

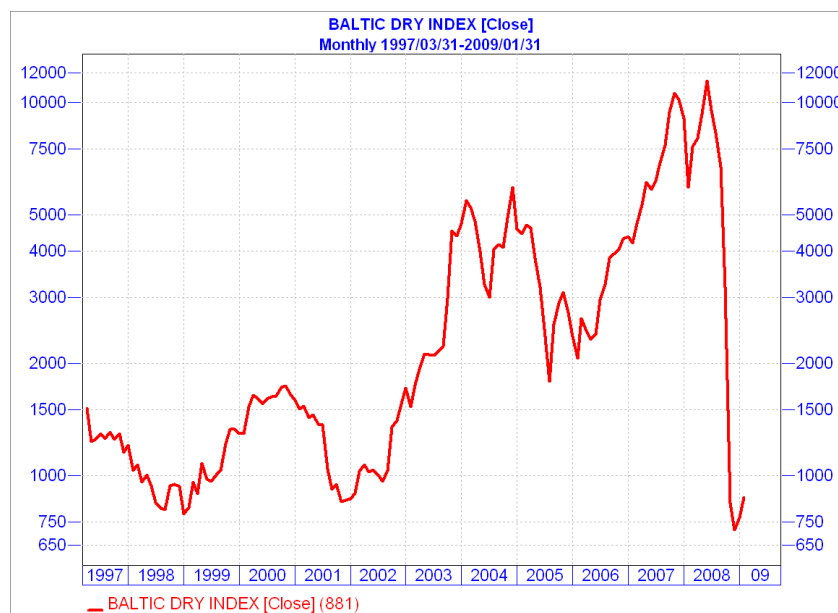
Tug of war

Uncertainty favours the long-term investor

By Charles de Kock

The world is locked in a tug of war between an extremely sharp slowdown in economic activity on the one hand, and unprecedented responses from fiscal and monetary authorities around the world on the other.

The macro-economic outcome is extremely difficult to predict with any degree of conviction; markets are incredibly fearful of what lies ahead. What started as a financial crisis in the developed world, rapidly spread to the real economy, the emerging world and even to bullet-proof China. The sharp drop in commodity prices illustrates just how quickly the world economy has come to a halt, with its upcycle of the past six years having been obliterated within a period of two quarters! Also the shipping industry, a key beneficiary of the commodity boom has all but dried up, with the implosion of transport costs as shown in the Baltic Dry Index (below). In the US, total car and truck sales tell a similar tale as annual growth rates have reached levels last seen in the early 1980s and employment levels at their weakest in nearly 30 years.

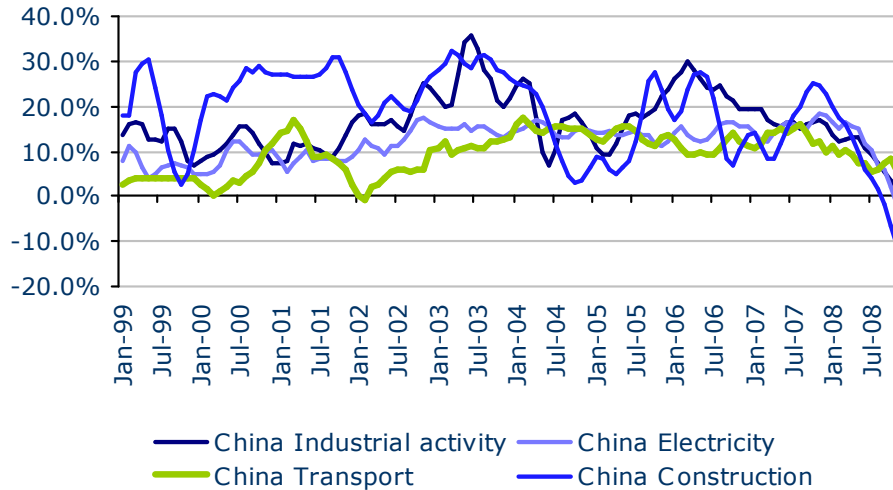


Source: I-Net Bridge

The decoupling that never was

'Decoupling' was the catchphrase of the past few years as experts sold the concept that the growth rates of emerging markets were unrelated to those of the developed markets. It is now clear to see that the world is very much 'coupled' after all, as emerging markets quickly mimicked the downturn of the developed world. And the Chinese economy did not come to the rescue, as was expected to be the case. In China conditions continue to unravel, shown by the sharp decline in electricity consumption which is a

clear indicator that the once resilient steel companies and smaller manufacturers feeding demand from the US and elsewhere are feeling the pain.



Source: Coronation

Following in the footsteps of the real economy the big losers in the financial markets were the banking shares, equities in general, emerging market currencies and commodities; with government bonds being the only winner as the flight to safety took form.

Gripped by fear

To illustrate the level of fear amongst investors, one need look no further than the 3-month US Treasury Bills. At the end of 2008, investors were happy to give their money to the US Government for a period of 3 months at a zero percent return; a situation only comparable to a depression or world war. While government bonds quickly became a huge favourite, corporate credit was dismissed, and good, solid BBB-rated corporate credit spreads moved back to levels last seen in the 1930s.

While the macro economic outlook remains poor, and newsflow is unlikely to improve in the near term, we know that the US government will stop at nothing to get the engine of the world's biggest economy running again. While this might well ultimately be inflationary, this does not seem to be of primary focus as the global liquidity response and synchronized interest rate cuts first need to evolve into spending.

How will the tug of war end?

While we do not know how or when this tug of war will end, we do know that many shares have been sold down to levels which offer the long-term investor the opportunity to acquire prime businesses at compelling prices. Shares such as Microsoft, Pfizer and Nokia, to name but three, are excellent companies with very healthy balance sheets trading at single digit multiples and attractive dividend yields. It is the investor's fear of risk and flight to safety which has created buying opportunities like these. In emerging markets there are even more compelling buys such as Gazprom, the biggest natural gas resource in the world; Unibanco, the fourth biggest bank in Brazil; and America Movil, the Latin-American equivalent of MTN, trading at PEs of 2.2, 6.4 and 9.3 respectively.

South Africa

Locally, we believe that there is some good news coming. Inflation is set to fall rapidly driven mainly by tumbling oil and maize prices; the local inflation number should be inside the target range by mid year. The Reserve Bank has already started the interest rate cutting cycle and we expect monetary policy will continue easing as inflation softens and news on the real economy continue to show a sharp slowdown in economic activity. In addition to easier monetary policy we have now seen a stimulatory budget as well. It is clear that the authorities in South Africa will do as much as they can to boost economic growth. Analysis

shows that equities outperform the other asset classes during periods of declining interest rates. We do not think it will be different this time.

As mentioned earlier, the macro-economic outlook is still very uncertain, and therefore the outlook for company profits is also very difficult to predict with conviction. But based on Coronation's tried and tested valuation criteria we are also finding many attractive businesses in the local market, especially in the small cap space. The likes of Iliad, Astrapak, Ceramic Industries and the JSE Ltd are very attractive companies with solid business models. Among the larger cap shares MTN catches the eye. Here is an excellent business trading at only an average rating. Investors normally expect to pay a premium for a business of this quality; now it can be acquired at a rating similar to that of the average South African business.

In the words of Warren Buffet: "Before reaching for that crutch, face up to two very unpleasant facts: the future is never clear and you pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values".

It is exactly because investors are so cautious and unsure of the future that we can today find many great businesses at attractive prices. It is an opportunity not to be missed.

Charles de Kock
Chief strategist
