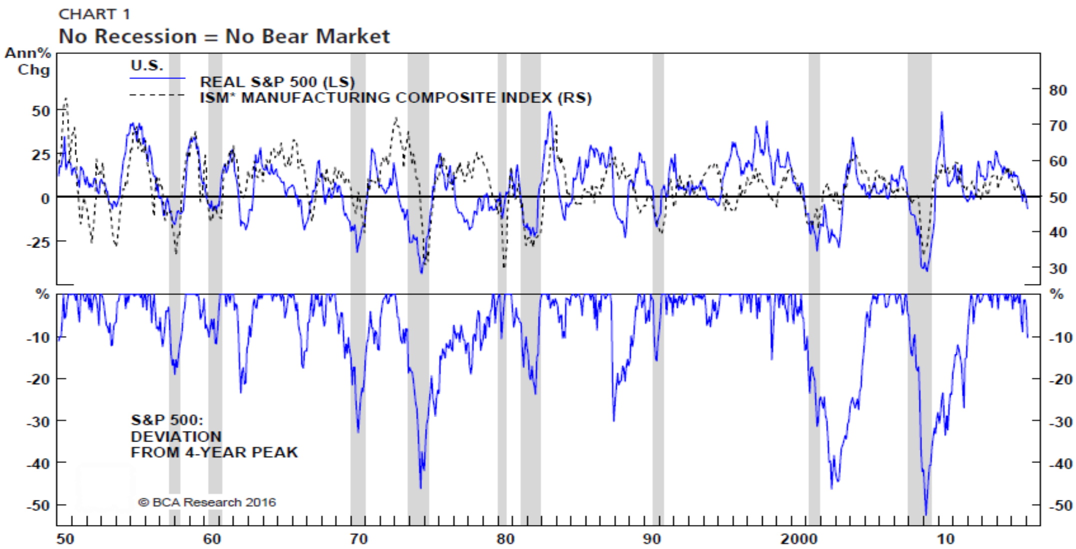
FOCUS: **Bear Market 2016?**

The key question for investors is whether the sell-off in global stocks is merely a correction, or rather the start of a prolonged bear market, coupled to deflation?

Chart 1 shows that historically bear markets have almost always coincided with recessions. Recessions, in turn, have usually been the product of major economic imbalances.



What, therefore, are the key questions that concern investors in 2016?

a) Is the trouble in high yield bonds the tip of the iceberg and leading indicator, just as the trouble in subprime was symbolic of a broader problem within the mortgage market?

The sense is that the answer is "no", for the following three reasons!

Firstly, there is little evidence of rising defaults within the much larger universe of investment-grade credit.

Second, the whole derivatives structure that once pervaded the mortgage market is largely absent from high yield, making the asset class much more transparent.

Third, unlike mortgages, high-yield debt is generally held by non-leveraged investors.

b) Aggressive Chinese currency devaluation? The potential of devaluation, led by China effecting a large and potentially highly disruptive devaluation, is something that the Chinese authorities will resist at all costs. The huge gap between annual real GDP and its potential long-term trend growth results in deflation. When all nations competitively devalue to gain a competitive advantage, foreign trade is disrupted and economic growth is depressed. Consequently, all nations lose.

However, there is a need for the corporate sector to accelerate productivity improvements in the face of margin pressure from the likes of China. As a result of companies competing over a smaller pool of spending (both in consumer and business-to-business markets), margins are under increasing pressure in many industries. Expect increasingly uneven growth across nations and regions.

c) Deflation?

Should we, as investors, be concerned and how should one react to deflation?

Excess supply is the root cause of deflation especially in the commodity space and for industrial commodities' it is rising inventories. The continuing decline in the purchasing power of the middle class, as a result of shrinking real wages and real incomes, is heightened by the use of disruptive technologies such as robotics in manufacturing, primarily implemented due to unwieldy and restrictive labour regulations. As a consequence, this disruptive pulse is impacting on wage and income deflation and is putting further downward pressure on prices.

Global deflation is ultimately good for the U.S. dollar and safer long-term bonds, but it has a devastating effect on stocks, real estate, commodities, junk bonds and higher yield bonds, or 'risk-on' investments, especially in Emerging Markets. The primary investment goal during deflation should be capital preservation.

The deleveraging or deflationary episodes of Japan, Sweden and Finland in the 1990s are particularly instructive. They show two distinct phases of deleveraging. In the first, households, corporations, and financial institutions reduce debt significantly over several years, while economic growth is negative or minimal and government debt rises. In the second phase, growth rebounds and government debt is reduced gradually over many years.

Deflationary healing is benchmarked by six important variables or factors that one should evaluate when gauging how today's deleveraging economies are progressing and what priorities governments/policy-makers are likely to prioritise. Without meeting these six conditions, growth and public-sector deleveraging are unlikely, as illustrated by Japan, and as such Japan has suffered two decades of slow growth and rising debt since its 1990 crisis.

1. Is the banking system stable?
2. Is there a credible plan for long-term fiscal sustainability?
3. Are structural reforms in place?
4. Are exports rising?
5. Is private investment rising?
6. Has the housing market stabilised?

During the first phase of deleveraging, households, corporations, and financial institutions all reduce their debt over several years − a painful period, with little or no real GDP growth and rising government debt.

Reviving GDP growth is absolutely essential for starting the second phase of deleveraging, in which public-sector deleveraging begins. But growth in times of deleveraging requires more than a cyclical upturn in demand. It is important, as shown by Sweden and Finland in the 1990s, that structural changes are implemented to shift economies from relying mostly on exports, as in the case of China currently, or consumption to a new growth model in which exports, investment, and consumption are more balanced. The State has an important role in facilitating financial stability! Even Developed Economies are in need of investment in infrastructure, education, and other public goods but appear too constrained by debt to fund this work.

The same debate is true of income polarisation because high earners are less likely to spend their money in a deflationary environment than people with lower incomes, giving rise to calls for further social engineering by the state when sound fiscal policies and spending are required.

Substandard education systems, as demonstrated by the likes of South Africa, restrain productivity growth, employment gains and economic advances. To compound matters, instead of investments in education, research and productivity-enhancing capital equipment, the emphasis has been on consumer spending and/or social grants. If the outcome is properly understood then it is easily remedied by constructive government budgeting.

In historic episodes of deleveraging, we see that countries often progress through two distinct, yet overlapping, phases of private and public sector deleveraging. Today's deleveraging economies face what seems to be a uniquely difficult situation: a weak global economy, banking troubles; debt defaults across some economies; baby-boomers retiring and little room for fiscal manoeuvring. Yet, globally, sovereign nations share many of the same challenges that have faced deleveraging nations historically, and therefore a full-blown deflationary environment seems unlikely.

d) Is the shape of the Bond yield curve still a valid predictor of recessions?

Yes, I believe so. There is no doubt that the US curve has flattened in spite of Chinese liquidation of US treasuries and post the FED rate hike in December; however, it still has a way to go before it is flat or inverts. See **Chart 2** below: comparing the yield curve shape in March 2009 (the start of the bull market S&P 500) and January 2016.

A flat or inverted curve has historically been a great predictor of recession (normally by approximately 11 months) and therefore equity bear markets. Given the current shape (the shadowed red line) and the conclusion drawn from **Chart 1** that there is no indication of an imminent recession, the present curve is therefore currently predicting a market correction and not a recession and therefore an outright equity bear market is unlikely.

In summary, this is an equity market correction. It is coupled with the OECD forecasts that three billion more middle-class consumers (the research defines middle class as having daily per capita spending of $10 to $100 in PPP terms) will emerge in the next 20 years compared with 1.8 billion today. They will drive up demand, which will occur when finding new sources of commodity supply, and extracting them, will become increasingly challenging and expensive, notwithstanding technological improvement in the main resource sectors.

In the short term, however, for South Africa, other than the positive impact of a lower dollar oil price on the South African economy, the economy remains riddled by low levels of confidence, significantly depressed levels of private and government fixed investment expenditure and decimated commodity prices. This is further compounded by concerns about South African political leadership (Zuma), while renewed Chinese growth concerns are also likely to weigh on sentiment, given that 60% of our mining exports go to Asia.

The current account deficit therefore is likely to remain substantial which, together with a subdued economic outlook, suggests the rand will remain relatively fragile and volatile, in spite of being oversold on most measures. Offshore investments and rand hedges therefore retain a strong investment logic.

South African Bond yields suffered from the explosive sell-off as a result of political ineptitude; the extreme recent weakness appears to be discounting a significant amount of bad news and could be representing fair value, given the uncertainty facing the FED rate trajectory and continued Quantitative Easing in Japan and the European Union. Relatively low yields of projected forward yield of 7.5% on REITS, compared to bond yield of 9.2% could well see constrained near-term REIT (listed property) returns.

Probably the best returns in this environment will be had in the Preference Shares, with the current gross yield of 10.25%. The forward gross yield is expected to yield 10.50%; this average yield should be achieved over the next 12 months given the expected MPC rate cycle. This yield compares favourably with one year money market yield NCDs of 8.4%.

Inflation-linked bonds are currently implying an inflation rate of 7.6%. South African CPI is forecast to average 6.3% for 2016; it has been anchored at the top end of the inflation target band, with maize prices expected to remain elevated due to continued drought conditions. The yield benefit therefore of preference shares, relative to other income returns, makes it an attractive long-term income generator.

Globally, central banks are still committed to close to zero interest rate policies. Economic fundamentals do count. This is particularly relevant when analysing China's slowing economic growth and the need for 'rebalancing' its economies mix, and the potential impact on the South African economy. It is important that structural changes are carefully handled to shift economies from relying mostly on exports, in the Chinese case, or consumption to a new growth model in which exports, investment, and consumption are more balanced. There are no quick fixes − sound fiscal and monetary policy and structural reforms to unleash private-sector business growth are vital and remind us how easily growth can be derailed in highly indebted economies if these basics are ignored.

In conclusion, as highlighted by OECD, urbanisation is an important driver of economic growth; in spite of policy decisions still driving markets and triggering continued investor uncertainty.

The long-term reality is that Chinese growth will not collapse and neither will global growth; nor will deflation take hold given the active steps being taken by central Banks to avoid such an outcome. Therefore, although this is a serious market correction and not a prolonged bear market, on the relative valuation matrix equities yielding 9.9% on a total return basis remain the preferred asset class, together with Preference Shares yielding 10.50%. A diversified portfolio of yield-focused investments should be well placed to benefit even in a deflationary environment.

Prepared by Mark Huxter, 26 January 2016