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Why business confidence may be the only economic indicator that matters

By Kyle Wales
As published by Sanlam Glacier on July 24, 2020

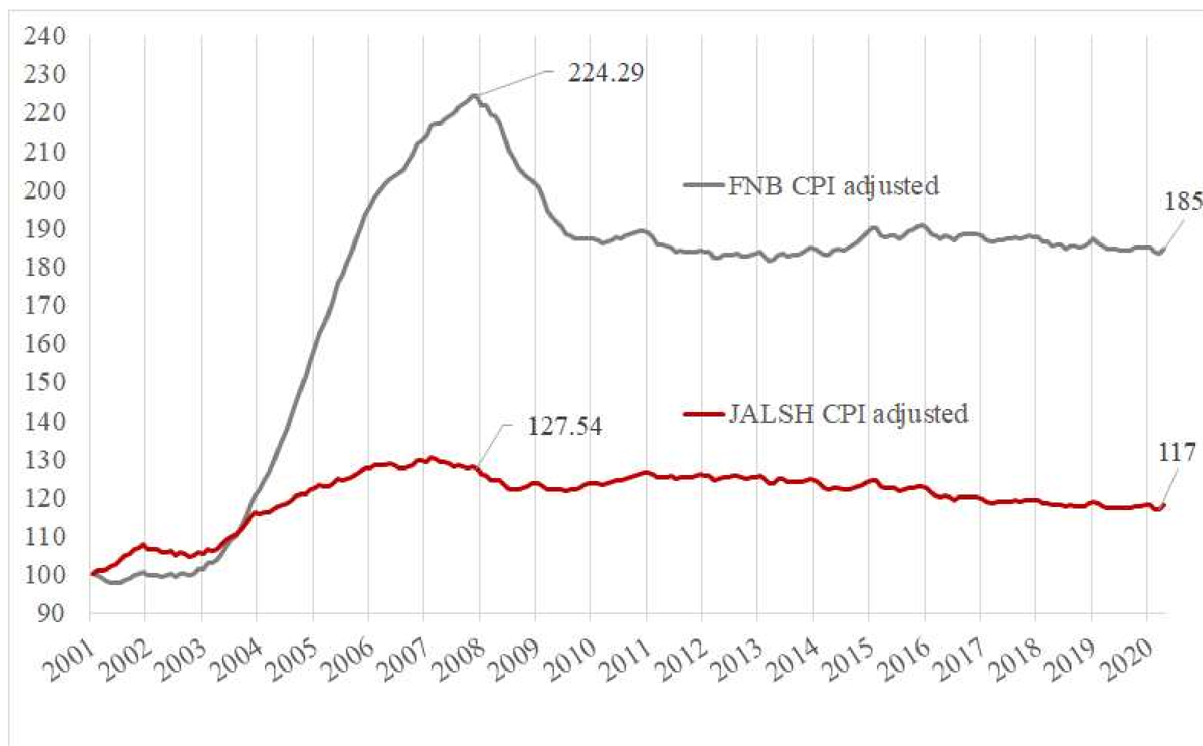
South Africans will not be surprised by the poor returns that South African assets have returned over the past decade. The stock market and the property market, bastions of the local savings and investment industry, tell the sombre story.

The level of the JSE ALSI today is 18% lower than it was in *real terms* on 31 December 2007. Investors, who typically require an excess return (or equity risk premium) to compensate themselves for the higher volatility associated with investing in equities, have been disappointed. In fact, South Africans would have earned higher returns over the past 13 years by investing in a local money market fund than in the local stock market.

Naspers and Prosus, accounting for 37% of the JSE ALSI combined, provided a rare ray of light in what has otherwise been a slow, steady decline. The figures I quoted above have benefitted from the *inclusion* of these two counters. An index which excluded them would have performed even worse.

The same trend can be seen in the property market. The FNB house price index is also lower by 7.5% in real terms since 31 December 2007. This is better than the performance of the ALSI, for sure, but the days are long gone when people used to sit at braais boasting how much money they had made on their third, fourth or fifth investment properties.

Chart 1: the ALSI and the FNB Property Index in real terms since 2001 (indexed to 100 on 31 Jan 2001, inception of FNB Property index)



The reasons for this underperformance are well known and needn't be rehashed here. South Africa's economic growth has been poor since at least the start of the Zuma presidency as a result of weak economic policies, failing parastatals and rampant corruption.

This has affected forward looking expectations of South African corporates, including earnings growth expectations which are an offshoot of this. The SACCI business confidence index is the lowest it has been since the index was started in 1985.

While Covid can take some of the blame, this trend was well underfoot even before the Covid crisis began.

Perhaps even worse though, by impairing future growth expectations, it has slashed the earnings multiple that the market applies to domestically-sourced earnings.

Due to the wealth effect, this is a far bigger deal than it sounds like. In his acclaimed 1976 book "Supermoney", George Goodman writing under the pseudonym "Adam Smith" explains why. He draws a distinction between money which you earn, put in a bank account and withdraw as needed, and "Supermoney" which is capitalized earnings.

Take a salary earner who collects R100 a month and saves 10% of that (R10). Should his salary double to R200, the maximum increase in his net-worth is R100 assuming he saves all the increase.

Now let's contrast his situation with the business owner whose business earns R100 per year in net profits. Should he decide to sell his business, a potential purchaser is likely to pay him a multiple of that net profit figure as a purchase price, let's assume 10X. If the net profit of his business then doubles, his net worth does not increase by R100 but rather by R1000 which is a 10X multiple applied to the increase in earnings of R100.

In South Africa, that windfall is happening in reverse because earnings multiples are falling on lower forecasted earnings.

So what, you may say? Those are only paper profits.

Not so. The wealth effect on spending has been well-documented. The retiree selling his house to buy a smaller property more conducive to his changed needs, is likely to use at least a portion of that excess on increasing his consumption. The same retiree is likely to draw a larger annuity to fund a more lavish lifestyle if he retires with a larger stock of savings than a more modest one.

Since one person's expenditure is another person's income, we should not underestimate the virtuous circle this sets into play for those with capital as well as for those without capital. Having made a profit on his second investment property, the young professional is likely to consider buying his third, fourth or fifth. This means conveyancers collect more fees, the fiscus collects more in capital gains, councils collect more in rates and taxes, and so on.

The decline in business confidence (which is contributing to a decline earnings in growth expectations and asset prices) is in turn driving a decline in consumption, which leads to further declines in business confidence and earnings growth expectations.

Currently, South Africa faces a dire credibility problem. It is easier to announce public sector expenditure cuts than it is to put them into practice. Government needs to show that it can implement the right policies in order to revive business confidence and improve the outlook for local asset prices.

When deciding what the right policies are, it should take the opinions of all stakeholders into account, but it should be especially sympathetic to businesses because they are the ones who are committing the capital and stand the most to lose.

Should government manage to do this, there is no doubt in my mind that the benefits will accrue faster than many expect, as improvements in business confidence will have a knock-on effect on domestic asset prices, which will in turn lead to further positive ripple effects in the wider economy.

Without the return of business confidence, the steady erosion of economic growth, prosperity and wealth will continue.

Kyle is a co-portfolio manager of Flagship Asset Management's global funds.