FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

18 October 2019
Volume 1026

Conversations with clients

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There are five topical market issues that we have provided responses to, that we hope you could use in your conversations with clients. These issues are trending currently, and we hope that the responses will help to enhance your knowledge of what's happening on the global and local investment landscape. The talking points are as follows:

1. Chin up, the rand has been OK.
2. New support for precious metals.
3. You have one million rand. Do you invest in US cash or SA bonds?
4. Recession around the corner? Maybe not.
5. The real victims of the trade war.

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Chin up, the rand has been OK

The US dollar is the reserve currency of the world. It's understandable, then, that when we talk about the rand's performance, we do so in relation to the greenback. But this shouldn't always be the case.

We invest offshore because we want two things:

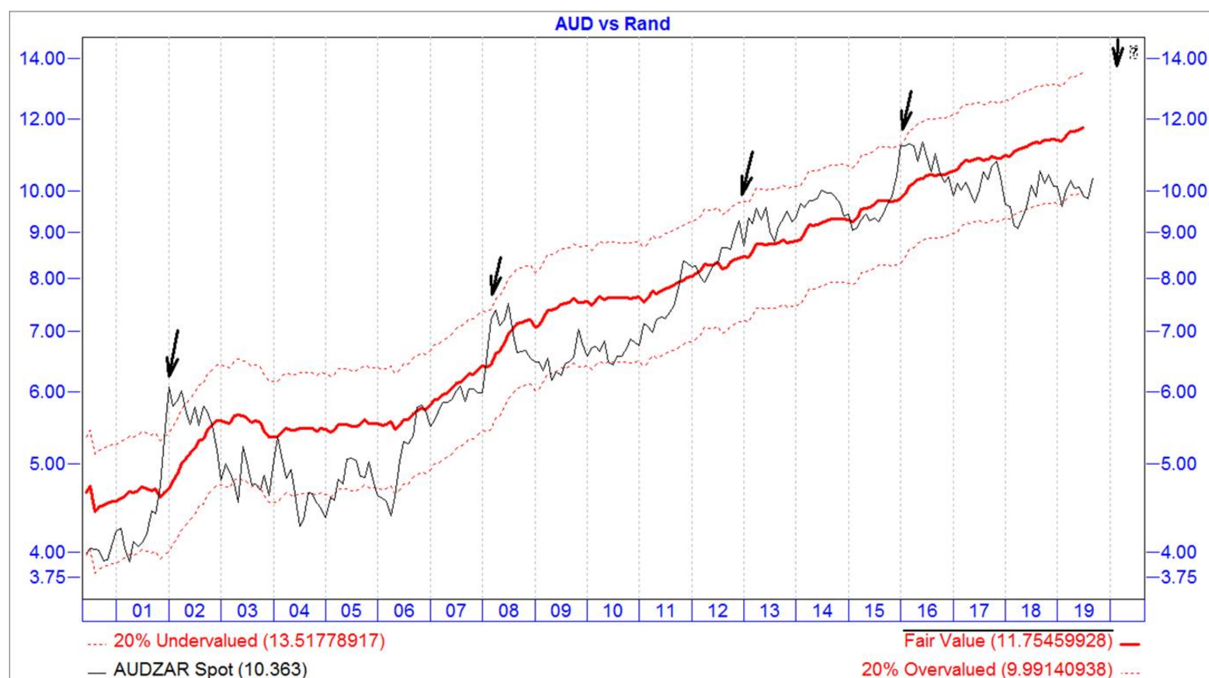
1) diversification, and

2) protection against a depreciating rand.

The US is not the only destination that offers these outcomes. This is important because right now, the US dollar is a very, very expensive currency. And if it enters a period of weakness, the returns from any investment domiciled in US dollars (cash, bonds, equities) will suffer. So, what are the other options available?

The first case is quite extraordinary. As a start, let's explore how the rand should have behaved versus the Australian dollar. Since the beginning of 2016, our inflation has been roughly 3,5% higher, per annum, than that Down Under. This means that the rand should have depreciated by a double-digit figure to maintain purchasing power parity equilibrium. It hasn't.

In fact, from 1 January 2016 to the end of September 2019, the rand has appreciated by 9.1% against the Australian dollar, and more than 20% if you want to work in real terms.



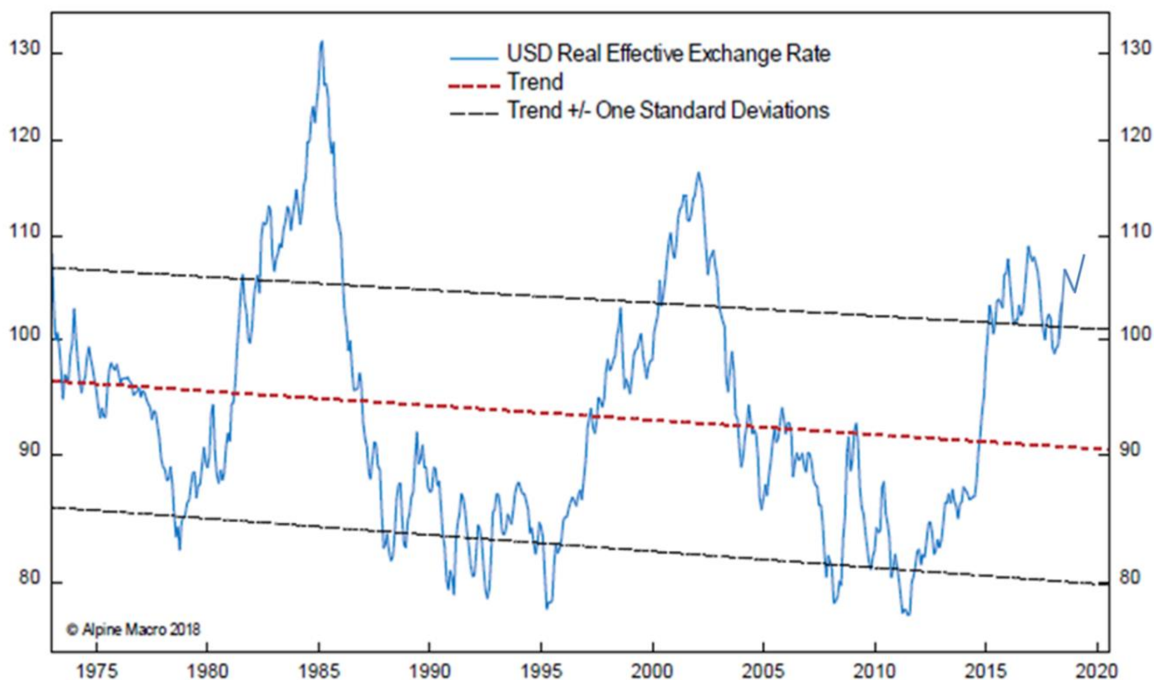
Source: INet, Obsidian Capital, October 2019

However, don't let nominal versus real appreciation confuse the message. The point is that while we cuss about our country, our currency has outperformed that of a very well-managed first world one. In our estimation, our currency has been stronger because the prices of the commodities we export have been stronger than those of the commodities that Australia ships.

So, why not buy Australian dollars, instead of US dollars, and remove some of the risk that the rand strengthens materially against the currency you've bought?

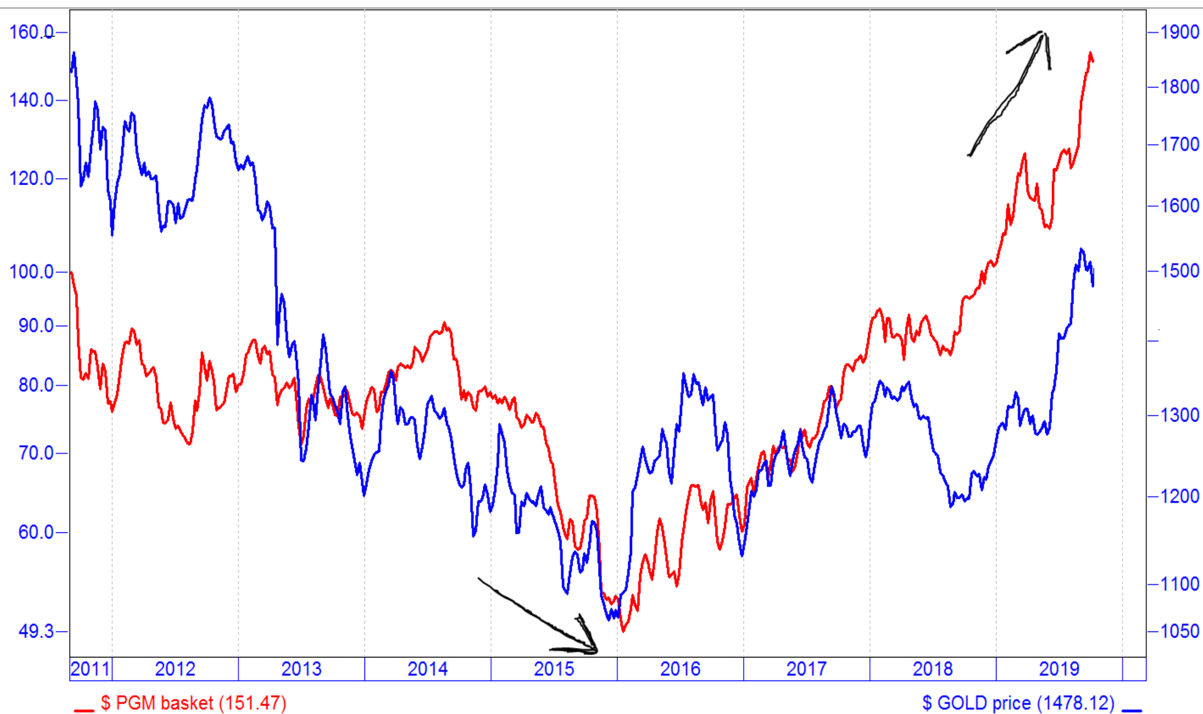
If you look at the same analysis of the rand against the pound and euro, the conclusion is similar but not quite as appealing; the rand currently trades at around fair value for both. The point to take to your clients is that if they want to take money offshore, there are safer options than the expensive US dollar, which from its current valuation, has the potential to weaken meaningfully.

But, we hear you ask, does the US dollar ever depreciate? A falling blue line in the next chart illustrates periods where the US dollar did just that. No currency goes up forever.



A new support for precious metals

Our domestic resource shares, particularly those that mine platinum and gold, have shone brightly on a rather dark investment return landscape. However, their strong performance has been, well, strange. The extent of their impressive v-shaped recovery is visible in the next chart.



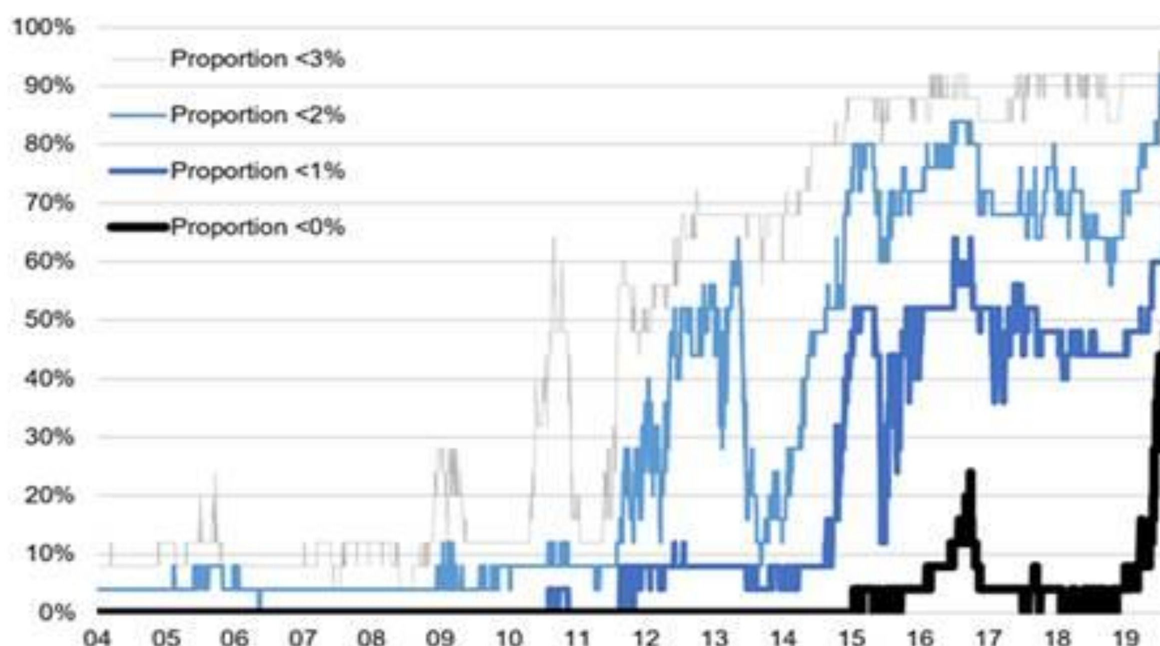
Source: INet, Obsidian Capital, October 2019

We say *strange* because global trade and manufacturing have slowed materially since early 2018, which is usually not a good environment for commodities. As an example, when we entered a similar manufacturing recession in 2015, we could not find a commodity, precious, bulk, or soft, that was on the up.

Initially, we rationalised their surging prices by highlighting their idiosyncratic supply-side constraints. As we've come to learn over the years, when a commodity price runs, demand is often in the wings. So, why would people be buying these precious metals hand over fist?

The traditional explanation would be that people are buying gold as a hedge against risk. We have much sympathy for this view. But this asset class might also be finding support from another, more unconventional source – beleaguered bond investors.

Of all the 10-year government bonds in issue around the world, half of them have negative nominal yields (see chart below). Said another way, half of the investors who own these bonds are happy to pay the people that have borrowed from them. If anyone knows where we can sign up to get paid for borrowing money, please forward us the details and don't worry if you don't hear from us again, we're just fine.



Gold doesn't grow, nor does it offer a yield, but once you own it, you don't have to keep paying the person you bought it from. This is the reality you must stomach when owning a negative yielding bond. We are warming to the idea that investors looking for safe-haven type assets may now be choosing precious metals over bonds because of the skinny investment case for the latter.

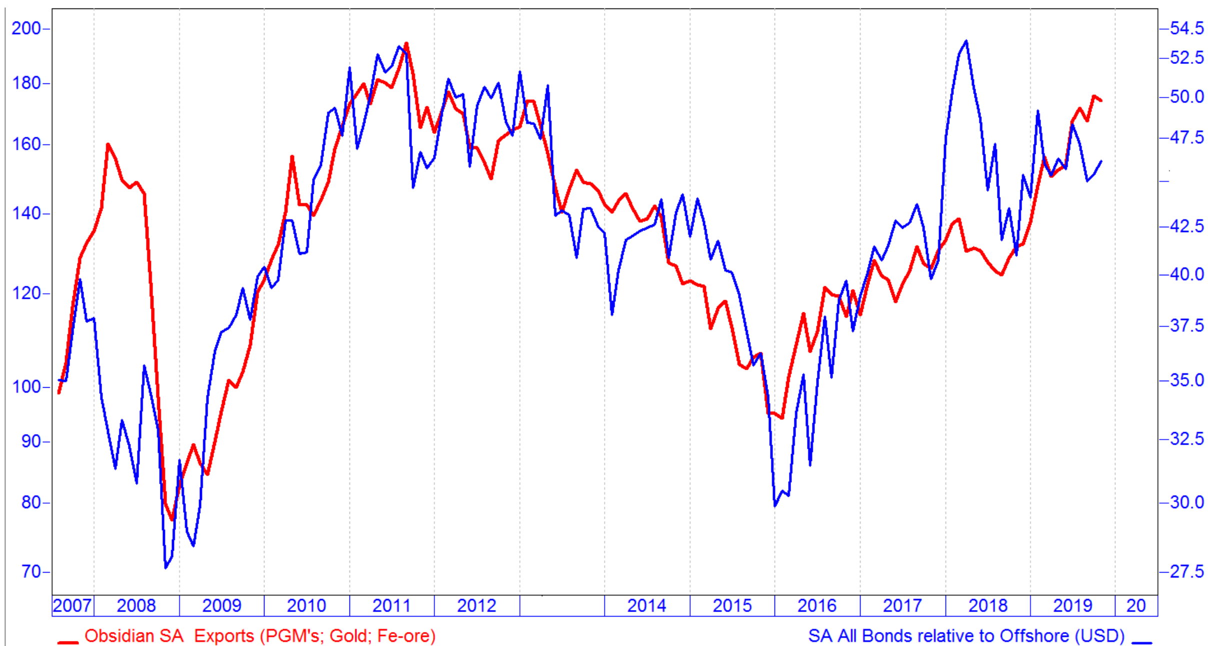
You have one million rand. Do you invest in US cash or SA bonds?

We've given you a large hypothetical amount because it sharpens the mind. And because we could all use a confidence boost, even if it's make-believe. Assume that these are the two asset classes you must choose between. Here is the supporting case for our bonds:

- their real yields (nominal-inflation) are some of the highest in the world;
- global asset allocators need yield, emerging market bonds will benefit;
- our inflation – the most fundamental driver of bond returns – is well contained;
- global growth is slowing, providing an environment where bonds usually perform well.

Yes, our country has fiscal challenges that could threaten the case for our government bonds, but in the absence of a pending default we believe those risks will remain parked for now.

If our punchy bond yields have benign inflation as a companion, we think the demand for this asset class will remain strong. The next chart provides graphical evidence of this.



Source: INet, Obsidian Capital, October 2019

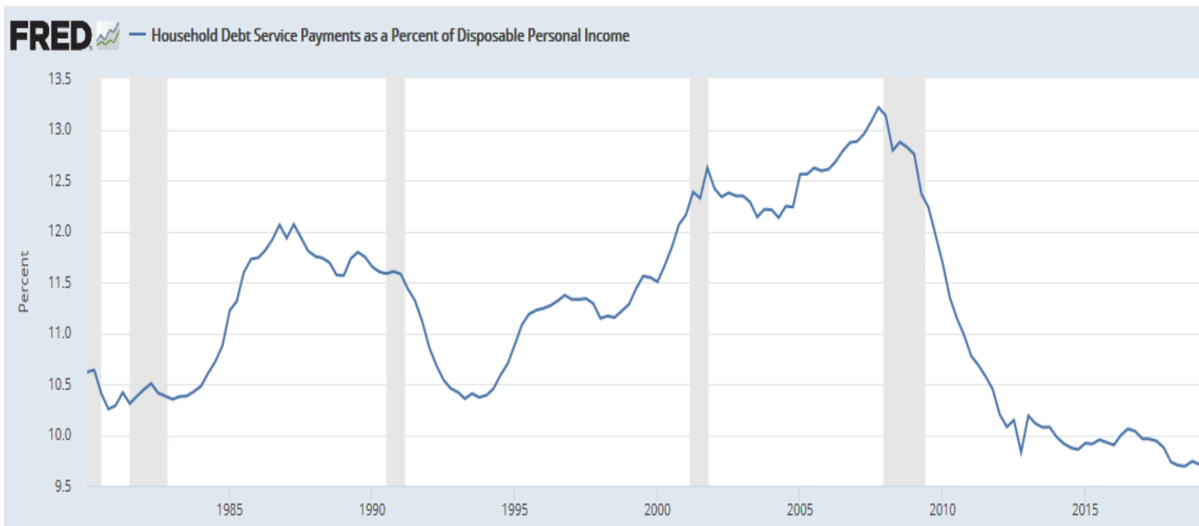
The blue line is the relative performance of the SA All Bond Index (ALBI) versus an investment in US dollar cash; when the blue line trends up, you're making more money in SA bonds than in US cash. The red line represents the prices of commodities that South Africa exports.

A rising red line is very important for the health of South Africa's finances. It usually supports the rand, which helps to control inflation, which is good for our bonds. If our commodity export basket continues to rise, it is likely that our bonds will be a better investment than US cash.

Recession around the corner? Maybe not.

An inverted yield curve and weak manufacturing data has heightened fears about a recession in the US. Under such a scenario, you'd want to overweight bonds in your portfolios to protect your client's capital.

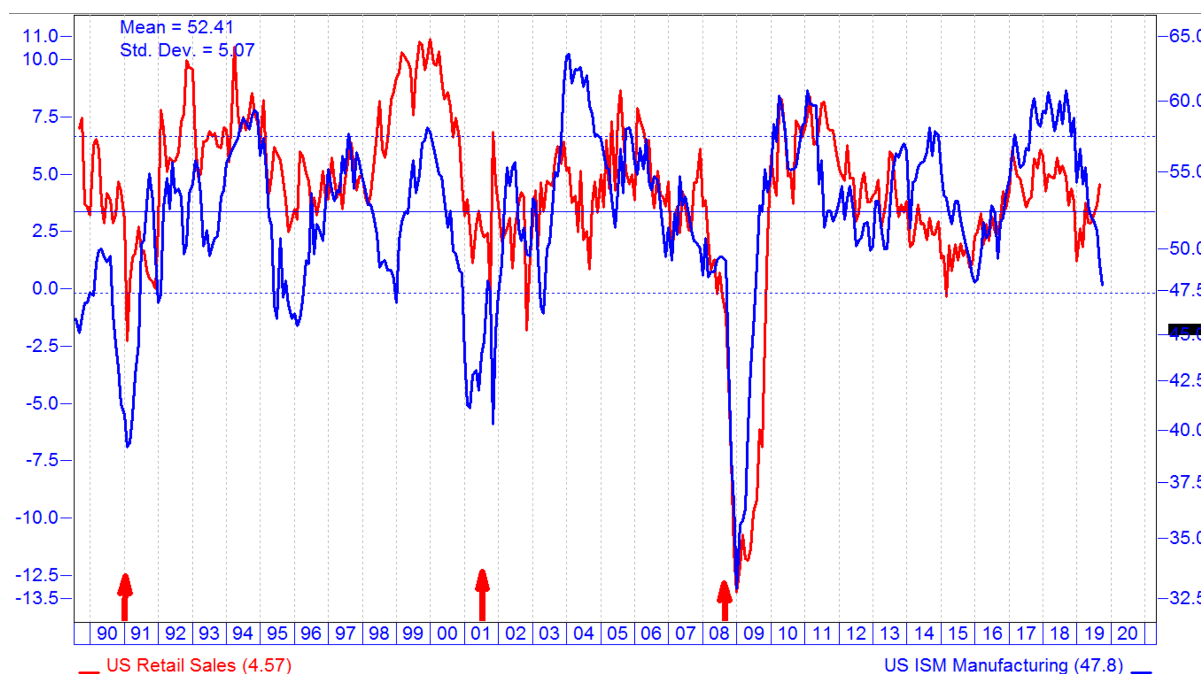
The conundrum here is that US consumers (and their counterparts in Europe) are financially healthy, confident, employed, and spending – not exactly the state that drags an economy into recession. The next chart shows what percentage of disposable income is needed to service household debt in the US. It's currently at 40-year lows, and well beneath the levels that preceded previous recessions.



The reason an inverted yield curve creates so much angst is that it usually happens when inflation is rising, and the FED is forced to raise short-term interest rates to get the consumer to pull back on their spending. Once the consumer stops spending, businesses drop production, and a recession ensues (oversimplified, but you get the idea).

But the recent inversion happened largely because of a drastic fall in the long-end of the yield curve, rather than a big rise in the short-end. As a result, we believe the consumer has not been put under pressure like they were at previous inversions. In fact, falling long bond yields – from which mortgages interest rates are priced – have allowed the consumer to refinance their home loans at cheaper interest rates, giving them even more capacity to spend.

The sharpest measure of consumer health is retail sales growth. In the next chart you can see how this indicator has climbed steadily through 2019, despite US manufacturing falling sharply. If the red line continues to drive higher, manufacturing should naturally pick up to meet the demand.

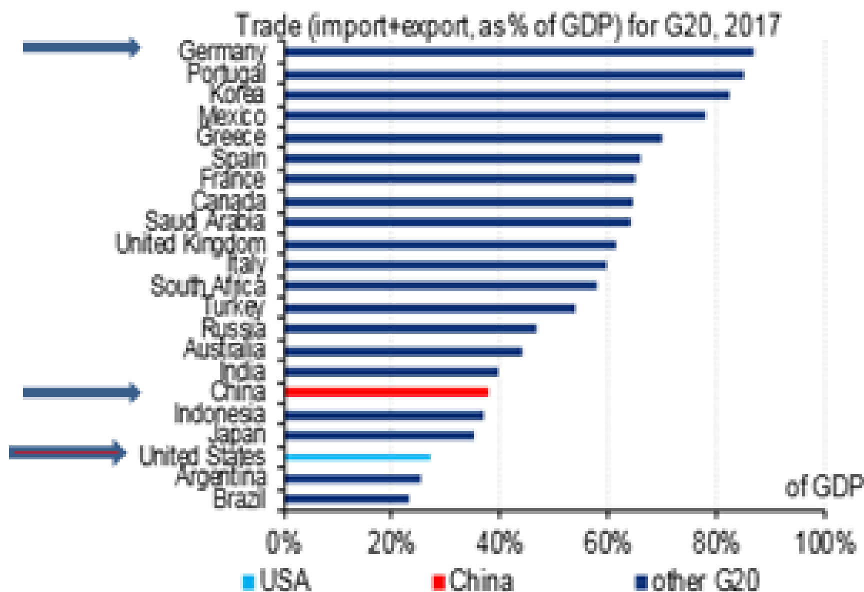


Source: INet, Obsidian Capital, October 2019

The conclusion here is that recessions don't usually happen when consumers are still spending. This picture could change if interest rates were to move up quickly, or consumer confidence was to fade. The former looks unlikely in the short term because central banks have turned dovish in the face of slowing global manufacturing, the latter could suffer if the trade war intensifies.

The real victims of the trade war

The picture most of us have of China's economy is that it's primarily an exporter of goods. So, as Donald no doubt schemed, impose tariffs on their exports and they should suffer, right? Turns out their economy is not what it used to be. The next graphic illustrates the 'openness' of several economies, i.e. how sensitive their economic fortunes are to the level of global trade.



The most open economy, as measured by imports + exports ÷GDP, is Germany, with more than 80% of their gross domestic product reliant on trade. China has migrated down this list in recent times to a point where less than 40% of their GDP is trade-reliant. The US sits at just under 30%. The point is that China is not just an exporter; they now have consumers that drive their growth, just as the US does.

The result of this is that, despite them being the warring parties, their economies are not the most vulnerable to the slowdown in trade they are causing. While they go hammer and tongs, they're wreaking collateral damage on other, more open economies.

Theoretically, they could push other economies into recession (Germany's industrial production is already contracting by 6% compared to a year ago) before they themselves reach that point. Luckily for everyone, there is an important election next year to consider that may temper The Donald's will to deepen the trade war.

In summary

The rand has only really been weak against the US dollar. As a result, there are still other currencies you can buy (Australian dollar, British pound, euro) where the valuations allow for the rand to depreciate meaningfully.

With half of all global 10-year bonds yielding less than zero, precious metals as an asset class look more attractive to safe-haven investors. This might provide an extra underpin for their prices going forward.

Our domestic bonds have very attractive real yields and with inflation contained, we expect their returns to be competitive against other asset classes, including an investment in US dollar cash. The direction of our commodity basket will play an important role in this asset allocation decision.

A healthy US consumer may push back the occurrence of a recession. Consequently, you may be able to stay invested in global equities for longer.

The trade war between the US and China is causing significant collateral damage to other economies, especially those who are heavily reliant on global trade.

Glacier Research would like to thank Warren Kelly for his contribution to this week's Funds on Friday.

Warren Kelly, Investment Professional

Warren graduated from UCT with a B.Bus.Sci in Finance. His early career experience was as a business analyst in the FMCG and hospitality industries where he focussed on improving company profitability. He joined Obsidian Capital in March 2014. Warren heads up Obsidian's business development and marketing function, part of which involves providing a window into the thinking of the investment team. Warren is married, has two children, enjoys running, reading, and travelling, and is increasingly drawn to the study of human psychology.