Absolute Return Partners

The Absolute Return Letter

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# Tigers in Africa

*"The great enemy of the truth is very often not the lie, deliberate, contrived and dishonest, but the myth, persistent, persuasive and unrealistic."*

John F. Kennedy

"Do you want to see another animal?"

My family were on the last leg of a wonderful trip to the Kruger Park in South Africa, and they were all getting a bit tired, but the French woman next to them had no such quarrels. "Yes", she quipped, "I would love to see a tiger". Everyone else was stunned into silence.

I am telling you this little tale, not to make fun of the poor French woman, but because it reminds me of something we are all guilty of from time to time – *unrealistic expectations*. As I have learned over the years, if we cut corners on our homework, we may be expecting things to unfold in a way that just *isn't* going to happen.

In the following, I will review a handful of 'African tigers' – concepts or ideas which have become so engrained that a substantial part of the investment public takes them for granted, even if more in-depth research suggests otherwise.

We are confronted by difficult choices almost every day. The easy way out is to follow the herd and believe that a tiger was just spotted in Africa. We all know, though, that it just isn't going to happen (in the wild).

## Tiger 1 – Equity returns will be just fine

Academics operate with an expression called recency. It basically means that we, as humans, assign greater relevance and importance to more recent events than we do to more distant ones. When equities delivered exorbitant returns during the great bull market of 1982-2000, it became the norm to expect double digit returns from equities, despite the fact that equities had rarely delivered such high returns before the 1980s (chart 1).

**Chart 1: U.S. market by decade**

| Decade | Nominal Gross Domestic Product | Real Gross Domestic Product | S&P 500 EPS | Inflation (Deflation) | S&P Total Return |
|---|---|---|---|---|---|
| 1930 - 1940 | -1.4% | 0.5% | -5.0% | -1.9% | 0.0% |
| 1940 - 1950 | 11.2% | 5.9% | 7.7% | 5.0% | 8.9% |
| 1950 - 1960 | 6.3% | 3.8% | 5.4% | 2.1% | 19.3% |
| 1960 - 1970 | 6.6% | 4.5% | 5.6% | 1.9% | 7.8% |
| 1970 - 1980 | 9.7% | 3.2% | 7.9% | 6.3% | 5.8% |
| 1980 - 1990 | 8.3% | 3.1% | 5.5% | 6.3% | 17.3% |
| 1990 - 2000 | 5.6% | 3.0% | 7.1% | 3.4% | 18.0% |
| **1930 - 2000** | **6.7%** | **3.5%** | **5.2%** | **3.3%** | **11.0%** |

Source: Vitaliy Katsenelson, http://www.marketoracle.co.uk/Article4303.html

The combination of high debt and deteriorating demographics will almost certainly lead to below average economic growth over the next 5-10 years, and with comparatively low economic growth, low earnings growth will follow. Any other expectation is entirely unrealistic. Now is not the time to be expecting double digit equity returns.

Obviously, rising P/E multiples could still result in decent equity returns, and modestly rising multiples are precisely what I need for the equity market to generate mid-single digit annual returns over the next several years. (For the record, that expectation is driven primarily by the very low interest rates environment.) I just don't think the multiple expansion is going to be massive, given the very strong headwinds I mentioned earlier.

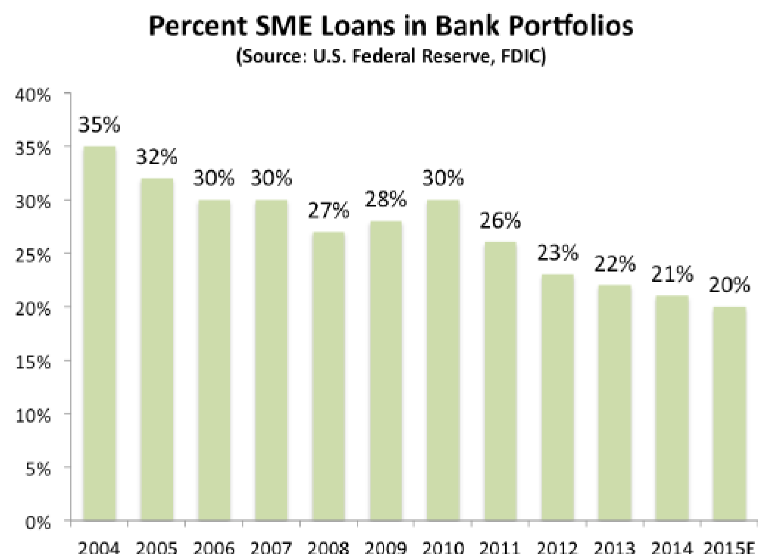
## Tiger 2 – Central banks are printing money

You often – very often – hear the following statement (or something similar):

*"The largest central banks all print money – the Fed, BoJ, BoE and now even the ECB."*

This is not true - they perform QE, and it is not the same. Hence the implications won't be the same either. Where excessive money printing is likely to lead to (hyper) inflation, QE is not. If the streets were being flooded with money, lending to SMEs (the nucleus of economic growth in most countries) would not be shrinking as fast as it is (chart 2).

**Chart 2: The shrinking importance of SME lending**




Source: Old Hill Partners

Japan is also a case in point. Inflation hasn't turned up almost 15 years after they engaged in QE. How do we explain this if banks all print money? QE will not lead to excessive inflation unless central banks lose control of commercial banks, and there is absolutely nothing to suggest that at the moment.

Having said that, we are not yet in deflationary territory, and we may never get there. Yes, inflation is now negative in a number of European countries, but it is largely driven by the collapse in oil prices. There is a fundamental difference between a deflationary shock driven by a dramatic price fall in an inelastic consumer good such as oil and widespread price falls across many consumer goods. Only the latter is actually deflation. The former is effectively a tax cut and could in fact be quite good for economic activity. That being said, the end result may still be outright deflation, but the jury is still out on that one.

## Tiger 3 – At least our pensions are safe

It sometimes baffles me how naïve otherwise shrewd people can be when it comes to their pensions. Here in the UK (and the US), where defined benefit plans (final salary schemes) are still fairly common practice, the vast majority of pension plans are now in the red (5 out of 6 in the UK) and will struggle to meet their obligations going forward (chart 3).

**Chart 3: How much of promised pensions can final salary schemes afford to pay?**

Note: UK only.
Source: Daily Telegraph

In reality, unless both bond yields and equities rise at the same time, there will be plenty of tears (see this story). Firstly, I don't expect bond yields to rise meaningfully for several years to come and, secondly, if they do, equities are not likely to be in particularly good form. You are damned if they do and damned if they don't, so to speak.

## Tiger 4 - Don't worry, everything will return to 'normal'

One of the responses I get most frequently when telling people that we face many years of relative economic hardship is that I shouldn't worry so much. Everything will return to the way it was prior to the financial crisis in 2008-09 (which really started in 2007 – the equity market just took a while to figure it out).

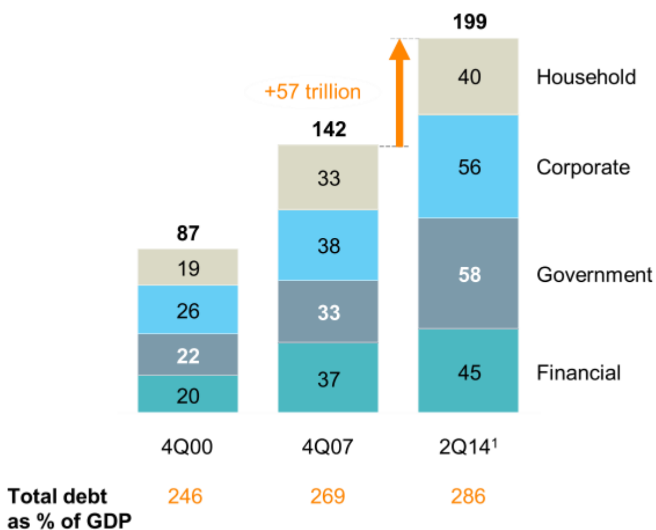
My response is almost always the same. How can a global economy that is $57 trillion (3 ½ times the size of U.S. GDP) more indebted than it was in 2007 return to 'normal' anytime soon? Nobody has yet given me a satisfactory answer to that question (chart 4).

And don't jump to the conclusion I am so often confronted with when speaking to Europeans. "Argh, it is those Americans again", people often say. "They have a debt problem; we don't" (apart from the Greeks, it must be implied). In reality, the U.S.

is nowhere near the top of the tree in terms of debt creation in recent years (chart 5). They get the attention, however, because the absolute numbers are so large.

**Chart 4: Global stock of debt outstanding by type**

$ Trillion, constant 2013 exchange rates



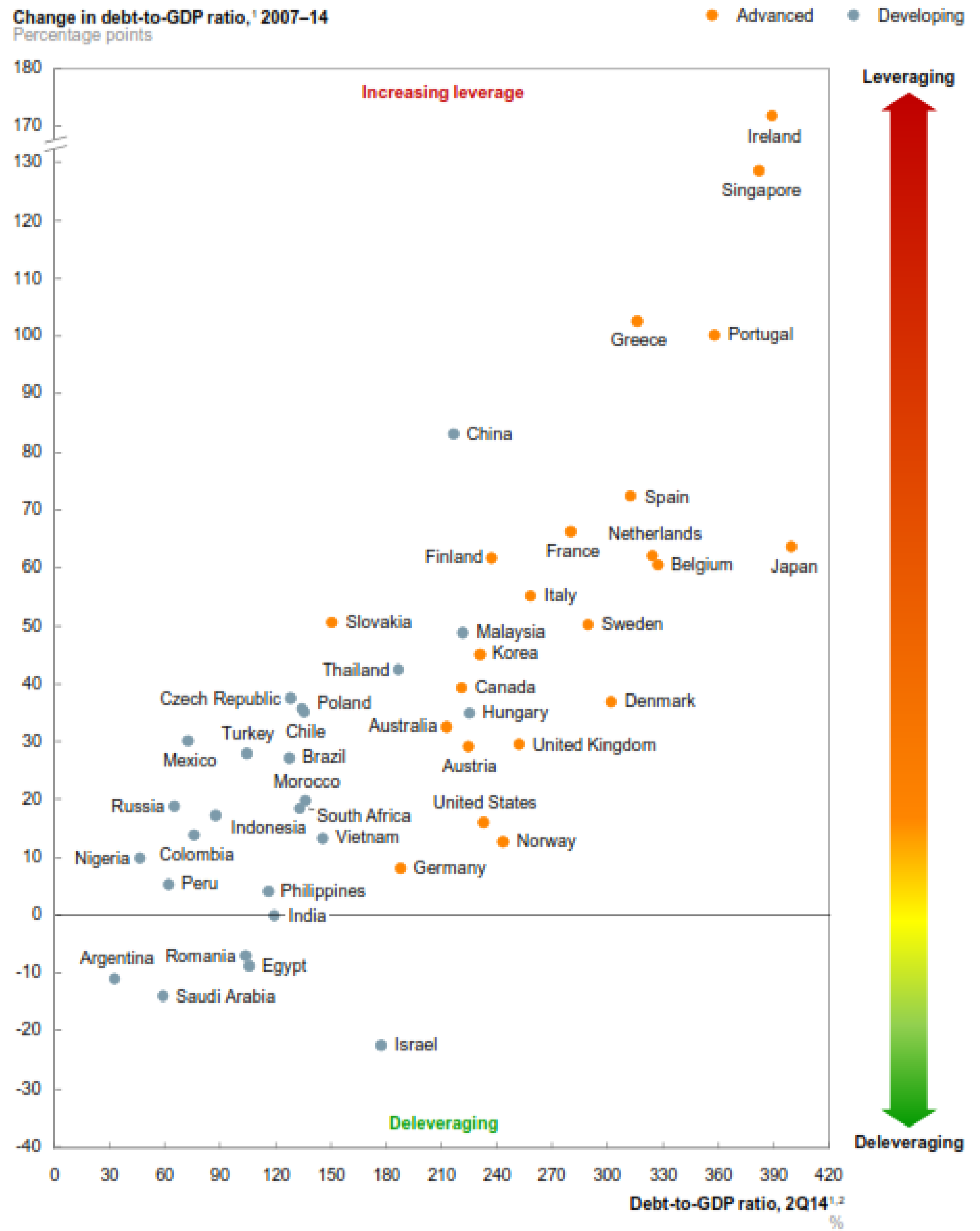

1 2Q14 data for advanced economies and China; 4Q13 data for other developing economies.
NOTE: Numbers may not sum due to rounding.

Source: McKinsey Global Institute, Haver Analytics, a.o.

It is hard to say how this problem is going to resolve itself, but it is beyond doubt that it (together with the changing demographics that I have written extensively about in recent months) will hold back economic growth for years to come. The pessimists expect it to turn into another financial crisis, but I think that is the least likely outcome (although not entirely out of the question).

Much more likely is an extended period of time with low economic growth, low inflation and therefore also low interest rates. Furthermore, the outcome could very well be vastly different from country to country. In Greece, for example, you probably won't find many right now who will tell you not to worry. But the worse the outcome in Greece, the less likely it is for the people of Italy, Portugal and Spain to demand concessions from their creditors.

**Chart 5: The ratio of debt-to-GDP since 2007 in various countries**




1 Debt owed by households, non-financial corporates, and governments.
2 2Q14 data for advanced economies and China; 4Q13 data for other developing economies.

Source: McKinsey Global Institute

## Tiger 5 – Grexit is inevitable

Around Europe there is a growing view that the Greeks have taken the mickey for long enough and must be controlled. Otherwise they can just leave. If it wasn't for the fact that both sides of the bargaining table, the Germans and the Greeks (conveniently ignoring the other Europeans for now), in reality want the same outcome, I would tend to agree that Grexit would be the most likely outcome of this crisis.

Given the domestic German objections to fixing (and financing) other European nations' problems (which I think most can understand), Mrs. Merkel have to be very careful what she says in public. And I fully understand that the Germans can't make silly concessions to Greece but, in reality, it is as much in German interest as it is in Greek interest to ride out the storm and keep Greece in the euro zone. I believe that much of what is going on is simply noise.

I am not sure the man on the street would necessarily agree (or even understand), but the Euro without a 'naughty boy' or two in the class room would be a much stronger currency, more like the old Deutschmark. Imagine how many fewer Audis and BMWs the Germans would have sold to the rest of the world if they still had the Deutschmark as their currency?

Precisely for that reason, the Germans have no interest in seeing a much stronger euro, and they have even less interest in witnessing the entire euro project falling apart, as so many are predicting. With domestic consumption in Germany running at a very pedestrian pace, the Germans are very reliant on its export sector to keep the economy going. One shouldn't be surprised at all if the parties suddenly find a 'miraculous' solution to the crisis.

## Practical implications

African tigers are imperative for several reasons but, most importantly, they often establish a strong consensus that you can go against in your investment strategy. One of our biggest success stories of recent years was an early recognition that this entire crisis would most likely lead to deflationary tendencies – not (hyper) inflation as the majority predicted.

So what is the biggest African tiger I see in front of me today? If it wasn't for the fact that we have politicians sitting around the table in Athens, I wouldn't hesitate to say Grexit.  However, politicians don't always act rationally (as we all know), which introduces a risk factor that you don't always have to worry about when investing.

For that very same reason, I continue to expect currencies to be a key asset class for years to come. With interest rates 'managed', currency markets will take upon themselves to make the necessary adjustments between weaker and stronger nations.

As the current interest rate environment is unprecedented, currency moves in the pipeline might also be unprecedented. I have a weird feeling that the choice of currencies in your portfolio will prove more important over the next few years than whether you invest in bonds or equities.

**Niels C. Jensen**
**4 March 2015**

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