

**OUTLOOK FOR 2018**

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The good news is that the global economy ended 2017 on a high note, and this positive momentum looks set to carry over into the New Year. All the major economies, including the US, Europe, Japan and China, are growing at the same time. This is the first “synchronised” upswing since the end of the Global Financial Crisis (GFC) in 2009. It is not that global growth is historically strong now – it is pretty much in line with long-term average growth. However, we’ve become so used to mediocre growth over the past decade, not only because consumers gradually reduced debt and banks repaired their perilous finances following the GFC, but also as further shock waves tripped up various large economies. Think of the US fiscal cliff and Japanese tsunami in 2011, the Eurozone debt crisis which reached a crescendo in 2012, and the commodity price collapse that accelerated between 2013 and 2015 pushing the likes of Russia and Brazil into deep recessions.

Of course there are always risks, especially given that the current US administration is the most unpredictable in living memory. However, there is also the danger that we become so focused on risks and the next crisis around the corner that we overlook signs of improvement and write off items of good news as one-offs. Instead, we could very well be at the early stages of a virtuous cycle of rising confidence, faster economic growth, job creation and fixed investment spending.

FAVOURABLE BACKDROP FOR MARKETS

With stronger economic growth, companies can grow top-line revenues. The bottom line is helped by the fact that financing costs (interest rates) are still very low and wage costs increasing very slowly. US companies have just been given a further gift of a massive corporate tax cut – from 35% to 21%. All this is positive for shareholders as we’ve seen from the strong equity returns in 2017. As the world economy returns to normal, interest rates should also rise. But with inflation still low around the world (although no longer so low that central banks have to panic about potential deflation), interest rate increases are expected to be gradual. All in all, it is what many commentators have called a “goldilocks environment” – not too hot (i.e. no overheating and runaway inflation) and not too cold (in terms of economic activity) – for financial markets.

The macro-economic backdrop is only one side of the coin for equity investors, the other is valuations. History shows that the more you pay (the higher the valuation) for a financial asset, the lower your prospective future return (also something for the Bitcoin enthusiasts to remember). Valuations for global equities have increased following the fantastic run in 2017 and are now above average for most markets. This suggests that longer-term returns will probably be below average but still reasonable in real terms.

LOCAL OUTLOOK BETTER

The outlook for South Africa is also (and quite suddenly) much better. To understand why, it is important to realise why things were so dire to begin with. Between 2013 and 2017, the global environment was extremely unfavourable towards South Africa: commodity prices collapsed, capital flowed out of the country (and other emerging markets) and the rand fell sharply, putting upward pressure on inflation and interest rates. The country also experienced the worst drought in a century, which not only hurt the farming community, but also resulted in a food price shock. And then there were the own goals, including load-shedding, restrictive new visa rules, surprise Cabinet reshuffles and political uncertainty in general.

Globally, things are now much more favourable towards us. The global economy is finally firing on all cylinders and South Africa as a small and open economy tends to follow the global cycle with a bit of a lag. Commodity prices have firmed up and capital has been flowing into emerging markets.

It also looks like we’ll see fewer own goals being scored. Specifically, sentiment around the political situation has improved substantially following the ANC’s December elective conference at Nasrec. Since winning the ANC presidency in a tight race, Cyril Ramaphosa has made all the right noises in terms of focusing on economic growth, investor confidence, combatting corruption and fixed state owned enterprises specifically. The latter is crucial, because though Eskom is no longer crippling the economy with rolling blackouts, it risks doing so with its debt burden. It is too early to tell to what extent he can walk the walk, since there are a number of constraints on his ability to implement wholesale reforms.

The rand roared ahead when it became apparent that Ramaphosa would win. The 10% rally against major currencies gives an idea of the kind of risk premium foreign investors attached to South Africa because of political uncertainty. A stronger currency improves the inflation outlook, which means that the real income growth of South Africans can improve. Since South Africans tend to spend what they earn, real income growth is the main determinant of consumer spending, which in turn accounts for around 60% of economic activity. South African households have also not been borrowing to spend, and have instead reduced debt relative to income over the past decade. A bit of borrowing growth could lift spending further. The other benefit of lower inflation is that it gives the Reserve Bank some room to potentially cut rates once or twice later this year.

The big potential headwind for consumers will come at the February Budget. The South African government needs to stop the unsustainable growth in its debt level, but its tax revenues have grown disapprovingly slow. At the

same time, the ability to cut spending is limited and the announcement of free higher education for low income students just adds to the long list of spending needs. Tax rate increases are therefore likely, possibly even an increase in the VAT rate. If the economy surprises on the upside – if we also have a virtuous cycle of sentiment, growth and investment, all of which are low and with plenty of room for improvement – tax revenue collection should also improve and limit the need for tax rate hikes. This is the tricky balancing act the Minister of Finance (whoever he or she will be in February) will have to follow: hike taxes too much and you might hurt the economy ending up with even less tax revenue.

INVESTMENT IMPLICATIONS

Thinking about the investment implications, it is clearly a positive backdrop for local bonds, the one local asset class that offers clear value. Despite the recent rally, bond yields are still higher than average and well above expected inflation. For equities, companies that focus on the domestic economy, and which have understandably been under some pressure in recent years, have the ability to improve earnings growth. But the JSE is dominated by companies that do business globally. While they should benefit from stronger global growth and firmer commodity prices, these shares are impacted in the opposite direction by the rand exchange rate than domestically-focused shares. This makes things tricky in the short term. If the rand strengthens, it could drag down the JSE at an index level but some sectors will do very well. Because of these global players listed on the JSE, the overall local market also never became cheap, even as the domestic economy struggled. However, bear in mind that it is a handful of global shares – Naspers, Richemont, British American Tobacco, and the mining giants – that drive the headline index. Though they offer exposure to global growth and protection against a weak rand, and do so without running into the complications of capital controls, where possible it is better to get these benefits in a less concentrated manner. In other words, through a broad basket of global equities.

The story for listed property is similarly complicated by the fact that the South African companies, with a few exceptions, have been expanding abroad. Given the lags inherent in the sector (due to the stickiness of rental contracts), it might take some time before the better domestic economic outlook lifts the performance of local property portfolios. Valuations seem to reflect this already, and the sector is fairly priced considering how large the exposure is to low-yielding markets (largely in Europe).

TACTICAL TILTS

Based on the above, our tactical asset allocation view at the start of 2018 is therefore to have a full exposure to equities in our Strategy funds, but with an underweight tilt to local shares and an overweight tilt to global equities. We are overweight local fixed income, given attractive yields and an improved inflation outlook. Given that rates are likely to rise in developed markets, we do not invest in global bonds. We have a small underweight position in local listed property, but this is balanced by a similar overweight position to global listed property, where yields are relatively attractive and growth prospects favourable.

