



## FROM THE CEO'S DESK

Reading extensively and from the writings of many widely-read financial authors, one realizes that the vast majority are more bearish than one can ever remember. We have, as investors, been bombarded by one of the best kept secrets of the modern financial period. To most, right now, it feels like we are swimming upriver, worried about crocodiles. We then come across the first of, what someone reports is, many whirlpools. And so the story goes....

I believe that, given the gravity of the financial woes and the risks inherent in the very solvency and survival of many, if not most, previously "bullet proof" institutions and corporates, we have to adopt a slightly different approach to our financial wellbeing. This is particularly relevant to those at, or approaching retirement, or any other trigger point in their lives.

Trying to establish the trajectory of the market over the next number of months, or even the next few years, is a tall order. What is appropriate is that we look at various facets of the market, asset classes, and understand the obvious, or more predictable, and work uphill from there.

One can, with reasonable safety, forecast the continued and accelerated lowering of official interest rates. This fundamental instrument of all Central Bankers typically has an effect on two participants in the market. Firstly, the investor is affected. Immediately after the rate is cut, the commercial banks move to drop deposit rates by a margin very similar to the official rate cut. In the recent past, those of you dealing with your cash at the banks will realise that the cuts in rates on offer are materially larger than the official Reserve Bank cuts. This is for two reasons. One, the banks are in a tough place, where they are trying to raise deposits from us at rates which allow them to make a "normal" margin when they lend them out again. If you lock your funds away for a year or more, at a given rate, and this is followed by several quick fire cuts in prime, the bank could be in a loss making position. And two, the banks are currently confronted by pressure from underperforming debt. Both of these factors support the widening of margins currently found when we attempt to place funds for any term of deposit. Interestingly, the folk on the other side of the equation, i.e. borrowers, are not enjoying a similar trend. They are experiencing exactly the opposite. Just a year or two ago, all of our banks, through a combination of self imposed competition and the impending introduction of the National Credit Act, were offering borrowers money at discounts of 2.5% to the recognized Prime Lending Rate. Now, with banks acting as

Doubling Thomas's to all clients, good or bad, the rates on offer are Prime at best and a premium to Prime wherever they can get away with it! The situation is further complicated with respect to borrowing levels. Where it was also common for borrowers to borrow close to the full value of a vehicle or property, the banks are now seeking significant equity to be injected by the borrower.

This has gummed up credit advances and is complicating the lives of good individual and corporate borrowers and their counterparties here in S.A. and, even worse, abroad. The bottom line on cash is it is a safe haven but after tax my view is it will be paying less than 6% by year end. Preference (pref) shares will fare slightly better for two reasons. Firstly, they drop by a percentage of what prime drops, and they are tax efficient.

The risk with them is a big dip in rates and the fact that corporates are foregoing ordinary dividends, which might flow over into the pref market. Most prefs are cumulative, making this a delay rather than a loss of dividend, but the investor needs to understand exactly what they are in and the risks attached, as all of the recently issued bank prefs are non cumulative.

Property has also been a favoured Asset class in S.A. in the last few years. We see this class being broken down into various sub sections, which include:

- Primary residential
- Investment residential
- Lifestyle residential
- Commercial unlisted (local and offshore)
- Commercial listed (local and offshore)
- Liberty Property via an endowment

The residential market, in pockets, has been rather heated over the last few years. Bargains now abound and if the borrower can get the bank to lend them cash, we are approaching a value proposition which will turn out to be one to remember in years to come. In the States, the banks have replaced Estate Agents as the vendors of property, so bad are their repossessions. Not too much has been said in the local press, but the situation in S.A., based on sources inside our banking sector, isn't much better.

Investment residential is still high risk as more stock appears on the market and tenants, able to sustain their lease payments, are few. Similarly, it will be a few years before Golf Estates are the vogue, unless the buyer is intending to live there. Whilst gearing costs will drop off significantly, the psyche of the speculative or luxury investor has been affected by recent global woes and will take time to regain the confidence of the recent past where strong and sustainable growth was almost



## IN THIS ISSUE

From the CEO's desk

Deflation

Medical schemes  
and waiting periods



financial services group



# DEFLATION

**An oft asked question is: "If deflation results in the cost of goods and services coming down, surely it is good for consumers"? Andrew Duvenage, NFB Johannesburg, answers this and explains the real nature of deflation.**

The last edition of Proficio featured an article called "The Paradox of Thrift" which delved into the current financial crisis and how some policy actions may not actually have the desired effect on the economic system in the short to medium term. One of the issues that was touched on very briefly was the concept of deflation. Deflation is a topic on many commentators' minds at present and we felt that it is worth revisiting and expanding on the issue and providing some insight into the subject.

A question that often comes from clients is "if deflation results in the cost of goods and services coming down, surely it is good for consumers"? The answer to the question has two parts. The first is that in the short term, the effects of deflation may provide some much needed relief for consumers. Who, after all, complains when they have more money in their back pocket at the end of the day? However, the more important result is in the medium to long term – and this is where the real nature of deflation becomes apparent, and which is also the subject of this article.

## What is deflation?

Deflation is defined as "a sustained decline in the general price level of goods and services". Thus deflation occurs when the inflation rate falls below zero – a negative inflation rate. This is different from disinflation – which is a fall in the prevailing rate of inflation.

## What causes deflation?

In classical economic terms, deflation can be caused by two distinct types of events. The first is what is known as a "negative demand shock"; this occurs when the demand for goods or services rapidly falls. The second factor is known as a "positive supply shock". This occurs when major improvements in efficiency or technology result in a surfeit of goods and services, which leads to falling prices.

In the context of the current financial quagmire the world finds

itself in, the issue at play is that the demand for goods and services has fallen. As consumers and corporates alike tighten their collective belt buckles, the demand for goods and services falls and in response so does the price of these goods and services. The reason for the decrease in spending relates to a single issue – and that is the much overdue repairing underway in both personal and corporate balance sheets. Individuals the world over are conserving cash in the face of uncertainty and mountains of debt. Similarly, corporates are in the (very painful) process of deleveraging or improving the balance between assets and liabilities in their books. The key point though is that spending has dropped off a cliff and as a result demand has dipped.

## So, what is the problem?

The problem with deflation is that it is one of those rare entities that once in existence is self-perpetuating. That is to say that deflation creates a vicious circle known as a deflationary spiral (the last one occurred in the 1930's and was called the Great Depression). In essence, what happens in a deflationary spiral is that because prices are falling, consumers have an incentive to delay purchases and consumption until prices fall further (why buy a car today if you know it will be cheaper in 6 months?), which in turn reduces overall economic activity. This really is the crux of the matter. As demand falls two things happen – inventories increase and capacity exceeds needs. The natural remedy for this is that companies start to retrench people and this in turn makes demand fall even further as unemployment rises. At the same time investment in new projects stops as existing capacity is often more than sufficient for reduced levels of demand.

Furthermore, while an increase in the purchasing power of ones money sounds beneficial, it can also cause hardship when a significant amount of one's net worth is tied up in illiquid assets such as property. This occurs because as the value of the asset falls, the

repayment amount starts to increase in relative terms – a phantom interest rate if you like. As an example, consider a scenario with 10% deflation and an interest free loan. After the 10% fall in the value of the asset, the repayment amount is effectively 10% higher the following year.

Based on this it is easy to see that deflation is a far more complex issue than simply a fall in the costs of goods. In the longer term it can result in huge amounts of damage to economies with rising unemployment and its associated knock-on effects directly and indirectly influencing the world's population.

## How do we stop this from happening?

One of the defining features of the financial crisis we find ourselves in has been the willingness of central banks the world over to act (albeit reactively). The approach has been multi-faceted, but the primary objective is the same and that is to try and stimulate demand. There are a number of tools that central bankers are using at present in order to stimulate demand and prevent the onset of deflation. We have focused on a few that are particularly relevant:

### 1) Cutting interest rates:

The first and most obvious reaction to a fall in demand is to reduce the cost of borrowing. In theory by cutting interest rates, consumers and business will borrow larger amounts of money with which they will spend or invest in projects. This would stimulate demand and counteract deflation. While in theory this will work, this approach is based on a very important assumption, and this is that banks will be willing to lend (and that consumers will be willing to indebt themselves further). As a result of the financial crisis, banks the world over are in the process of "deleveraging", or increasing their assets relative to their liabilities. This has, and will be one of the issues that could totally undermine the aggressive interest rate cuts we have seen across the world, as even when investors are willing to borrow, there is a very good chance that the banks will be unwilling to lend to them. While it is in a way understandable why the banks are doing this, it doesn't help the fact that by not lending, the credit squeeze is exacerbated. There is a lot of debate around this as taxpayers feel that seeing that it is essentially their money that is used to bail banks out, the banks should be obliged to act as conduits in the international monetary system as opposed to blockage points.

In a South African context though there is good news. The reserve bank has been criticized for being too slow in reducing interest rates, and whilst that may be true, the reality is that the governor is now in an enviable position with scope to aggressively cut interest rates in order to stoke the fires in South Africa's economic engine rooms.

### 2) Public Spending

Public infrastructure spending is another mechanism to stimulate demand. By rolling out massive spending projects with a focus on transportation, healthcare and education, governments are able to counteract deflationary forces. In the short term these projects create demand for materials and skills, and as a result jobs are both directly and indirectly created. In the longer term the impact of infrastructure spending is far more exciting as it effectively increases economic capacity. Thus as the world comes out of the economic crisis (as we believe it will), it has the ability to increase participation in the global economic activity.

Once again there comes a health warning or two with this approach. The first is that projects don't just happen over night. It can take a significant amount of time to roll these projects out and thus it can take a while for the intended effect of the spending to actually work its way into the system. In a South African context, whether by fate or design, our infrastructure spend (roads, rail, stadiums etc.) has been perfectly timed. We find ourselves in a wonderful position whereby the spending is actually happening just when we need it to.

### 3) Keeping international trade going

One of the major faults in the reaction to the great depression was that leaders allowed their countries to revert to protectionism. The imposition of trade barriers and tariffs may have seemed like a logical way to protect one's own country's industries, but it effectively had the opposite effect. International trade came to a virtual standstill and resulted in many industries collapsing. South Africa as a net exporter is vulnerable here. For the time being it appears that world leaders and central bankers are aware of the risk here and hopefully will avoid this pitfall.

## Where to from here?

In a South African context, the likelihood of deflation is very small. Economies like the USA, Europe and the UK have a far more realistic prospect of this happening, and seeing as they are our major trading partners, this is cause for concern. The reality is that despite the best efforts of the world's central bankers and policy makers, the massive stimulus packages that have been put in place have yet to take effect. That is not to say that they will not work, but rather that they have yet to gain traction. It is likely that this will take a while to happen as the world's economic systems attempt to recover from the crisis that we have just seen. Thus deflation will remain a concern for now, but it appears that the correct measures are in place to limit its effects as far as possible. Once the measures do gain traction, inflation will be reintroduced into the system. And so the balancing act will continue as central bankers will have to now prevent the huge amounts of money that have been injected into their economies from causing excessive inflation and causing devaluation in their currencies. ⊕

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## FROM THE CEO'S DESK *continued from front page*

taken as a given.

Commercial property, whether listed or not, is a function of location and tenant mix. This sector will always perform over the long term. In the immediate term, this sector is struggling with gearing, tenant failure and the very negative economic environment. We believe that when the recovery comes, this sector will respond earlier than some pundits think, amplified by a significant drop in interest rates and the consequent move by yield seeking investors and pension funds from cash to property.

The Liberty Property Fund, which NFB accesses via new or matured Endowment bonds, is a firm favourite. Throughout the last decade this fund has delivered inflation beating returns to clients who have needed income as well as very respectable capital growth for those who have not been comfortable to run the equity

gauntlet. Described as "rather pedestrian" when compared to equity over the last five years, the fund returned a decent 10% nett to investors last year, which is not to be sneezed at given the uncertainties of markets at present.

The final, and certainly not least relevant, class of investment is equity. This is the snake pit at present, where great risk of earnings disappointment exists as well as a difficulty for corporates to forecast. Leveraged companies are being punished, whether they have impeccable histories or not. Dividends, in some cases, and probably with increasing frequency, are being withheld, firstly to shore up income statements and secondly to act as a buffer in case the credit shortage and high cost of money persists.

Listed prefs run the risk of having their dividends delayed or simply withheld. At the end of it all, the investors who have run the

*continued on back page*

# FROM THE CEO'S DESK *continued from 3rd page*

gauntlet could be in for more disappointment before they are rewarded as will inevitably be the case.

Our view, and consistently so, is to diversify. This does not only mean in terms of free cash. This would include considering the effect listed share options, one's own private company shareholding, or a significant property portfolio might have on your personal risk. Income, in my opinion, has always been an important component of any investment. Perhaps the world has focussed too much on capital growth in the last decade. This was arguably due to sustained high inflation around the globe. If inflation stays at recent lows, or even in negative territory, it is probable that the world's top investors and advisors will revert to the income/dividend profile of investments as a driving determinant of choice.

Finally, to those very important and long-serving retirees and investors at large please remember that as rates drop and dividends on those favourite shares of yours are reduced or withheld, to avoid at all costs accepting an unusually high return which is advertised in the press or elsewhere. The unsuspecting South African investor is going to be a victim of scams and schemes aimed at those of us feeling the pinch as rates drop and cash flows are reduced. Feel free to contact your NFB advisor who will check these offerings out and can also report them to the Financial Services Board if they are found to be inappropriate.

**Mike Estment, CEO**

## MEDICAL SCHEMES AND WAITING PERIODS

**Contributions to a medical scheme are pooled and then used when members claim. To ensure that new members do not utilise the funds or claim unfairly, one of the restrictions which the administrator will use is the "waiting period".** Written by Leonie

Schoeman - NFB East London

In terms of the Medical Schemes Act no. 131 of 1998, medical schemes are no longer allowed to decline application for membership as a result of ill health, and their contributions may only be levied on the basis of income and number of dependants.

As a result of open enrolment, medical schemes have limited tools available to protect their risk pool and to ensure that members have access to fair and consistent benefits. These are

- **Waiting periods**
- Late Joiner Penalties
- Managed Care Interventions
- Deductibles

Medical schemes operate on the basis of cross-subsidisation, which means that everyone's contributions are pooled and used when members claim. If they do not apply these protocols and rules, then it creates an unfair opportunity for people who have never belonged to the medical scheme to join and claim immediately when they are sick, utilising contributions made by others over a period of many years. The medical scheme then also runs the risk that these members could leave the scheme directly after claiming for an expensive procedure, without having paid any contributions to the medical scheme.

### There are two types of waiting periods

1. A three-month general waiting period, which means that after joining the medical scheme, members must wait three months before they can claim.
2. A 12-month condition specific waiting period, which means that members must wait twelve months before they may claim for a specific medical condition or for any treatments related to that condition.

These waiting periods are applied to 3 different categories of clients

**Category A:** Members who have not previously belonged to a registered South African medical scheme and/or members who

have allowed a break of more than 90 days since resigning from their previous medical scheme.

#### Type of waiting period

- 3-month general waiting period
- 12-month condition specific waiting period

The member will not be entitled to Prescribed Minimum Benefit cover.

**Category B:** Members who have previously belonged to a registered South African medical scheme for a period of less than two years and have applied to join another medical scheme less than 90 days since the date of termination of their membership with the previous scheme.

#### Type of waiting period

- 12-month condition specific waiting period for conditions occurring within 12 months prior to date of application.

The member will be covered for the Prescribed Minimum Benefits

**Category C:** Members who have previously belonged to a registered South African medical scheme for a period of two years or more and have applied to join another medical scheme less than 90 days since the date of termination at the previous scheme.

#### Type of waiting period

- 3-month general waiting period
- The member will be covered for the Prescribed Minimum Benefits

(Prescribed Minimum Benefits were discussed in a previous issue). ⊕

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