Economic Update

1. SA manufacturing production worse than expected in January, recording almost no growth over the past year. The sector continues to struggle to gain momentum in a weakening global environment.

2. SA business confidence index weakened further in Q1 2019 to 28 points despite recent efforts by government to stimulate growth and investment. Confidence levels across all business sectors remain well below the critical 50 index level.

3. US retail sales better than expected in January 2019 after the shockingly weak December retail data that was revised even lower. Overall, however, retail sales are losing momentum.

4. US consumer inflation remained relatively subdued in February 2019 at 1.5%, but is still expected to drift modestly higher during the remainder of 2019 due to higher wages. Wage inflation is currently 3.4%.

5. US industrial production worse than expected in February 2019 but still well out-performing the Euro area.

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1. In January 2019, SA manufacturing production fell by a substantial 2%m/m, after increasing by a revised 1%m/m in December 2018 (monthly data is seasonally adjusted). The market was expecting production to decline by a more modest 0.5%m/m. Over the past three months (Nov 2018 to Jan 2019) production recorded growth of 0.4%q/q. The recent weakness in the PMI manufacturing data to 46 index points in February suggests that the manufacturing sector is likely to continue to lose momentum in the coming months. Clearly, the re-emergence of electricity outages could further curtail the performance of the sector, aggravated by the current slowdown in global growth. Overall, a challenging start to 2019.

Over the past year manufacturing activity has risen by a mere 0.3%y/y, after having achieved an average annual growth rate of 1.1% in 2018 as a whole. On a longer-term trend basis, SA manufacturing output remains far below the level of activity that prevailed before the onset of the global financial market crisis in 2008. In addition, and unsurprisingly, South African manufacturing has massively underperformed global manufacturing in the past ten years.

The SA manufacturing sector comprises ten major subsectors. The largest is food and beverages (25% of overall manufacturing), followed by the chemical sector (24%), and iron and steel (19%). At the other end of the scale, the clothing and textile sector comprises a mere 3% of total manufacturing, while the manufacture of electrical machinery is only 1.6%. Each of these ten major manufacturing sectors is comprised of a number of additional subsectors, which means that in total SA's manufacturing sector is divided into more than 40 distinct industries, each with its own performance characteristics. While the manufacturing sector (in total) recorded growth of only 0.3% over the past year, there was (as usual) a very wide dispersion in performance at a sub-industry level. This dispersion is currently highlighted by the massive growth gap between, for example, the production of food and beverages (+2.9%), and footwear (+8.9%) vs. basic chemicals (-4.7%y/y) and clothing (-1.6%).

As mentioned last month, in President Ramaphosa's State of the Nation Address in early February 2019 he suggested that the government will focus on encouraging manufactured exports. Unfortunately, lifting South African manufacturing activity, and especially manufactured exports, on a sustained basis is not an easy task. Competitive manufacturing requires a combination of factors, including supportive infrastructure (reliable power supply is obviously crucial), appropriate regulation, a stable and productive workforce, innovative and dynamic management, an appropriate balance between the use of technology and labour intensity, and access to financing. Unfortunately, in recent years SA has struggled to achieve the right combination of factors that would allow the manufacturing sector to flourish and grow in line with global trends, with one or two exceptions at a sub-industry level. Hopefully, the government will focus more actively on improving SA's ease of doing business (as the President suggested in SONA), which should start to encourage some investment back into SA manufacturing.

2. In Q1 2019 the RMB/BER Business Confidence index fell to 28, down from a revised 31 index points in Q4 2018. This was worse than market expectations for an increase in confidence to 32 index points. It is concerning that the confidence reading has fallen throughout 2018 and into Q1 2019, despite government's efforts to stimulate growth and investment. A reading of 28 suggests that the majority of business people surveyed (1 700 people are surveyed) were unsatisfied with current conditions. This is the lowest reading since the middle of 2017, when it reached 27 index points, and is similar to the rate of decline during the global financial crisis.

A breakdown of the confidence reading by sector suggests that four out of the five business sectors surveyed recorded a deterioration in confidence, namely retail trade (confidence index declined to 24 in Q1 2019 from 33 index points in Q4 2018), manufacturing (declined from 30 in Q4 2018 to 26 in Q1 2019), and wholesale trade (declined from 44 to 40) as well as building contractors (down from 32 index points to 23). In contrast, confidence levels amongst new vehicle dealers are the only sector that registered an improvement in confidence (increasing to 26 from 15 index points).

The confidence level in all five sectors remained well below the critical 50 index point level. Probably, as a result of weakness in domestic demand, businesses' ability to pass on higher costs has become more constrained. In addition, several external developments have also dampened the mood. These include the disruptive effects of load shedding in February, prolonged labour strikes in certain sectors of the economy, slowing growth in SA's main trading partners (ie the EU, China and the rest of Africa), more revelations about the extent of state capture and corruption in SA, the continued conflicting announcements on policies and priorities due to the variances within the ANC as well as the adverse impact of the expropriation without compensation dialogue on many investors' perceptions of the security of private property.

At the risk of stating the blindingly obvious, the current level of confidence is dramatically below the previous peak of 82 index points in Q3 2006. At that time the South African economy was growing at almost 6% a year. Clearly, the SA business sector currently lacks the level of confidence typically associated with a broad-based pick-up in economic activity, but most especially fixed investment spending. In recent years, the SA business sector has, unfortunately, become increasingly reluctant to increase fixed investment spending and expand employment.

Under current circumstances it is critical that the building blocks needed for increased business investment, for example supportive infrastructure, policy certainty, and adherence to the rule of law, are strengthened in a credible and consistent manner. Since taking the reins, the President has launched several initiatives to help reverse SA's economic decline. However, as encouraging (and necessary) as these have been, measures such as these to firstly expose past corruption, and then to deal with rebuilding institutions, will only bear fruit in the longer term. Equally, initiatives emanating from last year's job and investment summits will take time to deliver the desired outcomes of increased private sector fixed investment and employment creation.

3. In January 2019, US headline retail sales rose by a modest 0.2%m/m. However, this was better than market expectations, which was for sales to remain unchanged after a shock decline in December 2018. On an annual basis, US retail sales were up 2.3%y/y (in nominal terms), compared with growth of 1.6%y/y in December. Although the January data reflected an improvement in headline sales, the annual growth rate of 2.3% is well below the 2018 annual average of 4.9%.

If motor vehicle sales are excluded, retail sales increased by a much more substantial 0.9%m/m in January 2019. This was much better than expectations for growth of only 0.3%m/m. Excluding vehicle and gasoline sales, retail spending increased by a solid 1.2%m/m. Again, it was better than expected. **Overall, January's retail sales report was encouraging relative to the sharp decline in December 2018 (which was revised down in January 2019), especially if you exclude the weak vehicle sales data.**

All US retail sales data is measured in nominal terms. This means that changes in price (especially gasoline prices) can have a significant impact on both the monthly and annual rates of change in retail activity.

Perhaps the stand-out features of this month's US retail sales report were the strong rebound in sales of building materials (+3.3%m/m) as well as the growth in '**non-store retailing**' which includes electronic online shopping. For example, in January 2019, non-store retail sales rose by a substantial 2.6% month-on-month and by a robust 7.3% year-on-year. Strangely, the January data for non-store retailing might have been boosted by "gift cards" that are typically given for Christmas, but perhaps only spent in January. Non-store retailing achieved an average annual growth rate of 9.3% in 2018, after having grown by 10.8% in 2017, 10.1% in 2016 and 9.4% over the past five years. It is worth noting, however, that the January 2019 annual rate of growth of 7.3% is well below these recent averages.

While it might be fair to argue that the recent US government shutdown might have had a more significant impact on the performance of the US economy than was anticipated, a range of data including US retail sales suggests that the economy is systematically losing momentum. This loss of momentum is not suggestive of an impending recession, and it is certainly not as weak as the recent economic data reported in the Euro area, but it seems fair to expect that the US economy will not be as strong in 2019/2020 as it was in 2018.

4. In February 2019, US consumer inflation rose by 0.2%m/m, in line with market expectations, after recording no increase in each of the previous three months. The annual rate of inflation eased to 1.5%y/y in February 2019, down from 1.6% y/y in January 2019 and a recent high of 2.9% y/y in July 2018.

The monthly increase in inflation during February 2019 was partly due to the recent rise in the oil price as well as higher food prices and a further increase in housing inflation. In contrast, many other components of the US inflation basket fell during the month including vehicle prices, clothing, and medical supplies. During 2018 as a whole US consumer inflation averaged 2.5%, which is the highest annual rate of inflation since 2011. The US Federal Reserve has an informal inflation target of 2%, although they focus on a fairly wide range of inflation measures including core inflation and PCE inflation. For 2019 we expect US inflation will average around 2.1%.

Core consumer inflation, which excludes food and energy, rose by only 0.1%m/m in January 2019, which was slightly below market expectations for an increase of 0.2%m/m. **On an annual basis core inflation eased to 2.1%y/y from 2.2%y/y in January 2019 and has ranged between 2.1% and 2.4% in each of the past twelve months**. US core inflation averaged 2.1% in 2018 and has not risen above 2.4% during the past ten years.

On balance, despite the current fluctuations in the oil price, which have a fairly large impact on the headline inflation rate, the underlying rate of inflation in the US appears to be trending mostly sideways, with no real sign that higher wages are pushing prices higher. As mentioned above, we currently expect US headline inflation will average 2.1% in 2019, while core PCE inflation is projected at 2% in 2019 after recording an average of around 1.8% in 2018. Importantly**, the expected moderate upward drift in US inflation during 2019 does not appear robust enough to justify the US Federal Reserve adopting a more aggressive approach to monetary policy tightening, especially since the economy appears to be losing momentum.** We will continue to closely monitor the underlying inflationary trends, as a sharp increase in US inflation could unsettle global financial markets.

5. In February 2019, US industrial production increased by a mere 0.1%m/m (seasonally adjusted), which was below market expectations for an increase of 0.4%m/m. More concerning, manufacturing activity, which is the key component of industrial activity, declined by -0.4%m/m in February, also well below market expectations. Despite the weaker than expected February data, **over the past year US industrial production was up 3.9%y/y, which is well**

above the five year average annual rate of growth rate of a mere 1.3%, and only slightly down from 2018 annual average of 4.1%. Importantly, the annual rate of growth in manufacturing is noticeably softer.

Capacity utilisation in the industrial sector also weakened marginally in February to 78.22%, which is down from 78.26% in January 2019 and a recent peak of 78.8% in November 2018. While the current level of capacity utilisation would support a sustained pick-up in fixed investment spending, the recent weakness in US production as well as global trade will probably result in many industrial companies adopting a “wait-and-see” approach to new investment projects over the coming months. This trend already appears to be unfolding in US durable goods orders.

The US ISM has fallen from a peak of 60.8 in August 2018 to 54.2 in February 2019. This is the lowest reading for the ISM since October 2016. **The weakness in the ISM corresponds to a decline in PMIs around the world, but most especially in the developed world.** For example the PMI in the Euro area has slumped from 60.6 in December 2017 to 49.3 in February 2019. This weakness in global PMIs is also starting to reflect in actual production data. German industrial production fell by 3.3%y/y in January 2019, after declining by 2.7%m/m in December 2018 and -4.0%m/m November 2018.

Historically, there has been a good correlation between the US manufacturing business cycle and the overall economic cycle of the country. However, this relationship has become less pronounced in recent years as the size of the US manufacturing sector has dwindled. For example, back in 1997 (the first year for which the government has data on GDP by industry) the manufacturing sector represented just over 16% of the US economy. In late 2018 it had fallen to around 12%. Equally, US private sector employment is no longer highly dependent on manufacturing employment. Back in early 1980s, US manufacturing employment comprised around 20% of total employment. Today it is less than 9%.

While the US manufacturing sector is not as vital a component of the US economy as it used to be, it remains significant. **Sustained weakness in US industrial production, especially if it is accompanied by weakness in global manufacturing activity (which is becoming a more significant concern) could systematically weaken business sentiment in other sectors of the economy, thereby undermining their desire to expand and employ**. A sustained weakening of the US and Euro area labour markets at this stage of the business cycle would signal a significant broadening of the current economic slowdown. (In February 2019, US manufacturing employment was recorded at its highest level (12.834 million employees) since the global financial market crisis in 2008/2009).

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