

Overall summary

- The anticipated national budget was released, which supported business and financial markets.
- Local trade unions criticised the budget stance on inflation targeting, the rand as well as national debt.
- South Africa's socio-economic environment remains strained, as evidenced by the high take up of social grants, as well as, the high unemployment rate.
- Both local economic growth and inflation outcomes surprised positively, leading the local economy into a sweet spot.
- Advanced economies remain on the back foot, as pressure mounts in Greece as well as in other European nations,
- The US Federal Reserve hiked the discount rate, but emphasised that the federal funds rate would remain at exceptionally low levels.

Commentary

Financial markets

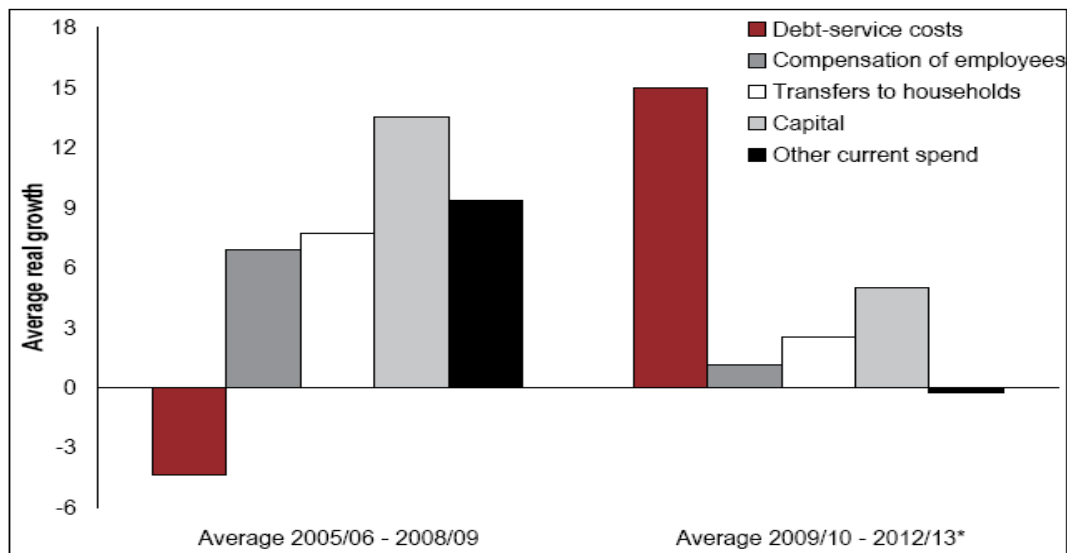
- The first two months of the year have proved tough for equity markets.
- The FTSE JSE All Share index fell 3.5% in January and returned a muted 37 basis points in February.
- The biggest drag has come from heavy weight resource stocks; with the top 20 counters down 7.3% for the year.
- Industrials have also weighed down 1.9% for the year, while financials have added some value, up 2% for the year to February.
- The real stars have been local bonds and property markets, which enjoyed a powerful rally during February.
- The All Bond index surged 2% as the budget deficit came in at 7.3% of GDP; lower than the October estimate of 7.6% of GDP.
- Other support for the bond market included lower inflation outcomes, as well as Eskom receiving only 25% hikes for its tariffs.
- Listed property markets also had a great month, up 5.75%.
- Property markets have both bond and equity like characteristics; the rally in bonds was magnified within this sector.
- The report this month will focus on the local economy with particular emphasis on the national budget, the country's socio-economic outcomes as well as on growth and inflation. Internationally, the focus is on the troubles in the euro area.
- Specifically, he quoted from a recent Cosatu statement saying, "...[It] is essential that we urgently adopt a completely new growth path to transform our economy into one based on labour-intensive industry and one that meets the basic needs of our people."
- Statements of this nature gave the impression that government policy had indeed started making some shift to the left, bowing to the pressure of the trade unions and communist party.
- Policies that the left favours include; moving the inflation target band higher to ensure lower interest rates; significantly weakening the rand to ensure better export competitiveness; and structurally higher budget deficits for increased government expenditure.
- Budget 2010 did not make any of these moves; the left were left fuming while business and financial markets cheered.
- The issue of inflation targeting in South Africa has come under fire of late, with the left arguing that a target band of 3-6% is too restrictive for an emerging market like South Africa.
- Furthermore, growth and employment imperatives should take centre stage in the determination of interest rates.
- The minister responded decisively to this issue by reaffirming that the Reserve Bank is to act independently without any fear, favour or prejudice and also to continue to pursue an inflation target of 3-6%. The latter is to be done within a flexible inflation targeting framework, which means that should external shocks push inflation rates out of the target band the Bank's actions should 'avoid unnecessary instability in output'.
- Although this has been touted as the Bank's 'new' mandate, it has already been applying these principles. Specifically, the Bank has cut interest rates by 5% since December 2008 but the inflation rate has consistently breached the 6% level since that time.
- Inflation averaged 7.15% in 2009, with only October and November coming in at 5.93% and 5.83% respectively.
- The Monetary Policy Committee consistently cut interest rates because of the widening output gap despite the high inflation rates.

Financial markets and business win this round

- Minister Gordhan presented his highly anticipated budget speech on the 17 February 2010.
- The minister's rhetoric alluded to a need for a new growth path, but his later pronouncements invariably pointed to more of the same.

- The budget argued for a stable and competitive real exchange rate but, made it clear that fixing the rand to a particular price was impossible.
- The Reserve Bank was encouraged to continue to accumulate reserves during periods of rapid capital inflows and also some exchange control reforms were announced. This was yet again a move that was welcomed by the markets, but seen as a blow to the aspirations of the left.
- The left also believes in structurally higher budget deficits to support increased public spending.
- Budget 2010 takes a diametrically opposed view, with budget deficits set to decline over the medium term from 7.3% in 2009/10 to 4.1% of GDP in 2012/13.
- The Budget also notes that higher government borrowing is only a temporary solution; that as the world recovers from the recession, those countries with low levels of debt will be better placed to take advantage of growth opportunities.
- On all three of these accounts it was clear that the left had lost this round.
- Moreover, the 2010 Budget Review reflects that going forward there will be little real growth in spending due to increased debt servicing costs.
- Figure 1 shows that during the years 2005/6 to 2008/9, when economic growth was strong and tax revenues were plentiful, real growth in expenditure was possible despite government running budget surpluses of 1.2% and 1.7% in 2006/7 and 2007/8.

Figure 1: Real growth in areas of expenditure, 2005/06 - 2012/13



* 2009/10 – 2012/13 are based on forecasts.

Source: Budget Review 2010, National Treasury

- Given that government is now set to run budget deficits, the cost of higher borrowing translates to greater expenditure on interest.
- Specifically, public debt is expected to rise from 23% of GDP in 2008/09 to about 40% in 2013 and will only stabilise in 2015.
- As such, figure 1 shows that real spending in debt service costs will crowd out real spending on compensation to employees, transfers to households and on capital expenditure.
- This is an outcome that is not likely to be favoured by the left but government's commitment to reduce debt levels makes this clash inevitable.
- South Africa's socio-economic environment continues to be challenging.
- Persistent ineffective response widens the divide between the rich and the poor. This inequality will continue to ensure that our political backdrop remains volatile.

The local socio economic backdrop remains volatile

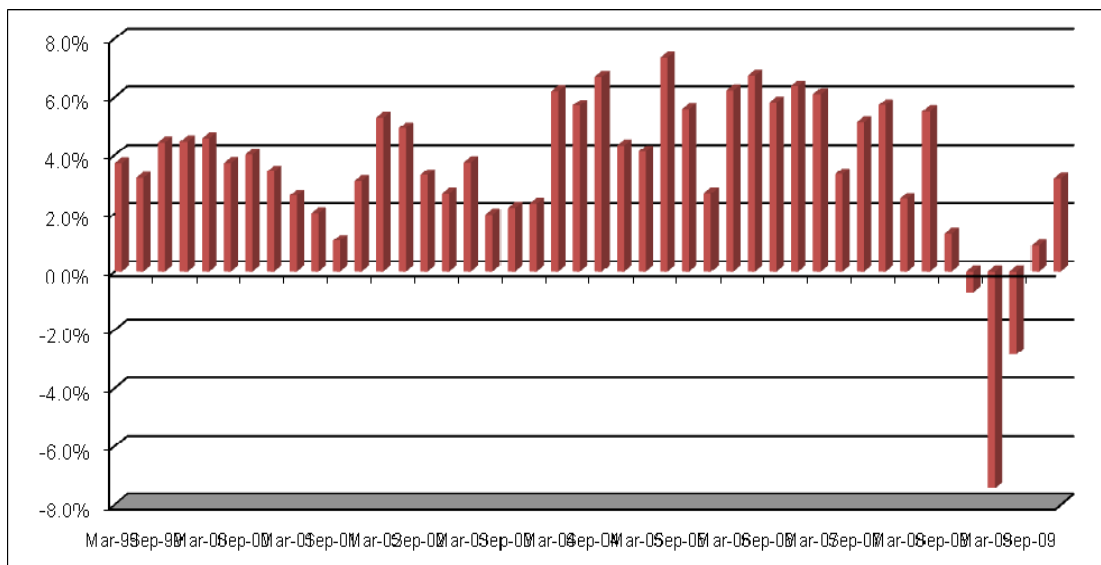
- The poverty levels in South Africa are most accurately reflected by the take up in social assistance transfers as well the high unemployment rate.
- Budget Review 2010 shows that nearly 14 million (of a population of 49 million) South Africans benefit from social assistance transfers.
- Over the past four years, expenditure on social assistance has increased by 12% per annum; from R57 billion in 2006/07 to R80 billion in 2009/10. Social grant transfers now make up 3.5% of GDP.
- There are 9.4 million beneficiaries of the child support grant while the old age grant has 2.5 million beneficiaries.
- Statistics South Africa recently released the fourth quarter 2009 Labour Force Survey.
- This showed that for 2009 as a whole, SA lost 870 000 jobs pushing the unemployment rate to 24.3%. South Africa's working age population (aged 15 to 64 years) stands at 31 million but the labour force (those employed or seeking employment) consists of 17 million people.

- Within our labour force, 4.1 million are unemployed or seeking employment, but an additional 1.6 million people are not captured in the official unemployment rate because they are classified as discouraged workers. Discouraged workers are unemployed people who have given up looking for work due to losing any hope of securing a job. Since they are effectively no longer looking for a job, they are excluded in the official unemployment calculation. If they are included, then the number of unemployed rises to 5.8 million people, bringing the broad unemployment rate to 31%.
- It has not all been doom and gloom; the local economy has just entered a cyclical sweet spot.
- Specifically, consider the latest economic growth and inflation outcomes that have both positively surprised the markets.

The local macro economy hits sweet spot

- South Africa entered a recession in quarter 4 of 2008, where economic growth fell 0.7%.
- Quarter 1 of 2009 recorded an even steeper contraction where growth fell by 7.4%.
- Positive growth was finally recorded in quarter 3 as seen in Figure 2.

Figure 2



Source: Inet Bridge, Advantage

- The market was pleasantly surprised by the final quarter of the year, which recorded growth of 3.2% bringing 2009 growth to -1.8%.
- The manufacturing sector, whose weight is 15% of the total value added, contributed 1.5 percentage points to quarter 4 outcome.
- This sector had a tumultuous year; despite the recoveries posted in the final quarters, it has fallen 10.7% for the full year.
- The other key underpin to quarter 4 outcome, was the value added by the general government sector. This sector's weight is 15.5% and it added one percentage point to the final quarter's outcome.
- Overall, the numbers were well received but it is important to note that the two sectors that drove 78% of the GDP outcome only make up one third of total GDP.

- The rest of the economy is showing signs of some improvement, but there is still considerable strain on households and business.
- Broad based economic recovery is essential for sustainable growth; the rebound in manufacturing and government spending alone is not sustainable.
- The rebound in the manufacturing sector is largely as a result of rebuilding of inventories given the steep retrenchment seen a year ago.
- Furthermore, higher government debt levels mean that real government spending is set to slow considerably.
- The Reserve Bank and the National Treasury forecast economic growth of 2% and 2.3% respectively for 2010.
- An upside surprise in growth implies that there is no longer a need for further lowering of interest rates.
- Yet, the latest CPI inflation outcome of 6.2% for January 2010 and the National Energy Regulator's pronouncement on Eskom's multi year price determination both surprised on the downside.
- What was encouraging about the latest inflation outcome is that core inflation eventually fell to within the target band. Specifically, CPI excluding food, non-alcoholic beverage, petrol and energy fell to 5.8% from 6.3% in December 2009.
- What is still worrisome is the high services inflation, which is still growing at 6.8% year-on-year.
- On 30 September 2009, Eskom applied to NERSA for annual price increases of 45% per year for the next three years. A month later, Eskom revised this down to 35%; NERSA finally agreed to tariff increases in the order of 25%. NERSA's consultation process was quite wide; including 427 written comments from stakeholders as well as 85 oral presentations made during public hearings.
- This outcome will lead to Eskom facing some cashflow shortfalls; measures to address this would include increasing its savings, borrowing additional finance and getting private equity injections into its proposed projects.
- Nonetheless, the lower than expected tariff outcome bodes well for the inflation outlook, which should now migrate towards the middle of the target band in coming months.
- A combination of rising growth and low inflation is typically known as the Goldilocks scenario; a real sweet spot for financial markets where the bears are kept at bay.
- Of course South African financial markets are largely driven by offshore developments, which mean that any fears or shocks there reverberate through our markets.
- Advanced economies are not out of the woods yet, developments in Greece remain a concern and the prospects of rising interest rates add to market volatility.

Advanced economies remain on the back foot

- The Economist recently reported that on 2 February 2010, George Papandreou, Greece's Socialist (Pasok) prime minister, stated that he was struggling to stop the country 'falling over a cliff', as he put it, in a gloomy television address.
- Greece has an ambitious plan to cut its 12.7% budget deficit to below 3% by 2012.
- Measures that the government has touted to achieve this include; freezing public wages; raising taxes and increasing the retirement age.
- These punitive measures are likely to lead to social unrest given that 20% of Greek's live below the EU poverty line and the economy will likely record another economic contraction for 2010¹.
- Newspaper reports have speculated that Greece is set to be bailed out by its European counterparts.
- Greece is also under fire because this nation has gone to great lengths to effectively hide its burgeoning debt crisis from the European Union.
- The New York Times reports that Wall Street tactics, akin to the ones that fostered subprime mortgages in America, have worsened the financial crisis, shaking Greece and undermining the euro by enabling European governments to hide its mounting debts.
- In 2001, just after Greece was admitted to Europe's monetary union, Goldman Sachs helped the government quietly borrow billions. That deal, hidden from public view because it was treated as a currency trade rather than a loan, helped Athens to meet Europe's deficit rules while continuing to spend beyond its means².
- Ben Bernanke, Chairman of the US Federal Reserve, has recently announced that he is looking into Goldman Sach's role in arranging contentious derivatives trades for Greece.
- Spain is another European country that remains in the doldrums; this economy is still in recession and the IMF's growth forecasts show that there is little respite in sight.
- Bloomberg reports that Spain is reeling from the collapse of a debt-driven construction boom, which has destroyed more than a million jobs and prompted households to slash spending and save record proportions of their income.
- The Spanish economy has contracted for seven quarters and its growth declined by 3.1% in 2009.
- The IMF sees a further contraction of 0.6% for 2010 as a whole, while the euro area is set to show some modest growth for the year.
- This economy has the highest unemployment rate in the euro region and has a budget deficit of 11.4% of GDP³.

¹www.economist.com

²www.nytimes.com

³www.bloomberg.com

- European woes are spread over a number of countries that have unflatteringly been dubbed the PIIGS. Specifically, the troubled economies are Portugal, Ireland, Italy, Greece and Spain.
- In the United States, the Federal Reserve has recently spooked markets by raising its discount rate by 25 basis points to 75 basis points; this is the rate charged to banks for direct loans.
- The Fed was at pains to explain that this move was set to encourage financial institutions to rely more on money markets rather than the central bank for short term liquidity needs.
- Bernanke stated that this was in response to the improved functioning of financial markets, which had now reduced the need for extraordinary assistance from the Federal Reserve.
- Furthermore, such adjustments were not expected to lead to tighter financial conditions for households and businesses and should not be interpreted as signalling any change in the outlook for monetary policy.

Impact on financial markets

- Financial markets are set for a most volatile year.
- It seems that the recovery is taking hold, but any adjustments to monetary and fiscal policy need to be carefully monitored as any errors could derail the recovery.
- The recovery firms, local and global equities and commodities will continue to be supported.
- Local bond markets have been supported by the smaller budget deficit and prospects for lower inflation in the next few months.
- Internationally, prospects for sovereign bonds in advanced economies remain under pressure as burgeoning government debt levels weigh on yields.
- Emerging markets have lower debt levels, which make its bonds attractive, but if economies overheat during this recovery then inflation will weigh on these markets.

Azola Lowan
Senior Research Analyst
Advantage Asset Managers

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Contact details:

Tel +27 11 575 4450 Fax +27 11 576 4450 Website www.advantage.am e-mail info@advantage.am
The Gabba, 2nd Floor, The Campus, 57 Sloane Street, Bryanston, Johannesburg, 2191
PO Box 330, Gallo Manor, 2052