

Commentary

Financial markets

After a sterling 7.9% return in March, the FTSE JSE All Share index managed a paltry -0.06% return for April. The ALSI initially enjoyed a strong run of about 3% in April but reversed these gains as news flow out of Greece turned decidedly negative on the back of default fears. Gold enjoyed a 5% rally to \$1169 per ounce on the back of investors seeking a safe haven from the uncertainty in Europe. Lower inflation outcomes for March and a fairly stable exchange rate benefited local bonds as the All Bond index returned 1.26% for the month. Listed property, which has bond like characteristics, also benefited; rewarding investors with a return of 1.85%. Returns from international markets were quite mixed with US markets delivering good returns on the back of a strong earnings reporting season and positive economic growth while European markets struggled due to developments in Greece.

The scope for further interest rate cuts are limited

Consumer price inflation has fallen to levels last seen in 2006 as the reading in March fell to 5.1% year-on-year. Food inflation is now only growing at 0.5% from the previous year and importantly, underlying inflation¹ is also now growing at 5.4% over the year. Producer price inflation for March came in at 3.7% year-on-year, slightly lower than consensus expectations of 3.9%. Falling maize prices have had a deflationary impact on agricultural food prices; pipeline price pressures remain contained as agricultural food inflation is still running at -8.2% from the previous year. Manufacturing food inflation is contracting at -1.5% year-on-year to March 2010. Despite these positive outcomes, recent utterances from the Governor of the Reserve Bank, Gill Marcus, at the Bureau for Economic Research, point to the end of the interest rate cutting cycle. Specifically, she stated that the scope for further easing was limited although this was dependent on future risks that might change that outlook. Some of the risks that the Governor highlighted included the volatility of the rand as well as the still fragile domestic economy².

IMF revises up global economic growth

The IMF released its latest World Economic Outlook (WEO) within which it revised up global GDP by 0.3% to 4.2% for 2010. The WEO notes that the global recovery is proceeding better than had initially been expected but that the recovery remained tepid in many advanced economies. As for most emerging economies, the recovery was solid, particularly in emerging Asia. The strength of the Chinese economy was recently reflected in their 11.9% economic growth rate for the first quarter of 2010.

The WEO highlighted a number of downside risks to their forecasts relating to public debt growth in advanced economies. They state that in the near term, a risk is that, if unchecked, market concerns about sovereign liquidity and solvency in Greece could turn into a full blown and contagious sovereign debt crisis. Furthermore, the main concern is that room for policy maneuvering in many advanced economies has either been largely exhausted or is much more

limited, leaving the fragile recoveries exposed to new shocks. In addition, bank exposures to real estate continue to pose downside risks, mainly in the United States and parts of Europe.

The Greek tragedy plays out

Eurostat, the European Union's statistical offices, recently announced that Greece's budget deficit for 2009 was 13.6% of GDP (higher than the previously reported 12.7% of GDP) and that Greece's government debt to GDP ratio had reached 115%. More alarming though was a note from Eurostat stating that it had reservations on the quality of the data reported by Greece and that further investigations were underway, which would lead to even more negative revisions.

Ratings agencies did not take kindly to these announcements; Bloomberg reports that Standard & Poor's (S&P) lowered Greece's credit rating to BB+ from BBB+ and warned that bondholders could recover as little as 30% of their initial investment, if the country restructures its debt. This downgrade marked the first time a euro member has lost investment grade rating (to junk bond rating) since the currency's 1999 debut; Greek bond yields spiked up violently on the back of these developments.

By the end of the month, Reuters reported that investors were finally calmed by the negotiation of a multi year bailout package for Greece and also agreement by this beleaguered nation to further austerity measures. Reuters reports that trade unions in Greece are vehemently opposed to austerity measures that may include Athens raising sales taxes, scrapping bonuses and enforcing a three year pay freeze. Furthermore, the Greek social affairs minister confirmed that pensions would be reformed in an attempt to save the country from collapse; reforms could include raising the retirement age and reducing pensions paid by state controlled corporations. News reports now suggest that Greece's aid package could be worth 100 – 130 billion euros over three years, as opposed to the initial plan of 45 billion euro aid for 2010 alone.

Economic recovery in the US affirmed

The Statement released by the Federal Open Market Committee (FOMC) highlighted that economic activity had continued to strengthen and that the labour market was beginning to improve. Also that household spending had picked up but remained constrained by high unemployment, modest income growth, lower housing wealth and tight credit. Financial markets were cheered by the Committee's commitment to maintain the target range for the federal funds rate at 0 to 0.25%; highlighting that conditions warranted exceptionally low levels of the federal funds rate for an extended period.

Companies on the S&P 500 index have reported first quarter earnings for 2010 and Bloomberg news reports 79.4% of the companies that have reported topped projections and beat analysts' estimates. Positive economic growth of 3.2% for the first quarter was largely attributable to consumer spending on durable goods and services perking up. These developments in the US led to the Dow Jones Industrial Average returning 1.4% for the month while European bourses like the CAC 40 in Paris were down 4% in April on the back of uncertainty in Greece.

¹CPI excluding food, non alcoholic beverages and petrol

²www.inet.co.za

Impact on financial markets

Developments in April continue to point towards what will be a most volatile year for financial markets. What remains critical is focussing on investments that are backed by strong fundamentals. A clear example of this is that despite the fallout in Greece, the appetite for emerging market bonds remains strong. In South Africa, for the year to April, foreigners have bought R32 billion worth of bonds on the back of a very attractive yield and good local fundamentals. We continue to believe that the global economic recovery is in place but sovereign debt will remain a key risk in some advanced economies.

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