Regime change

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> "2016 marked the beginning of profound change in the world order. It was an inflection point for governments, central bank power, policy stimulus and potentially also for economic growth and inflation."

Regime change

Profound changes in governments

Voters in the United States and Europe are railing against 'the establishment' and are demanding substantial change.

The new US government will be different to that of the last eight years in material respects. Regressive policies on protectionism, immigration and global relations will likely be economically negative, but will be somewhat balanced by a more favourable US corporate taxation dispensation, lighter touch regulations, a less repressive environment for the financial sector and potentially increased infrastructure spending.

Importantly, the new US government should be far more effective at implementing policy given the Republican clean sweep and a cabinet likely to be filled with experienced businessmen.

In Europe, the Brexit negotiations will bring substantial change. The UK has voted for separation from the EU and against immigration and globalisation. The UK and the EU face great uncertainties and risk as a result. Upcoming elections in important EU countries may also bring anti-establishment surprises and will, at the very least, see governments sympathising with some of the 'populist' concerns.

Changes in central bank power

The major global central banks played a vital role in stabilising the financial system during, and just after, the 2008/2009 financial crisis. Subsequently their actions have been highly unconventional and largely counterproductive. Average developed economy policy rates have fallen by nearly 4%, while their balance sheets have roughly tripled relative to GDP as a result of aggressive quantitative easing.

Directly and materially intervening in financial markets via quantitative easing has boosted asset prices (especially bonds and defensive equities) and disproportionately benefited the wealthy in society. Such buying of risky assets below intrinsic value amounts to redistribution from taxpayers to asset sellers.

In addition, since the crisis, many central banks have gained power in areas well outside of their core mandate - expanded regulatory scope and greater influence in shaping economic policy. They have exhibited a very damaging asymmetric responsiveness to financial market movements and volatility. Reacting more to downward moves amounts to an inherent subsidy to financial market risk-takers.

Not surprisingly, these central banks are perceived by the populist masses as a key part of the establishment and the elite. They are symbols of rule by technocrats and experts. This hostile sentiment will likely lead to a reduction in central bank power and may even lead to threats to their independence.

Change in policy stimulus

Given the perception that monetary policy is increasingly ineffective, it is likely that current aggressive monetary stimulus measures will be reined in.

Fiscal stimulus, to be pursued by the Trump administration, impacts on economic activity and inflation are inherently linked to the types of measures applied and their duration. They are generally more impactful when there is large excess capacity, unlike at present. Although fiscal stimulus is seldom an enduring boost to growth, the change in sentiment it's prospect seems to be supporting could be powerful.

Together with tightening monetary policy, developed economy yield curves are likely to rise and steepen - a change already underway - with material implications for most financial assets.

Inflation may be returning

After the financial crisis, inflation has been stubbornly low in developed economies and there have been fears of Japan-style deflation. The trend now seems to be turning with a decline in economic slack, particularly in labour markets, and energy prices moving higher. In addition, the populist policy direction is mostly inflationary: protectionism raises imported goods prices, curbing immigration boosts local wages and fiscal stimulus is inflationary if there is little economic slack.

Importantly, central banks seem inclined to lag the improvement in global growth and, after fighting hard against deflation, they may tolerate inflation rebounding to levels above target.

Economic growth may be picking up

The current global expansion has been particularly weak on an annualised growth rate basis, but of relatively long duration. Some have feared a structurally lower growth environment, due to the dampening effects of the excessive saving of ageing populations, financial sector over-regulation, a lower propensity to consume in emerging economies and waning technology innovation for businesses.

We believe many of these forces are not permanent. A much larger portion of the drag on economic growth was due to households deleveraging after a 20-year credit binge up to the crisis and the private sector sentiment dampening effects of extreme central bank actions. Corporates have been eschewing capital expenditure and favouring dividends, buybacks and mergers and aquisitions (with inevitable cost cutting and job losses). Consumers have been worried about the low return outlook, stagnant incomes, economic uncertainty and rising inequality.

Global economic growth looks to now be improving: after slowing in 2016 to a post-crisis low of 2.3%, it is expected to rise to 2.7% in 2017[1]. Forward-looking economic surveys are signalling much better times ahead (chart below), with a meaningful recent shift in both the US and the euro area consumer and business confidence. A self-sustaining rise in 'animal spirits' that boosts especially the investment side of the economy could be very good for economic growth.

[1] World Bank estimates

South Africa is different

Intriguingly, South African changes under way are mostly in the opposite directions to the developed world.

Here there are also likely to be large changes in government in the years ahead. The ANC's elective conference in December 2017 should bring substantial change in leadership as a result of voter pressure to address corruption and general government ineffectiveness. We believe these changes will be incrementally positive for the country. There may be political and currency volatility in the interim however as the current regime fights to maintain power.

In contrast to developed economy central banks, the South African Reserve Bank (SARB) has been a shining example of an effective independent central bank. Having tightened policy over recent years, counter to developed economy trends, the SARB's next move is likely to be a reduction in rates.

Also, in contrast to developed economy trends, the South African government has just ended a countercyclical fiscal stimulus programme, which has resulted in large fiscal deficits and rising debt issuance, and is now in fiscal consolidation mode as weak economic growth inhibits its ability to grow expenditure.

Developed economy confidence rebounds

Sources: National Statistical Offices, IMF, CitiGroup

Regime change

Sentiment is depressed and economic activity is weak and the economy may only expand by 1.1% in 2017 (despite drought non-recurrence) and 1.8% in 2018.

Global fault lines

Amidst the generally positive sentiment around, major potential threats include:

- Populist nationalists election gains in EU elections.
- Instability from China, facing high debt balances and global trade curbs.
- The unpredictability of the new US president.

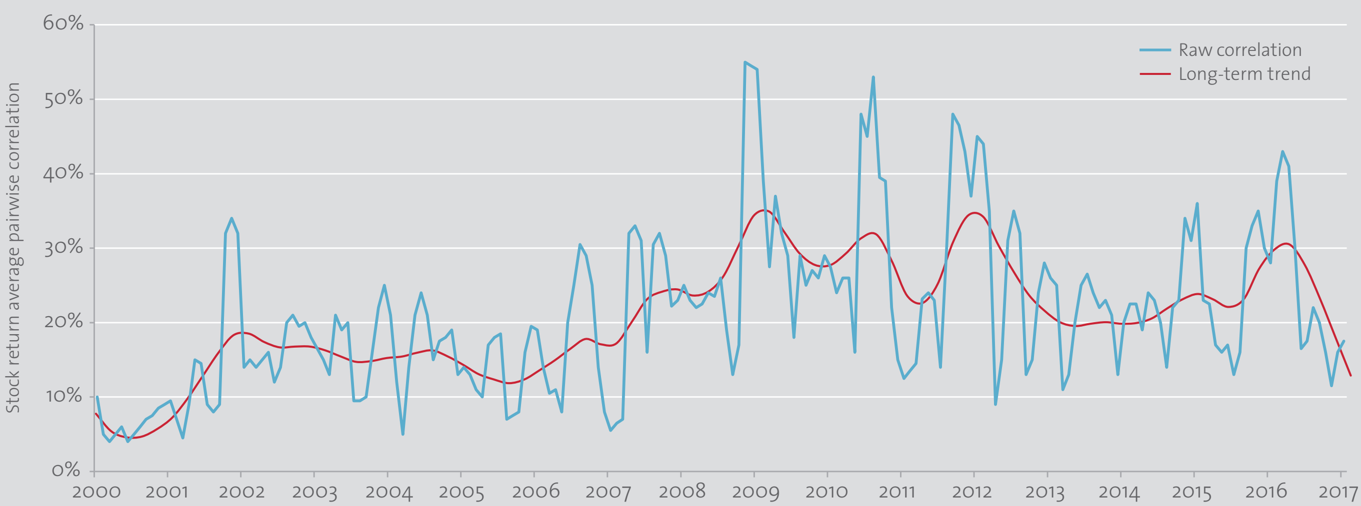
Outlook for markets

The 'regime change' described above, of improving sentiment and potentially stronger growth and inflation, is a good environment for global equities. However, on most measures, stock market valuations are very high and the continued outperformance of equities is reliant on any economic uptick translating into meaningful company earnings growth and enduring for years. (Still) very low bond yields continue to portend very low returns for all asset classes priced with low risk discount rates in mind.

The 'regime' of the past five or six years in financial markets has seen central bank interventions reduce the significance of economic fundamentals and price-insensitive investing strategies (such as passive and momentum) outperform as large caps have dominated and correlations have been high. Quality South African domestic stocks have been particularly strong as price-insensitive global emerging market investors have fed a powerful rerating virtuous cycle.

Style analysis shows that value has outperformed growth by a large margin in 2016 for the first time since 2006. We are seeing greater asset price dispersion (chart below) and thus great opportunities for stock picking strategies. The 'regime change' seems to be impacting financial markets and particularly seeing long-term, fundamental investing re-emerging as a very lucrative investment inefficiency to exploit. UP

Share price correlations have fallen



Sources: Citi Research, MSCI, Datastream

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