DAVIDSON

HELPING YOU MAKE THE RIGHT FINANCIAL DECISIONS FOR YOUR FUTURE!

2009 - A year of two parts!

The year began with plenty of pessimism. Both South African and International Investment Markets were reeling from what was touted as the worst economic crisis since the Great Depression.

The melt down of the Global Financial Markets in the second half of 2008 was termed a "1 in 80" year event. Not since the end of WW2 has the world seen such a decline in investor confidence.

The 2008 snapshot was:

SOUTH AFRICAN MARKETS		INTERNATIONAL MARKETS	
FTSE/JSE All Share	-23.2%	S&P 500 Index (US)	-38.5%
FTSE/JSE Financials	-25.7%	Dow Jones Index (US)	-33.8%
FTSE/JSE Resources	-28.4%	FTSE 100 Index (UK)	-31.3%
FTSE/JSE Industrials	-15.7%	Nikkei Index (Japan)	-42.1%
BESA All Bond Index	17.0%	MSCI World Index	-40.3%
SteFi	11.6%		

(*Source: I-Net)

In an attempt to avoid the next "Great Depression", 2009 saw leading central banks respond with now well documented stimulatory packages. By the beginning of March 2009 markets had reached the maximum point of pessimism – then everything changed. And what a change that was! It was definitely a year of two parts, the first two months and the next ten months.

Investors who held their nerve and stuck with their investment strategy were handsomely rewarded in 2009 – especially in the second part of the year!

The two parts of 2009 were:

First two months 2009	First 2 months	Last 10 months
FTSE/JSE All Share Index	-13.70%	53.11%
Shareholder Weighted Index (SWIX)	-13.74%	50.61%
BESA All Bond Index (ALBI)	-5.19%	4.43%
Short-term Fixed Interest Call Index	1.71%	6.54%
SA Listed Property Index	-3.89%	18.68%
MSCI World Index (Global Equities)	-9.00%	15.29%
Global Bond Index	2.09%	-17.24%
90-day US Treasury Bill	8.68%	-26.60%
One-Month UK Treasury Bill	7.91%	-16.63%
One-Month French Treasury Bill	-8.65%	31.74%
Rand/Dollar Appreciation	3.80%	2.16%
Inflation CPI (Nov 2009)	-13.70%	53.11%

So what does the longer term picture show?

As at 31 December 2009	1 Year	3 Years	5 Years
FTSE/JSE All Share Index	32.13%	6.53%	20.25%
Shareholder Weighted Index (SWIX)	29.91%	6.31%	19.37%
BESA All Bond Index (ALBI)	-0.99%	6.48%	7.12%
Short-term Fixed Interest Call Index	8.36%	9.62%	8.51%
SA Listed Property Index	14.07%	11.30%	21.57%
MSCI World Index (Global Equities)	4.91%	-3.69%	8.25%
Global Bond Index	-15.51%	8.85%	10.18%
90-day US Treasury Bill	-20.23%	3.49%	8.53%
One-Month UK Treasury Bill	-10.04%	-1.35%	6.11%
One-Month French Treasury Bill	-17.06%	7.62%	9.79%
Rand/Dollar Appreciation	20.35%	-1.46%	-5.50%
Inflation CPI (Nov 2009)	6.04%	8.48%	6.82%

The above tables highlight the following:

- International investors that panicked out of SA equities into the "safe haven" of US treasury bills, yielding basically nil in dollar terms, really lost out;
- Time tested growth assets of equities and property once again delivered over one year and five years and to a degree over three years which includes 2008 as one the three years; and,
- The yield on bonds (in particular SA Bonds) does not justify the risk.

Markets have started seeing a turn-a-round in risk aversion and positive economic growth rates coming through. We would however caution that the recovery does remain fragile and markets are likely to remain volatile for a continued period of time.

What can we expect going forward?

So, we know that 2009 was almost a complete reversal of 2008! What does 2010 hold in store for Investors?

- Consensus says we should have a strong Rand until after the World Cup with the Rand ending the year at around R8.10 to the US Dollar;
- Inflation will be hampered by proposed increases in electricity tariffs;
- Property and equities being the preferred asset classes for 2010.

Inflation is a big challenge! The middle class is bracing for a difficult 2010. Families will have to find additional cash to cover inflation plus price hikes in regulated goods like electricity, water and municipal rates – and won't be able to rely on salary increases or bonuses to get by.

Key Economic Factors for 2010

- The Global recovery appears to have gained traction;
- US housing market shows signs of recovery;
- Main economic problem of 2010 facing the Central Banks is when to withdraw their financial support and at what rate;
- South Africa appears to be slowly exiting the recession;
- The Governments three year infrastructure spend is set to continue beyond the World Cup; and
- Consensus is that the Rand will depreciate modestly reaching around R8.00 to the UD Dollar by year end.

The Economic outlook for 2010

The **global recovery has gained traction** and financial markets worldwide have posted impressive recoveries. Although many economies remain fragile, forward looking **economic indicators point to a further improvement in economic conditions during 2010.**

The key factor leading to the recovery has been the massive stimulus provided by expansionary economic policies (both monetary and fiscal), and the fading drag from the financial credit crisis.

The **US housing market**, which was at the heart of the global credit crisis in 2008/2009, has also improved; after a dramatic and protracted collapse in 2008. In particular, new and existing home sales have risen noticeably, while the average house price in the US has increased for six consecutive months. The rise in home sales over the past year has meant that the massive inventory overhang in residential property is starting to ease.

This does not mean that the housing market is overwhelmingly on the road to recovery. Homes sold as foreclosures remain extremely high, and there are numerous houses still at risk of default / foreclosure. Nevertheless, the housing market does appear to have stabilised, with clear indications that an improvement is underway, albeit off a very low base.

The **large emerging economies** (BRIC countries) continue to attract a great deal of attention, with Brazil and China currently at the core of that focus. Economic activity in **China** is actually accelerating, especially domestic expenditure. China's GDP grew by 8.9% year-on-year in the third quarter of 2009 and is up an impressive 7.7% year-to-date. All of this activity is domestically driven, with exports declining by an average of 20% year-on-year in the three months from July 2009 to September 2009 (chart 12). Despite the fall-off in exports (which has more recently improved a little), China is well on track to achieve at least 9% GDP growth for 2010 as a whole.

Brazil has rebounded impressively, after experiencing a sharp decline of 11.2%q/q (saar) in the final quarter of 2008 and a decline of 3.5%q/q (saar) in the first quarter of 2009. The economy's quick turnaround was driven mainly by substantial policy stimulus and the recovery of exports, despite the currency having strengthened by over 30% against the US Dollar in 2009.

The chief driver of exports has been increased demand for commodities from China. Although the run-up to next year's presidential election could hamper necessary changes to the current economic policy stimulus, the current growth rate of around 5% is set to continue in 2010.

At the start of 2010, the **main global economic uncertainty** is the timing and impact of a withdrawal of the unprecedented financial support, monetary accommodation and fiscal stimulus measures adopted by the US, UK, Europe and other countries to deal with the crisis. This uncertainty includes:

- A potential slump in economic activity in late 2010 and early 2011 should the withdrawal of the extreme financial support measures stall the recovery
- The risk that as the current liquidity levels are reduced, asset prices are viewed as over-valued
- The re-pricing of risk, especially corporate bonds, as the market assess the withdrawal of direct government support
- Worries about high government debt and large budget deficits in mature market countries; for example Greece.

It is therefore vital that the stimulus is withdrawn gradually and in conjunction with further evidence of the sustainability of the recovery; especially an improvement in labour market conditions.

The general view is that while there is evidence of a reasonable economic recovery that should unfold more fully over the next 12 months, **there are a number of factors that suggest that world growth (especially in the developed world) could lack acceleration into 2011**. These include continued conservatism by banks and households, a withdrawal of the extreme fiscal and monetary policy stimulus, increased cost of financial regulation, persistently high levels of unemployment and low levels of fixed investment, given the current excess capacity.

South Africa

Economic activity in South Africa appears to have stabilised, with very modest signs of improvement in a few key sectors. SA GDP rose by an encouraging 0.9% quarter-on-quarter in Q3 2009. This compares with a decline of -2.8% quarter-on-quarter in Q 2 2009 and a drop of -7.4% quarter-on-quarter in Q1 2009. The improvement in the economy during the third quarter was mainly due to a pick-up in the manufacturing sector off an exceptionally low base, following the massive depletion of excess inventories in the first half of the year. The construction sector also continued to show solid growth. This sector has now experienced 34 quarters of uninterrupted growth, making it South Africa's best performing sector since 2000.

In contrast, retail trade and financial services activity continued to slump, highlighting the plight of the consumer. Consumer spending remains under enormous pressure, with little sign of any real improvement. According to Stats SA, the economy shed around 770 000 jobs in both the formal and informal sectors over the past year. The sustainability of South Africa's economic recovery into 2010 is highly dependent on a pick-up in consumer spending, which itself is linked to consumer confidence and employment conditions.

Consumers are still effectively deleveraging, although some banks have indicated a willingness to slowly relax lending criteria. This pressure is really due to a combination of historical factors including prior increases in interest rates, a sharp decline in disposable income growth, tighter lending criteria within the banking system, a decline in house prices and increased job-losses. While this pressure will remain a factor for many more months, there is an expectation that the pressure will systematically ease during 2010. This expectation is based on the current low interest rate environment being sustained well into 2010, a further moderation in inflation (at least in the short-term), wage increases that are now rising above inflation (leading to a real increase in consumer income), less job losses as world growth (SA exports) improves and there is a natural boost that is associated with hosting the Soccer World Cup. There has also been a more positive wealth effect this year, with house prices starting to turn positive and equity market up handsomely, after a disastrous 2008.

It is clear from the latest GDP data release that **South Africa is slowly exiting the recession**. However, the recovery is not yet broad based and remains fairly fragile. Fortunately, South Africa's leading economic indicator is clearly moving in a positive direction, and there is a reasonably good relationship between the SA leading indicator and overall economic activity

This relationship suggests that the SA economy should recover more fully into 2010. For 2009 GDP is expected to have slumped by around 1.8%, but is then expected to expand by around 2.5% in 2010.

Unlike many of the developed countries in the world, South Africa already has a well **advanced infrastructural development programme**, with many major projects currently well underway. South Africa's fixed investment spending has risen from a low of 15% of GDP in 2002 to 22% of GDP currently. This has been South Africa's biggest economic success story in the past 5 to 8 years. As a result, the construction sector in South Africa has been the fastest growing industry, averaging real growth of 9.9% a year since 2002. More recently, most of this growth has been due to increased government investment spending, with public sector investment spending rising from a paltry 4% of GDP in 2002 to almost 9% of GDP in the middle of 2009. While not all of this increase relates to the World Soccer Cup, a significant portion of the rise has been spurred-on by the preparation for the World Cup. More importantly, government's three year budget for infrastructural spending clearly indicates that the current high level of infrastructural development is set to continue after the World Cup. In fact the 2011/2012 budget for public sector infrastructural activity reflects an increase of over 11% year-on-year, to almost R300 billion.

South Africa's **export volumes** rose encouragingly in Q3 2009, up almost 3%q/q, after dropping by more than 3% in Q2 and by a shocking 19%q/q in Q1 2009. The improvement in export volumes occurred despite the strong Rand, but clearly South Africa's balance of payments could have benefitted so much more from the higher commodity prices had the Rand not strengthened so significantly.

Looking forward into 2010, although SA exports have started to improve they are likely to struggle to accelerate significantly given the still strong Rand and sluggish world economic recovery. Fortunately, from a balance of payments perspective, import demand is also expected to remain fairly modest given the still weak domestic economy. This implies that although the trade balance is likely to weaken over the coming few quarters, this deterioration should be fairly modest. Given that we expect the services account deficit to widen only gradually, **the current account deficit should, therefore, hold onto the improvement that has transpired in the past few quarters**.

Looking further out, there is little doubt that South Africa's import demand will rise noticeably as the country continues with an extensive, and possibly unprecedented, infrastructural development programme. Consequently, the trade account is set to move back into deficit. 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.

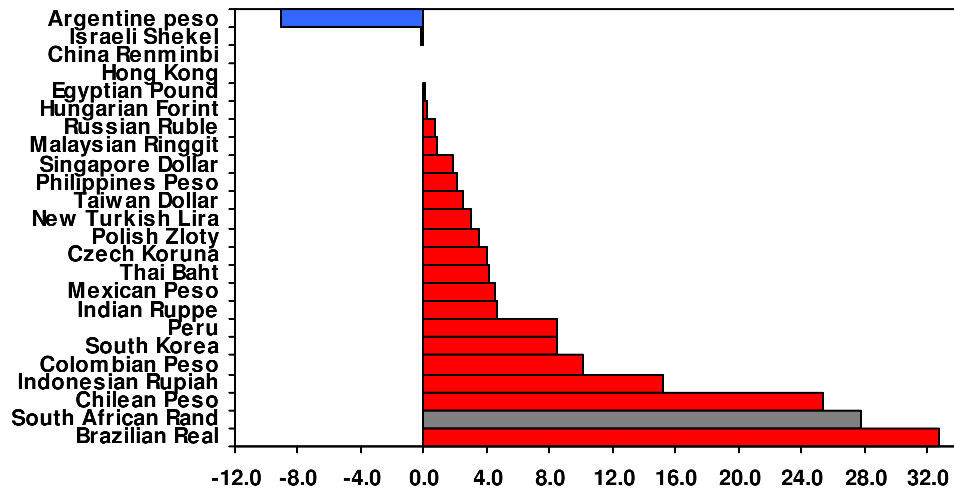
The annual rate of inflation moved back into the target range during October 2009 after being outside the target for 30 months. Although the rate of inflation is expected to move noticeably higher during the period December 2009 to January 2010, mainly for base effect reasons, it is then expected to move convincingly back into the target range during the early part of 2010, helped by lower food inflation. Later in 2010, there is a risk that inflation could move back outside the target, but this trend will be highly dependent on the electricity price increase that is to be concluded during the early part of 2010 and implemented around the middle of the year.

After cutting interest rates by a substantial 500bps from December 2008 to August 2009, the Reserve Bank opted to keep rates on hold during the final months of 2009 and will most likely decide to keep rates on hold until well into 2010. Although the economy has been extremely weak, the Reserve Bank remains concerned about the recent rise in wage demands as well as the pending increase in electricity prices. Fortunately, from an inflation perspective, the Rand has remained firm, while global inflation is extremely subdued.

In 2009 the Rand was the second best performing emerging market currency, rising by 27.7% against the USD. The best performing currency was the Brazilian Real, which gained a massive 32.7% against the Dollar. Most emerging market currencies gained against a weakening Dollar in 2009; although the Dollar actually weakened by only 2.4% against the Euro during the year.

In the past year, the Rand has been supported by a number of factors, besides Dollar weakness and the fact that the currency was oversold in 2008. (The Rand was the worst performing emerging market currency in 2008). These include, strong net foreign portfolio inflows in the South Africa equity and bond markets (+R76 billion into equities during 2009 and +R20bn in bonds), the trade account moving from a persistent deficit into a consistent surplus, and a reduction in foreign dividend outflows due to a reduction in SA company earnings.

The Rand is forecast to depreciate modestly against the Dollar in 2010, ending the year at around R8.10. This weakening bias reflects the expectation that South Africa's trade account will systematically weaken next year due to increased imports, while foreign investment inflows are not expected to be as robust in 2010, given the exceptionally strong inflows during 2009.



Conclusion

What a difference a year makes. The intense fear of a global banking system collapse at the end of 2008 has been dispelled and replaced by cautious optimism for a modest global economic recovery in 2010. The key risk to recovery is the timing and extent of the withdrawal of the unprecedented monetary and fiscal policy stimulus that was introduced in late 2008 and early 2009.

Emerging economies are firmly in the spotlight. The major emerging economies, with the exception of Russia, out-performed during 2009, attracting significant foreign investment inflows as global risk aversion dissipated. Policy management has proved effective, with most emerging economies managing to avoid the worst of the global credit crisis; although that was not necessarily by design.

As far as South Africa is concerned, the combination of a global economic recovery, sustainably low domestic interest rates, the hosting of the **2010 Soccer World Cup (which is estimated to add around 0.4 to 0.7 percentage points to SA GDP growth in 2010)**, ongoing infrastructural activity and a sound banking system should provide the basis for a solid, albeit somewhat unexciting, economic recovery in South Africa during the next 12 months.

Source: Kevin Lings, Chief Economist at Stanlib

Interesting snippets from the press

The Times, London published an article that proposed a theory that "market cycles move in phase with the moon". The article goes on to say that they now, backed up by decades of data and behaviour which can no longer be explained purely by rational analysis, the lunar theory has slipped into the mainstream. A company called Macquarie Securities has arrived at this "startling discovery" using research involving 14 senior analysts across five leading financial centres scrutinising data from 32 leading indicies over several decades. Two academic studies have found that returns around the new moon phase are nearly double those of corresponding full moon phase.

The report acknowledges that investors are unlikely to adapt their strategies to fit the new research and concludes that the relevance of the theory is "probably slightly more powerful than, say, better than good value stocks outperform in the long run".

Extracts from: "Crisis aside, the US is still the envy of the world" by Dr. White, a research associate at the South African

Institute of International Affairs:-

Talk of US decline is in vogue. Such talk has become especially popular with the powers, most notably China.

The financial crisis and the recession that followed support the notion of US economic decline and, along with it, the end of an idea: free-market economics and US-led globalization.

Such talk of waning US power and economic decline is not new. In the 1950s and 1960s, US dominance was challenged through the space race with the Soviet Union and war in Vietnam. The 1970s oil crisis triggered widespread skepticism in the US, much like the crisis today.

US economic might was challenged by both Japan in the 1980s and the European Union in the 1990s.

But just look at where all these players are today. If anything, the challenge of American supremacy in previous decades served to ignite productivity and innovation in a nation built on these very same virtues.

The big question is: can the US do it again? White megafinancial corporations in New York may be largely to blame for the financial crisis, US economic decline is most evident in Middle America.

This is the belly of the best, where the credit crunch and growing unemployment have crippled the manufacturing workshop and the breadbasket of a nation.

China may well emerge from this crisis more developed and more economically powerful, while the US is likely to be a battered and bruised giant in need of a dramatic makeover.

While China may become the global industrial powerhouse by 2015 and its economic size may reach that of the US just 20 years later, it will take China and any other emerging power a lot longer to reach US levels of human development and comfort. The US university system, for example, is light years ahead of any other country in the world.

The US may be in decline, but it is still a powerful and enduring force. The assumption that it will be replaced by an alternative power such as China may be premature.

Western-style values also carry enormous appeal. These attributes, along with the sheer size, capacity and capability of American economic might, should not be underestimated

And lastly, "It's not about being right all the time, but enough of the time"… from Michel Pireu's "Street Dogs"

While amateurs go broke taking large losses, professionals go broke by taking small profits – William Eckhardt.

Some people are convinced that being right is the single most important prerequisite for success in the stock market. Others will try to persuade you that they're right nearly all the time. In which case, you're either talking to the world's best investor; someone who's enjoying a classic case of beginner's luck or a liar.

The first, of course, is highly unlikely. Fortunately it's easy enough to check. The second scenario is a lot more likely. A while back, just about anyone could make a profit as share prices kept climbing. It's not that easy anymore. A lot of those people learnt an expensive lesson.

Still, the more likely scenario is that of the liar.

The plain and simple truth is that nobody can make investment decisions that always (or nearly always) turn out to be right. It's simply not possible.

What is possible is to be right more often that you're wrong. And, more importantly, to make bigger gains when you're right than losses when you're wrong.

The solution is surprisingly simple : cut your losses and let your winners run.

A quote that proves that the future is not ours to see …

"Tiger Woods never does anything that would make himself look ridiculous" – Golf Digest, January 2009 issue.

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