



The beginning of the recovery

Jeremy Gardiner, director at Investec Asset Management, believes that while the road is certainly not without bumps, 2013 will be remembered as the year the recovery began

The upside of living at the bottom tip of Africa is that we have been relatively sheltered from what has been going on in the global financial crisis. The downside is that we don't get to meet people who live in Athens, Madrid, Istanbul, Paris, Cairo etc. so we often assume that everything there is perfect and that we alone have problems. This is by no means the case. It's tough out there; the world has just emerged from the biggest economic crisis since 1929.

I had a youngster complaining to me recently that he was struggling to find a job in South Africa. 'Don't give up,' I replied. 'It'll get easier as the economy grows,' which is all you can say, but that is the sad reality of the economic times we live in. There is an entire generation in Europe that is unemployed!

There are encouraging signs that the world is healing and that economies have bottomed. Compared to 18 months ago, the economic numbers – and hence the newspaper headlines – are all improving. Interestingly, this is more the case in the developed world. The emerging world is still suffering the economic aftershocks of the recent withdrawal of investor flows, as well as the emotional trauma that comes with that.

But then, it is simply our turn. For the first two or three years of the financial crisis, emerging markets were shielded, as Dr Ben Bernanke, Fed Chairman, kept them buoyant while the developed world struggled. Now the developed world is improving and this will ultimately drag the emerging world out of its misery.

A look at the world in more detail

US

The US is recovering rather well economically, but politically leaves much to be desired. The political impasse, driven by their debt situation, is in many ways understandable. Their debt to GDP – around 107% and rising by about 2% a year – was 98% in 2010 and 66% in 2006. Put differently: it is up from about \$4 trillion in 1993 to current levels of \$17 trillion!

So, first we had the shutdown, which wasn't too serious. Unless you were a worker deemed 'non-essential' or a tourist unable to visit closed museums or parks, the impact was minimal. Markets clearly were not concerned. However, the Chinese – as the biggest holder of US debt – and the rating agencies were less impressed.

The debt ceiling, however, was far more serious. As with the shutdown, this has happened before. In fact, the ceiling had been raised 13 times since 2001. Will we have the same panic scenario in February next year? Hopefully lessons have been learnt and a solution can be reached before then. However, the risk remains significant, which is why Warren Buffett referred to the debt ceiling as 'a political weapon of mass destruction that shouldn't exist'.

If you can forget the above, the US is in relatively good shape. The housing market is recovering and, unlike their government, US consumers have managed to deleverage and are now able to borrow again. Banks are lending, delinquencies are at record lows, consumer confidence is at 6-year highs and finally, after four consecutive deficits in excess of a trillion dollars per annum, this year's shortfall will only be around \$650 billion. This number will keep declining going forward.

How are they managing to do this? A growing economy is helping by generating extra tax revenue, but most importantly, new technology – allowing the US to drill and extract gas where previously they couldn't – means that the US will be energy neutral within the next two to three years. They will therefore no longer have to import oil and gas, and will actually be able to export, which will boost their economy, cut their deficit and bring down their debt – manna from heaven indeed!

Europe – finally a help, not a hindrance

Finally, after six negative quarters – the longest recession since inception of the Euro 14 years ago – Europe is growing again, albeit by only 0.2% (Q2 2013). Mr Mario Draghi's pledge that the European Central Bank will 'do whatever it takes' has certainly brought calm to the region, with bond yields back to normal levels, stock markets at record highs and the health of the financial system improving. However, debt levels are at record highs as well, as are mortgage delinquencies and youth unemployment. This while bank lending and house prices are at record lows.

Italy – with €2.1 trillion of debt, Italy's debt to GDP ratio is forecast to reach 132% by the end of this year. This means they have the third highest debt levels in the world after the Japan and the US.

Spain – Spanish debt to GDP is 92.6%, up from 84% last year. Mortgages to homebuyers are down roughly a quarter this year, so banks aren't lending. On top of that, they are borrowing roughly €10 billion a month just to survive.

Portugal – Portuguese debt to GDP is around 124%, up from 108% last year. They decided to fund their €78 billion bailout by imposing tolls on 900km of roads. In some cases the toll costs exceed that of fuel. Needless to say, people used alternative routes and traffic volumes fell by as much as 50% last year.

Denmark – Just because you don't hear much about Denmark doesn't mean they don't have issues. Roughly a third of their banks have closed since 2008, following a property bubble that burst. Danish households are the most indebted in the world.

Greece – After €240 billion of bailouts, Greek debt to GDP is forecast to reach 176% by the end of this year, up from 156% 12 months ago. Plus, they're going to need another €11 billion next year.

France – French debt is €1.95 trillion, ranking just below Italy's €2.1 trillion. Their debt to GDP is 95% and the economy is likely to grow at less than 1% this year.

In essence, whilst Mr Draghi's words have restored confidence in Europe, debt levels remain dangerously high and are still rising. While their economies are growing – albeit only just – they are going to have to grow a lot more before they can start employing the unemployed, cutting their borrowing and reducing debt. Until then, their recovery can only be described as fragile.

The UK, on the other hand, is recovering nicely. Growth is expected to be around 1% this year and in the region of 2% next year. Household debt is down and consumers are borrowing again, banks are lending with mortgage approvals at 5-year highs, house prices are rising and Moody's upgraded the banking sector. In addition, having just experienced the best summer in 15 years, it is no wonder consumer confidence is at 3-year highs!

BRICS

It's not just South Africa that has had to suffer the after-effects of the decline in interest in emerging markets and the subsequent outflows – the BRICS are certainly no longer the place to be.

Brazil has seen its growth forecasts cut to 2.5%, their inflation is above 6% and their currency has been smashed to 5-year lows. All of this saw their debt rating cut after 10 years of upgrades. On the streets there are massive riots as their citizens – infuriated by the spending for the football World Cup – demand Fifa-style world-class hospitals and schools rather than stadiums. Expect this to continue and intensify as we get closer to next year's World Cup.

India was labelled a 'dream market' for investment a few years ago by none other than Warren Buffett. Since

then, they too have had their currency forced to record lows, they've seen a massive selloff in stocks and bonds, borrowing costs are at record highs, fixed investment is pulling out and their debt has been downgraded to almost junk.

A year to 18 months ago the Chinese hard landing was seen as one of the bigger threats to the global recovery. Throughout, Beijing denied the hard landing forecasts, instead insisting that they were deliberately engineering a slowdown in order to transition their economy from being 'manufacturing-driven' to 'consumption-driven'. Well, it looks as though they have succeeded, with growth expected to be 7.5% - 8% this year and the same expected for the next two years.

Of course Chinese planning has also identified that a global population increase from 7 billion to 9 billion by 2050, coupled with the fact that climate change is going to increasingly play havoc with crops, mean food shortages are going to become significant. To make provision for this, they have leased 3 million hectares of Ukrainian farmland for the next 50 years. They also bought Australia's biggest cotton farm in 2011 and they have purchased more than 50 Bordeaux vineyards to ensure they have enough wine!

Air quality, however, remains a significant problem, with pollution levels often more than double the levels perceived as unhealthy. Sixteen of the world's 20 most polluted cities are in China. Obviously this, coupled with rising disposable income, make them want to travel. China, with tourism expenditure of \$102 billion last year (up 40% from 2011) is now the world's biggest tourism market. It has pushed Germany and the UK – both spending approximately \$84 billion – into second and third place respectively.

Chinese central planning does not incidentally stop at food. In a rare moment of compassion (or maybe to avoid government having to act) they have identified that youth education and urbanisation have led to the neglect of elderly parents in rural areas. They have therefore passed a law, prescribing young people to care for their elderly parents. They have to call and visit regularly and if they don't, the parents can file a lawsuit against them. Also, living far away is not an excuse: companies have to allow parent visiting leave!

Africa

The debate about whether or not the Chinese have added value on the African continent will rage for decades to come. But one thing is certain: the Chinese have rebuilt Africa's basic infrastructure – roads, railways, airports and harbours. These were not philanthropic gestures – they were purely to ship commodities out of Africa. However, basic infrastructure then allows other industries – such as tourism, financial services and telecommunications – to prosper.

And prosper they have done. A recent report by the African Development Bank shows the top 20 fastest African economies are all growing in excess of 5% per year. In a recent poll of 500 executives across the US, Europe and Asia, 60% said their perceptions of investing in Africa had improved over the past three years, whilst 75% said they expected their perceptions to improve further over the next three years.

Africa's challenges are many, but perhaps the most significant over the next 40 years will be trying to educate and employ a growing population, which is set to double between now and 2050. With the average birth rate in Africa, according to the Population Reference Bureau, five times that of the European average, the availability of youth (which the developed world simply won't have) is either going to be what is known as a 'demographic dividend' or a 'demographic disaster'.

What is encouraging is that intra-African foreign direct investment projects are up significantly over the past five years. Also encouraging is the fact that South African corporates' are looking to invest closer to home. For many years after they were finally allowed to take money offshore, they avoided Africa, preferring instead to focus on the US, Europe, the UK and Australia, where most ran into a brick wall of well-organised competition. South African corporates today invest more on the African continent than China does. We understand Africa – it is in our blood, far more than someone from Europe or the US. As South Africans, we therefore have a significant competitive advantage on the continent.

South Africa

Back in South Africa, the withdrawal of investment flows has left us vulnerable. Rampant strike activity has

decreased our exports, thereby widening our current account deficit, weakening our currency and leading some to label us part of the 'Fragile Five', along with Indonesia, Brazil, India and Turkey.

This, of course, has not gone unnoticed by South Africans who, after having watched the global collapse from a distance – seemingly unaffected – now, ironically, as the recovery begins in the developed world, find ourselves more affected than before. This is because investment flows have headed home, leaving us slow, depressed (consumer confidence is at 10-year lows) and with significantly less disposable income as a result of rising living costs and a weak job market.

This on top of the fact that, according to the National Credit Regulator, of South Africa's roughly 20 million credit-active adults, nearly half have impaired credit records. Furthermore, rampant unsecured lending has led to a situation where many South Africans find their monthly debt repayments (which get taken off their salaries at payroll before they even hit their bank account) exceed their salaries in some cases by as much as 20%.

All of this saw workers taking to the streets with strike activity levels not seen for years, affecting exports, the rand, foreign investment, taxes to SARS and, most importantly, jobs. Hopefully 2014 will see an improvement in employer/employee relations, as we cannot afford to risk – in any way – alienating foreign investors or rating agencies any more than we already have.

An important consideration when trying to gauge how South Africa will fare going forward, is to consider how we rank versus the countries we compete with for investment. Nobody asks whether they should invest in the UK or SA, or the US or here. They are rather interested in whether they should invest in South America, Africa, Asia or South Africa. Interestingly, compared to the parts of the world with who we compete for investment flows, we actually compare quite favourably when it comes to most measures, including corruption, press freedom and debt to GDP.

That does not mean for a second that we can become complacent. We need to bring corruption levels down before it becomes endemic; we need to guard press freedom fiercely and we need to watch our debt levels. Although it does bear noting that our debt levels have been very prudently managed since 1994.

Conclusion

In summary: the world is improving and heading in the right direction. Debt levels in the developed world, however, are not. These remain perilously high and are increasing. Energy might come to America's rescue in this regard, but Europe won't be so lucky and will have to do it themselves.

South Africa's problems are numerous, but the most frustrating thing about many of our problems is that they need not be there. With the right leadership, many of our non-performing areas could be fixed reasonably quickly. By putting experts (rather than people without the requisite experience) into top jobs, problem areas are bound to heal and then this country will fly.

However, that requires leadership. The exit of Mr Malema and the introduction of Mr Ramaphosa have seen a significant shift in government's dialogue over the past ten months. 2012's aggressive anti-investment dialogue has been replaced by far more investor-friendly discussion, and those who were previously less vocal now becoming more prominent.

It may be early days, but the endorsement of the National Development Plan, the curtailing of MPs' expenses and the promulgation of the youth wage subsidy bill – despite howls of protests within the ruling party alliance – may just be the green shoots of sensible leadership on which this country has been hoping for so long.

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*As at end March 2013