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Recessions and crisis are as much about psychology as reality

Firstly on a positive note we can look forward to considerably lower interest rates this year and the petrol price is back to a reasonable level. Other than that, the news flow has been decidedly negative.

I can quite honestly say that 2008 was the worst year I have experienced in the markets. I am not going to spend much time reflecting on the last twelve months but rather focus on where we are now and how to deal with this situation. There are however a few points we should all be mind full of.

Don't you find it ironic that a small country at the tip of Africa where most of its inhabitants couldn't wait to leave, to go live in Australia, New Zealand, Canada, and the UK now seems to be the best place to live on the planet. South Africa has been very sheltered and protected from this madness. Unfortunately we won't emerge unscathed.

When I have been through a tough time I stop myself and realize that there is always someone in a worse situation than mine. We can all be very glad we don't live in the United Sates, UK, Europe or most other emerging markets. From the very peak of the markets to the very bottom, which was recorded on the 20th of November 2008, the Morgan Stanly World Stock Market Index was down 54.1%, the Emerging Markets Index down a massive 65.3% and there are some individual markets like Dublin that were down 76.8%. In comparison the worst point for the JSE Allshare Index was a negative 44.3%, which is horrific, but when comparing it to almost every other country in the world we have fared a whole lot better.

This whole crisis all stems from greed and low morals mainly in the United States and they have dragged us all down with them. I am afraid that this crisis is a case of Capitalism purging itself of excess and greed.

SA and the World Economy: The Way Ahead

Things aren't what they used to be

As the dust settles in the coming months the regulatory environment in the developed world is set to change dramatically in the future. The financial and banking systems are likely to undergo a massive overhaul. The amount of credit that will be available in the next five years will not be as much as what was available in the last five years. In my last news letter I spoke of an economic power shift taking place between the West and the East. Well I can say that the playing fields have now been leveled. At +/- $40 a barrel of oil and China without the United States consumer buying their exports no country holds a powerful position at this stage. What is important is how countries deal with the situation and who emerges more powerful than before.

Companies that work out how the future will change and adapt to take advantage of it will be the ones that emerge all powerful.

If you have a strong balance sheet, now is the time to buy out your competitors, as they will never be this cheap again.

Time will be the great healer

Time of course will tell us how this will all play out and whether the worst is over or whether we will still test new lows. One thing that is true is that 2009 is going to be a tough year for the major first world economies. The lowering of interest rates and the stimulus packages that are being made available will take time before they gain traction. One consolation is that the faster economies decline, the more rapidly they tend to bounce back.

The worst may well be in the price

It is important to understand that financial markets are forward looking and are able to recover long before the real economy. They may well have overestimated the damage caused to the real economies by the failures of bank and credit markets. You can expect equity markets to recover quickly at the sign of a positive future outlook.

By the time it starts to feel comfortable to invest, or you start reading positive headlines in the media and press, the market will already have recovered 25 to 30%.

Government intervention adds to uncertainty

Governments, in most countries, have intervened massively to save their banks and free up the credit markets. The results have not yet been obviously successful. However without the bank bail outs and intervention in the credit markets the outcome would probably have been too ghastly to contemplate.

The SA Economy and its Financial Markets

On a positive note the SA economy will be able to rise out of the global recession better than most economies. It is also unlikely that the SA economy will experience a recession. SA banks are very well capitalized and little stressed by the global banking crisis.

SA business generally can be regarded as lightly leveraged and have balance sheets strengthened by five years of improving profitability.

The SA government balance sheet after years of solid growth and prudent reserves is in a very good state to sustain the intended strong rate of growth in government spending.

Most important is that interest rates will drop significantly in SA in 2009, which will offer relief for borrowers and balance sheets including those of the banks. Research shows that SA households have not lost confidence in its prospects for an improved standard of living and will respond favorably to lower interest rates.

Let's not forget that the price of petrol has almost halved since the middle of last year. This will also have a positive effect on inflation, which is expected to drop sharply in the first half of 2009. The economic consensus is that we will be back in the reserve bank's target range of 3-6% by the middle of the year.

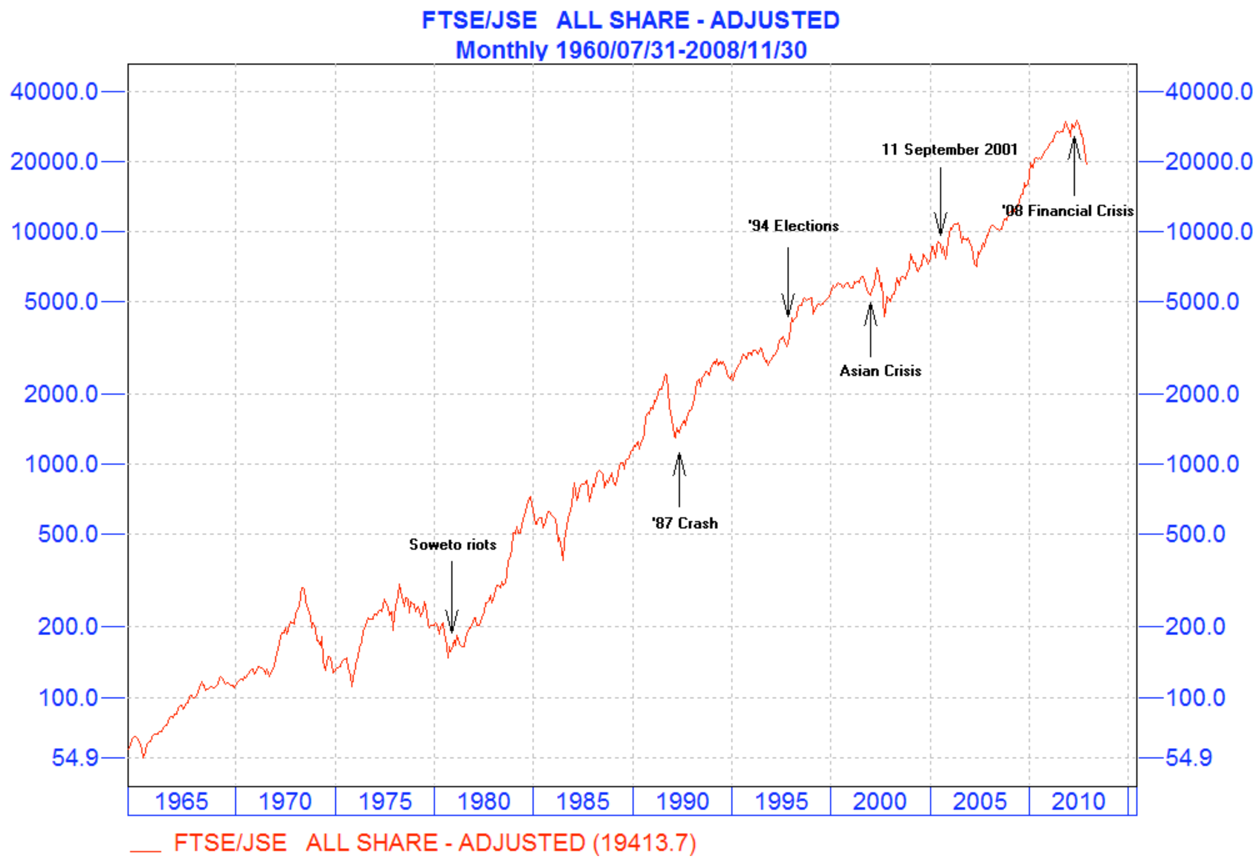
As inflation drops and interest rates are lowered, the SA consumer will spend again. This coupled with increased government spending will also help to increase GDP growth in SA. It is likely that the growth in the SA economy will continue to be supported by capital flows sufficient to maintain the strength of the Rand at current rates of exchange.

Crisis or Opportunity

The Chinese symbol for crisis is made up of two sub symbols, which are opportunity and caution. So the big question is which of these is this. Is this an opportunity to buy or is it time to sell everything you have and buy gold. I certainly don't advise the later as although gold can preserve value it certainly has not done anything during this Global financial crisis.

As Nathan Rothschild famously once said, "the time to buy is when there is blood in the streets"

Let's take a look at a 60 year graph of the Johannesburg stock exchange All Share Index. You will notice that after ever dramatic down turn there is very sharp recovery.



Here are a few quotes from some of the world's most respected Investors such as Warren Buffet, George Sores, Julian Robertson and Mark Mobius.

- *"Typical reaction by unsophisticated investors is to sell in a crisis whereas sophisticated investors buy in a crisis."*
- *"History shows that crisis always appear worse at the outset and that all panics are subdued in time."*
- *"When you have the proper perspective you will view these events as gifts."*
- *"If you have the psychological ability to add to your investments during a crisis, you will establish yourself as a superior investor."*

And lastly my all time favorite:

- *"When the market is fearful be greedy and when the market is greedy be fearful."*

Timing the market

This is something I hear all the time form clients. They want to try and time the market. I.e. sell equities and move into cash and then three months later reenter the market. This is not an investment strategy as it increases your risk dramatically and I can assure you that you will get it wrong more times than you will get it right.

Trying to time the market can be very detrimental to your investment growth. I will illustrate my point by using the following information supplied by I-Net Bridge.

“If you invested in the JSE between November 2003 and November 2008 and you remained fully invested, you would have had a return of 289%. By not being invested and missing the 25 best performing days (i.e. 1%), your return would have dropped to 29%.

The most important investment decision that you make is your asset allocation, which in turn dictates your risk profile and expected long term average return.

So the secret of how to make money is to buy cheap and sell expensive. It may sound easy, but it requires a brave person to act. Prices are cheap when times are bad and the outlook is gloomy. Recessions are as much about psychology as reality.

Having discussed and advised that jobbing or timing your long term investments is dangerous and not a sound investment strategy, I do however agree that it is prudent to time an entry into an asset class. When to invest or when to disinvest, given your investment term or time horizon can certainly have an impact on your investment return. It is certainly more prudent to invest in Equities or Property at the bottom of an economic cycle than at the top. We are certainly at the bottom or very close to it at this moment in time.

In conclusion

I can say that the sun will continue to shine, banks will lend money, companies will make profits and the stock market and property market will go up again. There are an overwhelming number of influencing factors, including political challenges that we face this year. While you can be certain that market volatility will continue in 2009 as the mood swings between enthusiasm and despondency, there are signs that the patient is out of intensive care. I am confident that we will finish 2009 in very positive way. The good times don’t last forever and thank goodness, neither do the bad times. That means we have good times to look forward to in the future so let’s not forget to laugh and have some fun along the way in 2009.

Best Regards,

Michael Westcott CFP®

Certified Financial Planner™