



The South African Index Investor Newsletter

www.indexinvestor.co.za

June 2011



A SWOT Analysis of Global Markets

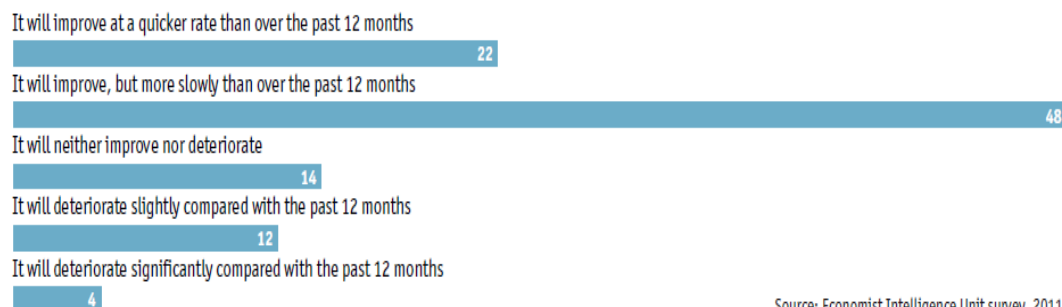
By Daniel R Wessels

The *Economist Intelligence Unit*, a research and advisory unit within the *Economist Group*, recently undertook a global survey among 800 institutional investors, corporate executives and expert interviews to gauge their expectations and opinions about economic and assets growth prospects in different regions of the world over the next 12 months.¹

Market sentiment:

The recovery of the global economy has been undermined by a series of shocks in 2011. For example, political unrest across North Africa and the Middle East (NEMA) has led to the collapse of regimes in Tunisia and Egypt and bloody conflicts in Libya. This turmoil led to a spike in oil prices, stoking inflation and denting investor confidence. Likewise, the massive earthquake and tsunami destruction in Japan caused a ripple effect across financial markets and the broader economy. Sovereign debt woes have once again emerged in the Eurozone, with Portugal joining Greece and Ireland in requesting a financial rescue package from the European Commission.

Notwithstanding these headwinds, the consensus among survey respondents is that the global economic recovery will continue, but there is disagreement over the pace of improvement. Just under one-quarter think that the pace of improvement will pick up over the next 12 months, but almost half say that the pace of recovery will slow over that period (Chart 1).

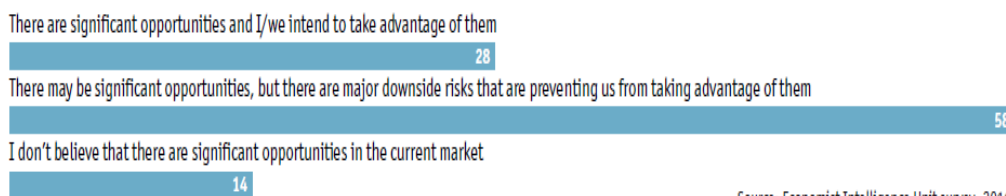


Source: Economist Intelligence Unit survey, 2011.

Chart 1: Global economic recovery

¹ It must be stated, however, that while the survey portrays experts' opinions it does not mean the expectations will necessarily come to fruition. In fact, as I indicated a number of times before, experts often miss the mark, simply because so many variables are at play at the same time and the inter-relationships often changes course. Nonetheless, it represents a fair opinion of how market experts currently perceive market dynamics going forward.

Respondents, however, are fully aware of the downside risks. Although 86% of respondents agree that there are significant opportunities in financial markets, 58% think that there are major downside risks that are preventing them from taking advantage of those opportunities (Chart 2).



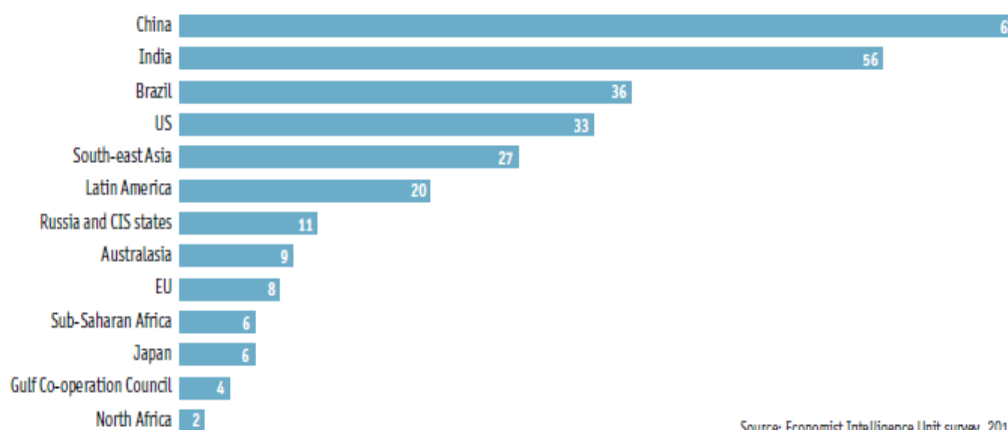
Source: Economist Intelligence Unit survey, 2011.

Chart 2: Action plan

Growth prospects:

More than 85% of developing countries grew quicker than the US economy between 2002 and 2008. Globalisation, open market policies, increased productivity and consumption contributed to this turnaround. After the financial crisis emerging markets have continued to grow, while the developed economies are largely struggling to recover. The IMF's latest *Global Economic Outlook* (April 2011) predicts that emerging markets will grow by 6.5% in real terms in 2011 and 2012, while advanced economies will grow by just 2.5% over the same period.

Not surprisingly, the survey respondents are bullish about the prospects for emerging markets. The majority view China, India and Brazil as being the most promising economies over the next 12 months (Chart 3).



Source: Economist Intelligence Unit survey, 2011.

Chart 3: The most promising economies

The emerging markets story is one that is likely to remain positive over the longer term and these countries have a number of key advantages over developed economies:

“The big emerging markets have strong population growth and are witnessing increases in productivity as people move from agriculture to manufacturing or from rural areas to urban areas. These are long-term positive drivers for these economies.”

“In many cases, these markets have got better competitive positioning in terms of labour costs, flexibility of operations, and greater policy flexibility. They also have a big advantage in terms of demographics, while a lot of the developed world has got a looming black cloud in that regard.”

While developed economies are struggling to sustain an economic recovery, the challenge for the emerging markets is very different. Their priority is to prevent the risk of overheating in a context of higher capital flows and rising inflation. As margins of excess capacity are used up, the signs of overheating are starting to become more visible.

“Sometimes it’s an issue with physical constraints—for example, you physically might not be able to get enough goods in and out of the country because the ports can’t keep up. I think we might also see an acceleration of policy tightening in emerging economies, as they realise that the inflation is stickier than they hoped, and it isn’t going to go away by the middle of the year because food prices aren’t going to collapse.”

Given the strong growth expected in emerging markets, it is no surprise that respondents believe that emerging-market assets will deliver good growth prospects for investors. China, India and Brazil are the most promising. Emerging market equities, in particular, are seen as attractive (Charts 4 and 5).

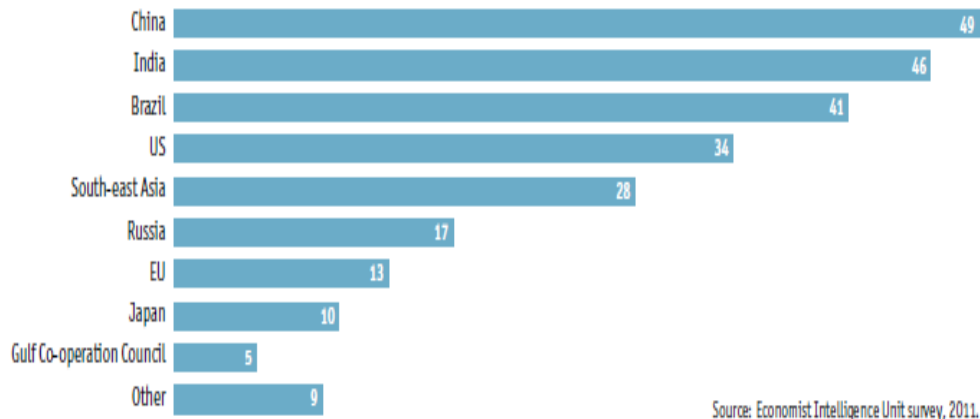


Chart 4: The most promising equity markets

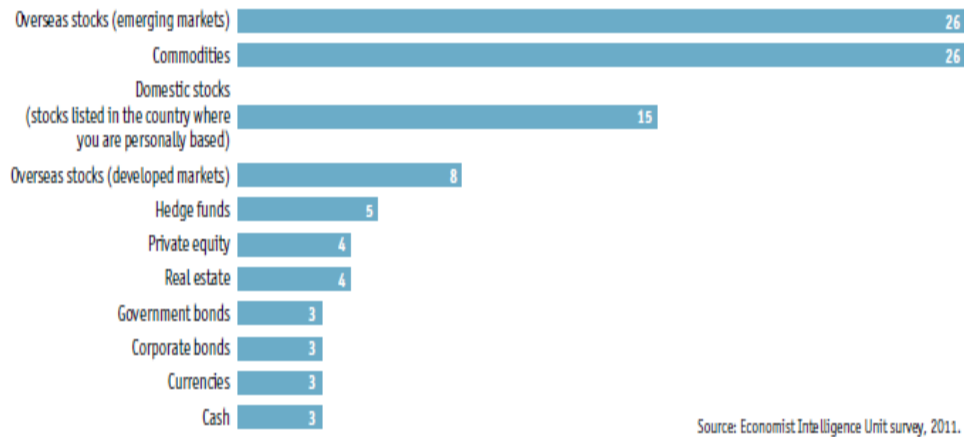


Chart 5: The most promising asset classes

A number of respondents share the enthusiasm for emerging-market equities, particularly in Asia: “These assets have got considerable competitive advantage because of the domestic growth prospects, in addition to the potential from export markets. “We continue to have an overweight position in Asia. Notwithstanding the most recent cooling-off in the equity markets, you have to think long term. There are secular trends that are now firmly entrenched to ensure that Asia, and China in particular, will become an increasingly important part of the global economy.”

“We are and continue to be very interested by the prospects of emerging-market equities. We certainly like emerging-market equities exposure from a strategic perspective, because of the growth rates in those economies, because of the increasing wealth of their consumers.”

Emerging markets:

Two-thirds of respondents believe that emerging-market assets offer very strong potential for growth, but are concerned that some markets could be overheating. And almost half of respondents agree that investors are pinning too much hope on emerging markets as a source of growth over the next 12 months (Chart 6).

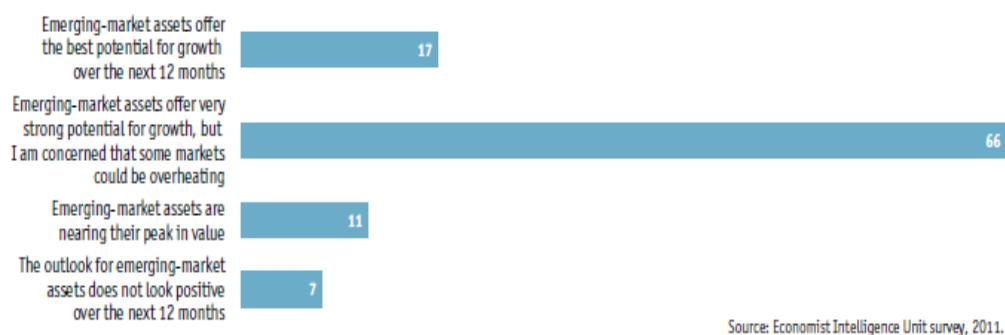


Chart 6: Downside risks

Research shows that the countries that are growing most rapidly do not always deliver the highest investment returns. Often, investors pay too high a price because the growth has already been priced into asset values.

“When an emerging-market *price to book ratio* gets above two, you tend to get pretty poor returns in the next two to three years. At the moment, the Asian average equity is trading about 2.2 times to book and Indonesia is trading at four times to book, suggesting that a lot of the good news in terms of expected future growth from Asia is already in the price.”

“Investing directly in emerging-market equities isn’t the only way to take advantage of the growth of these markets. Many of the biggest companies in the developed world are also seeing tremendous growth through exports to the emerging markets. Given the better track record of companies in the developed world in terms of governance, this can often be a preferable way of accessing this growth potential. And, given the high valuations of many stock markets in the emerging markets, it is often also cheaper to access the growth potential through such developed-market companies.”

Inflation fears:

The loose monetary conditions that followed the global recession have resulted in a considerable flow of liquidity around the global economy that has undoubtedly contributed to inflation, particularly in emerging markets.

In China, keeping inflation under control has become the single most important policy challenge but it is even a bigger problem in India. Consequently, central banks in India, Indonesia, Brazil and China have all tightened monetary policy in recent months.

“Inflation is certainly more of a problem than it was 12 months ago, but it needs to be put into context. It may be relatively high compared with the 1990s or earlier this decade, but we’re certainly not talking about inflation coming back to 1970s levels.”

Respondents expect over the next 12 months inflation of 5.1% in China, but as low as 1.5% in Japan (Chart 7).

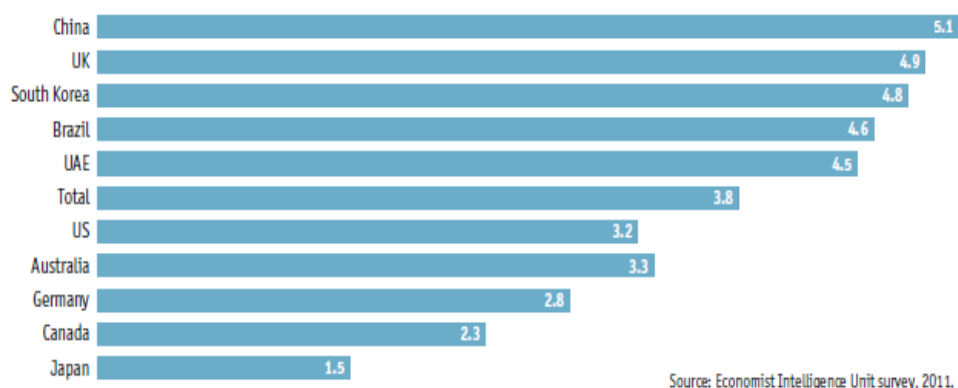
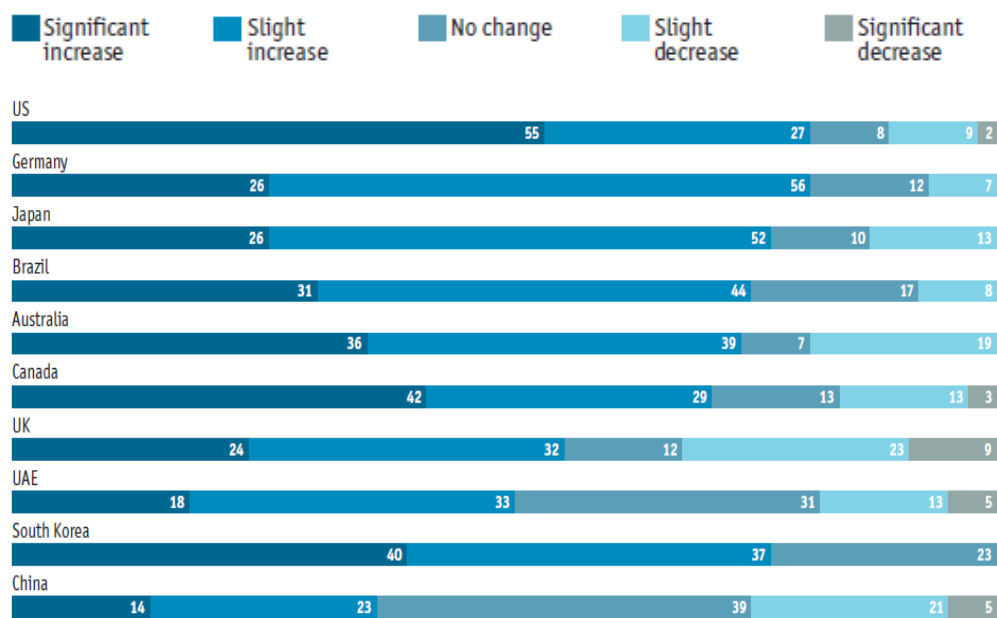


Chart 7: Inflation expectations

Developed markets:

Developed markets face daunting problems, including high levels of unemployment, weak financial sector and poor demographics. Developed markets today are synonymous with high levels of government debt. When one considers the cost of bail-outs from the financial crisis, weakening fiscal balances and sluggish medium-term growth prospects, it will remain a major issue for many years to come.

Respondents think that the US, Germany and Japan are the three countries that will most need to increase their debt levels over the next 12 months. The US will need to increase borrowing in part to pay for ongoing stimulus measures, while Germany will need to do so to fund bail-outs in the Eurozone and Japan to deal with the impact of the devastating recent earthquake.



Source: Economist Intelligence Unit survey, 2011.

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Chart 8: Increase in government debt

But despite the doom and gloom there is some optimism. For example, respondents regard the US as a good source of potential growth, placing it fourth after Brazil, India and China in their list of the most growth-friendly markets. Although it faces a range of structural problems, including a sharp rise in public debt and high long-term unemployment, many investors are optimistic about the prospects for the US.

“The US is much more able to produce competitive goods now, plus they have the additional power of brands that permit you to pass on higher costs. I think we are going to see that the US recovery surprises a lot of people.”

“Many US companies are sitting on large amounts of cash and now have a very big incentive to bring forward capital expenditure into 2011. If they bring forward two to three years’ worth of capex into this year, this could have a substantial impact on growth in the US over the summer months, which, in turn, would increase growth rates for the global economy, at least in the short term.”

Investors, however, are far less confident about other developed markets. For example, just 8% of respondents think that Europe offers the best prospects for growth in the global economy, and only 6% have the same view about Japan.

The prospects within the Eurozone are vastly different for the stronger core countries, such as Germany, than the much weaker countries around the periphery. Investor confidence in the region remains very weak. Moreover, the potential for Spain to join this list of bail-out countries is worrying, even though it appears unlikely.

“Spain is a very large borrower and, as a result, a lot of institutions, banks, and governments hold Spanish paper. That would cause far greater stress than Ireland, Portugal or Greece, because of the interconnectivity of European sovereign debt within the banking system.”

“The bulk of Greek debt is beyond its ability to pay and at some point they’re either going to have to extend a lot of the maturities or expect investors to have to take a hair cut. I think the market is fully expecting it (default), to the point that it won’t faze anybody. My concern is that one debt rescheduling won’t be sufficient. We’re going to continue in a process of more rescheduling, which will cause the markets to get nervous, and then the same thing will happen over again. I expect that we’ve got a lot of volatility ahead of us.”

Few respondents expect that this will lead to a complete break-up of the Eurozone. “I am confident that the Euro will survive. Ultimately I think Germany will do what it has to do to keep the Euro alive. It’s in Germany’s interest to keep it going, because it’s an export nation and because the collapse of the project would cause enormous costs for their financial sector.”

Commodities as an investment:

Merely a decade ago, prices of commodities were structurally low, supply usually met demand and only a few investors paid much attention to commodities as an asset class. Today, commodities are seen as second only to emerging market equities as offering the best opportunities for investment growth over the next 12 months.

Respondents expect commodities, such as oil and gas; agriculture and agribusiness; and mining and metals, to be those that offer the best opportunities for growth (Chart 9).

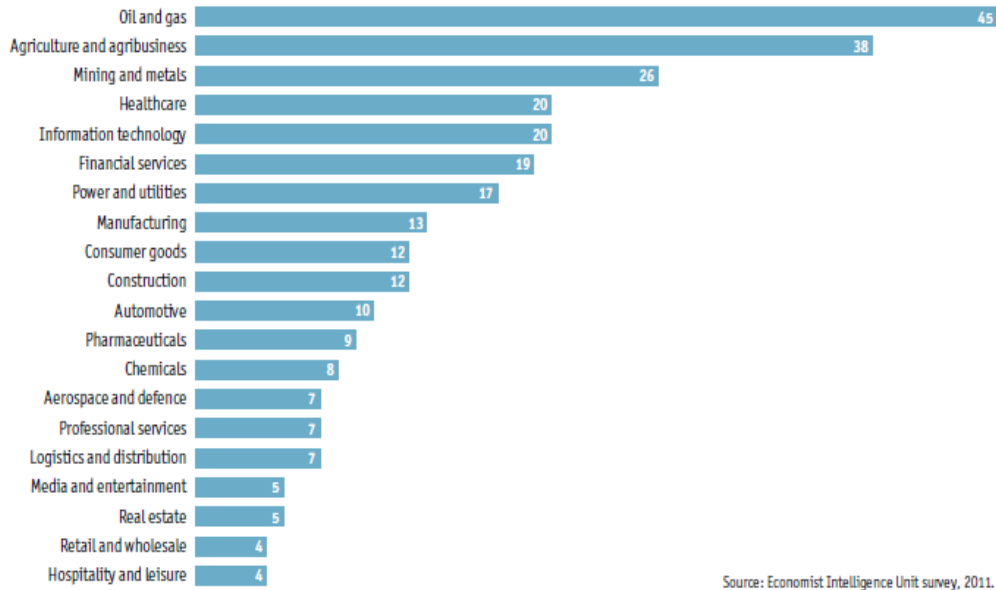


Chart 9: The most promising industries

Prices have been driven up sharply in recent months by a combination of supply constraints, strong investor interest and rising demand from emerging markets. Research from Barclays Capital shows that China, Brazil, India and the Middle East's share of global coal demand increased from 36% to 55% between 2000 and 2009, while their share of demand for soybeans rose from 33% to 44%.

“China, in particular, has a very commodity-intensive path of economic development that has a big influence on commodity prices. The rate of urbanisation in China is staggering, and continues to have a significant impact on demand for commodities. According to McKinsey, the urban population of China will expand from 572m in 2005 to 926m in 2025, before reaching 1bn by 2030. By 2025 there will be 221 cities in China that have more than 1m people. The number in Europe today is just 25.

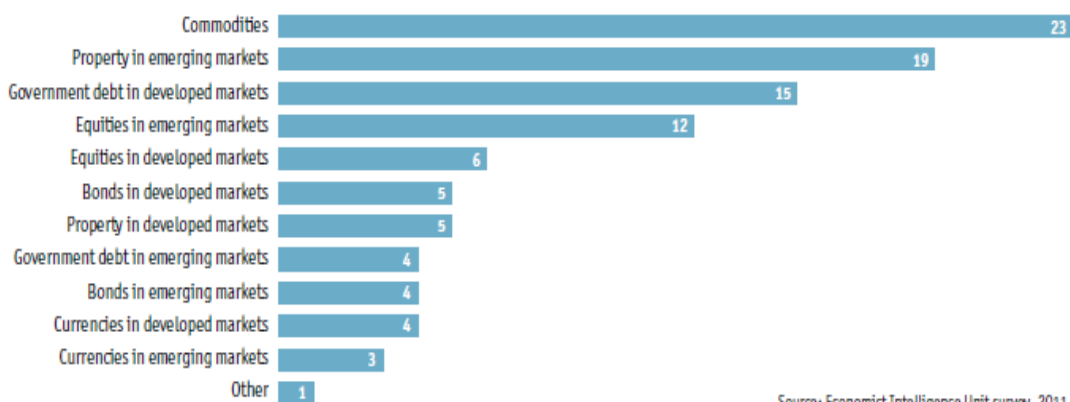
Oil prices rose significantly in early 2011 as civil unrest in the key producing MENA region led to a heightened risk premium in the market. So far, however, this political turmoil has not severely restricted supply.

In the agricultural sector, poor harvests in the second half of 2010 caused prices to rise sharply. “In my view, this is the most significant supply-side shock in the world economy since 1973 and it absolutely cannot be fixed in a hurry. We've got a very big structural problem on the agricultural supply side. I am very bullish on those assets that are in short supply.”

Bubble trouble:

Despite some fundamental drivers of higher commodity prices it is argued that the loose monetary and the quantitative easing (QE) policies from the Federal Reserve have contributed to a significant decline in the value of the dollar and at the same time an increase in the prices of dollar-denominated commodities. Therefore, respondents are of the opinion that commodities represent the most likely candidate for the next price bubble (Chart 10).

“From what we’ve observed, commodities are the most bubble-like asset at the moment. It feels to us like there’s a high speculative demand for commodities, and that’s driven some of these assets up to kind of bubble-like levels, which feels quite vulnerable.”



Source: Economist Intelligence Unit survey, 2011.

Chart 10: Candidates for price bubbles

Social unrest and the oil price:

The political turmoil that has spread across the NEMA region (Tunisia, Egypt, Syria, Yemen, Bahrain and Libya), has been one of the major stories of 2011 and many respondents think that further political turmoil in the Middle East is a likely scenario.

“In the long run, a new Middle East will be born and I think it will be a better Middle East than we have had to live with in the past. But along the way there will be volatility and uncertainty, and fairly violent demands for more redistributive political regimes, as well as for greater economic and political rights.”

The turmoil will have a dramatic impact on economic growth in the region and GDP growth may even fall as much as 50% in the near term. But the unrest is also having a significant impact on the oil price. As the unrest unfolded in Tunisia and Egypt, oil prices surged as markets reacted to fears that it could spread to the major oil exporters in the Gulf, such as Saudi Arabia. The crisis in Libya caused another jump in prices as export capacity (1m barrels of oil a day) was shut down.

The ongoing political instability in the region is likely to keep prices high in the short term. Respondents argue that it is fear, rather than a fundamental mismatch between supply and demand, that is driving the price increase.

Analysis by Standard Chartered suggests that an oil price of between US\$120 and US\$150 could take up to 1% from global growth momentum. And if oil prices rose to US\$200 a barrel, the impact would be considerably more severe. “Most of the world would be hit, and particularly Asia. And if it stayed that high for two to three quarters, we would predict a high possibility of double-dip recession.”

Political instability in the world’s leading oil producer, Saudi Arabia, which accounts for around 25% of global output, could have a severe impact on both oil prices and economic growth. “If the unrest spreads to Saudi Arabia, there would be demand destruction because people won’t be able to carry on with normal economic activities if the oil price is two or three hundred dollars a barrel. That would be extremely negative for all risk assets.”

“The lesson for investors is that they need to look more closely at regimes that may outwardly appear stable, but that have many social and economic problems that remain unaddressed. Technology and the spread of ideas through globalisation is exerting a powerful impact and serving as a catalyst for change. As people around the world become more interconnected and less atomised, they are becoming more aware of the freedoms that they don’t have.”

In summary, I highlight some of the *Economist Intelligence Unit’s* findings:

Opportunities to outperform

Most respondents expect the outlook for the global economy to improve over the next 12 months but the pace of recovery is likely to slow. Many investors are reluctant to make bold moves in light of major downside risks.

Emerging markets offer the best prospects, but there are concerns about overheating

Emerging markets offer the best prospects for economic and asset-price growth. But there are also concerns that these markets could be overheating and that investors may be putting too much faith in them as a source of long-term stable growth. Investment in companies in the developed world with strong exports to emerging markets may offer investors another attractive way to take advantage of these growth opportunities.

Developed-world growth, particularly in the US, rebalances global economic growth

The US is expected to benefit from an enhanced competitive position, while strong capital expenditure from US corporations may be an underestimated source of growth.

Commodities offer good growth prospects, but will be a risky asset class

Respondents think that the industries that offer the best growth rates are those that involve commodities: oil and gas; agriculture and agribusiness; and mining and metals. Again, there are concerns about overheating; commodities are viewed as being the asset class where bubbles are most likely to form and are seen as the most risky asset class over the next 12 months.

Investors are concerned about rising inflation and the impact on social stability

Geopolitical risk is often underestimated by financial markets. In particular, there are concerns about the impact of rising food and commodity prices on economic and political stability.

Eurozone debt crisis

The crisis in the Eurozone continues to deepen, with Portugal joining Greece and Ireland on the list of countries that have required emergency financial assistance. Respondents agree that default of a Eurozone country is looking increasingly likely, although few expect that this will ultimately lead to the break-up of the Eurozone.

Source:

Economist Intelligence Unit, 2011. "The search for growth: Opportunities and risks for institutional investors"