ECONOMIC COMMENTARY - By Etienne Vijoen, CFA

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The road might just be a bit bumpier

2018 turned out to be a bumpy ride. One of the rare points of agreement among investors is that they are relieved it's over. After a spectacularly positive January it became apparent that volatility would be much higher than the record-low levels during late 2016 and 2017. Among many uncertainties were, whether the Fed would raise rates too quickly, the looming trade war between President Trump and China, and the way Brexit would be concluded. Markets also became sceptical about the sustainability of earnings growth by technology firms, especially those priced on monthly active user growth.

The last quarter of 2018 turned out to be the worst in 10 years. The S&P 500, DAX and Nikkei declined by 14%, 13% and 17%, respectively. The JSE only gave up 6%, due to a relative outperformance in emerging markets after the crisis in August and September. The JSE ended 2018 down 13%, with the S&P 500, DAX and Nikkei down 7%, 13% and 17%, respectively. The Shanghai Composite lost 25% to round off a disastrous year for emerging markets.

This capped the worst ever 5 consecutive years on the JSE. Naspers, the largest company, made a low of R2362 during October, a massive 42% lower than its record high of R4142 in November 2017. This was due to Tencent coming under pressure amidst trade tensions and reluctance of Chinese authorities to approve the monetisation of new online games.

This was also the first time in history that the S&P 500 had a negative year while seeing double-digit earnings growth. The correction in valuation was much more than the 7% price decline indicates, resulting in valuations well below the long-term average.

Looking forward to 2019, there are reasons to be optimistic. Emerging market headwinds are expected to gradually dissipate. The number of expected interest rate increases by the Fed have been lowered. Markets are even starting to price in that the Fed will pause hiking rates all together.

Increases to date have been priced in, and lowered expectations can spark some dollar weakness. This in turn should be supportive to emerging economies' and commodities' prices. Early in January, Bank of America raised emerging assets to a "buy" recommendation for the first time in 3 years and other investment houses followed suit. Risk premiums on emerging market sovereign debt dropped substantially.

In South Africa inflation is well under control and the likelihood of more interest rate hikes has reduced. Naspers is on a rebound, on the hope of trade tensions being resolved. Authorities have also resumed approving online games for monetisation. The planned unbundling of Multichoice at the end of February should unlock value and help close the valuation gap between Naspers and its stake in Tencent. This will be supportive for the JSE. Locally we have world-class blue chip companies trading at very attractive valuations. A positive outcome, or at least more policy certainty after the general election, can help a much-needed recovery of the local market.

Internationally, markets have been driven by sentiment during the past year. Unlike with 2008/2009, fundamentals remain strong without one single threat to completely derail world markets. Brexit and trade tensions can, and should, be resolved in a sensible way. A more dovish Fed should calm distressed investors and chances of an IT bubble, like the one in 2000, are very slim. Selective stocks might become overvalued at times, but price advances have been justified by impressive revenue growth.

We expect 2019 will likely deliver its fair share of volatility. Historically, what happened during 2018 wasn't anything new, just more severe than we became used to. We don't see an imminent recession, although earnings growth might slow somewhat. This will create opportunities to buy quality stocks at bargain prices. Unemotional investors who continue to practice sound, proven principles will continue to accumulate wealth and earn inflation-beating returns. The road might just be a bit bumpier.

81 Dely Road, Hazelwood, Pretoria, 0081 | +27 (0)12 667 3771 | admin@efpc.co.za | www.efpc.co.za