Economic and market overview

5 December 2018

Global

The sharp sell-off in risk assets that began in early September and escalated in early October reflects a significant downgrading by investors of the economic outlook for 2019. There are several forces that could trip up risk assets in the next year, but it is premature to bet that the global economic expansion is ending. Our base-case scenario is still that the global expansion will continue at a moderate pace, sustaining our reasonably constructive outlook for risk assets.

In previous months, we've noted that it's likely for the economic expansion in the United States (US) to slow down compared to 2017 and 2018, but it won't grind to a halt. We expect the pace of economic growth in the world's largest economy to remain healthy and above average in 2019.

China, on the other hand, is expected to underperform, despite recent stimulus measures as credit growth remains depressed. Indicators of global trade volumes suggest that activity around the world is slowing, albeit at a measured rate, as the share of goods impacted by tariff increases to total world trade is still negligible. It's essentially the talk of trade wars that's spooked investors, rather than actual tariffs that's been implemented.

Falling unemployment and rising interest rates, coupled with rising inflation, will be a main theme in economies around the world in 2019. This scenario is already playing out in the US, with the European Central Bank likely to follow in the Federal Reserve's (the Fed's) footsteps by starting to raise rates in the latter half of the new year. The Bank of England has adopted a wait-and-see-approach to the ongoing Brexit saga as a "no-deal" outcome would weigh on economic activity in the UK and potentially slow the pace of interest rate policy normalisation.

A source of healthy investment returns over the next decade may just come from emerging markets. According to Iain Cunningham and Philip Saunders of Investec Asset Management, the last investment cycle belonged to the US. This has resulted in a very significant valuation divergence between US assets and Asian assets. The growth picture for Asia, looking forward over the next 5-10 years, is manifestly more constructive than is the case for the US. Even though the Americans are enjoying a sort of sugar rush of fiscal stimulus now which has boosted growth to pretty high levels, the underlying rate of growth, even with the Trump effect, is still actually quite modest by past comparison. Asia, on the other hand, has a growth dynamic which will act as a tailwind. That is where the middle-class emergences are strongest and these markets have been de-rating for quite a long time. Skilled investors will no doubt seriously consider capital allocation to select emerging markets – that's where valuations look the most attractive now.

South Africa

Economic growth in South Africa remains below par and well below the 5% annual growth in GDP that's required to significantly reduce this country's unemployment rate (currently at 27.5%). There are glimmers of hope as the Ramaphosa administration starts to make inroads into previously captured state-owned enterprises but much still needs to be done to repair the damage done in the Zuma era.

The significant reduction in the petrol price at the start of December would have come as a welcome relief to consumers. Throughout the second half of the year, household expenditure has remained under pressure due to higher fuel and administered costs, as well as higher taxes. In the absence of significant employment gains, household consumption is, however, likely to remain constrained. Households will further feel the pinch as retailers begin to push through rising costs as the capacity to absorb price pressures diminishes. Add to this the South African Reserve Bank's upwards trajectory of interest rates and South African consumers will have to wait a little longer before they can breathe a collective sigh of relief.

According to ClucasGray Asset Management, 2018 has been a year in which investors' resolve has truly been tested. Over the last year, there has been several high-profile company implosions – numerous widely owned companies that delivered gravity defying returns to investors for years, have endured a torrid year. Steinhoff and perhaps some of the property names where it appears other issues may have been at play aside, the overwhelming majority fell victim to a slowing earnings profile, coupled with elevated valuations, and in certain cases excess leverage. This is not the first time this has occurred, and it certainly will not be the last. In fact, many would argue it is the ordinary course of investments. It is under these circumstances that investors should disregard mere opinions and tweets and the breaking news of the day in exchange for fundamental research. Those who don't, will do so at their own (and their capital's) peril.

Market performance

November was another tough month for local equity markets despite the rally in emerging market equities. The listed property sector and equities in general continue to suffer from the weak economic environment, the former also being punished for disappointing company results as well as speculation of inaccurate financial reporting. Domestic bonds had a strong month (+3.9%) outperforming all other domestic asset classes. The asset class was supported by a strong rand (+6.6%) which benefited from improving terms of trade and a generally supportive global environment that saw foreign investors returning as net buyers (+R2.6bn) to the local market for the first time since July.

The South African Reserve Bank decided to increase the repo rate by 25 basis points despite lowered inflation and GDP growth forecasts. It was clear from the Monetary Policy Committee's statement that they are now targeting an inflation rate of closer to 4.5% per annum rather than merely keeping it below 6%, which explains much of their hawkish view.

The US stock market surged at the end of the month after the market interpreted Fed Chairman Jerome Powell's speech to be more dovish than expected, however (despite Trump's unhappiness with the Fed's rate hikes), a hike is still expected when the Federal Open Market Committee (FOMC) meets on 18 and 19 December.

South African Multi-Asset High Equity Funds delivered an average of -5.8% to investors during the last 12 months with their low equity counterparts ending up 0.2%.

Market indices[1]	30 November 2018		
(All returns in rand)	3 months	12 months	5 years
SA equities (JSE All Share Index)	-12.6%	-12.6%	5.5%
SA property (SAPY)	-5.5%	-21.3%	6.1%
SA bonds (SA All Bond Index)	2.4%	13.1%	7.8%
SA cash (STeFI)	1.7%	7.3%	6.9%
Global developed equities (MSCI World Index)	-10.7%	2.3%	14.1%
Emerging market equities (MSCI Emerging Market Index)	-10.5%	-7.3%	8.8%
Global bonds (Barclays Global Aggregate)	-6.9%	-1.2%	7.0%

[1] Source: Factset

Rand/dollar[2]	-5.4%	1.6%	6.4%
Rand/sterling	-7.1%	-4.2%	1.2%
Rand/euro	-7.9%	-3.5%	2.6%
Average South African Multi-Asset High Equity Fund	-7.5%	-5.8%	5.2%
Average South African Multi-Asset Low Equity Fund	-3.6%	0.2%	6.0%

Commentary – Are you checking your portfolio too often?

Warren Buffett doesn't have a computer on his desk. He invests for the long run and he doesn't let short-term stock prices impact his investment decisions. He advises investors to not "watch the market closely" highlighting that when investors are "trying to buy and sell stocks and worry when they go down a little bit – and think they should maybe sell them when they go up – they're not going to have very good results".

While it's important to keep abreast of developments on both a macro-economic and company level, it's important not to let a company's short-term stock price move unduly influence investment decision-making. In many cases, short-term market moves are purely random phenomena.

Alongside Warren Buffett, many other investment gurus have provided invaluable guidance to help investors manage their own lack of discipline. Let's look at a couple of well-researched conclusions that other experts came to.

As humans have evolved to feel losses significantly more than gains, an investor who experiences a stock price decline may be likely to make sub-optimal investment decisions. "When directly compared or weighted against each other, losses look larger than gains. This asymmetry between the power of positive and negative expectations or experiences has an evolutionary history. Organisms that treat threats as more urgent than opportunities have a better chance to survive and reproduce." - Daniel Kahneman, 2002 Nobel Prize winner for Economic Sciences

Nicholas Taleb, in his profound book, *Fooled by Randomness*, talks about the difference between noise and meaning. He uses the example of the happily retired dentist who builds himself a nice trading desk in his attic, aiming to spend every business day watching the market while sipping decaffeinated coffee. He watches his inventory of stocks via a spreadsheet with live price updates.

Taleb assumes that the dentist is quite a successful investor who will, on average, outperform US Treasuries by 15% per annum with a 10% volatility (or uncertainty). This translates into a 93% probability of success (defined as a positive return) in any given year. But seen at a narrow time scale, this translates into a mere 50.02% probability of success over any given second (as shown in the table below). Over the very narrow time increment, the observation will reveal close to nothing. Yet the dentist's heart will not tell him that. Being an emotional being, he feels a pain with every loss, as it shows in red on his screen. He feels some pleasure when the performance is positive, but not in equivalent amount as the pain when the performance is negative.

Probability of success at different time scales[3]	
1 year	93%
1 quarter	77%
1 month	67%
1 day	54%
1 hour	51%

[2] A negative number implies fewer rands are being paid per US dollar, so this implies a strengthening of the rand.
[3] Source: *Fooled by Randomness* by Nassim Nicholas Taleb

1 minute	50%
1 second	50%

If the dentist decides to examine his portfolio every minute during the day (assuming the markets are open for eight hours), he will have 241 pleasurable minutes and 239 minutes of pain. We know from Daniel Kahneman (and his late research partner Amos Tversky) that losses have a greater negative impact on investors than the positive influence of gains of a similar size, so by the end of the day the dentist will be emotionally drained.

If, instead, the dentist only looked at performance when he got his monthly statement from his stock broker, he is likely to have eight uplifting experiences in a year compared to four painful ones. If he examined the state of his investment affairs only once a year he's likely to have 19 pleasurable moments and only one painful one over the next 20 years.

By avoiding the impact of seeing short-term losses, an investor is more likely to be able to take a longer-term perspective – a key edge in investing.

Kahneman and Tversky were able to prove mathematically that individuals regret losses more than they welcome gains of the exact same size – two to two and a half times more. It was a stunning revelation: if you don't check your portfolio every day, you will be spared the angst of watching daily price gyrations; the longer you hold off, the less you will be confronted with volatility and therefore the more attractive your choices seem.

Is now not the time to replace CNBC with Supersport, and time spent examining your portfolio with time in the sun?