

June 2010

## Financial markets

The first half of the year has seen equity markets vacillating from trading deep in the red to enjoying euphoric rallies. A sovereign debt crisis in the Euro zone and to a lesser extent, fears of economic over-heating in China, have driven the volatility in equity markets. For the first six months of the year, equity markets have given investors a bumpy ride yet failed to compensate them with any return:



An investment in the BEASSA All Bond index would have rewarded investors with a return of 5.8% for the first half of the year while an investment in equity markets would have led to drawdowns. The FTSE/JSE All Share index is down 4.4% for the first half of the year while the Dow Jones Industrial Average is down 7.3%. Volatility indices like the VIXI and SA Volatility index have ratcheted up to a level above the critical 30 mark, indicating there is a good deal of fear gripping investors. For the same period, asset classes known for their safe-haven characteristics delivered positive returns as investors shied away from risky markets in favour of them. Specifically, gold rallied by 14% from \$1087 to \$1244 per ounce while 10-year US bond yields strengthened by 23% to a level of 2.96%.

The G20 Summit held in Toronto during the last week of June, failed to give markets any real direction as the US and European powerhouses sit with very different global priorities.

## Divergence of global priorities

US and European officials entered the G20 Summit with vastly different global priorities; each dictated to by their economic realities. The US called for greater focus on economic growth, urging nations not to move too quickly to implement fiscal cutting measures. On the other hand, European officials were pushing an agenda of fiscal austerity. The G20 Summit did little to bridge this divide, with the outcome effectively allowing different nations to follow their own growth/fiscal paths. The G20 statement highlighted a commitment 'to taking concerted actions to sustain the recovery, create jobs and to achieve stronger, more sustainable and more balanced growth' but this will be 'differentiated and tailored to national circumstances'. Furthermore, it was agreed that advanced economies should halve deficits by 2013 and stabilise or reduce government debt-to-GDP ratios by 2016. This lack of clear global policy direction left financial markets moving in and out of the red for most of the month as economic data also failed to reassure. A number of key economic indicators have given mixed signals on the strength of the US economic recovery. During 2008 and 2009, 8.4 million US jobs were lost due to the recession. The trend finally turned positive in 2010 with 500 000 jobs added in March and April alone. Unfortunately, the latest figures for May showed private sector employment had virtually dried up with only

government employing workers on a temporary basis for Census 2010. Furthermore, the housing sector, which played a key role in creating the credit crunch, is showing signs of slowing down on the back of a government tax credit expiring. As such, the Federal Open Market Committee has reiterated that low rates of resource utilisation, subdued inflation trends and stable inflation expectations were likely to warrant exceptionally low levels of the federal funds rate for an extended period.

The concern for the US is whether consumers will be able to maintain the growth momentum as fiscal stimulus measures expire, hence their call for prioritising growth. For Europe, the concern is that investors in government bonds are demanding greater assurance that governments will be able to pay them back. As such, they are demanding greater compensation for the risk they are taking via higher bond yields. European countries are therefore concerned with fiscal discipline to reassure their investors.

## Local economic data points to a stabilising economy

After surging during the past two quarters, the second quarter BER/RMB Business Confidence index took a breather to a level of 36 – still below the 50 level, which implies neutrality in confidence. This outcome signalled that economic growth will definitely come off the lofty high of 4.6%, recorded for the first quarter. This is only set to moderate as reflected by the still strong annual manufacturing growth rate of 9% released by Statistics South Africa for April 2010. Factors that will negatively affect second-quarter GDP growth include the effect of the May Transnet strike as well as any productivity losses experienced due to workers taking time off to experience the 2010 FIFA World Cup.

On the other hand, gains from the visitor spend related to the 2010 FIFA World Cup will provide a boost to economic growth. Visa card company recently released cardholder spending data that points to considerable gains. Specifically, during 1 to 20 June 2010, spending by international visitors in SA on Visa-branded cards exceeded \$128m (R974m) – up 54% from \$83m (R629m) during the same period in 2009. Furthermore, the number of transactions was 900 000 (45 000 per day on average) – up 60% from nearly 600 000 (30 000 a day on average) during the same 20 days in 2009. Visa data reflects that the biggest spenders were the United Kingdom; this followed by the US, Australia, France and Brazil. These five countries alone accounted for 51% of spending. Almost 100% of the spending was on leisure and business travel items like accommodation, restaurants, retail, auto rental and air travel'. SA Tourism has announced that they expect to gain R27 billion from the 2010 FIFA World Cup.

## Effect on financial markets

Risky assets have sold off considerably, which for the contrarian investor offers an excellent buying opportunity. Numerous studies show that investors do well if they buy during market lows and take profits as market rallies mature. Of course, there remain considerable risks; specifically, a double-dip recession could see markets returning to the lows seen in the past eighteen months.

What remains clear though is that the problems in European nations will take a number of years to be resolved. The Spanish economy makes up about 12.5% of the Euro zone and the European Commission forecasts this nation will have a 20% unemployment rate in the face of a budget deficit of 10.1% of GDP in 2010. Even halving this by 2013 (per the G20 Summit) still means a breach of the 3% limit advocated by the European Commission. Of course, Spain is not alone as a number of other (smaller) Euro zone nations have similar problems. Resolving these issues will keep markets on the edge as policy errors could have devastating consequences.

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