VUNANI FUND MANAGERS

Focused black-owned asset manager

Economic Commentary

While equity markets such as the S&P 500 and NASDAQ climb to new highs for the year to date the dollar has weakened. By now most commentators have moved to a more neutral / negative position on Trump. Tax cuts, if they are passed, are likely to be far less than was promised, as will most other policy initiatives espoused during the election campaign. Could it be then, that the bond and currency markets reflect slower levels of inflationary pressure and hence a lower trajectory in Fed rate hikes while the equity market reflects both this dynamic as well as the prospect of higher earnings growth? The Bank Credit Analyst models confirm the rebound in operating income expectations through to 2018 as underlying pricing power and volume growth gain a little more traction in the US economy. Europe and Asia similarly appear to be on the mend with policy at the ECB and CBoC becoming a little more restrictive as normal commercial lending activity in both regions firms. The weaker dollar has provided a little breathing space for the yen and euro, both of which have firmed against the dollar during the quarter.

On the face of it all seems normal. On this basis we should expect equity markets to continue to rise during the latter half of 2017, bond yields to remain at around current levels and the dollar swoon to abate. This “carry-on” scenario is seemingly mirrored in the CBOE VIX index which is trading at near all-time lows. The VIX index is the most prominent gauge for uncertainty in financial markets. When it is high, so too is uncertainty. But herein lies the paradox. History reflects that the index often sinks to very low levels just before some event creates a schism in financial markets. Developments within the current geo-political environment that could include: a policy disconnect between east and west, a deadlock in Washington regarding policy changes and fiscal stimulus, North Korea, the upcoming Italian elections or a change in the tone of central banks. But, in many ways, these are “known knowns”.

More serious would be a breakdown in one or more of the liquidity cycles. Importantly, the origin of these cycles differs. In the US, Europe and Japan liquidity created by central bank activity has found its way into asset prices. In China, asset price inflation in the form of rampant property prices is being funded by rising debt levels - a little reminiscent of the sub-prime crisis in the US in 2008. With a debt to GDP now touching 300%, the authorities in China have something of a dragon by the tail. Recently the authorities announced that they would introduce a new "counter-cyclical factor" to reduce exchange-rate volatility while undermining efforts to increase the role of market forces. In some ways, this announcement was not unexpected after China's downgrade by Moody's, which prompted speculation that the central bank was directly manipulating the currency as the PBOC’s daily fixings had "materially diverged" from the prescribed formula, resulting in a gap between the reference rate and currency’s spot value. The yuan’s 6.5 percent slide in 2016 created a vicious circle of capital outflows and bets on further currency weakness, prompting officials to burn through more than $300 billion of foreign-exchange reserves and to introduce tighter capital controls. As such, the new fixing formula may be a cheaper way to stabilise the yuan. Officials have already used the reference rate to guide the currency higher in recent weeks, setting the fixing at levels that were consistently stronger than analysts predicted, and certainly in the hours after the Moody's downgrade when the "herd action" may have prompted another sharp selloff absent central bank intervention in the other direction.

The short version of this very long story is that we will have to monitor carefully. For now, the weakness in the dollar has provided the CBoC with short-term relief. However, any hint of a devaluation would certainly spark a fallout.

South Africa is, after a long gestation period, facing an inflection point. While all news flow is directed at the state capture; the real issue lies in the capital allocation mismatch. SA lacks a policy framework that creates a competitive dynamic for the flow of capital into the country as the uncertainty surrounding “radical economic transformation” re-directs capital flow elsewhere. Our research piece during the first quarter of 2013 provided a framework that addressed four key drivers within the global macro environment. The first theme we explored was “America, the new emerging economy”. The second: “China driven by policy change”. The third: “Commodities, the trade of the last decade”. And, the fourth; “SA, at the start of structural decline”. Linking all four was the dollar, which we saw going higher. This scenario has played out almost as expected as capital flows through the currency markets created the return investors sought at the time. In order to correct the current impasse in domestic growth the factors that have led to the misallocation of capital, whether through re-purposing of state assets or policy deficiencies need to be addressed. We just don’t see how this is likely to be achieved as the objective of such change would be “radical economic policy reformation” as opposed to “radical economic transformation”.