

## Outlook into 2009

The financial market distress of 2008 was driven primarily by the calamitous collapse of global economic activity, which hit a wall in June of this year. Perhaps the best measure of this is global freight rates, which have fallen 96% since June 2008.

What started as perhaps a normal cyclical slowdown has been further aggravated by the freezing of credit access due to the credit crisis. It is difficult to understand the full magnitude and mechanism of the current credit crisis, but the cause of the crisis is a lot clearer.

From 2002 to 2007 credit growth in the global economy (including SA) surged to unprecedented levels. Global growth between 2002 and 2007 was the fastest on record and the surging commodity cycle and corporate profitability all reflected the excess liquidity that existed over that period. Money was too cheap for too long and this inflated the residential property bubble, which created an illusion that consumers could take on more debt without consequences, backed up by the apparently ever-rising value of their homes. This virtuous circle has ended, and the ability of the consumer to take on more debt to fund consumption has been significantly curtailed, leading to the global recession that the world finds itself in at the start of 2009.

The good news is that central banks around the world are aggressively cutting interest rates, and commodity prices -- including oil and food -- are falling precipitously. This will, at the least, stabilise the global economy in due course.

High credit spreads are still reflecting the lack of liquidity and trust in the global credit markets. We believe it is critical that credit spreads narrow before one can see the end in sight of the current global recession. The more recent narrowing of Libor rates are very encouraging on this front, but considerably more narrowing is still required.

The longer term prognosis on how the debt super-cycle plays out is very difficult to judge. It is tempting to suggest that the decades of credit extension will abate going forward and consumer savings rates will rise, putting pressure on growth. But in the shorter term, a combination of aggressive synchronised global monetary and fiscal policy may be successful in righting the ship quicker than expected -- and may indeed prove to be the sowing of seeds for another period of inflationary pressure down the road. What is certain, though, is that we need to see the signs of economic recovery first, before being too concerned about the inflationary impact.

As we enter 2009 the local equity market is down approximately 40% from its peak, with some blue chip shares down over 50%. Valuations based on historical measures look very attractive -- P/E multiples, dividend yields and Price/Book ratios all suggest a bias towards increasing equity exposures. We acknowledge that valuations for equities do look favourable and that, under almost any scenario, the equity market is due a significant bounce, but we caution that a sustained multi-year period of outperformance of the market -- in real terms -- is unlikely until we see a significantly higher level of profitability across the board. We believe the primary driver of a sustained bull market in equities is accelerating real earnings growth, and we regard it as unlikely that the explosive period of real earnings generation since 2002 can be maintained over the next couple of years. We expect to see excessive corporate profitability eroded over the next two years and this -- short of a spectacular turnaround in the prospects for the global economy -- is likely to prevent any market rally from extending into a sustained bull market. We do, however, not believe that now is the time to be shorting equities as the SA equity market has already been sold off more than at any time in its history (in US\$) and valuations are not stretched. South Africa will be cutting interest rates throughout 2009, and this coupled with relatively cheap valuations will also make it difficult to benefit from running aggressive short equity positions. We continue to favour investments in listed companies that are not only cheap in fundamental terms but also are in a position to rebuild

profitability. Companies that are defensive in nature, such as brewing and healthcare businesses, where relative valuations look very stretched due to investor confidence that their earnings will be maintained into a recession, should provide for some shorting opportunities over the coming year. The risk in this strategy would be that of a deepening recession deepens in 2009, so timing will be critical.

Bond markets look expensive across the world and we are cautious about being significantly overweight from current levels. We do, however, acknowledge that bonds are likely to continue outperforming equities while deflation remains a fear. Our view is that as 2009 progresses, global bond markets will become increasingly vulnerable to a sell-off.

The rand has been aggressively sold-off relative to the US\$, so much so that it is now approximately 30% undervalued relative to purchasing power parity. As a result, we would not suggest selling rand in favour of offshore currencies at these levels. We believe that the primary driver of the rand remains the commodity cycle, and we therefore do not anticipate significant strength in the rand before this cycle has bottomed.

Overall in 2009 we anticipate increasing our net equity exposures as corporate profitability unwinds and the global economic cycle bottoms. We will continue to monitor critical economic factors such as credit spreads, yield curves, freight rates and leading indicators in order to (hopefully!) help finesse the timing of this strategy.

It is very difficult to forecast returns for the coming year for some of the reasons outlined above, but beyond the possibility of a significant short term bounce in equities, we do not believe all the conditions are yet in place to have a sustained period of outperformance in equities relative to the competing asset classes.

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