Momentum, leverage and complacency

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> It is impossible to foresee the future, but winding back the clock can provide perspective on potential future scenarios that are difficult to contemplate when the world looks as rosy as it does now. In early 2018, it is instructive to look back 10 years and reflect on a remarkable decade when so much changed.

Momentum, leverage and complacency

The decade began optimistically, with relatively buoyant market conditions and very high commodity prices. This gave way to financial market collapse and a global recession. The unprecedented aggressive monetary stimulus that followed created one of the longest economic expansions on record and huge returns to investors. South Africa, from a very healthy starting position, experienced a surprising and severe economic deterioration over this decade. I set out below a few key features of this period, where we are now and what may lie ahead.

Where we were 10 years ago

2008 was a tumultuous leap year. China hosted the Summer Olympics in Beijing, Elon Musk's SpaceX launched the world's first privately developed space rocket to successfully make orbit (the Falcon 1), the Large Hadron Collider particle accelerator was inaugurated and Barack Obama was elected as the first black president of the USA.

It was a time of believing that house prices in the world's largest economy could only rise, and there was pervasive complacency that China's accelerating growth was sustainable in excess of 10% a year and that its insatiable demand for commodities would keep growing. This fuelled excessive financial leverage, a booming developed-world economy and over-investment in US housing and global mining.

In South Africa in 2008, Thabo Mbeki was president of the country, Trevor Manuel was finance minister, Tito Mboweni was SARB governor and the newly elected ANC president was Jacob Zuma. Mbeki was recalled by the ANC in September 2008 after a court ruled that corruption charges against Zuma were unlawful on procedural grounds.

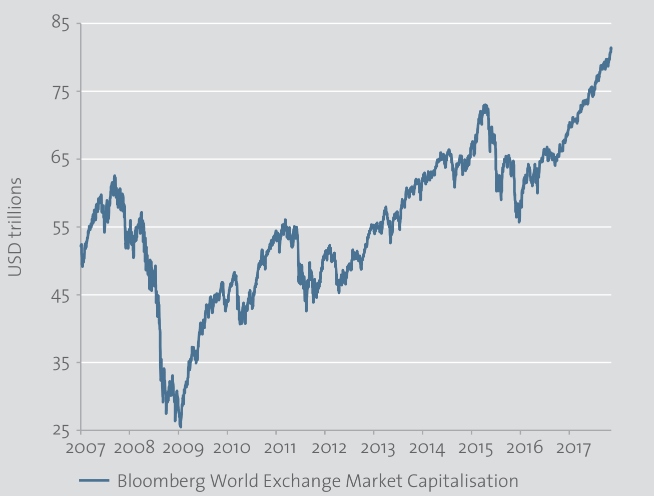
The last decade in global markets

The Global Financial Crisis, the worst period on financial markets since the Great Depression, lasted from October 2008 until March 2009. This resulted in the previously unthinkable demise of many longstanding and eminent financial institutions such as Lehman Brothers and AIG and led to huge government bailouts of other insurers and banks.

The reaction from authorities was large scale and co-ordinated. It involved fiscal stimulus and huge monetary accommodation measures. In the following years, the financial sector was far more strictly regulated, record low interest rates were maintained and huge asset purchase programs were undertaken to provide the global economy with sufficient liquidity support.

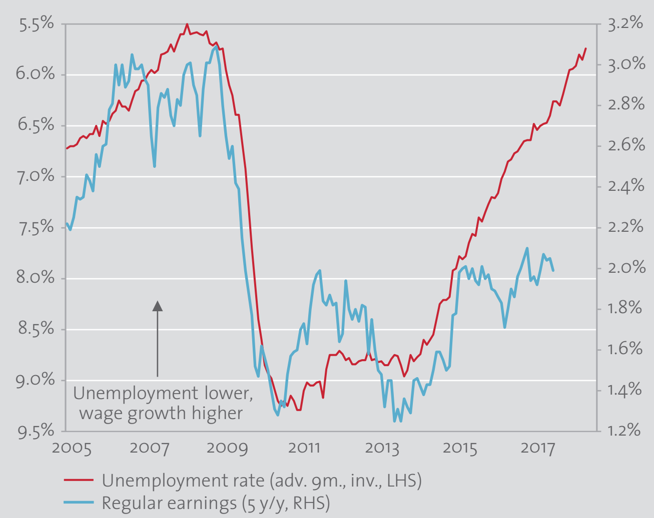
The recovery that started in 2009 has become one of the longest in history for most developed economies. However, this expansion has been weak compared to history, with industrial production yet to reach its pre-crisis peak. The plunge and

Value of world equities at all-time highs



Source: Bloomberg

Inflation pressures are building in developed economies



Source: Bloomberg, Capital Economics

subsequent long recovery in equity markets can be seen in the left graph on the previous page and the record low bond yields can be seen in a later graph.

South Africa's last decade

South Africa's dramatic economic decline since its very healthy 2008 economic position is summarised in the graph below. GDP growth rates have steadily declined from in excess of 4% a year to a rate that is one of the lowest in the world in 2017. A modest fiscal surplus has turned into a deficit that is stubbornly around 4% of GDP, and government debt has ballooned as a result. Debt to GDP has moved from below 30% to well above 50% and continues to rise.

Thankfully foreign investors have funded much of this debt increase, with their SA debt holdings moving from under 9% to over 40% of the (much larger) debt outstanding.

Although initially the SA economy was hit hard by the Global Financial Crisis, the decade of decline can largely be blamed on the severe economic mismanagement, policy uncertainty, ineffective policy implementation and corruption on the part of the SA government. In 2008, it would have been difficult to predict that such sound governance would deteriorate so far.

Complacency reigns

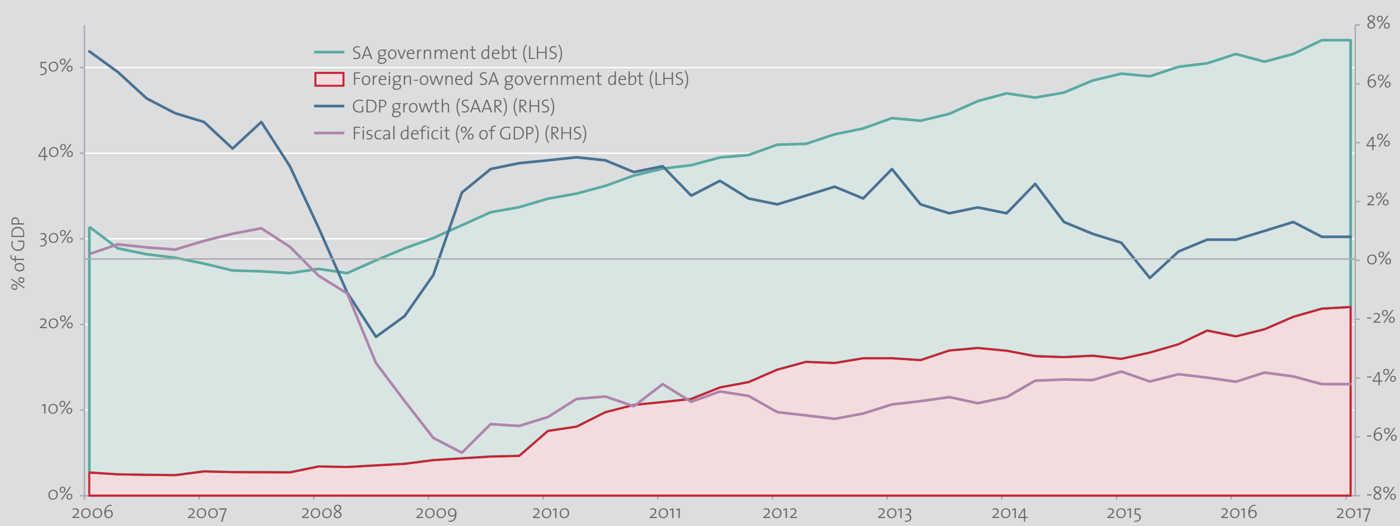
The long economic expansion is now synchronised across the world and is accelerating. General expectations are for low, and only gradually rising, inflation that is likely to keep monetary policy tightening restrained. These favourable conditions are fuelling positive business and consumer sentiment and are powerfully self-reinforcing and are building momentum. This is amplified by huge leverage in the system, which is manageable with current low interest rates.

Equity and bond market volatility is at record low levels, revealing investor complacency at a time when asset prices are very high. This low volatility is, to a degree, self-perpetuating as some market participants pursue strategies that profit from continued low volatility and others take actions that dampen volatility.

There is a large amount of capital explicitly pursuing a wide variety of (explicit and implicit) short volatility strategies that make modest, consistent gains if there is stability (common) and massive losses if volatility spikes (very uncommon).

Share buybacks, which have been a favourite pursuit of US firms, often enabled by leverage, reduce volatility by automatically buying shares on signs of weakness. Pervasive cheap credit dampens volatility as firms are able to borrow easily to smooth out any rough patches. The more than $2 trillion in assets that

South Africa's decade of economic decline



Source: Bloomberg, SARB

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has moved from active to passive funds since the Global Financial Crisis dampens volatility in that inflows follow asset price gains and thereby mute any potential price weakness.

Long bond rates have fallen materially over the last decade (graph below). This too indicates investor complacency about future rates of inflation. There is a marked difference between US long bond rates, which are pricing in inflation of around 2% a year and European (especially German) and Japanese rates, which demonstrate an absence of concern about inflation.

Looking ahead

In summary then, fundamentals are good, but asset prices are high and optimism and momentum prevails. Investor psychology can't generally be described as overly buoyant and reckless, however, which may imply that there are still good returns from financial markets to come. Monetary policy normalisation certainly lies ahead and fiscal stimulus in the US and Europe may add to late-cycle reflationary forces.

The dramatic and unexpected events and developments of the last decade should provide caution that the future may well not be so benign. In particular, unexpectedly higher inflation may catalyse a negative chain of events when central banks respond by normalising monetary policy faster than current market expectations. The right chart two pages back shows how lower unemployment rates lead wage increases, which will feed into general inflation. The wage growth trajectory looks positive.

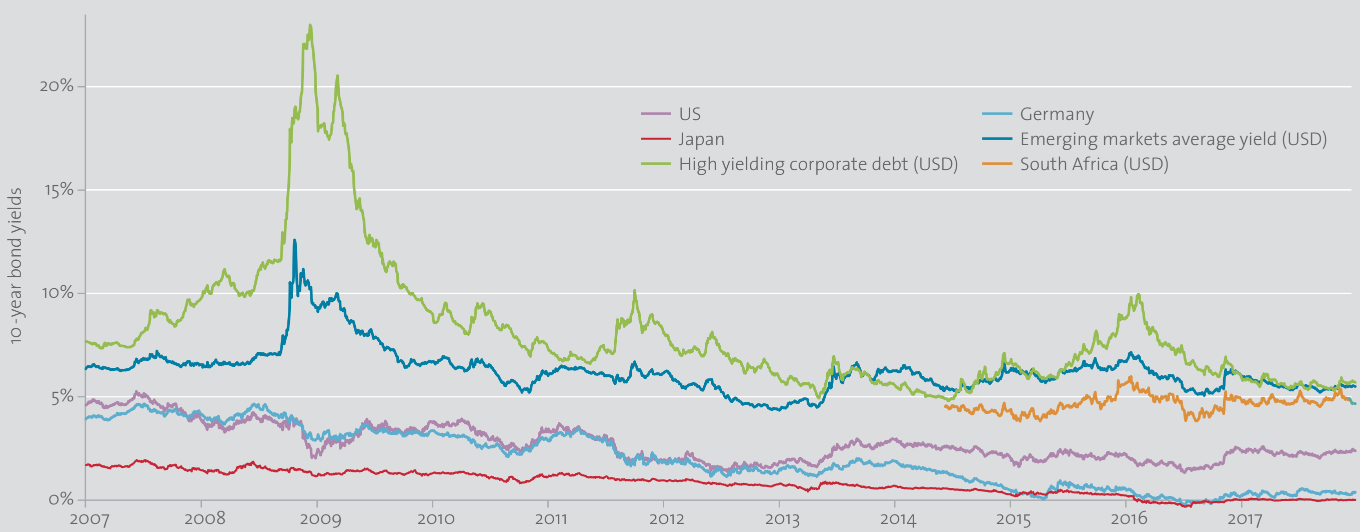
If interest rates and yields rise and asset prices fall, we may see debt issuer credit concerns and destabilising reactions from low volatility beneficiaries and the market participants (both active and passive) that believe the last decade was normal. Global debt stands at about 330% of annual economic output, up from 225% in 2008.[1]

Another potential risk is a material, unexpected slowdown in China's economic growth, which has been a large contributor to the last decade's expansion. The effects would be magnified by the high levels of debt China has built up over the period, especially within their state owned companies. China aims to tackle inequality, high debt levels, overcapacity and pollution, which is likely to weigh on their growth outlook.

In South Africa, the positive developments since the dramatic December ANC elective conference lead one to believe that the coming decade will see a much more positive economic trajectory than the last decade. The economy is very weak and beset by enormous structural problems, however, and so the progress will not be quick or easy. UP

[1] Bank for International Settlements

Long bond yields are low



Source: Bloomberg, Kagiso Asset Management

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