% for both next year as well as the medium term. So, it seems that inflation expectations amongst consumers are at fairly healthy levels already and will hopefully continue to gradually support expenditure going forward.

Global equities have been weak since May last year with the MSCI All Country World Index down 9% over this period. This has pushed the global equity risk premium to 5.8% aided by falling bond yields. The US 30 year bond yield is currently below the dividend yield of equities. What this means is that investors are not expecting any growth in earnings and dividends at current levels from the S&P 500 listed companies for the next 30 years. This is not very likely. The flight to safety will eventually end as inflationary expectations increase and GDP growth improves.



Source: BCA Research INC.

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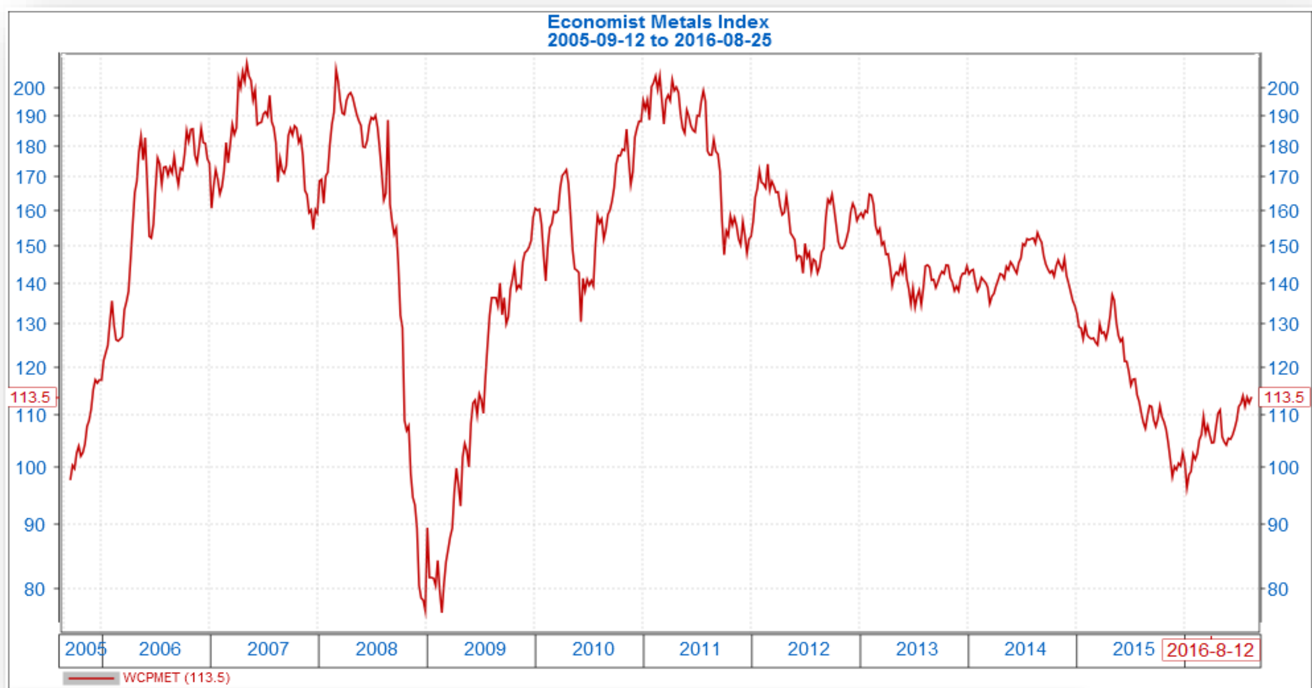
On the emerging market front, investors continue to be net buyers of both bonds and equities in search of yield due to mostly negative interest rates in the developed world. One interesting development is that investors are not viewing emerging markets as a homogenous group anymore due to divergent macro and monetary cycles. Investors are now more focused on specific countries and companies. To quote well known US entrepreneur and investor Robert Arnott, "in investing, what is comfortable is rarely profitable".

some time, but some supply is being removed out of the system. Low commodity prices for an extended period of time have resulted in hardly any new production capacity coming on stream. These under investments for nearly 20 years will likely cause spot prices to continue to gradually increase - with the exception of iron ore and steel which in our view will remain depressed for the foreseeable future. The cure for low commodity prices is therefore low commodity prices to balance out the excess supply!



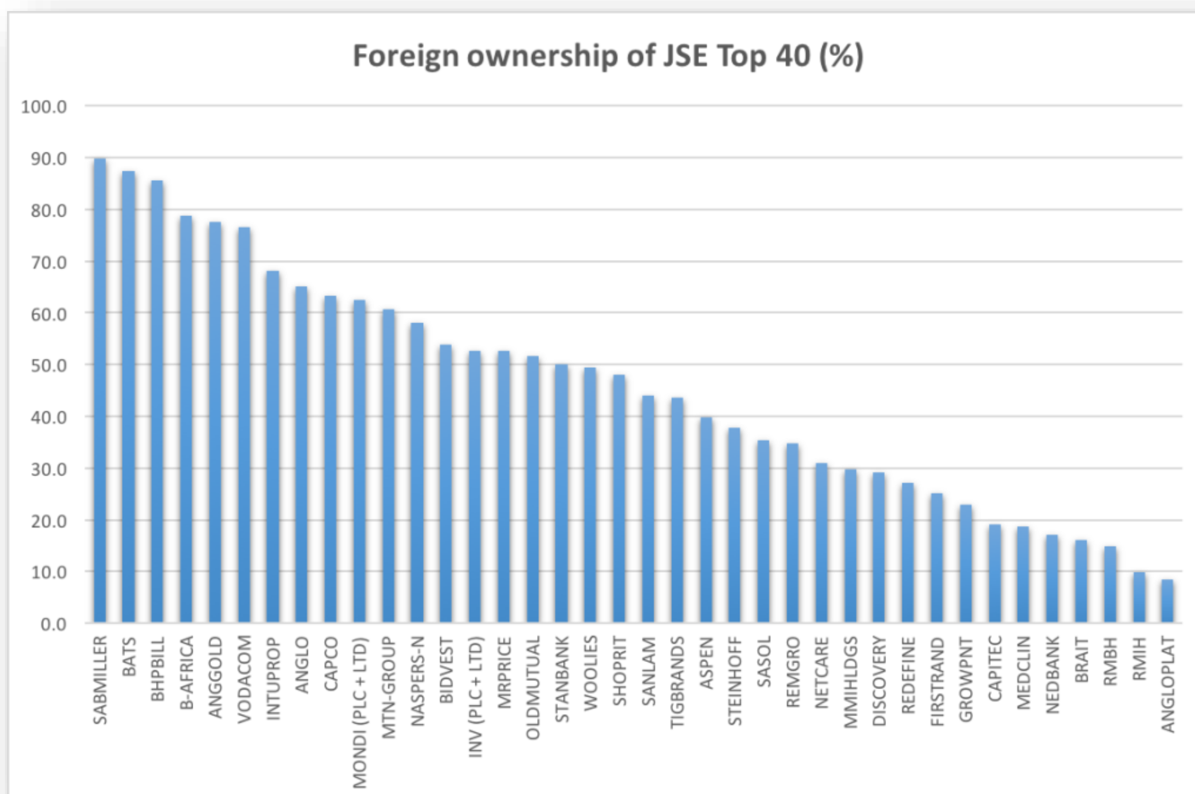
Source: Inet Bridge

The positive sentiment on emerging markets is to a certain extent spilling over into commodity prices as well. There is at last clear evidence that the necessary rebalancing of supply and demand is beginning to happen. Not so much on the demand side, as this has been steady for

It can safely be said though that the "new normal" in the future will probably be lower spot prices compared to historic levels due to on-going improvements in technology and efficiencies.

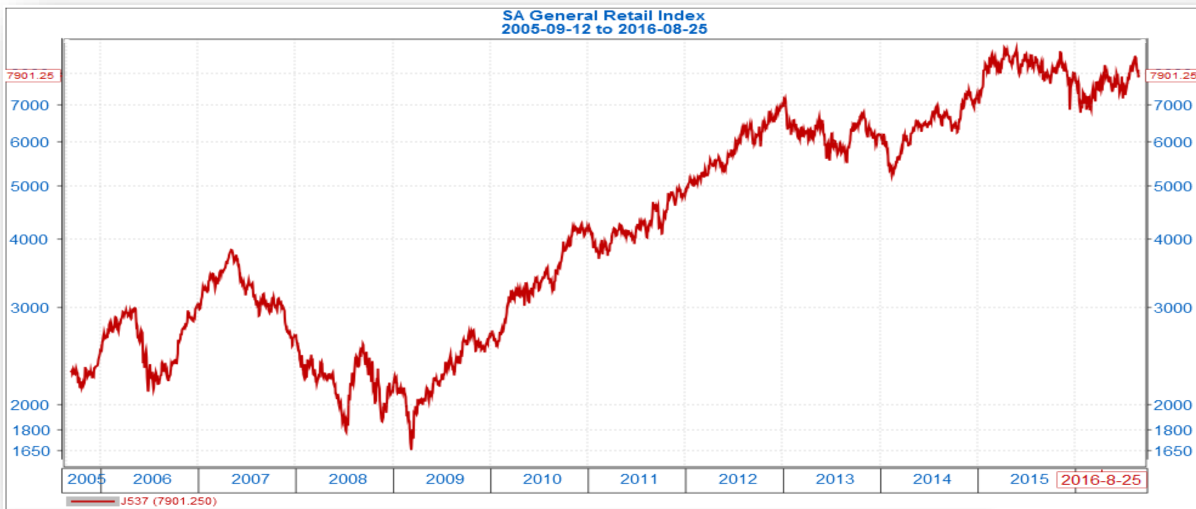
Locally

Following on the emerging market theme, the local bourse continues to gradually attract foreign flows as witnessed in a robust rand dollar rate over the last month or so (before the hawks and Gordhan saga re-emerged again that is). The JSE is currently 50 percent foreign owned (see chart)



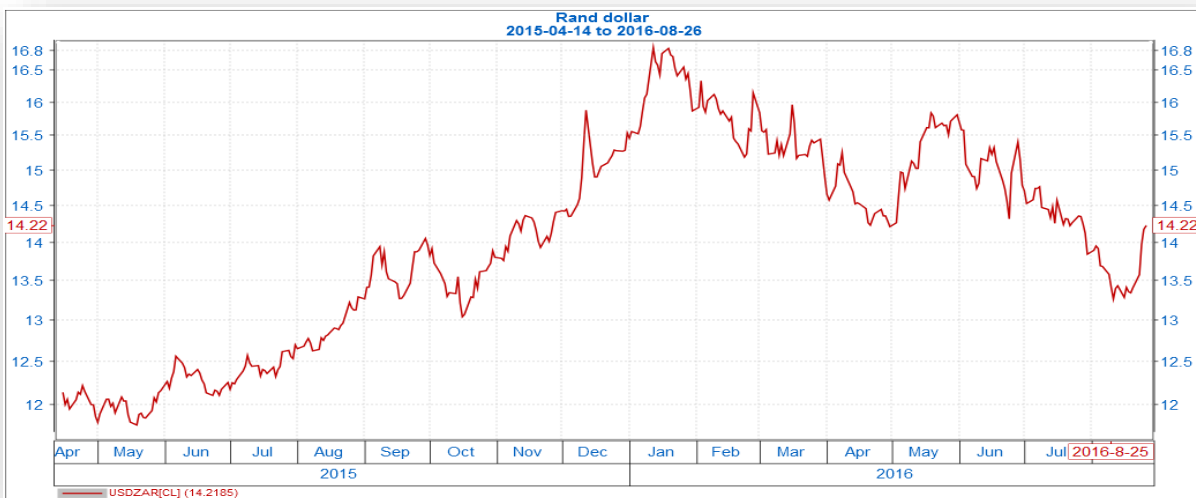
Source: Biznews

As mentioned previously, the divergence between emerging countries is now starker than ever. From a macro point of view, as an example, South Africa and Mexico are in a rate hiking cycle to protect their current account deficits whilst Russia and Turkey are in a declining interest rate cycle. Also at economic sector level, correlations have broken down completely. One good example in SA is the consumer discretionary sector. Despite the poor growth in the local economy and bearish views by most economists around the consumer, the index has gained 495% over the last 8 years (see chart). In our view two factors were (is) at play here. One being the large foreign ownership of our listed retail counters but also the fact that our retail companies are world-class with increasingly large exposures to foreign markets. So, poor local economic dynamics are becoming less important. Foreign investors have known this for years.



Source: iNet Bridge

Following great efforts by finance minister Pravin Gordhan and business, the last round of discussions with rating agencies proved rather successful with all of them keeping their ratings mostly stable with Gordhan ensuring them that efforts to reboot growth in 2017 will be successful. The latest rout of tensions between the Hawks and Gordhan will undoubtedly not be good news for our sovereign rating and has caused the rand to break through the R14 to the dollar level again. The latest inflation figure was better than expected helped by recent rand strength but will likely disappoint again in future due to the weakening trend in the currency of late. This could scupper our view that there would be no more rate hikes this year. Furthermore, the SARB remains focused on stability and will likely want to ensure a buffer in terms of real rates when the FED ultimately starts hiking rates.



Source: iNet Bridge

Local GDP growth will likely be close to zero for the remainder of the year but importantly, will hopefully not be negative which will be closely monitored by the rating agencies.

Time is running out to do something fundamentally supportive for the rating agencies. If Gordhan is eventually arrested, we anticipate an immediate downgrade with severe consequences for the rand.

The political leadership of the country remains ambiguous regarding their long term intentions which is not helping to boost confidence around labour, governance and mining rights.

To conclude:

- Despite driving down interest rates to zero and below in certain cases the global economy is staging its slowest recovery ever seen since the Second World War
- Recent comments by leading economist are suggesting that inflation is too low and that central bankers need to adjust their inflationary expectations upwards which will increase inflationary expectations amongst investors and consumers
- The latest G7 core inflation rate was published as 1.7%, not that far off from the 2% target rate of most central bankers
- Inflation expectations amongst consumers are at fairly healthy levels already and will hopefully continue to gradually support expenditure going forward.
- The US 30 year bond yield is currently below the dividend yield of equities. What this means is that investors are not expecting any growth in earnings and dividends at current levels from the S&P 500 listed companies for the next 30 years
- Following on the emerging market theme, the local bourse continues to gradually attract foreign buyers
- The latest rout of tensions between the Hawks and Gordhan will undoubtedly not be good news for our sovereign rating and has caused the rand to break through the R14 to the dollar level again
- If Gordhan is eventually arrested, we anticipate an immediate downgrade with severe consequences for the rand
- How political leadership and economic trends unfold will be key factors for our sovereign rating, the currency and investment markets

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Sincerely

Chris Botha

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