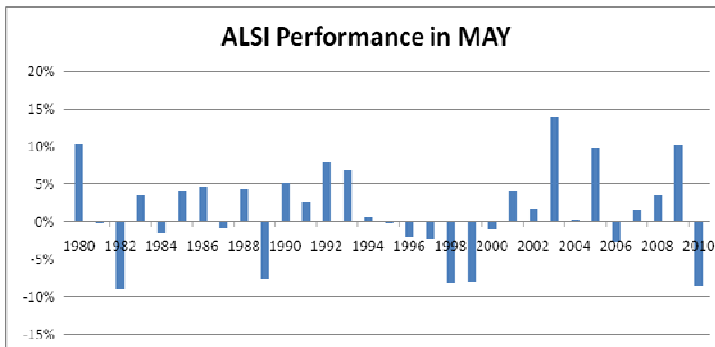


Commentary

Financial markets – “Sell in May and go away”

The age old adage of “sell in May and go away” seems to have played itself out convincingly. It suggests that in May it is time to sell equities in favour of bonds and that the investor should go off to enjoy summer holidays (in the northern hemisphere). A brief analysis reveals that since 1980, the FTSE JSE All Share index has suffered 13 losses out of 31 months since 1980 as reflected below:



Source: I-Net Bridge

During this last month of May, the FTSE JSE All Share index fell 5.1% while the All Bond index managed to close marginally in the red at negative 0.4%. The local equity market reported large losses despite positive local data on the back of further woes in the Euro zone. On the local front, economic growth increased while consumer price inflation decreased. Data of this nature is normally positive for equity markets, but local markets took direction from the selloff in the Euro zone. American markets as well as the emerging market composite were also affected, with the Dow Jones Industrial Average down 7.9% and Emerging Markets falling 9.1%. Volatility indices like the VIXI and SA Volatility index increased significantly, indicating that there is a good deal of fear gripping investors. Asset classes, known for their safe haven characteristics, delivered positive returns as investors shied away from risky markets. Specifically, gold rallied 4% to \$1207 while ten-year US bond yields strengthened by 9.8% to a level of 3.3%.

‘Shock and awe’ \$1 trillion package

Greece has increasingly come into the spotlight in 2010 due to its excessive government debt and budget deficits. Since March, the European Union and the International Monetary Fund (IMF) announced a number of bailout packages for this nation. Despite this, investors failed to be reassured and rather questioned the outlook of other debt-laden Euro zone countries like Portugal, Ireland, Italy and Spain. As such, equity markets across the globe sold off materially and the euro currency slid dramatically against the US dollar. On 10 May, investors awoke to ‘shock and awe’ as European Union finance ministers, central bankers and the IMF announced a \$1 trillion global emergency rescue package to stabilise the euro. This massive package included standby funds, loan guarantees, liquidity measures and European Central Bank purchases of Euro-denominated government bonds.

This bailout package came with certain strings attached – severe austerity measures. Countries in the Euro zone are to severely cut their budget deficits to 3% of GDP where the likes of Greece have deficits in excess of 13% of GDP. Slashing deficits involves painful adjustments like freezing wages, eliminating bonuses and instituting punitive pension reforms. The effect of this is that consumption expenditure virtually dries up and given that household expenditure drives two thirds of GDP, the outlook for economic growth in these nations is bleak. Investors also questioned the wisdom of throwing more debt onto debt-burdened nations and as such equity markets had a torrid month in May. Investors were not convinced that the Euro is out of the woods and as such piled into safer havens.

Local economic data point to a solid recovery

Local economic data including retail sales, vehicle sales, house price indices, leading indicators and gross domestic product (GDP) all pointed to an economy well on the road to recovery. Retail sales growth is a good proxy for the strength of the consumer and during the past 12 months these have been decidedly negative. The latest data release for March showed the first signs of the consumer coming back to life as retail sales grew by 1%. Vehicle sales have also been performing well, up 36% for the year to April, reflecting car-hire companies gearing up for the FIFA 2010 World Cup. Furthermore, the FNB House Price index grew 10.1% to April, reflecting the first month of double digit price growth since April 2008. The ABSA House Price index also confirmed the renewed vigour of the housing market as consumers benefitted from lower interest rates. The Reserve Bank’s leading economic indicators rose even further in March confirming the economy’s momentum.

First-quarter GDP rose to 4.6%, far exceeding the expectations of analysts. The largest contributors were the Manufacturing (1.3%) and Mining and Quarrying (0.8%) industries. Statistics South Africa noted that growth continued to be driven by mainly export demand as well as demand for coal and other metals. Manufacturing growth was primarily due to Asian demand for basic iron and steel metals as well as a rebound in motor vehicle demand. Inflation came in at 4.8% for April, lower than consensus expectations of 5%. The lower inflation outcome, in the face of improving economic growth, is likely to keep the Monetary Policy Committee on hold for the remainder of the year.

The effect on financial markets

Many might question why the South African market is affected by events in Europe. The reality is that problems in Europe tend to manifest themselves through two distinct avenues. Firstly, as investors pull out of equity markets into safe havens, they do so indiscriminately, which was experienced during the month of May.

Secondly, the European austerity measures are likely to lead to weaker European growth and a weaker euro which has direct implications for South Africa. Weaker European growth

results in these nations having less ability to demand South African's imported goods. As it stands, using the Reserve Bank's methodology for calculating the real effective exchange, the Euro zone is South Africa's largest trading partner for manufactured goods. Should the Euro zone be unable to maintain its demand for South Africa's exports, the country's economic growth will be negatively affected. Furthermore, the euro has weakened 11% against the rand and this immediately makes the country exports more expensive to Europeans. A weaker euro may well be Europe's saving grace as a demand for exports is likely to improve, benefitting exporting.

There is considerable fear and uncertainty in financial markets, volatility is set to remain until investors are convinced that Europe is on the road to recovery. It will be a bumpy ride and investors must keep their seatbelts on.

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