progressive prosperity

CRISIS OF CONFIDENCE…

Market Overview

September 2011

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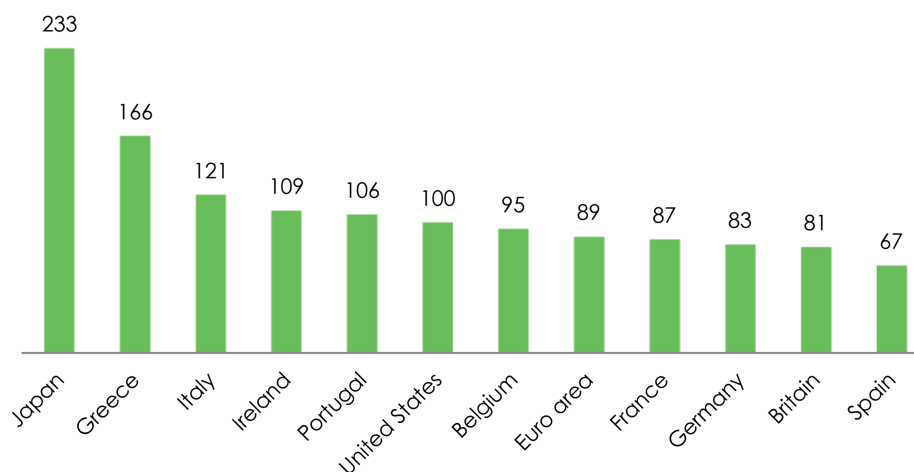
Third Quarter in Review

GLOBAL

Circumstances earlier this year suggested that the world economy was merely going through a mid-cycle slowdown. However, more evidence appeared during the quarter suggesting that this is a sustained slowdown and that the potential for a double-dip recession has grown. Global growth has started to splutter, three years into the debt-laden recovery. Amplifying the global growth situation has seen a loss of confidence in policymakers and their ability to deal with the challenges. Political bickering and policy paralysis has gripped the world at a time when structural problems, including the growing debt crisis, have escalated. One of the world's largest fixed interest asset managers compares developed countries' sovereign balance sheets to "an overweight diabetic on the verge of a heart attack".



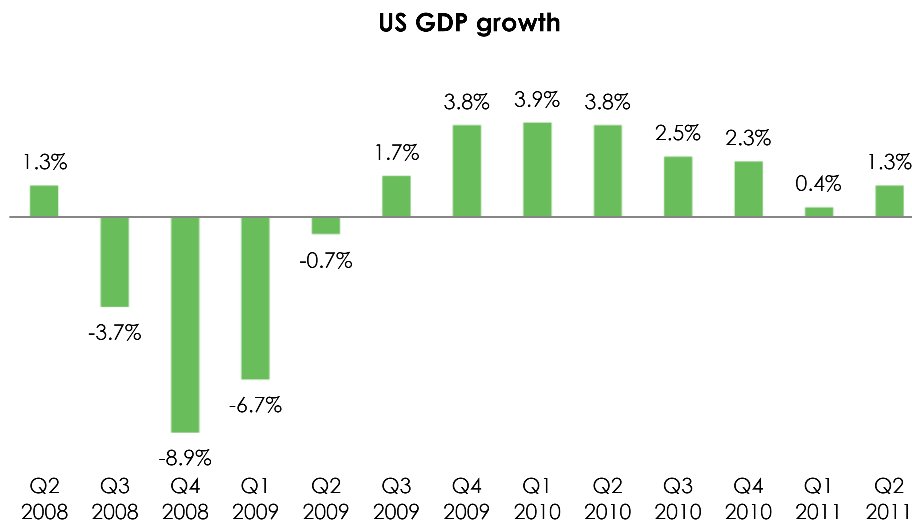
Source: IMF Financial Stability Report September 2011

The irresponsible way that the US debt ceiling was raised, together with the subsequent credit rating downgrade, triggered uncertainty amongst the investment community. Politically, there is growing concern that the US political system is broken and incapable of delivering on policy initiatives. It was only at the eleventh hour that Congress reached agreement on raising the federal debt ceiling and reducing spending by $2.4trn over the next ten years. Standard and Poor's responded by lowering its credit rating on US government debt for the first time ever from AAA to AA+ with a negative outlook.

US growth in the second quarter of this year decelerated to 1.3%. The slowdown was followed by a drop in leading indicators for both the manufacturing and services sectors. Economic data for the third quarter remained relatively firm in contrast, indicating that growth for the third quarter might beat expectations. This, however, is expected to be a short-lived trend.

The US Fed kept its accommodative monetary policy stance with the target rate at 0% to 0.25%, saying that it anticipates “exceptionally low levels at least through to mid-2013”.

It was expected that the Fed Chairman would announce a further round of quantitative easing at his Jackson Hole Speech at the end of August, the same platform where he announced QE2 last year. He disappointed in this regard, but hinted at additional tools that could be employed to promote a stronger economic recovery.



Source: US Bureau of Economic Analysis

At the extended September FOMC meeting, the Fed announced “Operation Twist” – a $600bn program which will see it sell short term debt and use the proceeds to purchase long term treasuries, thus lowering long term borrowing rates without expanding the Fed’s balance sheet. Ben Bernanke’s statement, that “there are significant risks to the economic outlook, including strains in global financial markets”, which followed the meeting, caused panic amongst investors. The minutes from that meeting revealed deep division amongst Fed members over the appropriate monetary policy. The Fed has kept QE3 on the back burner, deeming it a more “potent” tool that can be used if conditions deteriorate further.

Structural problems continue to hamstring the US economy. Unemployment has remained elevated at 9.1% and payroll data has been disappointing. Non-farm pay-rolls initially sparked fears of a double-dip recession, but the September figure of 103 000 new jobs and an upward revision to past data has been more consistent with positive, albeit weak, economic growth. On average, just below 100 000 jobs were created each month during the third quarter. Amidst weak employment, household income has stagnated, but surprisingly, retail sales have held up. The other structural issue is the housing market. House prices collapsed in 2008, and have been constrained by a foreclosure overhang and tough lending standards ever since. The situation is so grave that almost a quarter of all US mortgages are either at, or close to being in negative equity.

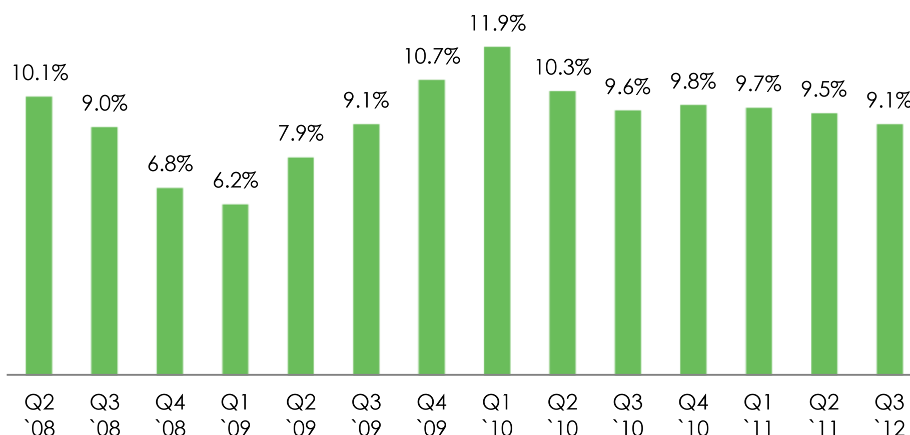
The European sovereign debt crisis continued to escalate during the quarter, engulfing Spain and too-big-to-fail Italy. The messy European political environment left markets uncertain about whether the continent will be able to get its act together.

As a short term solution, the European Central Bank announced it was ready to step in and buy Italian and Spanish bonds. And due to the escalation of the crisis in July, a second bailout package had to be agreed upon for Greece. European leaders have pledged that they will not allow any of the EU countries to go bankrupt, but their actions have fallen short and political debate has become fraught in some countries. The fear of a Greek default intensified when the EU initially delayed the next tranche of bailout money due to the country, demanding further fiscal austerity measures.

Until recently, both the German and French economies have held up reasonably well. However, the intensifying crisis and rapidly shrinking business activity in crisis stricken economies have shaken investor and consumer confidence in the core European countries, causing their economies to slow. The European Central Bank did not budge on reversing July's interest rate hike, as inflation has remained its main concern. Headline inflation for September rose sharply from 2.5% to 3.0%, but it was negatively influenced by Italian VAT rate hikes.

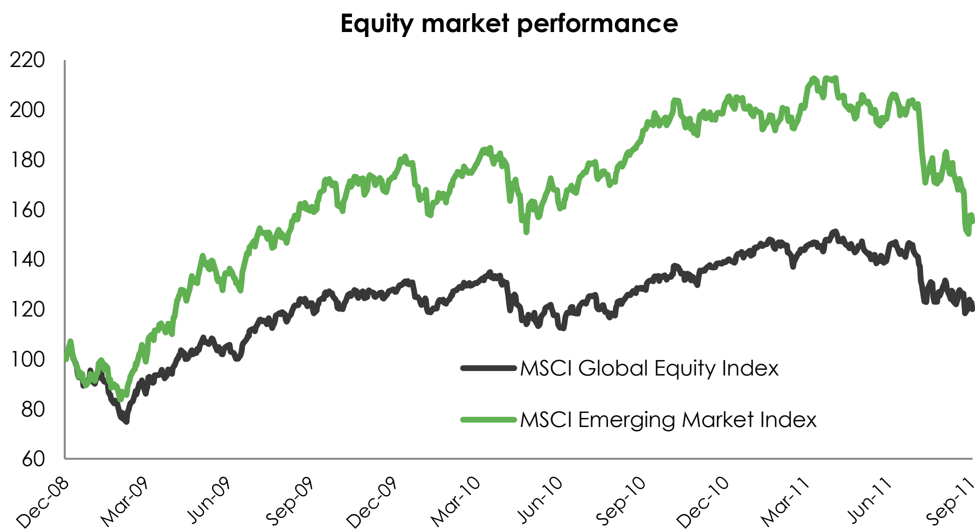
Alongside slower global growth, there has been a deceleration in emerging market economic growth. But emerging markets have made structural improvements over the last decade, compared to developed markets. Emerging market debt ratios are only one third of their developed market counterparts and domestic demand has been a bigger source of growth in emerging markets than in the past. So far, emerging market central banks have been fighting overheating economies and rampant inflation. As a result, Chinese officials raised interest rates again in July, but for now, it seems that Chinese inflation has peaked. Chinese economic growth has moderated somewhat, growing by 9.1% during the quarter. This is the slowest pace of GDP growth in two years and compares to 9.5% in the second quarter.

China GDP growth



Source: Trading Economics

The third quarter turned out to be one of the toughest quarters for investors since the end of 2008, with August and September particularly volatile months. The panic caused a severe and indiscriminate sell-off. The MSCI Global Equity Index lost 17.1% during the quarter, ahead of the MSCI Emerging Market Index's loss of 23.2% over the same period. While US company earnings reports were generally favourable, the S&P 500 ended the quarter 14.3% lower. Alongside emerging markets, European equity markets were also particularly hard hit. The German DAX Index suffered a 25.2% decline.



Source: INet Bridge

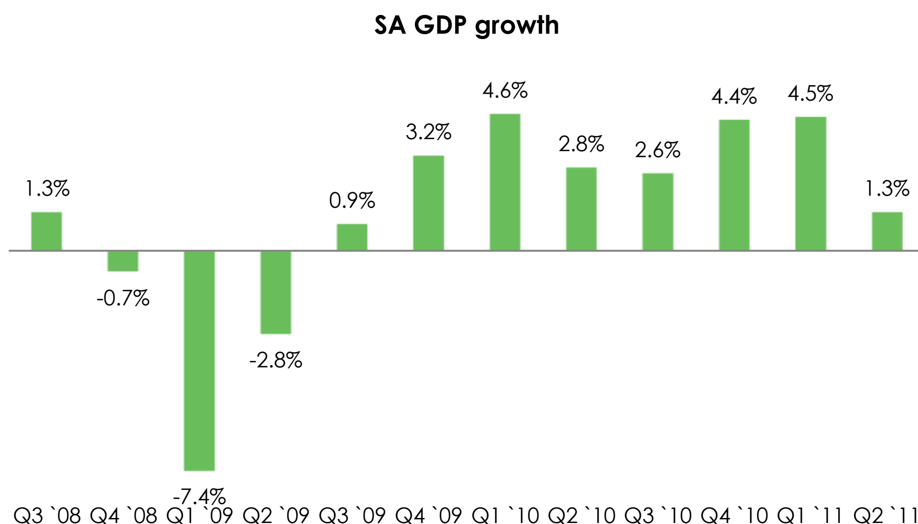
The result in the bond market must have been counterintuitive for many investors. Despite US debt being downgraded to AA+ and QE2 coming to an end, US Treasury yields fell by 130 basis points to below 2%, finishing September with one of the best quarterly returns on record. Bond yields have fallen to levels rarely seen outside of recession or wartime due to the flight to safety. The JP Morgan World Government Bond Index gained 3.1% during the quarter, despite currencies detracting from performance. The euro, plagued by the growing sovereign debt crisis and fear of country default, depreciated by 7.7% against the dollar. Gold's safe haven status saw the price rise 8.2% for the quarter, despite an 11% drop in September.

LOCAL

The South African economy was not isolated from global financial turmoil during the quarter. The slowdown in Europe, the country's biggest trading partner, negatively impacted the manufacturing sector and the global flight to safety was a setback for local financial markets. Growth forecasts have been adjusted downwards and previous expectations that interest rate hikes were imminent have been replaced by expected interest rate cuts. The domestic landscape has changed rapidly in a short period.

GDP growth in the second quarter of this year slowed to 1.3% from a downwardly revised 4.5% in the first quarter. During this period, growth in the cyclical sectors of the economy slowed, while the defensive sectors remained relatively robust.

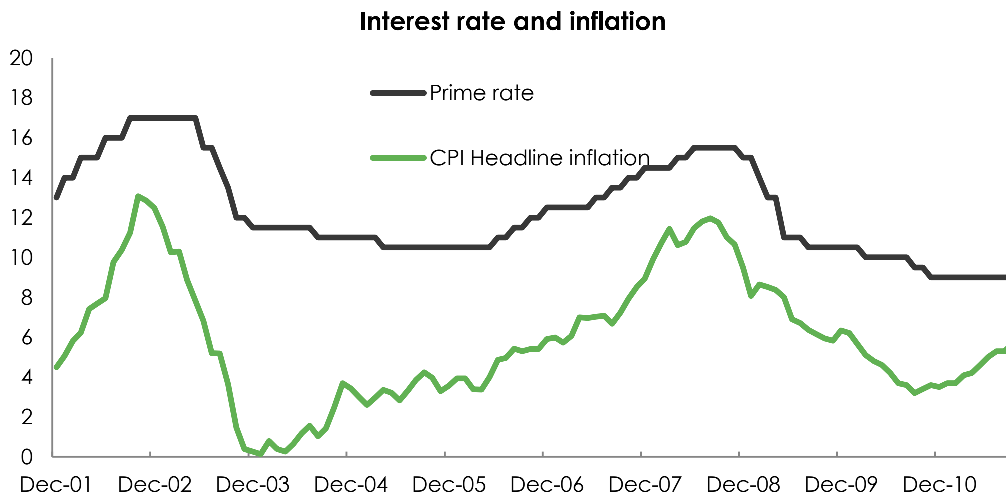
Growth in economic activity continued to deteriorate into the third quarter. Manufacturing output dropped unexpectedly in July, although it did recover somewhat in August. Strike activity presented a major drag on output in the manufacturing sector, but in general, the weakness was broad-based. In July, there was a major stand-off between unions and employers, with unions demanding wage increases of up to three times more than what companies were offering.



Source: INet Bridge

In response to slowing domestic growth and the major global issues, the Reserve Bank's Monetary Policy Committee kept interest rates unchanged at 5.5%. The Reserve Bank Governor has become much more dovish, preferring to focus on the risks to growth, instead of the expected short-term breach of the upper limit of the targeted inflation band. The Reserve Bank revised its growth forecast for this year to 3.2%, down from 3.7%, and for next year from 3.9% to 3.6%. The bank's inflation projections have remained broadly unchanged.

Consumer price inflation accelerated from 5.0% in June to 5.7% in September. Core inflation stabilised at 3.8%. The main contributors to rising inflation were higher transport and food costs. Inflation has been supported by the strength of the rand, and it will have to be seen how long current currency weakness lasts to determine the effect on consumer prices. The rand was the second weakest currency next to the Brazilian real during the quarter, depreciating by 16.4% against the US dollar. On 21 September, the rand experienced its worst one day fall since the onset of the financial crisis in October 2008. The rand started the quarter at R6.76 to the US dollar, but closed the quarter at R8.09 – touching R8.48 at its weakest point.



Source: INet Bridge

While the deteriorating domestic economy brought lower business and consumer confidence levels, domestic demand remained resilient. September saw a 30% year on year acceleration in vehicle sales. Retail sales grew by 7.1% year on year in August and at a three-month rate of 4.1%, indicating strength in consumer spending. Spending power has been driven by rising real disposable incomes as a result of wage negotiations that were struck at levels higher than inflation. Although income levels have increased, the employment backdrop has remained weak. Unemployment for the second quarter rose to 25.7% as the labour force grew faster than job creation, which has been reliant on the public sector. Foreign investors were net sellers of domestic equities during the quarter, selling R20.1bn worth of shares.

The FTSE/JSE All Share Index closed 5.8% lower to take its year to date return down to -5.4%. The main contributor to the weak performance was the resources sector which declined by 10.4%. Industrial and financial shares ended 3.2% and 4.4% lower respectively. However, the performance figures conceal the extreme volatility experienced by the local market during August and September as investor sentiment switched between risk-on and risk-off. Although the local equity market's performance during the quarter looks impressive compared to the decline in other global equity indices, once the return is translated into dollars, it is more in line with the 23.3% decline experienced by the MSCI Emerging Market Index.

The All Bond Index gained 2.8% during the quarter, ahead of cash's return of 1.4%. Foreigners were net buyers of R1.1bn worth of bonds: during July and August they were consistent buyers of local bonds, but when global risk aversion hit in September, they withdrew R18.5bn during the month. For the year to date, the All Bond Index is up 5.1%. Listed property's return has closely followed that of domestic bonds – it is up 2.2% for the quarter, and 5% higher for the year to date. The best asset class in rand terms for the year to date is global bonds, with a rand return of 30.1%.

Outlook

The direction of global markets will continue to be dominated by the European debt crisis over the remainder of the year. Political bickering and policy mistakes need to be replaced by decisive action and a credible plan to stem the tide and to prevent the euro-zone from crumbling any further. Part of this plan should include the recapitalisation of European banks and setting up a large enough bailout fund. The current European Financial Stability Facility is not sufficiently large to ensure euro-zone financial stability and a longer term solution is desperately needed. It will mean that core Europe - France and Germany - need to work together in solving the crisis and determining how the bailout fund should be expanded.

A solution to the European crisis is unlikely to address the root causes of the problem – economic imbalances across the region and a fundamental lack of competitiveness within peripheral Europe. Affected economies face a long and painful road to recovery, rebuilding their public finances and restoring competitiveness. Aside from the European crisis, macro-economic risks are high and policy makers will have a tough time navigating through them.

In the US, the growth outlook is bleak with policymakers having run out of bullets to combat deteriorating growth. The US economy has some momentum going into the final quarter of the year, but leading economic indicators continue to point to weaker conditions ahead. The Fed has delayed another round of quantitative easing, but should implement it if conditions warrant it. It is feared that the Fed's measures are ineffective, however. President Obama is gearing up for his re-election campaign which means that a lot of the problems might find short term solutions while structural issues persist. The three main structural issues - unemployment, the housing market and fiscal austerity - will continue to weigh on the US economy for an extended period.

The sudden synchronised slump in the G7 economies and the recent sharp fall in commodity prices suggest that inflationary pressures around the world could dissipate sooner rather than later. While most of the G7 economies have been struggling to grow, the key headache for emerging market countries has been too much growth and rising inflation. Should inflationary pressures continue to deteriorate; these countries will have more flexibility to counter a growth slowdown. Already, there has been a sharp deceleration in soft commodity indices, which should start to filter through to lower food prices.

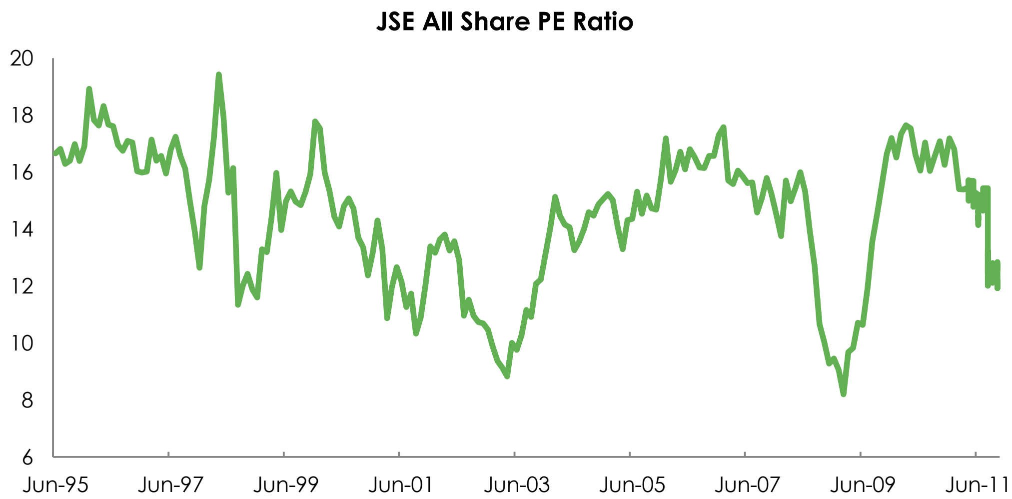
Global stocks could find a bottom and rally hard if European authorities present a credible plan to solve the debt crisis and recapitalise beleaguered banks. The world has been gripped by fears of a total meltdown in the euro-zone banking system, and the possibility of a renewed global recession. But some recent economic data have been surprising upbeat, indicating that economic conditions might not be as grave as initially thought.

Although not overly cheap, shares are looking fairly attractive. While there are heightened global macro risks, most of these have already been priced into share prices. Company earnings will come under pressure, but we still believe that they will be able to show positive earnings growth.
Global bonds, on the other hand, have benefitted from risk aversion and the flight to safety. Yields on US Treasuries have been pushed to all-time lows and are vulnerable to positive news flow. While central bank policy, lower economic growth rates and an inflation slowdown might all support lower bond yields, we feel that 10-year government bond yields close to 2% do not reward one enough for holding the instruments for the expected duration. Also, we take into consideration that equity dividend yields are currently in excess of bond yields. Over the next twelve months, we believe equities will outperform bonds.

On the domestic front, our economy will not be spared the effects of the global growth slowdown. Growth projections have already been revised down and economic growth for 2012 is now expected to range between 2.5% and 3.0%. It is mostly the cyclical sectors of the economy that will be affected by the slowdown, while defensive sectors are expected to remain resilient. The Reserve Bank's focus is squarely on domestic growth conditions. Even though the possibility of an interest rate cut has been priced into the market, the Monetary Policy Committee should at least leave interest rates unchanged over the next twelve months.

Inflation is expected to breach the upper limit of the Reserve Bank's targeted band, but this is expected to be temporary before inflation trends down again. A slowdown in global growth should help contain some inflationary pressures, but it remains to be seen what effect the depreciation of the rand will have on imported inflation. The length and magnitude of the rand's weakness will determine how much pass through there is on to inflation. The rise in administered prices and wages will continue to weigh on inflation. The rand's recent and sudden weakness has again illustrated the importance of offshore diversification.

From an equity market valuation perspective, the FTSE/JSE All Share Index is probably the cheapest it has been in the last two years. While it might get even cheaper, we believe it is attractively valued, given that company earnings should continue to show double digit growth. Local company earnings growth rates compare favourably with expected growth rates from other emerging markets. The domestic equity market should also be supported by the Reserve Bank's accommodative monetary policy stance.



Source: Inet Bridge

The bond market will find support from the global growth slowdown, low interest rates, and an attractive yield differential compared to other countries' bond markets. It is, however, vulnerable to upside risks from inflation, global risk appetite and fiscal slippage. National Treasury will struggle to cut expenditure over the next year and at the same time, might have been too optimistic with the economic growth forecast. The result is that revenues will come under pressure and the budget deficit will be larger than anticipated. Over the next 12 months, bonds should outperform cash, which is expected to provide a very low return above inflation.

The short-term outlook for financial markets is continued volatility and an increased risk of policy and political errors. We are, however, confident that officials will find the necessary solutions to stem the tide, but we are also mindful that because global structural issues will take an extended period to unwind, many developed economies will continue to face headwinds in the years to come.

Asset Class Returns

	3 Months	Ytd	12 Months
Headlines Indices			
Africa All Share	-5.84%	-5.36%	3.60%
Africa Top 40	-6.56%	-5.75%	3.57%
Africa Mid Cap	-1.98%	-3.25%	3.14%
Africa Small Cap	-2.27%	-5.31%	5.39%
Africa Fledgling	-0.25%	-3.68%	5.12%
Africa Resource 20	-10.39%	-13.41%	0.87%
Africa Industrial 25	-3.24%	1.37%	8.83%
Africa Financial 15	-4.38%	-2.74%	-3.54%
Africa Financial and Industrial 30	-3.66%	0.47%	5.15%
Africa Capped All Share	-5.48%	-4.91%	3.90%
Africa Shareholder Weighted	-4.28%	-3.69%	4.14%
All Share Economic Group Indices			
Africa Oil & Gas Index	-5.97%	-2.66%	10.35%
Africa Basic Materials Index	-10.83%	-13.32%	0.38%
Africa Industrials Index	-4.61%	-10.48%	-2.95%
Africa Consumer Goods Index	-2.10%	3.72%	13.36%
Africa Health Care Index	2.49%	3.56%	6.98%
Africa Consumer Services Index	-1.24%	-2.00%	6.09%
Africa Telecommunications Index	-4.56%	4.25%	11.83%
Africa Financials Index	-3.14%	-1.20%	-1.30%
Africa Technology Index	4.96%	12.19%	11.73%

All Share Sector Indices

Africa Chemicals	-9.65%	-8.31%	1.79%
Africa Electronic & Electrical Equipment Index	-5.65%	-7.52%	-2.25%
Africa Industrial Engineering Index	1.55%	7.99%	25.30%
Africa Automobiles & Parts Index	4.61%	35.48%	61.94%
Africa Beverages Index	8.28%	12.63%	17.68%
Africa Food Producers Index	3.17%	3.18%	11.60%
Africa Health Care Equipment & Services Index	-0.66%	6.39%	15.91%
Africa Pharmaceuticals & Biotechnology Index	6.07%	0.02%	-2.29%
Africa General Retailers Index	1.74%	3.54%	9.98%
Africa Travel & Leisure Index	-7.74%	-18.21%	-11.35%
Africa Media Index	-7.29%	-8.53%	3.91%
Africa Support Services Index	-7.51%	-20.18%	-8.70%
Africa Industrial Transportation Index	-6.89%	-13.42%	-3.43%
Africa Food & Drug Retailers Index	6.35%	5.49%	8.54%
Africa Fixed Line Telecommunications Index	-9.46%	-12.32%	-13.46%
Africa Banks Index	-3.33%	-3.11%	-3.12%
Africa Non-life Insurance Index	6.90%	10.15%	27.08%
Africa Life Insurance Index	-3.83%	3.28%	-2.70%
Africa General Financial Index	-9.16%	-12.24%	-7.58%
Africa Equity Investment Instruments Index	1.98%	6.83%	5.34%
Africa Software & Computer Services Index	5.16%	9.13%	8.04%
Africa Gold Mining	19.50%	6.14%	12.64%
Africa Platinum & Precious Metals	-9.73%	-25.40%	-11.08%
Africa Property Unit Trusts - (PUT)	3.12%	6.15%	8.84%
Africa SA Listed Property - (SAPY)	2.19%	5.01%	8.30%

Bonds, Cash & Inflation			
All Bond Index	2.81%	5.13%	5.92%
Stefi Composite	1.40%	4.28%	5.91%
CPI - New Headline (Previous Month)	1.46%	4.69%	5.34%
CPI - History Rebased (Previous Month)	1.46%	4.69%	5.34%
Currencies			
Rand Dollar Exchange Rate	19.70%	22.26%	16.31%
Rand Pound Exchange Rate	16.40%	22.31%	15.44%
Rand Euro Exchange Rate	10.53%	22.50%	14.38%
Dollar Euro Exchange Rate	-7.65%	0.01%	-1.73%
Dollar Yen Exchange Rate	4.84%	5.69%	8.33%
Commodity Prices			
Brent Oil (USD/Barrel)	-5.28%	11.81%	30.39%
Gold (USD/oz)	8.23%	14.28%	24.06%
Platinum (USD/oz)	-11.57%	-13.81%	-7.82%
Copper ($/Ton)	-23.33%	-26.78%	-11.45%
CRB Index	-11.80%	-10.41%	3.94%
Global Bonds & Equity			
Global Bonds (R)	23.36%	30.91%	22.32%
MSCI Global Equity (R)	-0.72%	5.47%	8.90%
Global Bonds	3.06%	7.07%	5.16%
S&P 500	-14.33%	-10.04%	-0.86%
Nasdaq	-12.91%	-8.95%	1.97%
MSCI Global Equity	-17.06%	-13.75%	-6.37%
MSCI Emerging Mkt	-23.19%	-23.53%	-18.14%

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