

International outlook

Climbing the wall of worry

By Tony Gibson, Senior portfolio manager
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The first quarter of 2012 was very strong, with the S&P (US) Index climbing by 12% - representing the biggest first-quarter gain since 1998. From its one-year low in October 2011, the S&P has now rallied by 28%. It is interesting to note that the 12% gain from US equities was a full 5% ahead of the gold price over the quarter. This clearly reflects the increase in risk appetite of investors as they switch out of defensive assets such as gold, and gain conviction that the US economic recovery is gaining traction.

Such a strong start to the year has inevitably led to a great deal of scepticism by market commentators, as is well illustrated by flipping through today's Financial Times (March 31st edition). Extracting a number of article headlines, a clear pattern emerges:

- 'Crisis is not yet over, EU reports warn'
- 'Monetary morphine has become fuel for risky assets'
- 'Investors ask if Wall Street rally can last'
- 'Strong quarter leaves fund managers cautious'
- 'Fears for recovery as oil costs soar'

The observation from this selection of headlines (from a single edition of a global financial journal) is that the first quarter's strong rise was unlikely to have been caused by an environment of excessive optimism and speculation. In contrast, it was more a case of equity markets rising despite the proverbial 'wall of worry' as presented by the majority of commentators who remain sceptical. There are numerous reasons to fan the flames of bearish sentiment at present, relating in the main to:

- The threat of further dislocations and a severe recession in Europe
- Threats to the US recovery from higher oil prices, weak demand and fragile confidence
- The threat of a hard landing in China

Dealing with these issues, we remain cognisant that growth in the indebted world will be insipid and that the path to a complete resolution of the European sovereign debt crisis will be a difficult one. However, the combination of an emboldened and powerful Germany, vigilant capital markets and an overly supportive European Central Bank (ECB) is enforcing profound behavioural change in Europe. It is clear that profligate behaviour will no longer be tolerated and that the ECB, with Germany's sanction, will provide the necessary support in exchange for structural reform and austerity. We believe that these features will prove to represent an effective combination of carrot and stick. The ECB's liquidity provision in the form of the so-called LTRO (long-term refinancing operation) is a clear game-changer and offers key advantages. As a consequence, systemic risk in Europe is clearly diminishing and we believe that we are nearing the time when bottom-up fundamentals become more important and the attractions of a financially robust corporate sector become clear.

The US economy - as we have predicted for a number of quarters - at last seems to be entering a self-reinforcing cycle

where faster employment growth leads to higher household income and increased consumer spending. There is increasing evidence from international companies that they are starting to experience the benefit of a steady improvement in economic activity in the US. Regarding China, there are encouraging signs that the fears of an economic hard landing were overdone. The authorities have begun modestly more accommodative policies which suggest the onset of an upturn in economic growth. This easing in financial policy is at a time when inflation pressures are abating without a sizable fall in economic output or profits. This definition of a soft landing occurs when multiples are modest (9.5 PE on 2012 forecasts) and profitability strong.

However, the crux of the underlying bearish argument revolves around the valuation of equity markets in relation to the abnormally low level of interest rates currently prevailing in most of the developed world markets. Cynics will point out that the cyclically adjusted price/earnings multiple - that is using 'normalised' profit margins for US companies - is about 70% above its average, going back to 1900. The fact that the US equity market is currently on a PE ratio (14.6 times), which is actually 11% below its historic mean, is quickly dismissed. These investors believe that current profit margins are way too high and are set to fall in response to rising interest rates, rising input costs, and rising cost of raw materials. In other words, under 'normal conditions', profit margins and therefore equity ratings are far too high.

Our argument is, however, a different one; starting with the belief that the global investment environment is at present in a very abnormal set of circumstances - and that these circumstances are not likely to change for some time to come. What has become known as the era of 'financial repression' has to be taken very seriously as the set of conditions within which investors must make decisions at present.

A growing number of strategists believe that this term accurately encapsulates how developed market debt markets are being distorted by central bank and government policies that keep interest rates at artificially low levels. Real bond yields, those adjusted for inflation, are at their lowest level since the 1970s in the US and UK. If the effect of this is to prevent market mechanisms from responding to inflation, this will pose big questions for investors' asset allocation strategies. Already the search for safe haven assets, combined with quantitative easing, means that yields are well below inflation rates in most developed countries.

The starting point - before considering what this term means - is to go back to basics. That would be to seriously consider what it is that political leaders around the developed world are hoping for as an outcome. Although we doubt that the relevant authorities would agree with the description, it seems that policy in both the US and Europe is asymmetrically in favour of inflation. The fundamental problem is that the developed world has simply accumulated too much debt, which in turn reflects the fact that politicians have been supporting unsustainable economic growth rates by means of running large deficits, and running up massive debt.

The numbers below clearly illustrate what is meant by the term 'financial repression'. Because of too much debt, interest rates are kept artificially low, but at the same time growth is anaemic and inflation is stubbornly entrenched in these economies. The result is that savers - those potential buyers of risk-free fixed-interest investments - are offered little incentive to do so, due to interest return yields being well below inflation.

FINANCIAL REPRESSION			
	France	US	UK
Government debt (as % of GDP)	102%	104%	97%
GDP growth (2012 forecast %)	0.2%	2.3%	0.6%
Inflation (annual CPI %)	2.3%	2.9%	3.4%
5-year real yields	(0.5%)	(1.8%)	(2.3%)

The first solution for over-leveraged governments is, on the face of it, clear - they need to grow their nominal GDP without increasing their debt. If they can generate 3.5% growth, their economy will double in 20 years and debt-to-GDP will halve. However, this clearly falls into the 'easier said than done' category - creating growth without any increase in spending is



currently a little like pushing on string. Nevertheless, one can be sure that governments will try everything in their power to stimulate their economies. However, there is another solution - one that governments will not discuss as it is clearly verboten - they can inflate their way out of the problem. Inflation has the same effect as growth - it increases GDP. When one looks at quantitative easing, the US\$3 trillion increase in money supply in both the US and Europe and 5%+ inflation in the UK (the peak in 2011), one can see that this is not merely a theoretical route that governments might utilise. It is a very real risk to investors' portfolios. If either (or both) of these stratagems succeed, one needs to hold a portfolio of real assets - real estate, commodities and equities.

The value on any individual investment must always be determined within the context of the risk assumed and the investment alternatives. The higher the risk-free rate (US treasury yields), the higher the return potential must be for an investor to accept additional risk. The current indebtedness of the US notwithstanding, an investment in US treasuries can hardly be referred to as 'risk-free'. In purchasing a 10-year US treasury bill with a yield of 2%, an investor not only assumes interest rate risk, but also faces the possibility of earning a negative real rate of return upon maturity due to inflation. Higher coupon bonds issued 5, 10, 20 and 30+ years ago are maturing each month, which is creating an increasingly large pool of assets that are seeking returns (higher than 2%) but are finding fewer and fewer adequate opportunities in the bond markets. We believe that this simple process of liquidity formation as a result of bond maturities will create an ever-increasing demand for higher returning equity securities.

This comes at a time when financial institutions around the world have equity exposure at historically low levels. This is well illustrated by Allianz, the German insurance group, which holds 90% of its assets in debt instruments, with only 6% in equities. Institutions such as this must, at some point, realise that rather than keep pouring money into low-yielding debt, as encouraged by governments and central banks, investors can escape the repression by buying 'riskier' assets such as equities. The uncomfortable truth for many investors is that this repression is likely to be a long-winded process with many ups and downs. There is of course the risk that this sends us along the route of a Japan-style scenario of low growth and volatile markets. What is far more likely - and condoned by politicians - is that we experience a prolonged bout of erosive inflation.

We are increasingly confident that the value in the equities held in our portfolios will continue to be realised. Well-managed companies should continue to compound book value and increase earnings - particularly if our view is correct that the recovery of the US economy will continue, rather than falter as has been the case in recent years. Most shares in our portfolios are trading at discernible discounts to their 'fair values'. However, too many investors remain focused on reaping short-term gains and avoid investing in companies which they perceive as not having a near-term catalyst. We are long-term investors, and are not particularly concerned with catalysts driving short-term share price appreciation.

Tony Gibson is a founder member of Coronation and a former CIO. He was responsible for establishing Coronation's international business in the mid-1990s, and has managed the Coronation Global Equity Alternative Strategy Fund since launch in 1996.

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If you require any further information, please contact:

Louise Pelsler

T: 021 680 2216

M: 076 282 3995

E: lpelsler@coronation.co.za

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