OVERBERG MARKET REPORT

Tuesday 10th September 2019

IN THIS WEEK'S BOTTOM LINE

Contributed by Nick Downing

- Negative yields across the Eurozone have more to do with the effects of quantitative easing than the threat of deflation. The sheer quantity of central bank bond purchases via quantitative easing programmes has led to a supply/demand imbalance in bonds

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Kirk Swart

- The South African economy rebounded in the second quarter with a positive Gross Domestic Product (GDP) growth figure of 3.1% quarter-on-quarter annualised. The biggest contributors to the growth were mining (14.4%), finance, real estate and business services (4.1%), trade, catering and accommodation (3.9%) and general government services (3.4%). The positive reading means that South Africa has avoided a technical recession which is defined as two consecutive quarters of negative GDP growth. An encouraging part of the GDP number is the 6.1% increase in gross fixed capital formation (GFCF) following 5 consecutive negative quarters. GFCF is an indication of the physical investment back into the economy. The main contributors to GFCF were an increase in machinery and equipment, transport equipment and residential buildings. Imports of machinery and equipment, mineral products and chemical products were the biggest contributors to the imports of goods and services which increased by 18.8%. Private consumption expenditure also increased by 2.8%. Worryingly, the agriculture and construction industries declined by 4.2% and 1.6% respectively.

- In the second quarter of 2019, the current account, which measures all transactions in goods and services between South Africa's residents and the rest of the world, unexpectantly widened to a deficit of R204.1 billion from R143.5 billion in the first quarter. The market expected a current account deficit of R134.5 billion. As a percentage of GDP, the current account deficit deteriorated to 4% of GDP in the second quarter compared with 2.9% in the first quarter. However, the decline can be viewed in a positive light as the bulk of additional imports consisted of machinery and equipment for fixed capital investment purposes.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Ingrid Breed

- The SACCI Business Confidence Index: Due Wednesday 11th September. Following a drop in the previous month to the worst reading since March 2019, the SACCI Business Confidence Index is expected to have improved marginally to 92.4 in August 2019.

- The RMB/BER Business Confidence Index: Due Wednesday 11th September. The RMB/BER Business Confidence Index is forecast to fall to its lowest levels since the second quarter (Q2) of 2017 to a reading of 24 amid continued policy uncertainty and its detrimental effect on sentiment.

- Mining Production: Due Thursday 12th September. According to consensus forecast the mining industry, which increased by 14.4% and contributed 1.0 percentage point to GDP growth in the second quarter (Q2), is expected to have increased output in July by 4.2% year-on-year and 2.7% month-on-month. This considerable expected increase in mining production is despite gold production likely to have suffered its 22nd consecutive month of contraction.

GLOBAL

Contributed by Nick Downing

- Although no specific date was given, senior trade negotiators from the US and China confirmed that high-level trade talks would resume in Washington in early October. These would be the first since talks were called off in Shanghai in July. For any real progress to occur, China will have to commit to structural economic changes while the US will need to repeal existing tariffs. With both sides growing further apart since talks began 18 months ago, there is little expectation of a meaningful breakthrough. However, the fact that talks are back on track lowers the risk of a further escalation in what has now become a trade war. Maintaining the status quo should provide comfort to global financial markets.

NORTH AMERICA

Contributed by Nick Downing

- Non-farm payrolls increased in August by just 130,000 down from 159,000 in July and below the average of the last three months of 156,000. The monthly average in 2018 was 223,000. While showing a clear loss in momentum, there is at least little sign of job losses. An increase in weekly hours worked and temporary hiring indicates that the job market remains firm. Moreover, the unemployment rate stayed unchanged for the third straight month at a historic low of 3.7% and wages increased by 3.2% year-on-year, which although down from 3.3% the prior month, is elevated in real terms after taking inflation into account. The manufacturing sector increased payrolls by a modest 3,000 over the month, taking the year-to-date total to only 27,000 compared with a total of 154,000 in 2018 over the equivalent period. By contrast however, the services sector continued to provide strong jobs growth. According to the separate ADP jobs report, the service sector added a substantial 184,000 payrolls in August, which indicates little sign of infection from the slowdown in manufacturing and the broader industrial sector.

- The Institute for Supply Management (ISM) manufacturing index, fell below the contractionary 50-level in August for the first time since August 2016, confirming that the global manufacturing recession has finally spread to the US. The manufacturing recession is attributed primarily to the trade war with China and associated supply chain disruptions. Among the survey's sub-indices, the forward-looking new export orders index fell to its lowest since April 2009. However, a manufacturing recession does not necessarily mean a US recession. The manufacturing sector accounts for a modest 11% of US GDP and was in recession for much of 2015 and 2016, while the broader economy continued to grow at around 2% annualised. By contrast with the manufacturing ISM, the services ISM rebounded sharply in August from 53.7 to 56.4, with all 16 service sectors in above-50 expansionary territory, indicating broad-based strength. The service sector of the economy contributes a much larger 80% to US GDP and for the time being remains in rude health. The ISM service index has been in expansionary mode for 115 straight months.

- The Beige Book, a summary of anecdotal information on economic conditions compiled eight times a year by all the Federal Reserve Districts, suggests US businesses remain optimistic about prospects despite trade policy uncertainty. Comments indicated delays in capital spending and weakness was flagged in the manufacturing and housing sectors. However, the report summarised that "the economy expanded at a modest pace through the end of August. Although concerns regarding tariffs and trade policy uncertainty continued, the majority of businesses remained optimistic about the near-term outlook."

- Federal Reserve Vice Chairman for Supervision, Randal Quarles, has proposed implementing the "countercyclical capital buffer", which regulates the amount of capital banks are required to hold, according to the economic cycle rather than keeping it constant. The capital requirement can be increased when the economy is over-heating and reduced in times of recession. Quarles said that "limiting pro-cyclicality, or being countercyclical, essentially means limiting both the highs and lows of a business cycle." The US economy tends to be more cyclical than most economies, with shorter uninterrupted expansions and a higher incidence of recessions. Implementation of the countercyclical buffer could extend the duration of economic expansions, which according to Quarles "could be adjusted quickly in response to economic, financial or even geopolitical shocks." Banks' capital ratios are extremely high with significant room for reduction to boost lending capacity.

- A study by the Federal Reserve to quantify the impact of trade policy uncertainty on economic activity concludes that the trade dispute and tariffs implemented in 2018 shaved about 0.8 percentage points from US GDP growth in the first half 2019. The trade war escalation this year is expected to shave GDP growth in the first half of 2020 by more than 1 percentage point. Fed Chairman Jerome Powell, while acknowledging the impact has said that "trade policy uncertainty is not something that central banks have a lot of practice in dealing with." Nonetheless, the Fed is expected to cut the benchmark fed funds rate by a further 25 basis-points at the next policy meeting concluding on 18th September. The fed funds futures market attributes a 90% probability of a 25 basis-point rate cut, and a 10% probability of a larger 50 basis-point rate cut.

CHINA

Contributed by Nick Downing

- China's trade figures were poorer than expected reflecting the impact from the trade war with the US and continued weakness in domestic demand. China's exports fell in August by 1% year-on-year reversing the 3.3% gain in July. Exports to the US were especially hard hit, falling by 16% on the year after falling 6.5% in July, despite expectations of some front-loading ahead of new tariffs imposed on 1st September. Meanwhile, imports from the US slumped in August by a sizeable 22.4%. Overall imports fell by 5.6% on the year the same as the decline recorded in July, indicating depressed domestic demand conditions. China's trade surplus fell from $45 billion in July to $34.8 billion in August. The weaker than expected trade data is likely to prompt bolder monetary and fiscal stimulus from China's authorities.

- The People's Bank of China (PBOC) cut its Reserve Requirement Ratio (RRR), which regulates the amount of capital banks are required to hold in reserve, for a third time this year and for a seventh time since monetary easing began in early 2018. The RRR was reduced for larger banks by 50 basis points and by 100 basis points for municipal commercial banks which only operate on a provincial level, in order to provide added assistance to private and smaller businesses. The cut in the RRR should free up an estimated $126 billion in additional potential lending. The monetary stimulus follows an announcement by the policy setting State Council last week that it plans to provide more support to the economy. The State Council stated that "we attach great importance to the development of infrastructure, high-tech, traditional industrial transformation, social services and new growth regions."

JAPAN

Contributed by Carel la Cock

- Japan is set to go ahead with an increase in consumption tax from 8 to 10% in October and economists predict there will be less of an impact on economic activity than the last time the consumption tax was hiked in 2014 from 5 to 8%. Prior to the 2014 tax hike, consumers ramped up purchases before the deadline, however data suggest that is not the case this time. The government has introduced some mitigating measures such as exempting fresh food and smoothing the implementation on large purchases such as cars and apartments. Although economists forecast there will be less of an impact on consumer demand after the tax hike, the economy remains subdued with the ongoing US-China trade disputes still impacting on the export driven economy. Japan's second quarter economic growth was revised downward from an initial estimate of 1.8% to 1.3%.

EUROPE

Contributed by Carel la Cock

- Germany's industrial production contracted in July by 0.6% month on month and 4.2% year on year, but at a lower rate than the 1.1% month on month decline in June. Within the subsectors, on a month on month basis, intermediate goods were down 0.7%, capital goods 1.2% and energy production 1.3%. Production of consumer goods were up 1.3% as well as production in construction by 0.2%, pointing to domestic activities continuing despite the slowdown in export driven manufacturing. In separate data released this week, exports increased in July by 0.7% month on month and 3.8% year on year while imports declined 1.5% on the month and 0.9% on the year. As a result, the foreign trade balance increased to €20.2 billion. The unexpected improvement in trade for July will help to ease fears that the economy is heading for a recession after marking a 0.1% contraction in the second quarter. This week French finance minister, Bruno Le Maire, has made fresh calls for the German government to increase public spending, saying "Germany must invest more now to support growth in its economy and the eurozone as a whole". Thus far Germany has refused to loosen its fiscus with its balanced budget or "black zero" enshrined in its constitution, but analyst say that German Chancellor, Angela Merkel, might have to rethink that policy if the global economic slowdown continues to bite.

UNITED KINGDOM

Contributed by Carel la Cock

- The UK economy expanded in July by 0.3% month-on-month ahead of expectations of 0.1% growth, with data pointing to businesses starting to stockpile once again ahead of the October Brexit deadline. This followed rhetoric in July from Prime Minister Boris Johnson about leaving Europe with or without a deal, increasing the likelihood of a disorderly Brexit. The latest data will alleviate fears of a recession after a 0.2% contraction in the second quarter mainly driven by an unwinding of the stockpiling in the first quarter, prior to the original Brexit deadline. The main driver of growth in July came from the services sector which accounts for nearly 80% of the economy. Services grew by 0.3% in July compared with growth of 0.08% from quarter one to quarter two. In a recent survey conducted by the Bank of England on the effect of Brexit on nearly 6,000 companies, the corporate sector revealed that capital spending was on average 11% lower due to Brexit uncertainty and that UK productivity was down between 2 and 5% as a direct result of Brexit. With Brexit set to continue (see below) the UK economy will remain weak in the third quarter as companies further delay capital expenditures and wage hikes until there is more clarity.

- Former British Prime Minister, Harold Wilson, famously said in the mid-1960s that “a week is a long time in politics”. And so it was this week for Prime Minister Boris Johnson as he faced six successive Commons defeats. These included parliament passing legislation to block his no-deal Brexit and twice denying him a snap election in October. With parliament prorogued until mid-October, the earliest date for a snap election will be in November, after the 31st October Brexit deadline. The House of Commons has essentially ordered the prime minister to try and renegotiate a Brexit deal, failing which he is to ask for another extension to the Brexit deadline. However, with the threat of a no-deal Brexit off the table, Europe will be less inclined to renegotiate the deal already agreed to. Mr Johnson has thus far maintained that Britain will leave Europe by the end of October and political analysts say that the matter might end up in the Supreme Court where Mr Johnson could try and find a loophole in the legislation blocking him from a no-deal Brexit. What is clear is that Brexit is far from concluded and that the uncertainty will remain, at least until the end of October.

FAR EAST AND EMERGING MARKETS

Contributed by Carel la Cock

- South-Korea and Japan have escalated their trade dispute after Japan in early July restricted export of hydrogen fluoride, a key ingredient for South Korean semiconductor producers. Consequently, exports in hydrogen fluoride fell in July by 83.7% month on month. This led to both countries removing each other from their respective trading white lists, meaning exporters must obtain special permits to trade with the other country. South Korea went further and said it will cancel the intelligence sharing pact, a move condemned by the United States. It all stems from a dispute regarding Japan’s use of wartime forced labour and a high court ruling in South Korea awarding damages against Japanese companies. Japan maintains all claims were settled in 1965 with a treaty. Tension has been steadily building and any further escalation would be detrimental for both economies, especially given the backdrop of the ongoing US-China trade war and weak global demand for both countries' exports.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	+ 5.28	55523
JSE Fini 15	- 4.61	15624
JSE Indi 25	+ 12.60	71709
JSE Resi 20	+ 4.59	42930
R/$	- 2.85	14.77
R/€	+ 0.93	16.31
R/£	+ 0.45	18.24
S&P 500	+ 18.81	2978
Nikkei	+ 6.51	21318
Hang Seng	+ 4.62	26681
FTSE 100	+ 7.55	7235
DAX	+ 15.79	12226
CAC 40	+ 18.14	5588
MSCI Emerging	+ 4.38	1008
MSCI World	+ 15.66	2179
Gold	+ 17.49	1505
Platinum	+ 19.39	947
Brent oil	+ 15.17	62.70

BOTTOM LINE

Contributed by Nick Downing

- By some measures, global equities have never been so cheap. For the first time ever, the dividend yield on the S&P 500 index, at 1.98%, exceeds the yield on the 30-year US Treasury Bond, at 1.94%. Pension funds, which have traditionally weighted investments heavily in favour of bonds, may turn increasingly towards equities, despite their greater volatility, as a source of income.

- The pricing anomaly stems from the massive decline in global bond yields. Around $16 trillion worth of sovereign and corporate bonds are now in negative yield territory, predominantly in Japan and European countries. Some economists argue that the phenomenon of negative bond yields signals the risk of spreading "Japanification", meaning a vicious cycle of deflation and the debilitating effect of negative interest rates on bank sector profitability. However, there is little indication of deflation yet in the Eurozone. While deflation has been a fact of life in Japan for decades, German consumer price inflation is stable at 1.7%, not far below the ECB's target of close to but under 2%. Meanwhile, earnings forecasts for 2019, although reduced since the start of the year, remain positive at 5-7% for developed economies and 9% for emerging economies. Negative yields across the Eurozone have more to do with the effects of quantitative easing than the threat of deflation. The sheer quantity of central bank bond purchases via quantitative easing programmes has led to a supply/demand imbalance in bonds.

- Low bond yields may be providing a once-in-a-lifetime time opportunity for governments to borrow more and increase spending on fiscal stimulus. For the first time, the US Treasury is considering issuing ultra-long-dated bonds with maturities of 50- and 100-years. Germany, which has persistently enjoyed trade and budget surpluses, is an obvious candidate to increase borrowing, boost fiscal stimulus and undertake a bold infrastructure spending programme. Germany's government is signalling it may finally abandon its long-held balanced budget in favour of extra borrowing.

- Low bond yields should encourage government borrowing while at the same time easing the shortage of bonds, thereby contributing to a healthy normalisation in bond yields back to positive territory. Although the total sovereign debt of developed economies has risen over the past twenty years from an aggregate of 45% of GDP to the current level of around 75%, low interest rates have brought down debt servicing costs to just 1.77% of combined GDP, the lowest since 1975. This, according to the OECD, is well below the recent peak of 3.9% in the mid-1990s. Oliver Blanchard, former chief economist at the IMF and a strong advocate of greater fiscal stimulus, said at the recent Jackson Hole central bankers' symposium that "it's pretty straightforward: If borrowing is cheaper you should probably do more of it."

- The greater risk is not Japanification of the Eurozone and after that the US, it is a "snap-back" in bond yields from heavily overbought levels. The catalyst for the snapback will be a recovery in economic activity resulting from increased central bank monetary stimulus, which has been gaining momentum since May. Global liquidity has increased sharply from its low point in December last year, which indicates a rebound in economic activity from the fourth quarter of the year. A snapback in bond yields, resulting from rising monetary stimulus, increased fiscal spending and a recovery in economic growth will be bad for bond investors but not for equity markets, which will benefit from the resulting boost to earnings growth.

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.