



SPECIAL REPORT: THE US DOLLAR IS MORE IMPORTANT THAN YOU THINK

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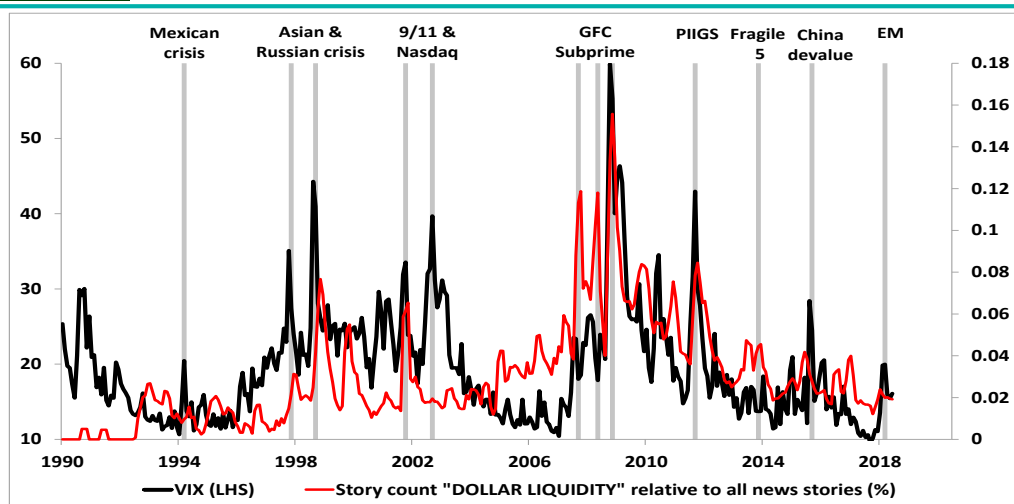


EXECUTIVE SUMMARY

Defining the concept of Dollar Liquidity and why is it so important to financial markets:

- As the barter system ended and the world started using money as a medium of exchange the question arose “how much money needs to be in the system?”. A simplistic illustration, if there were 10 bushels of wheat and ten coins then every bushel was worth one coin. The demand or supply of wheat obviously had an effect on the price. If money supply increased more than this demand/supply dynamics it would cause the price of wheat to rise more than the demand for wheat. This is known as **consumer inflation**. The same concept is also true in the case of **asset inflation**, yet it's drivers are misunderstood in the financial markets.
- After “[The Great Inflation of the 1970's](#)”, Central Bank policies became very much focused on the outlook of consumer inflation, becoming a prominent feature of the economic landscape. As a result investment decisions also become centred around consumer inflation cycles.
- However, behind the inflationary cycle (disinflationary in-fact), there was **secular growth in US Dollar monetary base**. The extra-ordinary growth in base money and the evolution of credit creation has had a profound effect on asset prices – which is largely unappreciated in our opinion.
- The **US Dollar** as the world's reserve currency plays a special role in this process.
- **Feature chart:** Astonishingly for us, there is a high correlation with causality in our opinion between every financial market cycle (VIX) and with the story count in which the world “DOLLAR LIQUIDITY” appears. This is another example of how the availability of US Dollars has a profound effect on financial markets.

FEATURE CHART: VIX AND WORD COUNT “DOLLAR LIQUIDITY”

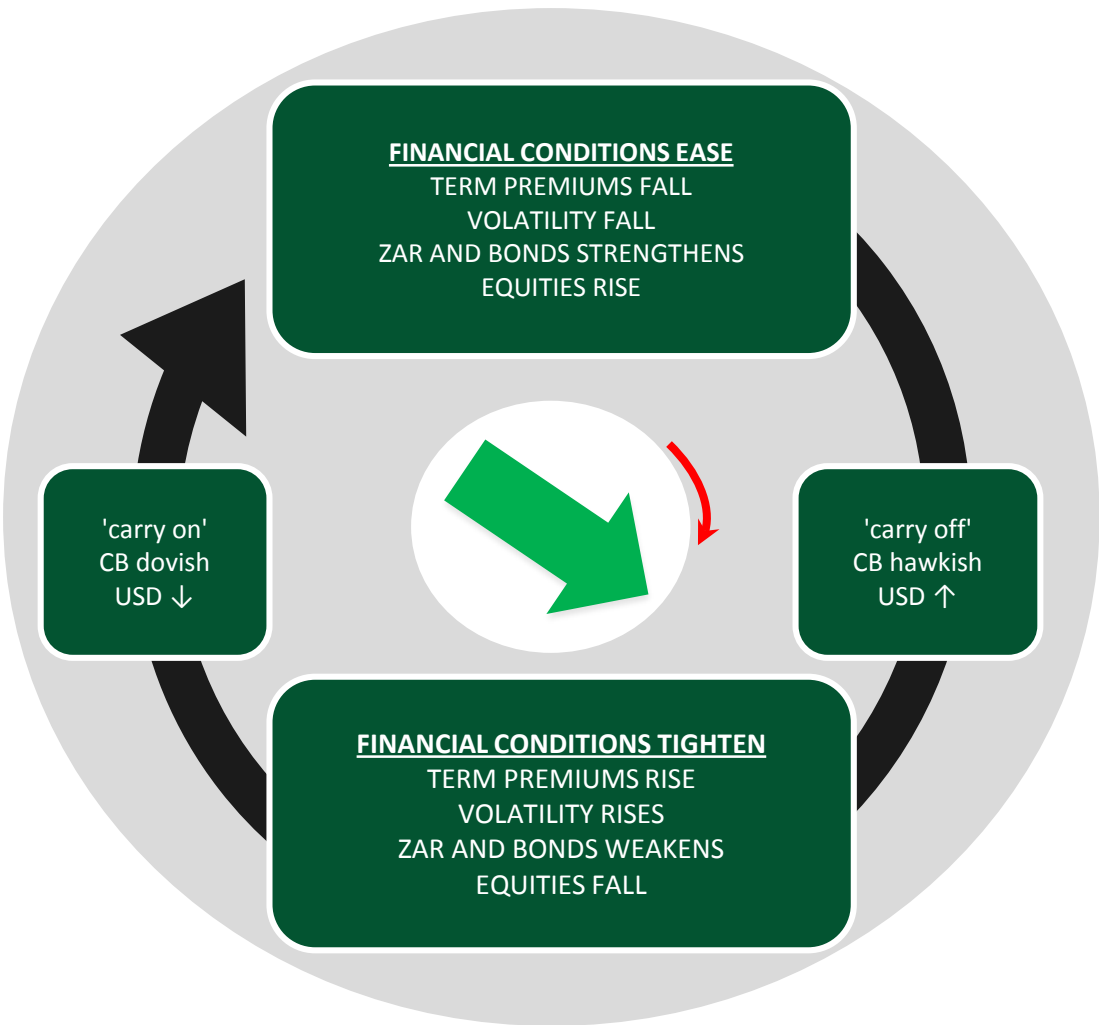


Source: Bloomberg, News trend function.

- **Bottom line:** Should Global \$-Liquidity and Global financial conditions fail to improve or even contract further we can expect a deflationary environment to materialise. In this environment we prefer to maintain defensive investment portfolios i.e. Cash over bond over equities.
- We cannot stress enough the importance of the **95 level on the US Dollar index**. A confirmed break above this level will mark the beginning of the next risk-off phase. More importantly, it is not the value of the US Dollar Index *per se* that matters, but rather what it represents - i.e. expansion/contraction in the pool of money.
- **South Africa:** Given our concern regarding the outlook on global \$-Liquidity and our inter-linkages with global capital markets we can not envisage a robust environment for asset returns and economic growth to materialize. For more on our investment recommendations see [page 10](#).

GLOBAL LIQUIDITY AND CREDIT CYCLE

- Below is our “*financial markets outlook clock*” which is a simplistic way to illustrate our view on global liquidity, credit cycle and implications for financial markets.
- We will only revise our arrow to “**FINANCIAL CONDITIONS TIGHTEN**” should the US Dollar index break above 95 index points on a sustainable basis and should our Global \$-Liquidity indicators move into negative territory. They have merely slowed down in 1H18.

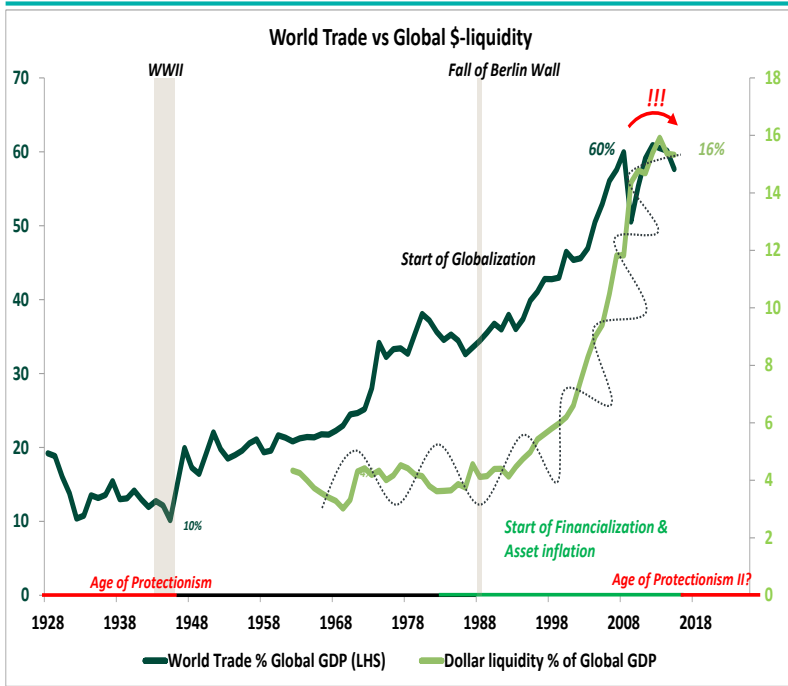


A PICTURE IS WORTH A THOUSAND WORDS, IN THIS CASE, ITS WORTH TRILLIONS OF USD IN GLOBAL TRADE



Source: Financial Times

THE MOST IMPORTANT CHART IN THE WORLD- DOLLAR MONETARY BASE

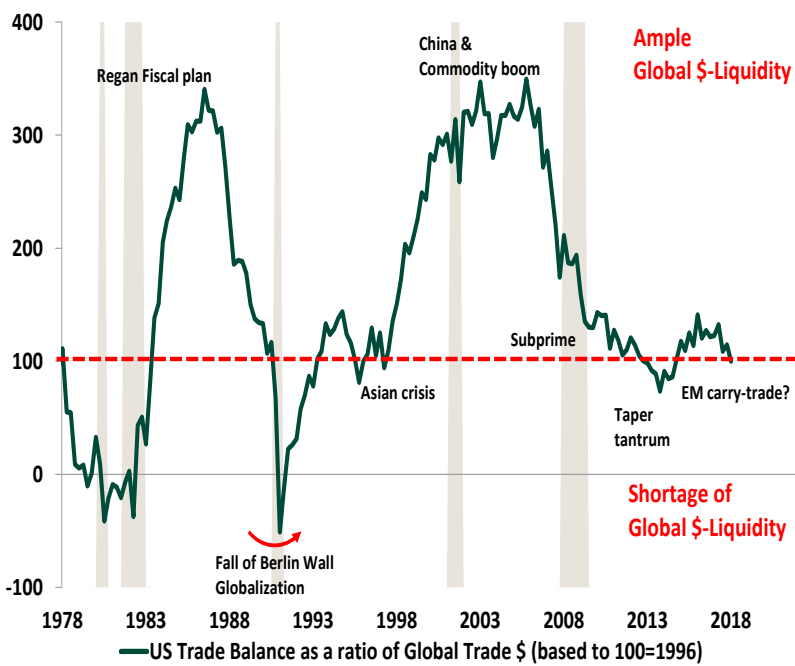


Source: DS

- The world order since WWII led by the US hegemony is in danger of breaking down. The trend in globalisation since the fall of the Berlin Wall is being threatened by **protectionist policies**.
- The political consequences of this photo gets a lot of coverage, we however would like the point out the importance of this photo with regards to the current **USD-based monetary system** that the world so heavily relies upon.
- The consensus is that the reversal of globalisation will be inflationary. We agree there can be an inflationary shock as tariffs and trade sanctions work through the system.
- We however believe the long-term outcome will be deflationary especially for asset prices.
- In this report we will define the concept of **dollar liquidity** and its importance to financial markets.

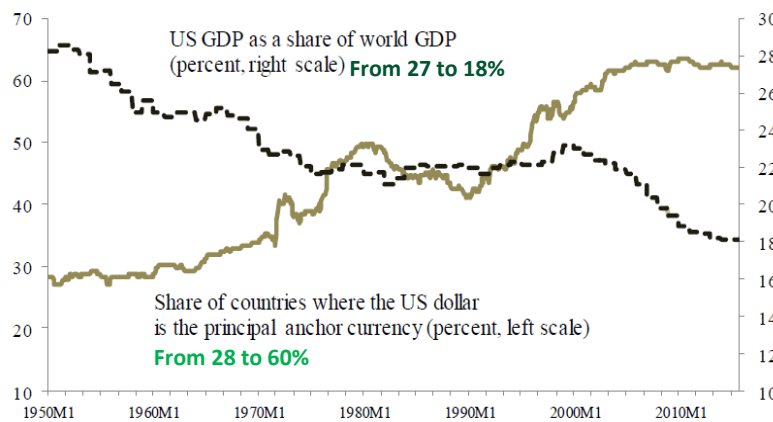
- A symbiotic economic relationship grew post the fall of the Berlin wall between the developed and developing economies with the rise of globalization. The US was a major consumer of the world's production and the consequence was a **\$11 trillion** cumulative trade deficit with the rest of the world – **during this period the world's USD monetary base grew from 4 to 16% of global GDP**.
- A consequence of globalisation was disinflation which allowed central banks to cut policy rates (discount factors). This helped stimulate economic growth and fuel asset prices. The destructive inflationary episode of the 1970's meant monetary policy became focussed on consumer inflation targeting.
- This caused investors to become obsessed with the monetary policy cycle. The market did not appear to pay attention to the extraordinary growth in the USD monetary base instead focussing on measuring the price of money (CPI) and not the quantum. This is still the case today. What resulted was all **asset classes out-performed GDP** as the rising tide of \$-liquidity lifted all ships.
- Now** that the USD monetary base or 'tide of liquidity' has started to recede central banks are starting to play an active role in controlling the quantum (via QE), and not just the price of the monetary base (via policy rates).
- We believe that with this shrinking USD monetary base it becomes as important to understand liquidity, global flows and the role the dollar plays as the reserve currency in order to identify the right investment destination.
- The **challenge** for investment manager will be for investors to identify the optimal asset class (beta) in a receding 'tide of liquidity environment'.

US TRADE BALANCE AS A RATIO OF GLOBAL TRADE



Source: DS
*US cumulative trade deficit relative by Global trade volume adjusted for inflation

WORLD RELIANCE ON USD AND USD DEBT VS NON-US ENTITIES



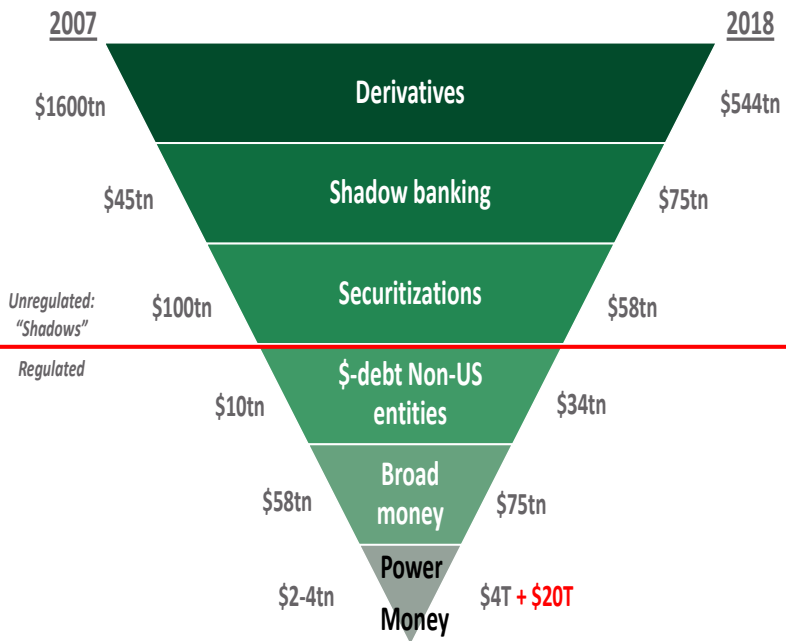
USD denominated debt outside the US by non-US entities

Non-Financial Corporates (debt issuance)	\$10tn
Non-Financial Corporates (swaps/hedging)	\$14tn
Other Financial Institutions (Asset managers, SWF's)	\$8tn
Banks	\$1.6tn
Governments	\$0.5tn
Total	\$34tn

Source: Carmen Reinhart, BIS and IMF debt statistics

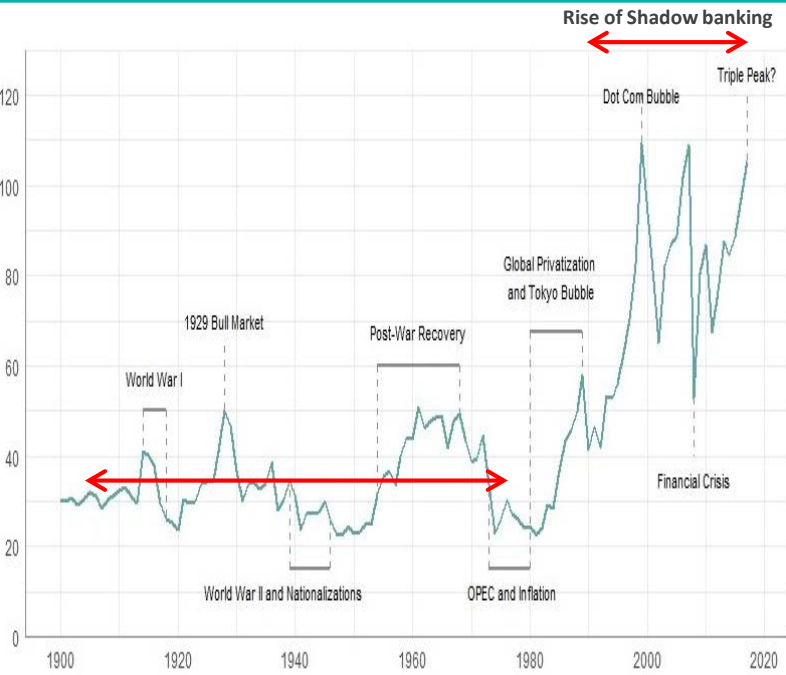
- As the world left the gold standard in 1971 and the **US dollar** became the **reserve currency**, it became the responsibility of the US to supply the world with enough dollars for the global economy to grow i.e. **Triffin Dilemma**.
- The **contraction** in this ratio throughout history has led to a number of busts. 1987 crash, Japanese bust in the late 1980's, 1998 Asian crisis, Tech bubble, the Great Financial Crisis of 2007/8 and PIIGS crisis in 2011.
- The 2007/8 GFC stands out because the contraction \$-Liquidity was so severe, the Fed had to get involved to add USD M0 as the falling **velocity of money and collateral** kept spiralling lower, creating a **negative feedback loop** between financial markets and the real economy.
- This ratio is now **losing momentum** again and if the US trade deficit shrinks because of Trump's protectionist policies, USD creation will be a major problem.
- History has shown that this will have a disinflationary effect on the world's economy and assets.
- The world at large and especially emerging markets are very exposed to dollar creation because of the **USD debt** the world has taken on since the GFC.
- Post WWII global trade took off and the importance of the dollar grew, this accelerated in the late 1980s. Today **60%** of the world's countries are linked to the dollar. The US GDP share of the world economy has however declined from **27 to 18%** over the same period – **remember the US is the only provider of USD base money**.
- Should global growth become less synchronized the US deficit will shrink. This will provide less USD into the global financial system resulting in a shortage of dollars. Tighter monetary policy from the Fed, a higher Fed funds rate and shrinking of the Fed's balance sheet, will further slow down USD creation.
- The **shrinking dollar monetary base** will slow down the credit creation process because the economy is so highly geared. This shrinking pool of dollars will cause the dollar to rise. The strengthening USD means **higher offshore USD funding**, this will hurt USD indebted nations/corporations.
- In this environment i.e. tighter global financial conditions, the infamous carry-trade will come under pressure and the misallocation of credit will be revealed. **EM's will be at the centre of the misallocation of credit**.

THE INVERTED DEBT PYRAMID, EVOLUTION OF MONEY CREATION



Source: BIS, IMF

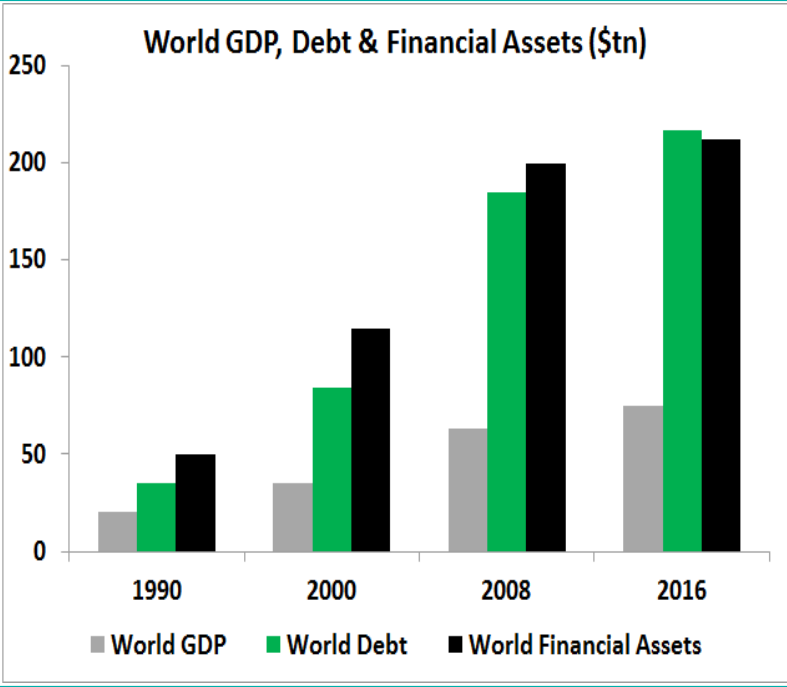
FINANCIALISATION : GLOBAL EQUITY MARKET CAP AS % OF GLOBAL GDP



Source: Global Financial Data

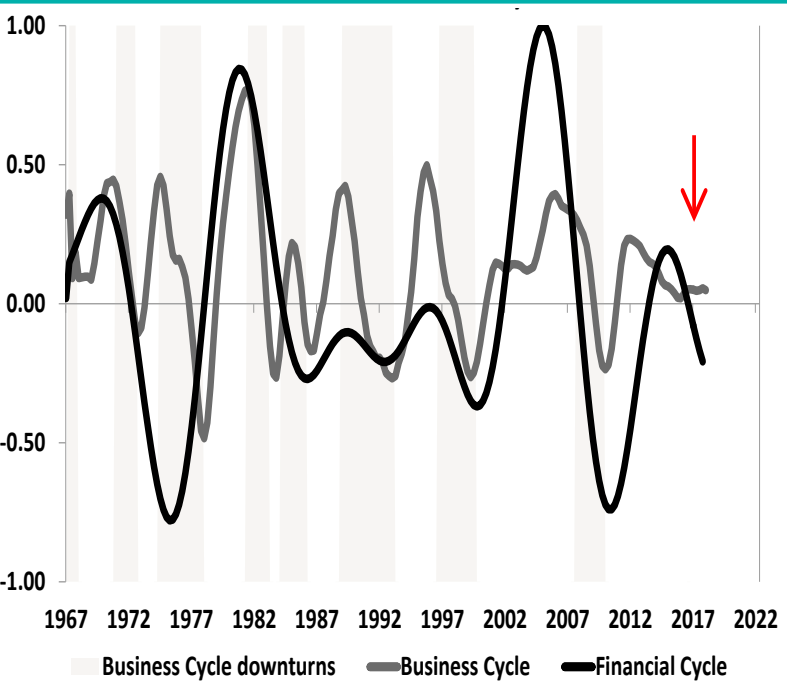
- On top of the ballooning monetary base we mentioned on [page-4](#), the debt creation process went through a **major evolutionary process** of its own and gearing in the system grew dramatically. The fractional banking system has been around for 600 years and banks traditionally lend out the same money 14 times. Just before the 2008 GFC global banks lent out the same money in excess of 40 times!
- The reason being, on top of the regulated banking sector there was the **shadow banking sector** that regulators failed to monitor. There was also the **Eurodollar system** - the dollar banking system outside the US, that no regulator monitored. All in all, there was more money and credit in the system than regulators, economists and analysts were aware of because it did not show up in consumer inflation. The important question is where is this excess money/debt. The answer lies in **asset inflation and how asset prices managed to out-perform the real economy for 30-years**.
- As regulators address the unregulated space and central banks (via QE) change the bottom of the pyramid, monitoring money supply has become much more complicated than monitoring the traditional M3.
- We cannot measure the pyramid real time. But changes to the base of the pyramid or dollar-liquidity has a major effect on the credit creation process and that we can measure. Hence all our research focusses around the drivers of the dollar and dollar liquidity.
- As the US trade deficit fuelled the global monetary base from 4 to 16% of global GDP, and the process of **Financialisation** began – the gap between the real economy and financial markets accelerated from the late 1980's accelerating up out of an 80-year old band.
- It is not just the global real economy that cannot afford a shrinking base of the money pyramid. The indebted balance sheets of the world cannot afford the asset deflation that will go hand in hand with shrinking money supply.
- In a volatile world where the growing US dollar monetary base of the last 30-years is changing, **we believe investors should pay more attention to the source of money**, even in the context of the South African investment industry.

GLOBAL GDP, DEBT AND ASSET VALUES



Source: BIS, IMF

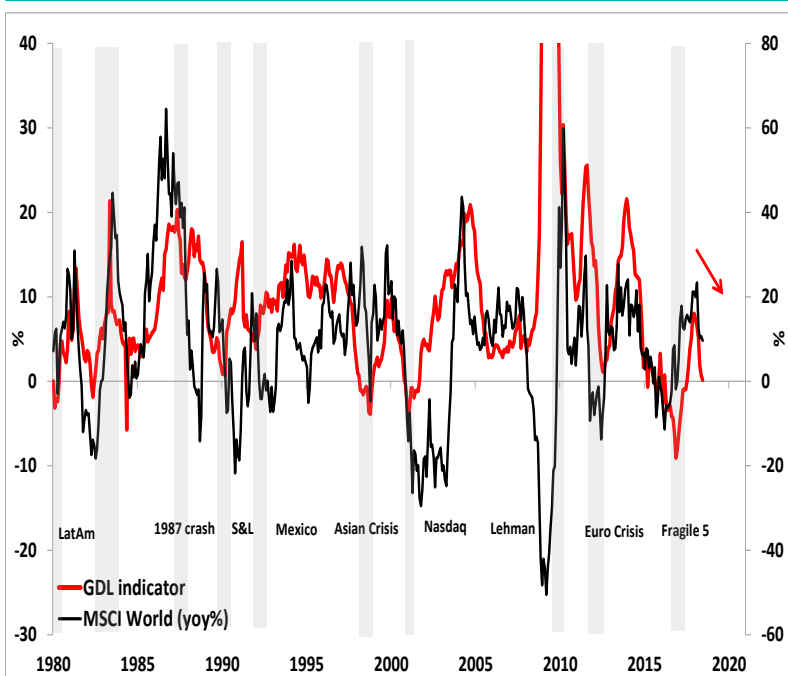
THE FINANCIAL CYCLE IN SA IS MORE IMPORTANT THAT YOU THINK



Source: SARB Financial Stability Review,
BIS speech "Monetary policy in the grip of a pincer movement" Claudio Borio March 2018

- The well known Business cycle and the less known Financial cycle:
- Most financial market participants tend to ignore or place less importance on the financial cycle and its impact on the business cycle. We believe this is a mistake for the following reason:
- There is a large amount of empirical evidence (BIS, LSE, IMF) suggesting that the financial cycle is larger and has a more meaningful impact on the business cycle and asset prices. In a financial cycle upswing new borrowing and rising asset prices boost economic growth, but over time an accumulation of unhealthy debt leaves the financial system more vulnerable to a downturn. Hence when the financial cycle turns and financial stress emerges, the economy faces a deeper recession than usual. Examples of this: Asian Crisis, Tech bubble and the GFC of 2008/9.
- The GFC of 2008/9 exemplifies the severity of a downturn in a financial cycle as demonstrated by the response of authorities i.e. QE and zero interest rate policies.
- The next downturn in the financial cycle will be no different to previous downturns. EM's and SA are vulnerable if the global financial cycle moves into negative territory. Misallocation of credit fuelled by the unintended consequences of the CB's actions will be exposed.
- The Financial Cycle is not a uniquely advanced market phenomenon , it also exists in South Africa. In fact it is larger and more disruptive than most people think – this is according to research from the SARB's Financial Stability Department.
- The business cycle is defined by the SA composite coincident indicator (employment, manufacturing, production capacity etc.). The financial cycle is defined by the co-movement of certain financial variables (equity market prices , property prices and total credit etc.)
- The South African business cycle has stagnated in recent quarters. More alarmingly, the financial cycle continues to be in a downward phase amid volatile global capital flows and the lack of credit demand in local economy. This raises the risk of a recession in SA over the next 6-12 months.
- Changes to the \$-Liquidity environment have caused the financial cycle to become more volatile which is proving to be challenging for policy makers and asset allocators.
- An important excerpt from a the BIS on financial stability: *"A more balanced monetary policy framework would place less emphasis on near-term inflation and more on the financial cycle"*.

GLOBAL \$-LIQUIDITY: MONETARY BASE



Source: DS

*US Dollar reserves accumulated by foreign central banks

GLOBAL \$-LIQUIDITY: BROAD MONEY SUPPLY



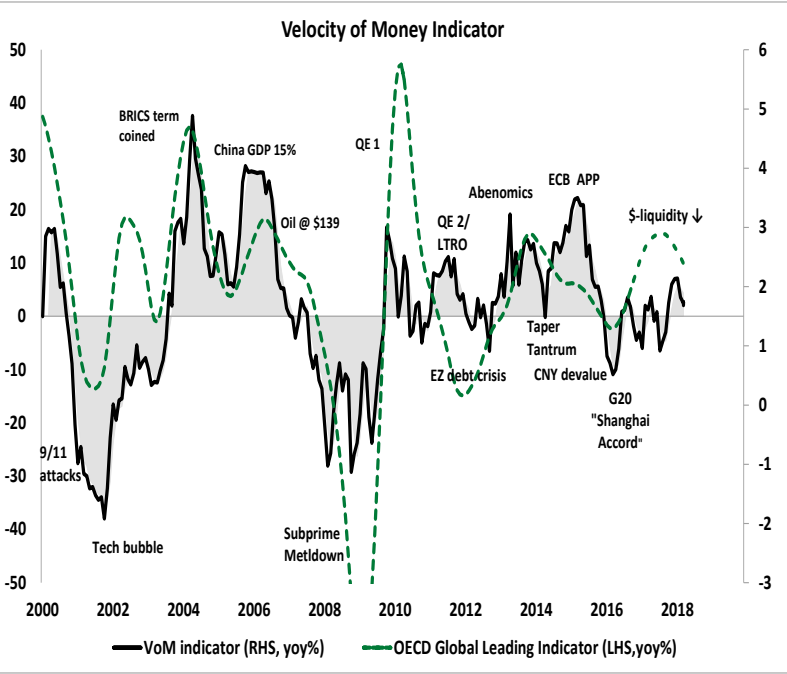
Source: DS

*Excess money supply of 30 largest economies relative to the US

- The four important indicators we monitor to determine changes in the \$-Liquidity environment are as follows:
- Our **Global Dollar M0-Liquidity indicator** is measured as narrow USD money supply in the form T-bills of the top 30 major central banks of the world held at the US Federal Reserve relative to US M0 in circulation.
- Typically the indicator would lose (gain) momentum or contract (expand) when the cost of USD funding would rise driven by changes to the Fed funds rate and the US trade balance.
- Since the 1980's a slowdown or a contraction in our indicator **has exposed the misallocation of credit** in different parts of the world/sectors.
- Our indicator has been in expansionary territory since 2016, fuelling asset prices (EM's in particular). Since the start of 2018 it has lost momentum, triggering a risk-off phase in financial markets. Our indicator is now in equilibrium i.e. at the zero line.
- A slowdown in global growth, the US trade deficit not growing and the Fed continuing with its path towards tighter monetary policy will not bode well for USD creation. **Because of this we believe the downside risks to financial markets will remain and intensify.**

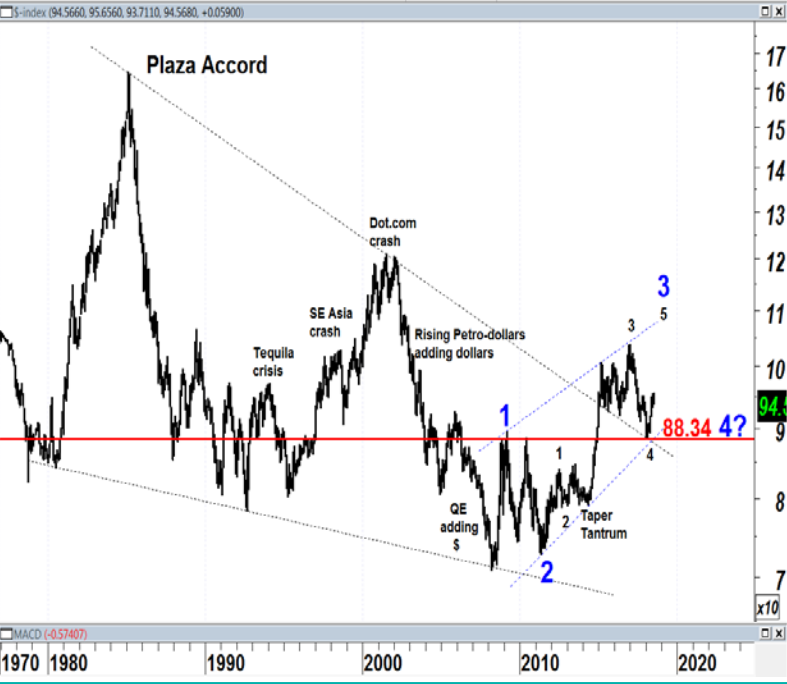
- Our **Global excess \$-money supply indicator** is broad money supply of the top 30 major economies converted into USDs relative to US M2 growth.
- When our indicator loses momentum it makes it difficult and more expensive for the rest of the world to borrows USDs offshore. The opposite is also true.
- Factors influencing our indicator and outlook:
 1. **Changes to the size of the US Federal Reserve's balance sheet.** Outlook : expected to shrink further.
 2. **US Treasury cash balances.** Outlook: expected to be neutral.
 3. **Repatriation of USDs from the Eurodollar system.** Outlook: expect this continue amid BEAT legislation.
 4. **Global growth and global trade** generates USDs. Outlook: losing momentum as reflected by our Global Velocity of Money indicator.
- Our Global excess \$-money supply indicator remains in a downtrend which will make USD funding expensive and tighten global liquidity conditions. Either global growth must accelerate or some central bank must stimulate to reverse this trend
- We can expect a deflationary bust for financial markets led by a **stronger dollar and a dollar shortage** in the next 6-12 months.

REAL-TIME VELOCITY OF MONEY



Source: Reuters, *Composite indicator that uses a number of variables - such as changes in money multipliers, changes in yield curves, corporate spreads and others

KING OF FINANCIAL MARKETS: US DOLLAR



Source: Reuters Metastock

- The traditional velocity of money indicator can only be calculated on a quarterly basis (lagged). Hence we have developed our own velocity of money indicator which can be calculated on a monthly basis.
 - Our **Velocity of Money Indicator** is a proprietary indicator that we monitor closely. It is a modernized version of Irving Fisher's work on the Quantity Theory of Money, $MV=PQ$.
 - We believe It is a useful indicator to understand the 'animal spirits' of the global economy and is also a leading indicator when compared to PMIs, stock prices and business cycle indicators at times.
 - Currently our VoM indicator is losing momentum indicating that that market participants are concerned about global growth and tighter global financial conditions.
-
- The monetary base as percentage of global trade (page-4) started to roll over post the 2008 GFC. The dollar started to rally as the total pool of dollars started to shrink driven by the financial system deleveraging.
 - With global interest rates at historical low levels, covered interest parity the prominent driver of currencies also started to break down. Empirical evidence from the [BIS](#) also suggests this.
 - It is a meaningful technical analysis signal that the dollar index failed to break back into the bear trend at 88 that has been in place since the 1985 Plaza Accord.
 - The US dollar index has now reached our first target level at 95 and we expect a consolidation phase over the next few weeks. A sustained break above this level will project a move to above the 2017 high at 103.80.
 - Investors in the carry trade will de-risk. It is the funding currency that will be forcing them out and not the fundamentals of where the money was invested. Exactly what happened during 1H18.
 - We often face the question, "but where will the money go?". The answer is nowhere, because most of the funds was never true savings, it was a loan created against some collateral. When the money returns to the source the loaned gets repaid.

MARKET OUTLOOK

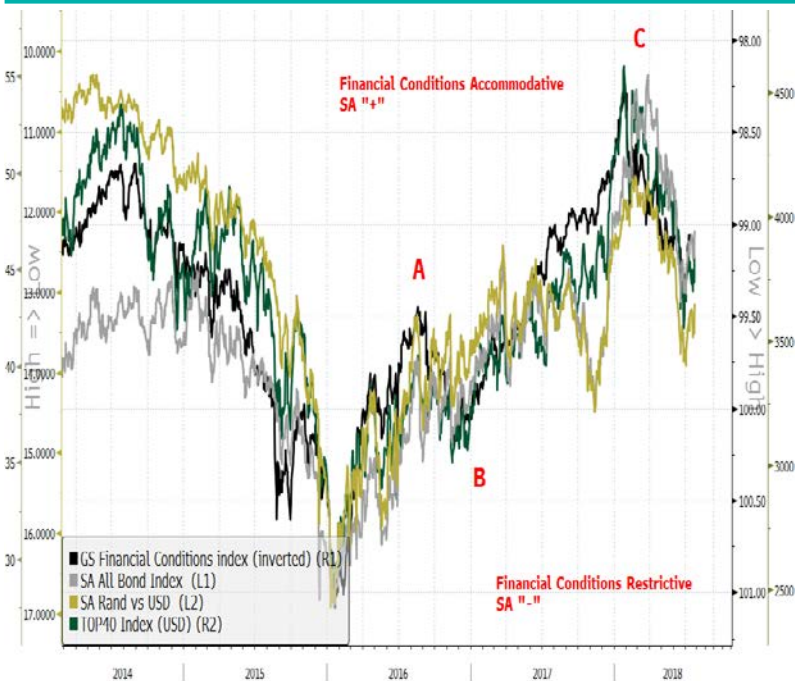
- Since the start of the year we have been warning that **\$-Liquidity** will contract and a risk-off phase will materialise. This supports our bullish US Dollar view.
- The slowdown in Global \$-Liquidity was due to tighter monetary policy actions by the Fed (shrinking of the balance sheet and rate hikes), the US treasury replenishing its 'call account' at the Fed draining \$400 billion from the banking system, the slowdown in the Chinese credit cycle and a slowdown in global trade and petro-dollar balances.
- We reached our 95 target level on the USD Index and we must take the decision whether this was the entire bull move in the USD or is the current consolidation merely a pit-stop. This will help to determine our outlook for the rest of the year. We expect the US and financial markets in general to consolidate, which will continue during 3Q18.
- We conclude the world needs an injection of Global \$-Liquidity soon to improve global financial conditions. If this fails to materialise we can expect global financial conditions to contract and the USD to appreciate. In this scenario, a stronger USD and rising offshore USD funding costs will lead to a risk-off phase. Dollar indebted countries, corporations and the carry-trades will be most impacted.
- Global flows (carry trade) will remain an important driver of financial markets.
- **Our preference would be to use tactical rallies to build defensive positions in their portfolios:**
 - **Currency:** Overweight USD, accumulate below or close to R13.00
 - **Fixed Income:** Underweight duration at 8.38% (10yr yield), we expect short-rates to remain unchanged and the long-end of the yield curve to steepen.
 - **Equity market:** Overweight positions in non-cyclical/defensive and hedge stocks. We prefer industrial and hedge stocks (ex-NPN) over resources, over financials and other interest-rate sensitive sectors. We prefer platinum over gold stocks. Within the industrials index we expect BTI, CFR, MND, BID to out-perform the index, but MTN to under-perform. The Health care sector and REM are close to support.
 - **Overall asset allocation:** Over the next 12-months we expect the local bond market to outperform the equity market. Cash holdings will remain attractive in this volatile environment.

FINANCIAL CONDITIONS AND EM ASSET CLASSES



Source: Reuters

FINANCIAL CONDITIONS AND SA (USD) ASSET CLASSES



Source: DS

- Since the so-called “Shanghai Accord”, the G20 meeting in Shanghai, the market took off with the assurance by these large economies to support the global economy.
- There was a correction post the Trump victory but the stimulus by the other central banks and the credit growth in China propelled the market higher.
- The point we want to bring across is that all risk assets are now highly correlated, which is a major complication for portfolio managers.
- This brings us back to the role the dollar plays. There is a very high correlation between the dollar and financial conditions. From 2011 to the end of 2015 the dollar rallied and the risk assets underperformed. During 2016 and 2017 the dollar weakened and risk-assets outperformed.
- It is not the value of the dollar *per se* that drives the relatives, it is what it represents. A weaker dollar indicates that there is more than enough liquidity in the financial system. The financial system has become very sensitive to the US dollar.

- It is very clear on this chart that SA markets are also driven by the changing global liquidity.
- With foreign participants owning substantial percentages of the [SA asset classes](#), this sensitivity to global financial conditions will remain in place.
- As discussed in the dollar section on page 9. The dollar index has reached an important target level at 95. As long as the dollar remains below this level we can expect risk assets to stabilise.
- The global economy is unlikely to accelerate in light of the current global geo-politics but the tricky part remains the action of the central banks.
- We will keep readers informed via our Short-term Flash Notes how the patterns are unfolding.

MARKET OUTLOOK

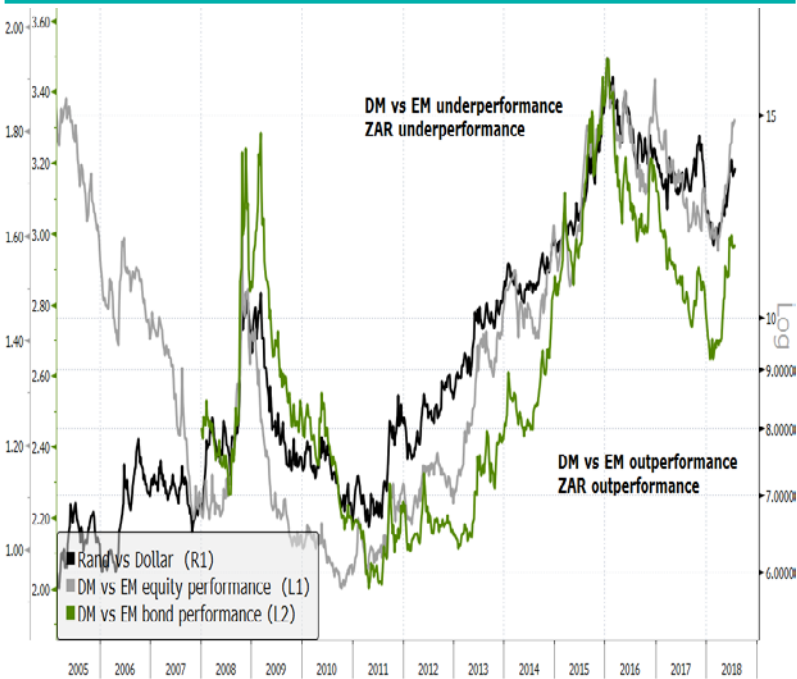
FOREIGN OWNERSHIP OF EM ASSETS

	Foreign ownership	
	Local currency bonds % of outstanding issuance	Local equity market % of market capitalization
Brazil	12	29
Columbia	26	10
Czech	35	21
Hungary	17	47
India	6	22
Indonesia	39	52
Malaysia	29	13
Mexico	28	30
Peru	39	6
Poland	30	18
Romania	18	9
Russia	34	20
South Africa	40	43
S.Korea	11	40
Thailand	15	19
Turkey	22	20
Average	25	25

Source: National sources ,IIF , Strate. As of June 2018

- EM's have not only become very integrated through global trade linkages (import/export channels) but also through financial linkages amid the growth in capital markets.
- On average foreign investors own 25% of the local bond and equity market in the emerging markets complex. Most exposed are Indonesia, South Africa, South Korea, Mexico, Brazil, Turkey, Hungary and Russia.
- Tighter global financial conditions i.e. rising cost of offshore USD funding will leave many EM's vulnerable to capital outflows from their respective bond and equity markets.
- We are **more** concerned about the **source of capital** (cost of offshore USD's) relative to the destination of capital.

THE RELATIVE OF DM/EM EQUITIES AND BONDS VS THE RAND



Source: DS

- It is very evident post the 2008 financial crisis how the value of the rand is being influenced by the relative performance of EM versus the advanced markets.
- According to [our models](#) the global flow of money and commodity prices are the major drivers of the value of the rand.
- These charts are now all testing resistance lines through the tops.
- The next few weeks will be challenging while the world gathers information whether global financial conditions will stop contracting.

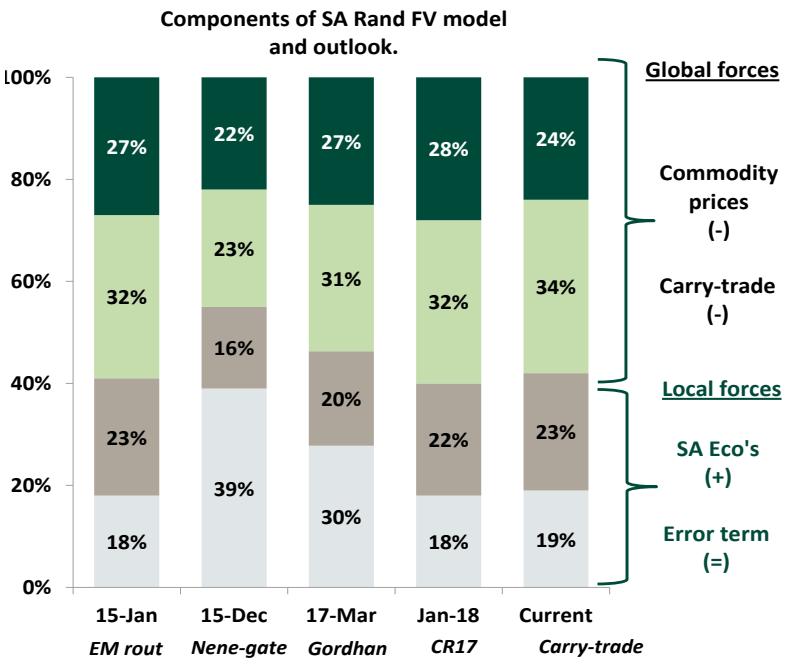
MARKET OUTLOOK

USDZAR TESTED AN IMPORTANT RESISTANCE



- It is ironic that two of the major political events in South Africa went hand in hand with a major reversal in global liquidity.
- Minister Nene got fired as the under-performance of the EM's came to an end in late 2015. The political guard changed in early 2018 as the global financial conditions started to tighten.
- The USDZAR is testing a major break-out level. We have indicated over the last several weeks that a correction phase is likely to play out during 3Q18.
- The monthly MACD has however turned up and a break above the June 2018 high at 14 will be a very negative signal for the rand. This level is also the 2001 high.
- A break above 14 will signal a move to above the January 2016 high.

GLOBAL HEADWINDS WILL NOT BODE WELL FOR OUTLOOK ON THE RAND



- We estimate the fair value of the USDZAR by using a combination of PPP metrics. However, we also incorporate global liquidity metrics such as the carry trade, commodity prices, and USD financial conditions.
- Our forecast for the USDZAR for the end of 2H18 is in the range of R13.20-14.00. Our bias is towards the upper-end of this range.
- After stress testing our model for an environment in which Global financial conditions become restrictive and our \$-Liquidity move into negative territory we arrive at a forecasted fair-value for the rand close to R14.20
- We expect the bulk of the move in the rand to come from weakening external liquidity conditions (i.e. the carry trade and commodity prices).

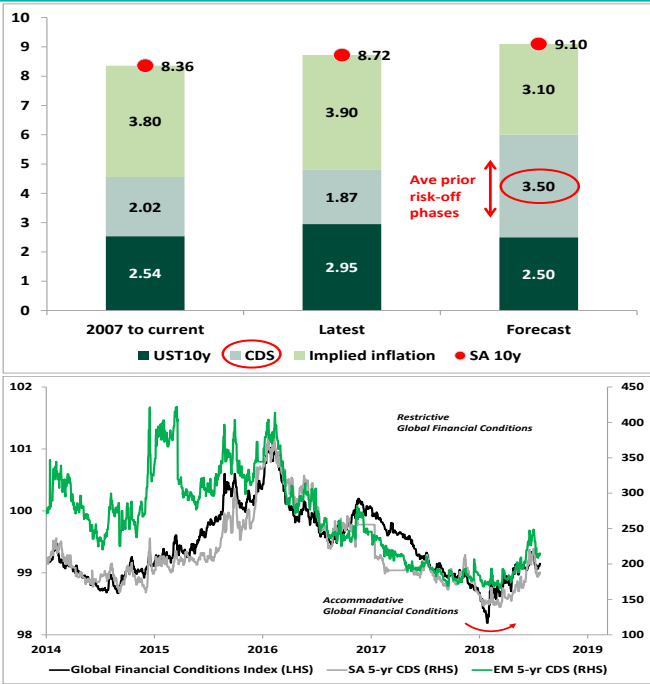
MARKET OUTLOOK

RSA 10YR YIELD, TESTED THE BULL SUPPORT LINE



Source: Reuters Metastock

1H18 IS A PERFECT EXAMPLE OF HOW TIGHTER \$-LIQUIDITY CAN BE NEGATIVE FOR SA BOND YIELDS



Source: DS, IIF

- The SA bond yield bottomed out as the country joined the CITI WGBI and remained in a bear trend with the other EM's until the end of 2015.
 - SA bonds benefitted from the risk-on environment during 2016 and 2017 notwithstanding a very negative local political environment.
 - The bond market sold off with all the other risk assets in 2018 to test an important trend reversal level.
 - We do not expect the 10 year yield to trade below 8.38% during the correction phase.
 - If there is another risk-off phase there is a high probability of the SA bond market breaking up out of the (blue) flag formation.
-
- Our negative outlook on SA and EM debt/credit stems from external vulnerabilities. Current outstanding FX-denominated debt in EM's (ex-financials) has climbed to a record high of \$5.5 trillion.
 - A continued slowdown in global trade would weigh on EM exporter's FX revenues, with the stronger USD making refinancing still harder for EM corporates with high levels of FX debt
 - **Fortunately for SA**, external debt levels relative to EM peers is low.
 - **SA external sectorial debt is as follows:**
 - Non-financial corporates 15%, EM ave. 26%
 - Government 5%, EM ave. 6%
 - Financial sector 10%, EM ave. 19%
 - Households 0.4%, EM ave. 3%
 - Unfortunately for SA, foreign ownership of local currency bonds is one the highest (as a percentage of GDP), leaving local interest rates vulnerable to the external \$-Liquidity conditions.
 - Tighter global financial conditions are likely to put pressure on implied credit spreads (CDS) which will put upward pressure on SA bond yields. 1H18 is a perfect example of the impact the international environment has on SA bonds.

MARKET OUTLOOK

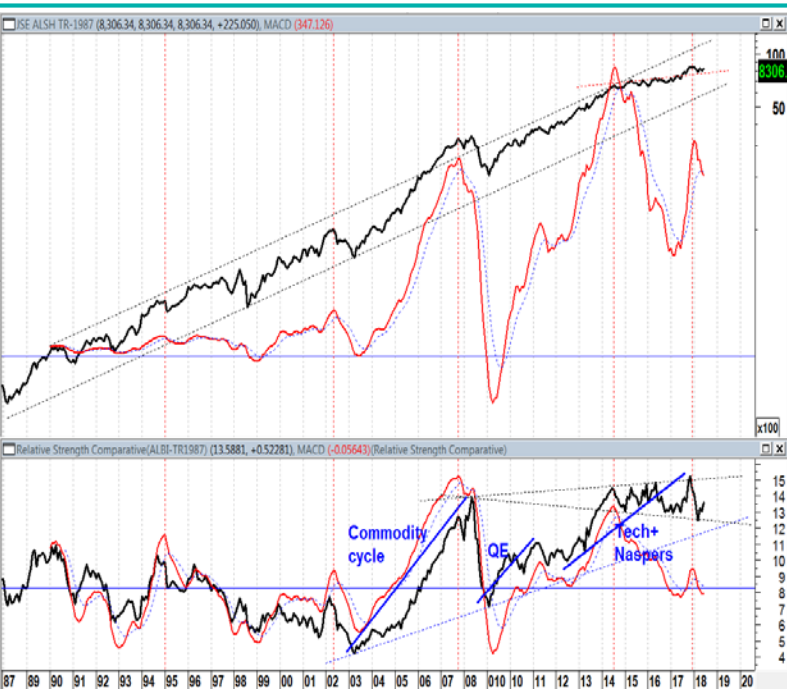
JSE ALL SHARE, OUT OF LONG-TERM BULL BUT HAS NOT GIVEN A SELL SIGNAL



Source: Reuters Metastock

- The equity market has been struggling to make any headway since the middle of 2014.
- During the risk-on phase of 2016-2017 the index has failed to break back into the original bull trend that has been intact since 1976.
- As long as the JSE All Share remains above the previous highs and the blue support line at 54867 there is no reason to be overly concerned.
- The monthly MACD which has a pretty impressive track record however confirms a major loss of bullish momentum.
- If the dollar accelerates again and the next risk-off phase starts we believe the equity will break down. As the foreign investors sell a weaker rand will not be able to protect the rand price, it will just soften the blow.

JSE ALSH TOTAL RETURN AND RELATIVE TO ALL BOND SINCE 1987

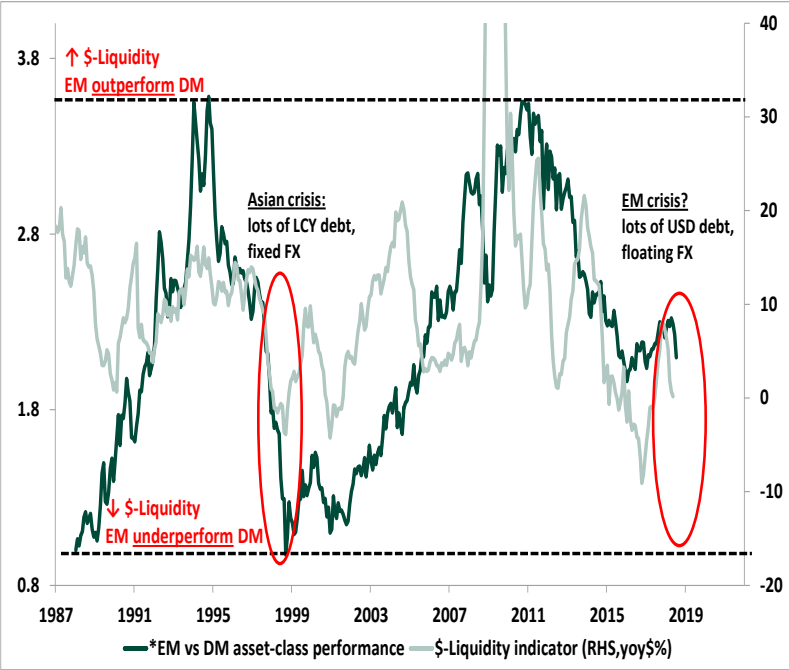


Source: Reuters Metastock

- The general consensus is that the equity market is a hedge against inflation.
- Ironically the SA equity market under-performed the bond market during the high inflation era of the late 1980 and 1990's.
- The start of the commodity cycle changed the trend and equities rallied away from bonds quite substantially.
- A break below the red dotted neckline will confirm a sell signal which should trigger further equity under-performance.
- The equities gave up a lot of relative performance during 1H18.

MARKET OUTLOOK

EM RELATIVE TO G20 ASSET CLASSES AND \$-LIQUIDITY



Source: DS, EM asset class performance is TR of MSCI EM, TR Bloomberg Barclay EM sovereign index and TR BBG EM carry-trade index. DM asset class performance is TR of MSCI G10, TR of Barclay DM sovereign index and TR DB G10 carry-index.

'FINAL STRAW THAT WILL BREAK THE CAMELS BACK': RE-PRICING OF USD MONEY



Source: Bloomberg

- Since the 1980's there has been major cycles of money flow moving in and out of emerging markets. We believe dollar liquidity played a major role in these cycles stemming from commodities being traded in dollars.
- It was not just the Fed that bailed out the markets in 2009. The big rally in EM's post the GFC was on the back of the commodity run which was fuelled by the Chinese 'bail-out'. The rising commodity prices (and petro-dollar balances) added many dollars to the financial system. Commodity prices peaked in 2011 and fell until the end of 2015 and EM's started to under-perform. The rising liquidity that triggered the risk-on phase of 2016-2017 came from the rising oil price (\$28 to 78) and the ECB flooding the system. This however came to an end in February 2018.
- This relative chart warned in 1994 already that emerging markets were slowing down although the crisis only materialised in 1997/8. In 1998 EM's especially SE Asia had fixed exchange rates and their currencies could not buffer them against capital out-flows. Most of these countries now have floating currencies and reserves, but post 2008 they have taken on substantial USD debt putting them in the same situation as in 1998.
- Hence our concern, if global liquidity does not improve soon EM's will be very vulnerable to major outflows again.
- As the US Dollar is the currency of the world, US interest rates are the base of rate of the price of money in the world too.
- Without going into the technical discussion of the composition of interest rates, one needs to understand the importance of the term-premium i.e. compensation that a investor demands in light of credit-risk, term-risk, inflation volatility risk etc.
- The US term-premium has been falling for many decades amid 1) the growing USD monetary base as surplus nations recycled their FX reserves back into the US bond market i.e. [Bernanke's saving glut](#) 2) because of the QE process by the Fed to compress risk.
- A slowdown in global growth and tighter monetary policy by the Fed will slowdown USD creation and as a result the term-premium is likely to rise. Traditionally the nominal yield declines as the term-premium rises. The rising cost of USD funding through the term-premium will not bode well for assets.
- To conclude: While we acknowledge the importance of the demand/supply dynamics in the real economy, we believe investors should pay more attention to the role money supply plays in the return of assets.