IMARA
Asset Management SA

# Communiqué

Monthly
South Africa

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## *The FED is trying to reassure investors. Is it working?*

### *Abroad*

Following the last monetary policy meeting in the US, the FED tried to reassure investors that US growth and inflation was on a sound footing which should allow the FED to raise interest rates at a gradual pace. Growth momentum appears to be adequate to cause further tension in the labour market with a corresponding increase in wage costs.


Although the FED seems confident that increasing interest rates is the correct path to take going forward, the bond market does not seem convinced with US 10 year treasury yields trading at 2.2% which is 30 basis points below their level at the beginning of the year. The lower yields are in fact suggesting very little inflation and maybe no further hikes this year. The weakness mainly stems from downward revisions in forecast inflation by most economists.

***5 –Year Forward Inflation Expected Rate***


*Source: Federal Reserve Bank of St. Louis*

The main drivers of the lower expectations are the fading of the Trump effect and declining oil prices. Our view is that the bond market is correct in that the FED might indeed hike slower than what they are communicating to the market.

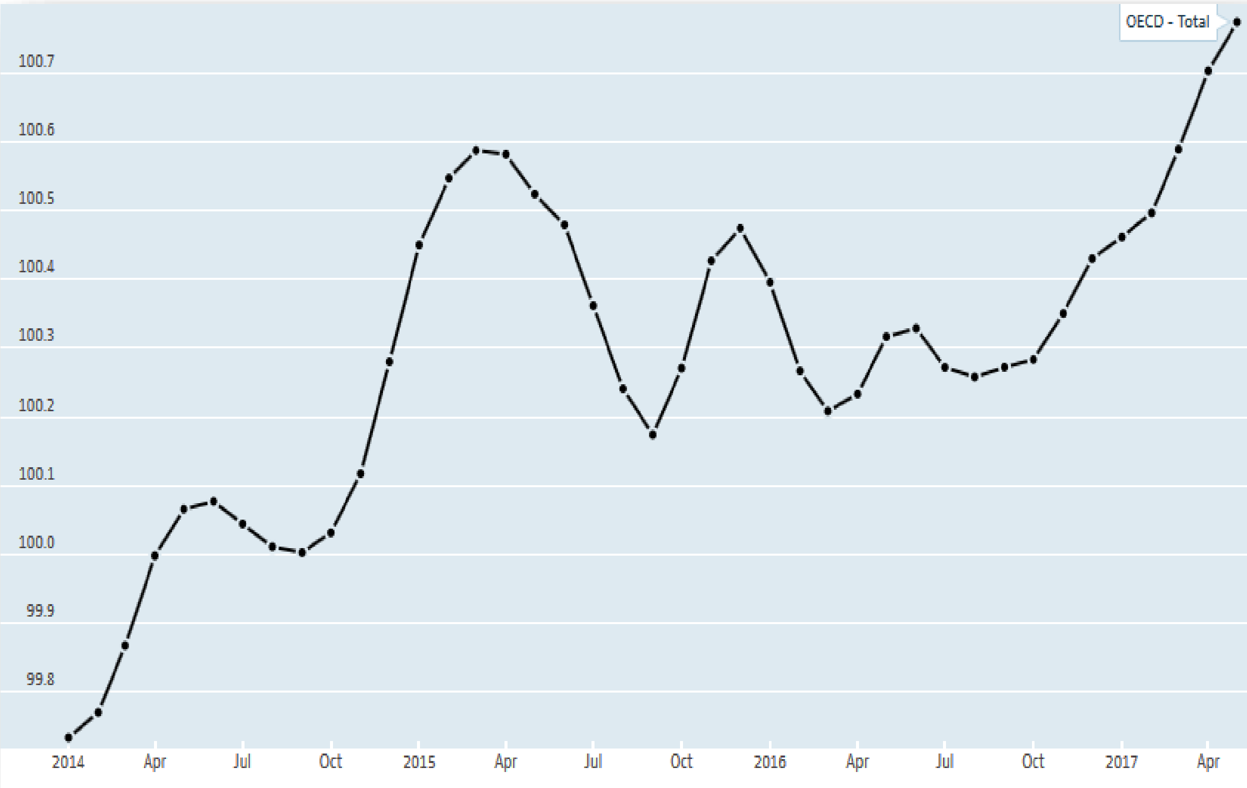
The budget situation in the US has worsened due to Americans delaying the payment of taxes as they await the promised tax cuts by the Trump administration which is having a negative impact on public finances. This has prompted the administration to realise the need to move forward swiftly on the issue around the debt ceiling – which is currently at its limit! Markets are hoping for a less ambitious compromise between Congress and the White House before September in order to avert a default (in servicing foreign debt) if no agreement can be reached.

In Europe, political risk has declined substantially with considerable progress being made in France, following the election of Emmanuel Macron who has swiftly implemented significant changes and has set a clear path for his vision of the future for Europe. This is one less thorn in the side of the ECB which is likely to normalise its monetary policy in 2018. We expect a tapering of asset purchases which will be the most likely outcome and that interest rates will not rise for some time.

Recent PMI numbers have continued to confirm improving growth prospects with the latest reading at 52.7 from 49.5 previously. Retail sales growth at 2.3% year on year was better than surveyed expectations for 2.1% growth. The major contributing economies to growth were Germany at 26%, France 21.7%, Italy 16.1% and Spain 11.4%. These countries all posted growth numbers that were better than expected.

Unemployment numbers are also improving, falling to 9.3% in May from 9.5% in March which is helping to maintain the positive consumer sentiment as indicated in the retail numbers above.

### *Consumer Confidence Indicator – Europe*

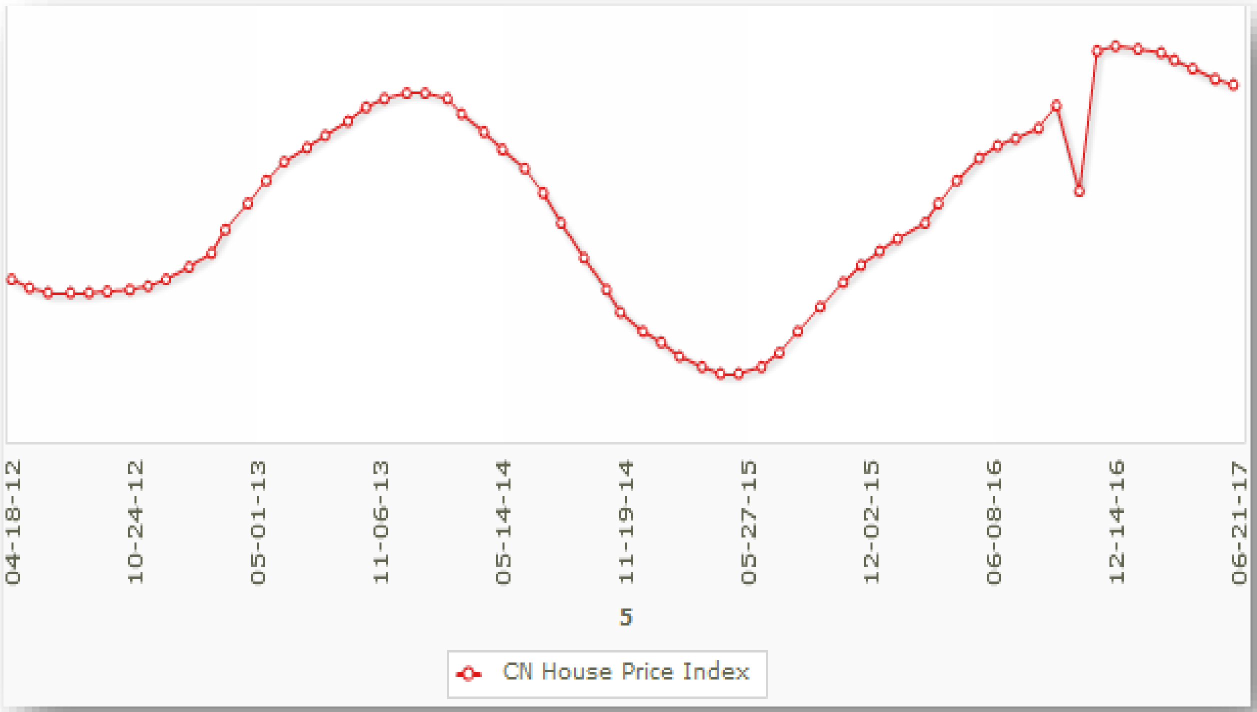



*Source: OECD*

Emerging markets continue to experience capital inflows accompanied by improving currency exchange rates particularly amongst commodity producing countries, but there are some short term potential headwinds.

Commodity prices are looking vulnerable as supporting economic data from China appears to be softening. Chinese imports and exports fell in April and were notably below expectations. Industrial production numbers were also weaker than expected. Industrial production rose 6.5% (expected: 7%) in April compared to 7.6% in March. Important to note for iron ore exporting emerging markets (2/3rds of sea borne trade is consumed by China) is that the "miss" was mostly explained by deceleration in the two largest steel consuming sectors, real estate and automotive industries. The government's initiatives to cut overcapacity in high polluting steel mills will likely cause further pressure in manufacturing and construction. The overall picture in China given recent data releases is consistent with a gradually slowing economy and the government's efforts to curb inflation in the residential real estate market (which seems to be working).

***Chinese House Price Index***




*Source: Fxstreet*

## *Local*

The rand continues to benefit from a slightly lower political risk premium (unlikely to last) and global flows into emerging markets. The trade weighted US dollar has fallen consistently over the past couple of months due to concerns that fiscal stimulus will likely be delayed in the US and better than expected European economic data.

Recent local economic data has been broadly positive. Local manufacturing production rose 0.3% year on year in March (expected: -2.4%) and April CPI also came in lower than expected at 2.2% (consensus 2.3%).

We expect the political landscape to weigh on the rand in due course and might also be impacted by lower commodity prices.

The risk of a shift to a more populist policy by the ruling party has increased with the president finding it more difficult to manoeuvre out of tight spots (he has been a master at it so far). The shift has been highlighted in Dr Dlamini Zuma's radical economic transformation plans. However, it does appear that the balance of power will likely continue to shift in favour of Deputy President Ramaphosa.

A further headwind for the currency and our investment markets will be future actions by the rating agencies. The last round of comments was for an unchanged sovereign rating but with a negative outlook by all agencies.

Less than 10% of our government debt is dollar –denominated but roughly 40% of the rand denominated debt (government bonds) is held by foreigners which make our market vulnerable to foreign sentiment. This holds true for JSE listed shares also. Having said that, despite all the macro and political headwinds, foreigners continue to pile into local assets.

***Bond yields (and the rand) recover every time after a setback***


*Source: FT.com*

Our local currency denominated bonds are currently in three rating sensitive indices. If we get downgraded deeper into junk status, foreigners will have to sell those bonds as they would fall out of the indices. This will have severe consequences for yields, interest rates, inflation, growth and ultimately employment. The cost of funding for government's infrastructure plans will skyrocket which will make those unaffordable. Analysts argue that for this to happen, S&P will need to downgrade by one notch and Moody's by another two. But, most strategists expect the exclusion from these indices to be a slow process (if at all). But it's possible.

And what about equities? Current weightings in SA equities by emerging market fund managers is at a 10 year high (the search for yield!) and is therefore vulnerable to macro-economic and political shocks. Main sectors exposed to the potential sell-off are banks and retailers due to very large foreign ownerships. Retailers in particular have been a favourite but can be volatile due to sentiment shifts. Currently about 2/3rds of the index is foreign owned.


*Source: Businesslive*

Further key features to watch are a potential roll-over in commodity prices (no bear market expected) and a stronger dollar (less of a risk) which could further exacerbate market weakness.

History suggests that ratings downgrade related sell-offs have always provided for very good entry points into equities.

Given the medium terms risks for a weaker rand, we remain overweight industrial rand hedges across various subsectors on the JSE.

## *To conclude:*

- Following the last monetary policy meeting in the US, the FED tried to reassure investors that US growth and inflation was on a sound footing which should allow the FED to raise interest rates at a gradual pace
- Although the FED seems confident that increasing interest rates is the correct path to take going forward, the bond market does not seem convinced with US 10 year treasury yields trading at 2.2% which is 30 basis points below their level at the beginning of the year
- In Europe, political risk has declined substantially with considerable progress being made in France, following the election of Emmanuel Macron
- Recent European PMI numbers have continued to confirm improving growth prospects with the latest reading at 52.7 from 49.5 previously
- The overall picture in China given recent data releases is consistent with a gradually slowing economy and the government's efforts to curb inflation in the residential real estate market
- The rand continues to benefit from a slightly lower political risk premium (unlikely to last) and global flows into emerging markets
- Our local currency denominated bonds are currently in three rating sensitive indices. If we get downgraded deeper into junk status, foreigners will have to sell those bonds as they would fall out of the indices which could have severe consequences
- Current weightings in SA equities by emerging market fund managers is at a 10 year high (the search for yield!) and is therefore vulnerable to macro-economic and political shocks
- Main sectors exposed to the potential sell-off are banks and retailers' due to very large foreign ownerships

Sincerely

Chris

**Chris Botha**