

THE QUART 40IFO

OFFICIAL QUARTERLY NEWSLETTER OF THE OSRIN GROUP
INCORPORATING OSRIN WEALTH & OSRIN ADVISORY

2018 in Review

Introduction – The First Serve

Welcome to the first edition of The Quart 40IFO. It gives the Osrin Group (Osrin Advisory and Osrin Wealth) great pleasure to launch the first edition of our quarterly market update, from which we hope you will benefit, and moreover, enjoy.

In July this year, Marina Pienaar, Leigh-Anne Chalker and I left the Stenham Group and formed Osrin Wealth, an Independent Financial Services provider. We were kindly offered the opportunity to share premises on the 9th Floor of 2 Long Street, Cape Town by Osrin Advisory (previously trading as Bernard Osrin and Associates) and moved into our new home on 2 July. We are most grateful to Bernard and his team (Tania, Anne, Linda and Colleen) for all the assistance and for their warm welcome.

For me personally, it has been a very emotional transition, returning to South Africa after working in office buildings located in Tel Aviv, Herzliya Pituach, 35 John Street, Holborn and 180 Great Portland Street, London, to now find myself sitting in my dear late uncle Eliot's office next to Bernard, looking out at majestic Table Mountain.

The idea of The Quart is to provide you with a brief quarterly snapshot of relevant global macro-economic data, economic policy and political outcomes tied specifically to investment market insights. We aim to keep it fresh and interesting and welcome comment and questions from you.

For this, the first edition, we have decided to review 2018 to date and look a little ahead to 2019, and thus this piece will be a little longer. We hope you are able to find some time on your upcoming holiday break to read through this first edition.

We also take this opportunity to wish everyone a Merry Christmas and Happy New Year. Enjoy the time off with friends and family and come back with batteries recharged for what promises to be an exciting 2019 on many fronts.

Jonathan Osrin

Compliments of The Season from all of us at
OSRIN WEALTH and OSRIN ADVISORY

[A QUART] Def; A unit of liquid measure of capacity, equal to one fourth of a gallon, or 57.749 cubic inches (0.946 liter) in the U.S. and 69.355 cubic inches (1.136 liters) in Great Britain. Or a unit of dry measure of capacity, equal to one eighth of a peck, or 67.201 cubic inches (1.101 liters).

The Quart is in session – Pre-Match Preparation

In this first edition, I have endeavoured to keep the format simple and easily navigable, and together with a summary overview, I highlight key themes around which market risk emerged during the year. I end with what I term the '2019 playbook' – essentially our summation of expected key developments and market themes for 2019, that investors should now be alerted to, so they can position themselves accordingly.

You will notice that I have decided to focus predominantly on global data, global economic policy outcomes and global political events.

For one, you will have far more access to local information, and probably less access to presentable global information. More importantly, local equity markets have been shown to be far more responsive to developments that shape global markets and particularly emerging markets (EM's), than they are to, for example, domestic GDP and inflation numbers, as important as these numbers are. Typically, when global equity markets rise, they rise in SA as well, and when US Treasury bond yields rise rapidly and the US dollar strengthens, the rand comes under pressure, leading to higher imported inflation, and a more aggressive SARB, which is bad for local business and the consumer.

An overview – The proverbial tale of two halves

For the better part of 8 months, developments in the US were progressing swimmingly. Equities were powering ahead and global trade was intensifying, driving China's manufacturing, heavy industry and export sectors once more, and stimulating global demand for resources. The IMF saw global growth expanding 3.9% in 2018 vs. 3.7% in 2017. The S&P had risen 8.5% to end-September, while the 10-Year Treasury yield meandered to 2.8%, a lot higher than corresponding yields in Europe and Japan, but indicative of a pretty tame outlook for US inflation and a conviction about a dovish Federal Reserve.

The JSE FTSE All Share Index traded pretty comfortably in a range between 57,000 and 60,000, but was coming off a very high base after Cyril Ramaphosa's victory in the ANC Elective Conference and subsequent swearing-in as President.

However, by September the investment environment began to change.

It is hard to pinpoint an exact moment. The North Korean imbroglio was not really a market mover, the populist coalition in Italy had already won the election in March, and President Trump had begun imposing limited tariffs on selected Chinese imports at the outset of the year.

There were five major contributing factors to the downward shift in investor sentiment in Q4 2018.

First, the US/ China spat deteriorated into all-out war when on September 17, the US announced 10% tariffs on US\$200 billion's worth of Chinese goods, increasing to 25% by the end of the year. The Trump administration also threatened tariffs on an additional US\$267 billion's worth of imports. Investors started running for cover and safe-haven US bonds strengthened, with yields coming down.

Second, in Europe, a populist coalition took over in Italy after March elections. It was never a question of leaving the eurozone as many had surmised. But by September it became clear that the government sought to propose a budget that fell foul of the euro area's tight fiscal requirements, and it was this issue – a probable irresolvable conflict between hard-line EU administrators and equally hard-line eurosceptics – that provided another reason to ditch equities.

Third, notwithstanding that the referendum took place as long ago as June 2016, and despite warnings of dire economic consequences, British and global investors appeared to take quite a sanguine view on the whole Brexit process. But complacency was replaced by concern once the timeline shortened, and the realisation that absent a deal by January 21, the UK would exit under a so-called hard Brexit scenario. The ongoing infighting between and within parties, reflected a country deeply divided on the issue. The urgency to thrash out a deal, which had no guarantee of being passed in the Commons anyway, saw risk perceptions intensifying.

Fourth, during H2 2018, Saudi Arabia reasserted its role as swing producer, retracting oil supply, which coupled with higher demand expectations and the diminishing disruptive impact of shale, took Brent crude up from an August US\$68/barrel to over US\$86/bbl by late September. This had the effect of raising inflation expectations, and engendering higher inflationary outcomes particularly in EM's.

Fifth and the most marked influence on global markets, was the evolution of Fed monetary policy signals. In late September/early October, Fed officials began indicating in a number of ways, that the Bank was far from done on rates and coupled with strong economic data, the yield on the US 10-year Treasury got to nearly 3.25%, which translates into nearly 125 basis points of risk-free real return. The Fed was becoming concerned with wage inflation, the pace of US growth, and the price effects of all that fiscal stimulus, mostly in the form of tax cuts to US corporates and households, not to mention possibly higher input costs due to increased tariffs.

I view the tone of the Fed in this period as the immediate cause of the correction in global stock markets that largely played out in October.

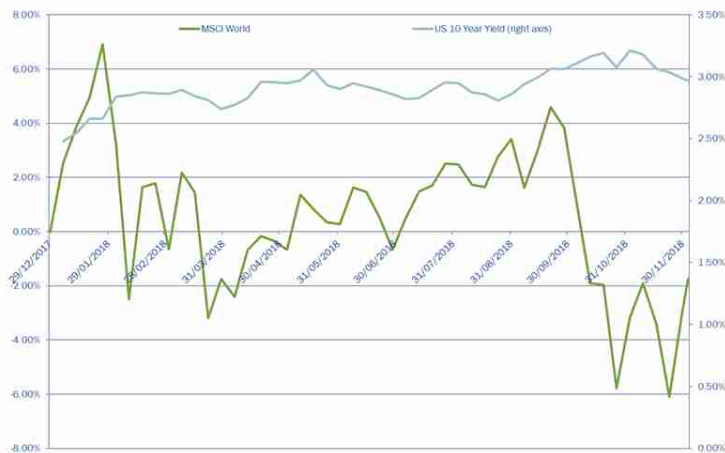


Figure 1: 10-year Treasury yield vs. MSCI World Index (including dividends) YTD (source: Bloomberg)

2018 – Big Game Highlights of the Year

The Fed - Into the Red Zone

The Fed, then under the stewardship of Janet Yellen, initiated its first hike in December 2015, taking the benchmark fed funds rate up 25 basis points from 0% - 0.25%, where it had languished since 2008. But thereafter it took a while to develop any policy tightening momentum. Only a single lift followed in 2016, and three in 2017 (all 25 bps). The Fed wanted gradual policy firming and minimal market disruption.

By 2018, the US economy had picked up another gear, growing 4.2% on the quarter in Q2 2018, and 3.5% in the following quarter for an annual growth rate of 3% by September. This is well above the longer-run trend. The unemployment rate fell to 3.7%, a 49-year low. Importantly, wage inflation got above 3% and the Fed's preferred core inflation gauge coalesced around the 2% target, which is actually quite low.

Notwithstanding a degree of policy tightening unmatched in the developed world where Central Banks in Japan and Europe are still conducting asset purchase (QE) programmes, and rates are extremely low, even negative, US economic health and higher risk-free returns, meant that not only was the US dollar the currency of choice in 2018, but US equities were significant outperformers.

I have shown how these factors prompted the Fed to take a slightly more hawkish view into Q4. Concern spread because inflation expectations were well grounded and because amid all the good GDP data were signs of weakening residential and business fixed investment, usually reliable leading indicators that an economic reversal could be closer than anticipated.

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The markets were looking for some guidance as to when the Fed would stop raising rates, that is to say where the Federal Open Market Committee (FOMC) saw the level of the so-called neutral (equilibrium) rate. The neutral rate is that rate which neither serves to stimulate nor retard economic activity. In late November, Chairman Powell said that the benchmark rate was “just below neutral”.

The response to Powell's comments was immediate and vigorous. The S&P surged 2.3% and the Nasdaq lifted 2.95% in a single session. The bellwether Dow Jones Industrial Average rocketed over 1,000 points in a week. Clearly the market felt that the Fed was being overly aggressive. At present, the fed fund futures market is pricing in a rate rise on December 16 and a 50% plus chance of only a single hike in 2019.

Trump – Scoring at both ends of the pitch

Those arguing that President Trump behaves very badly have a strong case, but those who argue that he doesn't have a coherent policy, do not. The President is a disruptor. He knows little, and cares even less, about global and regional political and economic alliances, which have been underwritten by the US at great cost, to keep the post-WWII and -Cold War peace. A single global power that wants to remain just that, has to pay for the privilege.

Trump represents a more isolationist American constituency, and his voter base has no interest in propping up a world order at its financial expense, nor in the so-called political elites that were its architects. So, he tears up the Trans-Pacific Partnership, threatens NAFTA, rails at NATO allies, encourages the UK to exit the EU and cosies up to despots everywhere. Additionally, he throws the economic textbook out of the window and provides the middle class with significant tax relief in a period of strong growth.

His belligerence is nasty, but the invective he uses galvanizes his supporters, and moreover, generates considerable uncertainty among allies and adversaries alike. And there is usually a kernel of truth to the complaint. A lot of his discourse, as with North Korea and Canada/ Mexico over NAFTA, was for show. He gained precious little out of these confrontations.

But when it comes to China, Trump is somewhat out of his league.

US consumers desperately need cheap Chinese durable goods, often manufactured by US companies in the Chinese periphery. They underpin low US inflation and increase consumer spending, which is about 70% of US GDP. In addition, China is not a currency manipulator. It runs a huge goods surplus with the US upward of US\$360 billion p/a, but it actually does what it can to prop up the Chinese yuan by buying dollars. It holds over US\$1.5 trillion in USD-denominated assets, mostly US Treasuries.

This means that it has tremendous leverage over Trump, such that when the Chinese slapped tariffs on US soya imports, the Trump administration had to channel federal funding to bail out US farmers. Any notion that China could be dumping Treasuries on the market would dramatically escalate Treasury yields and US borrowing costs as a consequence, which the US can simply not afford.

The mid-term elections were a wake-up call. Republicans

enhanced their Senate position, but they had safe seats to defend and in some instances the Democrat showing was strong, as was that party's performance in several gubernatorial races. The outcome in the House turned out worse than initially feared by Republicans, with the Dems winning 41 GOP seats for a gain of 39. Some of the gains were unexpected. Trump lost support among female voters, traditional Republican suburbanites and blue-collar workers in the American rust belt, in the main because of his abrasiveness and undignified style.

Trump's approach, which generally becomes more amenable in a one-on-one context, has apparently softened. The White House trumpeted "an incredible deal" communicated at the recent G20 Summit in Buenos Aires. Markets loved the news. But it was not really a 'deal', merely a cooling-off period during which no additional tariffs would be imposed on top of tariffs already in place.

Trump has identified illegal and unethical Chinese trade practices, which deny US firms easy access to its markets. The complaints should be around forced technology transfer, IP theft and unfair state subsidisation, not really about cheap Chinese exports. Eliminating these practices will take more than gestures of goodwill. It will require China to reconfigure the manner in which it does business.

This is why a satisfactory China trade deal will not be easy to attain, and why markets initially rallied but thereafter tumbled following the G20 announcement.

Brexit - Penalty Shootout

In November, UK Prime Minister May delivered on her promise and reached an exit deal with EU negotiators, which she managed despite a few resignations to get through her cabinet, and which has been ratified by all EU members. The electorate blames May for the failure to secure an acceptable deal. In reality, she was handed a poisoned chalice.

As I write, two weeks have been set aside for debate in the House of Commons, after which a vote is scheduled before the winter recess. The deal is almost certain to fail to pass by a Commons majority. If by January 21, there is no agreed deal, as in a decision with a parliamentary majority, hard Brexit kicks in and the official date of departure is slated for March 29. If May's deal fails, she will fall, and it is highly unlikely that the Europeans will wait for new elections, unless there are signs that a new government will support a second referendum which is arguably not legally permissible and almost certainly not politically doable.

The deal she has managed to strike, while deeply flawed, is absolutely the best deal the UK will receive economically. The EU cannot afford to appear weak in the face of populist secessionists, for fear that it will embolden similar elements elsewhere in the region. The deal provides for an all-UK customs union with the EU at least for now, which implies a continued common external trade policy with uniform external tariffs, and an inability for the UK probably until 2020 or later, to negotiate new trade deals. But a customs union does not guarantee soft borders. The EU has a customs union with Turkey, and that border

is hard. Because the UK exports very few goods to Europe it has every incentive to keep its import restrictions to a minimum to ensure the easy flow of goods along existing supply chains, so I don't envisage problems with the movements of goods. But customs union membership implies a degree of continued regulatory oversight by the EU.

What has principally been achieved is the end to freedom of movement from the EU and the end to future annual membership fees. The problem is that the deal is being pitched to an electorate and a political class that want two diametrically opposed outcomes. For Brexiteers, there are far too many concessions on sovereignty, and for the Remainers, there is far too much potential economic damage.

Emerging Markets – On the back foot

EM's are largely dependent on two factors to lift their economies - a voracious US consumer and the Chinese export sector, which are deeply interlinked. China is an economy in transition. Its leadership understands that to be too wedded to manufacturing and exports, leaves it vulnerable to volatile trade cycles. The Chinese middle class is growing apace and it is hoped that one day domestic demand will surpass trade in importance. This is the road to developed economy status where a domestic market is so substantial. The transition period will be lengthy and there will be bumps along the road.

In Q3 2018, Chinese growth advanced 6.5%, which is still a tremendous pace for such a large economy, but the slowest since the 2008/9 recession. China's economic clout should not be underestimated. It has enormous foreign reserves, and runs a massive trade surplus. Its command economy model allows for very detailed financial planning and tailored outcomes. But the days of China heavy-lifting EM's out of a slump, could well be over.

The EM universe suffered setbacks in 2018. In August/September amid a strengthening USD, Argentina and Turkey ran into dual currency and debt crises. Unlike SA, these countries' currencies are not liquid, and most of their foreign-owned debt is dollar-denominated. Investors became very risk averse towards EM's at this time, and SA suffered because of our EM representative status.

In the end, the Central Bank of Turkey responded to concerns by taking up rates to 24%, demonstrating some independence from its political masters. The crisis ebbed and markets regained some equilibrium. While I did not witness a repeat of the Asia crisis of 1997, the fragility of the global financial system was there for all to see. Turkey is a special case. It is the world's 17th largest economy, and much of Turkey's debt is held on the balance sheets of European banks and central banks.

It has been argued that many EM asset classes and specific markets are 'undervalued'. But as long as the risk of holding such assets is perceived to be unacceptably high in relation to the returns now available in higher-yield developed market jurisdictions, foreign investors will remain wary. It was only in late November that domestically-oriented stocks in EM's began to elevate. But overall in 2018, EM's have grossly underperformed developed markets.



Figure 2: Dollarised returns of various indices and the Stenham Equity Fund (source: Bloomberg)

South Africa – Out of Left Field

The local economy fell into recession again in Q2 2018. The excesses of the Zuma years finally worked their way into the economy. The new President came in at a time when growth was already waning, and underpinned almost entirely by Chinese demand for resources, as well as a sharp rebound in agricultural output thanks to our farmers. But the trade conflict between the US and China, and lower Chinese growth, saw raw material demand slow and prices plateau and then fall, and in agriculture, SA was coming off a much higher base. Manufacturing remained in dire straits, while consumption expenditure proceeded at a glacial pace and business investment flatlined. The concerns ahead of the ANC Elective Conference last December were replaced by 'Ramaphoria', and expectation levels rose unrealistically.

The new President actually took some tough policy and personnel measures to stabilise a deteriorating fiscal situation by bringing in a respected previous Finance Minister (later re-replaced), changing the hierarchy at SARS, and reconfiguring the boards at most State-owned Enterprises, which were haemorrhaging cash. He also tried to restore the integrity of some of our key institutions by altering leadership at the State Security Agency, the Hawks, Crime Intelligence, allowing our courts to get rid of the NPA leadership (just replaced as I write), and letting the Zondo Commission of Inquiry into State Capture dramatise the extent of corruption and weed out some alleged perpetrators.

However, the ANC is deeply divided, and threatened by populist elements united around former-President Zuma. This faction is now being given a voice by the EFF. The President has had to manage these divisions and perceived threats amid an overarching desire to maintain the unity of the Party and ensure the ANC's continued political supremacy.

Policy uncertainty and incoherence, and grave errors such as proposals to amend the Constitution to allow expropriation without compensation and dallying over the business-unfriendly Mining Charter, took their toll on investor sentiment.

Poor governance and outright criminality continued unabated in government. Legal challenges to presidential decisions arose almost daily. In any event, policy and personnel changes take time to work into tangible economic benefits. Political time runs much faster than do economic cycles.

2019 Playbook – Key Themes to Watch

US Monetary Policy and The Dollar

Markets will be Fed-watching again in 2019. By reason of Chairman Powell's 'just below neutral' assertion, the market is factoring in one rate hike in 2019. I think there could even be two. The Fed will not want to appear to be pandering to the markets, which are correcting at present.

This will mean that financial conditions could become tighter than expected, which could derail stocks even more and lead to investors opting for less risky higher yield options instead.

I argue for possibly two rate hikes in 2019 because there is still a lot of debate on the FOMC over where the neutral rate lies. I know it is lower than is the historical norm, but a year ago the consensus was that it was a little above 2%. Now it is closer to 2.75%. In any event, the Fed is likely to take rates above the neutral level because of a certain tolerance of a little inflation, and a desire to have more room to cut rates when the economy reverses. It also fears some Trump policy-induced inflation, and doesn't want to get behind the curve.

The Fed has four meetings in 2019 at which a rate move can be announced alongside economic projections and a Powell press conference. **It will probably leave the fed funds rate untouched in March 2019, but move in June. The critical issue is whether it thereafter moves in September and/or December. If it does, I foresee tougher times for stocks, amid a firmer US dollar.**

In addition, whatever the Fed does, there is simply no way that the current pace of US growth can be sustained. Once the Trump tax cuts have worked through the system, either spent, or part saved and/ or used to deleverage, growth will revert to the 2% range. This will have a direct impact on shares, the valuation for some of which are a little stretched right now.

Brexit and The Pound

May's deal as it stands could be damaging for the UK economy, of which the services sector, some of which is an intermediation mechanism to access the bigger European market, makes up 80%. New trade deals with Europe and the rest of the world will eventually be able to be negotiated after the exit but it will take many years of careful negotiations to iron out. To maintain the soft

Irish border, a backstop has been written in, anticipated to run until it is deemed no longer necessary and tying Northern Ireland to most of the single market rules.

The financial sector comprises 15% of UK GDP, with the City of London alone contributing 11%. This sector stands to be affected because of a loss of passporting rights into Europe. Financial services firms in the UK will now only have the most basic right of access to that market. Agriculture, which annually receives 4.5 billion euros in EU subsidies will now have to be self-funded. And the actual Brexit fee which will pay for all the obligations until the exit plus compensation for losses incurred by members, could run close to 50 billion euros.

The UK government, whichever one it is, will have to manage the transition, and find funds to deal with the effect of the fallout on lower income groups. The trade/current account deficits could balloon, and UK's fiscal position will likely deteriorate. The BoE does not have much room to stimulate.

Unless a second referendum or 'People's Vote' is held or a re-negotiation period with an extended transition secured, sterling should weaken, which could drive the FTSE100, a pound-hedge index.

Euroland

I view the concerns relating to the Italian budget as a little overdone, in fact more representative of broader long-term break-up fears. The populists could have achieved more with less fanfare had they formulated their spending intentions more circumspectly. Remember, it is the backstop German balance sheet that allows Italy to cheaply borrow all those funds needed to keep its welfare system in place. Some measure of compromise has already been offered and differences should be finessed. Under such conditions and amid a weaker pound, the euro could benefit.

Gold

The yellow metal typically does well in circumstances of high liquidity prompting speculation, runaway inflation, and severe financial crises. Its currency counterpart is the Japanese yen. Both assets yield nothing, but are a store of value in very uncertain times. I expect liquidity to continue to be mopped up by the Fed, and for inflation to remain contained. So, the only circumstances in which gold has a future above US\$1,200/oz is a severe global market shock, alternatively a more significant correction than I have hitherto seen in equities. It was instructive that when the October reversal was underway, both gold and the yen strengthened in tandem.

Should the market reversal resume, even deepen, then gold and the yen are favoured plays, and I would always want some exposure in case of a worst-case scenario.

South Africa

The key to 2019 will be the outcome of the General Election. Should the ANC put in a solid showing of 55% plus, and moreover should the President receive a high popularity rating, he would finally be able to say that he has a personal mandate. But the President is not elected directly. He is put forward by the ANC, so it is important that Ramaphosa is able to exert a measure of control over Luthuli House, because it is the ANC secretariat that controls the party lists. The President can choose his cabinet, but only two from outside the rank of MP's. **If all this is achieved, bolder reform initiatives are more likely, the questionable elements in government jettisoned, and the ZAR should respond accordingly.**

I project a better H2 2018 than H1, with growth of 0.8% this year, rising to 1.7% in 2019. I don't see inflation getting over the upper target band (6%) barring a global shock. I will almost certainly not experience a run on the ZAR because 88% of public debt is rand-denominated. I take issue with the SARB raising rates in November (oil price assumptions were too high), but if there are to be rate hikes next year, I do not envisage more than two precautionary moves, with the first quite early on.

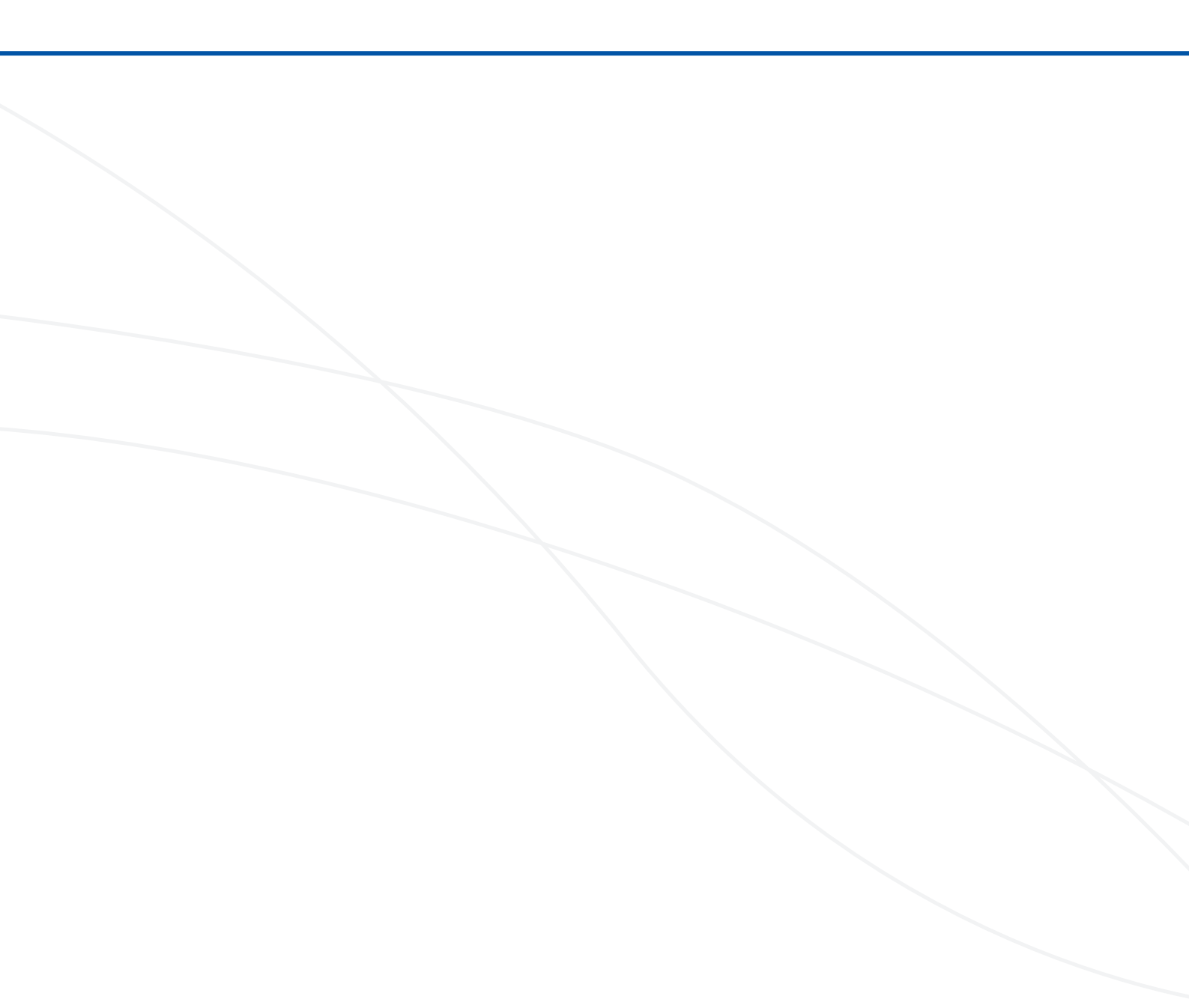
The public wage bill exceeds 35% of the budget and is crowding out spending on welfare and service delivery, debt servicing is the fastest growing line item, and total public debt excluding that of state-owned enterprises, is far too close to the 60% of GDP ratio red line, which generally scares EM investors.

But I think the worst of the fiscal slippage has already been experienced, although with rolling blackouts this might literally be hard to see. SOE's remain the main concern.

It was important that S&P recently kept its outlook for SA 'stable'. Rating agencies are waiting for the 2019 poll and for signs of further fiscal consolidation. Tax collection has improved, the fiscal deficit to GDP ratio will hopefully not get much above 4%, the public expenditure ceiling has been held steady by Minister Mboweni, and I expect business and consumer optimism to elevate off a low base.

I see the rand trading early on in a stable range around a pivot point of R14.20/USD with improvements ahead of the election on a potential CR victory.

**The Quart is adjourned.
'The Judge GPP'**



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