Dynamic Wealth
Established in 1971

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ECONOMIC & MARKET ANALYSIS

Dynamic Wealth is an Authorised Financial Services Provider

NOVEMBER 2008

MARKET ANALYSIS

TABLE 1: KEY MARKET INDICATORS: OCTOBER 2008

INDICATOR	29 August closing	Monthly movement	Expectation for the month
ALSI	20992	-2844 (-11.93%)	Increase
Industrial Index	20446	-940 (-4.40%)	Increase
Gold Index	1689	-156 (-8.46%)	Increase
Financial Index	15452	-2613 (-14.46%)	Increase
SA Property Index	271	-19 (-6.55%)	Increase
Rand/dollar	9.89	+156 (+18.73%)	Appreciate
Gold Price	$729	-$174 (-19.24%)	Increase
Dow Jones	9325	-1526 (-14.06%)	Increase
FTSE-100	4377	-525 (-10.71%)	Increase
Nikkei	85769	-2683 (-23.83%)	Increase
Hang-Seng	13968	-4048 (-22.47%)	Increase
R157	9.10%	+24 (+2.75%)	Decrease

The international and local share markets are experiencing one of the biggest bear and volatile movements since the large share market crash in 1992. In the US, the Dow Jones lost more than 36% since the news of the sub-prime crisis hit financial markets on 10 October 2007. In the same manner, London's FTSE lost 33.9%, the Nikkei in Japan 50.3%, the Hang Seng in Hong Kong 50.15%, the Sydney All-Share index in Australia 40.4% and the ALSI on the JSE 36.5%. Share markets remain jittery despite the positive sentiment created by the large banking rescue package of the US government to the tune of $700 billion, the decrease in interest rates of 50 basis points in the US and the presidential election victory of Mr. Barack Obama. Investors initially drove share prices higher, only to be shocked back to reality by worsening US economic fundamentals. News that the US unemployment rate increased substantially to 6.5% in October – the highest in 14 years – and that the non-farm payrolls dropped by 220 000 make a US recession all but a reality. Therefore profit risks for most US companies are on the cards.

Elsewhere, the decisions of the European Central Bank and the Bank of England to cut interest rates by 50 and 150 basis points respectively, as well as the news of the investment spending stimulation package in China were welcomed by most analysts and should eventually contribute to a more positive sentiment on international share markets.

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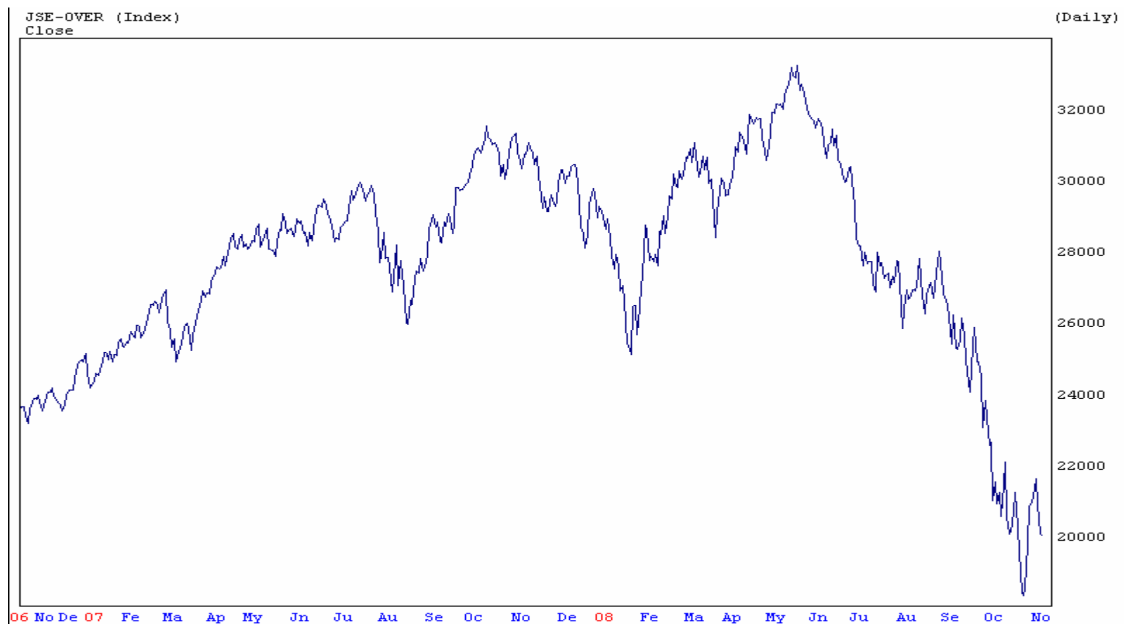
Figure 1: Will the JSE recover during November?



Despite a slight recovery of almost 12% in the JSE ALSI (between its lowest level of 17 812 points on 24 October 2008 and the closing at 20 030 points on 7 November 2008), the news of South Africa's credit rating being revised from a stable to negative outlook– due to the large deficit on the current account of the balance of payments, as well as negative indications that commodity prices will stay under pressure – may cause the volatility on the JSE to continue.

Nevertheless, we expect a recovery in share prices in November driven by further sharp decreases in the price of petrol, slower increases in food prices, sharp decline in the inflation rate, a stronger rand and international portfolio interest in South African shares. The somewhat more positive sentiment globally after the combined efforts by various countries to curb further recessionary pressures should also support commodity prices over the next few months. Therefore resources stocks on the JSE may hold its own.

TECHNICAL ANALYSIS

The Top 40 Index dropped a hefty 48.5% from its high on 22 May, and is now very close to the technical support level of 50%. It seems as if the Top 40 Index is establishing a base for 2008 – the low possibly being made on the 27th October. If the Index does not drop through the low of 16 122, the Top 40 Index will rally into 2009. Accumulating some shares at the current levels should be considered.

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TOP 40 Index

ECONOMIC ANALYSIS

INTERNATIONAL

Economic conditions in virtually every sector and every country worsened meaningfully since the second quarter of 2008. Indeed, international economic growth is forecast to decline by some 40% compared to 2007. Growth in especially developed countries such as the United States of America and Europe already disappeared, while developing countries are experiencing a marked slowdown in growth.

International economic growth is projected to decrease to 3% compared to 5% last year. The International Monetary Fund (IMF) also lowered the forecast for next year to 2.2%. In the US, the economy contracted by 0.3% in the third quarter after registering growth of 2.8% in the second quarter. According to the European Commission, a contraction in the third and fourth quarters will halve the EU growth rate of 2.7% in 2007 to a mere 1.4% in 2008. A further slowdown to only 0.2% in 2009 is expected. In China the growth rate for 2008 is projected at 8% from double digits last year. However, the growth outlook for 2009 is forecast to improve to 9%.

The faltering growth outlook contributed to commodity prices sliding at a brisk pace. The price of oil dropped to below $60 per barrel in late October compared to almost $150 in July.
Similarly, the platinum price dropped to levels of $800 per ounce from above $2200. Even the gold price – which normally acts as a safe haven during times of risk – slid from more than $1100 per ounce to below $800.

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The silver lining stemming from lower commodity prices is falling inflation and consequently lower interest rates in many countries. Even though inflation is due to remain subdued, it will be the last thing on central bankers' minds, as most are scrambling to soften the recession blow. As a result, world interest rates are to remain low for a prolonged period.

However, lower interest rates and the bank rescue packages of close to $4 trillion offered by governments will not be enough to break the recession shackles in the US and Europe. From the supply side, trust in the banking system needs to be restored in order to induce banks to resume their lending practices. And from the demand side, the massive cuts in interest rates should be complemented by fiscal stimulus packages, such as tax cuts and investment spending in order to induce property purchases by households – and to create jobs.

While the recovery period will be slow, developments in the US will be the key to this process. Newly elected president Barack Obama will face the mammoth task of reducing the fiscal deficit of more than 12% of gross domestic product, but simultaneously stimulating spending in the economy. It is worth noting that the US national debt burden increased from 5.7 trillion when the Bush administration took over 8 years ago to more than $11 trillion due to war and bank rescue package financing.

This will eventually catch up with the US and pressurize the strengthening dollar to weaken in the long run. The liquidity injected into the banking sector will evolve into inflation, pressurizing interest rates to increase, thereby neutralizing some of the dollar weakening. However, the net result could be rand positive as it will – in the long run – contribute to the rand strengthening again.

SOUTH AFRICA

Economic growth

Notwithstanding a slowdown in economic growth in the second half of this year (third quarter growth will be announced on 25 November), the growth rate for 2008 should still exceed 3%, thanks to high investment and government spending growth. The construction, transport and telecommunications as well as agricultural sectors should continue to be the star performers.

Considering the impact of higher interest rates and inflation, as well as the falling international demand for South African exports, the growth rate could recede to below 3% next year. Notwithstanding the views of other analysts, Dynamic Wealth is not projecting an economic recession for South Africa – as investment and government spending multipliers will support growth.

The recovery period is expected to commence in the second half of next year.

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TABLE 2: KEY ECONOMIC INDICATORS

ECONOMIC INDICATOR	Latest*	Period	Previous	2007	2006
Consumer Price Inflation (CPI)	**13.1%**	Sept	13.7%	7.1%	4.7%
Inflation Target (CPIX)	**13%**	Sept	13.6 %	6.5%	4.6%
Production Price Inflation: PPI	**16%**	Sept	19.1%	10.0%	7.7%
M3-Money Supply Growth	**15.2%**	Sept	15.4%	22.2%	22.8%
Private Sector Credit Growth	**16.4%**	Sept	18.6%	23.7%	24.1%
Repo Rate	**12%**	Sept	12%	11.0	8.0
Prime Rate	**15.5%**	Sept	15.5%	14.5%	12.5%
Current Account Deficit (CAD) – actual amount (R'billion)	**R39.1**	Q2	R41.1	R145	R112.4
Trade Deficit(-)/surplus (R'billion) – SARS amount[**)]	**-R61.6**	Jan- Sept	-R54.4	R69.3	-R68.6
Net foreign purchases of shares and bonds (R'billion)	**-R9**	Jan- Sept	R11.7	R83.8	R107.8
Reserves accumulated after financing of the CAD (R'billion)	**R19.9**	Jan- Sept	R18.2	R47.8	R29.7
Net cum. foreign reserves (R' billion)	**$32.1**	Oct	$33.6	$31.3	$22.98
Economic Growth	**4.9%**	Q2	2.1%	5.1%	5.4%
Retail Sales	**-5.5%**	Aug	-4.6%	5.1%	9.6%
Manufacturing Production-Volume	**0.4%**	Aug	3.5%	4.1%	4.8%
Unemployment (official definition)	**23.2%**	Q3	23.1%	25.5	25.6%

* The terms period, latest and previous refer to year-on-year growth for the latest and previous months. Economic growth refers to quarter-on-quarter growth expressed in annual terms adjusted for seasonal factors – previous refers to the same growth rate between the previous two quarters. Cumulative numbers refer to the total amount from the beginning of the year to the respective months.
** The trade deficit of the South African Revenue Service (SARS) differs from the South African Reserve Bank amount – the latter is used for calculating the CAD.

Imbalances abating

The imbalances contributing to the fast but unhealthy and therefore unsustainable economic growth rates over the last four years are finally showing signs of abatement.

Growth in credit to the private sector is plunging at a relatively fast pace. In addition, household consumption spending is receding in several categories. The falling savings rate changed to an increasing trend. Consequently, growth in money creation is also slowing.

Though these developments will lessen the pressure on inflation, many supply side imbalances remain. This includes the skills shortage, poor service delivery, lack of adequate production capacity and comparatively high growth in imports to finance infrastructure shortages. Until these deficiencies are rectified, a set level of inflation pressure (which was suppressed by the strong rand for four years) will remain.

The deficit on the current account of the balance of payments will also remain high due to structural problems with South African economic policy which induces increases in foreign payments and prevents higher increases in foreign receipts. Until the myriad of issues involved are addressed, the current account deficit will remain at levels of 7% of gross domestic product and higher.

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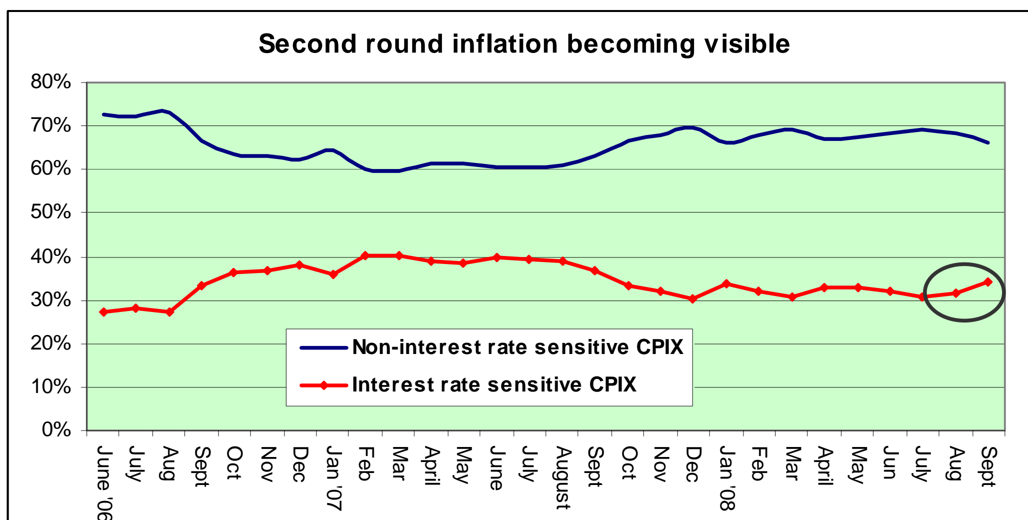
Inflation and interest rates

After finally reaching a peak in August at 13.6%, inflation is set to increase at lower rates. Apart from the aforementioned inflation drivers, a few developments need to be taken into account when focusing on the future course of inflation.

Firstly, the inflation target measure will change from the CPIX to CPI for all urban areas (CPIU) from January 2009. Due to some big changes in the weights of some goods and services, new inflation drivers will emerge. The new drivers will be rental inflation which will assume a weight of 16%, almost equal to that of food. In addition, the weight of the cost of motor vehicles will increase substantially. This will put upward pressure on the CPIU as car manufacturers already indicated progressive price increases of up to 25% (which started in August.) However, the weight of petrol will drop slightly. Though the new weightings will cause a technical drop in CPIU for January 2009, more clarity on the impact of these changes will be known in February when the CPIU for January is announced.

Secondly, the net impact of the drop in commodity prices must be weighed against the rand's depreciation. Commodity prices on average declined by 25% in dollar terms. Though the drop was only 20% in rand terms, it still indicates a net lowering impact on inflation.

In the third instance, the rand depreciation might contribute to second-round inflation affecting prices of many goods and services by the second half of next year. The impact of this phenomenon should be monitored closely considering that interest rate sensitive inflation (an indication of second-round effects) has only recently started to increase its contribution to CPIX. Indeed, the drop in the CPIX for September to 13% was caused by non-sensitive interest rate inflation which dropped from 20.4% in August to 18.8%. However, with interest rate sensitive inflation increasing at 8.1% in September compared to 6.8% only three months previously, its contribution to CPIX increased to 34% in September from 30% in July (see graph below).



Should the second round impact of the rand's sharp depreciation feed into prices at a stronger pace, the South African Reserve Bank might postpone interest rate decreases to June next year. The problem the Reserve Bank faces is that the second round of inflation only becomes visible after a prolonged period of time. This will complicate interest rate decisions.

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Conclusion

While world growth is faltering, the South African economy will continue to grow, albeit at a slower pace. Companies in most sectors will continue to make profits and unemployment increases will be subdued. While especially demand side imbalances are abating, those on the supply side remain. As this can easily cause a new burst of inflation, interest rates should not be reduced too aggressively.

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