



Winston Floquet

END Q2 2016

Global equities have been on a roller coaster ride in 2016 – down 12%, then up 16% and likely to end the half year largely unchanged. [CHART 1] This heightened volatility will probably become one of the many ‘new normals’ in the post global recession environment.

We are, almost certainly, entering a secular period of lower returns and higher risk. The economic backdrop is disheartening to say the least. It is concerning that the recovery – some eight years since the start of the global recession – has been nothing short of anaemic. And this is despite unprecedented central bank intervention. Indeed, little remains in the toolboxes of monetary authorities.

The fact that equities have weathered this year’s weak economic conditions and plummeting corporate results is surprising (and/or encouraging). In the US, Q1 earnings registered a dramatic decline, taking earnings all the way back to those achieved in Q3 2013. [CHART 2]

Historically, growth has been buoyed by massive increases in government, bank and consumer debt soaring to frightening levels in 2007. While these increases have been reeled back, deficits are still being incurred (albeit at more conservative levels) and total debt to GDP is actually higher now than in 2007.

What are the investment implications of slower economic growth, negative bond rates, elevated equity valuations, high sovereign debt, and waning effectiveness of monetary policy?

An investment in bonds such as 10 year US Treasuries will, if held to maturity, provide a certain and risk free return of 1.6% annually over the period. Although below the 2.2% rate of inflation, it is still an *absolute* return – better than the negative *absolute and real* rates in a growing number of other countries.(Some 31% of bonds in the Global Bond Index now have negative rates.)

Cash yields are zero and equities are trading at multiples well above historical norms. A key reason for the elevated equity valuations is that the alternatives are so unattractive. However, this alone should not be sufficient to sustain equity markets at above-average multiples: there clearly have to be other supporting factors. And, fortunately, there are.

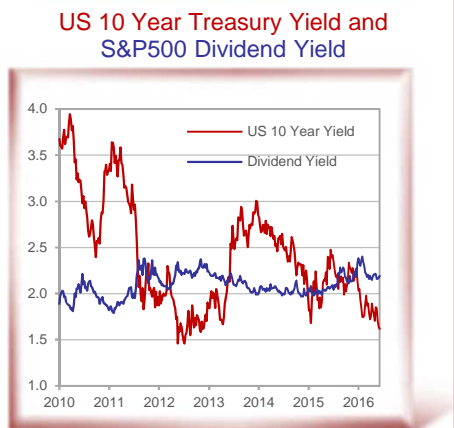
Global growth may not be stellar but it is not recessionary either. Corporate balance sheets are strong, leverage is modest relative to history and 87% of US corporate debt is now longer term and mostly refinanced at prevailing low rates. This means dividend distributions are, by and large, sustainable.

Profits are, at last, beginning to turn up. The consensus forecast for 2017 is a 13% rebound in earnings, both in the US and globally. [CHART 3] Cash holdings at investment institutions are well above average and should cushion the extent of any market correction.

In addition, dividend yields are particularly attractive compared with bond returns. In the US the average yield on the S&P is 2.2% compared with the 10 year Treasury yield of 1.6%. [CHART 4] In Europe, where bond yields are far lower, and negative in many countries, the yield comparisons are even more compelling. And, of course, dividends have the prospect of growth while bond yields are fixed.

Trailing p/e’s are, globally, well above 5 and 10 year averages. However, on a forward p/e basis, they are (thanks to the sharp earnings recovery expected next year) far less extreme: 16.4 vs 14.6 average. Although still at a premium this should be seen in the context of record low interest rates which appear likely to prevail for quite some time.

The well-established history of equities outperforming bonds and cash over the long term is unlikely to be derailed – despite the extreme and unpredictable outcomes of the negative yield phenomenon. But, the absolute levels of growth achieved will certainly be lower than those enjoyed in the past.



Flagship Asset Management (Pty) Limited

ICR House • Alphen Park • Main Road • Constantia • 7806 | Private Bag X21 • Constantia • 7848 • South Africa

Telephone +27 (21) 794 3140 • Facsimile +27 (21) 794 3135

Directors: WT Floquet CA(SA) MBA (chairman) | S de V Hudson BA LLB (ceo) | PD Floquet BCom CA(SA) CFA | NRO Brown BCom CA(SA)

www.flagshipsa.com | info@flagshipsa.com