

Market Dynamics

May 2009



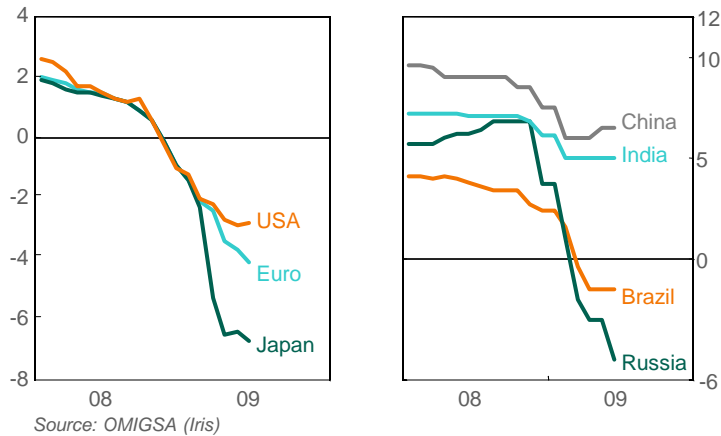
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World Economic Overview and Outlook

GDP growth forecasts for 2009



Markets rally on hopes of economic stabilisation



- ▲ The extremely pessimistic mood over prospects for the world economy lifted rather dramatically during May. This sudden improvement was largely the result of growing signs that the worst of the deep global slump may be over.
- ▲ Data releases over a broad front started to indicate that global economic conditions may be stabilising, even though there is no evidence of a meaningful recovery as yet.
- ▲ The more encouraging dataflow alleviated fears that the extremely expansionary global policy settings, in place for more than six months now, will be ineffective in bringing about an end to the global slump anytime soon.
- ▲ While a recovery may still be some time away, the signs of stabilisation have resulted in financial markets starting to 'price out' the risk of a doomsday scenario, in which the world gets trapped into a lengthy and severe bout of deflation as policy stimulus fails to work.
- ▲ Financial market movements were nothing short of spectacular over the past month, with bond yields rising sharply, emerging market currencies surging, the dollar weakening, and equity markets rallying strongly.
- ▲ The signs of stability beginning to set in are indeed supportive of our long-held view that global economic conditions should begin to stabilise by mid-year, and that a moderate recovery may take hold during the second half of the year.
- ▲ At the same time though, investors should guard against over-optimism in the short term, as there are still considerable downside risks and the recovery, when it eventually arrives, is likely to be slow and uneven.

OMIGSA view: *While global economic activity remains extremely depressed, the growing signs of stabilisation setting in are supportive of our long-held view that 2009 will be a year of two halves: a very weak first half and stabilisation and mild recovery in the second half.*

Local Economic Overview and Outlook

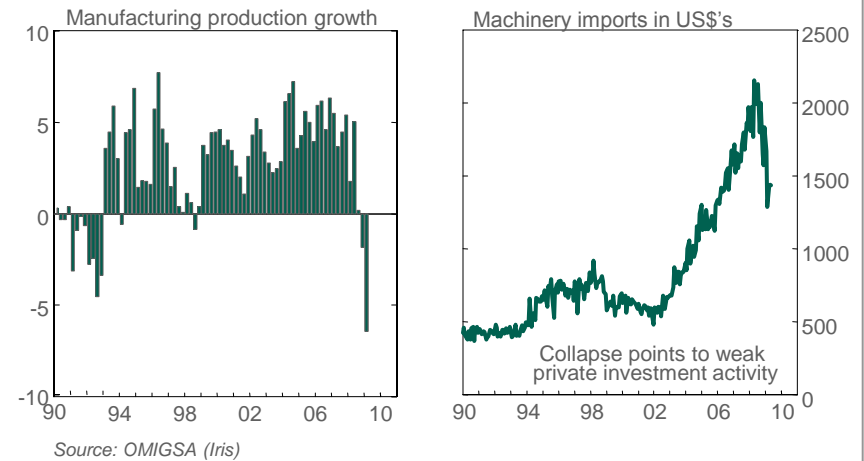
- ▲ The first quarter of 2009 saw a shocking 6.4% annualised contraction in SA. The weakness was widespread across virtually all industries, but mining and manufacturing, the two sectors directly in the firing line of the global slump, contracted by more than 30% and 20% at annual rates, respectively.
- ▲ Near-term prospects are still poor. Nevertheless, we think that the first quarter marked the depth of the local downturn.
- ▲ We do not expect any meaningful improvement during the second half of the year, as the economy will continue to face strong headwinds. A decent recovery is still expected in 2010.

OMIGSA view: *Local 2009 growth prospects are poor due to the global slump and intensifying local demand weakness.*

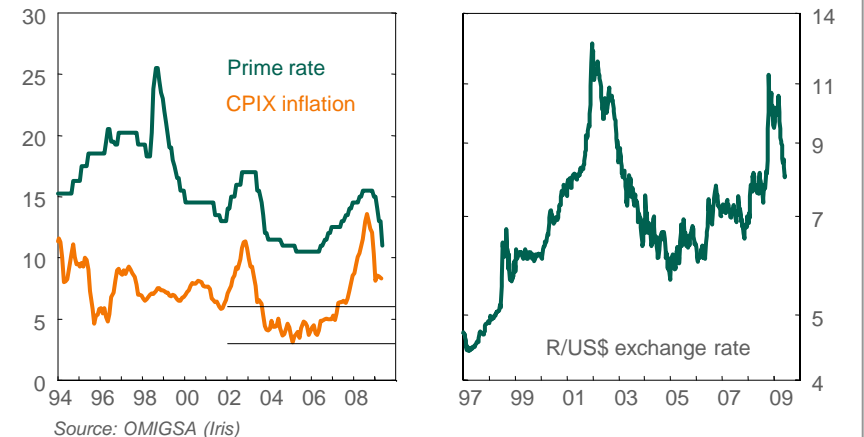
- ▲ Inflation remains sticky and the decline from the 13.6% peak in August last year has been much slower than expected. While we expect inflation to ease further from the current 8.4%, we now expect it to enter the target range only late in the year.
- ▲ Services inflation remains a considerable problem as a wide range of services continue to experience price increases that are significantly higher than the top end (6%) of the inflation target range.
- ▲ Medium-term prospects for inflation are not rosy owing to sustained, significant cost-push pressures, including electricity hikes, increases in municipal charges, and surprisingly-high wage settlements.
- ▲ The Reserve Bank cut rates by a further 100 basis points (bps). Another 50bp cut is possible, but we think we are now close to, if not already at, the lower turning point in the local interest rate cycle.
- ▲ The trade deficit has been smaller over the past three months, pointing to a welcome narrowing of our current account deficit.
- ▲ Global risk appetite is returning, commodity prices are rising and our trade balance is improving.

OMIGSA view: *The strengthening rand is a double-edged sword: It will improve the inflation outlook, but may aggravate the downturn in the economy as the mining and manufacturing sectors will be hard hit. We are close to, or at, the bottom of the local interest rate cycle.*

Real economy very weak



Inflation sticky, but rates decline; Rand firms



Equity Sector Overview and Outlook

Resources

- ▲ The basic materials sector delivered strong returns (16.2%) in May versus the FTSE/JSE All Share Index's (ALSI) 10.3%, with the gold, platinum and forestry/paper sectors outperforming, while coal mining, chemicals and construction were the laggards.
- ▲ 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.

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

Small Companies

- ▲ During May 2009, the Small Cap Index gained 4.8%, compared to the 11.3% gain posted by the FTSE/JSE Top 40 Index.
- ▲ While market commentators hypothesise about whether this is the start of a boom in the market (green shoots?), or just a bear market rally, we continue to focus on individual companies and the prospects for each one of them.
- ▲ Many companies reporting results show that times are tough, while prospects remain very uncertain and muted. The continued fall in interest rates is normally good for small and mid-caps relative to large caps.
- ▲ Within the universe of shares that this fund can play is the Alt-X Index. This index returned -62% in the last year, while small caps have decreased by 15.7%. Significant resources are being dedicated to re-assessing some of these companies, now that they are returning to normalised earnings, growth and price:earnings multiples.
- ▲ The waning appetite for additional risk among some funds is likely to increase small cap volatility, but this can provide us with good buying opportunities in the year ahead.

Investment Research view: *The average price:earnings (p:e) ratio at which small caps trade compared with large caps has widened to about a 25% discount. This is greater than the long-term norm and we expect that the recent interest rate decreases will eventually be the catalyst to this normalising.*

Equity Sector Overview and Outlook (cont.)

Financials

- ▲ In our previous commentary we stated that we expected the sector to consolidate around current levels in the near term, after its strong relative run.
- ▲ This indeed transpired, with the FTSE/JSE Financial Index returning a muted 2.6% for the month of May. It underperformed the broader market as the FTSE/JSE Shareholder Weighted Index (SWIX) gained 8.6% in the month.
- ▲ The banking sector was up 1.5% in the month, while the life insurance sector was up 10.4%, mainly lifted by Old Mutual which gained 13.5% in the month. The stock is up 48.5% over the last few months as concerns over the global economy have eased.
- ▲ 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. Slowdown in GDP growth, and a possible increase in unemployment, pose a headwind to the performance of the sector.
- ▲ On an absolute basis, we believe that the financial sector is looking attractive, and is underpinned by a high dividend yield.

***Investment Research view:** Financial stocks are facing a tougher operating environment, but this has been discounted in current prices. Valuations are looking attractive, especially for dividend yields.*

Industrials

- ▲ Industrials rebounded dramatically in May by 7.5%, but this still underperformed the overall market, which surged 10.3%.
- ▲ The appearance of “green shoots” across the globe has resulted in market sentiment turning extremely positive within a very short space of time. Some commentators are even calling it the end of the “Great Recession”. Resources, being more leveraged to an upturn, saw the largest benefit of the changing sentiment.
- ▲ Within industrials, some spectacular performances were seen in the more cyclical construction and related sectors, while the strong rand has added more support to the local consumer shares.
- ▲ Local economic indicators are still dismal, although some anecdotal evidence would suggest that more recently the consumer is seeing relief as a result of the lower interest rates.
- ▲ Our concern for the longer term remains that the G7 will have to pay for the stimulus provided, and this will mean slow growth, if not inflation in those areas. The impact on South Africa will not go unnoticed.
- ▲ In the near term, however, the impact of the billions spent on stimulus is starting to be felt, and manifests itself in a stock market rally.

***Investment Research view:** We would not totally abandon our defensive stance yet, as in the long run we are not comfortable that the after effect of the “Great Recession” has washed over yet.*

Equity Sector Overview and Outlook (cont.)

Property

- ▲ The listed property sector has been range bound so far this year, recording a near flat year-to-date return of -0.4%. The sector outperformed the All Bond Index's (ALBI) -4.6%, but underperformed the FTSE/JSE All Share Index's (ALSI) 7.4%, as "bombed out" equities staged some recovery.
- ▲ 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%).
- ▲ Market rentals have largely peaked and tenant arrears have increased.
- ▲ 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 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:** The sector represents fair value. It may continue to underperform equities if risk appetite remains, but is also likely to continue outperforming cash as interest rates fall, and bonds as inflation erodes real returns.*

Fixed Interest Overview and Outlook

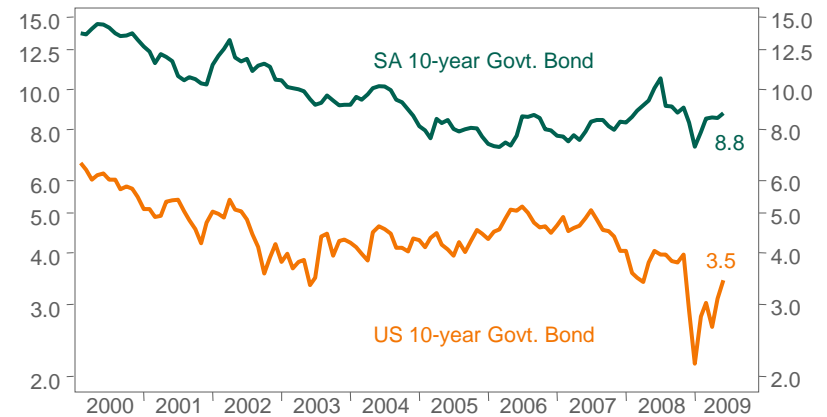
- ▲ Global bond markets have weakened in reaction to anecdotal evidence that the outlook for economic activity is improving, while concerns about the consequences of a massive liquidity injection are rising.
- ▲ The local bond market continued to weaken in tandem with global markets. This was despite weaker-than-expected first quarter Gross Domestic Product (GDP), Producer Price Inflation (PPI) and money supply growth numbers, plus another 100 basis points (bps) repo rate reduction by the South African Reserve Bank (SARB).
- ▲ The net effect of falling short-term interest rates and rising long-bond yields was a further steepening of the yield curve.
- ▲ The bond market is expected to trade in a range of about 100bps in the medium term, and is marginally better priced relative to low money market rates.

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.*

- ▲ In our money market funds we maintained an underweight duration tilt and a low cash holding, while we added to medium-dated and longer-dated money market instruments ahead of the May Monetary Policy Committee (MPC) meeting.
- ▲ The CPI-linked bond holding is kept at zero on valuation concerns, following the sharp decrease of real yields in March and April.

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

Local bond yields drifting higher in tandem with weaker global bond markets



Source: I-Net

- ▲ In the bond funds we are putting less emphasis on modified duration tilts, and are instead looking to add value by being correctly positioned on the yield curve.
- ▲ Given the general level of market rates, we are running underweight tilts to the 1-3 month and 12-month+ maturity bands. This is offset by a significant overweight tilt to bonds in the 7-12 year band.
- ▲ 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.

Economic Indicators to May 2009

	Latest Data		Previous Year
Exchange Rates:			
Rand/US\$	May-09	7.93	7.60
Rand/UK Pound	May-09	12.82	15.04
Rand/Euro	May-09	11.24	11.83
Rand/Aus\$	May-09	6.34	7.22
Interest Rates:			
Prime Overdraft	May-09	11.00%	15.00%
3-month NCD rate	May-09	7.10%	12.50%
R157 Long Bond Yield	May-09	8.25%	10.13%
Inflation:			
CPI (y-o-y)	April-09	8.4%	11.1%
National Accounts:			
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)	December-08	0.1%	4.9%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	December-08	6.4%	16.3%
Balance of Payments:			
Trade Balance (cumulative 12month)	April-09	-\$6.24	-\$11.06
Current Account (% of GDP)	December-08	-5.8%	-7.2%
Capital Account (% of GDP)	December-08	6.6%	10.0%
Forex Reserves (incl. gold)	April-09	\$31.96	\$33.65
Other:			
Manufacturing Production (y-o-y) (seasonally adjusted)	March-09	-11.5%	-1.2%

Market Indicators to May 2009

	1 Month (%)	Quarter (%)	Calendar Year (%)	12 Months (%)	3 Yrs (%)	5 Yrs (%)
Equity						
All Share Index	10.3	24.4	7.4	-25.9	6.5	20.3
Shareholders Weighted Index	8.6	23.0	6.1	-21.9	6.9	-
All Share/Resources 50%	8.7	23.1	5.5	-22.0	6.1	19.8
Top 40 Index	11.3	25.8	7.4	-28.9	6.2	19.9
RAFI® 40 Index	10.6	27.6	8.6	-18.1	7.3	21.4
RAFI® All Share Index	9.7	23.0	5.8	-19.2	6.1	21.3
Resources Index	16.4	29.3	14.7	-37.5	7.2	21.8
Financial Index	2.6	20.9	0.3	-10.6	-2.0	14.5
Industrial Index	7.5	20.5	2.8	-15.3	10.0	21.5
Mid-cap Index	4.9	18.0	8.3	2.1	8.6	23.1
Small-cap Index	4.8	14.4	3.5	-15.7	5.6	23.9
Interest-Bearing						
ALBI BEASSA	-0.4	0.6	-4.6	17.5	6.5	9.6
STeFI	0.7	2.5	4.3	11.5	10.0	8.9
Cash	0.7	2.2	3.9	11.0	9.7	8.3
Property						
SA Quoted Property Index	-3.0	3.6	-0.5	21.3	10.4	-
International						
MSCI World Index (R)	3.5	4.6	-6.8	-30.9	-1.6	5.4
MSCI World Index (\$)	9.2	30.8	7.2	-34.4	-7.4	1.1
JPM International Bond (R)	-2.3	-15.8	-14.8	10.7	14.3	10.7
US 1-month LIBOR (R)	-5.1	-19.8	-12.6	7.8	10.8	8.2
Inflation (Estimated)						
CPI	0.5	3.7	4.3	7.7	8.8	6.7

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Regulatory Information

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