

# Market Dynamics

January 2010

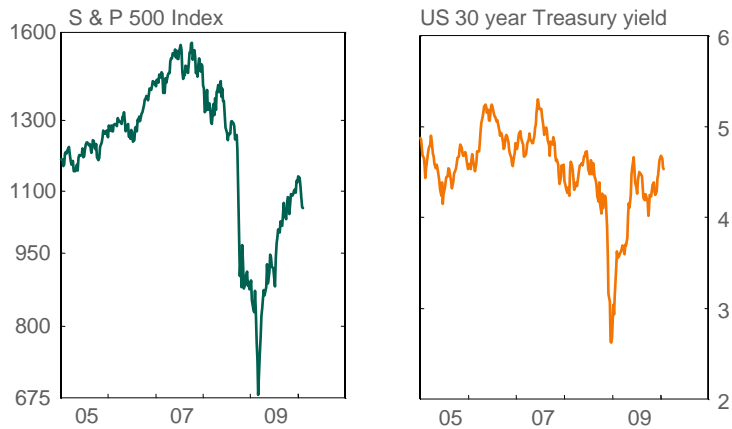


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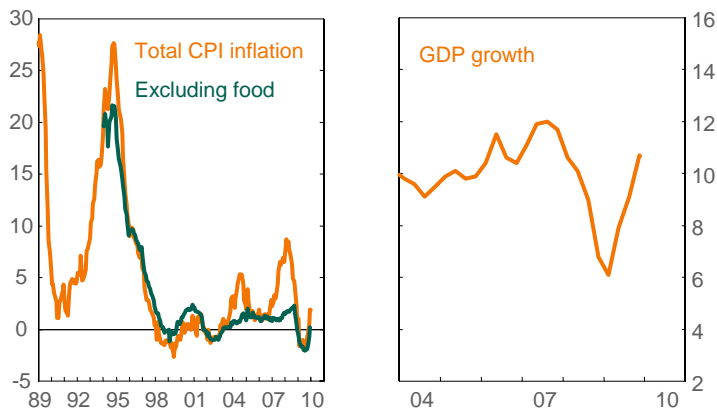
# World Economic Overview and Outlook

## US markets reflect renewed concerns



Source: OMIGSA (Iris)

## China inflation rises, growth booms



Source: OMIGSA (Iris)

- ▲ The past month saw a considerable degree of worry gripping investors around the globe, causing a sharp pull-back in equity markets around the world.
- ▲ The reasons for the concerns were very varied and included a spike in China's latest inflation numbers and a consequent tightening in policy by the Chinese Central Bank, US President Obama's bank plan, concerns over the implications of mounting fiscal problems in many countries, with Greece the prime focal point, and some signs that the global recovery is losing some momentum.
- ▲ While none of the worries mentioned above will derail the global recovery, markets, having rallied strongly last year, were clearly not priced for any bad news. It is therefore no surprise that this sudden stream of concern triggered a fairly sharp sell-off.
- ▲ Meanwhile, the global upswing remains on track, led by Asia and the US. US fourth quarter GDP growth came in at above-consensus 5.7% annualised. Yet, while stronger-than-expected, more than half of the gain in quarterly production was owing to slower inventory rundowns (i.e. less selling out of warehouses meant output had to rise). Final demand rose a far less robust 1.8%.
- ▲ In addition, recently released data in the US, the Eurozone and Japan indicate that the pace of the global recovery has started to lose some momentum. While this is not completely unexpected, it has raised concerns among some investors that the global recovery may falter completely. While we do not share this pessimistic view, there are still many structural obstacles in the way of the global recovery that will keep growth mediocre over the medium term.

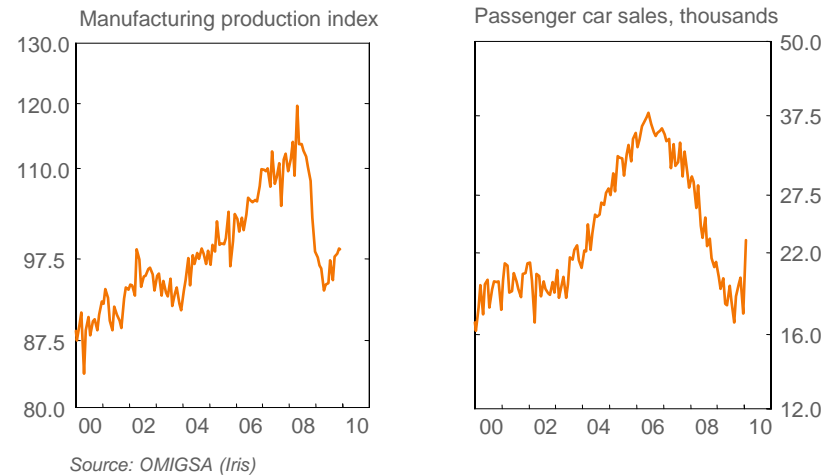
**OMIGSA Economic Research Unit view:** *While short-term prospects continue to brighten, there are still many obstacles and risks that cloud medium-term prospects for the world economy.*

# Local Economic Overview and Outlook

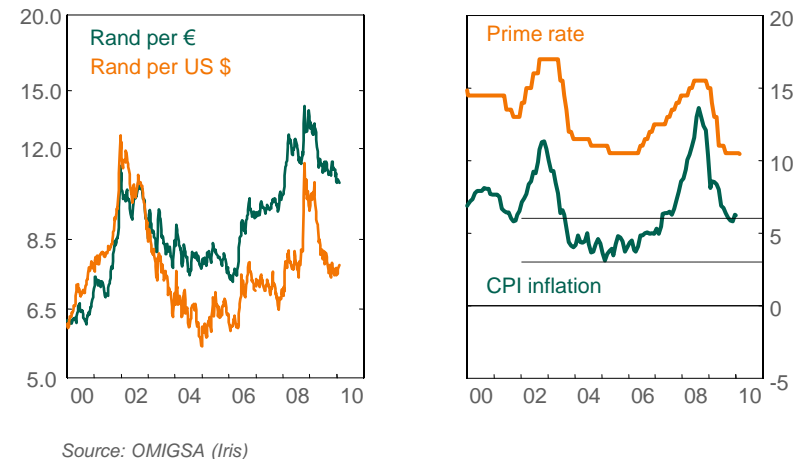
- ▲ Data released towards the end of 2009 suggest that the recovery in the economy that started in the third quarter continued in the fourth, but still at a very sluggish pace. A moderate recovery in exports, a slower pace of inventory depletion and ongoing growth in public sector spending are lending welcome support to the production side of the economy. Latest data suggest that consumer demand may finally also be showing some signs of life. New vehicle sales bounced quite strongly in January and mortgage lending by banks has increased moderately over the past few months. Nevertheless, more evidence of recovery is required to confirm that consumer demand has finally turned the corner.
- ▲ With consumption showing some signs of life, our view that growth may accelerate quite strongly from the second quarter of the year remains in place. The Soccer World Cup will provide a welcome additional impetus to the economy.
- ▲ The recent turmoil in global financial markets has left the rand surprisingly unscathed. While it weakened against the strengthening US dollar, it firmed sharply against the euro and moved broadly sideways against most of the other major currencies.
- ▲ Inflation jumped to 6.3% in December from 5.8% in November. This rise was largely expected and was essentially the result of a large cut in the petrol price in December 2008, not being repeated in 2009. We expect inflation to dip back into the target range in the second quarter and to remain just inside the target range for most of 2010. A better inflation performance will likely be prevented by another large electricity price hike, the lagged impact of sizeable wage hikes in 2009 and still rapidly rising administered prices in general (education costs, municipal charges, etc).
- ▲ While interest rates have probably reached a bottom and will likely remain at these levels for some time, there is an outside chance of another cut if the economy remains weak and inflation surprises on the positive side.

**OMIGSA Economic Research Unit view:** *The local economy is back in positive growth territory, but the recovery will likely be modest – especially from the side of consumer spending. This keeps open the possibility of a further lowering of local interest rates.*

## Recovery signs mount



## Rand firm, inflation just outside target range



# Equity Sector Overview and Outlook

## Resources

- ▲ We expect most mining companies to post substantially lower profits than their last set of record results, with pressure on earnings during 2009 due to materially lower commodity prices and/or volumes.
- ▲ The market has correctly “looked through” these unrepresentative results and continuing evidence of an earlier and stronger-than-expected recovery in China and India, with signs of stabilisation in the G7.
- ▲ Despite the debate regarding global growth, there is substantial value in certain shares and/or sectors – such as non-mining resources.
- ▲ Looking into 2010, we find similarities between H1 2010 and H1 2008, and we are taking into account the relatively more challenging conditions, especially the increased risk associated with high commodity and share prices. While the very strong rand has dampened the short-term outlook for some shares and the performance of the OM Mining & Resources Fund, it is also an ideal time to increase our offshore exposure.

**Investment 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. Mining valuations are not as compelling, due to the recent strong share price performance. While short-term conditions are tough for some non-mining resources companies, valuations are relatively attractive.*

## Small Companies

- ▲ The small cap and mid-cap indices returned -0.5% and -2.1%, respectively, for the month of January 2010, while the FTSE/JSE Top 40 Index returned -3.8%.
- ▲ The new year has started off with robust economic growth numbers, calls for increased banking regulations and reduced lending numbers out of China. Generally, this raised concerns about how strong the recovery will be when “stimulus” packages are slowly removed from the system.
- ▲ Numerous trading updates are starting to emerge and the consensus from companies’ management is that economic recovery in SA will start in mid-2010. We look forward to company earnings numbers with “cautious optimism”.
- ▲ The impacts of a stronger rand, lower volumes and deflationary pricing will emerge in the next round of results, and operating margins are expected to remain under pressure.
- ▲ Most of the comments from the retailers have indicated that discretionary spending remains subdued, given the effects of job losses and lower levels of spending power.

**Investment Research view:** *The average price/earnings (p:e) ratio at which small caps trade compared with large caps remains close to a 10% discount again.*

# Equity Sector Overview and Outlook (cont.)

## Financials

- ▲ The FTSE/JSE Financial Index gained 1.2% for the month of January 2010. It outperformed the FTSE/JSE Shareholder Weighted All Share Index (SWIX), which ended the month 2.6% down.
- ▲ Within financials, the banking sector provided the lift, returning 4.3% in the month, mainly boosted by strong performance from Standard Bank. In contrast, the life sector was down 2.1% mainly as a result of poor performance from Old Mutual, which was down close to 4% over the same period.
- ▲ The financial sector continues to benefit from an improved local economic environment following positive GDP growth for the third quarter of 2009, and expectations that the fourth quarter GDP will show continued consolidation of the trend.
- ▲ As the reporting season for the sector commences, we expect company results to show evidence of a tough operating environment in 2009, with loan impairment ratios for banks and policy termination rates for life companies remaining at elevated levels.
- ▲ However, we expect an operational recovery to commence sometime in 2010, supported by a stabilising economy and improved household incomes.

**Investment Research view:** *After a tough operating environment for financial stocks in 2009, we expect the situation to start improving sometime in 2010. Although there has been a re-rating of financial stocks over the last eight to 12 months, valuations on certain of the counters still look attractive with ratings still below historic averages.*

## Industrials

- ▲ The Industrial sector has started the year by giving back some of the previous year's gains, losing 2.7% in January 2010, but still outperforming the ALSI, which was down 3.5% over the same period.
- ▲ Performance was erratic across the sector, but the bigger losses were seen in the construction, healthcare and telecoms sectors. In the case of healthcare, it was just cooling off after some spectacular performance in previous months.
- ▲ Except for a few stragglers, retail shares held their levels, as did food manufacturers.
- ▲ The retailers' trading updates were mostly acceptable, although none shot the lights out. There were, however, two disappointing trading updates, JD Group and Foschini, and both these shares performed badly as a result. It does not seem as if the consumer went on a big spending spree over December 2009, and there are still lingering worries of a post-Christmas hangover.
- ▲ We are hopeful of some consumer recovery later in the first half of 2010, especially if job losses subside and perhaps even reverse slightly. However, we certainly don't expect a consumer boom given the indebtedness of consumers and some of the cost pressures facing them.

**Investment Research view:** *Industrials as a whole are fairly valued, although we still find pockets of value in some shares.*

# Equity Sector Overview and Outlook (cont.)

## Property

- ▲ Listed property showed its defensiveness relative to equities in January 2010. According to FTSE/JSE calculations, it delivered a total return of -0.3% compared to the All Share Index's -3.5%. Property is less defensive than bonds. The All Bond Index scraped in a positive return of 0.3%.
- ▲ Compared to bonds, property still offers less relative value than a year ago. Relative to other equities, it should continue to do better if the market falls further.
- ▲ Not surprisingly, the Capital Property Fund started the 2010 reporting season with a 14.4% distribution growth. This is a notably strong performance, which was not indicative of sector conditions. Capital expects distribution growth to fall to 9%-11% this year. Even if the lower-limit is achieved, it is likely to comfortably exceed the sector average.
- ▲ Many funds report in February 2010 and we are particularly interested in the degree to which vacancy rates and bad debts have increased, and how rental growth on expiry is still being achieved, as well as management expectations.

**Investment Research view:** *The sector is appropriately valued and can sustain positive nominal distribution growth, albeit at a slower rate over the medium term. Direct property market news flow may become more negative (e.g. office vacancy rates are heading for double digits in some markets), higher electricity costs constrain net rental growth and significant new space continues to be released. The optimism implicit in the strength in retailers' share prices is positive for listed property. On a long-term secular view, property remains attractive as existing rents are below viability rentals for new developments.*

# Interest Rate Overview and Outlook

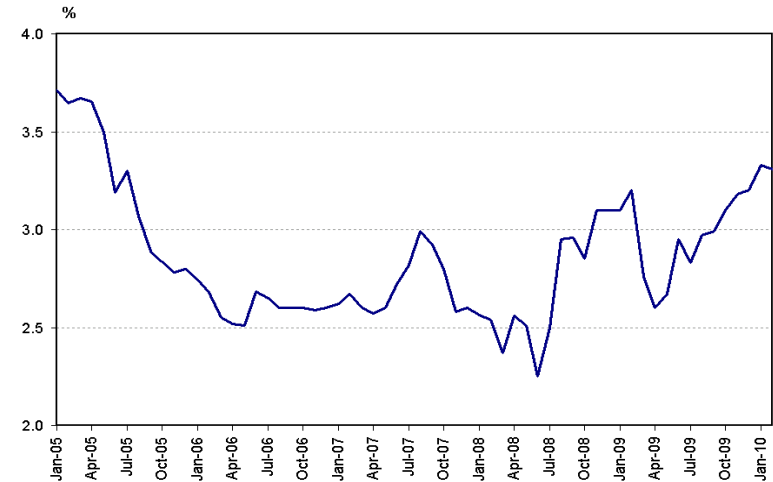
- ▲ The first month of 2010 will probably be remembered for its fairly wide trading range. The yield of the R207 RSA government bond (maturing 2020) closed the month at 9.17%. This is still slightly higher than the previous month's close of 9.13%, but below the weakest point of 9.43% around mid-January.
- ▲ This dramatic sentiment change was mostly the result of market perception that an easing bias is developing within the South African Reserve Bank's Monetary Policy Committee. The perception was fuelled by slightly better-than-expected December CPI, private sector credit growth and external trade data. Enough bullish momentum had been created to allow for rand weakness and worse-than-expected December PPI data to pass largely unnoticed.
- ▲ None of the recent data releases made us reconsider our view that the repo rate has bottomed at 7.0%. The largest public sector funding requirement since the early 1990's will remain an obstacle to sustainable lower bond yields on a longer time horizon.

**Futuregrowth view:** *A positively-sloped yield curve is expected to remain intact in the light of low, stable short-term interest rates and sustainable high net new issuance of long-term bonds.*

- ▲ Our money market funds combine a neutral-duration tilt with low cash holdings, while we used market weakness to increase our holding of medium-dated and long-dated money market instruments – still favouring floating as opposed to fixed rates, and tempered only by liquidity constraints.
- ▲ In our bond and income funds, we utilised market weakness around mid-January to reduce the underweight modified-duration tilt.
- ▲ In terms of yield-curve tilts, we are mainly running an underweight position in the 12-year+ maturity band and an overweight tilt to bonds with a term-to-maturity of less than 12 years.

**Futuregrowth view:** *In contrast to money market and RSA bonds, non-government debt continues to offer the promise of superior returns.*

**The yield of the R197 (maturity 2023) RSA CPI-linked bond increased to levels last seen in 2005.**



Source: I-Net, OMIGSA

- ▲ The RSA CPI-linked bond market is offering better value following the increase of real yields since the lows recorded in the first half of 2009. Market weakness was utilised to slowly accumulate holdings, given our more cautious longer-term inflation view.
- ▲ We maintain a low listed property holding based on a weak economic growth outlook, preferring attractively priced non-government debt instead.
- ▲ Preference shares have lost a little colour and we have been slowly reducing exposure, also in favour of corporate debt.

# Economic Indicators to January 2010

	Latest Data		Previous Year
<b>Exchange Rates:</b>			
Rand/US\$	January-10	7.62	10.18
Rand/UK Pound	January-10	12.17	14.89
Rand/Euro	January-10	10.56	13.14
Rand/Aus\$	January-10	6.73	6.49
<b>Interest Rates:</b>			
Prime Overdraft	January-10	10.50%	15.00%
3-month NCD rate	January-10	7.10%	10.85%
R157 Long Bond Yield	January-10	8.38%	7.42%
<b>Inflation:</b>			
CPI (y-o-y)	December-09	6.3%	9.5%
<b>National Accounts:</b>			
GDP Growth (y-o-y)	September-09	-2.5%	3.7%
GDP Growth (q-o-q, annualised)	September-09	0.9%	1.3%
HCE Growth (y-o-y) (Household Consumption Expenditure)	September-09	-4.1%	1.9%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	September-09	1.2%	13.4%
<b>Balance of Payments:</b>			
Trade Balance (cumulative 12month)	December-09	-\$1.83	-\$8.33
Current Account (% of GDP)	September-09	-3.2%	-7.5%
Capital Account (% of GDP)	September-09	4.9%	10.0%
Forex Reserves (incl. gold)	December-09	\$39.05	\$32.14
<b>Other:</b>			
Manufacturing Production (y-o-y) (seasonally adjusted)	November-09	-4.0%	-8.2%

# Market Indicators to January 2010

	1 Month (%)	Calendar Year (%)	Quarter (%)	12 Months (%)	3 Yrs (%)	5 Yrs (%)
<b>Equity</b>						
All Share Index	-3.5	-3.5	1.4	33.2	4.5	19.1
Shareholder Weighted Index	-2.6	-2.6	1.6	32.8	4.3	18.6
All Share/Resources 50%	-2.7	-2.7	1.4	34.0	4.3	18.2
Top 40 Index	-3.8	-3.8	1.8	33.0	4.3	18.9
RAFI® 40 Index	-2.9	-2.9	1.1	39.6	7.4	19.9
RAFI® All Share Index	-3.3	-3.3	1.3	35.6	6.1	19.3
Resources Index	-6.4	-6.4	1.6	30.2	5.2	22.7
Financial Index	1.2	1.2	2.9	39.4	-1.4	12.6
Industrial Index	-2.7	-2.7	0.4	33.1	6.7	19.2
Mid-cap Index	-2.1	-2.1	-1.1	35.5	6.2	20.3
Small-cap Index	-0.5	-0.5	3.4	29.4	3.2	19.5
<b>Interest-Bearing</b>						
ALBI BEASSA	0.3	0.3	1.6	1.7	6.3	6.9
STeFI	0.6	0.6	1.8	8.8	10.0	8.9
Cash	0.5	0.5	1.6	7.5	9.5	8.3
<b>Property</b>						
SA Quoted Property Index	-0.3	-0.3	1.7	15.1	8.2	21.7
<b>International</b>						
MSCI World Index (R)	-1.8	-1.8	-2.0	1.6	-5.5	7.1
MSCI World Index (\$)	-4.1	-4.1	1.7	37.4	-6.8	2.2
JPM International Bond (R)	3.0	3.0	-5.0	-21.2	10.2	10.1
US 1-month LIBOR (R)	2.5	2.5	-3.5	-25.4	4.7	8.7
<b>Inflation (Estimated)</b>						
CPI	0.2	0.2	0.5	6.2	7.8	6.7

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# Regulatory Information

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

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