

## Bad news creates investment opportunity

Economic recoveries do not run at a constant pace

Reading the financial pages of newspapers has been rather depressing of late. Europe has had to weather nothing short of a major crisis with the large indebted governments of Greece and other southern European nations exposed. It took massive intervention by the International Monetary Fund and the European Central Bank to prevent Greece from defaulting and contagion spreading to others. Adding insult to injury was the volcanic eruption in Iceland that caused massive disruption to air travel across virtually the whole of Europe.

In the US, the promising economic recovery has lost momentum as is evident from the slowing pace of employment gains and weak house sales. The disastrous oil spill in the Gulf of Mexico and subsequent disruption to drilling and fishing activity in the region has, like the volcanic ash in Europe, come at a time when the fragile economy and nervous financial markets are vulnerable to bad news.

China, who had seemed virtually immune to the normal economic cycle, is also showing signs of slowing down.

The combination of all the negative events have resulted in many gloomy headlines predicting a double-dip recession and in the case of one commentator, even a pending depression.

In reaction to the spate of bad news stock markets sold off across the world. Second quarter losses measured in US dollar terms averaged about 12% for the developed world and around 8% for emerging nations. Risk aversion again became the motto of many investors as they fled from equities to the supposed safety of US Treasuries.

Taking stock of where we stand in the economic cycle, and the valuation of financial assets, we at Coronation are less gloomy than the newspaper headlines would have us all believe. In our view the global economic cycle is behaving more or less as could be expected. It is in the nature of economic recoveries not to run at a constant rate. Initially, the gains are faster often due to restocking. Once inventories have been rebuilt the pace of recovery tends to reduce. This is the stage of the recovery we are in now.

One argument in support of a double-dip recession lies in the fiscal austerity being adopted by some European economies as they are forced to repair their poor financial balances. It is true that lower government expenditure and higher taxes are not conducive to economic growth. We do not argue with this reasoning. But, one has to point out that the severe austerity measures have in fact been taken by the smaller, weaker economies. Many of the larger ones such as Germany, France and Italy have not followed.

Acting as a strong counterweight to tighter fiscal policies is the extremely expansionary monetary policy still in place in all the major economies. Interest rates are exceptionally low and will no doubt have to rise at some point. But in our view the upward cycle of interest rates will be very slow indeed. Authorities will only start hiking rates once the pace of economic activity warrants it. The current slow patch in growth data points to central bankers keeping their policy rates at exceptionally low levels for as long as necessary.

We are also of the view that the private sector, not government, is the real engine of economic growth. Corporate balance sheets are in most cases very healthy due to sharply curtailed investment expenditure. Households, who were over indebted have also been repairing their balance sheets by saving more. We expect the corporate sector to start investing again and households to consume more now that the

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balance sheets of both sectors are much improved. Increased private sector spending should more than offset the expected fiscal tightening of governments.

The glut of bad news headlines and subsequent sell-off of risk assets has resulted in many stocks offering compelling value again. The MSCI trades at a forward price/earnings ratio of 12.3 times and a dividend yield of 2.7%. Historically this is a pretty attractive valuation level. Furthermore, when one considers the alternatives such as cash yielding close to zero and bonds below 3% we certainly have no hesitation in picking global equities as our preferred asset class.

The least preferred asset is global government bonds at today's exceptionally low yields. We are concerned that the consequences of zero interest rates and quantitative easing will lead to unexpectedly higher inflation. History has shown that equities offer investors the best protection against inflation. And when bad news abounds it creates an attractive entry point for the long-term investor who is prepared to look past the near-term uncertainties.

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