

# Market Dynamics

July 2009



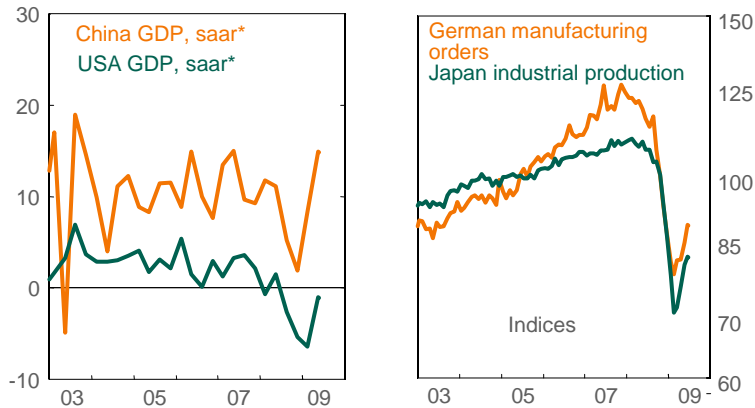
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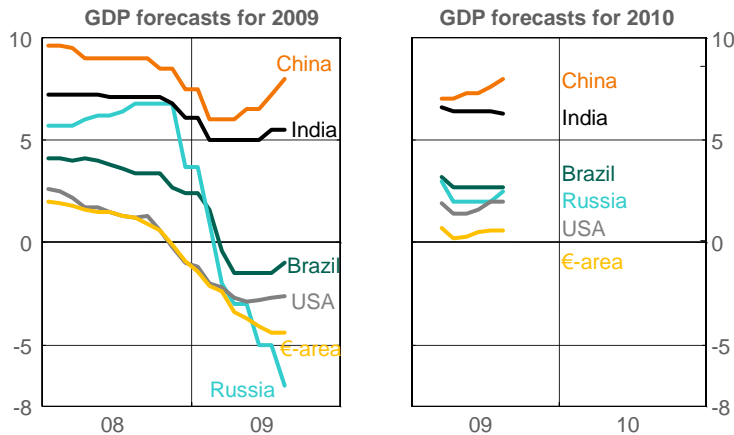
# World Economic Overview and Outlook

## Global recovery indicators



Source: OMIGSA (Iris)

## GDP forecasts: Economist survey



Source: OMIGSA (Iris)

- ▲ The global stabilisation signs that have been emerging since April continued during July. In fact, gross domestic product (GDP) growth figures for the second quarter, currently being released around the world, point to a sharp rebound in Asia, and a sharply reduced pace of contraction almost everywhere else. Thus, confidence that the global slump may be over increased sharply further over the past month.
- ▲ Emerging Asia saw a significant rebound in economic activity during the second quarter, with China leading the way. Chinese GDP rose an annualised 15% from an admittedly depressed first quarter. This is in contrast to a further contraction in US GDP in the same quarter, although the pace of contraction slowed to only 1%, compared to a 6% slump in the first quarter.
- ▲ With the latest global economic data looking decidedly more upbeat, consensus growth forecasts for the second half of this year, but especially for 2010, have been raised quite noticeably. With confidence growing that policy stimulus is finally beginning to pull the world out of the deep slump, and optimism about prospects for 2010 rising, the global equity rally continued over the past month.
- ▲ While short-term economic prospects have undoubtedly improved, medium-term prospects remain much more uncertain. With US consumers still deeply in debt, employment falling sharply, and the future inevitability of monetary and fiscal policy tightening, the US is likely to experience structurally slow growth for an extended period of time. The developing world is likely to continue to outperform the developed world for a while yet.

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

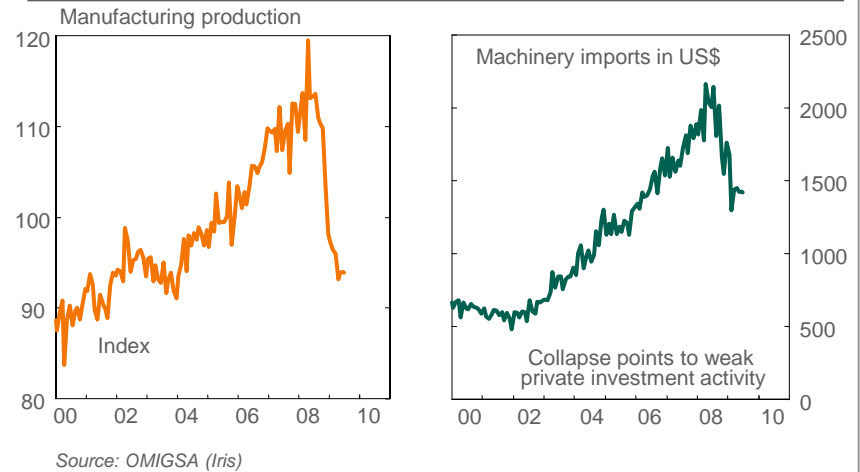
\*Seasonally adjusted annual rate

# Local Economic Overview and Outlook

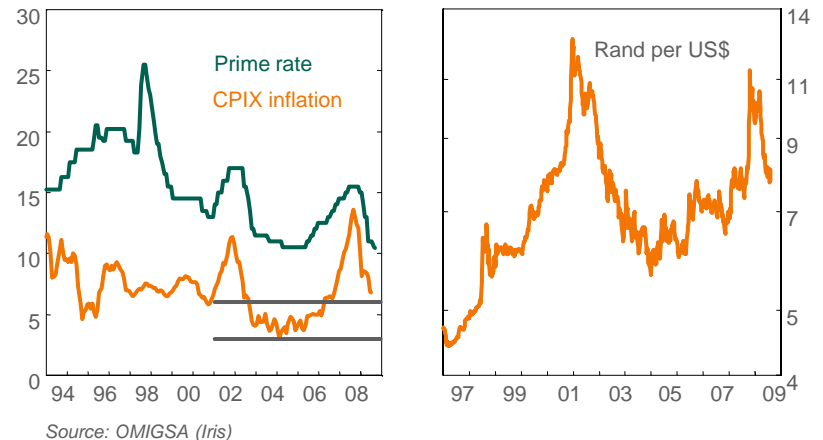
- ▲ Real economic data remains very weak and volatile, and we expect another negative growth number in the second quarter of this year. South Africa (SA) is clearly lagging the global business cycle, with local stabilisation signs only emerging – very tentatively – over the last few weeks as reflected by car and commercial vehicle sales. Similarly, the manufacturing purchasing managers' index (PMI) and electricity production data also improved in the latest round.
- ▲ Near-term prospects are still poor. While we expect some improvement during the second half of the year, a decent recovery is only expected in 2010. Of particular concern is the stressed financial position of consumers, despite lower interest rates and fairly high wage settlements. High debt levels, job losses and still-high cost increases (food, electricity, municipal charges, etc) have eroded buying power.
- ▲ On a more positive note, inflation surprised on the downside in June by falling to 6.9% from the 8.0% recorded in May. Slowing food inflation, in particular, is starting to make a positive contribution towards lower inflation. However, services inflation remains very sticky.
- ▲ More positive news saw a second consecutive trade surplus in June, causing the trade balance to improve sharply in the second quarter. The deficit on the current account (i.e. when offshore services payments are added to the goods trade balance) could be as low as 3% of GDP in the second quarter, compared to a still-large 7% in the first quarter.
- ▲ While the SA Reserve Bank's 50bp rate cut on Thursday went against consensus, we had not ruled it out completely, due to the weak economy. However, we are now likely to have reached the bottom of the local interest rate cycle.

**OMIGSA Economic Research Unit view:** *The local economy remains depressed and will recover only slowly during the second half of the year. This keeps open the possibility of a further lowering of local interest rates.*

## Real economy still very weak



## Inflation finally dips, but rates on hold



# Equity Sector Overview and Outlook

## Resources

- ▲ The basic materials sector delivered strong gains (10.7%) during the month, considering the poor performance of the gold sector (-0.3%)
- ▲ The strong performance was based on evidence of an earlier-than-expected recovery in China and India, with signs of stabilisation in the G7.
- ▲ We expect most non-gold 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.
- ▲ Despite the uncertainty regarding global growth, there is substantial value in certain shares and/or sectors – even on (lower) normalised earnings – such as ArcelorMittal.

## Small Companies

- ▲ During July 2009, the Small Cap Index gained 6.3%, compared to the 10.3% increase posted by the FTSE/JSE Top 40 Index.
- ▲ The current trading statements being issued by companies as a whole are painting a fairly negative picture on the last six months' trading environment. However, this was largely expected and the key now is how much of a recovery the next six months will deliver. The interest rate declines should start to impact on the SA economy in the next six months and this will be positive for small and mid-caps relative to the Top 40 Index.
- ▲ The very small shares in the small cap universe have really lagged the larger counterparts; this may be because of the low liquidity and higher risk in those shares. Internal resources are being dedicated to reassessing some of these companies.
- ▲ The risk appetite of investors appears to be picking up as the global momentum starts to improve, and this is likely to increase the size of funds flowing into the small and mid-cap space.

**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 remain compelling, despite the recent strong share price performance. While short-term conditions are tough for some non-mining resources companies, valuations are very attractive.*

**Investment Research view:** *The average price:earnings (p:e) ratio at which small caps trade compared with large caps has narrowed again to a 10% discount. This is more in line with the longer-term norm and we would be more comfortable with this level.*

# Equity Sector Overview and Outlook (cont.)

## Financials

- ▲ The FTSE/JSE Financial Index returned a strong 10.2% for the month ended 31 July 2009. It outperformed the broader market as the FTSE/JSE Shareholder Weighted All Share Index (SWIX) gained 9% during the month.
- ▲ The banking sector was up 6.6% in the month, while the life insurance sector gained a spectacular 16.1%, mainly lifted by Old Mutual, which gained 21.6%. The stock is up over 100% since it reached its lows in mid- March, as concerns over the global economy and Old Mutual's US credit exposure have eased. We still believe that there is value in the counter.
- ▲ The operational environment for financial sector companies is expected to remain tough in 2009. The sector will benefit from the recent interest rate cuts, although relief on earnings will only be seen in the medium term, as there is a lag before one sees a benefit on the bad debt line. The continuing recession and a possible further increase in unemployment pose a headwind to the performance of the sector.
- ▲ We believe that the market will look through these poor earnings.
- ▲ On an absolute basis, we believe that the financial sector is looking attractive, and is still trading below its long-term average.

**Investment Research view:** *Financial stocks are facing a tougher operating environment, but this has been discounted in current prices. Valuations are looking attractive, and are still below historic averages.*

## Industrials

- ▲ Industrials performed along with the rest of the market for the month of July, gaining 10.4%.
- ▲ The performance was spread widely, with no obvious distinction between defensive and cyclical shares.
- ▲ Shares like British American Tobacco and South African Breweries, which are generally regarded as defensive, were up more than 15%, while Steinhoff, Imperial and JD Group, clearly cyclicals, were also up strongly.
- ▲ The laggards were the food retailers, which are exposed to lower food inflation, as well as some of the construction shares (Murray & Roberts and PPC). Competition Commission investigations into both these sectors probably contributed to the lack of performance. Also, building plans passed confirmed that volumes in the building industry (outside of infrastructure) are not likely to recover quickly.
- ▲ Currently the sector is not showing much upside, and it seems that a full recovery is already priced into the sector.

**Investment Research view:** *The sector as a whole is fairly priced, with only pockets of value available. The cyclical shares are generally pricing in a full recovery in the economy in the next two years.*

# Equity Sector Overview and Outlook (cont.)

## Property

- ▲ The listed property sector returned 7.8% in July, bringing its year-to-date total return to 5.4% – remaining relatively range bound for the year. The sector has outperformed the All Bond Index's (ALBI) -4.4%, but underperformed the FTSE/ JSE All Share Index's (ALSI) 17.7% for the year-to-date. This pattern of relative performance may well be sustained for the rest of the year if the appetite for more risky assets holds.
- ▲ The listed property sector is fairly valued and offers defensive cash flows, albeit with lower growth over the next two years (7%-8%) than in the previous two (12%-14%).
- ▲ Property expenses (especially higher electricity, rates and taxes) are putting pressure on tenants' ability to afford space and landlords' operating margins.
- ▲ While vacancies are expected to rise over the next two years, the slowdown in building completions means that national vacancies are unlikely to rise to the crisis levels of above the 12% recorded in 2002, and may top out at 6%-7%.
- ▲ Expiring leases are still below market rentals, and continue to provide an uplift to revenue growth.

**Investment Research view:** *Market rentals have largely peaked and tenant arrears have increased.*

# Fixed Interest Overview and Outlook

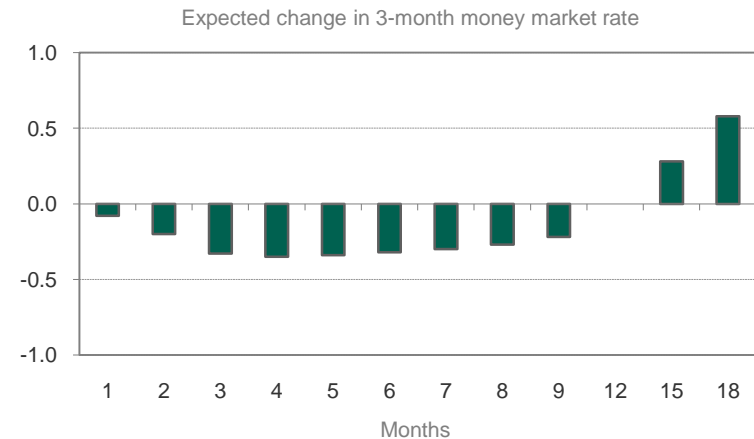
- ▲ Short-dated money market rates retraced to slightly higher levels, while bond yields ended the month stronger following earlier weakness. The yield of the 10-year RSA government bond traded as high as 9.3% before closing the month at 6.9% or 6 basis points (bps) lower than the previous month's close. The yield curve flattened as a result.
- ▲ The pull-back in bond yields followed continued improvement in global risk appetite, a strong rand (from mid-July) and a host of interest rate-friendly local data releases.
- ▲ The bond market is expected to trade in a range of about 100 bps in the medium term. Although still marginally better priced relative to the money market, the recent yield curve flattening has reduced the relative attractiveness of bonds, especially the risk of increased net bond issuance by National Treasury.

**Futuregrowth view:** *The positive slope of the yield curve is expected to remain intact in the light of low short-term interest rates and rising net new issuance of long-term bonds.*

- ▲ Our money market funds maintained an underweight duration tilt and a low cash holding, while we added to our holding of longer-dated money market instruments when market rates retraced to higher levels.
- ▲ In the bond funds, we have increased the modified duration into the weakness early in July and created an overweight tilt in the process. However, given the point in the interest rate cycle, we are putting less emphasis on the modified duration tilt, and are instead looking to add value by being correctly positioned on the yield curve.

**Futuregrowth view:** *Money market rates are currently unattractive, while non-government debt offers the promise of superior returns.*

## FRA market pricing a 70% probability of a 50bp rate cut in 3-6 months' time



Sources: OMIGSA & Bloomberg

- ▲ Given the general level of market rates, we are running underweight tilts to the one- to three-year and 12-year+ maturity bands. This is offset by a significant overweight tilt to bonds in the seven- to 12-year band.
- ▲ The RSA CPI-linked bond holding was kept at zero on valuation concerns, following the sharp decrease of real yields in March and April as well as our mildly bullish inflation view.
- ▲ We maintain a low listed property holding on a weak economic growth outlook, preferring nominal bonds and preference shares instead, while consistently looking to increase the holding of attractively priced non-government debt. Preference shares are starting to lose a little colour and we shall be looking at opportunities to slowly reduce exposure.

# Economic Indicators to July 2009

Exchange Rates:	Latest Data	Previous Year	
Rand/US\$	July-09	7.77	7.32
Rand/UK Pound	July-09	12.97	14.53
Rand/Euro	July-09	11.09	11.44
Rand/Aus\$	July-09	6.46	6.95

Interest Rates:	Latest Data	Previous Year	
Prime Overdraft	July-09	11.00%	15.50%
3-month NCD rate	July-09	7.60%	12.10%
R157 Long Bond Yield	July-09	8.37%	9.22%

Inflation:	Latest Data	Previous Year	
CPI (y-o-y)	June-09	6.9%	12.2%

National Accounts:	Latest Data	Previous Year	
GDP Growth (y-o-y)	March-09	-0.8%	3.8%
GDP Growth (q-o-q, annualised)	March-09	-6.4%	1.7%
HCE Growth (y-o-y) (Household Consumption Expenditure)	March-09	-1.8%	4.2%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	March-09	4.5%	13.9%

Balance of Payments:	Latest Data	Previous Year	
Trade Balance (cumulative 12month)	June-09	-\$5.27	-\$10.14
Current Account (% of GDP)	March-09	-7.0%	-8.8%
Capital Account (% of GDP)	March-09	6.1%	9.1%
Forex Reserves (incl. gold)	June-09	\$34.18	\$34.23

Other:	Latest Data	Previous Year	
Manufacturing Production (y-o-y) (seasonally adjusted)	May-09	-16.8%	0.9%

# Market Indicators to July 2009

	1 Month (%)	Quarter (%)	Calendar Year (%)	12 Months (%)	3 Yrs (%)	5 Yrs (%)
<b>Equity</b>						
All Share Index	10.1	17.8	14.6	-9.4	8.2	22.1
Shareholders Weighted Index	9.0	16.8	14.1	-5.4	9.3	22.7
All Share/Resources 50%	10.2	18.1	14.6	-4.8	8.8	21.8
Top 40 Index	10.3	18.2	14.0	-12.5	7.4	21.6
RAFI® 40 Index	11.8	21.5	19.3	0.7	10.1	23.5
RAFI® All Share Index	12.0	20.3	16.1	-1.0	9.2	23.2
Resources Index	9.8	16.3	14.6	-23.8	5.5	22.5
Financial Index	10.2	17.7	15.1	1.3	3.0	17.2
Industrial Index	10.4	19.4	14.2	5.1	13.9	24.1
Mid-cap Index	9.4	15.9	19.7	16.9	13.9	25.4
Small-cap Index	6.3	12.4	11.0	-1.3	9.6	24.5

<b>Interest-Bearing</b>						
ALBI BEASSA	1.3	0.6	-3.6	11.3	7.9	9.2
STeFI	0.7	2.2	5.8	11.0	10.1	8.9
Cash	0.6	1.8	5.1	10.1	9.8	8.3

<b>Property</b>						
SA Quoted Property Index	7.8	2.7	5.4	19.1	19.0	26.9

<b>International</b>						
MSCI World Index (R)	10.1	9.1	-1.8	-15.3	-1.2	7.6
MSCI World Index (\$)	8.5	18.0	15.9	-21.1	-5.1	2.9
JPM International Bond (R)	3.1	-3.1	-15.5	14.2	12.7	11.5
US 1-month LIBOR (R)	1.6	-7.2	-14.6	9.6	8.4	8.5

<b>Inflation (Estimated)</b>						
CPI	1.9	2.9	6.9	6.7	9.0	7.1

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)

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)

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)

**Gauteng:**

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

Mario Schoeman – Investment Marketing & Sales Executive: Fund of Funds

Tel: +27 11 217 1411

Cell: +27 83 269 8999

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

Taz Victor – Manager: Retail Distribution

Tel: +27 11 217 1002

Cell: +27 82 460 1495

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

**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

Des Bothma – Investment Marketing & Sales Executive: Retail

Tel: +27 51 505 2950

Cell: +27 82 410 2666

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

**Eastern Cape:**

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

Colin Archibald – Investment Marketing & Sales Executive: Retail

Tel: +27 41 502 4906

Cell: +27 82 804 1746

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

# Regulatory Information

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Physical address: Mutualpark, Jan Smuts Drive, Pinelands 7405

Telephone number: +27 21 509 5022

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