

Market Dynamics

August 2011

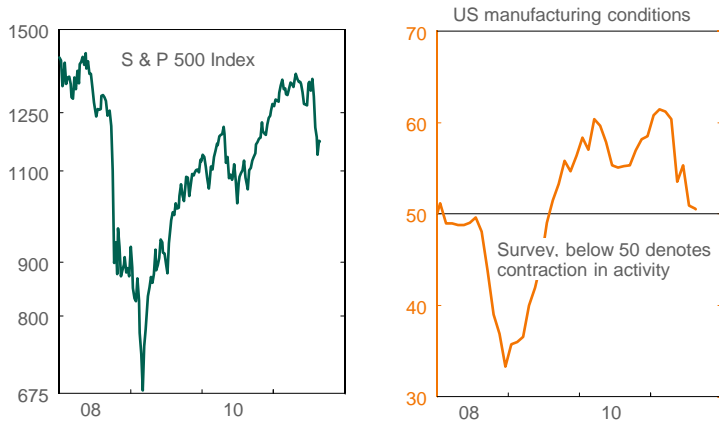


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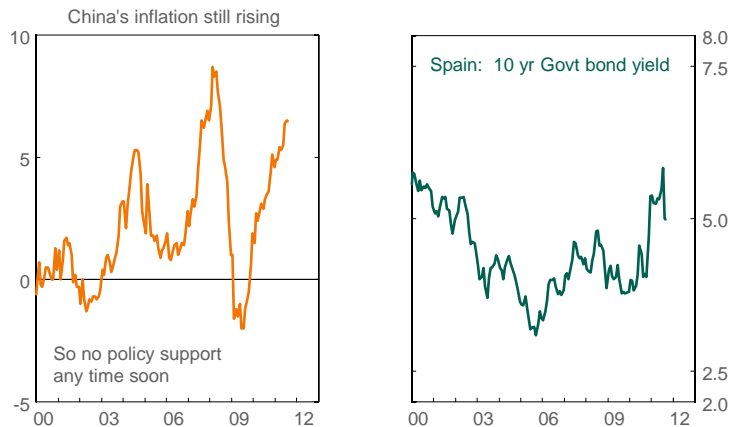
World Economic Overview and Outlook

Worries hit markets



Source: OMIGSA (Iris)

Worries are global



Source: OMIGSA (Iris)

▲ August saw extreme turmoil on global financial markets, but, fortunately, some stabilisation set in towards month-end. Panic that the world economy is on the verge of slipping back into recession and that policy makers have no ammunition left to counter such an outcome essentially lay behind the sharp sell-off on global equity markets. Concerns over the state of the world economy were already building in July, but were turned into full-blown panic early in August when rating agency Standard and Poor's downgraded the long-standing AAA sovereign rating of the USA by one notch. This not only sent a message to global investors over the risks and weaknesses of the world's biggest economy, but also reinforced the realisation that the USA faces many years of considerable fiscal retrenchment, the details of which are still to be thrashed out by US politicians.

▲ At the same time, the Euro-zone suffered a similar bout of panic as concerns over fiscal unsustainability spread beyond Greece to Spain, Italy and even France. In order to calm markets, the European Central Bank began buying the long-term government debt of Spain and Italy in order to reduce the financing burden. Towards month-end, markets appeared to have calmed down moderately, but the economic and fiscal situation in the Euro-zone remains of dire concern to global financial markets. Here also a long and painful road to stabilisation is in prospect, likely accompanied by more bouts of panic.

▲ Global growth lost further momentum over the past month. While the world has not relapsed into full-blown recession, concerns remain high that it may do so. A number of better-than-expected data releases in the USA towards month-end calmed markets' worst fears. Yet, it is still too early say with any degree of conviction that a recession will be avoided. Of particular concern is the risk of a negative feedback loop between financial markets and the behaviour of consumers and businesses. Plummeting equity prices not only have a considerable negative impact on households' wealth, but also depress sentiment and cast great uncertainty over future economic conditions. Such fears may cause spending cutbacks by businesses and households – precisely what recessions are made of.

OMIGSA Economic Research Unit view: *Global growth prospects remain very uncertain, and risks of the world slipping back into recession have increased further. Yet, we remain of the opinion that this will be avoided and that global conditions will improve moderately towards year-end.*



OLD MUTUAL

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Local Economic Overview and Outlook

▲ The loss of growth momentum in the second quarter, as suggested by incoming high-frequency data over the past few months, was confirmed as second quarter real GDP growth slowed to only 1.3% from a downwardly revised 3.5% in Q1 (first estimate was 4.8%). Contractions in mining, manufacturing and agriculture were primarily responsible for the weaker overall Q2 growth. While the hit to SA producers from lack of supplies from Japan (following the tsunami), local strikes and an extended school holiday played a role in the slowdown, the underlying tempo of activity in the local economy clearly slowed too. One of the key problems is that consumer spending growth has started to lose momentum after several quarters of solid expansion, but this has not been offset by stronger growth in domestic fixed investment and/or exports. Nevertheless, we expect activity to rebound moderately in the second half of the year as the interruptions of the second quarter fade away. But, it seems that the ongoing weakness in investment and exports (the outlook for the latter now looking even bleaker given the global growth slowdown), combined with the downward revision of Q1 growth, will cause growth for the full year to come in lower than our long-held 3.7% forecast. It now seems likely to come in at 3%-3.5%. The global economic slowdown will probably limit local growth in 2012 to roughly the same rate as 2011.

▲ With growth slowing, interest rate expectations have softened sharply, with most commentators now predicting that rates will not begin to rise before well into 2012. There is even speculation about another rate cut in coming months. While we agree with the first view, we do not think a rate cut is likely unless the local economy weakens sharply further in Q3. The problem is that inflation is still rising, at 5.3% in July (up from a cyclical low in February of 3.2%), the Reserve Bank's real repo rate is now very low and medium-term inflation risks remain considerable, with food prices still rising, high wage settlements over the past few months and still-rapid rises in administered prices such as electricity and municipal charges.

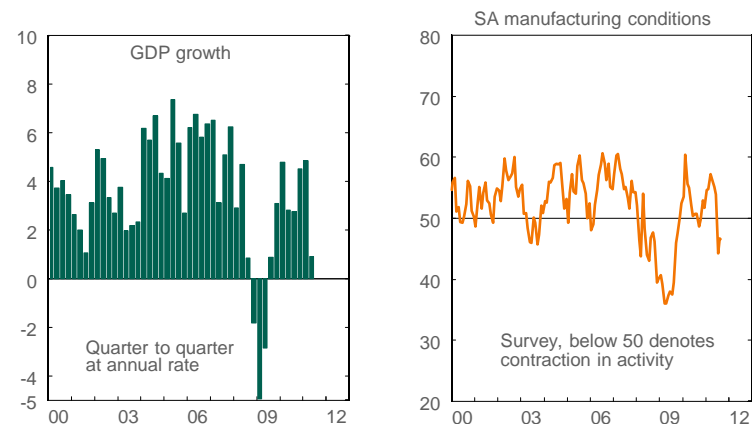
OMIGSA Economic Research Unit view: *The local recovery remains on track, although growth slowed sharply in the second quarter. Although we expect a rebound in the second half of 2011, growth for the full year will be about 0.5% weaker than our long-held 3.7% forecast, while 2012 should see a roughly similar growth performance.*

Rand softens on global worries, inflation rising



Source: OMIGSA (Iris)

SA recovery stalls, too



Source: OMIGSA (Iris)



Equity Sector Overview and Outlook

Resources

- ▲ The basic materials sector produced a return of -1.9% for the month of August, underperforming the FTSE/JSE All Share Index (ALSI)'s return of -0.3%.
- ▲ Precious metals had a better time of it, with the gold sector up 12.2% during the month and platinum up 4%, seemingly dragged along. With the coal sector up 7.1% (although flattered by corporate activity), the mining houses were the main culprit for dragging overall performance down. Their share price underperformance appeared to be more a function of international markets (particularly the LSE) than specific conditions. Of the two main drivers of results, iron ore prices remained firm during the month, and although the copper price came off, it recovered towards the end of the month and is still at extremely profitable levels.
- ▲ Strike season in South Africa largely has come and gone and despite the verbal militancy, settlements were largely in high single digits rather than the mid-teens initially demanded. The slight weakness in the rand, combined with strong precious metal, coal and iron ore prices, should lead to a strong margin recovery in the next reporting season if it persists. Nationalisation remains a relevant topic, although recent moves within the ANC could bring this to a head in the short term.

Equity Research view: *Following the de-rating of the mining houses, the majority of the global mining giants are now trading on ratings not seen since the dark days of 2008/9, despite the fact that balance sheets have been significantly strengthened. Their valuations remain relatively more compelling than the more pure plays, although with the industrial climate seemingly cleared up and a slightly weaker currency, some value is re-emerging in some of the purer plays.*

Small Companies

- ▲ The small cap and mid-cap indices returned -1.9% and -0.4%, respectively, for the month ended 31 August 2011, while the FTSE/JSE Top 40 Index returned -0.3%. The underperformance of shares at the small cap level highlights the concerns over the strength of the recovery in South Africa.
- ▲ The market was highly volatile in the month of August where global growth concerns, given excess debt levels, were highlighted every single day. The S&P downgrade of the United States (because of the political shenanigans over raising the debt ceiling), and the ongoing issues over rescue packages in the Eurozone, really emphasised how fragile the growth outlook is. Having over-gearred balance sheets generally limits the ability of countries to implement growth-supportive policy measures, and some painful decisions need to be taken in the future.
- ▲ There have also been sweeping changes to global growth forecasts - growth numbers out of the distressed areas will be fairly anaemic in the future. Most of the uncertainty surrounds the developed world and not the developing world. Emerging markets have slowed, but are still expected to show robust growth over the next few years, and this is where most international investors will continue to look for yield.
- ▲ With global growth under question, markets will continue to be nervous and volatile.

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 gained 1.3% for the month, outperforming the FTSE/JSE Shareholder Weighted All Share Index (SWIX) which was up 0.5% during the month.
- ▲ Within financials, the Banking Index gained 3.6%. August saw the start of the 2011 earnings season, with all the banks posting good growth as the operating environment continues to normalise. ABSA was the best performer in the month, benefitting from strong results and a reduction in its dividend cover. We see further potential for ABSA to reduce dividend cover in this low-growth environment.
- ▲ The life assurance sector lost 0.9%, mainly driven by the poor performance of Old Mutual, which was down 2.7% in the month. This was despite a good set of results released in August.
- ▲ For the balance of 2011, we expect the banks to continue their 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 will lift operating results in 2011. We believe some counters in the sector still present value, with ratings below historic averages.

Industrials

- ▲ Despite ending the month flat, August was a roller coaster for the Industrial Index. After falling about 9% in the first week of the month, the index managed to claw back the losses, particularly in the last week. The FTSE/JSE All Share Index (ALSI) experienced a similar pattern, and also ended the month flat. For the year-to-date, the Industrial Index is up 3% while the ALSI is down 2%.
- ▲ The recovery in share prices in the latter half of the month was helped by some solid results announcements. Heavyweight MTN reported flat results, but indicated it would be increasing its dividend payout (the MTN share price was flat). Retailers were the star performers as talk of a further rate cut surfaced, rather than the next move being up. The shares of Woolworths (+15%), Foschini (+8%) and Massmart (+10%) rallied hard. Woolworths produced strong results thanks to margin improvement in both food and clothing. Massmart's results were weak, hurt by costs associated with Walmart's investment as well as deflation in electronic goods. Richemont lost 7% in August (despite the rand losing about 5%), as investors grew concerned about the strength of the Swiss franc, which is pushing up manufacturing costs, as well as a slowdown in sales of luxury watches and jewellery in developed markets. The construction companies remained under pressure as government tender work continues to be elusive.

Equity Research view: We have for some time believed that the industrial sector was offering little value. While this view is unchanged, the volatility of the last month has seen share prices moving in opposite directions. Some of the more cyclical companies are offering long-term value, but many of the defensives are trading at even more expensive levels.



Equity Sector Overview and Outlook (cont.)

Property

- ▲ Listed property was a beneficiary of August's more benign interest rate expectations with a 2.8% total return. The market no longer anticipates an interest rate hike. Property underperformed the All Bond Index's 3.5% gains as property yields fell less than bond yields as a result of the reduced interest rate expectations. Property did outpace the All Share Index (-0.3%), but lagged the consumer services sector's 3.7% gain, the equity sector most closely linked to property .
- ▲ In August, listed property funds representing 62% of the sector by value reported their results. On average, distributions were 6.6% higher than the previous six months. Results season was disappointing on balance and highlighted the continued difficulties experienced in neighbourhood and community shopping centres, offices (especially B-grade) and hotels.
- ▲ Of those funds which provided guidance for future performance, two expect growth of 8-11%, two expect slightly negative to 3% growth, and heavyweight Growthpoint provided guidance between these two ranges.

Equity Research view: *The sector offers a one-year forward yield greater than 8%, which exceeds the 10-year bond yield, and distribution growth approximating inflation. Downside operational risk has reappeared, but base funding rates have reduced. Commercial building plans passed have fallen, which will facilitate rental increases in the recovery. Vacancies are plateauing, but may still increase in some pockets. 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). The direct commercial property market remains resilient. On a long-term secular view, property is attractive as existing rents are below feasibility rentals for developments, but building costs have softened.*



OLD MUTUAL

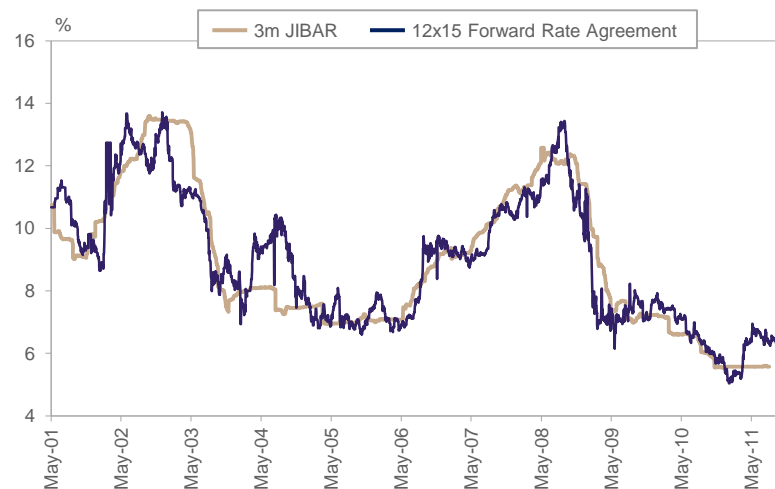
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Fixed Interest Overview and Outlook

- ▲ Growing uncertainty about economic growth prospects caused a fair amount of market volatility in August. Against this background, foreign investors continued to increase their South African bond holdings, taking their cue from relatively higher yields and healthier public finances. Bond-unfriendly data released during August included CPI, PPI, international trade and fiscal data. However, this was more than offset by weak activity data, particularly second quarter GDP. Moreover, the central bank made it clear that they are in no hurry to start the tightening cycle, considering weaker growth prospects and slowly rising core inflation. As a result, the forward money market is pricing in a small possibility of rate cuts during the next 12 months, following expectations of rising rates merely a few weeks ago.
- ▲ In light of the above, the yield of the 10-year RSA government bond declined sharply during the month, from 8.3% to 7.7%. Interestingly, buying also pushed the real yields of inflation-linked bonds lower, clearly reflecting concern about rising headline CPI. The All Bond Index returned 3.5% in August, followed by the Inflation-linked Index (3.4%) and cash (0.5%).
- ▲ It is worth noting that weaker growth prospects do not bode well for government's tax revenue targets. July fiscal data showed disappointing tax receipts, resulting in a higher budget deficit for the first four months of fiscal 2011/2012. Although it's still early days, the risk is rising for the budget deficit to be slightly higher than the target of 5.3% of GDP.

The forward rate market has started pricing interest rate cuts



Sources: Bloomberg, Futuregrowth

Futuregrowth view:

Recent market strength offered an opportunity to reduce interest rate risk as the market is getting too bullish on rate cuts. Corporate debt spreads keep tightening, forcing investors to become more price sensitive. Although low, inflation-linked bonds are still supported by multi-decade low short-term interest rates and rising headline CPI.

Economic Indicators to 31 August 2011

	Latest Data		Previous Year
Exchange Rates:			
Rand/US\$	August-11	6.99	7.37
Rand/UK Pound	August-11	11.35	11.31
Rand/Euro	August-11	10.05	9.35
Rand/Aus\$	August-11	7.47	6.58
Interest Rates:			
Prime Overdraft	August-11	9.00%	10.00%
3-month NCD rate	August-11	5.50%	6.30%
R157 Long Bond Yield	August-11	6.52%	7.23%
Inflation:			
CPI (y-o-y)	July-11	5.3%	3.7%
National Accounts:			
GDP Growth (y-o-y)	June-11	3.2%	2.9%
GDP Growth (q-o-q, annualised)	June-11	0.9%	2.8%
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%
Balance of Payments:			
Trade Balance (cumulative 12month)	July-11	\$1.14	-\$0.96
Current Account (% of GDP)	March-11	-3.1%	-4.4%
Capital Account (% of GDP)	March-11	7.8%	8.0%
Forex Reserves (incl. gold)	July-11	\$50.03	\$42.03
Other:			
Manufacturing Production (y-o-y) (seasonally adjusted)	June-11	1.0%	9.3%

Source: OMIGSA

Market Indicators to 31 August 2011

	1 Month (%)	Quarter (%)	Calendar Year (%)	12 Months (%)	3 Yrs (%)	5 Yrs (%)
Equity						
All Share Index	-0.3	-4.3	-1.8	16.9	6.8	10.1
Shareholders Weighted Index	0.5	-2.5	-0.4	17.1	8.6	11.2
All Share/Resources 50%	-0.1	-3.2	-0.1	17.4	9.2	11.1
Top 40 Index	-0.3	-5.0	-1.8	17.7	5.4	9.3
RAFI® 40 Index	-0.3	-5.0	-1.6	15.7	10.1	11.4
RAFI® All Share Index	-1.0	-5.3	-2.9	15.7	9.0	10.8
Resources Index	-1.3	-8.6	-8.6	14.8	-1.9	6.2
Financial Index	1.3	-2.2	1.7	9.7	9.5	6.7
Industrial Index	-0.2	-1.2	3.3	22.4	15.2	15.9
Mid-cap Index	-0.4	-0.1	-1.4	12.5	16.9	15.2
Small-cap Index	-1.9	-2.1	-5.0	12.4	8.9	11.3
Interest-Bearing						
ALBI BEASSA	3.5	5.2	7.4	9.0	11.7	9.8
STeFI	0.5	1.4	3.8	6.0	8.0	8.7
Cash	0.4	1.2	3.3	5.0	7.0	8.1
Property						
SA Quoted Property Index	2.8	5.6	7.3	14.5	18.5	17.6
International						
MSCI World Index (R)	-3.0	-7.8	2.1	9.2	-3.8	-0.3
MSCI World Index (\$)	-7.0	-10.1	-3.5	15.1	-0.7	0.4
JPM International Bond (R)	6.6	7.4	14.9	3.5	5.2	7.6
US 1-month LIBOR (R)	4.3	2.5	5.9	-4.9	-2.3	1.9
Inflation (Estimated)						
CPI	0.3	1.5	4.7	5.3	5.1	7.1

Source: OMIGSA

For more information, please contact:

Western Cape:

Old Mutual Investment Group South Africa (OMIGSA), West Campus: Entrance 2, 3rd Floor, Jan Smuts Drive, Pinelands 7405

Mike van Heerden – Senior Executive: Distribution

Tel: +27 21 509 5082

Cell: +27 82 450 4483

E-mail: mvheerden@omigsa.com

Paul Glendining – Investment Sales and Marketing Executive: Retail

Tel: +27 21 504 7690

Cell: +27 82 414 3412

E-mail: pglendining@omigsa.com

Nirdev Desai – Investment Sales and Marketing Executive: Retail

Tel: +27 21 504 6305

Cell: +27 82 419 4770

E-mail: ndesai@omigsa.com

Sue Brooks – Business Development Consultant

Tel: +27 21 509 3936

Cell: +27 82 728 8732

E-mail: sbrooks@omigsa.com

Gauteng:

Old Mutual Square, Umnotho Building, 3rd Floor, OMIGSA office, 93 Grayston Drive, Sandton 2196

Taz Victor – Investment Executive: Retail Institutional

Tel: +27 11 217 1002

Cell: +27 82 460 1495

E-mail: tvictor@omigsa.com

Eudrè Craven – Investment Executive: Retail Institutional

Tel: +27 11 217 1411

Cell: +27 82 447 2378

E-mail: ecraven@omigsa.com

Mokgadi Skwambane – Investment Sales and Marketing Executive: Retail

Tel: +27 11 217 1021

Cell: +27 71 681 0622

E-mail: mskwambane@omigsa.com

Wynand Gouws – Head: Retail Sales

Tel: +27 11 217 1664

Cell: +27 82 450 7386

E-mail: wgouws@omigsa.com

Sean du Buisson – Investment Sales and Marketing Executive: Retail

Tel: +27 11 217 1003

Cell: +27 82 926 6955

E-mail: sdubuisson@omigsa.com

Naleni Govender – Investment Sales and Marketing Executive: Retail

Tel: +27 11 217 1869

Cell: +27 83 472 0539

E-mail: ngovender@omigsa.com

Durban:

Viewz @ Westway, Office 3B, 11 The Boulevard, Westway Park 3611

Imtiaz Shaik – Investment Sales and Marketing Executive: Retail

Tel: +27 31 275 8305

Cell: +27 83 292 7860

E-mail: ishaik@oldmutual.com

Nondumiso Zulu – Investment Sales and Marketing Executive: Retail

Tel: +27 31 275 8305

Cell: +27 76 704 0282

E-mail: nzulu@oldmutual.com

Bloemfontein:

The Courtyard, 196 Nelson Mandela Drive, Bloemfontein 9300

Brian Vermeulen – Investment Sales and Marketing Executive: Retail

Tel: +27 51 505 2950

Cell: +27 83 408 0528

E-mail: bvermeulen@omigsa.com

Pretoria:

1st Floor, Glen Manor Office Park, Frikkie de Beer Street, Menlyn 0042

Hennie van Rensburg – Investment Sales and Marketing Executive: Retail

Tel: +27 12 369 7220

Cell: +27 83 286 2405

E-mail: hjansevanrensburg@omigsa.com

Eastern Cape:

3rd Floor, Mutual Plaza, Cnr Cape Rd & Langenhoven Dr, Greenacres, PE 6000

Brendan Capstick – Investment Sales and Marketing Executive: Retail

Tel: +27 41 502 4906

Cell: +27 74 762 8724

E-mail: bcapstick@omigsa.com

Regulatory Information

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

Physical address: Mutualpark, Jan Smuts Drive, Pinelands 7405

Telephone number: +27 21 509 5022

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