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INVESTMENT REVIEW

JULY 2017

BRIDGE FUND MANAGERS

"The right to be heard does not automatically include the right to be taken seriously."
Hubert H Humphrey

ECONOMIC OUTLOOK

Having raised official interest rates by 0.25% in June, the US Federal Reserve (the Fed) opted to keep them unchanged following their July policy meeting. Despite the significant stimulus provided to the US economy by the Fed since 2009, the economy is only expanding at a moderate pace and inflation has remained low. The Fed did indicate that it would start selling the large bond holdings it had acquired through quantitative easing programmes designed to lower borrowing costs and stimulate economic activity. Economists expect a more formal announcement regarding the Fed's plans to begin normalising its balance sheet following the September meeting. US unemployment continued to fall and is now at a 16-year low (chart 1).

There is growing evidence that the economic recovery in Europe is gaining momentum and that growth now appears to be self-sustaining. This should place upward pressure on inflation and allow the European Central Bank (ECB) to move away from its highly contentious zero-interest rate policy. The ECB has also maintained the cap on its bond buying programme at €60 billion per month, despite the obvious improvement in economic activity in the region. The market is clearly expecting a shift in policy soon as the Euro has appreciated significantly against the US dollar since the start of the year (chart 2).

Index	July %	12m %	YTD %
Dow Jones	2.7	21.8	12.3
S&P 500	2.1	16.0	11.6
FTSE 100	0.8	9.6	3.2
EURO STOXX 50	0.3	18.3	7.0
Nikkei 225	-0.5	20.3	1.7
Hang Seng	6.1	24.8	24.2
Australia	0.2	2.3	1.0

Source: I-Net Bridge

The Monetary Policy Committee of the South African Reserve Bank (SARB) unexpectedly cut official interest rates by 0.25% following their July policy meeting. The SARB's forecasts for core inflation were cut by 0.3% and 0.4% for 2018 and 2019 respectively and they expect inflation to remain below 5% throughout their forecast period. The SARB's lowered inflation expectations and the weak growth outlook support further interest rate cuts in 2017 and 2018, although the timing of future rate cuts will depend heavily on the rand exchange rate, oil prices and the domestic political situation. Most economists see scope for a further 0.25% reduction in interest rates later this year.

Consumer inflation dipped to 5.1% in June from 5.4% in May (chart 3), supporting the SARB's outlook for lower inflation in 2018 and 2019. Fuel prices dropped 1.6% month-on-month and are up just 2% over the past year. Following a further cut in the price of fuel, inflation is expected to fall further in July. Food inflation was unchanged at 7% year-on-year, although the price of meat products increased by 13% year-on-year. Business, investor and consumer confidence in South Africa remain depressed and at historically low levels suggesting economic growth will remain muted for the remainder of the year.

MARKET OUTLOOK

During July, global equity markets were supported by dovish comments from central bankers, as well as robust earnings growth from US companies that reported second quarter earnings. According to FactSet, of the S&P 500 companies that reported results during July, 73% beat analyst expectations for earnings and revenue growth. The average growth rate in earnings per share is 9.1% after 57% of the S&P 500 companies reported second quarter earnings, although that number is forecast to fall to around 7% by the time all companies have reported. Despite the stronger growth in earnings since the start of the year, most developed equity markets are trading on valuations substantially above their long-term averages, suggesting returns in the future will be lower.

Despite the more dovish outlook from central banks, global bond yields continued to drift higher during July (chart 4). Investors still expect the Fed and ECB to remove stimulus throughout 2017 and 2018, despite a pause in policy action during July. Bond yields are therefore expected to continue rising, placing downward pressure on capital values. Global listed property markets advanced during July on the back of rising global equity markets. Over the past year, global listed property markets have had little to cheer about and the threat of higher interest rates and bond yields continues to curb investor enthusiasm for the asset class.

Index	July %	12m %	YTD %
All Share	7.0	7.6	10.6
Resources	13.3	10.7	8.1
Financials	5.0	4.8	3.9
Industrials	5.7	7.9	15.1
Property	3.7	3.3	6.1
Bond	1.5	7.2	5.6
Cash	0.6	7.7	4.4

Source: I-Net Bridge

South Africa's equity market surged 7% in July on the back of strong gains in mining heavyweights Anglo American (+23.5%), BHP Billiton (+20%) and Glencore (+18.4%), as well as a recovery in the price of Naspers (+14.3%) following June's sharp decline. The resources sector was the clear winner in July, following a rise in commodity prices and a weaker rand and after the controversial new mining charter was put on hold pending a court ruling. Following a strong showing in July, the share price of Naspers has risen 44.4% since the start of the year (chart 5) on the back of strong moves in the price of Tencent Holdings in Hong Kong.

South African government bond yields fell almost 20 basis points during July despite a weaker rand and ongoing allegations implicating the controversial Gupta family and President Jacob Zuma in widespread state capture. The yield on government's benchmark R186 bond declined to 8.61% from 8.78% at the end of June (chart 6), following the SARB's decision to cut official interest rates. South Africa's listed property sector gained 3.7% during July, with the sector buoyed by the prospect of lower official interest rates in the short-term. Trading conditions remain tough but interest rate cuts may take some of the pressure off tenants.

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CHARTS

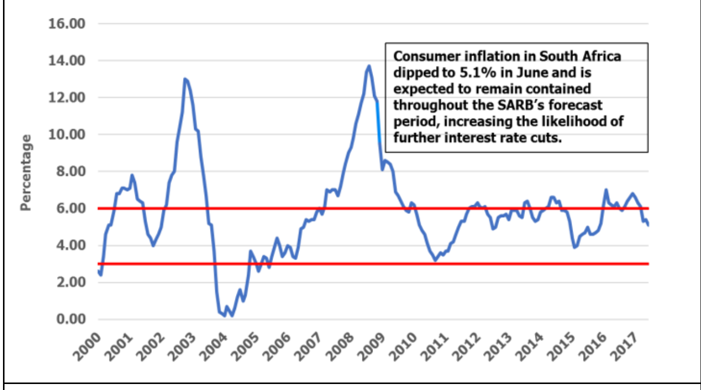
Chart 1: US Unemployment Rate (%)

Source: I-Net Bridge

Chart 2: USD/EUR Exchange Rate (USD)

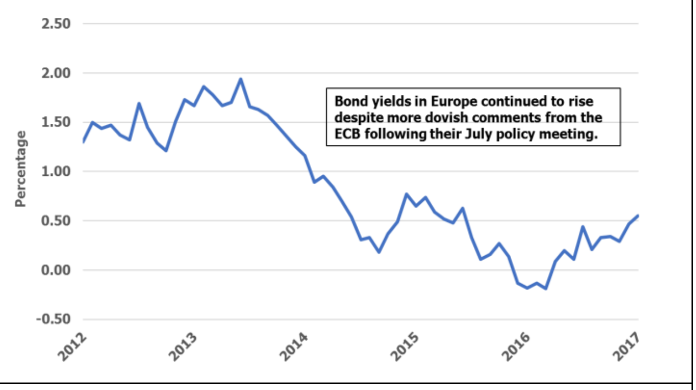
Source: I-Net Bridge

Chart 3: SA Consumer Inflation (%)



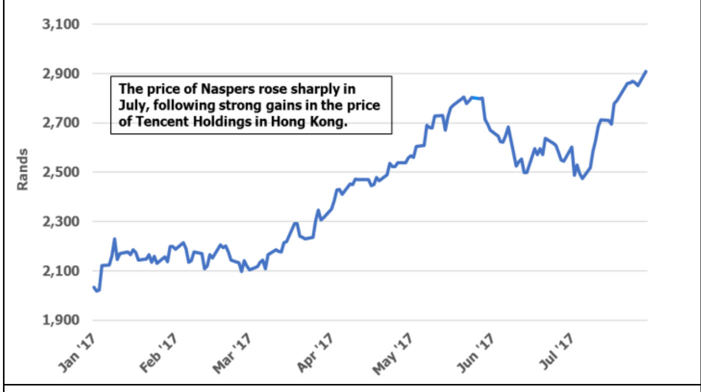
Source: I-Net Bridge

Chart 4: German 10-Year Government Bond Yield (%)



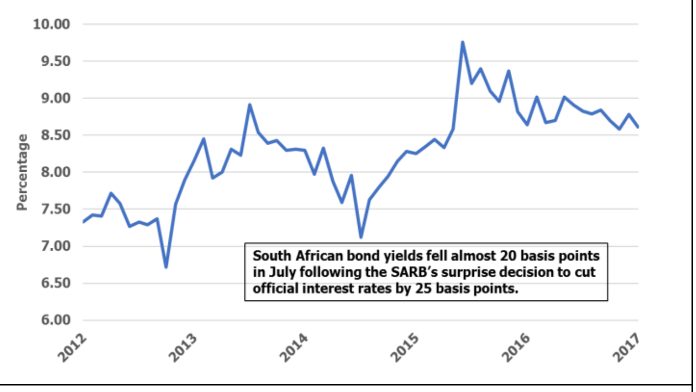
Source: I-Net Bridge

Chart 5: Naspers Share Price (ZAR)



Source: I-Net Bridge

Chart 6: R186 Government Bond Yield (%)



Source: I-Net Bridge

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