

Seeing the stock for the flow - Kagiso Asset Management Chief Investment Officer Gavin Wood

As financial analysts, much of our energy is spent assessing current information with the objective of valuing assets. It is very important for us to think about the sustainability of recent results we observe from the economy.

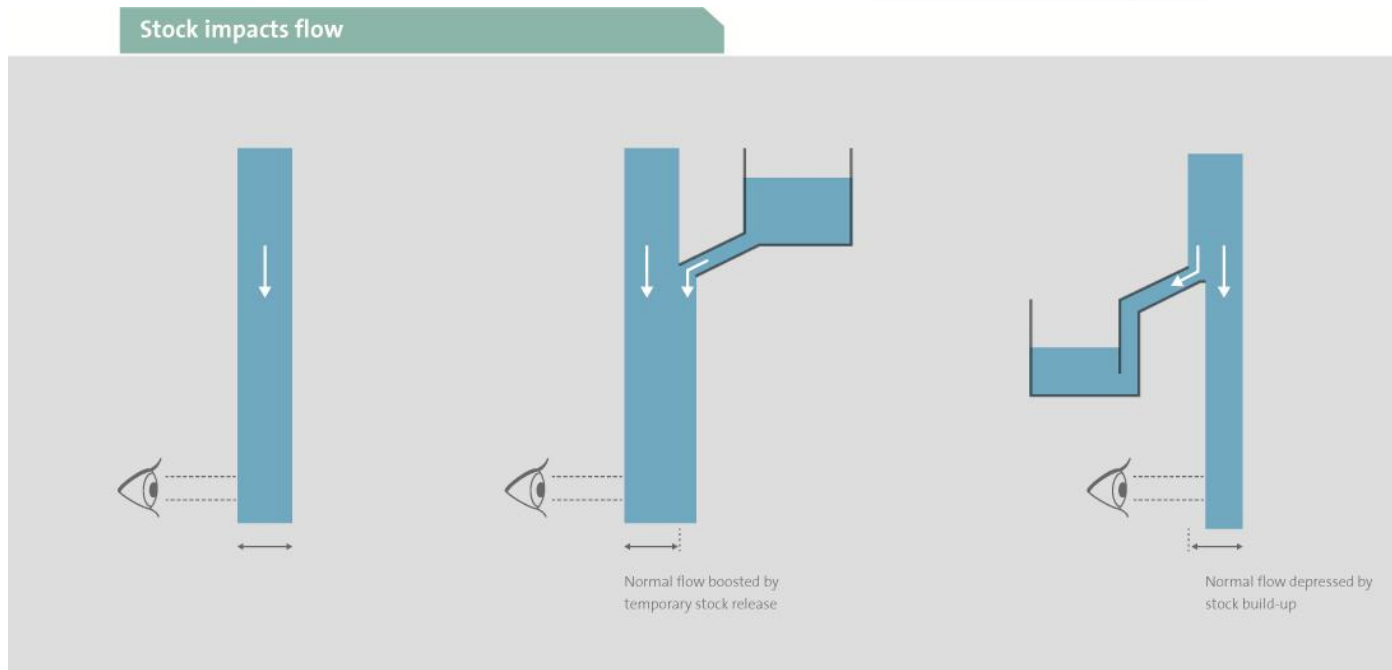
For this, it is vital to maintain a long-term perspective and to identify where changes in 'stock' items are impacting temporarily on 'flow' items. As a precursor to comments on some specific market features that look unsustainable, I re-look at the basic economic concepts of 'stock' and 'flow'.

'Stock' and 'flow' economic variables

'Flow' economic variables can be identified by the fact that a time dimension is required to give them meaning. That is: the variable has a value that is so much per unit of time. Some examples (per annum/per month/per week) are: your earnings from work, the profit achieved by a company and the budget deficit of a country. 'Stock' variables, on the other hand, have no time dimension - they are just so much (as measured on a given day). Examples are: the amount of petrol in your car, the amount of grain in a silo and the foreign exchange reserves of the central bank.

Flow variables often represent the change in a related stock variable over a period, for example: for a shop, the sales in a day (flow) equal the change in the money in the till (stock). An analyst is like someone sitting on the banks of a river measuring the amount of water flowing past in one day (a flow variable) and then using that limited information to assess how much water is upstream.

A very important influence on the flow of water arises from the presence of a dam upstream. If the water in the dam (a stock variable) is rising, this will cause the flow of water past our analyst to be lower than normal (see diagram below) and vice versa. Clearly, a simplistic calculation using only one day's flow measurement is likely to be flawed.



Below we outline some current, real world examples where we see these principles at work.

Gold

The price of gold has risen by more than five times in the last decade, after stagnating at low levels for most of the 1980's and 1990's. The important stock variables in this market are the amount of gold held for investment purposes (by central banks or private sector investors) and the amount of gold jewellery in the world. The important flow variables (in a specific year) are gold produced by mines, gold bought for jewellery production and the change in investment holdings of gold.

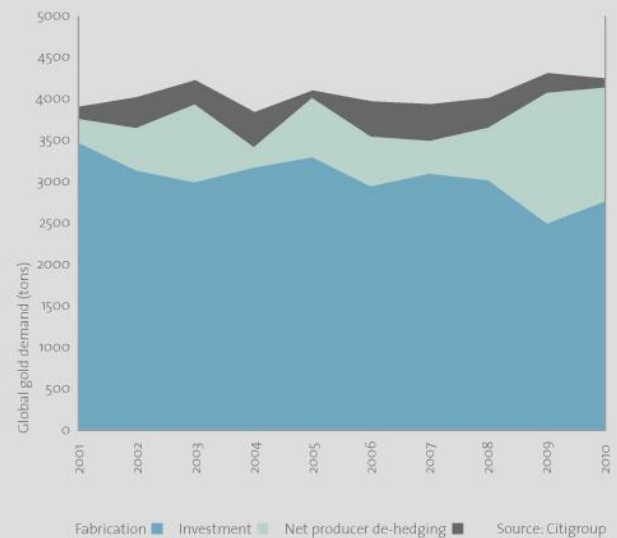
During the 1980's and 1990's, the fabrication demand for gold, the normal flow variable, was reasonably stable each year. However, investment demand for gold was so low each year that central banks had to sign agreements to limit the flow of gold they would release to the market from their stocks - so as not to unduly suppress the price of gold.

In the last decade, the investment demand for gold has risen dramatically, as can be seen in the graphs below, with the advent of gold exchange traded funds (ETF's). Gold demand has also been massively influenced by gold producer de-hedging (effectively buying back gold previously sold) and central banks changing from net sellers to net buyers.

Stock of gold ETF's versus gold price



The flow of gold demand



We believe the long-term outlook for the gold price is weak, given that the stock of producer hedges has just run dry. In addition, the current flow of investment demand requires ETF tons held to increase to fill this gap and to rise each year by the same record level, just to maintain its flow and therefore to sustain the current gold price.

Unsecured credit in South Africa

South African consumer expenditure has been particularly resilient through the last recession and is growing very strongly at present. This is despite the fact that our economy continues to shed jobs (although state sector jobs have held up and state sector wages have risen strongly).

We have been surprised at the high levels of retail sales (a flow variable) that have been achieved by the listed retailers during this time. Our sense is that consumption expenditure, particularly for lower income earners, has been significantly boosted by a substantial rise in unsecured loans (a stock variable) to these consumers.

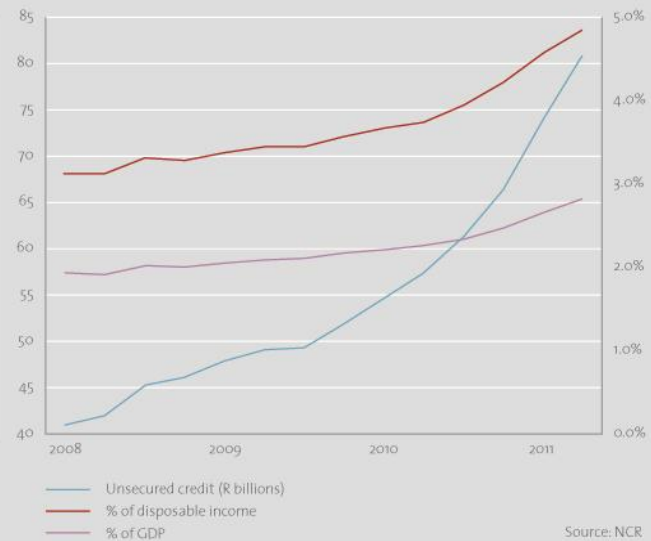
As can be seen in the graph below, the level of unsecured loans has doubled in the last three years (from R40 billion to R80 billion). The table below shows that a large part of this increase is due to average loan sizes and average loan terms rising substantially. The same consumers are borrowing more and for much longer. The level of these loans (stock) may be sustainable but the addition to annual consumption expenditure from this borrowing (flow) is unlikely to be sustainable. For this credit assisted expenditure to be sustainable, consumers would need to borrow the same amount again every year and thereby continuously increase their stock of credit.

The drivers of unsecured credit growth

	2005	2006	2007	2008	2009	2010	2011
African Bank average loan size (rand)	4,074	4,710	5,522	7,010	6,719	8,224	9,807
African Bank average loan term (months)	17	23	30	33	33	41	44
Capitec Bank average loan term (months)				11	11	17	24

Source: ABIL, Capitec, UBS

The evolution of the stock of unsecured lending



Source: NCR

Global stimulus

Continued US fiscal stimulus, manifesting in large budget deficits, can be seen as an unsustainable flow into the world economy, building up a stock of US government debt that ultimately must be repaid from the flow of tax revenues in future years.

On-going monetary stimulus in the US causes a flow of liquidity into world markets that manifests in a bulging Federal Reserve balance sheet (stock) that must one day be reduced via reversing the flow. This excess liquidity flow has (we think) temporarily boosted emerging market currencies, commodity prices and emerging market asset prices.

In conclusion

It is very important when analysing markets to consider the multitude of influences distorting recent observed economic flow variables and their impact on financial markets - not least of which are distortions from movements in stock variables.

August 2011

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