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INVESTMENT ENVIRONMENT

After an uncertain start, the outcome for 2010 was a good one for investors, particularly in SA. Almost everywhere, but particularly in the developed world, economic growth was better than expected, risks were more contained, and markets responded favourably. Concerns over sovereign risk and growth remain, but a more normal recovery lies ahead and extreme outcomes are increasingly unlikely.

5 January 2011

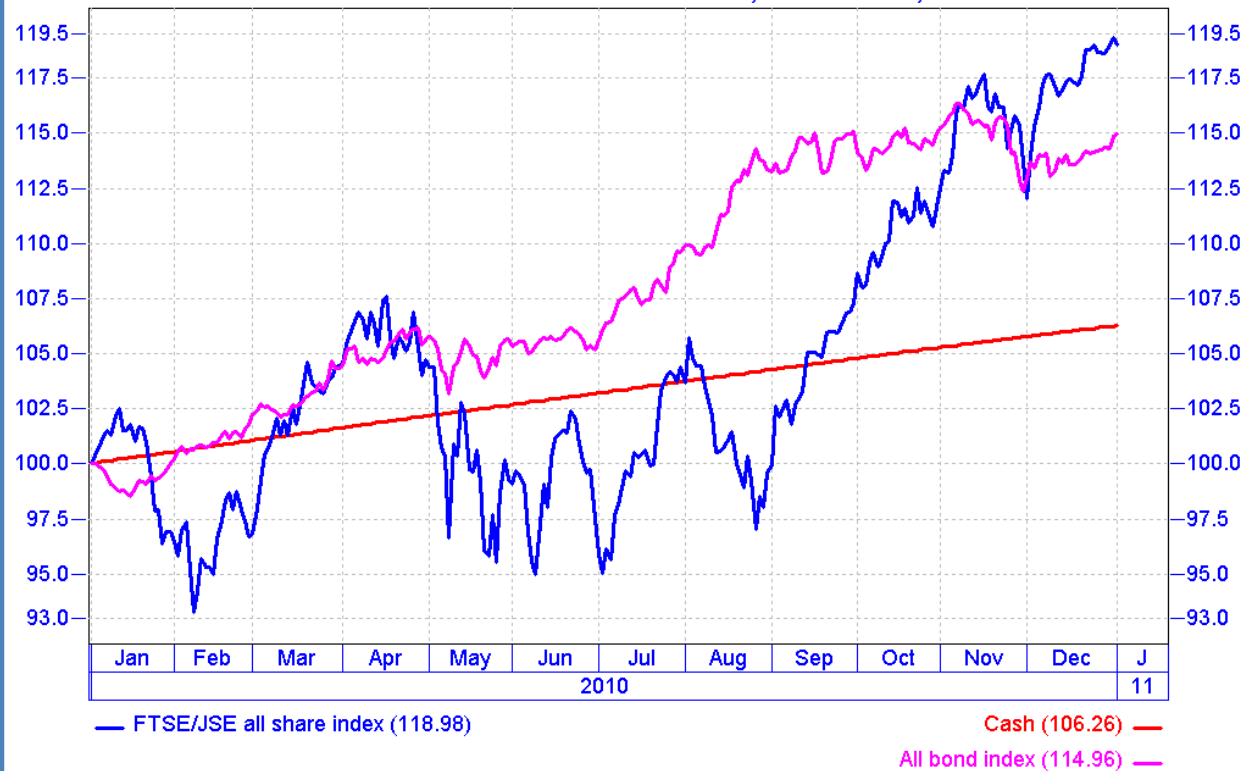
Market performance %

December 2010

Rand returns	Dec	Qtr	12m
JSE all share index	6.2	9.5	19.0
- Resources	7.7	16.5	12.3
- Financials	4.7	-0.1	16.6
- Industrials	5.4	7.8	27.4
All Bond index	1.7	0.7	15.0
S&P 500	-0.6	4.8	0.9
FTSE350	0.9	2.6	0.2
MSCI emerging	0.0	2.1	6.6
<i>Rand vs:</i>			
US dollar	7.2	5.1	11.8
Euro	4.0	7.0	19.6
Sterling	6.9	5.8	15.9

Offshore returns	Dec	Qtr	12m
S&P 500 (\$)	6.5	10.2	12.8
FTSE350 (£)	8.1	7.9	12.0
Topix (¥)	4.4	8.4	-1.0
MSCI emerging (\$)	7.1	7.4	19.2
MSCI world (\$)	7.4	9.1	12.3
Salomon world bond	-1.1	-3.2	3.0
<i>Currency vs. US dollar</i>			
Euro	3.0	-1.7	-6.6
Yen	3.2	3.0	14.7
Sterling	0.3	-0.6	-3.5

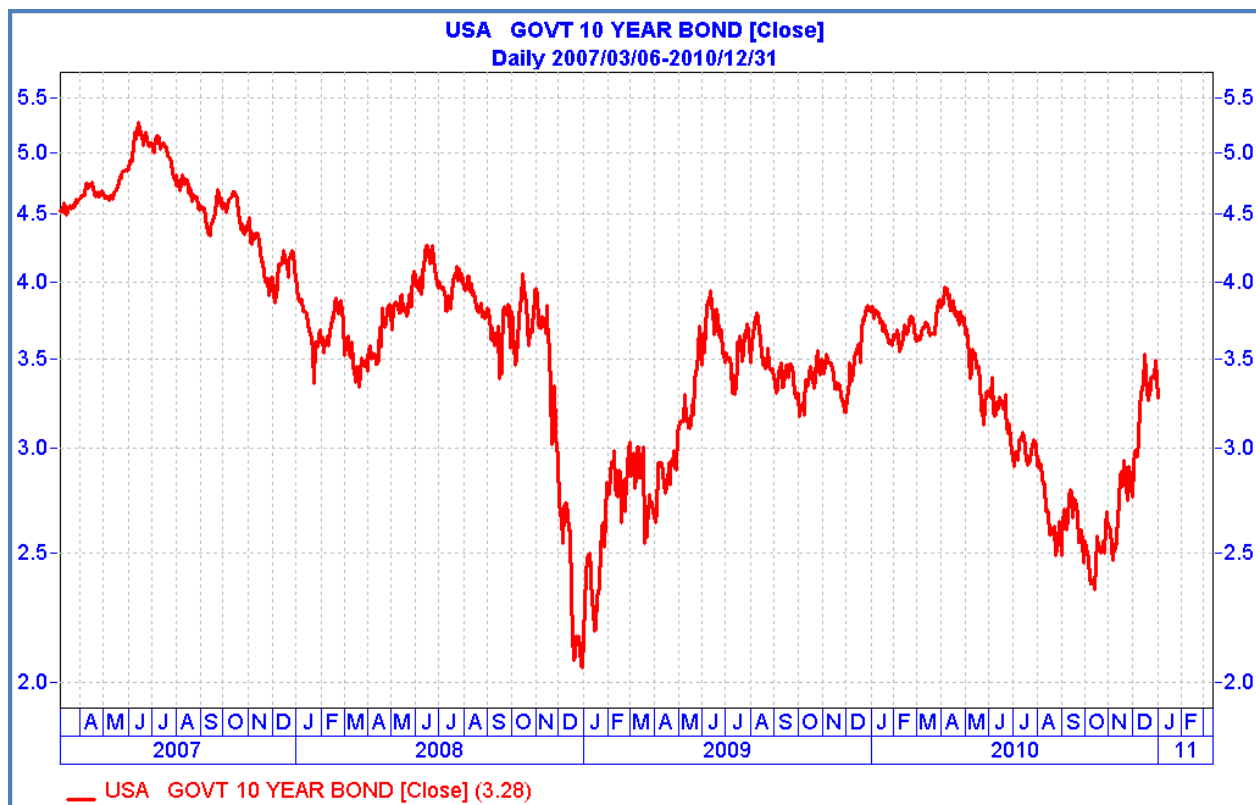
Asset class total returns: JSE all share index, All bond index, cash



As the chart shows, after an uncertain and volatile start to the year for equity investors, the second half was all about equity and by the end of December the JSE had achieved a return of 19%. The first half volatility was caused very much by enormous uncertainties about sovereign stability in Europe: Greece and then Ireland accepted bailouts from the EU. Although other sovereign problems remain, the support necessary to avoid one of these countries leaving the Euro has been provided, if only on a temporary basis. More policy changes are certainly needed, but for now the environment is more stable.

In the second part of the year, equities rose strongly not only because some risks had diminished, but also because it became clear that growth was better than most people had expected, both in terms of quantum and sustainability. Particularly in developed markets, such favourable outcomes were not priced in, and as a result equity markets responded well as risks dissipated.

Perhaps the most interesting price action of the second part of the year was in bond markets. Bond yields in the US – the key reference point for yields globally – rose very sharply from low points that had been struck as investors continued to buy safe haven assets as the consequences of the financial crisis were being felt, including potential sovereign defaults in Europe. Bond yields rose even though the Federal Reserve had made very clear its intention to institute a second round of “quantitative easing”, a means of expanding the money supply by buying government bonds. So even as the Fed started to buy bonds, prices fell. The low yields of October 2010 (see chart below) matched only those of December 2008, struck following the collapse of Lehman Brothers and the worst moments of the financial crisis, when it appeared that the financial system in the developed world might fail entirely.



The risks that pushed bond yields to lows again in 2010 were a bit different, but were consistent with what many commentators were describing as the “new normal”: a state of near-permanent low growth, low inflation, low interest rates and perhaps high unemployment.

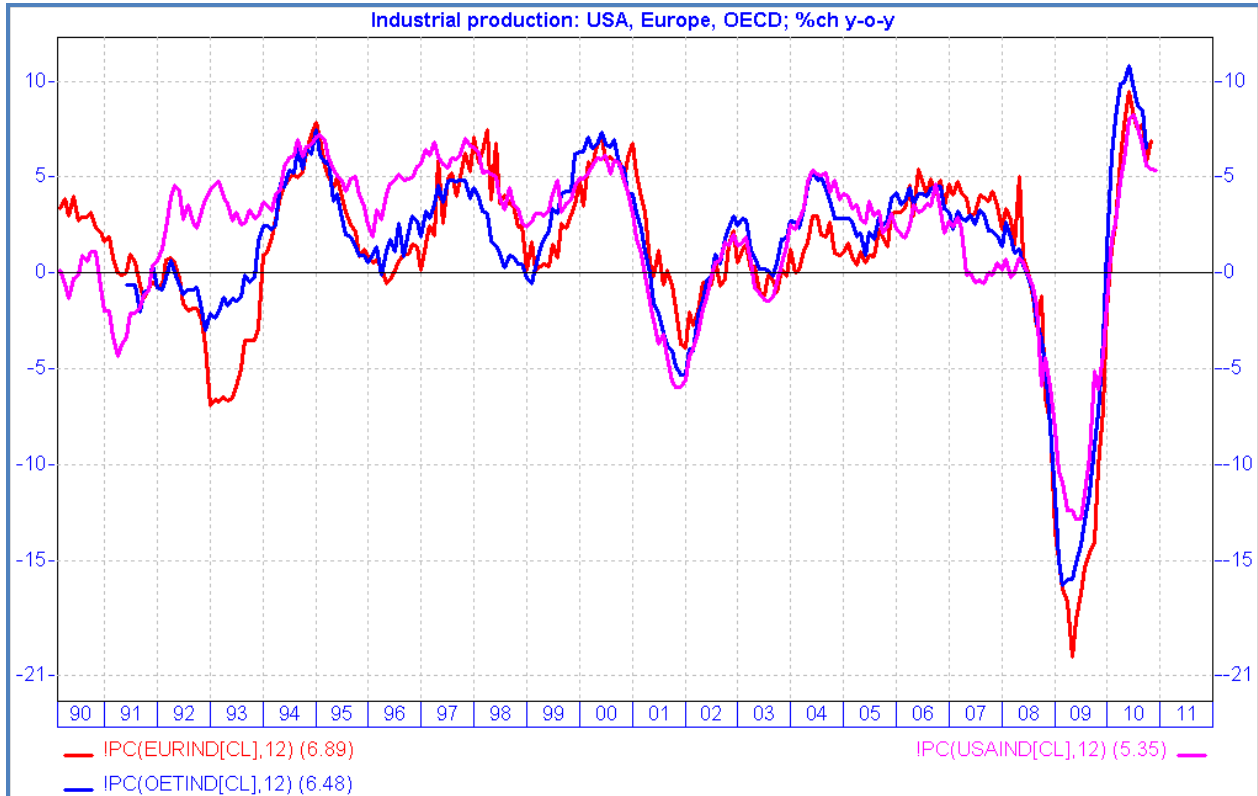
But this appears to have been unsustainable in the face of the combination of strong growth, receding systemic risk, and continued stimulus from fiscal and monetary authorities.

The ‘new normal’: dead, or just resting?

It all seemed so logical. The worst financial crisis of the post-war period, generated by a serious housing bubble (mainly in the US) and the leverage that went with it, left many banking systems fragile at best and in some cases at serious risk of collapse. Lending ceased, there were several runs on banks, and governments had to step in to prevent systemic failure. Failure occurs in financial systems when the payments system no longer works – i.e. when simple transactions cannot be completed because one or more of the banking system counterparties cannot honour a payment. But in effect, it is only necessary for some banks to distrust other banks for the outcome to be pretty similar to outright failure, and that is what happened. Under circumstances where the world was already slowing, a recession and a sharp rise in unemployment were guaranteed, and an inventory shock of massive proportions wasn't far behind. The result was that governments and households had more debt than at any time ever before, asset prices fell sharply, exacerbating the debt problem, the threat of deflation was never far away, and global trade collapsed.

Even though emerging markets escaped the financial crisis as such, they did not escape the effects. Dependent as they mostly were on exports to the developed world, many experienced severe recession and a contraction in trade. Domestic demand in most emerging markets could never be enough, whatever the stimulus, to make up the difference. A developed world problem, but with global consequences.

So it is easy to see how the “new normal” came to be defined. The first part of the recovery would be quite sharp as an inventory recovery got under way, but it would not have any sustainability because final demand had no way of recovering. Under circumstances where the credit cycle could not help because banks were unwilling to lend and borrowers were even less willing to borrow, it would be unlikely that any recovery would be very robust. It would be years before households and governments got rid of the debt they had accumulated, and therefore years before a return to any sort of trend growth. And it would be years before the developing world, however strongly it managed to grow domestically while its major export markets were moribund, managed to fill the growth gap.



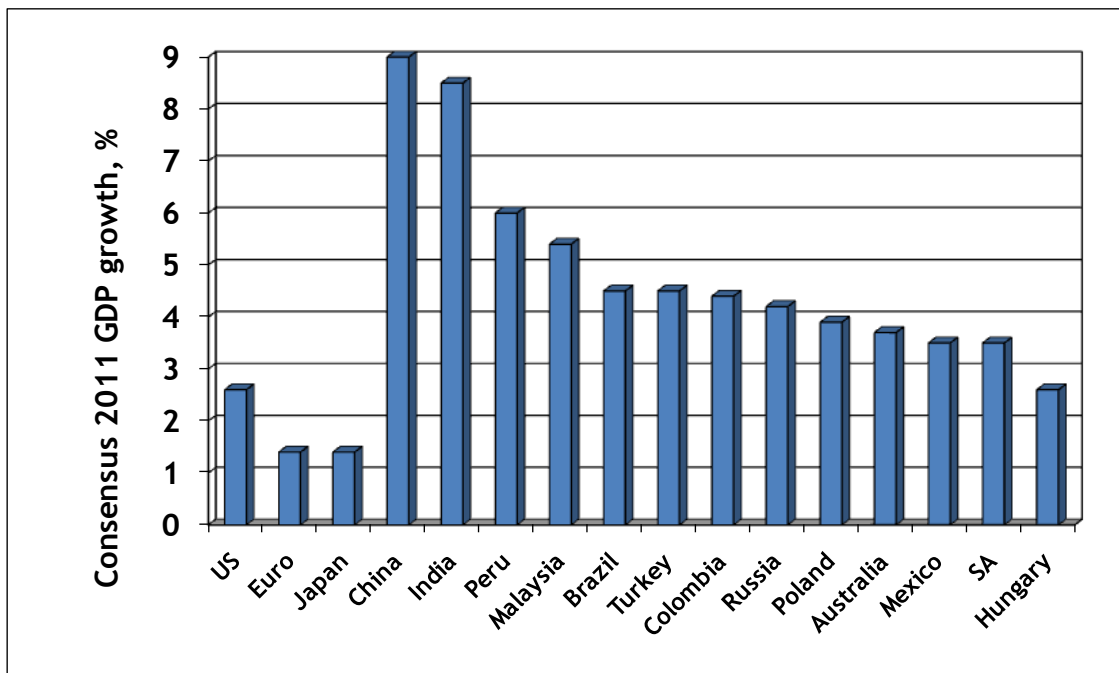
That is particularly true in the US, where the most recent manufacturing statistics (not reflected in the production numbers in the chart above) have in fact strengthened since mid-2010. Add to that the fact that consumers have been more inclined to spend money, and revenues in services business have been quite strong, then aside from housing markets, economies look much more robust than anybody predicted.

As a result, commodity prices were very strong in the latter part of 2010, even while some of the restocking demand that had been evident from China at lower prices was no longer a factor.

The shape of things to come

This all means that the outlook has changed substantially for the better. Forecasts for US growth in 2011 are rising fast, and in some cases, economists are expecting strong rates of growth to be sustained throughout 2011 – perhaps at 4% real. That means not only that “sub trend growth” is not immediately on the horizon, but that there is a reasonable prospect of a cyclical upswing strong enough to reduce the unemployment rate and move the US back to a state that looks much more like a “normal” (as in “Old Normal”!) cycle.

If that happens, it has very beneficial consequences for the rest of the world. Little as it may be liked by some, the fact of the matter is that the US remains a gigantic engine for world growth. Fast as China is growing, the US is still much larger, at around a quarter of global GDP, and it is capable of pulling the world along with it – more particularly the developed world. A more robust US would be very good for Europe as well as Asia. That’s why markets have been robust as the consensus view has started to change. Not all of this is yet reflected in consensus numbers for 2011; while forecasts for 2011 are mostly for lower growth than in 2010, that doesn’t mean growth won’t be quite strong, as the chart shows.



Of course there are problems. First of all, the US remains highly indebted and the government has no apparent plan that credibly reduces its fiscal deficit on the basis of spending cuts – so the plan, as so often in the past with the US, is much more dependent on growing out of the problem than it is for, say, the UK, where proposed austerity programmes of alarming proportions have caused shock waves all along Whitehall. But a stronger US recovery now doesn't necessarily mean the "new normal" is dead: there will still be a bill to pay later, and unless robust growth remains in place for some time, it may just be deferring the issue. Second, Europe's specific problems require much more attention than they have had up to now. The political difficulties are substantial but need to be overcome if the Euro is to retain credibility. Eventually we think they will be because the cost of the alternative would be very high, but for now the state of stumbling from one temporary solution to the next will be the order of the day.

Valuation and investment consequences

If the world turns out more like the old normal, it means that the consequences for investors will be quite significant. If we assume the US returns to trend growth, markets will pay a higher premium to benefit from that growth. Europe will benefit, but essentially will continue to fumble along. Emerging markets will continue to fly, but are more likely to run into early problems with inflation and overheating. This means that the relative premium for emerging market growth relative to developed market growth may decline. Domestic demand has already been a theme in emerging markets, and it will continue to be so. Higher domestic demand should help to correct trade imbalances, but the imbalances are still very large. Higher domestic inflation will probably not be sufficient to prevent exchange rates rising, which should additionally help with the imbalances.

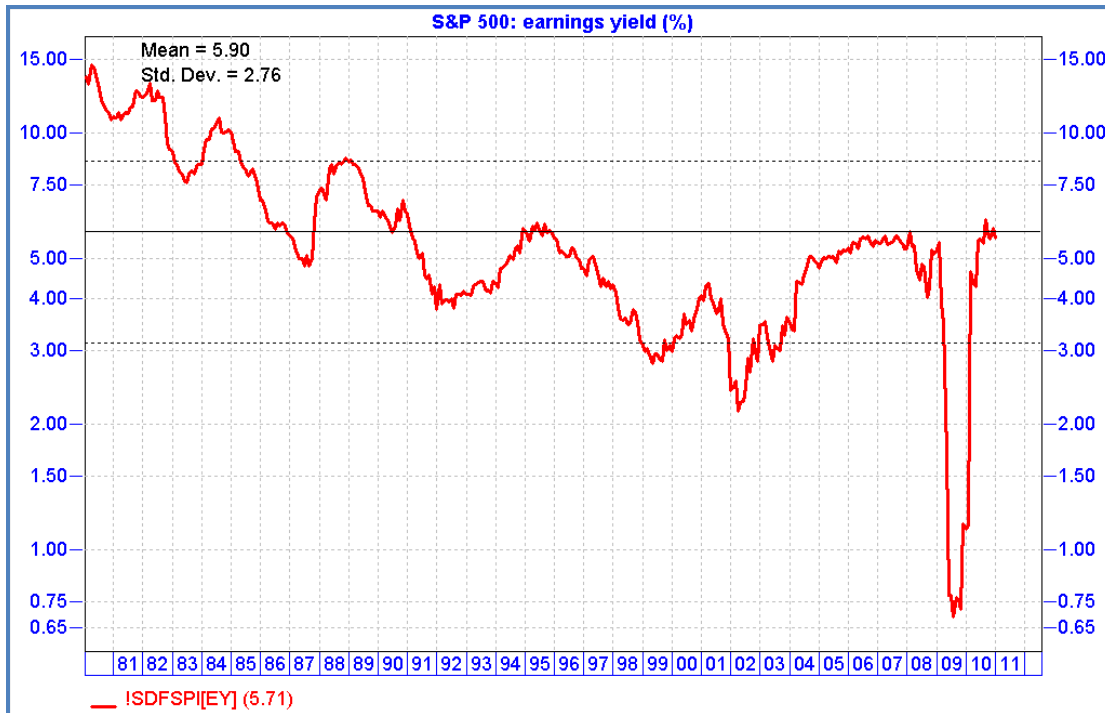
As a result, and particularly given the relative cheapness of developed world equity, it is hard to conclude otherwise that 2011 may produce a switch in enthusiasm for emerging markets, even if they continue to grow faster than the developed world.

A second conclusion is that if this more benign scenario transpires, exchange rates may prove to behave differently than expected, particularly the dollar. For now, the consensus is that further dollar weakness is necessary to account for the relatively looser monetary policy, but if the US economy starts to create jobs that looser policy will change quite quickly. We can't be sure that that will necessarily change the logic that has kept developed world currencies relatively weak against the rest, but it certainly would change a key underlying driver. For investors, the trouble is that currencies are notoriously unpredictable; our conclusion is that 2011 could turn out to be different to the past two years, as there are plausible reasons why the consensus view could turn out wrong, and one of the risks we think investors need to be aware of in 2011 is that currencies could be a key source of volatility and unexpected outcomes.

Valuation considerations reinforce that view. Although we don't think emerging markets by and large are overpriced, it is certainly true that better outcomes are priced in than are priced in for developed markets.

Higher economic growth may or may not be a driver of equity returns. In fact, there is no logic or historical evidence that it should be – as always, it depends on the starting price you pay and on the ability of companies to capture the growth and deliver it to shareholders. Companies can always make themselves larger, but in a fast growing economy, it is easier for companies to do this at the expense of shareholders – and so the growth can be easily diluted.

As the chart of the earnings yield on the S&P 500 index shows, US equity is now as cheap as it has been at any time in the past twenty years. Higher yields, which you can see in the early part of the chart which goes back to 1980, were the result either of much higher inflation or much higher interest rates than currently prevail.

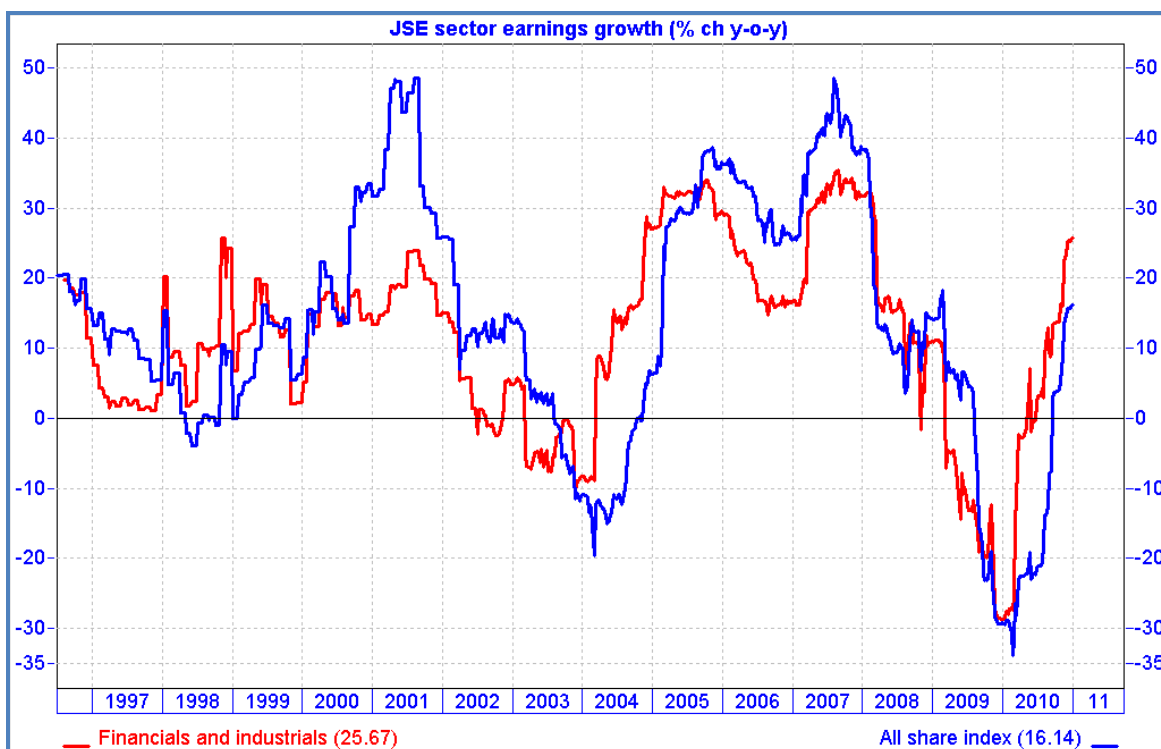


Given that the investment traffic has for the past two years been pretty much one way into emerging markets, one of the likelihoods for 2011, it seems to us, will be that valuation considerations combined with a changing relative growth pattern will start to reverse the flow somewhat. Investors may begin to remember that while emerging markets continue to have better macroeconomic factors than developed markets, both from a fiscal and a monetary point of view, the micro risk factors (governance, accounting, and regulatory issues) are typically higher as well.

South Africa

South Africa, as usual, sits in the middle of these global forces. It is looking forward into a period where growth should be reasonable and improving prospects in the developed world should add to that. Domestic growth is likely to remain quite strong while the interaction of low inflation and high wage settlements remains so favourable: notwithstanding high increases in administered prices, SA's current inflation rate is 3.6%, well inside the target range, and is likely to remain so even if it does not remain quite so low.

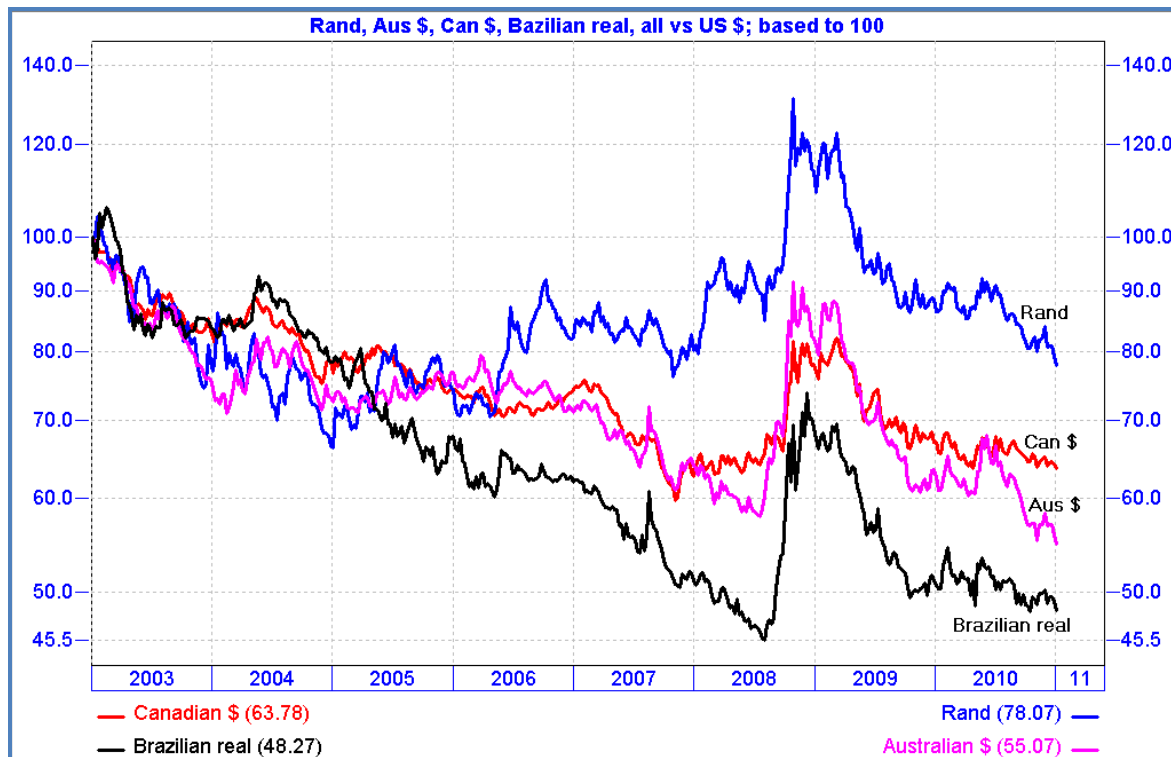
Companies in SA, as globally, are financially very robust. Balance sheets are strong and companies have emerged from the recession with high margins and have managed to cut costs very quickly. The result has been a return to very strong aggregate earnings growth, as the chart shows.



There is still more to come, as commodity producers have yet to report the benefits of recently high commodity prices. Against that, the current reporting phase takes place against last year's very low base, and the "benefit" of that will soon start to fade. This means that at some point in 2011 the peak in earnings momentum will be seen, though if the more benign scenarios for the world turn out to be correct, there is still room for earnings surprise.

If global interest rates remain quite low, as we expect, the pressure for SA interest rates to rise will not start until domestic demand begins to push inflation higher. The rand is a very significant factor in inflation, and without a material change inflation will remain contained.

The rand continues to be driven more by global factors than domestic. The rand's strength against developed market currencies over the past year (it rose almost 12% against the US dollar in 2010) was more to do with the state of the US and European economies and policy settings than with domestic conditions and productivity. As the chart below shows, the rand very largely tracked a similar path to the Australian dollar throughout 2010, and strength was the default mode for most commodity producing currencies.



The rand even managed to continue to strengthen after the announcement of the medium-term budget policy statement in October, which clearly outlined the government's intention to enable a "more competitive" exchange rate, and which included changes to capital controls which relaxed restrictions on residents and domestic retirement funds, allowing them to hold larger amounts in foreign currencies. Even at the time, it wasn't clear that the policy package presented in the statement taken as a whole was likely to weaken the rand.

The rand appears overvalued on most measures, trade weighted or otherwise, but at the same time it appears the economy is unable to capitalise on its weakness relative to some peer group currencies, as shown in the chart above. The chart bases a range of commodity currencies (all relative to the US dollar) to the same point in 2003, and shows that although the rand has moved similarly to the other currencies since the financial crisis began, it remains relatively weaker over the period. In particular, the chart shows that the success of economies is much less dependent on the absolute value of the exchange rate than is commonly believed, otherwise Brazil would be nowhere near as successful as it is. Success is at least as much, and probably more, about productivity as it is about the exchange rate. If the world's growth balance changes as we expect, then some rand weakness is likely, but it may not be a very disruptive change. Consequently, we think investors should be diversified, but should not build portfolios dependent on the rand weakening in order to capture return.

Conclusion

If the New Normal is not dead, at the very least "sub trend growth" is further off than we thought, and when it arrives, it will likely look like a normal cyclical slowdown. In the meantime, it appears that the world growth cycle will be quite robust. The New Normal looks very like the Old Normal.

The interesting question is whether the risks will turn out to be the same old problems re-emerging (for example, sovereign risk in Europe, and unstable government finances almost everywhere in the developed world) or whether completely new risk events will take the stage. The old problems appear largely contained; they can induce volatility but probably not meltdown unless financial systems are threatened.

For now, 2011 is starting off on a relatively even keel, and we think that is likely to remain the case for a while. At some point, the problems that growth brings – limited capacity, inflation, rising interest rates - will emerge, but these are more likely issues for 2012. Valuations in SA are no longer compelling, and investors need now to be very careful of overpaying, and much more alive to valuation risk. Offshore markets offer reasonable valuations and the rand we think offers a reasonable entry point. As always, diversification and quality are key. We wish all our clients a very prosperous 2011!