MARKET MATTERS

01 OCTOBER – 05 OCTOBER 2018

OLD MUTUAL MULTI-MANAGERS

FUEL TO THE FIRE

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Last Wednesday, South Africans saw yet another petrol price increase of R1 a litre. Unfortunately, the bad news did not end there as global oil prices have moved higher ahead of the imposition of sanctions on Iran by the US in November. The rand also weakened further in response to a sell-off in global bonds.

The US 10-year bond yield – the benchmark rate for global markets – shot up from 3.05% to 3.20% in 48 hours (bond yields and prices move in opposite directions). Markets responded to stronger-than-expected economic data by raising expectations of future interest rates. Most major bond markets sold-off in sympathy. Against the backdrop of low unemployment and factories run close to full tilt, the higher oil price could also be inflationary in the US as workers are better placed to demand higher wages while firms can pass on rising costs to consumers.

Though President Donald Trump has complained bitterly about the higher oil price, he is largely responsible for it, by pulling out of the Iranian nuclear agreement and re-imposing sanctions. Other OPEC oil producers, Saudi Arabia in particular, have been unwilling or unable to ramp up output to make up for Iran being shut out of global oil markets.

PAIN AT THE PUMP TO PERSIST

There is not much to be done about the local petrol price unfortunately. About half of the R17 per litre petrol price is a simple function of global petroleum prices and the rand-dollar exchange rate. About 15% is margins earned by various players in the value chain, and the remainder various levies. The Road Accident Fund levy is R1.93 per litre and the fuel levy R3.37. The government could in theory cut those levies, but would then need to raise taxes elsewhere. The fuel levy is expected to raise R70 billion in the current fiscal year.

The impact of the fuel price on the local economy will depend on a number of factors, such as the extent to which motorists can avoid unnecessary trips and companies absorb costs rather than pass them on to consumers. The bottom line is that it is not good news for the local economy, and talk of $100 oil, premature as it may be, is a dim prospect.

Higher fuel costs eat into households' income and businesses' margins while increasing the trade deficit and potentially increasing inflation. The petrol price's direct weight in the consumer price index is quite small at 4.5%. The question is the second round impact of firms increasing selling prices to make up for higher input costs. Unlike the US, the weak domestic economy means fuel price increases can be deflationary as businesses and individuals have to cut spending on other items in other areas to keep tyres moving on the tarmac. While last week's Jobs Summit and the recently announced stimulus package are steps in the right direction, they are very unlikely to impact economic growth rates in the short term.

The SA Reserve Bank (SARB) is likely to wait a while to assess the second round impact of petrol prices before hiking the interest rate, but the chance of a rate increase this year has certainly increased. The September monetary policy committee (MPC) meeting was a close call as it is, with three of the seven members supporting a hike. This despite a marked deterioration in the growth outlook while the inflation outlook (at that stage) had not changed much. It doesn't help that several other emerging market central banks – including Russia, Indonesia, Turkey and the Philippines – hiked in the past few weeks, heaping peer pressure on the SARB. And of course, the big gorilla, the US Federal Reserve, also hiked in September and intends to continue gradually increasing rates in the coming months, depending on its reading of the American growth and inflation outlook. The Fed's next hike will likely be in December.

EQUITIES SLIP

The fuel price shock was not the only bad news last week. After declining by around 4% in September (depending on your choice of index), local equities fell further last week. The FTSE/JSE All Share index fell to 54 409 points, lower than where it was a year ago. The reasons were mostly global, and other equity markets have also been weaker. The jump in US yields and the dollar put pressure on emerging markets, while new concerns around Italy have come to the fore.

JITTERY ABOUT ITALY

Italy's new populist government announced it would ignore European Union rules in its budget for the next three years, increasing borrowing and spending in order to stimulate its moribund economy.

It is hard not to have sympathy with their position: real per capita incomes are still below 2008 levels. The Italian economy has been in a depression over the past decade. Its membership of the euro single currency means the traditional avenues of stimulating the economy through interest rates and currency devaluation are no longer available. The European Central Bank is in the process of unwinding monetary stimulus, so fiscal policy is what remains.

The problem is that the Italian government is already highly indebted, to the tune of 130% of GDP. It needs to borrow from the market not only to fund new spending, but also to roll over existing maturing debt. Comments by the Deputy Prime Minister that they will ignore the markets and push ahead with their plans are therefore naïve. The Italian government's cost of borrowing for 10 years has doubled since April to 3.4%.

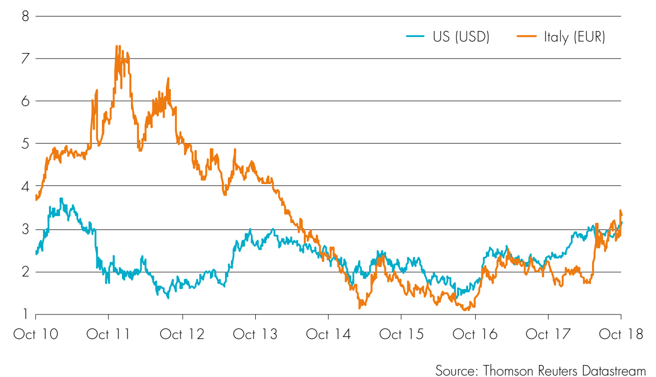
A few years ago, Greece was a constant source of concern for markets. The fear was that it could cause the unravelling of the single currency if it chose to leave the euro or was forced off it. But Greece's importance to the Eurozone is tiny compared to Italy's, so these developments will be watched closely. Ultimately, markets have a way of knocking sense into stubborn politicians, whether Greece's Prime Minister Tsipras, President Erdogan in Turkey or our own former President Zuma (who was forced to backtrack on his appointment of Des van Rooyen as Finance Minister in December 2015). Sanity usually prevails, in other words, but at the cost of market stability. If concerns escalate, it is likely to weigh on South African markets as was the case back in 2012, when investors were panicking over Greece and the other southern European economies unflatteringly called the PIGS (Portugal, Italy, Greece and Spain). But we are still nowhere near those levels: back then, Italian 10-year yields spiked all the way to 7% and Greek yields to 38%.

ATTRACTIVE INTEREST RATES ON OFFER

It is worth pointing out that the South African government, with a much lower debt level (55% of GDP) currently has to pay 9.2% annually to borrow over ten years, 6% more than the Italian government. Much of this reflects exchange rate risk - the rand is more volatile than the euro - and inflation differences. But for all our faults, it is hard to argue that the Italian government is much more creditworthy than our own. That is tough for Finance Minister Nene, who will have to borrow around R190 billion in the next year, but is a boon for investors who can earn the interest. Since private credit is ultimately priced off the government yield curve, money market rates are also attractive. In fact, real interest rates in South Africa are among the highest in the world, unfortunately constraining economic growth.

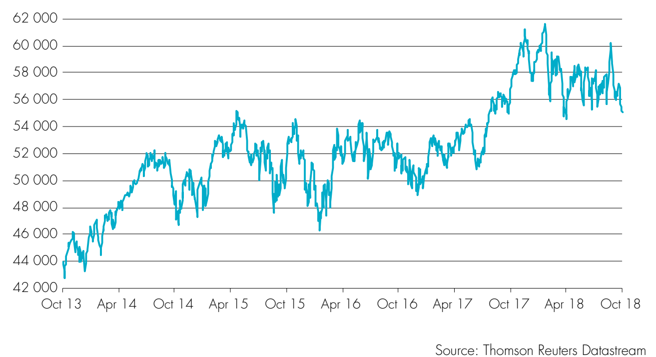
In other words, while returns from South African equities have been poor over the past year (and mediocre over the past three), there are other sources of returns available to investors with diversified portfolios. Another area that continues to do well is global equities, which delivered 17% in the year to end September in rand terms. At this stage, regulatory limits mean that balanced funds will typically have South African equities as a major component to achieve long term growth. This means that these funds as a category have delivered subdued returns. However, there is no reason to believe that low returns from local equities are a permanent feature, and that an asset class that delivered 7% above inflation over the past 110 years will return less than inflation indefinitely.

CHART 1: US AND ITALIAN 10-YEAR GOVERNMENT BOND YIELDS, %



Source: Thomson Reuters Datastream

CHART 2: FTSE/JSE ALL SHARE INDEX



Source: Thomson Reuters Datastream

CHART 3: OIL PRICE IN RAND

Source: Thomson Reuters Datastream

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 165.0	-0.87%	-0.87%	2.95%	7.39%
United States	S&P 500	US$	2 886.0	-0.96%	-0.96%	7.93%	13.09%
Europe	MSCI Europe	US$	1 681.0	-1.64%	-1.64%	-6.46%	-4.54%
Britain	FTSE 100	US$	9 600.0	-1.91%	-1.91%	-7.70%	-2.49%
Germany	DAX	US$	1 318.0	-2.08%	-2.08%	-6.10%	-6.39%
Japan	Nikkei 225	US$	209.1	-1.43%	-1.43%	3.50%	13.91%
Emerging Markets	MSCI Emerging Markets	US$	1 010.0	-3.63%	-3.63%	-12.78%	-8.43%
Brazil	MSCI Brazil	US$	1 843.0	6.59%	6.59%	-8.90%	-14.99%
China	MSCI China	US$	75.3	-4.57%	-4.57%	-14.90%	-11.62%
India	MSCI India	US$	519.5	-4.77%	-4.86%	-14.98%	-6.74%
South Africa	MSCI South Africa	US$	432.0	-6.90%	-6.90%	-28.60%	-15.13%

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	54 409.0	-2.33%	-2.33%	-8.56%	-4.55%
All Share	All Share (Total Return)	Rand	7 949.0	-2.18%	-2.18%	-5.93%	-1.55%
TOP 40/Large Caps	Top 40	Rand	7 036.0	-2.39%	-2.39%	-5.53%	-2.10%
Mid Caps	Mid Cap	Rand	14 720.0	-1.37%	-1.37%	-13.28%	-4.05%
Small Companies	Small Cap	Rand	19 173.0	-1.07%	-1.07%	-8.80%	-5.88%
Resources	Resource 20	Rand	2 878.6	1.57%	1.57%	25.91%	25.06%
Industrials	Industrial 25	Rand	12 878.0	-3.36%	-3.36%	-14.81%	-13.33%
Financials	Financial 15	Rand	8 891.0	-4.84%	-4.84%	-8.41%	7.94%
Listed Property	SA Listed Property	Rand	1 880.0	-1.98%	-1.98%	-23.70%	-17.44%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	923.1	-0.87%	-0.87%	-2.64%	-1.44%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	607.3	-1.41%	-1.41%	3.33%	6.03%
Government Bonds	BESA GOVI	Rand	601.3	-1.52%	-1.52%	2.55%	5.24%
Corporate Bonds	SB JSE Credit Indices	Rand	113.7	-2.07%	-2.07%	-9.90%	-14.96%
Inflation Linked Bonds	BESA CILI	Rand	253.2	0.32%	0.32%	0.24%	1.15%
Cash	STEFI Composite	Rand	404.1	0.13%	0.13%	5.51%	7.26%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	84.9	2.36%	2.24%	26.66%	48.88%
Gold	Gold Spot	US$	1 203.0	0.92%	0.92%	-7.25%	-5.13%
Platinum	Platinum Spot	US$	822.0	1.11%	1.11%	-11.61%	-10.07%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14.78	-4.24%	-4.22%	-16.22%	-7.76%
ZAR/Pound	ZAR/GBP	Rand	19.38	-4.85%	-4.85%	-13.62%	-7.74%
ZAR/Euro	ZAR/EUR	Rand	17.03	-3.58%	-3.58%	-12.74%	-6.04%
Dollar/Euro	USD/EUR	US$	1.15	0.87%	0.96%	4.43%	1.74%
Dollar/Pound	USD/GBP	US$	1.31	-0.66%	-0.89%	2.92%	-0.13%
Dollar/Yen	USD/JPY	US$	0.01	0.03%	0.03%	0.94%	1.22%

Source: I-Net, figures as at 5 October 2018

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ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Mining and manufacturing production
- FNB/BER Consumer confidence index

US

- Small business optimism
- Inflation
- Consumer confidence

EUROPE

- Eurozone industrial production

CHINA

- Trade balance
- Credit growth

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