BELMONT
ASSET MANAGEMENT

# MARKET COMMENTARY - QUARTER ENDED 31 DECEMBER 2018

## MARKET REVIEW

Global equity markets declined sharply during the last quarter of 2018 as investor concerns about the outlook for the global economy increased against a backdrop of tightening global monetary conditions, US-China trade tensions and European political uncertainty. While global growth held up reasonably well during the second half of 2018 at 2.8%, this was lower than the 3.3% evident in the first half of the year and became increasingly reliant on the US economy. There was a noticeable slowing of growth across most other regions, including Europe, Japan and China.

| INDEX | 3 MTH TOTAL RETURN IN USD (%) | 3 MTH TOTAL RETURN IN EUR (%) | 3 MTH TOTAL RETURN IN GBP (%) |
|---|---|---|---|
| MSCI WORLD | -13.4 | -12.0 | -11.4 |
| S&P 500 (US) | -13.5 | -12.1 | -11.5 |
| FTSE EUROPE EX UK | -13.0 | -11.6 | -10.9 |
| FTSE ALL SHARE(UK) | -12.3 | -10.9 | -10.3 |
| TOPIX (JAPAN) | -14.7 | -13.3 | -12.7 |
| MSCI EMERGING MARKETS | -7.5 | -6.0 | -5.3 |
| MSCI ASIA EX JAPAN | -8.7 | -7.2 | -6.5 |

## The US

The S&P 500 Index fell by 13.5% in US dollars.

US Gross Domestic Product (GDP) grew an annualised 3.4% in the third-quarter compared to 4.2% in the second quarter, but the labour market was strong. Unemployment fell to 3.7% in October, a 49-year low. Headline inflation rose 2.2% year-on-year, down from 2.7% at the end of the previous quarter. Consumer confidence fell from 138.4 to 128.1.

The Federal Reserve (Fed) announced another increase in its target interest rate despite heavy criticism from President Trump, but in its guidance reduced the likely number of further increases in 2019 from three to two. This was less dovish than markets had been expecting. Quantitative tightening continued in order to reduce the size of the Fed's balance sheet.

At the G20 summit in December, Trump met with Chinese General Secretary Xi Jinping. The US agreed to a 90-day deferral in planned tariff increases to allow more constructive negotiations to take place. China outlined its intention to buy a 'very substantial' amount of agriculture, energy and other goods from the US to reduce the trade imbalance.

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## Europe

### *Eurozone*

The FTSE Europe ex UK index fell by 10.9% in euros and by 13.0% in US dollars.

Economic data continued to point to slowing momentum in the eurozone economy. Eurozone third-quarter GDP grew 0.2% quarter-on-quarter (1.6% year-on-year). The flash composite purchasing managers' index for December showed business activity slowed to the weakest level in over four years. Part of the reason for the slowdown in Europe has been a sharp decline in the manufacturing sector's new export orders. This appears to be partly attributable to a slowdown in demand from China, but domestic political factors have also been headwinds.

In France, the "gilets jaunes" protests surrounding the cost of petrol led to widespread unrest in key cities as support for President Macron reached new lows and this appeared to significantly dent business confidence. Macron has since announced fuel duty cuts and other stimulus measures to ease the tensions. In Italy, the government's confrontation with the European Union over its budget led to higher borrowing costs in Italy during the course of 2018. In December, the Italian government agreed to delay some spending measures and submitted a budget with a lower projected deficit, helping to bring borrowing costs back down.

Despite the slowdown in growth, the European Central Bank (ECB) ended its quantitative easing programme in December, noting the broad-based nature of the firming in wage growth across the region. The central bank reiterated that interest rates would remain at record low levels until at least mid-2019.

### *UK*

The FTSE All Share index fell by 10.3% in sterling and by 12.3% in US dollars.

Prime Minister Theresa May finally concluded a draft withdrawal agreement with the EU, but this was harshly criticised in the UK and May struggled to gain sufficient support from parliament for its agreement in its initial form. One of the main issues is the backstop arrangement to avoid a hard border between Northern Ireland and the Irish Republic. A "meaningful vote" on the agreement was deferred until 14 January. This sparked a no confidence vote in May's leadership of the Conservative Party, which she won by 200 to 117. The UK is expected to formally leave the EU by 29 March 2019 when the Article 50 period expires with May's withdrawal agreement, or an amended version of it, being ratified. If not, the UK will exit the EU with "no deal". But the UK Parliament had been increasingly vocal in seeking out other possible solutions.

The Bank of England held its rate at 0.75% by unanimous vote in the December meeting of the monetary policy committee. They stated that uncertainty around Brexit had intensified considerably and that the near-term outlook for global growth had softened with inflation expected to fall below the 2% target in coming months, primarily due to the falling oil price. UK third quarter GDP was confirmed at 0.6% quarter-on-quarter.

## Japan

The Topix index fell by 17.6% in yen and by 14.7% in US dollars.

Japanese third quarter GDP fell to -0.6% quarter-on-quarter, with natural disasters having weighed on personal consumption and capital investment more than initially estimated. Inflation declined to 0.8% year-on-year in November due to slower growth in food prices, cost of transport and housing. Unemployment increased slightly to 2.5% in November.

The Bank of Japan (BoJ) kept its aggressive stimulus in place at its final meeting of 2018. Continued low inflation suggests no end in sight for the central bank's negative short-term interest rates and asset purchases. The BOJ's accommodative policy reached a milestone in November as its balance sheet holdings exceeded the country's annual economic output. In comparison, the Federal Reserve's balance sheet equals about 20% of US GDP.

## Emerging Markets

The MSCI Emerging Markets Index fell by 7.5% in US dollars.

***China:*** The MSCI China IMI Index fell by 10.8% in US dollars. China's economy recorded its weakest quarterly growth since the global financial crisis. Third quarter GDP grew 1.6% quarter-on-quarter, leaving growth up 6.5% year-on-year. Chinese import growth slowed from 37% year-on-year in January to 3% in November, explaining part of the weakness in global exports. Following a clampdown on lending from the shadow banking sector, Chinese money supply growth has slowed, coinciding with a slowdown in the pace of retail sales growth and industrial production. In response to this slowdown, China is seeking to stimulate the economy with a combination of monetary and fiscal measures, particularly in the face of external headwinds emanating from the ongoing trade dispute with the US.

***Russia:*** The MSCI Russia IMI Index fell by 9.0% in US dollars, the sharp fall in crude oil prices being among the headwinds. Interest rates were increased by 0.25% to 7.75%.

***Brazil:*** The MSCI Brazil IMI Index rose by 14.3% in US dollars. Brazil outperformed other emerging markets and the real strengthened following the election of President Jair Messias Bolsonaro. Bolsonaro is seen to be market friendly given his agenda to simplify taxes, privatise state-owned enterprises and implement pension reform, which should see Brazilian debt decline.

***India:*** The MSCI India IMI Index rose by 3.2% in US dollars. Oil's steep decline helped energy-importing countries such as India. A widening rift between the government and the Reserve Bank of India culminated in the unexpected resignation of the central bank governor. A former civil servant was appointed as the new head of the central bank.

## South Africa

South Africa managed to lift itself out of recession by posting GDP growth of 2.2% quarter-on-quarter. This comes as a welcome reprieve for the economy even if it is only in the short-term. On a longer view, domestic real GDP growth has lagged both average global growth and its emerging market peers since the 2009 financial crisis, according to the Bureau for Economic Research. With business and consumer confidence remaining on a weaker path and unemployment very high, president Cyril Ramaphosa has his hands full in boosting the economy to its required growth levels.

Inflation was recorded at a lower rate of 4.5% year-on-year, mainly due to a significantly lower oil price and lower food inflation. In spite of this dovish evidence however, the Reserve Bank decided to raise the interest rate by 0.25% to 6.75%.

***The Rand and the JSE:*** The rand ended the quarter slightly weaker, depreciating by 1.4% against the US dollar and 0.3% against the euro, while it gained a modest 0.7% against sterling. Succumbing to heightened pressure in global financial markets, the JSE performed poorly for a second consecutive quarter, with the All Share Index losing 5.3%. This was true for almost all sectors, with the industrials index down 7.7%, resources down 5% and property down 7.5%.

## INVESTMENT ENVIRONMENT AND OUTLOOK: *Has the US Fed tightened too much?*

A feature of the past quarter was the sudden capitulation of global economic growth expectations and sharp downward corrections in economically sensitive asset prices such as shares and oil. The dominant force at play appears to have been US monetary policy which became excessively tight relative to prospective growth and inflation but ongoing tariff wars no doubt played a role too. Tighter US monetary policy (chart 1) was a consequence of the Fed's oft-stated intention to normalise the term structure of US interest rates (known as the "yield curve"). Aggressive quantitative easing (QE) following the global financial crisis of 2008 created downward distortions in interest rates, especially short-term rates (chart 2):

Chart 1: US Federal Reserve Credit extended to the US Banking System, $bn

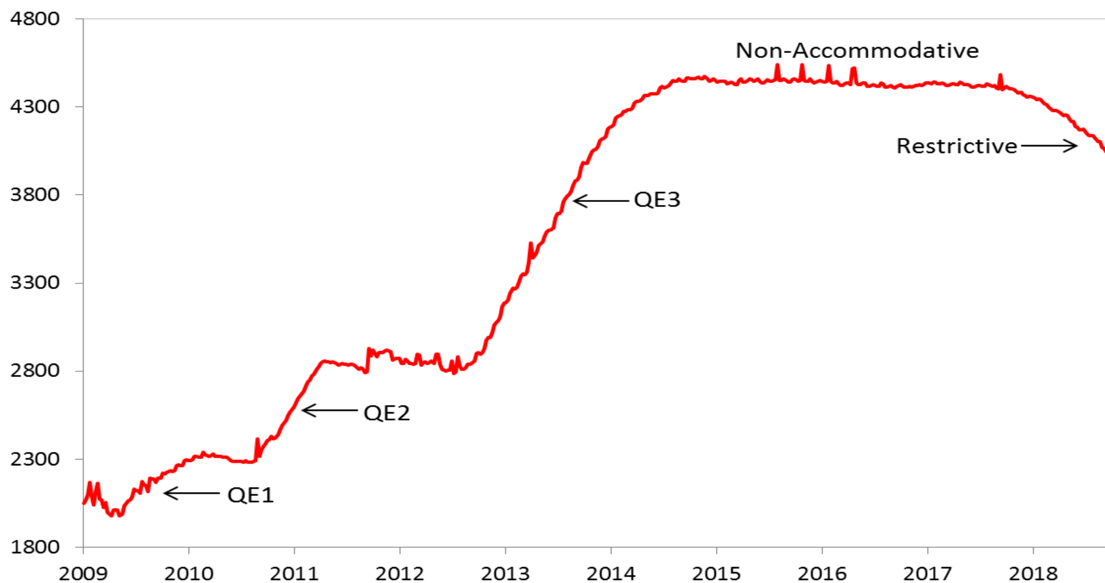
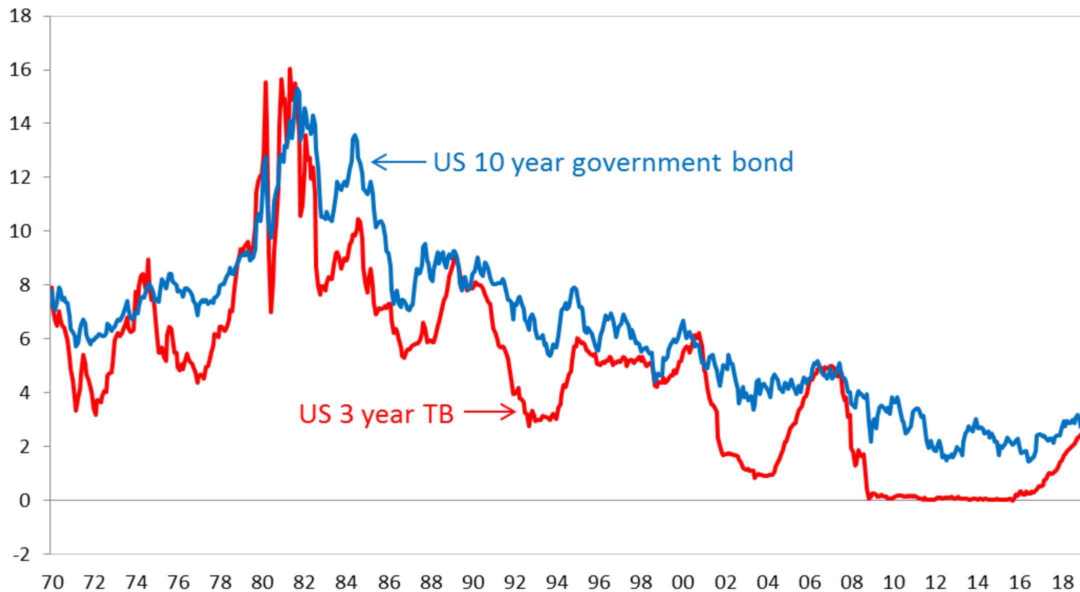


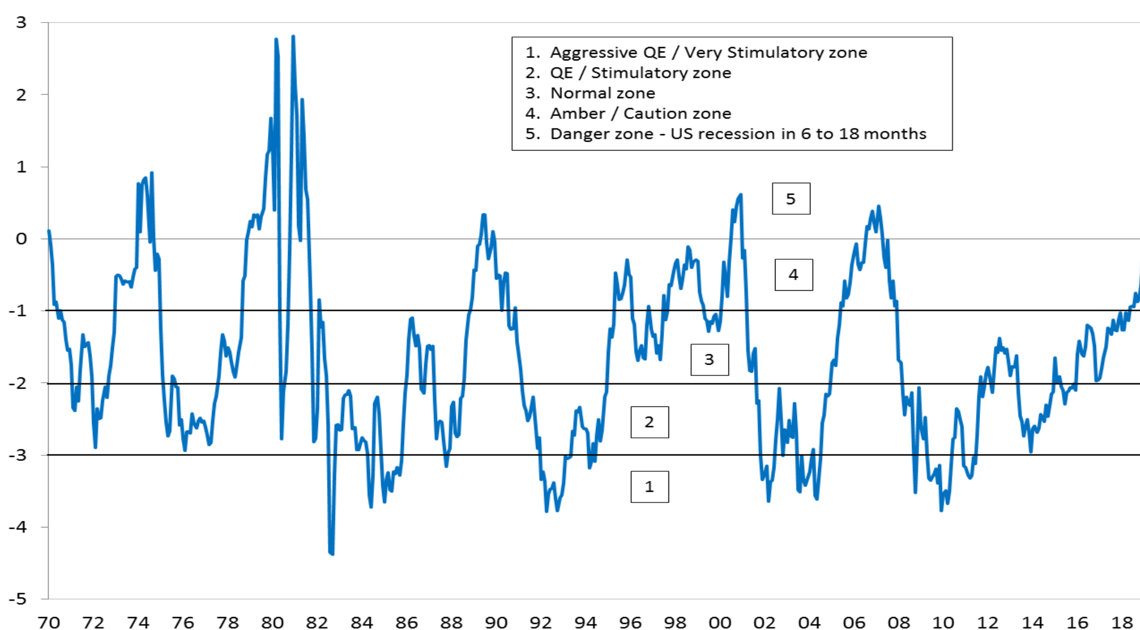
Chart 2: Short (3m) and longer term (10yr) US interest rates (%)




In order to achieve the higher target interest rates the Fed switched from not supplying any new liquidity (2015-2018) to actually r*emoving* liquidity from the banking system from early 2018, i.e. from chart 1 it can be seen that the Fed changed from being non-accommodative to restrictive approximately 12 months ago. With short-term rates rising faster than longer-term rates, the yield curve has come close to inverting (short rates higher than longer rates, chart 3). In the past this situation has usually led to recession within 6-18 months* so the recent reversal in growth expectations, asset and commodity prices is understandable.

*The Yield Curve as a Predictor of U.S. Recessions, Arturo Estrella and Frederic S. Mishkin, Federal Reserve Bank of New York, Current Issues in Economics and Finance, June 1996, Volume 2 Number 7.

Chart 3: Yield curve inversion, % (US 3 month TB – US 10 year Government Bond)



We believe that the Fed is acutely aware of the above and both slowing economic and inflation data support chairman Powell's recent conciliatory comments regarding further interest rate increases. While there is no guarantee that they will not do anything "crazy" (Trump's opinion of recent Fed policy), the most likely scenario is a return to a less restrictive monetary policy stance and even to QE if growth slows dramatically. On the fiscal side some sort of trade deal with China seems likely, as is fairer cost-sharing with NATO. On balance we believe investment fundamentals could improve in 2019 after the setbacks of 2018.

**SOUTH AFRICA:** *Going for growth vital but requires bolder fiscal and monetary policies*

In our view, and perhaps to appease outside interests such as ratings agencies, South Africa has been following unnecessarily harsh and hence counter-productive fiscal and monetary policies. These include ill-considered personal income tax and VAT increases in the last two Budgets, and an obsessive desire to defend the Rand through higher interest rates when domestic demand was already dead or dying. Going for growth and attracting foreign inflows is usually a far better way to ensure a strong currency and contain inflation as the US has proved twice now ("Reaganomics" I & II). Admittedly under Jacob Zuma attracting foreign investment was problematical so sub-optimal policies were perhaps understandable but this no longer applies under Cyril Ramaphosa.

Reflecting its unease with the basis of SA monetary policy, the ANC has expressed a wish in its pre-election manifesto to nationalise the SA Reserve Bank. However president Ramaphosa has stated that the SARB's independence would remain sacrosanct as long as it maintained "flexibility" in its quest to contain inflation between 3% and 6%, in the interests of job creation and economic growth. While a constitutional change to its mandate is unlikely, time will tell whether the SARB is persuaded to take a more flexible interpretation of its existing mandate.

Notwithstanding the above, there is scope for SA investment fundamentals improving in 2019.

**STRATEGY:** *Quality once again available at a reasonable price*

US corporate earnings growth may slow before picking up again but we do NOT believe the US Fed is going to choke off US and global economic growth through further rises in the Fed Funds target rate at this time. This accepted, the equity risk premium (ERP) and its proxy, the forward earnings yield on the S&P 500 share index, has returned to value territory and full exposure to quality equity investments is once again indicated (chart 4):

Chart 4: S&P 500 share index earnings yield (%)

Noting that 70% of the JSE is made up of dual-listed offshore companies, by extension this portion of the JSE also offers good long-term value. With the remaining 30% consisting mainly of SA banks and retailers which are also cheap, we are comfortable in recommending a full exposure to a balanced spread of JSE sectors and shares for onshore portfolios.

## INDICES BY SECTOR

| | | Sector | 29-Dec | 2018<br>29-Mar | 29-Jun | 28-Sep | 28-Dec | *3 months* % Chg | *6 months* % Chg | *9 months* % Chg | *12 months* % Chg |
|---|---|---|---|---|---|---|---|---|---|---|---|
| J150 | 1 | Gold Mining | 1304 | 1105 | 1060 | 996 | 1376 | 38.2% | 29.8% | 24.5% | 5.5% |
| J537 | 2 | General Retailers | 8017 | 8575 | 6930 | 6810 | 7179 | 5.4% | 3.6% | -16.3% | -10.5% |
| J177 | 3 | Mining | 27351 | 25386 | 29982 | 31068 | 32057 | 3.2% | 6.9% | 26.3% | 17.2% |
| J835 | 4 | Banks | 9619 | 9808 | 9085 | 8952 | 9162 | 2.3% | 0.8% | -6.6% | -4.8% |
| J272 | 5 | General Industrials | 203 | 202 | 180 | 174 | 175 | 0.6% | -2.8% | -13.4% | -13.8% |
| J857 | 2 | Life Assurance | 43992 | 43545 | 38786 | 43304 | 43284 | 0.0% | 11.6% | -0.6% | -1.6% |
| J580 | 3 | Financial | 47450 | 44820 | 42072 | 42449 | 41300 | -2.7% | -1.8% | -7.9% | -13.0% |
| J353 | 4 | Beverages | 231 | 220 | 231 | 177 | 172 | -2.8% | -25.5% | -21.8% | -25.5% |
| J357 | 5 | Food Producers | 10807 | 9785 | 8948 | 7852 | 7462 | -5.0% | -16.6% | -23.7% | -31.0% |
| J203 | 6 | **All Share Index** | **59505** | **54865** | **57160** | **55790** | **52737** | -5.5% | -7.7% | -3.9% | -11.4% |
| J200 | 7 | **Top 40** | **52533** | **48795** | **50980** | **49587** | **46727** | -5.8% | -8.3% | -4.2% | -11.1% |
| J273 | 8 | Electronics | 12186 | 12865 | 13498 | 12933 | 11949 | -7.6% | -11.5% | -7.1% | -1.9% |
| J211 | 9 | Industrial 25 | 79085 | 71103 | 75342 | 68994 | 63684 | -7.7% | -15.5% | -10.4% | -19.5% |
| J235 | 10 | Construction | 22 | 24 | 22 | 22 | 19 | -13.6% | -13.6% | -20.8% | -13.6% |

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