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Are volatile equity markets providing opportunities?

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Significant declines in the FTSE JSE All Share, down 13.57% since only the end of June, have seen many investors abandoning ship. Others are now contemplating whether it's time to significantly down weight equities in favour of more defensive asset classes. This correction has been marked by aggressive selling out of resource stocks (down 27.46%) into financial stocks particularly (up 9.28%) and relatively flat returns for industrials (down 0.91%).

Persistently poor US economic releases, signs that the Euro-zone is set to slow further and concerns that emerging market growth may not be resilient as thought are leading to fears that global growth could be seriously impacted and that demand for commodities will fall significantly as a result. Is the correction in commodity stocks signalling an end to the current bull market in commodity prices? And what are the merits of equities as an asset class right now?

Stephen Brown and Mashuda Cassim, co-managers of the top performing RMB Value Fund provide their insight on recent market movements and the opportunities they currently identify in the market.

We understand the markets concerns regarding global growth prospects, but believe that the sell off of resource stocks has gone too far. The move has possibly been accentuated by market perception that a switch from resources to financials is warranted by valuation measures.

Some commodity prices have declined, but not to the extent the correction in resource stocks would suggest. The oil price remains elevated, as do the prices of bulk commodities like coal and iron ore, and while base metals have corrected, margins in many cases still remain attractive. We also maintain that growth in China and other emerging regions will remain relatively robust, limiting the extent to which commodity prices will ultimately correct.

Consequently, strong earnings are likely to provide a solid underpin to counters in coming months. Earnings releases will see the unwinding of current higher valuation measures, a factor seen by many as detracting from investment in resource counters. This was seen with the recent release of half year results for Anglo American and BHP Billiton and was further supported by equity declines. Their respective P/ E ratios have fallen from the upper teens down to around 11. Our internal forecasts indicate that this trend will continue with the release of earnings at the end of the year, a period for which the diversified miners will enjoy the full benefits of price increases for iron ore and coal, finalised in recent negotiations, and then further into 2009. This could see these stocks trading on single digit P/E's.

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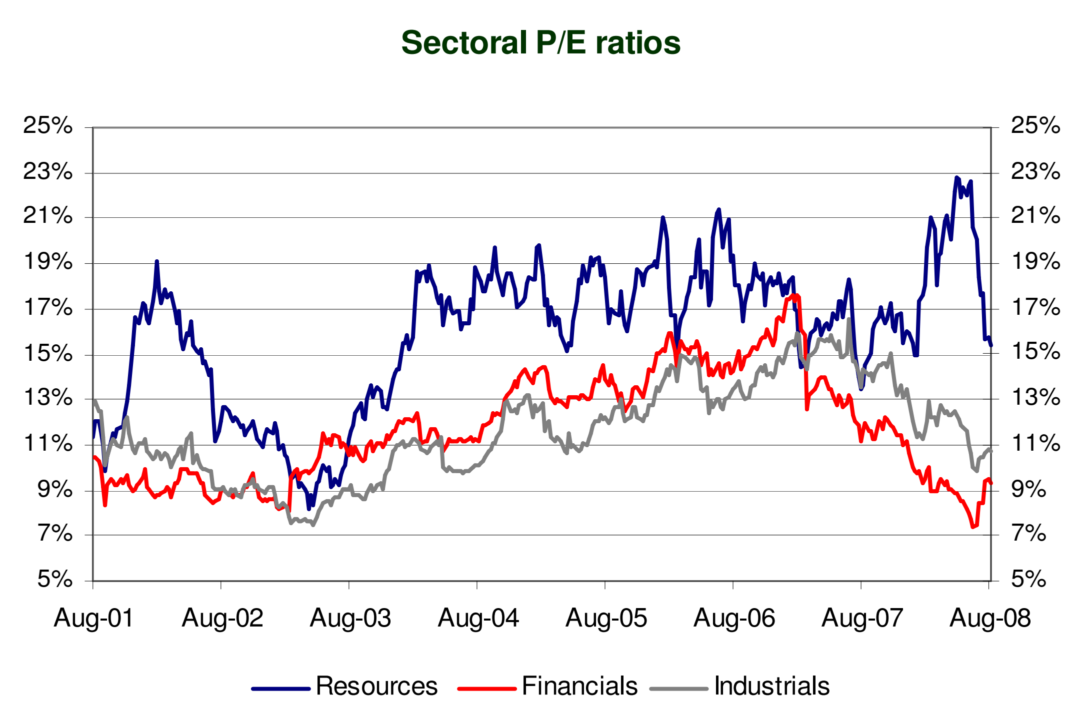
Resource counters are now on attractive forward multiples



Source: I-Net August 2008

The US Dollar has strengthened quit substantially and the gold price has corrected. It however remains at levels that hint that the dislocations brought about the decline in US house prices and extensive financial losses may not yet have reached a conclusion. Consequently the structural underpin commodities have enjoyed as investors have hedged against financial losses and the inflationary threats posed by the Feds reflationary efforts and high oil prices, could have further to run. Expectations for when that the US Fed will begin increasing interest rates have been extended, meaning that real interest rates in the US remain negative, as they do in many other regions. Negative interest rates are by definition good for commodities.

We are also questioning the dichotomy between a relatively firm rand and a scenario which would entail significantly lower commodity prices. The recent ascent of the rand undoubtly aggravated the decline in resource stocks, but we believe that the headwind posed by the current account deficit and slower local and global growth will see it weakening in coming months. If the rand remains strong commodity prices will likely have to remain firm!

Despite our preference for resource counters we do acknowledge that financial stocks are trading on very attractive multiples and have been up weighting our exposure to this sector. We are also maintaining our limited exposure to domestically orientated industrial counters, especially interest rate sensitive retail stocks which could be more susceptible to a pro-longed downturn locally. Defensive holdings in this space include healthcare stocks, Netcare and Medi-clinic, and global luxury good player Richemont, which enjoys the defensive attributes provided by its tobacco arm. Its luxury goods business is also cheap relative to its global peers. We remain weary of interest rate sensitive assets on a broader basis though. They are likely to remain vulnerable to earnings downgrade in an environment of high inflation and interest rates.

Our belief that the commodity theme has not ended and that the rand will ultimately weaken has also encouraged us to hold our full allowable offshore exposure in global resource counters.

In closing, in our view, exposure to the local equity market over the next two to three years is an increasingly attractive proposition, given the significant declines in local markets, first in FINDI counters and more recently in resource counters. This means many stocks now offer significant value. Resources stocks have the added benefit of still solid earnings expectations. Global equity markets are currently discounting very negative forecasts for global growth, particularly in developed regions. When fundamentals improve in the US and other developed regions, improved investment sentiment will provide a further underpin for local equity markets.

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