

21st January 2010

Hi all

A global and local economic update

Last year was an excellent year for the stock markets, although some would argue that it did not feel like a good one. The enormous crash of 2008 seems like a distant memory. Depression was avoided, but the recession was inevitable. Markets rallied well on the back of enormous fiscal stimulus packages from global central banks. This allowed companies to restructure without going into liquidation. Large drops in interest rates globally have also helped consumers get through the recession without losing everything.

Global investors banked on a rapid rise in earnings to rationalise the current high prices for stocks. This drove markets upwards and the sustainability of this rally is the burning question for 2010. The rand ended strongly against first world currencies based on large inflows of investment into emerging markets (recovering from huge outflows in 2008). SA is attractive to investors for resources, interest rate differential and tradability of the currency.

Investment analysis on lump sums to 31 December 2009

Source – Spotlight Investor	3 months	1 year	5 yrs	29 Oct 07 – 9 Mar 09	9 Mar 09 – 30 Sep 09
JSE INDICATORS					
<i>FTSE/JSE Top 40 index</i>	11.4%	28.6%	18.5%	-42.6%	24.3%
<i>Small cap index</i>	4.8%	22.8%	21.4%	-46.6%	26.1%
<i>Mid cap index</i>	4.3%	30.2%	22.3%	-36.9%	33.0%
<i>Financial sector</i>	5.2%	22.7%	11.7%	-53.9%	33.1%
<i>Industrial sector</i>	8.4%	27.7%	18.5%	-36.8%	32.3%
<i>Resources sector</i>	15.6%	32.7%	23.7%	-41.6%	16.6%
<i>Property Unit Trusts</i>	5.1%	7.8%	15.5%	-29.2%	10.3%
<i>Money-market Fund</i>	1.8%	9.1%	8.9%		
<i>Rand / USD rate</i>	1.6%	21.0%	-5.4%	-60.9%	22.5%
<i>Rand / EURO rate</i>	1.7%	19.9%	-6.4%	-38.7%	14.9%
GLOBAL INDICATORS					
<i>FTSE (£)</i>	5.2%	24.1%	-2.5%	-48.6%	34.4%
<i>S&P 500 (\$)</i>	7.2%	28.1%	-1.7%	-56.1%	34.1%
<i>DJ Euro 50 (€)</i>	3.3%	21.0%	1.3%	-51.8%	44.2%
<i>Hang Seng</i>	2.6%	52.0%	9.0%	-64.1%	45.8%
<i>Nikkei (Yen)</i>	2.3%	19.0%	-1.7%	-57.4%	16.0%

Actual returns for 3 months for lump sum investments after costs have been deducted

Annualised returns for 1 and 5 yrs for lump sum investments after costs

Global indicators in the currency of residence

Analytical review – Indicators

Understanding market movement is not quite as simple as looking at a few indicators and then making a call. We thus need to apply some logic to some trusted indices and then identify the risk we are taking on our portfolios. Too many indicators (which are often sentiment surveys) result in too much noise and make it more difficult to think logically.

To refresh your memories on the AJM indicators, the fundamental principle of logic makes me feel comfortable with the information being analysed. Hypothetically, when consumers have more money (hourly labour costs) and can spend a bit more (personal consumption), companies are stimulated to produce more products to sell, resulting in higher turnovers and thus profits (dividend yields). Higher profits mean that your dividends are higher and, by implication, the value of your shares should be more. As soon as you want to sell those shares, other investors will want to buy into a good company that is making ever increasing profits, and thus the price will go up.

This seems so easy. But throw in greed, day trading, millisecond trading, hedge funds, (repetition with the last sentence in this par), economic analysts, and a whole host of market noise, and that simple trend in the share prices is tossed around like a balloon in the Cape of Storms. So we throw in investor psychology to add a reality check.

In reality, investors and traders are all trying to second and third guess the market, and thus the share price usually moves up at least 6-12 months before the profits are expected to rise. So if you wait for profits to rise, you are the sucker who is making others wealthy.

Just to complicate matters, markets also tend to overshoot themselves (investors usually overreact and either continue selling stocks when things are down, or continue to buy long after the signals turn downwards). This usually results in investors changing their minds on a strategy and buying or selling at the wrong time. Having said that, aggressive investors often make good profits on these overreactions, but it becomes risky.

AJM Indicators (see Q4 2008 report for motivation and explanations)

1. Real Hourly Earnings – These have continued to shoot up, which bodes well for continued growth in PCE. The question is how much of this is linked to the American stimulus package and thus, how sustainable is it? Europe is unfortunately not in the same position.
2. Personal Consumption Expenditure (PCE) – This, too, has not disappointed, which also bodes well for an economic recovery in the US at least. Ditto on Europe and the stimulus package correlation.
3. Federal Reserve rate – This is looking positive in the US as interest rates have plummeted, which should provide easier credit for spending. Will consumers apply and be approved for credit 12-18 months from now, considering the long-term savings prediction? Euro looks less rosy, although YOY rates are starting to drop now.
4. Price vs earnings – Back up to expensive in the US and most economies. Will earnings grow, or will prices drop?
5. Currency valuations – The USD has been hammered and, by all accounts, overdone. The Euro is too strong and the GBP is bouncing around in-between.
6. The price of debt – Both corporate and government debt are back to normal levels. Emerging markets debt is on the high side. The question of government defaults on their debt in light of the huge stimulus packages will determine interest rates and inflation, and thus the course of markets in the latter part of 2010.
7. Investor psychology – On the back of a good recovery in 2009, investors are likely to discount bad news. There are also many waiting to get back into the market and the longer it runs, the

more concerned cash holders will be. Conversely, a short slide in markets will attract that cash back into the market, so real buying opportunities are going to be difficult unless there is another recession. No-one is really sure where profits are going to come from (after the rise in profits from cost savings which is where I think the market is at the moment). The really tough economic environment we are entering may be too much for many.

Investment discussion

Global governments have taken on huge amounts of debt to ensure that the financial system did not collapse and that consumers did not lose their shirts and skirts (and their houses and businesses). Some time in the near future there will be monetary tightening again, which will dampen growth. Managing this debt while stimulating the economy will result in a delicate balance between hyperinflation and deflation. Only growth will offset their debt, so no or very slow growth can bankrupt an economy. Government bonds may continue to rise and thus may become more attractive. Emerging markets bonds have been very attractive but are vulnerable (as are their currencies). As prices rise, first world bonds may just prove the place to be.

Interest rates in first world economies are very low and you may find that investing in stocks for the dividends could be a better option. Emerging markets have high interest rates but high currency volatility. For longer term investors, diversified hedge funds or equity risk-managed funds are thus more appealing.

Comparing the current price of shares globally (expensive) and the low earnings growth achieved by companies at present, I would suggest that investors are expecting a sharp recovery in earnings. The state of the US consumer (who has controlled the direction of markets for the last 10 years) is likely to disappoint for the first time in recent memory as debt and buying what you can't afford have become very unfashionable. Debt options have run out and the US Fed can do nothing over and above the huge stimulus packages already distributed. Banks are also still not in the clear, with many waves of mortgage re-financing still to hit them. The probability of a strong sustainable recovery appears limited.

China and India will continue to grow apace. China is becoming less reliant on exports to the US for companies to make profits. The growth of the Chinese consumer has gained a momentum that will not be stopped quickly (we have experience of the effect US consumers had on the US). China's heavy investment into African mining and industry has not been charitable which suggests that Africa will benefit from growth in China. Very much a roller-coaster ride, I expect, and it will be important to know your profit and loss margins so that that you do not end up at the bottom of the ride.

One word of caution is that global sentiment has driven inflows into emerging markets have resulted in over-inflated prices. Expect possible disappointment in 2010 and volatility over the next two years.

Complexities in Europe, with a strong Euro, will continue as debt burdened countries in the Eurozone are vulnerable to default and drag down the more affluent economies. Growth will possibly be dependent on exports to China and India, which are likely to be the consumers of the decade. This does not bode well for the Euro, which will have to juggle between wealthy and bankrupt economies.

Industrials in SA have just reached record highs and I fear this may be on short-term excitement of earnings growth coming through, as well as huge foreign investment coming into SA. There is no doubt that activity leading up to the Soccer World Cup is monumental, and will reflect in earnings for 2010. Investors may well be disappointed when they review industrial opportunities in 2011.

Investment strategy

I think sitting on your moderate portfolio for 12 to 18 months may be a good call. I would propose a moderate asset allocation to equities, with the option of expanding this if good buying opportunities arise. The SA investment market has excellent fund managers who focus on dividend-yielding stocks and manage downside risk. It would be risky not to have a healthy dose of South African equities in your portfolio.

Globally, the reality of funding the stimulus packages, government debt risks and slower earnings growth may surprise markets negatively later in the year. Once again, there are good fund managers who work outside the indices to offer attractive propositions. Diversified hedge funds still offer an excellent lower-risk strategy, but it will be important to have some liquidity in your portfolio to buy into any bargain opportunity that arises out of the expected volatility.

Setting up your portfolio in this way will mean that the huge debate about double dip recessions and various assorted shapes of a recovery will not keep you awake at night. The secular bear market we have seen in first world economies over the last decade will end and the shape of the recovery will determine the time you need to spend in the market. If you need cash within two years, have it available.

Investor sentiment is buoyant and thus it is likely that the markets will continue to rise (lots of money driving up prices) while the momentum is up. These prices may not be sustainable and it will be brave not to follow the herd while markets climb. As soon as investors realise that earnings will continue to disappoint, a reality check is likely to moderate this stance.

I would love to chat to you about your views if you feel your portfolio is not aligned to this thinking, so please give me a call to chat.

Kind regards

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