INVESTMENT NOTES

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3 of 2018

What to make of falling share prices?
Markets down 10% in 10 days.

The US S&P 500 Index closed at 2581 on Thursday 8 February 2018, down 10.2% in nine trading days from its all-time high of 2873 on Friday 26 January 2018 (graph 1).

Similarly, the FTSE/JSE All Share Index traded at 55903 on Friday 9 February, down 9.4% from its all-time high at 61685 on Thursday 25 January 2018 (graph 2).

Here is what we think

A valuation gap has developed in equity markets since monetary authorities started increasing money supply in response to the global recession in 2008/9. The valuation gap is evident from the ever-increasing price-to-earnings ratio of the index (graph 3).

The average of the S&P 500 price-to-earnings ratio over the past 50 years is approximately 20 times.

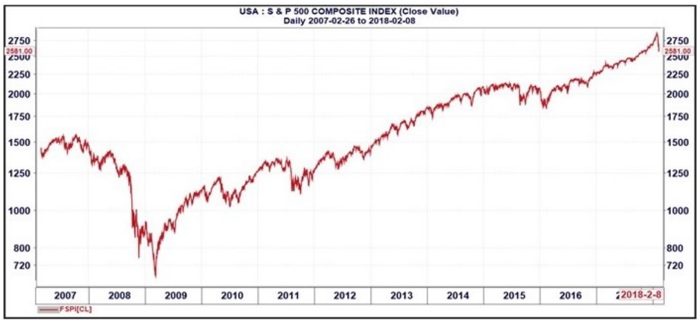
With interest rates at a historic low point, financing cost of operations in the US was cheap relative to its history and share prices benefited, but share prices in the US have increased by too much in too short a period.

The Federal Reserve Bank of New York started to increase interest rates as far back as 2016, but rising interest rates became much more topical recently. The yield on the generic 10-year US government bond increased from 2.05% on 7 September 2017 to 2.85% on 8 February 2018 (graph 4).

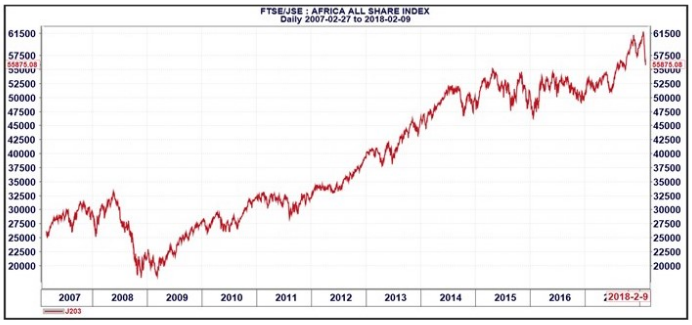
It is evident that the era of cheap money that supports share prices worldwide is drawing to a close. Historically, company tax cuts cushioned the impact of higher interest rate costs, but increased budget deficits in the short term may limit the impact at present. Another factor contributing to rising interest rates, is the higher inflation expectation, driven by wage increases.

Investors are now reducing exposure to shares, particularly to highly priced US markets, thus prompting the current market sell-off. Equity markets worldwide are following US equities down.

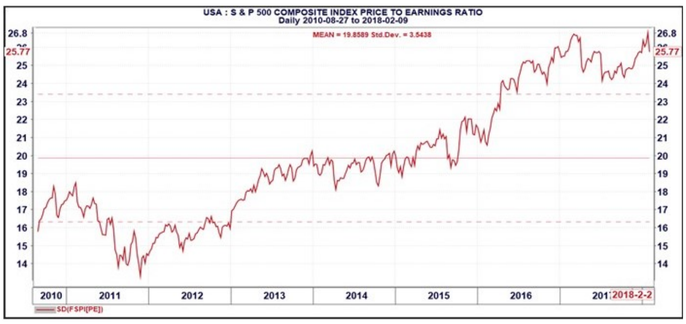
Graph 1



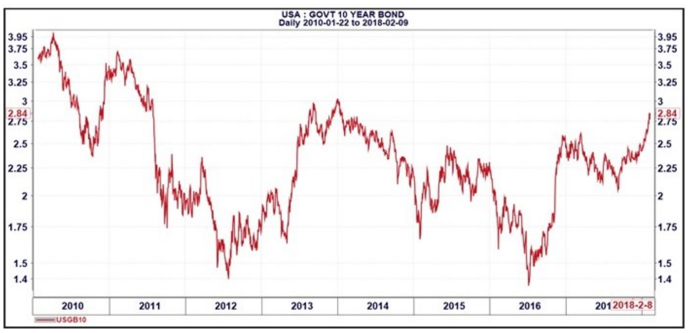
Graph 2



Graph 3



Graph 4

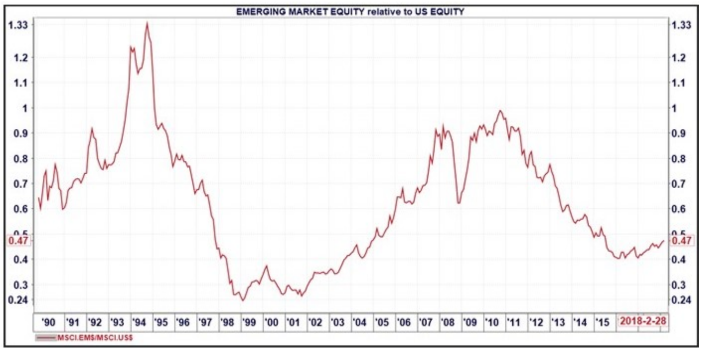


What is going to happen next?

We continue to believe that shares are likely to outperform bonds, money market instruments and property in 2018. As stated previously, we believe that share prices in the US are fully valued and that other developed equity markets (e.g. Europe) and emerging markets are likely to fare better than US equities (graph 5).

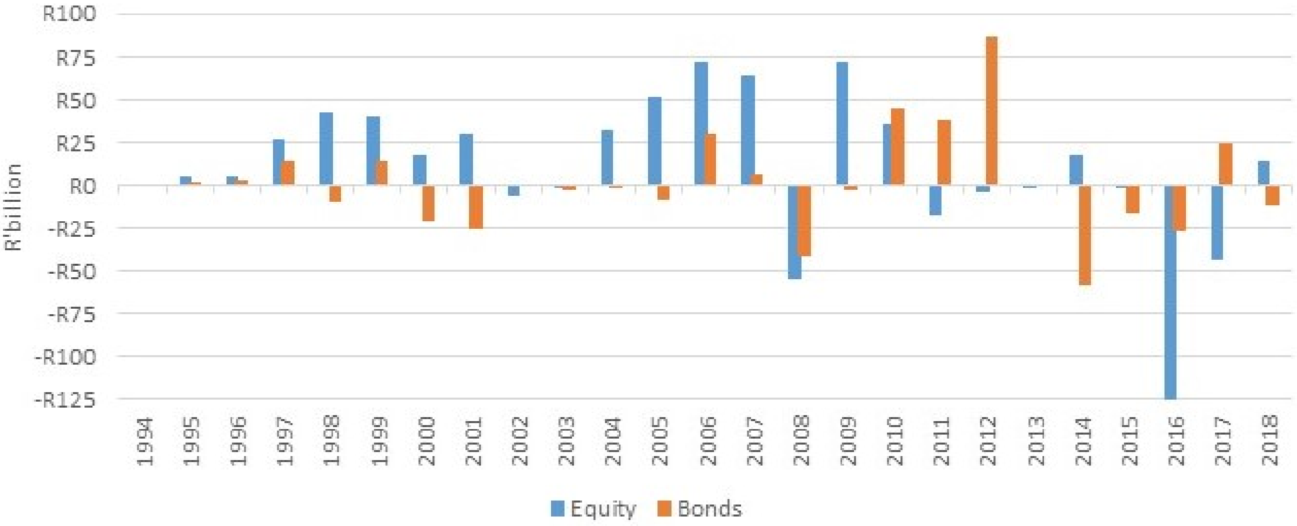
If this is the case, money that is being withdrawn from developed equity markets (e.g. in the US) will find its way into emerging equity markets during the course of the year.

Graph 5



The South African equity market has been attracting money from abroad in 2018 for the first time since 2014. Incidentally, foreign investors are withdrawing money from South Africa. It is not clear, but it could possibly be because of South Africa's sovereign credit rating downgrades and the credit rating downgrades of state-owned enterprises such as Eskom (graph 6).

Graph 6: Foreign cash flow to/from SA financial markets



Finally, one should not discount the possibly positive impact of a potential "Southern African Spring" as governance and economic issues that have long concerned financial markets are addressed in South Africa and Zimbabwe in 2018.

What should retirement fund members do?

Investment markets are fickle at present and any short-term reaction may have long-term consequences. Members are advised to take great care and to focus on their long-term investment objectives.

Younger members' greatest asset is their future service, during which they are expected to contribute to their retirement savings. They should be concerned typically with achieving sufficiently high investment returns over the longer term, rather than current volatility in prices (price fluctuation risk). Conversely, closer to retirement, members' greatest asset is the value of past contributions to retirement savings, as reflected in the value of their current retirement savings portfolio. These investors should typically concern themselves with cash flow planning and eliminate unnecessary price risk from that part of their retirement savings portfolios that will be required in cash in the near future. A large part of members' savings – and this applies even to those members that are closer to retirement – is in respect of cash flow that is only required in the medium to long term, and these members should not be overly concerned with short-term volatility.

Members who are uncertain about what to do should approach an accredited financial adviser for assistance.

Data obtained from IRES INet.

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