EFFICIENT GROUP

ECONOMIC COMMENTARY

- Francois Stofberg

Newsletter

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WELCOME TO THE NEW YEAR!

I trust that you have had a good rest over the holidays and that it has been a good start to the new year. May 2019 be a prosperous year! Let's recap on the week that has passed and what made the markets move:

Have investors gone mad? Yes, they have!

During 2018 global markets were down, considerably. In the US, the S&P 500 was down somewhat, 5%, and in Japan the Nikkei was down about 10%. Similarly, the STOXX 600 in Europe was down 10%. The MSCI Emerging Markets, an index that tracks (by weight) the stock exchanges of emerging markets, was down 15%. Although in SA our beloved JSE contracted by 12%, it's nothing compared to Chinese markets which contracted by 25%. Imagine you were to retire in China and a year later 25% of your savings were "gone". Or, imagine you were an investor in SA and just found out that the JSE had its lowest 5-year cumulative return in history (by the way, that's more than 130 years). No wonder investors are a bit skittish. But, why have global investors, from small retail investors to large asset managers, gone mad? Why have markets been forced down to these cheap levels?

The answer doesn't seem to lie in fundamentals but rather in emotions. Although uncertainty is rife, global investors seem to believe we're already in the worst recession we have ever been, and ever will be in. These investors seem to be worried about two major themes which they believe will ultimately reduce earnings, and consequently stock prices, to Armageddon levels. Firstly, slower global growth and secondly, protectionism and politics. Tariffs and trade wars fall in both these categories.

Concerning slower growth, three themes are evident. In the US, Trump's tax stimulus has now run its course, which should contribute to the normalization of US GDP, back to long-term averages around 2.5% (down from 2018's close to 4.5%). There is very little in terms of fundamentals (labour, capital, technology) to suggest that the US growth will fall considerably below trend growth (as markets seem to suggest). However, in the US, many are simply calling for a recession because of the duration of the current bull run. But, bulls don't die of old age, the Fed hikes (read hacks) them to death. Investors seem keen to believe that the Fed will surely overstep and hike interest rates too much or too quickly – or both! We believe this is unlikely for a data-dependent Fed under pressure from, literally, everyone.

In China, although the story can be made a lot more complicated it basically comes down to an economy that is structurally slowing down. By this we mean that their decades-long, state-funded infrastructure scheme is slowing down as debt has ballooned. Consequently, Chinese authorities are trying to educate factory workers and their children, to become service-sector employees and high-tech manufacturers – a task even more difficult than their three-decade economic miracle. However, although the Chinese economy is slowing down, like the US economy, the slowdown is steady and nowhere near the cliff global investors are expecting.

A third growth-theme global investors are worried about is the trade wars. However, it seems like the Chinese are coming to grips with the fact that they cannot fight the US and tame debt at the same time. So, they have started to make concessions towards the US. They have dropped the "Made in China 2025" from all their campaigns, political chatter, and even state media; they'll have to learn to play the subtle game of cloak and dagger (global politics). They have introduced better intellectual property protection, to remove some of the forced technology silliness. Most importantly though, they have allowed three major long-term capital investors (Tesla, Exxon Mobil, and a large Swiss fund manager) to open shop in China without any joint venture (forced technology transfer) requirements. We believe that some favourable deal or other will be sealed by March. If not, global growth might have a hiccup, but no catastrophic shutdown like markets would have you believe.

Protectionism and populism seem to be leading the polls around the world, and Brexit is not the only concerning trend. By March, the Brits will be out of the European Union (EU). Our view is that the exit will occur, by hook or by crook. Getting there will, however, place a tremendous amount of pressure on both the UK and the EU (read dollar strength). Fundamentally, we believe most of the split has already been felt by (priced into) economies and markets. Uncertainty will, however, continue to weigh markets down whilst increasing volatility. Also, concerning about this trend of protectionism is the amount of EU-country elections that will kick off in March and run throughout 2019. It seems likely that populism will continue to increase and with it, more radical politics that appear to favour the downtrodden. However, these populist notions will most likely lead to fundamentally weaker (poorer) economies in the long term.

In summary, growth, albeit lower than last year, will most likely continue along long-term trends. Healthy growth should support healthy earnings. These should, in turn, lead to healthy price increases. It is, however, concerning to note that emotion-driven sentiment can lead to a self-fulfilling recession. That is, stock owners feel poorer at current valuations and spend less. Lower stock prices influence confidence and thereby economic behaviour, to ultimately drag down spending even more. Finally, this dangerous concoction boils over into a full-blown recession. So, let's hope that global investors leave emotions in 2018 and turn back to logic, quickly.

81 Dely Road, Hazelwood, Pretoria, 0081 | +27 (0)87 944 7999 | info@efgroup.co.za | www.efgroup.co.za