Independent Investment Consultants

MARKET OVERVIEW - OCTOBER 2009

SOUTH AFRICA

ECONOMY AND MARKETS

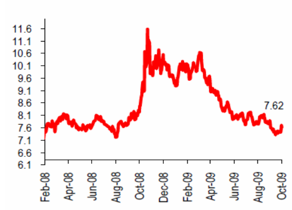
INTEREST RATES

The repo rate is at 7% - remaining unchanged at the September meeting. Domestic interest rates have probably bottomed - but this is not a definite. The August headline production inflation came in at negative 4% year on year. While declining imported producer price inflation will lower inflation, the stickier problem for local inflation is service prices, which are excluded from PPI stats.

INFLATION

The CPI number for August came in at 6,4% year on year. Despite sticky areas, inflation has shown a steady decline from August 2008 of 13,7%. The monthly inflation at 0,3% was encouraging. While food inflation is slowly coming into alignment, this was counteracted by an increase in various service fees. Annual inflation for services came in at 8,1% from 8%.

CURRENCY Rand/Dollar



	J203 ALSI	J210 Resource 20	J211 Industrial 25	J212 Financial 15	J253 Property	RSA Bonds ALBI
September 2009	0.3%	-0.6%	0.8%	-0.7%	2.1%	0.1%
12 Month return	7.7%	1.1%	14.1%	5.9%	19.0%	9.1%
Current PE (Price/Earnings)	14.3	13.5	13.8	17.3		
Long Term PE (Price/Earnings) 10 years	14.5	14.2	15.1	12.3		
Current DY (Dividend/Price)	2.7%	2.2%	2.1%	4.1%		
Long Term DY (Dividend/Price) 10 years	2.7%	3.3%	2.0%	3.1%		

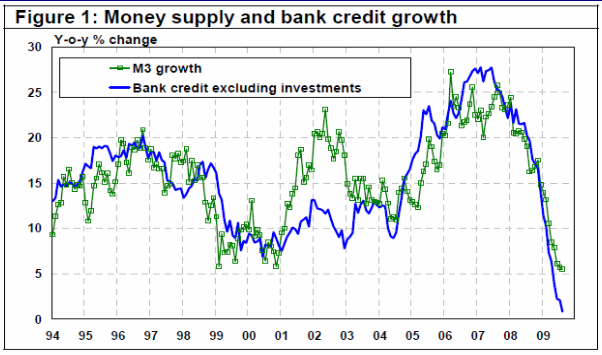
MONEY SUPPLY

On the assumption that economic growth is largely tied to credit extension, the year on year change in money supply and extension of bank credit is an important indicator to monitor.

Nedbank noted that the growth in credit has slowed to the lowest levels since their records began in 1968. In August credit grew by 2,3% year on year, but private credit extension is virtually flat increasing at just 0,8% year on year. The chart alongside indicates the massive decline in the annual rate of credit extension.

A year back credit was still advancing at just under 20% year on year. The implication is that consumer spending will remain weak as individuals rebuild balance sheets and pay down debt, while being reluctant to take on new debt. Weak growth may lead the Reserve Bank to cut interest rates by another 0,5% in this cycle.

Figure 1: Money supply and bank credit growth



FIXED INCOME AND PROPERTY

MONEY MARKET

The 3 month Jibar rate was running at 12,2% a year back. It has declined to its current 7,03%. This is similar to the rate on the 3 month NCD, which has also declined from 12% in December 2008. It does appear that we are close to the bottom of the interest rate cycle.

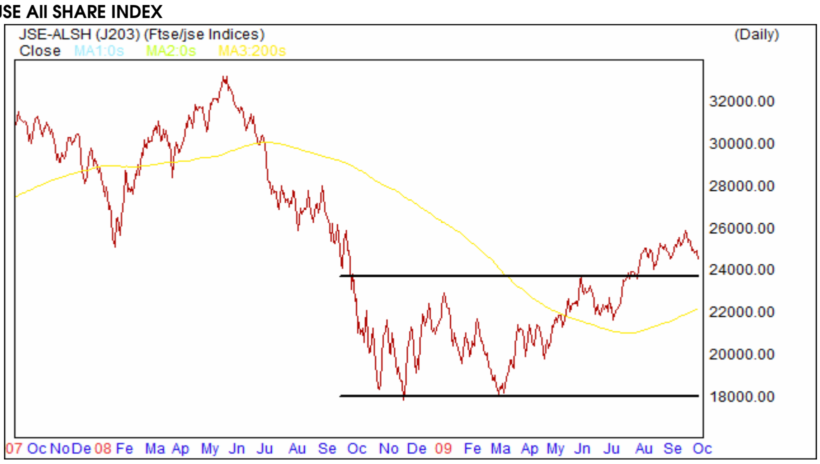
BOND MARKET

While shorter dated rates have moved down substantially, longer dated yields have ticked up, resulting in losses for the year to date for an investment into local bonds of over 2%. Yields are trading in a range, with some possible drift back to their July peak of 8,78% for the R157. There is however strong demand. At current implied inflation, bond yields are fair value, but still not overly attractive.

PROPERTY MARKET

Following a large decline in October 2008, local listed property has slowly but steadily moved up, resulting in a 12 month total return of 19%. Reported earnings are reasonable, with escalations on new leases of around 8%, plus growth on new leases because spot rentals are higher than expiring leases. However the growing vacancy levels may be problematic. The one year forward yield is running at approximately 9,18% assuming an 8% escalation.

JSE All SHARE INDEX



In recent weeks the momentum that has driven prices up for the last 7 months started to slow with prices pulling back from the 26 000 level to 24 500.

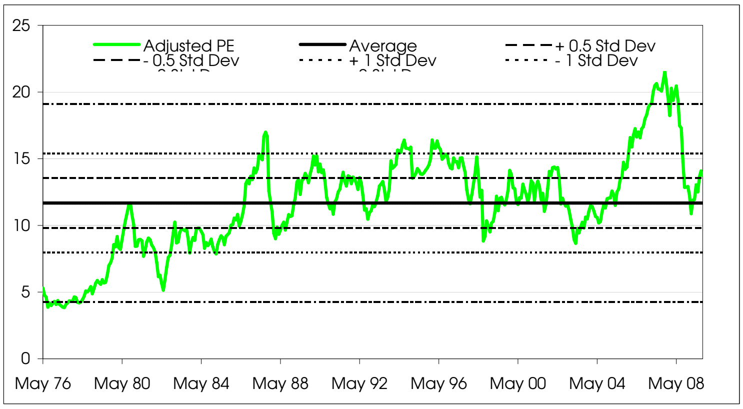
The gains for the last 6 months and year to date have been very solid off the low base that was established. When adjusted for the strong rand in dollar terms global investors have received a double positive return.

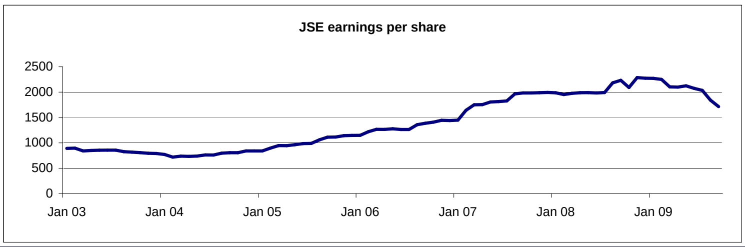
As indicated below, as prices have moved up, so valuations have reduced and it is therefore understandable that investors are taking some profits.

Given the price momentum and also the currently more expensive valuations, our shorter term outlook remains cautious. Should prices pull back to a level where valuations are once again attractive, then it makes sense to increase exposure again.

This is not a time to be out of equities, but a time to be slightly underweight.

JSE PRICE TO EARNINGS USING ADJUSTED EARNINGS





These two charts paint a long term picture of SA equity valuations.

The price to earnings ratio is the price paid for R1 of earnings generated. Because companies themselves go through periods of high and low earnings cycles, there are different methodologies to smooth or adjust the level of earnings, so as to present a more accurate valuation chart.

Company earnings (graph 2) themselves move from periods when they are running at high levels, to periods when they are depressed. They are however far less volatile than the share prices. Knowing that earnings in total tend to be mean reverting, we adjust current earnings to their long run normalised level.

Using these adjusted earnings we calculate the given price at any point in time to the adjusted earnings to produce the PE chart (graph 1). From history we calculate that the average price paid for R1 of earnings was 11,68 times.

Many times however investors were prepared to pay 15 times and at the peak even 20 times adjusted earnings. While returns from any point in time cannot be determined with 100% accuracy, the probability of increased returns increases when the price is lower. Conversely the prospective future return declines when the price, as determined by the PE or adjusted PE increases. For the bulk of the time however, the overall valuation of the market trades at 1/2 standard deviation from the long term mean.

With company earnings having declined in 2009 by 25% to date and prices having moved up, the PE ratio has moved back to around 14 times. This is starting to get close to 1 standard deviation away from the long term average of 11,68 times. On this basis we are recommending an underweight position to local equities.

GLOBAL MARKETS

The month of October has notoriously been one which has seen many stock market declines. This may be largely mythical, given the data produced by respected research house, Ned Davis in the US.

According to them the worst average month for returns of the Dow Jones industrial index is September with a loss of 1,1%. February and May have also shown small losses on average. October is the fourth worst reflecting an average gain of just 0,1%.

After the disastrous 2008 where global equity markets fell 40% in dollar terms, 2009 has seen a rebound with the FTSE world index up 28,6% to the end of September and the average global equity fund up by a similar percentage.

As investors have become risk seeking, so it has been generally the more riskier shares that have run up sharply. These are known as the high beta cyclical shares. The sectors here include discretionary consumer, energy and materials.

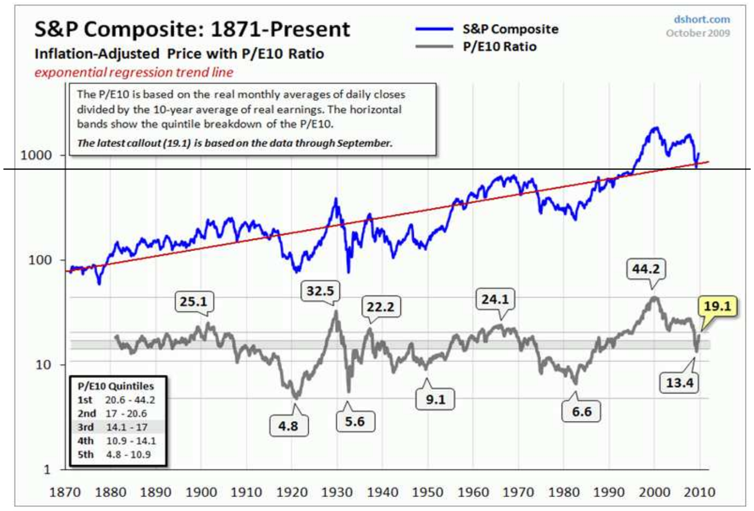
In contrast the more stable and defensive shares like consumer staples have generally lagged for 2009 and its this area that appears relatively attractive. Other sectors in the more defensive category include healthcare and telecommunications.

For the year to date, the US market is up 20,8%, but large value shares are only up 8,19%.

Valuation of S&P500

From an overall valuation perspective, earnings for the SAP 500 peaked at an annual $85. In the last 2 years they declined dramatically to the current annual estimate for 2009 of $39,35. Ned David believes that normalised earnings should be around $60.

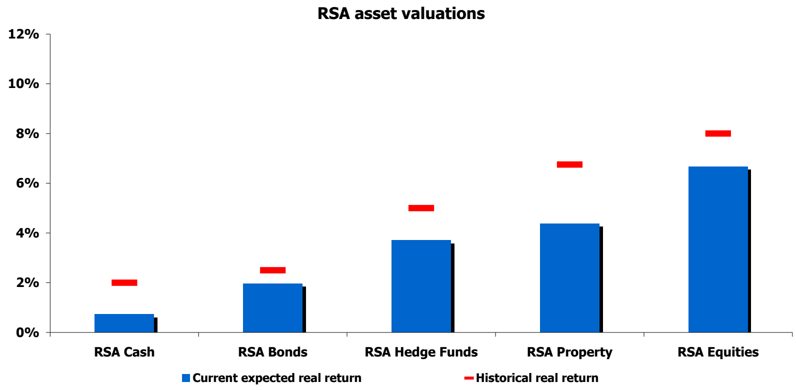
The Bank of America Merrill Lynch chief equity strategist is more optimistic looking for $70 in 2010 and $80 in 2011, which can support a S&P500 target of 1200. This is around the level that Ned Davis has indicated they would be exiting. The index is currently at 1071 - so 12% off the next important level.



The chart above is a long term price in blue of the US markets as represented by the S&P500 index. The graph line below represents the price earnings based on trailing 10 years of real earnings to provide a smoothed or adjusted valuation graph.

In a similar fashion to the local market, the US markets have re-rated dramatically from their lows in March where the price fell to a historical PE of 13,4 times to the current 19,1 times smoothed earnings. Analysing the data into quintiles, the current valuation level is starting to head back into the more expensive values.

LONG TERM EXPECTED REAL RETURNS



This table provides an indication of the current expected real returns from local assets relative to longer term real rates from the assets.

What is noteworthy is that valuations for local asset classes appear to be correctly reflecting the risk profile. i.e. an investor expects a lower return from a lower risk investment such as cash. As the risk of the asset class escalates, so the same investor will expect a gradually higher return.

At the same time it does not appear that assets are priced for decent long run returns.

- Cash is not attractive when compared with longer term expected real rates of taking into account. The implied inflation is running at 6,45%. Historically before tax money market should yield 1,5% to 2% real rate. i.e. cash is proving to be expensive at the current yields.

- Bonds have been expensive for a while now and in June and July the yields moved up to 8,78% for the R157 on the scare of additional issuance. Bonds have lost just over 2% year to date. At current yields relative to longer run expected inflation, they are still not fantastic value.

- The current yield for all local equities is at 6,67%. We can conclude that equities are starting to appear more expensive, given the level of re-rating.

HOUSEVIEW

LEGEND - RELATIVE TO BENCHMARK

High Overweight	++
Overweight	+
Neutral	=
Underweight	-
High Underweight	- -
Change from previous month	**BOLD**

	Current
RSA Equities	-
RSA Bonds	-
RSA Cash	-
RSA Hedge funds	=
Offshore	+
OFF Equities	-
OFF Bonds	=
OFF Cash	-
OFF Property	+
OFF Hedge funds	=

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