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INVESTMENT OVERVIEW

1 February 2011

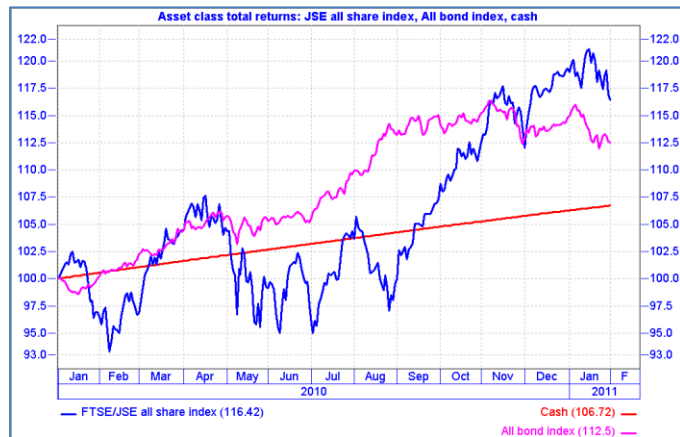
An interesting start to the year. Disruptive weather and widespread floods, political upheaval in North Africa, and a sudden change in the rand all overshadowed Davos, which was more interesting for the corporate deals struck than economic insight. Still, the focus for investors shouldn't have changed: this year will test the resolve of many central banks as inflation rises. Will that be a challenge for markets?

Market performance

%

January 2011

Rand returns				Offshore returns			
	Jan	Qtr	12m		Jan	Qtr	12m
JSE all share index	-2.2	3.4	20.6	MSCI US (\$)	2.4	9.4	22.5
- Resources	-0.5	6.8	19.4	MSCI UK (£)	-0.3	3.9	16.6
- Financials	-1.5	0.7	13.4	MSCI Japan (¥)	1.1	11.9	2.7
- Industrials	-4.1	1.5	25.6	MSCI emerging (\$)	-2.7	1.5	22.8
All Bond index	-2.1	-2.4	12.2	MSCI world (\$)	2.3	7.5	19.8
MSCI US	11.0	12.4	15.4	Salomon world bond	1.2	-2.4	3.8
MSCI UK	8.1	6.7	9.8				
MSCI emerging	5.5	4.3	15.7				
<i>Rand vs:</i>							
US dollar	-7.8	-2.7	6.2	Currency vs. US dollar			
Euro	-10.0	-1.1	7.3	Euro	2.4	-1.5	-1.1
Sterling	-10.1	-2.7	5.9	Yen	-1.2	-2.0	10.0
				Sterling	2.7	0.0	0.2



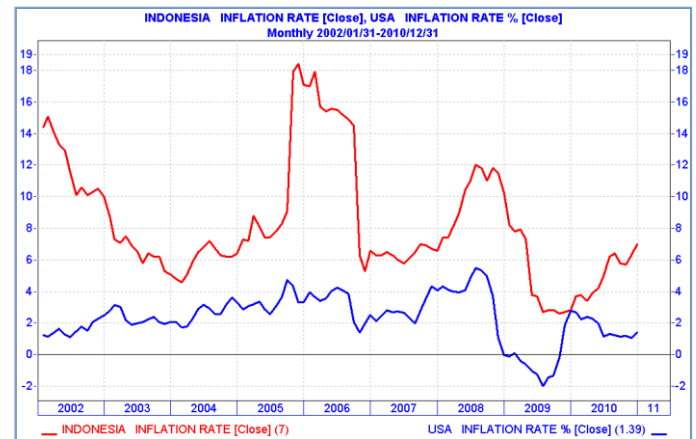
Some complicated and potentially disruptive news over the month, including widespread floods in the productive parts of Australia, affected commodity prices and thus markets. Least important was the world's most important economic talking shop in Davos, where not much seems to have happened, but which emphasised the very large amount of corporate activity on the go, which is pretty much a global phenomenon. Companies find it cheaper to buy existing businesses than to start new ones, a fact reflected in the huge amounts of merger and acquisition activity last year and supporting our view that listed equity in some regions is historically inexpensive.

Markets as a whole were somewhat mixed, but notably, emerging markets did worse than the rest in dollar terms, and were actually down for the month. This partly reflects the point we have been making – that there is better value in developed markets than emerging at present – but also a rising concern over the emergence of inflation. The reason markets are worried is not so much that inflation of itself is bad for markets, but that in the case of some emerging markets the potential for a disruptive policy response is quite high. The reason for this is that emerging markets are reluctant by and large to take action that might have the result of allowing their currencies to strengthen; but the policies that allow currencies to be weaker than their "natural" level are the same that stoke inflation. Inflation is now rising in many emerging markets, no doubt about that. Even though in many places inflation remains within targeted ranges, if inflation rates rise sharply and are not tempered early, the disruption later could be severe.

The chart below shows why the concern is increasing. It shows Indonesia's inflation rate against the headline US rate. In spite of the widening gap, the currency has strengthened over the past year. That's the result of the US pushing very hard to revive its domestic economy by extraordinary measures ("quantitative easing", higher fiscal stimulus) which have led to dollar weakness. Many Asian countries have implicit or explicit dollar pegs, which means in essence and the attempt to maintain a relatively weak currency over the past year has just come out in domestic inflation. It is an inevitable result. Now that the inflation gap has appeared, the consequence should be a weaker currency.

The fact that it hasn't yet means that the imbalance that is giving rise to the higher inflation has yet to be successfully contained. The possible outcomes are a disruptive change in domestic interest rates, or a disruptive weakening in the currency, or some combination of the two. That's why markets are increasingly concerned. For most Asian countries, the reference point is not just the dollar, but competitiveness relative to China, which is not always the easiest thing to measure.

For outside investors, the worry is that the imbalance leads to a disruptive change which resets asset prices or domestic incomes to account for the rising uncompetitiveness, which will usually be the result of domestic inflation. This concern is partly expressed in January's market behaviour. If Asian central banks are behind the inflation curve, as some appear to be, it would not be a surprise to see more of the same.



This doesn't change the long-run secular shift in economic power away from the developed world. The signs of that shift are everywhere, and investors need to be aware of it. But in the short run, cyclical effects can dominate, and 2011 is starting out pretty much like that.

These changes are going to affect SA as well; not perhaps because we have an inherent inflation problem, but because normal cyclical factors are going to reassert themselves globally, particularly in the developed world. As developed world returns improve, and the economic environment stabilises, more investors will be searching for reasonable returns, and will be less concerned with capital preservation. This means we expect that more funds will flow to developed markets than has been the case over the past year or two; this is no reason of itself to own equity in developed markets – chasing the money can lead to very expensive mistakes - but valuation appears to us to support the case, as we have pointed out before.

Conclusion

So, will it be a challenge for markets? Probably; but these are the challenges of a normal economic cycle. All this means that the price behaviour in January appears to us to support our expressed view that SA investors should be using their offshore allowances and increasing the offshore components of their portfolios, particularly in developed markets. Even though we think the rand is somewhat overvalued (though less so now than at the beginning of January), we don't think investors should count on the rand to deliver the return because there may not be a sudden or extreme change. The underlying offshore asset must be able to justify its own existence and deliver a reasonable return. Cyclical issues are likely to dominate 2011, and therefore interest rates will become an issue at some point. There will also be unusual disruptions (such as the political turmoil in North Africa) and probably a return of the problems that beset Europe last year. So investors need to be vigilant and careful: the basic principles of investing don't change, and valuation and diversification still count.