IN THIS WEEK’S BOTTOM LINE

- South Africa’s financial markets have had a tough year so far. At the close of trade on 12th October the JSE All Share Index had lost -10.14% year-to-date and the ZAR/$ had depreciated -14.74%. We are not alone. The MS World Index lost -1.90% and the MS Emerging Market Index -15.40%. As the most liquid emerging market, our currency, equities and bonds ebb and flow in tune with global markets. This begs the question, what is driving global markets?

SOUTH AFRICA ECONOMIC REVIEW

- Growth in manufacturing production slowed in August to 1.3% year-on-year from downwardly revised growth of 2.8% in July. On a month-on-month basis manufacturing production grew by a slender 0.1% compared with 1.4% in July, although July’s numbers were flattered by there being extra working days in the month. Besides the iron and steel sector where output growth increased from 1.1% on the year to 2.1%, there was a broad-based slowdown across manufacturing sectors. The biggest culprits were motor vehicles where growth slowed from 8.2% to 1.3% on the year and the food and beverages sector, which slowed from 5.8% to 3.3%. Fortunately, the slowdown in manufacturing growth is not nearly as bad as indicated by the ABSA/BER manufacturing purchasing managers’ index (PMI), which fell in August from 43.4 to 43.2, deeper into sub-50 contractionary territory and its lowest since June 2017. The PMI was likely affected by sentiment surrounding land expropriation rather than hard fundamentals. Given the positive contributions in July and August, manufacturing production would have to contract in September by at least 4.0% on the year, for the sector to make a negative contribution to GDP growth in the third quarter (Q3). This seems unlikely, which bodes well for the economy pulling out of recession in Q3.

SOUTH AFRICA POLITICAL REVIEW

- President Ramaphosa accepted the resignation of finance minister Nhlanhla Nene and replaced him with Tito Mboweni, former governor of the SA Reserve Bank (SARB). The rand rallied on the news, gaining on the day by 3% against the US dollar. The rand’s appreciation was far greater than other emerging market currencies, signalling the market’s approval. The market rewarded Rampahosa for his moral courage, his commitment to root out corruption, as well as his choice of replacement. Ramaphosa’s willingness to sacrifice a political ally should make it easier for him to replace other cabinet ministers with far more questionable allegiances to the Guptas than Nene. Tito Mboweni is well known by domestic
and global investors, having served as SARB governor for 10 years between 1999 and 2009. He is expected to maintain the Treasury’s current course of fiscal prudence. Mboweni’s appointment should ensure that the Medium-Term Budget Policy Statement (MTBPS) to be presented on 24th October, is not clouded by political hectoring which is likely to have been the case, were Nene still at the helm.

- As President Ramaphosa burnishes his anti-corruption credentials by accepting finance minister Nene’s resignation, the EFF’s credentials have, by contrast, been tarnished by the SA Reserve Bank’s report on financial mismanagement at VBS Mutual Bank. EFF Deputy President Floyd Shivambu’s brother Brian Shivambu is among those reported to have received gratuitous payments from VBS Mutual Bank. From his payment of R16.1 million he allegedly paid around R10 million to Floyd Shivambu and R1.3 million to the EFF. While the EFF are dismissing the allegations, it is reported that the ANC are scaling the moral high-ground, referring all ANC party members, named in the list of gratuitous payment recipients, to the party’s integrity commission.

SOUTH AFRICA: THE WEEK AHEAD

- Retail sales: Due Wednesday 17th October. According to consensus forecast, retail sales growth is expected to have slowed in August to 0.5% year-on-year from 1.3% in July. While the public-sector wage settlement earlier in the year will have boosted household disposable income, consumer confidence is being undermined by weak jobs growth and rising fuel prices.

- Mining production: Due Thursday 18th October. According to consensus forecast, mining production is expected to have contracted in August by 4.0% year-on-year. While a slight improvement on the 5.2% contraction in July, the mining industry has been beset by regulatory uncertainty, infrastructure bottlenecks and falling international commodity demand. However, the weaker rand would have helped to compensate for falling dollar-based commodity prices.

GLOBAL

- The S&P 500 Index suffered its worst one-day drop since February on Wednesday last week, contributing to the longest losing streak in Trump’s presidency. Trump blamed the Fed for being too hasty in hiking interest rates, stating that: “I’d like our Fed not to be so aggressive because I think they’re making a big mistake.” The catalyst for the sell-off was a spike in the 10-year US Treasury bond yield to a seven-year high of 3.26%. Higher long-term interest rates typically lead to a tightening in financial conditions and raise the discount rate that is used to value stocks. However, the attractive yield prompted strong inflows and by the end of last week the yield had fallen back to 3.14%. After the week’s sell-off all
major US equity indices had dropped below their 200-day moving averages while the CBOE VIX Index, a key measure of market volatility, increased to its highest since February. The S&P Tech index was the worst affected, falling 7% on the week. The US sell-off rippled across global markets causing the FTSE All-World Index to drop for six straight days, erasing all its gains for the year.

- In its bi-annual World Economic Outlook, the IMF lowered its global economic growth forecast for 2018 and 2019 to 3.7% in both years down from its July forecast of 3.9%, citing an escalation in trade tensions and protectionism. The IMF criticised the administration’s imposition of tariffs and its fiscal stimulus, which at the top of the economic cycle, it feels is mis-timed. The IMF report stated that: “Procyclical stimulus, which is contributing to rising global imbalances and heightened risks to the US and global economies, should be withdrawn.” The report described the fiscal stimulus as unsustainable, lowering its forecast for US GDP growth in 2019 from 2.7% to 2.5%, a marked slowdown from the 4.2% growth achieved in the second quarter this year. However, the annual IMF gathering of central bankers and finance ministers, held this year in Bali, was characterised by a softening in attitude towards US trade tactics. In the past three months the US, although raising the stakes in its trade relations with China, has successfully concluded the United States-Mexico-Canada Agreement (USMCA), put Eurozone auto tariffs on hold, finalised a free-trade deal with South Korea and agreed to hold bilateral trade talks with Japan.

- The Brent oil price fell back from its four-year high of $85 per barrel to below $80 following reports from the US Energy Information Agency (EIA), Organisation of the Petroleum Exporting Countries (OPEC) and the International Energy Agency (IEA), all indicating higher than expected supply and lower than expected demand. In its weekly US petroleum report the EIA reported a surge in oil inventories for a second straight week, impressive given the large increase in exports. US crude oil output increased to a record 11.2 million barrels per day. In its monthly oil market report, OPEC reported total OPEC supply increased in September by 0.13 million barrels per day, with rising output in Iraq, Libya, Nigeria and Angola more than making-up for the decline in supply from Iran and Venezuela. Moreover, Saudi Arabia and the UAE reiterated that they will increase production if necessary. Meanwhile, both OPEC and the IEA lowered their forecasts for total oil demand in both 2018 and 2019, premised on rising trade tensions and slowing economic growth in some regions. Weaker demand and rising supply should lead to lower oil prices over the next 12-18 months.

NORTH AMERICA

- Inflation data was softer than expected for a second straight month. Core consumer price inflation (CPI), which excludes food and energy prices due to their volatility, increased in September by just 0.1% month-on-month matching August’s increase. On a year-on-year basis, core CPI remained unchanged at 2.2% but the annualised rate of the past three
months registered 1.8%, indicating a softening in inflationary pressure. Service inflation remained firm with shelter and medical care prices both rising by 0.2% on the month. However, used vehicle prices fell a precipitous 3.0% on the month. Core service inflation increased 0.2% on the month while core goods inflation fell by 0.3%, curbed by the strengthening dollar. Headline CPI also increased by just 0.1% on the month with the year-on-year rate falling sharply from 2.7% to 2.3%, pressured lower by a 0.5% decline in energy prices. Energy price inflation is expected to decline over coming months as the past year’s rapid oil price rise creates a favourable comparative base effect. The overall data indicates that inflation remains well anchored despite the economy’s strong growth rate and the lowest unemployment rate since 1969.

- The University of Michigan US consumer confidence index slipped in October from 100.1 to 99.0 although remained at elevated levels, close to its 14-year high. The decline is attributed to a softening in the expectations measure, which fell from 90.5 to 89.1. The current conditions measure fell by less from 115.2 to 114.4. The survey was conducted just prior to last week’s sharp decline in US equity markets, which may affect next month’s reading. Nonetheless, the gauge of current views on personal finances fell to its lowest since May while the median expected gain in annual income weakened from a previous 2.1% to 1.7%. At the same time, households’ expectations for inflation over the next year increased from 2.7% to 2.8%, although the longer-term inflation expectation fell sharply from 2.5% to 2.3%, indicating that inflation expectations are well anchored. The buoyant consumer confidence reading suggests household spending, which contributes over two-thirds of US GDP, will remain strong over coming quarters. However, the fading effect of tax cuts and the impact of rising interest rates may start to take their toll from mid-2019 onwards.

- Retail sales increased in September by a lower than expected 0.1% month-on-month, matching August’s increase and well below the 0.6% consensus forecast. However, the weak data can be largely explained by the effect of Hurricane Florence. Although contributing to a substantial increase in car sales of 0.8% on the month, as damaged vehicles were replaced, it also undermined spending in restaurants and bars, which suffered the biggest decline in two years. The more meaningful and less volatile “control” retail group sales, which excludes autos, gasoline and building materials due to their volatility, increased by a robust 0.5% on the month after showing nil growth in August. The 3-month-on-3-month annualised growth rate in control group sales registered an impressive 4.8% in September, pointing to yet another strong contribution from real consumption growth to third quarter (Q3) GDP. In Q2 real consumption grew by 3.8% quarter-on-quarter annualised.

CHINA

- China’s export growth unexpectedly accelerated in September despite the rollout of additional US export tariffs. Export growth increased sharply from an already elevated 9.8% year-on-year in August to 14.5%. Exports to the US increased by 14% on the year building on
the 13% gain in August. While the rapid increase is attributed in part to the front loading of orders ahead of the imposition of additional tariffs on 24th September, the data nonetheless confirms that China’s exports are holding up well in the face of rising restrictions. China’s trade surplus with the US increased 21% on the year to a record $34.1 billion. China’s import growth, meanwhile, slowed from 19.9% to 14.3%, reflecting a meaningful slowdown in domestic demand. Domestic factors appear to be affecting China’s growth outlook more than the expected slowdown in external demand.

JAPAN

- Core machinery orders, excluding those for ships and power equipment, a closely watched leading indicator of corporate capital spending, surged in August by 6.8% month-on-month, unexpectedly increasing for a second straight month after rising by 11.0% in July. Orders are now at their highest monthly level since January 2008, prompted by rising business confidence and rising capacity shortages. Orders in the manufacturing sector increased 6.6% on the year and non-manufacturing orders by 6.0%. The upbeat data prompted the Cabinet Office to upgrade its outlook on machinery orders, which it now sees as “picking up”, confirming a positive upward trend in business investment spending. This bodes well for productivity improvements and the sustainability of the current economic upswing.

EUROPE

- Minutes from the ECB’s September policy meeting generally support President Mario Draghi’s upbeat statement made last month. ECB chief economist Peter Praet observed in the minutes that: “High-frequency indicators had stabilised and remained at elevated levels, underlining the overall robustness of economic activity.” Praet indicated he was comfortable with current market expectations for the first small interest rate increase in the fourth quarter 2019, followed by small and infrequent rate increases. ECB policy makers generally agreed that while the risk from weaker external demand may have increased, this risk would be mitigated by the underlying strength of the Eurozone economy.

- Eurozone industrial production showed the first month-on-month increase in three months in August, rising 1.0% after falling by 0.7% in both June and July. The increase is impressive given the 10% decline in motor vehicle production, ahead of new EU emission regulations. Industrial production would have increased by around 1.9% on the month if vehicle production had remained unchanged from July’s level. Improvement was broad-based across industrial sectors, with capital goods, durable and non-durable consumer goods all increasing by at least 1.4% on the month. The data is encouraging and should maintain recent strength in the months ahead as normal vehicle production resumes. Vehicle production contributes around 9% of total Eurozone industrial production.
UNITED KINGDOM

- UK GDP increased in August by just 0.1% month-on-month. However, the 3-month-on-3-month growth rate to end August registered a solid 0.7%, matching the previous month and marking the fastest growth rate since the fourth quarter (Q4) 2016. July’s growth rate of 0.4% on the month was sufficiently strong, with unusually hot weather boosting consumer spending, that quarter-on-quarter GDP growth would register a solid 0.6% in Q3 even if September shows the same mild growth as in August. The data confirms that although GDP is running below its longer-term trend rate of 2% due to the impact of Brexit uncertainty on business investment, the economy has rebounded from its soft patch at the start of the year. The trade deficit narrowed in the three months to end August to £2.8 billion down significantly from £6.1 billion in Q2, indicating that the improvement in net trade will make a substantial contribution to Q3 GDP growth.

FAR EAST AND EMERGING MARKETS

- In its bi-annual World Economic Outlook, the IMF lowered its emerging market economic growth forecast. It forecasts growth will remain unchanged from the 2017 level of 4.7% in both 2018 and 2019, down from its earlier July forecast of 4.9% and 5.1%, respectively. The report states that: “Growth was revised down for Argentina, Brazil, Iran and Turkey, among others, reflecting country-specific factors, tighter financial conditions, geopolitical tensions, and higher oil import bills.” The IMF cited weakening emerging market currencies, exacerbated by capital outflows, which are prompting a tightening in monetary policy and lifting the cost of financing overseas debt burdens. The IMF forecasts growth in emerging Europe will slow from 3.8% in 2018 to 2.0% in 2019 due mainly to Turkey’s slowdown and growth in Latin America to register just 1.2% in 2018 rising to 2.2% in 2019, hurt by the expected recession in Argentina. Its 2018 forecast for sub-Saharan growth was cut from 3.4% to 3.1%, attributed to its reduced forecast for South Africa’s growth from a previous 1.5% to just 0.8%.

- Due to its heavy reliance on trade, Singapore’s economic data is closely followed as a barometer for world trade. Encouragingly, the Monetary Authority Singapore (MAS) downplayed the effect of trade tensions. The MAS chose instead to tighten monetary policy for a second time this year amid strong economic data and a projected increase in core inflation. GDP grew in the third quarter (Q3) by a robust 4.7% quarter-on-quarter annualised up strongly from 1.2% in Q2. In the first three quarters of 2018, Singapore’s GDP grew by 3.8% year-on-year, marking the fastest growth for that period since 2013. The trade war between the US and China appears to be having little impact on Singapore’s economy. If anything, the trade dispute may bring about opportunities in the longer-term as trade flows are redirected.

- Nigeria’s main opposition party, the People’s Democratic Party (PDP), last week elected Atiku Abubakar as its leader ahead of the country’s general election in February 2019. Nigeria’s election race between Abubakar and incumbent Muhammadu Buhari is expected...
to be close with both leaders adopting markedly different manifestos. While Buhari stands for policy continuity with little economic reform, although a firm handle on corruption, Abubakar has promised sweeping economic reforms. He has pledged to shrink the federal government deficit, cut state expenditure, decentralise budgeting to state governments, introduce a free-floating exchange rate and privatise the massive state oil company. While his fiscal austerity might dampen economic growth over the short-term his reforms, if successfully implemented, would significantly boost equity market performance.

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<th>KEY MARKET INDICATORS (YEAR TO DATE %)</th>
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TECHNICAL ANALYSIS

- The spike in the rand/dollar rate to R/$15.50 in the first week of September may mark the peak in the currency’s recent decline.

- The rally in the US dollar index has reached its medium-term goal suggesting a correction from current levels. The dollar remains below a major 30-year resistance line suggesting the bull run in the dollar may be over.

- The British pound has broken back below key resistance at £/$1.35 suggesting a trading range of £/$1.30-1.35. The £/$1.28 level is expected to provide strong resistance.

- The JPMorgan global bond index is testing the support line from the bull market stemming back to 1989, which if broken will project further sharp increases in bond yields.

- The US 10-year Treasury yield has broken above resistance at 3.0% and 3.20%, paving the way for a new 3.20-3.30% trading range. However, any further move highly is likely to meet stiff resistance, especially at the key 3.50% level.

- The benchmark R186 2025 SA Gilt yield has spiked higher to 9.30% but is expected to meet stiff resistance at this level, limiting any further likely upside. The R186 may retrace a portion of its upward move taking the yield back to the 8.80% level and thereafter 8.60%.


- The Brent oil price has decisively broken above key resistance at $80 per barrel, opening-up the $100 level, which just two months ago seemed far-fetched. However, any spike higher to the $100 level is likely to be short-lived, a blip rather than the start of a sustainable trend higher. The outlook for base metals prices is less certain after the copper price retreated sharply from the key $7000 per ton level. A decisive break below $6000 per ton would herald a bear market in copper and base metals’ prices.

- Gold has developed an inverse “head and shoulders” pattern, which indicates a price recovery and a test of the $1400 target level.

- Despite the consolidation since the start of the year the break in the JSE All Share index above the key resistance level of 60,000 in December signals the early stages of a new bull market.
BOTTOM LINE

- South Africa’s financial markets have had a tough year so far. At the close of trade on 12th October the JSE All Share Index had lost -10.14% year-to-date and the ZAR/$ had depreciated -14.74%. We are not alone. The MS World Index lost -1.90% and the MS Emerging Market Index -15.40%. As the most liquid emerging market, our currency, equities and bonds ebb and flow in tune with global markets. This begs the question, what is driving global markets?

- A Bank of America Merrill Lynch survey of US fund managers indicates a sharp decline in investor confidence. 60% of fund managers cited a trade war as the biggest risk to global financial markets, the highest allocation to any single risk since the Eurozone sovereign debt crisis in 2012. In the update of its World Economic Outlook the IMF flagged increased risks to global growth posed by intensifying trade wars, leading it to cut its global growth forecast for this year from 3.9% to 3.7%.

- The IMF forecasts total global trade volume will grow by 4.2% this year and 4.0% next year, down from its previous respective forecasts of 4.8% and 4.5%. These are still heady growth rates though. It appears the fundamentals are not nearly as bad as the souring in sentiment would suggest. Let’s look at the fundamentals. So far, the US has raised tariffs on around half of all Chinese imports. China has retaliated. However, since it imports less from the US than it exports it will have to resort to other measures if, in the worst-case scenario, the US raises tariffs on all Chinese imports. China is likely to restrict sales of materials, equipment and other components which are key to US manufacturers’ supply chains. China may also punish the US indirectly by reducing tariffs on imports from its other trading partners.

- The US-China trade war headlines may be dramatic but the expected impact on aggregate global demand for goods will be minimal. The price elasticity of demand for much of China’s trade with the US is quite high. This means the quantity demanded is likely to adjust by less than the adjustment in price. In any event, if buyers are put off by the resulting price increase, they will look elsewhere. Trade will be redirected. Besides, the yuan’s 10% depreciation versus the dollar since its peak earlier in the year largely mitigates much of the price adjustment.

- Fortunately, despite the US-China trade war, trade elsewhere is steadily becoming freer. Following four years of negotiation the EU and Japan, the world’s second and fourth largest trading blocs, concluded a historic bilateral trade deal in July. The trade deal creates the world’s largest free trade pact covering about a third of global GDP. The trade deal extracted significant concessions from both sides and comes as a welcome counterbalance to growing US trade protectionism. Encouragingly, the NAFTA agreement has been successfully renegotiated with minimal increase in protectionism. The biggest change appears to be in the name, now known as the United States-Mexico-Canada Agreement (USMCA). Meanwhile, President Trump and European Commission President Jean-Claude
Juncker have pledged to work together to negotiate towards a broad reduction of tariffs. The temporary trade truce between the US and EU signals a de-escalation of the trade conflict amid broadening resistance from US businesses and Republican politicians.

- Provided the trade war does not spread beyond the US and China, which seems unlikely given positive developments elsewhere, the effect on global trade and global GDP will be negligible. The effect on China and the US will also be mild. With steady growth in domestic demand, China depends less on exports for its GDP than it used to, now less than 20% of GDP compared with around 50% as little as 20 years ago. China’s exports to the US account for an estimated 2.5% of its GDP while US exports to China account for as little as 1% of its GDP.

- Although certain industrial sectors will undoubtedly be impacted the global macro-economic effect will be far less than indicated by prevailing negative sentiment. The risks are exaggerated and over-priced, creating an attractive buying opportunity. Fundamentals always reassert themselves.

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