AJM ASSET MANAGEMENT STRATEGIES (PTY) LTD

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Hi all

A global and local economic update

The optimism in global markets during 2010 has moderated. Markets are quite volatile but are struggling to break through key indicators. Global markets have done better than emerging markets overall. In SA, losses in property, small and mid-cap stocks have been offset marginally by a small gain in resources.

Earthquake and radiation scares in Japan have had a minimal impact on the global market. Apart from China, which has started aggressive interest rate hikes, most markets are keeping rates at record lows for as long as possible to try and stimulate consumer spending. The after-effects of quantitative easing are still being reflected in stocks in the US and Europe. We are entering a busy period of corporate year ends during which earnings forecasts and accrual earnings will be extensively analysed.

Investment analysis on lump sums to 31 March 2011

Source – Spotlight Investor	*3 months*	*1 year*	*5 yrs*	*10 yrs*
JSE INDICATORS				
FTSE/JSE Top 40 index	1.7%	12.4%	10.6%	15.9%
Small cap index	-6.0%	8.4%	8.3%	24.5%
Mid cap index	-6.3%	10.2%	11.2%	22.7%
Financial sector	0.4%	1.9%	3.1%	10.5%
Industrial sector	0.8%	19.9%	14.1%	16.7%
Resources sector	1.5%	10.4%	11.3%	17.7%
Property Unit Trusts	-5.0%	3.9%	3.4%	17.1%
Money-market Fund	0.9%	6.7%	8.9%	9.2%
Rand / USD rate	-3.6%	6.3%	-1.9%	1.6%
Rand / EURO rate	-9.8%	2.6%	5.1%	3.1%
GLOBAL INDICATORS				
FTSE (£)	0.5%	3.3%	-0.2%	0.5%
S&P 500 ($)	5.4%	13.4%	0.3%	1.3%
DJ Euro 50 (€)	4.6%	-0.7%	-3.8%	-3.6%
Hang Seng	1.8%	10.8%	8.3%	6.3%
Nikkei (Yen)	-5.1%	-12.0%	-10.6%	-2.8%

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

I recently attended a presentation by an asset manager who has written an algorithm that will determine whether you should buy or sell a stock, index, commodity or currency. His company applies this algorithm fairly convincingly and it thus makes investment decisions very easy as you just have to look at the algorithm (and naturally unbelievable returns are shown to encourage you to invest).

Regardless of the merits of the algorithm or the appropriateness of the company, the fact that this asset manager has complete confidence in his predictive algorithm makes decision making in the investment process clear. Advisers and analysts spend an inordinate amount of time and effort understanding which set of indicators they feel confidence in and why. I think there must be more literature on indicators than on stock analysis. I continually read articles pointing out irregularities in many indicators quoted daily by the experts.

With so many convincing but divergent opinions on the market, we believe the only reliable investment strategy is risk management. AJM adopts the principle that if the risk of achieving above average returns is higher than what is tolerable, then it would be better to manage downside protection during these periods when risk is higher.

We at AJM do, however, have confidence in the indicators below and thus turn to these for the asset allocation calls we make for our clients. We acknowledge that markets tend to overshoot on the upside as well as the downside, which suggests that risk management is a more conservative strategy. We believe that waiting for more traditional indictors to spark buy or sell signals increases the risk of making errors and thus will ultimately lead to lower returns.

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

1. Real Hourly Earnings – US hourly earnings continue their downward trend which started in June 2010 and dropped more rapidly in Nov 2010. Stimulus packages could potentially change this pattern, but it is a real cause for concern and warrants a much more cautious view now.
2. Personal Consumption Expenditure (PCE) – After a strong upward trend in 2010, this has also followed the hourly earnings tend quite strongly. These two indicators are moving contrary to the intention of quantitative easing in the US and may be exacerbated if QE3 fails to materialise.
3. Federal Reserve rate – Possibly still too early to call it, but the relative rate does seem to be dropping. In mitigation, the margins are very small so this is a less convincing indicator at present.
4. Price vs earnings – Prices remain above the long-term average. The effect of the stimulus packages on consumers will determine the sustainability of earnings growth forecasts. If these drop significantly, P:E ratios will climb, making prices unsustainable for any length.
5. Currency valuations – The USD is much weaker against other first world currencies. It will be a brave investor who capitalises on this as it appears the only reasonable strategy for the US to get out of its debt quagmire is to weaken the currency. It may be a good speculative play in the short-term and very long-term.
6. The price of debt – The differential between interest rates and bond rates is historically low but is still widening. 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 – Investors are desperate to see markets climb again, and the lacklustre growth we have experienced in global markets for the past 10 years is fuelling the speculation that we are starting a long road to recovery. First world economy consumers do not appear to be participating in this optimism and most ordinary citizens in the US are trying to clear the mountain of debt they hold. SA consumers appear to be less onerously effected but the trend is similar. In the US, the Fed appears to concur as it would start raising rates if the consumer was back on track. Inflation and high oil prices are not going to be good news for consumers.

Investment discussion

As always, there are two sides to an investment decision. One is always reminded that as much research you do to sell a stock is done by the other party to buy the stock. One of you will make the wrong choice. Prices will remain fairly stable when there are similar numbers of buyers and sellers. More buyers will drive the price up, while too many sellers will drop the price.

On the positive side of the global world:

- Companies have cut expenses and have fairly strong balance sheets, suggesting that they are poised to expand and develop and thus increase their share prices.
- Many investors still hold cash and thus are waiting for buying opportunities for the future. This will result in a flood of buying during any downturn, which could ensure that the downturn is not material.
- Global market momentum is continually on the up and stock market volatility is relatively low, indicating stability.
- Cash is offering almost zero returns (except in emerging markets), which stimulates investors to take more risk.
- Dividend yield growth is generally coming in better than expected
- Emerging market growth is monumental and, although reflected in the price, is unlikely to slow down any time soon.

On the negative side of the global world*:*

- Inflation rates globally are starting to rise quite dramatically and the cost of living for consumers is much higher than most inflation data suggests. For example, electricity and petrol in SA are excluded from CPI as the general population uses subsidised electricity and public transport.
- Quantitative easing (round 2) in the US is almost over and it is unlikely QE3 will be affected. This will result in the US Fed not buying its own bonds, but leaving it up to the market to subscribe. I am not sure who else will be buying US bonds except China (to protect its existing holdings).
- US debt is at the upper limit of its statutory target. Tax cuts previously instituted can only be reversed to alleviate this debt.
- Interest rates will be on the rise soon, with Eurozone and China already kick-starting the phase.
- Oil price hikes do not assist consumers in building disposable income to spend.
- There seem to be a multitude of factors that add pressure on consumers, not relieve them
- Stock prices are on the high side.
- Bank lending is still very tight and banks are not much better off than they were in 2008

Ultimately, the balance of risk appears to be on the high side for equity (high risk but I don't really see the high reward in the short-term). Although the markets have bounced back, the factors causing the global meltdown in 2008 have not materially resolved themselves.

The US is weighed down by debt and split political controls make bold policy decisions unlikely. While corporate earnings are ticking up on the back of heavy spending cuts in 2009, consumers are still struggling to make ends meet. It is at the consumer level that concerns over the US recovery are targeted. The weaker USD will assist in debt repayment as well as export competitiveness. Companies that are providing products and services to emerging markets are the likely winners.

The old comparison between the US today and Japan in the late 80s and 90s is coming back to haunt us again. The trend is extremely similar except that the US reacted much more quickly to the crisis. It will be interesting to see if the end of QE2 will have the same effect as in Japan, which will not be a pretty picture.

Sovereign debt default and bank liabilities remain the focus for European economies, a stumbling block for really positive sentiment towards this sector. The added hurdle of a very strong Euro in relation to the USD does not make global trade for the Eurozone any easier.

While the flavour of the moment is emerging markets, their relatively high price to earnings yields suggests that this must be a more risky strategy. Rising interest rates will slow growth and it appears that China is at the forefront of this process. It is likely that interest rates and inflation will be aggressively advanced and thus direct investment into emerging markets including South Africa is likely to be a speculative strategy until valuations return to more attractive levels.

The global trend of rising inflation and monetary tightening to manage debt is an overriding dampener to the start of the next global bull market. The trend is in fact consistent with a period of equity consolidation, with first world economies being in a secular bear market for about 12 years now. That does not mean that there are not wonderful opportunities available, but we have to be more selective, and thus it is only the more diversified strategies that will give investors any comfort.

Investment strategy

AJM is particularly nervous about world markets including SA at present, as there are too many issues that could severely dent investor confidence and thus market prices. While we do hear the voices of most analysts who are calling a strong recovery in equity prices off the strong cut-backs in 2009 and 2010 and better earnings, we feel that the factors weighing on consumers and manufacturing costs will damage growth prospects to well below the current expectations. Any action taken by investors will result in a sharp sell-off, which may result in a much slower recovery off the current values.

We are thus urging clients to be cautious with their asset allocation models and would rather remain in cash or very stable funds that have significant downside protection.

The current rand valuation against other trading partners is attractive and thus it is a good time to take advantage of the more attractive opportunities in global markets. While most investors have been burnt badly by the exposure to offshore equities over the last 10 years thanks to high volatility and a strong rand, we do believe that this is an important diversification strategy to ensure more robust portfolios in ever changing markets.

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

Kind regards

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