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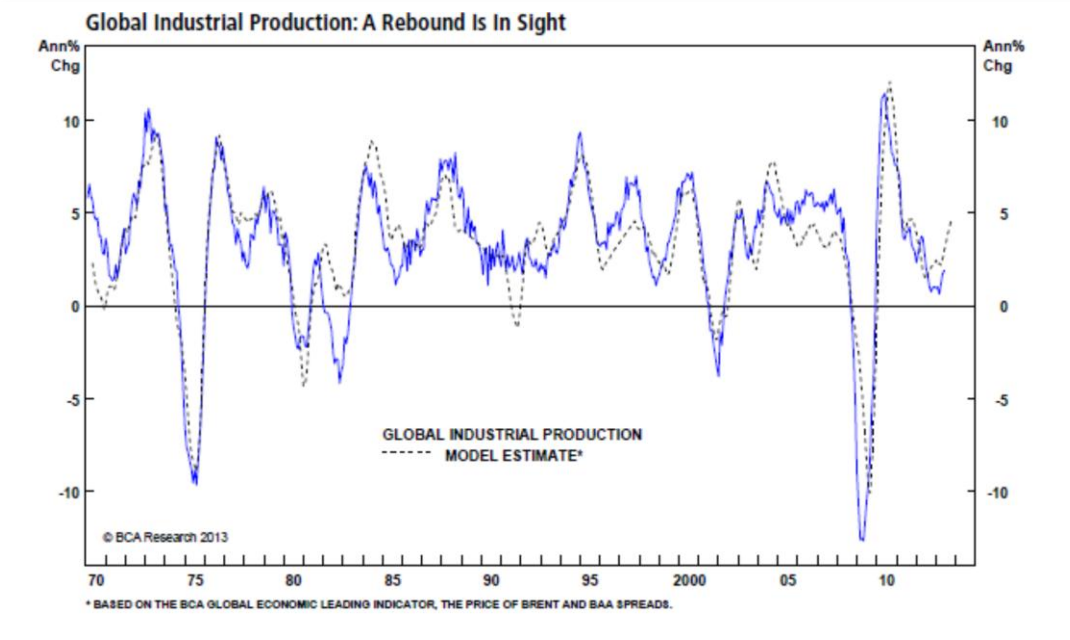
International

Cooling on Stimulus?

The world economy remains in a low inflationary or even deflationary cycle and is characterised by inadequate aggregate demand and excess savings. Globally, QE programmes have not yet led to increased final consumption but have managed to stabilise investment markets at least. Markets, in our view, will remain data dependant for a while still as fundamental underpinnings gain traction. Three key issues will likely drive markets in the short term. The first being the timing of tapering of QE by the Fed which thankfully clarified and reinforced its stance on this matter recently, stating that policies will remain data dependant, particularly on the unemployment front. Secondly, is whether China can successfully manage structurally slower growth without causing a crash landing and thirdly whether Japan's reflationary efforts will produce tangible results. Our expectations are for better than expected numbers from the US and that China will also surprise on the upside as recent comments by authorities confirmed that target growth of 7% will be sustained through stimulus programmes if needed. In Japan, Abenomics appears to

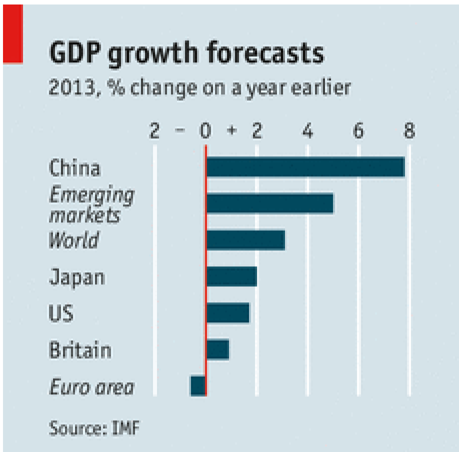


Source: BCA Research 5 July 2013

be bearing fruit. Money and loan growth have gained traction and for the first time in many years inflationary expectations have risen to slightly above 1 percentage point. Business and consumer confidence have also increased thanks to a devaluation of the Yen and aggressive QE. In Europe, growth remains subdued but stable except for Germany where green shoots continue to emerge. German unemployment has stabilised at around 6%, a 20 year low, and manufacturing companies have emerged highly competitive and should improve even further as we expect the Euro to remain weak relative to the dollar. A further positive factor is that global industrial production appears to be turning up after slowing for nearly three years.

In short, the world is growing albeit at an anaemic rate which is quite normal after a deep recession and bursting credit bubble as consumers largely continue to deleverage.

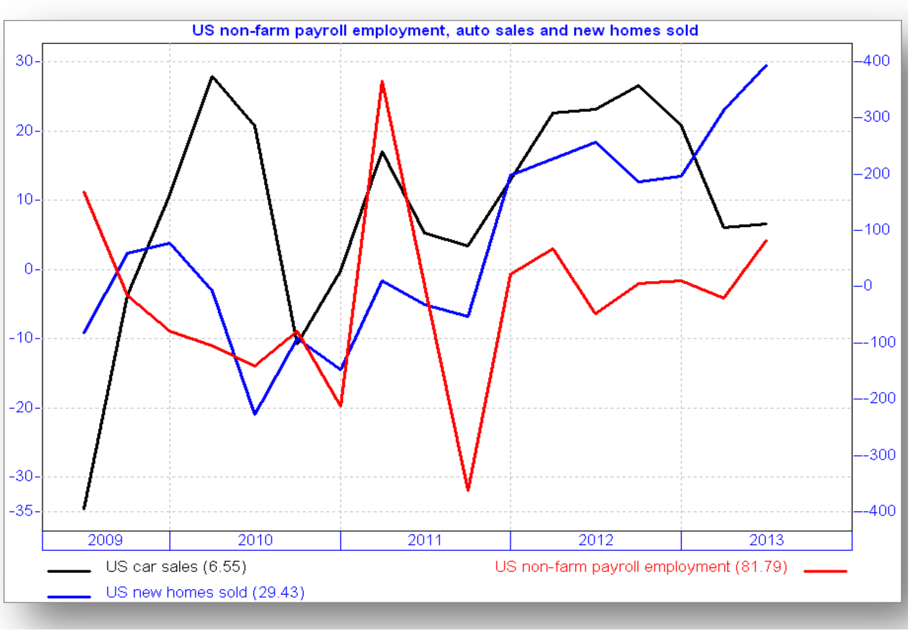
The IMF shaved its global growth forecasts from previous estimates in April mainly due to an expected slowdown in emerging markets. Expected growth for Britain and Japan however were revised upwards.



Source: The Economist 13th July 2013

Given the low, or in some cases, no impact on a recovery in consumer expenditure by the various QE programmes, it was interesting to note comments made by Mark Carney, new governor of the Bank of England, recently. In minutes of the July Monetary Policy Committee meeting, he clearly stated his intention to retreat from relying on the bank's flagship QE programme as the only means of stimulating the economy and that a mixed strategy was the preferred route. The new emphasis will be on guiding financial markets. Guidance, according to the BOE, can be used to stimulate growth by giving households and businesses more confidence to borrow and spend as guidance could stabilise markets and even cause positive moves, particularly in equity markets. Our understanding therefore is that QE will remain but that additional stimulus will be resisted by certain members of the MPC.

Following the huge surge in stocks since the beginning of the year, investors were bracing themselves for a major correction in stock markets, as anticipated in the June Communiqué. This happened in early June with major markets declining by as much as 9% on average. The correction however was brief as many investors were underweight equities in particular and have aggressively re-entered markets as equity prices at that point reflected underlying fundamentals more realistically. Negative real yields on interest bearing instruments further prompted investment flows into equities.



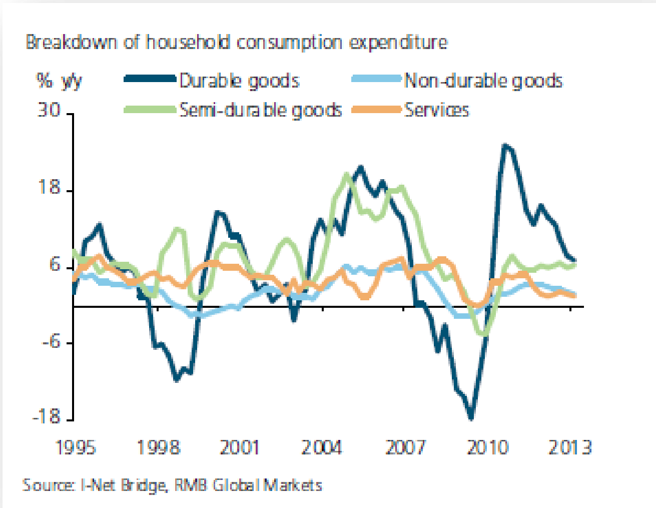
The renewed grounds for optimism are mainly supported by positive developments in the US. Job creation has gained momentum and capital goods orders have ticked up aggressively indicating increased capital spending by corporates in anticipation of higher consumer expenditure in due course. The auto sector will probably continue to strengthen as per capita sales remain low and the median age of the US auto fleet remains very high. As can be seen in the above chart, employment, auto sales and new homes sold have all turned positive on a quarterly percentage change basis.

Furthermore, housing investment remains very low compared to what is required by new housing formation in an environment of rising homebuilder optimism. Despite the positive indications mentioned, it's important to remember that stock prices are anticipatory in nature and that the strong rebound witnessed lately is predicting a stronger US economy. Therefore, we expect the market to remain volatile and data dependant, Ben Bernanke and his QE included.

South Africa

Local equities declined alongside world markets following comments by Bernanke that QE might be slowed towards the end of the year. The JSE declined by 7% in early June as foreigners switched into US equities on expectations of higher interest rates in the US as tapering of QE might suggest reflation in the US economy. Subsequent comments by the Fed have however calmed investors as it stated that any change in QE will be data dependant, particularly jobs data, which although moving up, is still relatively weak. The JSE has subsequently rebound by approximately 4% after the low reached in June.

On the economic front, the demand side GDP growth breakdown indicated that consumers are under pressure. Debt levels remain high and growth in remuneration continued to slow. Household consumer expenditure slowed to 2.3% quarter on quarter in 1Q13 from 2.4% previously, led by durable and non-durable goods.

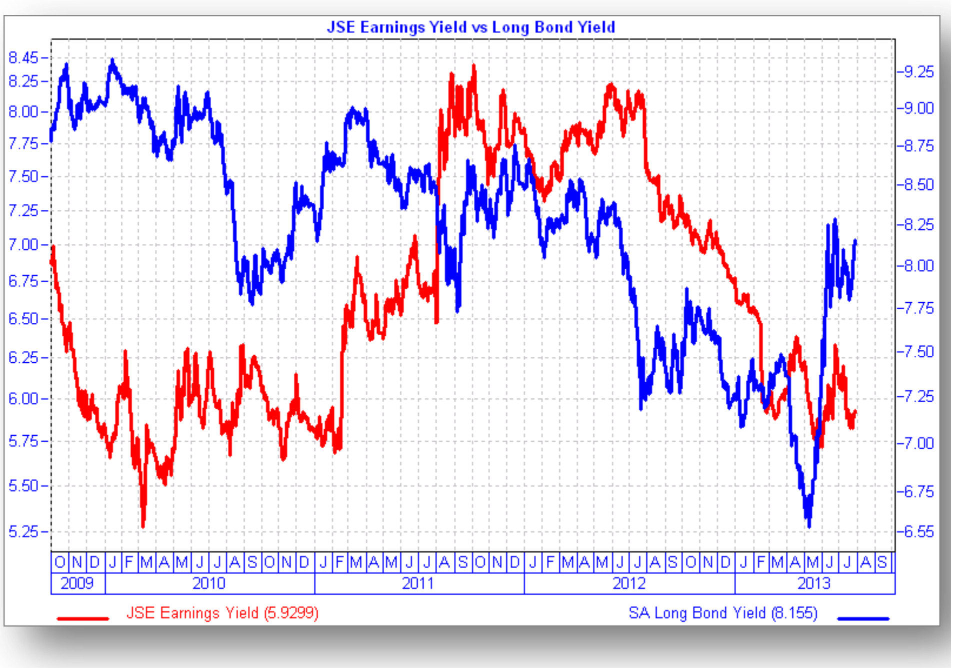


Source: RMB Global Markets Research 12 July 2013

We remain concerned about the trade deficit and the impact it might have on the local currency and potential investment outflows going forward despite the deficit narrowing to R11bn in May after widening to R15.9bn in April. Although better than expected, the number recorded was the largest deficit recorded in absolute numbers. Most economists remain sceptical of this positive trend and expectations are that the deficit will reach 6% of GDP in 2013.

Declining commodity prices remain a risk for the deficit and the rand. Price weakness was particularly evident during the last 2 months led by weakness in the gold price. We expect the rand to be range bound between USD/ZAR9.80 and USD/ZAR10.30 to the dollar for the foreseeable future following some stability in markets after more clarification by the Fed on QE as mentioned above. However, a worse than expected deficit, labour unrest and continued weakness in commodity prices going forward, could present increased risk for a weaker rand.

- The above factors are of particular importance as 30% of shares listed on the JSE are held by foreign investors. So, despite fundamental factors for equities going forward looking positive, there are risks of capital flight out of emerging markets, particularly if the Fed surprises, commodities deteriorate further or the current account deficit widens to more than 6% of GDP.



Despite rebounding strongly in July, local equities remain fairly valued. The yield gap between listed shares and long bond yields currently stands at 2.2% which effectively is the hurdle rate for company earnings to grow at to compensate investors for investing in a risky asset (equities). The current earnings yield on equities is 6%, so valuations are not stretched by any means. We remain cautious on resource counters despite offering value at current levels. Industrial stocks, particularly rand hedges, appear expensive but the risk of a material derating, in our view, is unlikely as earnings upgrades are expected in due course due to the weaker exchange rate. Higher earnings will lead to lower multiples which might present us with a buying opportunity, particularly if the risks mentioned above have been mitigated.

In conclusion

- **The world economy remains in a low inflationary or even deflationary cycle and is characterised by inadequate aggregate demand and excess savings.**
- **Markets, in our view, will remain data dependant for a while still as fundamental underpinnings gain traction.**
- **Three key issues will likely drive markets in the short term. Firstly, the timing of tapering by the Fed, secondly whether China can avert a crash landing and thirdly that Japan can sustain its reflationary trajectory.**
- **Growth in Europe remains subdued but stable, except for Germany, where green shoots continue to emerge. German unemployment has stabilised at around 6%, a 20 year low, and manufacturing companies have emerged highly competitive and should improve even further.**
- **Another positive factor is that global industrial production appears to be turning upwards after slowing for nearly three years.**
- **In the US, we expect the positive trends in auto sales, new home sales and employment to gain momentum.**

- **In South Africa, the demand side GDP growth breakdown indicated that consumers are under pressure, debt levels remain high and growth in remuneration continues to slow.**
- **Despite fundamental factors for equities going forward looking positive, there are risks of capital flight out of emerging markets, particularly if the Fed surprises, commodities deteriorate further or the current account deficit widens to more than 6% of GDP.**
- **Despite rebounding strongly in July, local equities remain fairly valued. The yield gap between listed shares and long bond yields currently stands at 2.2%, which is a fairly low hurdle rate for earnings growth.**
- **We remain cautious on resources despite the sector offering value.**
- **Industrial stocks, particularly rand hedges, appear expensive but the risk of a material derating, in our view, is unlikely as earnings upgrades are expected due to the weaker exchange rate.**

Sincerely

Chris

Chris Botha

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