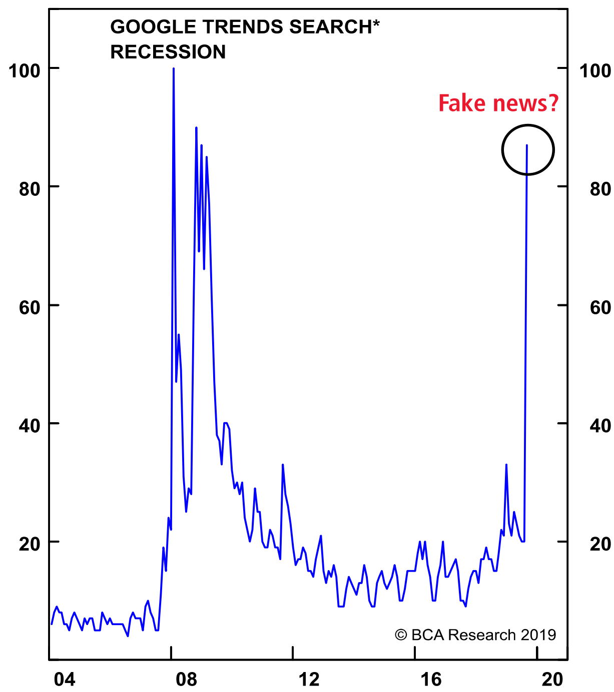
integrity asset management

Market Synopsis – August 2019

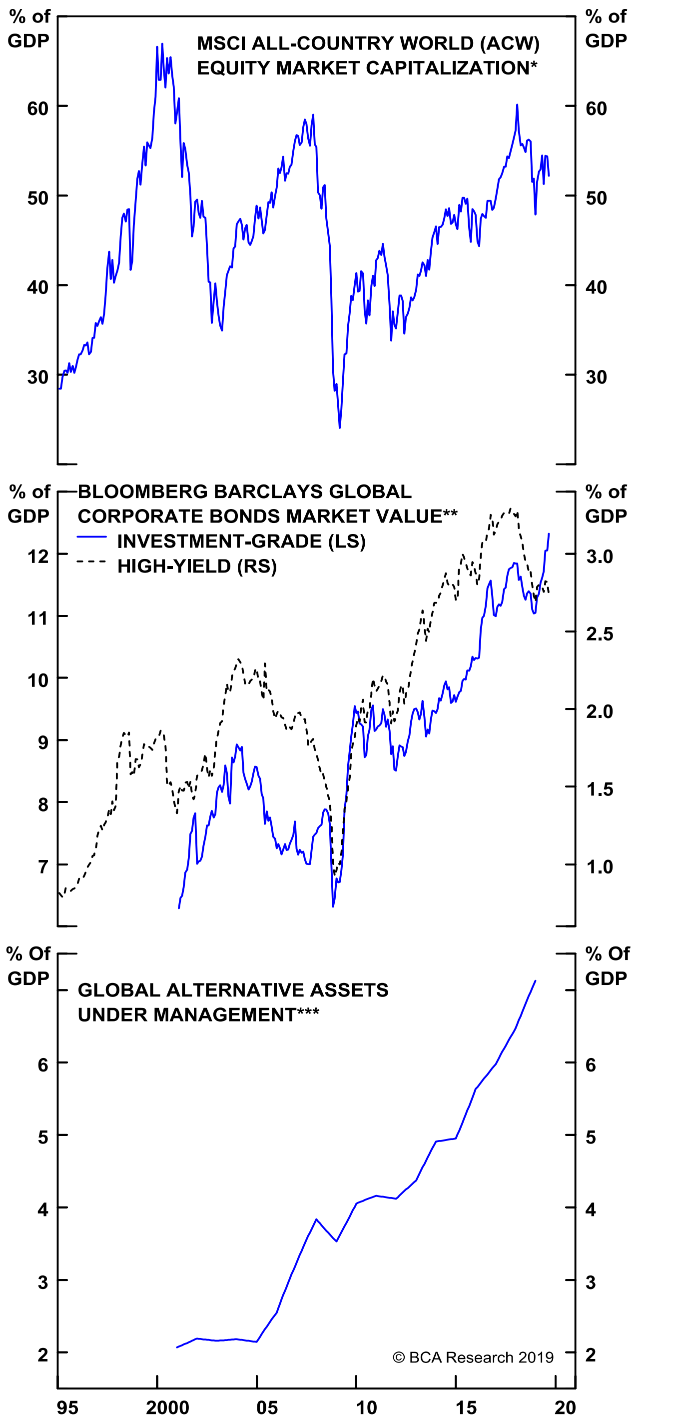
The inversion of the 2 year/10 year yield curve earlier in August caused front page hysteria in the US increasing the public's fear of an imminent recession. This, coupled with turbulent trade war conditions, heightened the risk-off posture of investors leading to significant volatility in risk asset prices. US President Donald Trump ("Trump") turned to Twitter to blame Democrats and "Fake News Media" for the recent downturn in US equities. These remarks, made just a few days after the aforementioned section of the US yield curve inverted, were a feeble attempt to deflect attention away from the trade war, while providing an escape goat for any economic weakness that might occur throughout the remainder of his presidency. But does the larger point still stand? Is a recession around the corner? The recent developments have caused the masses to turn to Google in search for answers. The word "recession" has spiked recently to levels seen prior to the 2008 Financial Crisis. This despite underlying US growth maintaining its degree of resilience throughout the third quarter – see Figure 1. The issue is whether the current angst will lead to an actual recession.



* BASED ON INTEREST OVER TIME, WHERE NUMBERS REPRESENT SEARCH INTEREST RELATIVE TO THE HIGHEST POINT ON THE CHART FOR THE GIVEN REGION AND TIME. A VALUE OF 100 IS THE PEAK POPULARITY FOR THE TERM. A VALUE OF 50 MEANS THAT THE TERM IS HALF AS POPULAR. LIKEWISE, A SCORE OF 0 MEANS THE TERM WAS LESS THAN 1% AS POPULAR AS THE PEAK.

Figure 1 – Surge in Google searches of the word "recession"

A sudden drop in confidence has the potential to generate a self-fulfilling cycle where rising pessimism leads to less private sector spending, higher unemployment, lower corporate profits, weaker equity prices and ultimately, even deeper pessimism. There are two factors based on the current market environment that contribute to the probability of such a vicious cycle occurring. Firstly, the market value of risk assets is elevated especially in relation to the gross domestic product ("GDP") in many economies – Figure 2.



* SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).
** SOURCE: BLOOMBERG BARCLAYS INDICES.
*** SOURCE: PREQIN LTD.
ASSETS UNDER MANAGEMENT INCLUDE PRIVATE EQUITY, REAL ESTATE, INFRASTRUCTURE, PRIVATE DEBT, NATURAL RESOURCES.

Figure 2 – Relative global risk asset value elevated

As a result, any pullback in equity prices or jump in credit spreads will have a significant impact on the sustainability of financial markets. The second factor that may contribute to the probability of a downturn is that policymakers' ability to react to adverse shocks is more constrained relative to past conditions. Interest rates are currently at all-time lows especially in Europe and Japan which are already at zero or in negative territory. Even in the US, the zero lower bound constraint – though softer than once believed – remains a formidable obstacle. Figure 3 shows that the US Federal Reserve ("Fed") has cut rates by over five percentage points, on average, during past recessions which is impossible based on current conditions in the event that the US experiences a major downturn.

Accommodative fiscal policy could help support growth. However, both political and economic considerations are likely to limit the policy response. Despite China currently stimulating its economy, there are major concerns surrounding the excessively high debt levels which has caused policymakers to take on a more reactive, tentative approach.

Japan is set to go against most of its peers by scheduling to raise the consumption tax on October 1st. Although several offsetting measures are in place to mitigate the full impact of the tax increase on the Japanese economy, the net effect will remain a tightening of fiscal policy. Germany has considered launching its own Green New Deal; however, no clear action plan has been set. Additionally, Trump has mentioned the idea of cutting payroll taxes, only to abandon it once it became clear that the Democrats were unwilling to comply.

Despite the aforementioned risks, we maintain our view that the global economy is currently experiencing a downturn in the manufacturing cycle which is expected to have bottomed. The economy should plough ahead for the next 12 to 18 months until a downturn is expected. There are a number of positive factors that one must consider. Firstly, the downturn in global manufacturing over the past 18 months has not transferred to the much larger service sector.

Even in Germany, with its large manufacturing base, the service sector PMI remains above 50 and is, in fact, higher year-on-year. This suggests that the latest global slowdown is more similar to that of 2015-16 than the 2007 -08 or 2000-01 downturns. A further consideration is that manufacturing activity should benefit from a turn in the inventory cycle over the remainder of the year. A slower pace of inventory accumulation reduced US growth by 90 basis points in the second quarter and is set to deduct

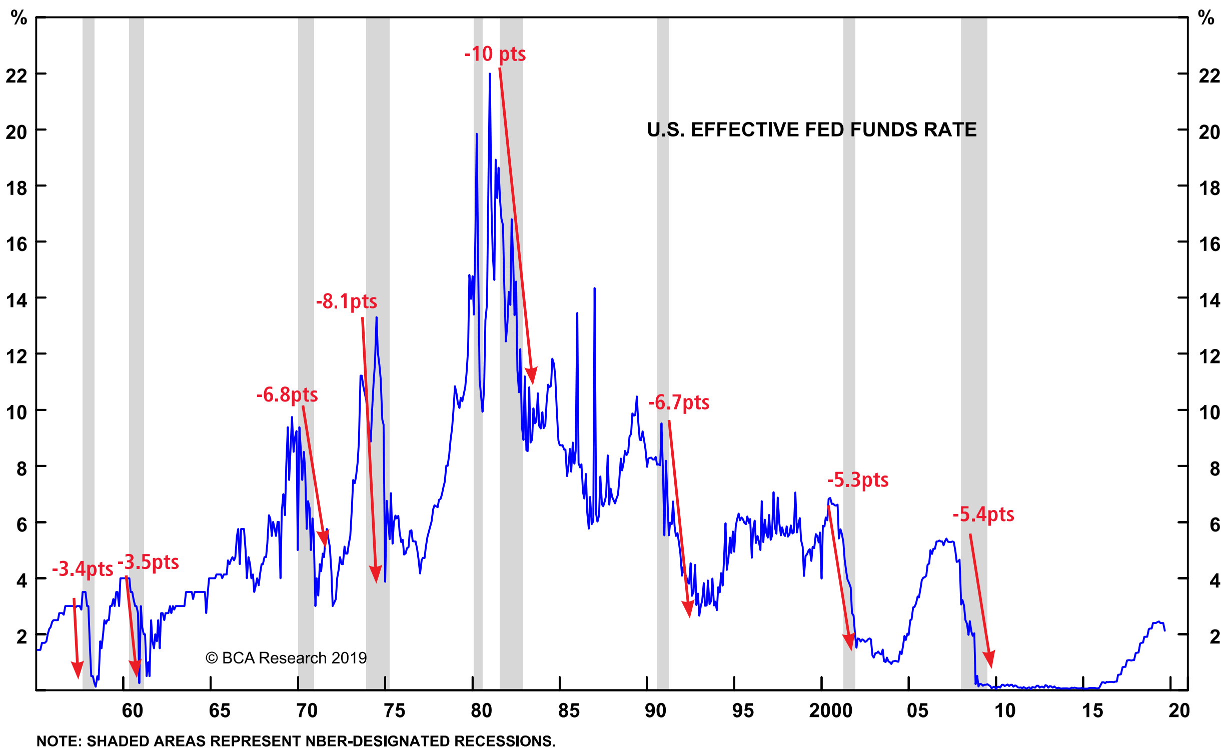


Figure 3 – US historic rate cut cycles

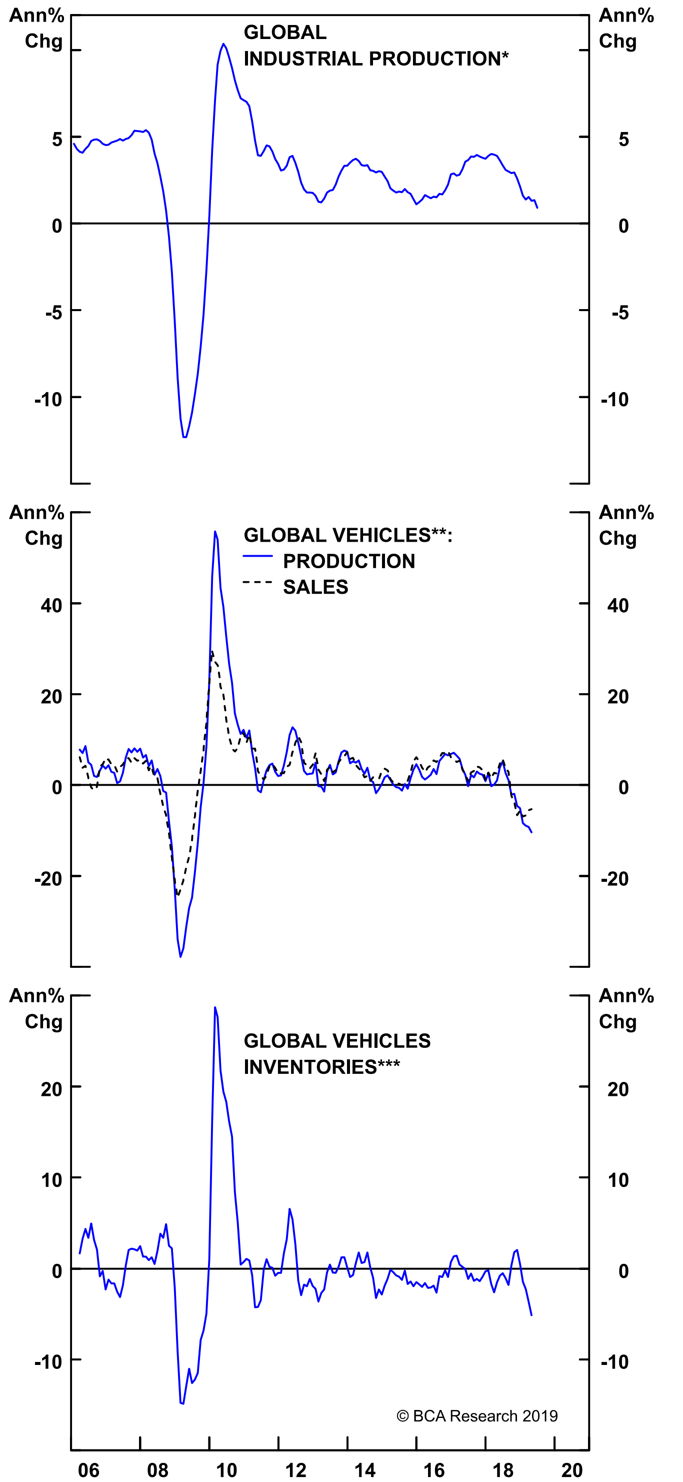
another 40 basis points from growth in the third quarter, according to the Atlanta Fed's GDPNow model. If one excludes inventories, US GDP growth would have been 3% in Q2 and is expected to be 2.7% in Q3 – far from recessionary levels especially given the weak global backdrop.

Looking outside the US, change in inventories is negative and has also detracted from growth. This trend in inventory is inline with what many firms commented in the Markit manufacturing surveys whereby they stated that they are liquidating inventories. Ultimately, falling inventory levels imply that sales are outstripping production, which cannot persist indefinitely.

Additionally, and related to the second point, the automobile sector has been the major contributor to the global manufacturing slowdown. This compared to 2015-16, when declining energy capex was the main driver in the downturn. According to Wards, global vehicle production is down about 10% year-on-year, which is the biggest drop since the Great Recession – see Figure 4. Germany's economy is impacted the most from the significant drop in automobile production which explains a lot of the current weakness.

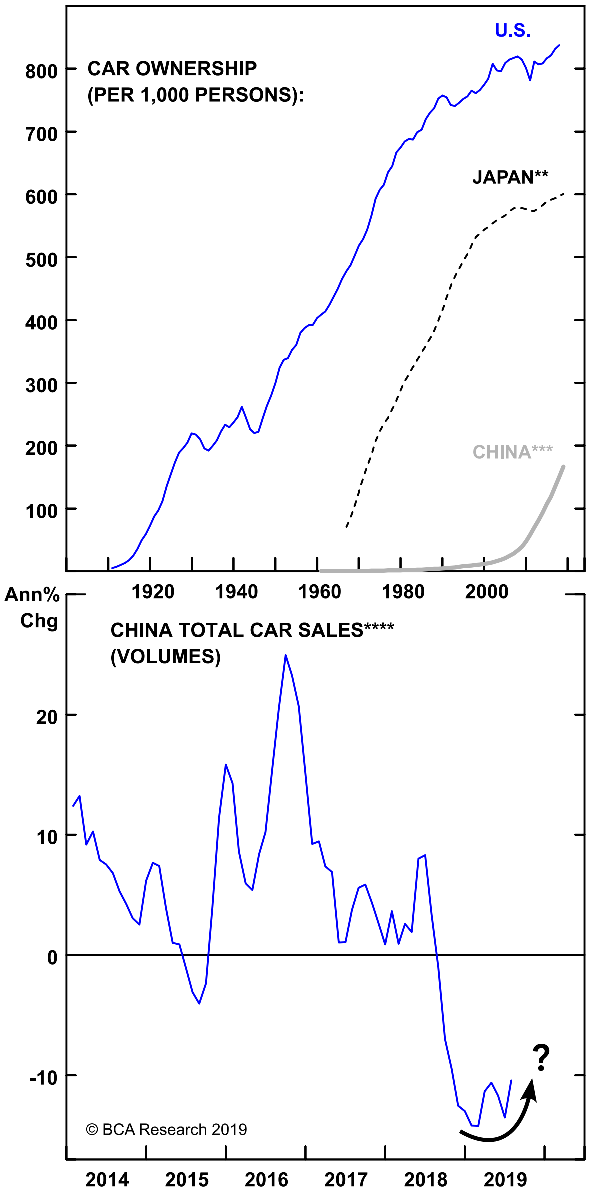
Importantly, motor vehicle production growth has fallen more than sales growth, which explains some of the decline in inventory levels. Despite secular shifts in automobile ownership preferences, there is still significant upside to automobile usage especially in emerging markets. Per capita automobile ownership in China is only one fifth compared to the US, and quarter of Japan – Figure 5 on the following page. This suggests that there is potential for a reversal in Chinese auto sales despite the recent drop.

The anticipated recovery in automobile output later this year, will ultimately lead to the recovery in global manufacturing. One way we expect to capture this turnaround in the automobile sector is with our investment in Daimler AG ("Daimler") and BAIC Motor Corporation Limited. Figure 6 on the following page shows that the MSCI All Country World Autos index, with Daimler being the third largest constituent, is trading near its lows on both a forward price-to-earnings and price-to-book basis and has an attractive dividend yield of nearly 4%.



* INDUSTRIAL PRODUCTION VOLUME EXCLUDING CONSTRUCTION. SHOWN AS A 3-MONTH MOVING AVERAGE; SOURCE: NETHERLANDS BUREAU FOR ECONOMIC POLICY ANALYSIS.
** SHOWN AS A 3-MONTH MOVING AVERAGE; SOURCE: WARDS.
*** PRODUCTION GROWTH LESS SALES GROWTH. SHOWN AS A 3-MONTH MOVING AVERAGE.

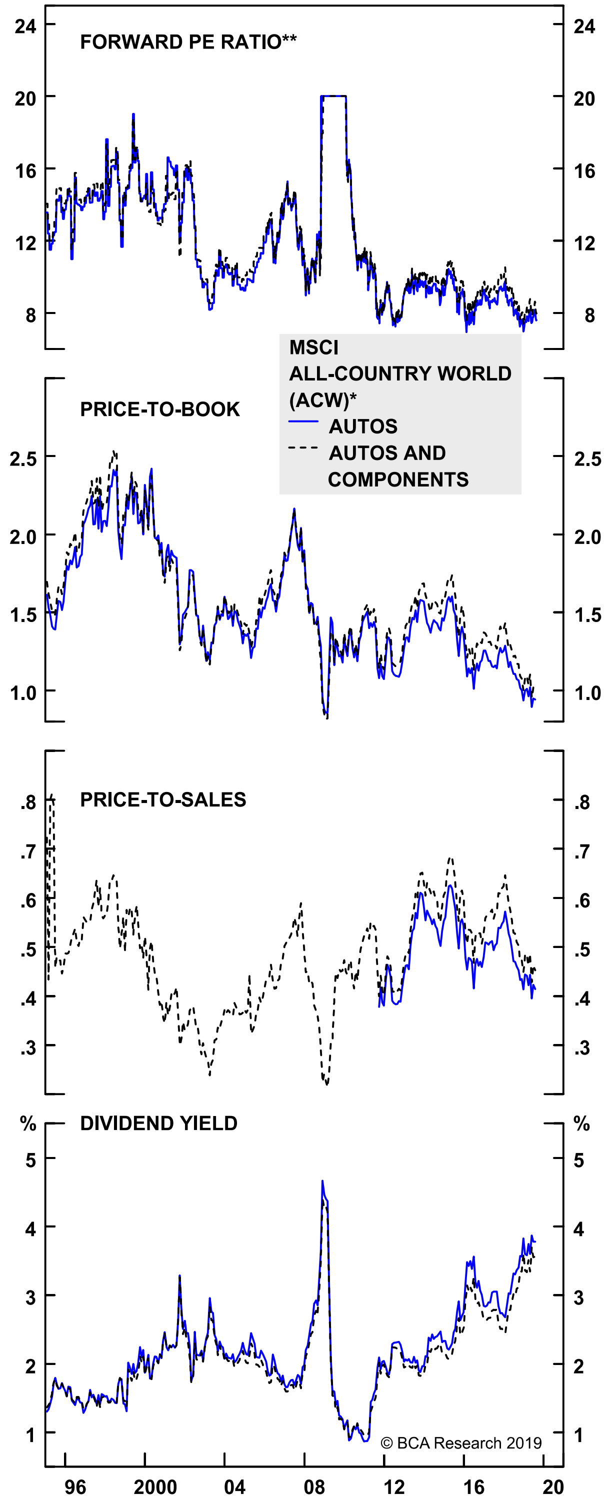
Figure 4 – Global vehicles sales have been a drag on manufacturing



* SOURCE: FEDERAL HIGHWAY ADMINISTRATION AND BUREAU OF ECONOMIC ANALYSIS (BEA).
** SOURCE: JAPANESE AUTOMOBILE INSPECTION & REGISTRATION INFORMATION ASSOCIATION.
*** SOURCE: NATIONAL BUREAU OF STATISTICS OF CHINA.
**** SHOWN AS A 3-MONTH MOVING AVERAGE.

Figure 5 – Chinese automobile ownership rates still have blue sky

Finally, as we have discussed at length in the past, globally the neutral rate of interest is higher than the market currently perceives. As a result, monetary policy is currently stimulative and will only become increasingly so as the Fed and several other central banks continue to cut rates.



* SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).
** BASED ON 12-MONTH-FORWARD EARNINGS, REFINITIV DATASTREAM / IBES DATA. SHOWN TRUNCATED AT 20.

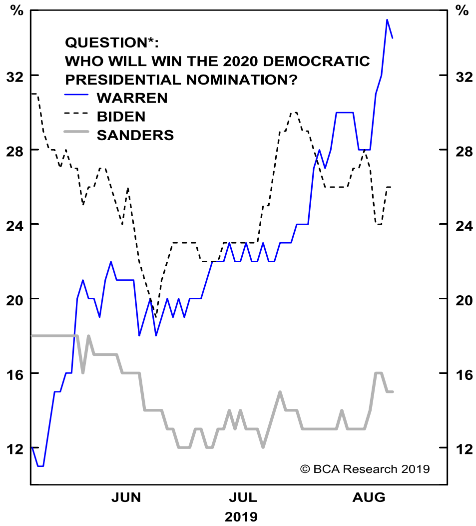
Figure 6 – Global automobile manufacturers show compelling value

The points discussed above will not matter much if the trade war spirals out of control. It is impossible to know what will happen with certainty, but we can deduce the likely course of action based on the incentives that both sides face. Trump has shown a clear tendency in recent weeks to try to de-escalate trade tensions whenever the equity market drops. This is not surprising: Despite his efforts to deflect blame for any selloff on others, he knows full well that many voters will blame him for losses in their investment accounts and for slower domestic growth and rising unemployment. What about the Chinese policymakers? An increasing number of market commentators have warmed up to the idea that China is more than willing to let the global economy crash if this means that Trump would not be re-elected. If this is China's true intention, they will resist making any deal and could even try to escalate tensions as the US election approaches.

Although an intriguing thesis. It is not particularly plausible. US goods exports to China account for 0.5% of US GDP, while Chinese exports to the US account for 3.4% of Chinese GDP. Total manufacturing value added represents 29% of Chinese GDP, compared to 11% for the United States. There is thus no way that China could torpedo the US economy without greatly hurting itself first. Any effort by China to undermine Trump's re-election prospects would invite extreme retaliatory actions, including the invocation of the War Powers Act, which would make it onerous for US companies to continue operating in China. Even if Trump loses the election, he could still wreak a lot of havoc on China during the time he has left in office.

If Trump were to feel that he could not run for re-election on a strong economy, he could try to position himself as a "War President," hoping that Americans rally around the flag. That would be a dangerous outcome for China and the globe. In any case, it is not clear whether China would be better off with a Democrat as president. The popular betting site PredictIt currently gives Elizabeth Warren a 34% chance of winning, followed by Joe Biden with 26%, and Bernie Sanders with 15% – see Figure 7. This means that two far-left candidates with protectionist leanings, who would stress environmental protection and human rights in their negotiations with China, have nearly twice as much support as the former Vice President.

All this suggests that China has an incentive to de-escalate the trade war. Given that Trump also has an incentive to put the trade war on pause, some sort of compromise between the US and China as well as between the US and other players such as the EU, is more likely than not. Provided the trade war does not spiral out of control, we remain of the view that it is likely that global equities and other risk assets will outperform over the next 12 to 18 months. Since it might take a few more months for the data on global growth to improve, equities will remain in a choppy range over the near term, before moving higher later this year and into 2020.



* SOURCE: PREDICTIT.

Figure 7 – Current US presidential surveys

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

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Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 520.30	7.5%	18.5%	26.5%
Brent Crude	60.43	-7.3%	12.3%	-21.9%
USDZAR	15.1954	7.2%	5.7%	3.4%
EURZAR	16.6842	5.8%	1.3%	-2.1%
GBPZAR	18.4686	6.7%	0.7%	-3.0%
JSE All Share TRI	8 261.20	-2.4%	6.9%	-2.6%
JSE Resources TRI	2 988.27	-1.0%	11.0%	5.8%
JSE Industrials TRI	13 915.80	-2.8%	12.1%	-4.0%
JSE Financials TRI	8 851.84	-4.0%	-4.9%	-7.1%
JSE Listed Property TRI	1 860.38	-3.6%	1.0%	-5.5%
S&P 500	2 926.46	-1.8%	16.7%	0.9%
Euro STOXX 50	7 251.62	-1.1%	16.9%	3.8%
FTSE 100	6 602.49	-4.1%	11.0%	1.4%
Nikkei 225	33 262.89	-3.7%	4.7%	-7.5%
Hang Seng	73 973.91	-7.1%	2.4%	-4.4%

Source: Bloomberg, as at 30 August 2019