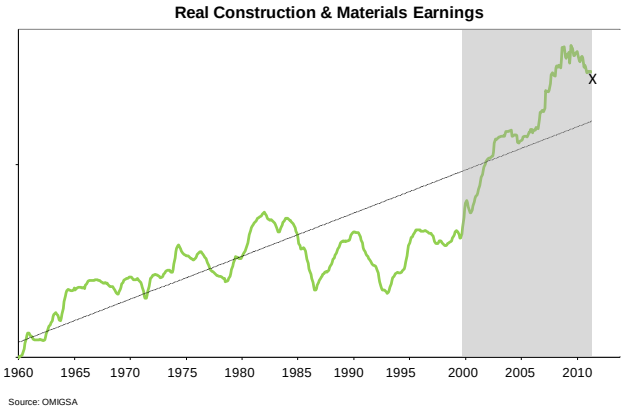
OMIGSA Comment – Siboniso Nxumalo, Analyst: Construction

More downside ……..than upside risks in construction

Recently there has been a lot of negative press coverage on the South African construction sector. The sector is said to be under severe pressure post the highly successful hosting of the 2010 FIFA World Cup.



As we stand at the end of 2010 (point X on the graph), we notice that construction earnings are still way above the long-term trend-line earnings. Long-term real earnings growth (1960-2010) shows that construction earnings grew at 7.1% (on a compound annual basis), but from 2000-2010 (shaded part) they grew at an unprecedented 17.1%, more than double the previous growth rate.

With this in mind, it's probably fair to assume that there is now more downside risk (earnings disappointments) in construction earnings than there is upside risk (earnings surprises). The earnings base created by the recent construction boom will be very difficult, if not impossible, to grow earnings from. There is less construction work going around and more companies competing for that work, so the environment has become very competitive. Recent poor construction results only serve to confirm this theory that profits are, and will be, under pressure going forward.

However, in the world of investing everything has a price, and construction companies are currently trading at a significant discount to other industrials. This implies that the market is aware and has discounted the inherent earnings risks. At OMIGSA we prefer construction companies with strong balance sheets (large cash positions) which are diversified outside of South Africa, such as Aveng and Wilson Bayly.

26 Nov - 02 Dec 2010 in a nutshell

Global: Global equities returned to positive territory this week, on positive data from the US and the announcement by the European Central Bank that it would prolong measures to steady the financial system. The S&P 500 in the US gained 2.00%, while the European market shares collected 0.58% and emerging market stocks were 1.36% higher.

South Africa: Positive global macro-economic data did not do much to lift the local bourse this week, as it bucked the global trend, with the FTSE/JSE All Share Index falling 0.49%. Industrials were the winners, rising 0.38%.

Markets and Economics - Highlights

Global

- A monthly survey showed Americans' confidence in the economy rose in November to the highest level in five months amid more hopeful signs. The reading is an encouraging sign at the beginning of the holiday shopping season. But confidence remains weak as Americans grapple with high unemployment. The Conference Board said. Tuesday its Consumer Confidence Index now stands at 54.1, up from a revised 49.9 in October. Analysts were expecting 52.0. November's reading marks the highest point since June's 54.3.
- The European Central Bank has stepped up efforts to contain the continent's government debt crisis, with its president, Jean-Claude Trichet, announcing it would prolong measures to provide ready cash to banks and steady the financial system.
- Brazil posted a trade surplus of $14.9 billion in the first 11 months of 2010, down 35.4% from

the same period last year, the Development, Trade and Industry Ministry announced. The sharp fall was attributed to a rise in imports, which were boosted by the good conditions of the Brazilian economy in 2010.

South Africa

- Manufacturing activity showed signs of life as factory activity increased and mangers expected conditions to improve further, suggesting that SA's economic recovery may be gathering steam. The Kagiso Purchasing Managers' Index bounced back to 52.9 in November from 49.8 in October.
- South Africa's trade account recorded a R3.2 billion deficit in October compared with a R3.2bn surplus in September. Exports dropped by 6.3% month on month in October, while imports were 7% higher, the South African Revenue Services said.
- Residential property prices are not likely to recover soon. According to First National Bank's house price index, the average house price growth slowdown continued last month. The index recorded a 3.8% year-on-year increase, slightly lower than the previous month's 3.9%.
- South Africa's central bank sees more "definite" signs of a recovery in consumer spending and the prospect of further interest-rate cuts is "limited". While the bank previously signalled that interest rates would probably stay on hold, "heightened uncertainty" means conditions changed rapidly, allowing the bank to lower rates earlier this month, said Governor Gill Marcus.

Key Indicators:

Market	Index	Movement for the period		Year to Date
		%	Index Value @ 02.12.2010	% Performance Return
United States	S & P 500 (US$)	2.00%	1,222	9.59%
Europe	Euro Stoxx 50 (Euro)	0.58%	2,781	-6.24%
Emerging Mkts	MSCI Emerg Mkts (US$)	1.36%	1,114	12.59%
South Africa	FTSE/JSE All Share (ZAR)	-0.49%	31,145	12.57%
Global	MSCI (US$)	1.06%	1,237	5.91%
ZAR/Dollar	Rand/US $ (ZAR)	-1.85%	6.90	-6.63%
ZAR/Pound	Rand/£ (ZAR)	-1.85%	10.74	-9.44%
ZAR/Euro	Rand/Euro (ZAR)	-2.89%	9.11	-13.16%
JSE	Industrials	0.38%	29,697	17.64%
JSE	Financials	-2.55%	20,885	8.06%
JSE	Resources 20	-0.11%	54,402	6.50%
JSE	Small Companies	-0.73%	32,265	15.70%
JSE	Listed Property	-3.56%	379	17.34%
JSE	RAFI® ALSI	-0.83%	6,425	11.70%
JSE	RAFI® 40	-0.49%	6,269	12.11%
JSE	SWIX	-1.44%	6,520	13.69%

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