Cytonn Q1’2019 Markets Review

Global Markets Review

Introduction

The global economy is expected to record a slower growth compared to 2018, with the IMF in their January World Economic Outlook Update projecting 2019 growth to come in at 3.5%, against growth of 3.7% in 2018. Headwinds to global growth include the weakening financial market sentiments owing to (i) the current uncertainty on the direction of trade policy between the US and China, (ii) Britain’s exit (“Brexit”) from the European Union, and (iii) higher debt levels in emerging and development economies, especially those dependent on commodity exports, such as Nigeria. Reduced consumption expenditure in major global economies such as Germany has also been touted as a major reason for reduced economic growth, as it has consequently led to reduced industrial production, as evidenced by the decline in the Germany’s Purchasing Managers Index (PMI) to 47.6 in February 2019.

United States:

The US economy grew by 2.9% in 2018, and is expected to grow by 2.5% and 1.8% in 2019 and 2020, respectively, according to the IMF. The slower growth is anticipated owing to a removal of the one-off tax benefits enjoyed in 2018, the fiscal stimulus injected by increased government spending, and an expected decline in the prices of commodities, compared to 2018. In March, the Federal Open Monetary Committee (FOMC) maintained the Federal Funds Rate at the range of 2.25% - 2.50%, citing:

i. The current low inflation of 1.5%, being below the 2.0% target,
ii. Low unemployment rate currently at 3.8%, which is below the Non-Accelerating Inflation Rate of Unemployment (NAIRU) of 4.6%. A reading of below 4.0% considered to be close to full employment, and,
iii. Slowing economic growth caused by reduced household spending and business fixed investment in Q1’2019, evidenced by the 1.0% decline in new vehicle demands, and the 4.0% decline in car sales as at February 2019.

The stock market has been on an upward trend, with the S&P 500 gaining by 11.9% during the first quarter of 2019. The gain was largely supported by improved earnings by a majority of counters in financial services, oil and gas, consumer goods and technology, largely attributed to the implemented tax reforms by the current administration, as the corporate tax rate was reduced to a uniform rate of 21.0% from the previous revenue-based tiered system that had the lowest tax for corporations at 25.0%. US valuations are still higher than their long-term historical average with the Shiller Cyclically Adjusted P/E (CAPE) multiple currently at 29.9x, which is 76.4% above the historical mean of 16.9x.

Eurozone:

According to the IMF, the Eurozone is expected to grow at rate of 1.6% and 1.7% in 2019 and 2020, respectively, lower than the 1.8% growth recorded in 2018. The projected 2019 growth was revised lower by 0.3% points, as the regional growth was downgraded following dampened sentiments in major economies such as Germany, which has seen reduced private consumption, and declining industrial production especially in the automobiles sector, following the introduction of the revised auto emission standards amid subdued foreign demand. Uncertainty over the United Kingdom's (UK's) exit from the European Union ("Brexit") has also led to increased uncertainty in the Eurozone regarding the impact, and the type of exit deal to be adopted by the UK. Other major economies facing uncertainty include France and Italy, with uncertainty in France arising from the ongoing intermittent yellow vest movement and industrial protests. The yellow vest movement protests are motivated by rising fuel prices and high cost of living. Italy dipped into a recession, as it grapples with reduced domestic demand and consumption coupled with higher sovereign debt servicing obligations due to the rising yields on government issued debt.

The European Commercial 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, indicating that it was unlikely to make changes to the policy rate until the end of the year, adopting an easing stance from its earlier expectations of an interest rate hike in Q3'2019. With the ECB having completed its Quantitative-easing program, they are likely to adopt a more accommodative monetary policy through the use of Targeted Long-Term Refinancing Operations (TLTRO), which essentially involves the bank issuing loans to commercial banks, for onward lending to commercial enterprises and households, so as to consequently spur economic activity and boost spending. Inflation has remained subdued, currently at 1.2%, below the 2.0% target.

The Stoxx 600 index rose by 12.0% in Q1'2019 as gains in the equities markets were driven by the increased purchases by investors taking up positions in anticipation of the earnings season, coupled with a flight from fixed income securities, as several securities' yields have slipped into negative territory. The P/E ratio is currently at 17.5x, 10.5% below the historical average of 19.5x, indicating markets are currently trading at relatively cheaper valuations.

China:

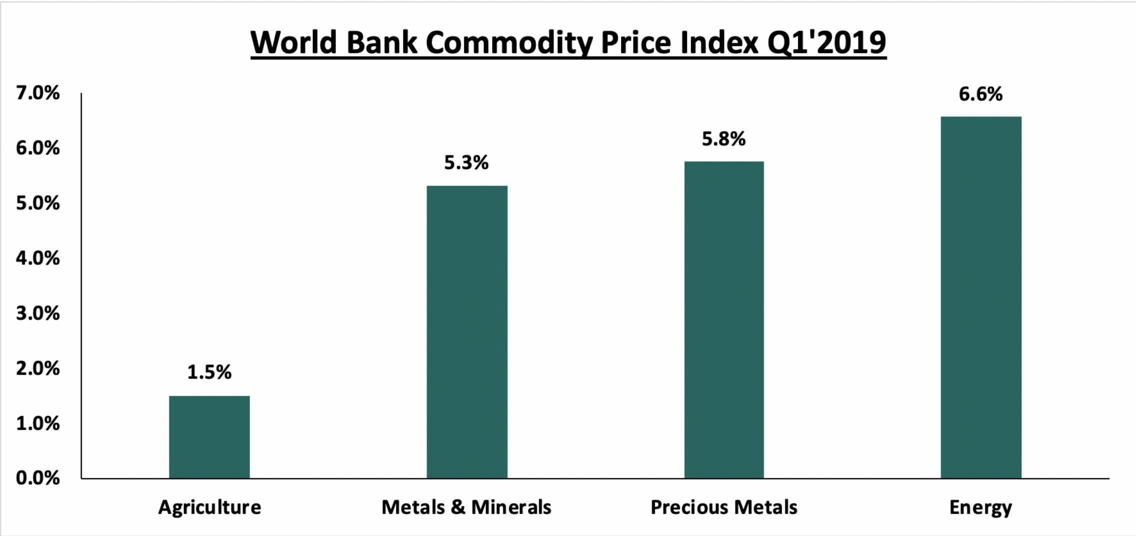
The Chinese economy is estimated to have grown by 6.6% in FY'2018, the slowest growth rate since 1990. The major cause of the relatively slower growth was the prolonged trade dispute between the US and China, which culminated in a 90-day truce in January 2019, as US and China negotiated on trade terms, coupled with intellectual property ownership, a major issue used by the US to instigate tariffs against China.

The IMF expects China to grow at 6.2% in 2019, comparable to the Chinese government's target of "around 6.5%". In order to support economic recovery, the government has adopted a more accommodative stance by injecting liquidity in the economy by reducing the reserve requirements for banks, and resuming public investment, which should result in increased liquidity and consequently higher domestic consumption.

Renewed optimism of a resolution of the trade war has improved investor sentiments, and consequently, the Shanghai Composite has gained by 20.1% in Q1'2019, with the largest gaining sectors being real estate, communication services, healthcare, industrials and financial, with gains of 31.6%, 29.1%, 27.2%, 21.7% and 18.7%, respectively. The gains have led to the market's valuation rising by 1.4% above the historical average to 14.7x compared to the historical average of 14.5x.

Commodity Prices:

Global commodity prices were generally on a recovery trend in Q1'2019. According to the World Bank Commodity Prices Index, energy, precious metals, minerals, and agriculture segments gained by 6.6%, 5.8%, 5.3% and 1.5%, respectively, during the quarter. Below is a chart showing the performance of select commodity groups for Q1'2019.



As per the chart above,

i. All the highlighted commodity groups recorded increased prices, as the gains in energy were majorly driven by the recovery in oil prices, owing to disruptions in the production of oil in some oil producing areas such as Venezuela and Iran, coupled with OPEC’s agreement to cut oil supply. Brent prices rose by 18.9% to USD 67.1 per barrel in March 2019, from USD 56.5 per barrel in December 2018,
ii. The gains in agriculture were largely driven by the gains in oils & meals, timber and other raw materials, which recorded gains of 2.5%, 2.3% and 2.3%, respectively. The gains were however weighed down by the 0.7% decline in beverage prices.