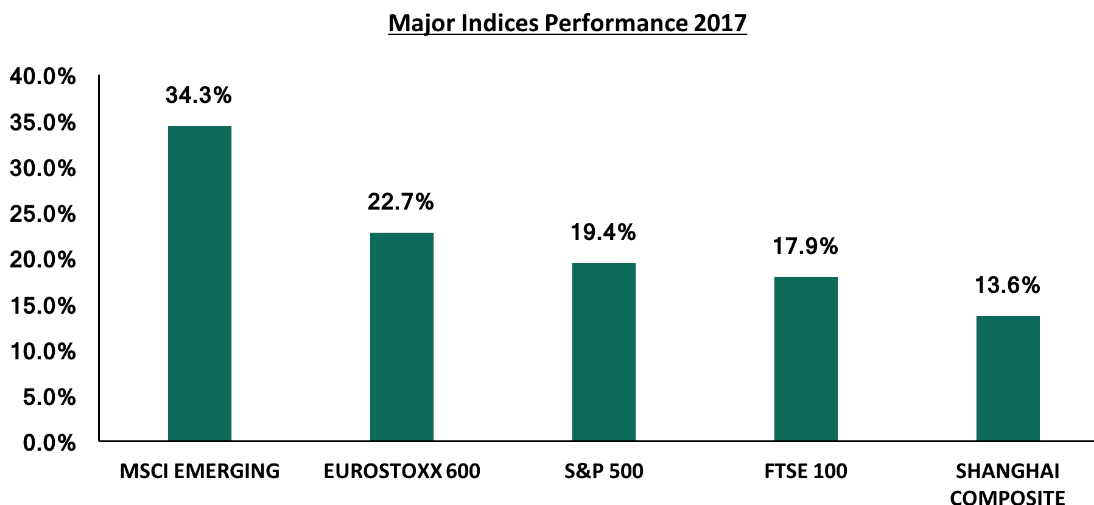
Cytonn Annual Markets Review - 2017

Global Markets Review

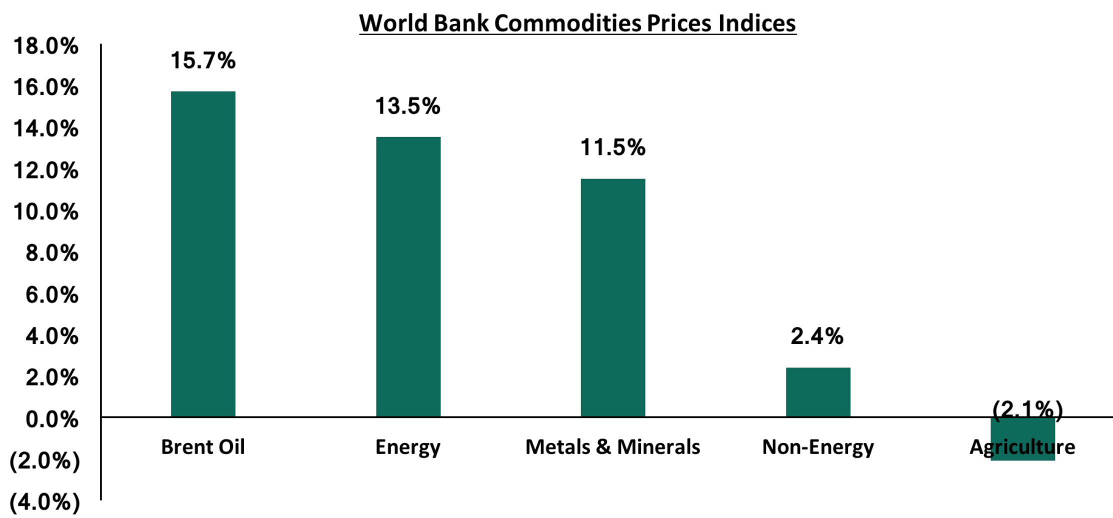
The year 2017 was characterized by an upswing in global economic growth, with growth in the US and China gaining momentum and the recovery in the Eurozone gathering pace. Global GDP growth in 2017 is expected to come in at 3.6%, higher than the 3.2% registered in 2016. A resurgence in global demand, with notable pickups in investment, trade, and industrial production, coupled with stronger business and consumer confidence being the key factors supporting the global growth. The Central Banks reversed trend, gradually removing the accommodative policies that were used to support the economic recovery since the 2008 global financial crisis.

In terms of trade, the World Trade Organization (WTO) upgraded their outlook for world trade growth in 2017 to 3.6% from their 2.4% expectation in April 2017, citing a resurgence in Asian trade flows as intra-regional shipments picked up, and as import demand in North America recovered after stalling in 2016. This is an improvement from the 1.3% recorded in 2016, defying expectations of a slowdown in trade following the anti-globalisation campaigns witnessed in major global economies such as the US.

Global equity markets registered gains driven by improved investor sentiment due to better than expected corporate earnings, improved global economic growth outlook and improvement in commodity prices. The MSCI Emerging index performed better than other global indices, rising 34.3%, while the Shanghai Composite lagged with a return of 13.6%.



Global commodity prices have registered gains in 2017, with crude oil, metals & minerals, and energy registering gains of 15.7%, 13.5%, and 11.5%, respectively, while agriculture experienced a decline of 2.1%, according to the World Bank Commodity Prices Index. The rise in energy prices was driven by gains in Brent crude oil prices that rose 15.7% to USD 63 per barrel, supported by a sustained cap on oil production by OPEC countries and Russia, despite increased US shale oil output. Below is a chart highlighting the performance of select commodity prices, with 15.7%, 13.5%, 11.5%, 2.4% and (2.1%) returns for Brent oil, energy, metals & minerals, non-energy and agriculture performance, respectively.



United States

The Fed has been on a tightening cycle, having started in December 2016 with a 25 bps interest rate increase, and followed this with 25 bps hikes each in March, June and December. The Federal Funds rate ended the year at 1.25% - 1.50%, from a range of 0.5% - 0.75% at the beginning of the year. The increase was driven by:

- a strong labour market, with an average of 174,000 new jobs added every month during the year and the unemployment rate at lows of 4.1% in December, compared to 5.0% unemployment rate that is considered full employment in the US economy, and
- relatively strong annual economic growth, which came in at 2.3% in Q3'2017, and expectations for 2017 growth is at 2.2% compared to 1.6% in 2016, driven by increased consumer spending.

The stock market performance registered gains, with the S&P 500 rising 19.8%, supported by strong growth in corporate earnings and expected implementation of pro-growth policies under the administration of President Trump, including tax reforms that will result in corporate tax rates falling to 21% from 35%. In terms of valuations, the Cyclically Adjusted Price/Earnings (CAPE) ratio is currently near historical highs at 32.5x, far above the historical average of 16.8x, indicating an overvaluation of the market.

Eurozone

Recovery in the Eurozone improved in 2017 with the region expected to grow by 2.2% in 2017 compared to 1.7% growth experienced in 2016. The labour market recovery also continued, with the unemployment rate dropping to 8.8% in October 2017 from 9.8% in December 2016.

The European Central Bank (ECB) maintained the base lending rate at 0.0%, and the rates on the marginal lending facility and deposit facility at 0.25% and (0.40%), respectively, throughout the year. As the economy recovers, the ECB plans to reduce their quantitative easing programme by reducing the monthly bond buying program to EUR 30.0 bn from EUR 60.0 bn as from January 2018, with the option to extend the stimulus package beyond September 2018. Inflation remained low during the year at 1.5% compared to a target of 2.0%, thus warranting the continuation of loose monetary policy.

Euro zone stock markets were on a positive trend with The Stoxx 600 index gaining 21.9% during the year, driven mainly by solid corporate earnings growth and margin expansion due to higher Eurozone and international growth. In terms of valuations, the Stoxx 600 Index is currently trading at a P/E of 20.8x, slightly higher than its historical average of 20.3x.

The manufacturing sector recorded a strong growth, with the Eurozone's Flash PMI rising to a 79-month high of 60.0 in November 2017, with multi-year highs seen for all the main indicators of

output, demand, employment and inflation, further supporting the Eurozone’s economic recovery.

China

The IMF expects China’s 2017 growth to come in at 6.8%, a tad higher than the 6.7% recorded in 2016, amid a rebound in global trade and rising household incomes. This is also higher than the Chinese Government’s expectation of a 6.5% growth for 2017. However, despite this strong growth, China’s increasing debt levels and dependency on credit to fuel growth continues to pose a major financial stability threat to the global economy, and could be the catalyst for the next global crisis.

To curb this financial stability risk, Chinese authorities have undertaken a number of policy and regulatory measures aimed at reducing macroeconomic imbalances without an adverse impact on growth, among them:

- Refinancing government debt with cheaper debt, which will ease the cost of servicing the debt,
- Introduction of debt-to-equity swaps in a bid to trim China’s corporate debt loads, and
- A slow down on accumulation of new debt

The stock market recorded positive returns during the year, with the Shanghai Composite advancing 11.7% in 2017, supported by MSCI’s potential inclusion of 222 large cap Chinese A shares in the MSCI World Index and easing liquidity concerns. In terms of valuations, the Shanghai Composite index is currently trading at a P/E of 16.8x, slightly lower than the historical P/E of 17.0x