OPINION / COLUMNISTS

SHANE WATKINS: Hold on to your money and your country

You could be forgiven for thinking that equity markets are back in buying territory — not so

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29 SEPTEMBER 2022 - 17:39 *by* SHANE WATKINS

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At the beginning of the year we wrote that 2022 would be a year to avoid capital losses, rather than a year to generate positive returns. As anticipated, equity markets globally have declined significantly. In the year to date, the Nasdaq is down 30% and other equity markets are down about 20%. The JSE is down 14%, cushioned by a weaker rand.

Given these precipitous declines you could be forgiven for thinking that equity markets are back in buying territory. Not so. Markets that have become expensive over decades do not become cheap over months. Positive trends that have persisted are reversing.

If anything, as the year has progressed the outlook has dimmed. Earnings expectations for companies have not properly adjusted to the deteriorating outlook. This is due to an investor bias known as "recency bias", where investors anchor their expectations on their recent experiences and do not give adequate weighting to changing circumstances.

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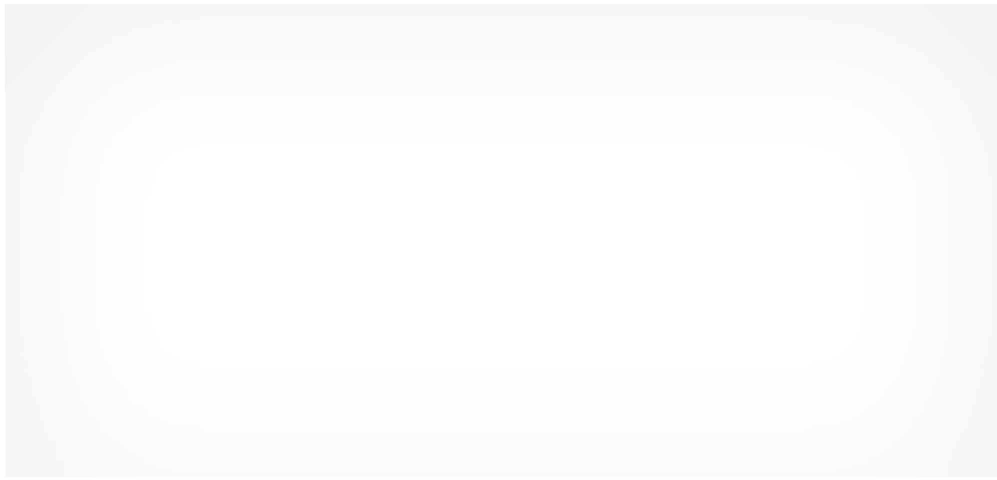

The value of income-producing assets is determined by the earning power of the assets and the rate at which we discount those future earnings. In this "present value" equation, earnings are the numerator, and the denominator is the discount rate.

Consider the outlook for earnings first. Economic growth in China has slowed from 8% trend growth to be negative in the second quarter of 2022. It's hard to see China returning to previous growth rates. Europe is already in a recession. Growth in the US is still positive but decelerating. Tax rates and interest costs are rising. Energy co[illegible]re hugely higher, in some cases above 10 times what they were a year

ago. A global investment bank expects US company earnings over the next 12 months to miss expectations by 25%.

It is evident that the numerator in our equation (company earnings) is likely to decline. What about the discount rate (our denominator)? US long bond rates have risen from less that 0.5% to almost 4%. The Federal Reserve has implemented hikes of 75 basis points (bps) three times already and markets are pricing in a 90% likelihood of another 75 bps hike in November.

The European Central Bank has said that despite recent hikes, “policy rates remain far below levels that will ensure a return of inflation to 2% ... and further hikes will be appropriate to slow demand and avoid persistent upward pressure on inflation”.

Higher rates are certain. This translates into a meaningfully higher discount rate. Investors add a premium to the discount rate depending on perceived risks. Lower earnings and higher discount rates mean meaningfully lower asset prices, even from current levels.

An additional problem is that almost a decade-and-a-half of very low interest rates has driven investors into risky assets. Additionally, the high returns that we have seen in risky asset classes over the past decade has made diversification seem costly and unnecessary. Portfolios are mostly positioned the same way, and when investors realise that things have fundamentally changed, this overcrowding will make repositioning difficult.

Other factors such as the increased dominance of passive investing mean that market outflows are not going to be met with fundamental buying. Increased volatility and especially downside volatility is to be expected. Price declines across asset classes that have previously been negatively correlated are likely. As my exasperated old high schoolteacher used to say to me, “final warning”.

On a personal note, I moved my family to Australia in January and three months later I moved them back to SA. Choosing where you live and invest your time and energy is probably the most important decision you will make for yourself and your family. Moving countries has been an expensive and taxing journey, but in the end very much worth it.

When we left SA we were focused on all that was wrong in our country: load-shedding, violent crime, corruption. But in Sydney we realised we had lost sight of the warmth of the African people, the beauty of our land, our family and friends, and our incredible lifestyle.

Returning to SA gifts us the opportunity to contribute to making the country a better place for all. Around the world there is what Andrew Garfield has called “an epidemic of meaninglessness”. In SA we certainly do not have this problem — we have relevance and purpose and our lives have meaning if we contribute to the greater good.

The rest of the world has increasing challenges. In the US, there have been more school shootings than days in the year. There is a war raging in Europe that has killed tens of thousands. China still has Covid-19 lockdowns, an authoritarian crackdown and potential for a conflict with Taiwan. Democracy and globalisation are on the decline.

SA is far removed from many of these problems. We need to see Africa and our own country more positively — a change in mindset. Whatever we have achieved has been gifted to us by being in SA.

My purpose in sharing my experience is not to convince people that wish to explore abroad to stay. Rather, I want to convince those who choose to stay to focus on the numerous positives and recognise how blessed we are to live in Africa.

• Watkins is chief investment officer of All Weather Capital.

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