Tactical asset allocation view

4th Quarter 2011 – Authorities underwhelm markets

Behind the curve

Not many will miss the third quarter of 2011, a period that provided the nastiest set of market declines since the financial crisis took hold in 2008. In truth, these bitter seeds were sown well before the start of the quarter, as the two major detractors of value, the European sovereign debt crisis and concerns around a double-dip US recession were both known concerns at the start of the quarter. As time unfolded, the potential outcome in both cases appeared worse than initially expected. As yet unable to find a convincing solution to an accelerating sovereign debt crisis, European authorities continued to muddle through, providing just enough as required to avert a full-scale financial meltdown, but never grasping the concept of "shock and awe" as introduced in the initial stages of the financial crisis by their American counterparts. For their part, US politicians provided a perfect example of an own goal, fudging a seemingly simple increase in their debt ceiling amidst a period of stalemate bi-partisan politics at a time when the world craves decisive leadership.

Europe on the verge

The financial crisis of 2007 has entered a new, and potentially dangerous, phase. The solvency crisis that initially gripped the periphery European Union member states of Greece, Ireland and Portugal has now started to move into the larger economies of Italy and Spain. Whilst the deteriorating credit spreads of these nations reflect their growing risk, the share prices of major French banks came under significant pressure. The two are unmistakably linked as banks are directly exposed to the reducing creditworthiness of these sovereigns through their issued debt held on their balance sheets as part of their regulated capital requirements. The chance for European authorities to deal with a far lesser problem has been missed. In context, the combined contribution of the three periphery and problematic regions mentioned amounts to no more than 6% of European Union GDP, and 8% of bank assets. The introduction of Italy alone changes what was, at the time, a manageable position.

Europe requires a two pronged approach to deal with both the recapitalization of weaker banks and the introduction of liquidity (via bond purchases) for authorities to get ahead of the curve. What does this take in monetary terms? After all, the German parliament's majority vote in favour of increasing their contribution to half the total European Financial Stability Fund of Euro 440 billion, whilst a very positive step forward, was largely expected and provided short relief in markets. Combined funding requirements of European banks and sovereigns indicate this amount to be significantly more than Euro 1,000 billion. The European Financial Stability Fund may have to consider the use of leverage to meet its intended purpose, as present commitments fall short of the required total sum. For now, very large unknowns remain, and nobody can be sure as to how the future of the European Union will play out. Greek default, in all or part, is increasingly being priced in as an inevitable outcome.

Double-dip across the pond?

A huge electronic board on Time Square reminds passing New Yorkers of the growing debt burden that the United States faces. The number increases relentlessly and the amount is now approaching USD14,5 trillion. If stacked as a pile of dollar bills, it would stand almost four times the distance of the Earth from the moon. How is this debt calculated? Simply, it is the total national debt which includes both publically held debt (being all treasury securities held by individuals, institutions and foreign governments) as well as intra-government debt (which are treasuries held by the Federal Government against future liabilities such as pensions, health care and social security).

Whilst most impressive as a total number, the issue needs some context and the way of providing this is by comparing debt against the gross domestic production (the total economic productivity) of the country in question. Given that the total GDP of the United States stands at USD15 trillion, it means that this ratio of debt to GDP is now 97%. This is an alarming number whose trend, unfortunately, is ever upward. By way of comparison, the US debt to GDP post World War II, a period of significant economic stress, reached 129%. The recent low-point for this ratio was achieved under President Clinton where it fell to 57%. The bursting of the dot-com bubble, rising unemployment, tax cuts , increasing fiscal spending and the sub-prime crash have resulted in the present level.

Congress can deal with this issue in three ways; cut spending, raise taxes or increase borrowing. Ultimately any one or combination of these decisions must be made in order to increase growth (or GDP) or they risk placing further pressure on the creditworthiness of their nation's debt. In this context, the threat of a double-dip recessionary scenario is of concern, but there appears to be a silver lining as, although weaker, the forward-looking indicators reflect some degree of growth based on lower commodity prices, a relatively weaker US dollar and a normalization of the Japanese economy and demand post their earthquake and tsunami. The US remains vulnerable to the eventual European outcome and the Chinese economic cycle.

Emerging markets suffer a flight to safety

Emerging markets did not escape the carnage of the quarter, suffering a significant flight to the "safety" of the US dollar and government bonds (are they truly risk-free?) as a risk-off environment returned. Equity and bond losses were magnified in US dollar terms as, by way of a painful example, the rand depreciated by over 13% in September, doing a little better than the Brazilian real. It has been our view that any weakness in these markets should provide a buying opportunity based on both valuation and growth prospects. Over the past year we had preferred to gain exposure to these markets via the mega-cap global players, found largely on the S&P 500, where valuations were attractive and where there was reduced currency risk. Our investment case for emerging markets is that they remain attractive when compared to traditional developed markets, based on their economic fundamentals, low levels of debt, and attractive demographics.

For now, correlation of emerging markets and their currencies remain high. But not all emerging markets are of equal opportunity. Whilst as a group emerging markets account for more than half the world's GDP and account for almost all of its growth, temperatures in the varying economies that make up this group vary significantly. A recent assessment by The Economist ("Some like it hot") suggests that based on six indicators some countries (including, unfortunately, South Africa) look decidedly undercooked versus those that risk overheating (such as Brazil and India) and those that look well positioned for continued growth (including China and Singapore).

Back on the road to Mangaung

The six factors mentioned above focused on economic variables and excluded issues such as political risk. In the area of politics, South Africa remains consistent, as things are never dull. Currently, the ANC is pursuing a (second) disciplinary hearing against its Youth League leader, Julius Malema. Whilst a number of charges have been put forward against the ebullient leader, these do not include his agenda of nationalising

mines and banks, a previously tried and ruinous policy that this country can ill-afford. Cynthia Carroll, CEO of Anglo American, commented in a recent interview that, having experienced the consequences first hand in Zambia, she believed the South African government has not made it clear enough that they don't support nationalisation as a policy. If these perceptions remain, there is bound to be concern around foreign fixed investment. The political temperature will continue to increase in the year ahead as the ANC heads back to Mangaung for its leadership conference at the end of 2012.

That rand again

In the previous quarter we suggested that the rand remained highly vulnerable to capital outflow given the extent of flows into our bond market and that the trend could reverse, not due to SA specific risks but on a return to global risk aversion. This was experienced in dramatic fashion during the month of September where, as mentioned, the currency lost significant ground. Currencies have proven a destination for risk-averse capital. Whilst the Japanese and Swiss stemmed the flow of capital to their currencies so as to remain competitive, the Australian Reserve Bank has made no such move. Despite high household debt (155% of disposable income), consecutive rate increases and a stable economy have seen a significant appreciation in the Australian dollar which is now viewed amoungst some global bond managers as being the world's most overvalued currency. By contrast, if the European Central Bank prints money, or if the European Financial Stability Fund buys up debt, the Euro will likely lose significant ground to the US dollar.

Happy birthday, number 7,000,000,000

October marks the symbolic birth of the seven billionth human on our planet. Whilst we can't obviously identify the individual precisely, the issue highlights the exponential growth in human population and the resultant strain being placed on Earth's finite resources. Over the last century we have experienced a decline in resource prices in real terms but the pattern of the past decade has bucked this trend and may mark a paradigm shift in he world's assumption of ongoing cheap prices for metal and agricultural commodities. This has significant consequences for investments and growth rates of economies.

Positioning portfolios

Whipsaw: To be victimized in two opposite ways at once (Wikipedia).

The noise level in the market has risen considerably as measured by volatility. With this comes inevitable confusion as investors ride an emotional roller-coaster. Those in the fortunate position of having significant cash flow, such as Warren Buffett's Berkshire Hathaway, have seized on the volatility as an opportunity to embark (for the first time in their history) on a share buy-back initiative, recognizing significant value in their own company.

not alone and this has been a significant trend in equity sting. In this regard, investors today focus on many statistical variations of risk. Our approach to risk remains the avoidance of permanent loss of capital and this requires a focus on valuations, fundamental risks inherent in an investment and caution around leverage.

With the scale of significant unknowns in the market today, we maintain a neutral stance to asset allocation with a positive bias based on the current attractive valuation of risk assets. It is worth noting that concerns being priced into the market mean that global equities now trade on a forward valuation of only 10 times earnings! We have moved over the past two quarters towards a far more defensive asset allocation outlook which has served us well given the extent of loss experienced over this time. Whilst not defensive enough, we did experience benefit in the introduction of some gold exposure in certain of our core offshore portfolios and were rewarded in the quarter (at last) for our tactical overweight offshore position based on our view of overbought rand levels as measured by purchasing power parity. Our underweight developed government bond position, particularly US treasuries, has proven costly over the past year as yields continue to test stronger levels in a risk-averse environment. The rand weakness experienced means that we now reduce the extent of this exposure but we expect the increased volatility to provide further opportunities for tactical rebalancing of portfolios. Of interest, our structured product team will be introducing an investment in agricultural commodities as a way of investing in the theme of finite resources.

	Q4 2011	**Q3 2011**
Domestic	Neutral	Underweight
Equity	Neutral	Marginally overweight
Fixed Income	Marginally underweight	Marginally underweight
Cash	Marginally Underweight	Underweight
Property	Marginally overweight	Neutral
Alternative	Neutral	Neutral

	Q4 2011	**Q3 2011**
Offshore	Neutral	Overweight
Equity	Neutral	Overweight
Fixed Income	Underweight	Underweight
Cash	Marginally underweight	Marginally underweight
Property	Marginally overweight	Marginally overweight
Alternative	Neutral	Underweight