A tale of two worlds

By Jeremy Gardiner, director, Investec Asset Management

As predicted, 2010 has stumbled along both economically and from an equity market perspective, as the aftershocks of the credit crisis have rattled skittish investors. Of course, the fact that this is largely a developed world crisis has been highlighted both in terms of growth and the resultant stock market returns, with the developed market and emerging market numbers looking like they are from two different worlds.

At the end of the nineties, a US-obsessed investment world saw global investment flows skewed heavily towards US equity markets and the US dollar, the logic being that the US companies 'had the best management' and that the US dollar was the world's reserve currency. So for US equity markets to return nothing for the first decade of this century was not what Americans (or the world) were expecting and this year is not much better, with the Dow Jones up only 4% year to date.

The dollar's rout continues as well. Having peaked in 2002, it has been subject to a vicious bear market ever since, and with further quantitative easing on the way, don't expect strength any time soon. US debt to GDP is close to 100%, and if you add US state pension liabilities, the figure is closer to 130%. Adding to the dollar's woes is the fact that the Chinese hold roughly 65% of their $2.4 trillion of reserves in the US dollar. They obviously won't be adding to this level and will be trying everything in their power to diversify. In addition, the leading Gulf states are in discussions around launching a 'euro-style' Gulf currency and the Asians are already trading in the Chinese Yuan and gold.

Austerity plans are underway, with higher taxes and government spending cuts the order of the day. However, this is a tightrope that needs to be walked very carefully, as too much austerity risks pushing the US economy (or any other economy for that matter) back into recession, as fears of a double-dip recession abound.

Joseph Stiglitz, Nobel prize-winning economist, warned recently that by cutting spending, the US Government risks exactly that. Rather, he advised, redirect spending away from the exorbitant amounts currently being spent on two very expensive wars against an enemy that, according to him, doesn't exist. Spend on those two wars has apparently just passed the $1 trillion level. One bit of good news is that TARP, the Troubled Asset Relief Programme designed to save the banks, auto and insurance companies, is going to cost a lot less than expected. Lower costs for the auto and insurance sectors have helped and the US taxpayer stands to make $1 billion on the Citigroup rescue.

Is this the end of America? Not at all. The Americans will definitely come back, as will the dollar, but probably not as the world's only super power and not with the dollar as the world's reserve currency.

Across the pond, the European fight for survival continues. The UK, in true British style, is taking austerity 'on the nose', and these efforts have recently been lauded by the IMF. The Greeks have been saved for the next three years, but their debt will rise from 120% to 150% as a percentage of GDP as a result of their 'assistance' from the IMF. The Irish attempts to resuscitate their beleaguered banking system continue. They have just downgraded their growth forecast from 0.8% to 0.2% and they too have been saved from possible collapse, but only until next year.

The euro has held up reasonably well, as a diversifier from the US dollar, and with the Chinese announcing last week that “Europe is a major market for Chinese Reserves”. But in this world, a currency holding up ‘reasonably well’ is not where you want to be! Brazil’s finance minister, irritated by having the strongest currency in the world last year, recently highlighted a global currency war, as countries around the world, desperate to get their economies going, see exports as the panacea, and drive their currencies competitively lower. China keeps the yuan artificially below the purchasing power of the US dollar and ignores American complaints. The Asians have to devalue to compete, and the Americans have to print more dollars to try and remain competitive. But you need a strong balance sheet to compete in this war, and South Africa has lost over R1 billion over the past year in vain attempts to curb our rampant rand.

On that subject, volatility-weary South Africans are constantly wary about the next big currency collapse. However, current rand strength is not a coincidence or some random event. There is a fundamental global shift underway from the low-yielding west into the higher-growth rest. Our currency and markets may well stay stronger for longer. Over the World Cup, Investec Asset Management hosted a conference in Cape Town attended by 80 of the world’s top 300 investment professionals, discussing their thoughts around portfolio positioning in this new world. They included the heads of the world’s top sovereign funds, the heads of the world’s top consulting actuary firms (who direct global pension fund flows), the heads of several of the world’s top pension funds and central bank governors.

Almost without exception, they said that they had been punished for being way too developed market-focussed and are now actively raising their exposure to emerging markets and frontier markets such as Africa. This is reflected in emerging market and commodity currencies such as the rand, and also in equity markets, with India up 18%, Indonesia up 45%, Malaysia up 27%, Singapore up 14%, Thailand up 44% and South Korea up 13% year to date*.

Similarly, Latin America is basking in the attention that comes with growth, and South Africa – positioned between the West and the East and with 37% of our trade with Asia and 34% with Europe, saw a return of roughly 11% from our equity market over the year to date*.

So in addition to the Rand benefitting from the global search for yield, it is further fuelled by the fact that we are a commodity currency, plus our deficit and debt as a percentage of GDP are at least half of that of the developed world. So it a strong cocktail of positive factors driving our currency.

Is there anything we can do to curb the currency strength?

1. Lowering interest rates further would reduce our appeal from a yield perspective.
2. Further liberalization of exchange controls, on companies and banks, and the amount pension funds and unit trusts can take offshore, would reduce some of the pressure.

Other less favourable methods would include further Central Bank intervention, but this is expensive as we’re up against much stronger balance sheets and as we have seen over the last year, doesn’t necessarily work. Taxing currency inflows as Brazil did is a possibility, however this would hit local asset prices, thereby hurting investors, plus it would increase Government’s cost of borrowing and it doesn’t necessarily work.

In summary, as we have said before, this was not a global financial crisis; it was a developed world crisis. While the emerging world was not unaffected, recovery has been far quicker. Expect the developed world investment environment to remain under pressure for some time to come, as austerity programmes coupled with deleveraging destroy growth, earnings and subsequent returns.

So what should investors be doing?

Central bankers around the world are terrified of being responsible or blamed for pushing their economy back into recession, so you can therefore rely on interest rates staying lower for quite a while longer. In addition, as the global currency war rages, countries such as SA have found their currencies strengthening beyond their control and if this persists will need to drop rates again so as to neutralise the currency strength and ensure growth doesn't collapse. Deflation in this environment is unlikely; mild inflation is more likely and global investors in their search for yield will head towards the currencies/markets that offer at least some yield.

Against this backdrop, cash returns will remain poor. Bonds, although not exciting, will at least give a return, and investors will therefore once again, through a lack of options, see equities as the place to be going forward. A word of caution though: in a low inflation, low growth environment, equity returns are unlikely to repeat the performance South Africa investors have enjoyed over the past five years.

Finally, although the Rand will probably stay stronger for longer, now would be a good time for those investors wishing to diversify a portion of their portfolio offshore.

** Source – Economist; 31 December 2009 to 29 September 2010, in US dollars*

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