The Bear Necessities

An Analysis of the Investment Climate

Bay Asset Managers (Pty) Ltd

Dr Adrian Saville
Chief Investment Officer

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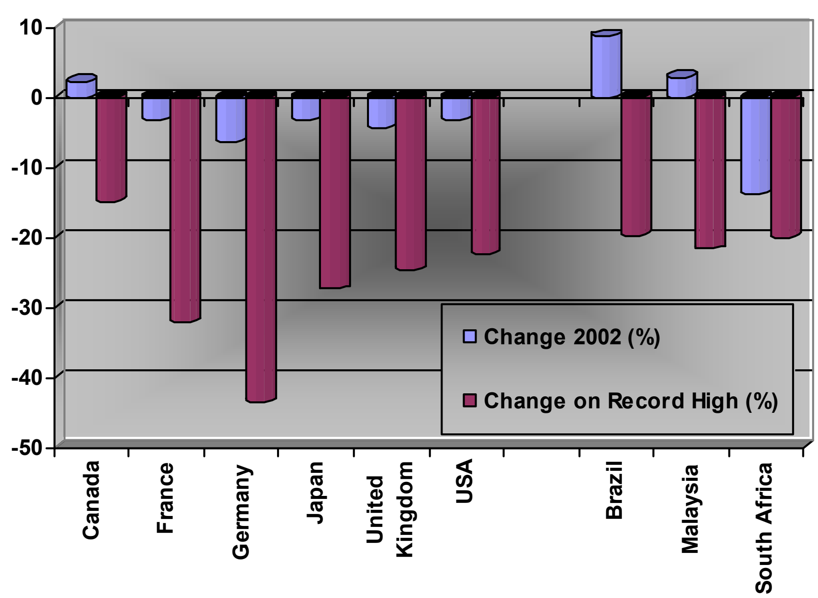
Introduction

This report is provided as a service to the clients of Bay Asset Managers (Pty) Ltd, the company's subsidiaries and its associates. The aim of the report is to provide an overview of the key performance drivers and performances of equity, bond and cash markets over the course of 2002. Against this backdrop, the report then turns to consider the key drivers of asset performance in 2003. The principal objective of this forecasting exercise is to offer comment on forecast asset class performance, and to provide clients with a view into our thinking behind the extant positioning of our clients' investment portfolios.

Market Backdrop (Or, More Simply, Market Drop)

Towards the end of last year, in a commentary on the state of global equity markets, we outlined the generally poor performances recorded by the world's leading stock markets over the course of 2002. The last few weeks of the year did little to alleviate this trend. Thus, the bear market that was initiated in 2000 is now grumbling into its third year of existence. This market weakness has been influenced and aided by a range of factors, including, *inter alia*, the bursting of the high-tech bubble in early 2000, the slump in business investment over the past three years, the September 11th attacks in the United States of America (US) and the crisis of confidence caused by the wave of huge North American and European corporate scandals that have unraveled over the last eighteen months. Against this backdrop, Figure 1 provides a summary of the investment returns generated on various stock markets over the course of 2002.

Figure 1: Equity Market Indices (% Change 2002)



Source: I-Net Bridge

The net result of the above declines was the World MSCI US$ index running flat over the course of the year, delivering a net return of 0.1 percent year-on-year. Of course this aggregate eclipses many of the better and worse performances across regions, countries and sectors. By way of example, the past year saw Emerging Market equity indices generally doing better than their more economically advanced counterparts. Conversely, technology stocks, which had been under severe pressure prior to 2002, pushed further south through the course of the past twelve months, serving to drag sector indices deeper into the red than broader market averages. Specific performances aside, 2002 ended on a sour note, with equity investors being pulled into a third year of straight declines. The net result is that investors now find themselves in the grip of the worst bear market in equities since the 1930s.

The above investment anemia was further beleaguered by turbulent currency conditions. On this score, on the back of the global economic growth slowdown, fears of war and a hefty trade deficit, the US$ slipped 9.5 percent on a trade weighted basis, making the greenback the worst performer amongst 'hard' currencies during 2002. Furthermore, this recent reversal in fortunes for the US$ looks likely to persist in the near and medium terms. By way of example, we forecast the US$:€ rate to reach 1.15 by mid-year, with weakness stretching the rate to 1.20 by early 2004. In addition, in the midst of equity and currency turbulence, investors found little place for shelter. Indeed, the most obvious traditional stores of wealth during market turmoil – gilts and cash – offered little or no protection to investors in 2002. As evidence of this, yields on cash fell to forty year lows in the US, where the Federal Reserve took base lending rates down to 1.25 percent through a series of aggressive cuts over the course of the year.

To our minds, whilst the cuts made during 2002 are vital in nursing the world's largest economy back to health, the extent and speed of the cuts has left a dark cloud hanging in the economic and investment atmosphere in the US. Indeed, we would go so far as to argue that the odour emitted by these policy actions is one of desperation. To boot, interest rates in Europe offer little by way of comfort, with three-month money market rates in the Euro zone ending 2002 at 2.87 percent. Finally, the confused state of global capital markets was further plagued over the course of the past year with the increased threat of war in the Middle East, as well as South East Asia (headed up by North Korea's withdrawal from the Treaty on the Non-Proliferation of Nuclear Weapons [NPT] in late 2002). From these economic and political events, it was a few short steps that helped gold surge to five-year highs in the final weeks of the year (ending the year 23.4 percent in US$ terms). Oil prices swelled more than 45.0 percent (in US$ terms) over the same period.

The Domestic Rising and Setting

On the domestic front, 2002 was a year of mixed blessings. With few sectoral exceptions, equities stumbled through the course of the past year, with the broad market ending the year 2.3 percent off in Rand terms. In US$ terms, however, the market surged as the Rand hauled back a hefty 40.0 percent of its value against the US$ and lesser (but nevertheless impressive) gains recorded against other leading currencies. However, the weakness recorded by the Rand in 2001 had significant negative repercussions as the economy headed through 2002. The two most obvious negative manifestations of the collapse in the Rand in 2001 were the sharp spike in consumer price inflation (with consumer price inflation appearing to have peaked at 14.5 percent in November of last year), and interest rates which were cranked steadily higher as price inflation moved increasingly further away from the South African Reserve Bank's (SARB's) 3.0-6.0 percent target. Without becoming weighed down by detail, the net result of the SARB's efforts to expunge price inflation was a prime lending rate of 17.0 percent by year end.

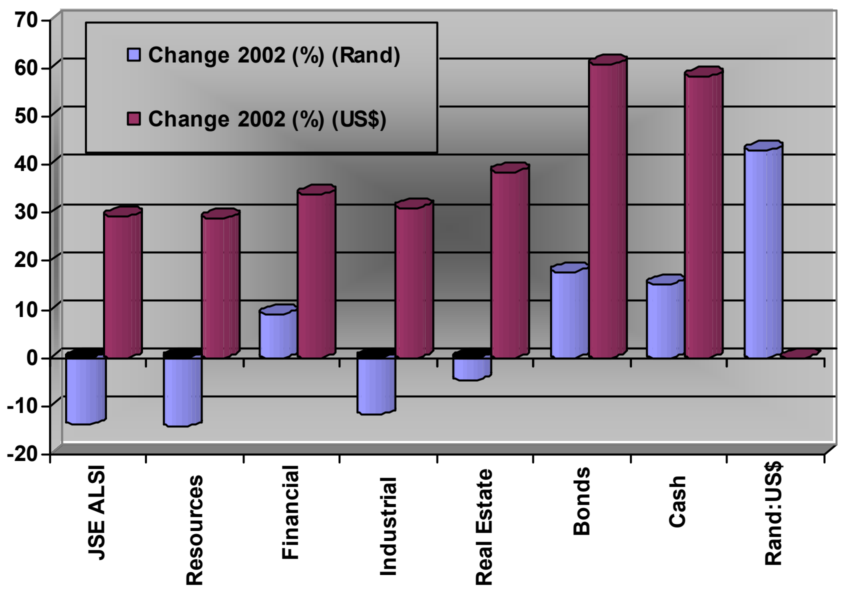
To a large extent, the tighter monetary environment weighed heavily on the domestic equity and the property sectors, in particular. As reflected in Figure 1, above, equities ended the year down 13.8 percent (as measured by the All Share Index), with the stronger Rand undermining domestic commodity-based and export-oriented equities. Global equity and bond market weakness did little to aid local sentiment. As noted, the upshot of these influences was a generally disappointing performance by local equities, with resource stocks and financial counters heading smartly downwards (with sector indices off 14.2 percent and 11.9 percent, respectively, for the year). Industrials proved to be the sectoral exception, with the Basic Industries Index firming 9.1 percent over the course of 2002, whilst the Real Estate Index shed just 4.5 percent over the same period.

That aside, and in contrast to the disappointing equity market performance, the recovery of the Rand aided bond prices, particularly in the latter part of the year, with the market netting a return of 17.8 percent over the course of 2002. On a risk-reward basis, however, cash was king, with yields firming significantly over the course of the year. From a broader perspective, however, it was a difficult time for investors exposed to South African markets (albeit significantly better than that experienced by investors exposed to North American, European and Japanese equity and bond markets. Figure 2 provides a summary of domestic asset class performances for 2002.

Leaving the domestic setting aside for the moment, and with the investment disasters of 2002 (and the first month of 2003) now behind us, our attention is now firmly fixed on prospects for the current year, with the key output of our investment forecasts being the successful positioning of client's portfolios. Against this backdrop, we set out below our near-term forecasts for 2003. These forecasts are placed under three broad headings:

- global capital and stockmarket forecasts, where we focus attention on the world's leading economies;
- domestic capital and stockmarket forecasts, where we focus attention on the world's leading economies; and
- investment positioning, where we pay particular attention to asset allocations and stock picks in the global setting, but with an emphasis on the domestic market.

Figure 2: Domestic Equity Performances (2002)



Source: Bay Asset Managers (Pty) Ltd

Global Capital and Stockmarket Forecasts: More of the Same?

How down is down? Despite the sell off that has taken place in North American and European equities over the past three years, it appears that further weakness is in store in the near- to mid-term. On this score, equity ratings remain at historically high levels (with the S&P 500, by way of example, still trading at twice its long-term average), and earnings struggling to play catch up (see Figure 2). Growth in gross domestic product (gdp) in the US is forecast to run along at 2.3 percent in 2003, whilst Euro-zone growth is forecast to battle to lift above 1.5 percent. The Japanese economy will suffer a worse outcome, as on-going structural rigidities will confine gdp growth to the 0.5-1.0 percent range. An absence of pricing power will further undermine corporate profitability. Japan should witness another year of deflation (consumer prices are forecast to fall by 0.7 percent), whilst the European and US economies will record modest price inflation. Our forecasts are for consumer prices to rise by 1.7 percent and 1.9 percent, respectively, over the year. As a consequence, we are unlikely to see corporate profits making any headway of consequence in these regions. Rather, equity ratings will continue to come down to meet a flat performance by earnings.

If we apply some simple valuation tools to this scenario, the argument for equities is a poor one. A useful starting point is to compare the earnings yield on stocks with the yield on bonds (note that we confine our analysis to the world's largest equities market – the US, which we use as a proxy for all industrialised markets). To get an earnings yield for the market as a whole, one needs to take the inverse of the price-earnings ratio (using forecast earnings) of the S&P 500. With a forward price-earnings ratio of 33.0, the earnings yield on the S&P 500 is about 3.0 percent (by our own confession, an optimistic forecast). The yield on long-term treasury bonds is 3.8 percent – almost a full percentage point higher than the earnings yield on stocks. The difference over the course of a year is material, particularly in a low price inflation environment. Investors buying assets today are garnering 3.0 cents in earnings for every US$ invested in stocks, versus 3.8 cents in interest income from an investment in bonds (assuming the bonds are held to maturity). In a price inflation environment of 1.9 percent, the differential is a factor of almost two (1.1 cents in real earnings per US$ held in equities, versus 1.9 cents in real earnings per US$ held in bonds). Another way to think about the relationship is to take the inverse of both yields. That gives us the familiar price-earnings ratio (of 33.0) in the case of the S&P 500 and a price-interest ratio of 26.3 for the bonds. The latter ratio is rather unorthodox, but it does offer a clear picture of how the market has priced one year's worth of uncertain earnings income from equities versus the guaranteed income from bonds. Interestingly, cash sits on a price-interest ratio of 77.5 on current money market yields. In this setting, we favour bonds over equities, and bonds over cash. In considering the prospects for equities, it is also informative to consider the relative time valuation of equities. On this score, despite the significant sell off of the past three years, US equities still sit on a price-earnings ratio that is more than twice the long-term average. This further reinforces our bias away from equities in developed markets.

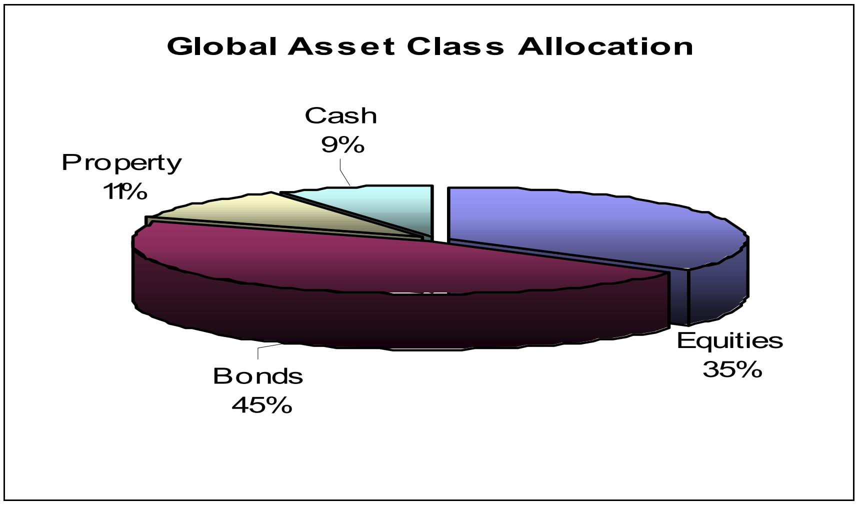
Source: MetaStock

Valuation issues aside, in response to the above factors, monetary authorities will attempt to breathe life into economic activity by pushing interest rates lower (with the Bank of

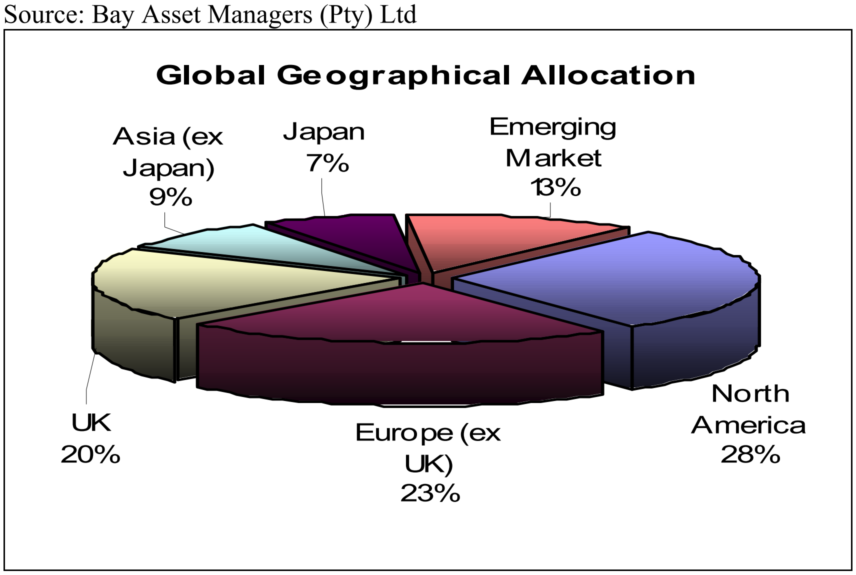
Japan standing out as an obvious exception). We see rates in the US softening by a further 50 basis points by mid year (taking the base lending rate to 0.75 percent), with the European Central Bank following suit (taking rates down to 2.25 percent by the third quarter of 2003). In this setting, whilst government and corporate bonds could offer comfort through sweeter yields (5.00-6.25 percent on either side of the Atlantic, and 1.35 percent in Japan), the prospects for capital appreciation are slim. Further, in thin interest rate environments, cash becomes an almost fruitless home for funds. However, where cash is held, we remain in favour of the Euro where, as intimated, we see the US$:€ rate offering some help to investment portfolios over the course of 2003. Our views on other leading currencies see Sterling as modestly overvalued (circa 15.0 percent), and the Yen as undervalued (circa 5.0 percent) against the US$.

In the above setting, the macroeconomic bugbear (for want of a better term) is war in the Middle East. Here, everything hinges on the outcome of relationships between the US, Europe, the United Nations, Iraq and, to a lesser extent, North Korea. Our view, however, is that an attack on Iraq, led by the US, is almost inevitable and, as every economic historian knows, war is good for business. Near term, however, it would be hard currencies (principally the US$), oil (up to US$40.00-43.00 per barrel on technical indicators) and gold (clearing US$400 per ounce on technical indicators) that would be the obvious winners. Losers would almost inevitably be Emerging Market currencies (including the Rand, although the 'gold price effect' could act as an ameliorating factor) and Emerging Market economies (with Asia bearing the brunt of the burden as a result of the region's oil deficit and reliance on global trade). Some Latin American economies could benefit under this set of conditions. As a region, however, Latin America remains in a political tangle, making it a doubtful destination for investment funds.

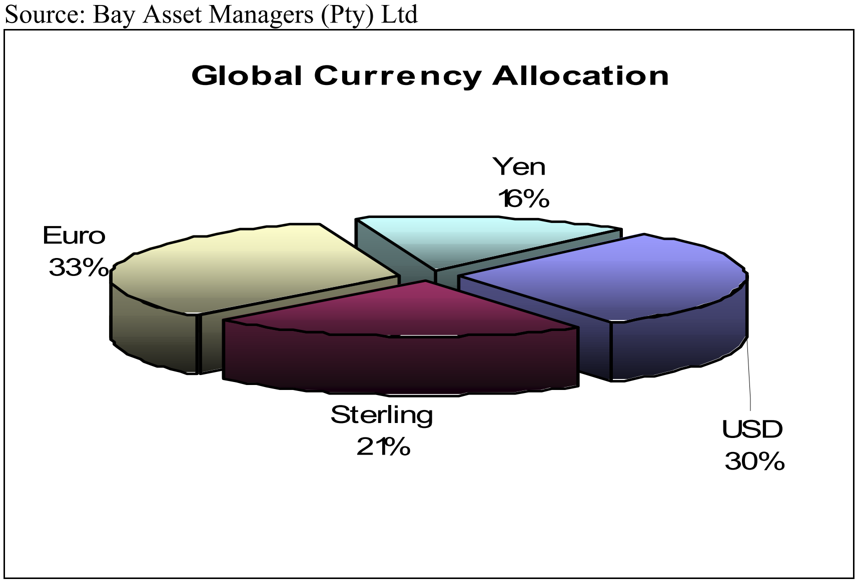
Pulling the above views together, we remain overweight € and ¥, and underweight Sterling and US$. Further, inside of these currencies, we favour cash and bonds over equities (where we have been heavily underweight for almost two years). We also remain overweight industrialised economy exposure over Emerging Market weightings. In contrast to this, we have marginally upweighted commodity exposure. The play, however, is strategic (war), rather than structural (economic growth), and so must be considered a trading stance. Figures 3-5 below summarise our current investment weightings on global asset allocations.



Source: Bay Asset Managers (Pty) Ltd



Source: Bay Asset Managers (Pty) Ltd



Source: Bay Asset Managers (Pty) Ltd

War. What Is It Good For?

Turning attention to the domestic setting, we see the US$200 billion Iraqi war stimulus as being a weak global economic trigger. Further, with traditional global factors – such as equity market movements and global economic growth – unlikely to have significant positive influences on local economic outcomes, our attention is focused on international political events and local monetary factors as the key drivers of asset market returns in 2003. On this score, we see two sets of issues as critical. The first is the likelihood of an Iraqi war, and the implications for currencies, commodities and economic growth. The second is a set of exogenous domestic monetary factors that are likely to unwind over the course of the current year.

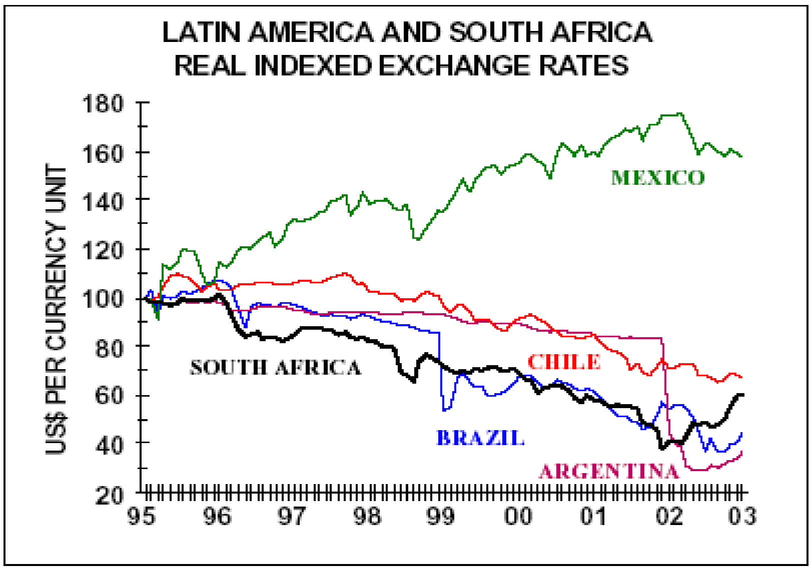
Considering the war situation first, as the US heads towards (what now appears to an almost certain) war with Iraq, global capital markets and asset prices have started to respond. Global capital – and especially the more mobile 'hot money' – is moving away from Emerging Markets and back into safe havens such as treasury bills, government bonds, other near-dated paper and commodities (especially oil and precious metals). As a consequence, spreads on Emerging Market sovereign bonds have started to widen, as yields in the US have continued to decline. By way of example, the South African-US gilt yield differential (sovereign risk premium) now stands at 12.35 percent versus 12.16 percent at the start of the year. Moreover, as noted by Johan Lamprecht (Emerging Markets Economist, First National Bank), whilst the worlds' equity markets have been under extraordinary pressure over the past few weeks, commodity prices (oil and gold in particular) have been strong, with the outlook remaining bullish. As noted above, under a war scenario, we see gold and oil prices heading quickly higher to clear US$400 per ounce and US$40 per barrel, respectively.

As the probability of war in Iraq increases (as it is likely to do over the next few weeks), investors also can expect to see more market volatility. Emerging Market asset prices should weaken in sympathy. That said, fragments of emerging economy's asset markets could benefit from the above events. In the case of South Africa, the most obvious beneficiaries would be precious metals producers and mining houses (such as Anglogold, Angloplat, Armgold, BHP Billiton, Goldfields, Harmony, Implats, Northam and Mvela Resources). Currency weakness could further influence export-sensitive, import-dependent and hard-currency priced businesses. On these grounds, an obvious case study is Sasol, which would receive a double whammy from higher oil prices and a weaker Rand.

On a more general note, however, it is our view that any war-induced Rand weakness would be a temporary phenomenon. Put simply, we see fair value for the Rand at close on R7.70 to the US$ and R8.30 to the €. Figure 6 provides evidence of the extent of Rand undervaluation despite the recent currency strength.[1] In this setting, we suggest

[1] Despite the 'crudeness' of the measure, it is interesting to note that *The Economist's* Big Mac Index places fair value for the Rand at circa R5.00 to the US$. Albeit anecdotal, the data provides further evidence in favour of arguing for Rand strength as opposed to Rand weakness. Sometimes the trend is not your friend.

employing Rand-hedged and commodity-based counters as portfolio insurance, but are only on-weight to modestly overweight these positions given that we see an Iraqi war as being a quickly settled matter, and Rand weakness as a temporary aberration. We would also be shy of bonds and firmer on cash. Again, however, we see these as temporary (and arguably even unnecessary) measures for investors (as opposed to traders). Furthermore, the shorter the war, the better the news for Emerging Markets as capital will quickly flow back to the investment periphery.[2] The risks to this strategy are a drawn out military operation in Iraq and the extent to which the SARB sees Rand strength as undesirable (the Growth, Employment and Redistribution strategy calls for 10.0 percent undervaluation of the Rand to promote export competitiveness) .



Source: Econometrix

The second set of key market moving factors identified above is a set of exogenous domestic monetary factors, which includes interest rates, consumer price inflation and the foreign exchange rate. Considering these factors in reverse order, and having already commented on the currency at various points, it is our view that whilst the currency is likely to remain 'volatile', the firmer trend of 2002 should remain in place in 2003. The outbreak of war could take the Rand from its current R8.50:US$ levels up into the R9.50-R10.00 range. However, in all probability, we see this outcome as being temporary, and expect the Rand to average R8.40 to the US$ over 2003, ending the year at close on R7.75 per US$. This setting is likely to aid bond prices in particular, as consumer price inflation heads closer towards the SARB's 3.0-6.0 percent target.

Considering price inflation then, the most recently released data show a decline in consumer price inflation from 14.5 percent in November 2002 to 14.4 percent in December 2002, with CPIX down from 12.7 percent to 12.4 percent over the same

[2] Estimates made by Johan Lamprecht (Emerging Markets Economist, First National Bank) are for a war that should not last much longer than about one month, as the Iraqi army seems to be considerably weaker than it was in 1991.

period. To our minds, this almost certainly suggests that inflation peaked in November 2002. Nevertheless, some components of the basket are displaying signs of price stickiness, with an absence of domestic price competition serving as a critical influence in this regard. Thus, we expect price inflation to continue to slow as we move through 2003. However, we do not share the same optimism as some economists, whose forecasts suggest consumer price inflation could head into the 3.0-6.0 percent target set by the SARB before the year is out. More specifically, we see consumer inflation averaging 9.6 percent over 2003, and ending the year at 7.1 percent (year-on-year).

The implication of the above is that whilst interest rates can be expected to fall in sympathy with the improvement in the inflationary environment, the decline is not anticipated to be as aggressive as some economists are forecasting. Indeed, we see rates declining by as little as two percent over the course of 2003, with the first cut of 100 basis points coming in the middle of the year, and the second cut of a further 100 basis points being made in September. The two swing factors, however, are the possibility of an early cut (March) due to sharper than anticipated improvements in the inflationary outlook and monetary environment. We see the likelihood of this outcome as 'improving', particularly on the back of the most recent monetary data, which show growth in private sector credit extension having plunged to 4.7 percent year-on-year in December (a seven year low), whilst M3 (the broadest measure of money supply) growth fell to 12.8 percent in December (from 15.5 percent in November). These improvements heighten the probability of an 'early cut' to fifty percent. The second swing factor takes the form of an interest rate cut offered up as an early Christmas gift from the SARB – this is only likely to materialise in the event of structural barriers giving greater way than we anticipate. We see the likelihood of this outcome as 'low'. In this declining but 'sticky' interest rate environment, investors should look to lighten bond exposure and lift equity exposure as the year unwinds (but not as rapidly as some economic forecasts are suggesting).

Considering asset price performance, if we reapply the simple valuation tool used above for US equities and bonds to the South African market, the argument for domestic capital markets over leading capital markets is compelling. The argument also sharpens investment focus, in that it provides marginal weight to bonds over equities. Again, a useful starting point is to compare the earnings yield on stocks with the yield on bonds. On this score, with a forward price-earnings ratio of 9.2, the earnings yield on the JSE Securities Exchange is about 10.8 percent. The forward yield on long-term government bonds is 12.3 percent – one-and-a-half percentage points higher than the earnings yield on stocks. Given our forecast for price inflation, the real difference in returns is again material. Investors are getting a forecast real return of 1.2 cents in earnings for every Rand invested in stocks, versus 2.7 cents in interest income for an investment in bonds (assuming the bonds are held to maturity). Applying the price-earnings ratio argument developed earlier, the price-earnings ratio on equities is 9.2, and the price-interest ratio is 8.1 for the bonds. Cash sits on a price-interest ratio of 7.7 on one-year yields. In this setting, as in the US, we favour bonds over equities, and bonds over cash. However, in comparing domestic yields to global yields, we find local assets extremely attractively priced.

Anecdotal evidence encourages us further. By way of example, the recent decline in the level of indebtedness of domestic households stands in marked contrast with the trend in major overseas countries. Thus, South African consumers are in far better shape than consumers in more developed markets. Similarly, the number of compulsory company liquidations amongst South African firms dropped dramatically in December to single digit levels for the first time ever. Both pieces of data suggest that, at least in the near to medium term, the South African economy will outperform leading global counterparts.

That aside, we also consider local assets to be well priced on a time relative basis, with equities some 30.0 percent undervalued. Thus, we favour bonds and equities over cash, and are willing to upweight equities in a declining interest rate environment. We also express a preference for upweighting domestic assets in global asset allocation portfolios. Using risk profile as taxonomy, the table below summarises our extant asset allocation stance. The table suggests that in a static setting, investors can look to bonds, property and cash as inflation beating investment vehicles. Equity exposure serves as the most important base for capital accumulation.

Table 1
Domestic Asset Allocation by Risk Profile

	Yield	Risk Profile				
		Aggressive Growth	High Capital Growth	Balanced Growth	Capital Preservation	Income Generation
Equities	3.4	80.6	75.0	60.0	48.0	43.2
Bonds	11.6	12.3	17.5	25.0	31.3	34.4
Property	13.5	4.5	5.0	10.0	11.0	13.8
Cash	12.9	2.6	2.5	5.0	9.8	8.7
Total		100.0	100.0	100.0	100.0	100.0
Implied Forward Yield			5.1	5.6	6.9	8.0
Implied After Tax Yield			2.8	3.1	3.8	4.4

Source: Bay Asset Managers (Pty) Ltd

Drilling down into asset classes, with regard to equities, we remain overweight value, underweight growth, with core holdings including Goldfields, Anglos, BHP Billiton, Mvela Resources, Aflife, ABIL, Clientele, Sasol, PPC, Cashbuild, WBHO, Group5, Hudaco, Argent, Dorbyl, Aspen, Tourvest, Brandcorp, Oceana and Pikwik. Considering bonds, short-dated paper remains in thin supply, which has led to pricing anomalies. Further, our interest rate and price inflation forecasts lead us to gravitate towards longer-dated positions. This view is reinforced by the fact that the SARB's determination to extinguish inflationary pressures could lead to inflationary and interest rate outcomes that are lower than is currently being anticipated by the market. For 'technical' reasons, the recent re-weighting of the domestic bond index in favour of longer-dated paper reinforces our view in favour of longer-dated bonds. On the back of this, core gilt holdings include the R184, R177 and R194, and core non-government fixed income instruments include the TK01 and E168. If price inflation eases to the extent anticipated, then it would make sense to gravitate towards longer-dated bonds.

Summing It Up

Summing up our investment views, we see 2003 as having the following in store for investors:

- War will be quick, and good for commodities and 'hard' currencies, but painful for equities. Further out, each of these events should reverse as investors head back in search of the lower hanging fruit of Emerging Markets. Gold and oil are winners – but only as trading positions.
- Leading global asset markets remain steeply priced, meaning that it will be another tough year for American, European and Japanese investors – almost regardless of asset class. This alone should be reason enough for Emerging Market Investors to stay at home.
- At home, the Rand should do well, and bonds are likely to score early victories in 2003, being overtaken by equities and cash as we head deeper into 2003.
- Stockpicking remains the key to portfolio success, with value still beating growth as an investment style in equities, and longer-dated positions beating short-dated plays in bonds.