

# Market Dynamics

June 2011

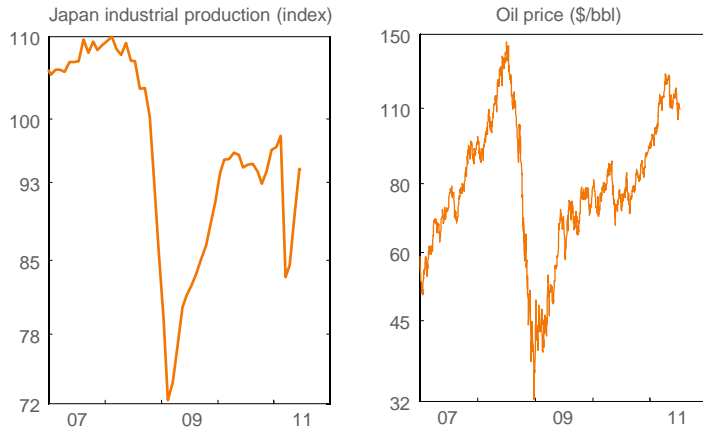


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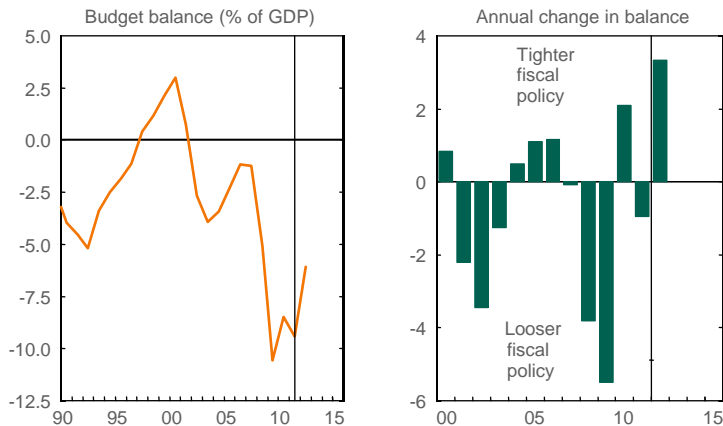
# World Economic Overview and Outlook

## Japanese industrial production and the oil price



Source: OMIGSA (Iris)

## USA budget deficit to narrow sharply next year



Source: OMIGSA (Iris)

- ▲ The global economy settled into a period of slower growth during the second quarter of 2011. This came on the back of a number of economic events as well as concerns and risks for investors. Amongst these were the effects of the Japanese earthquake, high oil and other commodity prices, rising inflation, higher interest rates, continued fear from the Greek debt fall-out plus fears over a sharp slowdown in the Chinese and US economies.
- ▲ The Japanese earthquake impacted substantially on the global supply chain and thus slowed industrial production across the globe. This was exacerbated by the impact on investor confidence by the other events mentioned above.
- ▲ We were of the opinion that these impacts on growth were temporary and that world growth would return to the moderate growth path that started to emerge during 2010 and early 2011. Indeed, Japanese industrial production rebounded in a V-shaped recovery and will similarly improve production elsewhere. Also, commodity prices eased from the highs of early 2011 and thus boosting corporate and individual confidence. Lower commodity prices have also eased inflation and interest rate fears.
- ▲ Some of the negative sentiment during the quarter also emanated from the uncertainty around the Federal Reserve Board's quantitative easing (QE) policy, set to end in June. Although the Fed did not announce a third round of QE, its exit strategy will be passive and gradual – meaning that there will not be an effective tightening in policy for some time.
- ▲ Another positive came with the announcement by the International Energy Agency of a 60 million barrel oil sale out of strategic oil reserves over a 30-day period. This could potentially be renewed after the initial 30 days. The impact was an immediate reduction in oil prices.
- ▲ Thus, the soft patch in growth in the second quarter now seems as if it indeed was temporary – and not the start of a sustained downcycle in global growth. We expect growth to recover in the second half of the year.

**OMIGSA Economic Research Unit view:** After a soft patch in global growth during the second quarter, we expect growth to rebound during the second half of 2011. Substantial risks remain – including fiscal policy tightening globally – so we cannot expect more than moderate growth going forward.



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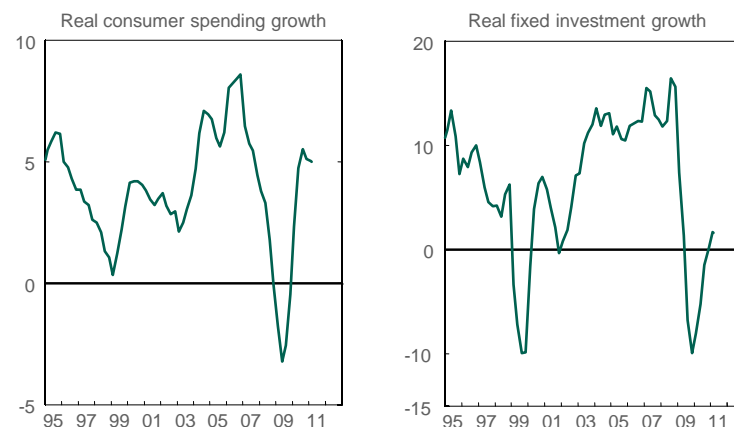
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# Local Economic Overview and Outlook

- ▲ During the second quarter we saw continued evidence that the local economic recovery remained on track. First quarter GDP came in at a seasonally adjusted annualised rate of 4.8%. Within this performance was a strong showing from consumer spending, supported by strong real income growth. However, given the uptrend in inflation, we expect this real income boost to wane somewhat over the rest of the year. This should result in somewhat slower consumer spending growth going forward.
- ▲ Fixed investment growth continued on the recovery path – albeit slower and later than consumer spending. Fixed investment growth normally lags the rest of the economic cycle. Investment by the private sector and public corporations (Transnet & Eskom) rebounded nicely, while that by general government continues to lag behind.
- ▲ Despite decent first quarter growth data, the economy is certainly not booming. Car and retail sales, as well as indicators such as consumer credit extended and building plans passed, suggest growth is still moderate and even slow compared to the previous upcycle. Despite this, we expect 3.7% GDP growth in 2011, rising to about 4% by next year.
- ▲ Inflation rose to 4.6% in May. This is up from a cyclical bottom of 3.2% in September 2010. The primary drivers of this cycle were food and energy prices. Indeed, core inflation (i.e. headline excluding food and energy) is now only at 3.2% after bottoming at 3.0%. We expect inflation to end the year at about 5.5%. Recent petrol price declines (unexpected only a few months ago) and the strong rand are acting as powerful brakes on inflation.
- ▲ We still expect the interest rate upcycle to start around the end of the year. The exact timing – and the extent of rises in the cycle – will depend on factors such as food and oil prices, the rand and the strength of the demand cycle.

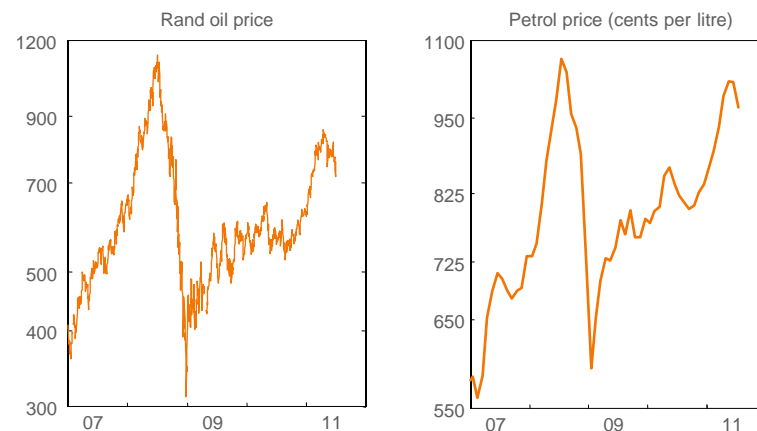
**OMIGSA Economic Research Unit view:** *The local recovery remains on track. However, weakness in a number of areas still stands in the way of a faster recovery. Inflation is on a moderate uptrend and interest rates are expected to start rising somewhere between the fourth quarter of 2011 and the first quarter of 2012.*

## Consumer spending and fixed investment growth



Source: OMIGSA (Iris)

## Rand oil price and petrol price



Source: OMIGSA (Iris)



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# Equity Sector Overview and Outlook

## Resources

- ▲ The basic materials sector produced a return of -4.8% for the quarter ending June 2011, underperforming the FTSE/JSE All Share Index (ALSI)'s -0.6% return.
- ▲ The big underperformers were the gold and platinum miners, returning -13% and -7.7%, respectively. The continuing strong rand and concerns about commodity prices, wage negotiations and threats of nationalisation all appeared to have had a negative impact. Although small, the coal mining sector managed a very credible outperformance, returning 6.1%.
- ▲ The market seemed to have spent the last month reacting to the sentiment shifts about Greek refinancing prospects, and commodities were no exception. Although the issue is resolved for another few months, it is unlikely to go away completely, and we believe it will continue to dog the market. Japanese data was surprisingly good, but generally global industrial production has slowed over the past months. Whether this is temporary or a shift to a significantly lower growth environment is unclear, but with commodity prices generally still around record highs, we believe it's not the time to take aggressive bets; generally the fund is still positioned defensively.
- ▲ While the very strong rand has dampened the short-term outlook for some shares and the performance of the Mining and Resources Fund, it is also an ideal time to increase our offshore exposure to further optimise the risk-adjusted return.

**Equity Research view:** *The diversified miners are protected by their exposure to a variety of commodities and currencies in their portfolio, as they typically have the best assets and tend to remain profitable, even in commodity downturns, unlike some of the pure and smaller miners. Diversified miners' valuations are relatively more compelling than smaller or single commodity plays. Non-mining resources companies' valuations are relatively attractive too.*

## Small Companies

- ▲ The small cap and mid-cap indices returned 2.3% and 3.3%, respectively, for the three months ended 30 June 2011, while the FTSE/JSE Top 40 Index returned -1.3%.
- ▲ The outperformance of shares at the small/mid-cap level was a function of better value and illiquidity in a weak market.
- ▲ Market performance has been fairly flat for the year so far, and there appears to be more risks on the horizon. Most of the uncertainty stems from concerns over the developed world, rather than the developing world. Emerging markets are still showing good growth numbers and inflation is still an issue in these areas. The success of the quantitative easing policies will be increasingly questioned, and the belief in austerity packages is starting to wane. The European debt restructurings, exits from the Eurozone and the survival of the euro are still big question marks. Sovereign debt default by the peripheral European countries remains one of the biggest issues for investors.
- ▲ Markets will continue to be nervous given the potential for a full-blown banking crisis across a debt-ridden Eurozone.

**Equity Research view:** *The average price:earnings (p:e) ratio at which small caps trade compared with large caps is now at a small discount.*



# Equity Sector Overview and Outlook (cont.)

## Financials

- ▲ The FTSE/JSE Financial Index ended up 1.3% for the quarter, marginally ahead of the FTSE/JSE Shareholder Weighted All Share Index (SWIX), which was up 0.2%. Within financials, the Banking Index was down 0.9%, while the life assurance sector gained 0.9%, and general financials added 1.6%.
- ▲ The insurance sector was dragged down by Old Mutual, which gave up some of the strong gains made in the first quarter.
- ▲ Within banks and general financials, strong performance came from Nedbank, which was up 5.4%, as well as Investec, which gained 5% in the quarter. However, these gains were offset by poor performance from other counters, notably African Bank, which reported disappointing growth in earnings at their interims.
- ▲ For the balance of 2011, we expect the banks to continue the focus on costs as revenue growth remains subdued. Capital levels will also be a focus area with potential for increased dividends.
- ▲ Life companies should continue to show an improving trend in lapse-experience and recurring-premium sales, due to improving real household incomes. Cost management will also become an issue in a sector with limited growth prospects.

**Equity Research view:** We expect the financial services sector to benefit from the recovering economy, which should begin to lift operating results in 2011. We believe some counters in the sector still present value, with ratings below historic averages.

## Industrials

- ▲ The Industrial Index delivered 3.7% for the second quarter of 2011, outperforming the FTSE/JSE All Share Index, which fell 0.6% over the same period.
- ▲ The Industrial Index was dragged down by the larger companies, which were also negatively impacted by the rand strengthening. SABMiller declined 3%, British American Tobacco (BAT) fell 3% and Naspers dropped 5%. The big winner was Kumba Iron Ore, which rose 4%.
- ▲ The selective offshore companies are offering some upside, but this is premised on the rand weakening. SABMiller has made an offer for Australia's Fosters Beer business, and this questions the company's strategy of being an emerging market brewer – this may affect the valuation. Richemont continues to trade upward as Swiss watch exports continue to race ahead.
- ▲ Many of the retailers are looking fully priced going into the up-leg of the interest rate cycle, but share prices should be supported by the strong dividend yields that are on offer. The food retailers are likely to benefit from rising food inflation.
- ▲ The big mobile telecommunications companies have both outperformed year to date, after increasing their payouts to shareholders. These stocks are now looking fairly priced.

**Equity Research view:** The industrial sector is not offering much value as a whole based on our valuation. Investors need to be selective and perhaps consider the opportunities being presented by the lower-quality companies.



# Equity Sector Overview and Outlook (cont.)

## Property

- ▲ The FTSE/JSE SA Listed Property Index (SAPY) provided a 5% total return (3.8% capital, 1.2% income) for the second quarter of 2011. This exceeded the FTSE/JSE All Share Index (ALSI)'s -0.6% return, and the All Bond Index (ALBI)'s 3.9%.
- ▲ The capital gain was a function of the 37 basis point (bps) fall in bond yields. Absent the strong bond market, there would have been little capital gain in listed property. This has been the pattern over the past two years.
- ▲ Property again demonstrated its defensiveness, as it barely budged when equities sold-off (and recovered) in June. On a short-term measure against bonds, property yields are currently at the more expensive end of their recent trading range.
- ▲ News over the quarter on balance was unsupportive, with companies continuing to find conditions tough. Funds with high office exposure (e.g. Sycom Property Fund which reported in June) have struggled, often having to reduce rentals on net lettings.

**Equity Research view:** *The sector offers a one-year forward yield of 8.3%, equalling the 10-year bond yield, and distribution growth approximating inflation. Downside operational risk has declined and funding conditions are easier. Commercial building plans passed have fallen materially, which will facilitate rental increases in the recovery. A genuine recovery in property conditions may take longer than many anticipate, with higher electricity and rate costs constraining net rental growth, and over-rentals possibly developing in time (a key concern). Large capital raisings may constrain prices. The direct commercial property market remains resilient. On a long-term secular view, property is attractive as existing rents are below feasibility rentals for new developments but building costs have softened.*



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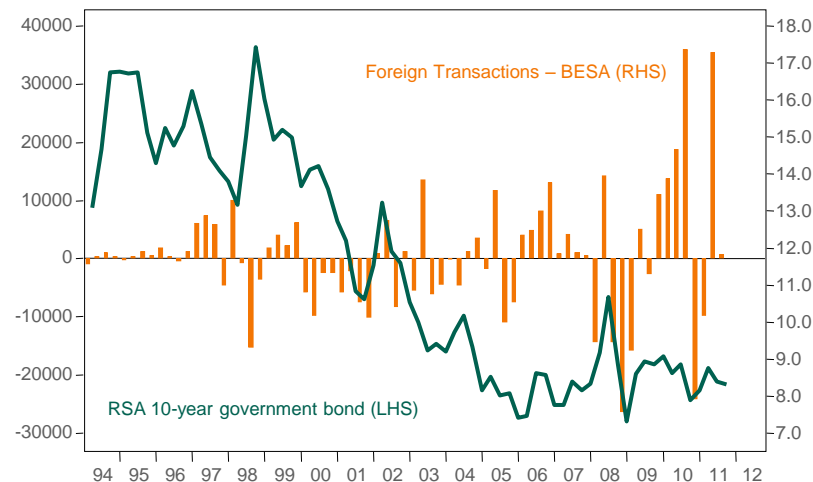
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# Fixed Interest Overview and Outlook

- ▲ Lower bond yields in advanced market economies; a sharp decline in crude oil prices; the decision by the South African Reserve Bank (SARB) to keep the repo rate at a multi-decade low; rand stability; and non-resident purchases of local bonds totalling a net R35.6bn, all led bond yields to decrease during the second quarter. As a result, the All Bond Index (ALBI) returned 3.9%, outperforming both cash (1.4%) and the FTSE/JSE Inflation-linked Bond Index (3.8%).
- ▲ The ongoing concerns about further Greek debt restructuring had no visible impact on market sentiment towards most emerging markets, including South Africa. Rising local inflation also failed to spook market participants because it is behaving largely in line with general expectations, while core inflation still appears to be relatively benign.
- ▲ Recent market events did not change our core investment view and, therefore, our broadly defensive investment strategy. Although inflation has behaved relatively well until now, partly due to the lagged effect of the rand's strength, the medium-term outlook remains a concern from an interest rate point of view. It therefore follows that the central bank will be required to start the policy tightening cycle later this year – as a repo rate at the lowest level since 1974 is unsustainable against this background.
- ▲ A sizeable holding of cash, variable-rate bonds and inflation-linked bonds are preferred over fixed-rate bonds. The current steepness of the yield curve slope and the expectation of monetary-policy tightening in the month ahead, favour an underweight position in short-dated bonds.

## Strong foreign buying of local bonds



Sources: I-Net, Futuregrowth

### **Futuregrowth view:**

*Recent market strength offered an opportunity to reduce the holding of short-dated fixed-rate bonds in anticipation of future monetary policy tightening. Corporate debt spreads keep tightening, forcing investors to become more price sensitive. Expectations of a more bearish medium-term inflation outcome are contributing to a slightly improved outlook for inflation-linked bonds, offsetting low real yields.*

# Economic Indicators to 30 June 2011

	Latest Data		Previous Year
<b>Exchange Rates:</b>			
Rand/US\$	June-11	6.76	7.67
Rand/UK Pound	June-11	10.83	11.44
Rand/Euro	June-11	9.80	9.37
Rand/Aus\$	June-11	7.24	6.44
<b>Interest Rates:</b>			
Prime Overdraft	June-11	9.00%	10.00%
3-month NCD rate	June-11	5.50%	6.60%
R157 Long Bond Yield	June-11	7.50%	8.03%
<b>Inflation:</b>			
CPI (y-o-y)	May-11	4.6%	4.6%
<b>National Accounts:</b>			
GDP Growth (y-o-y)	March-11	3.7%	1.4%
GDP Growth (q-o-q, annualised)	March-11	4.8%	4.8%
HCE Growth (y-o-y) (Household Consumption Expenditure)	March-11	5.0%	2.3%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	March-11	1.7%	-8.0%
<b>Balance of Payments:</b>			
Trade Balance (cumulative 12month)	May-11	\$2.01	-\$1.53
Current Account (% of GDP)	March-11	-3.1%	-4.4%
Capital Account (% of GDP)	March-11	7.8%	8.0%
Forex Reserves (incl. gold)	May-11	\$50.09	\$41.53
<b>Other:</b>			
Manufacturing Production (y-o-y) (seasonally adjusted)	April-11	0.5%	9.3%

Source: OMIGSA

# Market Indicators to 30 June 2011

	1 Month (%)	Quarter (%)	Calendar Year (%)	12 Months (%)	3 Yrs (%)	5 Yrs (%)
<b>Equity</b>						
All Share Index	-2.0	-0.6	0.5	24.6	4.5	11.4
Shareholders Weighted Index	-1.5	0.2	0.6	24.4	7.5	12.4
All Share/Resources 50%	-1.7	0.7	1.4	25.6	8.3	12.4
Top 40 Index	-2.4	-1.3	0.9	25.7	2.5	10.7
RAFI® 40 Index	-2.3	-1.2	1.2	24.9	9.8	12.6
RAFI® All Share Index	-1.9	-0.9	0.6	25.1	9.4	12.3
Resources Index	-3.1	-5.7	-3.1	20.9	-7.5	7.5
Financial Index	-2.0	1.3	2.0	17.3	14.7	7.9
Industrial Index	-1.1	3.7	3.4	32.0	16.6	17.7
Mid-cap Index	0.0	3.3	-1.3	19.1	20.8	17.0
Small-cap Index	-0.2	2.3	-3.1	18.8	11.3	13.4
<b>Interest-Bearing</b>						
ALBI BEASSA	0.2	3.9	2.3	11.3	13.4	8.9
STeFI	0.5	1.4	2.8	6.2	8.3	8.8
Cash	0.4	1.2	2.4	5.2	7.4	8.2
<b>Property</b>						
SA Quoted Property Index	1.2	5.0	2.8	20.5	26.6	19.0
<b>International</b>						
MSCI World Index (R)	-2.2	1.0	8.2	16.0	-3.7	1.8
MSCI World Index (\$)	-1.5	0.7	5.6	31.2	1.1	2.9
JPM International Bond (R)	-0.5	3.6	6.5	-2.6	1.4	6.5
US 1-month LIBOR (R)	-0.7	0.3	2.6	-11.4	-3.7	1.6
<b>Inflation (Estimated)</b>						
CPI	0.0	0.8	3.2	4.6	5.2	6.9

Source: OMIGSA

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# Regulatory Information

## **Old Mutual Investment Group (South Africa) (Pty) Limited**

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