Market Synopsis – September 2019

Global equities are hovering roughly 5% below the January 2018 all-time highs and the S&P 500 is close to breaking out above its July 2019 record. Meanwhile, yields are rebounding and global value equities have sharply outperformed momentum plays over the last couple of weeks. Are these trends durable? Global economic growth remains the key. If economic activity around the globe stabilises and ultimately improves, equities will break out and bond prices will suffer in the coming year. Alternatively, these recent financial market developments will undo themselves. Even though current activity remains weak, the outlook for global growth is looking up despite trade wars, Brexit, Middle East tensions and problems in the interbank market. We therefore continue to favour equities over bonds. If the USD weakens, as we expect, our pro-risk stance will strengthen further.

The US is near the end of a potent mid-cycle slowdown and as a result a recession should be avoided. Current conditions support an improvement in US activity into next year and beyond – this despite key recessionary indicators, such as the yield curve and the annual rate of change of the Leading Economic Indicator ("LEI"), still sending conflicting signals. US growth will intensify because of five fundamental factors that will ultimately push the LEI higher and force the yield curve to re-steepen: A promising housing rebound, robust household spending, a stabilising manufacturing sector, limited inflationary pressures and a pick-up in money and credit trends – we have discussed these factors at length in the past.

In addition, US monetary conditions will continue to support asset prices and worldwide economic activity for at least the next 18 months. The US Federal Reserve ("Fed") will ease policy further and is a long way from tightening. Last week, the Federal Open Market Committee ("FOMC") cut the Fed funds target rate by 25 basis points to 2%. Additionally, while the median projection shows that Fed members expect no more rate cuts for at least the next 18 months, the reality is more subtle. Among 17 FOMC members, 7 expect to cut the fed funds rate by another 25 basis points by year end and 8 foresee a lower policy rate in late 2020. We believe that three 25 basis point rate cuts still remain on the cards for 2019. The Fed remains highly data dependent and is particularly sensitive to depressed inflation expectations. This means the Fed is acutely aware of the danger created by a sudden tightening in financial conditions. If by December the market has not moved away from discounting another cut in 2019, the FOMC will likely deliver this easing. Otherwise, financial conditions could suddenly tighten, which would hurt inflation expectations and the economic outlook. If global growth does not recover in early 2020, the Fed would probably cut rates an additional time in the first quarter, which would validate the current 12-month pricing in the Overnight Indexed Swap curve.

The risks to the repo market created by the combination of the dwindling of excess reserves, the bloated securities inventory of primary dealers financed via repo transactions and the growth in the issuance of Treasuries materialised last week. This resulted in the Secured Overnight Financing Rate ("SOFR") suddenly spiking above 5% last week – see Figure 1. To calm the market, the Fed injected USD 75 billion each day last week starting Tuesday to bring repo rates closer to the Interest Rate on Excess Reserves ("IOER"). But this is not a long-term solution.

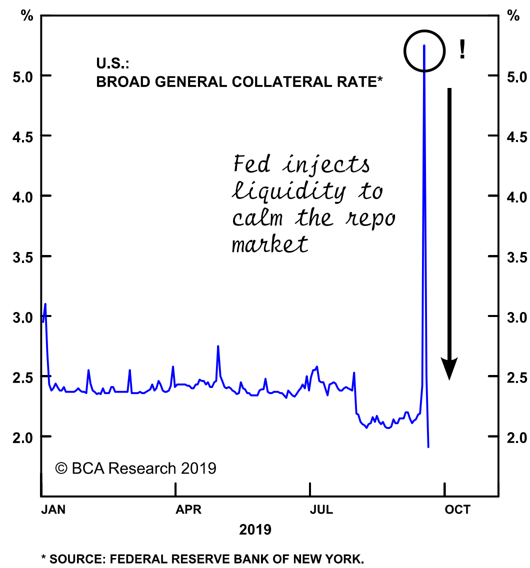


Figure 1 – Market strain in repo market

Paradoxically, the crystallisation of the repo market tensions is good news for the global economy because it will force the Fed to again expand its balance sheet as soon as next month. The supply of funds to the repo market needs to increase permanently, which means that banks' excess reserves must re-expand. Higher excess reserves ease global liquidity conditions. Interbank markets have thus boxed the FOMC into adding welcomed stimulus to the global economy. Allowing commercial bank excess reserves to grow anew which will have a greater positive impact on global growth compared to rate cuts alone.

The liquidity injected will find its way to the rest of the world. The USD trades 25% above its long-term, fair-value estimate of purchasing power parity. A growing fiscal deficit, indirectly financed by a larger Fed balance sheet will therefore lead to a larger US current account deficit, which in turn, will lift global FX reserves. As a result, the Fed's custodial holdings of securities on behalf of other central banks will rise. This implies that global USD based liquidity will stop contracting relative to the inventory of US dollar-denominated foreign currency debt it supports. Higher excess reserves will also ease global financial conditions. By boosting USD-based liquidity, a larger Fed balance sheet will dampen offshore USD interest rates. In addition, rising excess reserves depreciate the USD, which further cuts the cost of credit for foreign entities borrowing in USD. This phenomenon is especially significant for Emerging Markets ("EMs"). Therefore, we should see an easing of EM financial conditions, which are heavily dependent on EM exchange rates. Historically, looser EM financial conditions lead to stronger global growth – see Figures 2 and 3.

While this outlook generally points to a rebound in global growth, which will create a positive environment for risk assets, markets are never a one way street. The situations in the UK, China and Iran, amongst other, should be closely monitored for external shocks to the above view.

Against the above macro backdrop, we maintain our position to favour equities relative to bonds over the next 18 months to two years. As we have shown in the past, equities perform well up to six months before a recession starts. Meanwhile, yields have upside, which implies an outperformance of equities versus bonds. The short-term picture is more complex: P/E ratio expansion was responsible for 90% of the S&P 500's gains since it bottomed on 24 December 2018. US operating earnings are expected to contract for at least eight more months – see Figure 4. If yields increase through the rest of the year, multiples will likely contract. The S&P 500 is thus set to continue to churn over this time frame.

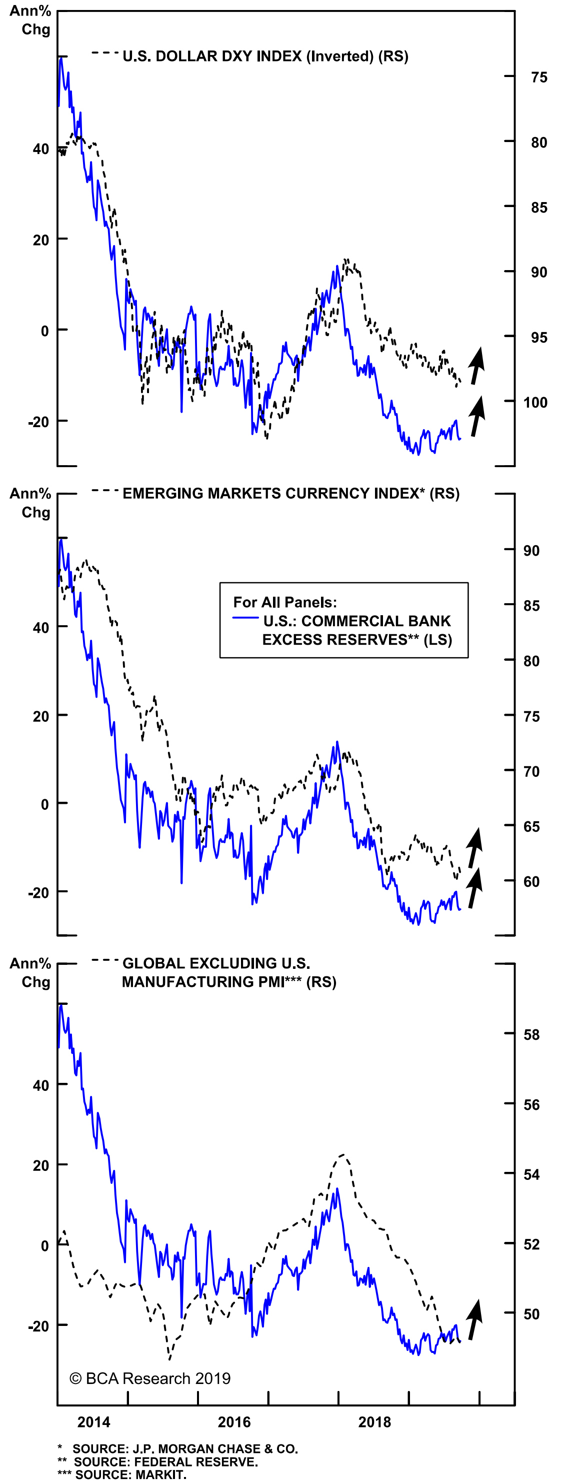
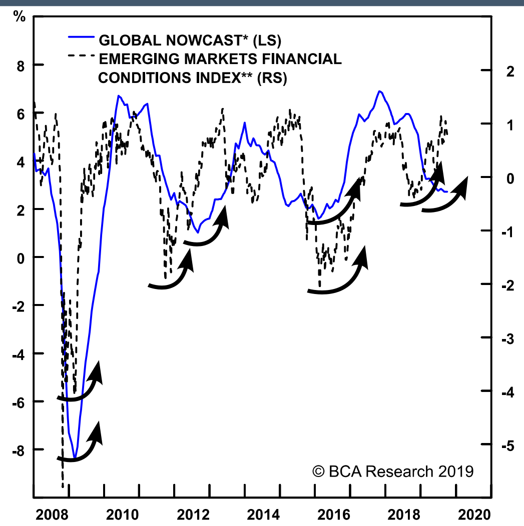


Figure 2 – Increase in excess reserves provides growth impetus

With this in mind, even more than in the recent past, strategy dictates investors focus on internal share market dynamics – this echoes our views articulated in previous editions of Market Synopsis: Equity investors should favour

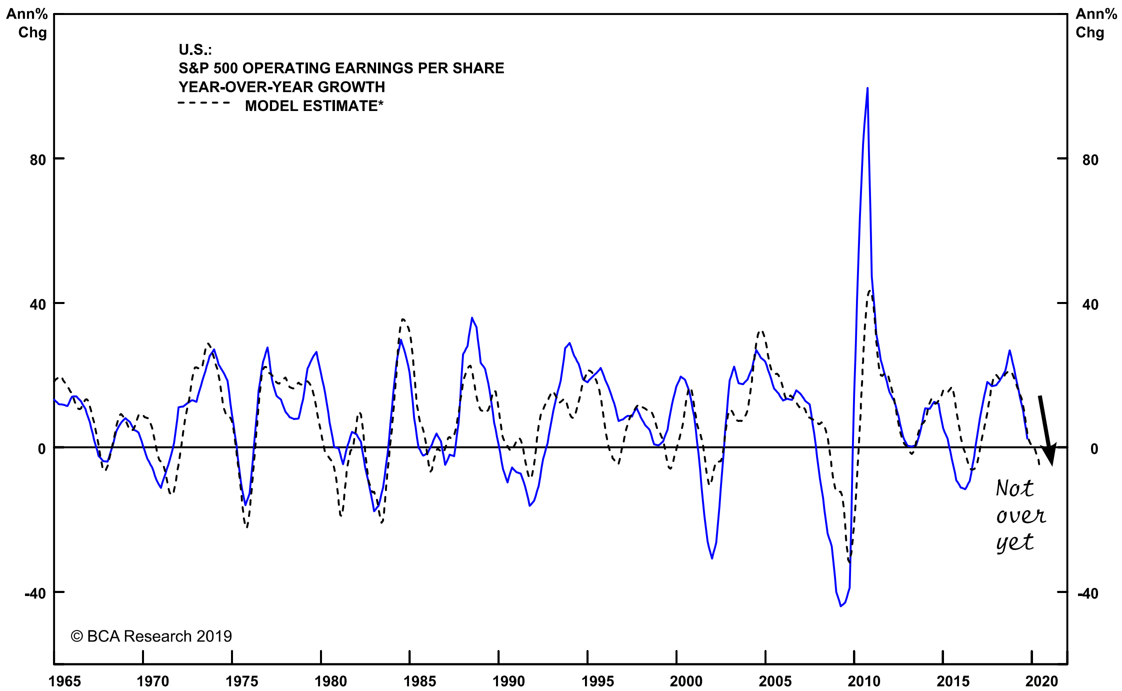


* BASED ON ISM NEW ORDERS-TO-INVENTORY RATIO, U.S. INTERMODAL FREIGHT CARLOADS, U.S. HIGH-YIELD OAS FOR INDUSTRIALS, EUROPEAN BUSINESS CONFIDENCE, JAPANESE BUSINESS CONFIDENCE FOR SMALL/MEDIUM-SIZED ENTERPRISES, CHINESE FINANCIAL CONDITIONS, KOREAN EXPORTS, BALTIC DRY INDEX, GLOBAL EARNINGS-TO-INVENTORY RATIO, AND GLOBAL INDUSTRIALS/CONSUMER STAPLES RELATIVE EQUITY PERFORMANCE.
** BASED ON CDS SPREADS AND TRADE-WEIGHTED CURRENCIES; GDP-WEIGHTED AVERAGE OF BRAZIL, CHILE, CHINA, CZECH REPUBLIC, HUNGARY, INDONESIA, INDIA, KOREA, MEXICO, SOUTH AFRICA, AND TURKEY.

Figure 3 – Easing EM financial conditions to support growth

financials and energy at the expense of technology and healthcare for, amongst others, the following reasons:

- Rising bond yields lift financials' net interest margins. They also negatively impact multiples for technology shares, which carry a large percentage of their intrinsic value in long-term cash flows and their terminal value. Thus, rising yields correlate with an outperformance of financials relative to technology. In addition, financials' valuations are very depressed relative to technology, while comparative earnings estimates are equally undemanding.
- Rising yields also hurt healthcare shares. Additionally, the rising popularity of Democratic progressives like Senator Elizabeth Warren requires investors embed a risk premium in the price of healthcare shares. The progressives want to nationalise healthcare insurance and compress healthcare profit margins from drug makers to hospitals.
- Energy valuations remain very attractive relative to the S&P 500. Energy shares will outperform if global growth recovers and lifts global bond yields.
- These sectoral recommendations argue that investors should favour European relative to US equities. Financials and energy are overrepresented in European equities while technology and healthcare are large overweight exposures in the US.
- Furthermore, European activity is more sensitive to global economic momentum than the US. Thus, when global yields rally and the world economy stabilises, European equities will outperform their US counterparts.
- Additionally, European banks trade at 0.6 times book value which makes them the ultimate value play, one



* BASED ON THE CHANGE IN QUALITY SPREADS, NEW ORDERS, AND THE GAP BETWEEN PRODUCTIVITY GROWTH AND PERSONAL INCOME GROWTH-PER-CAPITA.

Figure 4 – S&P 500 earnings growth to remain under pressure

highly geared to easier European financial conditions and higher yields. These sectoral and regional biases are also consistent with value equities outperforming growth equities.

As is to be expected of an unwavering value manager, these views are expressed in our funds and clients' portfolios, by being overweight financials (banks specifically) and energy shares, whilst being underweight healthcare and technology shares. Regionally, we also remain overweight Europe ex United Kingdom.

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

Tel: (021) 671 2112
Cell: 072 513 2684 / 084 601 1025
E-mail: nic@integrityam.co.za / herman@integrityam.co.za
Website: www.integrityam.co.za

integrity asset management

Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 472.38	-3.2%	14.8%	23.5%
Brent Crude	60.78	0.6%	13.0%	-26.5%
USDZAR	15.1715	-0.2%	5.5%	7.3%
EURZAR	16.5422	-0.9%	0.4%	0.8%
GBPZAR	18.6446	1.0%	1.7%	1.2%
JSE All Share TRI	8 277.02	0.2%	7.1%	1.9%
JSE Resources TRI	2 973.97	-0.5%	10.5%	4.9%
JSE Industrials TRI	13 788.35	-0.9%	11.1%	3.5%
JSE Financials TRI	9 158.47	3.5%	-1.6%	-2.0%
JSE Listed Property TRI	1 866.03	0.3%	1.3%	-2.7%
S&P 500	2 976.74	1.7%	18.7%	2.2%
Euro STOXX 50	7 560.05	4.3%	21.9%	7.9%
FTSE 100	6 798.42	3.0%	14.3%	3.2%
Nikkei 225	35 207.83	5.8%	10.8%	-7.8%
Hang Seng	75 357.61	1.9%	4.3%	-2.7%

Source: Bloomberg, as at 30 September 2019