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Market Overview: May 2018

ARTICLE SUMMARY

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In May, financial markets were generally driven by a strengthening dollar, rising global bond yields and increasing concerns over a global trade war, all of which weighed on world equity markets and on emerging markets in particular, including South Africa. A rising oil price also fed the more cautious investor sentiment. In South Africa, most asset classes delivered negative returns, while higher inflation and a weaker rand weighed on sentiment.

Strong US data, including robust retail sales and factory data, fuelled expectations of a faster pace of Federal Reserve interest rate hikes for the year, with the market now factoring in a 50% chance of a third 25bp hike in 2018, compared to only two previously. This came even as the Fed left rates unchanged at its 2

May meeting, as its statement referred to “further gradual increases” likely being necessary, given the strength of economic growth and rising inflation. The positive impact of Trump’s tax cuts is expected to feed into the economy in the coming months. The yield on the 10-year US Treasury bond reached a seven-year high of 3.095% mid-month before retreating to end May at 2.83%, below the key 3.0% level – a level where historically, bonds have started to become more attractive versus equities. This consequently added to equity market volatility. And on 31 May, President Trump announced 25% tariffs on aluminium and steel imports to the US from Canada, Mexico and the EU, which were greeted with dismay and threats of retaliation from the affected countries.

Elsewhere, Italy’s political crisis - in which two anti-establishment parties garnered the most electoral support - sparked weakness in European bonds and the euro. Eurozone GDP growth for Q1 2018 slowed to 2.5% (q/q annualised) from 2.8% previously, as expected, but this was attributed to temporary factors – economists still expect Europe to continue to expand strongly this year. GDP growth in the UK slumped to 1.2% (q/q/ annualised) in Q1 2018 from 1.4% the previous quarter, hit by the extreme cold weather in February and March and weaker household spending. The Bank of England left interest rates unchanged at its May meeting. In China, the May Purchasing Managers Index rose to 51.9 from 51.4, beating expectations of a dip and showing that manufacturing production was not slowing as feared. Some analysts are forecasting a slowdown in 2018, below the government’s targeted 6.5% GDP growth rate, as a result of the crackdown in corporate lending activity.

Looking at global equity market returns (all in US$), the MSCI All Country World Index returned 0.2% in May. Emerging markets delivered -3.5% (MSCI Emerging Markets Index), while the MSCI World Index (for developed markets) returned 0.7%. Among developed markets, US indices were in the black: the S&P 500 produced 2.4% and the Dow Jones Industrial 30 1.4%, while the Nasdaq delivered 5.7% (supported by a strong tech stock performance). In Europe, the Dow Jones EuroStoxx 50 posted a -5.8% return, with France’s CAC 40 producing -4.1% and Germany’s DAX 30 -3.6%. The UK’s FTSE 100 lost 0.7% and Japan’s Nikkei

25 returned -0.9%. Among larger emerging markets in US$, the strongest performer for the month was the MSCI China with 1.9% and the MSCI Russia with 1.2%. The weakest markets included Brazil's Bovespa at -17.0%, the MSCI Turkey (-12.8%) and the MSCI South Africa (-6.7%). The Bloomberg Barclays Global Aggregate Bond Index (US$) returned -0.8%, while the EPRA/NAREIT Global Property Index (US$) delivered 2.3%.

Commodity prices were mixed for the month. Brent crude oil gained 3.2% to trade at over US$77 per barrel at month-end amid supply disruptions caused by rising political unrest in the Middle East and Venezuela, as well as fresh sanctions on Iran, although this high price is expected to be relatively short-lived as Russia and OPEC discuss lifting production levels. Gold lost 1.3%, while platinum gained 0.3% and palladium was up 2.4%. For industrial metals, aluminium was up 1.5%, copper rose 1.1%, lead gained 5.4% and nickel jumped 11.5%. On the downside, tin lost 3.2% and zinc fell 0.9%.

In South Africa, a weaker rand, rising oil price and tax increases fed through to higher inflation, again denting growth prospects for the country. CPI inflation jumped to 4.5% y/y in April from 3.8% y/y in March. Taking note of this, of rising US interest rates and the weaker currency, the SA Reserve Bank (SARB) kept interest rates on hold at its 23-24 May meeting, as expected, while sounding more hawkish than previously. However, the SARB left its 2018 and 2019 CPI forecasts unchanged at 4.9% and 5.2%, respectively, while raising its 2020 outlook to 5.2% from 5.1%. The SARB expects the rand to remain volatile amid outflows from emerging markets (EM) generally as US interest rates continue to rise – in May global investors withdrew significant amounts of capital from EM bond and equity markets, including South Africa.

Local bonds moved weaker on these factors, with the yield on the 10-year SA government bond rising from 8.2% to 8.6% at the end of May. The BEASSA All Bond Index delivered -2.0% for the month. Inflation-linked bonds (Composite ILB Index) produced 0.1%, and cash as measured by the STeFI Composite Index returned 0.6%. With a stronger US dollar in May, the rand depreciated 1.4% against the greenback, but gained 2.0% against both the UK pound sterling and the euro.

Meanwhile, on 25 May S&P Global Ratings affirmed South Africa's sub-investment grade credit rating at BB (foreign currency) and retained its stable outlook, saying the improvement in economic growth remained tentative and that government debt would remain above 50% of GDP. Its outlook also included the view that the government would undertake economic and social reforms. On this topic, the Ramaphosa team appeared to make progress towards reforming state-owned enterprises (SOE's) during the month, appointing new board members and top management to several troubled groups. Forensic investigations and enquiries were also ordered. President Ramaphosa also tried to reassure investors that he would not allow the ANC's more aggressive land policy to damage the economy.

SA equities continued to reflect the more volatile global market conditions and investor reluctance to take on more risk: the FTSE/JSE All Share Index (ALSI) posted a -3.5% monthly total return, weighed down by losses across most sectors apart from Resources.Valuations on SA equities improved marginally as a result of the price move.The ALSI's forward price-to-earnings (P/E) ratio fell from 14.7 times to 13.9 times at the end of May,a level we see as being around fair value to slightly cheap. Although the Resources 10 Index returned 4.7 % (due largely to the stronger US dollar and generally higher commodity prices), Financials produced -6.3%, Property shares delivered -5.9% and Industrials were down 5.1%.

According to Morningstar data, the average ASISA SA general equity fund returned -3.7% for the month. The average multi-asset high equity (balanced) fund delivered -2.0%, while multi-asset low equity funds averaged -0.8%, and multi-asset income funds returned 0.4% on average.

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