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Hi all

A global and local economic update

Contrary to the predictions of more doom and gloom from some analysts (including AJM), the indicators have shown a fairly good start to the year. The year on year figures are looking amazing, but one needs to remember that 9th March was the bottom of the market slide and the start of the latest recovery.

The 10yr annual returns of all the offshore markets are shocking. This is slightly distorted downwards as it excludes compounded returns and reinvested dividends, but the same applies to the SA market figures.

Investment analysis on lump sums to 31 March 2010

Source – Spotlight Investor	*3 months*	*1 year*	*5 yrs*	*10 yrs*
JSE INDICATORS				
FTSE/JSE Top 40 index	***3.6%***	***40.1%***	***18.0%***	***15.4%***
Small cap index	***4.7%***	***39.5%***	***18.8%***	***21.4%***
Mid cap index	***8.5%***	***48.9%***	***20.8%***	***20.6%***
Financial sector	***10.4%***	***48.2%***	***11.2%***	***10.1%***
Industrial sector	***3.8%***	***47.0%***	***19.3%***	***11.6%***
Resources sector	***1.6%***	***33.8%***	***20.6%***	***20.9%***
Property Unit Trusts	***5.1%***	***20.7%***	***12.9%***	***19.6%***
Money-market Fund	***1.8%***	***7.9%***	***9.3%***	***10.0%***
Rand / USD rate	***0.0%***	***22.6%***	***-3.5%***	***-1.3%***
Rand / EURO rate	***5.4%***	***22.0%***	***-4.3%***	***-4.8%***
GLOBAL INDICATORS				
FTSE (£)	***6.2%***	***50.7%***	***3.0%***	***-1.3%***
S&P 500 ($)	***5.4%***	***50.1%***	***-0.2%***	***-2.5%***
DJ Euro 50 (€)	***-0.9%***	***41.5%***	***0.4%***	***-5.7%***
Hang Seng	***-2.3%***	***56.5%***	***9.5%***	***2.0%***
Nikkei (Yen)	***5.8%***	***36.8%***	***-1.0%***	***-5.9%***

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

Investment analysis is time dependent (the reason why analysts are always wrong). Short-term market volatility sways thinking and the start to both stock market collapses and bull runs is largely driven by singular sentiment that drives appetite or panic as the case may be. AJM has committed to keeping an eye on some tried and tested economic indicators for guidance on the markets going forward. Let us look at the indicators in some detail to sift through the noise, the rhetoric and the assumptions we make.

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

1. Real Hourly Earnings –.These grew consistently during 2009 but are plummeting again, largely due to a rise in inflation. This translates into 90% of employed people in the US being worse off with their inflation-linked hourly earnings than they were last year. A similar scenario is evident in Europe, where all indicators are showing upward trends except hourly earnings which are also plummeting from gains last year. While most economists do not take this indicator into consideration, it has shown to be highly correlated with consumer spending (and thus markets), and forms the basis for a fairly conservative outlook on first world economies.
2. Personal Consumption Expenditure (PCE) – This is driving upwards in all first world economies. Reviewing the model depicted by Joseph Ellis, personal consumption will lag real hourly earnings by 3-6 months. The second part of 2010 may well lead to disappointment in the stock markets. It is also unclear how much of this is related to the benefit of stimulus packages and thus how sustainable it is going forward.
3. Federal Reserve rate – This is looking positive in the US and Europe as interest rates are very low. This will stimulate borrowing and thus economic growth. Will banks be in a position to lend going forward? We will have to wait and see. With a fine balance between repaying huge debts and tightening the available cash in the system, central banks seem to indicate that rate increases will be delayed for as long as possible and will be very gradual.
4. Price vs earnings – Prices are high, waiting for earnings to rise. There appears to be some recovery which is giving impetus to equities. The stimulus packages and a replacement of inventories have helped considerably and the sustainability of this is uncertain. Forecasts for 2010 and 2011 may be more enlightening for longer-term price direction. You can bet that markets will react way ahead of time, so a longer-term view may be the better strategy to adopt.
5. Currency valuations – How quickly things can change. The Euro is on its back thanks to Greece and other European countries struggling to survive. This could take a while to unravel. The Euro will offer some excellent buying opportunities over the next 12 months. You may have to be patient though, as the very weak Sterling may even be a better option for the long-term.
6. The price of debt – Both corporate and government debt are back to normal levels and are thus not showing any clear signs of weakness or strength. With debt a specific issue at the sovereign level, sudden panic may result in good opportunities, especially with debt ridden economies that will be prevented from defaulting at all costs (taking the lead, it appears, from the IMF and Eurozone on Greece)
7. Investor psychology – Not much change from the commentary in my previous report. Markets are upbeat, and so are investors. This could continue until we get a rude awakening such as a debt default - the shocking news is likely to come from the banking / debt side of the market (I did draft this note before Goldman's news). To plan for this is going to be difficult, but listening to your own personal risk profile may be the best advice you get this year. How much do you like losing money in the short-term, against the benefit of historically longer-term good growth? Historically, bad news gets shrugged off when sentiment is positive, so one can expect markets to remain on an upward trend until this sentiment changes.

<u>Investment discussion</u>

Any investment that outperforms cash comes with its own element of risk. What shook the markets 18 months ago was that even cash could result in a total loss of capital (Lehman Brothers and about 250 US banks that were liquidated), not to mention the unwinding of all those "acronym banking structures" which are still raising their ugly heads today (with Goldman).

This is no comfort, but it reminds us that investing in equity is risky and that the higher the risk environment, the more handsome the profits. Take March 2009, when most investors were even too scared to hide under the bed with all the bad news erupting around them. Well, that turned out to be about the best time to jump into equities. The astute investor may have looked at some historic trends and some key indicators, increased their weightings in equity at this point and enjoyed the ride.

Looking at 2010, we have almost forgotten when we received the last investment panic attack, so sentiment is positive. Markets have rebounded and earnings are picking up. The jury is out on whether this earnings pick-up is thanks to the injection of stimulus packages (even China pumped money into the system).

A few trends have occurred in the global market that will have consequences for long-term investors.

<u>Stimulus reversal</u> - The huge stimulus packages by first world economies will need to be unwound. Tightening fiscal policy reduces available cash for spending, developing and building. Inflation and weaker currencies are all cause and effect of this tightening process. Europe, the US and Japan are in the same boat in this regard, which does not shout out "equity boom" any time soon. Cash-flush economies will do better going forward.

<u>Regulation</u> - The range of crises and corporate defaults, along with undisclosed risky investments by banks, has sparked a regulatory drive. The lack of regulation was one of the many keys to entrepreneurial growth that made the US into the major player it was. It is likely that increased regulation to protect rich folk from losing their money on risky investments may choke that growth going forward. In emerging economies (of which SA is one), we are seeing a relaxation of regulation in many instances. The revision of the Companies Act and easing of Estate Duty will facilitate entrepreneurial growth, and similar trends are playing out in other emerging markets.

<u>Debt management</u> - Consumers dictate the market and heavily indebted first world consumers are now focused on improving their balance sheets by reducing debt and increasing savings (not much left for spending). Emerging market populations are arising out of a cash only environment. The sheer mass of new spenders in China, India and Africa are buying, retailers are selling, and producers are producing. These sound like growing economies.

<u>Sovereign debt</u> - Europe is shell-shocked by the unintended consequences of having a central currency, and sovereign debt defaults within its membership seem to be in a precarious balance. The weaker Euro may well assist the industrial might of Germany in becoming more competitive, although only the emerging markets are buying extensively. How the US is going to manage its ballooning deficit is also questionable, and most scenarios don't seem to have a happy ending in the medium term. There is the added complexity of China owning a large chunk of US treasury bonds, and the US thus being fairly dependent on that source of funding.

All in all, the emerging markets look more likely to grow while first world economies and their consumers appear to be in a consolidation phase. The old analogy of stream trains not being able to alter course quickly is still very applicable. Emerging markets are thus likely to continue growing, which will benefit the global economy as well. First world consumers have eventually reverted from spenders to savers and it is unlikely that this will suddenly reverse. Banks that have severely constricted lending facilities are not anticipated to open the flood gates and start indiscriminate lending again. In addition, the enormous government debts accrued from stimulus packages need to be repaid without rampant inflation and currency devaluations. The markets are currently priced for all good news scenarios.

Investment strategy

Our thoughts have not changed since the last report. We felt that the markets needed to settle down once the effects of the stimulus packages had worked through the system, which is likely to be during the second half of 2010. There are still many crises that will plague the markets going forward, including sovereign debt issues and unwinding complex debt structures. The continued upward movement in markets is luring investors back in - many investors are waiting in cash for buying opportunities. We feel this is a risky option, especially in light of corporate valuations, low corporate earnings, hourly earnings figures and a variety of crises that could disrupt markets if regulators and federal reserves/central banks get their fine balancing act wrong. Having said that, earnings do seem to be picking up, many indicators are showing positive trends, and maybe central banks are on top of things and will be able to unravel their excessive debt in a controlled manner.

Global equity are better than global cash at present as the dividend yield generated out of equities is better than the cash return you are currently earning. However if the recovery is anything but V-shaped, it may be better to earn nothing and lose nothing. Multi-manager hedge funds offer investors managed risk but more consistent returns and are possibly the route to go for long-term investors who do not want to be in cash or speculate on market swings.

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 continues. These prices may not be sustainable, but it will be brave not to follow the herd while markets climb. A reality check could moderate this stance. Investors who have a low tolerance for capital loss in the short-term, and are happy to wait on the sidelines for a while, should be aware that buying opportunities may arise going forward. The downside (there are always two sides to the future) is that there is so much cash waiting to enter the market, you may miss out.

The local unit trust industry has a multitude of funds that provide various levels of downside risk management (not guarantees) and are possibly the best option for the more cautious investor to gain exposure to equity.

Emerging markets are the place to be globally. Taking into account the higher inflation rates and volatile currencies, some astute global fund managers believe that it is better to access this buoyant growth via companies in first world economies that sell their products and services to emerging markets. There are a few offshore fund managers who are taking a strategic view on this and are worth considering in a portfolio. Emerging markets are highly priced and thus could re-rate, causing some capital losses in the short-term.

In summation, we are taking a cautious strategy for the next 12 months, but accept that markets could continue to drive upwards while optimism prevails.

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

Kind regards

ALASTAIR MACKIE