

Overall summary

- Risky assets initially rallied at the beginning of 2010 but soon reversed its gains as China announced measures to curb its economy.
- A stark contrast has emerged between emerging countries (particularly Asia) and advanced economies; where the former are enjoying strong growth and the latter are still suffering from the impact of the recession.
- Relative to advanced economies, China has made gains during this recession and concluded 2009 with a growth rate of 8.7%.
- Fears of an overheating economy have led Chinese authorities to mop up some liquidity in the system through measures like raising reserve requirements.
- Compared to strong Chinese growth, advanced economies are still struggling; consumption expenditure remains weak and while stimulus measures dwindle, these economies will be under more pressure.
- Advanced nations are faced with tough decisions as they attempt to ensure fiscal sustainability in the face of ballooning national debt levels.
- Rising default risks in Greece have raised the alarm on finances in the euro zone.
- As expansionary monetary and fiscal policy comes under threat, so will returns from risky assets.

Commentary

Financial markets

- Risky assets experienced considerable volatility during the first month of the year.
- During the first half of the month resource stocks as well as some commodities rallied in excess of 6% but soon lost its steam and reversed the gains. Specifically, the FTSE JSE All Share index fell 3.5% for the month, pulled down mainly by a 6.4% fall in resource stocks.
- The reversal in stock performance was largely as a result of news from China, which pointed to policy measures instituted to douse the galloping economy.
- This speaks to the dichotomy in global economic performance between emerging and advanced economies. The latter are widely expected to end 2009 deep in the red while emerging markets are expected to record positive growth for 2009.
- Furthermore, emerging markets entered the recession with healthy debt levels, while the opposite is true of advanced economies.
- The impact of this is that 2010 and beyond evidence is likely to show emerging markets continue to shine while advanced economies will continue to produce subpar growth levels as it attempts to bring down unsustainably high debt levels.
- The report this month will focus on this dichotomy; first by highlighting the strength of China and then contrasting that to the experience of advanced economies.

The Chinese growth engine is firing on all cylinders

- The Chinese economy proved to be resilient against the global recession, registering a growth rate of 8.7% for 2009. This was boosted by quarter 4 GDP growth of 10.7%.
- While advanced economies were mired in recession, China actually made gains during this recession. A particularly notable gain is that China has surpassed Germany to be the world's largest exporter – a position that China is likely to maintain for years to come.
- Furthermore, China has surpassed the United States with respect to car sales.
- The stark contrast of Chinese growth relative to advanced nations is illustrated in figure 1.

Figure 1



Source: Economist.com

- These developments have come on the back of exceptional stimulus measures that have many concerned about this economy overheating.
- On the onset of the global economic crisis, Chinese authorities rolled out an unprecedented \$586 billion stimulus package.
- Furthermore, Chinese bank lending of \$1.4 trillion in 2009 alone has led to speculative activities in property and equity markets.
- Effects of this are starting to show as inflation rose 1.9% from December 2008 to December 2009. In response to this the central bank has started to remove liquidity from the system by raising banks' reserve requirements.
- This weighed heavily on risky assets, as investors began selling on the fear that the Chinese central bank would raise official interest rates halting this powerful growth engine.
- The Economist recently wrote that the central bank would likely raise rates when inflation breaches the 3% level; something that it reckons could happen as soon as February¹.
- China continues to come under pressure to revalue its currency as detractors of this nation's growth argue that its export strength lies in its artificially valued currency.
- Currently 6.82 yuan buys \$1; a rate that has been in place since 2008.
- The Economist notes that in 2009, Chinese officials

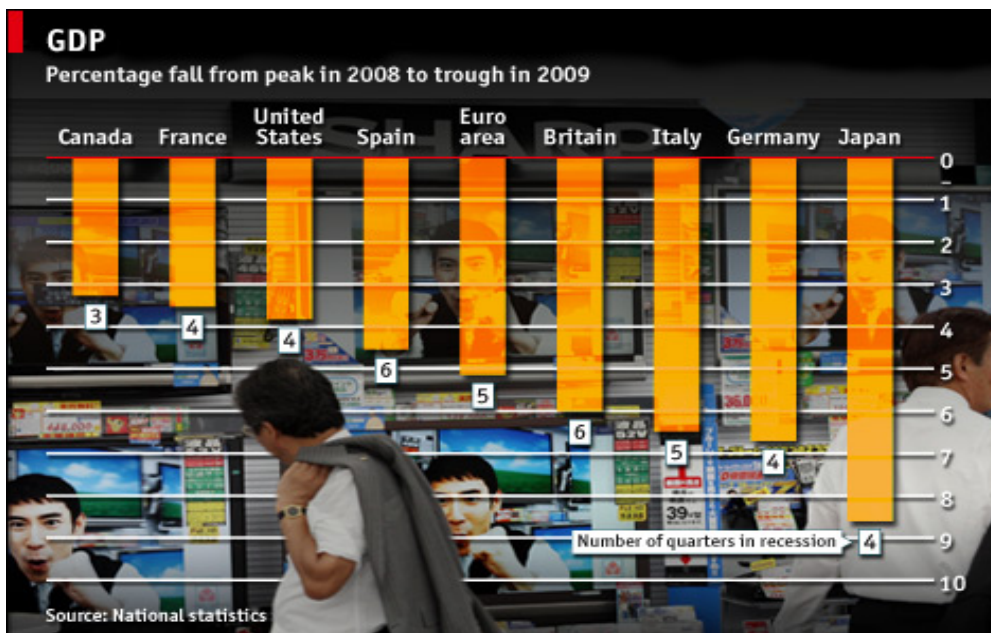
argued that it had to hold the yuan stable against the US dollar due to falling exports, weak GDP, as well as negative inflation.

- Given that exports, growth and inflation have rebounded convincingly, it will be interesting to see how the issue of the currency plays out and more particularly how Chinese export performance is impacted.
- Prospects of tighter policy in China led to equity and commodity markets taking a heavy knock in January 2010.
- The Dow Jones Industrial Average as well as the Morgan Stanley Emerging Markets index both made gains at the beginning of the month, only to reverse due to heightened risk aversion. The Dow finished the month down 3.5% while the Emerging Market index fell 5.6%. News of positive growth in key developed markets could not stem the selloff.

Advanced economies bear the brunt of this recession

- In sharp contrast to China's potential overheating, advanced economies continue to look anaemic.
- Most advanced economies exited recession in quarter 3 of 2009.
- The Economist provides an excellent graphic, figure 2, which reflects the severity of this recession on advanced nations. Specifically, it depicts the percentage fall from the peak in GDP in 2008 to the trough in 2009.

Figure 2



Source: Economist.com

¹www.economist.com

- Japan suffered the largest contraction over this period, where GDP fell by 8.6% from peak to trough over four quarters. In contrast, Canada was the best performer of the G7 nations; posting a 3.3% contraction from peak to trough over three quarters. This is largely a reflection of Canada's commodity wealth that has benefitted from Chinese demand.
- Another notable point is that unlike the majority of the advanced nations, the United Kingdom, as well as Spain, failed to exit the recession in quarter 3.
- Statistics on the fourth quarter outcome are not available for Spain as yet, but recently Britain announced 0.1% growth for the final quarter of 2009.
- In as much as there was relief that the longest post-war recession was over, there was disappointment about the magnitude of the rebound, as expectations were pegged around growth of 0.4%.
- For the full year, UK economic growth fell 4.8%, just shy of the contraction of 5.1% recorded in 1931.
- The US reported better than expected quarter 4 GDP numbers.
- A resounding 5.7% growth rate was recorded, beating expectations of a 4.8% growth. Despite this news, the markets failed to be inspired due to the composition of the rebound.
- The Bureau for Economic Analysis (BEA) highlights that the pick up in real GDP growth reflected a slowdown in the rate at which businesses drew down inventories; while inventories were drawn down for the seventh straight quarter this was much less than in quarter 3.
- Another contributor was the slowdown in imports (a subtraction in the calculation of GDP).
- All in all these contributions to real GDP growth were partially offset by slowdowns in federal spending, consumer spending, and residential housing in quarter 4.
- For 2009 as a whole, real GDP fell 2.4% after 0.4% growth in 2008.
- The BEA notes that the downturn in 2009, as a whole, reflected downturns in business investment and exports, and larger declines in inventory investment and consumer spending. The latter is in line with a rising personal savings rate, which now stands at 4.6% for the US economy.
- The current rebound in US GDP is a factor of restocking where business had previously cut production severely and are now building up inventories to more normal levels.
- A critical issue is that demand must improve to sustain the economic recovery.
- Poor growth in consumption expenditure continues to be a risk for US growth. This rose by 2% from quarter 3, a number below the increase of 2.8% recorded in the previous quarter.
- It is difficult to foresee a rebound in consumption expenditure in the face of a rising savings rate, still high unemployment and fiscal consolidation.

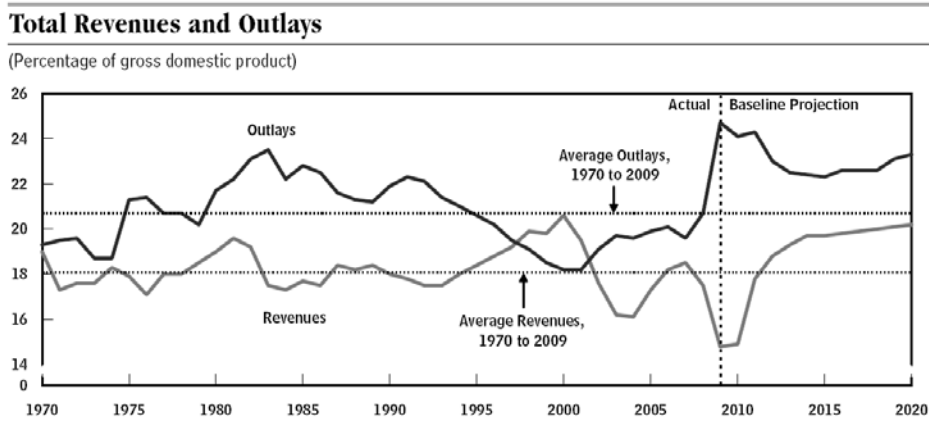
Fiscal consolidation is one of the big themes of 2010

- Fiscal consolidation is likely to be one of the great themes of 2010.
- Governments around the globe increased expenditure in an effort to avert or minimise the impact of recession. In so doing, the many issued bonds pushed up national debt levels. Bringing these debt levels back to sustainable levels is likely to be a difficult exercise.

National finances of the US and Greece.

- The US budget deficit ballooned in 2009 and there is only a slight improvement expected for 2010.
- In 2009, the US reported the largest post war deficit on record; a deficit of \$1.4 trillion or 9.9% of GDP.
- The US Congressional Budget Office (CBO) has recently announced budget estimates for the forthcoming year; the federal budget is set to show a deficit of about \$1.3 trillion for fiscal year 2010, which is 9.2% of GDP.
- The CBO also mentions that these accumulating deficits will push federal debt held by the public to significantly higher levels.
- At the end of 2009, debt held by the public was \$7.5 trillion, or 53% of GDP; by the end of 2020, debt is projected to climb to \$15 trillion, or 67% of GDP.
- With such a large increase in debt, plus an expected increase in interest rates as the economic recovery strengthens, interest payments on the debt is poised to skyrocket.
- The CBO projects that the government's annual spending on net interest will more than triple between 2010 and 2020.
- Figure 3 highlights the evolution of revenues and outlays in the US. It becomes clear that in 2009, outlays (expenditure) far exceeded government revenues, bringing about the above mentioned federal deficit.

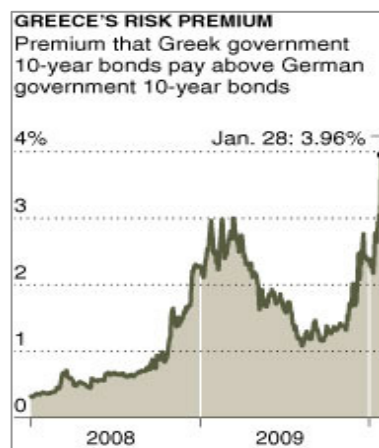
Figure 3



Source: Congressional Budget Office

- Recently, President Obama delivered his state of the nation address where he made promises to freeze non-security spending for three years.
- The Economist notes that once military spending and entitlements (like government-provided health insurance for the poor and the elderly and Social Security) are stripped out, less than a fifth of the budget is left to freeze; and that freeze would be counteracted by the jobs bill that Mr Obama urged Congress to pass². This simply illustrates the difficulty in policy decision making in an environment of restrictive fiscal policy.
- The US is not alone in making these tough decisions; Greece is another country in the spotlight due to its burgeoning deficit.
- The New York Times³ recently wrote that shortly after Abu Dhabi rescued Dubai, prominent European nations also face the prospect of bailing out Greece. Furthermore, the market has pronounced swift and brutal judgment on Greece via the premium now required above German bonds, figure 4. By the end of January, Greece's risk premium (a measure of the risk investors perceive in Greek debt) rose to 3.96%; the highest level since the euro was adopted.
- The New York Times states that this move by the market is a reflection of the scepticism around the practicality of Greece's plans to reduce the 12.7% deficit to 8.7% of GDP this year and eventually to within the EU limit of 3% of GDP by 2012.
- The Greek economy makes up 2.5% of GDP in the euro zone. The Economist notes that Greece is likely to require €51 billion this year, to cover its budget deficit, to roll over its short term borrowings and to redeem its maturing longer term debt; much of which comes due in April and May.
- The outcome of Greece's bail out will become clear early in February when the European Commission assesses the state of this nation's finances.
- The critical issue of course is that of contagion, if Greece falters what about other European nations like Portugal and Spain?
- Spain has yet to emerge from recession and has the highest unemployment rate in the euro area at 19%, while Portugal's budget deficit is running at three times the EU limit at 9.3% of GDP in 2009.

Figure 4



Source: Bloomberg The New York Times

²www.economist.com

³www.nytimes.com

- A clear reflection of the shift in global power and dynamics in favour of emerging markets, China in particular, is evidenced by recent rumours that Greece has asked China to buy up €25 billion of its debt. Apparently Greece had tried to place its debt with China and failed. The Greek finance ministry has denied these allegations.
- Nonetheless, what is clear is that we are witnessing the most powerful reassessment of global dynamics that will irrevocably alter the way that we do business.
- Threats to the expansionary policy (as in the case of China raising reserve requirements) will spook the market with global and local equities, as well as resulting in commodities pulling back.
- Local bond markets had a torrid 2009, with yields rising as governments began announcing the need for increased supply to fund the budget deficit.
- During the month of February, the Finance Minister will provide clarity on the issue of bond supply.
- If the deficit is revised downwards then bonds could rally. Bond markets would also benefit if another interest rate cut is announced in March but, in the context of rebounding local growth, this is unlikely.

Impact on financial markets

- Financial markets are likely to be most volatile this year.
- If the economic recovery holds, then financial markets will do well, only if fiscal and monetary policy remains expansionary.

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