Communiqué

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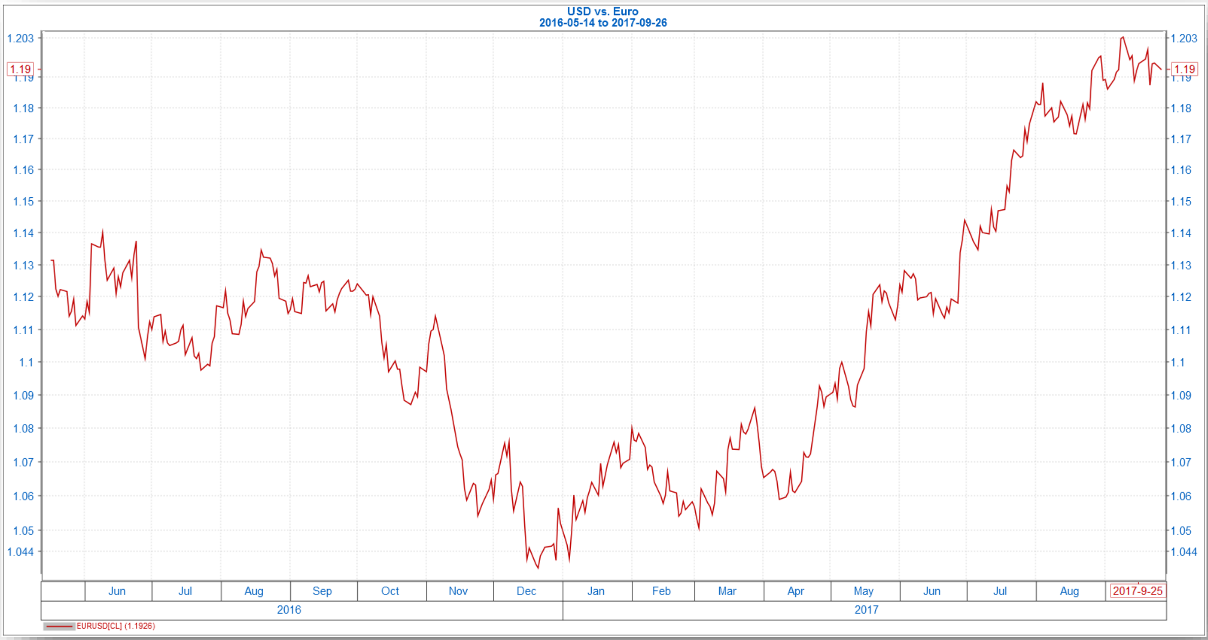
Central Banks might wait a bit

Abroad

Doubts have increased on the ability of central banks to wind down their loose monetary policy given that inflation is struggling to reach their 2% target. The trend in the US is particularly worrisome for the FED as core inflation in July on a year on year basis slowed to 1.4%. Inflation there has been slipping for some months now. Despite this though, economic growth has been steadily improving accompanied by solid progress in the US job market. It is therefore widely expected that price indices should eventually recover which will lead to rising inflation. But this is no guarantee at this point in time.

The FED's ability to increase interest rates will be a key factor for the ECB in their interest rate decisions. This is particularly important for the Euro relative to the dollar as a premature cut back on monetary stimulus might cause the Euro to strengthen further against the dollar which will compromise the rebound in both growth and inflation, preventing any monetary tightening.

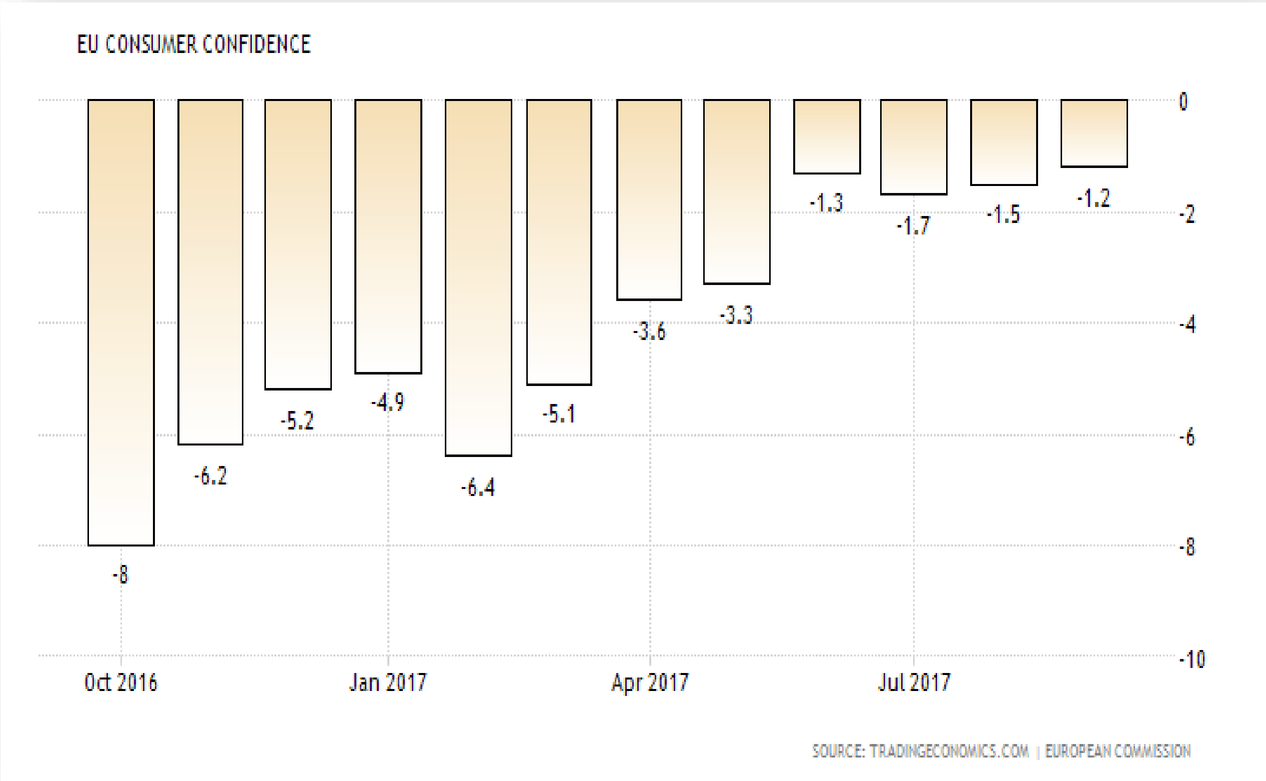
Dollar has weakened against the Euro



Source: Imara/Iress

For several months now, weak inflation and political disagreements in Washington have weighed on the dollar which has lost 7% against the euro since the beginning of the year. The move was accentuated by renewed confidence in the Eurozone due to better than expected economic data.

Eurozone consumer confidence – continues to improve



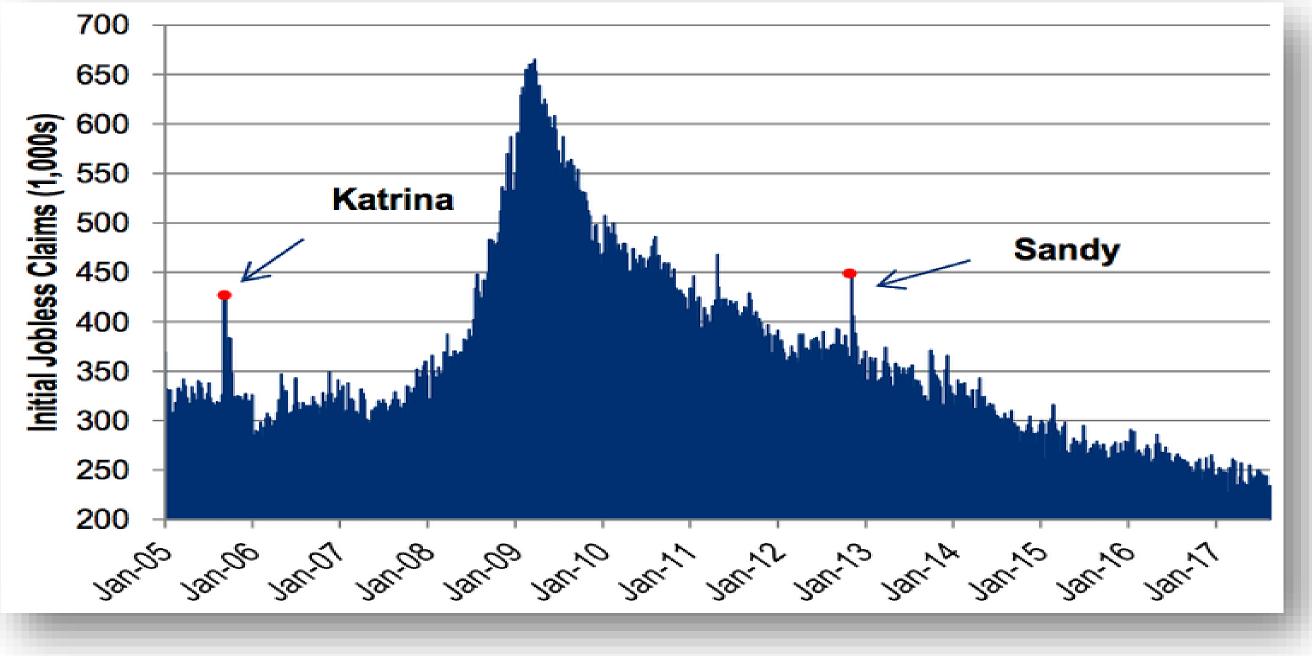
Source: Tradingeconomics

Given the strength in the euro, the risk of course is that the recovery in growth could falter due to the large export base in the region which benefits mostly from a weaker currency. Before the ECB can even start considering tightening its monetary policy, it will need to consider the deterioration in financial conditions due to the rise in the euro.

The Democrats and Republicans have reached an agreement to raise the US debt ceiling for three months to aid victims of hurricane Harvey. The reduction in debt default risk was accompanied by a decline in sovereign yields. The agreement will likely also revive confidence in a vote on tax reforms later this year which should benefit the dollar as it will signal that certain plans by Trump may actually be passed.

Hurricane Harvey and Irma will likely cause a spike in jobless claims in the near term as suggested by historical evidence. This, together with a spike in gasoline prices, could well have a negative impact on growth and might cause the FED to pause a while.

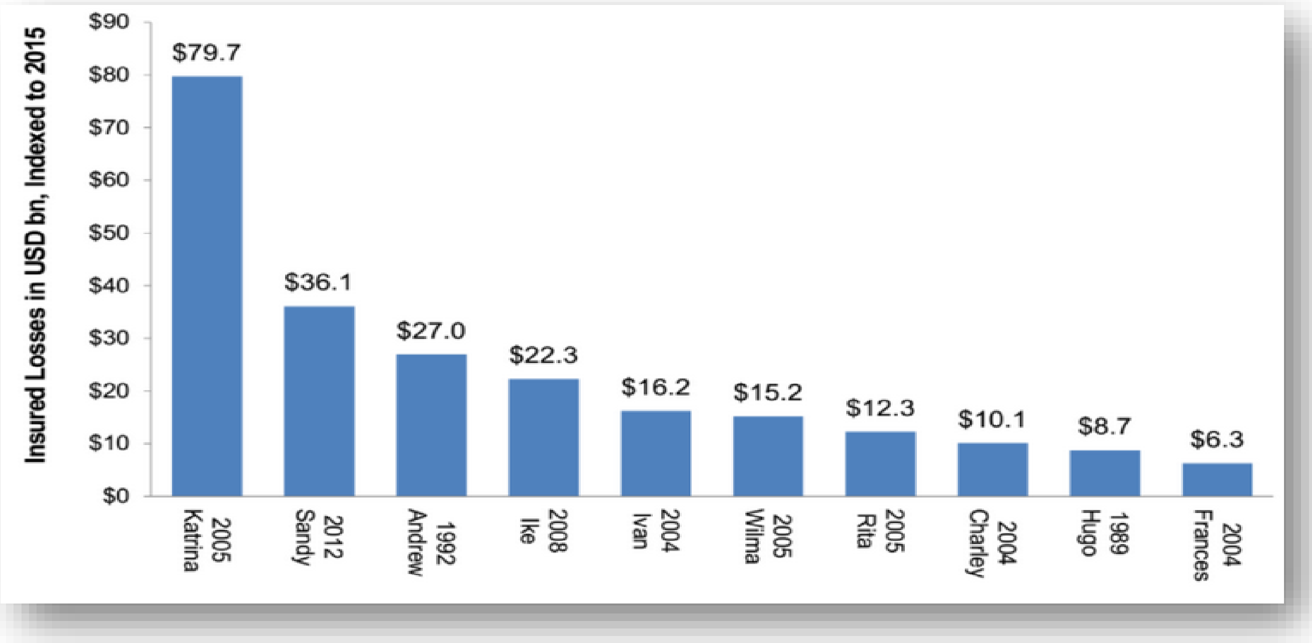
Harvey – likely impact jobs negatively in the short term



Source: Business Insider

Current forecasts are indicating that Harvey could be the most expensive natural disaster in US history, at about $160 billion.

Harvey – Likely the costliest yet



Source: Business Insider

Prior to the storms, estimates were for the US economy to grow at about 2.8 percent to 3 percentage points, well above trend. Economists from Goldman Sachs, Moody's and other firms have slashed their estimates for third-quarter GDP growth following the storms. Goldman Sachs now believes GDP will increase at just a 2 percent rate this quarter after cutting its estimate by 0.8 percentage point. Moody's estimates the combined cost of both storms, including property damage and lost output, at $150 billion to $200 billion. Most economists however see the fourth quarter getting a boost as rebuilding begins, but had not yet estimated the impact.

Regarding the US stock market, Morgan Stanley's Chief Strategist, Mike Wilson, suggests there might be a pullback towards end October. The catalyst may very well be the tax reform debate, particularly if Congress does not look like it is in agreement on main elements. But stocks should resume their climb after a bit of a sell-off if stimulus and tax reforms are approved.

According to Wilson, there's another trend he says could lift the market in the fourth quarter this year. Both retail and institutional investors, who have been waiting for a correction, still have cash to put to work, and they could start to do that in the next couple of months.

Local

Following the better than expected second quarter GDP growth of 2.5 percent on an annualised basis, further analysis is suggesting that household final consumption expenditure might be rebounding which grew strongly at 4.7 percent quarter on quarter. A rebound in key areas that were previously contracting due to high inflation appears to have been the main drivers. These sectors include spending on food, up 10%, as well as clothing and footwear, up 27%.

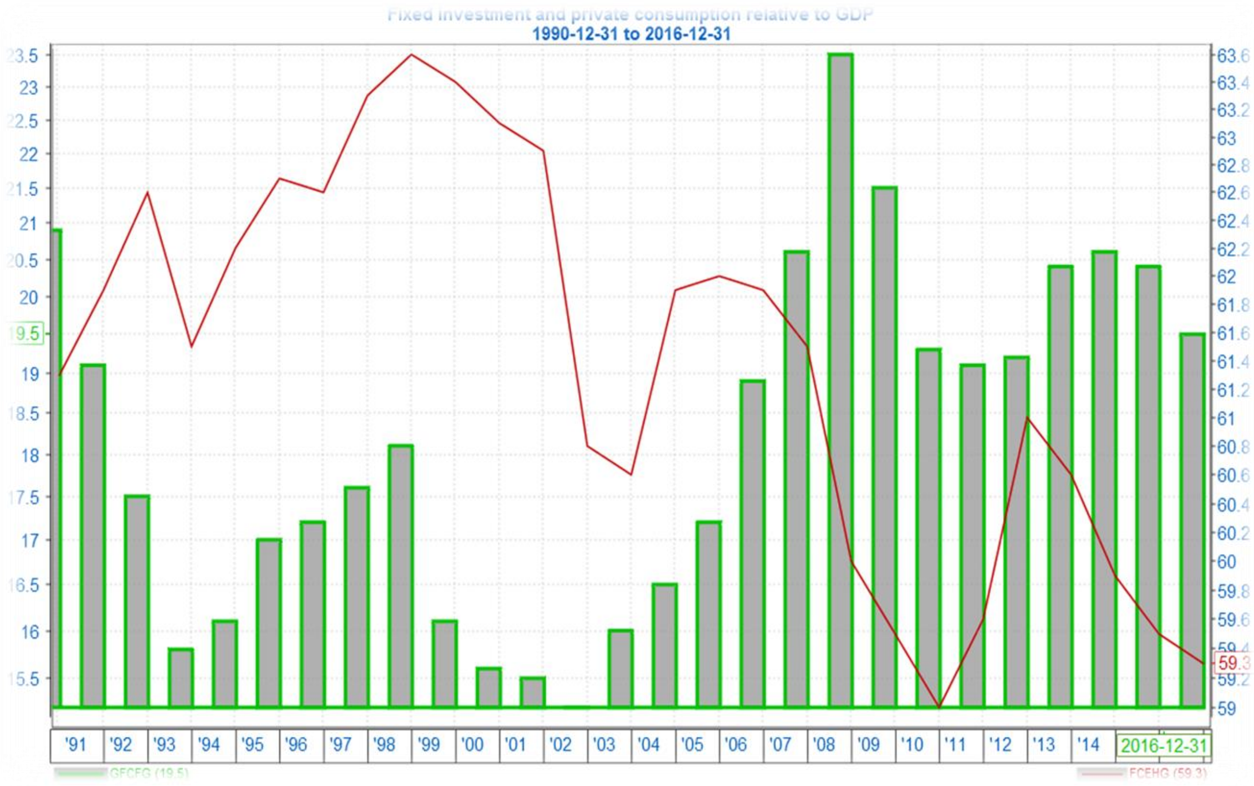
SA Consumer spending – on the mend?

Source: Tradingeconomics

IMARA Asset Management SA

However, a worrying trend remains rising unemployment in line with GDP weakness. Historically, there has been a tendency for wage growth to be lower when unemployment rises. This ultimately usually has a negative impact on household spending which is needed to drive expansion in fixed capital formation by business.

Final Consumption (Red) and Fixed Investment (Green) relative to GDP – they correlate



Source: Imara/Iress

Despite this we are of the opinion that household expenditure could gradually improve due to lower borrowing rates and declining inflation.

The ANC succession in December will likely be the main driving force for local investment markets in the near term. Should markets begin to price in a reformist win and a cyclical recovery in consumer expenditure ensues, ratings downgrades could be pushed out by 6 to 12 months which should lead to further strengthening of the rand exchange rate. This will also support a longer monetary easing cycle due to the favourable impact on inflationary expectations.

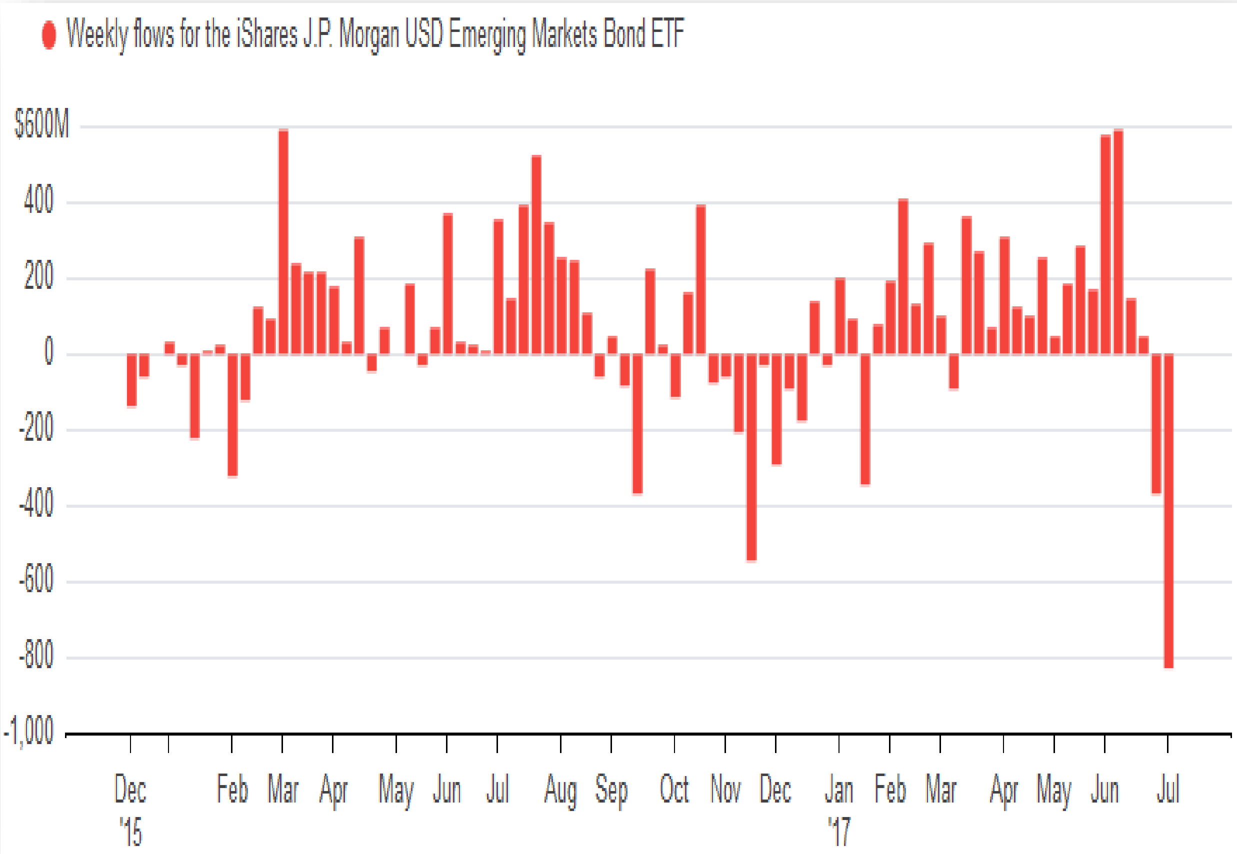
If the above pans out, we could expect a cyclical recovery in GDP growth momentum to approximately 1.5% in 2018 according to JPMorgan economists. The obvious risks to the above scenario will be a non-reformist outcome in December, a weaker rand, higher inflation and no further monetary easing which could lead to GDP growth not higher than 0.7% in 2018.

From a global perspective, we continue to witness improving emerging market data with higher growth being recorded which should filter through to local GDP growth, especially if inflation continues to drift lower. However, we may not benefit if we remain non-reformist after December.

Most emerging markets are experiencing disinflation which has supported strong international flows into emerging markets year to date, easing financial conditions. Cumulative inflows into local bonds year to date have been just over R5bn, the highest it has been since 2012**. We expect inflows to continue in due course if sizable yield differentials between developed markets and emerging markets remain. But this will be highly dependable on what happens to US interest rates and decisions by the FED.**

It's telling that these bond buyers respond negatively to even a relatively tame rise in developed-market yields. Recent outflows out of emerging market bonds and currencies were sparked by more hawkish comments by the FED with investors now ascribing a 75% probability of another rate hike by the FED in December.

Emerging market bond purchases – The FED might cause more outflows in the short term



Source: Bloomberg

It's natural for central bankers to tighten monetary policies in response to increasing growth and inflation. And this isn't necessarily bad for emerging markets as developed markets are their biggest trading partners which in turn should boost these economies. But the yield play by investors could cause more volatility.

So, as always, it will be interest rates that will determine asset prices for currencies, equities and bonds. And this will be driven by the US Federal Reserve!

To conclude:

- Doubts have increased on the ability of central banks to wind down their loose monetary policy given that inflation is struggling to reach their 2% target
- The FED's ability to increase interest rates will be a key factor for the ECB in their interest rate decisions
- For several months now, weak inflation and political disagreements in Washington have weighed on the dollar which has lost 7% against the euro since the beginning of the year
- Given the strength in the euro, the risk of course is that the recovery in growth could falter due to the large export base in the region
- Current forecasts are indicating that Harvey could be the most expensive natural disaster in US history, at about $160 billion
- The catalyst for a slight market correction could be the US tax reform debate, particularly if Congress does not look like it is in agreement on main elements. But stocks should resume their climb after a bit of a sell-off if stimulus and tax reforms are approved (which is likely)
- Following the better than expected second quarter GDP growth of 2.5 percent on an annualised basis, further analysis is suggesting that local household final consumption expenditure might be rebounding
- Cumulative inflows into local bonds year to date have been just over R5bn, the highest it has been since 2012
- The ANC succession in December will likely be the main driving force for local investment markets in the near term
- **We expect inflows to continue in if the sizable yield differentials between developed markets and emerging markets remain. But this will be highly dependable on interest rate movements in the US.**

Sincerely

Chris

Chris Botha