



International outlook

The (financial) world is not about to end – it is merely dealing with reality for the first time in a number of decades.

by **TONY GIBSON**



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In recent weeks there has been no shortage of doom and gloom headlines in the press, covering the ongoing problems of, among others: the sovereign debt crisis in Europe; the budget debate in the US, and the increasingly anaemic economic indicators from the developed economies. These factors, coupled with extreme market volatility in August and September, elicited immediate comparisons in the financial media to the volatility experienced during the financial crisis of 2008. Increasingly it is believed that we are experiencing a return to the financial crisis of late 2008. In fact, current equity risk premiums appear to be reflecting equal or greater risk than in December 2008. This phenomenon can be seen by examining the Chicago Board Options Exchange's Volatility Index (VIX), a measure of market expectations of near-term volatility as expressed by S&P stock index option prices. Some interesting comparisons that emerge are as follows:

- Corporate profits and balance sheets are materially stronger than they were in 2008.
- The Federal Reserve has kept borrowing rates at historic lows, and has made clear that they will maintain low Fed Fund rates for the foreseeable future.
- The US banking system has significant reserves (more than \$1 trillion in aggregate reserves) with aggressive write down imbedded in current assets.

While the S&P downgrade of the US government debt may have been the final trigger for the August sell-off, the solvency of the US government does not appear to be the primary concern of markets, as evidenced by the fall in yields on 10-year Treasuries following the rating change. Many factors contributed to the tumultuous markets experienced in the third quarter. These included questions regarding the sustainability of corporate profit levels, high unemployment levels, and uncertainty regarding the solvency of certain European countries and the potential for contagion to spread to other economies. With regard to corporate profit margins, we believe that concerns regarding sustainability are warranted; given that the net profit margins of major US corporations are at, or near, all-time highs. The profit margin expansion witnessed over the past decade and longer has been aided by factors including decreased corporate tax rates and rising government expenditures. The most recent increases in profit margins are largely on the back of cost controls rather than revenue increases, and may even reflect underinvestment by certain businesses. For companies whose margins have expanded as a result of underinvestment, margin levels may well not be sustainable.

Date	Event	VIX Level
15 Sep 2008	Lehman Brothers chapter 11 filing	31.7
16 Sep 2008	AIG bailed out by US government	30.3
8 Aug 2011	Day following S&P downgrade of US credit	48.0
30 Sep 2011		43.0

In 2008, it took nine months for the level of volatility to reach these elevated numbers – whereas in August 2011 it took just six or seven trading days. Investors, still fearful from events in 2008, sold first and asked questions later. The implication is that investment risks are currently the same as, or greater than, those during the disruptive events of 2008. However, we believe that comparisons with October 2008 are overdone. Current European sovereign risks aside, the fundamentals are somewhat different today for a number of reasons:

However, many better managed companies in developed markets have also focused on long-term returns on capital as opposed to near-term performance. These companies continue producing strong operating results and often repurchase their shares too. We view this as an opportunity to invest at attractive valuations, and over the medium term believe that attractive returns on assets will be realised irrespective of periodic volatility.

That said, in the short term fear in investment markets remains acute, with most potential investors staying well away from risk assets such as equities. After all, it is difficult to have conviction when we are bombarded on a daily basis with news of the imminent collapse of the euro, the US dollar, and the overall banking system. In order to gain some perspective of the current turmoil, it may be helpful to contemplate, hypothetically, what an economics lecturer may tell his class in **2021**, regarding the years immediately following the 2008 credit crisis. The points highlighted by the lecturer would, in all likelihood, track the following sequence:

- Sometime during the last two decades of the 20th century, core economic growth from the developed world economies began to slow. This, coupled with a rapid ageing of their populations would, all things being equal, have resulted in the gradual decline of living standards of these countries' citizens. This would not just be in terms of current lifestyle, but also future benefits such as healthcare and pensions.
- However, the governments and citizens of the developed countries were very reluctant to accept this outcome. Increasingly the citizens turned to the easily available credit as a means of supplementing their lifestyles. The accumulation of these increased borrowings by the citizens was predicated on the belief that historic economic growth patterns (and salary increases) would soon resume. Likewise, their countries' governments also relied increasingly on debt markets to cover their spending over-runs.
- In 2000, a massive speculative bubble in the technology sector burst, causing a major loss of investment wealth by the citizens of the developed world. This in turn led to a loss of investment confidence by investors, and inevitably, economic growth fell.
- Governments in the developed world should have let the free market work through this economic cycle. Unfortunately, however, the response of the developed world central banks was to cut interest rates to unprecedented levels so as to avert recession. Additionally, interest rates were held at these low levels for a number of years – far longer than was justified by economic necessity.
- The result was that consumers, already having been attracted to the world of easy and cheap credit, now became fully confirmed 'debt-addicts'. Debt began to be taken at an alarming rate, particularly when it came to home ownership by increasingly uncreditworthy new buyers.
- More so than ever, the undeniable decrease in economic growth was remedied by more and more debt. Their governments followed suit – supplementing falling tax receipts with increased borrowings. All developed governments were guilty – but Greece, Spain and Portugal were most definitely the worst offenders. The UK and the US were of course also on this debt accumulation wave. This is well illustrated by the fact that, in the prior decade, the volume of lending in the United States grew five times as fast as the real economy.
- Persistent and inappropriately low interest rates led to a housing bubble with all its exotic new debt and derivative instruments. This bubble eventually burst in late 2008, effectively bankrupting the developed markets' banking system. This chapter has been well documented and need no explanation at this point.
- Following 2008, the citizens of the developed economies largely realised that their credit addiction had to end. This was essentially forced upon them due to their banks dramatically tightening lending standards. However, individuals also came to the realisation that the long-held notion that 'things will soon get better' was delusional.
- But the developed world governments did nothing of the sort. They were not honest enough to tell their citizens that a severe bout of belt-tightening by their governments was essential. Neither did they tell them that social benefits had to be cut, and taxes raised in order to stem the continued burgeoning



levels of national debt that their governments were accumulating. Nor, of course, were their electorates willing to hear this message should they have accurately communicated such.

- In 2011 the developed world was, on balance, characterised by weak and ineffective leadership. Leaders who essentially hoped that they would see out their terms of office before their bad and unsustainable policies caught up with them.
- Fortunately that same year, investment markets communicated their unwillingness to tolerate the situation any longer. In the period starting 2011, investors, specifically bond market investors, forced leaders to make changes. This they did by refusing to continue funding their deficits; delivering the very clear message – ‘change your ways or be put out of business’.
- Changes, that dithering politicians would otherwise never have made, were rapidly implemented in the years that followed. This was particularly true in Europe where the rules were changed; thereby allowing a remodelled Europe to move forward on a more disciplined and united basis.
- Similarly, the US financial system was also modified, with the objective of achieving sustainable growth. But with the one big difference – this time growth would be achieved within the confines of the new, lower

growth, reality. This was of course forced upon these administrations by the dual fears of a drying-up of bond finance from emerging markets and credit rating downgrades by the rating agencies.

The conclusion that he will give to his class

Following the credit bubble that burst in 2008, the five-year deleveraging from 2008 to 2013, was an extremely difficult one for the global economies. It took a number of years before the financial system stabilised. The changes that occurred during this post-bubble period were ultimately forced upon governments; but not because the elected leaders had the will or desire to make them. It was rather due to the fact that investment markets had had enough of weak and duplicitous political leadership. Importantly, these changes were essential to restore confidence to the world's financial system.

In the period following 2012, sustained economic growth from the developed world economies resumed. While growth rates were lower than those enjoyed in the early 2000s, this new level of growth has proven to be at a more sustainable level. The most favourable consequence of the recalibration of developed economy growth expectations is that the prospect of another financial meltdown is much reduced. Importantly, the growth that is currently being experienced is neither based on the excessive build-up of debt nor unrealistic expectation of future economic growth rates. 📊