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Asset Management

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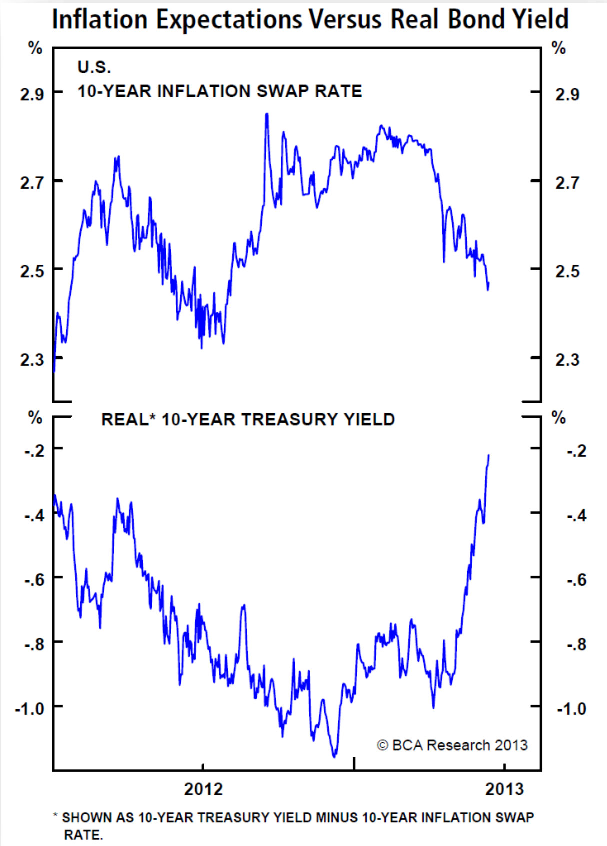
International

The Fed sets the course for a reset phase

Violent bull markets must be accompanied by violent corrections; particularly this time around as the recent bull market was driven by policy actions and cheap money. Asset class valuations did in our view not correlate with underlying economic fundamentals, so we view the corrective phase we have entered as quite normal and is likely to set the stage for more handsome returns down the line.

The Fed officially announced it was considering a gradual tapering of QE. Ben Bernanke also stressed that a reduction in bond buying could be reversed should economic fundamentals deteriorate, especially if US employment data does not show a sustainable improvement. This of course had the expected effect on US long bonds with yields rising sharply in anticipation of potentially higher interest rates later this year as inflation is now expected to creep up. Real bond yields are also rising which effectively indicate that inflation expectations are actually falling and are currently undershooting the Fed's target which does not support a reduction in the bond-buying programme.



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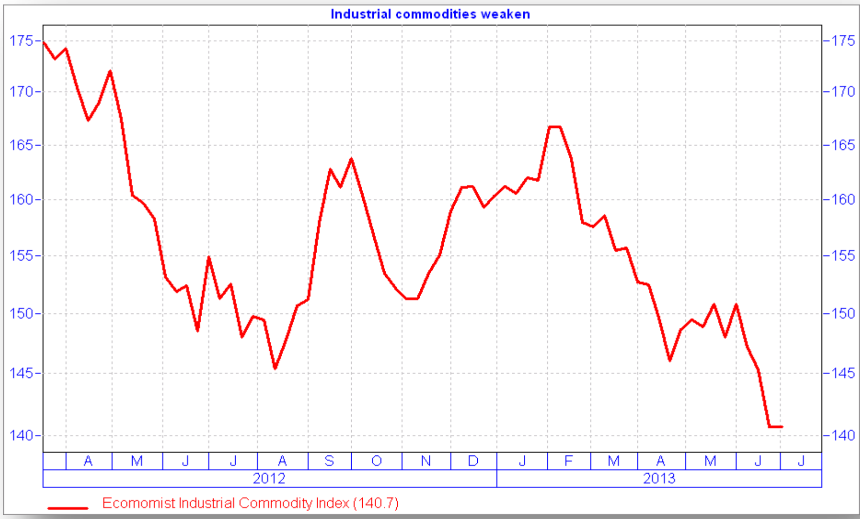
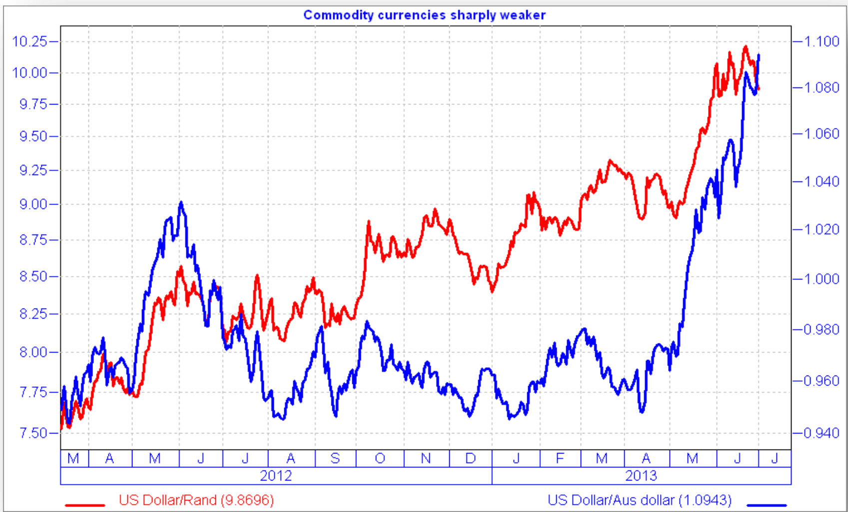
Emerging markets felt the brunt of this as investment capital flew back into developed markets on expected higher yields once QE ends. In our opinion, investors have to some extent lost their way. Firstly, a tapering of QE is in fact bullish for equities, as this indicates that the economy is actually growing better than expected as reflation typically boosts company profits and margins and hence share prices. Secondly, underlying economic data remains fairly subdued, particularly on the job front, so we think that the current weakness in equity markets is an ideal long term buying opportunity as valuations are now far more realistic given underlying fundamentals.



On the global economic front, the US is still steadily expanding, Europe remains in recession, although stabilising, and Japan continues to fight deflation. However, a series of recent Chinese data is suggesting that growth there is perhaps not as robust as expected. Chines president, Xi Jinping, has stated that he is happy with the current pace of softer growth as this will provide a better backdrop for corporate restructuring. Commodities and commodity currencies are carrying the burden of this slower growth with both the Aussie dollar and Rand weakening substantially against the US dollar which was accompanied by an aggressive sell-off in commodity stocks, which might not be over yet.

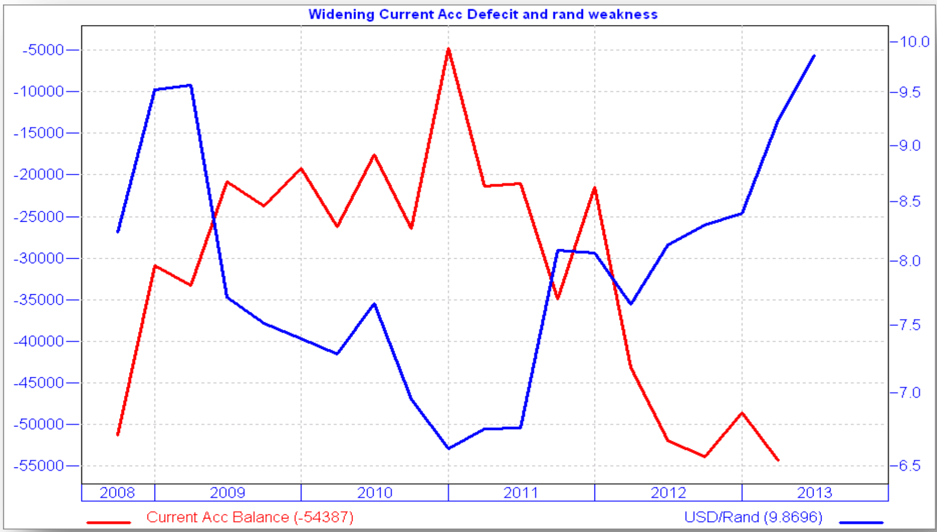
The global economy is still suffering from sluggish demand and excess saving, and employment in the US remains weak. Because of this, QE should be around for a bit, and investors should resist panic and selling, as current prices are reflecting fundamentals more accurately. Patience will be rewarded, as the current backdrop sets the stage for potentially good returns towards the end of the year and into 2014.

Some relative calm returned to global markets recently, with US 10 year treasury yields dropping back below the 2.5% level. Risk aversion has also moderated somewhat as the VIX index (Chicago Board Options Exchange Market Volatility Index) dropped to 16(from over 20) at the time of writing.



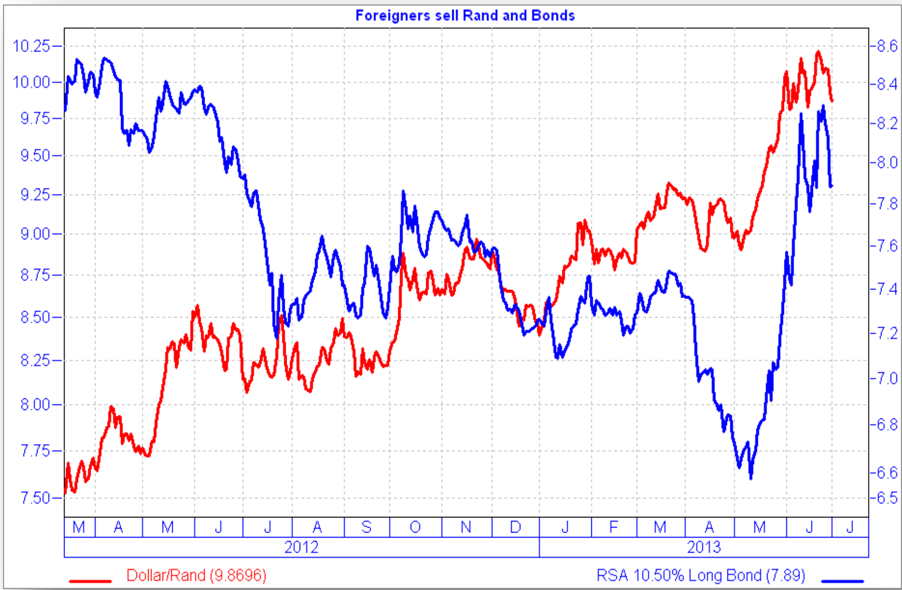
South Africa

The main concern locally is whether the big capital outflows driven by foreigners have stabilised. If outflows continue, the rand will remain weak, putting further pressure on our current account deficit. Bloomberg consensus forecast data is for the current account deficit to widen to 6.9% of GDP over the next quarter from 6.5% previously. So, structurally, the trend going forward is for a weaker rand and potentially higher bond yields. As can be seen in the chart below, a very high correlation exists between a weakening currency and worsening current account deficit.



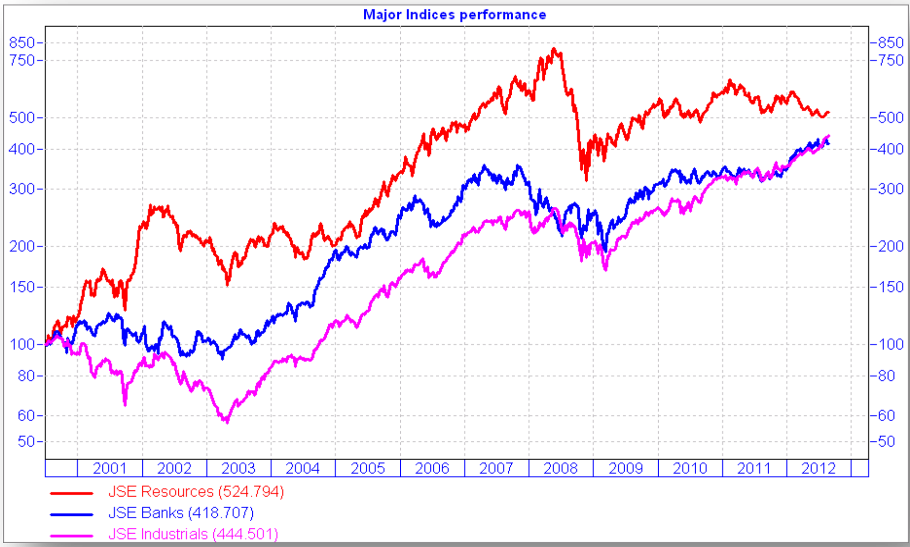
The rand has regained some ground at the time of writing, gaining 2.3% against the US dollar as sentiment towards risky assets and emerging markets improved slightly after IMF President Christine Lagarde said that the Fed's tapering of QE might not be "around the corner". We expect local bonds and the currency to remain volatile in the near term, primarily due to global risk aversion or appetite but also expected labour issues locally are expected to deteriorate with salary and wage demands way in excess of inflation, particularly on the mining front.

The rand weakened by 7% against the US dollar during the month accompanied by net selling of our local bonds and equities. This will undoubtedly cause deterioration in the inflation outlook going forward and could force the SARB to hike interest rates locally towards the end of the year. However, local data suggests that the consumer remains under pressure, particularly on the durable and semi durable front. High levels of debt are also hindering spending. One can therefore expect that the SARB might let inflation breach the official target for a while if largely driven by exogenous factors like a weak rand and higher administered prices. Given the above pressures, our view for now is that rates will remain unchanged for quite a while given slowing consumption and poor GDP growth. Consensus GDP growth for 2013 currently stands at 2.2%, from 2.5% previously, and 2.7% for 2014 from 3% previously.



On the local exchange the main theme remains weakness in commodity stocks and industrial rand hedges continuing to outperform. We expect this trend to continue over the near term but one could potentially expect a recovery in resource counters towards the end of the year as earnings upgrades come through due to the weak rand. We prefer to remain overweight industrial counters on a risk adjusted basis.

In Conclusion



- Violent bull markets must be accompanied by violent corrections; particularly this time around as the recent bull market was driven by policy actions and cheap money.
- The Fed officially announced it was considering a gradual tapering of QE.
- A reduction in bond buying could be reversed should economic fundamentals deteriorate, especially if US employment data does not show a sustainable improvement.
- Underlying economic data remains fairly subdued, particularly on the job front (US), so we think that the current weakness in equity markets is an ideal long term buying opportunity.
- QE should be around for a bit, and investors should resist panic and selling, as current prices are reflecting fundamentals more accurately.
- The main concern locally is whether the big capital outflows driven by foreigners have stabilised. If outflows continue, the rand will remain weak, putting further pressure on our current account deficit.
- The rand weakened by 7% against the US dollar during the month accompanied by net selling of our local bonds and equities.
- Commodity stocks remain weak due to soft spot prices and we think this trend will remain in the short term.
- We continue to prefer industrial rand hedges on a risk adjusted basis.

Sincerely

Chris

Chris Botha