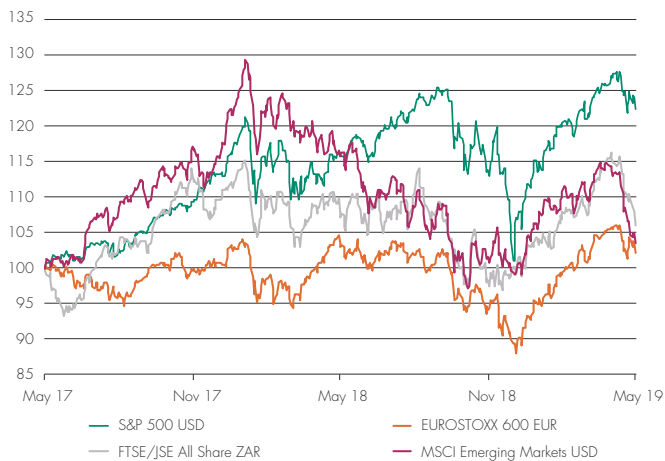


## TRADE WAR ESCALATION WEIGHS ON MARKETS

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Investors remain on edge following the escalation of the US-China trade battle. Apart from raising tariffs on Chinese imports, the Trump administration has also effectively blocked Huawei and other firms from using US technology. The market is increasingly internalising the indications that the White House's actions are not just motivated by the trade deficit with China, but also by longer-term strategic competition between the two superpowers. The trade spat is therefore unlikely to be resolved immediately. However, talk of a new "Cold War" is premature, as the extensive trade links between the two countries mean both still have an incentive to work together. In contrast, there was very little trade between the US and the old Soviet Union.

### CHART 1: GLOBAL EQUITIES DOWN ON TRADE UNCERTAINTY



### MOVING PARTS

Global trade has many moving parts, making it difficult to judge what the exact impact will be. We have already seen declines in US imports from China following the imposition of tariffs on certain goods last year, while imports from a country like Vietnam have surged, presumably as some companies are shifting production there (and elsewhere) to avoid tariffs. This is China's loss and Vietnam's gain. Nonetheless, the Organisation for Economic Cooperation and Development (OECD, the club of rich nations) warned that overall growth in global trade is set to slow to 2%, below the growth rate of the global economy. In other words, trade is becoming a smaller component of total economic activity. That by itself is not a problem, unless it creates uncertainty that results in firms postponing hiring or investment decisions. (You could say the same thing about Brexit, which continues to consume the UK's ruling class and has cost Prime Minister Theresa May her job.)

### INFLATION STILL LOW

US consumers have also seen some price increases over the past year due to higher tariffs, and now an expanded set of goods could see price increases.

But overall US consumer inflation remains low for a number of reasons. These include the fact that, while Chinese imports are significant, most goods sold in the US are not manufactured in China. The dollar has also strengthened this year, putting downward pressure on imported prices. Finally, US consumers spend much more on services than on goods.

Indeed, the minutes of the previous Federal Reserve (Fed) monetary policy meeting, released with a three-week lag and always scrutinised by investors, show a greater focus on inflation being too low than too high. The Fed sees the recent dip in inflation as being driven by 'transitory' factors. This might be the case, but such temporary factors cannot explain why core inflation has averaged only 1.6% since a 2% target was officially adopted in 2012.

One implication is that the Fed might have tightened policy too quickly, despite trying hard to be gradual. There is some evidence to support this view, with bank lending cooling in the past few months while the interest-rate sensitive housing and vehicle markets have certainly slowed. Business investment has also moderated. Institutions like the Fed are slow to admit mistakes, and the shift to its current 'patient' stance is as much of a mea culpa as we're likely to get at this stage. The market is signalling that rate cuts are looming, with the US 10-year Treasury yield down to 2.3%, the lowest level since early 2017. The market might have to wait a while for the patient Fed to oblige.

### CHART 2: 10-YEAR US TREASURY YIELD %



The Fed is the single most important central bank in the world, anchoring borrowing costs for the world's reserve currency. The European Central Bank (ECB), the other major central bank, also released meeting minutes last week. These showed that ECB policymakers are concerned that their optimism that growth would pick up later this year has been dented, and are discussing additional measures to support the economy. Other central banks are not sitting still. So far this month, Malaysia, New Zealand and the Philippines have cut, while the Reserve Bank of Australia hinted that it would cut at its next meeting in June, pretty much a U-turn from its position at the start of the year.

## ON HOLD

One central bank that remains wedded to its views, if less so than before, is our Reserve Bank. Its Monetary Policy Committee (MPC) left the repo rate unchanged at 6.75%, with two out of five members arguing for a cut.

The case for lower rates is strong. Next week we will probably get official confirmation that the economy contracted by around 1.5% in the first quarter. This will make it difficult to achieve full-year growth rates well above last year's 0.8%. Indeed, the Reserve Bank now expects growth of only 1% this year (down from its previous forecast of 1.3%), and while it expects growth to rise to 1.8% next year, the risks are to the downside.

Meanwhile, data from Stats SA show that annual consumer inflation surprisingly dipped in April to 4.4%, while most economists expected 4.6%. It is the 13th month in the past two years that inflation undershot expectations, according to the Reuters poll. Over time, one would expect economists to overestimate inflation as often as they underestimate. The fact that inflation is persistently lower than expectations is telling.

A big petrol price hike saw petrol inflation rise to 12%. Food inflation was surprisingly low, especially meat inflation, partly due to lower exports following the foot and mouth outbreak. Food prices are volatile and cyclical, and there are already signs that food inflation should rise in coming months. Core inflation – which measures prices for items other than food, fuel and energy – declined to 4.1%. It has been below the mid-point of the Reserve Bank's 4% - 6% target range since September 2017, and below the upper-end of the range since February 2010. It better reflects the underlying inflationary pressures in the economy, and as is the case globally, firms struggle to pass on input cost increases to consumers. This is good for bonds, the asset class most sensitive to inflation, and bad for domestic equities, given that it implies lower margins.

**CHART 3: LOCAL INFLATION AND RATES**



Source: Refinitiv

The Reserve Bank's forecast is for headline inflation to average 4.5% in 2019 (down from 4.8%), and 5.1% in 2020 (down from 5.3%). This is much closer to the mid-point of the target range, and therefore opens the door to a rate reduction.

The Reserve Bank's argument for keeping rates high has long rested on four pillars. Firstly, inflation expectations remain close to 6%, instead of being anchored close to the mid-point of the range. Secondly, growth is being held back by structural factors outside the control of the Reserve Bank (such as load-shedding, political uncertainty and skills shortages). Thirdly, the rand is vulnerable to sudden depreciation due to shifts in global risk perceptions (particularly expectations of US interest rate changes) and a weaker rand in turn could feed into higher inflation. Finally, the current stance is still characterised as 'broadly accommodative'.

It is the last two arguments that are questionable. They imply the MPC is not nearly as 'data dependent' as it likes to say it is. Though the rand is indeed vulnerable, the Fed has clearly signalled that it is on hold. But more importantly, the pass-through of rand weakness to consumer inflation has been persistently weaker than estimated over the past decade. And if the repo rate was really at an accommodative level, consumer borrowing would be much higher. (In fact, the real repo rate of 2.3% is in line with, and not below, the Reserve Bank's already-high estimate of the theoretical neutral real interest rate.)

Either way, the odds of a rate cut has increased. While such a move would not by itself lift the economy out of the doldrums, every bit helps. If combined with policy reforms from the new Cabinet, it could provide a much-needed boost to confidence.

## KEEP CALM

The year started off well for local investors, with returns closer to what we expect from asset classes longer-term. May has been a setback, with local equities and local listed property in particular pulling back sharply. This had nothing to do with the elections or any other political developments, but were driven by global concerns stemming from the escalation of the trade conflict, as well as a few company-specific issues. Other asset classes are still ahead of cash year-to-date, with local bonds having a good month and global returns still in double-digit territory in rand terms. Diversification has therefore helped this year. Local investors have experienced a run of disappointments, and the recent volatility is likely to compound their despondency. But remember that markets typically overreact to headlines and uncertainty, and this is probably one of those instances.

# INDICATORS

## EQUITIES - GLOBAL

| DESCRIPTION      | INDEX                 | CURRENCY | INDEX VALUE | WEEK   | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR  |
|------------------|-----------------------|----------|-------------|--------|---------------|--------------|---------|
| Global           | MSCI World            | US\$     | 2 095.0     | -1.04% | -3.85%        | 11.20%       | -1.09%  |
| United States    | S&P 500               | US\$     | 2 826.0     | -1.19% | -4.07%        | 12.72%       | 3.59%   |
| Europe           | MSCI Europe           | US\$     | 1 617.0     | -1.10% | -4.04%        | 8.82%        | -8.02%  |
| Britain          | FTSE 100              | US\$     | 9 252.0     | -1.02% | -4.30%        | 7.77%        | -10.39% |
| Germany          | DAX                   | US\$     | 1 256.0     | -1.64% | -3.38%        | -3.38%       | -11.61% |
| Japan            | Nikkei 225            | US\$     | 193.2       | 0.09%  | -3.24%        | -4.86%       | -5.92%  |
| Emerging Markets | MSCI Emerging Markets | US\$     | 987.0       | -0.90% | -8.53%        | 2.17%        | -13.04% |
| Brazil           | MSCI Brazil           | US\$     | 1 950.0     | 4.73%  | -5.34%        | 0.31%        | 1.88%   |
| China            | MSCI China            | US\$     | 73.6        | -4.62% | -13.05%       | 4.57%        | -19.93% |
| India            | MSCI India            | US\$     | 595.3       | 4.77%  | -0.62%        | 6.68%        | 7.84%   |
| South Africa     | MSCI South Africa     | US\$     | 447.0       | -4.49% | -9.88%        | 0.45%        | -18.43% |

## EQUITIES - SOUTH AFRICA (TR UNLESS INDICATED OTHERWISE)

| DESCRIPTION              | INDEX                     | CURRENCY | INDEX VALUE | WEEK   | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR  |
|--------------------------|---------------------------|----------|-------------|--------|---------------|--------------|---------|
| All Share (Capital Only) | All Share (Capital Index) | Rand     | 54 424.0    | -3.13% | -7.01%        | 3.20%        | -4.01%  |
| All Share                | All Share (Total Return)  | Rand     | 8 094.0     | -3.10% | -6.95%        | 4.71%        | -0.80%  |
| TOP 40/Large Caps        | Top 40                    | Rand     | 7 179.0     | -3.26% | -7.31%        | 5.13%        | -0.73%  |
| Mid Caps                 | Mid Cap                   | Rand     | 15 118.0    | -2.87% | -6.47%        | -1.34%       | -2.17%  |
| Small Companies          | Small Cap                 | Rand     | 17 792.0    | -1.19% | -2.12%        | -0.91%       | -13.23% |
| Resources                | Resource 20               | Rand     | 2 861.3     | -3.35% | -6.85%        | 6.28%        | 12.85%  |
| Industrials              | Industrial 25             | Rand     | 13 183.0    | -3.17% | -8.37%        | 6.19%        | -6.95%  |
| Financials               | Financial 15              | Rand     | 9 499.0     | -3.22% | -4.76%        | 2.04%        | 3.19%   |
| Listed Property          | SA Listed Property        | Rand     | 1 862.6     | -1.43% | -3.34%        | 1.17%        | -7.29%  |

## FIXED INTEREST - GLOBAL

| DESCRIPTION             | INDEX              | CURRENCY | INDEX VALUE | WEEK  | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|-------------------------|--------------------|----------|-------------|-------|---------------|--------------|--------|
| US Aggregate Bond Index | Bloomberg Barclays | US\$     | 491.9       | 0.43% | 0.80%         | 2.71%        | 2.87%  |

## FIXED INTEREST - SOUTH AFRICA

| DESCRIPTION            | INDEX                 | CURRENCY | INDEX VALUE | WEEK   | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR  |
|------------------------|-----------------------|----------|-------------|--------|---------------|--------------|---------|
| All Bond               | BESA ALBI             | Rand     | 671.1       | 1.07%  | 1.34%         | 5.99%        | 7.92%   |
| Government Bonds       | BESA GOVI             | Rand     | 664.5       | 1.08%  | 1.35%         | 6.04%        | 7.52%   |
| Corporate Bonds        | SB JSE Credit Indices | Rand     | 98.3        | 0.49%  | -1.61%        | -3.54%       | -17.69% |
| Inflation Linked Bonds | BESA CILI             | Rand     | 261.2       | -0.03% | -0.78%        | 3.04%        | 2.63%   |
| Cash                   | STEFI Composite       | Rand     | 422.6       | 0.14%  | 0.47%         | 2.85%        | 7.29%   |

## COMMODITIES

| DESCRIPTION     | INDEX           | CURRENCY | INDEX VALUE | WEEK   | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR  |
|-----------------|-----------------|----------|-------------|--------|---------------|--------------|---------|
| Brent Crude Oil | Brent Crude ICE | US\$     | 69.2        | -3.90% | -3.83%        | 28.22%       | -12.35% |
| Gold            | Gold Spot       | US\$     | 1 285.0     | 0.63%  | 0.16%         | 0.31%        | -0.85%  |
| Platinum        | Platinum Spot   | US\$     | 803.0       | -1.59% | -10.58%       | 1.26%        | -11.56% |

## CURRENCIES

| DESCRIPTION  | INDEX   | CURRENCY | INDEX VALUE | WEEK   | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR  |
|--------------|---------|----------|-------------|--------|---------------|--------------|---------|
| ZAR/Dollar   | ZAR/USD | Rand     | 14.40       | 0.06%  | -0.70%        | -0.36%       | -13.76% |
| ZAR/Pound    | ZAR/GBP | Rand     | 18.33       | 0.05%  | 1.69%         | -0.05%       | -9.33%  |
| ZAR/Euro     | ZAR/EUR | Rand     | 16.16       | -0.47% | -0.71%        | 1.95%        | -9.88%  |
| Dollar/Euro  | USD/EUR | US\$     | 1.12        | 0.00%  | 0.18%         | 2.41%        | 4.46%   |
| Dollar/Pound | USD/GBP | US\$     | 1.27        | 0.06%  | 2.26%         | 0.68%        | 5.40%   |
| Dollar/Yen   | USD/JPY | US\$     | 0.01        | -0.72% | -1.96%        | -0.28%       | 0.03%   |

Source: HNet, figures as at 24 May 2019

# THE WEEK AHEAD

## SOUTH AFRICA

- Money supply and credit growth
- Trade balance
- Producer inflation
- Absa Manufacturing Purchasing Managers' Index

## US

- House prices
- Pending home sales
- Consumer confidence
- Trade balance
- Personal income and spending

## EUROPE

- Eurozone economic sentiment
- Eurozone credit growth

## JAPAN

- Retail sales
- Consumer confidence
- Industrial production
- Unemployment

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