Communiqué

Monthly
South Africa
November 2017

Illovo Edge, 3rd Floor, Cnr Harries & Fricker Roads, Illovo. Johannesburg
+27 11 550 6181

In a sweet spot, for now

Global

Global equity markets have continued to drift higher and in some cases, have reached new record highs. Developed economies are in a “sweet spot” of moderately above trend growth accompanied by low inflation and easy monetary policy with only the US likely to continue to gradually hike key interest rates. As a result, we expect global markets to continue drifting higher given this supportive environment but will be vulnerable to any news that upsets industry consensus on moderate growth, low inflation and low interest rates.

The US interest rate markets are pricing in less than one FED rate hike until the end of 2018 but given the rising inflation (albeit slow) backdrop we expect at least two rate hikes over the next twelve months. US treasuries could therefore be vulnerable in the event of any inflationary surprises. However, if inflation does surprise on the upside, this could be supportive of the dollar and US equities.

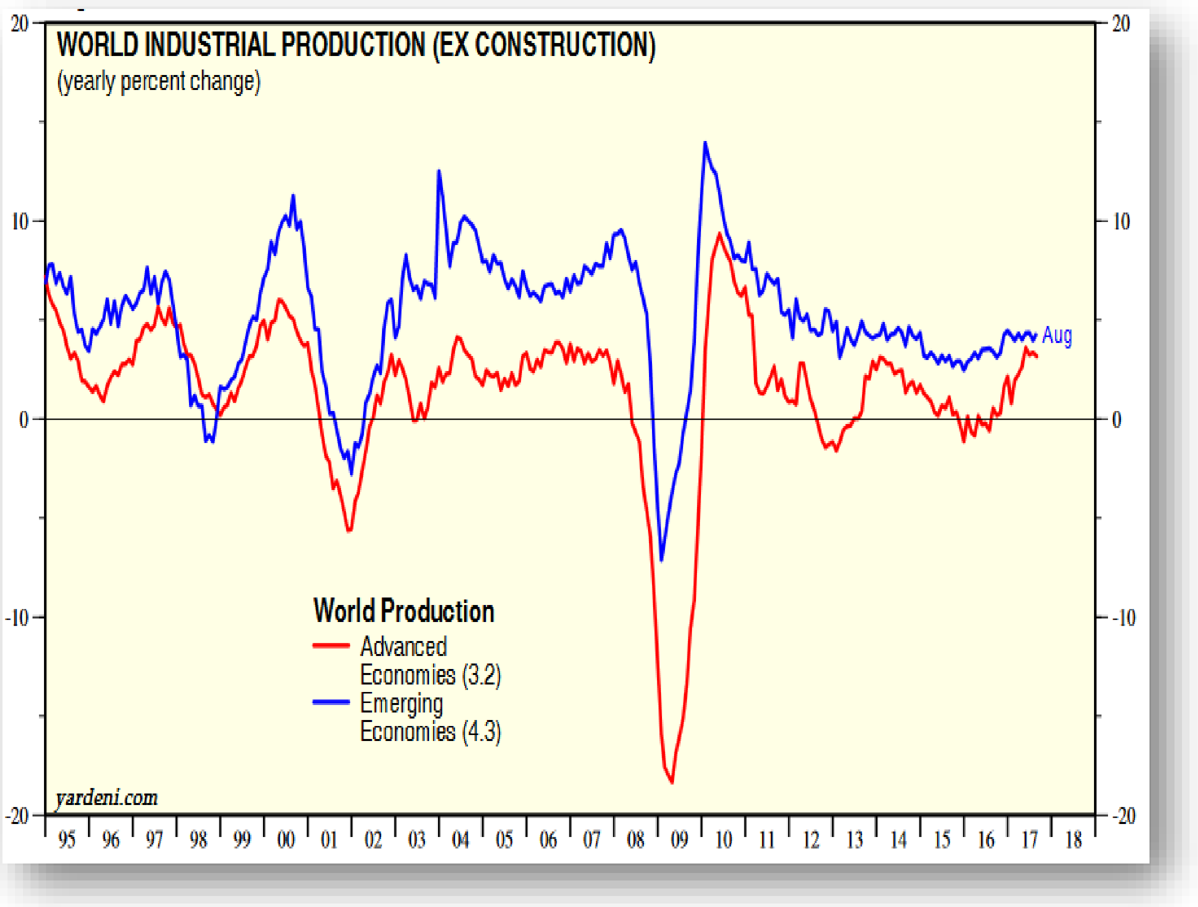
US core inflation – likely to rise

So far, US inflation has surprised on the downside, with core inflation for August reported at only 1.7% but it’s likely that this will start to pick up in coming months as the unemployment rate has been below 4.5% since March 2017 and the economy is currently near full capacity.

In Europe, the strength of the Euro has been the main theme in 2017 so far which has dampened the economic recovery somewhat but is nonetheless recovering. The ECB is the main factor standing in the way of further currency strength as it could start warning about the deflationary impact of the strength in the euro and potentially delay the tapering of quantitative easing.

We are currently witnessing an unusual convergence in the global economy. Global industrial production currently stands at 3.7% year on year, the highest it's been in five years. Also, emerging market and developed market growth rates have not been this similar since 2001.

Global Industrial Production – the great convergence



Source: Yardeni Research October 2017

The rise in industrial production has been very supportive of industrial metal prices, up 20% year on year. Expectations by most economists are for global GDP to continue to grow above 3.5% for the next two years which implies an extension of industrial production and metal prices.

IMF hikes global growth forecast

Table 1.1. Overview of the *World Economic Outlook* Projections
(Percent change, unless noted otherwise)

		Projections		Difference from January 2017 *WEO Update*[1]		Difference from October 2016 WEO[1]	
	2016	2017	2018	2017	2018	2017	2018
World Output	**3.1**	**3.5**	**3.6**	**0.1**	**0.0**	**0.1**	**0.0**
Advanced Economies	**1.7**	**2.0**	**2.0**	**0.1**	**0.0**	**0.2**	**0.2**
United States	1.6	2.3	2.5	0.0	0.0	0.1	0.4
Euro Area	1.7	1.7	1.6	0.1	0.0	0.2	0.0
Germany	1.8	1.6	1.5	0.1	0.0	0.2	0.1
France	1.2	1.4	1.6	0.1	0.0	0.1	0.0
Italy	0.9	0.8	0.8	0.1	0.0	–0.1	–0.3
Spain	3.2	2.6	2.1	0.3	0.0	0.4	0.2
Japan[2]	1.0	1.2	0.6	0.4	0.1	0.6	0.1
United Kingdom	1.8	2.0	1.5	0.5	0.1	0.9	–0.2
Canada	1.4	1.9	2.0	0.0	0.0	0.0	0.1
Other Advanced Economies[3]	2.2	2.3	2.4	0.1	0.0	0.0	0.0
Emerging Market and Developing Economies	**4.1**	**4.5**	**4.8**	**0.0**	**0.0**	**–0.1**	**0.0**
Commonwealth of Independent States	0.3	1.7	2.1	0.2	0.3	0.3	0.4
Russia	–0.2	1.4	1.4	0.3	0.2	0.3	0.2
Excluding Russia	1.8	2.5	3.5	0.0	0.2	0.2	0.6
Emerging and Developing Asia	6.4	6.4	6.4	0.0	0.1	0.1	0.1
China	6.7	6.6	6.2	0.1	0.2	0.4	0.2
India[4]	6.8	7.2	7.7	0.0	0.0	–0.4	0.0
ASEAN-5[5]	4.9	5.0	5.2	0.1	0.0	–0.1	0.0
Emerging and Developing Europe	3.0	3.0	3.3	–0.1	0.1	–0.1	0.1
Latin America and the Caribbean	–1.0	1.1	2.0	–0.1	–0.1	–0.5	–0.2
Brazil	–3.6	0.2	1.7	0.0	0.2	–0.3	0.2
Mexico	2.3	1.7	2.0	0.0	0.0	–0.6	–0.6
Middle East, North Africa, Afghanistan, and Pakistan	3.9	2.6	3.4	–0.5	–0.1	–0.8	–0.2
Saudi Arabia	1.4	0.4	1.3	0.0	–1.0	–1.6	–1.3
Sub-Saharan Africa	1.4	2.6	3.5	–0.2	–0.2	–0.3	–0.1
Nigeria	–1.5	0.8	1.9	0.0	–0.4	0.2	0.3
South Africa	0.3	0.8	1.6	0.0	0.0	0.0	0.0
Memorandum							
European Union	2.0	2.0	1.8	0.2	0.0	0.3	0.0
Low-Income Developing Countries	3.6	4.7	5.3	0.0	–0.1	–0.2	0.1
Middle East and North Africa	3.8	2.3	3.2	–0.6	–0.1	–0.9	–0.2
World Growth Based on Market Exchange Rates	2.4	2.9	3.0	0.1	0.0	0.1	0.1
World Trade Volume (goods and services)	**2.2**	**3.8**	**3.9**	**0.0**	**–0.2**	**0.0**	**–0.3**
Imports							
Advanced Economies	2.4	4.0	4.0	0.2	–0.2	0.1	–0.2
Emerging Market and Developing Economies	1.9	4.5	4.3	0.3	–0.4	0.4	–0.2
Exports							
Advanced Economies	2.1	3.5	3.2	0.1	–0.2	0.0	–0.8
Emerging Market and Developing Economies	2.5	3.6	4.3	–0.1	–0.3	0.0	0.1
Commodity Prices (U.S. dollars)							
Oil[6]	–15.7	28.9	–0.3	9.0	–3.9	11.0	–5.1
Nonfuel (average based on world commodity export weights)	–1.9	8.5	–1.3	6.4	–0.4	7.6	–0.6
Consumer Prices							
Advanced Economies	0.8	2.0	1.9	0.3	0.0	0.3	0.0
Emerging Market and Developing Economies[7]	4.4	4.7	4.4	0.2	0.0	0.3	0.2
London Interbank Offered Rate (percent)							
On U.S. Dollar Deposits (six month)	1.1	1.7	2.8	0.0	0.0	0.4	0.7
On Euro Deposits (three month)	–0.3	–0.3	–0.2	0.0	0.0	0.1	0.2
On Japanese Yen Deposits (six month)	0.0	0.0	0.0	0.0	0.0	0.1	0.1

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during February 1–March 1, 2017. Economies are listed on the basis of economic size. The aggregated quarterly data are seasonally adjusted.
[1]Difference based on rounded figures for the current, January 2017 *World Economic Outlook Update*, and October 2016 *World Economic Outlook* forecasts.
[2]Japan's historical national accounts figures reflect a comprehensive revision by the national authorities, released in December 2016. The main revisions are the switch from the System of National Accounts 1993 to the System of National Accounts 2008 and the updating of the benchmark year from 2005 to 2011.
[3]Excludes the G7 (Canada, France, Germany, Italy, Japan, United Kingdom, United States) and euro area countries.
[4]For India, data and forecasts are presented on a fiscal year basis and GDP from 2011 onward is based on GDP at market prices with FY2011/12 as a base year.

2 International Monetary Fund | April 2017

While the global backdrop remains supportive of emerging markets in the near term, there are three potential catalysts for weakness in this asset class.

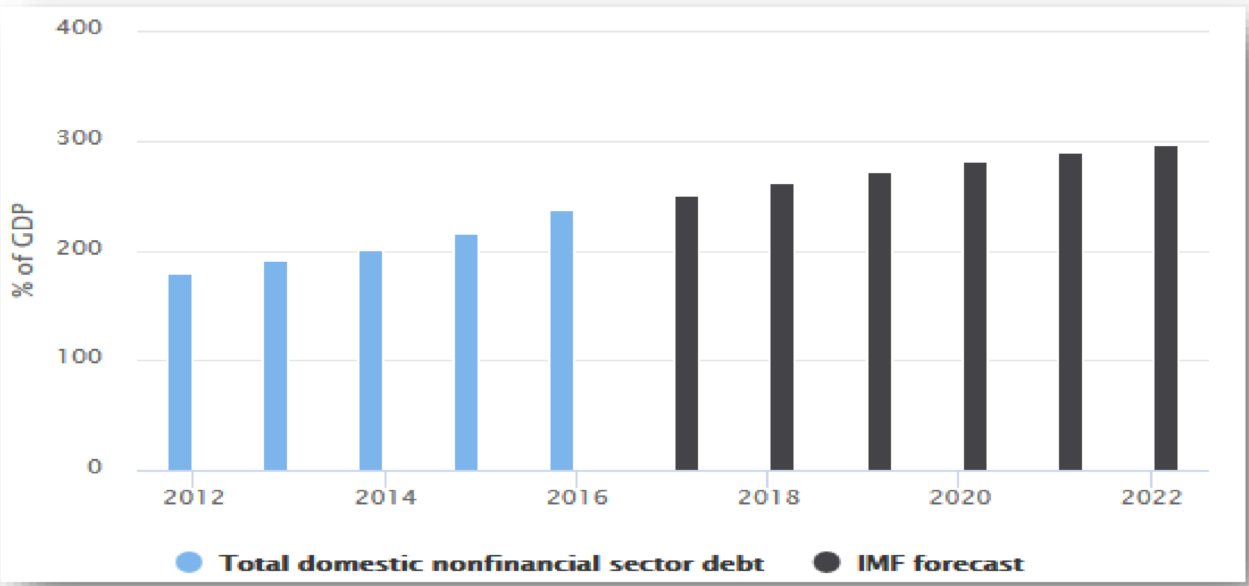
Firstly, Chinese economic growth has beat expectations year to date mainly due to higher credit extension but also due to synchronised global growth. It is however possible that growth in credit extension and infrastructure projects might slow after the upcoming Chinese Communist Party conference as growth initiatives were more than likely "fast tracked" to ensure impressive growth around the Party conference. This could have a negative impact on commodity prices accompanied by a global disinflationary impulse which will likely lead to heightened volatility in emerging markets and currencies.

Secondly, higher inflation in the US offers a potential headwind for emerging markets given higher recent earnings growth. Despite inflation in the US being low, improving labour market conditions and rising wages could at some point reverse this trend.

Thirdly, is rising debt levels in China. According to the IMF, China's economy is reliant on too much debt and the enormous boom in credit could lead to a new financial crisis. "International experience suggests that China's current credit trajectory is dangerous with increasing risks of a disruptive adjustment and/or a marked growth slowdown," the report said.

GDP in the world's second largest economy is set to grow by 6.7% this year and 6.4% next year, better than the 6.6% and 6.2% growth rates the IMF forecast at the beginning of the year. Moreover, synchronized global growth and continued government spending should see these levels be maintained in the near term.

Chinese debt is ballooning



Source: UK Telegraph October 2017

"Sustainable growth - growth that can be achieved without excessive credit expansion - was likely much lower than actual growth over the last five years," the IMF said.

Analysts at the organisation estimate that if credit was growing at a sustainable rate, GDP would have increased by an average of 5.3% per year from 2012 to 2016 rather than the 7.3% reported. A slowdown in this economy will have a severe impact on emerging market economies and markets.

However, despite the above risk, we expect Chinese authorities to continue to "engineer" growth of 6% to 6.5% to calm any fears.

Local

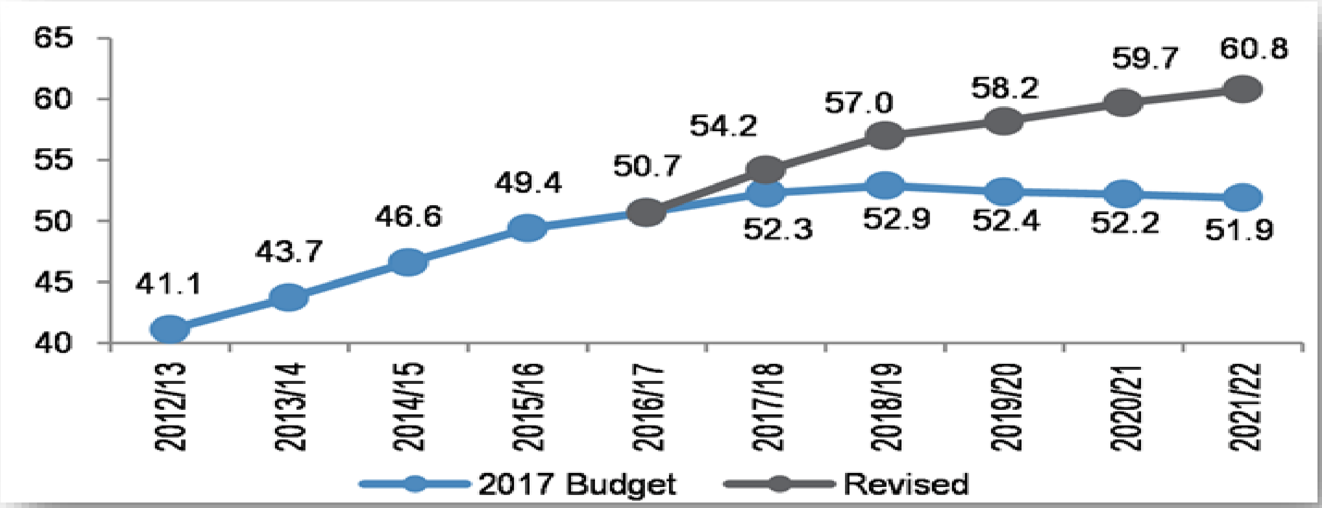
Minister Gigaba delivered a sobering mid-term budget with plenty of reality checks. The fiscal deficit increased to 4.3% of GDP from 3.1% previously due to lower than expected tax collections (lower GDP growth) and is now more in line with IMF forecasts. The shortfall will partly be addressed by selling a R4bn stake in Telkom. Some of the proceeds will also be used to save SAA and the Post Office from bankruptcy. A case of throwing good money after bad money then. Unfortunate.

A bit surprising was a rather sharp reduction in economic growth expectations with the Ministry cutting growth for 2017 to 0.7% from 1.3% announced in February which again is spot-on with the latest IMF forecast.

Following the budget, bond yields spiked to 9.2% (8.5% at the beginning of October) accompanied by the rand breaking through the key R14 to the dollar level given the expected fiscal shortfall and the funding thereof. The jump in the 10 year bond yield obviously means that servicing of new long term debt will be more expensive, further worsening the deficit. A mitigating factor is that most of government debt in the form of long term bonds is owned by locals, with debt owed to foreigners amounting to only 2% of GDP.

Post the mid-term speech, economists now expect Moody's as well as S&P to downgrade local currency debt by at least one notch to BB+. The declining GDP per capita, worsening debt to GDP and deteriorating fiscal position have heightened the risk of further downgrades towards the end of November whereas previous expectations were only for downgrades in March next year.

SA gross debt to GDP – outlook worsened after budget



Source: JP Morgan October 2017

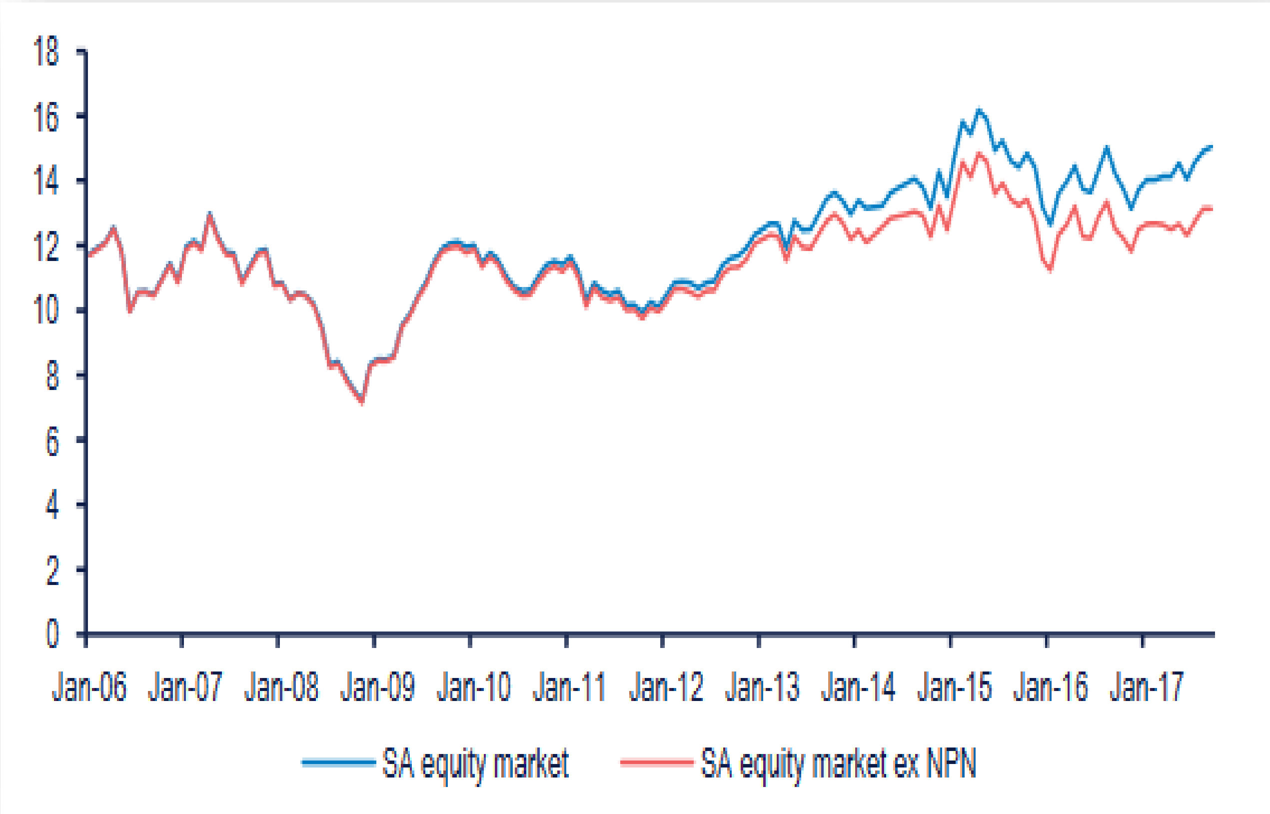
IMARA
Asset Management SA

The weakening currency could cause inflation to rise again (after entering a declining trend) which will make a further rate cut in the fourth quarter unlikely putting more strain on very poor consumer sentiment.

The political outcome after December will also be a key consideration for prospects in 2018. A potential outcome at this stage is too close to call but a compromise outcome is however likely. As things stand now, we are in a binary trade situation with the rand and bonds moving either way. If there is no change, expect further rand weakness accompanied by spiking bond yields and the inverse occurring if a positive change occurs.

Despite some headwinds, we remain positive on local equities, particularly rand hedges given the potential downgrades. The SA equity market is trading on a forward price earnings ratio of 15 and 13 if Naspers is removed which is not onerous compared to historical standards. Furthermore, nearly 40% of the market has dividend yields that exceed 4%, the highest proportion since 2011.

SA Equities price/earnings ratio - inexpensive ex Naspers



Source: Investec Bank October 2017

The post Nenegate period has seen consistent large outflows from the local equity market accompanied by large inflows into local bonds due to the attractive yield differential between local and foreign bonds.

We anticipate that foreign selling of local equities could very well reverse as we expect earnings upgrades to be forthcoming given the improved global growth backdrop and large rand hedge component of the local market. A positive result at the ANC elective conference will lend further support to local equities. We also expect commodity prices to remain firm due to improving global growth which will also support local earnings.

To conclude:

- Developed economies are in a “sweet spot” of moderately above trend growth accompanied by low inflation and easy monetary policy with only the US likely to continue to gradually hike key interest rates
- US inflation has surprised on the downside but is likely to pick up in coming months as the unemployment rate has been below 4.5% since March and the economy is near full capacity
- The ECB is the main factor standing in the way of further euro strength as it could start warning about the deflationary impact of the strength in the euro and potentially delay the tapering of quantitative easing
- Global industrial production currently stands at 3.7% year on year, the highest it’s been in five years. Also, emerging market and developed market growth rates have not been this similar since 2001
- Despite Chinese debt concerns, we expect authorities to continue to “engineer” growth of 6% to 6.5% to calm fears
- Minister Gigaba delivered a sobering mid-term budget. The fiscal deficit increased to 4.3% of GDP from 3.1% previously due to lower than expected tax collections
- The shortfall will partly be addressed by selling a R4bn stake in Telkom
- The political outcome after December will be a key consideration for prospects in 2018. A potential outcome at this stage is too close to call but a compromise outcome is likely
- We remain positive on local equities, particularly rand hedges given more potential downgrades

Sincerely

Chris

Chris Botha