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SUDDEN STOP: THE PERILS OF TURNING INVESTOR SENTIMENT

By Haakon Kavli, PhD

Douglas Adams, author of The Hitchhiker's Guide to the Galaxy, once observed: "It's not the fall that kills you. It's the sudden stop at the end".

Economists have their own interpretation. *Sudden stop* has become a widely adopted term for an abrupt slowdown, or reversal, of capital flows to emerging markets. The stop tends to come with severe economic repercussions. Common consequences include sharp currency depreciations, banking crises, recessions and corporate bankruptcies. And as would be the case in Douglas Adams' analogy, the potential harm increases with the height of the fall.

Sudden stops strike predominantly in liquid, higher risk asset classes like emerging markets. Studies have found that they are preceded by large portfolio inflows, meaning global investors are piling into shares and bonds in the emerging economy. As this goes on, the emerging economy becomes increasingly dependent on foreign financing, while foreign investors accumulate a larger stake in the local financial markets.

And while portfolio inflows happen gradually, the stop is, well, sudden. This is relevant for South Africa. Between 2000 and 2015, the average net foreign purchases of South African shares and bonds amounted to R40 billion a year, adding up to more than R600 billion. The current value of these investments will be even greater due to capital appreciation.

The R600 billion number suggests we have plenty of distance to fall, should foreign appetite for South African assets suddenly dissipate. The consequences can be serious and a prudent investor should carefully monitor developments in these portfolio flows. History provides some guide as to what factors should be on our radar.

Sudden stops are typically triggered by a global tightening of monetary policy or unexpected events, like the Russian default in 1998 or the 9/11 terrorist attacks in 2001, that increase volatility and risk aversion in global markets. In today's environment, however, monetary policy has remained ultra-accommodative for years, volatility is low and investors appear ever hungry for risk. But this may be turning.

The Federal Reserve in the US has signaled three hikes to come in 2017, the first of which was delivered in March. The European Central Bank is expected to taper its quantitative easing policy this year. Even China's central bank, the People's Bank of China, has indicated it will remove monetary stimulus this year. A large coordinated effort to tighten global monetary conditions would have the potential to cause market volatility and a loss of risk appetite.

In other words, all the conditions for a sudden stop of capital flows to South Africa could potentially be triggered in the near future. What's more, data from 2016 suggest this may already be well underway. Since January 2016, foreigners have sold R150 billion worth of South African shares.

The outflow in 2016 from local equities was five times as large as the average annual inflows over the preceding 15 years.

While these numbers are staggering, the market response was muted for several reasons. First of all, the portfolio outflows were cancelled out in practice by the AB InBev acquisition of SABMiller. This transaction does not reflect in the data referred to above, and as such the actual net flows were near zero. It is also relevant that much of the outflows were explained by foreigners selling their SAB shares prior to the delisting. If we ignore all outflows in the beverages sector, the net portfolio outflows amount to R57 billion in 2016 according to data available from the SA Reserve Bank and the Johannesburg Stock Exchange.

Due to the offsetting effects of the SABMiller delisting, we have not yet seen the classical market response to a sudden stop. Typically this would include a sharp depreciation of the currency and falling asset prices. Instead we have seen the rand strengthen by roughly 5% in 2017 and by 16% since the start of 2016. Local equities have been roughly flat since the start of 2016, but are up more than 3% year to date. Global volatility is at a record low, with realised 90-day volatility on the S&P 500 index at 7% versus average volatility of 16.5% over the last 30 years. Market data does not suggest any disruption.

However, we can’t dismiss the risk of a sudden stop based on the lack of market symptoms alone. Firstly, we cannot rely on transactions like the SABMiller acquisition to cushion the blow of future portfolio outflows. Secondly, data on flows and the global monetary policy cycle must be considered. The question then is whether we will see a fully-fledged sudden stop with all the associated consequences; a gradual winding down of positions by foreigners with no severe consequences; or, continued appetite for South African assets and continued positive performance of the rand, local equities and local bonds.

While markets remain complacent, investors should use the opportunity to ensure their portfolio is sufficiently diversified to withstand a turn of global sentiment. Or you may simply choose to look at the bright side: we are just falling, and falling doesn’t kill you.

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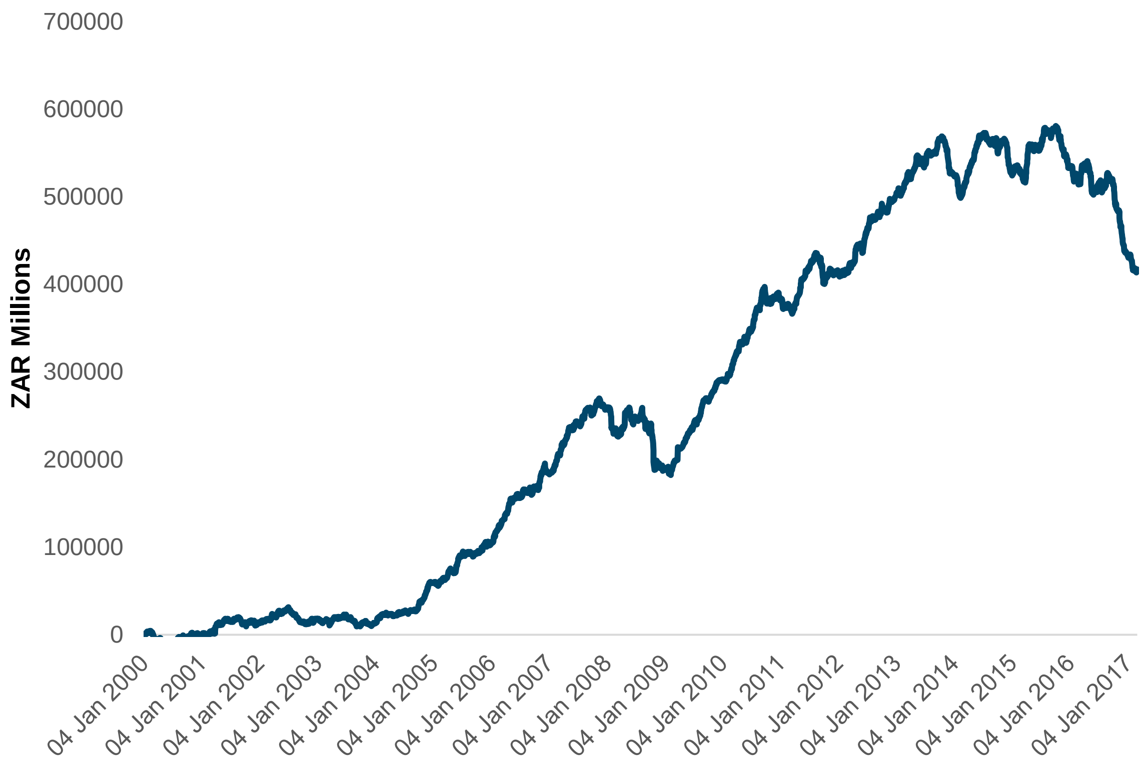
Ends

Cumulated portfolio flows to South Africa (Source: Bloomberg)



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Haakon Kavli joined Prescient Investment Management in April 2015 as a research analyst. He graduated M.Com (Economics) with distinction from UCT in 2012 and PhD (Economics) from the University of Pretoria in 2016. His PhD research has been published in internationally ranked journals and won the award for Best Paper in Monetary Economics from the Economic Society South Africa. Haakon was a lecturer at the University of Cape Town from 2011 to 2015, where he taught economics, finance and portfolio optimisation.

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- Prescient Investment Management is a signatory to the United Nations Principles of Responsible Investing (UN PRI) and pledged to the Codes for Responsible Investing in South Africa (CRISA).
- The Prescient Global Income Fund, now known as the Prescient Global Income Provider Fund, was ranked by Morningstar as the 7th top performing fund for 2015.
- **More recently, the Prescient Income Provider Fund won the Raging Bull Award for the Best South African Multi-Asset Income Fund, Best South African Interest-Bearing Fund as well as a certificate for the Best South African Multi-Asset Income Fund on a risk – adjusted basis over five years to December 31, 2016.**
- Morningstar data also confirmed that The Prescient China Balanced Feeder Fund has been the top performing South African domiciled fund for the second year in a row.
- Prescient Investment Management was the first institution in Africa to be granted a Qualified Foreign Institutional Investor (QFII) licence by the China Securities Regulatory Commission (CSRC).
- Prescient Investment Management was named Overall Investments/Asset Manager of the Year at the Imbasa Yegolide Awards 2011, Absolute Return Manager of the Year in 2013 and Bond Manager of the Year and Responsible Service Provider of the Year in 2015.
- The full details and basis of the award can be obtained from the fund manager.
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