

Seed Market Overview

May 2012

Local

Economy

April vehicle sales declined month on month but rose 10.5% year on year. This is relatively strong, coming off a higher base. March manufacturing data released in April was however very weak, with output falling by a seasonally adjusted 4.3% month on month and 2.7% year on year. Mining production remained weak in March with total output still down 9.8% year on year. The unemployment rate increased to 25.2% from 23.9%. Should these weaker numbers persist, it will have the effect of lower interest rates for longer.

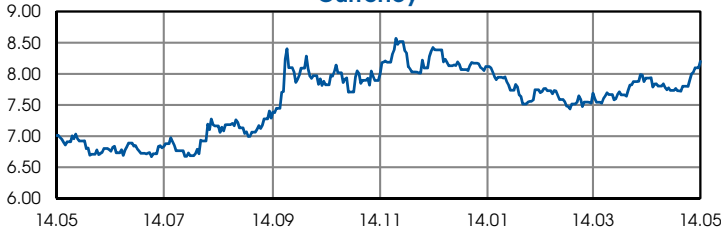
Inflation

Producer Price Inflation (PPI) continues to fall back and in March declined from 8.3% to 7.2% year on year. The weaker European demand and lower commodity prices assisted in bringing down producer inflation. Inflation, as measured by CPI, has also been easing back and fell to 6% year on year in March from 6.1% in February. CPI is likely to hover above the 6% level for most of 2012 due to rising food prices, administered prices, and also due to the weaker rand.

Interest Rates

As consumer inflation falls back to 6%, the Reserve Bank's decision to hold the repo rate at 5.5% for an extended period of 18 months is vindicated. The mixed but generally weaker economic data that has been released over the last month, together with the fact that the inflation rate is now at the upper target level of 6%, means that interest rates will likely be left at the lower rates for longer. This is an ongoing theme for most central banks around the world.

Currency



— ZAR/USD Exchange Rate

Cash

The Reserve Bank continues to adopt an accommodative policy, i.e. the short end of the interest rate curve continues to be suppressed by the Reserve Bank. By holding the repo rate at 5.5%, while inflation remains at 6%, short term interest rates continue to remain very unattractive. The disincentive to hold cash continues to force investors to take on higher risk as the Reserve Bank has little desire to increase interest rates. 3 month Jibar, which drives money market returns, is very steady at 5.53%. 6 month and 12 month Jibar are steady at 5.8% and 6.15% respectively.

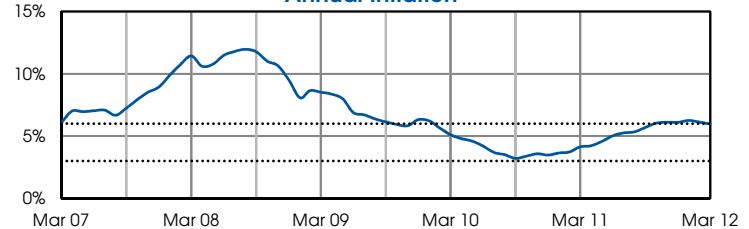
Bonds

In April, Citi Bank announced that the SA Government Bond Index would be eligible for inclusion into the World Global Bond Index. This had an immediate impact on flows into the bond market and also the yield. For April the All Bond Index (ALBI) gained 1.81% as foreigners invested a net R13.9 billion. Over the last 12 months the return from bonds came in at 12.7%. The yield on the government bond R204 fell from 7.58% to 7.29%, where it is currently trading.

Property

SA Listed Property gained 2.6% in April and at the end of the month was up 10.85% for the year to date, once again outperforming cash, bonds, and local equities. For the past 12 months the return was 19%. The historical yield at the end of April was 6.69% and assuming income growth of 5.5% over the next 12 months, the forward yield comes in at around 7%. Both property and bonds appear to be more on the expensive side now.

Annual Inflation



— Headline Inflation

Local Equities: Certain Sectors Looking Expensive

On the first trading day in May the market moved to a new high, closing at 34,482. It is interesting to note that the high was made despite the fact that a large portion of the market – the resource sector – is still down over 35% from its 2008 highs. In other words the new market high has been driven by financial and industrial companies.

Business value is ultimately dependent on earnings growth and, as a sub sector, certain of the general retailers have been exceptionally good at growing their earnings over the last 10 years. This sub-category includes Cashbuild, Mr Price, Massmart, The Foschini Group, Truworths, Woolies, and Holdsport among others.

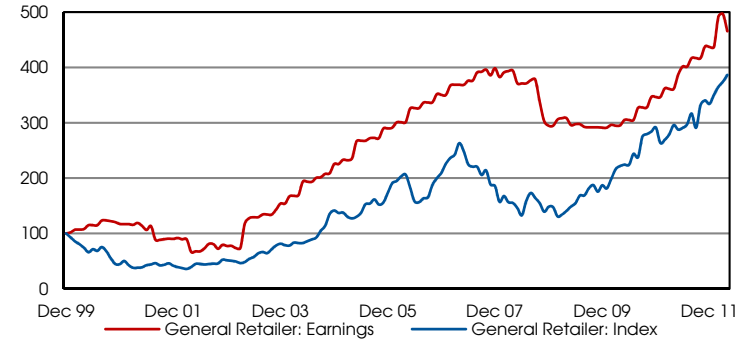
The chart alongside reflects the General Retail Index relative to its earnings from 2000, both indexed to 100. Over this period, these companies have managed to grow their earnings by 13.2% pa which compares reasonably well to the overall market, which over the same time period grew earnings by 15% pa. From 2000 the share prices have actually lagged earnings growth, however the starting valuations in January 2000 for this sector were expensive with the average PE at around 20.

At times investors become very enthusiastic about certain businesses and are willing to place higher and higher multiples on earnings. This was the case in January 2000 for these shares, and again from around March 2010 as prices relative to historical earnings moved through the 18 times level (i.e. PE above 18). Continuing growth in underlying earnings have, however, been supportive of the higher prices. This is also recognised in the February official retail sales growth rate, which moved up very firmly to an annual 7.2%.

There is some concern now that the rate of retail growth, when combined with the high levels of unsecured debt, is not sustainable. A cursory view of the results and trading updates issued by some of this sector gives a sense of generally firm growth:

Mr Price, in its trading update for the year to March expects headline EPS to increase by between 18% and 23%. The Foschini Group will release its annual results to March at the end of May and is expecting headline earnings per share to be up between 20% and 23%. Truworth's interims reflected a 14% gain in headline earnings and it is planning 6% growth in trading space. Holdsport, the owner of Sportsman's Warehouse and Outdoor Warehouse, announced that its earnings for the year to February should be up around 20%. Massmart announced a 44 week sale update to the end of April with total sales growing by 14.7% and comparable store sales growth up 8.9%.

These gains across retailers give an indication of why prices have moved up so sharply. The debate now is whether prices are discounting too much growth.



Income Generating Assets (30/04/2012)

	Cash	Bond	Property
1 Month Return	0.4%	1.8%	2.6%
12 Month Return	5.5%	12.7%	19.0%
Current Yield	5.6%	7.9%	6.7%

Capital Generating Assets (30/04/2012)

	ALSI	RESI	INDI	FINI
1 Month Return	2.8%	2.8%	3.6%	2.2%
12 Month Return	8.1%	-9.6%	20.2%	18.7%
Current PE	13.0	8.8	18.9	13.2
10 Year Average PE	14.0	15.2	15.0	12.3
Current DY	3.0%	2.9%	2.6%	3.8%
10 Year Average DY	2.9%	2.5%	2.3%	4.0%

Chinese Economy

The Chinese economy has been a key driver of global economies over the last two decades driving up the demand, and hence price, of base commodities. This has been beneficial for many resource rich emerging markets. By driving down the prices on finished products, China has helped reduce inflation in developed market consumer orientated economies.

Given the country's massive influence on the global economy, it is understandable then for investors to try and anticipate the direction and magnitude of future growth. The critical question being asked at present is, "Will Chinese authorities be able to engineer a soft landing, or will the inevitable slowdown be a lot harder?"

Goldman Sachs' chief China equity strategist, Helen Zhu, believes that China will achieve a soft landing as the government moves from its aggressive monetary tightening back to a more normalised economic policy. Goldman Sachs' view is that China will achieve 8-9% GDP growth in 2012 and 2013. In March the Chinese government lowered their own economic growth target from 8% to 7.5%. Actual 2012 Q1 annual growth came in at 8.1%, down from 8.9%.

There are definitely competing views to the bullish for longer case. A major concern is that China has an excessively high savings rate and that as a country it will take a long time to move from an investment and export biased economy to one driven by domestic consumption. Another concern is the wage price pressure. Cheap Chinese production has been built on an abundance of migrant labour at low rates. Anecdotal stories abound as to how wage pressure is building up.

Goldman's view with respect to the potential consumer uptake is that there are approximately 400-500 million mass market Chinese consumers who have a government that is looking to increase safety nets such as housing, health care, unemployment benefits, education, etc. This should encourage these citizens to increase their spending.

The research has identified 4 main Chinese consumer segments:

- **Mass market:** 400-500 million lower tier workers. They may have been in urban area for a while.
- **Core middle class:** 100-150 million. They will typically own their own homes and have a reasonable amount of disposable income, saving up for children's education etc.
- **Aspirational luxury buyers:** 10-20 million. They are well exposed to western ways.
- **Movers and shakers:** +1 million

The chart alongside on consumer spending indicates that while retail sales slowed to 11% in Q1, real urban household spending accelerated from 6.8% to 8.2%. This was also supported by firmer urban household income, which rose 10% year on year in Q1, up from 8.2% in 2011.

Key to Chinese growth, and their ability to spend at the retail level, is ongoing productivity. Rural areas comprise around half of the urban population and the Chinese authority's objective is to move around 200 million people from rural to urban areas over the next 10 - 20 years. The planning and infrastructure that this requires should continue to sustain investment related economic growth for years to come.

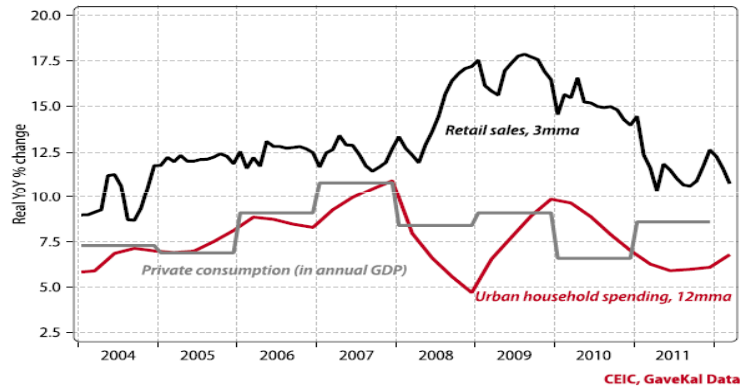
Impact Across Various Sectors

The Chinese economy is important for so many companies around the world. A developed market manufacturer, such as Apple, relies on Chinese company Foxconn with some 1 million workers assembling its iPhone and iPad devices. There has been wage pressure at this level, which will impact on margins. Many other manufacturers face these same pressures.

Developed market fast food retailers such as Yum Brands, which operates the fast food outlets KFC and Pizza Hut brands, are benefiting immensely from the rise of consumerism in China. Yum Brands will be opening at least 600 restaurants in China this year and its reported operating profit from China rose 14% in the first quarter.

Major global commodity suppliers such as Billiton, as a producer of iron ore, will continue to rely on ongoing infrastructure spend in China and the huge demand for the base materials that it supplies. At Billiton's March steel forecast, the producer said that it was seeing signs of flattening demand for iron ore from China. They remain bullish longer term on demand, given the ongoing urbanisation of China.

Consumption indicators are mixed but growth seems decent



Seed Outlook

Local Market

Equity

The market was up nearly 3% in April, and with the earnings relatively flat, the ALSI's PE increased from 12.7 to 13. The market is therefore slightly cheap on a pure PE basis (10 year average PE of 14), but with earnings 10% to 20% above their trend the risk is that earnings disappoint going forward. Adjusting earnings to more normal levels results in a PE slightly in excess of 14. We therefore maintain a neutral equity value.

Property

Property has returned more than 13% over the past 5 months and as such has probably run ahead of its fair value. With a forward yield of around 7%, one can expect real returns of around 5%, which in itself is good, but with operating costs increasing sharply, there is the risk that earnings disappoint.

Bonds

Bonds are still not offering investors good value relative to their historic yields. Interest rates remain at historic lows worldwide, which has resulted in large flows into higher nominal yielding markets (read South Africa). With inflation risks to the upside, one shouldn't expect good real returns from here.

Cash

Cash rates have remained steadfastly under 6% for over a year and on a real basis are therefore offering cash holders a negative return - even before the impact of taxes. The only value in cash currently is that it provides liquidity.

Global Market

Currency

At the end of April the rand was around 10% too strong when compared to a variety of other currencies. We expect that it will depreciate by 2.3% per annum on a real basis versus the US dollar over the next 5 years, and as such Seed portfolios are tilted to global (hard currency denominated) assets. The rand has weakened from R7.75 to R8.25 in the first half of May.

Equity

Global equity remains our asset class of choice, more particularly high quality developed market equity. The slight fall in equity markets in April has resulted in global equity showing more value than a month ago (after a strong increase) and we await more weakness to increase the allocation further.

Fixed Income

Bonds in developed markets remain expensive on all measures, and are therefore to be avoided. While the yields of the highest quality bonds continue to fall, those of lesser quality continue to climb. This anomaly is bound to revert, and our belief is that the lower yields will move up and not vice versa.

Alternative

Cash rates are low, but there is increasing scope for good equity managers to produce alpha and we therefore prefer to hold global alternatives to global cash on a tactical basis.

Current Asset Class Valuation

Local Equity	=
Local Property	-
Local Bond	-
Local Cash	--
Global Currency	+
Global Equity	=
Global Fixed Income	--
Global Alternative	=

Legend

Very Cheap	++
Cheap	+
Fair Value	=
Expensive	-
Very Expensive	--
Change in Valuation	*

Seed Flexible – Deviation from Benchmark (30/04/2012)

