06 December 2016

2017……………?

Four questions for 2017

It is the time of year when market commentators are asked to look into the proverbial crystal ball to see what lies ahead for markets. Crystal ball-gazers were often wrong in 2016, as it was the year of political surprises both internationally (Brexit and US elections) and locally (Public Protector reports, charges brought and dropped against the Finance Minister, local government elections). 2017 is bound to be full of surprises too, but for now there are four key questions to ask from a macro point of view.

1. What does Trumponomics look like?

Perhaps the most obvious area to start is with the new Donald Trump administration. What will its policies be? While Trump said a lot of controversial and contradictory things on the campaign trail, the market has seized on his plans for tax cuts and infrastructure spending, while hoping that he does not follow through on the potentially damaging plans to raise import tariffs.

Some commentators are also referring to the return of "Reaganomics". However, the starting conditions are very different. President Reagan slashed taxes and ramped up defence spending, but probably the most important contributor to the Reagan boom was that the Fed's interest rate was 19% in 1981 at the start of his first term and the US experienced a deep recession. As inflation declined, rates halved over the next four years and the US economy took off. US equities and bonds entered a multi-year bull market. By contrast, Trump will start his term with ultra-low rates and low unemployment, and with the current bull market already eight years old.

What happens in the US matters greatly for us in South Africa, not so much because we export a lot to the US (we do, but it is not our main export partner), but because the US influences global financial markets. Changes in risk appetite on global markets tend to spill over to our markets, and therefore impact the returns on your investments, but changes in appetite also influence the real economy through the exchange rate channel. A stronger dollar typically results in a weaker rand, which in turn places upward pressure on local inflation and interest rates.

2. What will the Fed do?

At the beginning of 2016, the expectation was that the Federal Reserve would increase interest rates four times in 2016 (by 1% in total). In the end, only one 0.25% hike is likely on the 13th of December. As we head into 2017, the expectation is that the Fed will deliver two or three hikes of 0.25% as inflation drifts up to its target of 2%.

If the Fed raises interest rates by more than is currently priced into the market, it could result in a stronger dollar, and pressure on emerging market currencies such as the rand. However, despite unemployment falling and employment growth of around 1.6% per year, wages have not responded much to the tighter labour market, growing by around 2.5%. Therefore, while the Fed is expected to increase interest rates, it is likely to do so gradually.

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3. Will the local economic recovery gather momentum?

There is reason to believe that things are gradually improving as the impact of the shocks that hit the economy over the past three years fade:

- Commodity prices have stopped falling, and have firmed somewhat, especially coal and iron ore (two key exports for South Africa). A return to pre-2011 prices is not expected, but as long as prices do not fall further, the mining sector can grow again off a low base.
- Though the severe drought is still persisting in some regions, it is easing and decent summer rainfall is expected in the eastern parts of the country. It might take a few years for agricultural output to return to normal, but the sector should return to growth (off a low base). Grain prices doubled in 2015, a food price shock for consumers, but have since receded substantially.
- There has been no load-shedding in over a year and Eskom is optimistic that it can maintain electricity output without disruption, partly as a result of new generation capacity coming on stream.
- The exchange rate has stabilised at a level that is still weak enough to be supportive of exporters, import-competing business and tourism, but that will likely not lead to further sustained upward pressure on inflation and interest rates. In fact, inflation is expected to decline next year to around 5%, which means that real household income growth should improve.

There is not going to be a boom, but growth forecasts still appear very pessimistic, suggesting a positive growth surprise is possible.

4. Will South Africa finally put the downgrade *bogey* behind it?

Following a tense recent period in which the three major global ratings agencies assessed the local economy, government policy and more, South Africans headed into the festive season feeling a bit more at ease, knowing that the country maintained its investment grade rating. Moody's, Fitch and S&P Global Ratings all expect economic growth to improve from very low levels over the next two to three years, and are comfortable with government's fiscal management and its plans for stabilising public debt. They also noted that South Africa's institutions are strong (especially the judiciary) and that the South African Reserve Bank's monetary policy is independent and credible.

However, as it stands now, both Fitch and S&P rate South Africa only one notch above sub-investment (or junk) status. Both have a negative outlook, suggesting that the next ratings move is down. We could therefore experience a repeat of the recent stressful period again in 2017. Faster growth is needed to avoid the drop, since it is economic growth that ultimately ensures that debt levels are sustainable. All three agencies warned that that crucial structural reforms could be hampered by political infighting. These reforms are needed to raise South Africa's economic growth rate on a sustained basis and secure the investment grade rating.

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Investing in 2017

Whatever the outcome of these or other important events next year, the reality is that the future is always uncertain and it therefore makes sense to spread your risks in a diversified portfolio. The shocks of 2016 illustrated the importance of sensibly diversified portfolios over concentrated, fearful ones. The Brexit vote had little lasting impact on markets (apart from the pound, which remains very weak). Similarly, the Trump victory initially knocked equity markets, but for no more than a day. This cautions against a knee-jerk reaction to unexpected events. While few predicted a Trump win, those who did mostly warned that it would lead to a market correction. The opposite happened, illustrating why it is so difficult to build portfolios around specific events where the outcome is uncertain even if the timing is known (elections, referenda, ratings announcements).

Some suggestions:

1. Focusing on valuations can prevent you from letting emotions take over. We are all human after all. For instance, when the rand hit R16.90 to the US dollar in January 2016, emotions were high and many investors took money offshore. However, valuation-based approach suggested that the rand was very cheap and therefore more likely to appreciate than depreciate, which is exactly what happened.
2. So as we head into the New Year, investors are urged to stick to their financial plans and not be swayed by the headlines, surprises and unexpected developments they are bound to encounter.
3. Invest in companies that meet your pre-determined investment needs.
4. Understand the companies you are investing in. Be careful of tips and avoid the herd mentality.
5. Make sure that you and your Portfolio Manager are aligned on points 1 to 4.

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