OVERBERG MARKET REPORT

Tuesday 4th December 2018

IN THIS WEEK'S BOTTOM LINE

- Support for the EFF is likely to wane ahead of the upcoming general elections as the VBS scandal erodes the party's anti-corruption credentials. This is good news for the ANC and its more moderate economic manifesto. However, it is only a matter of time before a populist party takes power in South Africa unless the economy can successfully address the unemployment problem. The jobless rate is the biggest risk to South Africa's stability. It has one of the highest unemployment rates in the world, at 27.7%. Amongst the youth, aged 15 to 24, the unemployment rate is 52.8%, a massive threat to the social fabric of the country.

SOUTH AFRICA ECONOMIC REVIEW

- Total new vehicle sales volumes declined sharply in November by 4.6% year-on-year, which the National Association of Automobile Manufacturers of South Africa (NAAMSA) attributed to unscheduled work stoppages and industrial action at various plants. Despite the weak data, there were some encouraging signals. While total new commercial vehicle sales declined by 3.0%, the medium and heavy commercial vehicle segments increased by 17.5% and 4.7% on the year building on the prior month's respective growth rates of 15.3% and 9.0%, respectively. The trend suggests a pick-up in mining, construction and transport activity. Encouragingly, total new export sales grew by 2.5% on the year with solid order books indicating further growth over coming months. The passenger vehicle segment, which accounts for around 65% of total new vehicle sales, was the weak link in the overall data showing a decline of 5.4% on the year. Weak jobs growth, elevated fuel prices and the recent interest rate hike are likely to keep passenger vehicle sales under pressure over the medium-term.

- The ABSA/BER manufacturing purchasing managers' index (PMI) makes for encouraging reading, rising sharply in November from 42.4 to 49.5, a whisker from the key 50 threshold which separates expansion from contraction. Among the sub-indices, the employment index was the only one to lose ground, from 44.2 to 43.5. By contrast, the business activity index gained from 40.3 to 49.2, the inventories index from 41.4 to 50.2 and the purchasing commitments index from 43.8 to 54.3. The purchasing price index also moved in the right direction from 84.7 to 78.6, indicative of easing inflationary pressures helped by falling oil prices and the strengthening rand. Forward-looking indicators, including the new sales orders index and the index measuring expected business conditions in six months' time, both strengthened, from 39.0 to 50.3 and from 41.7 to 48.6, suggesting improving buoyancy in the manufacturing sector in 2019.

- Producer price inflation (PPI) accelerated in October from 6.2% year-on-year to 6.9% well above the 6.3% consensus forecast. The chief culprit was the higher oil price causing petrol and diesel inflation to increase from 18.8% to 24.1% and from 22.8% to 28.9%, respectively. Excluding petroleum products, PPI inflation remained well anchored, rising only slightly from 4.1% to 4.2%. Besides petroleum products, other PPI categories showed a moderating trend in line with weak domestic demand. Textile, clothing and footwear inflation fell from 2.8% to 2.7%, while metals, machinery and computing equipment inflation eased from 4.7% to 4.6%. Despite the spike in October's headline PPI reading, the outlook remains benign. Since its peak two months ago the oil price has dropped from $85 per barrel to $62, a 27% decline, while the rand has strengthened versus the US dollar by around 11% over the same period, signalling a sharp easing in imported fuel price inflation over coming months. The expected moderation in PPI should ease pressure on the South African Reserve bank to push through additional interest rate increases.

- As expected the FNB/BER consumer confidence index (CCI) fell from its elevated level of +22 in the second quarter (Q2) to +7 in Q3, although it remains well above its long-term average of +2, calculated since 1994. Despite sharp falls in confidence readings, consumers remain optimistic about the business cycle and optimistic that household finances will improve over the next 12 months. The volatility in consumer confidence is attributed to tightening financial conditions, political uncertainty and social instability. These latter factors are likely to affect consumer confidence in the run-up to the national elections next year, after which confidence should start to stabilise amid reduced political and policy uncertainty.

- The RMB/BER business confidence index (BCI) unexpectedly deteriorated in the third quarter (Q3) from 34 to 31, falling further below the neutral 50-level. Some recovery had been expected following the decline from 40 to 34 in Q2, helped by President Ramaphosa's Jobs Summit and Investment Conference. However, any benefits stemming from these initiatives were outweighed by lingering concerns over land reform, social unrest and strike action. The BCI, at its current level of 31, indicates that around 70% of respondents are unhappy with current business conditions. Business confidence traditionally leads the investment cycle by around nine months, which indicates little chance of a pick-up in fixed capital formation until at least the second half of 2019.

- The trade balance posted a deficit of R5.6 billion in October adding to the deficit of R3.8 billion recorded in September. The month of October tends to mark a spike in import demand as inventories are restocked ahead of the festive season. Exports increased by a solid 8.5% month-on-month although this was outdone by a 9.7% surge in imports. Encouragingly, imports of vehicles, transport equipment, machinery and equipment all increased, perhaps indicating renewed investment spending. For the year-to-date, exports have increased by 6.6% compared with the same period last year while imports have gained by 13.3%, resulting in a year-to-date trade deficit of R8.8 billion compared with a trade surplus of R49 billion in the same period last year. While a sharply weaker oil price should reduce pressure on imports over coming months, uncertainty over global trade stemming from US/China protectionism, may hurt export demand.

- Growth in private sector credit extension (PSCE) moderated in October from 6.3% year-on-year to 5.8%, brought down by a reduction in corporate credit demand. Corporate credit extension fell by 1.9% month-on-month pulling down the annual growth rate from 5.4% to 3.9%. Household credit growth improved slightly from 5.1% on the year to 5.2%, with credit rising by 0.6% on the month. However, "other loans and advances", which includes unsecured loans, fell by 2.1% on the month with year-on-year growth slowing from 5.7% to 4.3%. Overall credit growth, although checked by the South African Reserve Bank's recent interest rate hike, should recover following next year's national election amid an expected recovery in business and consumer confidence.

SOUTH AFRICA: THE WEEK AHEAD

- Third quarter GDP: Due Tuesday 4th December. The economy is expected to have exited recession in the third quarter (Q3) with quarter-on-quarter annualised growth of 2.2% compared with a contraction of 0.7% in Q2, helped by the base effect of low comparative data. While mining and agriculture may have detracted from economic growth, other sectors including manufacturing, trade and transport showed some improvement.

- Balance of payments: Due Thursday 6th December. The current account, included in the balance of payments, is expected to have deteriorated slightly in the third quarter (Q3) to 3.4% of GDP compared with 3.3% in Q2, attributed to a decline in the size of the trade surplus.

- South African Chamber of Commerce and Industry (SACCI) business confidence index: Due Thursday 6th December. The SACCI business confidence index, which gained for two consecutive months in September and October, coinciding with the appointment of Tito Mboweni as finance minister, and President Ramaphosa's Jobs Summit and Investment Conference, is expected to have maintained positive momentum in November. The SACCI index gained in October from 93.3 to 95.8.

GLOBAL

- At the G-20 Summit in Buenos Aires, President Trump and President Xi Jinping agreed that in return for Chinese concessions the US would postpone by 90 days the threatened tariff increase from 10% to 25% on $200 billion of Chinese goods. The initial date for the tariff increase had been the 1st January 2019. In return, China will cut tariffs on American made cars and in addition, according to a White House statement begin negotiations on "structural changes with respect to forced technology transfer, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft." Although the truce is encouraging, China and the US remain poles apart in their negotiating stance with little evidence so far of a sustained breakthrough.

NORTH AMERICA

- Federal Reserve minutes confirmed that "another increase in the target range for the federal funds rate was likely warranted fairly soon", signalling the near certainty of a further 25 basis point rate hike at the upcoming meeting on 18-19th December. However, the minutes indicated that monetary tightening would break from its pattern of the past two years of rate hikes at every alternate meeting. There was a shift in discussion from concerns of an overheating economy, which prevailed at the start of the year, to concerns relating to trade policy, the fading effect of fiscal policy and the lagged impact of monetary tightening. According to the Fed minutes, monetary policy will likely return to a more flexible approach after December's expected rate hike, responding to changing economic conditions.

- Fed Chairman Jerome Powell gave equity markets reason to cheer last Wednesday in a speech at the Economic Club of New York, stating that the current fed funds rate is "just below the broad range of estimates of the level that would be neutral for the economy." The statement contrasts with his remark last month that the fed funds rate is "a long way from neutral at this point." The suggestion that the Fed may move more slowly in hiking interest rates boosted the S&P 500 index by 2.3% last Wednesday, its biggest increase since March. Meanwhile, the Fed's Vice Chairman Richard Clarida said that despite record low unemployment "there may still be some further room for participation", pointing to labour participation levels which remain below their levels of ten years ago. Federal Reserve Bank of Minneapolis President Neel Kashkari echoed Clarida's sentiments, stating that: "If the economy is creating 200,000 jobs a month, month after month after month, we cannot be at maximum employment."

- The price index for core personal consumption expenditures (PCE), the Fed's preferred measure of inflation, which excludes food and energy prices, eased in October from 1.9% year-on-year to 1.8% its lowest reading since February and below the Fed's 2% target. Headline PCE, including food and energy, remained unchanged at 2% although well below its recent peak of 2.3% recorded in July. It should fall further over coming months helped by the lagged effect of sharp declines in the oil price. The moderation in inflation data supports the Fed's more "dovish" monetary policy outlook.

- Personal income, aggregated from salaries, wages and investments, increased in October by 0.5% month-on-month, the strongest gain since January, powering a 0.6% increase in personal spending, the biggest increase since March. The savings rate reduced from 6.3% to 6.2%, indicating robust consumer confidence. The overall data suggest consumer spending, which accounts for over two-thirds of US GDP, will continue to be a strong driver of US economic growth in the fourth quarter.

- New homes sales fell in October by 8.9% month-on-month the biggest decline since last December with year-on-year sales falling by 12%. Meanwhile, home price growth continued to slow. Year-on-year growth in the S&P CoreLogic Case-Shiller National Home Price Index fell in September from 5.7% to 5.5%, attributed to growing inventories of homes on the market and the impact of rising interest rates. The average rate for the 30-year fixed-rate mortgage has increased from 4.0% to 4.8% since the start of the year. According to the Federal Home Loan Mortgage Corporation (Freddie Mac) chief economist, Sam Khater: "Almost all the trends in the US housing market have been negative in recent months as housing market activity continues to adjust to higher mortgage rates."

CHINA

- The official manufacturing purchasing managers' index (PMI) remained unchanged in November at 50.0 at the dividing line between expansion and contraction. The official non-manufacturing PMI fell from 53.9 to 53.4, dragging the composite index down from 53.1 to 52.8. While the independent Caixin survey, which focuses on smaller and private sector companies, lifted slightly in November from 50.1 to 50.2, the survey nonetheless confirms the ongoing weakness in the economy. According to Capital Economics senior China economist Julian Evans-Pritchard: "With credit growth still on a downward trajectory and regulators yet to unleash off-budget fiscal support, growth is likely to slow further in the coming months." The slowdown is likely to be compounded as front-loading of orders ahead of additional tariffs comes to an end. However, more aggressive monetary policy easing and fiscal stimulus are expected to be implemented in early 2019, which should bolster economic activity in the second half of that year.

JAPAN

- Japan's industrial production increased in September by a solid 2.9% month-on-month its first increase in two months. On a year-on-year basis, Industrial production grew by 4.2% more than reversing the 2.5% contraction in September. The data prompted the Ministry of Economy, Trade and Industry (METI) to upgrade its assessment to "production is picking up moderately" from its previous assessment that "while production is picking up moderately, there are signs of weakness in some areas." Strong retail sales in October provided additional evidence of a strong economy at the start to the fourth quarter (Q4), confirming that the GDP contraction in Q3 was a once-off caused by severe weather and the earthquake in Hokkaido. Retail sales grew in October by 1.2% on the month, up from 0.4% in September, lifting year-on-year growth from 2.2% to 3.5% its fastest since December 2017.

EUROPE

- In its bi-annual Financial Stability Review the ECB acknowledged that risks to the Eurozone's financial system had increased since its last review in May. The ECB said risks included "disorderly market reactions to political or policy uncertainty in the euro area, further stress in emerging markets with possible spillovers to advanced economies and a sharp turnaround in US macro-financial prospects." The ECB cautioned that while there was no contagion yet to other sovereigns from the rise in Italian sovereign borrowing costs, "increased market tensions could spread to other government bond markets in the event of further Italian stress." While the ECB plans to halt its asset purchase programme at the end of December it has repeatedly reassured financial markets that it would not hike interest rates before mid-2019.

- Eurozone consumer price inflation (CPI) moderated in November from 2.2% year-on-year to 2.0% helped by a slowdown in energy price inflation from 10.7% to 9.1%. Core Eurozone CPI, excluding energy, food, tobacco and alcohol, declined from 1.1% to 1.0%, well below the ECB's target of just below 2%. The benign inflation data, while unlikely to deter the ECB from halting its asset purchase programme at the end of December should prompt it to retain accommodative interest rates for the foreseeable future.

- Swiss GDP unexpectedly shrank in the third quarter (Q3) by 0.2% quarter-on-quarter in sharp contrast to 0.7% growth in Q2. The decline in economic activity is attributed to the slowdown in European growth, which affected Swiss exports. Exports fell in Q3 by 4.2% on the quarter. With 19% of Swiss exports destined for Germany, its biggest trading partner, Germany's GDP contraction in Q3 was particularly damaging. According to Switzerland's State Secretariat for Economic Affairs: "The strong, continuous growth phase enjoyed by the Swiss economy for one and a half years was suddenly interrupted. Switzerland is thus following the significant economic downturn seen at the same time in other European countries, particularly Germany." Swiss household consumption and domestic investment spending remain buoyant and should restore the economy to growth in Q4.

UNITED KINGDOM

- Ahead of the crucial parliamentary vote on whether to accept Prime Minister Theresa May's Brexit Withdrawal Agreement, the government and Bank of England (BOE) published projections on how a disorderly Brexit would affect economic growth. A disorderly Brexit is one with no trade deal and no transition period with trade disruptions at the border.

According to the government's projections, a disorderly Brexit would result in the economy being 6.3-9.0% smaller after 15 years than if the UK remained in the EU. Acceptance of the Withdrawal Agreement would result in the economy being smaller by 0.1-1.3% after 15 years. The BOE projected that the economy would be 1.25-3.75% smaller by the end of 2023 under May's plan than if the UK remained in the EU but under a worst case no-deal scenario would be more than 10% smaller. Under criticism for scare-mongering, BOE governor Mark Carney admitted that this worst-case scenario where "everything goes wrong" had a very low probability.

- In its bank Stress Tests, the Bank of England (BOE) concluded that the seven major UK banks "have levels of capital and liquidity to withstand even a severe economic shock that could be associated with a disorderly Brexit." In its worst-case scenario combining Brexit with a synchronised global recession, UK GDP is projected to fall 8%, unemployment to rise to 7.5%, residential property prices to drop by a third and the exchange rate to drop by 25%. The Stress Tests confirm that banks have sufficient capital to make capital returns and distributions to shareholders.

FAR EAST AND EMERGING MARKETS

- India's GDP growth slowed in the third quarter (Q3) to 7.1% year-on-year, down from 8.2% in Q2. Despite the slowdown, India remains the world's fastest growing large economy. The slowdown is attributed to the surge in oil prices and a tightening in monetary policy. India imports the bulk of its oil consumption. However, the outlook for GDP growth has brightened over the past two months with the oil price retreating almost 30% from its peak levels. Over the same period, the rupee has strengthened by around 5% versus the US dollar which combined with the falling oil price should reduce inflation and lower the need for the Reserve Bank of India to implement further interest rate hikes. Furthermore, with national elections due in 2019, the government is likely to increase fiscal stimulus, providing an additional boost to growth.

- Brazil's GDP grew in the third quarter (Q3) by 0.8% quarter-on-quarter its fastest growth since Q1 2017. Although helped by the base effect of subdued Q2 growth, which was exacerbated by the truck drivers' strike, the underlying trend remains positive. Year-on-year growth was also positive at 1.3%, confirming the country's exit from a severe two-year recession. Despite the improving economic outlook unemployment remains high by historical standards at 12% and the budget deficit is unsustainable at 7% of GDP. Newly elected President Jair Bolsonaro has pledged to cut the deficit by reducing the size of government and by reforming the country's pension system, which should place the economic recovery on a more sustainable footing.

KEY MARKET INDICATORS (YEAR TO DATE %)

JSE All Share	- 12.48
JSE Fini 15	- 7.79
JSE Indi 25	- 19.29
JSE Resi 20	+ 5.37
R/$	- 9.60
R/€	- 4.38
R/£	- 3.89
S&P 500	+ 4.37
Nikkei	- 0.84
Hang Seng	- 9.15
FTSE 100	- 8.13
DAX	- 11.24
CAC 40	- 4.87
MSCI Emerging	- 12.22
MSCI World	- 1.75
Gold	- 5.03
Platinum	- 12.64
Brent oil	- 11.09

BOTTOM LINE

- Support for the EFF is likely to wane ahead of the upcoming general elections as the VBS scandal erodes the party's anti-corruption credentials. This is good news for the ANC and its more moderate economic manifesto. However, it is only a matter of time before a populist party takes power in South Africa unless the economy can successfully address the unemployment problem. The jobless rate is the biggest risk to South Africa's stability. It has one of the highest unemployment rates in the world, at 27.7%. Amongst the youth, aged 15 to 24, the unemployment rate is 52.8%, a massive threat to the social fabric of the country.

- President Ramaphosa has addressed the unemployment issue through recent initiatives including the Jobs Summit and Investment Conference. Investment spending will create jobs. However, full employment will not be achieved until labour laws are amended. The root of the problem, as identified by the credit rating agencies lies with South Africa's labour law rigidities.

- South Africa's employment-GDP elasticity, which measures the relationship between the change in GDP and the change in employment, has maintained a steady downtrend. Research shows that the biggest culprits are mechanisation and rising unit labour costs. Fifty years ago, the employment-GDP elasticity was 1.2%, which meant that a 1% change in GDP resulted in employment growth of 1.2%. Employment-GDP elasticity now stands at just 0.5%.

- Labour costs have risen progressively since 1994 due to burdensome labour laws and trade union regulations. In the ensuing years, there has been a continuous rise in employment costs as a percentage of total private sector output, diminishing the incentive to hire.

- Proof that labour laws and trade union restrictions are bad for jobs growth is evident in the Quarterly Labour Force Statistics. In the third quarter, informal sector jobs increased by a massive 6.7% on the quarter and 12.2% on the year. By contrast, informal sector jobs fell 0.6% on the quarter and 1.1% on the year. The informal sector does not suffer the same burden of trade union regulations and rigid labour laws.

- State and union intervention has been successful in boosting wages for holders of "decent" jobs but at the expense of rising joblessness. Decent jobs cannot be imposed, they depend on rising productivity, which in turn requires improved education and skills training.