The Weekly Focus

A market and economic update

14 September 2009

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Newsflash

The JSE All Share Index had risen by 98% in dollar terms since the 9th of March.

Paper demand driving commodities

- Canadian Investment Research House, BCA, notes that anecdotal evidence continues to accumulate regarding long-term institutional investors raising their strategic allocation to commodities and related investments.
- This “paper” or investment demand (to differentiate it from end-user demand), along with stockpiling in China, helps to explain why commodity prices have risen sharply in 2009 while most economies were still in the doldrums.
- These sharp moves in the prices of copper, platinum etc have confused many investors because end demand has been weak for much of the year.
- BCA suggests that many investors are buying commodities as a hedge against future inflation and a lower US dollar. These investors are concerned that certain measures adopted by central banks, such as quantitative easing (governments buying back bonds) and debt financing will lead to high inflation and a weaker dollar.
- BCA do not agree with the inflation fear, but agree that commodities are attractive as an asset class because they offer both inflation protection and are a play on the Chinese growth story.
- BCA do not think that commodities are overpriced at this stage, although they are vulnerable to short-term setbacks on any growth disappointments because they have moved up ahead of global economic activity (this is different from the past).
- They note that last week the US dollar fell to 2009 lows against the euro, Swiss franc and Aussie dollar. Despite the possibility of rallies along the way (such as during stock market corrections), they think the dollar could still decline by 10-15% over the next year, for a variety of reasons. One reason is that reduced safe-haven demand is dollar-bearish because funds flow out of low-yielding US Treasury Bills and into riskier assets with higher prospective rates of return outside the US.
- Also, they think the dollar is a counter-cyclical currency and tends to weaken when global growth is recovering. In addition, China is likely to continue to gradually diversify its massive foreign exchange holdings away from the dollar into other currencies.
- The Canadian and Aussie dollars are BCA’s top currency picks because of their commodity views.
- Below we show a graph (Graph 1) of the US dollar’s trade-weighted index, i.e. an index comprised of the dollar against its major trading partners.
- It shows how the dollar has depreciated quite sharply so far in 2009, starting in March when the equity markets bottomed.

- The chart shows the dollar's down-trend to be firmly intact for now, although any correction in stock markets could cause a dollar rally if investors turn risk-averse again and buy back into US Treasury Bills.

Graph 1

JSE corrects on Monday morning

- As of Friday's market close, the JSE All Share Index had risen by 98% in dollar terms since the 9th of March. The move since the JSE's dollar low on 24th of October was 105%. No question, this is a very big move.
- In rand terms, the JSE was up 41% from the 9th of March, or 43% from the rand low on the 20th of November 2008.
- Friday marked the 8th anniversary since the terrorist attack on the US and the JSE hit a 2009 high. It is also now one year since Lehman Bros hit the wall.
- The "elastic" may have become a bit too stretched in the short-term, leading to the sell-off on the JSE on Monday morning. Maybe our stock market is leading the big western markets this time round instead of always being a follower.
- According to Citibank, foreign investors have now invested a net R60 billion on the JSE so far in 2009, some R6 billion more than they sold in 2008. With a dollar return of almost 100% since early March, they could be forgiven for taking some profits if they are doing so this Monday morning. After all, rand strength has been extremely favourable for these investors so far.

- If one looks at the “new” SA price-to-earnings (PE) ratio, the average since 1994 has been 14.6 and currently the JSE All Share Index is trading on an historic PE of 13.9. That is based on very weak earnings, the E in PE, from virtually all JSE sectors so far in 2009. As the earnings recover and increase into 2010, the PE ratio (price divided by earnings) will decline if the market remains at these levels.

Snippets of Info

- Merrill Lynch is forecasting that the US S&P 500 stock market Index will rise by 15% over the next year.
- They are forecasting some dramatic earnings increases, from a very low base, for Japan of 114% in 2009 and a further 81% in 2010; similarly for South Korea, they are forecasting that earnings will grow by 60% in 2009 and by a further 30% in 2010.
- US stock market analyst, Elaine Garzarelli, says her quantitative system of valuing the US stock market remains bullish at 83%. She sees market corrections as buying opportunities and recommends being very overweight in the US stock market in resource shares, industrial shares and consumer discretionary shares, overweight in IT shares and financial shares and very underweight in defensive sectors like health care, consumer staples (necessities) and utilities (mostly electricity companies).

Paul Hansen
(Director: Group Advisory Services - Investments)

Economic Update

What a week! Equity markets surged to year highs, the gold price soared past $1000/oz and the Rand strengthened, trading at levels last seen in 2001. The OECD (Organisation of Economically Co operative and developed countries) released their leading economic indicator for July, which continues to show an improvement, and stronger signs of recovery in most OECD countries, especially the G7 group of countries (US, UK, France, Italy, Germany, Japan and Canada). After a 23% (local currency) decline in the Chinese equity market in August, it has since rebounded about 12% as China continues to power ahead with their most recent economic data in strong confirmation of this view. At the G20 meeting last week, the finance ministers and central bank governors emphasized that fiscal and monetary policy would not be reverted for a while, as the financial crisis is not yet over, and they hope to minimize the chance of a double dip recession.

Back home, the bond market ended the week slightly stronger due to the strong Rand and good corporate bond auctions held during the week, due to increased demand. Manufacturing production was much higher than expected in July, with industrial activity levels appearing to have stabilized, albeit at a very low level.

Global

- The **Gold price** breached the $1000/oz level last week on the back of momentum and safe haven buying; dollar weakness and financial market uncertainty. Also, many investors still view gold as a potential inflation hedge. What is of interest is that ETF's (exchange traded funds) are now the 6th largest holders of gold in the world.
- South African gold production fell by 9.3%y/y during the second quarter to its lowest level in 86 years! We are now the world's 3rd largest producer, falling behind China and the USA.
- The Bank of England left their interest rate unchanged at 0.5%; it has been at this level since March this year. Similarly the Bank of Canada left their rate unchanged at 0.25% and the Reserve Bank of New Zealand left their rate at 2.5% after cutting it by 5.75% since July this year.

- **The OECD leading economic indicator** for July shows stronger signs of a recovery in most OECD countries, especially the G7 economies. Within the G7 countries, the improvement in France and Italy is now very noticeable.

- *The OECD countries comprise around 61% of world GDP. The OECD-Total covers the following 29 countries, namely: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Korea, Luxembourg, Mexico,* *Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States.*

- There is a fairly strong relationship between the OECD leading indicator and industrial production, which suggests that industrial production, will continue to improve in the months ahead. Importantly, there is a very basic relationship between the OECD leading indicator and industrial/metal prices. **This relationship would suggest a further improvement in commodity prices over the next 6 to 12 month. T**he OECD leading indicator excludes the BRIC (Brazil, Russia, India & China) countries, which are obviously also key to the commodity price outlook.

- **China continues to power ahead:** In contrast with the stock-market 'worry' during August, most recent Chinese economic data appear to confirm that the economy continues to power ahead; and if anything, the recovery is becoming somewhat broader based. For example, August Industrial Production was up 12.3%y/y, Auto production was up 90%y/y, cement 24%y/y and steel 22%y/y.
- **Domestic demand remains strong**. Retail sales growth continues to accelerate, up 15.4%y/y in August. Fixed asset investment was up 33.6%y/y in August, M2 (money supply) growth was 28.5%y/y in August, while loan growth was 34.1%y/y.
- Perhaps the most significant and recent change now evident in China's economy is a revival in exports**. For 2009 we forecast China's GDP to grow by 8%, down from 9% in 2008. In 2010 GDP growth is expected to improve to around 9.5%.**

South Africa

Key reasons why the Rand is currently especially strong (and not just because the Dollar is weak):

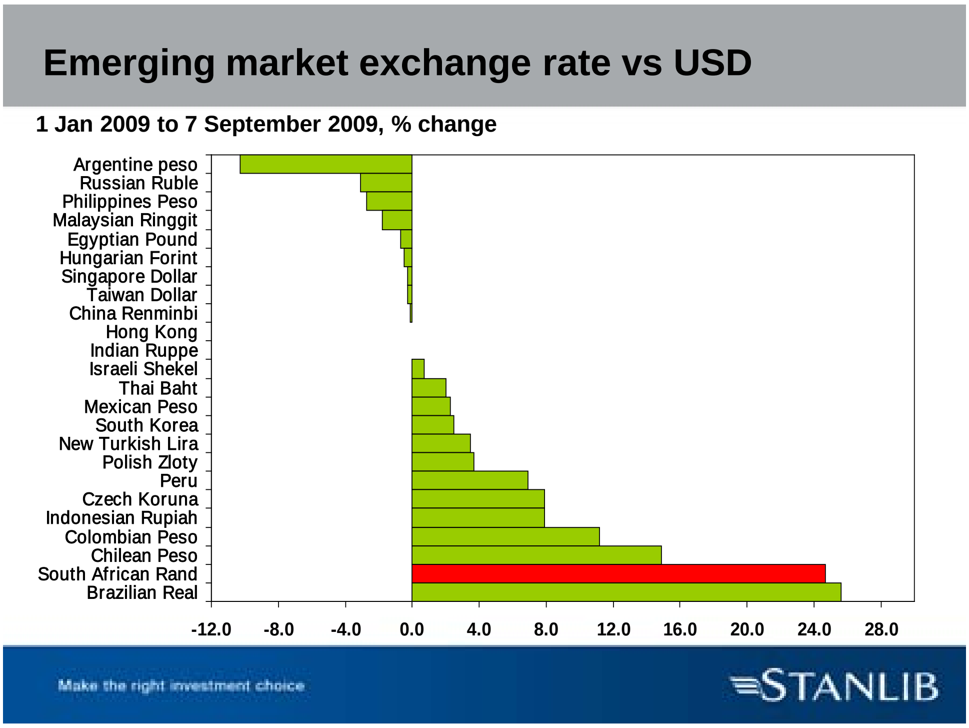
- SA is now running a trade surplus due to sharply declining imports. Dividend outflows have fallen sharply; our current account deficit has improved dramatically from 7% of GDP in Q1 2009 to 3.2% of GDP in Q2 2009. We are running a positive interest rate spread when measured against the major developed economies. Our foreign currency credit rating was upgraded on 16 July 2009 to an 'A' rating.
- Foreign tourism inflows have improved noticeably this year, helped by the sporting events. There has been a large increase in investment flows into emerging markets this year, including SA. Year-to-date foreign investors has purchased (net) almost R60bn of SA equities; reversing the outflows we saw last year.

- SA's foreign exchange reserves have risen significantly to over $36 billion in August 2009. Our banking, financial system and fiscal balances have weathered the global financial crisis extremely well, and the possible MTN/Bharti deal (for which exchange control approval has been sought) could have led to additional 'speculative' strength.

Our **current outlook for the Rand** is as follows:

- A uniquely large range of Rand-positive factors are currently combining to impact the currency. These positive factors are expected to remain mostly 'in-play' for the next 3 to 6 months. The Dollar is expected to remain under pressure.
- The technical fair-value for the Rand is around R8.20/$. **Hence the Rand is currently considered to be over-bought or technically over-valued**. We are currently forecasting a Rand/Dollar rate of around R8.00/$ by year-end 2009 and R8.40 by end 2010.
- The Rand remains an extremely volatile currency by emerging-market-currency standards; we don't expect that this will change. Internationally the Rand is viewed as the key 'risk' trade currency. The Rand was the **worst performing emerging market currency in 2008** and as can be seen from the graph below (Graph 2), **up until early September 2009, the Rand was the second best performing emerging market currency!**

Graph 2



- In July 2009, SA **manufacturing production** rose by a robust 3.3%m/m (seasonally adjusted). The market was expecting an increase of 0.8%m/m. This means that production has now increased for three consecutive months, after declining for ten consecutive months. Although manufacturing activity is still down at levels that prevailed as far back as 2004, there are now clear signs of stability and an improvement, off a very low base, in some industries.
- **On an annual basis, production is still down a very substantial 13.7%y/y,** but this is at least much better than the decline of -21.7%y/y recorded in April 2009. Manufacturing activity certainly appears to be moving past the worst of the recession, although the stability/improvement is still not broad-based but rather still confined to selected industries.
- Given recent signs of stability and tentative improvement in the local PMI (purchasing manager's index) readings, we expect manufacturing activity levels to show further signs of improvement in the coming 3 to 6 months.

Kevin Lings and Melissa Dyer (née Rankin)
(STANLIB Economics and Group Advisory Services)

Rates

The following yields are calculated using an annualised seven-day rolling average as per the unit trust industry standard. These rates are expressed in nominal and effective terms and should be used for indication purposes ONLY.

Standard Bank Money Market Fund

Nominal: 7.56% per annum

Effective: 7.82% per annum

A constant unit price will be maintained. Past performance is not necessarily a guide to future performance. A schedule of fees and charges and maximum commission is available on request from the Manager. Commission and incentives may be paid and if so, are included in the overall costs. The yield is calculated using an annualised seven-day rolling average as at 11 September 2009.

STANLIB Cash Plus Fund

Effective Yield: 8.18%

This is a current yield as at 11 September 2009.

STANLIB Dividend Income Fund

Effective Yield: 5.56%

This is a current yield as at 11 September 2009.

Glossary of Terminology

Bonds — A bond is an interest-bearing debt instrument, traditionally issued by governments as part of their budget funding sources, and now also issued by local authorities (municipalities), parastatals (Eskom) and companies. Bonds issued by the central government are often called “gilts”. Bond issuers pay interest (called the “coupon”) to the bondholder every 6 months. The price/value of a bond has an inverse relationship to the prevailing interest rate, so if the interest rate goes up, the value goes down, and vice versa. Bonds/gilts generally have a lower risk than shares because the holder of a gilt has the security of knowing that the gilt will be repaid in full by government or semi-government authorities at a specific time in the future. An investment in this type of asset should be viewed with a 3 to 6 year horizon.

Cash — An investment in cash usually refers to a savings or fixed-deposit account with a bank, or to a money market investment. Cash is generally regarded as the safest investment. Whilst it is theoretically possible to make a capital loss investing in cash, it is highly unlikely. An investment in this type of asset should be viewed with a 1 to 3 year horizon.

Collective Investments — Collective investments are investments in which investors‟ funds are pooled and managed by professional managers. Investing in shares has traditionally yielded unrivalled returns, offering investors the opportunity to build real wealth. Yet, the large amounts of money required to purchase these shares is often out of reach of smaller investors. The pooling of investors’ funds makes collective investments the ideal option, providing cost effective access to the world’s stock markets. This is why investing in collective investments has become so popular the world over and is considered a sound financial move by most investors.

Compound Interest — Compound interest refers to the interest earned on interest that was earned earlier and credited to the capital amount. For example, if you deposit R1 000 in a bank account at 10% and interest is calculated annually, your balance will be R1 100 at the end of the first year and R1 210 at the end of the second year. That extra R10, which was earned on the interest from the first year, is the result of compound interest ("interest on interest"). Interest can also be compounded on a monthly, quarterly, half-yearly or other basis.

Dividend Yields — The dividend yield is a financial ratio that shows how much a company pays out in dividends each year relative to its share price. The higher the yield, the more money you will get back on your investment.

Dividends — When you buy equities offered by a company, you are effectively buying a portion of the company. Dividends are an investor’s share of a company’s profits, given to him or her as a part-owner of the company.

Earnings per share — Earnings per share is a measure of how much money the company has available for distribution to shareholders. A company’s earnings per share is a good indication of its profitability and is generally considered to be the most important variable in determining a company’s share price.

Equity — A share represents an institution/individual’s ownership in a listed company and is the vehicle through which the are able to “share” in the profits made by that company. As the company grows, and the expectation of improved profits increases, the market price of the share will increase and this translates into a capital gain for the shareholder. Similarly, negative sentiment about the company will result in the share price falling. Shares/equities are usually considered to have the potential for the highest return of all the investment classes, but with a higher level of risk i.e. share investments have the most volatile returns over the short term. An investment in this type of asset should be viewed with a 7 to 10 year horizon.

Financial Markets	Financial markets are the institutional arrangements and conventions that exist for the issue and trading of financial instruments.
Fixed Interest Funds	Fixed interest funds invest in bonds, fixed-interest and money market instruments. Interest income is a feature of these funds and, in general, capital should remain stable.
Gross Domestic Product (GDP)	The Gross Domestic Product measures the total volume of goods and services produced in the economy. Therefore, the percentage change in the GDP from year to year reflects the country's annual economic growth rate.
Growth Funds	Growth funds seek maximum capital appreciation by investing in rapidly growing companies across all sectors of the JSE. Growth companies are those whose profits are in a strong upward trend, or are expected to grow strongly, and which normally trade at a higher-than-average price/earnings ratio.
Industrial Funds	Industrial funds invest in selected industrial companies listed on the JSE, but excluding all companies listed in the resources and financial economic groups.
Investment Portfolio	An investment portfolio is a collection of securities owned by an individual or institution (such as a collective investment scheme). A funds' portfolio may include a combination of financial instruments such as bonds, equities, money market securities, etc. The theory is that the investments should be spread over a range of options in order to diversify and spread risk.
JSE Securities Exchange	The primary role of the JSE Securities Exchange is to provide a market where securities can be freely traded under regulated procedures.
Price to earnings ratio	Price to earnings ratio or p:e ratio, is calculated by dividing the price per share by the earnings per share. This ratio provides a better indication of the value of a share, than the market price alone. For example, all things being equal, a R10 share with a P/E of 75 is much more "expensive" than a R100 share with a P/E of 20.
Property	Property has some attributes of shares and some attributes of bonds. Property yields are normally stable and predictable because they comprise many contractual leases. These leases generate rental income that is passed through to investors. Property share prices however fluctuate with supply and demand and are counter cyclical to the interest rate cycle. Property is an excellent inflation hedge as rentals escalate with inflation, ensuring distribution growth, and property values escalate with inflation ensuring net asset value growth. This ensures real returns over the long term.
Resources and Basic Industries Funds	These funds seek capital appreciation by investing in the shares of companies whose main business operations involve the exploration, mining, distribution and processing of metals, minerals, energy, chemicals, forestry and other natural resources, or where at least 50 percent of their earnings are derived from such business activities, and excludes service providers to these companies.
Smaller Companies Funds	Smaller Companies Funds seek maximum capital appreciation by investing in both established smaller companies and emerging companies. At least 75 percent of the fund must be invested in small- to mid-cap shares which fall outside of the top 40 JSE-listed companies by market capitalisation.
Value Funds	These funds aim to deliver medium- to long-term capital appreciation by investing in value shares with low price/earnings ratios and shares which trade at a discount to their net asset value.

Sources: Unit Trust and Collective Investments (September 2007), The Financial Sector Charter Council, Personal Finance (30 November 2002), Introduction to Financial Markets, Personal Finance, Quarter 4 2007, Investopedia (www.investopedia.com) and The South African Financial Planning Handbook 2004.

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