

CIO REPORT FOR THE MONTH ENDING 28 FEBRUARY 2010

Wrapping up the month ... Not the Shock we Expected

In the News:

The much anticipated announcement by NERSA that electricity tariffs were to be increased by between 25% and 26% each year over the next three years was well received by the market, given the significantly higher initial proposals. The first round impact on CPI will be small but the increases are still of significant concern to mining and manufacturing who are the major consumers.

Surprise of the month

On the last working day of February Kumba announced that it would no longer recognize the long term procurement agreement with Arcelor Mittal SA (AMSA). This decision was prompted by Kumba's assertion that AMSA did not renew its mineral rights under the new mining dispensation and, as a result, the agreement was no longer valid.

On the Economic Front:

Fourth-quarter US GDP growth was revised upward to 5.9% annualized, driven by upward revisions to the contributions from business investment and inventories.

The 7.2% m/m drop in US existing home sales to 5.05m annualised in January, from 5.44m, means that the boost from the home buyers tax credit has now been completely reversed.

The US Federal Reserve raised the discount rate by 25bp to 75bp, the first step towards normalizing the spread between the discount rate and the interest on the excess reserve rate which is currently 25bp but normally 100bp. There was no change to policy rates which are expected to remain at current levels at least into next year.

The EU embarked on a muddle through solution for Greece, not wanting to over commit given the potential for a number of other EU members who could also progress to basket case status on the back of complacency, but also recognizing the risks to the EU itself if insufficient assistance is provided.

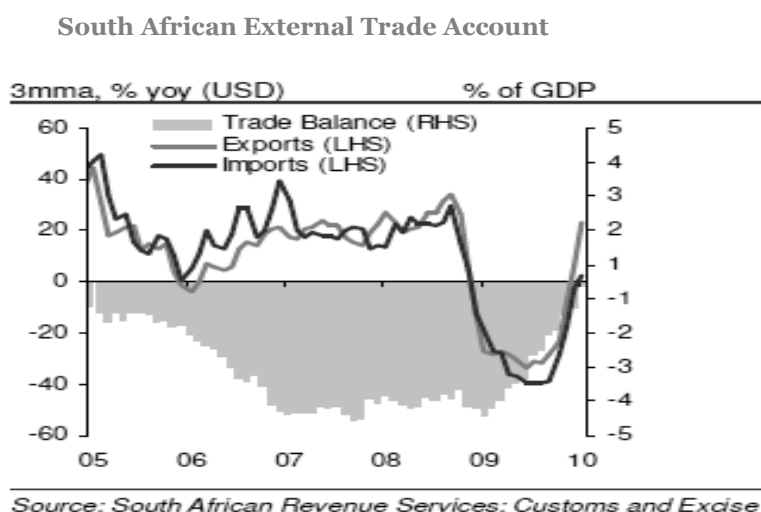
The volatility in MSCI Free World \$ index continued with a gain of +1.4% following January's -4.3% decline. The US was the relative outperformer with the S&P gaining 3.1% while the weak Euro and Sterling saw the Dax (-2.0%), Cac (-2.6%) and FTSE (-1.4%) all slip in US \$ terms. Emerging markets took the middle ground, gaining 0.4% although performances were mixed (Brazil +5.2%, Russia -5.2% and Turkey, as expected, a casualty of sovereign concerns, falling -12.4%).

Commodities were mostly stronger, despite US \$ strength, on the back of the solid Chinese growth story and entrenchment of the global recovery, with Gold (+3.3%), Platinum (+2.6%), Copper (+3.2%), and Nickel (+9.4%) all gaining. Brent Oil (+7.9%) reversed the January fall of (-7.9%).

The US \$ gained against the Euro (+1.7%) and Sterling (+4.8%), the third straight month of strength. The US unit has now gained almost 7% over the Euro in three months. The Rand slipped 1.0% to the US \$ but gained 0.7% on the Euro and 3.8% against the stumbling British Pound.

Local Markets

In South Africa the trade account recorded a seasonal deficit of R3.3bn in January compared to a seasonal surplus of R3.7bn in December. Exports in USD terms were down 18.8% mom (up 34.5% yoy) while imports were down 3.6% mom (down 1% yoy). As result, the 12-month trade deficit has narrowed to \$522mn , -0.2% of GDP, the lowest since 2004. In January 2009 the deficit was at -3.9% of GDP, narrowing every month since then.



GDP growth in 2009Q4 increased to 3.2%qoq annualized rate after 0.9% growth in Q3. This was above consensus of 2.6% with government spending accelerating to 7% qoq annualized and finance 1.1% qoq annualized (the first positive quarter since 2008Q4). Growth for the 2009 full year is estimated at -1.8%

Private sector credit extension declined 1.1% yoy in January. A sharp fall in corporate borrowing and a slow take up of credit by households, led to the fall. The indicator shows that businesses are reluctant to expand operations which could lead to sluggish demand for property across all sectors.

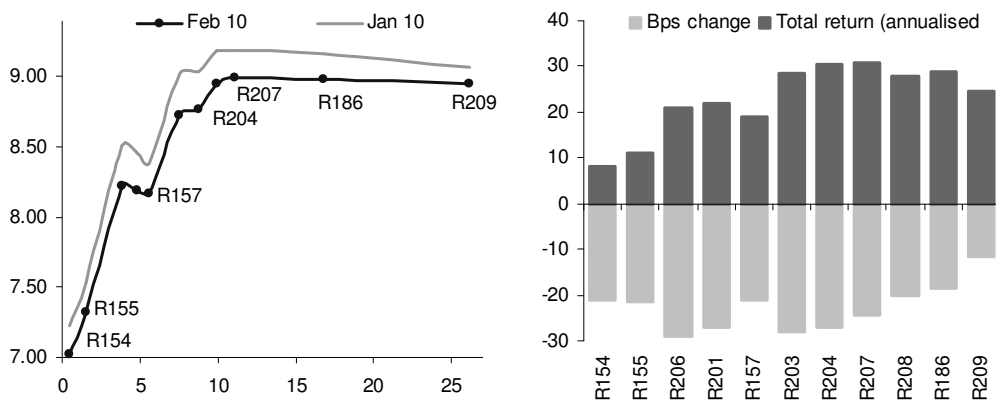
Before we forget, February is Budget month (we will not even mention the State of the Nation address). There was a time when the budget was a major event but the 2010 Budget must rank as the most non-event budget of all time. Recession induced revenue constraints left little wiggle room for Minister Pravin Ghordan who, despite his eloquence, could not introduce any real meat onto the bones of the budget. The end result carefully balanced the need to support the nascent economic recovery in the near term, whilst committing to gradual budget deficit reduction over the medium term as revenues recover and spending growth is kept in check. The plan is to stabilize the debt to GDP ratio at just above 40% over the medium term, a level that is considerably lower than many emerging and developed markets, but still relatively constraining.

The most market sensitive information was probably that the minister made it clear that “the construction of an NHI system requires several parallel reform processes that build on existing resources and capacity in both the public and private sectors. There are many different configurations of national health insurance arrangements around the world. SA needs to develop its own affordable and sustainable reform path. A range of options is being explored.” This suggests that the likelihood of disruptive and hasty implementation of any changes to the current health care dispensation is unlikely in the short to medium term – a sensible approach.

Domestic Fixed Interest: Sizeable bond rally in February

Bonds outperformed the money market handily in February with yields rallying just over 20bp across the curve to produce a 2.0% (26.3% annualised) return for the All bond index against 0.6% (7.2% annualised) for the Stefi. Despite a relatively uniform yield decline across the curve, the 7-12 year and 12 years and over sub-indices outperformed (2.3% each) due to positive convexity while the 1-3 year and 3-7 year underperforming (0.9% and 1.6% respectively).

SA government bond yield curve: yield changes and total returns



Domestic Equities

The JSE All Share clawed its way to a 0.4% gain on the month, underperforming all other asset classes. Major sectors Platinum (-3.9%) and General Miners (-0.2%) contributed to the Resource sector falling 1.0%. Good performances from Industrial Transportation (+12.4%) and Retailers (+6.6%) trumped Beverages (-5.1%) to give Industrials a 1.2% boost and Real Estate (+6.7%) and Life Insurance (+5.0%) offset Banks (-1.8%) to see the Financial sector return 0.6%. The S.A Listed Property Index rose 5.8% over the month.

Anglo American took the opportunity to announce a fairly significant restructuring across the group with a rights issue in both Anglo Platinum and De Beers including debt for equity swaps and also the sale of the Taramac European operations. Although material project risks remain, primarily at Minas Rio in Brazil, there was no significant market response and the moves are viewed as long term positive for Anglo’s (and cynics may say it was spurred in part by Xstrata’s unwelcome approach).

How has our outlook changed?

What is influencing our outlook?

Positive news continues to outweigh the bad and this is providing the necessary underpin for the market to catch up with itself, a healthy part of the consolidation process. Inflation remains of little concern globally (particularly in Europe) and this will keep interest rates low even as other stimulus packages are phased out.

Greece will be resolved, as Dubai was before, and new challenges will be faced and dealt with. The major economic powerhouses such as the US and Germany are clear of recession, China and the developing world in Asia continues to grow strongly which will help Japan and also support demand for commodities which is net positive for both economic activity in South Africa as well as assisting the rand which in turn is positive for inflation.

On balance our outlook has improved – it's not all blue sky but the clouds are dissipating.

SARB MPC: will they cut or won't they?

Budget, inflation positive for bonds despite faltering expectations of a March cut

The long end of the money market curve backed up slightly with the 9 and 12 month NCDs up 10bps, we also saw rate cut hopes subside with the short dated FRA up about 5bp on the back of better than expected economic data. We think that the bond rally was protected from these negative money market trends by a market friendly budget – no changes to monetary policy and a marginal improvement in this year's fiscal projections – plus better than expected inflation data and relief that Eskom's tariff increases were "only" 25% per annum over the next three years.

Fixed Interest

Looking forward, the MPC is likely to be the key focus for this month. Our strategy continues to favour the long end of the money market curve, where rates are higher than fair value, in bonds we believe that risk/reward favours the 3-7 year area of the bond curve, which offers some protection against the potential for rising yields at the long end of the curve, in particular we still believe that the continued improvement in the economy and positive corporate earnings expectations should see credit outperform its government benchmarks all along the curve.

Equities

We remain confident that, despite volatility, equities will outperform other asset classes in the months ahead and thus have kept our marginal overweight exposures. If anything, risk to our position has decreased as the economic indicators are now clearly swinging into growth and the shape of the recovery is largely as expected: the consumer will be a late arrival but, off the low base of Q1 and Q2 in 2009, things will look rosy initially.

We remain underweight offshore given our expectation of continued stability of the rand.

What did we do at portfolio level: Fund Managers' Commentaries

CASH PLUS UNIT TRUST FUND (CIS)

The Fund performed well in the month, comfortably beating the benchmark by 0.4% . This performance was driven by the strong performances by both bonds (ALBI + 2.0%) and domestic property (+5.8%), both of which outperformed Cash (+0.6%).

On the bond side, given our view that risk/reward favours the possibility of higher yields at the long end of the curve, and our constructive view on credit spreads, we have reduced the duration of the portfolio by selling bonds with more than 10 years to maturity and investing the proceeds in corporate bonds in the 3-7 year area of the curve.

Although there were no purchases, relative performance increased Property exposure to 7.8% over the month and bond exposure remained steady. The monthly distribution was enhanced by property income received in the month and the annualized distribution yield rose to 7.4%, 0.2% above the comparable benchmark yield of 7.2% but ahead of the call index return of 6.6%.

The good monthly performance, plus the base effect, resulted in the rolling one year return being 1.0% above the benchmark.

MONEY MARKET FUND

The benefit of holding money market assets with durations longer than the benchmark continues to benefit the fund. Performance for the month was 0.1% above the benchmark.

CAPITAL PROTECTED FUND

The position in the portfolio remains unaltered in that it still has a December 2010 call option on the Top 40 to a notional value of 20% of the portfolio. The top 40 was marginally down in February and in turn this had a slight negative impact on the value of the call option. Including interest, the fund had a positive month delivering a return of 0.4% which marginally underperformed the benchmark by 0.2%.

EQUITY UNIT TRUST FUND (CIS)

The Equity Unit Trust performed below its benchmark by 0.7% as stock selections underperformed. Despite the good performance from BTI, the holdings in Impala Platinum, Sasol and the Banks held back relative performance.

There were cash outflows in the month and as a result a number of holdings were trimmed with only KAP being sold out in full. A small position in Hulamin was opened.

Net equity exposure fell slightly to 96.6% from 97.7% as a result.

GLOBAL BALANCED UNIT TRUST FUND (CIS)

The Balanced Unit Trust marginally underperformed its benchmark by 0.5%, as a result the underweight bond exposure and the below benchmark foreign position where, despite achieving a return of 2.0%, the exposure is at 60% of the benchmark. Equities performed in line with the ALSI.

There were no changes to the equity portfolio and at months close domestic equities stood at 57.1%, slightly above the 55.0% benchmark. Although bonds were traded in the month, bonds remain underweight at 9.9%. Foreign exposure was also unchanged and remains underweight at 8.6%.

On a net basis, the fund remains overweight cash at 23.4%.

DOMESTIC BALANCED FUND

February was a positive month for the equity market primarily driven by the mid caps. The bonds had a very good month. The asset allocation of the fund was the biggest detractor to the relative performance in that the fund is marginally underweight bonds and equities. The total fund delivered a return of 0.5% and underperformed the benchmark by 0.7%, which returned 1.2% for the month under review.

We remained net buyers of equities during the month. The equity component marginally underperformed the SWIX on a relative basis in a month were the SWIX returned 1.0%. The biggest detractors to the portfolio were Hulamin, Impala and Mevelaphanda. The biggest contributors to fund were Accelor Mittal, MTN and Shoprite. The number of counters remained at 42 with existing holdings added to.

The bonds underperformed the ALBI which delivered a return of 2.0%.

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