OVERBERG MARKET REPORT

Tuesday 11th December 2018

IN THIS WEEK'S BOTTOM LINE

- It has been an Annus Horribilis for JSE investors. The JSE All Share Index shed 15.18% in the year to end November cementing the worst five-year period for the JSE in fifty years.

SOUTH AFRICA ECONOMIC REVIEW

- The current account deficit widened slightly from 3.4% to 3.5% of GDP in the third quarter (Q3), due mainly to a decline in the trade surplus. A narrower deficit on the services and income account was offset by a decline in the trade surplus. The trade surplus declined from R38 billion or 0.8% of GDP in Q2 to R14 billion or 0.3% of GDP in Q3. However, trade activity picked-up with both merchandise exports and imports rising. From Q2 to Q3, export growth increased from 6.6% quarter-on-quarter to 10.6%, while import growth increased from 0.8% to 12.7%, indicative of a general recovery in economic momentum. The current account deficit should subside over coming quarters, with the falling oil price and the strengthening rand helping to keep the import bill in check.

- Real GDP grew in the third quarter (Q3) by 2.2% quarter-on-quarter annualised, recovering from the upwardly revised contraction of 0.4% in Q2 and 2.6% contraction in Q1. Among the main contributors, manufacturing, agriculture, domestic trade, transport and communication, and finance, grew in Q3 by 7.5%, 6.5%, 3.2%, 5.7% and 2.3%, respectively. The detractors were mining, construction, and power and water, which shrank by 8.8%, 2.7% and 0.9%. Gross domestic expenditure expanded by 3.2% on the quarter, reversing the 2.9% decline in Q2. The main contributors were a 12.7% increase in inventories, 2.2% increase in government expenditure and 1.6% rise in household expenditure. However, fixed investment shrank by an alarming 5.1%, capping three straight quarters of contraction after declining 0.7% in Q2 and 3.4% in Q1. The Q3 GDP data, while lifting the country out of recession, is little more than a technical recovery from the low base recorded in the first half of the year. A more sustainable improvement will require bold structural reform, investment spending and meaningful jobs growth.

- South Africa continued to haemorrhage foreign capital from its bond and equity markets in the week ended 7th December, with foreigners selling a net R7.83 billion in equities and a net R0.57 billion in bonds. In the year-to-date foreign investors have sold a net R49.86 billion in equities and a net R64.30 billion in bonds, a staggering total net outflow of R114.16 billion. While the investment outflows can be partly blamed on country-specific concerns surrounding land expropriation legislation and depressed domestic economic growth prospects, the bulk of the outflows are attributable to generalised global aversion to emerging market risk.

SOUTH AFRICA: THE WEEK AHEAD

- Quarterly Employment Survey: Due Tuesday 11th December. The Quarterly Employment Survey, which showed a 0.7% quarter-on-quarter decline in non-farm jobs in the second quarter (Q2) is expected to have maintained its downward trend in Q3 amid lacklustre economic growth and weak business confidence.

- Mining production: Due Tuesday 11th December. Mining production, which contracted in September by 1.8% year-on-year is expected to have remained under pressure in October due to strike activity at Sibanye-Stillwater. However, international demand for mining resources remains firm despite brewing trade tensions between the US and China.

- Manufacturing production: Manufacturing production is showing signs of gradual recovery over the past few months contradicting the depressed ABSA/BER manufacturing survey data. The October numbers are expected to show a further improvement, building on the 0.1% year-on-year growth recorded in September.

- Consumer price inflation: Due Wednesday 12th December. Helped by subdued food price growth and an ebb in fuel price increases, consumer price inflation (CPI) is expected to have remained at 5.1% year-on-year in November, unchanged from October's level. A moderation in CPI is expected in coming months, helped by the significant 184 cents per litre decline in the petrol price in December and expectations of a further similar price cut in January.

- Retail sales: Due Wednesday 12th December. Despite an absence of jobs growth and weak household credit extension, consumer confidence remains elevated, which is likely to have contributed to a strengthening in retail sales growth from 0.7% year-on-year in October to around 1.4% in November.

- Producer price inflation: Due Thursday 13th December. Producer price inflation (PPI) is expected to have subsided slightly from 6.9% year-on-year in October to 6.7% in November, helped lower by a pullback in fuel prices and subdued food price inflation.

GLOBAL

- Canada's arrest and the US request for extradition of Huawei Chief Financial Officer Meng Wanzhou threatens the fragile trade truce between the US and China. Although the pretext for the extradition charge is a violation of Iran sanctions, the greater concern is Huawei's march on 5G cellular network technology. 5G is central to China's Made in China 2025 initiative, which is the main target of the Trump administration's trade offensive. The move on Huawei follows a similar move against its smaller rival ZTE last year, which was eventually hit with a $1.4 billion fine. The drive by the US and its Western allies for secure 5G connectivity has resulted in Huawei being excluded from key 5G contracts in the US, Japan, UK, Australia and New Zealand due to concerns over industrial espionage. 5G connectivity will be so integral to everyday life that governments have become increasingly focused on using firms that can be trusted. Despite Meng Wanzhou's arrest, China's Commerce Ministry spokesman Gao Feng said of the trade talks with the US that: "We're full of confidence about reaching an agreement in the next 90 days."

NORTH AMERICA

- Nonfarm payrolls increased in November by 155,000 well below the 237,000 recorded the prior month. Payrolls have averaged 170,000 in the past three months compared with an average of 220,000 in the first eight months of the year. However, the unemployment rate remined unchanged at 3.7% equal to its lowest rate since 1969, while wages grew by a solid 3.1% year-on-year for the second month running, marking the strongest wage growth since 2009. While jobs growth may be slowing, solid wage growth should keep consumer spending buoyant. Meanwhile, the broader U-6 measure of unemployment, which includes part-time workers and those too discouraged to look for work, increased from 7.4% to 7.6%. The U-6 data indicates continued slack in the labour market, which the Fed will likely consider in its rate setting policy.

- The University of Michigan US consumer confidence index remained unchanged in December at a historically elevated level of 97.5 despite rising stock market volatility. While the expectations index slipped for a third straight month, the current conditions index gained from 112.3 to 115.2 boosted by falling fuel prices. The survey's chief economist Richard Curtin provided an upbeat assessment: "As long as job and income growth remain strong, rising prices and interest rates will not cause substantial cutbacks in spending." Encouragingly, survey respondents' inflation expectations moderated, with the average expected inflation rate in five to ten years reducing from 2.6% to 2.4% and expectations over one year reducing from 2.8% to 2.7%.

- The Business Roundtable CEO Economic Outlook Index, while remaining at historically high levels, slipped in the third quarter (Q3) for the third quarter running from 114.2 to 109.3, attributed to concern over rising trade tariffs. Trade tariffs are undermining the benefits of the bold corporate tax cuts at the end of last year from 35% to 21%, which pushed the CEO Economic Outlook Index to a record high in Q4 2017. However, Jamie Dimon, who chairs the Business Roundtable said the impact of the competitive US corporate tax rate would be more than once-off, providing cumulative benefits over the next decade. The Business

Roundtable, which commended the Trump administration's deregulatory agenda, forecasts US GDP will grow in 2019 by 2.7%.

- The US trade deficit increased in October by 1.7% month-on-month to $55.5 billion, its highest since October 2008 and the fifth straight monthly increase, attributed to the combination of strong domestic demand and the impact of trade tariffs on exports. For the year-to-date the trade deficit increased by 11.4% compared with the same period in 2017. The trade deficit with China is the main culprit, surging in October by 7.1% on the month to $43.1 billion amid a sharp decline in soybean shipments and a general collapse in China-bound exports. Exports to China fell in October by a massive 30% year-on-year.

- The yield curve, measuring the gap between two and ten-year Treasury yields fell in the past week to 0.11% a sharp decline from 0.55% at the start of the year and its lowest since June 2007. The yield curve, is on the edge of inverting, sending danger signals to financial markets. Since the 1950s, every recession in the US has been preceded by an inverted yield curve. Ominously, while at the start of the year the narrowing yield curve was being led by a combined rise in both short- and long-dated yields confirming an improving outlook in both long-term and short-term growth, the recent trend is being led by a decline in long-term yields. Long-term growth expectations are falling. While inverted yield curves have reliably predicted recessions, the time to recession from inversion has varied from a few months to over two years. For instance, it inverted in 2005, more than two years before the recession struck and still a favourable environment for equity markets. Moreover, a flat yield curve as experienced today, is not a reliable indicator, with economic growth and equity markets continuing to rise in the following period more times than not.

- Federal Reserve policy members are signalling that the predetermined course of steady quarterly 25 basis-point rate hikes may shift to a more data dependent trajectory. While a rate increase is expected at the Fed's policy meeting on 18-19th December, which would be the ninth, lifting the fed funds rate to a range of between 2.25%-2.50%, market expectations for three rate hikes in 2019 have been significantly cut back. While jobs and economic growth date remain strong, inflation is easing. Federal Reserve Bank of Atlanta President Raphael Bostic echoed last week's comments from Fed Chairman Jerome Powell that the fed funds rate is "just below" estimates of the neutral rate, which is neither accommodative nor restrictive. Bostic said: "I currently think we're within shouting distance of neutral, and I do think neutral is where we need to be." Dallas Fed President Robert Kaplan said: "I'm very attuned to the possibility, if not the probability, that the economy is going to look very different in the first half of 2019 than it does today, because fiscal stimulus is waning…..We ought to shorten up on our assessments and be willing to be very patient."

CHINA

- China's weaker than expected trade data signal a broad slowdown across China and many of its trading partners. Growth in China's imports fell in November to just 3.0% year-on-year from 21.4% the previous month, which indicates a more concerted drive from China's authorities to boost domestic demand via monetary and fiscal stimulus may be necessary in 2019. Export growth slowed from 15.6% to 5.4% the slowest growth rate since February. While some slowdown had been expected, due to an easing in frontloading ahead of the imposition of tariffs, the decline took analysts by surprise. However, exports to the US maintained a solid growth rate of 10% on the year. The trade surplus with the US increased in October to a record monthly high of $35.55 billion rising in the year to date to $294.6 billion, already exceeding the annual record of $275.8 billion recorded in 2017.

- The Caixin-Markit services sector purchasing managers' index (PMI) unexpectedly jumped in November from 50.8 to 53.8 recovering from a 13-month low to its highest level since June and more securely above the key 50-level which separates expansion from contraction. Among the PMI sub-indices, the forward-looking new business index increased from 50.1 to 52.5 although the employment index slipped from 51.1 to 50.7. The business expectations index, measuring expected conditions over the next 12 months, fell to a four-month low but remains relatively elevated at 56.1. While the PMI data are mildly encouraging, they are unlikely to deter authorities from boosting fiscal and monetary stimulus in 2019.

JAPAN

- The Nikkei-Markit services sector purchasing managers' index (PMI) eased slightly in November from 52.5 to 52.4 but remained close to the six-month high posted in October. The data confirm that the economy has rebounded sustainably from the soft patch in the third quarter (Q3) when activity was undermined by severe weather and the earthquake in Hokkaido. According to Markit economist Joe Hayes, the data builds "a stronger case for a rebound in the Q4 GDP number." Moreover, survey respondents indicated that domestic demand was sufficiently strong to warrant pricing increases, which bodes well for the Bank of Japan's attempts to raise the country's inflation level.

EUROPE

- The Sentix Eurozone Investor Confidence Index fell in December from 8.8 to -0.3 in negative territory for the first time in four years and well below the multi-year peak of 32.9 posted in late 2017 and early 2018. The key 0-level demarcates optimism from pessimism. The economic expectations sub-index fell further into negative territory to -18.8 its weakest since August 2012. The decline in investor confidence is attributed to a combination of factors including escalating trade tensions, Brexit uncertainty, Italy's fiscal crisis and social unrest in France.

- German manufacturing orders unexpectedly increased in October for a third straight month, rising 0.3% month-on-month after rising 0.1% in September and 2.3% in August. While domestic orders fell 3.2%, the decline was more than made up by a 2.9% increase in foreign orders with demand from the Eurozone rising by a solid 7.3%. By manufacturing sector, consumer goods orders fell 1.7% while capital and intermediate goods orders increased by 0.4% and 0.8%. The encouraging manufacturing data indicate a strong start to Germany's fourth quarter (Q4), signalling a potential rebound in Q4 GDP following the contraction in Q3.

- The leaders of Italy's coalition government comprising the League's Matteo Salvini and the 5 Star Movement's Luigi Di Maio indicated a willingness to compromise their budget plan to avoid being sanctioned by the European Commission. According to Salvini: "I have no interest in a clash with Europe. It's in nobody's interest. We will find an agreement in the end. We are working on it with alacrity." However, the European Commission has not yet seen any concrete details, only that the government will not budge on its election promise to reduce the retirement age from 67 to 62 and its introduction of a "citizenship income" of €780 a month for the poor and unemployed. While the appearance of a more flexible approach from Italy has helped the 10-year government bond yield lower to 3.07% compared with 3.70% in October it remains far above its level of around 1.7% before the national elections.

UNITED KINGDOM

- Prime Minister Theresa May called off the crucial vote on her Brexit Withdrawal Agreement amid growing signs that it would be defeated in parliament. May said she would head back to Brussels to seek better terms from the EU especially relating to the Irish border, the most controversial part of the withdrawal agreement. The main options open to the UK now include the UK leaving on terms similar to the existing withdrawal agreement but with a slight variation, a Norway-style membership of the European Free Trade Association, leaving the EU without a trade agreement, or not leaving the EU at all either with or without a second referendum. The European Court of Justice ruled on Monday, the day before the crucial vote, that the UK can unilaterally reverse its decision to leave the EU without the approval of its EU counterparts, provided the decision follows a "democratic process". This means that in theory parliament can decide without seeking recourse to a second referendum. In the past week, an amendment was passed in parliament giving parliament the final "say" on any Brexit decision taken by government. According to analysts at JPMorgan, the probability of "no Brexit" lies at 40% and the probability of "no-deal" lies at 10%.

- The IHS Markit composite purchasing managers' index measuring activity across the manufacturing, services and construction sectors, fell in November from 52.2 to 51.1, the lowest reading since its post Brexit referendum slump in July 2016. The decline is attributed to a sharp fall in the services PMI from 52.2 to 50.4 perilously close to the 50-level which demarcates expansion from contraction. Moreover, the service sector accounts for around 80% of UK GDP. IHS Markit chief business economist Chris Williamson observed that: "Uncertainty in relation to the withdrawal agreement and the possibility of no deal was often reported to have caused companies and customers to cancel or postpone spending and investment decisions." The surveys are consistent with a severe drop in GDP growth in the fourth quarter (Q4) to 0.1% quarter-on-quarter compared with 0.6% in Q3.

FAR EAST AND EMERGING MARKETS

- The Reserve Bank of India's (RBI) governor Urjit Patel unexpectedly resigned, unsettling India's financial markets. While citing personal reasons, the nature of the resignation with immediate effect, suggests Patel's decision may have been driven by a continued conflict with government. India's government, with national elections due early next year, has been infringing on the RBI's independence, pressurising the central bank to ease bank lending restrictions and ease its monetary policy. Patel's resignation comes less than a week after the RBI left the benchmark repurchase rate unchanged at 6.5% for the second straight policy meeting after hiking the interest rate twice earlier in the year. With consumer inflation currently at 3.31% well below the RBI's target of 4%, monetary policy is likely to follow a wait-and-see approach especially given the pending change in governorship.

- Turkey's GDP shrank in the third quarter (Q3) by 1.1% quarter-on-quarter under the weight of a currency crisis earlier in the year, a spike in inflation which exceeded 25% in October and sharply higher interest rates. The central bank lifted its key lending rate to 24% in September. On a year-on-year basis, GDP growth slowed in Q3 to 1.6%, decelerating from 5.3% in Q2 and 7.2% in Q1. The slowdown is attributed to a decline in private consumption and investment spending with the construction sector contracting by an especially steep 5.3% on the year. According to Jason Tuvey of Capital Economics, "more timely evidence suggests that the downturn deepened in Q4."

KEY MARKET INDICATORS (YEAR TO DATE %)

JSE All Share	- 15.24
JSE Fini 15	- 12.83
JSE Indi 25	- 22.52
JSE Resi 20	+ 4.85
R/$	- 13.96

R/€	- 7.33
R/£	- 7.33
S&P 500	- 1.34
Nikkei	- 6.79
Hang Seng	- 13.93
FTSE 100	- 12.57
DAX	- 17.77
CAC 40	- 10.73
MSCI Emerging	- 16.89
MSCI World	- 7.16
Gold	- 3.86
Platinum	- 15.14
Brent oil	- 9.95

BOTTOM LINE

- It has been an Annus Horribilis for JSE investors. The JSE All Share Index shed 15.18% in the year to end November cementing the worst five-year period for the JSE in fifty years.

- Even the stalwart blue-chips of the market, which have traditionally been so reliable in preserving capital, have suffered heavy losses. The JSE is littered with the carcases of fallen angels. Shares in Mediclinic, Tiger Brands, British American Tobacco and Aspen all fell by more than 40% in the year to end November, MTN by 33%, and Naspers, Richemont and Anheuser-Busch InBev by 17%, 19% and 22%. Around 65% of shares on the JSE have dropped by over 20%, meeting the definition of being in a “bear market”.

- The anaemic state of the equity market is not sustainable. Unfortunately, small retail investors are starting to throw in the towel, which is typical of a market bottom. This group of investors tends to buy high and sell low. They buy when the market is euphoric, not realising that investing then presents the highest risk. They sell when markets are despondent, not realising that this point represents the highest potential for capital returns.

- When the supermarkets have sales, people flock to shops. However, when the JSE has a sale, people run scared. Benjamin Graham, widely known as the "father of value investing" wisely said that: "Investors should purchase stocks like they purchase groceries, not like they purchase perfume." They should buy at cheap prices when markets are weak, not at high prices when markets are expensive.

- The shares that the scared retail investors are selling are being snapped-up by willing buyers, who have been waiting patiently for this opportunity. These are the smart investors. Warren Buffett, one of the most successful investors of all time, describes the stock market as a "device for transferring money from the impatient to the patient."

- A good indication that we are very close to the bottom in the stock market cycle is the aggressive buying by the highly regarded turnaround specialist, Value Capital Partners. As the name suggests, the company has a value-based approach to investing, buying shares when they are on "sale" not when they are expensive. They obviously see a bargain in PPC Cement and Grand Parade Investments, purchasing shares in both companies to the value of R22 million and R115 million, respectively, over the past three weeks.

- From these depressed levels it is likely the JSE will bottom-out and turn gradually upwards in the new year, with confidence likely to return after the National Elections. The post-election period, characterised by bolder structural economic reforms should usher-in a new market cycle.

- Depression will make way for hope, then relief, followed by optimism, excitement and eventually euphoria. It is a good time to be investing. 2019 may well be an Annus Mirabilis, a Wonderful Year.