

STANLIB Weekly Focus

An economic and market update

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 STANLIB

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Newsflash

It is said by many that oil as the leading commodity in the world sets the pace and the probability is high that that oil prices may have hit bottom.

Uncertainty remains high: not for the faint-hearted

- With economies around the world sliding fast (negative growth) and fears that company earnings will decline sharply around the world, investor nervousness remains extremely high.
- This is clearly illustrated in the US by the volatility index (VIX), which is still hovering around 50, compared with its long-term average of around 20. Also, the gap or spread between US (and other country) corporate bond yields and government bond yields remains very elevated (almost 5 standard deviations away from the 20 year average in the case of US BAA-rated bonds), indicating just how difficult it is for companies to raise cash currently, let alone individuals.
- If Japan's exports were down 35% year-on-year, as they were (also the average of Korea, Singapore and Taiwan exports were down 25%), then how much will our exports decline, especially with SA being such a big commodity exporter and what effect will this have on SA company earnings?
- American commentator, John Mauldin, talks about the massive damage caused by the bursting of no less than three bubbles in his country: the housing bubble, the credit bubble and the consumer spending bubble. As a result, house prices are down 25% and still falling, car sales have plummeted (how will GM and Chrysler survive the next year?), banks are buckling, retail stores are in the red (Circuit City has gone bankrupt, with 30,000 employees) and jobs are being lost left, right and centre (unemployment claims are up 30% in the past six weeks). Some are calling commercial property the next "sub-prime" disaster.
- The problem is the US, UK and Europe are in uncharted territory: they have never witnessed such a combination of economic catastrophes that threaten to cascade into a deep, long-lasting recession. How long will it last and how deep will it go? No-one knows. The age of deleveraging (cutting back debt) could mean that stock markets may remain subdued for many years.
- With such high uncertainty and risk, one is tempted to say that at this stage - until more clarity arrives - investing in risky assets like shares, other than in a small way, does not make sense.
- Are you likely to be appropriately compensated for the extra risk you're taking in shares/share unit trusts (high reward in return for taking high risk)? The answer to that remains highly uncertain!

Is there any hope?

- As Warren Buffett has indicated, fear and uncertainty are the friend of the long-term investor because they cause share prices to decline to very attractive levels. Buy when everyone is despondently selling, they say.
- When one considers all the sharply negative news about sliding economies over the past few weeks, it is almost a miracle that the MSCI World Index remains 7% higher than its 20th November low (similar to both 2002 and 1996 levels). Yes, the down-trend remains firmly intact, but markets have not as yet made new lows.
- The Japanese Nikkei Index is at its lowest since October 28th (almost there) and is once again down 80% from its record high twenty years ago; during the course of history if anyone had bought a market when it was down 80% they would probably have done very well in years to come.
- At Friday's close, the JSE All Share Index was still up about 10% from its November low of 17,800 and today (Monday) the index has gained over 2% at time of writing.
- So is there some hope that shares in November were already discounting a very bleak picture? After all, there are some big positives, with oil and petrol prices down dramatically (over 50% in the US). This stimulus alone is said to be far better than any fiscal stimulus that Obama could come up with.
- Interest rates are at multi-year lows in many countries and hopefully will fall sharply in SA in 2009 (3% further declines expected in SA by STANLIB).
- Anglo American was down 68% from its record high as of this morning, Arcelor Mittal was down 73% and Standard Bank almost 40%. All three shares are back at or close to their 2008 lows. Are these falls not already discounting "the worst"? Certainly one would hope so.
- After all, it is said by many that oil as the leading commodity in the world sets the pace and the probability is high that that oil prices may have hit bottom. If so, this is potentially a good sign for other commodities, such as platinum, copper, aluminium, coal and iron ore. The Baltic Dry Freight Shipping Index (cost of shipping bulk commodities like iron ore and coal) seems to have turned the corner over the past two weeks and is already 47% above its low (it was down 95%). That could also be a good sign for commodity prices.
- The rand gold price hit an all-time record high today and its proxy, New Gold, the Exchange Traded Fund that trades on the JSE as a share, is up 47% in the past year. Meanwhile, the rand platinum price has picked up nicely too and is now trading at December 2007 levels.
- The JSE Resources PE (price-to-earnings) ratio has tumbled from a peak of 23.5 last May to the current 8.5. Yes it is true that analysts are forecasting a big decline of almost 40% in earnings, but that could certainly change for the better. The point is that there is now a fairly high possibility that commodity prices are at or close to their bottoms, especially in rand terms; and our resource share prices are driven by rand commodity prices, not dollar prices.

- Another positive is that China's Shanghai Composite Index seems to be forming a bottom and is breaking its downtrend after tumbling over 70% from its peak. Seeing that this market started the rot for all stock markets, perhaps this is also a good sign. Could it be the new leader?
- As an aside, below is a chart of the pound relative to the dollar, showing the massive fall in sterling over the past five months, illustrating in turn the dire condition of the British economy and banking system, even relative to the sad-looking US economy and banking system.



Source: I-Net Bridge

Paul Hansen
(Group Director, Retail Investing)

Economic Update

Well, what a way to kick start the year!

The most powerful country in the world, for now, inaugurated its 44th president, with Barack Obama becoming the 1st African American president of the United States. A temporary cease fire was finally achieved in the Gaza strip, after a massive loss of life, and Zimbabwe continues to struggle to form a coalition government after its elections nearly a year ago. Back home our general elections look set to take place this April, with the newly formed COPE (Congress of the People) Party gathering momentum.

Just last week, after posting a dismal Q4 GDP figure of -1.8%/y, the UK economy joined the ranks of Japan, Germany and the USA in entering a recession for the first time since 1991. China also posted its slowest growth in 7 years, with a deteriorating housing market and export sector, recording Q4 growth of 6.8%/y. This took the annual growth rate for 2008 down to 9% from over 11.5% in 2007! For this year we expect growth to slow even further to 5.5%/y.

Locally, this week sees the final consumer inflation figures released for 2008, before the new CPI basket comes into effect. The new weightings will be released next week and the jury is still out on exactly what effect this will have on our current inflation figures. With inflation falling, and credit easing, we expect the Monetary Policy Committee to have enough room to cut our interest rate by an additional 50bps next week Thursday, although some players in the market are calling for a full 100bps cut. The interest rate meeting has been moved forward by a week, so as not to clash with the Budget speech on the 11 February 2009. At STANLIB we are currently forecasting a 50bps cut at every MPC meeting this year, which will take the Repo rate down to 8.5% and Prime to 12%.

South African economic outlook for 2009

Against the backdrop of a sharply weakening global economy, economic activity in South Africa has slowed substantially in recent months; especially consumer spending and export activity. Furthermore, the outlook for the next few quarters points to ongoing weakness, with the current slowdown expected to broaden across most components of the economy. For 2009 we forecast GDP to slump to only 1.5%/y, with almost all sectors of the economy coming under pressure. Fortunately, infrastructural activity remains solid, the petrol price has declined by more than 44% in the past six months and consumer inflation is expected to fall-off significantly during the course of 2009. This should allow for further cuts in interest rates. Domestic economic conditions are

expected to slowly improve during the second half of 2009 and into 2010 helped by a pick-up in activity associated with the Soccer World Cup, increased fiscal stimulus, further easing in interest rates and an improvement in world economic conditions.

Consumer under pressure, with bad debts expected to rise further

- During Q3 2008 real disposable household income grew by a very modest 0.2%q/q, annualised. The slowdown in income growth mainly reflects the fact that wage growth has not kept pace with inflation. In 2008 CPIX inflation is expected to have averaged 11.3%, while wage growth was around 10.0%.
- In addition, there has been a reduction in employment. **An estimated 74 000 people lost their jobs in Q3 2008**, with more job losses expected over the coming quarters. The combination of these two factors (lower real wage growth and a slowdown in employment growth) has meant that real growth in disposable income has slowed measurably in the past few quarters. This has translated into a fall-off in consumer activity, especially given the relatively high interest rates. Unfortunately, the consumer sector is heading towards recession, with the retail trade sector already firmly in recession.
- It should be no surprise that consumer confidence fell further in Q4 2008 to -4 from -1 in Q3 2008. This is the lowest level of consumer confidence since Q1 2004. The confidence level is also below the long-term (25 years) average of a mere 1.7 index points. The fall-off in confidence is understandable given the increased concerns about the global financial/economic crisis, high interest rates, relatively high food inflation, increased debt servicing costs, slowing house price growth, increased political instability, and the intermittent electricity outages. We would expect confidence levels to fall further during the first half of 2009 considering the general slowdown in the domestic economy and the worsening employment situation.
- **In Q3 2008 the ratio of household debt to disposable income eased to 75.3% compared with a peak of 78.5% in Q1 2008.** This partly reflects the fact that consumers have become more cautious, following a four year credit festival. This ratio is expected to continue to subside into the first half of 2009 as the growth in household debt slows. Already the growth in household's credit card debt has slowed from well over 35%/y/y throughout most of 2007 to a mere 5%/y/y currently. In terms of the conventional measure of debt servicing costs the ratio has started to level-out, and should start to ease during the course of 2009.
- Although the household debt to disposable income ratio improved in Q3 2008, **the incidence of bad debts and debt defaults has continued to rise.** There has already been a noticeable increase in provisions for bad debts amongst banks and retailers, while insolvencies are noticeably higher. **The consumer remains under enormous pressure from a cash flow perspective** with little relief in sight, until inflation starts to ease and interest rates are cut

meaningfully further. Fortunately, the petrol price has fallen in each of the last six months and by more than 44% since the peak in the middle of 2008.

Infrastructural activity still a key positive

- The construction sector held up well in Q3 2008, growing by a very welcome 15%q/q (annualised). While the residential building sector is under pressure, construction activity associated with infrastructural activity is holding up well.
- SA fixed investment spending maintained solid growth of 10.0%q/q (annualised) in Q3 2008, up from a revised 6.0%q/q in Q2 2008. In 2007 fixed investment spending grew by an extremely robust 16.3%y/y, which is the strongest annual growth in investment activity since 1980.
- The solid performance in Q3 2008 was **mostly driven by the public sector**, where investment spending grew by an incredible 28%q/q, annualised, contributing around 80% of the total quarterly increase in fixed investment activity. The public sector investment spending is coming off a very low base, but nevertheless the rate of increase since the end of 2006 has been spectacular and is clearly providing a very significant offset to the general economic slowdown in South Africa. In fact, the increase in public investment spending this year, up until end Q3 2008, has accounted for around 60% of the overall GDP performance in 2008. That is not all that surprising given that consumer spending actually declined in Q3 2008.
- According to the **latest Medium Term Budget Policy Statement**, the solid growth in public sector fixed investment spending, especially by public corporations is expected to be maintained over the next few years. This is reflected in the **budgeted increases in public sector investment** activity across a broad range of infrastructural activity including electricity, roads, harbours, airports, stadium, rail and water.
- Investment spending by the private sector has slowed appreciably over the past few quarters, and is expected to continue over the next 18 months given the economic slowdown, decreasing capacity utilisation, limited access to credit facilities, weakening business confidence, concerns over the supply of electricity and a weakening residential property market.
- Despite the slowdown in the rate of growth, **fixed investment activity reached an impressive 24% of GDP in Q3 2008**. This is the highest level of investment spending since the beginning of 1984. The country has an informal target of increasing investment spending to over 25% of GDP and maintaining it at that level for a number of years. At this stage SA is well on its way to achieving that target.

Consumer inflation should fall-off sharply in 2009, allowing for further rate cuts

- The sharp drop in the oil price, together with the slowdown in domestic demand, has significantly eased inflationary concerns. The 12-month CPIX inflation rate fell from a peak of

13.6% in August 2008 to 12.1% in November and is set to fall sharply over the coming months as base effects, a lower petrol price and the reweighting of the CPI basket take effect.

- The recent depreciation of the rand (**which declined by 28.5% against the Dollar during 2008 and by 26.9% on a trade-weighted basis**) will push up the cost of some imported goods, partly counterbalancing the downward trend in inflation, but we expect inflation to enter the target range of 3% to 6% before the middle of this year.
- The SA Reserve Bank opted to cut the Repo rate by 50bps to 11.50% with effect from 12 December 2008. This was the first cut in rates since April 2005. In deciding to cut rates the Reserve Bank highlighted the fact that inflation is expected to continue its downward trajectory, assisted by the global developments. The exchange rate remains the most significant upside risk to the inflation outlook.
- The decision to cut 50bps before the end of last year appears sound, and appropriate given the circumstances. Had the Reserve Bank waited until 2009 to cut rates, they would have run the risk that the economy could have worsened over the next few months and that many more individuals and companies would have found themselves in extreme financial distress, leading to further job losses.
- However, cutting rates by 100bps or more could have led to unexpected consequences in the exchange rate market. In addition, a very large cut may have been interpreted by some as the Reserve Bank moving away from the policy of inflation targeting at a time when they, in fact, remain very concerned about the risk of higher inflation.
- **The interest rate reduction in December 2008 sets the tone for successive interest rate cuts of 50bps in each MPC meeting this year as long as it does not result in undue volatility in the financial markets**, which now appears to have settled down somewhat following the extreme movements experienced in October and November 2008. We expect the repo rate to bottom out at a higher level than in the previous cycle at about 8.5% which would keep it at about 3% in real terms. This should ensure that the anticipated recovery in consumer demand in 2010 is not too strong in terms of credit demand and does not result in renewed pressure on the current account in terms of a massive importation of consumer goods.

Fiscal policy likely to remain counter-cyclical

- Fiscal policy should support growth through an ongoing improvement in infrastructure spending. The Medium Term Budget Policy Statement published in October 2008 projected the budget deficit to widen to 2.0% of GDP in fiscal year 2009/10, but it is possible that some extra measures may be introduced in February's budget to stimulate activity further. Nevertheless, we do not anticipate the deficit widening beyond about 3% of GDP unless the slowdown in activity becomes more pronounced and reduces tax revenue by more than anticipated.

- At the end of November 2008, government tax revenue was running well behind budget, after being ahead of budget in the early part of the tax year. Most sources of tax revenue are behind budget, including VAT, the fuel levy, customs duties, transfer duties and personal income tax.
- The slowdown in tax revenue confirms that economic conditions have deteriorated significantly in recent months. Furthermore, it is very likely that taxes on profits and income will also come under increasing pressure (especially company tax) in the months ahead.
- **While government expenditure is also behind budget, National Treasury is facing a significant revenue shortfall and a larger than envisaged budget deficit in 2008/2009 as well as in 2009/2010.**
- Fortunately, over the past few years the Minister of Finance has substantially reduced government's debt as well as the debt servicing costs contained in the budget and has built up a handsome surplus. While it is unlikely that the Minister will substantially reduce taxes in this year's budget; the generally healthy fiscal position should ensure that government will not have to increase taxes in the face of a revenue slowdown.
- The focus in this year's National Budget, once again, is likely to be on the expenditure side of the budget, especially the increased infrastructure spending, the fight against crime, industry support, support for Eskom, World Cup 2010, increased social payments, skills development and education, and improved health care.

Current account deficit is expected to remain a significant risk to the Rand

- In Q3 2008 South Africa recorded a current account deficit equivalent to 7.9% of GDP. The growth in SA's exports slowed in Q3 2008, on the back of sluggish world demand as well as a slump in international commodity prices. Imports also rose fairly modestly in Q3 2008, largely reflecting the general slowdown in the domestic economy. This means that the trade deficit widened significantly in Q3 2008 to R44.3bn from R34.3bn in Q2 2008, an increase of R10.0bn or 0.4% of GDP.
- **The services account remains under pressure.** As a percentage of GDP the services account was recorded at deficit of 6.0% of GDP in Q3 2008. It is clear that the services account has been widening significantly over the past few years, mostly due to an increase in net dividend outflows. In Q3 2008, the net dividend outflows amounted to 2.7% of GDP; averaging 3.2% of GDP over the past four quarters.
- Given the large foreign ownership of South Africa's equity market (at around 20% to 25%), net dividend outflows from listed shares has risen noticeably over the past few years, increasing from a mere R10 billion, on an annualised basis, in Q1 2000 to a peak of R88.7 billion in Q4 2007. Dividend outflows have since eased-off to R62.9 billion in Q3 2008, possibly reflecting the slowdown in corporate earnings as well as the increased selling of SA equities by foreigners during the course of this year.

- **During 2008 foreigner's sold a net R55bn of SA equities, which is very substantial, and should lead to some reduction in net dividends outflows during the course of 2009.**
- Fortunately, although SA still recorded a relatively large current account deficit in Q3 2008, we were able to finance it. Net foreign capital inflows amounted to R60.6 billion, more than offsetting the current account deficit (non-annualised) of R52.8bn. This foreign capital inflow comprised mostly what is referred to as "other investment", which would include the "carry-trade" of R20.55 billion. It also, fortunately, included 'Net Foreign Direct Investment' of R19.9bn, which according to the Reserve Bank comprised mostly of long-term loan and short-term trade finance extended to domestic subsidiaries by non-resident holding companies. In addition there was the acquisition of the remaining shares in a South African motor vehicle manufacturing company by its foreign parent company. In contrast, Portfolio Investment reflected a net outflow of R12.97bn in the quarter, which continued into Q4 2008.
- **Looking forward, the current account is likely to improve**, albeit modestly, in the quarters ahead. This is on the back of a slowdown in the domestic economy; and hence some moderation in import demand, as well as a reduction in dividend outflows, due to softer corporate earnings.
- However, looking further out (2010 and beyond), there is little doubt that South Africa's import demand will rise noticeably as the country embarks on an extensive, and possibly unprecedented, infrastructural development programme. Consequently, the trade account is set to remain in deficit for the foreseeable future. Hopefully, the development of SA's infrastructure, especially the port and rail infrastructure, will lead to some increase in exports in the years to come.
- Irrespective of the potential increase in exports, SA is set to run a current account deficit for many years. Ironically, this is actually crucial for the development of the country given that most of the key capital equipment needed to enhance the productive capacity of the country will have to be imported. We will therefore continue to focus on the funding of the current account deficit for years to come, and **the Rand will remain at risk in terms of both direction and volatility.**
- **In 2008 the Rand was the worst performing emerging market currency, declining by 28.5% against the USD.** This is despite South Africa's relatively high interest rates. The depreciation of the Rand reflected a number of negative factors, which prevailed during the year. The most obvious of which was the increased global risk aversion associated with the global credit crisis. This resulted in foreigner's selling around R55bn of SA equities during the year, highlighting South Africa's vulnerability to gyrations in foreign portfolio investment. The shock electricity outages in the early part of the year also did not help matters.
- **The technical fair-value for the Rand is around R7.50 to R8.00 to the USD.** This does not imply that the currency will firm back to those levels, but it does provide a useful indicator that the Rand is currently significantly oversold. However, given South Africa's ongoing current

account deficit and the fact that almost all emerging economies are struggling to attract steady foreign capital inflows, this implies that the Rand is likely to remain oversold for the foreseeable future.

- **We currently expect the Rand to end 2009 at around R9.80 to the USD, but importantly, we also expect the Dollar to remain under pressure against the Euro for most of 2009.**

Implications for domestic investors

- The current economic, business and investment environment remains extremely challenging. Approximately 60% to 70% of the world economy is currently in recession, including the US, Germany, UK, and Japan. Key commodity prices have fallen sharply, with the Economist Metal Price Index down 51% in Dollar terms during 2008. South African corporate earnings are under pressure, with much room for further disappointment. Most major companies are now focused on cost containment and we have started to see increased retrenchments.
- The noticeable improvement in the outlook for inflation, coupled with the general slump in economic activity has allowed most central banks around the world, including South Africa, to cut interest rates. Further rate cuts are anticipated in South Africa during 2009.
- At the same time, most countries, including South Africa, are embarking on a program of increased government spending, especially in the form of infrastructural development. The combination of further rates cut and increased fiscal stimulus should provide the basis for a solid economic recovery into 2010.
- Consequently, while we remain cautious on the outlook for most asset class, especially equities, in the short-term (6 months), there is good reason to look to increase exposure to more risky assets, including the equity market, as the year progresses, especially as it becomes clearer that the global economy recovery is taking hold.
- **Now is the time for patience and thorough, consistent, analysis.**

Kevin Lings and Melissa Rankin
(STANLIB Economics and Group Retail Investing)

Rates

The following yields are calculated using an annualised seven-day rolling average as per the unit trust industry standard. These rates are expressed in nominal and effective terms and should be used for indication purposes ONLY.

Standard Bank Money Market Fund

Nominal: 11.68% per annum

Effective: 12.33% per annum

A constant unit price will be maintained. Past performance is not necessarily a guide to future performance. A schedule of fees and charges and maximum commission is available on request from the Manager. Commission and incentives may be paid and if so, are included in the overall costs. The yield is calculated using an annualised seven-day rolling average as at 24 January 2009.

STANLIB Cash Plus Fund

Effective Yield: 12.16%

This is a current yield as at 23 January 2009.

STANLIB Dividend Income Fund

Effective Yield: 9.75%

This is a current yield as at 23 January 2009

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Collective Investment Schemes in Securities (CIS) are generally medium to long-term investments. The value of participatory interests may go down as well as up and past performance is not necessarily a guide to the future. An investment in the participations of a CIS in securities is not the same as a deposit with a banking institution. CIS are traded at ruling prices and can engage in borrowing and scrip lending. Different classes of units apply to this portfolio and are subject to different fees and charges. A schedule of fees and charges and maximum commissions is available on request from STANLIB Collective Investments Ltd (the Manager). Commission and incentives may be paid and if so, would be included in the overall costs. This portfolio may be closed. Forward pricing is used. TER is the annualised percent of the average Net Asset Value of the portfolio incurred as charges, levies and fees. A higher TER ratio does not necessarily imply a poor return, nor does a low TER imply a good return. The current TER cannot be regarded as an indication of future TERs. This portfolio is valued on a daily basis at 15h30. Investments and repurchases will receive the price of the same day if received prior to 15h30 The Manager is a member of the Association of Collective Investments.