



ALREADY AN EVENTFUL YEAR

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Though the year is still young, it is already very eventful. As will be apparent when looking at first quarter statements, the contrast between the general sense of optimism on the streets and around the braai fires and disappointing short-term investment returns is rather stark. It was a tough first quarter for most multi-asset class funds, with the unusual combination of weaker global equity markets and a stronger rand dragging one-year returns. At least inflation declined to 4% in February, lowering the hurdle for achieving real terms.

SENTIMENT BETTER

Sentiment has turned for the better in South Africa and the country is increasingly standing out among emerging markets, and this time for the right reasons. Huge challenges remain, but the economy is benefiting from three tailwinds. Firstly is clearly the prospect (with some initial evidence) of improved governance and the return of sensible policy-making under President Ramaphosa. Secondly, the global economy is humming along nicely and as a small open economy, South Africa tends to follow the global cycle with a bit of a lag. Thirdly, local consumers are already benefiting from lower inflation which has boosted real incomes and spending power. The interest rate cut in March will also help. This is a huge improvement from a year ago, when we suffered downgrades, a technical recession and huge political uncertainty. Moody's has recognised this, announcing that they are maintaining South Africa's investment grade credit rating, and upgrading the outlook to stable.

RETURN OF VOLATILITY

Compared to this fairly happy picture, global equity markets have experienced a torrid time in the first quarter as volatility returned after a long quiet stretch in 2017. The JSE has followed global markets lower.

Global risk appetite surged in December and January, fuelled by tax cuts in the US and strong global growth. But since early February, three broad concerns have led to rising volatility. Firstly, there is a worry that strong growth and tightening labour markets will lead to inflation jumping and central banks – particularly the US Federal Reserve – slamming on the brakes.

Secondly, the high-flying technology sector has come under sudden pressure as investors fear a regulatory backlash against dominant companies like Facebook and Amazon. Naspers, the biggest share on the JSE has similarly had a tough time as global tech sold off. These shares traded at high valuations after a strong run and were vulnerable to reversal, but there is no evidence yet that their business models are fundamentally threatened.

TRADE SPAT

Thirdly, and perhaps most significantly, has been the concern that the world's two largest economies are heading toward a trade war after US President Trump announced tariffs on Chinese goods and China retaliated with tariffs on mostly agricultural imports from the US. The background is firstly long-standing complaints that China is pilfering US intellectual property, but more recently that the US trade deficit has ballooned to record levels (in nominal terms). However, the trade deficit is not a sign of the weakness of the US economy, but rather its strength as improving domestic demand draws in more imports. US exports are also at record high levels.

We live in a globally integrated world where almost no piece of machinery, equipment or consumer product is made in a single country in its entirety. Parts are typically sourced from several places, and even assembly can happen in different places. The same good can cross borders a number of times before it is finalised. Detangling these complex supply chains can be like unscrambling an egg. Another layer of complexity is that companies from one country often export to another from a third; the two biggest exporters of cars made in the US to China are German (BMW and Mercedes). This also means that if you try to block imports from China, there is a good chance imports from India or Vietnam will surge, doing nothing to reduce the deficit.

Markets tend to sell first and ask questions later, but it really does appear too soon to argue that a full-on trade war is looming. Both sides have a lot to lose.

GLOBAL MACROECONOMIC BACKDROP STILL HEALTHY

Nonetheless, it is safe to say that uncertainty is back on markets, and particularly with regards to the unpredictable US president, and markets never like uncertainty. But looking beyond this, the global economic picture is still healthy. Growth is solid, inflation still low and central banks accommodative. After all, even though the US Federal Reserve is hiking rates, they are still negative in real terms. In Japan and Europe, they are negative in nominal terms. Companies are generating strong profit growth. Major bear markets have historically only occurred during US recessions (1987 was a notable exception), and there is no sign of a looming recession there or at any other major economy.

Therefore, investors who follow a considered approach, grounded by a proper financial plan, can avoid a knee-jerk reaction to market turbulence. After all, while corrections are always unpleasant, they are also fairly common, especially after a strong run-up in equities.

NO PAIN, NO GAIN

To benefit from the superior long-term real returns from equities, one has to be prepared to experience some short-term distress. An appropriately diversified portfolio – as our Strategy Funds are – will reduce this discomfort, because not all asset classes have struggled: buoyed by lower inflation, a rate cut and the Moody's reprieve, bonds have delivered 8% returns year to date. But the discomfort can never be eliminated completely in funds that aim to generate above-inflation returns, since nobody can time these ups and downs consistently.

It is also worth considering that a portion of most balanced funds, usually around a quarter, is exposed to global markets directly and the rand's 13% appreciation against the dollar is a further dampener on these returns. Should the rand depreciate in the near future – and remember not too long ago many thought it impossible for the rand to do anything but depreciate – this situation will reverse itself. The importance of diversification is precisely that we don't know exactly what the future holds and therefore need to be prepared for a range of outcomes.

SIT TIGHT, DON'T FIGHT OR FLIGHT

For investors, it's hardly comforting to hear that they should "sit tight" or "focus on the long term" when faced with dramatic headlines and disappointing returns. Instead, the fight or flight response tends to kick in. This is normal. But remember that the fight or flight response evolved in a very different set of circumstances, certainly before we were able to do proper financial planning. When looking at markets, we should do our best to ignore our instinctive reptilian brains and engage the more reflective mammalian parts. One way is to remind ourselves of the general principle that financial plans should be amended in response to changes in your personal circumstances, but not in response to financial markets changes.

