

## International outlook

2008 was a free-fall; 2009 was a bungee snap-back; so what will 2010 bring...?

By TONY GIBSON

The chart below shows the VIX Index. Put simply this is a measure of the volatility of the S&P index; or put another way, it represents how large and frequent share price movements have been over the past 20 years. As can be seen below, until mid-2008 the index ranged from around 10, up to 45, thereafter it went haywire, spiking at an unprecedented 80, before stabilising within the more 'normal' range of 20-30.

While this index is an indicator much used by the investment community, a brief summary of its recent history is necessary to provide explanation and perspective. It will also help in assessing the implications for the future.

### The 1989-2002 period

The index was relatively volatile during this period as the global financial system was buffeted by many financial shocks. These stresses and strains included:

- The Savings and Loans financial crisis in the US - 1989
- The Mexican crisis - 1994
- The Asian Crisis - 1996-97
- The Russian default and Long Term Capital collapse - 1998
- The Tech bubble bursting - 2000

The key observation to make during this period is that, during these 13 years, the index moved in a range from 10 to 45. During the most severe moments, referred above, the index spiked briefly to an all time high of 45 - reflecting the very severe uncertainty caused by the crises to which the financial world was subjected.

### The 2003-2007 period

During these 'wonderful' Fed Chairman Greenspan induced low heart-beat years, the index stayed in a very low band - mostly between 10 and 20. This was a reflection of the growing belief that the financial world had reached a state of Nirvana, whereby volatility and the risk of financial catastrophe were deemed to be a thing of the past. The major contributors to this sanguine state of affairs were a combination of the massive liquidity availability, low inflation, excessive financial innovation, and poor financial regulation. With hindsight, and as the index clearly illustrates, it was something of a fairytale period.

### 2008 Onwards

We are all very much aware of what happened in 2008-9; so no history lesson required. A look at the index during this period says it all. The world faced a financial Armageddon; and this

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was only averted by the financial authorities around the world taking extreme and unprecedented measures to avert a prolonged and painful depression. The index, after rising to 80 in late 2008, again fell sharply to around 25. Although this clearly reflects renewed faith and participation by investors in global equity markets, it must be highlighted that the current level is still well above the range prevailing over most of the past decade. Again, some perspective is needed.

The consensus which had been so negative during 2008 and early 2009 quickly adjusted to a more stable outlook in the second quarter of 2009, and after that time seemingly embraced the idea that the global economy was recovering. The investment community took shares materially higher in the period from April onwards, in particular in emerging markets. However, some doubt crept back in during the final quarter, largely induced by the financial wobbles experienced in Dubai.

The key question that needs to be addressed is whether the current index level of around 25 is backward or forward looking? After all, prior to the 2008 meltdown, any level over 20 would suggest a world in some degree of financial crisis. This indicator is certainly supported by the behaviour of the gold price which rose by 24.7% during 2009. This rise suggests an environment in which investors have little faith in the financial system - as represented by paper currencies. It is true to say that part of this move represents inflationary concerns - with the US 10 Treasury yield moving up from 2.2% to 3.5% - but another part merely reflects concerns over the health of the global financial system. At present, we still detect an underlying level of scepticism regarding the global recovery, both within companies and within the investment community.

The following extract from an investor report, written by one of Coronation's international managers, sums up the current level of investor concerns very well.

'In the month of November, short-term US Government Treasuries were providing investors with a guaranteed negative rate of return on their capital. Even today one only receives two basis points for lending money to the US Government for 90 days. This is, in our opinion, just one example of a bubble of pessimism that exists today. It is extremely dangerous to try to predict when a bubble might end. However, it is quite clear that investors will not be able to tolerate such a low rate of return indefinitely, particularly as the economic landscape continues to improve. The investment professionals, who not many months ago were predicting the world's end, will have to redirect their investors into 'more' risky assets. It is likely that pressure will come from the investor base itself. The nine month chart of stock gains looks too alluring for investors not to be pulled back into the market, as investors typically only seem to know the prices and not the values of their investments. In other words, they tend to buy more when stocks move higher.'

## 2010 Outlook

In developed markets, leading indicators such as industrial production and consumer credit statistics appear to have bottomed. Earnings have surpassed (lowered) expectations and easy year-on-year comparisons abound for companies and economies. This will at the very least create the appearance of a recovery if nothing else. On the other hand, for many industries, revenues may have stabilised, but anecdotal evidence suggests no sign of sales growth. Many management teams in the real world have no visibility and remain sceptical of a coming economic rebound, especially a strong one. That said, some expectations for recovery look too sanguine in industries such as the capital goods sector where company profit margins have held up well, despite significant falls in capacity utilisation. In other words pricing pressure was less severe than in prior recessions. The question to ask is whether it is truly different this time, or did the downturn happen so quickly that pricing pressure never took hold? It seems that more pricing

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pressure is to come in sectors such as capital goods, thereby proving to be a disappointment to those who expect operating leverage to be significant.

While this debate will no doubt be resolved in 2010, the point is that the easy money across the equity markets was made in 2009 by those investors adopting a momentum, or non-differentiating, buying approach. By comparison, investors that do the hard work in analysing the constituent sectors of the markets and stocks will continue to be rewarded as they find fundamentally undervalued stocks.

Turning to the overall level of markets, even after the recent sharp recovery in equity markets, returns over the past 10 years have still been unusually poor, in fact negative in most markets. Certainly taking long-term 100 year history as a guide, this fact would lead one to expect above average returns over the next 10 years.

It must be remembered that the period from September 2008 to early March 2009 was an anomaly because the demand for cash became the overriding consideration for investors. It was a giant margin call with a mad rush to raise money. While in many circumstances this selling was very logical, it created an illogical pricing of perfectly good assets. Investors were able to buy great businesses at significant discounts to their intrinsic values. The lessening demands for liquidity over the past nine months have only partially reconciled the discrepancy between the prices and the underlying compound returns that investors are likely to achieve by being invested in these businesses. Investors were, for a variety of reasons, taking cash out of equities at exactly the time when their expected compound rates of return were at their highest.

There are many uncertainties and risks facing the financial system as we move into 2010. These risks will multiply as long as politicians remain obsessed with being re-elected rather than taking the often painful decisions that are needed were a longer-term perspective to be taken. All indications are that we are now moving into yet another bubble era, fuelled by easy money and effectively free money. It is, however, also true to say that this new bubble era will inflate more slowly than previous ones, due to the realisation that rules governing the banking sector need to be tightened, thereby averting another credit fuelled bubble for many years to come.

Investors are therefore faced with a conundrum. That is, if they subscribe to a very bearish medium-term outlook, they must therefore also subscribe to the view that interest rates will remain at (probably) negative real rates for the next few years. How, therefore, does an investor preserve wealth in real terms? Under this scenario it would seem that a portfolio of intrinsically undervalued global equities will prove to be the only sensible investment which will produce attractive income and capital returns to long-term investors.

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