Macro fatigue, anyone?

by **KARL LEINBERGER**

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The global economic outlook is clearly pretty grim. Most developed economies face the prospect of a prolonged period of stagnation. We also think the risk of inflation is high. If we are right (sometimes in life you pray you are wrong!), then we all face the daunting prospect of allocating capital in a stagflationary environment.

The crisis in Europe is very much an 'after-shock' from the 2008 financial crisis. In 2009 policymakers threw unprecedented fiscal and monetary stimulus at the problem. In so doing they pulled the global economy back from the abyss. But they did not succeed in reducing total leverage in the system. In bailing out an over-indebted private sector, all they succeeded in doing was to buy some time and shift the debt burden from the private sector to the public sector. Today, the governments of most OECD countries are over-indebted. Massive fiscal deficits are keeping economies ticking over, but doing little to kick-start growth. The flaws in the European Union, described by a sage observer in the 1990s as a burning house with the fire exits locked, have been brutally exposed. And finally, as politicians have dithered, the crisis has spread from the embattled periphery to Italy and Spain.

Not uplifting stuff for investors. And this is after four gruelling years in what has been the most volatile period in market history.

We expect the macro-environment to remain challenging and markets to remain volatile.

But it's not all bad news. I see three things to be positive about:

1. *The news is out.* Most of the bad news and challenges we face have been well flagged, are essentially well understood, and feature in the media headlines on a daily basis.

2. *Out of this crisis will come the structural reforms we so desperately need.* As a sceptical investor, I am sorry to say that I have no faith in my fellow man. I believe that it is only in times of crisis, when there are no other alternatives that politicians can be relied upon to enact the deeply-needed structural reforms that are in all of our long-term interests. Smaller and leaner governments, a sounder and more sustainable European Union, more appropriate retirement ages, better capitalised banking systems and more sustainable entitlement programmes will come out of this crisis and be the foundations for the next upcycle.

3. *Bad news usually produces low prices.* As an investor one needs to be ready for when bad news provides an investment opportunity. As Warren Buffet says, in this game you need to be greedy when others are fearful.

The obvious question for the long-term investor then is: to what extent is the bad news discounted in asset prices? In our opinion, there is not a lot of symmetry out there.

Global Equities are attractively priced with many blue chips trading on 12 – 14 PE multiples and 3% – 4% dividend yields. A decade ago the outlook was good, stock prices were high and investors paid heavily for that, enduring a full decade of virtually no return. Today, bad news has produced low prices. This is always fertile ground for the long-term investor.

Global Bonds are overvalued. At 2% – 3% yields, government bonds present an asymmetrical payoff, in our view. Limited upside with the prospect of heavy losses should any of the following scenarios come to pass: higher inflation; any normalisation in short rates from current crisis levels, or finally any kind of a meaningful economic recovery. In general, credit is also keenly priced as a global search for yield has driven down credit spreads. The one exception to this is high quality financial sector credits that have collapsed as the European banking crisis has intensified.

Global Property offers opportunity. Yields are now at mid- to high-single digits throughout Europe, Asia and Australia and this asset class is one of the best priced inflation hedges available today.

Dollar Cash as an asset class is often overlooked. Crisis-level interest rates and attractive valuations elsewhere argue against a high allocation, but we think that a healthy allocation makes sense nonetheless given the risks in the system. Global equities are up substantially from the financial crisis lows and we think one should keep some powder dry should equity markets again provide an opportunity similar to that of the first quarter 2009.

Local Equities on the other hand, are trading close to fair value. The All Share Index is virtually at its all-time high and many domestic consumer-facing stocks are trading at all-time high ratings. For the biggest building block in a balanced portfolio, this is not a time to be brave.

Local Bonds are overvalued in our opinion. They are anchoring off 30-year low short rates and have been flattered by a desperate global search for yield, sparked by zero cash returns in the world's major cash markets. In addition to this our concerns about inflation are even more marked in South Africa than they are offshore.

In conclusion, we do not expect the world's problems to disappear and we do not expect markets to be any less testing than they have been since the onset of the financial crisis almost four years ago. But we do expect opportunity. Volatility, emotion and newsflow: these are the friends of the long-term investor.