EFFICIENT GROUP

ECONOMIC COMMENTARY

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Newsletter

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A TURBULENT AUGUST

If you're a regular to the world of finance, you'll know that August is a very riotous month. This year was unfortunately not any different to previous Augusts. Tensions in the Middle East, and between Hong Kong and mainland China, have been escalating throughout 2019. Europe's largest economy, Germany, has fallen ill and the second largest economy the United Kingdom is still muddling along with talks of Brexit; now with a new prime minister at the helm. In fact, the whole of Europe is a bit under the weather, so much so, that the European Central Bank (ECB) will most likely soon restart aggressive quantitative easing (QE). All of these factors made investors wary of an impending recession.

To top it all, our golden child (the United States) initially published some poor flash-statistics and had investors very worried. As a result, money flowed out of riskier markets, which included South Africa, towards the safety of US$ (currency and bonds) and gold. Since then, the US$ has been trading much stronger; currently around $1.10 against the Euro. US-yields fell from 3% at the start of 2019, down to 1.5%. Gold prices increased by 8.8% to $1,523. Falling interest rates in the US caused an inversion of their treasury yield curve, which sent frightened investors over the cliff; usually 22 months after the US yield curve inverts the US economy goes into a recession. In South Africa, the rand depreciated to R15.50-levels in August and markets contracted by 2.68%. In the US markets were down by 2.24%.

But recessions are a good and necessary part of business cycles and shouldn't be feared to the extent that we've seen happen in August. The process of creative destruction ensures that scarce resources, most notably capital and labour, are optimally applied and in so doing produces long-term sustainable growth. Recency bias however, makes investors believe that the next recession will be like the last recession, the 2008/09 global financial crisis. However, we believe that should a recession occur it will most likely be limited to a specific country or region. But even if it is a global recession, it won't look anything like the bubonic plague-type recession we had during 2008/09. New rules and regulations that were enforced after the previous recession do a lot better to govern the game:

+ transparency is the new norm;
+ social responsibility has become a strategic advantage; and
+ watchdogs grew big teeth.

All of which are aimed at protecting consumers.

We also don't believe that a recession is imminent. The US and Chinese economies are still strong and trade wars haven't been nearly as costly as many believed they would be. Even though corporate investment is low (and declining), corporates have enough cash to invest once the hick-up has past. But, like previously the US is kept alive by a strong consumer; published statistics on payrolls and jobless claims have been stellar. And if jobs continue to be created fast enough to absorb new entrants, the consumer will remain strong. The US Federal Reserve Bank (Fed) have also done their part to keep the current expansionary cycle in the US going, building on a decade of momentum. After decreasing interest rates for the first time in July, by 0.25%, we believe another rate cut is due in September, possibly by 0.50%. Similarly, the Chinese economy is kept on target, 6% - 6.5%, by a supportive government. Chinese authorities have reduced bank capital requirements and they've fiddled with their interest currency to support exporters. If that wasn't enough to convince investors that we'll be alright, empirical evidence has proven that the impact of the trade war is much less than theoretical models predict. Most notably during this current trade war, there hasn't been any real supply friction, imperfect substitutability, or a reduction in consumption. As a result, the loss to the consumer, who is paying for the tariffs, has been limited to 0.37% of GDP in the US. Far from the 2%-3% reduction in global demand some of the theoretical models were indicating. After we saw another round of trade war retaliation during the last week of August, Chinese authorities called for another truce. Like them, Trump will be eager to work towards a solution before his re-election campaign kick-off. Our base-case is therefore to hear something about a truce before October 2019, and to have a deal before October 2020.

In South Africa unemployment figures have reached something of an all time high, 29.1% during the second quarter of 2019. However, strong mining and manufacturing data suggest that we might see a good recovery in economic performance during the same quarter. Our forecast for GDP growth in 2019 is however, still only 0.60%. Inflation statistics released by Statistics South Africa (StatsSA) were also favourable. During July inflation fell to 4.0%. Considering the current global easing cycle, and the lowflation we're experiencing in SA, the South African Reserve Bank (SARB) will most likely reduce interest rates in September by another 0.25%.

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