Dynamic Wealth
Established in 1971

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ECONOMIC & MARKET ANALYSIS

Dynamic Wealth is an Authorised Financial Services Provider

JUNE 2008

MARKET ANALYSIS

TABLE 1: KEY MARKET INDICATORS MAY 2008

INDICATOR	30 May closing	Monthly movement	Expectation for the month
ALSI	31859	+1098(+3.57%)	Increase
Industrial Index	25139	+801(+3.29%)	Increase
Gold Index	2226	-23 (-1.02%)	Volatile
Financial Index	18257	1335 (-6.81%)	Decrease
SA Property Index	261	-21(-7.29%)	Decrease
Rand/dollar	R7.62	+7(+0.91%)	R7.70-R8.15
Gold Price	$886	Nil	$860-$900
Dow Jones	12638	-181(-1.42%)	Decrease
FTSE-100	6053	-34 (-0.56%)	Increase
Nikkei	14338	+488 (+3.53%)	Increase
Hang-Seng	24123	-1632(-6.34%)	Decrease
R157	10.14%	+64 (+6.74%)	Increase

Due to record increases in the international prices for food and oil (18.35% increase over the past six weeks), world financial markets continued its uncertain and volatile movements during May and the first two weeks of June. Commodity prices and commodity share prices increased while retail, financial and property share prices decreased. The Dow Jones and FTSE indices have been volatile each week since 30 April, moving in opposite directions. Inflation and interest rate uncertainties overshadow these markets.

The oil price debate contributes to the volatility. Different studies from different angles come to different conclusions. Thus, the forecast for the oil price within the next two years range from $40 per barrel to $200 per barrel. Further uncertainties on the US inflation vs recession issues also contribute to the volatile movements on international bourses. Given the current inflationary pressures caused by the rising oil prices, higher interest rates across the globe become more certain. Therefore, economic growth for 2008 was downscaled by the World Bank from 5.0% to 3.8%. Japan seems to be the exception with an expected sharp increase in economic growth for 2008 to more than 3.0% from almost zero in 2007. Therefore it is expected that the Nikkei index will continue to rise sharply.

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Figure 1: The difference in performance of the JSE resource 20 and financial indices

Domestically, the skew performance on the JSE continues (see Figure 1). The sharp increases in commodity prices, especially platinum, coal, iron ore and soft commodities are pushing up the Resources 20 index nearly on a daily basis (27.91% increase for the year to date) against the financial index (down by 22.3% for the year). In this sense the ALSI has gained just more than 7% since the beginning of the year until the close on Friday, 13 June 2008. The volatility is illustrated by the downward movement from the 14.75% level on 22 May to 5.1% on 6 June.

The main fundamental drivers of the share, bond, money and property markets in South Africa are the two imbalances, namely the increasing inflation rate and the escalation in the current account deficit. Inflation X is expected to reach the 12% level by August, up from the 6.3% of August 2007. In the same manner the current account deficit as % of GDP has increased from 6.9% in the first quarter of 2007 to 9.0% in the first quarter of 2008 (see the Economic Analysis). These two imbalances, together with the international oil price, US sub-prime problems, $/Euro exchange rate and world inflation will dominate the movement in share prices for the rest of the year.

TECHNICAL ANALYSIS

The Top 40 index weakened substantially in May – breaking the upward trend line. The index has now started to form a classic head and shoulders formation, which is indicating that a market reversal is about to take place. As can be seen from the chart, the right shoulder is currently being formed. If this does happen and the Top 40 index breaks down through the neckline 28650, the index will like fall some 10% to 15% from its current level to 25550.

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Figure 2: TOP 40 Index

ECONOMIC ANALYSIS

INTERNATIONAL

Sharply increasing inflation expectations driven primarily by high oil prices (touching $139 per barrel in June) are dominating the world stage. To counter the rising oil and food driven inflation, interest rates are being increased worldwide. Due to the adverse impact of these developments on consumers, protests against the high oil prices are being held all over the world. As such, an International Oil Summit was held on 22 June. The main message was that supply cannot keep pace with demand.

Though the BRIC countries are having an ever increasing impact on the world economy, it is the developments in the United States (US) that are determining world economic trends. The main actors are increasing inflation and a fragile consumer driven economy. The US predicament is that it has to counter inflation, but cannot do so with higher interest rates as it will dampen economic growth prospects even further. As a result, the government and central bank are employing jaw boning tactics trying to talk the dollar stronger in an attempt to lower import prices (especially oil) and thus inflation increases. Current estimates by the International Monetary Fund show that the weaker dollar is responsible for about one-third in the increase of the oil price.

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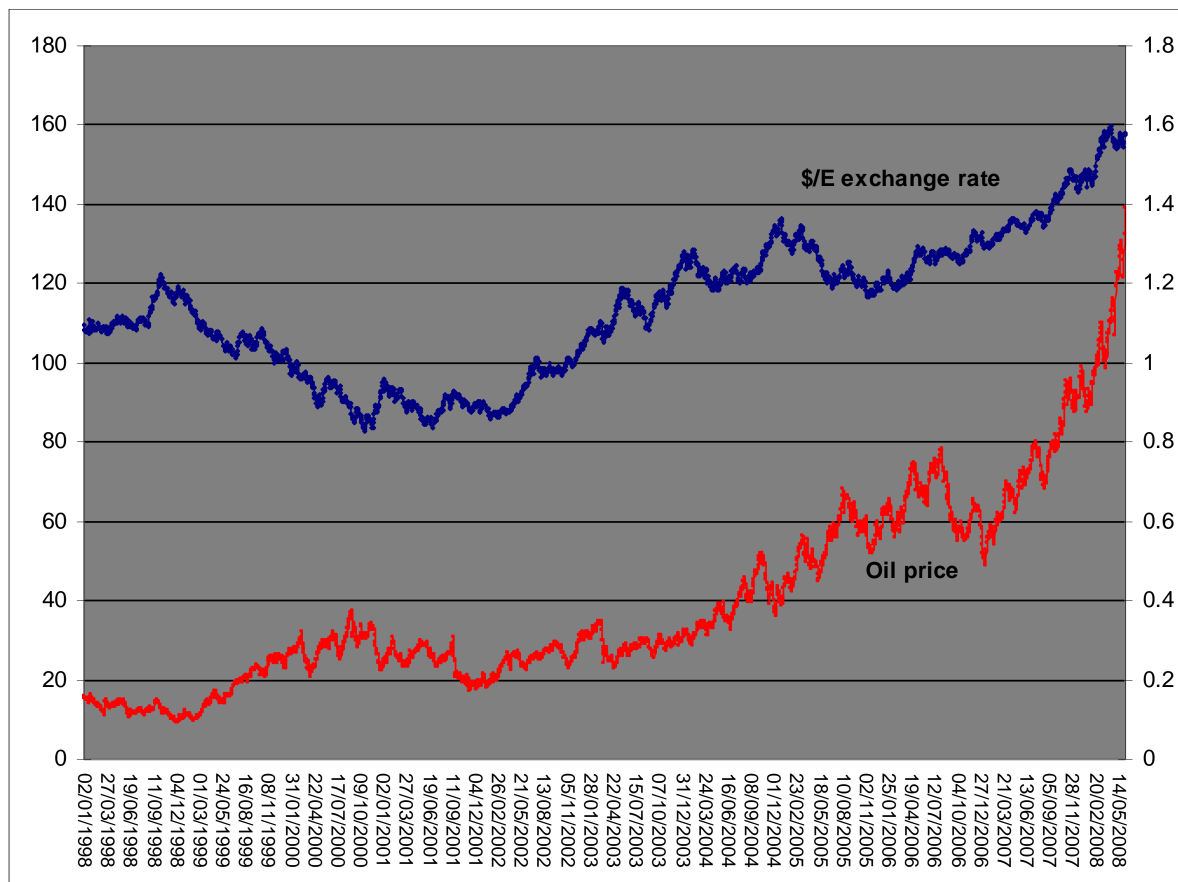
Figure 3 – Oil price increases as dollar weakens



For this 'stronger dollar jaw boning' strategy to be successful though, the dollar appreciation must outweigh the imported inflation. And the appreciation must be sustainable. In both cases this appears to be very unlikely.

Firstly, even though the dollar has at times appreciated by 4% since the start of the jaw boning tactics a month ago, prices are rising faster in countries which make up the bulk of US imports. And Asian inflation hit 7.5% in April – double the rate a year ago. In the Middle East, the inflation rates of oil exporters such as Saudi Arabia, Oman, Qatar and Kuwait are on course to double from last year's already higher rates.
Secondly, a stronger currency must be driven by fundamentals. This does not appear to be the case in the US. The trade deficit is increasing again as exporters are not able to produce more, while unemployment has risen to 5.5%.

Therefore, until such time when fundamentals point to a strengthening currency, the appreciation might be of short-term nature.

SOUTH AFRICA

Economic growth is slowing, the currency is on a declining trend, inflation is increasing and interest rates are set to increase further. Though enough cause for pessimism, it also forms part of the economic rebalancing package. The end result will be a sounder economy.

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TABLE 2: KEY ECONOMIC INDICATORS

ECONOMIC INDICATOR	Latest*	Period	Previous	2007	2006
Consumer Price Inflation (CPI)	**11.1%**	Apr	10.6%	7.1%	4.7%
Inflation Target (CPIX)	**10.4%**	Apr	10.1%	6.5%	4.6%
Production Price Inflation: PPI	**12.4%**	Apr	11.8%	10.0%	7.7%
M3-Money Supply Growth	**21.1%**	Apr	21%	22.2%	22.8%
Private Sector Credit Growth	**19.6%**	Apr	22.6%	23.7%	24.1%
Repo Rate	**12%**	June	11.5%	11.0	8.0
Prime Rate	**15.5%**	June	15%	14.5%	12.5%
Current Account Deficit (CAD) – actual amount (R'billion)	**R41.1**	Q1	R38.1	R145	R112.4
Trade Deficit(-)/surplus (R'billion) – SARS amount)**	**-R31.6**	Jan-Apr	R20.9	R69.3	-R68.6
Net foreign purchases of shares and bonds (R'billion)	**R18.1**	Jan-Apr	-R22	R83.8	R107.8
Reserves accumulated after financing of the CAD (R'billion)	**R8.7**	Jan-Apr	R6.4	R47.8	R29.7
Net cum. foreign reserves (R' billion)	**$32.9**	Apr	$33.1	$31.3	$22.98
Economic Growth	**2.1%**	Q 1	5.3%	5.1%	5.4%
Retail Sales	**-0.3%**	Apr	-1.5%	5.1%	9.6%
Manufacturing Production-Volume	**9.8%**	April	-1.1%	4.1%	4.8%
Unemployment (official definition)	**23%**	Sept'07	25.5%	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.

ECONOMIC GROWTH

Economic growth momentum (growth between quarter four and quarter one annualized and adjusted for seasonal factors) for the first quarter has slowed to 2.1% from 5.3% in the fourth quarter. However, a fact missed by most analysts is that economic growth was still 4% if compared to the first quarter of last year. This is a remarkable accomplishment considering the electricity crisis, higher interest rates and rising oil and food prices.

Growth momentum was driven by the construction, trade and finance sectors. The construction sector sparkled again with momentum growth of 14.9% to contribute 0.5% to the growth rate of 2.1%. Despite higher prices and interest rates, the trade sector registered a growth rate of 3.6% (compared to 2.1% in the fourth quarter), while the financial sector recorded 4.9% (8.5% in the fourth quarter). Not to be missed is the 12.5% growth momentum of the agricultural sector.

However, mining growth momentum contracted at a rate of 22.1%, subtracting 1.1% from the economic growth rate. Manufacturing also contracted 1%, thereby lowering the growth rate by 0.2%.

Apart from the electricity crisis, growth momentum was also adversely affected by the Easter public holidays falling in the first quarter (second quarter last year), thereby subtracting production. Though the growth momentum for the second quarter will be affected by the higher inflation and interest rates, it might advance due to the public holiday technicality.

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On the demand side, household spending momentum growth (3.3%) outpaced income growth (2.7%) and as such increased dissaving by households to 0.7% of disposable income from 0.6%. Investment spending momentum accelerated to 14.7% from 14.1% in the first quarter. This contributed to gross domestic expenditure accelerating at a pace of 14.2% outpacing production growth by far.

INFLATION AND INTEREST RATES

Though the repo rate was increased to 12%, pushing the prime rate to 15.5% on 12 June, the end of the increasing cycle is in sight. Another increase of 50 basis points in August seems a foregone conclusion, but it might be the last rate increase in this cycle – permitting oil prices not increasing further.

The Monetary Policy Committee in its statement increased its inflation forecast to an average of 12% in the third quarter, after which it should gradually trend downward to reach the inflation target band in the third quarter of 2010.

However, electricity and oil price increases will determine the magnitude of the inflation increase. Should the government assist Eskom, the inflation impact of electricity rate increases can be limited. And if oil prices decline, the increase in the CPIX will fall sharply.

Another factor to be watched closely is international developments in interest rates. Should rates increase in the EU and US, it might lead to an outflow of portfolio capital which will contribute to the rand depreciating. Should the depreciation be severe, interest rates might have to be increased beyond August.

CURRENT ACCOUNT DEFICIT

The CAD momentum increased to 9% of Gross Domestic Product (GDP) in the first quarter from 7.5% in the fourth quarter due to spending exceeding production. Though the highest CAD in the country's history, it must be viewed with caution.

Firstly, electricity problems contributed to slower production, thereby lowering the GDP and exaggerating the relationship between the CAD and GDP. Secondly, electricity outages contributed to lower exports, thereby increasing the trade deficit.

Thus the CAD might have been lower under normal conditions. However, the CAD will remain large as the big infrastructure imports are only starting. And it will be sustained until the electricity problem is fixed and oil prices subside (as together with machinery it is the biggest import items). The CAD will thus for some time remain a big risk for the rand exchange rate, inflation and interest rates.

OUTLOOK

Lower economic growth, high inflation and more pressure on interest rates remain to be the outlook. However, all can change in an instant should oil prices fall back to the $100 per barrel level. This will however only happen if OPEC and non-OPEC decide to produce more oil, or if Chinese economic growth plummets, sending the world close to an economic recession – something that should be avoided.

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