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Asset Management

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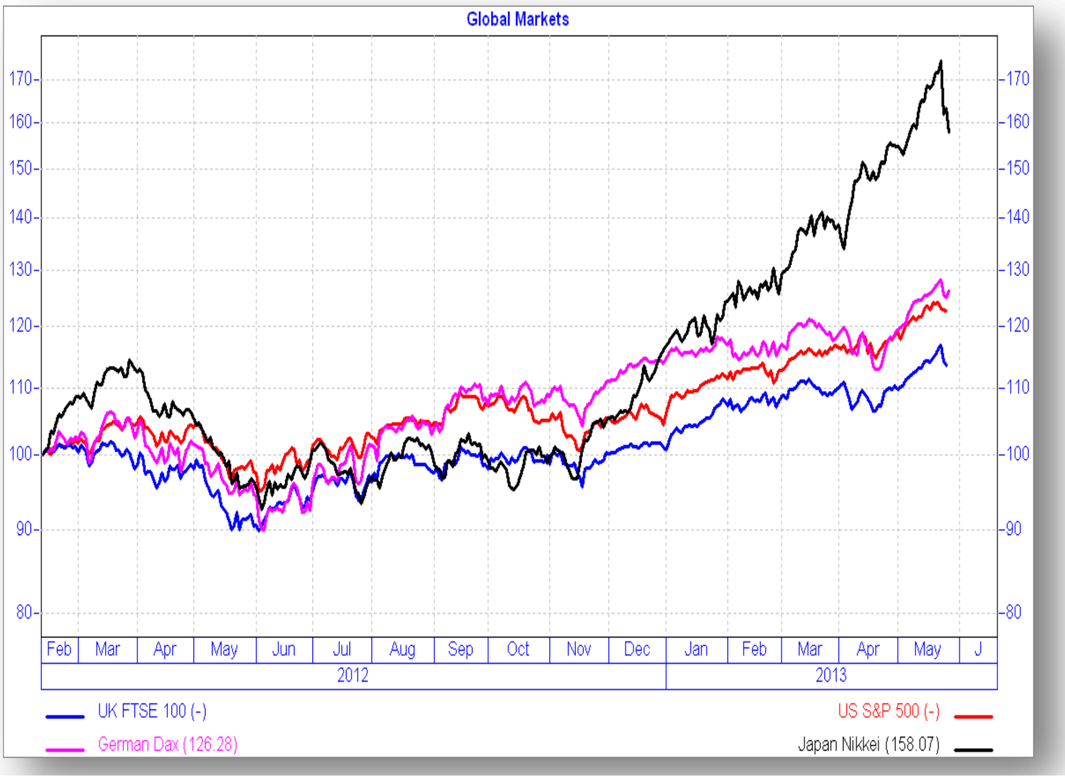
Risky assets the only way to preserve wealth!

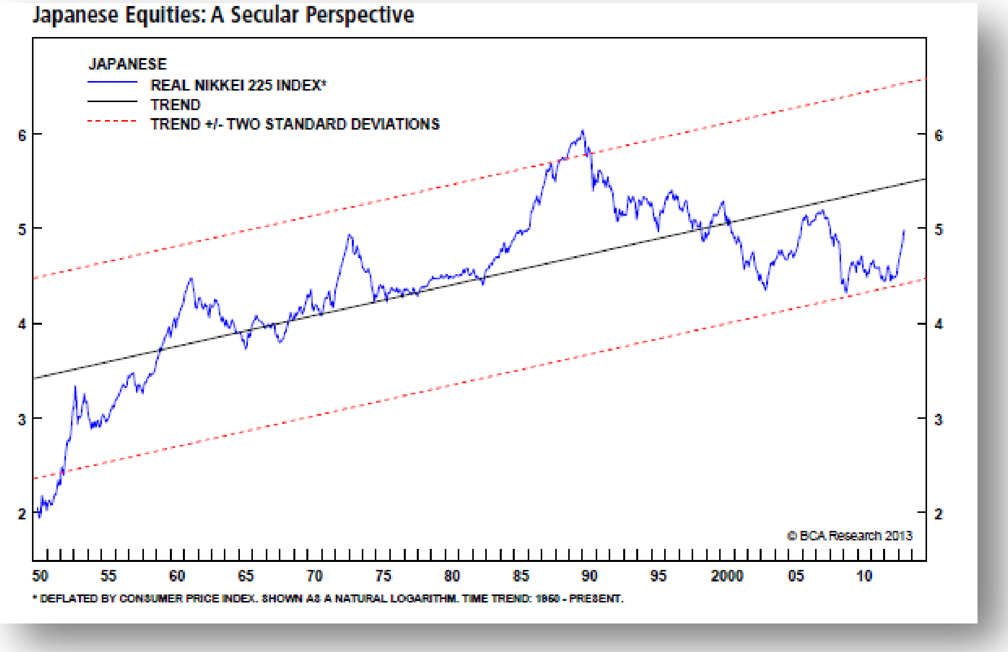
International

Global stock markets have performed exceptionally well year to date supported by better than expected corporate profits in the US and continued quantitative easing(QE); now also occurring in Japan, together with talk of some form of deregulation of the Chinese economy. The S&P 500 as an example is up 16% year to date. Currently, indications are that stock markets could be entering a correction phase, which we would welcome as being a healthy and cleansing event. Internationally, there are many under invested participants waiting for a pullback in equities to increase exposure on any price weakness. We, therefore, expect any correction to be relatively short lived.

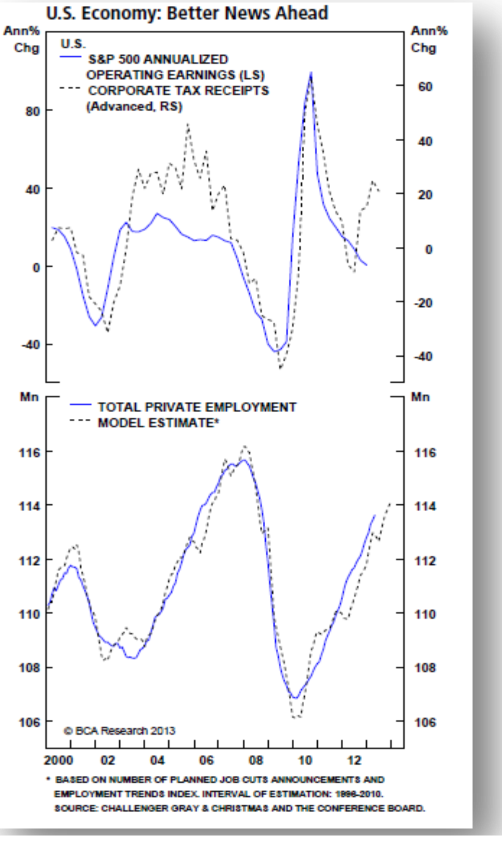


Unfortunately, given global interest rates [non – existent in real terms], the only way to preserve wealth is to increase exposure to risky assets. Not ideal, but then that is the world we currently live in!

The Japanese share market declined by 10% in May after very strong gains year to date – up 26%. The likely reasons for the sell-off were a poor PMI (Purchase Managers Index) reading from China and a sharp rise in Japanese long bond yields. The Japanese economy is going through an important policy shift with Shinzo Abe focused on ending deflation with his own form of QE. In the event of "Abenomics" succeeding, we anticipate the Yen to weaken and stock prices to eventually continue to rise. This could also prove positive for commodity prices and resource stocks in due course.



Source: BCA Research, 24th May 2013



In the US, growth has continued at a moderate pace this year. Economic growth in the first quarter was supported by continued expansion in household consumption aided by recent improvements in the job market; although overall employment is still somewhat weak.

GDP is estimated to have grown at an annual rate of 2.5% in the first quarter of this year after increasing by 1.8% in 2012. The improving trend in employment and consumption has, therefore, largely offset the drag on the economy from reduced government spending and tax increases. Economists had estimated that the current deficit reduction policies would slow the pace of real GDP by approximately 1.5% in 2013.

Federal Reserve Chairman Ben Bernanke, in his testimony to congress recently, made it clear that the focus going forward will be on employment and price stability (read inflation) and that given current indicators, will maintain a highly accommodative monetary policy and "will continue its securities purchases until the outlook for the labour market has improved substantially in a context of price stability".

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House prices in the US continue to recover which should continue to support the stock market in terms of the "wealth effect".

As can be seen in this chart, there is a strong correlation between house prices and the stock market.

Corporate profits in the US have continued to beat expectations mainly as a result of expanding margins and cost reductions. Approximately two thirds of the margin expansion can be explained by lower interest charges and reduced taxes as funding is obtained at record low interest rates and US multinationals are paying lower tax from their off-shore operations.

In China, the government is planning for private businesses and market forces to play a larger role in the economy, the intention being, to accelerate private consumption as a meaningful driver of GDP growth going forward(as discussed in last month's Communiqué). China's leaders are also planning to loosen foreign exchange controls thereby reducing price distortions and potentially allowing the market to determine the price of the Renminbi which could lead to increased foreign investment.

These developments were to some extent spurred on by concerns of a slowing economy due to fewer exports to Europe (which remains in recession, although stabilising) and slower investment growth. Rising labour costs and strengthening currency have also reduced manufacturing competitiveness. In his speech recently, Mr Li Keqiang, prime minister, said "If we place excessive reliance on government steering and policy leverage to stimulate growth that will be difficult to sustain and could even produce new problems and risks."

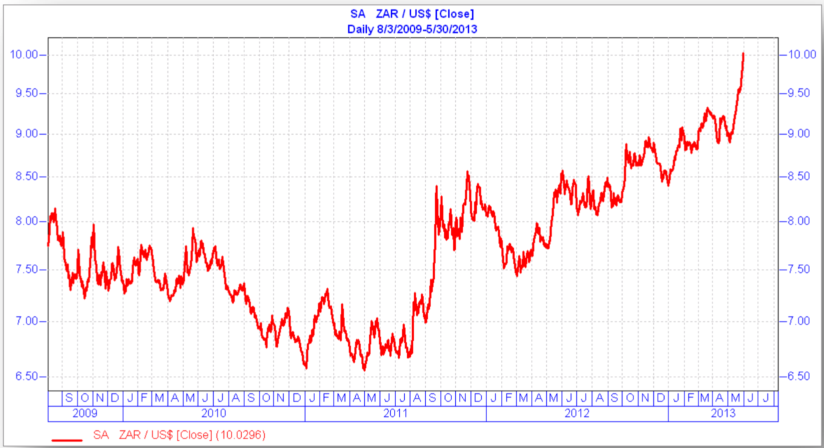
In our opinion, all markets have run ahead of fundamentals [earnings growth prospects] and are being fuelled by continuing 'loose money' policies by Central banks, driving investors into the 'search for yield at all costs 'game.

We reiterate, any correction in market prices is therefore healthy. We anticipate that fundamentals will improve in due course, as growth in the US, hopefully, accelerates and prospects in Europe strengthen.

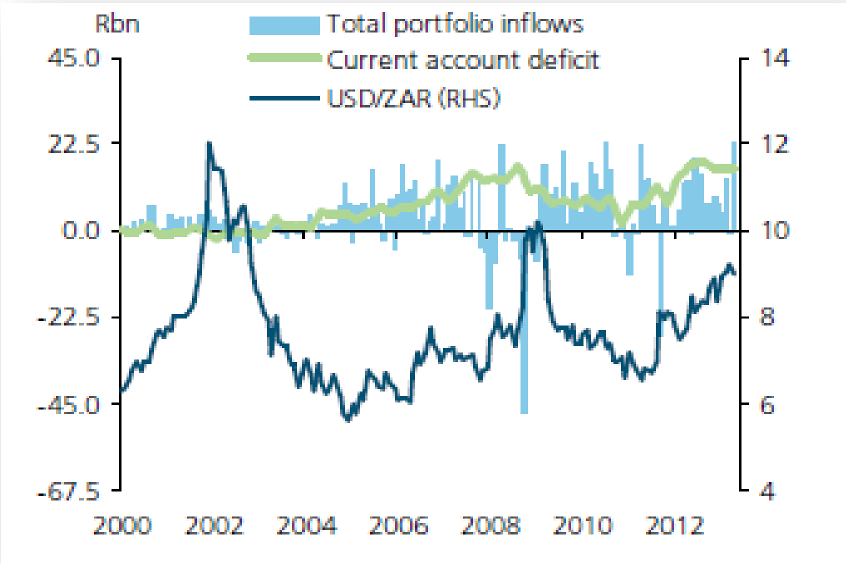
South Africa

The weak rand, current account deficit and potential labour unrest remain the major thematic concerns locally. The current account widened substantially last year and economists generally expect this trend to worsen in 2013, which will put further pressure on the rand - though it has weakened a lot already. The volatile labour environment and above inflationary wage settlements will tend to make South Africa a less attractive investment destination. Therefore, the present concerns by the market around the funding of the deficit.

The chase for yield remains a theme which has supported our local bond and equity markets, but risks are increasing that foreign capital will not support the funding of the deficit as things in Europe and elsewhere improve.



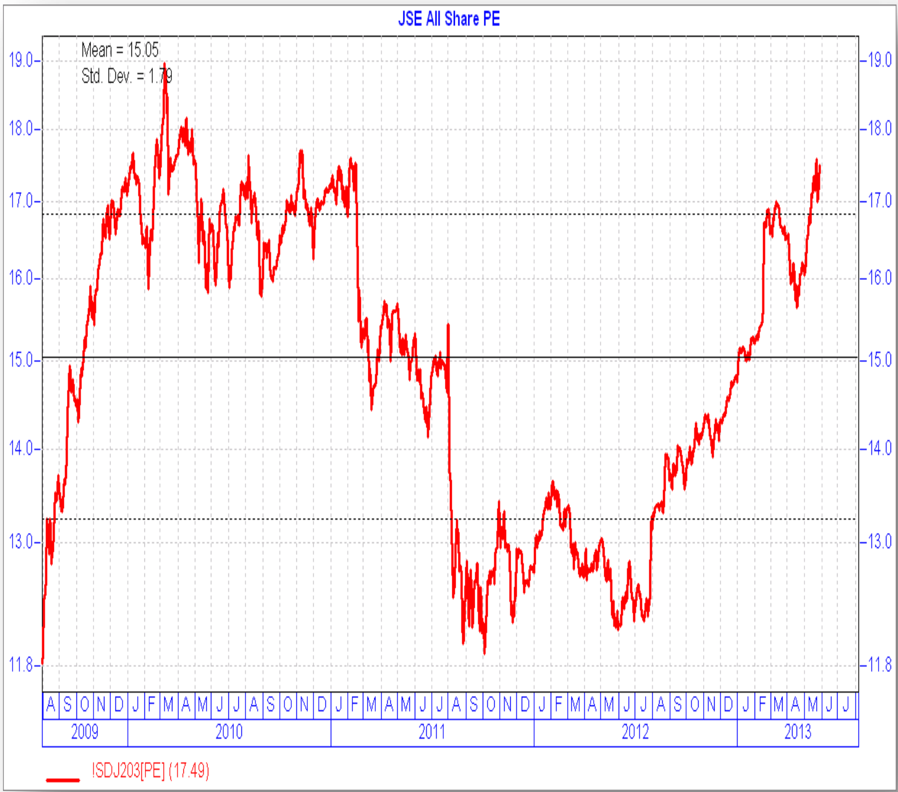
Trade statistics for March indicated a narrowing deficit to R7.9bn from R9.5bn in February but market participants were not convinced that this trend will continue, thus selling of our bonds and equities by foreigners, culminating in Rand weakness. The trade deficit for the first quarter widened by R12bn to R42bn compared to fourth quarter 2012.



Source: RMB Global Markets Research, 16th May 2013

As expected the SARB left the repo rate unchanged at the March MPC meeting with a neutral view on inflation going forward. However, the latest quarterly GDP number came in at 0.9% on an annualised basis compared to the expected 1.6%, further pressurising our currency. With growth this low, particularly in manufacturing, with somewhat subdued inflation, we believe there is a real chance of an interest rate cut.

Source: Standard Bank Macroeconomic Research, 28th May 2013



The JSE, in line with other markets, delivered a strong performance year to date with a return of 7%. Main drivers continue to be industrial Rand hedges. On a current PE ratio of 17.5x, the market appears expensive compare to its long term average of 15x. We expect the market to correct somewhat in conjunction with global markets. A weaker rand will be beneficial to Rand hedge counter profitability, which should filter through to corporate results during the second half of the year. Thus equity valuations could move towards more reasonable levels. We, therefore, will consider using market weakness as a buying opportunity.

In conclusion

- Global markets and the JSE appear to be entering into a correction phase which we view as healthy.
- We will consider using weaker markets as a buying opportunity, as global macro-economic and fundamental indicators are generally looking up.
- Housing data in the US continues to recover and there are positive signs emerging on the employment front.
- The positive correlation between US housing prices [continuing up-ward trend] and share prices will be positive for the US and equities globally.
- US corporate profits are surprising on the upside driven by reduced costs and margin expansion.
- Chinese authorities are aiming to open up the economy to make private investment more inclusive which should put China on a more sustainable growth path.
- Locally, the Rand is set to remain weak in general, given current account concerns and expected labour tensions.
- Local GDP growth is faltering and manufacturing is slowing, which could lead to a rate cut later this year.
- The JSE appears expensive on a P/E basis in the short term, but should move towards more favourable valuations in the second half of the year as Rand weakness will buoy profits.
- Weakness in the local market may be used as a buying opportunity as equities remain the best way to preserve and grow wealth over the long term.

Sincerely

<u>Chris Botha</u>

<u>Dave Eliot</u>

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