integrity asset management

Market Synopsis – July 2017

As a result of the Global Financial Crisis, the last few years have been characterised by ultra-accommodative monetary policy and quantitative easing in the form of large scale purchases of government bonds by central banks. In some instances this has even resulted in negative interest rates. These unprecedented levels of monetary stimulus provided a strong tailwind for asset prices.

With global growth on the recovery path, the time has come for monetary policy to start normalising. The US Federal Reserve ("Fed") was first to start with the process of policy normalisation, with asset purchases tapering off and finally concluding towards the end of 2014. This was followed by a gradual normalisation in interest rates, resulting in four 0.25% interest rate increases since 17 December 2015. The Fed has also given notice of its intention to start reducing the size of its balance sheet by the end of the year.

At the European Central Bank ("ECB")'s Forum on Central Banking in late June, several major central banks outside of the US hinted towards a recalibration of monetary policy: The heads of the Bank of England ("BoE"), Bank of Canada ("BoC") and the Swedish Riksbank all took a less dovish tone, signalling that the diminished threat of deflation has reduced the need for ultra-stimulative policies.

The BoC followed up by increasing rates in July and warned that more rate increases are to be expected. In addition, the BoC now expects the economy to reach full employment and achieve its inflation target by mid-2018, much earlier than previously anticipated. The Riksbank has also backed away from its easing preference at its most recent policy meeting.

Despite Europe's structural challenges and flaws of the single currency, from a cyclical economic perspective, solid momentum this year will allow ECB president, Mario Draghi, to scale back the ECB's ultra-accommodative monetary stance by tapering its asset purchases program early in 2018.

The notion that "emergency" levels of accommodative monetary policy are no longer required is underpinned by the further improvement in the Purchasing Managers' Index ("PMI") for the advanced economies in July. Additionally, a reduction in labour market slack and output gaps is also adding to the gradual build-up of inflationary pressures. As seen in Figure 1, industrial production has been gradually recovering over the course of the last year and a half.

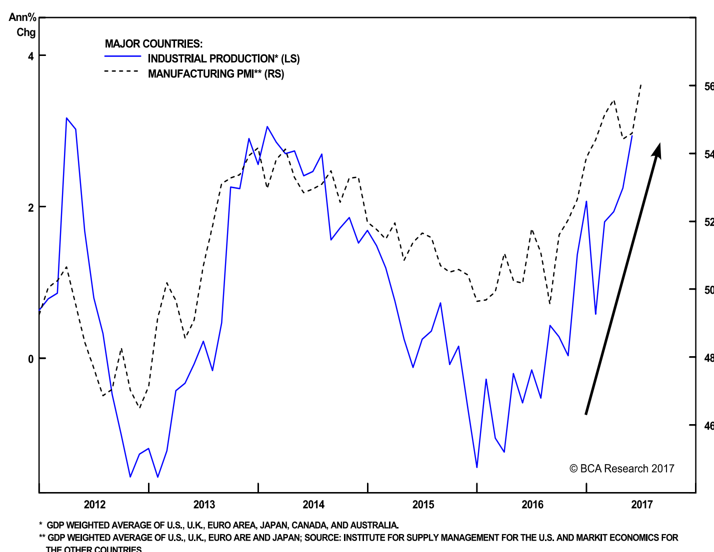
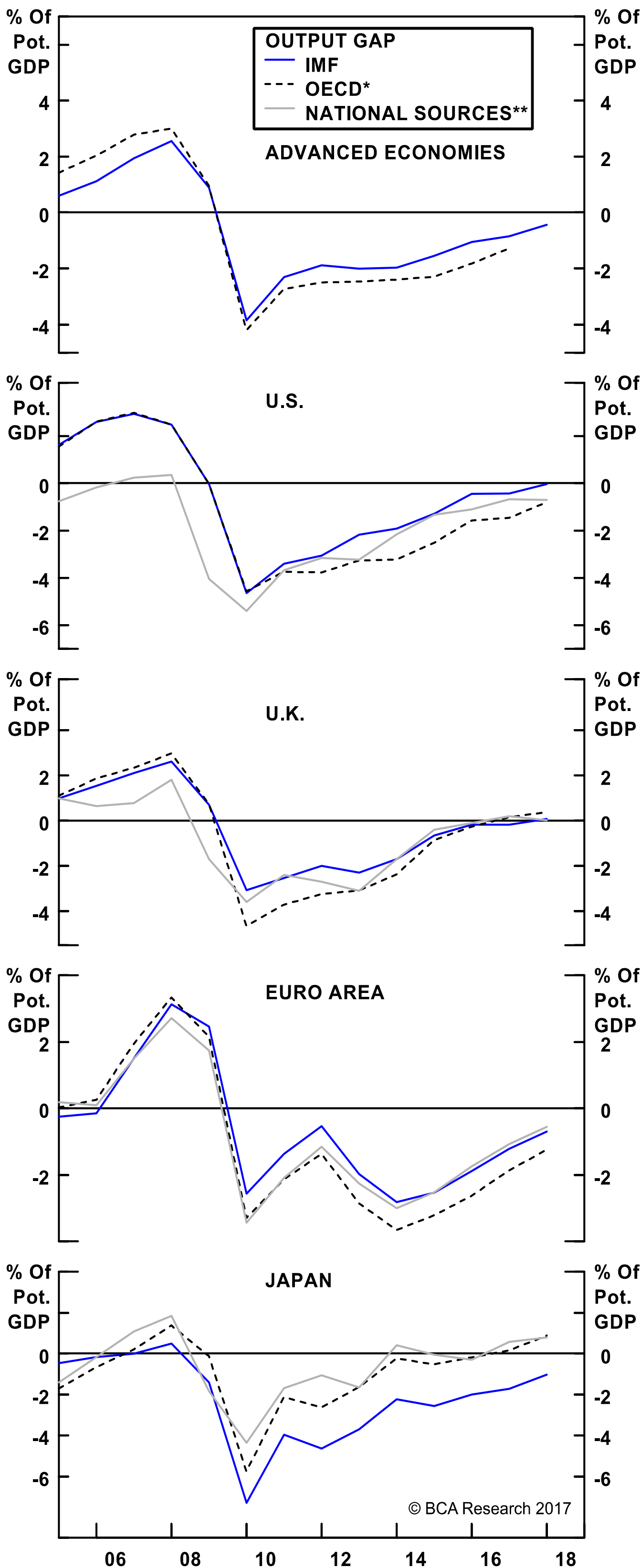


Figure 1: Recovery in industrial production remains intact

The reduction in spare capacity since 2009 is shown in Figure 2. It is evident that most of the advanced economies are moving towards the point where they are producing at capacity. Several measures are also suggesting that the US is now edging closer to full employment. Historically, reduced labour market slack has corresponded with higher inflation, as seen in Figure 3.

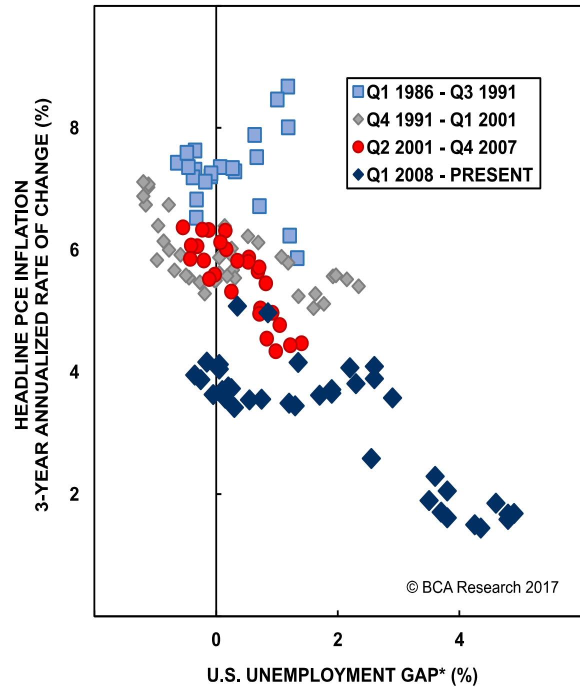
To date, the decrease in spare capacity has not yet translated into higher inflation. The reason for this is that inflation is a highly lagging indicator and usually does not peak until well after the onset of a recession and does not bottom until well after it has ended (Figure 4).

Furthermore, the relationship between production slack and inflation is usually highly non-linear: When an economy has plenty spare capacity, even a reasonable decline in slack tends to have little impact on inflation. However, when there is little to no spare capacity, even a small decrease in slack could cause a large increase in inflation. It can therefore be concluded that continued decline in slack globally will ultimately put upward pressure on inflation.



* G7 COUNTRIES FOR THE OECD OUTPUT GAP.
** INCLUDES DATA FROM THE U.S. CONGRESSIONAL BUDGET OFFICE, THE EUROPEAN COMMISSION, THE U.K. OFFICE FOR BUDGET RESPONSIBILITY, AND THE BANK OF JAPAN.

Figure 2: Output gaps have narrowed since 2009



* DIFFERENCE BETWEEN THE UNEMPLOYMENT RATE AND THE LONG-TERM NAIRU. SOURCE: THE FEDERAL RESERVE, BLS, AND BEA.

Figure 3: Reduced slack corresponds with higher inflation

Adding to this, a recovery in oil prices will further increase the cyclical pressure on inflation. At a recent press conference in St. Petersburg, Saudi Energy Minister, Khalid al-Falih, indicated that no changes are currently needed to the production deal under which OPEC and non-OPEC producers agreed to reduce oil production by 1.8 million barrels per day. This leaves open the possibility for even deeper cuts, should global inventories not draw down fast enough, or for production cuts to be extended beyond March 2018. Should the cuts in oil production be successful in reducing oil inventory sufficiently, the resulting increase in prices is bound to add pressure on inflation.

Meanwhile, several structural changes will gradually lift inflation over the next five to fifteen years. One of these changes is the decline in productivity growth, especially in developed countries. Whilst there are numerous examples of innovation and changing business models (including Uber, robotics and Amazon, to name a few) which are transforming the way in which society operates, the impact is not showing up in aggregate productivity data. As seen in Figure 5, productivity growth in the developed world has been slowing since the early 2000s. Although

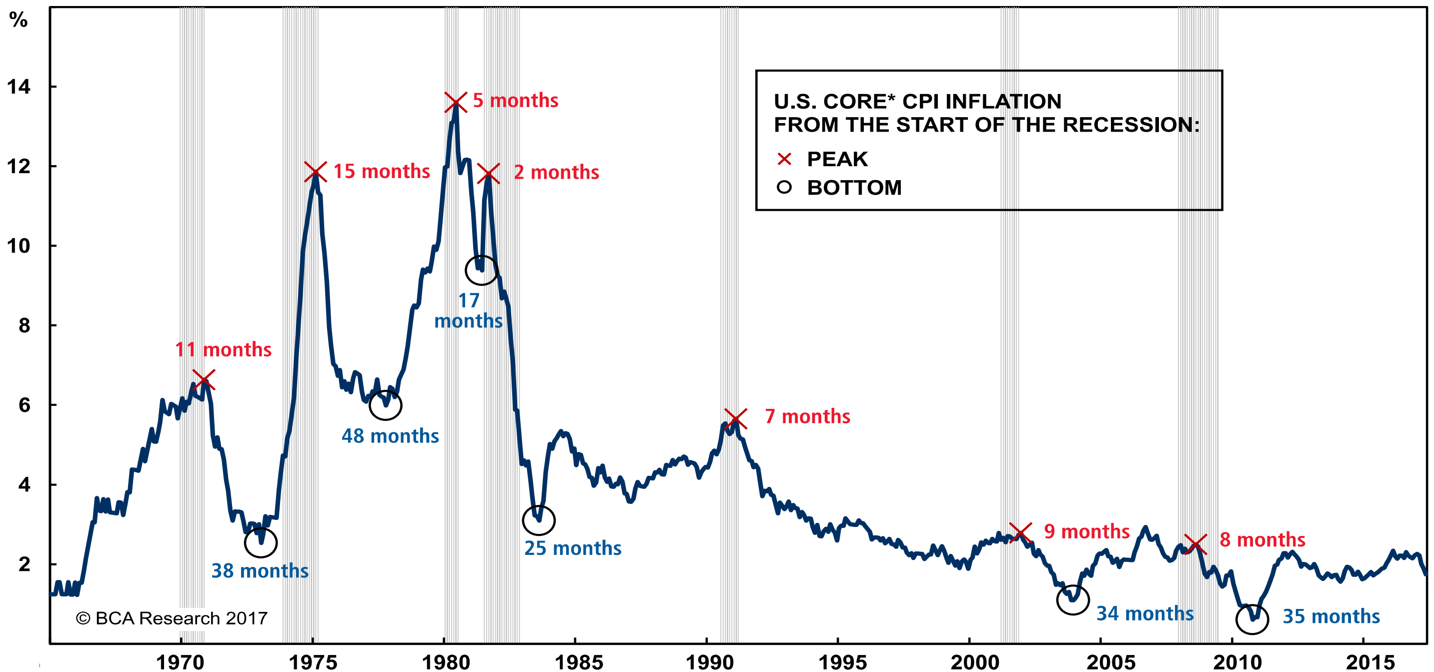


Figure 4: Inflation is a lagging indicator, usually only peaking well into a recession and bottoming well after the recession's end.

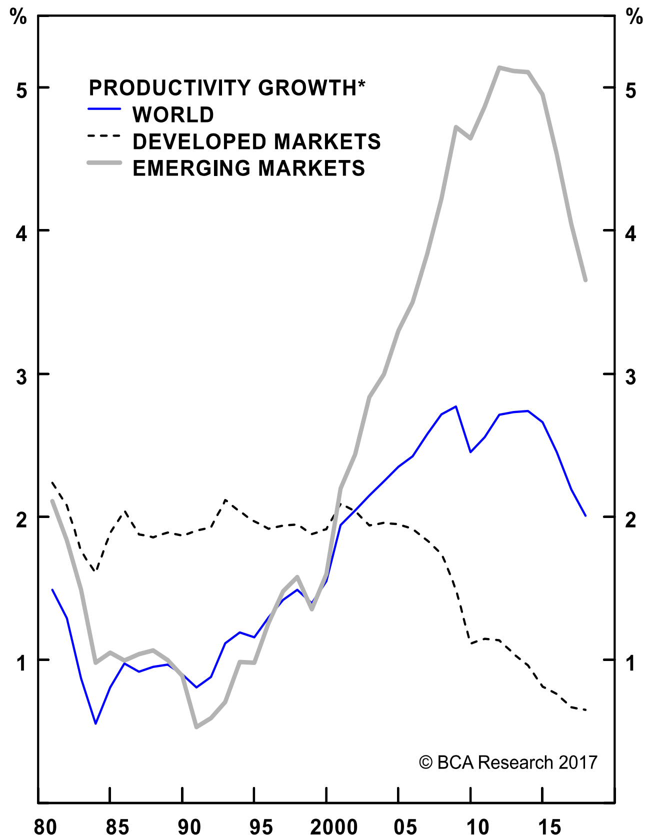


Figure 5: Productivity growth has been declining for some time

productivity is surging in certain companies, there is still a long tail of low productivity firms which are pulling the average down. It also remains an open question whether today's new innovations are as transformative as previous new technologies, including indoor plumbing, electricity, the internal combustion engine and the internet.

Considering that gross domestic product ("GDP") must equal gross domestic income ("GDI"), it follows that, should productivity growth remain weak, slow income growth could end up depressing savings by more than it depresses investment. This in turn could push up equilibrium real interest rates, causing inflation to rise, unless central banks respond by raising policy rates.

The retirement of millions of highly paid baby boomers could also lead to labour shortages and lower aggregate savings. Typically, an individual's consumption tends to peak late in life due to increased spending on healthcare. The aggregate effect of an aging population could be a substantial decline in the household savings rate in the US, Germany and China. The reduction in the savings rate in the latter two countries will reduce their considerable current account surpluses, which have been major contributors to the global savings glut and the corresponding low level of real interest rates.

Japan serves as a prime example of the pitfalls of excessively low inflation. Had Japan experienced higher inflation in the early 1990s, the Bank of Japan ("BoJ") might have been in a position to decrease real interest rates far enough into negative territory, without running into the zero-bound constraint on nominal rates. In turn, this could have prevented the vicious circle whereby falling inflation pushed up real rates, causing weaker growth and even lower inflation.

What was previously a unique Japanese problem is now viewed as a concern in many countries, with many economists now advocating that central banks should target an inflation rate above the standard 2%. The reasoning behind this is that, should inflation run at 4% and a deep economic downturn require real rates to be reduced to -3%, central bankers can cut nominal rates to 1%. However, should inflation run at 2%, reducing nominal rates to -1% could be difficult to achieve, since people could elect to hold cash over a negative-yielding asset.

A further lesson from the Great Recession and the recession following the dotcom boom is that burst asset bubbles can have detrimental consequences for economies. If equilibrium inflation had been higher going into the housing bust, nominal house prices would have declined by less for any change in real prices. As a result, fewer mortgages would have gone underwater. In addition, had the underlying inflation rate been higher, lenders would have been far less inclined to offer zero-interest mortgages, thereby enforcing more discipline on both lenders and borrowers.

An additional benefit of higher inflation is the increased ability to adjust real wages: Should an adverse economic shock necessitate lower real wages and inflation is low, it will most likely prove difficult to convince workers to accept lower nominal wages. However, inflation has the ability to decrease real wages over time. This holds especially true for the euro area, where labour markets are highly inflexible and many countries do not have the ability to respond to adverse shocks with countercyclical fiscal policy or currency depreciation.

Lastly, it appears that globalisation, traditionally a strong deflationary force, is fading. As seen in Figure 6, global trade has been stagnating. Conversely, political populism, historically a strong inflationary force, is on the rise.

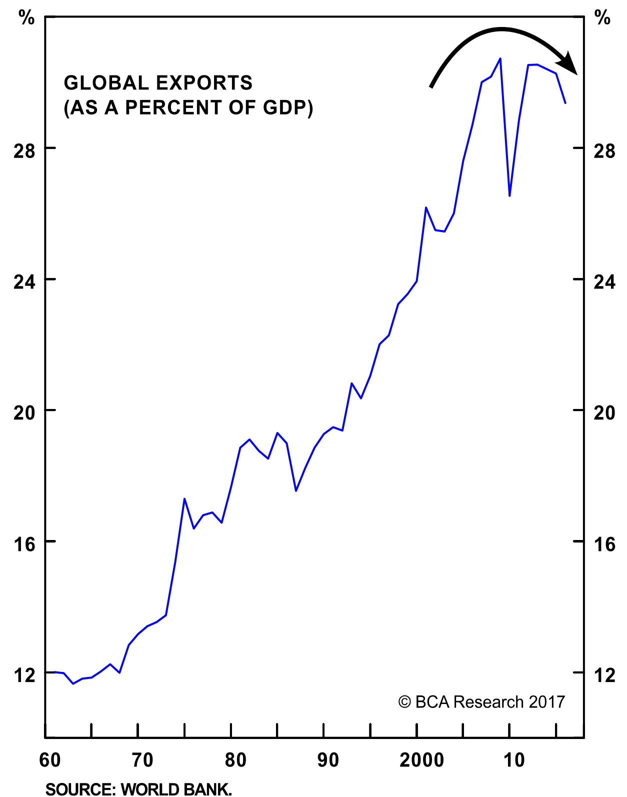


Figure 6: Globalisation is stagnating

Part of the slowdown in globalisation can be attributed to diminishing returns: After tariffs fell steadily over the second half of the twentieth century, most goods now move across country borders duty free. As a result, further trade liberalisation will yield increasingly less impact on global trade. The same applies to outsourcing, with growing evidence suggesting that many firms have outsourced too much. Likewise, globalisation benefitted largely from the increase in the global labour force resulting from the integration of Eastern Europe and China into the capitalist economy. Unfortunately, nothing similar is waiting on the horizon.

In conclusion, the table appears to be set for higher inflation and interest rates: The economic slack which characterised the last eight years is being absorbed, while several structural forces will push inflation higher. In the

light of this, it can be argued that several central banks are behind the curve in raising interest rates. Should this hold true, these central banks will be forced to increase rates more aggressively as inflation picks up next year. This would cause their bond yields to rise and currencies to appreciate, ultimately sowing the seeds for a slowdown or mild recession in 2019.

For the time being, the bull market in equities is supported by a combination of robust earnings growth, steady real GDP growth of around 2%, and low bond yields. Globally, earnings per share continues to accelerate, in line with the recovery in industrial production. In the US, Europe and Japan, profit acceleration appears to be widespread in the Basic Materials and Consumer Discretionary sectors. In most cases, Industrials, Energy, Health Care and Consumer Staples are also performing relatively well, with Telecommunication Services being the bad apple.

Things are likely to get less rosy for US equities once profit growth peaks, as valuations are becoming somewhat stretched. In contrast, the earnings recovery in Europe and Japan is behind the US and is only expected to peak later. Due to the relative earnings cycle and more attractive valuations, we continue to prefer European and Japanese equities relative to their US counterparts. In addition, rising inflation expectations should be beneficial for gold and gold producers, as gold has traditionally been a hedge against inflation.

For more information on this Market Synopsis or to discuss solutions provided by Integrity Asset Management, please contact us at:

Tel: (021) 671 2112
Cell: 072 513 2684 / 084 601 1025
E-mail: nic@integrityam.co.za / herman@integrityam.co.za
Website: www.integrityam.co.za

Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 269.65	2.3%	10.2%	2.3%
Brent Crude	52.52	9.6%	-7.6%	9.6%
USDZAR	13.03	-0.4%	-5.2%	-0.4%
EURZAR	15.30	2.4%	5.9%	2.4%
GBPZAR	17.10	0.4%	0.9%	0.4%
JSE All Share TRI	7 684.15	6.4%	10.0%	6.4%
JSE Resources TRI	2 093.89	11.7%	7.0%	11.7%
JSE Industrials TRI	14 103.62	5.7%	17.0%	5.7%
JSE Financials TRI	8 108.29	5.7%	3.9%	5.7%
JSE Listed Property TRI	2 229.69	3.6%	6.0%	3.6%
S&P 500	2 472.10	2.0%	10.4%	2.0%
Euro STOXX 50	6 947.91	0.8%	7.6%	0.8%
FTSE 100	6 146.30	0.8%	5.5%	0.8%
Nikkei 225	30 773.61	-0.4%	5.4%	-0.4%
Hang Seng	71 916.48	5.3%	25.8%	5.3%

Source: Bloomberg, as at 28 July 2017

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