FOCUS: THOUGHTS FOR 2019
2019 is the Year of the Pig: a year of fortune and luck. Really? According to the Chinese astrology, 2019 is a great year to make money, and a good year to invest!

US interest rate and yield curve. The change in the statement that the Federal Open Market Committee (FOMC) merely '*judges*' rather than '*expects*' that further rate hikes would be needed was 'intended to better convey the data-dependency' and that 'monetary policy was not on a pre-set course'. Nevertheless, this does not mean the Fed has finished raising interest rates. The minutes note the 'contrast between the strength of the incoming data on economic activity and concerns about downside risks evident in financial markets'.
Policy will ultimately take its cue from the economic data, which is still holding up surprisingly well. We still expect the Fed to hike its policy rate probably twice more in the first half of this year. Indications are for the US 10 year at 2.50 Yield to Maturity (YTM). The USD will remain strong, supported by safe-haven demand.

Volatility in global markets a concern. The Bank of America strategist, David Woo, is most worried about volatility in global markets − particularly in the developing world − since the 2008 financial crisis. He said the Democratic takeover of the House will weaken Donald Trump's hand on trade, making a deal with the Chinese less likely, and spur a fight over the U.S. debt ceiling.
Some Emerging-market equities slid into a bear market last year, as escalating trade tensions between Washington and Beijing led investors to flee riskier assets. Concerns are amplified by examples such as China's vice foreign minister summoning the U.S. ambassador to protest the arrest of Huawei Technologies Company's chief financial officer, adding another wrinkle to the spat between the two largest economies.

Here's what else Woo had to say: "The market is starting to realise that this issue won't go away anytime soon. You want to buy EM? I wouldn't touch EM with a 10-foot pole *until there's a resolution between the U.S. and China*. Up until now, Beijing has been careful not to let the genie out of the bottle because it's difficult to put it back in. But we may be slowly reaching that point where it will be more and more difficult for Chinese policy makers to make concessions. There's no question that the concessions that the White House wants, which you could argue are legitimate, are over Intellectual Property (IP). And IP is where it gets very complicated."

"The only thing I'm confident in is that volatility will be high next year. The recent softening in US core inflation won't prevent the Fed from raising interest rates again and, with real economic growth likely to remain above trend in the near term, we still expect two more 25bp rate hikes in the first half of the 2019 year. But it does suggest that the Fed won't hesitate to move to the side-lines if activity growth begins to slow more sharply. The jobs market remains at historically tight levels, with the housing market possibly having peaked but showing no signs of a slump."

Despite the strength of economic data coming out of the US, several high-profile firms across the retail, financial and auto sectors have announced job cuts and issued downward earnings revisions, a signal of waning confidence. When considering flows into US assets, we have recently seen a broad sell-off in the credit market, accompanied by a slump in equity markets. On the reverse side of this trade has been a resurgence of buying of US treasuries, with the 10-year note trading at a yield of 2.69% on December 31, after peaking at 3.23% only two months earlier, a multi-year high. We believe this to be the market signalling concern around global growth and the pricing-in of heightened expectations of a US recession.

EU - potentially heading for a "technical recession" led by an economic slowdown in Germany; even if a German recession is avoided this is of limited comfort: the bigger picture is that, having slowed sharply last year, *Germany's economy is likely to remain weak this year.* We remain neutral on the EUR vs. the USD and the CHF (Swiss franc). We expect the dollar/euro to end 2019 and 2020 at 1.10/€ and 1.15/€, respectively.

The European Central Bank's (ECB's) forecasts for GDP suggest a 1.7% print in 2020 & 2021. This is based on the forecast of an improvement in exports by as much as 100bps over the coming two years. Considering that EU growth has been driven primarily by exports, we expect that the slowdown in Chinese demand − overlaid with the trade war-driven skittishness of purchasing managers across the world − renders these estimates optimistic. On the positive side, unemployment continues to improve, along with a gradual uptick in wage growth in the EU. Political risk and a divergence of the underlying data between core and peripheral Europe continue to weigh on sentiment and spending. Regarding BREXIT the EU are just not interested in offering the UK special terms.

UK – BREXIT. We are unlikely to see either a no-deal exit or scrapping of the whole futile exercise; leaving any other outcome negative for the economy. The immediate problem is largely about the quantum of money to settle the EU and ironically, as in any divorce, money is the UK's main bargaining chip. Suspicions have been raised in Europe that Britain aims either to default on what it owes, or to tie a financial settlement to trade concessions later in the talks. The reality, despite all the Brexiteers' bravado, is that the EU holds all the other cards in these negotiations; especially on the other two divorce issues, citizens' rights and the Irish border "backstop".

We remain positive on the undervalued GBP vs. the USD. We see dollar/sterling at 1.35/£ and 1.40/£. Despite this paradigm-changing set of circumstances, employment in the UK is near record levels and wage growth is proving to be quite healthy. During fiscal 2018, third quarter GDP grew the most in two years, driven by exports (on the back of a weaker pound) and household spending. Business spending decreased the most since the pre-2008 crisis, as Brexit uncertainty continues to suppress prospects for robust growth.

Asia – China slowing, and Japan wedded to Quantitive Easing (QE). The Chinese government has taken steps to reverse sluggish growth in the economy, using targeted monetary and fiscal tools to achieve this end. In the short term, the trade war and deleveraging will continue to weigh on growth. In the medium term, infrastructure spend will be augmented to support the ongoing urbanisation and modernisation drive in the economy. Regardless of the outcome of this trade war, global supply chains will be affected, and the cost of re-alignment will weigh on profits. We still expect the Japanese currency to strengthen a bit further against the dollar this year to 105/$; largely due to safe-haven flows, which help to explain why the yen is one of the few currencies that has done even better than the dollar.

Asset Class expectations:
Equities: expect the current DM (Developed Markets) equity rally to continue, thus retaining a positive view on the asset class. Cautious on EM (Emerging Markets) equity.
Bonds: On the credit side, investment grade bonds look more attractive because of the 2018 spread widening.

Real estate equities: are still expected to underperform but to a lesser extent post the December re-pricing.

Commodities: expectations of weaker manufacturing activity give a neutral on commodities overall. Oil remains in an environment in which we expect prices to increase on the back of further supply cuts. *Indeed, given the slowdown in the Chinese economy, we think industrial commodity imports will remain subdued in the coming months.*

On South Africa:
We doubt that Emerging Market equities will generally fare any better in 2019. In fact, we think that those in Emerging Asia will mostly perform even worse as China's economy loses more momentum. While we expect the SA economy to rebound from a rather dismal performance in 2018, we expect growth to remain below the five-year average of 1.9%. Analysts forecast a 1.4% expansion in 2019. While growth in South Africa is likely to strengthen in the next few quarters, the pace of economic recovery will be weaker than most expect.

One bright spot in the local economy is the continued growth of an emerging middle class, though admittedly off a low base. Living Standards Measure (LSM) data and the continued above-trend growth of high-skilled wages in South Africa are supporting the creation of an economic class that is traditionally able to drive growth, through improvements in productivity and increased spending power. Having said that, government efforts are woefully short of creating an environment conducive to the sustained proliferation of such a group. Hence the SA consumer remains severely constrained by "administrative cost increases" and below trend growth which have decimated discretionary income.

The high SA fiscal debt burden and precarious financial position of state-owned entities, specifically SAA and Eskom, leave the South African economy increasingly defenceless in the face of a less supportive global economy.

The large fiscal deficit and sizeable contingent liabilities remain a concern, and measures to address these constraints will be important. Rothschild's Martin Kingston said in an interview that recapitalising Eskom could cost the country its last investment grade credit rating but that there was "no other obvious solution" if Eskom was to survive. "The government knows that putting money into Eskom is going to exacerbate a downgrade scenario. But I think it is going to have to bite that bullet," Kingston said. "The level of debt on Eskom's balance sheet is completely unsustainable." Eskom's debt has ballooned from around R106 billion to more than R419 billion over the past decade, while electricity sales have fallen. South Africa's high external financing needs, as reflected by the current account and budget deficit, will continue to weigh on the rand, thereby contributing to inflationary pressures.

Budget 2019 and Moody's reaction to it. Moody's has stressed that a decision for example to transfer SOE debt to the Government balance sheet comes with moral hazard and, as the power producer has already twice delayed the release of its turnaround plan, this clearly reflects both the complexity of its strategy and execution challenges as substitutes challenge their prior monopoly status.

PIGS “Prescribed Investment Guidelines”: The ANC stated in its election manifesto that it would “investigate the introduction of prescribed assets on financial institutions’ funds to unlock resources for investments in social and economic development”. This will allow the state to dictate to the contractual savings industry as to asset class allocation and to whom the funds are ultimately deployed.

Elections globally are becoming uniquely difficult to call; as such, anticipate SA polling stats to be materially wide of reality. Therefore, don’t fixate on outcomes but rather on the ability of the ANC to implement structural economic change within the constraints of the Constitution. While we do not have any special insight into SA politics, the question does arise as to whether Cyril Ramaphosa will be recalled post-election results; whether the spectre of coalition politics becomes the new normal.

Expect **the SARB** to lift rates again by 25bp in the first half of 2019 *if risks* to the inflation outlook persist. The tightening cycle suggested by the Quarterly Policy Meeting is for four increases of 25bp by the end of 2020.

SA Industry strikes are turning out to be some of the most violent in years. Employers’ attitudes to employment are hardening and, as a result, many will be looking at ways to reduce their future dependence on manpower. A 2014 study by labour lawyer Frans Rautenbach found a correlation between union density and employment growth; the correlation showed employment growth was strongest in times when union density was weak.

Disruption triggered by the 4th Industrial Revolution, and the constraints placed on a future workforce by SA’s below par education system, reinforces the ‘poverty trap’ and makes SA vulnerable to continue below trend growth.

Education: Of the 512,735 learners who wrote the NSC examinations in 2018, only 33.6% received the marks necessary to apply for university entrance (National Senior Certificate Examination Report, 2018). This figure has a strong correlation with the 38.2% unemployment rate for youth (aged 15-36) and the 3.3 million (32.4%) of 10.3 million youth who are ‘Not in Employment, Education or Training’ (NEET). These figures do not adequately account for those who are ‘Not Economically Active’. The Organisation for Economic Co-operation and Development (OECD) reports that South Africa has the highest youth unemployment rate in the world at 53.4% (2017). Nearly two-thirds of unemployed people in South Africa are under the age of 36.

2019 promises to be another testing year for investors, as a confluence of market forces conspire to bring about volatility and more prolonged divergences from fair value. It is imperative in such instances for us, as investment professionals, to conduct rigorous back testing of theses to aid us in unbiased and candid decision-making. We continue to emphasise investment in quality companies, with identifiable competitive moats, good management, and stellar free cash flow generation, resulting in good earnings visibility through the cycle.

Successful investors scale into positions as the market gets cheaper and scale out as it becomes more expensive. Trying to time, while nice, the bottom or top with exact precision is an exercise in futility.

Mark Huxter & Anda Tyali, January 2019