Communiqué

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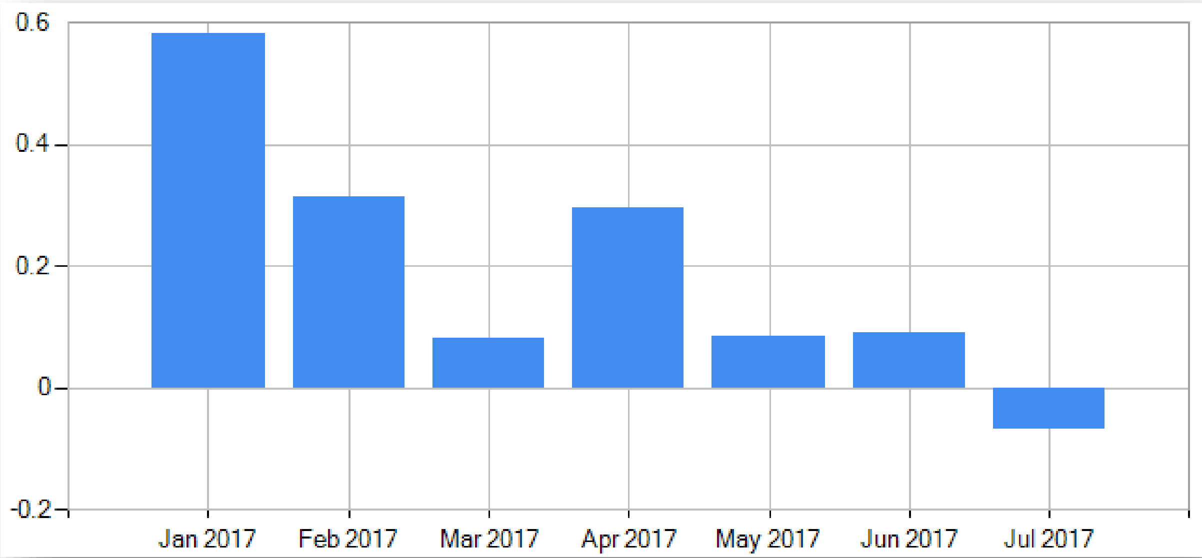
There is growth, but where is inflation?

Abroad

The minutes from the last Federal Reserve meeting in the US point to the uncertainty regarding inflation forecasts and hence the pace at which tighter monetary policy will be implemented. Recent inflation numbers were below expectations with core inflation decreasing from 1.8% to 1.5%, below the stated 2% target of the FED. In fact, as can be seen in this chart, month on month inflation as a percentage has actually gone into negative territory with July decreasing by -0.7%.

US Inflation month on month % change



Source: StatBureau

The general notion has always been that inflation is a bad thing. Most people don't like inflation as they would prefer that a currency hold its value for a long period of time to protect their purchasing power.

But the recent drop in US inflation may be a sign of fresh economic weakness and is perplexing to Federal Reserve officials who are now wrapping up the central bank's stimulus campaign.

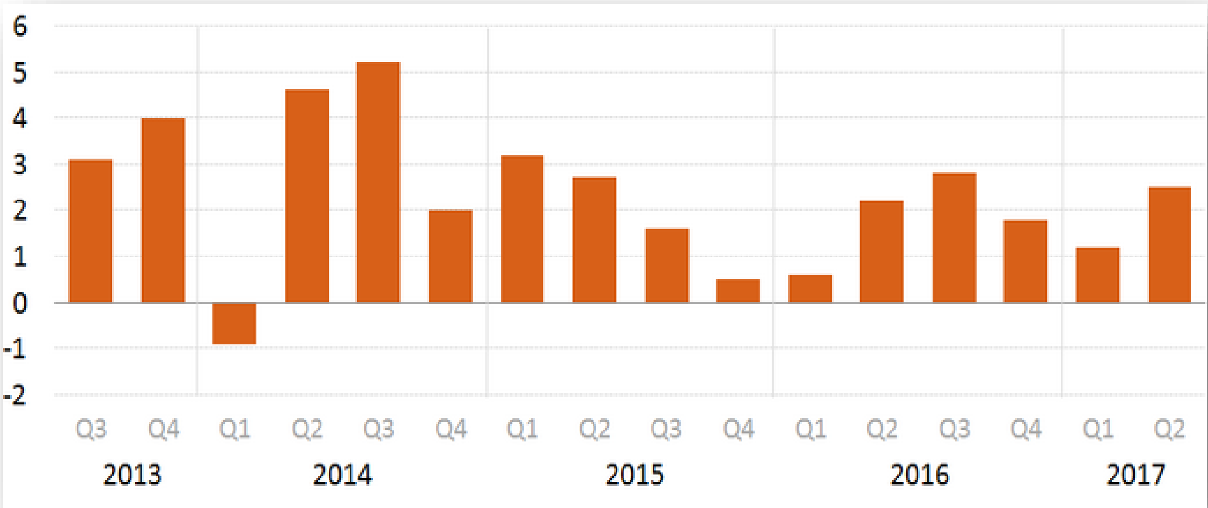
The FED believes that modest inflation has important economic benefits, and it has aimed since 2012 to keep prices rising at an annual pace of 2 percent. The problem is that the Fed is on track to fail for the sixth straight year. Inflation has been stubbornly sluggish.

A little inflation can brighten the economic mood, causing wages and corporate profits to rise more quickly. Economists like to point out that this is an illusion. If everyone is making more money, then no one can buy more stuff. Prices just go up. But the evidence suggests people enjoy the illusion and, importantly, they respond to the illusion by behaving in ways that increase actual economic growth, for example by working harder in order to be able to spend a little more.

The potential low inflation trajectory might very well alter the FED's pace of rate hikes. To quote FED Chairperson Ms Yellen: " It's premature to reach the judgment that we're not on the path to 2 percent inflation over the next couple of years," Ms. Yellen said. "We're watching this very closely and stand ready to adjust our policy if it appears the inflation undershoot will be persistent." Even though the institution believes the drop in prices is due to temporary factors, several members remain concerned over the ability for prices to rebound.

Beyond price inflation, the momentum of the US economy remains an issue. Growth in the US increased by 2.1% year on year in the second quarter of 2017 but this was way below expectations of 3% year on year growth mainly due to pledges made by Mr Trump and other republicans. The reality of political negotiations will likely cause downward revisions in both growth and inflation.

US Real GDP quarter on quarter percentage change



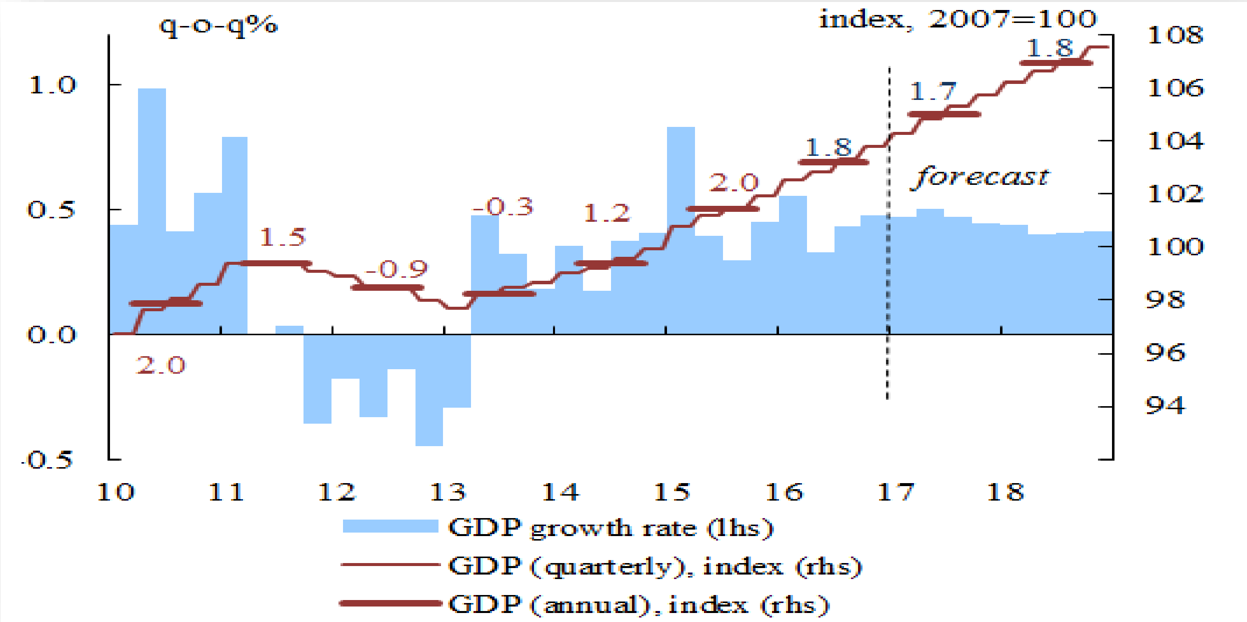
Source: US Bureau of Economic Analysis

The rise of the euro to EUR/USD 1.18 against the dollar reflects both disappointments regarding Trump to enact significant reforms in the US but also more favourable economic trends in the European economy. This supports our view that the European Central Bank will be less accommodative towards the end of the year by slowing the pace of asset purchases but that interest rates will remain low for some time still. The rise in the euro is however weighing on equity markets in the region due to the large export base within listed companies.

Despite the rise in the euro, the European economy has entered its fifth year of recovery and is now reaching all EU Member States. This is expected to continue at a largely steady pace this year and next.

In its latest forecast, the European Commission expects euro area GDP growth of 1.7% in 2017 and 1.8% in 2018 (1.6% and 1.8% previously). GDP growth in the EU as a whole is expected to remain constant at 1.9% in both years (1.8% previously).

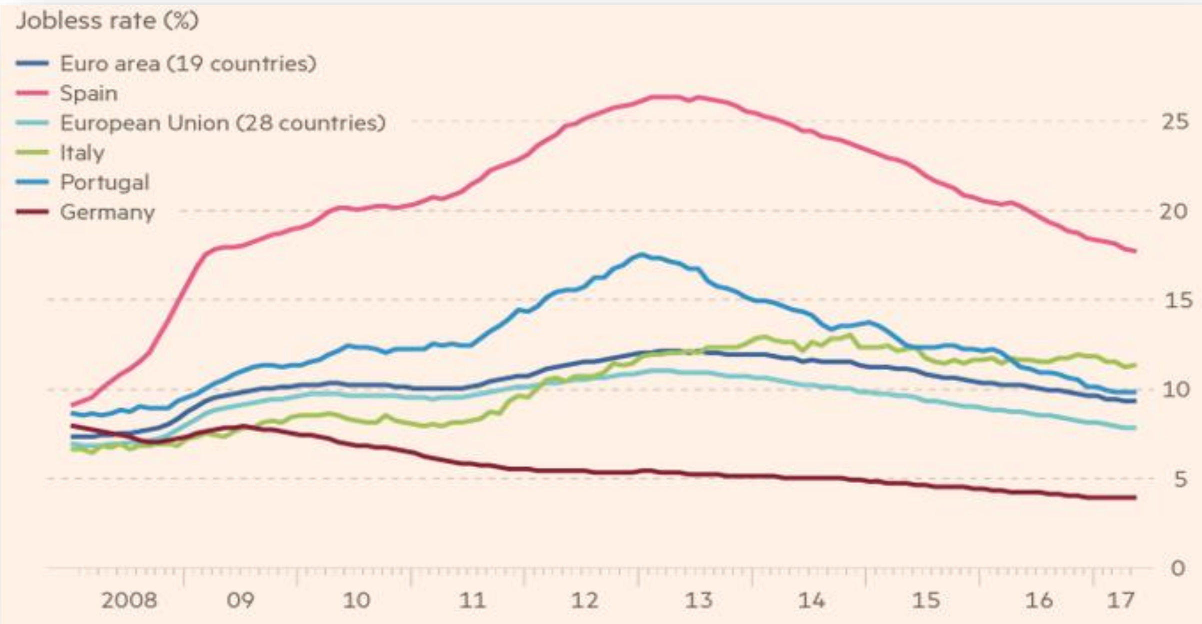
Eurozone expected GDP growth



Source: European Commission: Spring Forecast 2017

We expect headline inflation in the region to improve slightly due to a rebound in oil prices which will likely support wage negotiations going forward, needed to lift underlying inflation. This will likely also support the recovery in employment as the jobless rate continues to decline.

Employment in Europe recovering



Source: FT.com

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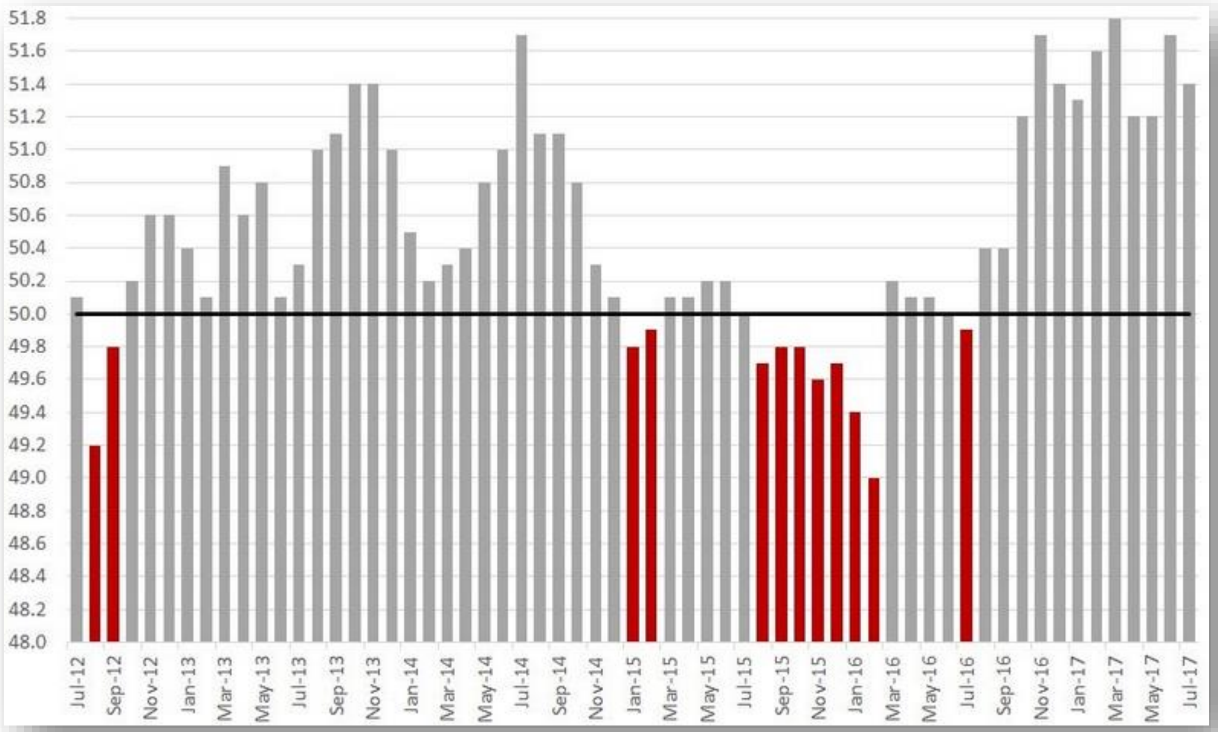
Industrial metal prices continue to increase and could generate some inflationary pressure. Robust economic activity in China remains the main driver of metal prices and is set to continue which could make it easier for central bankers to normalise monetary policy (higher rates).

Chinese growth surprised on the upside with second quarter GDP growth of 6.9% year on year, however, leading PMI numbers are indicating signs of a slowdown but are still above the threshold of 50. The Purchasing Managers' Index for July 2017 was reported at 51.4 compared to 51.7 in June. The government's growth target of "6.5% or more" should still be comfortably reached in 2017 which bodes well for emerging markets including South Africa.

Chinese Manufacturing PMI



Source: Business Insider : Australia

Local developments

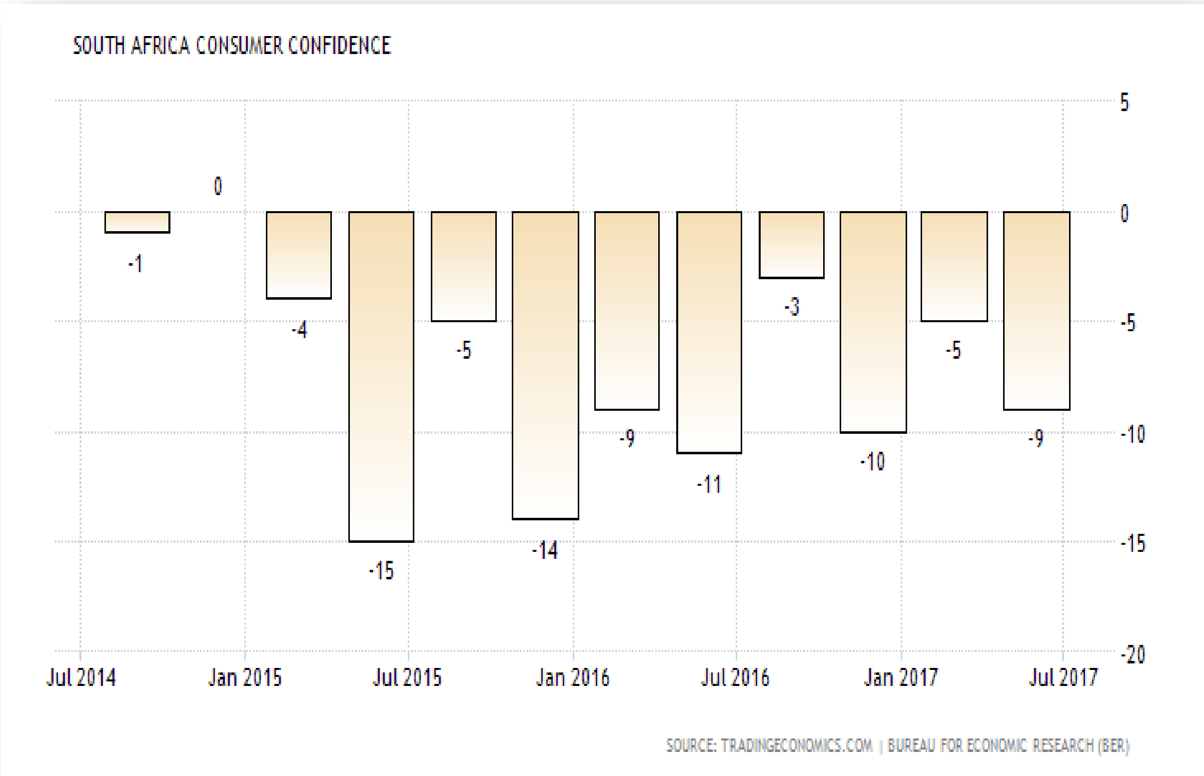
SA domestic equity prices have been softish of late given policy paralysis, political risk and weakening economic growth.

The December 2017 ANC elections remain the key catalyst for any policy shift, needed for a turnaround in business and consumer confidence which is required to accelerate GDP growth which could support a rerating of our stock market. A positive outcome of the elections could also spur on more foreign buying of locally listed shares which could very well cause the rerating of shares to overshoot as an earnings recovery (on better GDP) will take some time to filter through.

The Latest Bureau for Economic Research Consumer Confidence Index data shows that despite a pick-up from the previous period, the index for the second quarter still came in at – 9, meaning that economic morale remains subdued.

This can likely be attributed, to some degree, to the credit rating downgrades and the recession (technical).
Economist Jason Muscat emphasises that policy certainty is key in turning the situation around. To Quote: “Things were looking up at the beginning of the year. We were expecting higher growth than where we are now. But, the Cabinet reshuffle and subsequent rating downgrade introduced a lot of uncertainty. And consumers are now telling us that the expectations for the next 12 months for economic growth are considerably lower.”

SA Consumer Confidence Index – not looking good



Source: Trading Economics

Given the low growth environment, we expect shares exposed to the local economy to underperform in the near term and therefore prefer companies with a sizable offshore earnings base, particularly those exposed to consumer discretionary spending in Europe (our portfolios are positioned for this).

In a study done by J.P. Morgan Cazenove, the threshold for an increase in domestic corporate profit margins is at least 1% GDP growth. Growth below this level causes margin contraction. With expected growth of 1% in 2018, it is likely that margins will remain flat at best for the next year.

SA economic outlook

Calendar year	2013	2014	2015	2016	2017	2018	2019
Percentage change		Actual		Estimate		Forecast	
Final household consumption	2.0	0.7	1.7	0.9	1.3	2.0	2.3
Final government consumption	3.8	1.8	0.2	1.4	0.9	0.0	0.4
Gross fixed-capital formation	7.0	1.5	2.5	-3.6	1.5	1.6	2.8
Gross domestic expenditure	2.8	0.5	1.7	-0.3	1.3	1.8	2.2
Exports	3.6	3.3	4.1	-1.2	1.9	4.9	5.0
Imports	5.0	-0.5	5.3	-3.6	2.0	4.3	4.9
Real GDP growth	**2.3**	**1.6**	**1.3**	**0.5**	**1.3**	**2.0**	**2.2**
GDP inflation	6.6	5.7	4.0	7.2	6.4	5.9	5.8
GDP at current prices (R billion)	3 549.2	3 812.6	4 013.6	4 322.3	4 657.5	5 029.9	5 440.6
CPI inflation	5.8	6.1	4.6	6.4	6.4	5.7	5.6
Current account balance (% of GDP)	-5.9	-5.3	-4.3	-4.0	-3.9	-3.7	-3.8

Source: SA National Treasury

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To conclude:

- The FED remains uncertain regarding inflation forecasts and hence the pace at which tighter monetary policy will be implemented
- Recent inflation numbers were below expectations with core inflation decreasing from 1.8% to 1.5%, below the stated 2% target of the FED
- A little inflation can brighten the economic mood, causing wages and corporate profits to rise more quickly
- The reality of political negotiations will likely cause downward revisions in both growth and inflation in the US
- The rise of the euro to EUR/USD 1.18 against the dollar reflects both disappointments regarding Trump to enact significant reforms in the US bout also more favourable economic trends in the European economy
- Chinese growth surprised on the upside with second quarter GDP growth of 6.9% year on year however, leading PMI numbers are indicating signs of a slowdown but are still above the threshold of 50
- SA domestic equity prices have been softish of late given policy paralysis, political risk and weakening economic growth
- The Latest Bureau for Economic Research Consumer Confidence Index data shows that despite a pick-up from the previous period, the index for the second quarter still came in at – 9, meaning that economic morale remains subdued
- Given the low growth environment, we expect shares exposed to the local economy to underperform in the near term and therefore prefer companies with a sizable offshore earnings base

Sincerely

Chris

Chris Botha