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A turning point in the inflation cycle – the silver lining

When days are dark friends are few

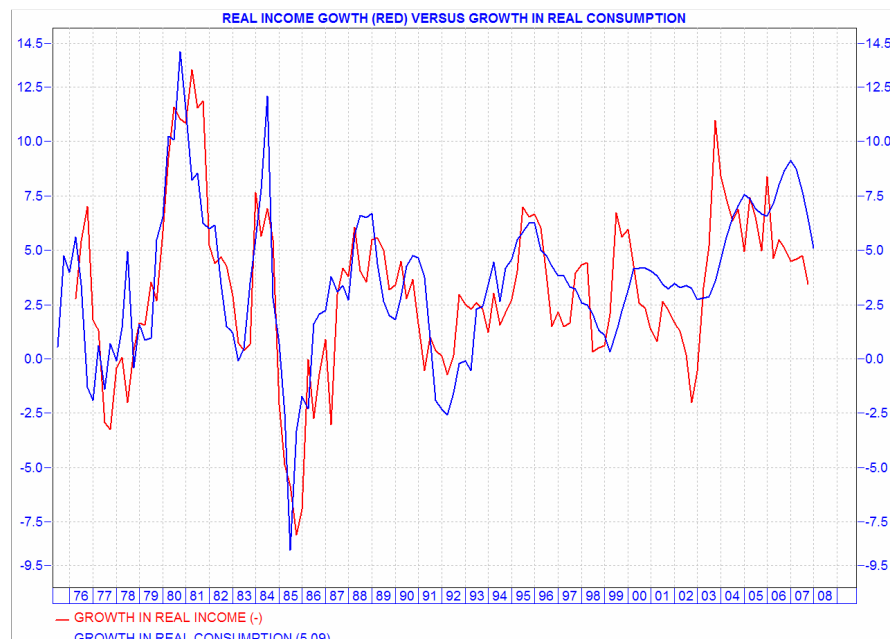
Currently there is a very intense focus on the downswing in the domestic economy – how deep and how protracted will this be? Just as no-one believed that there could be a turning point in the upswing we experienced over the last few years, a point of despair will be reached where it will look like the future will never be bright again. Looking at the current rating of some companies we get a sense that we are already stumbling into this phase but with a backdrop of spiraling global food inflation, energy prices, domestic political uncertainty and rising interest rates, sentiment could well get worse before it gets better.

Watch for the turn in the inflation cycle

Growth in the most important part of the South African economy, the consumer sector, is currently on the skids and the reasons are clear: discretionary spend is being eroded by rising interest rates and accelerating inflation. The latter is as important as interest rates though and we believe that a turning point in the inflation cycle could arrest the slowdown. This tipping point in inflation will not necessarily be orchestrated by the Reserve Bank, but could merely be a function of the base effect coming through in inflation towards the end of the year. Stabilizing price levels could therefore be as important as a peak in the rate cycle. Why do we say that?

Why containing inflation is important

Real income growth determines real spending and a contraction in real income growth will put general economic activity under pressure. In the attached graph we show real income growth relative to real consumption growth and it is clear that the two cycles are tied together. The last real example of how inflation impacted both income and consumption was seen at the turn of the century. The currency crisis came about towards the end of 2001, but it was not only until the end of 2002 that the full inflationary impact as a result of the currency weakness came through. At that stage nominal wage growth has already accelerated to 10%, but inflation (measured by CPIX) was also running at double digits and caused a contraction in real wages, albeit marginal. A commensurate slowdown in general economic activity followed.



Source: I-Net Bridge

What happened thereafter was actually the interesting part. Real wage growth accelerated from the trough in 2002 to a peak of almost 7% towards the end of 2003, but this was a function of a dramatic slowdown in inflation and not a further acceleration in nominal wage growth. Nominal wage growth as a matter of fact averaged just over 10% between 2003 and 2007. This acceleration in real wage growth was probably the most important driver of the consumption boom. But, it also made people complacent about the future and their ability to service the escalating mountain of debt. Their expectations that long term inflationary pressures would be limited, with a commensurate lid on interest rates, resulted in an ever-increasing demand for goods and services and spilled over into asset price inflation.

Economies move in cycles

Cycles repeat themselves and this time will be no different. An economic upswing will happen, but not until we rid the economy of the financial excesses that built up in recent years. But, the upswing when it does come should be more muted than the last one. Given that the current inflation cycle is linked to global supply-issues around raw materials and the fact that we are unlikely to see the same kind of currency appreciation as we did between 2002 and 2004, reduction in the rate of inflation is expected to be less aggressive and will therefore have a more limited impact on real wage growth. The current economic downswing will probably be comparable to the late-nineties when we saw almost 3 years of slowing growth in real spending, from a peak of 6.25% at the beginning of 1996 to a trough of less than 1% in 1999. This also followed on a period of a huge accumulation of debt in an environment of loose monetary policy and very aggressive asset price inflation.

Distinguish between the intrinsic value of a company and share prices

Making money in bull-markets is as easy as cycling downhill – momentum does the work for you. Investment horizons get shortened because returns that are normally made over a few years are often squeezed into months. You buy the dips and you ride the next wave...until the waves disappear! It is then when you realize that making money is not supposed to be easy. You also realize that the underlying value of a company and its share is not the same thing and that the two can actually dislocate for very long periods of time. The value of a company is merely the future cashflows in today's terms and in bull-markets investors often end up paying for future cashflows they are unlikely to see, which is financial suicide.

Current economic conditions are becoming increasingly less favourable for domestic companies and this could mean that cheap companies could get cheaper still. But, it is important in this environment to focus on companies' abilities to grow cash earnings in the long term, instead of focusing on the short term movement in share prices. Good buying opportunities for long term investors normally emerge during periods of extreme pessimism and this time will be no different.

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