



# Platform

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Independent Insight in an Uncertain World

# PLEXUS

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## EXTREME VOLATILITY IN MARKETS – WHAT IS THE REASON?

The rout in global financial markets is continuing, characterised by extreme swings of up to 5% in some markets. There are a couple of reasons behind the extreme volatility.

At this stage the major factor seems to be the possibility of Greece defaulting on its debt on its own terms. If that happens, the entire Eurozone financial system would be at risk as some major banks' balance sheets will come under huge pressure. This in turn is likely to trigger a liquidity crisis that will certainly rub off on the rest of the world. In addition, the European Union would come under scrutiny, as would the existence of the euro.

The European Union and the rest of the world cannot afford another liquidity crisis of the same magnitude as in 2008/09. We are of the opinion that Greece will be allowed an orderly default where some of its debt will effectively be written off by other governments, and that vulnerable banks will be recapitalised by the European Financial Stability Facility (EFSF) that is financed by members of the Eurozone to combat the sovereign debt crisis. The debt crisis and Greece deadlock have already dented business confidence in the Eurozone and resulted in the contraction in both the manufacturing and services sectors of the economy.

A combination of other factors are also contributing to the extreme volatilities in the markets. Besides the Eurozone debt crisis which started in the Mediterranean countries and Ireland last year, uncertainty was exacerbated by the uprisings in the MENA countries, resulting in a strong rise in the oil price due to supply concerns. Then Japan's terrible twin disasters struck and had an immediate impact on China as global economic growth locomotive. Consumer and business confidence is under heavy pressure in the US as employment has stagnated with austerity measures implemented in the government sector. Although the rebuilding of Japan is on schedule the strong yen is hurting exports, while China's normal seasonal strength in its manufacturing sector is below par. Growth in global manufacturing halted for all intents and purposes and a currency war between the majors developed with the Swiss and Japanese at the forefront to stave off further appreciation of their already overvalued currencies, resulting in the Swiss pegging their currency against the euro at lower levels.

But what will bring the extreme volatilities down and calm the markets? The markets obviously want to see central bank action that will ensure growth and, most importantly, restore confidence. Our studies have indicated that the most important factor in restoring order in financial markets is value. In fact, very rich market valuations and weakening economic indicators had resulted in increased volatility long before the 2008/09 market crash started. This behaviour can also be traced to other stock market crashes

over the past 40 years. Volatility subsided only when market valuations returned to levels where major investment houses saw good value again. That preceded better economic fundamentals. Are we there yet? We certainly think we are approaching those levels where financial institutions start bargain-hunting.

Is this the bottom in stock markets? The major sell-off in gold recently caught our attention. The top of anxiety in financial markets in 2008 coincided with a major sell-off in gold. We think there is a more-than-equal chance that we are hovering around the bottom in risk asset markets. However, we do believe there is a real risk of another deep sell-off in the S&P 500 that could shave off another 15%, especially if another unnamed black swan appears. That would be the ultimate bargain we are waiting for.

We are of the opinion that all markets correctly reflect the height of anxiety. Asset classes that we favour at this point in time are emerging-market equities and bonds, silver and platinum, emerging-market currencies and the euro as currency.

Our least favoured asset class currently is mature-market bonds, especially the long end. We think the Fed's "Operation Twist" whereby the Fed will sell shorter-term Treasury holdings and buy long-term debt and mortgage-backed securities to support mortgage refinancing activity, will probably keep long bond prices higher, so we will refrain from shorting them outright. But it is a bubble in the making.

Emerging markets have been on the receiving end of risk aversion, resulting in a flight of capital out of emerging economies to significantly lower risk assets such as hard currencies and mature-market bonds. The fall of the rand in line with other emerging-market currencies has cushioned the local market. R100 invested in the FTSE/JSE All Share Index at the end of last year would be worth R92,53. In contrast, U.S.\$100 invested in the same index at the same time would only be worth U.S.\$76.27! Secondary rand hedges such as dual-listed foreign companies and primary rand hedges such as mining and resources stocks benefitted substantially from this.

Our studies indicate that the rand is currently correctly priced given the global anxiety or volatility levels that we measure. If global capital becomes more concerned about the global economy or another black swan emerges from somewhere, anxiety levels could approach those during the peak of the great liquidity crisis of 2008/2009. In that case we would not be surprised to see the rand trading above 10 against the U.S. dollar. We do, however, think that 8.50 may have been a bottom of the rand in the short term. We base this on our research that indicates risk assets such as U.S. equities are again approaching value territory that will attract major market players. In the past, low valuations led to anxiety or volatility levels dropping gradually afterwards. Do not be surprised to see the U.S. dollar falling back to the R7 level in coming months. At this stage we are therefore taking an interest in domestic financial and industrial companies and considering going long of the rand. But, there is a real risk that the U.S. dollar may peak at above R10 should the current global financial crisis take a turn for the worse.