

The end of the free lunch

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There is no such thing as a free lunch. Yet recent times have provided South African savers with something close to this, as risk-free returns from money market investments have comfortably beaten inflation and riskier asset classes.

This may be coming to an end. The South African Reserve Bank (SARB) now forecasts economic growth contracting by 6.1% this year and inflation falling to 3.1%. In response, they have cut the repo rate by 250 basis points over the last two months to 3.75%. Lower interest rates can be thought of as a lifejacket for indebted businesses and consumers who must continue to make interest payments despite a lower stream of income. It is a necessary policy response to support an economy in recession. Unfortunately, for net savers who are invested in cash proxies, such as money market funds, lower rates decrease their future return opportunities.

Reinvestment yields on money market instruments have fallen from approximately 7.5% at the start of the year to 4.5% today. Fund returns do not reset immediately, but investors should expect them to trend down towards similar levels as existing investments mature. While less attractive than recent years, a 4.5% return remains higher than current inflation. But how long will low inflation last? This is an important and difficult question to answer. The consensus view is that inflation will remain low or fall further in the short term, as decreased demand from lockdown closures and the decline in energy prices depresses prices. Longer term, economic theory suggests that a weak rand, higher government spending and the SARB's printing of money to support its current bond buying programme will put upward pressure on inflation. Whether South Africa, and the world, follows this economic theory remains to be seen. It does however seem likely that cash-like investments will struggle to protect real wealth over the coming years.

As often happens, new opportunities open up as others close. As money market returns have fallen, probable future returns from other asset classes have increased. The yield on the FTSE/JSE All Bond Index (ALBI) is above 10% for the first time since the global financial crisis and more than double the short-term jibar rate. The yield differential, or pricing disparity, between medium-risk assets, such as bonds, and low-risk assets, such as cash, has seldom been higher. Put differently, probable returns from riskier assets, such as bonds, appear attractive in absolute terms, and especially attractive relative to lower returns from cash proxies.

It is a similar story for South African equities. The dividend yield on the FTSE/JSE All Share Index (ALSI) is now only marginally lower than short-term cash rates. Think about that for a moment. One can earn a similar yield from holding equities, where earnings and dividends grow over time, as holding cash, the return from which is static. While equity dividends are volatile, and will likely fall in the short term as companies adjust to current difficulties, it is probable that they will grow over the next five years. For context, ALSI dividends have grown more than 250% over the last 10 years.

The recent high real returns from cash proxies were a unique investment opportunity for many savers. Lower short-term interest rates suggest this has past, and future returns will be more in line with the low risk nature of such investments. For those who have benefited from money market exposure over recent years, it may be time to consider adding exposure to other asset classes. This is hard to do, especially in current times, and more volatile assets do not suit everyone. However, disparities such as those highlighted above, suggest that investors with a reasonable time frame should benefit from owning bond and equity assets at current prices.

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