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Hi all

[A global and local economic update](#)

Investors climbing into the market stimulated some healthy returns during the latter part of the year. It has been a great end to a volatile year, with local markets the place to be. This is all contrary to the thoughts of most local fund managers, who increased offshore exposure this year based on valuations and a strong Rand. Markets continue to ignore the great debt of consumers in the US and Eurozone and have been driven by strong balance sheets, some solid earnings growth and the prospect of a steady growth year in 2011.

[Investment analysis on lump sums to 31 December 2010](#)

Source – Spotlight Investor	3 months	1 year	5 yrs	10 yrs
JSE INDICATORS				
FTSE/JSE Top 40 index	12.7%	14.6%	12.6%	15.2%
Small cap index	11.5%	20.7%	13.2%	23.5%
Mid cap index	7.8 %	26.4%	16.6%	22.6%
Financial sector	-1.1 %	10.4%	5.1%	8.7%
Industrial sector	10.4%	24.0%	16.4%	14.4%
Resources sector	22.1%	10.4%	13.5%	18.8%
Property Unit Trusts	2.2%	15.3%	7.8%	16.3%
Money-market Fund	1.5%	6.9%	8.9%	9.3%
Rand / USD rate	3.2%	10%	-1.0%	1.3%
Rand / EURO rate	5.7%	18.9%	-3.2%	-2.2%
GLOBAL INDICATORS				
FTSE (£)	9.6%	12.3%	1.7%	-0.8%
S&P 500 (\$)	12.0%	11.6%	-0.1%	-0.6%
DJ Euro 50 (€)	2.8%	-4.9%	-3.2%	-5.0%
Hang Seng	1.1%	6.8%	8.8%	4.5%
Nikkei (Yen)	8.7%	-2.8%	-8.7%	-2.9%

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

This year's themes and strategies appear to be no different from those of last year. Markets are that much more expensive, sovereign debt is that much higher and banks are still heavily geared negatively with the hope that government bonds will not collapse. First world economy debt has increased and long-term bond rates have risen substantially over the last 6 weeks, reflecting the implied risk.

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

1. Real Hourly Earnings – US hourly earnings continue their downward trend, which is cause for concern. The financial stimulus packages adopted by the US distort this chart favourably. However, the equity recovery in 2010 was very much in line with the uptick in this index. We were just unsure of its sustainability, which is now being clarified. This is a strong cause to be cautious at present.
2. Personal Consumption Expenditure (PCE) – After a strong upward trend in 2010, it has stabilized and is moving sideways. This is also an area of concern. Once again the stimulus packages do effect this pattern positively.
3. Federal Reserve rate – Rates have suddenly stopped their upward trend, but it is too soon to get any direction on this one, so it is better to wait for more clarity in the first few months of 2011.
4. Price vs earnings – Prices remain high against long-term averages which may not be sustainable. The effect of the stimulus packages on consumers will determine this sustainability.
5. Currency valuations – No call to make at the moment, as there is so much speculation on all sides. The USD still being the reserve currency and showing some strength recently will be the banker if equities fall this year. However, the sovereign debt issues faced by the US highlight the importance for most investors to have a balance of 4 currencies (USD, GBP, Euro and ZAR).
6. The price of debt – Government bond rates remain low, except in Europe where risky economies have exceedingly attractive bond rates (if the Euro bail out plans are upheld). Emerging markets are still offering attractive yields.
7. Investor psychology – No-one wants to miss out on the action, so we can expect investors to jump into the market at this point, which will continually push prices up. Investors should really look at the environment in which they are purchasing to determine the longer-term merit of buying stocks (*no change to my comment from the last newsletter*). Generally though, there seems to be a sentiment that governments and reserve banks are not going to drop any bombshells. The myriad complexities revolving around the reduction of government debt, and the view that no defaults will materialise are too complex for most to understand, and thus our naturally optimistic psyche boosts this confidence. Any sort of reality check will be a shock to the system.

Investing for the probability of success

Reluctance by AJM to get into the equity market during the second half of 2010 has been met with strong criticism in the face of rising share prices. AJM's investment strategy is based on the probability of success and failure. If there is a higher probability of failure based on the information at hand, we prefer to maintain low exposures to equity. However, if there is a probability of success, it will be worthwhile to increase equity exposure.

The reality is that there are always two sides to an opinion. When you buy 1000 Anglo shares based on your research that says it is well priced, there is some other "less well-read than you obviously" investor who has done the same research as you and believes it is overpriced. This happens daily to thousands of shares, and a trader will provide attractive returns to investors if he gets about 55% of these calls right.

The current predicament that we face is that the “two sides” of the debate are researched from two different places. On the one side, there is much technical analysis that suggests that markets can only go up, assuming that the global macro-economic status will continue without major shocks. In contrast, there is also strong evidence of high sovereign and consumer debt continuing, banking structures remaining extremely vulnerable, and inflation and unemployment biting into disposable income for consumers and governments.

Against the well-known calculation of equities providing real returns above inflation of +7.5% over time, I have used the Nikkei (Japanese Stock market index) in previous reports that show an annualised return of **-4.6%** per annum for 22 years. The market was at 29 000 on Dec 1988 (from where I took the calculation), and rose to 38 000 a year later. Two and a half years later, it had slumped to 16 000 (surely a really good time to buy), which was true as it jumped to 21 000 a year later. However, had you stayed in the market, you will have returned **-2.6%** per annum from mid 1992 to Dec 2010 (18 years on). The message is simple, buy what is truly a discounted price, not what everyone else is doing.

The immediate response from analysts to the above is that US and Eurozone are nothing like Japan. I tend to agree on Eurozone, as the diversity it has in economies and industry will provide better risk management (in spite of the recent debt crisis). However, the nail in the Nikkei coffin (amongst others) was ultimately the consumer who refused to spend in spite of negative interest rates, 0% interest loans and significant tax rebates and refunds. I thus wait to see how the US consumer reacts to the quantitative easing over the 2-3 year period.

AJM believes that there is substantial evidence to be cautious until we have a better idea of how the debt crisis is resolved, and how consumers (many of whom owe more on their homes than what they are worth) react to the highly indebted social trend we experienced over the past 15 years. While stock prices may continue upwards for some of 2011, it is ultimately future dividend yields that will dictate the direction thereafter.

Investment discussion

In trying to sift out the noise, we always try to look at the real facts.

- Job losses and employment data have historically (with the exception of real hourly labour) continued downwards well after a market recovery.
- Emerging markets are all growing at much faster rates than the US, Europe, UK, Japan, Canada and Australia.
- Africa is no longer the forgotten continent, and a long-delayed resurgence in consumerism is taking place.
- Fund managers in the UK and US who want to invest in Africa have a choice between Ghana (or other West African economies) or South Africa. Expect inflows into SA to continue for longer than expected thanks to a highly sophisticated banking system and a solid Reserve Bank (in spite of the outflows in January), though it will be highly volatile.
- The US can only reduce its massive debt burden by exporting goods or having a weaker currency.
- China still holds more than 50% of US government debt, but doing anything about it will cause major losses. Who will get out of this chicken-and-egg situation intact if at all?
- Inflation is on the up, which will eventually effect interest rates and ultimately spending patterns.
- Oil is not cheap, and the analysts who predicted a substantially more expensive oil price 2 years ago are cashing in their bonuses.
- The gold analysts who predicted a rise in commodity prices 10 years ago are also cashing in their bonuses and royalties on books they have written on how to predict the commodity cycle.
- Weather patterns have played havoc with agriculture and food inflation is going to be a killer in 2011.

- Ironically grain surpluses in SA for 2011 will end up on the rubbish heap as farmers cannot afford to reduce their prices, but are not allowed to export to needy economies (competition commission).
- Spain, Greece, Portugal and Ireland are bankrupt. The dominant player in the Euro (Germany) cannot afford to let them default or exit the Euro. We have no historic precedent to visualise the outcome on these economies or the greater Eurozone.
- Most emerging economy stock markets are expensive.
- Most developed economy companies are trading at very low valuations.
- Any insight into US consumers will be thankfully received..... We do know their debt burden is not getting better, neither is their disposable income, and savings rates have recovered off very low levels but are still hovering around the 4-5% level, which is very low.
- The global population is getting older, and most pension funds (the old defined benefit type) are significantly underfunded (by between 30-50%). Watch this space for an increase in savings by consumers, further reducing disposable income.
- Banks are still highly geared to sovereign debt (similar to the credit crisis – package a whole lot of high risk debt together to make it low risk debt), so the stakes on keeping things on an even keel are high.
- With emerging economies and Africa in particular on a strong growth path, equities are likely to provide good returns based on speculative inflows. This may not be sustainable. Short-term volatility will be very high, so investors need to review their short-term goals carefully.

Investment strategy

In SA, equities are largely overvalued which significantly increases the risk of slower share prices. A strong recovery in dividend yields off the lows of 2009 attracts investors, as well as more streamlined staff and better balance sheets. It does remain though a risky option for the shorter-term. For more conservative investors, AJM recommends keeping a lower exposure to equity or using the array of protected equity funds on offer. Value-styled managers provide a less risky longer-term positive return.

The SA currency is too strong, but while there is still global money coming into SA it is unlikely to weaken materially. Offshore companies are much better priced, and thus more attractive for longer-term returns. Emerging markets like SA show strong growth, but the share prices are all overvalued and thus the growth in the economy may not be reflected in the share price growth in 2011.

Globally, there are great fund managers who will avoid the index to find a host of very reasonably priced stocks. Cash is returning nothing and government bonds are at very low levels (bonds reduce in value as the price escalates). AJM still favours fund managers who invest in stocks that benefit from emerging market consumer growth (listed on the major exchanges) suggesting that in spite of developed market doldrums, these sectors may well surprise on the upside.

Speculation in global higher risk bonds may be worthwhile, but one should be reminded that it is speculative. Corporate bonds are attractive in that they offer better rates than government bonds and most companies have strong balance sheets at present. Global hedge funds continue to give an annual return of about 2-3 x cash so are still worthwhile to have as an alternative.

I would love to chat to you about your views if you feel your portfolio is not aligned to this thinking.

Kind regards

ALASTAIR MACKIE