

AJM ASSET MANAGEMENT STRATEGIES (PTY) LTD

Reg. No 2002/006592/07

15 a Tokai Road, Tokai, Cape Town
 Licensed Financial Services Provider - FSP 5588
 Tel : + 27 21 713-2508 ; Fax : +27 866 855-199
 Cell: +27 82 600-6618

E-mail: alastair.m@mweb.co.za Website: www.ajmglobal.com

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Hi all

[A global and local economic update](#)

Whew, and the experts said equities was the best buy in July!!! The volatility has been thanks to continued uncertainty on debt management in the US and in particular Europe, and a string of disappointing economic data. The SA equity and bond markets were not spared either hence the run on the Rand, although the SA market managed to recover to a more manageable loss during September. Just to remind you that the 10 yr numbers mean that the return is per annum, so the DJEuro has lost 5.3% per annum for a 10 yr period. Anyone remember Japan from 1990??

In June we had a strong rand, the Eurozone debt was unresolved, QE2 in the US was about to end, gold was at an all-time high and China had already increased interest rates to slow down growth. With the deteriorating Greek crisis, weak economic indicators and a poor response to the US's next quick fix, investors rushed out of risky emerging markets and equity into US treasuries, thus strengthening the USD. How anyone could regard US bonds as secure is confusing at best!

[Investment analysis on lump sums to 30 September 2011](#)

Source – Spotlight Investor	3 months	1 year	5 yrs	10 yrs
JSE INDICATORS				
FTSE/JSE Top 40 index	-4.8%	2.3%	5.7%	14.7%
Small cap index	-2.6%	2.5%	7.4%	21.6%
Mid cap index	-1.8%	0.6%	10.8%	21.1%
Financial sector	-2.8%	-6.2%	0.5%	10.0%
Industrial sector	-1.1%	7.6%	12.3%	17.7%
Resources sector	-9.0%	0.1%	3.0%	14.9%
Property Unit Trusts	-0.9%	0.1%	7.1%	14.5%
Money-market Fund	1.3%	5.8%	8.7%	8.9%
Rand / USD rate	-14.9%	-13.5%	-0.3%	1.3%
Rand / EURO rate	-8.7%	-13.4%	-1.7%	-2.7%
GLOBAL INDICATORS				
FTSE (£)	-10.5%	-6.2%	-2.0%	1.2%
S&P 500 (\$)	-11.3%	0.9%	-3.0%	1.2%
DJ Euro 50 (€)	-22.3%	-19.6%	-9.0%	-5.3%
Hang Seng	-19.0%	-20.0%	0.3%	6.0%
Nikkei (Yen)	-11.7%	-9.7%	-11.9%	-1.3%

Actual returns for 3 months for lump sum investments after costs have been deducted

Annualised returns for 1 and 5 yrs for lump sum investments after costs

Global indicators in the currency of residence

Analytical review – Current environment – a reality check

Just to put the current scenarios into place, we thought it may be worthwhile to reflect on what has happened over the past couple of years, and how this is currently impacting the future direction of markets.

Economic expansion since the 80's has been largely due to the expansion of credit. That means that spending has been funded by borrowings. This has been at a consumer and corporate level and more recently on a government level. This is not only in the US but across all first world economies, and more recently emerging markets have been sucked in as well. This seemed quite a good idea at the time, until you have to repay the debt, which is around now.

Now that countries and consumers have been shaken by the banking crisis in 2008, a collective effort to lighten the load is starting both with consumers and governments (well in theory at least). To change this direction from over-borrowing, there are only some hard choices that can be made.

- Governments can spend less – usually hits social spending, education, pensions infrastructural spending – a vote killer
- Governments can increase revenue – Taxes, levies, exports and reduction in imports (of which oil and resources is a huge factor for first world economies) – a vote killer as well
- Consumers can spend less – reduces imports, reduces industrial production causing job losses
- Federal Reserves can weaken the currency – good for exporters but bad for investors and inflation

Taking any combination of the above can only mean bad news for consumers. Cash strapped consumers plus governments who are reducing expenditure is not an environment conducive for rapid growth prospects.

Markets have dropped quite considerably over the last few months as investor pessimism sets in about the likely outcome of the European debt mess. It is thus likely that the markets will bounce back quite sharply when the dust settles after Greece defaults (this seems to be the only option and appears to be priced into the market). While sorting Greece's debt will be good for Greece (in particular the Greeks who can then stop striking and relax more), we hope that European financial institutions that will have lost fortunes have been assisted to avoid bankruptcy. Even if this all works out well, the global economy is not in any better shape as a result. The debt crises of Spain, Italy, Portugal, US and Japan still need to be resolved. How Greece defaulting/restructuring effects world markets will at least give investors a precedent of what to expect with the others.

Recovering out of US, Eurozone and Japanese debt (are they too big to fail) comes with some serious pain. The right decisions (according to history) do not get you re-elected for president, and the longer it takes to muddle through the options, the more dramatic the consequences. Unfortunately, the two key figures that are probably prepared to make difficult choices are unlikely to be re-elected, namely Obama and Merkel. It is unfortunate that they may have been the saviours, but will probably be recorded in history as villains.

The investment environment is thus a place of extreme anguish and investors will run at any sign of weakness. In spite of fair equity prices (provided profits continue at the current level), investors will not be thinking rationally in this environment, and thus great caution should be exercised when investing overweight in equity.

On the political front, we are seeing the young unemployed becoming fairly vociferous across the globe. The UK managed to put a cap on it temporarily, but there is a growing unease about the diversity between the haves and the have not's. Julius's campaign in SA is not isolated, and it is likely that we could see similar dissent in the US, China and many other parts of the world. This will make tough decisions on economic policy even harder on governments, probably resulting in compounding the problems we are facing rather than alleviating them (just look at how the Greeks reacted to sorting their own debt out).

AJM Indicators (see Q4 2008 report for motivation and explanations)

1. **Real Hourly Earnings** – US hourly earnings continue their downward trend and are looking ugly in the face of rising inflation. This particular indicator is extremely negative for markets in the near future, and we really need to see some change in this direction before we can hope for any material upswing in consumer spending. A sudden drop in inflation may do the trick. It is possible that with severe competition for business and a large drop in oil prices (low demand), inflation could surprise downwards in 2012 which may be the stimulus needed.
2. **Personal Consumption Expenditure (PCE)** – This also looks really bad and the US Fed's Twist programme really only looks good in the cartoon drawings as it does very little to help consumers. This downward trend also suggests current dividend yields are not sustainable.
3. **Federal Reserve rate** – The relative rate continues its drop. This adds weight to the other indicators, suggesting poor times ahead for consumers.
4. **Price vs earnings** – Stock prices are offering better value, but then earnings have held up thanks to some serious cost-cutting by most global companies. It is worth reminding investors that both dividends and stock prices drive this ratio. A drop in dividends shoots up the ratio (and thus value) quite sharply. Investors control the price, business controls the dividend.
5. **Currency valuations** – The USD is still weaker than other first world currencies although is benefiting from the recent flight to "safety". This demand causes the USD to strengthen off the lows experienced last year. Existing debt in the US does not encourage high holdings in USD.
6. **The price of debt** – European bonds are at give-away prices, for good reason, reflecting the risk of investment in these countries. The extra layer of bail-out reserve protection is still to be finalised. The debt restructuring (in my humble opinion what the US's Operation Twist is about) by the US appears not to worry anyone too seriously (yet) as seen by strong US bond demand. Emerging markets are still offering attractive yields with a more stable economic outlook.
7. **Investor psychology** – Investors now suddenly doubt the global economic recovery. Consumers all over the world are feeling the pinch in the home environment, not helped by a multitude of factors including high oil and food prices. The markets are certainly not pricing in a failure, although investors are nervous and quite rightly so. While analysts are encouraging investment into economies that are growing well (emerging markets), this has traditionally been a poor strategy.

Investment discussion

The markets are in turmoil thanks to the massive debt crises that swamps the US and Europe (and one almost forgets Japan), which has a ripple effect across almost all markets.

The US should be tackled in two parts. From an economic perspective, housing, employment, debt, and consumer spending are all still sliding. Economic growth is going nowhere, and whether it shrinks or bumbles along around 1% is only of technical interest for AJM investors. History shows that by the time the analysts call it a recession, the damage in the stock market will have already been done. Tackling the other part (being the stock market), prices are still above long-term trends and future earnings seem unlikely to materialise in spite of strong corporate balance sheets. Markets mostly do not follow economic growth. In addition, growth in emerging market consumers is clearly evident, and many companies listed on the NYSE will derive huge profits from this.

Europe cannot see its way out of the debt crisis, and it is unfortunately impacting the market as well. However, as the Euro weakens (it is the only likely scenario) this can only benefit Germany (as the powerhouse) once competitive pricing kicks in. The UK appears to have no imminent crises looming, but the impact of the global slowdown on consumers, spending and production follows a fairly predictable pattern. The UK is already seeing severe cost-cutting so it appears that they are ahead of the curve on this one, and we may find the UK recovering slightly earlier than others. Don't hold your breath though; this is unlikely to be imminent.

While SA markets have been relatively resilient to the recent turmoil, the sharply weaker currency will play havoc with inflation, but may stimulate exports. The global slowdown can only negatively impact resource consumption, although a

slower China will still stimulate demand. High labour costs are continuing to dampen direct investment into SA. Our financial services compete favourably with almost all first world economies, but this cannot be materially translated into jobs. This is a significant stumbling block to opening up SA as the gateway to Africa (not helped by declining visas to heroes). It is happening at the entrepreneurial level by S Africans, but foreigners are still reticent. Foreign investors will buy SA stocks and bonds, but then they can sell those just as easily (as experienced over the last two weeks).

The common theme from investment analysts is the expansion of emerging markets over the next 20 years, overtaking first world economies of the US, Europe, UK, Japan and Australia. We have included brief comments on some of these.

India is extremely exciting, and was ranked second in recipients of global foreign direct investment, and will probably remain as one of the top 5 for 2011. Exports have risen dramatically.

China has increased interest rates to slow down growth. Infrastructural expenditure has slowed but the extent of the demand to provide for the growing middle income, and the consumption relating to this is not likely to change. China's manufacturing and resulting exports is contracting on the back of lower global demand and wage increases. Ironically, China has an internal debt problem as their local governments have extended themselves with the infrastructural expansion with loans from central government. China has the balance sheet to avoid a crisis, so this is unlikely to stir trouble, but will accelerate the slower growth rate.

Brazil and Mexico are also experiencing shrinking consumer spending and slower exports of iron, oil and concrete which are their main sources of revenue. The economic outlook is thus determined by the demand for resources and could lag other markets.

Investment strategy

AJM has unfortunately painted a fairly gloomy picture on the outlook of the global economy. The bulk of analysts and fund managers note that considering the investment options available, equity is the best place to invest:

- Cash is giving you below inflationary returns
- Bonds likewise, and are vulnerable as long-term rates rise off their records lows
- Property likewise, and prices are continuing to fall
- Equity is giving you above-inflation dividend yields and potential capital growth

We at AJM believe that global investors are not prepared for a sustainable slow/no growth environment. We thus continue to feel that getting a below inflationary return in cash for the short-term is better than exposing yourself to market risk that could match the catastrophic position the global economy and global financial structure is in.

The above is also taking into consideration that:

- Markets have taken a hammering
- Global companies are in fairly good shape and are very well positioned for taking control of the next growth phase
- Equity is a long-term investment

AJM is watching the markets very closely and should we feel that the global environment is settling down to normal economic trends, we will act as quickly as we can to ensure that we capitalise on well-priced assets. There could be opportunities now for increasing equity weightings in Germany and the US, but severe health warnings for serious volatility will be issued, and some patience will be needed.

Kind regards

ALASTAIR MACKIE