Market Synopsis – June 2019

Global growth has faltered, more than initially expected earlier this year, and bond yields around the world have thus cratered. German yields have plunged below -0.3% and US yields briefly dipped below 2%. Even if the S&P 500 remains near all-time highs, the performance of cyclical sectors relative to defensive ones is corroborating the implied recession signal from the bond market. Bonds and equities are therefore not as much in disagreement as appears at first glance. To devise an appropriate investment strategy, now more than ever, investors have to decide whether or not a recession is on the near-term horizon. Answering yes to this question means bond prices will continue to rise, the USD will rally further, equities will weaken, and defensive stocks will keep outperforming cyclical ones. Answering no, one should sell bonds, sell the USD, buy equities, and overweight cyclical sectors.

We stand firmly in the "no" camp: We do not believe a recession is in the offing. While the recent growth slowdown has been painful, it is not the end of the current business cycle. In addition, we expect non-US equities to outperform US equities and we are positive on gold equities. Oil prices should also benefit from the upcoming improvement in global growth.

Investors betting on a recession often point to the inversion of the 3-month/10-year yield curve and the performance of cyclical stocks – we have discussed the signal value of the yield curve inversion at length in a previous edition of the Market Synopsis. However, one must also remember Paul Samuelson's famous quip that, "markets have predicted nine of the five previous recessions." In any case, these market moves tell us what we already know: Growth has weakened. We must decide whether it will weaken further. A simple model based on the yield curve slope and the new orders component of the ISM Manufacturing Index shows that there is a 40% probability of a US recession over the next 12 months – see Figure 1.

One needs to keep in mind that in 1966 and 1998, this model was flagging a similar message, yet no recession followed over the course of the next year. This means one must consider the fundamentals of US growth, which we have done in detail in Market Synopsis over the last six months. The summary remains true: The US housing market remains on firm footing. US households are in good shape with real consumer spending growing at above trend pace. The unemployment rate is at a fifty year low and inflation remains benign. Despite these positives, the weak global backdrop can still capsize the domestic US economy. If global growth worsens, the USD will strengthen, quality spreads will widen and equites will weaken. All these factors will result in tighter financial

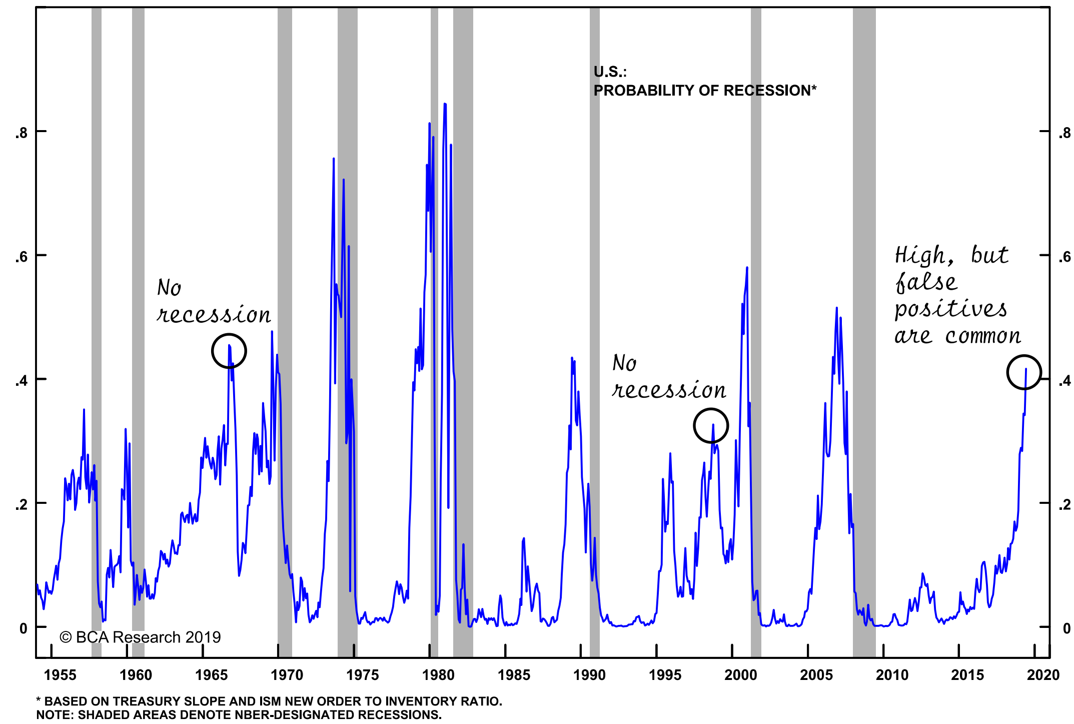

Figure 1: Probability of US recession

conditions. Since economic and trade uncertainty is still high, further deterioration in external conditions will cause US capex to collapse. Employment would follow, confidence will suffer and consumption fall. Global growth therefore still holds the key to the future

As the world's foremost trading nation, Chinese economic activity lies at the centre of the global growth equation. The China-US trade war remains at the forefront of investors' minds. The meeting between US President Donald Trump and Chinese President Xi Jinping over the last two days was important. Trump's relaxation of sanctions against Huawei and the announcement that "we are talking again" are positive. No additional tariffs will be levied on the remaining USD 300 billion of untaxed Chinese exports to the US, but the previous levies will not be meaningfully changed. Removing this USD 300 billion sword hanging over global growth is a positive at the margin. However, it also means that the can has been kicked down the road and that trade will remain a source of headline risk at least until the end of the year.

Trade uncertainty will nudge Chinese policymakers to ease policy further. In previous speeches, Premier Li Keqiang set the labour market as a line in the sand. If it were to deteriorate, the deleveraging campaign could be put on the backburner. Today, the employment component of the Chinese PMI is at its lowest level since the Global Financial Crisis – see Figure 2. This alone warrants more reflationary efforts by Beijing. Adding trade uncertainty to this mix guarantees additional credit and fiscal stimulus.

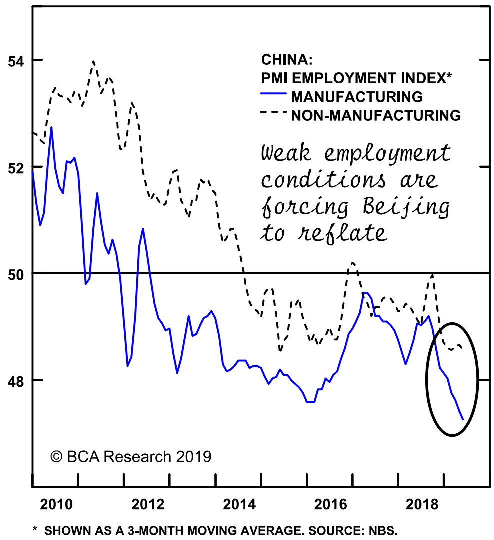

Figure 2: Weak employment forcing policymakers' hand

We are already seeing one traditional signpost that Chinese stimulus is having an impact on growth. Within the real estate investment component of GDP, equipment purchases are growing at a 30% annual rate, a development that normally precedes a rebound in manufacturing activity. We are also keeping an eye out for the growth of M1 relative to M2. When Chinese M1 outperforms M2, it implies that demand deposits are growing faster than savings deposits. The inference is that the money injected in the economy is not being saved but is ready to be deployed. Historically, a rebounding Chinese M1 to M2 ratio accompanies improvements in global trade, commodities prices, and industrial production – see Figure 3. China is, however, not worry free. Auto sales are still soft, global semiconductor shipments remain weak and capex has yet to turn the corner. The turnaround in credit and in the key indicators listed above, however, suggests the slowdown is long in the tooth. In the second half of 2019, China should begin to add to global growth once again.

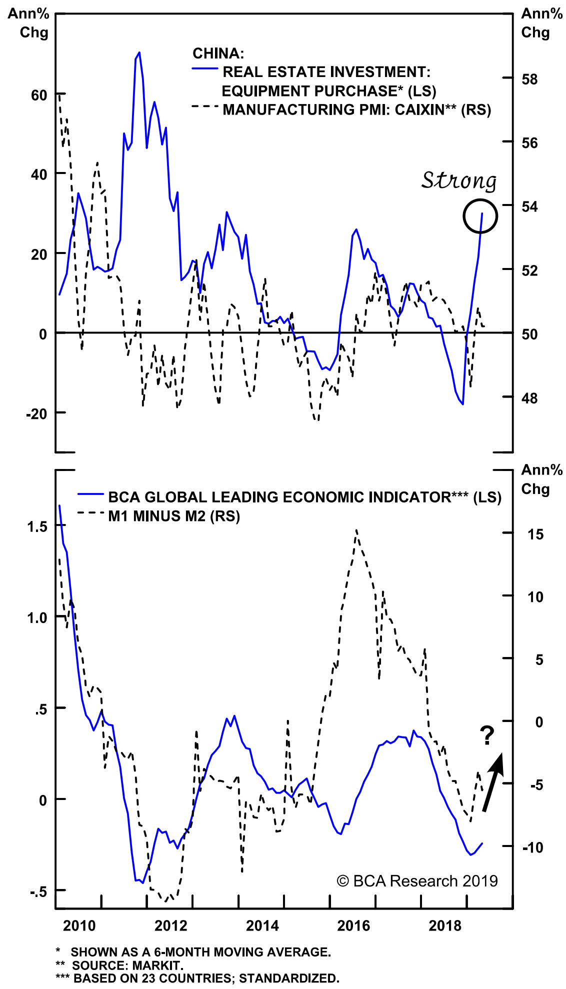

Figure 3: Chinese stimulus bearing fruit

While China is important, it is not the only consideration. Global central banks are running a brand new experiment. It seems they have stopped targeting realised inflation and are increasingly focused on inflation expectations. The collapse in inflation expectations is worrying central bankers – see Figure 4. Falling anticipated inflation can anchor actual inflation at lower levels than would have otherwise been the case. It also limits the downside to real rates when growth slows, and therefore the capacity of monetary policy to support economic activity. Essentially, central banks fear that permanently depressed inflation expectations renders them impotent.

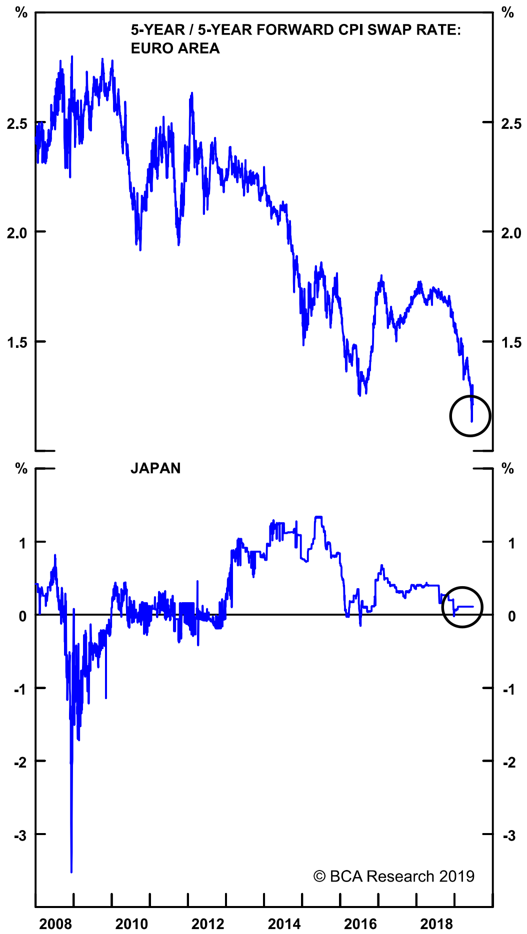

Figure 4: Inflation expectations are dropping

The change in policy focus is evident for anyone to see. As recently as January 2019, 52% of global central banks were lifting interest rates. Now that inflation expectations are collapsing, other than the Norges Bank, none are doing so – see Figure 5. Instead, the opposite is happening and the Royal Bank of Australia, Royal Bank New Zealand and Royal Bank of India are cutting rates.

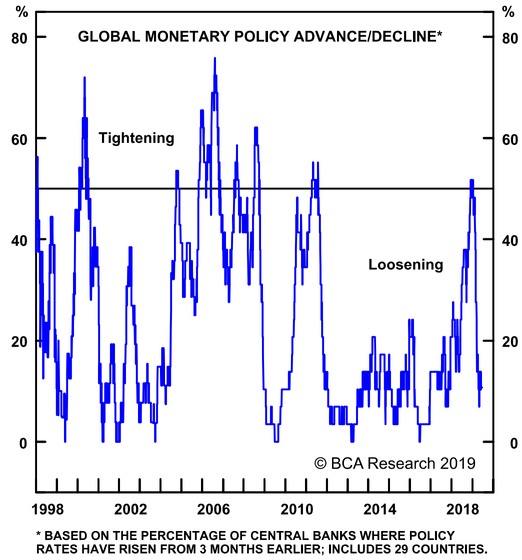

Figure 5: Global central banks markedly more dovish

The European Central Bank ("ECB") stands at the vanguard of this fight. The ECB is aware of the deflationary headwind it faces and knows it needs to act pre-emptively. Four months ago, it announced a new TLRTO-III package to provide plentiful funding for stressed banks in the European periphery. On the 6th of June ECB President, Mario Draghi, unveiled very generous financing terms for the TLTRO-III. Last week, at the ECB's Sintra conference in Portugal, ECB Vice President, Luis de Guindos, professed that the ECB could cut rates if inflation expectations weaken. The following day, Draghi himself strongly hinted at an upcoming rate cut in Europe and a potential resumption of the ECB QE program. With financial conditions in Europe easing and exports set to pick up in response to Chinese growth, European loan demand should regain some vigour. Meanwhile, the TLTRO-III measures, which are easing bank funding costs, should boost banks' willingness to lend. The European credit impulse is therefore set to move back into positive territory this fall. European growth will rebound, and contribute to improving global growth conditions.

The US Federal Reserve ("Fed") did not cut interest rates last week, but its intentions to do so next month were clear. First, the language of the statement changed drastically. Gone is the Fed's patience; instead, there is an urgency to "act as appropriate to sustain the expansion." Second, the fed funds rate projections from the Summary of Economic Projections were meaningfully revised down. The FOMC's unwillingness to push back very dovish market expectations signals an imminent interest rate cut.

Like other advanced economy central banks, the Fed's sudden dovish turn is aimed at reviving waning inflation expectations. In order to do so, the Fed will have to keep real interest rates at low levels, at least relative to real GDP growth. Since the Fed intends to conduct easy monetary policy until inflation expectations have normalised to the 2.3% to 2.5% zone, our liquidity gauges will become more supportive of economic activity and asset prices over the coming two to three quarters.

The pending global economic rebound should provide support for equities on a cyclical horizon. This is particularly true for global (non-US) equities, where valuations are more attractive than in the US. In the above mentioned environment, gold producers are particularly attractive. Central banks are targeting very accommodative policy settings, which will limit the upside for real rates. Moreover, generous liquidity conditions and a falling USD should prove to be great friends to gold. Structural forces reinforce these positives for gold. EM reserve managers are increasingly diversifying into gold, fearful of growing geopolitical tensions with the US. Meanwhile, G-10 central banks are not selling the yellow metal anymore – see Figure 6. This positive demand backdrop is materialising as global gold producers have been focused on returning cash to shareholders instead of pouring funds into capex. This lack of investment will weigh on output growth going forward.

This emphasis on returning cash to shareholders makes gold companies particularly attractive. Gold producers are trading at a large discount to the market and to gold, itself as investors remain concerned by the historical lack

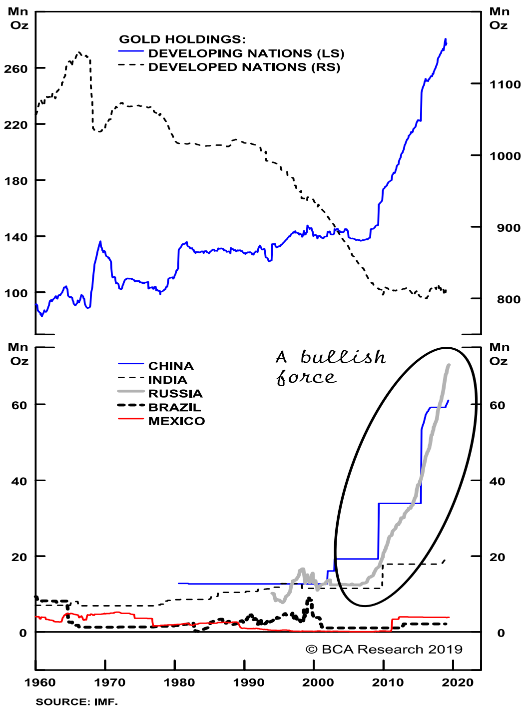

Figure 6: Central bank gold demand strong

of management discipline. However, boosting dividends, curtailing debt levels and only focusing on the most productive projects, ultimately creates value for shareholders. A wave of consolidation will only amplify these tailwinds.

To conclude: After faltering economic activity, we expect Chinese stimulus and dovish central banks to reinvigorate global growth over the rest of 2019 and beyond. Against this backdrop, equities should do well, especially cyclicals. Regional tailwinds are also starting to favour European and emerging market equities. These trends are echoed in our global equity and global flexible funds.

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	1 409.45	8.0%	9.9%	8.5%
Brent Crude	66.55	3.2%	23.7%	-14.2%
USDZAR	14.0869	-3.4%	-2.0%	11.1%
EURZAR	16.0218	-1.6%	-2.7%	8.2%
GBPZAR	17.8824	-2.9%	-2.5%	6.1%
JSE All Share TRI	8 673.20	4.8%	12.2%	7.3%
JSE Resources TRI	3 209.30	10.3%	19.2%	26.0%
JSE Industrials TRI	14 109.65	4.4%	13.6%	1.9%
JSE Financials TRI	9 919.15	1.4%	6.5%	7.5%
JSE Listed Property TRI	1 952.64	2.2%	6.0%	-2.7%
S&P 500	2 941.76	6.9%	17.3%	8.7%
Euro STOXX 50	7 336.82	6.0%	18.3%	4.9%
FTSE 100	6 732.44	4.0%	13.1%	1.3%
Nikkei 225	34 152.83	3.5%	7.5%	-1.9%
Hang Seng	81 449.09	6.7%	12.8%	-2.1%

Source: Bloomberg, as at 28 June 2019

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