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Challenging Conventional Wisdom

NEWSLETTER

Monthly Newsletter – February 2016

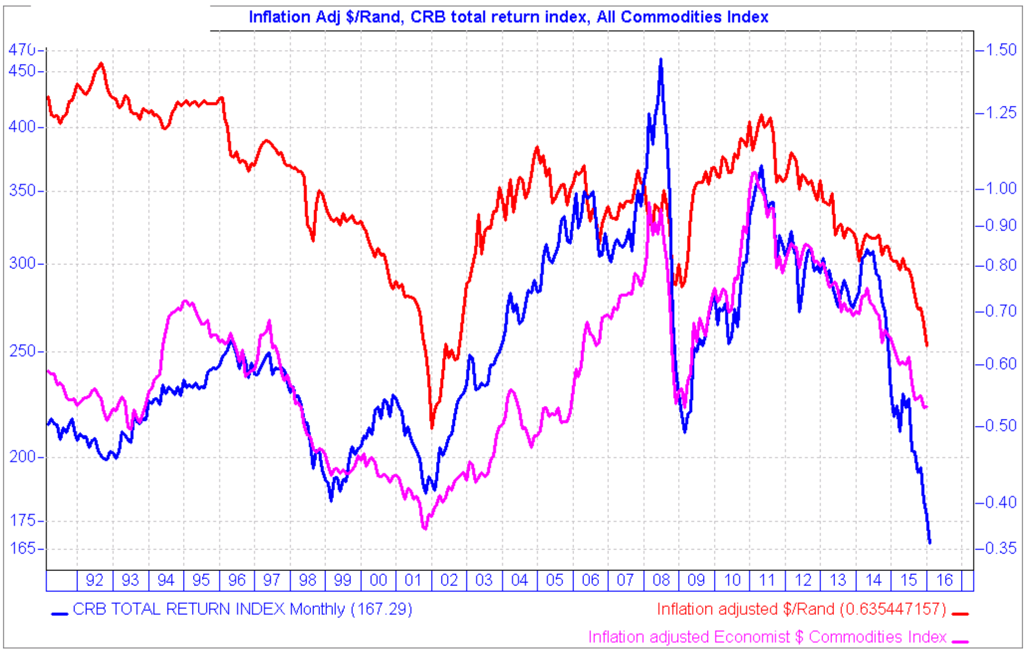
Market mayhem: where to from here?

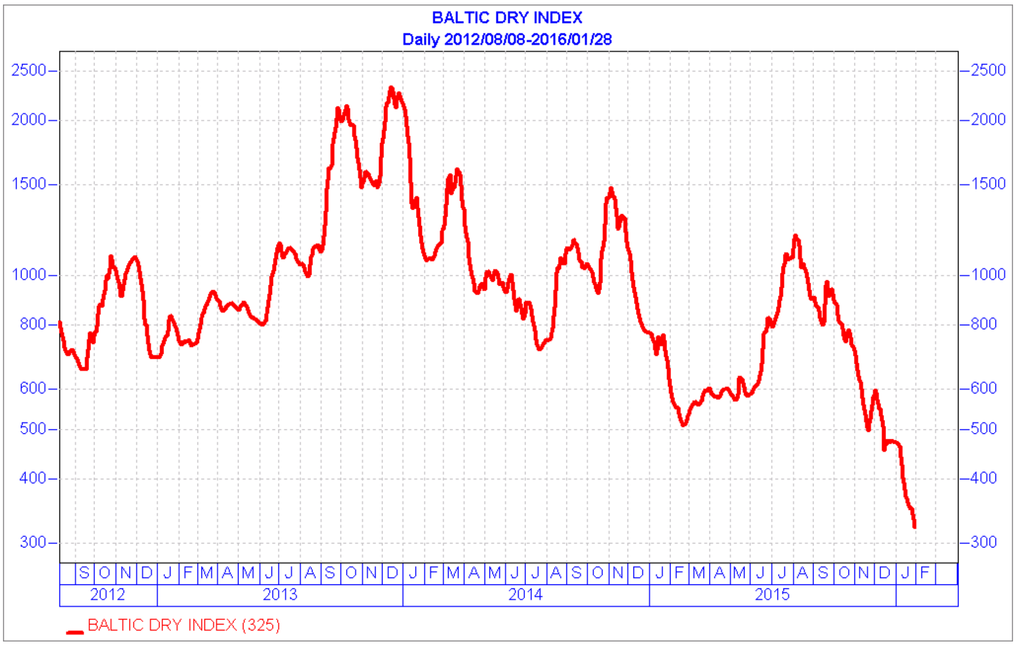
"The recent financial market volatility has many people wondering if this stock-market decline will turn into a bear market. Others are wondering if a recession is imminent. Still others wonder if a full-blown market crash or a financial crisis like 2008 is in the offing."

Those were the words of Barry Ritholtz on Bloomberg after a rough ride in the equity markets over the last two months, which included the nastiest first week of January in recorded history.

I don't claim to have the answer to Ritholtz's questions, but it is worth taking a closer look at what has transpired.

To start, let's look at some updated graphs. First, the CRB Total Return Commodities Index dropped below a level last seen in 1973. And freight indices, which we watch as potential "canaries" of a turn, offered no respite.





Let's start with the simple truism that while every deep sell-off first has to pass the 10% correction mark, not every 10% correction becomes a deep sell-off. Since 1950, the Standard & Poor's 500 Index has experienced a decline of 10% or more once every two years on average.

Note that the distribution doesn't fit some nice, clean pattern and it isn't just even or odd years. Like waves, there is a tendency for declines to come in sets. Why is 10% classified as a correction? "Why not?" is just as good an answer as any.

As for bear markets, since 1928, we have seen at least 23 sell-offs of 20% or more, which is the official definition of a bear market. Again, why 20%? Perhaps because that is double the magnitude of a correction. Those 23 bear markets over a span of 85 years work out to one about every 3½ years or so.

But their appearances are not a smooth bell curve – we sometimes go a decade or so without seeing one. My colleague, Michael Batnick, has observed that "drawdowns of 20% or more have happened in 26% of all years. On five of those 23 occasions, stocks still ended up positive on the year. It's not unusual for those double digit declines to be of little importance: 57% of the years with 10% drawdowns finished positive."

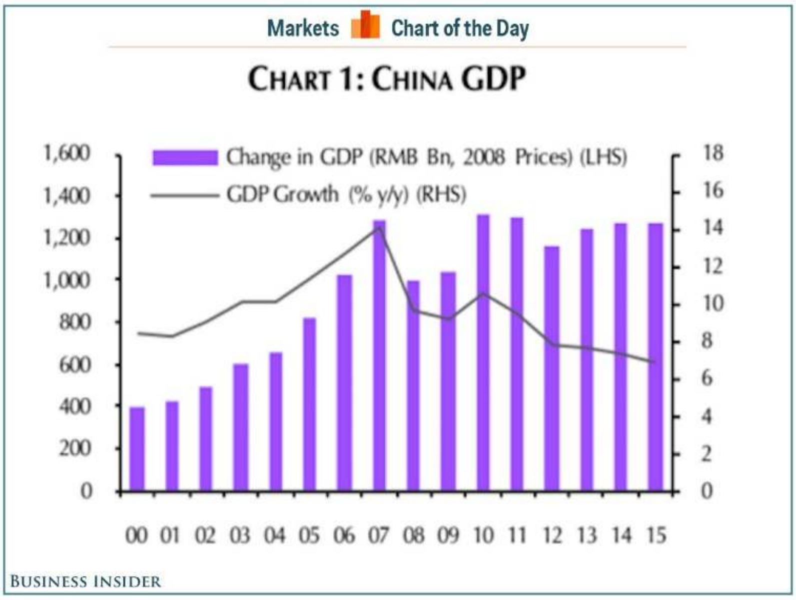
A more recent theme has been the sudden positive correlation between Oil & Equities being interpreted as a sign of recession. We would question that. It certainly is true that the US economy experienced massive capital expenditure in the oil industry in recent times, and that those capital budgets have been savagely cut in the wake of lower prices. How quickly we forget, though, that high oil prices strangled global growth in recent years.

Moreover, just as the cure to high prices was high prices, so the cure to low prices will be low prices. The long anticipated news of the end of sanctions in Iran helped oil prices to headlong falls (even though they'd still been selling the stuff off-market), however, rumours that OPEC might make production cuts bounced the oil price US$8 off its lows.

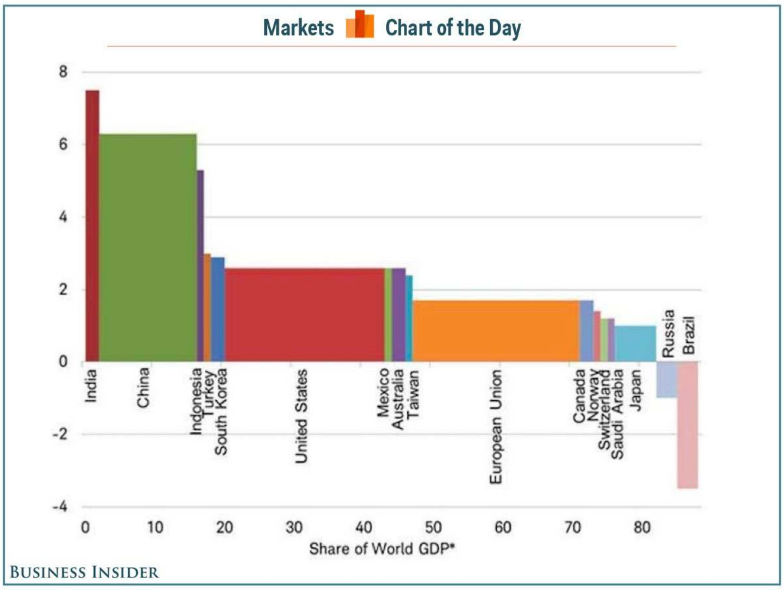
A positive response to positive news – could there be an attitudinal change in markets coming through here?

The blood on the floor in the Resources sector leads me to think of the game Cluedo, and the all-important question: “Whodunnit”? The butler with a candlestick perhaps? Well the poor old butler getting a thorough round of blame is of course, China, for having the temerity to grow more slowly than it has in the past.

Just how bad is this growth deficit? Ten odd years ago GDP growth rates north of 10% were common for China, and now those naughty folks have dropped to only 7%. Let’s see what 7% GDP contributes to global growth in these graphics:



As we can see – the absolute value of growth hasn’t changed because the base has grown so much.



China is a very important contributor to global growth and commodity offtake, but don’t forget the big picture. A big chunk of the China growth story is related to demographics (namely the ratio of workers to dependants). This reached globally unprecedented levels because of the one-child policies implemented in the late 1970s.

That effect has peaked in 2013 in China, but five years out, we should still see healthy growth of, say 4%, through productivity gains, as their workforce gains experience. Germany is a good example of how this phenomenon matures.

Clearly then, the missing side of the discussion is that over-investment happened, and we are not only seeing low commodity prices from over-supply. We are also seeing a massive clearing of inventories as evidenced by London Metal Exchange inventories, which have collapsed by as much as a half in the last few years.

Add to that the clearing out of stock held by commodity ETFs (exchange traded funds) and it's clear that a hurricane ripped through the sector.

So why on earth would one ever consider investing in this forsaken sector? Our own commentary in proposals to discretionary share portfolio clients has carried the following advisory: "Our broad strategy is that Resources are inexpensive (albeit distressed by market conditions) …" and the proposals all went out with an underweight relative in Resources.

Why have any? The most important theme an informed investor needs at the back of their minds is that the blunt instrument used to deal with difficult economic times is quantitative easing. We do believe that it will work (economically speaking), just as the quantitative easing used to fund World War II worked.

The war ended with blinding flashes at Hiroshima and Nagasaki, and the economic consequences were flashes of inflation much later – but with money printing, the bill always comes due, and it's a wise person who stays humble enough to acknowledge they can't forecast when.

The commodity cycle has experienced terrible pressure. Share prices are incredibly low – Anglo American is one-fifth of its book value and Billiton one-third and everything obvious to the naked eye would tell you it's all hopeless. If you believed that in relation to the crash of 2008, then you missed a once in a generation opportunity to buy Financials & Industrials. History may look back on early 2016 in the same manner with respect to Resources.

It is certainly true that Resources shares earnings are much more volatile than Industrials and the shares are riskier as a result. However, in the chaos surrounding Nenegate, when the daylights were sold out of SouthAfrica (Pty) Ltd, an important point on commodity currencies was forgotten: if commodity currencies fall, then that acts as a shock absorber to commodity producers.

That is not a forecast on the rand by the way – after all we need to see Pravin "Flash" Gordhan strut his stuff and produce the necessary budget and fiscal policy to prevent a ratings downgrade. We think he will – but that is the topic for another essay.

- Warwick Lucas

The most important leadership skill: empathy

Ask anyone what you need to be a good business leader, and you'll get answers like 'vision' or 'strategic thinking skills'. But a new study from a US-based Development Dimensions International (DDI) suggests that the single most important leadership skill is listening, or empathy.

This conclusion comes from a report called High-Resolution Leadership. DDI analysed assessments taken by 15 000 participants being considered for leadership at 300 companies in 18 countries, and looked at which of eight standard interaction skills had the biggest impact on overall performance.

DDI asked the participants' managers to independently evaluate them on decision making, coaching, engaging, planning and organising, in addition to their overall job performance.

Overwhelmingly, empathy topped the list as the most critical driver of overall performance. Following closely behind empathy was involvement. DDI researchers found that "involving others is nearly equal to empathy in its impact on overall performance, and it highly relates to higher leader performance on two of the five domains: decision making and planning."

Of course, all the empathy in the world won't help if the leader can't execute strategy. But the bottom line is that great leaders need both EQ and IQ to achieve maximum success.