Market Dynamics

November 2011

OLD MUTUAL
Investment Group

Contents

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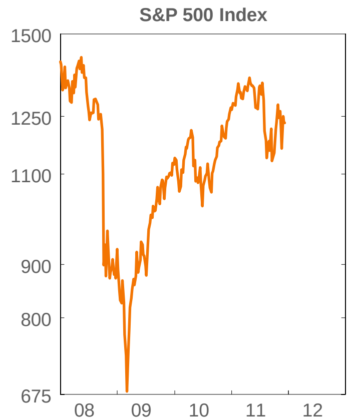
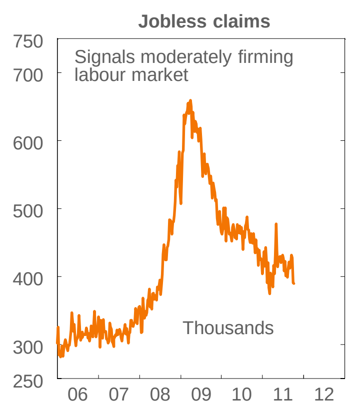
World Economic Overview and Outlook

Markets remain worried over debt and growth



Source: OMIGSA (Iris)

USA data surprises on the upside



Source: OMIGSA (Iris)

- November was another month of wild swings as global financial markets experienced a sharp sell-off, but a strong rally in the last three days erased a large portion of the earlier losses.
- The volatility was primarily driven by developments around the European debt crisis which were catalysed by an unexpected announcement of a referendum by the Greek Prime Minister. This was exacerbated by bickering policymakers who couldn't agree on how to deal with the intensifying crisis; Italy's fiscal situation continued to deteriorate, further fuelling the fire. The likelihood of a breakup of the Eurozone gained a firm hold in the minds of investors.
- Bowing to international and market pressure, Greece not only dropped the referendum idea, but also replaced their Prime Minister and approved more fiscal austerity measures. Italy also replaced its government with a presidentially-appointed 'technocratic' government to oversee fiscal austerity and economic reforms. So, as the month drew to a close, markets rallied, driven by these positive events, a rate cut by the European Central Bank (ECB), a series of better-than-expected economic data releases out of the US, and policy easing in the developing world.
- In spite of these positive developments, the crisis has clearly not been solved yet and many painful fiscal and economic changes lie ahead; economic prospects are very gloomy over the short- to medium term.
- Economic data out of the US has been surprising on the upside for some time now, easing fears of a 'double-dip' downturn in the US. Still, overall growth remains pedestrian. There are concerns over prospects for 2012 and beyond, as fiscal austerity also looms large in the US, despite the inability of the politicians to agree on what form tighter fiscal policy must take over the medium term.
- Overall, global prospects remain uncertain, but we remain of the opinion that moderate growth, rather than renewed, broad-based recession, is the prospect for 2012.

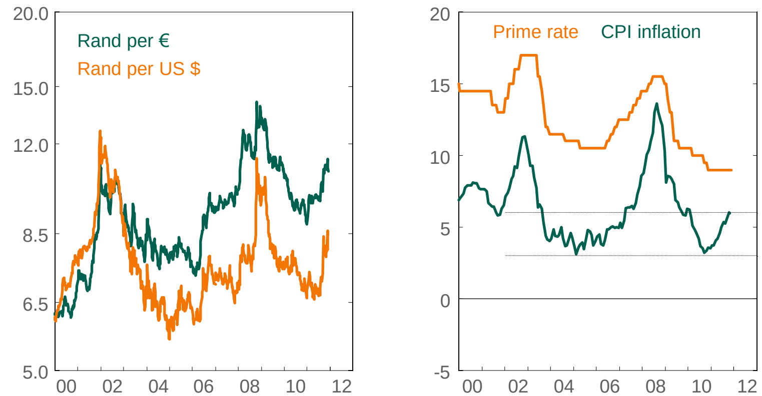
OMIGSA Economic Research Unit view: *Concerns over the Eurozone debt crisis have eased a bit, but a long and rocky road still lies ahead. We expect moderate economic growth globally in 2012, but the Eurozone will likely have a recession. Interest rates are set to remain low for an extended period globally.*

Local Economic Overview and Outlook

- The local economy continues to expand, but at a very moderate pace. Third quarter gross domestic product (GDP) increased by only 1.4% at an annual rate from quarter two, but was still 2.9% higher than a year before. A key characteristic of the economy over the past year is the wide divergence between sectors. Whereas output in agriculture, mining, manufacturing and electricity all contracted by between 1% and 3.5%, output in trade, the financial sector, government, transport and communication all rose between around 3.5% and 4.5%.
- The outlook for the local economy has taken a turn for the worse, largely owing to deteriorating global economic prospects. So, while growth for the 2011 calendar year will still exceed 3%, forecasts for 2012 have generally been lowered to around 2.5%.
- The panic over the Eurozone crisis and deteriorating prospects for the world economy caused a sharp weakening of the rand, and the exchange rate weakened to levels last seen in May 2009. Yet, as panic subsided, the rand clawed back a part of its earlier losses
- Inflation edged up further in October to 6.0%. Yet, the so-called 'core rate' has remained unchanged at 3.8%. This implies that the rise in inflation is still primarily being driven by food, fuel and electricity prices. Looking forward, inflation risks have clearly increased, owing to the weakening of the rand. However, we still think inflation will peak at between 6% and 7% in the months to come, and then start to drift lower. This crucially assumes that the rand will stabilise, oil will remain around $110, and food inflation will also start to ease early in 2012.
- With the economy still growing slowly, and risks skewed to the downside, interest rates are set to remain on hold well into 2012, despite the weaker rand and the uptrend in inflation.

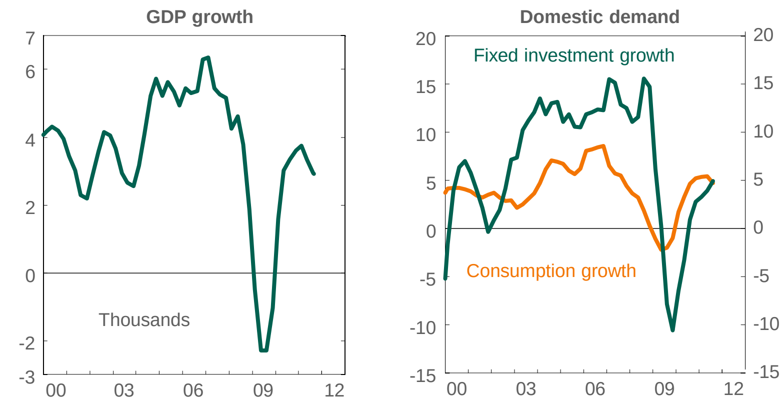
OMIGSA Economic Research Unit view: *The local recovery continues at a pedestrian pace and prospects for 2012 have deteriorated along with weaker global prospects. Yet, a recession is not foreseen, unlike the deep slump that followed the sub-prime crisis is 2008.*

Rand weak on global worries, inflation rising



Source: OMIGSA (Iris)

SA economy growing slowly



Source: OMIGSA (Iris)

Equity Sector Overview and Outlook

Resources

- The basic materials sector produced a return of 1.1% for the month of November 2011, marginally lagging the FTSE/JSE All Share Index (ALSI)'s return of 1.6%.
- Following a strong October, November was shaping up to be disappointing, until co-ordinated global central bank activity on the last day of the month provided a strong boost to shares, pushing the index into positive territory.
- Virtually all the sectors rallied but, for the month as a whole, performance was varied. Oil and gold were the strongest of the major sectors, with mining houses and industrial metals also showing a positive return. The laggard sectors were paper and platinum. Although Europe is a major market for most commodities, it is particularly important for platinum and paper.
- Although all commodities have been under some pressure, there appears to be a resurgence of buying when prices drift down too far. Consensus seems to be that, although times are difficult, they haven't and won't reach the all-time low seen in 2008/2009.
- Commodity prices have all come off from mid-year highs and, although the market fundamentals still appear to be reasonable, there is an increasing fragility to these fundamentals. At the very least, some consumers – notably the hard-pressed steel mills – are taking advantage in order to force pricing adjustments for raw materials. However, prices for most commodities are still above marginal cost levels and producers are still operating with comfortable margins.

Equity Research view: *We continue to favour the larger, higher quality, and/or better-priced counters such as Anglo American and BHP Billiton, while the rand weakness has increased the attractiveness of certain SA-based miners.*

Small Companies

- The small cap and mid-cap indices returned 1.0% and 2.0%, respectively, for the month ended 30 November 2011, while the FTSE/JSE Top 40 Index returned 1.5%.
- The market had a major boost at the end of the month, based on Chinese rate cuts and increased financial support for Europe from the International Monetary Fund (IMF) and the US.
- Some positive sentiment after a tough four months is very welcome, but it doesn't change the fact that the world is still over geared. Global growth will remain muted, and the market will continue to swing from panic and nervousness to complete over exuberance. This is a traders market where fair values are vital in trying to outperform, as the market prices will continue to be volatile. This creates good opportunities for those that have done their homework.
- Investor confidence will slowly return over the longer term and the austerity packages and deleveraging will occur. However, there will likely be unexpected shocks along the way and it will not be an easy ride. Two of the main concerns are inflation and interest rates, both of which could exceed current expectations. Some restructuring of the Eurozone treaties or countries is also definitely on the cards.
- Emerging markets have slowed, but are still expected to show robust growth over the next few years. China, in particular, appears to be trying to stabilise the growth rate.

Equity Research view: *The average price:earnings (p:e) ratio at which small caps trade compared with large caps is now at good discount.*

Equity Sector Overview and Outlook (cont.)

Financials

- The FTSE/JSE Financial Index had a soft month, gaining 0.8%, underperforming the FTSE/JSE Shareholder Weighted All Share Index (SWIX) which was up 2.0% during the month.
- Within financials, the Banking Index gained 1.3%, while the life assurance sector gained 1.9%.
- For the balance of 2011, we expect the banks to continue their focus on costs as revenue growth remains subdued. Capital levels will also be a focus area, with the potential for increased dividends.
- Looking beyond 2011, we recognise that banks are altering their asset mix (to high return and high growth advances) and repricing new loans. Both these actions will be supportive of interest margins going forward, which will be positive for returns.
- Life companies should continue to show an improving trend in lapse-experience and recurring-premium sales due to improving real household incomes. Cost management will also become an issue in a sector with limited growth prospects.

Equity Research view: *We expect the financial services sector to benefit from the recovering economy and the reduction in bad debts, which will lift operating results in 2011. We believe some counters in the sector still present value, with ratings below historic averages.*

Industrials

- November was another volatile month. The Industrial Index was down 4.5% three weeks into November, but finished the month up 1.5% after a strong rally, particularly on the last day of the month when a number of the big central banks in US, UK, Europe and Canada cut lending rates. The rand was similarly volatile.
- The Industrial Index is now up 11.1% year to date, and the FTSE/JSE All Share Index (ALSI) is up 5.1%.
- With the rand relatively stable during the month, it was up to the local stocks to drive the industrial sector higher. During November, MTN and retailers, Foschini Group, Mr Price, Lewis and Clicks, were all up more than 5%.
- Another strong performer was PPC, as cement sales seem to have bottomed and turned upwards. PPC also reaffirmed that it would maintain its dividend payout policy. There seems to be strong demand for retail shares from offshore investors, who probably expect interest rates to remain low for an extended period of time.

Equity Research view: *Relative to our valuations, the industrial sector continues to be slightly overvalued – particularly the more defensive companies like Shoprite, British American Tobacco and Tiger Brands. The pockets of value tend to be in the smaller companies and some of the cyclical large caps*.

Equity Sector Overview and Outlook (cont.)

Property

- The FTSE/JSE SA Listed Property Index (SAPY) provided a negative 0.9% total return in November. This was despite a 1.6% return for the FTSE/JSE All Share Index (ALSI), 2.5% from general retailers, and a flat All Bond Index.
- Many funds reported in November. Conditions remain difficult, especially in the office sector.
- Sector distribution growth has slowed to below the rate many in the market had anticipated. We remain bearish in this regard and expect distribution growth to fall below inflation. The prospects for some of the funds that reported have improved.
- Following the price movement, listed property now offers improved value relative to both nominal bonds and equities. It is more defensive compared to other equities as most of its earnings are based on medium-term contracts. As a result, it should perform relatively better in an economic downswing, even if property is also under pressure.

Equity Research view: *The sector offers a one-year forward yield greater than 8%, which comfortably exceeds the 10-year bond yield, and distribution growth close to inflation. Downside operational risk has reappeared, but base funding rates have reduced. Vacancies are plateauing, but may still increase in some pockets. 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 (our key concern). The direct commercial property market remains resilient, although signs of strain are appearing. On a long-term secular view, property is attractive as existing rents are below feasibility rentals for developments, even with softer building costs.*

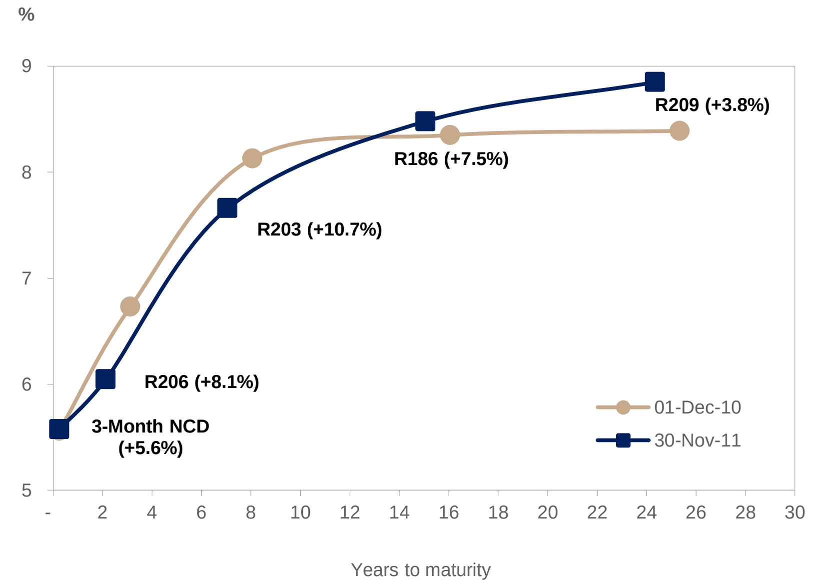
Fixed Interest Overview and Outlook

- "Seeking a lasting solution for Europe's problems" is an often-repeated and somewhat meaningless phrase these days. Our scepticism about the latest Eurozone agreement, noted at the end of October, proved to be well founded, judging by events over the past month. Euro depreciation against the other major currencies; political turmoil in Greece and Italy; a sharp rise in bond yields to new Eurozone-era highs (as the peripheral governments find it harder to lure investors); and growing evidence of the broadening economic slowdown in Euroland are all symptoms of the severe shortcomings of the European Union in its current format.

- Once again, small open economies like ours were exposed to the might of global sentiment swings − resulting in another round of broad-based rand weakness and upward pressure on local bond yields. This has forced the market (and the South African Reserve Bank) to adjust its near-term inflation expectations upwards. Concern about rising inflation, and some improvement in general consumption expenditure, convinced our central bank to keep the repo rate at its current multi-decade low, thereby dampening earlier unrealistic rate-cut expectations.

- As a result, the yield of the benchmark 10-year RSA government bond rose by 40 basis points (bps) during the month, before settling at 7.9% or 5bps higher at month end. Following closely on the heels of a particularly weak October, the inflation-linked bond market returned with a vengeance, as sharply falling real yields reflected strong demand by those fearing higher future inflation. The official Inflation-linked Bond Index rendered a monthly return of 2.5%, followed by cash (+0.5%) and the All Bond Index (+0.01%).

Yield-curve steepening offers an investment opportunity (asset returns over one year in brackets)



Sources: I-Net, Futuregrowth

Futuregrowth view:

Our investment view remains defensive, with a focus on short-term capital preservation while carefully considering potential investment opportunities into market weakness, especially with regards to long-dated fixed-rate bonds.

Economic Indicators to 30 November 2011

	Latest Data		Previous Year
Exchange Rates:			
Rand/US$	November-11	8.12	7.09
Rand/UK Pound	November-11	12.75	11.04
Rand/Euro	November-11	10.92	9.22
Rand/Aus$	November-11	8.33	6.81
Interest Rates:			
Prime Overdraft	November-11	9.00%	9.00%
3-month NCD rate	November-11	5.50%	5.55%
R157 Long Bond Yield	November-11	6.77%	7.46%
Inflation:			
CPI (y-o-y)	October-11	6.0%	3.4%
National Accounts:			
GDP Growth (y-o-y)	September-11	2.9%	3.4%
GDP Growth (q-o-q, annualised)	September-11	1.4%	3.1%
HCE Growth (y-o-y) (Household Consumption Expenditure)	June-11	4.9%	4.7%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	June-11	2.4%	-5.2%
Balance of Payments:			
Trade Balance (cumulative 12month)	October-11	$0.32	-$0.86
Current Account (% of GDP)	June-11	-3.3%	-2.9%
Capital Account (% of GDP)	June-11	3.3%	3.6%
Forex Reserves (incl. gold)	October-11	$49.73	$44.41
Other:			
Manufacturing Production (y-o-y) (seasonally adjusted)	September-11	6.9%	1.7%

Source: OMIGSA

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Market Indicators to 30 November 2011

	1 month (%)	Quarter (%)	Calendar year (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)
Equity						
All Share Index	1.6	7.1	5.1	11.7	18.8	9.5
Shareholders Weighted Index	2.0	6.1	5.7	12.5	19.6	10.1
All Share/Resources 50%	1.5	6.8	6.7	12.9	19.9	10.2
Top 40 Index	1.6	7.6	5.6	12.7	17.9	9.0
RAFI® 40 Index	1.4	6.3	4.5	11.5	20.2	11.0
RAFI® All Share Index	1.2	6.0	2.9	9.4	19.2	10.1
Resources Index	2.1	8.3	-1.0	6.6	14.5	6.9
Financial Index	0.8	3.6	5.4	10.3	15.8	4.8
Industrial Index	1.5	7.6	11.1	17.1	24.7	14.5
Mid-cap Index	2.0	4.9	3.4	6.6	25.6	12.9
Small-cap Index	1.0	2.5	-2.6	1.9	16.6	8.7
Interest-Bearing						
ALBI BEASSA	0.0	0.6	8.0	9.9	9.6	8.8
STeFI	0.5	1.4	5.2	5.8	7.5	8.6
Cash	0.4	1.2	4.5	4.9	6.4	7.9
Property						
SA Quoted Property Index	-0.9	-0.6	6.7	9.1	18.3	14.4
International						
MSCI World Index (R)	0.1	14.0	16.3	16.5	5.1	1.0
MSCI World Index ($)	-2.4	-1.5	-5.0	2.0	13.0	-1.4
MSCI World Emerging Markets (R)	-4.3	4.5	1.2	1.0	15.1	
MSCI World Emerging Markets ($)	-6.7	-9.7	-17.4	-11.5	23.6	
JPM International Bond (R)	1.4	13.1	29.9	23.0	-0.3	9.6
US 1-month LIBOR (R)	2.6	15.8	22.7	14.5	-6.5	4.7
Inflation (Estimated)						
CPI	0.3	1.3	6.0	6.2	5.2	7.1

Source: OMIGSA

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