BELMONT
ASSET MANAGEMENT

MARKET COMMENTARY – QUARTER ENDED JUNE 2018

MARKET REVIEW

During the second quarter of 2018 escalating tensions over US trade tariffs dominated the headlines. Following through with his election campaign promise to reverse unfair trade practices, US President Donald Trump expanded the scope of previously announced tariffs on US imports of aluminium (10%) and steel (25%) to include those from the European Union (EU), Mexico, and Canada. He also threatened to levy tariffs on imports of European motor vehicles, prompting the EU to respond with potential retaliatory tariffs on select imports from the US. Further trade tariffs were implemented against China due to alleged intellectual property theft and China also vowed to take retaliatory measures.

Trade war concerns led to equity market declines in economies heavily reliant on US demand, particularly those of emerging markets. The US dollar strengthened against most other currencies which was another headwind for emerging markets.

INDEX	3 MTH TOTAL RETURN IN USD (%)	3 MTH TOTAL RETURN IN EUR (%)	3 MTH TOTAL RETURN IN GBP (%)
MSCI WORLD	1.7	7.2	8.1
S&P 500 (US)	3.4	9.0	9.9
FTSE EUROPE EX UK	-2.7	2.5	3.4
FTSE ALL SHARE(UK)	2.8	8.3	9.2
TOPIX (JAPAN)	-3.0	2.2	3.1
MSCI EMERGING MARKETS	-8.0	-3.1	-2.2
MSCI ASIA EX JAPAN	-5.4	-0.3	0.5

The US

The S&P 500 Index rose by 3.4% in US dollars.

The U.S. economy is showing signs of broad-based strength across the manufacturing and services sectors and commercial and residential real estate. The unemployment rate reached an 18-year low of 3.8%. The recent passage of tax stimulus at both the corporate and individual level has spurred growth and helped to counterbalance tightening Federal Reserve (Fed) monetary policy.

As expected, the Fed raised its target rate by 0.25% to between 1.75% and 2.0% and marginally increased its 2018 forecasts for growth and inflation. It now anticipates two further rate increases for this year and three for 2019.

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Europe

Eurozone

The FTSE Europe ex UK index rose by 2.5% in euros but fell by 2.7% in US dollars.

The Eurozone experienced some political uncertainty during the quarter. There were concerns that Italy might need to hold fresh elections following the inconclusive outcome of the March vote. Markets feared that this would turn into an effective referendum on Italy's membership of the euro. However, a governing coalition was eventually formed between populist parties, the League and the Five Star Movement. The coalition announced Giuseppe Conte as the country's next Prime Minister. In Spain, Mariano Rajoy was forced out of office by a no confidence vote in parliament and Socialist leader Sanchez took over as Prime Minister. In Germany, Chancellor Angela Merkel clashed with sister party the CSU over immigration policy.

Eurozone economic data pointed to growth at a slower pace that last year. First quarter GDP fell to 0.4% quarter-on-quarter, down from 0.7% in the fourth quarter of 2017. Inflation rose to 1.9% year-on-year in May, driven predominantly by higher oil prices. The European Central Bank (ECB) announced that interest rates would not be going up until at least the summer of next year, although they did confirm that eurozone quantitative easing would come to an end by the end of this year.

UK

The FTSE All Share index rose by 9.2% in sterling and by 2.8% in US dollars.

At the end of last quarter, markets were convinced that the Bank of England would raise rates in May. However, May and then June came and went with no action. The absence of a rate hike contributed to a renewed decline in the value of sterling against a strong US dollar. As a result, the more internationally exposed large market capitalisation UK-listed companies outperformed their smaller counterparts. Ongoing merger and acquisition activity also supported returns over the period.

UK members of parliament debated and voted on 15 amendments to the EU Withdrawal Bill. They voted to reject an amendment which would have allowed parliament to block a 'no deal' Brexit.

Japan

The Topix index rose by 1.1% in yen but fell by 3.0% in US dollars.

Japanese equities started the quarter strongly, slid with news of a decline in the country's GDP and were volatile throughout June with each new trade-related move from the US and counter-move from China or the EU. The yen fell 4% against the U.S. dollar, giving a boost to Japan's export-driven corporations. Gross domestic product shrank in the January-March period, after nine consecutive quarters of growth. In June, the Bank of Japan's (BoJ's) policy board essentially conceded that their goal of 2% annual inflation is out of reach in the near term. BOJ leaders also said they must maintain an ultra-loose monetary policy, since labour markets are tightening without prices rising.

Emerging Markets

The MSCI Emerging Markets Index fell by 8.0% in US dollars. There was a sharp reversal of foreign capital inflows as investors weighed the ramifications of a strengthening US dollar, heightened global trade tensions and uncertainty related to elections in Latin America.

China: The MSCI China IMI Index fell by 3.3% in US dollars. Chinese stocks lost ground after five consecutive quarterly gains. The MSCI China IMI was resilient during April and May when selling pressure surfaced in emerging markets. However, escalating trade tensions with the U.S. finally took their toll on Chinese equities, along with tighter credit regulations that weighed on overall business activity. Data for May revealed slower industrial output and retail sales.

Russia: The MSCI Russia IMI Index fell by 6.3% in US dollars. The US enforced sanctions on various Russian oligarchs and companies to punish the country for actions in Crimea, Ukraine and Syria as well as alleged attempts to destabilise Western democracies.

Brazil: The MSCI Brazil IMI Index fell by 26.2% in US dollars, its worst quarterly decline since 2015. Worries mounted over October's presidential election and progress on fiscal reforms to help pave the way for sustainable economic growth. In May, Brazil's central bank unexpectedly left interest rates unchanged. A truck drivers' strike paralysed the economy and further intensified the stock market selloff.

India: The MSCI India IMI Index fell by 2.2% in US dollars. India's central bank has raised its benchmark interest rate for the first time in four years, citing concerns about growing inflationary pressures stemming from rising oil prices and recent currency depreciation.

South Africa: Despite the new wave of optimism following the election of Cyril Ramaphosa as president, GDP growth disappointed with a 2.2% decrease over the previous quarter. This contraction was largely driven by slower growth in the manufacturing and mining industries as the prices of rare metals and iron ore came under pressure. At current levels, the decreasing feasibility of mining gold and platinum is of particular concern to the South African economy and could increase the risk of further mine closures and job losses in future.

Local consumers suffered a double blow in the second quarter, as the petrol price reached an all-time high and Value-Added Tax (VAT) was increased by 1%. The South African Reserve Bank however offered some reprieve, voting unanimously to leave the interest rate unchanged. The Consumer Price Index (CPI) was up by 4.6% year-on-year, which came in slightly below expectations. Rates are forecasted at this stage to remain on hold until mid-2019.

Cyril Ramaphosa's recent goal to kickstart the economy by attracting $100bn of foreign investment in the next five years was off to a good start as Saudi Arabia and the United Arab Emirates each pledged $10 billion for investment in the energy and tourism industries.

The Rand and the JSE: The Rand retreated by 16.1% against the dollar, 9.2% against sterling and 9.9% against the euro as the oil price rallied and emerging markets once again fell out of favour over trade war fears. Meanwhile share prices on the JSE thrived on the back of a weaker Rand, notably with a 4.5% increase in the Top 40 index and a 21.4% jump in the resources index. On the flipside however, local (Rand-exposed) companies suffered the reverse effect. Financials ended down 8.1% for the quarter while general retailers were worst affected, falling 19.2%.

INVESTMENT ENVIRONMENT AND OUTLOOK: *A few headwinds blowing*

In this forward-looking section of our report, we highlight a few dominant factors affecting the current investment outlook. Space does not permit covering the literally thousands of possible variables (not to mention the impossible, also known as surprises!).

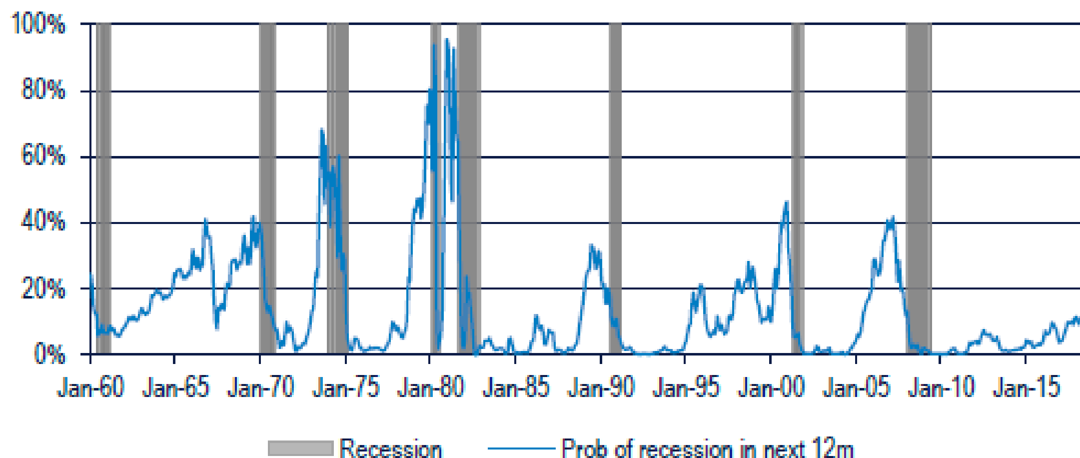
In our view, the most important features of the current international economy are the potential for retaliation to further Donald Trump-led US import tariff increases ("trade wars") and US Federal Open Market Committee (FOMC) -led increases in the federal funds target overnight rate. We could also mention the oil price as it is up 60% in the past 12 months but as this is largely as a result of a booming global economy coupled with lagging supply it may slow growth in the short term. It is however unlikely to abort it owing to the self-adjusting nature of the oil price.

The other two factors constitute man-made interference in the economy and as such they can more easily affect the outlook for global economic growth. This has implications for corporate earnings growth, share prices and ultimately of course portfolio investment strategy.

As stated in our previous report, we believe that Trump is using tariffs as a negotiating tactic to level an undoubtedly tilted playing field and that contrary to popular perception average global tariffs ultimately may end up *lower*. Support for this view is the world's largest free trade agreement recently concluded between the EU and Japan which, although the US was not a party to it, is a step in the right direction.

Rising short term interest rates in the US are of greater concern if the US Federal Reserve (Fed) is too "hawkish" and raises interest rates too much. In the past this has led to yield curve inversion (short rates higher than long rates) followed by economic recession and equity bear markets. This is encapsulated in a model developed by Arturo Estrella and Frederic S. Mishkin of the New York Fed who developed a robust recession-prediction model based on yield curve inversion ("The Yield Curve as a Predictor of U.S. Recessions" 1996). In this paper they claim that the yield curve—specifically, the spread between the interest rates on the ten-year Treasury note and the three-month Treasury bill—is a valuable forecasting tool. It is simple to use and significantly outperforms other financial and macroeconomic indicators in predicting recessions two to six quarters ahead. Although no model is perfect, it is comforting that this model is still showing a low probability of recession (chart 1):

Chart 1: New York Fed model and probability of recession in next 12 months

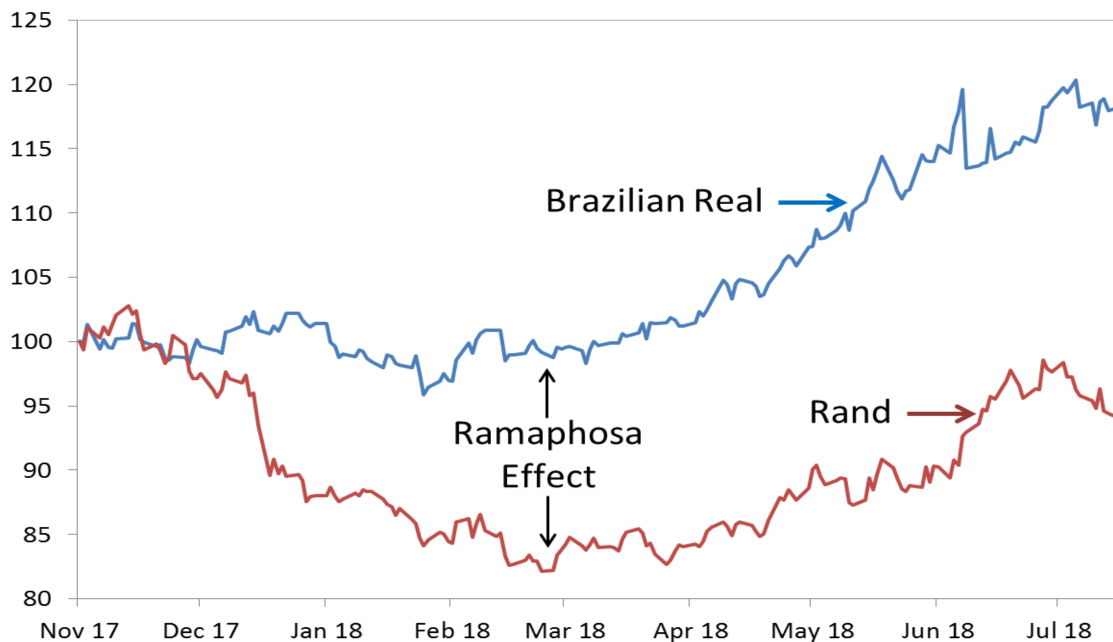


We conclude that while there may be volatility due to both the abovementioned factors, on balance neither yet indicate a negative outlook for both the world economy and equity investments.

SOUTH AFRICA: *Emerging market and oil price blues*

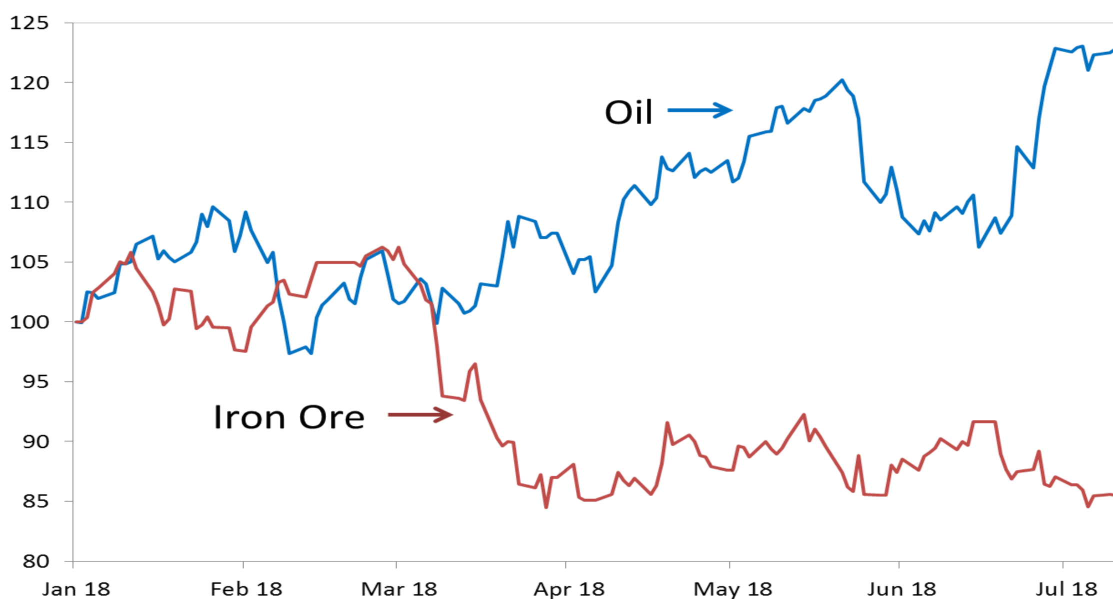
While the euphoria following the appointment of Cyril Ramaphosa as SA President has partially reversed, the Rand has still done well relative to other emerging market currencies such as the Brazilian Real since Cyril Ramaphosa was elected leader of the ANC in December 2017 (chart 2):

Chart 2: SA Rand and the Brazilian Real since election of Cyril Ramaphosa (based to 100)



Perhaps more important in explaining recent Rand and other emerging market currency weakness is the sudden fall in commodity prices especially iron ore since Donald Trump implemented US import tariffs on steel (25%) and aluminium (10%) in early March. This was exacerbated by a rising oil prices partially as a result of sanctions on Iran (Chart 3):

Chart 3: Oil and iron ore spot prices in US$ (based to 100)



Additionally, because SA is both a large oil importer and iron ore exporter, worsening terms of trade in respect of these commodities naturally puts pressure on the R/$ exchange rate, inflation and interest rates. It is therefore not surprising that interest rate sensitive sectors such as retailers and banks suffered reversals while rand hedges, energy and defensives returned to favour. This trend could once again reverse if trade wars prove to have more bark than bite but either way emerging market volatility seems set to continue, with SA volatility unnecessarily worsened by SARB inflation targeting. According to Investec strategist Brian Kantor, "The problem for South Africa with a Reserve Bank that targets inflation is that so little of the inflation experienced in SA is under its control. The exchange rate takes its own course – driven by global sentiment – so pushing prices higher or lower, that in turn drives spending lower or higher. Interest rates that may rise with more inflation and then fall with less inflation make monetary policy pro-cyclical rather than counter-cyclical."

STRATEGY: *Equity bull market intact but we remain cautious and highly selective*

After the sharp correction in global equities in the first quarter, the US bellwether S&P 500 index has recovered close to its January highs as global growth has continued and the fear of the impact of trade wars has receded. With the dividend yield on the S&P 500 having risen to just below 2%, alarm bells are no longer jangling and this coupled with the favourable fundamentals mentioned above, indicates holding overall equity positions rather than selling. However heightened volatility causes anomalies between different sectors and shares to arise periodically and these may be exploited.

This also applies to the JSE of which about 70% consists of dual-listed international shares. A significant portion of the remainder such as banks and retailers are largely driven by sentiment surrounding SA inflation and interest rates. As current rand weakness runs its course, such shares may provide buying opportunities of which advantage should be taken.

INDICES BY SECTOR

		Sector	30-Jun	29-Sep	29-Dec	2018 29-Mar	29-Jun	3 Months % Chg	*6 months* % Chg	*9 months* % Chg	*12 months* % Chg
J177	1	Mining	21 835	25982	27351	25386	29982	18.1%	9.6%	15.4%	37.3%
J211	2	Industrial 25	71 312	75 729	79085	71103	75342	6.0%	-4.7%	-0.5%	5.7%
J353	3	Beverages	230	211	231	220	231	5.0%	0.0%	9.5%	0.4%
J273	4	Electronics	14 267	12 894	12186	12865	13498	4.9%	10.8%	4.7%	-5.4%
J200	5	**Top 40**	**45 422**	**49 376**	**52533**	**48795**	**50980**	4.5%	-3.0%	3.2%	12.2%
J203	6	**All Share Index**	**52 163**	**55 580**	**59505**	**54865**	**57160**	4.2%	-3.9%	2.8%	9.6%
J150	7	Gold Mining	1 185	1 325	1304	1105	1060	-4.1%	-18.7%	-20.0%	-10.5%
J580	8	Financial	40 046	41264	47450	44820	42072	-6.1%	-11.3%	2.0%	5.1%
J835	9	Banks	7 176	7570	9619	9808	9085	-7.4%	-5.6%	20.0%	26.6%
J235	10	Construction	21	21	22	24	22	-8.3%	0.0%	4.8%	4.8%
J357	11	Food Producers	9 294	9142	10807	9785	8948	-8.6%	-17.2%	-2.1%	-3.7%
J272	12	General Industrials	174	176	203	202	180	-10.9%	-11.3%	2.3%	3.4%
J857	13	Life Assurance	35 707	37029	43992	43545	38786	-10.9%	-11.8%	4.7%	8.6%
J537	14	General Retailers	6 384	6 556	8017	8575	6930	-19.2%	-13.6%	5.7%	8.6%

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