Market Dynamics

September 2011

OLD MUTUAL
Investment Group

Performance through Focus

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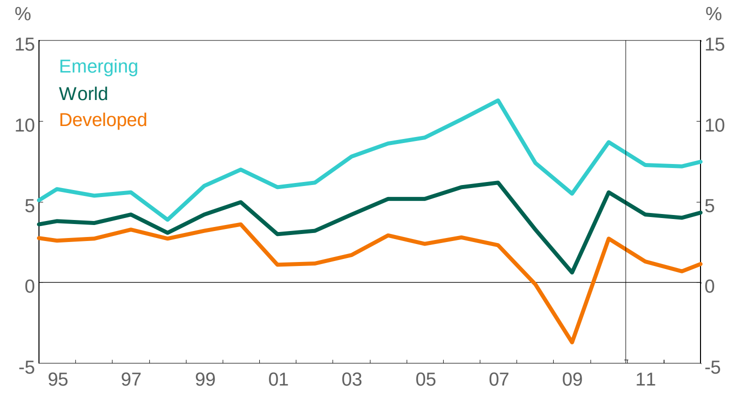
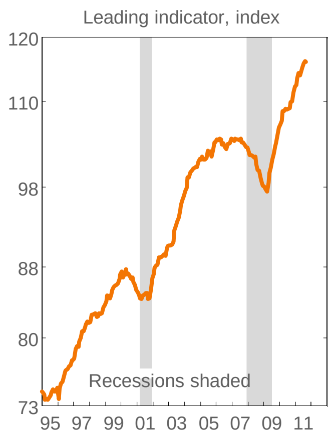
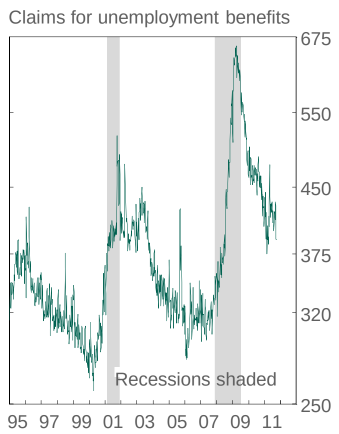


Source: OMIGSA (Iris)

Recession in USA not so clear cut





Source: OMIGSA (Iris)

- The third quarter was characterised by extreme market volatility due to ongoing concerns about the state of the global economy, European debt issues and the downgrading of key countries by ratings agencies. Although the world economy was slowing at the start of the quarter, a significant slowing was not on the cards. At least not until policymakers disappointed markets by their collective indecisive actions. This, in turn, impacted on consumer and business confidence. Combined with the negative wealth effect associated with market turmoil, the world economy could now be on the brink of another recession.
- The quarter started off with mixed news. Another Greek support package had markets relieved, but very soon the bickering around the raising of the US debt ceiling and resultant ratings downgrade, plus renewed concerns about Italy and Spain, had the markets in turmoil again.
- By the end of the third quarter there were still no decisive policy action by the Europeans, despite the significant pressure on them by the US, the IMF and markets. Thus market volatility continued unabated. It seems that some form of support for European banks, à la the USA-style TARP (troubled asset relief programme), could be in the offing, but continued bickering about a bigger (or leveraged) EFSF (European Financial Stability Facility) and refusals of the Germans to support a Eurobond meant that no lasting solution was yet found.
- Thus, in the face of slowing growth momentum, the world could be on the brink of a renewed recession. However, such a recession will likely be shallow compared to the 2008/2009 recession. In the US, corporates are still very healthy, with excellent profits. They are also far leaner than at the start of the 2008 crisis. Since they have not overextended themselves in terms of spending on employment and fixed investment, they do not have to cut spending significantly, which could have induced a sharp recession.
- Nevertheless, it seems clear that the world is set for a period of very soggy growth. This will mostly come from developed economies, as emerging economies are widely expected to be far more robust.

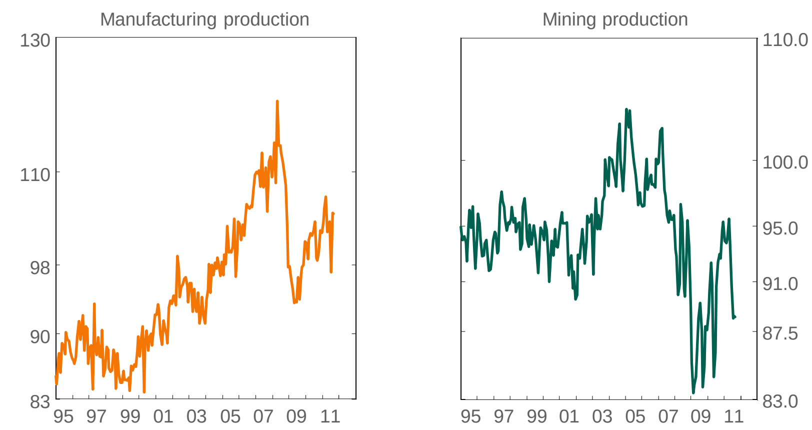
***OMIGSA Economic Research Unit view:** Global growth prospects remain very uncertain, and risks of the world slipping back into recession have increased further. Yet, we remain of the opinion that this could still be avoided by decisive action.*

Local Economic Overview and Outlook

- After the momentum loss in local growth experienced during the second quarter, expectations were that growth would rebound during the third quarter. However, incoming data suggests that such a rebound is by no means going to be very strong. Continued weakness in manufacturing and mining production, electricity generated and construction will likely keep GDP growth fairly muted. Thankfully, there has been some rebound between the second and third quarters in vehicle and retail sales.
- Ongoing weakness in investment and exports (the outlook for the latter now looking even bleaker given the global growth slowdown), combined with the downward revision of Q1 growth will cause growth for the full year to come in at around 3.3% – lower than our long-held 3.7% forecast. The global economic slowdown will probably limit local growth in 2012 to roughly the same rate as 2011.
- Recent market volatility around the ongoing European debt crisis has led to a renewed bout of risk aversion. As part of this flight of capital away from risky assets (read Emerging Economies), the rand has weakened markedly from the strength seen early in the year. However, local fundamentals remain healthy – e.g. SA's government debt to GDP ratio is far lower than most other countries – plus very healthy returns locally versus elsewhere should help the rand regain some stability.
- With growth slowing, interest rate expectations have softened sharply, with many analysts now predicting that rates will not begin to rise before well into 2012. There is even speculation about another rate cut in coming months. While we agree with the first view, we do not think a rate cut is likely unless the local economy weakens sharply further in Q3. The problem is that inflation is still rising and medium-term inflation risks remain considerable.

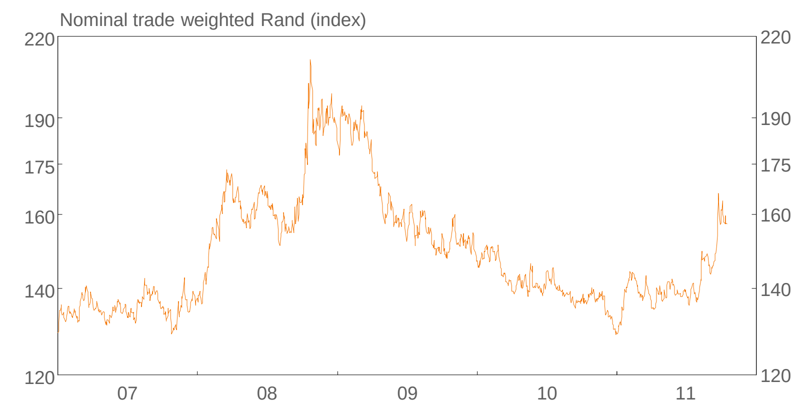
***OMIGSA Economic Research Unit view:** The local recovery remains on track, although growth has slowed and will likely remain unexciting despite some rebound in the second half of 2011. Growth for the full year will be around 3.3%. Interest rates are likely to remain on hold until deep into 2012.*

Manufacturing and mining production



Source: OMIGSA (Iris)

Trade weighted Rand



Source: OMIGSA (Iris)

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Equity Sector Overview and Outlook

Resources

- The basic materials sector produced a return of -10.8% for the quarter ending September 2011, underperforming the FTSE/JSE All Share Index (ALSI)'s -6.0% return.
- The quarterly performances of the individual sectors varied widely, with the gold sector returning a stellar 19.5% and the coal sector eking out a positive 1.1%, while every other resources sector fell by 10% or more. As the global economic situation came under pressure from the uncertain situation in the Eurozone as well as the stuttering USA economy, the gold price performed its job as a safe haven. Of the major metals, precious or industrial, gold was the only one that managed a significant rise (in US dollar terms), with iron ore being the only other significant commodity to hold up. The long forecast fall of the rand has led to margin pressure being alleviated at South African operations for the time being, although other SA issues (safety, health, productivity, threats of nationalisation etc.) continue.
- The market appears to be reaching the conclusion that continually fudging Greece's debt refinancing isn't going to make the issue disappear. In particular, copper, down by 25% for September, appears to have already priced in a slowdown, even though current prices for copper are still 17% above 2010 lows, let alone the lows seen during 2008. With the Swiss Franc now officially off the list of safe havens, gold reigns supreme in that regard, although the recent $300/oz fall shows that even gold isn't immune to current market volatility.

***Equity Research view:** With the de-rating of the mining houses, the majority are now trading on ratings not seen since the dark days of 2008/2009, despite the fact that balance sheets have been significantly strengthened. 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 of the SA-based miners.*

Small Companies

- The small cap and mid-cap indices returned -2.3% and -2.0% respectively for the three months ending 30 September 2011, while the FTSE/JSE Top 40 Index returned -6.6%.
- The market remains highly volatile and this quarter has been no different. Global growth concerns, given excessive debt levels, are making investors nervous. This lack of investor confidence, and a distinct lack of clarity with regards to the future, is causing investors to sit on the sidelines. The irony of using a leveraged special purpose vehicle to deal with the Eurozone issues is priceless. The Eurozone debt and political issues seem far more difficult to sort out than the average investor realises. The fact that US politicians are now telling the Europeans to "get their act together" highlights the worry about the ramifications of a weak Eurozone for American companies. Ultimately, some kind of Greek default would be appropriate, and ongoing German support is critical to sorting out most of the Eurozone problems. The signs of an ongoing credit freeze continue to appear and this is a major source of concern. This credit freeze is exactly what will tip economies into recession and remove the potential of reducing the debt through economic growth.
- Emerging markets have slowed, but are still expected to show robust growth over the next few years. China, in particular, appears to be well placed to continue growing.

***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 fell 3.1% for the quarter, outperforming the FTSE/JSE Shareholder Weighted All Share Index (SWIX) which was down 4.3% during the month.
- Within financials, the Banking Index lost 3.3%. August saw the start of the 2011 earnings season, with all the banks posting good growth as the operating environment continues to normalise. ABSA was the best performer in the quarter, benefitting from strong results and a reduction in its dividend cover. We see further potential for ABSA to reduce dividend cover in this low-growth environment.
- The life assurance sector lost 3.8%, mainly driven by the poor performance of Old Mutual, which was down 9.4% in the quarter as global risk aversion picked up. Liberty Holdings was a strong performer during the quarter after its latest results showed that its persistancy issues were stabilising.
- 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 potential for increased dividends.
- 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, which will lift operating results in 2011. We believe some counters in the sector still present value, with ratings below historic averages.*

Industrials

- After a volatile September in which the Industrial Index fell 3.3% over the quarter, the index is now flat year-to-date. This compares with the FTSE/JSE All Share Index (ALSI), which is down more than 5% year-to-date. The big news of the month was that the rand lost 16% against the US dollar and 11% against the pound.
- The hardest hit industrial stocks during September were Richemont and Kumba Iron Ore, both down 11%, Naspers, down 4% and MTN, down 8%. The clothing retailers also came under severe pressure. The Foschini Group, Truworths and Mr Price were all down in the region of 10%. With the majority of clothing imported, investors were worried about the negative impact that rising input costs would have on profit margins.
- The two big industrial defensives were just that: SABMiller was up 3% after announcing that the board of Foster's brewing in Australia was in support of its revised offer. British America Tobacco's (BAT) share price rose 10% as the rand weakened and investors sought the resilient earnings offered by the tobacco industry.

***Equity Research view:** For much of this calendar year, we have not been seeing much value in the industrial sector. The recent market volatility has shaken things up. Many of the cyclical companies are now offering long-term value, while many of the defensive companies are looking over priced. It is now all about getting the timing right.*

Equity Sector Overview and Outlook (cont.)

Property

- The FTSE/JSE SA Listed Property Index (SAPY) provided a 2.2% total return (1% capital, 1.2% income) for the third quarter of 2011. This exceeded the FTSE/JSE All Share Index (ALSI)'s negative 5.8% total return and the FTSE/JSE All Bond Index (ALBI)'s positive 2.8% total return.
- In August, listed property funds representing 62% of the sector, by value, reported their results. On average, distributions were 6.6% higher than the previous six months. Results season was disappointing on balance and highlighted the continued difficulty experienced in neighbourhood and community shopping centres, offices (especially B-grade offices) and hotels.
- In September, the Investment Property Databank (IPD) released direct property index returns for the first half of 2011. These results showed that the direct property market is beginning to take strain as the index recorded a total return of 4.3%, which was made up of zero capital gain and 4.1% income return. This does not compare favourably with the 13% total return produced by the index in 2010, which was made up of 9% income return and 4% capital return.

Equity Research view: *The sector offers a one-year forward yield greater than 8%, which exceeds the 10-year bond yield, and a distribution growth approximating inflation. Downside operational risk has reappeared, but base funding rates have reduced. Commercial building plans passed have fallen, which will facilitate rental increases in the recovery. 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 in time (a key concern). The direct commercial property market remains resilient. On a long-term secular view, property is attractive as existing rents are below feasibility rentals for developments, but building costs have softened.*

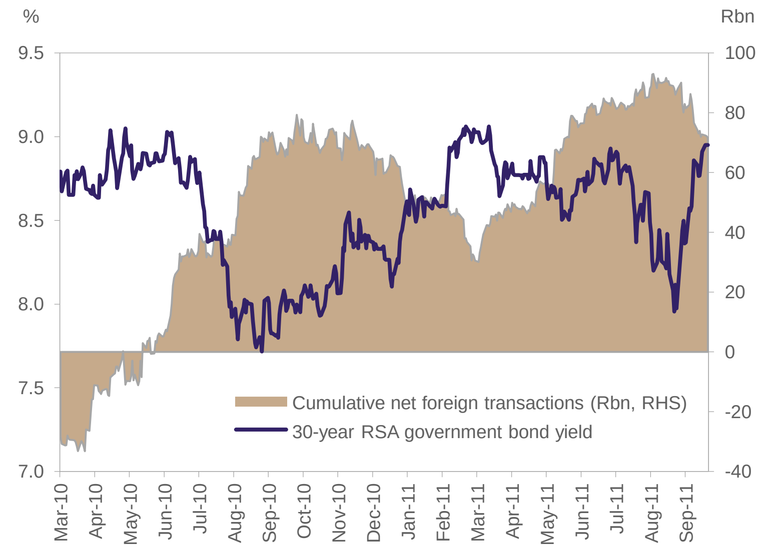
Fixed Interest Overview and Outlook

- The bond market experienced significant investor sentiment swings during the third quarter of 2011, resulting in a wide bond trading range. The yield of the benchmark 10-year government bond traded between 8.5% and 7.5%, before ending the quarter at 8.3%, a mere 12 basis points stronger than the close on 30 June 2011.

- The forward money market reflected similar swings in expectations. It swung from pricing in near-term rate hikes to rate cuts in a matter of days, before interest-rate bulls were forced onto the back foot towards quarter-end. The move to a more bullish interest-rate outlook earlier during the third quarter was the net result of a combination of weak global and local economic data releases, strong foreign demand for local bonds and persistent rand strength. However, the latest surge in global risk aversion finally dented the seemingly bullet-proof rand and the local bond markets, in turn forcing unrealistic rate-cut expectations on the back foot. As feared, the pile of local bonds in foreign hands again showed its dark side towards the end of the quarter. A net reduction of about R18bn of foreign bond holdings in September caused market yields to retrace sharply to higher levels. The rand once again revealed why it is a high beta currency, as it lost almost 10% in real terms against a basket of currencies over the 12-month period ending 30 September 2011.

- Our investment view still centres on rising inflation and ongoing rand volatility, as concern about the Eurozone debt debacle continues to threaten global growth prospects, commodity markets and, by implication, exposed small open economies like South Africa. It is also worth noting that weaker growth prospects do not bode well for government's tax revenue targets. Taking our cue from the most recent data, it is unlikely that the Minister of Finance will be in a position to offer good news in terms of the current fiscal year's budget deficit (or, for that matter, for the forthcoming fiscal year).

Net bond selling in September by foreign investors caused bond yields to increase sharply



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.

Economic Indicators to 30 September 2011

	Latest Data		Previous Year
Exchange Rates:			
Rand/US$	September-11	8.09	6.96
Rand/UK Pound	September-11	12.60	10.92
Rand/Euro	September-11	10.83	9.47
Rand/Aus$	September-11	7.82	6.71
Interest Rates:			
Prime Overdraft	September-11	9.00%	9.50%
3-month NCD rate	September-11	5.50%	5.90%
R157 Long Bond Yield	September-11	6.99%	7.30%
Inflation:			
CPI (y-o-y)	August-11	5.3%	3.5%
National Accounts:			
GDP Growth (y-o-y)	June-11	3.2%	2.9%
GDP Growth (q-o-q, annualised)	June-11	1.3%	2.8%
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)	August-11	$1.25	-$1.32
Current Account (% of GDP)	June-11	-3.3%	-2.9%
Capital Account (% of GDP)	June-11	3.3%	3.6%
Forex Reserves (incl. gold)	August-11	$51.09	$43.87
Other:			
Manufacturing Production (y-o-y) (seasonally adjusted)	July-11	-6.0%	7.1%

Source: OMIGSA

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Market Indicators to 30 September 2011

	1 Month (%)	Quarter (%)	Calendar Year (%)	12 Months (%)	3 Yrs (%)	5 Yrs (%)
Equity						
All Share Index	-3.6	-5.8	-5.4	3.6	10.6	8.8
Shareholders Weighted Index	-3.3	-4.3	-3.7	4.1	11.4	10.0
All Share/Resources 50%	-3.4	-4.9	-3.5	4.1	12.0	9.7
Top 40 Index	-4.0	-6.6	-5.8	3.6	9.4	7.9
RAFI® 40 Index	-4.0	-6.7	-5.6	2.0	12.2	10.1
RAFI® All Share Index	-4.5	-7.8	-7.3	1.6	10.9	9.4
Resources Index	-4.6	-10.0	-12.8	1.6	4.9	5.1
Financial Index	-2.9	-3.1	-1.2	-1.3	9.3	5.2
Industrial Index	-3.1	-3.3	0.0	7.8	16.9	14.3
Mid-cap Index	-1.9	-2.0	-3.3	3.2	18.6	14.4
Small-cap Index	-0.4	-2.3	-5.3	5.4	11.0	10.8
Interest-Bearing						
ALBI BEASSA	-2.1	2.8	5.1	5.9	10.0	9.0
STeFI	0.5	1.4	4.3	5.9	7.8	8.7
Cash	0.4	1.2	3.7	5.0	6.8	8.0
Property						
SA Quoted Property Index	-2.1	2.2	5.0	8.3	19.0	17.4
International						
MSCI World Index (R)	5.0	-1.0	7.2	10.8	-0.5	-1.0
MSCI World Index ($)	-8.6	-16.5	-11.8	-3.8	0.5	-1.7
JPM International Bond (R)	13.2	22.2	30.1	21.2	7.4	8.7
US 1-month LIBOR (R)	14.9	18.6	21.7	15.5	-0.3	3.1
Inflation (Estimated)						
CPI	0.3	1.4	5.0	5.6	5.0	7.0

Source: OMIGSA

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