**Communiqué**

Monthly
South Africa
July 2018

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

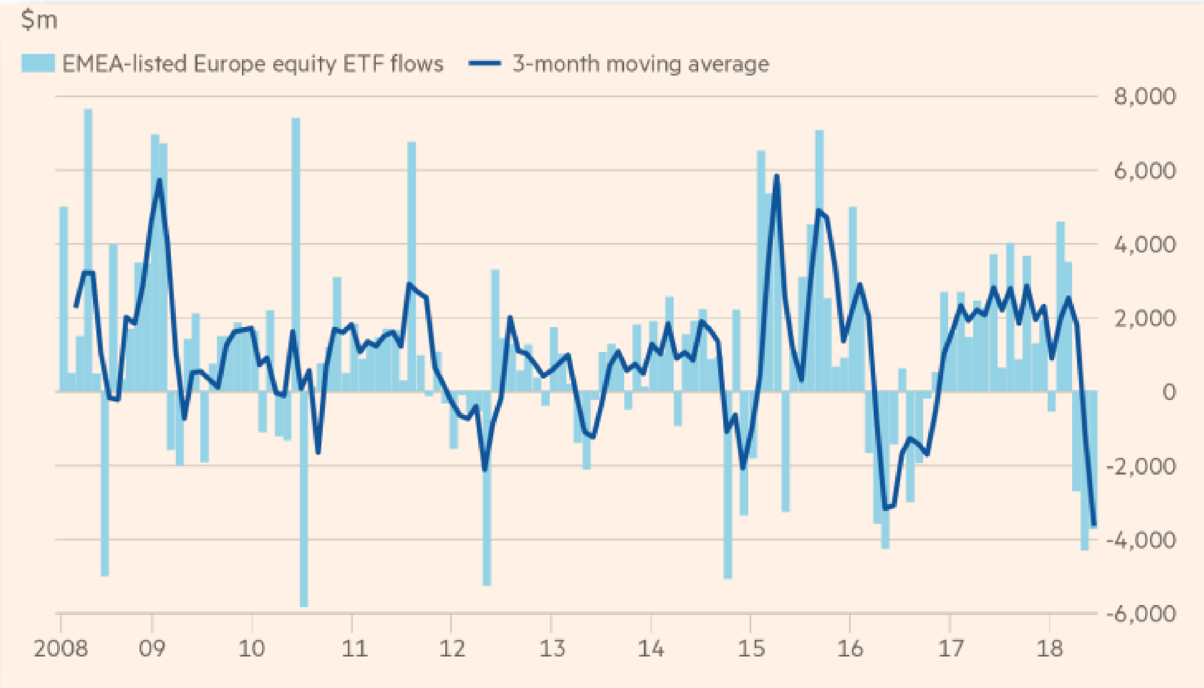
# *Trade War worries*

## *Abroad*

Trade tensions between the US and the rest of the world have not caused any dramatic moves yet but there are some signs emerging that equity investors are becoming more nervous about the possible economic impact this might have on the global economy.

Eurozone equities have substantially underperformed US equities for some time despite weakness in the euro against the dollar which usually benefits European companies due to the large export base in the region. A contributing factor might be political risk in the region, particularly in Italy but the main reason is likely market concerns around rising trade tensions. European companies export far more goods and services than their US counterparts and will therefore be more exposed to the negative impact trade tensions might have on the economy and ultimately company earnings.

***European equity flows – experienced big sell-off YTD***




*Source: Financial Times*

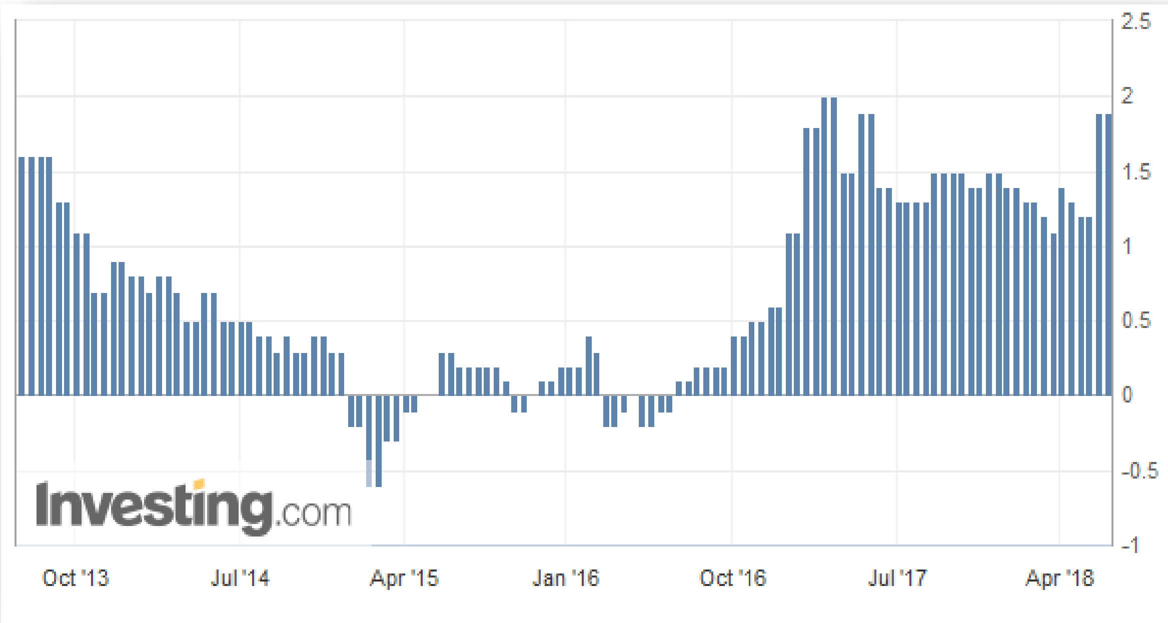
We have also witnessed weakness amongst large market capitalisation stocks due to their higher exports compared to mid and small market capitalisation stocks. More domestically focused mid and small cap stocks have outperformed large stocks recently due to the perceived lower risk exposure to a trade war.

Moreover, listed equities in China have also experienced substantial weakness of late despite most of the companies that dominate the MSCI China Index generate their revenue in China. The accompanied weakness of the renminbi against the dollar also reflects concerns around rising trade restrictions from the US in particular.

Despite nervousness in equity markets, advance economies appear to have entered the third quarter with solid economic growth momentum. The US economy appears to have strengthened by a significant margin in the second quarter with a consensus number of around 4 percent on an annualised basis expected. The pick-up in the pace of GDP growth is more than likely being supported by improved consumption due to a strong labour market and recent tax cuts.

Recent data in Europe also indicated that growth there is steadily improving with price inflation rising albeit somewhat slower than the ECB prefers.

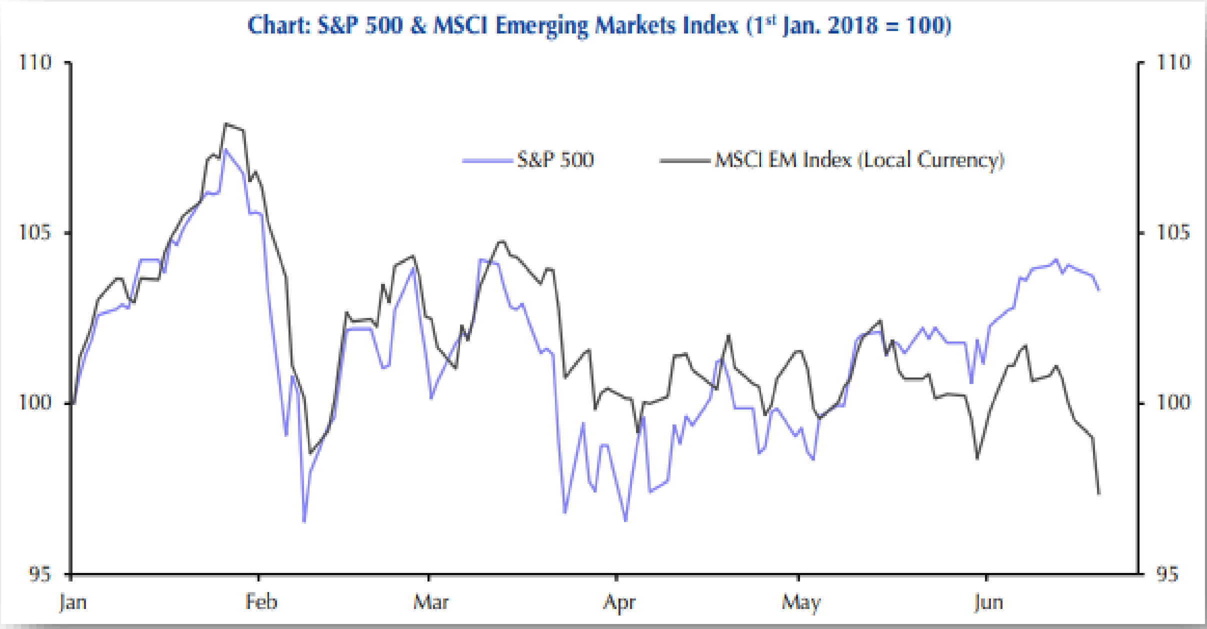
***Eurozone Consumer Price Index (CPI) year on year***




*Source: Investing. Com*

Emerging market equities have experienced larger outflows relative to developed markets due to fears that they will be impacted more severely if trade wars escalate as they are generally large exporters of basic materials which up to now has been the main talking point regarding import duties and protectionism. This has been accompanied by currency weakness which will likely weigh on economic growth in these regions.

***S&P 500 vs. MSCI Emerging Markets Index – severe outflows of late***




*Source: Capital Economics*

Following a prolonged period in which most emerging markets central banks have loosened monetary policy, the recent currency weakness has shifted the balance, prompting rate hikes in Argentina, Turkey and Indonesia. Mexico and Brazil will likely follow suit with South Africa under pressure to also hike if the rand weakness further. But for now, we expect the SARB to remain on the side-lines as the rand has regained some ground and inflationary expectations fairly benign in the short term.

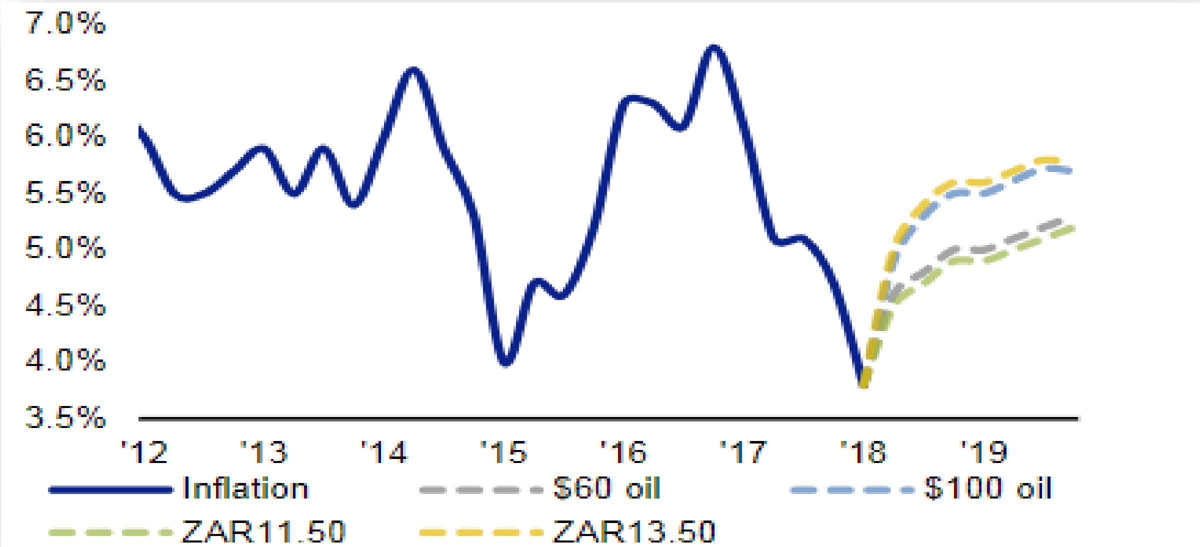


IMARA
Asset Management SA

## *South Africa*

Historically, SA's consumer confidence moved with inflation and interest rates. For now, we expect interest rates to remain flat for the remainder of the year depending on inflationary expectations. The SARB currently forecasts inflation at 5% for the next 18 to 24 months with risks to the upside from a weaker rand and/or higher oil price. It is likely that the SARB will consider hiking the repo rate in the event of the rand trading towards the R14.5 to R15.0 level against the dollar.

***SA CPI inflation estimates at different ZAR and oil prices***



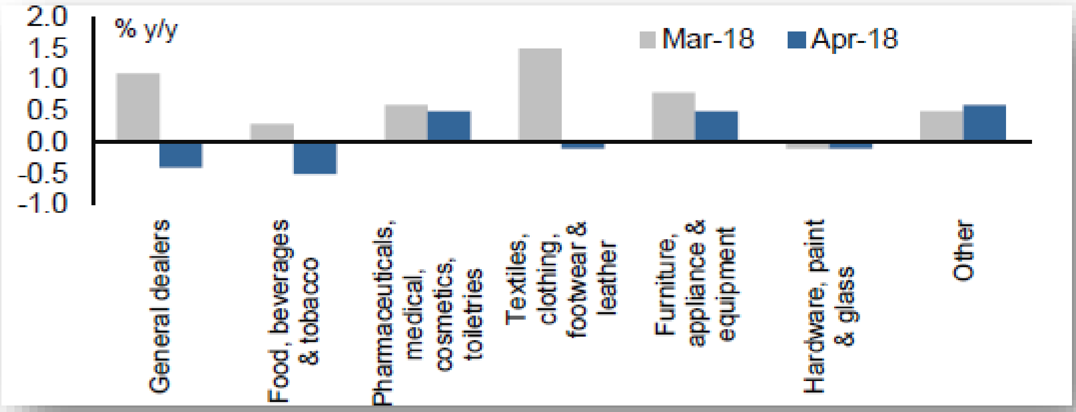

*Source: Avior Capital Markets*

From a consumer perspective (largest contributor to GDP), retail sales growth fell 0.5% year on year in April from 4.6% growth previously, substantially below market expectations of 4.5% growth for April. The negative number is more than likely due to the VAT increase which was effective 1 April 2018 making a negative contribution to GDP for the quarter.

Retail inflation rose to 2.0% year on year in April, from 1.6% previously but remained well below CPI inflation of 4.5% year on year indicating that retailers' operating margins continued to remain supressed in a competitive environment as they sacrifice price increases to maintain market share.

Despite consumer sentiment improving substantially in the beginning of the year, households are still facing challenges. Credit extension remains fairly muted due to high indebtedness. Furthermore, elevated unemployment rates and increases in personal income taxes (and the VAT hike) are also contributing to a tough consumer environment. The elevated oil price will also cause negative knock-on effects in due course impacting consumption patterns.

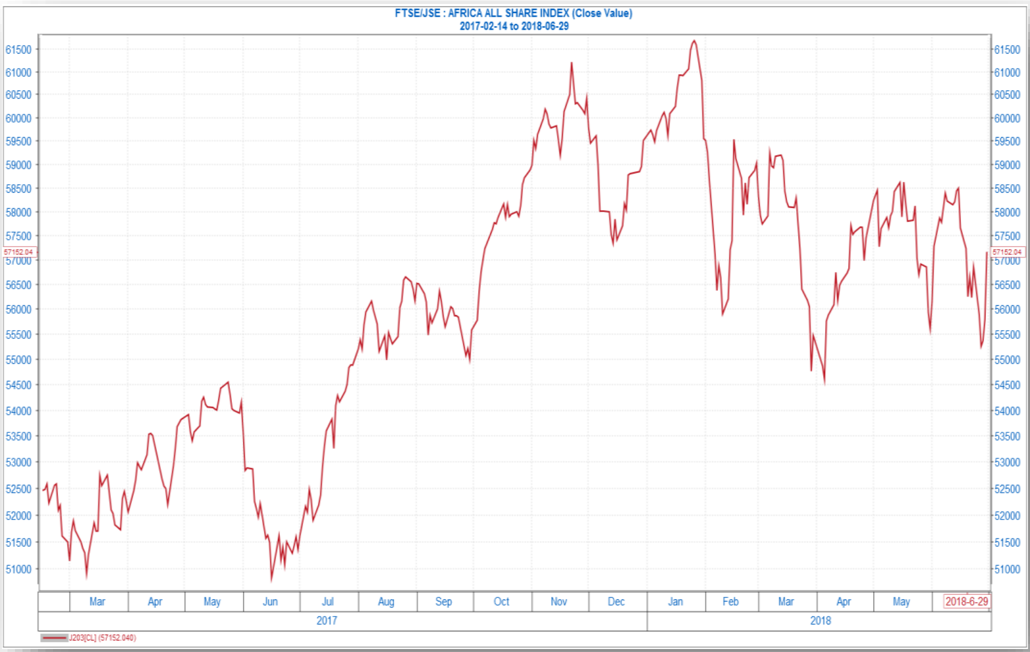
***Retail sales growth per sub category***




*Source: Investec Bank*

We expect volatility in our bond and equity markets to remain in the near term as investors watch domestic political and policy developments with primary concerns around land expropriation, mining charter and fiscal sustainability of SOE's. To quote recent comments by the IMF; "clearly articulating policy and regulatory decisions related to land reform in a fair, transparent and market-friendly manner would help remove uncertainty, which is currently weighing on investor sentiment".

***JSE All Share Index – year to date negative 1.2% including dividend yield***




The JSE YTD delivered a negative return of 4.3% in absolute terms but is only down by 1.2% if one includes the current dividend yield of 3.1%.

*Source: Iress/IAMSA*

## *To Conclude*

- Trade tensions between the US and the rest of the world have not caused any dramatic moves yet but there are some signs emerging that equity investors are becoming more nervous
- Eurozone equities have substantially underperformed US equities for some time despite weakness in the euro against the dollar which usually benefits European companies
- More domestically focused mid and small cap stocks have outperformed large stocks recently due to the perceived lower risk exposure to a trade war
- Recent data in Europe indicated that growth there is steadily improving with price inflation rising albeit somewhat slower than the ECB prefers
- Emerging market equities have experienced larger outflows relative to developed markets due to fears that they will be impacted more severely if trade wars escalate
- Historically, SA's consumer confidence moved with inflation and interest rates. The SARB currently forecasts inflation at 5% for the next 18 to 24 months with risks to the upside from a weaker rand and/or higher oil price
- We expect volatility in our bond and equity markets to remain in the near term as investors watch domestic political and policy developments with primary concerns around land expropriation, mining charter and fiscal sustainability of SOE's

Sincerely

Chris

**Chris Botha**