NOT QUITE A NEW DAWN YET

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Tuesday brought the news that the local economy contracted by much more than expected in the first quarter. This certainly dents the "new dawn" narrative that has prevailed since President Ramaphosa took office. However, before we get carried away, let's put the disappointing growth numbers in context and examine what they mean for expected returns.

Gross domestic product (GDP) – the broadest measure of economic activity – declined by 2.2% in the first quarter compared to the fourth quarter of last year. (This number is adjusted for inflation and seasonality, and is an annualised rate.) Such quarterly numbers can be volatile. It was considered more than likely that the first quarter number would be lower, as the fourth quarter was very strong, But it ended even lower than the worst estimates. The agriculture sector unexpectedly slumped by 24%, following a strong performance with record crops last year. Mining and manufacturing also experienced sharp declines. These three sectors are traditionally more volatile, and were responsible for the sharp decline in exports during the quarter. The steadier services sectors – which also account for a larger share of overall economic activity – fared somewhat better, but clearly not well enough to push the GDP growth number into positive territory.

The comparison period is also important. While the economy shrank compared to the fourth quarter, it is 0.8% larger than a year ago. It is still supported largely by household spending, which grew 3.1% in real terms over the past year. Households have benefited from lower inflation while income growth has remained in the 7% to 8% range. Therefore, real disposable incomes have increased, supporting real growth in spending. Looking ahead, this is likely to slow somewhat as inflation is ticking up cyclically (due to the petrol price hikes, VAT increase and base effects), while wage growth seems to be slowing. The ability of workers to negotiate wage increases well above inflation seems to be waning, as indicated, most recently, by the public sector agreement.

THE NEED **FOR NEW SPEED**

The economy therefore needs other growth drivers. Specifically, private sector fixed investment needs to pick up from depressed levels. Over the past few years, South African corporates have not invested much locally, as slow growth, a weak currency and political uncertainty weighed on business confidence. Sentiment has improved under President Ramaphosa, but it will take some time to translate into expansion plans being signed off and implemented. Private sector fixed investment was positive in the first quarter, but only grew 0.6%. At any rate, key confidence-boosting measures such as the new mining charter are still to be finalised, but government has promised that it will happen soon. Uncertainty around other issues, such as land reform and the solvency of key state-owned enterprises (SOEs) should be cleared up sooner rather than later. Government is at least taking the lead with the restart of the massive independent Power Producer Procurement Programme (IPPPP).

LIMITATIONS OF GDP

China manages to release GDP numbers within a week of quarter-end, a reason to treat them with some suspicion. South Africa is at the other end of the spectrum. Our GDP numbers are released toward the end of the following quarter. This means that we are really dealing with old news, even if there is a lot of useful information in the GDP report. GDP numbers also tend to be revised upwards over time as new information becomes available to Stats SA. Last year's recession was revised away as was the one in the early 2000s. The more recent economic indicators are more relevant and show more reason for optimism. The unit number of new vehicles sold grew by 2.4% year-on-year in May, according to Naamsa. Exports posted strong growth of 13% year-on-year.

The Bureau for Economic Research/Absa Manufacturing Purchasing Managers' Index (PMI) remains stuck in a low gear. It dipped below 50 index points in May to 49.8 index points. However, the average level for the first two months of the second quarter is above the first quarter average and the neutral 50-point level. Like the outlook for the economy as a whole, the outlook for manufacturing is favourable, but struggling to get going.

The Markit/Standard Bank PMI, covering the entire private sector (not just manufacturing), was at 50 index points. This means that while there was no improvement in business conditions in the second quarter, there was also no further deterioration.

Importantly, the global economy is still doing well, and this has in the past supported our small open economy. The J.P. Morgan Global PMI edged higher in May and at 54 index points it's consistent with solid growth in the world economy, across both services and manufacturing.

A sharp slowdown in global economic growth would be very damaging to our own prospects, but this does not appear to be on the horizon. It is a risk though, that by the time the local economy finally gets going, the US economy – which this month is entering its ninth year of expansion – could slow down and trip us up. Again, this is not something we expect. The other risk is more immediate, that the current negative patch for emerging markets escalates, with further large capital outflows and weakening exchange rates. The rand was sharply weaker last week, with the GDP numbers compounding the general emerging market selling pressure.

The local economy is much better hedged against a weaker rand, with businesses and individuals having built up substantial offshore asset positions. This will also increase the revenues of exporters and make the country a more attractive tourist destination. But if the adjustment from one level to another is sudden and large, it can be very disruptive to both sentiment and activity. This is where positive political developments help. Since December, our position relative to other emerging markets such as Brazil and Turkey has improved because of a more favourable political climate.

JSE NOT THE **SA ECONOMY**

The other question is what all this means for return prospects, especially given how disappointing returns have been? Morningstar reported last week that the average retail balanced fund delivered just 3.2% over 12 months to end May and 3.6% annualised over three years (longer-term returns of 6.8% per annum over five years and 8.2% per annum over 10 years are better and ahead of inflation).

Normally, declining economic growth would be bad for the stock market, since it limits companies' ability to generate profits for shareholders. But the JSE at benchmark level no longer reflects the SA economy. Some key companies do most of their business locally, but the biggest ones are all global in nature. What happens to the local economy is therefore less relevant to the JSE from a revenue and profit point of view, or in terms of sentiment. The latter will largely be dictated by what happens on global markets, and global equity markets have trended higher in recent weeks. In fact, the FTSE/JSE All Share Index was up last week. At any rate, markets are forward-looking and most companies have already reported results on the period including the first three months of 2018.

The other thing to remember is that even those companies on the JSE that focus on the domestic economy do not correspond with the GDP breakdown. There are a few manufacturing companies on the JSE – mainly food and steel producers - but they are a small part of the bourse. Similarly for construction firms, while clearly no SOEs (apart from Telkom) or other government agencies are listed on the JSE. The biggest domestically-orientated companies provide services – like banks, insurers, cell phone companies and retailers – and the service sector is still growing.

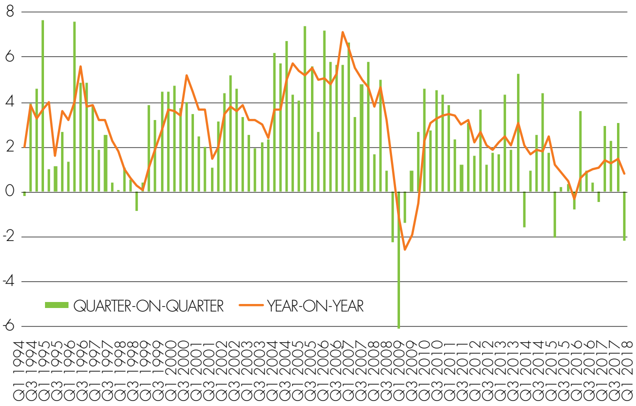
The fact that the rand is now closer to its 2017 average exchange rate of R13.30 per dollar means that local investors can finally benefit from the decent returns on offer from global markets. The rand gained 13% in 2016 and another 13% in 2017 against the US dollar, and this subtracted from the 20% to 30% exposure most balanced funds have to global assets.

Finally, the SA Reserve Bank is highly unlikely to cut rates in response to the disappointing economic data, as its current focus will squarely be on the evolving emerging markets sell-off and the fact that some other emerging market central banks have started hiking rates (India, Indonesia and Turkey). But for local fixed income, a weak economy can in fact be good news since it places downward pressure on inflation and long-term yields over time.

DON'T OVERREACT TO THE HEADLINES

The weak first quarter GDP number is extremely disappointing, and growth forecasts for 2018 will have to be revised downwards. But the outlook for the remainder of the year is still that the local economy will pick up speed, especially against the backdrop of decent global growth. It is easy to grow despondent about the prospects for the local economy and investment returns as a result. However, by now we should know not to make emotional, knee-jerk investment decisions based on big bold news headlines. After all, the average balanced fund delivered 9.8% in 2017, a year that saw a technical recession (since revised away), downgrades to junk status and cabinet reshuffles left, right and centre. When we look back at some point in the future, 2018 might still end up being a good year.

CHART 1: SOUTH AFRICAN REAL GROSS DOMESTIC PRODUCT GROWTH

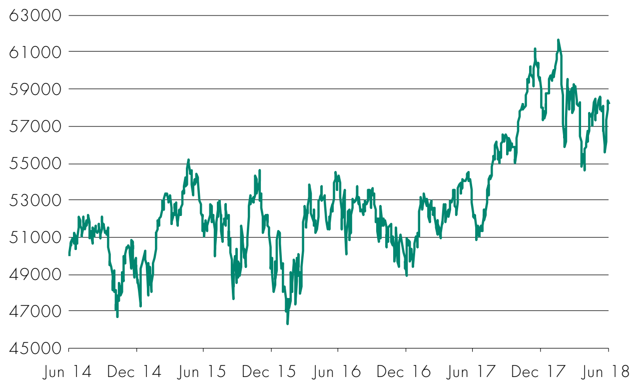


Source: Stats SA

CHART 2: EMERGING MARKET CURRENCIES AGAINST THE US DOLLAR, INDEXED TO 100

Source: Thomson Reuters Datastream

CHART 3: FTSE/JSE ALL SHARE INDEX



Source: Thomson Reuters Datastream

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INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 138.0	1.38%	2.15%	1.66%	11.12%
United States	S&P 500	US$	2 779.0	1.61%	2.74%	3.93%	14.17%
Europe	MSCI Europe	US$	1 751.0	1.10%	1.98%	-2.56%	4.35%
Britain	FTSE 100	US$	10 300.0	0.18%	0.91%	-0.97%	8.65%
Germany	DAX	US$	1 420.0	1.28%	1.87%	0.40%	8.65%
Japan	Nikkei 225	US$	207.2	2.35%	1.56%	2.54%	14.37%
Emerging Markets	MSCI Emerging Markets	US$	1 150.0	1.77%	2.59%	-0.69%	12.86%
Brazil	MSCI Brazil	US$	1 659.0	-7.32%	-7.78%	-17.99%	-2.98%
China	MSCI China	US$	95.2	3.34%	4.23%	7.61%	29.13%
India	MSCI India	US$	576.3	1.16%	1.46%	-5.68%	5.75%
South Africa	MSCI South Africa	US$	543.0	-0.37%	2.65%	-10.25%	9.04%

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	58 224.0	1.64%	3.68%	-2.15%	12.06%
All Share	All Share (Total Return)	Rand	8 381.0	1.67%	3.71%	-0.82%	15.44%
TOP 40/Large Caps	Top 40	Rand	7 452.0	1.97%	4.21%	0.05%	16.71%
Mid Caps	Mid Cap	Rand	15 655.0	0.17%	0.87%	-7.78%	6.03%
Small Companies	Small Cap	Rand	20 274.0	-1.67%	-1.10%	-3.56%	2.28%
Resources	Resource 20	Rand	2 725.1	5.08%	7.03%	19.20%	43.81%
Industrials	Industrial 25	Rand	14 526.0	2.30%	4.90%	-3.90%	8.14%
Financials	Financial 15	Rand	9 170.0	-2.17%	-0.63%	-5.53%	20.07%
Listed Property	SA Listed Property	Rand	2 017.9	-0.67%	0.54%	-18.11%	-6.84%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	939.9	0.00%	0.00%	-0.86%	1.13%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	602.3	-2.18%	-2.63%	2.48%	7.33%
Government Bonds	BESA GOVI	Rand	597.3	-2.33%	-2.81%	1.88%	6.72%
Corporate Bonds	SB JSE Credit Indices	Rand	116.3	-2.42%	-2.54%	-7.85%	-17.67%
Inflation Linked Bonds	BESA CILI	Rand	253.7	-1.13%	-1.07%	0.42%	2.52%
Cash	STEFI Composite	Rand	395.0	0.13%	0.15%	3.15%	7.38%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	76.4	-0.29%	-2.06%	14.01%	59.15%
Gold	Gold Spot	US$	1 299.0	0.39%	-0.46%	0.15%	1.56%
Platinum	Platinum Spot	US$	906.0	0.67%	-0.77%	-2.58%	-3.31%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	13.07	-2.89%	-2.82%	-5.27%	-1.13%
ZAR/Pound	ZAR/GBP	Rand	17.51	-3.26%	-3.54%	-4.40%	-6.05%
ZAR/Euro	ZAR/EUR	Rand	15.39	-3.84%	-3.51%	-3.45%	-6.05%
Dollar/Euro	USD/EUR	US$	1.18	-0.85%	-0.93%	1.78%	-5.08%
Dollar/Pound	USD/GBP	US$	1.34	-0.45%	-0.82%	0.67%	-5.29%
Dollar/Yen	USD/JPY	US$	0.01	0.01%	0.65%	-2.78%	-0.33%

Source: I-Net, figures as at 8 June 2018

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ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Retail sales
- Mining production

US

- Small business optimism
- Consumer inflation
- Federal Reserve interest rate meeting
- Retail sales
- Industrial production

EUROPE

- European Central Bank interest rate meeting
- Germany ZEW Sentiment Index
- Eurozone unemployment
- Eurozone industrial production
- UK inflation

JAPAN

- Bank of Japan interest rate meeting

CHINA

- Vehicle sales
- Credit growth
- Retail sales
- Fixed investment
- Industrial production

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