EXPECTING THE UNEXPECTED IN 2017

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2016 kicked off on an inauspicious note, but in many respects the year didn't turn out that bad. It started with global market turmoil, commodity prices plunging and emerging markets were especially hard hit. The rand eventually slumped to a record low of R16.90 per US dollar after the shock dismissal of Finance Minister Nene in December. But January turned out to be the bottom for many falling financial indicators, not least the rand. Meanwhile, although both were unexpected, neither the Brexit vote nor the election of Donald Trump as US president caused a lasting increase in investors' risk aversion. In fact, the Trump win set off an equity rally as investors expect lower taxes, less regulation and bigger budget deficits to be good for company profits. In contrast to a year ago, 2017 has kicked off with markets generally in an optimistic mood. December was a strong month for global equity markets, with the MSCI All Countries World Index returning 2% in US dollar terms. Global growth picked up in the last few months of 2016, led by the US, Japan and China.

On the local front, there were heightened political uncertainty and conflict at the highest levels of government, but South Africa emerged from 2016 with its investment grade credit rating intact.

What worked and what didn't work

In general, the strategies that didn't work for local investors in 2015 worked well in 2016. The resources sector was the worst performer on the JSE in 2015, but the best performer in 2016. Domestic bonds had a historically bad year in 2015 but turned out the top local asset class with a 15% return in 2016. Emerging market equities were pummelled in dollar terms in 2015 but outperformed developed markets last year.

Investors have become used to the offshore component of their funds doing well as the rand depreciated by an annual average of 18% from the start of 2011 to the end of 2015. With the rand strengthening 13% against the US dollar during the course of 2016, this became a detractor. However, from a diversification and valuation point of view, it still makes sense to have offshore exposure.

Better outlook for South Africa

The local economy is expected to improve in 2017 as the impact of the shocks of the past few years – including the commodity price slump, load-shedding, devastating drought, disruptive strikes and rising inflation – fade. The rand has stabilised and firmed up and the inflation and interest rate outlook has also improved supported by a peak in food prices. The rainfall picture in the east of the country already looks much better than a year ago. Meanwhile, less restrictive visa regulations and a competitive exchange rate have caused a boom in tourism. Better global growth should also be good for our economy.

Tax increases in support of the Finance Minister's aims to retain fiscal credibility and our investment grade credit rating loom as potential headwinds for the economy this year, but Treasury is likely to be careful not to derail the recovery with excessive tightening. South Africa is likely to be on edge again in 2017 given that the country is still on the cusp of junk status. We are not alone though, as S&P Global recently pointed out that it expects more downgrades than upgrades globally this year, after 2016 saw three downgrades for every upgrade. Of the130 countries with a credit rating from S&P, just seven have a positive outlook, with 30 given a negative outlook. The average S&P sovereign rating is now BBB to BBB-, similar to South Africa's rating.

The succession debate within the ruling party is likely to heat up during the year and grab headlines (probably causing market volatility). However, the last two years have seen politics stress testing our key institutions (including Treasury, the South African Reserve Bank the courts and media) but they held up well.

Globally, all eyes will be on Washington D.C. this year as Trump promises to be the most unpredictable occupant in the White House in modern times. A few blocks away, the Federal Reserve will decide on when and how to follow up on December's 0.25% rate hike. Participants in that interest rate meeting expect to raise rates three times in each of the next three years. It is important to note that they were expecting four hikes a year in 2016 (but only one realised).

China and oil

Two further important issues for 2017 are the oil price and China. Following a surprise agreement by members of the Organisation of Petroleum Exporting Countries (OPEC) to cut output, brent crude gained 12% in December to end the year at $56 per barrel, above the 2016 average price of $45 per barrel. This move does not represent an oil price shock. Even at current higher levels, the oil price is below the five-year and three-year averages of respectively $83 and $65 per barrel. However, sustained price increases would be negative for South Africa's inflation outlook and, since the country is an importer, our trade balance. OPEC has historically struggled to get its members to stick to production targets, as producers have a strong incentive to cheat by increasing production to benefit from the higher price. An even bigger problem for OPEC is that North American shale oil producers can quickly increase production as the oil price rises.

China saw an increased pace of economic activity in the second half of last year, but this coincided with a large build-up in debt that is not sustainable.

The longer-term challenge of rebalancing the economy away from manufacturing and exports towards services and consumption remains. Last year also saw capital outflows in the region of $800 billion, falling foreign exchange reserves and a weakening currency. While China has capital controls in place, they are not always effective, and go against its stated aim of opening up its markets and promoting the yuan as a global reserve currency. China's central bank reduced some pressure on the yuan by shifting from a peg against the US dollar to a basket of currencies, but it might be forced to hike interest rates. Of course a further unknown for China is a possible trade war with the US if Donald Trump follows through on his threat of punitive import tariffs.

Looking into 2017, we remain focused on the appropriate horizon, proper diversification and valuation. While the market mood was sunny at the start of the year, there is bound to be volatility as we enter a new global political era that coincides with the upward leg of a US interest rate cycle.

Investing amid uncertainty

Since no one has a crystal ball (at least one that works consistently), appropriate diversification remains the foundation of a successful investment strategy. Although the rand is no longer in free fall, global exposure is still important from a diversification point of view. Within the global equity universe, emerging markets look attractive since fundamentals are improving, while sentiment took a Trump-induced knock in the fourth quarter of last year. Locally, the longer end of the yield curve is more appealing than the short end. Long bond yields are also attractive and above expected inflation. While the Reserve Bank is likely to keep the repo rate at 7% for most of the year, short rates have probably already peaked.