# OVERBERG MARKET REPORT

Tuesday 10th May 2016

## SOUTH AFRICA ECONOMIC REVIEW

- The SA Chamber of Commerce and Industry (SACCI) Business Confidence Index (BCI) edged higher from 81.2 in March to 82.5 in April marking the fourth straight monthly increase. However, the business confidence reading still remains close to its historic low of 79.6 reached after Nenegate in December last year. The largest positive contribution to the BCI came from the real value of building plans approved, while the largest detractors came from the rand exchange rate, export volumes, equity market prices and new vehicle sales.

- In a Bloomberg survey 12 out of 13 economists expect Standard & Poor's (S&P) credit rating agency to cut SA's sovereign debt rating to sub-investment grade (junk status) by the end of the year. Only four economists expect the rating downgrade at the upcoming meeting in June while the majority expect S&P to wait until December. It is expected that S&P will delay in order to see how the economy responds to a weaker currency and the lifting of the drought. In addition, the rating agency will want to see if the National Treasury can adhere to its deficit targets especially with regards to fiscal demands from state-owned enterprises. The upcoming local elections may also help resolve current political uncertainty and therefore support a delay in S&P's key decision.

- Moody's credit rating agency surprised the markets, which had expected a rating downgrade, by leaving SA's sovereign debt rating unchanged at "Baa2" a notch above the other agencies Standard & poor's and Fitch. Moody's said the country was probably approaching a turning point after several years of slowing growth, that the latest budget and fiscal plan would likely stabilize and eventually reduce government debt, and that recent political developments, although disruptive testified to the underlying strength of SA's institutions. In its statement Moody's said economic growth would gradually strengthen as various supply-side shocks receded: "Specifically, the electricity supply is now more reliable, the drought is ending and the number of workdays lost to strikes has shrunk significantly."

- Speaking in parliament Finance Minister Pravin Gordhan was confident that the government would be able to stick to its deficit targets despite weakness in economic growth. This years' budget projected a state deficit of 3.2% of GDP in the current fiscal year declining to 2.4% in three years. According to Pravin Gordhan centralized government procurement through the Public Procurement Office, would be key to controlling state expenditure. The

initiative which began in April, would enable more efficient purchasing saving around R25 billion a year.

- On the conclusion of its visit to SA between 18th April and 4th May the IMF mission team gave an upbeat assessment of the country's economic outlook. Laura Papi who headed the IMF mission forecast economic growth of 0.6% in 2016 but a gradual recovery from 2017. Papi said: "Risks to this outlook are tilted to the downside and include further shocks from China, heightened global financial volatility and sovereign credit rating downgrades. On the upside, the recent dialogue between government and social partners could catalyse reform implementation and invigorate growth." The IMF report cited welcome progress in easing infrastructure bottlenecks with specific reference to electricity supply, commitment to reform of state-owned enterprises, and improvement in public procurement.

- The Barclays manufacturing purchasing managers' index (PMI) surged higher from 50.5 in March to 54.9 in April well above the 50.2 consensus forecast, and the highest since August 2013 remaining well above the expansionary 50-level. All sub-indices were above the 50-level indicating a broad-based and sustainable improvement. The business activity index increased from 47.7 to 56.4, and the employment index increased from 48.4 to 50.5 above the 50-level for the first time since March 2014. The new sales orders index climbed from 53.1 to 58.4 signaling a robust improvement in the months ahead, with increased demand attributed to import substitution and rising exports. Meanwhile the input prices index fell from 87.8 to 77.7 reflecting an ebb in inflationary pressure in positive response to the recent strengthening in the rand. The overall data is encouraging suggesting the manufacturing sector may have turned the corner. The index measuring manufacturers' expectations in six months' time increased from 51.1 to 55.9.

- According to the Labour Force Survey the unemployment rate jumped from 24.5% in the fourth quarter (Q4) last year to 26.7% in Q1 the highest rate since the new data series was initiated in 2008. Employment declined by -355,000 during the quarter with the formal sector shedding -217,000 jobs and the informal non-agricultural sector shedding -111,000. Meanwhile the number of unemployed people increased by 521,000 as new entrants joined the jobs market. Eight out of the ten economic sectors recorded job losses led by the trade and manufacturing sectors with losses of -119,000 and -100,000, while the mining sector lost -10,000. By contrast the community and social services sector created 52,000 jobs mostly in the public sector, and surprisingly the agricultural sector created 16,000 in spite of the drought. The dismal employment data makes the SA Reserve Bank's (SARB) job extremely difficult. Stuck in a classic stagflation environment with rising inflation despite rising unemployment the SARB may refrain from hiking interest rates at the upcoming policy meeting on 17-19th May.



GREYTON OFFICE 028 254 9013, 9 DS Botha Street, P.O.Box 180 Greyton, 7233 | SOMERSET WEST OFFICE 021 852 6040, 17 Bright Street, Cnr of André Pretorius
HERMANUS OFFICE 0861 007534, 9 Patterson Street, Hermanus 7200 | JOHANNESBURG OFFICE 0861 277 387 | email info@overberg.biz | web overberg.biz
DIRECTORS Nick Downing, Brett Birkenstock, Gielie Fourie | Reg No: 2001/019896/07 | Authorised Financial Services Provider, License No: 783

- Although the decline in total vehicle sales decelerated from -14.3% year-on-year in March to -9.2% in April the monthly volume fell to the lowest since December 2010. The drop in passenger vehicle sales improved slightly from -13.7% to -13.2% with a more pronounced improvement for commercial vehicle sales from -15.1% to -0.9%. Total vehicle exports grew a robust 18.6% month-on-month helped by the base effect of fewer Easter-related trading days in March. On a year-on-year basis total exports grew 39.2% recovering from the phasing out of some high-volume models over previous months. While export figures are encouraging domestic sales reflect weakness in both consumer and business confidence amid subdued economic growth, rising inflation and tight lending criteria.

## SOUTH AFRICA: THE WEEK AHEAD

- SA first quarter (Q1) unemployment: Due Tuesday 10th May. The unemployment rate is likely to have increased from 24.5% in Q4 as a result of the economy shedding seasonal jobs created over the festive season and due to new entrants entering the jobs market. With economic growth at less than 1% the prospects for jobs growth are slim.
- Mining production: Due Thursday 12th May. The year-on-year contraction in mining production is expected to deepen from -8.7% in February to -11.2% in March according to consensus forecast, a substantial deterioration from the -5.5% decline in January. The mining industry is being affected by low commodity prices and weak demand from China, as well as rising input costs especially the cost of labour.
- Manufacturing production. Due Thursday 12th May. Having improved from a -2.6% year-on-year contraction in January to 1.9% growth in February manufacturing production is expected to fall -1.0% in March according to consensus forecast. Although the Barclays manufacturing purchasing managers' index increased to 50.5 in March above the expansionary 50-level for the first time since July last year, the base effect of year-ago comparative data will contribute to a negative reading.

## NORTH AMERICA

- Non-farm payrolls increased by just 160,000 well below the 200,000 consensus forecast. The service sector added 65,000 jobs and education and health added 54,000 while the retail sector shed 3,000 and jobs in manufacturing and construction remained unchanged. The unemployment rate remained unchanged at 5.0% but the broader U6 measure improved from 9.8% to 9.7% indicating continued reduction in labour market slack. Average hourly earnings increased a robust 0.3% month-on-month lifting the year-on-year rate of growth

from 2.3% to 2.5% and average weekly hours increased from 34.4 to 34.5 signaling rising wage pressure. Growing wage pressure may prompt the Federal Reserve to hike interest rates in June in spite of the weak headline payroll number.

- The Institute for Supply Management (ISM) non-manufacturing index increased more than expected from 54.5 in March to 55.7 in April well above the 54.7 consensus forecast, signaling an acceleration in the pace of growth in the services sector. Among the sub-indices, business activity eased from 59.8 to 58.8 but remained at elevated levels, while the forward-looking new orders index moved sharply higher from 56.7 to 59.9 its highest since last October. The employment index increased from 50.3 to 53.0. According to Anthony Nieves, chair of the ISM survey committee: "The majority of the respondents' comments reflect optimism about the business climate and the direction of the economy." The data suggests the first quarter (Q1) slowdown in US GDP growth was largely due to seasonality and should rebound in Q2.

- According to the Labour Department's productivity report US worker productivity fell in the first quarter (Q1) for a second straight quarter by -1.0% quarter-on-quarter annualized although an improvement on the -1.7% decline in last year's Q4. Despite slow output growth labour compensation per hour increased 3.0% quarter-on-quarter annualized. The trend of rising labour compensation is expected to strengthen further in the months amid declining slack in the jobs market. Unit labour costs, which measures how much growth in labour compensation is outpacing growth in output, increased 4.1% quarter-on-quarter annualized. The data confirms that productivity remains at depressed levels as firms remain hesitant to increase investment into efficiency-boosting equipment. The productivity report indicates that wage pressures are starting to build which bodes ill for earnings growth, as well as for inflation and interest rates.

**CHINA**

- China's foreign exchange reserves increased in April for a second straight month albeit a modest $6.4 billion to $3.219 trillion. The data reflects a reduction in capital outflows in response to a stabilization in the economy. However, the lull in capital outflows may be short-lived. The economy is following a dangerous pattern of rising indebtedness and deflation, which will ultimately result in capacity reduction and economic rebalancing. With the dollar expected to resume its upward trajectory in response to rising interest rates the Chinese yuan may suffer further devaluation in the second half of the year in turn diminishing the country's foreign exchange reserves.

- China's trade data deteriorated sharply in April giving back March's better than expected improvement. In US dollar value terms exports fell in April by -1.8% year-on-year down from +11.5% in March and below the 0.0% consensus forecast. Imports fell -10.9% on the year compared with -7.6% in March and worse than the -4.0% consensus forecast, marking the 18th straight month of shrinking imports. Imports from Australia and South Africa continued to shrink at double digit rates in spite of the recent uplift in commodity prices. Growth in China's copper imports slowed from 40% year-on-year in March to 5% in April.

**JAPAN**

- Finance Minister Taro Aso, in his testimony to the Upper House Financial Affairs Committee, reiterated that Japan would intervene in the foreign exchange markets if necessary to prevent the yen's strength from hurting the economy. The last time Japan intervened in the forex markets was in last 2011. Aso said Japan has never engaged in competitive devaluations and would not do so in the future but would intervene in the event of drastic one-sided movements in the exchange rate.

- Total monthly average cash earnings per regular employee increased in March by 1.4% year-on-year up from 0.7% in February, marking the second straight monthly rise and posting the largest gain since July 2014. The larger than expected increase is attributed to robust bonuses and other special pay which increased 19.8% on the year. Wage increases are a key prerequisite to breaking Japan's deflationary spiral and restoring sustainable positive inflation. While wage increases have been modest due to firms resorting to lower-paid temporary workers there is growing evidence that more regular workers are being hired due to growing shortages in the labour market.

**EUROPE**

- Germany's manufacturing orders increased in March by a substantial 1.9% month-on-month the strongest gain since last June and well above the 0.5% consensus forecast. February's decline was also revised upwards from an initial -1.2% estimate to -0.8%. As a result of the unexpected gain in March manufacturing orders in the first quarter (Q1) increased 0.5% quarter-on-quarter. According to the German economy ministry: "Manufacturing orders' start to the year was solid… Business expectations have continued to brighten recently, pointing to a continuation of the moderate upswing." While domestic manufacturing orders fell in March by -1.2% on the month export orders jumped 4.3% more than reversing the previous month's -2.1% decline.

## UNITED KINGDOM

- The Markit manufacturing purchasing managers' index (PMI) fell sharply from 50.7 in March to 49.2 in April well below the 51.2 consensus forecast and the first reading below the contractionary 50-level since March 2013. The steep decline is attributed to uncertainty ahead of the EU referendum, the impact of currency strength on export competitiveness, and weak global conditions. Among the sub-indices, the output index fell from 52.9 to 50.1, the employment index from 48.5 to 47.6, and the forward-looking new orders and new exports orders indices from 51.9 to 50.4 and from 49.9 to 49.5, respectively. The silver lining to the data is that the slowdown should be temporary with a recovery likely once the EU referendum is concluded.

- The Markit services purchasing managers' index (PMI) fell more than expected from 53.7 in March to 52.3 in April mirroring similar weakness in manufacturing and construction PMIs. Although the decline is partly attributed to the introduction of the National Living Wage, which helped push the input price index to its highest level since January 2014, a rising number of firms cited the EU referendum as affecting activity. The composite PMI combining services, manufacturing and construction, fell sharply from 53.6 to 51.9 which is consistent with quarter-on-quarter GDP growth of just 0.1% well below the 0.4% recorded in the first quarter.

## FAR EAST AND EMERGING MARKETS

- Fitch credit rating agency cut Brazil's sovereign credit rating to "BB" two notches into "junk" status in line with the rating of the other two agencies Standard & Poor's and Moody's. Fitch also kept Brazil under negative watch for a further potential downgrade. In its policy statement Fitch said: "The maintenance of the negative outlook reflects continued uncertainty surrounding the progress that can be made to improve the outlook for growth, public finances and the government debt trajectory." President Dilma Rousseff is facing impeachment and likely to be suspended from office in the next few days to face trial in the Senate. Market confidence is growing with the prospect of a new government but the country remains mired in deep recession and rising unemployment, and it is far from certain what shape the broad coalition government will take.

- The Reserve Bank of Australia (RBA) unexpectedly cut its benchmark interest rate by 25 basis points to 1.75% a new record low. The rate decision is attributed to easing concerns over inflation amid subdued wage growth and an absence of inflationary pressure globally. The decision to cut interest rates was also helped by an easing in house price growth in response to macro prudential measures. House price inflation has been one of the undesired side effects of record low interest rates.



GREYTON OFFICE 028 254 9013, 9 DS Botha Street, P.O.Box 180 Greyton, 7233 | SOMERSET WEST OFFICE 021 852 6040, 17 Bright Street, Cnr of André Pretorius
HERMANUS OFFICE 0861 007534, 9 Patterson Street, Hermanus 7200 | JOHANNESBURG OFFICE 0861 277 387 | email info@overberg.biz | web overberg.biz
DIRECTORS Nick Downing, Brett Birkenstock, Gielie Fourie | Reg No: 2001/019896/07 | Authorised Financial Services Provider, License No: 783

## KEY MARKET INDICATORS (YEAR TO DATE %)

| | |
|---|---|
| JSE All Share | + 1.29 |
| JSE Fini 15 | - 3.98 |
| JSE Indi 25 | - 2.85 |
| JSE Resi 20 | + 15.55 |
| R/$ | + 2.22 |
| R/€ | - 2.45 |
| R/£ | + 3.45 |
| S&P 500 | + 0.72 |
| Nikkei | - 14.80 |
| Hang Seng | - 8.02 |
| FTSE 100 | - 2.04 |
| DAX | - 7.10 |
| CAC 40 | - 6.78 |
| MSCI Emerging | + 0.85 |
| MSCI World | - 1.20 |
| Gold | + 19.10 |
| Platinum | + 17.28 |
| Brent Crude | + 17.44 |

## TECHNICAL ANALYSIS

- The rand remains below successive support levels suggesting a continuation in the rand's depreciation.



GREYTON OFFICE 028 254 9013, 9 DS Botha Street, P.O.Box 180 Greyton, 7233 | SOMERSET WEST OFFICE 021 852 6040, 17 Bright Street, Cnr of André Pretorius
HERMANUS OFFICE 0861 007534, 9 Patterson Street, Hermanus 7200 | JOHANNESBURG OFFICE 0861 277 387 | email info@overberg.biz | web overberg.biz
DIRECTORS Nick Downing, Brett Birkenstock, Gielie Fourie | Reg No: 2001/019896/07 | Authorised Financial Services Provider, License No: 783

- The US dollar index is testing a major 30-year resistance line, which if broken will pave the way for further strong gains in the currency.

- Despite the recent uptick in bond yields the long-term JPMorgan global bond index bull trend remains intact, with the yield targeting a new low during the fifth and final wave.

- The US 10-year Treasury yield has broken above key resistance levels of 1.8% and 2.0%. However, there is unlikely to be a major bear trend in US bonds as the deleveraging phase is still in its early stages.

- The benchmark R186 SA Gilt yield broke out of its long-term bull trend as a result of "Nenegate". The new bear trend for the R186 is underpinned by resistance at 9.0% with a risk of further upside to 10.50%. While SA bond yields may fall in line with global bonds they are unlikely to return to the bull trend.

- The MSCI World Equity index has broken downward from a rising trendline which has been intact since the 2008/09 global financial crisis. Given the magnitude and duration of the 2009-2015 bull market the overall correction is likely to reach a downside target for the MSCI World Equity index of 1,400.

- Since the 1950s the Dow Jones and S&P 500 have displayed 7-year up-cycles and the top of the current US equity cycle is likely to have just occurred. The next major wave down will complete the 16-17 year secular bear market that started in 2000. The secular bottom should occur around June 2016.

- The S&P 500 index has broken downward from a rising wedge pattern, which is traditionally a trend-changing pattern. The downward trend is likely to remain intact unless the index decisively regains the 2070 level. A further negative signal is that the Dow Jones Transport Index, traditionally a lead indicator for the broader market, is leading the broader market lower on the downside.

- Despite the recent price rally Brent crude's break below the key $30 support level in February suggests a continuation of the weakening long-term trend to a downside $25 target. Copper is regarded a reliable lead indicator for industrial commodity prices and barometer of global economic growth. Despite its recent rally the copper price broke below the key $4,500 support level in February suggesting further downside ahead.

- Gold has broken its recent downtrend by rising decisively above the $1100 resistance level. An extended break above $1250 is needed to confirm the end of gold's bear market.

- The JSE All Share index is testing an important resistance line but if this remains unbroken the index is likely to move back below the 24-month moving average at 50,700 in turn opening a downside target of 45,000 and an ultimate target of 43,000.

**BOTTOM LINE**

- Although the JSE All Share index has dropped around -4.5% over the past fortnight it still remains vulnerable to further declines. The All Share index is up +12% from its lows in early January and appears dramatically over-priced on a price-earnings (PE) multiple of 21.2x around 40% above its 14.8x long-term average. Some of the premium rating is explained by the high valuations of large multinational stocks such as Naspers, British American Tobacco and SABMiller, hence the 28.2x PE multiple of the Industrial 25 index.

- Part of the JSE's high valuation is attributed to the jump in resource stocks. The Resources 20 index has gained +21% since the start of the year and trades on an excessive 23.8x PE ratio despite weak fundamentals.

- Resource companies are suffering balance sheet stress exacerbated by dwindling cash flow and rising interest rates. Although commodity prices have increased over the past month this has a lot to do with the weaker dollar. The dollar may soon reassert its strength. The Federal Reserve appears to be preparing for an interest rate increase, which is more likely to be in June than September to avoid overlap with the presidential election.

- China buys over half the world's supply of raw materials and is therefore the price setter for resources. Although there have been signs over the past three months that China's economy has stabilized the outlook is still fragile. A dangerous pattern of debt and deflation is evolving.

- The property sector appears to be bottoming out but inflation, capital spending and industrial indicators remain in a downtrend. China's company debt to GDP has surged since the massive 2009 stimulus programme and currently stands at 215% of GDP. Moreover, the debt overhang is centered on the industrial, construction and property sectors, which are the traditional consumers of raw materials.

- Debt and deflation contagion from China is probably a far greater risk to equity markets than weakening oil prices, or Fed interest rate hikes. As China's rate of economic growth



GREYTON OFFICE 028 254 9013, 9 DS Botha Street, P.O.Box 180 Greyton, 7233 | SOMERSET WEST OFFICE 021 852 6040, 17 Bright Street, Cnr of André Pretorius
HERMANUS OFFICE 0861 007534, 9 Patterson Street, Hermanus 7200 | JOHANNESBURG OFFICE 0861 277 387 | email info@overberg.biz | web overberg.biz
DIRECTORS Nick Downing, Brett Birkenstock, Gielie Fourie | Reg No: 2001/019896/07 | Authorised Financial Services Provider, License No: 783

slows down there will be growing evidence of bad debts and insolvent banks, which will renew the downward pressure on commodity prices and the JSE Resource sector.

- Declines in the All Share index are likely to be led by the resources sector. Recent price action in resource stocks may lead us to believe that the sector is turning the corner. However, the fundamental outlook remains extremely uncertain.

## Disclaimer

Information and opinions presented in this Report were obtained or derived from public sources that Overberg Asset Management believes are reliable but makes no representations as to their accuracy or completeness. Any opinions, forecasts or estimates herein constitute a judgement as at the date of this Report and should not be relied upon. There can be no assurance that future results or events will be consistent with any such opinions, forecasts or estimates. Furthermore, Overberg Asset Management accepts no responsibility or liability for any loss arising from the use of or reliance placed upon the material presented in this Report.



GREYTON OFFICE 028 254 9013, 9 DS Botha Street, P.O.Box 180 Greyton, 7233 | SOMERSET WEST OFFICE 021 852 6040, 17 Bright Street, Cnr of André Pretorius
HERMANUS OFFICE 0861 007534, 9 Patterson Street, Hermanus 7200 | JOHANNESBURG OFFICE 0861 277 387 | email info@overberg.biz | web overberg.biz
DIRECTORS Nick Downing, Brett Birkenstock, Gielie Fourie | Reg No: 2001/019896/07 | Authorised Financial Services Provider, License No: 783