Cutting through the noise: economic trends to focus on

At this year's All Access Summit, Arthur Kamp, economist at Sanlam Investments, cut through the noise, focusing on a handful of economic trends long-term investors need to watch.

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“Essentially, when there is uncertainty in the market around the outcomes of economic policy it can cause a lot of volatility in asset prices. So, the key thing is to keep an eye on those long-term values,” says Kamp. “Firstly, my job is to watch world events, in particular those events that have an impact on debt markets - events that drive interest rates.”

Why are interest rates so important?

“Essentially, interest rates are used in all valuations of assets,” says Kamp. Global interest rates are currently very low, and global rates are important because South Africa benchmarks off them (SA interest rates should be equal to global interest rates plus an appropriate emerging market risk premium.)

“The exceptionally low interest rates post the great financial crisis (GFC) is no error,” says Kamp. “Quantitative easing was a deliberate policy to avoid, among other things, a deflationary environment in which debt keeps on growing. They did the right thing by lowering interest rates.” But the result is the highest debt levels in developed markets since the second world war, with no incentive for central banks to raise rates and thereby the cost of repayments. As a result of this policy, Sanlam Investments was able to take a (correct) view for many years that developed market interest rates would stay low.

Strong demographics set to reverse

It’s not just the GFC and the resultant policy that lowered rates. Kamp argues that the biggest driver of interest rates is having a large part of the population entering working age, a trend that has been much stronger in emerging markets.

“Globally one of the big drivers of savings has been China and the very high levels of saving in China, which has contributed to what Ben Bernanke once called the ‘savings glut’,” says Kamp. When you’re at working age, you are earning your most income. When you’re in retirement, you’re more or less consuming. So, if you’re going to save, it’s while you’re of working age.

What we’ve been through globally is a period of higher savings because of demographics. And that has put significant downward pressure on real interest rates.

“But things are about to change,” warns Kamp. Looking at forecasts for Japan and Germany running up to 2050, their labour force is expected to fall by about 30%. In China it’s expected to drop by 10%. The longer-term savings trend in these economies is therefore likely to decline, which will put significant upward pressure on future interest rates. Especially if governments are looking to invest more in infrastructure spending, for which there is a dire need. “But these trends take decades to play out,” Kamp points out.

Inflation is the hook to hang returns on

“The other important economic trend is expected inflation, because our jobs as asset managers are to beat inflation over the long term,” says Kamp. In the short term economists have a fair chance at forecasting inflation, but that doesn’t help asset managers with long bonds. They need long-term rates and need to know what the average rate of inflation over 10 years will be. “That I don’t know,” says Kamp, “so I go back to long-term fundamentals.”

Mean inflation in SA since 1921 has been 5.25% per year. Incidentally, the Reserve Bank’s track record since it has started implementing inflation targeting is also close to 5.25%. Sanlam Investments’ long-term required rate for SA long bonds is therefore 8.25% (5.25% + 1% required from US long bonds + a 2% risk premium required for SA debt post its last credit downgrade).

The currency is SA’s no 1 concern

“In Germany, because of their history, they worry about inflation, in the US they worry about a depression, in SA we worry about the rand.” Kamp uses purchasing power parity to determine the fair value of the rand, which was the reason Sanlam Investments was overweight the rand in 2008, underweight in 2011 and overweight in 2015 after the dismissal of Finance Minister Nene.

Currently, the house view on the rand is positive – provided that the Reserve Bank keeps up the good work of keeping SA inflation low. The rand now trades two standard deviations away from its purchasing power parity exchange rate (i.e, it’s oversold/undervalued).

“The last couple of years SA acquired more net foreign assets than net foreign liabilities – for the first time since the data started in the late 1960s. So, if the Reserve Bank can anchor inflation at low levels we could in the long term get to a point that we no longer have to worry about the currency. But to get there we would need to fix our fiscal policy.”

What would it take to fix SA’s economy?

We’re at a sweet spot in terms of demographics, but need to unlock our income potential further via vital steps such as telecommunications reform and the up-skilling of the work force to make the country more attractive to investors. “A more optimistic mood over the long term would be highly beneficial to the economy,” says Kamp, “but the most important lever to pull is to fix fiscal consolidation."

According to Kamp, a successful consolidation is where you cut expenditure relative to GDP, particularly consumption. You check the balance sheet of the state and make sure you're acquiring assets. In other words, if you're running a loose fiscal policy at least make sure your debt is because of the development of assets. And align your tax structure with growth. "We've cut spending, but unfortunately we've cut capex and we still have a very high level of consumption spend."

South Africa is still dependent on foreign investment and Kamp views the recent loan from China to Eskom as positive. "There is nothing wrong with countries financing one another. The opening of capital borders is one of the key reasons why economies have been able to grow the way they have over the last couple of decades. We have this view that SA institutions have a lot of cash and they're not investing it. If they're not investing in SOCs and we're getting the capital from elsewhere, why is that? One of the issues that we have is asymmetry of information. One is not exactly sure of what is happening inside these SOCs. The returns from them are exceptionally low and there is still some risk there. Our SOCs are only just beginning to turn around – it will take a while."

Walls and trade wars lower growth and stoke inflation

Upward-ticking global interest rates, local inflation anchored around 5.25% and the rand weakening gradually along with the inflation differential with its trading partners are all trends that will play out over the long term, "but in the short term a few other things are happening," says Kamp. "For decades you had American presidents leading a country into the world and promoting fair play, liberalism, and democracy. Now you have a country that's starting to put up barriers. We're particularly seeing a disengagement between the US and China."

The second thing that is starting to happen is changes in trade. "If the world is moving towards protectionism, then we have a problem. The world will end up with lower growth and higher inflation," says Kamp. "Protectionism is not just about tariff barriers. But let's do the calcs on the tariff barriers." In a recent study, the IMF worked on the assumption that the US raises tariffs on all imports by 10%, and everyone that it trades with retaliates with 10% tariff hikes. What does that do to global trade? The IMF calculated that it would reduce global real GDP by a substantial 0.5%. In addition, there could also be second-round knock-on effects such as a loss in investor confidence and suppressed investment markets, but those are not quantifiable.

Kamp remarks that the US has entered a policy gamble. "Trump has commenced on a very large fiscal expansion. Not only has he cut taxes, but he's spending more. He's heading for a significantly high deficit. He's stimulating an economy which most economists reckon is at full employment. He's making the Fed's life difficult and he's sowing the seeds for ultimately a downturn in the US economy, despite the short-term stimulus and growth. The US midterm elections on 6 November is significant for investors worldwide."