

23<sup>rd</sup> July 2010

Hi all

## [A global and local economic update](#)

There were no surprises during the last three months, especially for AJM clients who were generally in agreement that the continuous rise in stock prices was unsustainable, and that the economic climate did not reflect a booming future. The more defensive strategy has thus far proved valuable. The SA market has come out of this period fairly well, with only the resources sector feeling the pinch. Global trends continue to show that emerging markets are more resilient than first world economies.

## [Investment analysis on lump sums to 30 June 2010](#)

Source – Spotlight Investor	3 months	1 year	5 yrs	10 yrs
<b>JSE INDICATORS</b>				
FTSE/JSE Top 40 index	-7.2%	17.5%	13.5%	14.4%
Small cap index	-3.7%	20.6%	14.8%	21.8%
Mid cap index	-0.5%	29.4%	18.3%	21.1%
Financial sector	-7.2%	18.1%	7.3%	9.5%
Industrial sector	-4.0%	22.5%	16.1%	11.5%
Resources sector	-8.8%	14.8%	15.0%	19.2%
Property Unit Trusts	-0.6%	18.6%	9.7%	19.2%
Money-market Fund	1.7%	7.5%	8.9%	9.5%
Rand / USD rate	-2.4%	1.0%	-2.8%	-1.2%
Rand / EURO rate	6.2%	15.1%	-3.0%	-3.8%
<b>GLOBAL INDICATORS</b>				
FTSE (£)	-10.5%	17.2%	-0.1%	-0.0%
S&P 500 (\$)	-9.6%	13.4%	-2.9%	-3.3%
DJ Euro 50 (€)	-10.7%	-1.8%	-5.0%	-7.3%
Hang Seng	-4.9%	9.5%	-4.1%	-6.0%
Nikkei (Yen)	-11.2%	-5.8%	-4.1%	-6.0%

Actual returns for 3 months for lump sum investments after costs have been deducted  
 Annualised returns for 1 and 5 yrs for lump sum investments after costs  
 Global indicators in the currency of residence

## Analytical review – Indicators

### AJM Indicators (see Q4 2008 report for motivation and explanations)

1. Real Hourly Earnings – US hourly earnings continue to drop. Over the last two years, this indicator has led the trend in PCE and markets. It will be worth watching this space closely.
2. Personal Consumption Expenditure (PCE) – This index trails hourly earnings by 3-6 months and true to form it followed the rise in hourly earnings in 2009, and is at present still rising. It is thus expected that consumption will track earnings downwards during the latter part of 2010 and 2011. PCE has been a reliable indicator of the markets 3-6 months into the future.
3. Federal Reserve rate – Rates are still at historic lows assisting the recovery. The one strong indicator of no further recession is that the yield curve is not inverted (long-term bonds earn lower than current bonds).
4. Price vs earnings – Expected earnings are rising on the back of stronger current earnings. Companies have cut back expenses dramatically and it is thus difficult to determine how continued earnings growth will be generated without consumer activation. Prices are on the high side but not unreasonable.
5. Currency valuations – The Eurozone appears to have averted defaulting partners thanks to some fairly unpopular bailout packages and China's commitment to support Eurozone bonds. China has continued buying US bonds but has been talking about diversifying its holdings for a number of years. The US has been vulnerable for some time and both the US and China are in a catch 22 situation. If China stops buying US bonds, the USD and its purchasing power implode along with China's existing holdings. I am not sure who stands to lose more. While Spain, Greece and a number of other countries are not in the clear by any account, the risk of default appears to be less ominous, although the steps to contain the debt problems will be felt for a while. The repayment of US government debt seems to be based on plans that are fraught with difficulty. The relatively strong USD thus looks vulnerable, and the weaker Euro and Sterling are looking more attractive for patient investors.
6. The price of debt – Both corporate and government debt are back to normal levels and are thus not showing any clear signs of weakness or strength. Emerging markets, with their higher inflation, offer better bond rates and the added incentive of stronger economic recovery stabilising these economies and making higher bond yields less risky. First World economies have low bond rates and are unlikely to offer any attraction as rates can only rise.
7. Investor psychology – When investors do not understand a future outcome, uncertainty and panic sets in. The divergent opinions on how the White House is resolving the US debt mountain is fuelling uncertainty. In addition the "Global Village" has resulted in economies being closely intertwined, creating further uncertainty over a multitude of scenarios and more panic. As a result, most investors have rushed once again into cash.

#### To elaborate a bit more on investor psychology:

Uncertainty prevails at any time in market history, so this is not a new scenario. However due to the severity of the current global debt problem, with history against most of the solutions, it is not surprising that we are going through a very unsettled period.

Traditional investment theory works on the principle that markets are efficient, in that you have a willing buyer and a willing seller, and thus the price is always a true reflection on the value of a stock. Market patterns, however, show that investors are irrational and that emotions at the time of trading play a huge role in market direction.

Bubbles are created by investors when the excitement of something growing rapidly, combined with greed, results in prices being driven well above realistic values. Conversely, there is almost always an overshoot when the panic sets in. While companies like Marketpsych have designed

models to measure “the Fear Factor”, the model work well only some of the time (like all other one-dimensional models).

The debate continues on the best investment style but there is no doubt that traders who can exclude emotion from their trading will have a much better chance of success, as will those that can think clearly during periods of panic and euphoria.

Whether you believe in double dip recessions (the US Bureau of Economic Research has not declared the recession of 2007 over yet) or not, we will need to revert to the probability of risk or failure in combination with our investment goals to determine your asset allocation.

### **Investment discussion**

In previous reports we have discussed at length the financial and housing crisis, excessive sovereign debt in many countries, as well as the restrictions on lending. With so much speculation in circulation, let's look at the facts to determine the possible downside risk or upside reward going forward.

- The US housing market still shows further downside risk (there is much more to elaborate on but most discussions end up at this point).
- Recent legislation regarding bank lending is fairly lenient, but banks are still very tight with money. Banks do remain vulnerable and exposed to sovereign default.
- Personal debt has been transferred to Government debt, which still needs to be repaid.
- The tools a government has to reduce this debt are a combination of:
  - Higher taxes – Already starting but will pick up momentum shortly
  - Lower expenditure (like military spending after WW2) – UK already starting
  - Inflation – Some way off in first world economies, and closer for emerging markets
  - Weaker currency
  - Grow really fast to repay the debt – only emerging markets are realistic participants
- Views of the US Government and the financial world on the above appear to be vastly different, with each solution appearing to cause other even worse scenarios.
- Almost all first world economies have the same debt problem, some (US and Japan) worse than others.
- Stimulus packages have resulted in up-trends for many companies, which have reflected in the market recovery thus far.
- There is enormous stockpiling of cash and bonds held by global investors which will need to find a home as markets settle.
- A collapse of the Euro and of over-indebted Eurozone countries seems to have been averted by support from various sectors. The global environment is working very hard to ensure that crises do not happen.
- The growth from baby-boomers is over. Most first world countries benefited from the post WW2 baby boom, where young families built businesses, bought houses, consumed and created private wealth over the last 30 odd years. These creators of wealth are older now and the older generation in first world countries starts to live off the system through pensions, medical aid and lack of contribution to the economy.
- Companies have been through a stringent cost-cutting and operational streamlining programme to make them lean and mean. Earnings have reflected this, which is positive.

To sum up, it appears we have a fair road to travel to rebuild confidence and consumer spending and the liquidity to accommodate such growth. That does not mean there are no opportunities for growth, it is just that more generous stock selection and manoeuvrability in the market will give investors a better chance of finding growth.

Europe seems to have put together some emergency plans that may work although, without radical reform in the specific countries concerned, further shocks must be expected. The global economy has shown a strong commitment to avoid defaults thus far, but higher taxes and more

stringent money will create their own hold on the markets. However, a weaker currency will catapult exports and thus the industrial powerhouses of Germany and France.

Once again, the emerging markets are where things are happening. Yes, there is plenty of risk, but the consumers are spending, the governments are spending, and most emerging markets are resource driven economies that are producing. While China may well be slowing down, and may continue to slow down for some years, consumer spending in India and China will continue as it did in the US over the last 20 years.

Africa has also started rumbling and, in spite of the fears of investing in Africa, the World Cup has shown that we have a magnificent infrastructure and streets free of wild animals. Add to that a liquid market and a growing population that wants to consume, and we may well find that many obstacles are overcome.

### **Investment strategy**

It is possibly not the best time to radically increase your exposure to equity. Small steps at strategic times will be a prudent strategy going forward, especially if you are largely underweight equity.

The theme of benefiting from consumers who are still consuming tends towards the emerging markets and investing in first world companies that generate profits out of emerging markets is a good equity strategy.

There is always uncertainty when investing in equity and it is this uncertainty that creates opportunities for investors. There are so many investors waiting to jump back into the market that any weakness is taken advantage of. This is true for stocks as well as companies.

The popular trend has been to use ETFs for investment as they are liquid. But be careful what you wish for. When you jump out of the market quickly, the money has to come from somewhere. Banks have collapsed on liquid bank deposits and markets have crumbled on forced selling (ala 2008). ETFs also hold the top stocks - and it is not always the top stocks you want to hold.

Investors can be guided by their view on the market.

- Global economies will bumble along until consumers are back on track, then holding your even weighting of equity is viable (with a bit of patience). More conservative investors can enjoy varied levels of downside protection using selected fund managers;
- Recession will extend till 2011 then sit on the sidelines in cash and multi-manager hedge funds.
- The next global equity boom is just around the corner, then feel alone and go with overweight equities, using stocks and fund managers with an emerging market bias (in either sector or company profile). You may have to sit back and wait.

AJM is cautious and, while the next recession/slowdown may not crash equity markets, there will be sufficient volatility around these levels to create opportunities for the investor who gradually buys into the market. Investors should not be completely devoid of equities, so underweight or moderate equity holdings at this point are prudent, depending on your risk tolerance. Use funds with downside protection if you want to have exposure with lower risk.

I would love to chat to you about your views if you feel your portfolio is not aligned to this thinking.

Kind regards

**ALASTAIR MACKIE**