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15th July 2011

Hi all

A global and local economic update

The last quarter has been fairly volatile but overall rather flat in both local and global markets. One year returns reflecting the strong growth we experienced in the latter part of 2010 are a bit misleading. The lack of direction in global markets suggests investors are extremely uncertain about the global economic recovery.

The rand strength continues, largely determined by foreign inflows into the SA bond market where you can get 8.5% as opposed to 2.5% in USD, as well as higher commodity prices. The Reserve Bank has adopted a fairly strict strategy which gives global investors confidence in SA bonds. The Rand will remain highly volatile as factors driving it are largely beyond our control.

Investment analysis on lump sums to 30 June 2011

Source – Spotlight Investor	3 months	1 year	5 yrs	10 yrs
JSE INDICATORS				
FTSE/JSE Top 40 index	-2.4%	22.6%	8.3%	14.4%
Small cap index	0.9%	15.1%	9.9%	22.6%
Mid cap index	2.9%	14.8%	13.3%	21.3%
Financial sector	-1.2%	12.4%	3.3%	8.9%
Industrial sector	2.2%	31.5%	15.6%	15.8%
Resources sector	-5.5%	18.2%	5.4%	15.9%
Property Unit Trusts	4.8%	8.5%	8.4%	16.0%
Money-market Fund	1.3%	6.0%	8.8%	9.0%
Rand / USD rate	0.1%	11.5%	1.6%	1.7%
Rand / EURO rate	-1.8%	-4.9%	-1.3%	-3.7%
GLOBAL INDICATORS				
FTSE (£)	-3.0%	17.8%	0.1%	1.2%
S&P 500 (\$)	-1.8%	26.2%	0.4%	0.5%
DJ Euro 50 (€)	-4.3%	18.8%	-3.4%	-4.3%
Hang Seng	-5.4%	11.3%	6.6%	5.6%
Nikkei (Yen)	-0.6%	4.6%	-8.7%	-2.6%

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

Not much has changed in the markets or in terms of economic news since our last report. Debt-ridden countries are in even worse shape and there are further additions to the list. The manner in which this debt is to be repaid is unclear. Inflation is still sharply on the rise in most economies. Companies are in fairly good shape financially with strong balance sheets, but earnings seem to be declining. Sales do not appear to be as buoyant as expected and so consumers in most economies are still vulnerable.

The multitude of indicators available makes the information extremely noisy. While it is enormously interesting to study all the recent data and review its impact on the market, at AJM we believe it best to continue relying on the indicators below to determine an investment strategy for the future.

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 accelerated in November 2010. Stimulus packages are out of the system (for the moment), so this particular indicator is extremely negative for markets in the near future.
2. Personal Consumption Expenditure (PCE) – After a strong upward trend in 2010, this has also followed the hourly earnings trend 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 – The relative rate is showing a more definitive drop. This adds weight to the other indicators, suggesting poor times ahead for consumers.
4. Price vs earnings – Prices remain well above the long-term average in most economies. Earnings growth appears to be slowing (and many market prices are thus dropping steadily). There are a few exceptions such as Russia and France, but expensive appears to be the common trend.
5. Currency valuations – The USD is still much weaker than other first world currencies. Ironically, when investors panic they invest in the USD. This demand causes the USD to strengthen. Existing debt crises in the US does not encourage high holdings in USD.
6. The price of debt – European bonds are rising rapidly, reflecting the risk of investment in these countries. Emerging markets are still offering attractive yields.
7. Investor psychology – Investors believe that the global economy will recover and are patiently waiting for this to happen. The long-held belief that equity is the only place for real growth suggests that you hang in for the long-run. Consumers all over the world are feeling the pinch in the home environment, not helped by a multitude of factors including high oil and food prices. The markets are certainly not pricing in a failure, although investors are nervous and quite rightly so.

Investment discussion

The recovery has stalled. The problem is not the ability to produce goods and make profits. Large corporates continue to sit on a cash hoard and mid- to large sized companies have capacity to borrow funds for development, at low rates if necessary.

The problem is on the demand side. American consumers, constituting 70 per cent of the total US economy, cannot and will not buy enough to get it moving. They justifiably worry that they will not be able to pay their bills or retire. Banks, with equal justification, are reluctant to lend to individuals. But as long as consumers hold back, companies remain reluctant to hire new workers or raise wages, feeding the vicious cycle.

The normal demand supply issues above (which AJM groups as “state of the consumer” and weights strongly), may be exacerbated by political changes in the US over the last three years. Higher taxes, government-led medical schemes and regulated financial sectors place constraints on a free-market system. There is strong evidence showing slower growth in the more welfare-state

type economies like Europe, whereas free-market principles encourage entrepreneurship and growth.

It is generally accepted practice to look at what the wealthy countries do and follow suit with something similar. Who are the wealthy countries – China! China is unique in that its economy has been driven by government infrastructural expenditure. But then it did have (and still has) enormous surpluses to fund this. The free market principle for China has largely been around labour. However as the recovery stalls, China has increased the level of securities banks have to hold, increased interest rates as inflation starts to rise, secured the supply side of its growth (resources – buying production from producing economies), and secured consumption of its produce by investing heavily in India and Africa. Both these regions have developing populations in vast numbers.

It was only a year or two ago that we were talking about China decoupling from the US. Well it has happened very much behind the scenes. Yes, China still needs the US (holding \$1 trillion in US government bonds, not to mention the ability to export products to US consumers), but to a much lesser extent. At the same time, the US needs China more than ever. The QE2 programme was not about putting money in the hands of consumers, but buying up government bonds. If US politicians cannot find a solution before August, China is their lender of last resort.

Once again, let us look at the facts:

- Growth has slowed in the US economy. Every time the US GDP has dropped to below 2%, it has led to a recession – Watch this space.
- QE2 bail-outs in the US are stopping mid-July. Thus far, they have not solved the chronic unemployment problem or the weak housing sector.
- QE2 basically converted long-term US bonds into short-term government debt – buying time to settle the debts. It's similar to Greece, but on a mammoth scale.
- The next tool for the US government is spending cuts and higher taxes
Spending cuts = cuts in jobs and services.
- Greek debt is not a huge problem. Debt in Greece, Portugal, Spain, Ireland and Italy is a monstrous problem.
- Greek default will impact European banks, who will recover after some pain. If other countries follow suit, this pain could take longer to heal.
- On the US labour numbers:
 - Private sector development stimulates long-term growth – and private sector small businesses are not in great shape.
 - Unemployed people are remaining unemployed for an all-time high of 40 weeks on average.
 - 44% of unemployed folk have been so for more than 6 months.
- Global inflation is on the way up, and quickly.
- Taxes in first world economies are on the way up.
- Government spending in most first world economies is slowing.
- Even though the oil price has fallen about 10%, consider that the oil price is still up more than 40% since a year ago. Inflationary pressure will not decrease anytime soon.
- China is pushing up interest rates to reduce inflation, which will slow down growth moderately.
- The SA bond markets are attracting foreign investors seeking better returns than first world bond rates. The Rand remains strong on these inflows.
- South Africa lags in export growth relative to the other emerging markets. This can only improve with labour competitiveness (ha ha) and a weaker rand. Take your pick for the likely scenario.
- SA domestic savings are low. Relying on volatile foreign portfolio inflows to fund the current account over the medium term is not a sustainable solution.
- SA debt-to-income ratio is very high.
- SA exports are not competitive due to Rand strength and labour costs.

Investment strategy

History does repeat itself, time and time again. Economies that have stimulated growth by furthering debt have a poor track record of long-term sustainable growth. This does not bode well for the US and Europe.

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.

Most analysts are calling a continued recovery in equity prices off the strong cut-backs in 2009 and 2010 as well as anticipated better earnings. They also believe that the plummeting housing crisis will start turning, which will stimulate employment and in turn boost consumers.

AJM feels there is sufficient evidence that consumers in most first world economies are struggling, and most economic changes occurring at present are not favourable to alleviate their plight. Manufacturing costs and many other factors weighing on consumers will limit growth prospects to well below the current expectations. In addition, many smaller businesses are feeling the pinch, and it is these companies collectively that drive economic prosperity.

The big question is how these factors affect equity markets. It is quite possible that markets will rise on the back of sentiment that stopping QE2 suggests the economy cannot be doing too badly and the belief that both the US Fed and the Eurozone will continue with damage control to resolve the sovereign debt burdens (may even include QE3).

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 investment strategies. While most investors have been burnt badly by exposure to offshore equities over the last 10 years thanks to high volatility a strong Rand and poor equity returns in first world economies, we do believe that this is still an important diversification strategy to ensure more robust portfolios in ever changing markets. However, the Rand could remain strong for a while as the interest rate differential in SA offers global investors an attractive return. Watch this space as interest rates start climbing.

Emerging markets are definitely the economies that will grow strongly over the next few years. The problem is that this sentiment is generally accepted and is already reflected in the price. (For example, although Camps Bay is the hottest property in the Cape, property prices vs rental income are exorbitant). By investing in this environment you are backing growth stocks, a strategy that has worked only for selected periods, the last being the build-up to the IT bubble. You need to get in and out at the right time and this therefore tends to be a more high-risk strategy.

We at AJM thus urge our clients to be cautious with their asset allocation models and recommend remaining in cash or very stable funds that have significant downside protection. We do feel that there will be better opportunities to buy stocks in the near future. Multi-manager hedge funds are still an extremely good diversification strategy to provide more consistent returns over difficult times.

I would love to chat to you about your views if you feel your portfolio is not aligned to this thinking or if you would like to discuss this document further

Kind regards

ALASTAIR MACKIE