

Equity Research • Insight

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Houseview

International macro economy

Economic growth

- Developing economies generate economic growth well above that of developed economies. The superior growth is driven by investment and trading with increasing support from accelerating household consumption due to their expanding middle-class.
- Developed economy growth is expected to be constrained by low household consumption. Investment spending should be the leading economic growth driver.
- We do not see a double dip recession developing in late H2:10 and 2011. Developed economy growth is slowing, raising concerns about further weakness in the employment and property markets.
- Developed economy household spending is being restrained by job losses, low income growth and household balance sheet deleveraging.
- Housing markets in the US, UK and EU remain weak despite mortgage rates reaching record low levels. This is due to the household debt overhang, weak house pricing and high levels of unemployment in what is a jobless recovery.
- Global trade continues to recover, driven by increased business spending. Air transport activity continues to strengthen but shipping metrics remain very volatile due to erratic investor participation.

Monetary policy

- Disintermediation continues away from banks toward primary capital markets, mainly corporate and government bonds. Bank lending remains constrained despite apparently adequate capital ratios. Ongoing weakness in the property market and uncertainty about the quality of bank loan book, where loans are held to maturity and have not been marked-to-market.
- Developed economy central banks are expected to maintain their ultra-accommodative policies until final demand starts to demonstrate a sustained pick up in growth. Short-term interest rates remain ultra-low until at least mid-2011.
- The ultra-low short-term interest rates in the US, Japan, EU and UK create cheap financing for developed market investor carry-trades.
- Developed markets create the benchmarks for global interest rates.
- The Fed has indicated that it will not let its balance sheet shrink in the face of the slowing US economy. As the Fed's mortgage assets expire they will be replaced with treasury purchases. Further quantitative easing is expected if the US economy slows below 1.0 percent growth.

Fiscal policy

- Public debt in developed economies is accumulating fast due to a sharp fall off in tax revenues and aggressive countercyclical stimulation. The massive expansion in fiscal deficits seen in H1:2010 in developed economies is expected to decline over the next five years. The fiscal austerity announced to reduce these deficits has undermined the growth outlook in the UK and EU over the next few years. There is a marked difference in approach between the US and Japan, and Europe and the UK. The latter two economies have chosen a course of fiscal austerity to reduce their fiscal deficits with a view to slowing the accumulation in public debt in response to the sovereign debt crisis which emerged in Europe in late H1:10.
- US remains committed to provide supply-side stimulus to support economic growth until it becomes sustainable.
- Currencies
- The global search for yield is causing capital flows from developed to developing economies. In many developing economies, capital and not trade flows are driving their currency strength.
- The current concern regarding the slowdown in growth in developed economies in H2:10 is creating increased risk aversion and resulting in strong capital flows into the USD, Swiss Franc and Japanese Yen.
- Current relative USD strength appears to be driven by risk aversion and greater economic and sovereign debt weakness in Europe.
- Recently announced policy intervention to weaken the Yen appears inadequate in the face of strong capital inflows from exporter repatriated earnings, reversing carry trade due to rising Japanese real interest rates, and Chinese investment in Japanese bonds, as part of their foreign reserve diversification.

Domestic economy

Economic growth

- SA economic growth is expected to be modest led by household consumption as the manufacturing lead is fading and the trade deficit is expanding.
- The strongest area of household spending is in low income groups, where there is high wage growth and exceptionally low income consumer inflation. This is expected to support cash rather than credit retail.
- Gross fixed capital formation growth is expected to remain low, constrained by low rates of private sector investment. SA's large manufacturers currently have spare capacity as their utilisation rate is only 78 percent. The main source of capital formation is expected from parastatals - mainly the electrical utility, Eskom, and road work from Sanral. SA companies are increasingly expanding offshore due to growing domestic regulation and increasing infrastructural challenges.
- Household debt levels are at 80 percent - slightly below record highs. This will continue to be a major constraint on middle-class household consumption growth. SA's lending cycle is in a slow upswing where private sector credit extension is being driven by household mortgage growth and not business growth.
- The current account deficit is widening again driven by imports rising faster than exports. The ZAR is not weakening despite the widening current account deficit. This is because the surplus in the balance of payments financial account plus gold and foreign exchange reserves is greater than current account deficit.

Monetary policy

- Policy remains accommodative with real short-term interest rates below the long-term real 3 to 4 percent level. The consumer inflation target band remains 3 to 6 percent.
- Producer inflation is more cyclical than consumer inflation. Pressure in the inflation pipeline has been building but looks likely to ease in coming months as mining commodity prices soften. Consumer inflation looks likely to come under renewed supply side pressure from utility tariff increases and a sharp rebound in agricultural commodities.
- Despite an increase in issuance, SA bond yields have continued to shrink pulled down by lower benchmark US yields and stronger foreign portfolio demand.

Fiscal policy

- SA's budget deficit is projected at 6.2 percent for fiscal 2011 reducing to 4.0 percent by 2013. The deficit is projected for the next four years at least pushing up public debt levels from a low of 22 percent to GDP in 2009 to 45 percent in 2014.
- Policy is distributive in response to expanding social needs. There is a trend where social expenditure is crowding out capital expenditure.
- Latest data shows fiscal revenue growth stronger than expected due mainly to higher international trading activity. This reinforces SA's bond market fundamentals supporting foreign interest in SA bonds.
- Treasury is facing growing infrastructural backlogs at provincial and particularly municipal level. The latest infrastructural backlog among municipalities is R495 billion.
- The public sector borrowing requirement is expected to remain above R100 billion per annum for the next three years.

Currency

- SA's GDP growth differentials are negative compared with other major developing economies, especially the BRICs.
- SA's inflation differential with developed economies is expected to narrow until early 2011 when it is expected to start widening again.
- SA's current account deficit looks likely to stay above 5 percent per annum for the next five years.
- Foreign portfolio inflows are offsetting the widening current account deficit and in doing so sustaining ZAR strength against developed economy currencies.
- The current sharp pickup in M&A activity is not expected to materially strengthen the ZAR. The capital inflows resulting from some of these deals are likely to be routed outside the currency trading market.

Commodities

- Physical commodity demand growth in developing economies is expected to continue even if at a slightly slower pace in H2:10. Their demand for raw materials remains above developed economies due to the expansion of production and infrastructure, compounded by their accelerating consumption base and widening middle class.
- The long-term outlook for energy and metal commodities remains compelling. Inventory adjustment in response to the H2:10 slowdown combined with reduced investment demand is causing the current softness in prices.
- Crude oil price range bound between \$70 and \$80 per barrel in the slowdown in H2:10.

- Agricultural soft commodities (wheat, sugar and coffee) are rising in response to supply side problems associated with drought and logistics.
- Industrial commodities are likely to weaken in the face of slowing H2;10 developed economic growth.

SA equity market

- Current equity market weakness is due to increased fear of a double dip in developed economy growth, especially in the US. Increased risk aversion associated with slowing US economic growth and concerns about sovereign debt issues in Europe are undermining US equity markets.
- The massive size and liquidity of the US equity market dictates that international equity markets are highly correlated with its movement.
- SA EPS growth over next 12 months is forecast at 37 percent and 16 percent in the year thereafter. The high growth in year one is due to resources in general and mining in particular.
- The current All Share forward price earnings ratio of 9.6 times is cheap relative to the long-term average of 11.8 times.
- Foreign equity portfolio inflows are expected to continue but at a substantially slower pace than in 2009. The thrust of inflows are expected to be directed into bonds in the current risk averse equity environment.
- M&A activity has picked up markedly in international markets injecting additional volatility into the All Share index.
- Trading volumes in the SA equity market are expected to remain below R10bn per day due to reduced foreign participation and an expected shift in domestic asset allocation in favour of fixed income assets.
- Dual listed and resource stocks dominate the SA equity market.

Equity investment strategy

- Overweight emerging market exposure.
- Focus on defensive dual listed with strong emerging market exposure.
- Overweight new technology exposure in media and mobile telecommunications
- Underweight resources.
 - Maintain a slight underweight in dual listed miners. Underweight gold and platinum
 - No earnings support is expected in H2:10 from revenue ZAR hedges.
 - Overweight exposure in bulk raw material used in the production of carbon steel (iron ore and coking coal).
 - Underweight industrial metals due to softening commodity prices, no support from the ZAR, and increasing domestic regulatory and infrastructural issues.
- Underweight financials.
 - Underweight banks. Focus on consumer and not business banking.
 - Overweight exposure to micro-lending.
 - Underweight investment banks due to weakening equity markets, tougher trading environment and reduced asset management performance fees.
 - Underweight life insurance due to weaker capital market performance.
 - Overweight short-term insurers due to expanding vehicle sales and recovery in the underwriting cycle.
 - Underweight real estate and be selective in defensive highly traded counters.

- Overweight industrials
 - Overweight defensives - healthcare, tobacco and beverages
 - Overweight general retailers and cash-oriented apparel retailers. These stocks are not cheap but offer earnings momentum.
 - Overweight deep cyclical retail like furniture to capture the slow recovery in private sector credit extension. These stocks have more cyclical gearing the banks.
 - Underweight capital formation sensitive sectors such as construction, electrical and electronics. Private sector investment rates are very low and public spending remains necessary but slow.
 - Be selective in business cycle industrials. Overweight motor vehicle retailers/distributors. Underweight industrial engineering due to slowing manufacturing growth. Underweight chemicals due to sluggish economic growth. Overweight industrial transport due to strong vehicle sales and expanding logistics demand.
 - Neutral weight support services due to low revenue growth but strong cash flows supporting dividend growth.
 - Overweight mobile telecommunications for moderate revenue growth, acquisition potential and increasing cash flows and dividend payouts.
 - Avoid fixed-line telecommunication due to intensifying competition and strategy uncertainty.
 - Underweight leisure and travel due to weak casino revenue growth and high base effects in the travel industry created by the World Cup.

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