# Interest rates, subdued growth put pressure on equity returns

By David Crosoer

22 Aug 2013

When measured in rands, the South African equity market has returned an impressive 20.89% over the past 12 months. We've also observed double-digit annualised nominal returns over three years (17.50% pa), five years (13.11% pa) and seven years (14.35% pa).

These returns have comfortably outpaced CPI inflation (which has averaged 6.64% over the equivalent seven-year period) and are broadly consistent with a long-run equity market return expectation of 7% after inflation.

International equities also performed strongly over the past 12 months, outpacing South African equities by over 20% when measured in a common currency (with local underperformance largely due to the significant depreciation of the rand).

However, it is unlikely that the equity market in aggregate will continue to deliver the kind of real returns that we have experienced in the past.

This applies to both local and international markets and is based on the view that equities are not starting from an inexpensive position. Currently, equity performance is also vulnerable to two economic fundamentals in particular.

## Normalisation of interest rates

The first of these is the normalisation of interest rates from record lows, which will provide considerable headwinds to the discount rate applied to future earnings. This concern recently assumed centre stage as comments from the US Federal Reserve on the potential easing of their $85 billion a month stimulus programme brought forward market expectation of when Chairman Ben Bernanke would increase short-term interest rates. The US ten-year bond (widely regarded as the global risk-free rate) sold off violently and ended the second quarter yielding 2.5% after trading at around 1.6% not long before.

Despite this sell-off, it is far from clear that US ten-year rates are about to normalise. The US economy, despite improvements in house prices and auto sales, still remains vulnerable to the headwinds caused by increasing interest rates. In addition, significant deflationary pressures remain, with annual CPI inflation at less than 2% and unemployment at 7.4%. At this stage, it is still difficult to determine whether Bernanke's comments signal the end of the loose monetary policy game or a temporary aberration in continued record low interest rates.

Our second consideration is the reality of sub-par economic growth (in the aftermath of the credit-induced growth of the recent past).

Poor local fundamentals (a weak rand and stubbornly high inflation), the challenges facing the local mining industry (weak export markets and spiralling costs) and pressure on the local consumer (who, for the most part, remains poorly educated and heavily indebted) mean that the South African economy continues to perform poorly. The South African Reserve Bank revised down its expectation of economic growth to 2% in 2013. The local economy clearly requires significant structural adjustments to regain competiveness, although at this stage the major adjustment mechanism appears to be the rand, rather than the necessary reforms.

## Uncertainty and concerns

Elsewhere, economic growth was also revised downwards. The International Monetary Fund (IMF) for instance now expects the global economy to grow by 3.1% in 2013 and 3.8% in 2014, a downward reduction of 0.25%. This expectation arguably remains optimistic, given that expected trend growth for the world economy in the absence of a de-leveraging financial crisis is around 3.3%, according, for instance, to the Organisation of Economic Co-operation and Development (OECD).

Uncertainty about global interest rates and concerns about global growth prospects will make it difficult for aggregate earnings growth to surprise on the upside. The global environment remains challenging, and there continues to be significant risk that policy-makers both locally and abroad will get their timing wrong when exiting from record low interest rates.

Investors should therefore continue to hold portfolios diversified across both asset classes and asset managers, placing an emphasis on managers who focus on investing with companies that can generate real earnings growth. It is our expectation that investing with bottom-up stock-pickers will provide investors with the best prospects for generating meaningful real returns in the future.


## ABOUT DAVID CROSOER

David Crosoer is executive: research and investments of PPS Investments.


- Interest rates, subdued growth put pressure on equity returns - 22 Aug 2013
- There's more to it than asset allocation - 27 Jun 2013
- A different inflation cycle - 16 May 2013

View my profile and articles...