

26<sup>th</sup> October 2010

Hi all

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

The period ending June saw a large slump in equity prices, and a subsequent change in global sentiment drove markets upwards. Global investors who are earning nothing in USD/Euro/GBP cash are desperately looking for returns, and are now prepared to take more risk to achieve that. Precious metals holding safe haven statuses have also seen strong inflows, as have equities on the back of a better dividend yield than cash. It is interesting to note that the bullish sentiment in gold and silver has not filtered through to the capital intensive mining industry. A global attraction in emerging markets and SA in particular has attracted strong inflows driving up prices and the currency. Whether it is exuberance or future fundamental growth that is attracting investors will be key to the level of aggression in your portfolio.

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

Source – Spotlight Investor	3 months	1 year	5 yrs	10 yrs
<b>JSE INDICATORS</b>				
<i>FTSE/JSE Top 40 index</i>	9.7%	16.1%	12.2%	14.2%
<i>Small cap index</i>	9.6%	15.3%	12.8%	21.8%
<i>Mid cap index</i>	9.4%	23.2%	17.1%	21.7%
<i>Financial sector</i>	12.6%	18.5%	7.9%	10.0%
<i>Industrial sector</i>	16.9%	24.7%	16.0%	12.3%
<i>Resources sector</i>	3.7%	9.1%	11.6%	17.6%
<i>Property Unit Trusts</i>	7.4%	17.9%	9.5%	17.1%
<i>Money-market Fund</i>	1.7%	7.2%	8.9%	9.3%
<i>Rand / USD rate</i>	6.5%	6.3%	-1.6%	0.5%
<i>Rand / EURO rate</i>	-1.4%	13.0%	-4.2%	-3.9%
<b>GLOBAL INDICATORS</b>				
<i>FTSE (£)</i>	14.8%	8.0%	-0.7%	-1.2%
<i>S&amp;P 500 (\$)</i>	10.8%	7.0%	-1.4%	-2.4%
<i>DJ Euro 50 (€)</i>	9.7%	-4.8%	-3.4%	-5.7%
<i>Hang Seng</i>	10.6%	6.5%	7.7%	3.6%
<i>Nikkei (Yen)</i>	-0.8%	-5.4%	-6.8%	-4.9%

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 are variable with a slight downward trend. The financial stimulus packages adopted by the US favourably distort this chart. The current data shows no clear pattern at present.
2. Personal Consumption Expenditure (PCE) – This is also showing a rather indistinct pattern but has stopped rising. Any additional stimulus packages would change this outlook, but the contra will be inflationary pressure as a result of the stimulus.
3. Federal Reserve rate – Rates are continually rising which tends to suggest a prelude to an economic slowdown. An upward-shaped yield curve is not normally a typical environment for an imminent recession. The probability of a slowdown is higher.
4. Price vs earnings – Earnings bouncing off the lows of 2009 are all looking positive. Prices do seem high against long-term averages which may not be sustainable. The outlook going forward is less murky and is largely dependent on stimulus packages to stimulate consumer spending.
5. Currency valuations – The sharply weaker USD should be a call to attract inflows. However the call to pump money into USD taking the current debt predicaments the US is facing makes it a highly speculative call. The reports of a currency war suggest that it is best to be out of the game.
6. The price of debt – Government bond rates are all at very low rates in line with inflows away from cash. Emerging markets are still perceived to be more risky, but are attracting investment money which is driving up currencies and pushing bond prices down.
7. Investor psychology – No-one wants to miss out on the action, so we can expect investors to jump into the market at this point, which will continually push prices up. Investors should really look at the environment in which they are purchasing to determine the longer-term merit of buying stocks.

### **Investment discussion**

There is always diversity of opinion regarding the future paths of economies and markets. Consensus amongst analysts is rarely confirmation of the future. Why does this time appear more difficult? It is not really, it is just that we have experienced a period of economic history where problems have continually been resolved, only to require further resolution elsewhere. The problems in first world economies (over-indebted economies and consumers, rising unemployment already above manageable levels, a Eurozone with untested challenges within its fold, consumption and production dropping, and consumers who cannot afford to retire) are old recurring problems. It is just that the US is running out of options to stimulate consumers and repay debt.

The US for example has been manipulating the economy and markets for 15 years. Every time there is a crisis, there is a fix, and the consumer bounces back. I remember in 2007 when the only argument for the US market not crashing was that the US Fed would not let it happen. And this has continued as the Federal Reserve in the US and most other countries have stepped in to avert a complete breakdown in the financial system. In some instances it has worked (the TARP to provide security to banks worked as this has mostly been repaid). The bailouts and quantitative easing will work if the economy grows at above 3.5% for the next 10 years, but there are few who actually believe any first world economy will grow at that level in the near future. Herewith the first dilemma for investors; what happens if growth is low for an extended period.

Japan has been a very quiet disaster for 20 years. It is a first world economy that has never recovered from the collapsing property and financial markets in the late 80's. While the Japanese

central banks and policy makers were very slow to react, the challenges the US faces are not dissimilar to those Japan faced back then. Japan discovered that you can give consumers money (tax cuts, rebates, purchase incentives etc), but you cannot dictate what they do with it. Japanese consumers have been savers for 20 years in an environment of zero to negative interest rates. Tell a Japanese equity investor that equity is a long-term investment and you should buy and hold (Japanese equity market has performed – 5% pa for 20 years - \$100 is now worth \$25 21 years later), and you may encounter the sharp side of a samurai sword.

While it is inconceivable to think that the US consumer would hibernate like the Japanese, the state of the US consumer is dire and thus unpredictable. Odds appear better that they try and prepare for a more financially secure life, hence AJM's call for a more cautious approach.

Why are we still so focussed on what happens in the US. Firstly it is the global currency so its health has a direct bearing on global prices and trade. Secondly, it is still the biggest economy and thus the biggest consumer. But watch this space, it was only 2 years ago that analysts laughed at the thought of China's exports being independent of the US consumer. If you look back at previous reports, AJM has for quite a while noted that China is focussing on creating other markets, and the highly populated regions of India and Africa have benefited, along with their own internal consumption explosion.

Some facts:

1. Companies globally are in good shape. They have cash on hand to spend, cut their costs and losses, and streamlined staff compliments, so are lean and mean for business.
2. The TARP bailout to prevent banks collapsing in 2008 (where the US taxpayer made 700bn available) has largely been repaid (at worst a \$40bn loss)
3. The comparisons with the US now and Japan in the 90's (thus far) is close, and the circumstances similar
4. Emerging market consumers are on a tidal wave of prosperity from poverty, and will continue to grow and develop for many years to come
5. Quantitative easing will in theory stimulate consumers to start spending, which will stimulate production and thus business activity
6. US consumers however have landed with some harsh realities and thus may slow spending and become savers for an indefinite period
7. Federal banks have taken on huge amounts of debt to stimulate the consumer, way in excess of normal limits of cyclical economics and thus are not in a position to resolve this without some material tools like inflation and weaker currencies
8. High inflation, higher taxes, lower handouts, weaker currencies and tougher economic times do not get you re-elected, and politics is going to have a bigger hand in the US going forward than economics
9. GDP Growth rates above 3.5% of GDP that are needed to repay first world economy debt and stimulate employment requires a very active and participatory consumer. First world economies do not have this at the moment
10. Many European economies do not have the tools of higher inflation and weaker currencies to relay debt and stimulate the economy, and thus will rely entirely on cuts in spending and increased taxes
11. Company prices to earnings ratios are high, factoring in a good recovery in production (in developed markets) or continued growth (in emerging markets). Any slowdown is not currently considered likely by investors.
12. Financial institutions are by no means in the clear with regards to securitized debt (all those nasty acronyms that imploded financial institutions in 2008), and there are still some nasty shocks awaiting

Weighing up the above facts leaves us with no clear picture. Does this mean we sit on our hands, invest in cash and earn 0.15%pa (in USD or Euro), and wait for clarity? Not necessarily. We need to remember that we are global investors, and we do have choices about how we invest.

There will always be companies that have sound business models that provide services or products to willing buyers and will make fantastic profits from this, and are currently trading at a very low value for a number of reasons. We need to align ourselves with fund managers who have a track record and process to identify these stocks and sectors. This by no means suggests that past performance is a guide to future performance. However, the good fund managers do it right more often and I will back fund managers who stick to what they do well.

In addition, there are new technologies and new markets that are developing that will be the market leaders in 10 years time. Having the risk tolerance and patience to invest in these companies will be rewarded.

I think the uncertainty about the future suggests we are in for some surprises over the next 12 months. If we get another serious shock, expect a sharp downturn in stock prices. If we experience lacklustre growth going forward, don't be surprised if many first world companies do well against overvalued emerging companies that are inflated due to a buying frenzy at present.

The global currency war is likely to happen, so currency strategies will be highly speculative. While cash and bonds in US, UK, Europe and Japan are giving you next to nothing in return, fund managers will seek any opportunity to make money. Following the herd will also be highly speculative as markets are trading at expensive prices.

The US housing problems continue, and in fact further revelations about how the fancy debt structures were sold and monitored are likely to cause another wave of crises in the financial services sector, as well as doing further damage to the housing market. Reports coming out from US consumers do not paint a rosy picture about the outlook.

### **Investment strategy**

In the current environment, continued exposure for the long-term is still prudent, but downside protection will make you sleep easier. There are enough concerns to warrant erring on the side of caution. Short-term trends are going to be very confusing (and will lure investors in or out of the market in waves) making it very difficult not to change strategy. Managing your own level of risk is going to be the most prudent strategy, so it is vital to ensure that you have the correct asset allocation to suit your tolerance for short-term capital losses.

For aggressive investors, do not be afraid to take some profits and sit on your hands and be patient about re-entering the market. For conservative investors, do not be afraid to hang in with good equity managers while the rest of your portfolio is structured to manage downside risk. SA income funds are returning 3-5% above inflation (tax-free in RA's preservation funds and living annuities) which is very healthy during expected low growth periods. In addition, there are many fund managers (both locally and globally) who manage downside risk really well.

If you venture into the global market from SA do it for diversification not speculation on a weakening currency.

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

Kind regards

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