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WEEKLY REPORT

OVERBERG MARKET REPORT

Tuesday 19th November 2019

IN THIS WEEK'S BOTTOM LINE

Contributed by Nick Downing

- South African confidence is riding the crest of a wave. Not only have the Springboks brought home the Webb Ellis trophy to the delight of nearly all South Africans, the government's programmes of economic structural reforms and initiatives are gaining momentum.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Werner Erasmus

- Mining production surprised to the upside in September, increasing 0.2% year-on-year. The annual increase was well above the consensus forecast contraction of 2.4%. It also showed a solid recovery from the contraction of 3% recorded in August. Iron ore (up 8.2%) and non-metallic metals (up 13.6%) led the way adding 0.9 and 0.8 percentage points respectively. The biggest negative contributors included diamonds (down 15.7%) and manganese (down 7.3%) which negatively contributed 0.6 and 0.5 percentage points. On a quarterly basis, however, the mining sector shrank 1.6% in the three months ending in September compared with the previous three months. The sector's performance, combined with weak retail and manufacturing data, points to a weak third quarter for the overall economy. The mining industry continues to face high costs of production, declining ore grades, sporadic power outages, relatively subdued commodity prices and uncertain global growth prospects, particularly in China. Low productivity in the sector and the cost base of mines in South Africa also continue to be a concern.

- September's retail sales were downbeat, increasing marginally by 0.2% year-on-year and 0.5% month-on-month, well below the consensus forecast of 1.9% growth on the year, a clear indication that consumers are under pressure and cutting back on spending. While sales in the textiles, clothing, footwear and leather goods sector grew by 3% on the year, general dealers' sales – a category that accounts for almost half of all sales – fell by 0.7%. On a quarterly basis, retail sales increased by 1.1% in the third quarter of 2019 compared with the third quarter of 2018. The largest contributors to this increase were: all 'other' retailers (up 4.2% and contributing 0.5 of a percentage point); and retailers in textiles, clothing, footwear and leather goods (2.3% and contributing 0.4 of a percentage point). Retail sales are expected to remain under pressure in the short-term given low consumer confidence and various other headwinds faced by consumers such as elevated fuel prices, below inflation wage increases and higher taxes.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Werner Erasmus

- Consumer Price Inflation: Due Wednesday 20th November. According to consensus forecast, consumer price inflation (CPI) will have decreased to 3.9% year-on-year in October, to its lowest level since March 2018, edging towards the lower end of the Reserve Bank's target range of 3-6 percent. This expected CPI decline is attributed to lower petrol prices, resulting from a stable rand and restrained international oil prices. Furthermore, CPI is expected to stay unchanged on a month-on-month basis at 0.3% while core CPI is also expected to be unchanged at 4% on the year, amid subdued domestic demand.

- South African Reserve Bank Interest Rate Decision: Due Thursday 21st November. On the back of low inflation expectations, declining GDP forecasts and falling interest rates globally, the South African Reserve Bank's (SARB) Monetary Policy Committee (MPC) is expected to cut the repo interest rate by 25 basis points to 6.25%. However, there has been a shift in consensus since the Medium-Term Budget Policy Statement (MTBPS), highlighting the deterioration in government's fiscal metrics and the change in Moody's outlook for South Africa's sovereign credit. The shift has left some analysts forecasting that the MPC will hold back from further rate cuts until after the upcoming 2020 Budget and Moody's rating review.

GLOBAL

Contributed by Nick Downing

- The Dow Jones Industrial Index cut through the 28,000 level for the first time, amid a strong return in global equity investor confidence. Investors are cheered worldwide by falling geopolitical risk, synchronised global monetary easing and signs of recovering economic growth. A Bank of America survey found that cash held worldwide by asset managers had fallen in the first week of November to its lowest level since June 2013, while the allocation to global equities was at its highest in 12 months. With expectations of a cyclical economic recovery and rising long-term interest rates, interest in traditional "value shares", typically represented in the bank, financial and industrial sectors, is being rekindled. Bank shares have strongly outperformed over the past two months as the bond yield curve has steepened from its previous inverted shape, in turn boosting bank interest margins. Value shares have performed poorly compared with "growth shares" over the current 10-year bull market but this may be changing. The value share and growth share components of the S&P 500 index have shown widely diverging performance over the past decade, of 120% versus 235%, and so a mean reversion could entail a considerable outperformance by value shares over coming months. Despite rising investor confidence there are, as always, some concerns. As the saying goes, bull markets climb a wall of worry. The price of some collateralised loan obligations, which package illiquid "junk" or highly leveraged corporate loans, are falling sharply, while junk bond exchange traded funds are experiencing record "short" volumes, potentially spelling trouble ahead for the corporate debt market, and signalling a red flag for the equity rally.

NORTH AMERICA

Contributed by Nick Downing

- Retail sales rebounded in October, rising 0.3% month-on-month, recouping the unexpected 0.3% contraction in September. However, most of the spending increase was on essential items including food and beverages and gasoline. Gasoline sales increased by 1.1% on the month, whereas consumer spending on discretionary items such as clothing and furniture, suffered declines. Retail sales excluding gasoline and vehicle sales, which tend to be volatile, grew by just 0.1% on the month. On a year-on-year basis, total retail sales grew by a steady 3.1% although this is a sharp drop from 4.1% in September and marks the slowest annual growth since May. Retail sales would have to show a strong reacceleration in November and December for fourth quarter (Q4) consumer spending to maintain its Q3 pace. Although a tall order, retail spending tends to pick-up over the festive season and early indications suggest the trend will be maintained this year, amid record low unemployment, a rising stock market and solid wage growth. Consumer spending is closely watched by economists as it accounts for over two-thirds of US GDP and is currently keeping the economy afloat during the existing recession in the manufacturing sector. Online sales continued to enjoy strong growth, rising in October by 0.9% on the month and 14.3% on the year.

- There is little evidence that tariffs levied in September on imported Chinese consumer goods have fed into higher consumer price inflation (CPI). While CPI increased in October by an elevated 0.4% month-on-month, the increase is attributed to volatile energy prices. Gasoline and electricity prices increased by 3.7% and 1.8% on the month, although medical care prices also gained by 1.2%. However, apparel prices fell 1.8%. Core CPI, excluding energy and food prices, due to their volatility, increased by a more subdued 0.2%. On a year-on-year basis, while headline CPI picked-up to 1.8% from 1.7% the prior month, core CPI slowed from 2.4% to 2.3%. Meanwhile, the Fed's preferred inflation measure, the personal consumption expenditures price index remains muted at just 1.3%, well below the central bank's 2% target. At the producer price inflation (PPI) level, inflationary pressures are also absent. PPI fell in October to 1.1% on the year down sharply from 1.4% the prior month, to its lowest since October 2016. The inflation outlook appears to be in the sweet spot, not high enough to warrant a tightening in monetary policy or too low to raise the threat of deflation. The yield spread between 10-year US Treasury bonds and Treasury Inflation Protected Securities (TIPS) of the same maturity, indicating the bond market's expected annual inflation rate over the coming 10 years, has encouragingly risen from a low point of 1.5% in September to the current level of 1.7%. This is low by historic standards but not deflationary.

- In its twice-annual Financial Stability Report on the resilience of the US financial system, the Fed observed that: “The core of the financial sector appears resilient, with leverage low and funding risk limited relative to the levels of recent decades.” However, the report identified historically high debt in the non-financial sector as a source of concern, especially in the leveraged loan or below-investment grade market. Instability could ensue if leveraged loan spreads widen dramatically from current low levels. The leveraged loan market has grown rapidly as companies take advantage of the existing low interest rate environment and as investors search for yield. Meanwhile, Fed Chairman Jerome Powell, in his congressional testimony, indicated little risk of this year’s interest rate cuts being reversed, stating that “there’s no sign that things are overheating or anything like that.” His testimony signals that despite the pause in rate cuts the bias remains for further monetary easing.

CHINA

Contributed by Nick Downing

- China’s economic output indicators continued to lose momentum in October. On a year-on-year basis, retail sales growth and industrial output growth slowed to 7.2% from 7.8% the prior month and from 5.8% to 4.7%, respectively. Meanwhile, fixed-asset investment growth in the ten months to end October fell to 5.2% compared with the same period in 2018, its slowest since the data series began in 1998, down from 5.4% in the January to September period. There were some bright spots. Fixed-asset investment in technology sectors grew by 14%, the housing and residential construction markets remained buoyant and the urban unemployment rate fell to 5.2% from 5.1% in September. The National Bureau of Statistics maintains that despite the economic slowdown, GDP growth will hit the government’s target of 6-6.5% in 2019. Nonetheless, the subdued data raises the likelihood of continued fiscal and monetary stimulus over coming months, comprising key interest rate cuts and liquidity injections in addition to infrastructure spending.

JAPAN

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- Japan’s economy grew at a modest 0.2% quarter on quarter annualised in Q3, missing analysts’ forecasts of a 0.8% expansion. It was the fourth straight quarterly rise, but the slowest rate in a year and markedly down from the 1.8% printed in Q2. The key drivers for the growth came from private consumption, business investment and government spending, which added 0.8 percentage points (pp), 0.6 pp and 0.4 pp to the annualised quarterly growth respectively. Private consumption makes up roughly 60% of Japan's GDP and has been an important source of growth in the last year. Net exports of goods and services detracted 0.6 pp from growth as a result of a 0.7% drop in exports while imports rose 0.2%. Private sector inventories also made a negative 1.2 pp contribution. The latest growth figures show that private consumption was impacted less than expected by the rise in consumption tax in October. Although analysts expect some pullback in consumer spending in Q4, measures to smooth the consumption tax effect have successfully prevented a ramp-up in spending in Q3 which would have resulted in a sharper slump in Q4.

EUROPE

Contributed by Carel la Cock

- Against expectations, Germany narrowly avoided a technical recession, albeit with negligible quarter-on-quarter growth of 0.1% in Q3, helped by private and government consumption. Germany's export led manufacturing sector has cooled considerably in recent months, impacted by the protracted US-China trade war, uncertainty over Brexit and a slow-down in the global economy. However, the strong labour market which employs a record 45.4 million people, has been a key driver of economic growth and has offset the slump in net exports. German finance minister, Olaf Scholz said "Looking at the German economy, which is really resilient and globally active, you have to understand there's slower growth in the world. This has an impact on the economy in Germany. We are cautiously optimistic, predicting a rebound in growth next year. It's slower growth, but it's not a crisis"

UNITED KINGDOM

Contributed by Carel la Cock

- UK retail sales surprised on the downside, sliding 0.1% month on month in October compared to expectations of a 0.2% expansion, although analysts cautioned not to read too much into the figures, given evidence of the "Black Friday" effect. Black Friday incentivises consumers to put off purchases and wait for discounted deals in the last weekend of November. However, consumer spending has been a key driver in supporting economic growth and economists will be nervously hoping for a similar sharp rebound in retail sales experienced in November last year. Expectations of modest economic growth in Q4 depend largely on strong domestic consumption, but with a recent softening of the labour market and slowing wage growth, there is a risk of GDP contraction.

- UK prime minister, Boris Johnson, disappointed business leaders by announcing that the government will scrap the previously announced corporation tax cut, to 17% by 2020, in favour of freeing up roughly £6bn for the National Health Service. Johnson said, "the NHS is the nation's priority, and because we believe emphatically in fiscal prudence". The government has committed to balance the books, excluding capital investment, from this month. Johnson was quick to point out that corporate tax rates have steadily come down from 28% to 19% under the Conservative coalition government since 2010. The Labour party under the leadership of Jeremy Corby released their election manifesto this week in which various tax increases were tabled. Amongst the proposed tax hikes are personal income taxes, which are set to rise for high income earners, the establishment of an "excessive pay levy", a £5bn-a-year financial transaction tax as well as a corporation tax increase to 26%. Although corporation tax could increase to 2011 levels if Labour wins the elections, it remains one of the lowest corporation tax rates amongst developed markets comparing favourably to Germany's 30% and France's 31%. The political parties are in full election mode with Britain heading to the polls on the 12th December. From market responses thus far, a Tory win would be generally positive for the UK stock market.

FAR EAST AND EMERGING MARKETS

Contributed by Carel la Cock

- The International Monetary Fund (IMF) forecasts that emerging market (EM) GDP will grow by 4.6% in 2020, up from 3.9% expected this year. The sharp pickup would be the fastest recovery since the global financial crisis. Some analysts remain unconvinced, given the IMF's poor forecasting track record since 2012. In the last 7 years the IMF has consistently overestimated EM growth. The sharp recovery is expected to come from Latin America, the Middle East and Central Asia. Consensus private sector EM growth forecasts of 4.1% are more in line with growth for the current year. Some analysts are more upbeat, expecting most EM economies to recover and show faster growth next year. Examples of economies that could grow from a low base are Argentina and Turkey, both hit by currency crises this year. However, on the opposite side of the spectrum countries such as India, Russia, Brazil and Mexico are growing below long-term trends with no clear catalysts on the horizon to spark growth. One of the reasons why EM growth struggled in 2019 was general tightening in monetary policy to support currencies. However, currencies have since stabilised and most of the larger emerging economies have room to either cut rates in 2020, loosen fiscal policy or do both. Nonetheless, emerging markets need the US Dollar to weaken from its current relative strength. Global demand for the dollar has increased and is unlikely to ease in the coming year despite the Federal Reserve's recent efforts to expand its balance sheet. Some feel that the global financial system still demands much more liquidity, lowering the likelihood of sustained dollar weakness, which in turn could cause EM growth to be more subdued than forecast.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	+ 7.07	56467
JSE Fini 15	- 0.88	16236
JSE Indi 25	+ 8.82	69301
JSE Resi 20	+ 13.13	46433
R/$	- 3.10	14.81
R/€	+ 0.40	16.40
R/£	- 4.49	19.19
S&P 500	+ 24.54	3122
Nikkei	+ 17.00	23416
Hang Seng	+ 4.61	26681
FTSE 100	+ 8.61	7307
DAX	+ 25.08	13207
CAC 40	+ 25.08	5929
MSCI Emerging	+ 8.95	1052
MSCI World	+ 21.33	2285
Gold	+ 13.95	1459
Platinum	+ 11.30	882
Brent oil	+ 14.36	62.26

BOTTOM LINE

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- South African confidence is riding the crest of a wave. Not only have the Springboks brought home the Webb Ellis trophy to the delight of nearly all South Africans, the government's programmes of economic structural reforms and initiatives are gaining momentum.

- Quick on the heels of his second Investment Conference, President Ramaphosa launched the Tshwane Automotive Special Economic Zone (SEZ), utilising 162 hectares of idle municipal land. The Ford Motor Company is the anchor investor with an investment of R3 billion, initially creating 7,000 jobs. A further nine companies have confirmed they will establish facilities by January 2021. Additional SEZs will be set up in Gauteng, in the West Rand, Ekuhuleni, Sedibeng and Johannesburg developmental corridors, luring investors with incentives, putting out the red carpet rather than red tape. SEZs have been so effective in promoting the vehicle manufacturing industry, that the government will be rolling out the SEZ model to other industries, in particular textiles, clothing and footwear, and agricultural processing, food and beverages, and logistics, rail, capital equipment and machinery.

- Ramaphosa's Investment Conference highlighted South Africa as the ideal launch pad for businesses tapping into the broader African market, made all the more relevant by the signing this year of the African Continental Free Trade Agreement (AfCFTA). Signed by 54 out of 55 countries in Africa and commencing in July 2020, the trade agreement will cover a population which by 2040 will be bigger than China and India combined. Member countries have pledged to cut trade tariffs to zero on 90% of all goods. Currently, only 18% of African exports are traded within the continent compared with 60% in Asia. The scope for growth is huge. The UN Economic Commission for Africa forecasts a 50% increase in intra-continental commerce in four years. To facilitate increased trade, the demand for infrastructure will surge, comprising road, rail and urban development. At the African Investment Forum hosted last week in Johannesburg by the African Development Bank and Infrastructure Consortium for Africa, it was announced that infrastructure investment commitments in Africa exceeded $100 billion in 2018 for the first time, rising year-on-year by a massive 24%. This figure can only grow under the auspices of the AfCTFA.

- These and other initiatives, including the Integrated Resource Plan, the Renewable Energy Independent Power Producer Programme, allocation of broadband spectrum, and repeal of visa constraints, are encouraging. Furthermore, implementation risk is low.

- However, the government needs more than initiatives. Significant structural reforms are required, first and foremost to stem the rising tide of expenditure on public sector wages. This is the elephant in the room and at the root of Eskom's survival. Does the government have the spine to follow the example of the great economic reformers of the 20th century, China's Deng Xiaoping, Singapore's Lee Kuan Yew or Britain's Iron Lady, Margaret Thatcher? Moody's credit rating agency appears to think not. This contributed largely to the institution's decision to lower its rating outlook for South African sovereign debt from "stable" to "negative", paving the way for a rating downgrade to junk status.

- Moody's attributed its change in outlook, not just to the deterioration in South Africa's fiscal strength but also to "the reform obstacles that the political landscape represents. The history of political infighting that has generated policy uncertainty in the past remains." Despite Ramaphosa's ascendancy to the leadership of the ANC in December 2017 and the ANC's decisive victory in the national elections in May this year, his government lacks the authority to implement unpopular but essential reforms. The government's lack of authority is showcased in Finance Minister Tito Mboweni's Medium-Term Budget Policy Statement, where instead of prescribing difficult policy decisions, he instead made a set of proposals. Proposals, while well meant, will not achieve what is required. The country needs decisions, an action plan and steadfast implementation.

- SAA has announced the bold step of laying off 900 staff, around 20% of its workforce, to cut costs and improve productivity. Perhaps this is a signal of things to come at Eskom and other state-owned enterprises. We will be watching closely for signs that the government is committed to taking the bitter medicine required to restore confidence, not just among the credit rating agencies but at street level and in the boardrooms of South Africa's private sector.