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Underneath the turbulence opportunity is certain for the astute investor

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Arthur takes on the role of Chief Investment Officer. Arthur is ex Quaystone, having spent eight years in portfolio management and analysis with BoE Asset Management. Prior to that he was with Syfrets Managed Assets where he managed the highly successful Syfrets Prime Select Fund from its inception until his departure. Arthur is a Chartered Financial Analyst with a depth of experience in all aspects of asset management.

In the story *Peter Pan* by JM Barrie, the main protagonist was a boy who refused to grow up. Magically Peter Pan was able to fly, with the help of some pixie dust and happy thoughts. Without the happy thoughts however, flight could not be sustained.

There is no question that the happy thoughts ended on Wall Street this week and with the pixie dust of cheap capital in short supply, the investment banks crashed to earth. Too much borrowed money, channeled via extremely complex vehicles into assets of dazzlingly poor quality has resulted in a cataclysmic credit crunch. Subprime and Alt-A mortgages, Credit Default Swaps, Freddie, Fannie and Auction Rate Securities are all interrelated hotspots in this crisis.

As investors with long time horizons, the key question for Hermes Asset Management is what are the long term consequences of all this turmoil?

We expect a great deal of posturing and platitude from the financial regulators and legislators in the affected markets. Having shown themselves as either complicit or incompetent, one can expect the authorities will eventually overreact from a regulatory viewpoint. More complex banking rules and oversight are definitely on the way and not just in the US and UK.

Globally, banks are already adjusting to a world of scarce capital. Many will have to trim their balance sheets to a more appropriate size and bank customers are likely to find credit harder to come by. Globally, there is already evidence of slower lending by banks.

The US and the UK are going to adjust to a less leveraged and more regulated banking system just as their economies slow to a crawl. Although policy rates in the US are at 2%, lowering rates further is unlikely to stimulate the economy as high interest rates are currently not the problem.

The heavily indebted American consumer is also unlikely to see any relief through lower taxes. The US Government budget deficit will be higher than at any time since the Second World War once the costs of the recent successive bailouts are added up. The final number is likely to be north of $1.5 trillion. With over-burdened banks and consumers, tough credit conditions, many thousands of banking sector retrenchments and a constrained government, slower US economic growth will be the trend for some time.

The easiest and most likely way for the US to maneuver its way out of this morass is to let a higher inflation rate shrink the debt. We certainly don't see an American President on the horizon that can convince his nation of the merits of increasing taxes while cutting government expenditure.

Ultimately the status of the US Dollar as the global reserve currency and the US Treasury Bill as the ultimate risk free instrument could be called into question. How will investors view ballooning deficits and rising inflation combined with a stagnating economy?

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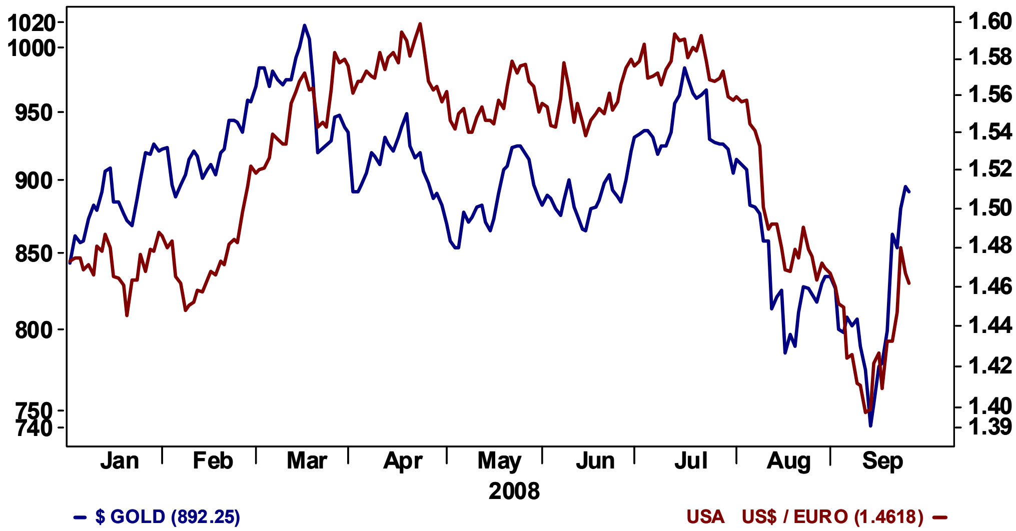
DOLLAR GOLD PRICE AND US DOLLAR/EURO EXCHANGE RATE



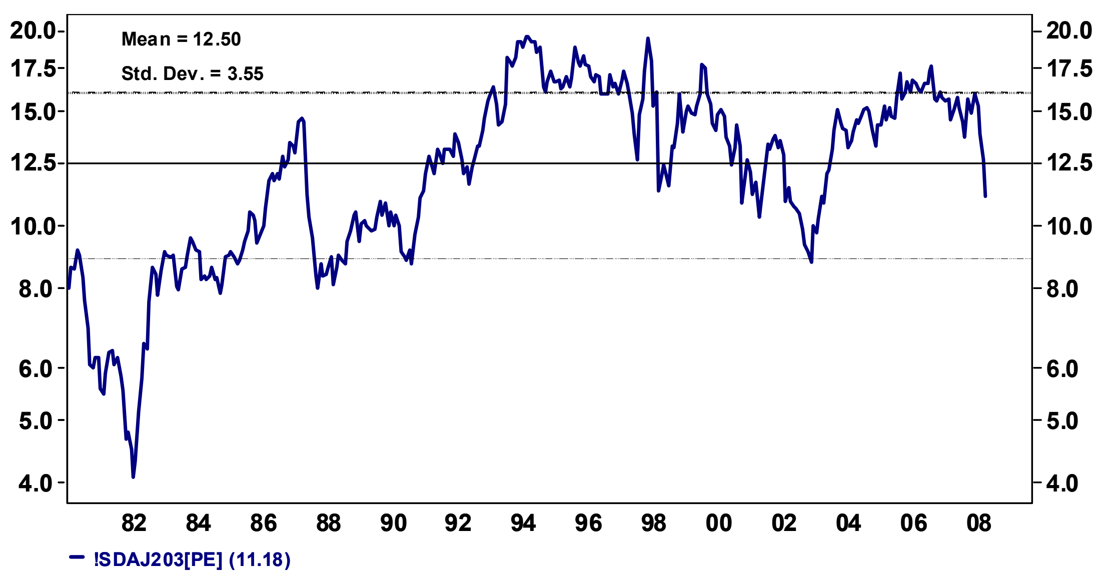
This scenario leaves commodities between slowing growth and a weak dollar. With Chinese growth forecasts being scaled back in recent days, it remains to be seen what the driving forces will be for the mining companies in the coming months.

The long term impact on other leverage dependent markets is also uncertain. Hedge funds, private equity, securitisation and some property investments could be affected.

Increased risk aversion is already in evidence. Emerging market risk spreads have more than doubled from their lows of 2007 and billions have been withdrawn from emerging market equities and bonds as investors have sought relative certainty. Similar widening spreads can be seen in most asset classes. We expect these spreads to remain above the low levels of recent years.

In South Africa, equity markets are not expensive and parts of our economy continue to grow unaffected by the global credit crunch. Our consumers are not nearly as heavily borrowed as those in developed markets and there will be room to lower interest rate in the future. If Asia continues to grow at a fast pace our commodity producers should benefit, while concerns about the US Dollar will benefit the gold price.

FTSE/JSE ALL SHARE PE



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The immediate impact on our markets has come from elevated risk aversion. Our unsettled domestic politics are unlikely to help although many other emerging markets currently have political issues.

We do not expect the world to stay the same, but underneath the turbulence opportunity is certain for the astute investor. A significant down-rating in equities has already happened, the outlook for the SA economy, while more moderate, is not bleak and a conservative, well diversified portfolio of undervalued companies should remain a cornerstone of a long term investment strategy.

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