Economic Update

August 2019

Capricorn Asset Management

a member of **Capricorn Group**

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In the recent past we've seen growth expectations being cut back. However, it now seems that globally and domestically we are experiencing a proper growth scare. This means that analysts are starting to factor in a worse-than-expected impact on the economy from global factors such as the trade- and currency wars, rising tensions in the near- and far-east and the perceived policy exhaustion. Geopolitical tension is now the tail wagging the proverbial dog, which is the economy and financial markets. Judging by the sharp risk-off sentiment that took hold in the financial markets, investors are worried. These worries are finding expression in falling confidence indicators, weak equity markets, and lower bond yields as well as weakening Emerging Market currencies.

A global growth scare is broadly understood to mean that global growth falls below 3%. This does not happen often. Furthermore, a global recession is normally experienced when global growth falls below 2.5%. Therefore, on a world-wide scale recessions are gauged somewhat differently to that of a single economy where two consecutive quarters of contraction is defined as a recession.

The USA economy is still looking quite strong. Unemployment is at an all-time low, which means that, from a domestic perspective, the USA economy is not in need of policy stimulation. There is indeed a debate amongst the members of the Federal Reserve on this issue. Some members are against further interest rates cuts, while some are in favour of further easing as "insurance" against the knock-on effects that will emanate from the weakness in global trade and falling manufacturing confidence.

This means that the market is probably going to be disappointed by the pace at which the Fed is likely to ease. For most of the rest of the world, monetary easing is definitely on the cards. Over the past few months, apart from the Fed, as many as 20 central banks have cut rates, including the Bank of Namibia. The European Central Bank (ECB), the Bank of Japan (BoJ) and the Bank of England (BoE) have not moved yet. The BoE's last move was a hike in rates in February 2018. However, these three "big guns" are widely expected to take some action as the macroeconomic outlook worsens and as the threat of deflation looms larger than that of inflation.

This means that highly indebted consumers and governments the world over are getting a reprieve from the pressures of rising hard currency debt servicing costs. Furthermore, global bond yields keep falling as yield-bearing investments become ever scarcer. One can conclude that even domestic bond yields in Namibia and SA would have been higher, were it not for the global downdraft in bond yields.

The Chinese economy is still cooling. Add to this the effect of the "trade wars", then it means that its demand for goods and services from the rest of the world is declining sharply. Weakening Chinese growth weighs down commodity prices, which is an added worry for commodity dependent economies like Namibia, copper rich Zambia and oil producers like Angola and Nigeria.

Brexit might, ironically, be a positive for Namibia in the end. A UK that finds itself out in the cold could prove to be a friendly trading partner. Europe itself is feeling the tremors of political shifts at home and abroad. However, there seems to be a dichotomy developing between (1) domestic consumption being helped along by consumer confidence and low-to-negative interest rates and (2) the manufacturing and trade sectors where confidence and activity is waning. Germany, for instance, experienced marginal economic contraction recently.

Therefore the main views and themes that we highlighted in the recent past, are still playing out:

- Global economic weakness and fears of deflation. The dreaded "R" word (recession) is being bandied about freely and threatens to become a self-fulfilling prophecy.
- A soggy outlook for the domestic economy. Here recession is reality. However, we do not agree that current conditions can be typified as a depression. If unemployment is the yardstick, then yes, Namibia is in a depression and has always been. Recent policy statements (Economic Summit) and –actions (a cut in interest rates) should, in time help to turn things around. A pick-up in regional trade is a long hoped for vision that should get some legs from the newly inaugurated port facilities. And credit growth is turning up. There is hope yet.
- Cut-backs in inflation expectations. In Namibia the most recent number came in at 3.6% and in SA at a much lower than expected 4.0%. It remains our view that inflation is likely to remain in the 4% to 5% range in both Namibia and SA for the foreseeable future, which is until 2021. It could even fall below these levels at times. The one factor to watch, though, is maize prices. It has recently risen sharply in the US and in SA. If sustained, this could put upward pressure in the food price chain. Food, oil and the exchange rate remains, as ever, drivers of inflation volatility.
- Monetary easing in the form of lower interest rates, foreign and domestic. Monetary policy is expected to provide relief and stimulus to economies in an environment where fiscal policy can do very little. The deepening domestic recession will continue to pull rates downward.
- Difficulties in the Fiscal arena. We will get a clearer picture from October's interim Budget. However, it promises not to be a pretty one. Revenues will be severely constrained by general economic weakness while there will be no shortage of demands on the Fiscus to spend more. This applies equally in Namibia and in neighbouring SA. In fact, we expect that fiscal slippage in SA will lead to some form of downgrade of the sovereign credit rating. It is however mostly priced in as it seems from the relative levels of bond yields, credit default swaps and currency movements that SA and, by extension Namibia, is trading as non-investment grade, or BB status as opposed to BBB, which is the lowest rung of investment grade.

In the light of the foregoing, our investment perspectives also remains largely unchanged. Yields on the Money Market will continue to drift down as expectations of interest rate cuts take hold. Fortunately, lower inflation means that a fair real return is still achieved. Lower interest rates will revive the "hunt for yield" theme, which should benefit high yielding bond markets like our own. Investors are likely to look to Emerging Market bonds to provide yield in a world of low and falling bond yields.

Listed property remains a "value proposition". Its current yield is better than ten year bond yields. This should shield the patient investor from weak economic fundamentals currently being faced by the asset class. By weak fundamentals we mean that rental escalations are likely to remain low and vacancies high. And that costs are being pushed up via rates and taxes and the need to find alternative electricity supply sources.

As far as equites are concerned, we quote from our previous update note: "The share prices of companies are unlikely to perform well in an environment where earnings are constrained. Therefore, the equity market is likely to continue to move largely sideways, with bouts of volatility to the downside and the upside as the risk-on risk-off sentiment is driven by geopolitical news and speculation about the likely reactions of policy makers." However, falling bond yields and monetary easing should provide support to equity markets.

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