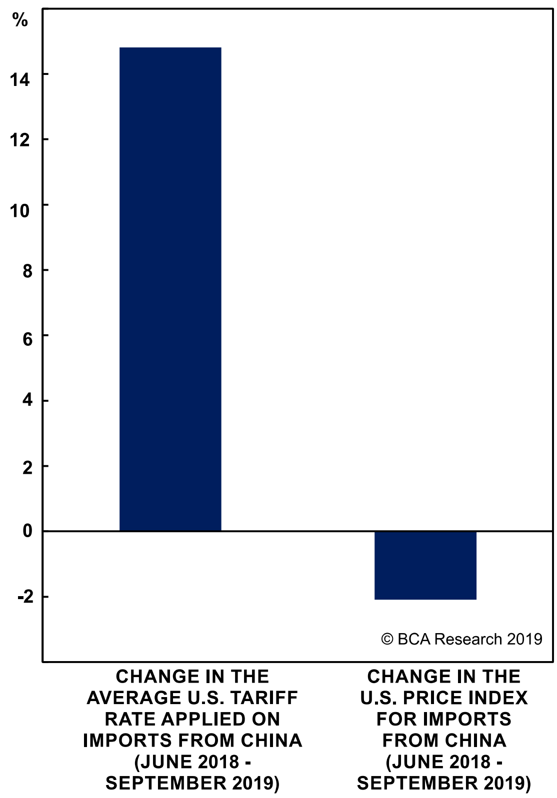
Market Synopsis – October 2019

Global investors have become more circumspect and will only be jarred back into action once the global economic recovery intensifies and geopolitical concerns dissipate. This implies that tangible evidence regarding improving economic momentum as well as the de-escalation of the US-China trade war is required. During the month we received promising news on the latter: China agreed to a number of concessions including the purchase of between USD 40 billion to USD 50 billion of agricultural products per year from the US, improved market access for US financial services companies and enhanced transparency of currency management – all these in exchange for suspending additional tariffs of between 25% to 30% on USD 250 billion of Chinese imports already taxed.

Despite this improvement in negotiations, there is still much more to be done – especially considering that the current phase 1 text, mentioned above, has not been finalised. The self-imposed deadline for concluding the deal is before the Asia-Pacific Economic Cooperation summit in Santiago, Chile during mid-November. There are still a number of issues that remain unresolved, such as how enforcement and resolution mechanisms will be incorporated into the deal. One would thus not be overly pessimistic to expect further delays or even a complete breakdown in talks. The interim deal also raises the question of how intellectual property protection will be incorporated into the negotiations. This will ultimately form part of phase 2 in the overall negotiations and will only occur once phase 1 is completed. Based on the findings of the independent and bipartisan US Commission on the Theft of American Intellectual Property, US producers lose between USD 225 billion and USD 600 billion annually from intellectual property theft. China is considered one of the worst offenders. This remains a significant concern for the US and has been one of the major contributors to the trade war. As a result, substantial progress will need to be made in this regard to ensure that US President, Donald Trump ("Trump"), does not introduce the planned tariff of 15% on an additional USD 160 billion of Chinese imports on the 15th of December.

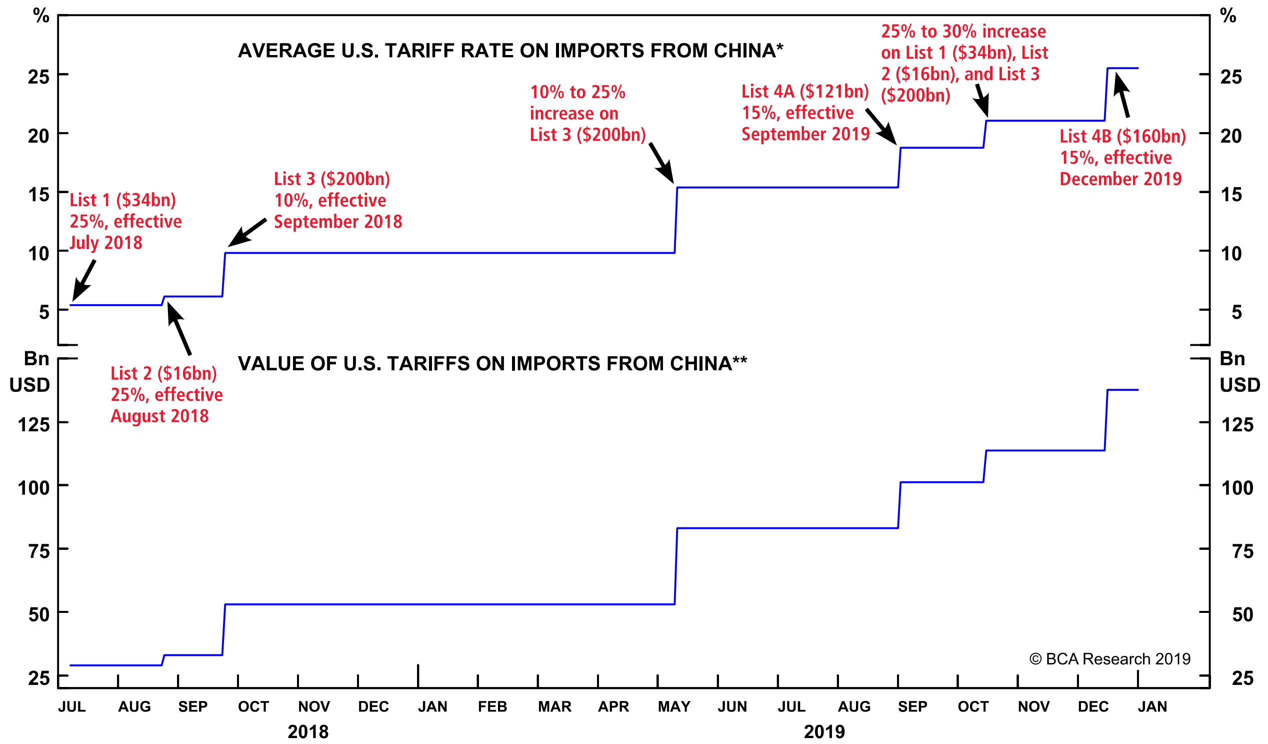
These developments over the last couple of weeks have raised the prospects of a possible ceasefire between the US and China in this turbulent year and a half. Trump has placed his credibility at stake by placing specific focus on his ability as a "master negotiator" and constantly commenting on the "smooth" progress of the negotiations towards a favourable deal for the US. Similar to the United States–Mexico–Canada Agreement, which replaced the North American Free Trade Agreement, Trump will turn his strategic focus towards marketing for his campaign. He will then again broadcast his ability to finalise a new deal on behalf of the America people – this despite the deal placing the country and its trade affairs in almost exactly the same position as before.



SOURCE: CALCULATIONS BASED ON DATA FROM THE BLS AND PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS (PIIE).

Figure 1 – US consumers pay the bulk of the tariffs

From a political point of view, this is the right strategy to follow as Trump has always had a higher regard by US voters for his ability to handle the economy above all else. If the trade war negotiations were to deteriorate, this would negatively impact the US economy and hurt the prospects of Trump's re-election. Despite what Trump says, the burden of the tariffs is ultimately borne by the US consumers rather than the intended targets, Chinese businesses: As seen in Figure 1, US import prices from China have decreased only marginally compared to the significant increase in tariff rates on Chinese imports over the same period. The most recent round of tariffs is placed on Chinese goods which have little competition



* INCLUDES TARIFFS OTHER THAN SECTION 301. UNDER SECTION 301 OF THE TRADE ACT OF 1974, THE U.S. TRADE REPRESENTATIVE INITIATED INVESTIGATIONS TO DETERMINE WHETHER CHINA'S ACTS, POLICIES, AND PRACTICES RELATED TO TECHNOLOGY TRANSFER, INTELLECTUAL PROPERTY, AND INNOVATION ARE UNREASONABLE OR DISCRIMINATORY, AND BURDEN OR RESTRICT U.S. COMMERCE. THE USTR HAS BROAD AUTHORITY FOR A RANGE OF POSSIBLE RESPONSIVE ACTIONS TO MEET THE GOAL OF ELIMINATING OR OTHERWISE RESOLVING THESE UNFAIR PRACTICES, SUCH AS THE IMPOSITION OF DUTIES OR OTHER RESTRICTIONS ON GOODS OR SERVICES.
** CALCULATED USING AVERAGE TARIFF RATE AND 2018 IMPORT LEVELS.
NOTE: CALCULATIONS ARE BASED ON DATA FROM THE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS (PIIE). LAST TWO TARIFF HIKES ARE POSTPONED AND / OR PENDING.

Figure 2 – **Progression of tariffs on Chinese imports**

globally. This will only increase the ability of Chinese businesses to pass through these costs to the consumer. Should all the announced tariff hikes be implemented, the effective tariff rate on Chinese imports would increase from roughly 15% from late August to as high as 25% in December – see Figure 2. The proposed tariffs, if fully implemented, would reduce US household disposable income by more than USD 100 billion. To put this into perspective, this will negate the benefits of the well publicised 2017 Trump tax cuts. Therefore, Trump cannot let the trade war escalate without seriously hampering his chances of being re-elected.

A major risk to a favourable resolution of the trade war is pushback from China on the back of the increased desperation of Trump to finalise a deal. This could lead to the derailment of the trade negotiations if China decides to take a hard-line stance and protract the negotiations past what would be safe for Trump to gain favour in the elections. While this risk is a factor one must consider, there are a number of reasons why it is unlikely to occur: Firstly, despite China's exporters being able to maintain their pricing power throughout the trade war, export volumes have suffered. Chinese export volumes to the US have plummeted by nearly 22% year-over-year in September. Secondly, the crippling sanctions on ZTE have demonstrated that China is highly dependent on US technologies which ultimately gives Trump leverage in the trade negotiations. Lastly, it would be easier for China to negotiate with Trump in this first term in office than in his second. China trying to run the clock in hopes that Trump would not be re-elected was a plausible strategy a few months ago when Joe Biden was the most likely candidate for the Democratic nomination. Since then, Elizabeth Warren has surged in the polls. Should she receive the Democratic nomination it will be no less of a threat to trade matters than in the case of Trump. Ultimately, all these factors push us towards the notion that China will be just as focused towards suppressing trade tensions over the coming weeks.

The cooldown in US-China trade tensions during October was not the only good news to comfort global markets. The risk of a hard Brexit has diminished markedly: Initially with the EU's deadline extension to 31 January 2020 and, more recently, with the call for general elections on 12

December 2019. Throughout the entire Brexit ordeal, there has been insufficient political support within the British ruling class for a hard Brexit. Our conviction has only increased as polling data indicates that there is an increased number of voters that would choose to stay in the EU should there be another referendum – see Figure 3.

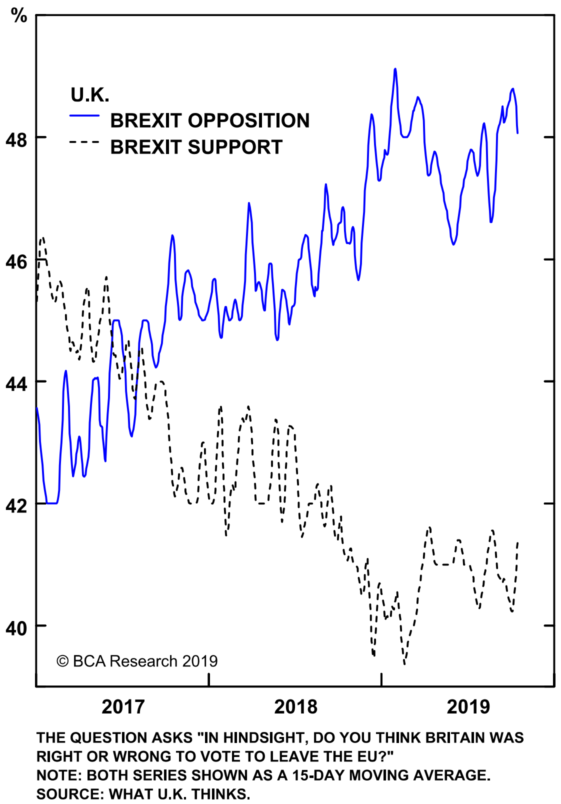


Figure 3 – Voters in opposition to Brexit

Focusing on global financial conditions, there has been a significant tilt towards easing over the past five months, mostly as a result of the dovish stance of many central banks. The US Federal Reserve ("Fed")'s decision to purchase Treasuries will increase USD liquidity which will contribute to easier financial conditions. All this tied in with the ramped-up Chinese stimulus, with both money and credit growth above expectations in September, should lead to a spur in global growth. It is estimated that changes in Chinese credit growth leads global growth by roughly nine months – see Figure 4.

Despite the risks in the global markets, both on an economic and geopolitical level, we continue to remain overweight global equities over the short to medium term. In the end, the direction of equity prices depends on the underlying companies' ability to beat earnings expectations. In the US, earnings season has started with

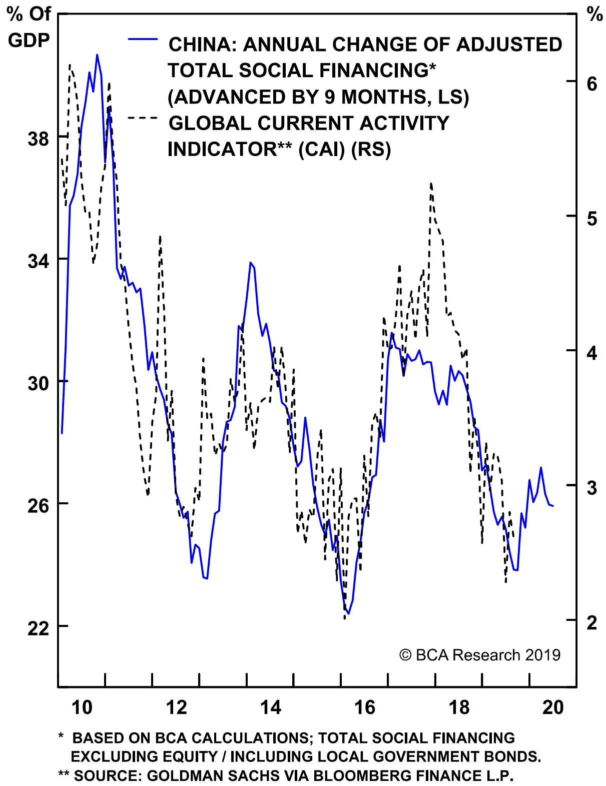


Figure 4 – Chinese monetary stimulus should help global growth

analysts expecting S&P 500 EPS to decline by 4.6% in Q3 relative to the same quarter last year. So far during this earnings season, 83% of the 63 S&P 500 companies that have reported have beaten estimates. This might be indicative that current estimates are probably too grim. Looking ahead, earnings growth should increase as nominal GDP growth accelerates – see Figure 5. European and Emerging Market ("EM") equities generally outperform the global benchmark when global growth accelerates. This due to the more cyclical nature of the companies in these markets. Furthermore, as global growth increases, the USD, being a countercyclical currency, should weaken which will further benefit these cyclical equities – see Figure 6.

Financials should be included as part of the cyclical sector due to their sensitivity to monetary conditions. As global growth improves, long-term bond yields will increase. Based on the current dovish stance of central banks, short rates will remain at current levels which will lead to steepening of yield curves. This will provide a boost to the banking sector's bottom-line as well as equity prices. Furthermore, on a relative basis, cyclical equities are trading at lower levels compared to their defensive counterparts. Additionally, non-US equities are inexpensive

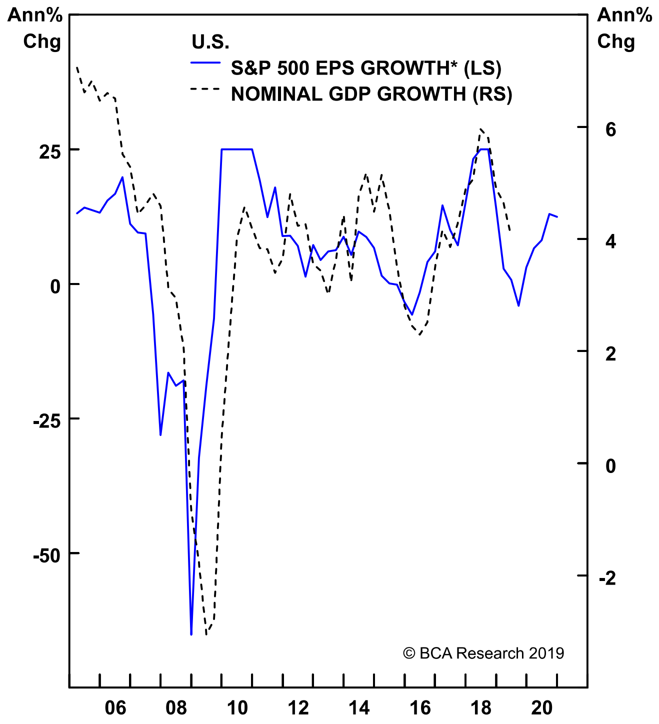


Figure 5 – Earnings growth tied to nominal GDP growth

on a comparable basis to the US especially when factoring in the sector composition differences across regions.

Based on the above, we continue our stance to overweight global equities over the short to medium term. In addition, we have positioned our global portfolios to overweight European equities relative to the US with a view to overweight EMs in the near future.

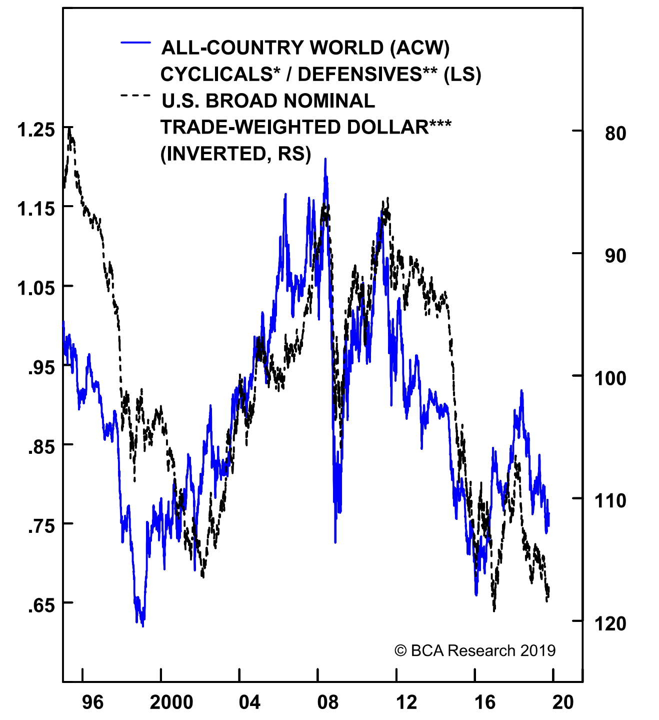


Figure 6 – Cyclical equities outperform when the USD weakens

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	1 495.65	1.6%	16.6%	23.1%
Brent Crude	60.61	-0.3%	12.7%	-19.7%
USDZAR	14.9913	-1.2%	4.2%	1.5%
EURZAR	16.6672	0.8%	1.2%	-0.2%
GBPZAR	19.2878	3.4%	5.2%	2.4%
JSE All Share TRI	8 453.62	2.1%	9.4%	10.4%
JSE Resources TRI	3 152.78	6.0%	17.1%	16.2%
JSE Industrials TRI	13 638.71	-1.1%	9.9%	11.8%
JSE Financials TRI	9 446.00	3.1%	1.5%	5.4%
JSE Listed Property TRI	1 888.04	1.2%	2.5%	0.1%
S&P 500	3 046.77	2.4%	21.5%	12.4%
Euro STOXX 50	7 673.25	1.5%	23.7%	16.4%
FTSE 100	6 746.01	-0.8%	13.4%	7.7%
Nikkei 225	36 969.25	5.0%	16.4%	6.5%
Hang Seng	77 147.53	2.4%	6.8%	10.6%

Source: Bloomberg, as at 30 October 2019