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Equity market update

By Quinton Ivan, Head of Equity Research
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Equity markets had a fantastic start to the year with the MSCI World and the MSCI Emerging Market indices returning 11.7% and 14.1% (in US dollars) respectively for the quarter. Risk assets received support during the quarter from the approval of a bail-out for Greece and another tranche of easing by the European Central Bank (ECB) via the long-term refinancing operation (LTRO). Financial markets have seemingly shrugged off concerns over the European sovereign crisis, a soaring oil price and a potential Chinese hard landing.

While the 'risk on' switch may be pressed at present, we remain cautious on the global economy. Europe remains in crisis and an orderly default from over-indebted sovereigns (like Greece and possibly Portugal and Ireland) is a likely outcome. We expect some fiscal transfer from Germany and France to the periphery in exchange for these sovereigns relinquishing some of their financial autonomy. While Europe may avert a recession, a period of stagnation is a certainty. The key risk remains a vulnerable banking system in the event of a disorderly default.

The US economy, on the other hand, continues to recover - employment, retail sales and housing data all show an improving trend. While economic growth has the potential to surprise on the upside in 2012, the US financial system relies on investor confidence. If one blocks out the name of the country and looks at the magnitude of the budget deficit, coupled with the unprecedented fiscal and monetary stimulus thrown at the global crisis, you would be hard pressed to understand why US treasury yields are so low.

A further risk to global economic growth remains China. It is an unbalanced economy driven by significant investment in infrastructure and very little domestic consumption. As a large consumer of commodities, the fortunes of resource shares will rise and fall with Chinese demand. During the quarter, China revised its target growth rate to 7.5%. While still robust, this is a significant slowdown from prior years and spooked markets causing a sell-off in commodities and other risk assets.

Austerity in the world's major economies virtually guarantees a low-growth environment. This low growth will be punctuated with periods of significant volatility as markets react to the news of the day. We continue to believe that inflation remains a threat longer term, given accommodative monetary and fiscal policies in the world's major economies. This is the price to be paid for running three-decade low interest rates together with three-decade high debt levels. In a low-growth, high-inflation environment, equities remain our preferred asset class for producing inflation-beating returns. We continue to hold what we consider to be a neutral equity exposure. At the time of writing, the All Share Index is very near an all-time high and is certainly not pricing in a sharp correction in the global economy. This, coupled with our view that domestic equities are fairly valued, does not justify higher exposure. Global equities, on the other hand, are discounting some probability of a global downturn. We remain of the view that global equities are far more attractively valued than domestic equities, and consequently our domestic balanced portfolios remain close to their 25% offshore limits.

The return of risk appetite saw the rand appreciate by 5% relative to the dollar for the quarter. We believe the rand is overvalued and maintain a high exposure to rand hedge investments such as MTN, Naspers, SABMiller and British American Tobacco. These shares remain attractively valued relative to pure domestic businesses and will benefit from a depreciation of the rand. At quarter end, approximately 62% of our equity portfolios were invested in rand hedge counters.

The All Share Index returned 6% for the quarter. Financials were the best performer with a 12.8% return. Industrials returned 10.5% and resources lagged with a -3.4% return. Resource shares have now underperformed financials and industrials over 3, 5 and 10-year periods. We remain slightly overweight resources in our equity and balanced portfolios. Although most commodity prices remain high, we believe that resources currently offer value, with selected resource shares trading at less than 10 times our assessment of normal earnings. The sustainability of Chinese demand remains the great imponderable and we do not have sufficient conviction to justify higher exposure at current prices. Our preferred resource holdings remain Sasol, the diversified miners (specifically Anglo American) and Mondi. We remain underweight gold shares as we believe they are overvalued based on our assessment of normal earnings. We also remain concerned over declining grades, impact of safety stoppages on production and enormous cost pressures faced by these businesses (labour, electricity and water).

Banks returned 15.6% for the quarter, outperforming other financials. We have advocated the attractiveness of South African commercial banks in previous commentaries, and while we have taken some profits, we remain overweight on the basis that valuations are attractive at 9.5 times our assessment of normal earnings and price-to-book ratios of 1.7 times. Earnings remain below our assessment of normal as a result of depressed net interest margins, driven by 30-year low interest rates, and high credit loss ratios.

The South African economy, while by no means booming, continues to show reasonable growth. Despite a strong rand, inflation remains above the SARB's target range of 3% to 6%. Although food inflation appears to have peaked (for now), we expect inflation to remain above target until around mid-2013 driven by high administered prices, above inflation wage settlements and accommodative monetary policy. Monetary policy is already loose as evidenced by a negative real repo rate. This, coupled with inflation that is above target, points to the next meaningful move in interest rates to be higher. Given these headwinds, we remain defensively positioned, owning companies with quality franchises, pricing power and robust business models. One such company is Mediclinic International, the investment case for which is detailed on page 12. We are cautious on consumer-facing businesses and believe current valuations that combine high ratings with high earnings do not provide a sufficient margin of safety. We continue to find value in selected small caps with approximately 30% of equity invested outside the ALSI40.

We expect markets to remain challenging for the foreseeable future. In an environment where equities are no longer breathtakingly cheap, stock picking becomes more important. We remain committed to our philosophy of investing for the long term and capitalising on any mispriced opportunities as markets respond to short-term news and where emotion trumps reason.

Quinton Ivan joined the Coronation investment team as an equity analyst in 2005 and was appointed Head of Equity Research in 2012. He currently analyses retail, construction and pharmaceutical stocks and comanages the Coronation Equity and Balanced Plus funds as well as Houseview Portfolios.

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