ALUWANI Market Outlook

- July 2017

Global activity has remained decent, in the context of still accommodative monetary policy settings in developed economies. In the US, growth expectations remain robust, the labour market tight and the Fed is still tightening. The European economy remains well supported, with the Eurozone continuing to benefit from very accommodative monetary policy. Brexit fears have negatively affected the pound, and the BOE could be hiking rates there in the near future. Indicators are that the Chinese economy will continue to slow, albeit in a moderate fashion over the medium term. The fixed investment slowdown that authorities were able to reverse in 2016 is likely to resume, weighing on growth in that economy going forward.

The return of animal spirits over the course of 2016 and into H1 17, has buoyed performance in risky assets including global equities, commodities, credit and EM currencies. supported by a better economic outlook. Global equities could still benefit from proposed tax reform in the US and solid activity linked earnings growth. However, the Chinese slowdown dulls the outlook for commodities somewhat, limiting the depth and likely the length of the cyclical recovery in both commodity exporting and Asian EMs.

The US$ weakened moderately in 2017 to date on the back of a moderation in expectations of Trump pro-growth policies and to some extent unfavourable trends in relative growth patterns relative to trading partners. We expect that the US$ will continue to trade within a range, with tightening in the Eurozone supporting the EUR. EM currencies could fare less well. Industrial commodities appear to have peaked following a rally that started in January 2016. The commodities recovery should moderate if Chinese authorities elect to allow continued rebalancing away from investment.

The South African economy experienced a technical recession in the two quarters to March 2017. The SARB estimates that the economic cycle has been in a downturn since December 2013. We expect that growth will swing positive into H2 17, due to base effects and the ongoing recovery in the Agricultural sector. However, the dearth of confidence in the domestic economy should continue to constrain any recovery. The announcement of a new controversial mining charter by the DME and the recommendation by the Public Protector that parliament change the constitution to amend the mandate of the SARB roiled markets in June. These moves followed on yet another rating downgrade (Moody's) earlier in the month, amidst continuous revelations from leaked emails illustrating the extent of corruption in the state.

Confidence across every sector in the economy is now at a low ebb, with most indicators showing the worst confidence levels since the 2008/09 financial crisis. The impact of the confidence deficit on economic activity will be large, but is difficult to predict. Our forecast for economic growth have been pared back as a result, and we expect to see growth expectations revised lower for 2017 and 2018 in the months ahead.

CPI is now below 6.0% and continues on a downward trajectory, with dis-inflationary trends well entrenched. The dearth of demand is likely to keep core inflation anchored close to 5.0% in the coming years. We forecast that CPI will remain within the 3-6% target range through to 2019. The key risk to this outlook remains the currency, which could yet sell-off in the event of further downgrades.

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South Africa's local currency bonds are now rated a notch above non-investment grade by S&P(BBB-) and Moody's (Baa3). Both rating agencies have the rating at negative outlook. Downgrades by these rating agencies would push domestic local currency bonds out of Citi's WGBI index and Barclays' global bond indices, leading to outflows of between US$8bn and US$10bn. This is a risk into H1 18, which is when both agencies are expected to make announcements.

The possibility of ratings downgrades should remain a key headwind for the currencies in the coming twelve months. Growth is going to be weaker and pressures on the fiscus more pronounced. The ruling party is currently focused on its elective conference in December 2017, and prospect of an immediate policy response to the current economic malaise are low. If anything, political developments have done more harm to the political economy, a risk that will hang over the economy at least until a new leadership is chosen and potentially continue after that if a more radical approach to transformation is favoured by the winner.

The current inflation outlook together with the weak growth backdrop is supportive of rate cuts. However, the risk to the inflation outlook could make the Bank hesitant and makes the monetary policy outlook less dovish than would have otherwise been the case. We expect that the SARB could leave rates unchanged for now. The risk here is that the SARB elects to move anyway, and judges the downgrade risks as remote for now.

We would advocate for more defensive positioning on a multiple asset basis. Domestic equity could underperform as slow growth weighs on earnings and confidence on multiples. The rand hedged part of the equity space could benefit from a weakening bias in the currency. Bonds are most exposed in the event of a downgrade. Cash, while made vulnerable by possible rate cuts, could be the place to wait developments play out into January 2018.

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