

# Market Dynamics

October 2009

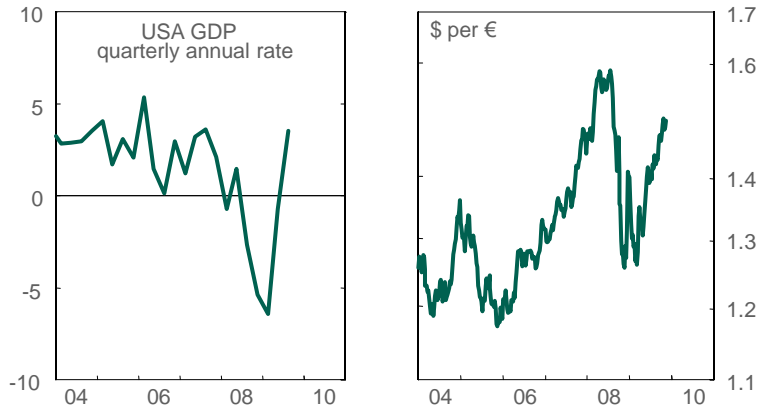


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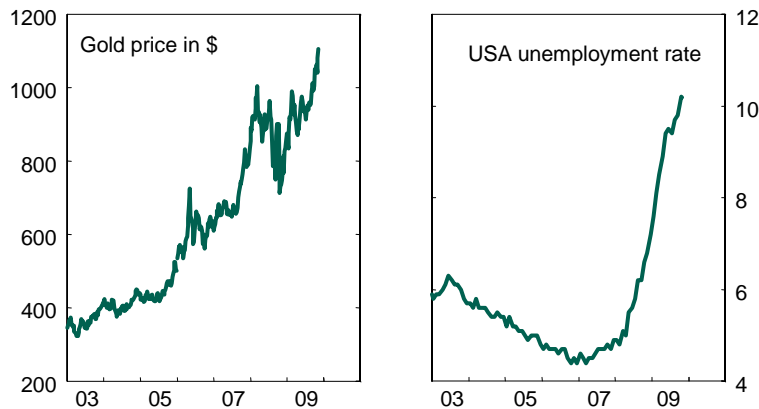
# World Economic Overview and Outlook

## USA recovers, \$ weakens



Source: OMIGSA (Iris)

## Gold rises, US unemployment still a worry



Source: OMIGSA (Iris)

- ▲ The global stabilisation signs that have emerged since April 2009 have gradually been transformed into outright economic recovery over the past few months. The upturn, which was first evident in Asia, has spread over a fairly broad front and overall global growth was fairly solid during the third quarter. As an example, US Gross Domestic Product (GDP) growth accelerated from -6% and -1% annualised in the first and second quarters of 2009 to +3.5% in the third.
- ▲ The solid global recovery and extreme liquidity creation have undermined the value of the US dollar. As it slipped further over the past month against all major currencies, precious metal prices benefited, with gold rising to an all-time high.
- ▲ While the strength of the recent economic upturn has surprised most analysts, there are still considerable concerns over the sustainability of the recovery. The key concerns revolve around the eventual fading of stimulus measures, weak labour markets around the world and ongoing debt de-leveraging by highly indebted households in many parts of the world. These concerns flared up again during the second half of October on the back of some weak high frequency data released in the US. As a result, equity markets fell back fairly sharply towards month-end.
- ▲ We share these medium-term concerns. As a result, and given the limited risk of any meaningful rise in global inflation over the next 12 to 18 months, economic policy settings will remain expansionary until such time as policymakers are confident that the risk of a serious growth relapse has faded.

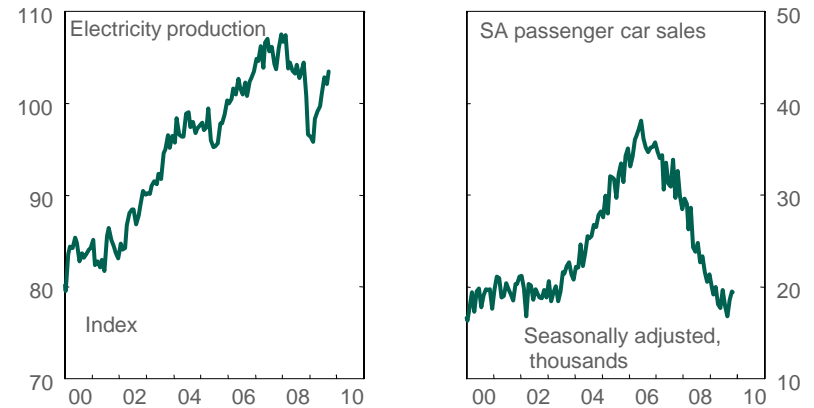
**OMIGSA Economic Research Unit view:** *While short-term prospects continue to brighten, there are still many obstacles and risks that cloud medium-term prospects.*

# Local Economic Overview and Outlook

- ▲ The latest local data releases point to a moderate recovery in the local economy. The economically sensitive volume of electricity generated continued its uptrend in September and is more than 25% up from the cyclical low recorded in February. Key indicators, such as mining and manufacturing production, also rose moderately in the third quarter, pointing to a moderate recovery in Gross Domestic Product (GDP) in the third quarter, following the cumulative 3% decline over the preceding three quarters.
- ▲ While there are clear signs of a recovery in certain production sectors of the economy, consumer demand remains weak. Car sales are at best stabilising at extremely depressed levels, credit demand remains weak and retail sales are also yet to show any meaningful recovery signs.
- ▲ On a more positive note, inflation has eased a little further to 6.1% in September. The strong rand, decelerating food inflation and weak consumer demand hold the promise of a further deceleration in the months to come. But, while the shorter-term inflation prospects have improved, there are still some significant medium-term risks, including still-high wage demands, rapid rises in administered prices (especially electricity), and stubbornly high inflation expectations.
- ▲ The rand initially weakened sharply on the back of concerns over government's huge borrowing requirement over the next few years, as confirmed in the Medium Term Budget Policy Statement, but soon began to firm again on good foreign trade data (R4bn surplus in September) and the continued rise in precious metal prices.
- ▲ The interest rate outlook is now uncertain. With rates down sharply from their peaks and the economy showing early signs of recovery, the South African Reserve Bank left rates unchanged at their last two meetings. However, downside inflation surprises and/or failure of consumption to recover could trigger yet another rate cut.

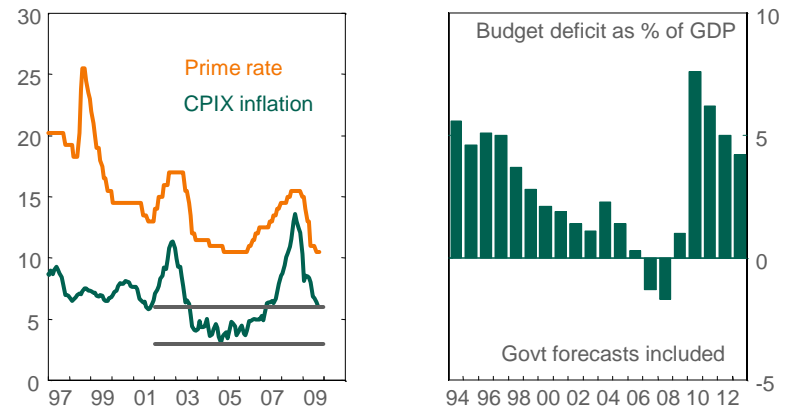
**OMIGSA Economic Research Unit view:** *The local economy remains depressed and will recover only slowly during the second half of the year. This keeps open the possibility of a further lowering of local interest rates.*

## SA economy: recovery signs



Source: OMIGSA (Iris)

## Inflation eases, rates on hold. Budget deficit widens sharply



Source: OMIGSA (Iris)

# 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.
- ▲ Continued evidence of an earlier-than-expected recovery in China and India, with signs of stabilisation in the G7, has been somewhat dampened lately by rapidly strengthening producer currencies such as the rand.
- ▲ Despite the uncertainty regarding global growth, there is substantial value in certain shares and/or sectors – such as Anglo American plc.

**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.*

## Small Companies

- ▲ During October the small cap and mid-cap indices returned 2.6% and 4.5% respectively, while the FTSE/JSE Top 40 Index increased by 6.3%.
- ▲ The reporting season continued in October and trading conditions remain difficult, especially in the automotive and residential property markets. Margins remain under pressure and most businesses have aggressively cut costs and strengthened balance sheets.
- ▲ Interest rates remain low and ultimately this will feed into GDP growth and help to maintain the current levels in the market. It may, however, prove to be a long, slow recovery with subdued earnings growth.
- ▲ Prospect statements remain cautious, reflecting the lack of visibility for most companies for the year ahead.
- ▲ The risk appetite of global investors has increased as we have moved past the worst of the credit crisis, and they are now looking for solid growth in the world's emerging markets.

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

# Equity Sector Overview and Outlook (cont.)

## Financials

- ▲ The FTSE/JSE Financial Index had a strong performance in October and marginally outperformed the FTSE/JSE Shareholder Weighted All Share Index (SWIX). The SWIX ended the month 4.4% up while the Financial Index gained 4.8%.
- ▲ Within financials, the banking sector gained 3.5% while the life sector went up 9.7%. Old Mutual's 15% rise boosted the life sector's performance during the month.
- ▲ The financial sector continues to benefit from improved sentiment that the worst of the recession is over, and that positive GDP growth is imminent.
- ▲ However, we expect the operational environment for financial sector companies to remain tough in 2009, with loan impairment ratios for banks and policy termination rates for life companies remaining above trend.
- ▲ Although impairment ratios for some banks may still show an uptick, the rate of decline has slowed, and we believe earnings will surprise in the medium term as the ratios begin to recover.

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

## Industrials

- ▲ Industrials continued their upward trajectory in October, up 5.1%.
- ▲ The performances were varied across sectors, with healthcare and rand hedges standing out from the crowd. SABMiller, Reinet and Steinhoff were all up in the mid-teens. Netcare and Adcock were both up more than 10%.
- ▲ The construction shares continued the rollercoaster ride, all trading down on the month, but this followed some months of very strong performances, so a breather was long overdue.
- ▲ Job losses of more than 700 000 since the same period last year were way ahead of consensus and have dampened the market enthusiasm for the credit furniture retailers. Surprisingly, the clothing retailers were not tarred by the same brush (this month anyway).
- ▲ Telecoms also had a damp performance, partly due to Parliament's focus on interconnect fees that are due to come down.

**Investment Research view:** The sector is now starting to look expensive and we struggle to find many shares with significant upside.

# Equity Sector Overview and Outlook (cont.)

## Property

- ▲ In October, the listed property market delivered a total return of 1.3%, which was lower than equities' total return of 6% but higher than bonds' negative return of -0.2%. Year to October the sector total return was 11.9%, lower than equities' return of 25.7% but higher than bonds' negative return of -2.3%.
- ▲ Vacancies continue to increase, with declining capital growth in the direct commercial property market. The Investment Property Databank (IPD) for the six months to June 2009 shows the direct property total returns slowed to an annualised 7% from 13% in 2008. Income return was 8.4% (8.3% in 2008) and capital return was negative 1.6% (4% in 2008). This is the first time in seven years that direct commercial property capital returns have been negative.
- ▲ Vacancies within the listed property market have also been increasing, reflecting what is happening in the overall direct property market, although levels are still immaterial at less than 5% currently. Vacancy increases have been notable within line shops in community/neighbourhood shopping centres, small industrial tenants (<2500m<sup>2</sup> of lettable area) and speculative A-grade office space.

**Investment Research view:** *In our view, 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%).*

# Fixed Interest Overview and Outlook

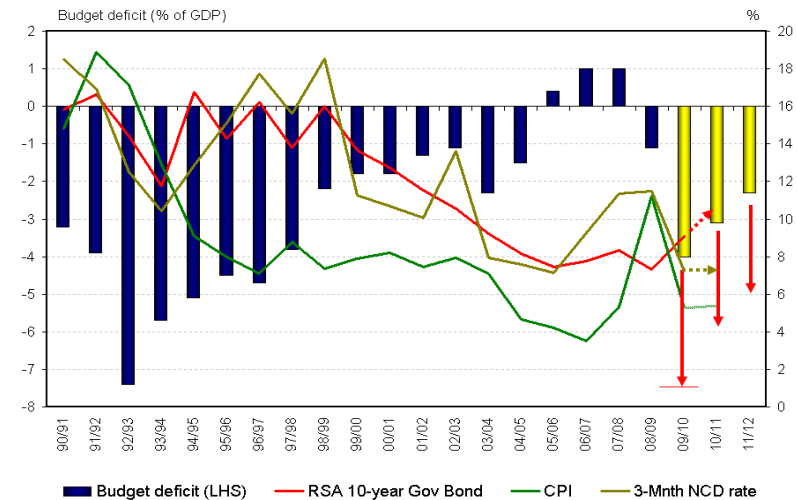
- ▲ The slope of the yield curve continued its steepening trend during October. As a result, bonds once again underperformed cash, with the 12-year+ maturity band rendering the worst performance.
- ▲ The mid-term national budget did not deliver any major surprise in terms of net new funding, but instead highlighted the fact that it would not be easy reversing the higher budget deficit in a short space of time. Marginally better-than-expected inflation and monetary aggregate growth data rendered some momentum to the post mid-term budget bond relief rally.
- ▲ We maintain that RSA bond yields should remain elevated, considering our view of: 1) upside risk to inflation on a 12-18 month view; 2) interest rates having bottomed; and 3) sustained high levels of net new issuance in months to come. We maintain a healthy appetite for corporate and other non-government debt, still offered at attractive spreads over RSA government debt. Market weakness will be used as an opportunity to slowly accumulate CPI-linked bonds.

**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 used market weakness to add to our holding of medium-dated and longer-dated money market assets. We continue to favour floating-rate over fixed-rate instruments.
- ▲ In the bond funds, we maintained an underweight modified duration.
- ▲ In terms of yield curve tilts, we are running underweight positions to the one- to three-year and 12-year+ maturity bands, while holding an overweight tilt to bonds in the seven- to 12-year band.

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

## Strong, sustained supply of new RSA government bonds



Sources: National Treasury, OMIGSA & I-Net

- ▲ The RSA CPI-linked bond market is looking more interesting from an investor's point of view, compared to a few weeks ago.
- ▲ We maintain a low listed property holding on a weak economic growth outlook, preferring nominal bonds instead, particularly attractively priced non-government debt. Preference shares have lost a little colour and we have been slowly reducing exposure.

# Economic Indicators to October 2009

	Latest Data		Previous Year
<b>Exchange Rates:</b>			
Rand/US\$	October-09	7.81	9.77
Rand/UK Pound	October-09	12.81	15.68
Rand/Euro	October-09	11.49	12.45
Rand/Aus\$	October-09	7.03	6.68
<b>Interest Rates:</b>			
Prime Overdraft	October-09	10.50%	15.50%
3-month NCD rate	October-09	7.15%	12.30%
R157 Long Bond Yield	October-09	8.41%	9.09%
<b>Inflation:</b>			
CPI (y-o-y)	September-09	6.1%	13.1%
<b>National Accounts:</b>			
GDP Growth (y-o-y)	June-09	-2.8%	4.2%
GDP Growth (q-o-q, annualised)	June-09	-3.0%	5.0%
HCE Growth (y-o-y)	June-09	-3.6%	3.3%
(Household Consumption Expenditure) GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	June-09	5.7%	11.3%
<b>Balance of Payments:</b>			
Trade Balance (cumulative 12month)	September-09	-\$2.52	-\$9.36
Current Account (% of GDP)	June-09	-3.2%	-7.3%
Capital Account (% of GDP)	June-09	4.6%	8.1%
Forex Reserves (incl. gold)	September-09	\$38.54	\$35.12
<b>Other:</b>			
Manufacturing Production (y-o-y) (seasonally adjusted)	August-09	-14.7%	0.5%

# Market Indicators to October 2009

	1 Month (%)	Quarter (%)	Calendar Year (%)	12 Months (%)	3 Yrs (%)	5 Yrs (%)
<b>Equity</b>						
All Share Index	6.0	9.7	25.7	29.2	7.1	21.1
Shareholders Weighted Index	4.4	9.1	24.5	29.3	8.0	20.9
All Share/Resources 50%	5.6	9.9	26.0	28.8	7.6	20.6
Top 40 Index	6.3	9.3	24.5	27.3	6.4	20.7
RAFI® 40 Index	7.1	10.6	31.9	36.7	10.1	22.7
RAFI® All Share Index	7.3	10.7	28.6	33.5	9.1	22.2
Resources Index	7.5	8.8	24.7	30.9	5.3	22.7
Financial Index	4.8	9.5	26.0	29.9	1.3	15.3
Industrial Index	5.1	10.7	26.5	26.8	12.3	22.5
Mid-cap Index	4.5	12.2	34.4	44.1	12.6	23.7
Small-cap Index	2.6	11.2	23.5	27.5	8.9	22.6
<b>Interest-Bearing</b>						
ALBI BEASSA	-0.2	1.4	-2.3	9.3	6.9	8.0
STeFI	0.6	1.9	7.8	9.9	10.1	8.9
Cash	0.5	1.6	6.8	8.8	9.7	8.3
<b>Property</b>						
SA Quoted Property Index	2.1	6.1	11.9	29.9	13.6	25.6
<b>International</b>						
MSCI World Index (R)	1.5	6.3	4.4	-5.3	-3.7	8.3
MSCI World Index (\$)	-1.8	6.5	23.3	19.2	-5.5	3.2
JPM International Bond (R)	3.3	4.1	-12.0	-8.2	11.3	11.3
US 1-month LIBOR (R)	3.4	0.0	-14.5	-19.4	5.7	8.8
<b>Inflation (Estimated)</b>						
CPI	0.0	0.3	7.3	6.1	8.7	7.1

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# Regulatory Information

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

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