

Market Dynamics

January 2011

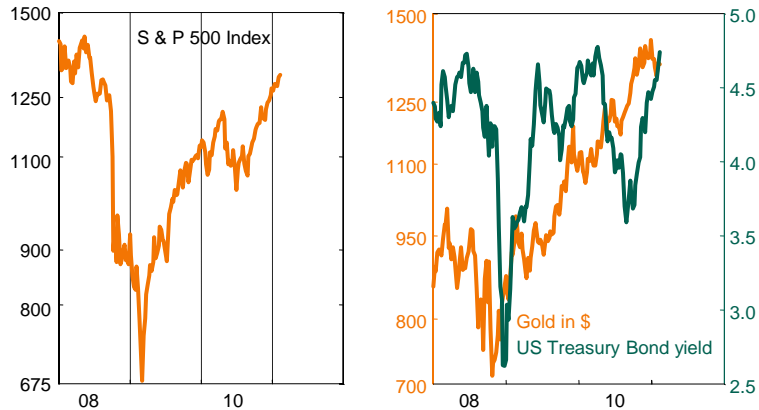


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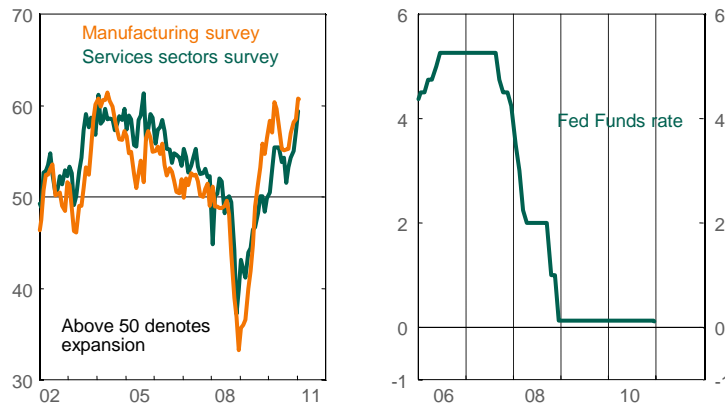
World Economic Overview and Outlook

Equities & bond yields rise as recovery signs strengthen; gold softens despite rising inflation fears



Source: OMIGSA (Iris)

US surveys point to improving growth, yet rates to stay low



Source: OMIGSA (Iris)

- ▲ January will probably best be remembered for the eruption of political troubles in Egypt. Pro-democracy social unrest was triggered by similar events in Tunisia, and surging food and energy prices against the backdrop of high unemployment and a very unequal distribution of income and wealth in the country. Concerns that the troubles may spread to other surrounding countries, many of which are large oil producers, caused the oil price to spike back up over \$100 per barrel. The unrest also raised some questions about the political stability of developing countries in general.
- ▲ Yet, in spite of these woes, global equity markets were not too negatively affected. After extending the rally of December into the first few weeks in January, markets briefly sold off quite sharply on risk aversion, but recovered as concerns over a wider Middle East crisis faded, macroeconomic data from around the world kept on coming in strong, corporate earnings continued to surprise on the upside in the USA, and policymakers in the developed world signalled a need for ongoing support to still-fragile economies.
- ▲ Incoming real economic data from around the world continued to point to an acceleration in activity towards the end of 2010 after the soft patch that hit global activity during the middle quarters. As a result of the better data consensus, global growth forecasts for 2011 were lifted moderately further. Overall, global growth is still generally expected to be slow in 2011, but the recent data has strongly raised confidence that the global recovery will be sustained, in spite of still-considerable structural headwinds.
- ▲ The biggest risk to global financial markets remains that inflation rises unexpectedly sharply, forcing policymakers to tighten policy sooner or more aggressively than currently expected. The recent further rise in global commodity prices, especially food and oil, has undeniably increased these risks.
- ▲ We have held the view since last year that the global recovery would be sustained, despite structural headwinds and 'rolling mini-crises'. This view remains in place, but with growth now moving onto a sounder footing globally, the focus will continue to shift to potential cyclical constraints, predominantly inflation.

OMIGSA Economic Research Unit view: *The global recovery is moving onto a sounder footing, but with stronger growth also come cyclical pressures. Inflation holds the biggest threat to the world economy in 2011.*



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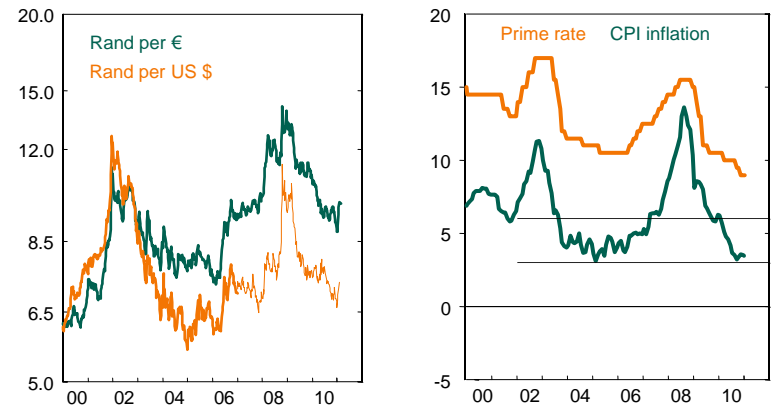
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Local Economic Overview and Outlook

- ▲ The key local event in January was a sharp weakening of the rand, following on the equally sharp strengthening in December. The sudden change in sentiment was likely driven by a bout of emerging market risk aversion from global investors on the back of the crisis in Egypt. While South Africa is fully democratic, the troubles in Egypt hold a clear warning that local growth and employment need to accelerate considerably to ensure long-term social and political stability.
- ▲ The news on the local economy over the past month was generally good. Incoming high-frequency economic data points to a notable acceleration in economic activity in the fourth quarter of 2010. We estimate that gross domestic product (GDP) growth could have improved to about 4%, compared to 2.6% in the third quarter. 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 further in 2011, and our projection of little over 3.5% remains unchanged.
- ▲ The softer rand is welcome, provided the recent weakening does not turn into a full-blown slump in coming months. At around R7.25/US dollar, local exporters and companies competing with imports are a little better protected, without the rand holding a serious threat to inflation prospects.
- ▲ 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.
- ▲ Declining inflation, sustained rand strength and a slow economic recovery in 2010 resulted in lending rates falling to the lowest level since 1974. This is only sustainable if inflation remains well within the target range, inflation expectations come under better control and wage demands moderate. We are sceptical that these will all occur over the medium term, so we expect rates to start rising sometime in future. Recent oil, food and rand developments have turned the focus back to the timing of the first hike. This could occur at any time from about the third quarter of 2011 onwards.

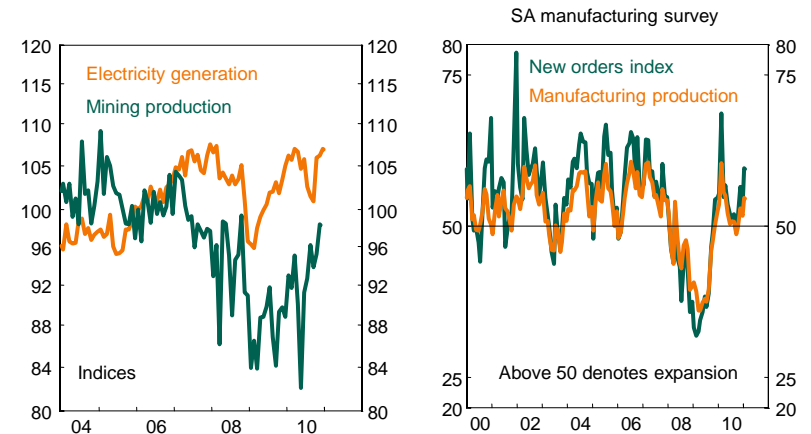
OMIGSA Economic Research Unit view: *The local recovery is showing signs of gathering momentum. With oil and food prices rising and the rand softening, the focus has turned back to the timing of the start of the interest rate up-cycle in SA. We expect this to start around the turn of the year.*

Rand weakens; inflation starts moderate uptrend



Source: OMIGSA (Iris)

SA data points to firmer Q4 growth



Source: OMIGSA (Iris)

Sources: Kagiso Trust Investments and BER



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Equity Sector Overview and Outlook

Resources

- ▲ The basic materials sector produced a return of -0.1% for January, outperforming the FTSE/JSE All Share Index (ALSI)'s -2.2% return. The coal mining, forestry & paper and steel sectors managed to outperform, while the laggards included the construction, platinum and gold mining sectors.
- ▲ The Old Mutual Mining and Resources Fund continued to outperform the benchmark, and is ranked first amongst its peer group over both the three- and five-year periods.
- ▲ We had previously stated that we found similarities between 2010 and 2008, and these similarities are increasingly apparent in 2011. Given high commodity prices, high share prices, a cyclical slowdown in China and the high debt levels in some European Union (EU) countries, managers should take the increased risk into account.
- ▲ 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 -3.6% and -4.8% respectively, for the month ended 31 January 2011, while the FTSE/JSE Top 40 Index returned -1.7%. The underperformance of shares at the small/mid-cap level was due, in part, to profit-taking after a spectacular 2010.
- ▲ The market was very strong over the last quarter based on capital flows into emerging markets and a major allocation swing from bonds into equities. Despite profit-taking in the new year, there are also other global strains that are emerging. Social unrest in the Middle East and highly disruptive weather patterns have made investors cautious about the year ahead. Food inflation is now a global phenomenon and is triggering unrest in areas with high proportions of disaffected youth. Lack of jobs and rising food prices are proving to be strong stimulants for regime change.
- ▲ Internationally, concerns remain around European bank stress tests and continued European bail-out agreements. Economic growth numbers are being revised down in China and strong inflationary pressures are emerging. These factors will have a major impact on how the rest of the world fares throughout 2011.
- ▲ Portfolio managers are more cautious about the year ahead and only modest returns are expected from most asset classes.

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 1.5% for the month of January 2011. This was well ahead of the FTSE/JSE Shareholder Weighted All Share Index (SWIX), which lost 3.4% over the same period.
- ▲ The Banking Index was down 2%, while the life assurance sector was up 2.7%. The strong performance in the life sector was mainly as a result of a rebound by Old Mutual, following a sell-off in December, which was prompted by a delay in concluding the sale of its US life operations.
- ▲ The weakness in the banking sector was in line with the overall market, which was weakened by renewed emerging market fears on the back of political unrest in the Middle East. ABSA and African Bank were the worst performers in the month, each losing in excess of 5%, while further downside for the sector was limited by FirstRand, which ended the month flat.
- ▲ Results season for the financial year 2010 commences in February and we expect the results to confirm that 2010 was a challenging year for the sector. However, going forward into 2011, we expect better operational performance compared to 2010 as the benefits of lower interest rates on debtors books, as well as a strengthening economy, begin to emerge.
- ▲ Life companies should continue to show an improving trend in lapse experience due to improving real household incomes, while single premium sales will be supported by the stronger equity markets.

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 still below historic averages.

Industrials

- ▲ The industrial sector underperformed the overall market in January, down 4.1%, while the ALSI lost only 2.2%.
- ▲ Most of the underperformance came from the construction and retail sectors.
- ▲ Construction was severely hit by a profit warning from both Murray & Roberts and Aveng. Murrays referred to tougher trading conditions in South Africa and the Middle East and slow cash collections on government contracts, while Aveng's earnings have suffered due to the lower steel price and a difficult manufacturing trading environment. The Australian division is also expected to be affected by revenue recognition as a result of the floods, but the company is not able to estimate the full extent of the damage yet.
- ▲ Retailers, which had been rerated last year, pushed by incredible demand from offshore investors, saw a reversal in their fortunes in January as foreign investors, wary of the weakening rand, have been taking profits. This sudden turn of sentiment was brought on by the sudden deterioration of the rand, as well as more evidence that the downward interest rate cycle was most probably over.
- ▲ The rand hedges showed resilience in the month as one would expect.

Equity Research view: The pullback in retailers and construction share prices is providing opportunities that we have been awaiting for a while. The sector as a whole is considered defensive in uncertain times, with cash piles and high dividend yields that are attractive.



Equity Sector Overview and Outlook (cont.)

Property

- ▲ The sector lost 4.2% in January after last year's 29.6% return. This was caused by a sell-off in the bond market that saw bond yields rise by almost 50bps, which raised the required listed property yield, resulting in lower prices. The FTSE/JSE All Share (-2.2%) and the All Bond (-2.8%) Indices did slightly less badly, but general retailers sold off more aggressively (-9.2%).
- ▲ Conditions in the bond market are a key short-term factor determining listed property capital values. The interest rate market is now pricing in a certainty of at least a 50bp rate hike by the end of the year. This was not anticipated a month ago.
- ▲ Reporting season begins in February. With property operating conditions still tough but stable, we will be looking for indications of whether conditions have bottomed.
- ▲ Following January's price movements, property now offers improved relative value compared to equities in general, and less downside risk. Property yields relative to bonds are little changed on a rolling forward basis.

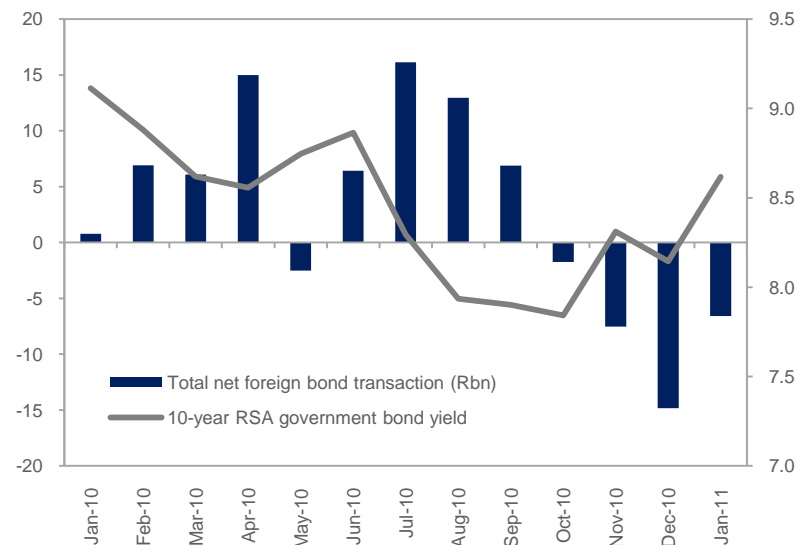
Equity Research view: *The sector offers better value and provides a one-year entry yield of 8.8%, with distribution growth at least as high as inflation (expected around 6% over the year). Downside operational risk has declined, funding conditions are easier (although interest rates are higher) and 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

- During January, global and local economic growth generally reflected a continuation of an improving trend, while incidents of accelerating inflation in both developed and emerging economies are increasing. Global bond markets generally weakened in anticipation of higher inflation and more monetary policy action. Against this backdrop, net selling of local bonds by foreign investors, which started in October 2010, continued unabated and has, if anything, gained momentum from rising risk aversion brought about by political strife in North Africa. Broad-based rand weakness, partly explained by the foreign selling, the decision by the South African Reserve Bank to leave the repo rate unchanged and rising global bond yields, also played a part in local bond market weakness.
- The yield of the benchmark 10-year RSA government bond raced to higher levels. It started the year at a yield of 8.15%, before closing the month at 8.62%, its weakest point since July 2010. The release of slightly better-than-expected local inflation data, a very successful US dollar-denominated offshore bond placing by Eskom and the news of an improved ratings outlook for the country by two major international rating agencies failed to bring about balance to a market crowded with short-term sellers.
- Recent data releases and events strengthened our view that the inflation (and interest rate) cycle has turned the corner. Although inflation could still remain relatively well behaved in the near term – due to the lagged effect of significant rand strength last year and limited pricing power in light of the slow economic recovery, the medium-term outlook is more concerning. It therefore follows that the central bank will be required to start the policy-tightening cycle sooner rather than later, as a repo rate at its lowest level since 1974 is unsustainable against this backdrop.

Profit taking by foreign investors is partly to blame for rising bond yields



Source: I-Net Bridge, JSE

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 is contributing to a slightly improved outlook for inflation-linked bonds, despite low real yields.

Economic Indicators to 31 January 2011

	Latest Data		Previous Year
Exchange Rates:			
Rand/US\$	January-11	7.18	7.62
Rand/UK Pound	January-11	11.49	12.17
Rand/Euro	January-11	9.84	10.56
Rand/Aus\$	January-11	7.15	6.73
Interest Rates:			
Prime Overdraft	January-11	9.00%	10.50%
3-month NCD rate	January-11	5.50%	7.10%
R157 Long Bond Yield	January-11	7.88%	8.38%
Inflation:			
CPI (y-o-y)	December-10	3.5%	6.3%
National Accounts:			
GDP Growth (y-o-y)	September-10	3.2%	-2.4%
GDP Growth (q-o-q, annualised)	September-10	2.6%	0.9%
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%
Balance of Payments:			
Trade Balance (cumulative 12month)	December-10	\$1.73	-\$1.84
Current Account (% of GDP)	September-10	-3.0%	-3.1%
Capital Account (% of GDP)	September-10	4.1%	4.8%
Forex Reserves (incl. gold)	December-10	\$42.72	\$39.05
Other:			
Manufacturing Production (y-o-y) (seasonally adjusted)	November-10	4.1%	-4.4%

Source: OMIGSA

Market Indicators to 31 January 2010

	1 Month (%)	Calendar Year (%)	Quarter (%)	12 Months (%)	3 Yrs (%)	5 Yrs (%)
Equity						
All Share Index	-2.2	-2.2	3.5	20.7	7.8	12.7
Shareholders Weighted Index	-3.3	-3.3	2.2	20.0	8.6	12.4
All Share/Resources 50%	-2.6	-2.6	2.6	21.0	9.5	12.7
Top 40 Index	-1.7	-1.7	4.2	19.8	6.6	12.3
RAFI® 40 Index	-1.3	-1.3	4.1	20.4	11.2	13.8
RAFI® All Share Index	-1.2	-1.2	4.3	21.1	10.7	13.2
Resources Index	-0.5	-0.5	6.8	19.4	1.7	12.5
Financial Index	-1.5	-1.5	0.7	13.4	7.6	7.1
Industrial Index	-4.1	-4.1	1.5	25.6	15.2	15.8
Mid-cap Index	-4.8	-4.8	-1.1	26.7	17.0	15.6
Small-cap Index	-3.6	-3.6	3.1	20.7	6.4	13.4
Interest-Bearing						
ALBI BEASSA	-2.1	-2.1	-2.4	12.2	9.4	7.2
STeFI	0.5	0.5	1.5	6.8	9.1	8.9
Cash	0.4	0.4	1.2	5.7	8.2	8.3
Property						
SA Quoted Property Index	-4.2	-4.2	-2.5	24.5	15.1	15.6
International						
MSCI World Index (R)	11.0	11.0	11.0	14.1	-2.4	6.0
MSCI World Index (\$)	2.3	2.3	7.5	19.8	-1.0	2.6
JPM International Bond (R)	8.4	8.4	-0.1	0.7	3.9	10.7
US 1-month LIBOR (R)	8.6	8.6	3.3	-4.6	0.1	6.4
Inflation (Estimated)						
CPI	0.4	0.4	0.7	3.6	6.0	6.6

Source: OMIGSA

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Regulatory Information

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