STRATEGY NOTE:
EQUITY STRATEGY
'THE STRAW' THAT BREAKS THE CAMEL'S BACK

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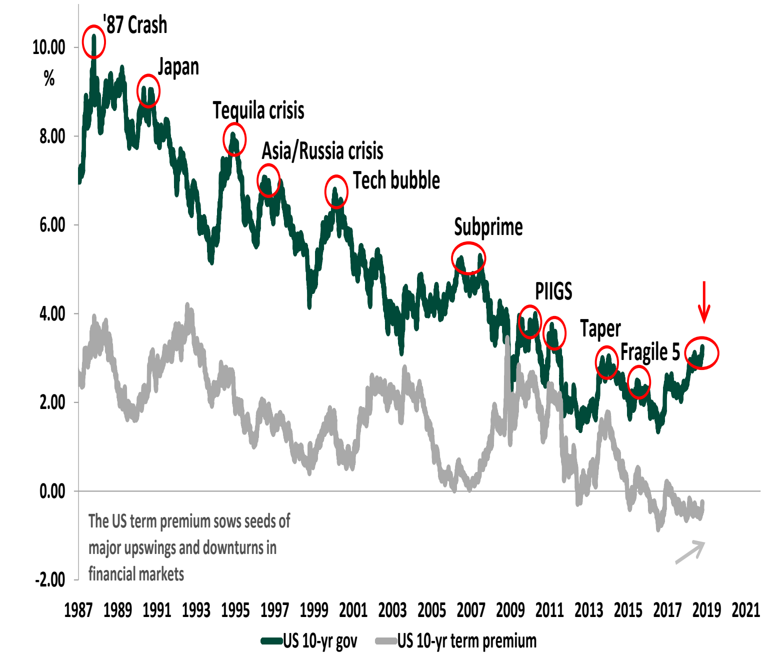
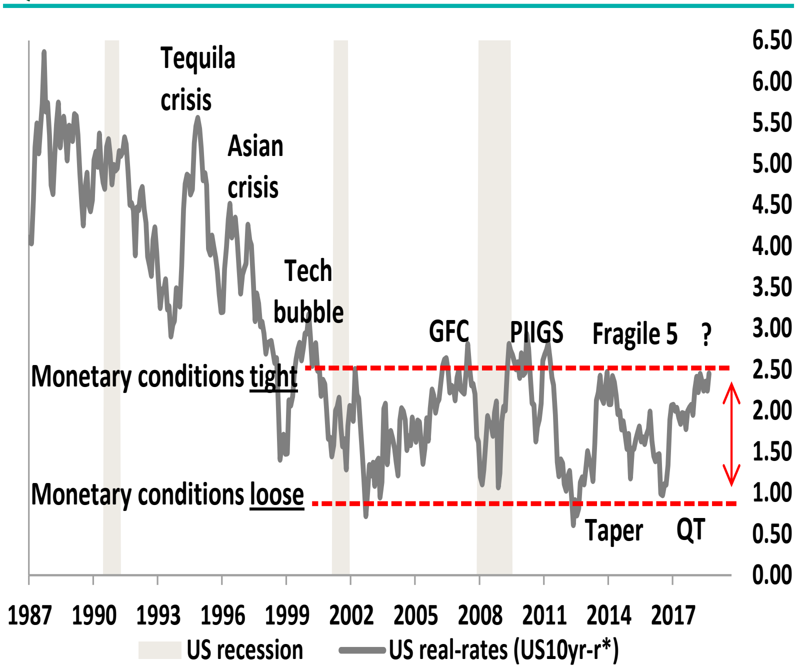
A SHARP RISE IN THE US INTEREST RATE HAS ALWAYS PRECEDED A FINANCIAL MARKET DOWNTURN – THIS TIME SHOULD BE NO DIFFERENT



Source: DS, Nedbank CIB

- To begin with, the theory we have held for many years is that changes in credit play a far bigger role in determining asset prices. More specifically, we believe the **US dollar (the reserve currency of the world) and US interest-rate (world's risk-free-rate)** cycle play a vital role in determining changes in asset prices and the global economy, especially after the gold standard was abolished in 1971.
- **In this note, we explain why we believe we are approaching historical thresholds, where tighter monetary conditions in the US have traditionally been the 'straw that breaks the camel's back' for the equity market and economic growth.**
- This time should be no different.

US REAL INTEREST RATES INDICATE WE ARE CLOSE TO THE END OF THE CURRENT EQUITY BULL MARKET AND ECONOMIC CYCLE



Source: DS, Federal Reserve of NY, Nedbank CIB

- We define **US real interest rate** as the spread between the US 10-year bond yield and the natural rate of interest (r*).
- The ***Laubach-Williams r* estimate*** is basically the real short-term interest rate at which the US economy is at equilibrium, i.e., where unemployment and inflation are at the 2% target. This enables us to gauge monetary conditions in the US relative to the underlying economy.
- Historically, US real interest rates have been an accurate indicator for measuring monetary conditions and gauging turning points in the financial and economic cycle.
- During the "Volker era", US real interest rates rose steadily and ranged from **4-10%**. However, from the late 1990s, it has become evident that central banks would bail out the financial system (Greenspan/Bernanke put) and, as a result, US real interest rates have ranged from **1-3%**.
- **Since the late 1990s, it has also been quite evident that when US real interest rates rise to the upper band of the 1-3% range, monetary conditions become too tight, leading to a liquidity crunch in financial markets, marking the end of the economic cycle.**

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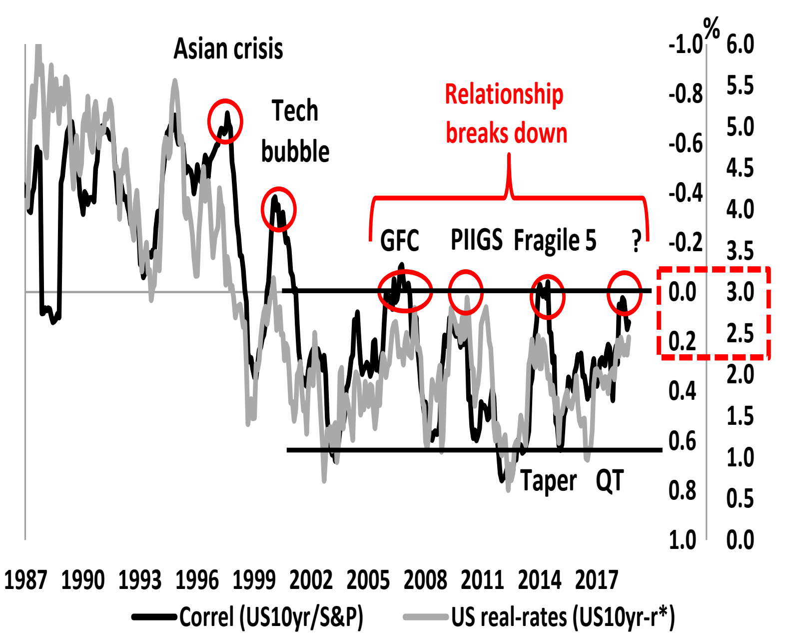
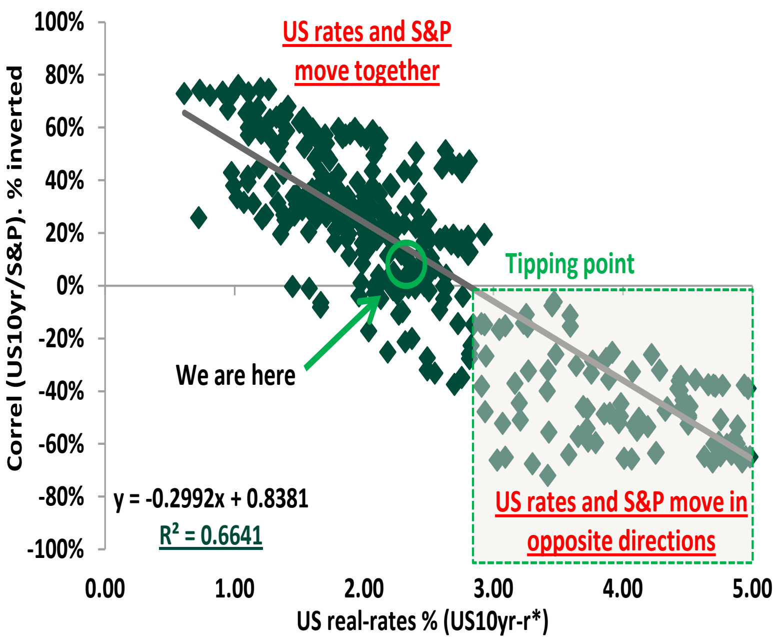
RISK-OFF EPISODES TEND TO OCCUR WHEN THE RELATIONSHIP BETWEEN US REAL INTEREST RATES AND THE US 10YR/S&P 500 CORRELATION BREAKS DOWN



Correlation refers to weekly changes between the US 10yr and S&P 500 (12m rolling); Source: DS, Federal Reserve of NY, Nedbank CIB

WHAT LEVEL OF US 10YR REAL INTEREST RATE WOULD 'BREAK THE CAMEL'S BACK'? TRADITIONALLY, IT HAS BEEN AROUND 3%



Source: DS, Federal Reserve of NY, Nedbank CIB

- Since the late 1980s, it has been evident that a strong relationship exists between the **US real interest rate and the US 10yr/S&P 500 correlation**, which has been **mainly positive**, i.e., interest rates rise and the S&P 500 rallies, and vice versa.
- However, there have been a number of instances when this relationship has **'broken down', resulting in major risk-off periods** – the Asian crisis, the tech bubble, the GFC, the PIIGS crisis, the 'taper tantrum' and the Fragile 5 crisis.
- These severe bouts of risk-off episodes occurred mainly because monetary conditions became too tight.
- As monetary conditions tighten, the relationship between US real interest rates and the US 10yr/S&P 500 correlation moves **from positive to less positive/negative, i.e., interest rates rise, but the S&P 500 starts to fall.**

- We have **calculated that** the approximate range of US real interest rates that we believe will be 'the straw that breaks the camel's back'.
- The **'tipping point'** at which the relationship between US real interest rates and the S&P 500 moves from being positive to negative (which is the risk-off phase) is when US real interest rates rise to **2.70-3.00%,** as reflected in the scatter plot.
- The US real interest rate is currently at **2.64%.**
- US economic growth has been supported by the **expansionary fiscal package**, but when this effect starts to lose momentum, the natural rate (r*) is unlikely to rise at the same speed as the US 10yr rate. Therefore, we believe the real interest rate will likely rise; this would be the 'tipping point' for financial markets.

The bottom line:

- **Monetary conditions are too tight**, and we are close to the 'tipping point', where higher US real interest rates begin to hurt equity prices and growth. US corporations are highly leveraged, and rising real interest rates will be damaging to their balance sheets.
- The **SA stock market** has a higher correlation to the performance of the S&P 500 than to the rand. Hence, we believe the JSE will also come under pressure if the above scenario unfolds.

COMPLETELY DIFFERENT PICTURES: S&P 500 AND MSCI WORLD EX US

Source: Reuters, Nedbank CIB

- After the sell-off in January 2018, the **S&P 500** worked higher in a rising wedge. This rally completed the Elliott wave count since the 2009 low, and the MACD failed to confirm the new high, **confirming the loss of momentum**. The market has subsequently broken down out of the 2018 bull trend, targeting the bottom of the bull channel at 2,553.
- The general rule in Elliott wave analysis is that on completion of a five-wave structure, the market tends to correct the fifth wave, which **targets a correction to 1,821.** This level is also a 50% retracement of the bull trend since the GFC.
- Price action of the **MSCI-World ex US** after the GFC lacks textbook bull-market characteristics. Not one wave is an extension of a previous wave, confirming the lack of a strong trend.
- The risk-off phase since the start of the year is currently finding support at 1,906. **The next risk-off phase projects a move to 1,612**. A break below the latter targets a move to the low from 2010-12 of 1,328; this would materialise only if the S&P 500 breaks below 2,553.

JSE SHAREHOLDER WEIGHTED ALL-SHARE INDEX (JDALS) TESTING SUPPORT

Source: Reuters, Nedbank CIB

- **The JSE Shareholder Weighted All-Share Index** formed a wedge pattern from 2014-17. Wedges are usually the penultimate wave in an Elliott wave structure. The rally in late 2017, therefore, completed the bull wave pattern that started after the GFC.
- During the 2018 risk-off phase, the index corrected to the mid-point line of the previous consolidation phase at 11,337. A rally from this line to test the blue neckline at 11,911 is possible, but we do not believe the correction phase is over.
- Our **target level** for this correction phase remains at 10,788, with our preferred count at the **2015 low of 9,983**.
- <u>If our fundamental work above materialises</u> the downside potential for the S&P 500, MSCI World ex US and JSE (Weighted All-Share index) is a correction in the range of **20-30%** from current levels.