

Commentary

Financial markets

After having struggled in the first two months of the year, equity markets sparkled in March; the FTSE JSE All Share index returned 7.9% for the month. Returns were strong across the three major sectors of the ALSI for the month. On the local front, the Monetary Policy Committee cut interest rates while internationally positive news flow around the situation in Greece brought some relief. Property markets have enjoyed particularly strong returns, up 9.9% for the quarter. Property markets will tend to do very well in an environment of rallying equity and bond markets. The latter have benefitted from the surprise cut in interest rates in March as well as the positive news from the budget last month. For the quarter, the All Bond Index has delivered a return of 4.4%. Commodities like oil and gold have treaded water for most of 2010; Brent crude prices have failed to convincingly break the \$80 per barrel level while bullion is sitting around \$1100 per ounce.

A surprise cut in interest rates sends the markets soaring

Governor Marcus surprised markets by announcing a further 50 basis point interest rate cut, bringing the repo rate down to 6.5%. The Monetary Policy Committee's (MPC) stance was informed by their view that despite clear signs of the economy emerging from recession, the pace of the recovery was expected to be slow. Specifically the Bank now expects a growth rate of 2.6% for 2010; 60 basis points higher than their prior forecast. The Committee's decision was also informed by an improvement in the inflation environment.

During the month the Reserve Bank released the first quarter's Quarterly Bulletin (QB) which shed some light on the expenditure side of the economy in the final quarter of 2009. Consumer expenditure typically contributes about two-thirds to total output and as such, the health of the consumer is critically important to the strength of the economy. The QB revealed that for the first time since the second quarter of 2008, real final household consumption expenditure finally turned positive in the final quarter of 2009. The QB highlights that the overall improvement in expenditure by households was underpinned by a turnaround in real household disposable income; after five consecutive quarters of negative growth, real disposable income of households increased at an annualised rate of 2.7% in the fourth quarter of 2009. The QB attributes this stronger year-on-year growth in compensation of employees in the fourth quarter and a further moderation in consumer price inflation over the period.

In as much as we are beginning to see an improvement in real household expenditure, our view is that this is likely to remain constrained for some time given the still high consumer debt levels. Specifically, household-sector debt relative to disposable income edged higher from 78.4% in the third quarter of 2009 to 79.8% in the fourth quarter; implying that consumers have limited ability to take on additional debt despite lower interest rates. Households will begin to spend significantly only when they feel that their economic prospects and job security have improved.

Real spending is therefore a factor of the health of the business sector. The QB reflects that real fixed capital outlays by private business enterprises, which contracted markedly in the first three quarters of 2009, declined at a much slower pace in the fourth quarter of 2009. Business confidence is said to be improving as reflected by the RMB/BER Business Confidence index (BCI). Specifically, after rising by five points to 28 during the fourth quarter of 2009, the BCI jumped by a further 15 points to a level of 43 during the first quarter of 2010. In as much as this is a positive outcome, the level is still below 50, which means that many of the respondents remain pessimistic about their outlook.

It is clear then that economic growth is improving but there still remain considerable risks, which is one of the reasons that the MPC cut rates further; in an effort to reinforce the sustainability of this recovery. Of course the MPC needs to balance this with the inflation rate as growth tends to go hand-in-hand with inflation. On this front, the MPC holds the view that inflation will remain within the target band to 2011.

The MPC statement discusses that the benign inflation environment globally bodes well for SA as the risk of imported inflation is relatively low. Also that there is now greater certainty with respect to electricity tariff increases following the decision by the National Energy Regulator of South Africa (Nersa) to grant price increases to Eskom in the order of 25% per annum, which was in line with the Bank's previous assumptions. The MPC has now revised their assumption down to 20% as municipalities were granted lower increases. Food inflation has also helped to improve the inflation trajectory; food inflation is now only growing at 1% from last year. Also oil prices have remained range bound at \$70 - \$80 per barrel. Another source of comfort for the MPC was the inflation expectations survey which reflects that analysts, labour and business have lowered their inflation expectations as shown below:

The MPC statement also discussed at length the impact of a stronger Rand on the economy. Specifically that a stronger rand exchange rate is a positive factor in the inflation outlook but that an excessively strong exchange rate was a cause for concern from the perspective of overall macroeconomic balance. Furthermore that it was difficult to determine with precision an appropriate level of the exchange rate, but at recent levels the exchange rate might contribute to constraints in the recovery of export and import-competing sectors of the economy.

All in all, the MPC surprised the markets by cutting interest rates and justified the decision via a slow economic recovery and falling inflation. The forward rate agreement curves give an indication of what future interest rate moves the market is pricing in. The 3 and 9 month curves stand at 6.54% and 6.65% which implies that the markets are pricing in no interest rate cuts in the next three months but there is a small probability of seeing rates rise in nine months time. The local economic picture remains promising; headwinds to local financial markets would likely come from international markets.

Jittery markets assured as Greece given bailout package

During the last week of the month, the financial press was abuzz with news relating to a long awaited Greek bail out. Reuters reported that the leaders of Germany and France had clinched a deal on a joint European-IMF financial safety net for debt-stricken Greece at an EU summit, in an effort to restore confidence in the euro. Financial markets welcomed the bail out with the German Dax returning 9.8% in March. Similarly the Dow Jones Industrial Index and the Morgan Stanley Emerging Market index posted strong returns of 5.15% and 7.95% respectively.

The euro area is by no means out of the woods; Reuters writes that Greece must borrow about 16 billion euros between April 20 and May 23 alone to refinance maturing debt. What should assist Greece is the standby aid package which surely will reassure credit markets and likely avert the need for it to request aid. The rest of the PIIGS (Portugal, Italy, Ireland, Greece and Spain) also continue to struggle. Fitch recently downgraded Portugal's sovereign debt rating by one notch to AA- and the Economist reports that deep reforms to Spain's economy look unlikely as the Socialist Prime Minister, Mr Zapatero, seems set to conserve social peace by keeping trade unions happy at the expense of implementing tough austerity reforms.

Azola Lowan, CFA

Senior Research Analyst

Advantage Asset Managers