



Politics – the art of the possible

by CHARLES DE KOCK



CHARLES DE KOCK is a senior portfolio manager with 26 years' investment experience. He plays a leadership role in the asset allocation process and is responsible for the management of a number of client portfolios.

The final quarter of 2012 was marked by a flurry of political events, both locally and abroad. In the US, President Obama won a second term. In China, the new leadership of the Communist Party was announced. The Japanese held an election won by Shinzo Abe who has already announced a number of new economic policy initiatives. In Europe, Mario Monti, the caretaker Italian prime minister, announced that he would be stepping down and that elections will be held early in 2013. And, of course, in South Africa we had the much anticipated ANC conference in Mangaung, where some changes in leadership were made – the most notable being that Cyril Ramaphosa replaced Kgalema Motlanthe as deputy president of the ANC.

These political events are interesting and, as one would expect, received lots of news coverage. The point I wish to make is that no matter whether the new leaders were elected or appointed, whether they are liberal or conservative and whether they are from the developed or the emerging world, they are all going to be faced with some stark economic realities. Back in 1867 Otto von Bismarck described politics as 'the art of the possible'. In my opinion this remains true today.

What are these economic realities?

- The world is still recovering from the great financial crisis.
- Growth is weak and unemployment high.
- Governments around the world are saddled with unsustainable debt burdens.
- Heavily indebted countries can therefore not use aggressive fiscal policy in order to stimulate their economies.

- Monetary policy is already at an extreme, with zero interest rate policy and quantitative easing the norm in the Western economies.

Some specific economic realities facing South Africa:

- While the rest of the world is struggling, demand for our exports such as platinum, iron ore and other minerals will be soft.
- Sharply rising wage and other costs have made South Africa an uncompetitive producer.
- The high cost of labour and increasing militancy of labour unions lead to more mechanisation and fewer jobs.

Viewed against this backdrop political leaders will have to deal with what is possible as opposed to what is desired.

This applies to all countries. In the US, president Obama and the Democrats will have to agree to some spending cuts, while the Republicans will have to concede to tax increases. Europe, in order to keep the eurozone from breaking up the deficit countries, will have to continue its unpopular austerity programmes, while the Germans will have to agree to more financial assistance in various forms.

The rating agencies have already downgraded South Africa on deteriorating fundamentals, and the minister of finance will have to manage the budget deficit very carefully in the years ahead. Some spending plans will have to be put on hold, and it is my view that the ruling party will, at some point, have to get tougher with the trade unions or watch the country's competitive position erode with dire consequences for trade balance and the value of the rand.

Macro-economic expectations

The great financial crisis is not over. It will take many years, even decades, to work off the high debt levels and restore confidence in the financial system. A long period of below par economic growth for the global economy is to be expected. Interest rates will have to rise to more normal levels eventually, but monetary policy is likely to remain accommodative for some time to come. Interest rates will remain negative in many countries.

We remain firm in our view that inflation will rise once economic activity recovers and the monetary authorities will tolerate it to a degree. A period of financial repression is likely, which will help in alleviating the great debt burdens of governments.

Implications for asset allocation

The search for yield has been the dominant investment theme over the past few years. It has driven yields way too low and in our opinion has led to a bubble in yield instruments. This is an area to be very wary of. We prefer inflation linkers as

well as floating rate bonds. Overall returns in the interest-bearing arena will be very low over the next number of years.

We continue to find value in selected global equities, both in the developed and emerging world. The ultra-low interest rate environment is helpful for the pricing of risk assets and we see equities outperforming bonds materially over the medium term.

Within equities the demand over the past two years has been almost exclusively towards defensive-type businesses, such as cash retailers. Many of these shares have become far too expensive and we have reduced our holdings to very low levels. We prefer the cheaper more cyclical shares on valuation grounds.

The South African current account deficit is very wide and is a key fundamental, in our view, that the rand will weaken over time. In mandates, where we are permitted to invest offshore, we hold close to maximum exposure.

Based on valuation we therefore prefer equities to bonds and global equities to domestic ones. 