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Is Trump's latest scandal a bridge too far for investors?

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After the US election, equities and the US dollar rallied on the expectation that President Donald Trump would deliver business-friendly tax cuts, regulatory reform and infrastructure spending. However the latest controversy around the US president was one too many for US equity investors.

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The S&P500 and Nasdaq indices roared ahead to new record highs a few days ago. Moreover, an eerie calm had descended on markets, with actual and implied volatility declining to multi-year lows. The CBOE Volatility Index (VIX), also known as Wall Street's fear gauge, fell to a level last seen in 1993. Volatility has also been subdued on bond and currency markets.

But the latest saga, with a special counsel appointed to investigate links between Trump's election campaign and Russian officials, led to a substantial equity sell-off and jump in the VIX on Wednesday and Thursday, as the message finally hit home that his presidency would achieve very little in terms of policy changes as long as it was mired in controversy.

The trade-weighted US dollar index fell back to its pre-election level. Gold, traditionally seen as a safe-haven asset, rose.

The broader backdrop remains favourable, however. Firstly, US inflation is surprisingly low, despite signs that the labour market is tightening with employers struggling to find workers (even as some workers struggle to find jobs because of skills or geographic mismatches). Expected inflation, measured both by surveying consumers and by what is implied in bond yields, also remains low. This means it is still very likely that the Federal Reserve will hike interest rates only gradually, though a June increase is still on the cards. A rates shock to the global system is therefore unlikely.

Better global growth

Secondly, global growth has picked up, both in developed and emerging economies. The US had a disappointing first quarter, in what seems to be a repeat seasonal anomaly. But it created an average of 185,000 jobs per month this year, which is faster than growth in the labour force, and unemployment fell to a cycle low of 4.4%. Available economic data for April has been pretty good. In other words, it is not as if the US economy needs stimulus from the White House.

First quarter gross domestic product (GDP) growth in the Eurozone was strong, with the powerhouse German economy posting a record 11thconsecutive quarter of positive growth.

Japan's economy has expanded for six consecutive quarters, the best run since 2006. Among emerging economies, China had a very strong first quarter. The available data for the second quarter is softer as expected, but still solid. Elsewhere, in South-East Asia in particular, growth is accelerating, while Indian growth is steady around 7%, despite the demonetisation shock last year. Russia emerged out of recession in the first quarter.

Brazil, the largest emerging market after China and India, was also gripped by political scandal (again) last week with President Temer - appointed last year after his predecessor was impeached - accused of authorising bribery. Like with Trump, markets initially responded favourably to Temer's ambitious reform agenda, which is now surely in doubt. Brazil suffered 11 consecutive quarterly GDP declines until the fourth quarter of last year – its worst recession on record - but the first quarter is expected to be positive. Fresh political instability might derail this recovery and Brazilian shares and the real fell sharply.

Strong earnings growth

Thirdly, the recent global earnings season was the best in six years, with Japan recording the highest year-on-year growth of 28% in earnings per share, followed by Europe (23%) and the US (14%). Some of this is due to a recovery in the oil price, but better economic conditions also support the ability of companies to grow profits. Ultimately, shares follow earnings, not politics.

What are the implications for local investors

The JSE largely shrugged off the global sell-off, mainly because of Naspers, which rose further last week after Tencent, the Chinese internet giant in which it has a stake, posted 41% earnings growth. Resources shares also had a strong week. Naspers now constitutes 15% of the JSE All Share Index (and 20% of the SWIX, the index favoured by fund managers). This means that more than half of the year-to-date index returns have been delivered by only one share. While Naspers's performance is obviously welcome for its shareholders, it does create concentration risk, especially for passive investors.

The rand sold off as global risk aversion set in (as it usually does) with the controversies around President Temer hurting emerging market sentiment. However, stepping back a bit, the global backdrop described above remains favourable for emerging markets. The combination of gradual expected US interest rate hikes, a softer US dollar, low yields across the developed world and a cyclical rebound in global growth are supportive of emerging market equity and bond markets.

A rand-dollar exchange rate of between R13 and R14 still implies falling inflation during the course of the year, and possible interest rate cuts. The Reserve Bank has repeatedly said that it's focusing on risks to the exchange rate, and is therefore very reluctant to cut. However, it may be in a position later this year where credit ratings downgrades not resulted in sustained rand weakness, but rather in a more lasting blow to business and consumer confidence. The case for a rate cut would then be very strong.

South Africa is likely to post positive first quarter growth when GDP numbers are released early next month. After the fourth quarter contraction, it would mean avoiding a technical recession of two consecutive negative quarters. This will largely be due to a rebound in mining and agriculture.

Manufacturing, retail and wholesale sales were negative in the first quarter. Retail sales declined by 1.1% on a seasonally adjusted basis in the first quarter, largely due to the 6.4% slump in clothing sales. The motor trade, covering new and used car sales, petrol stations and workshops, had a positive quarter (in nominal terms). The International Monetary Fund last week upgraded its 2017 forecast for South Africa's growth rate slightly to 1%.

Focusing on the bigger picture

Politics can cause volatility on markets, as we've experienced in South Africa over the past 18 months. However, over time, fundamentals matter far more. These still appear to be solid globally, and improving from a low base locally. Political scandals are far more likely to grab news, but the key for investors is to ignore the noise. At the same time, no one can consistently predict the future.

ABOUT THE AUTHOR

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