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CAUTIOUS OPTIMISM

About the great crash of 1929, JK Galbraith wrote: “Some years, like some poets, some politicians and some lovely women are singled out for fame far beyond the common lot, and 1929 was clearly such a year”. Later, people would speak of “before 1929” or “after 1929”.

In retrospect, watershed years such as 1929 can be seen as a break with the past, after which old rules and norms no longer apply. People change and look at things differently. Behaviour patterns alter. The 44% fall in US equity prices since September 2000 constitutes the biggest US bear market since 1929. Possibly we shall look back on 2002 and say that it was the year in which many things changed.

Equity markets tend to move in cycles with long bull markets being followed by lengthy periods of stagnation. For example the US Dow Jones Industrial Index, after reaching a low of 162 in 1949, enjoyed a 16-year bull market until 1966 when it reached 1,000 but did not break through this level until 1982. In retrospect one can divide the market’s history into eras, each of which is characterised by different investor behaviour. At the end of a long bull period one finds extreme optimism and indeed recklessness. Ultimately bear markets are characterised by caution and conservatism. Where previously investors placed great emphasis on the growth potential of companies, poor returns makes them focus more on current earnings and dividends. Probably we are at one of these important turning points.

One of the illusions which may have been shattered by recent events is the belief that the stockmarket will deliver returns which will provide a comfortable retirement for the post second world war baby boom generation. The boomers, who are now aged between 40 and 57, account for much of the developed world’s savings. Their response to the new uncertainties could well be to save more and spend less, which would have an adverse effect on economic growth. We have already seen this process at work in Japan where the stockmarket bubble has been followed by a decade of stagnation.

Comparing current events with 1929 and the 1930’s evokes an alarming collective memory. It is important that we should not get too pessimistic about the future because changing circumstances create new opportunities. The mere fact that prices have fallen so much means that global equity markets are a better investment now than they were two years ago. However we must recognise that people in general have expected too much from the markets and that we are probably entering a new era of lower returns.

It is impossible to predict how events will develop, but among the trends which may become manifest, and for which we must watch are:

- An increase in saving which creates a deflationary environment in Europe and North America. Japan is already in deflation.
- Economic and market leadership passing to the emerging markets with their younger population and higher growth rates.
- Investors valuing assets differently, placing less emphasis on growth and more on current earnings.

These trends would be beneficial for South Africa and provide investment opportunities. We are part of the universe of emerging markets. Resources could benefit from growth in Asia, and our equity valuations are cheap by world standards. Accordingly, we can be cautiously optimistic about our prospects. A prudent policy of saving and investing in companies that offer value will continue to give superior returns. However investors should not expect too much from the market. Rather they must look to protect their wealth and the benefits of gradual compounding of returns should prevail over the long term.

Commentary by Sandy McGregor, Director