

# Market Dynamics

February 2011

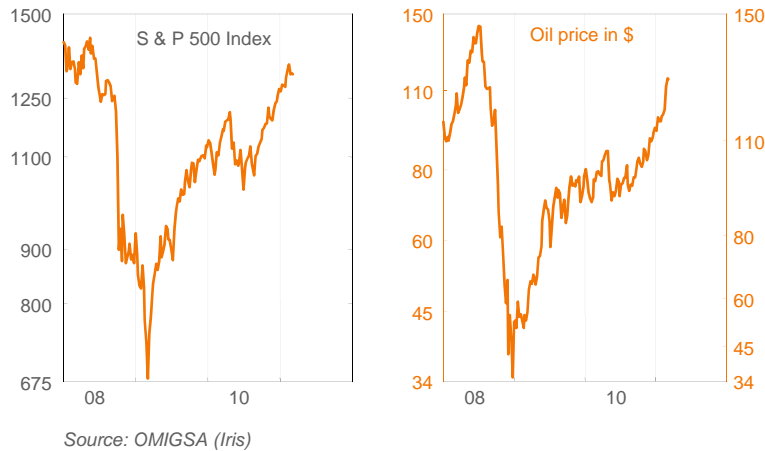


# Contents

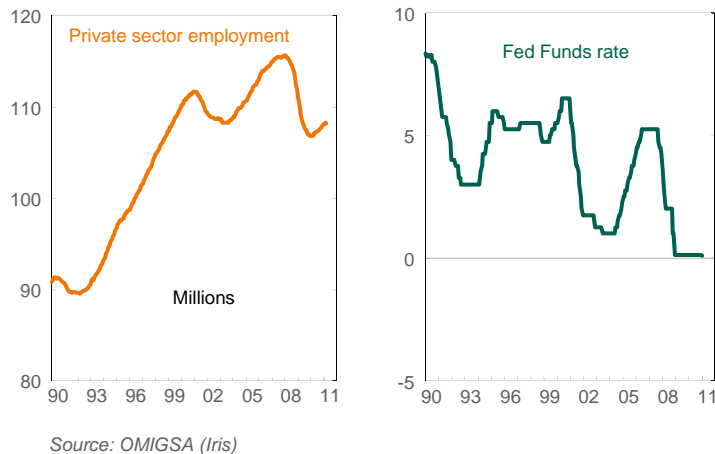
▲ Economic Overview and Outlook	1-2
▲ Equity Sector Overview and Outlook	3-5
▲ Fixed Interest Overview and Outlook	6
▲ Economic Indicators	7
▲ Market Indicators	8
▲ Contact Details	9
▲ Regulatory Information	10

# World Economic Overview and Outlook

## Equities fall back on Middle East troubles and surging oil price



## US data point to improving growth, yet rates to stay low



- ▲ February will best be remembered for the continuation and spread of political troubles in the Middle East and North Africa. Pro-democracy social unrest, which had already caused the resignation of leaders in Tunisia and Egypt, caught on in other countries in the area, most notably Libya, Bahrain, Algeria and Oman. Concerns about disruptions to global oil supply flared up as reports circled that output in Libya, which produces about 2% of the global total, had almost halved by late February. In reaction oil prices spiked, reaching almost \$120 per barrel at one stage, before easing off on reports that Saudi Arabia was increasing production to ensure sustained supplies. With the situation in the Middle East very fluid, there is great investor uncertainty about how long this current situation may last and how badly the world economy will be affected via a possible further rise in oil prices and/or a disruption in oil supplies.
- ▲ In addition to the short-term risks and uncertainties to the global economic outlook, the unrest also raised some questions about the political stability of developing countries in general and what the economic policy implications would be over the medium term. We think it will raise the urgency in developing countries to keep economic growth going and to achieve a more equal distribution of income. This, in turn, may also imply more lax policies than would have been the case otherwise. At the same time, though, great care will have to be taken to ensure price stability, as inflation and price shocks have proved to be a potential trigger of political instability.
- ▲ Global equity markets reflected the growing global risks from the situation in the Middle East, rising oil and food prices, the continued tightening of monetary policy in the developing world and ongoing fiscal tightening in the developed world. As a result, equity prices extended their January declines, although the sell-off was fairly moderate as the still-solid global recovery, good earnings reports and unattractive alternative investment options lent some support.
- ▲ Despite the building risks and headwinds for the world economy, incoming data suggests the global expansion is alive and well, with the developed world, in particular, now delivering the marginal growth surprise. While risks have risen in recent weeks, we remain confident that the recent developments will not entirely derail the global recovery, but this requires calm to return to the Middle East soon, allowing oil prices to ease.

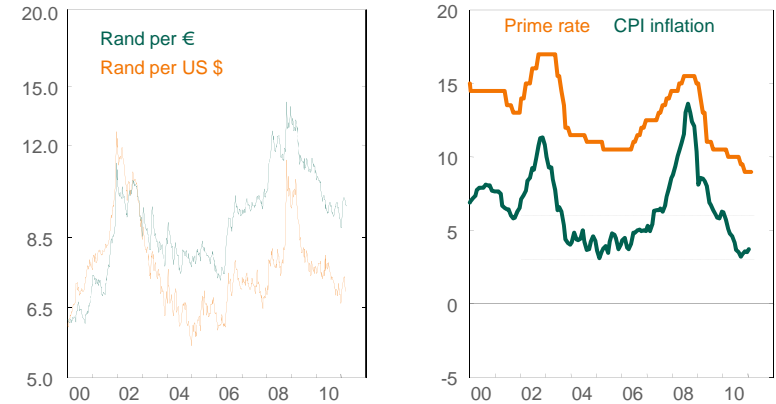
**OMIGSA Economic Research Unit view:** Recent troubles in the Middle East, rising oil prices and ongoing policy tightening have clouded the outlook for the world economy. We remain confident, though, that the expansion will not be derailed.

# Local Economic Overview and Outlook

- ▲ The key local event in February was the Budget. While financial markets reacted very little to the budget proposals, commentators were generally far more critical. In particular, the upward revision to the projected budget deficits over the next three years is of concern. While the deficit is still projected to decline over this period, deficit reduction is now only expected to start in 2012/13 and will take place at a slower pace than previously projected. The deficit for the 2011/12 fiscal year is projected to be over 5% of gross domestic product (GDP), uncomfortably large two years into the economic recovery. The concern is that sustained strong gains in current spending by government will eventually end up in permanently larger deficits and/or a further rise in the tax burden and/or cutbacks in spending on infrastructure. Any or all of these will hold serious negative long-term implications for South Africa (SA)'s growth prospects.
- ▲ February also saw a gradual recovery of the rand, following the sell-off in January. Rising commodity prices, good foreign trade data and a perception that SA is not particularly susceptible to Middle East-type political troubles probably contributed to the currency's recovery. Nevertheless, we remain of the opinion that it remains overvalued, and that a moderately softer rand will do more good than harm to local economic prospects over the medium term.
- ▲ The news on the local economy over the past month was generally good. Our assessment over the past few months that local economic growth probably accelerated quite firmly in the fourth quarter of 2010 was confirmed, with a 4.4% annualised number being released. For the full 2010 calendar year GDP is estimated to have increased by about 2.8%. We maintain our long-held view that growth will improve moderately in 2011, and our projection of little over 3.5% remains unchanged.
- ▲ A relatively stable rand over the remainder of 2011, following the recent weakening, is indeed key to inflation prospects in 2011. The surge in global food and energy prices, together with the recent weakening of the rand, has already started to put upward pressure on the petrol price as well as local maize and wheat prices. While we are still forecasting a relatively moderate rise in inflation to about 5% by 2011 year-end from the current 3.5%, we are concerned that inflation risks are now skewed to the upside. Interest rates will remain on hold for some time to come still, but the first hike in rates may occur somewhere between the fourth quarter of 2011 and the opening months of 2012.

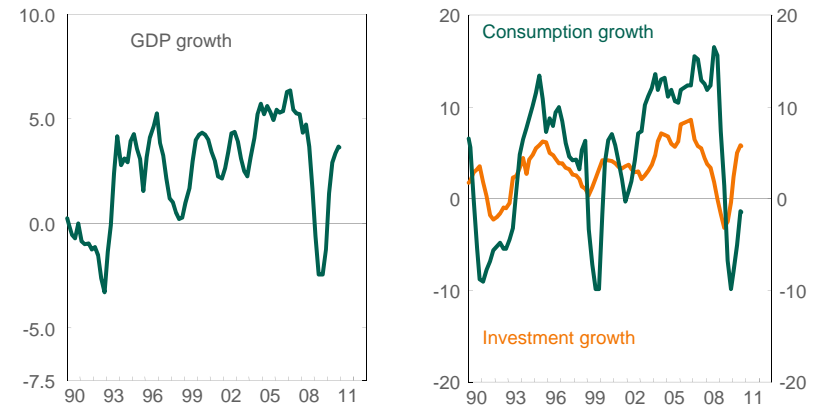
**OMIGSA Economic Research Unit view:** *The local recovery gathered momentum in the fourth quarter of 2010. Together with rising oil and food prices, the focus has turned back to the timing of the start of the interest rate up-cycle in SA. We expect this to begin around the turn of the year.*

## Rand firms, inflation on moderate uptrend



Source: OMIGSA (Iris)

## SA recovery on track, investment lags



Source: OMIGSA (Iris)



# Equity Sector Overview and Outlook

## Resources

- ▲ The basic materials sector produced a return of 4.7% for February, outperforming the FTSE/JSE All Share Index (ALSI)'s 2.8% return. The oil & gas, gold mining and steel sectors managed to outperform, while the laggards included the construction, platinum and chemical sectors.
- ▲ We had previously stated that we find similarities between 2010 and 2008, and the fund was actively being positioned to take into account relatively more challenging conditions, especially the increased risk associated with high commodity and share prices. These similarities are increasingly apparent in 2011.
- ▲ While the very strong rand has dampened the short-term outlook for some shares, we feel it is also an ideal time to increase our offshore exposure to further optimise the risk-adjusted returns.

**Equity Research view:** *The diversified miners are protected by their exposure to a variety of commodities and currencies in their portfolios, 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 -0.9% and 0.1% respectively, for the month ended 28 February 2011, while the FTSE/JSE Top 40 Index returned 3.3% over the same period. The underperformance of shares at the small/mid-cap level was due to a solid performance by large cap mining stocks in the month.
- ▲ The market was very strong over the month, driven largely by the basic materials and oil & gas sectors. Concerns over oil supply disruptions and Middle East tensions impacted on the prices of many commodities. The bigger picture now concerns the threat of inflation and interest rates hikes that may be needed to curb global inflation. Markets do not like rising interest rate environments, and coupled with increased political unrest, this could lead to some short-term weakness.
- ▲ The concerns centre on whether or not the Chinese population will embark on the same demonstrations as those experienced in the Middle East. Food inflation will nevertheless remain a global phenomenon, and will be a key trigger in causing regional turmoil.
- ▲ Economic growth numbers are being revised down in China, but the United States appears to be on a firmer recovery than initially thought. Europe still remains in the doldrums despite the strength in Germany.

**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 was down 0.4% for the month of February 2011. This was behind the FTSE/JSE Shareholder Weighted All Share Index (SWIX), which was up close to 2% for the month.
- ▲ The Banking Index was down 2.4%, while the life assurance sector was up 2.5%. The life sector performance was driven by the continued rebound of Old Mutual, following December losses, as well as some strong performances from Discovery and Liberty, following encouraging results announcements recently. Discovery's international operations showed signs of turning around, while Liberty results showed that policy lapses are eventually being brought under control.
- ▲ The weakness in the banking sector was mainly driven by Standard Bank, which was down 5% in the month. Speculation about a change in strategy at the bank, as well as uncertainty around its retrenchment programme, contributed to the poor performance. ABSA's lacklustre results added more pressure on the sector, while Nedbank's solid results did little to offset the losses.
- ▲ Going into 2011, we expect the banks to focus on the cost line as revenue growth remains subdued. Results will also be supported by a recovery in credit losses, while any possible rise in interest rates later in the year could support net interest margins. Life companies, on the other hand, should continue to show an improving trend in lapse experience and recurring premium sales due to improving real household incomes.

**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 sector continued to underperform the overall market in February, up 1.8% compared to the overall market, which was up 2.8%.
- ▲ The performance was mostly in the rand hedge shares as risk aversion increased and the rand took some pressure. With the rand being so volatile, this performance could easily switch in months to come.
- ▲ With speculation about the upward spiralling food inflation internationally, combined with a weaker rand, food retailers attracted a lot of buying. They have had a tough year, trading against the headwind of food deflation, or very low inflation, and now the tide is turning in their favour. Woolworths was up 14% in the month, which was primarily after releasing an excellent set of results.
- ▲ The construction shares continue to struggle, particularly Murray & Roberts, who announced large write-offs, followed by the immediate retirement of both the CEO and Financial Director. These shares are eventually starting to look attractive, even though the environment for construction is still not improving, and faces some big headwinds with government capital spending not matching previous years, and the private sector remaining reticent to invest.

**Equity Research view:** The industrial sector does not appear to have much upside as a whole, yet we are starting to see some value in the construction shares. However, many shares in the sector remain relatively defensive, with strong balance sheets and dividend yields.



# Equity Sector Overview and Outlook (cont.)

## Property

- ▲ Listed property lost 1.2% in February, with bond yields edging slightly higher. This was despite the gain in the FTSE/JSE All Share Index (ALSI) (2.8%) and general retailers (2.1%) and a flat All Bond Index (although the long-end index lost 1.5%).
- ▲ During February, many property companies released results and guidance. On the whole, these were below market expectations, with significant increases in office and industrial vacancies reported, consistent with our more bearish short-term outlook. Bucking the trend, heavyweight Growthpoint's operational results and outlook were welcome. On balance, the market may modestly revise down sector distribution growth expectations.
- ▲ Following the year-to-date price movements, property now offers improved relative value compared to equities in general (listed property's outperformance against the ALSI over the past 12 months has been erased), with less downside risk.

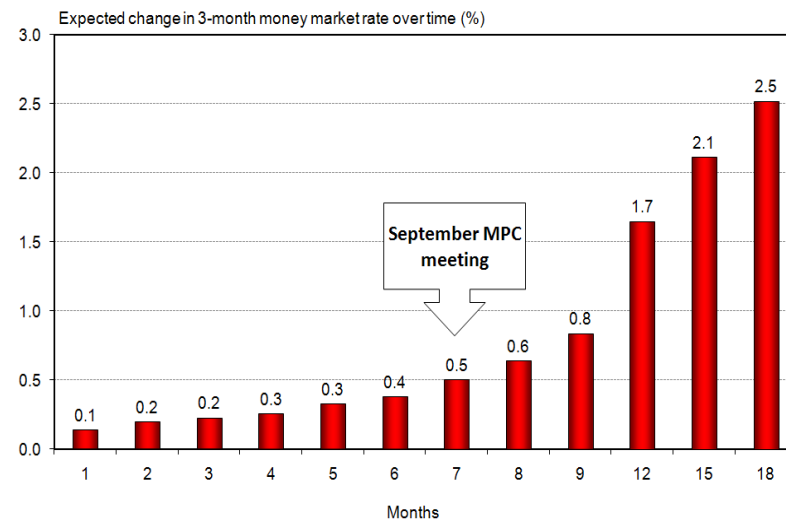
**Equity Research view:** *The sector offers a 1-year forward yield in line with bond yields, improved value relative to equities and distribution growth (about 6% expected) higher than consensus inflation estimates. Downside operational risk has declined, funding conditions are easier and commercial building plans passed have fallen materially. 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.*



# Fixed Interest Overview and Outlook

- ▲ One of the main drivers of market sentiment over the past month has been the impact of political strife in North Africa and parts of the Middle East. These events, and in particular Libya, caused crude oil prices to spike by 13% in February. While this was softened somewhat by rand strength, it did not offer enough of a cushion. We can hardly ignore another sharp rise in petrol/diesel prices combined with the soft commodity market bull rally. It therefore does not come as a surprise that market inflation expectations of 6.3% (the difference between the 10-year fixed-rate and inflation-linked bonds) are ahead of economic consensus forecasts.
- ▲ As could be expected in this environment, in February the inflation-linked index rendered the highest return of the three interest rate subclasses, with +1.0%. This was followed by the money market (+0.4%) and the All Bond Index (+0.1%). The low return of the All Bond Index was caused by rising long-dated bond yields, whereas short- and medium-dated bonds marginally outperformed cash. The continued steepening of the yield curve is the net result of rising future inflation expectations and of a worse-than-expected outcome with respect to the funding requirements by National Treasury for the 2011/2012 fiscal year, as tabled on 23 February 2011.
- ▲ Recent data releases and events have strengthened our view that the inflation (and interest rate) cycle has turned the corner. Although inflation could still be relatively well behaved in the near term, due to the lagged effect of the rand's strength last year, the medium-term outlook is more concerning. It therefore follows that the central bank will be required to start the policy-tightening cycle, as a repo rate at its lowest level since 1974 is unsustainable against this backdrop. However, it is important to note that the interest rate market has priced in a lot of bad news, leaving some room for a near-term relief rally. The soft commodity bull rally has been going on for around seven months and could lose momentum. Secondary drivers, such as an expected total coupon flow of R15bn in March, could also potentially assist in stemming the most recent selling tide.

The market has priced in a 50 basis point repo rate increase by September and a total of 2.5% in eighteen months' time...



Source: Bloomberg

## Futuregrowth view:

*Although the yield curve is expected to retain its positive slope, given that we have reached the lower turning point in the inflation and interest rate cycle, current steepness offers a near-term tactical opportunity. 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, despite low real yields.*

# Economic Indicators to 28 February 2011

	Latest Data		Previous Year
<b>Exchange Rates:</b>			
Rand/US\$	February-11	6.96	7.69
Rand/UK Pound	February-11	11.31	11.73
Rand/Euro	February-11	9.61	10.49
Rand/Aus\$	February-11	7.09	6.74
<b>Interest Rates:</b>			
Prime Overdraft	February-11	9.00%	10.50%
3-month NCD rate	February-11	5.50%	7.10%
R157 Long Bond Yield	February-11	7.77%	8.17%
<b>Inflation:</b>			
CPI (y-o-y)	January-11	3.7%	6.2%
<b>National Accounts:</b>			
GDP Growth (y-o-y)	December-10	3.7%	-1.2%
GDP Growth (q-o-q, annualised)	December-10	4.4%	3.1%
HCE Growth (y-o-y) (Household Consumption Expenditure)	September-10	5.8%	-2.6%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	September-10	-1.4%	-6.7%
<b>Balance of Payments:</b>			
Trade Balance (cumulative 12month)	January-11	\$1.48	-\$0.53
Current Account (% of GDP)	September-10	-3.0%	-3.1%
Capital Account (% of GDP)	September-10	4.1%	4.8%
Forex Reserves (incl. gold)	January-11	\$46.80	\$39.64
<b>Other:</b>			
Manufacturing Production (y-o-y) (seasonally adjusted)	December-10	0.8%	3.4%

Source: OMIGSA

# Market Indicators to 28 February 2011

	1 Month (%)	Calendar Year (%)	Quarter (%)	12 Months (%)	3 Yrs (%)	5 Yrs (%)
<b>Equity</b>						
All Share Index	2.8	0.6	6.8	23.6	4.6	14.1
Shareholders Weighted Index	2.0	-1.4	5.0	21.2	5.6	13.4
All Share/Resources 50%	2.2	-0.5	5.3	22.7	6.6	13.6
Top 40 Index	3.3	1.6	8.4	23.9	3.5	14.0
RAFI® 40 Index	3.1	1.8	8.6	24.3	8.3	15.2
RAFI® All Share Index	2.5	1.3	7.6	23.7	7.5	14.2
Resources Index	5.3	4.8	12.9	26.9	-2.1	15.5
Financial Index	-0.4	-1.9	2.7	11.7	5.0	7.0
Industrial Index	1.9	-2.3	3.0	26.1	13.0	16.4
Mid-cap Index	0.1	-4.7	-1.8	22.1	13.7	15.1
Small-cap Index	-0.9	-4.5	-0.1	18.0	4.1	12.2
<b>Interest-Bearing</b>						
ALBI BEASSA	0.1	-2.1	-0.4	10.1	9.8	7.1
STeFI	0.4	0.9	1.5	6.7	8.9	8.9
Cash	0.4	0.8	1.2	5.6	8.1	8.2
<b>Property</b>						
SA Quoted Property Index	-1.2	-5.3	-3.2	16.3	13.0	13.8
<b>International</b>						
MSCI World Index (R)	0.1	11.1	11.3	10.8	-3.3	5.8
MSCI World Index (\$)	3.6	5.9	13.7	22.3	0.4	3.3
JPM International Bond (R)	-3.0	5.2	-0.4	-4.1	0.8	9.8
US 1-month LIBOR (R)	-3.3	4.9	-2.1	-9.2	-2.3	5.4
<b>Inflation (Estimated)</b>						
CPI	0.6	1.1	1.2	3.6	6.0	6.7

Source: OMIGSA

For more information, please contact:

**Western Cape:**

Old Mutual Investment Group, 3<sup>rd</sup> Floor, West Campus, Mutualpark, Pinelands 7405

Mike van Heerden – Senior Executive: Distribution

Tel: +27 21 509 5082 Cell: +27 82 450 4483

E-mail: [mvheerden@omigsa.com](mailto:mvheerden@omigsa.com)

Paul Glendining – Investment Marketing & Sales Executive: Retail

Tel: +27 21 504 7690 Cell: +27 82 414 3412

E-mail: [pglendining@omigsa.com](mailto:pglendining@omigsa.com)

Nirdev Desai – Investment Marketing & Sales Executive: Retail

Tel: +27 21 504 6305 Cell: +27 82 419 4770

E-mail: [ndesai@omigsa.com](mailto:ndesai@omigsa.com)

Sue Brooks – Business Development Consultant

Tel: +27 21 509 3936 Cell: +27 82 728 8732

E-mail: [sbrooks@omigsa.com](mailto:sbrooks@omigsa.com)

**Gauteng:**

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

Taz Victor – Investment Marketing & Sales Executive: Fund of Funds

Tel: +27 11 217 1002 Cell: +27 82 460 1495

E-mail: [tvictor@omigsa.com](mailto:tvictor@omigsa.com)

Wynand Gouws – Head: Retail Channel Management

Tel: +27 11 217 1664 Cell: +27 82 450 7386

E-mail: [wgouws@omigsa.com](mailto:wgouws@omigsa.com)

Eudrè Craven – Investment Executive: Retail & Institutional

Tel: +27 11 217 1411 Cell: +27 82 447 2378

E-mail: [ecraven@omigsa.com](mailto:ecraven@omigsa.com)

Sean du Buisson – Investment Marketing & Sales Executive: Retail

Tel: +27 11 217 1003 Cell: +27 82 926 6955

E-mail: [sdubuisson@omigsa.com](mailto:sdubuisson@omigsa.com)

Mokgadi Skwambane – Investment Marketing & Sales Executive: Retail

Tel: +27 11 217 1021 Cell: +27 71 681 0622

E-mail: [mskwambane@omigsa.com](mailto:mskwambane@omigsa.com)

**Durban:**

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

Imtiaz Shaik – Investment Marketing & Sales Executive: Retail

Tel: +27 31 275 8305 Cell: +27 83 292 7860

E-mail: [ishaik@oldmutual.com](mailto:ishaik@oldmutual.com)

**Bloemfontein:**

PHG Building, 196 Nelson Mandela Drive, Bloemfontein 9300

Brian Vermeulen – Investment Marketing & Sales Executive: Retail

Tel: +27 51 505 2950 Cell: +27 83 408 0528

E-mail: [bvermeulen@omigsa.com](mailto:bvermeulen@omigsa.com)

**Pretoria:**

1<sup>st</sup> Floor, Glen Manor Office Park, Frikkie de Beer Street, Menlyn 0042

Hennie van Rensburg – Investment Marketing & Sales Executive: Retail

Tel: +27 12 369 7220 Cell: +27 83 286 2405

E-mail: [hjansevanrensborg@omigsa.com](mailto:hjansevanrensborg@omigsa.com)

**Eastern Cape:**

3<sup>rd</sup> Floor, Old Mutual Place, Cnr Cape Rd & Langenhoven Dr, Greenacres, PE 6000

Wynand Gouws – Head: Retail Channel Management

Tel: +27 11 217 1664 Cell: +27 82 450 7386

E-mail: [wgouws@omigsa.com](mailto:wgouws@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

Old Mutual Investment Group (South Africa) (Pty) Limited is a licensed financial services provider, FSP 604, approved by the Registrar of Financial Services Providers ([www.fsb.co.za](http://www.fsb.co.za)) to provide intermediary services and advice in terms of the Financial Advisory and Intermediary Services Act 37 of 2002. Old Mutual Investment Group (South Africa) (Pty) Limited is a wholly owned subsidiary of Old Mutual (South Africa) Limited. Reg No 1993/003023/07.

The investment products are market-linked. Products are either policy based or unitised in collective investment schemes. Investors' rights and obligations are set out in the relevant contracts. Market fluctuations and changes in rates of exchange or taxation may have an effect on the value, price or income of investments. Since the performance of financial markets fluctuates, an investor may not get back the full amount invested. Past performance is not necessarily a guide to future investment performance.

Personal trading by staff is restricted to ensure that there is no conflict of interest. All directors and those staff who are likely to have access to price sensitive and unpublished information in relation to the Old Mutual Group are further restricted in their dealings in Old Mutual shares.

All employees of Old Mutual Investment Group (South Africa) (Pty) Limited are remunerated with salaries and standard short-term and long-term incentives. No commission or incentives are paid by Old Mutual Investment Group (South Africa) (Pty) Limited to any persons. All inter-group transactions are done on an arm's length basis.

In respect of pooled, life wrapped products, the underlying assets are owned by Old Mutual Life Assurance Company (South Africa) Limited, who may elect to exercise any votes on these underlying assets independently of Old Mutual Investment Group (South Africa) (Pty) Limited.

In respect of these products, no fees or charges will be deducted if the policy is terminated within the first 30 days. Returns on these products depend on the performance of the underlying assets.

Old Mutual Investment Group (South Africa) (Pty) Limited has comprehensive crime and professional indemnity insurance, as part of the Old Mutual Group cover. For more detail, as well as for information on how to contact us and on how to access information, please visit [www.omigsa.com](http://www.omigsa.com).