AUGUST

# SYGNALS

2011

## MONTHLY UPDATE

## KEY INDICATORS

| | | 1 Month | 3 Months | 6 Months | 1 Year | 2 Years | 3 Years | 5 Years |
|---|---|---|---|---|---|---|---|---|
| J203T | FTSE/JSE All Share Index | -0.3% | -4.3% | -2.4% | 16.9% | 14.2% | 6.8% | 10.1% |
| J210T | FTSE/JSE Resources 20 Index | -1.5% | -8.8% | -13.3% | 14.2% | 8.8% | -2.0% | 6.0% |
| J211T | FTSE/JSE Industrials 25 index | 0.3% | -1.2% | 6.7% | 24.4% | 21.1% | 15.3% | 16.3% |
| J212T | FTSE/JSE Financials 15 Index | 1.2% | -3.5% | 2.3% | 8.3% | 10.5% | 8.4% | 5.6% |
| J403T | FTSE/JSE SWIX Index | 0.5% | -2.5% | 1.0% | 17.2% | 14.8% | 8.6% | 11.2% |
| J303T | FTSE/JSE CAPI Index | -0.2% | -4.0% | -1.8% | 17.0% | 14.6% | 7.8% | 10.8% |
| ALBI | BESA All Bond Index | 3.5% | 5.2% | 9.6% | 9.0% | 11.7% | 11.7% | 9.8% |
| STeFI | STeFI Index | 0.5% | 1.4% | 2.8% | 6.0% | 6.7% | 8.0% | 8.7% |
| | MSCI World Index in SA Rands | -2.8% | -7.6% | -8.8% | 8.6% | 2.3% | -4.4% | -0.8% |
| | Rand/US Dollar Exchange Rate | 4.6% | 2.9% | 0.5% | -5.1% | -5.1% | -3.1% | -0.6% |
| | Rand/Euro Exchange Rate | 6.1% | 2.4% | 4.5% | 7.4% | -5.0% | -3.8% | 1.7% |
| | Headline CPI | 0.9% | 1.8% | 4.1% | 5.3% | 4.5% | 5.2% | 6.5% |
| | Core CPI | 0.9% | 1.6% | 3.5% | 4.2% | 4.1% | 5.4% | 5.6% |
| | PPI | 2.7% | 7.8% | 11.3% | 8.9% | 8.3% | 4.1% | 8.4% |

*"Debt is a two-edged sword. Used wisely and in moderation, it clearly improves welfare. But, when it is used imprudently and in excess, the result can be disaster."*

*Bank for International Settlements paper presented at the Jackson Hole summit*

Four years after the collapse of Lehman Brothers, panic once again gripped the financial markets as the European Union struggled to contain the sovereign debt crisis. Renewed signs of economic weakness globally and the downgrading of US debt by S&P rekindled concerns about the quality of all government debt. Amid summer holidays cut short for political leaders, social unrest in the UK, Hurricane Irene hitting the East Coast of the US and more violence in Syria and Libya, August brought back memories of the dark days of 2007.

As global recession threatened, the Federal Reserve pledged to keep interest rates near zero through at least mid-2013, the European Central Bank intervened in the bond markets and the Bank of England indicated it is ready to add more stimulus if needed. Snatching victory from the mouth of defeat, the last week brought an amazing swing in sentiment as the threat of a global double dip recession lessened on the back of stronger economic data.

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SYGNIA
THE SUM OF ALL THINGS

## EQUITY MARKETS CRASH AGAIN OR DO THEY?

The month started on a positive note as US lawmakers reached an 11th hour deal to raise the US debt ceiling. Moody's and Fitch rating agencies affirmed the US's AAA credit ratings, albeit warning that downgrades were possible if lawmakers fail to enact debt reduction measures and the economy weakens further.

Economic weakness became self-evident as growth in global manufacturing activity ground to a halt in July.

Spain's and Italy's borrowing costs soaring amid concerns about possible bail-outs. The cost of bailing out Italy has been estimated at US$1.4 trillion, with Spain requiring another US$700 billion, far in excess of what is available.

Money poured into the safety of US Treasuries (despite the S&P downgrade), gold and the Swiss and Japanese currencies. The ECB intervened by buying Irish and Portugese bonds and promising to lend unlimited funds to banks for six months. Many banks in Greece, Portugal, Ireland and Spain remain totally shut out of market funding and rely entirely on the ECB. Both Italy and Spain re-iterated their commitment to further austerity.

Gold, in a bouncy ride mirroring the swings in sentiment, started the month at US$1 614 an ounce, rose to a peak of US$1 917 an ounce, before ending the month at US$1 800 an ounce.

Unsurprisingly there were no interest rate increases in sight from the UK, the ECB and the US. In fact, the ECB announced that it is reviewing its assessment of inflation risks on slower growth in the euro area.

In a dramatic move the S&P lowered its rating for long-term US debt from AAA to AA+ citing becoming less confident about the US's ability to cut its US$14.3 trillion debt in the face of political discord. S&P ranks 18 countries as AAA, including Australia, Hong Kong and the Isle of Man. New Zealand is the only other country with a AA+ rating. The US responded by accusing the rating agency of a US$2 trillion error in its calculations. China, the largest foreign holder of US debt with a US$1.1 trillion investment, warned that Washington needed to "cure its addiction to debts" and "live within its means".

Markets tumbled further, the gold price spiked and the Rand weakened to above R7/US$. The Fed announced that it would leave interest rates unchanged till mid-2013, while the ECB bought Spanish and Italian bonds for the first time ever in order to push down yields.

Economic data brought little support. The US's second quarter GDP growth came in at an annualised 1.3%, after increasing by just 0.4% in the first quarter of 2011, less than previously estimated. And although US inflation of 3.6% in June lessened the risk of stagflation, Goldman Sachs estimated that the US faces a one-in-three chance of a recession within the next nine months. In China inflation accelerated to the fastest pace in three years in July (6.5%), limiting the scope for monetary easing. The Bank of England cut its 2011 growth forecast for Britain to 1.5% and warned the eurozone debt crisis was a "significant" threat to the country's economic recovery. It also indicated that it is ready to add more stimulus if needed. The only bright spot was China's trade surplus of US$31.5 billion, the largest in two years.

And the social landscape offered little but dejection as scenes of looting by London's rioters, all young, opportunistic, angry and organising phenomenally fast over social media, dominated the news.

As the situation worsened, France, Italy, Spain and Belgium joined Turkey, Greece and South Korea in imposing bans on short-selling of financial shares, while Germany called for a Europe-wide ban on naked short-selling.

French President Nicolas Sarkozy announced new austerity measures and cut France's growth forecast to 1.75% in 2011 and 2012. All three main rating agencies confirmed France's AAA rating.

Concerns about the economy completely overshadowed the second-quarter reporting season that has seen earnings-per-share top estimates at 76% of the 429 companies in the S&P 500 that reported results since July 2011. It is telling that more S&P 500 companies are buying their own stock back than at any time since the depths of the credit crisis.

The summit held between Sarkozy and German Chancellor Angela Merkel to discuss the eurozone crisis proved a disappointment with Germany strongly opposing anything that might create a "debt union" whereby Germany would effectively underwrite its deadbeat eurozone partners. One popular idea involves the creation of new government bonds backed by all the nations of the eurozone. Both countries insisted that the existing €440 billion bail-out fund is "sufficient". Merkel has little room to manoeuvre in the face of powerful opposition to a debt union from the German voters (according to a YouGov poll 59% oppose all futher bail-outs) and her own coalition partners who insist that forcing countries to cut debt and boost growth is the correct solution. The eventual agreement included a promise to create a eurozone governing body and a proposal for a EU-wide tax on financial transactions. As this would require unanimous approval by all 27 member nations, it is a proposal doomed to fail. Germany's Bundesbank waded in by criticising the EU bail-out policies as a drift towards a debt union without "democratic legitimacy" or treaty backing.

Economic newsflow continued to dampen the mood as the possibility of a double dip recession gained traction. The 17 member eurozone GDP grew by a meagre 0.2% quarter-on-quarter in the three months to June 2011 (1.7% year-on-year), down from 0.8% in the first quarter. The abruptness of the slowdown raised the possibility that the ECB might have to reverse the interest rate hikes announced in April and July.

Concerns about Europe's banks flared up again after an unnamed bank tapped an emergency ECB borrowing program for the first time since February. The news, combined with a Wall Street Journal report that the Fed is concerned European banks might be forced to repatriate funds from US subsidiaries in the event of a liquidity shortage, caused more panic.

Oil prices fell as Libya's civil war appeared to near its end. However, the euphoria that followed the rebels' triumphant capture of Tripoli soon gave way to confusion and renewed fighting.

Towards month end all eyes turned to Bernanke and his annual address at the Jackson Hole, Wyoming, gathering of global central bankers. It was at Jackson Hole last year that Bernanke unveiled the Fed's US$600bn bond-buying programme that became known as QE2. There were many who pinned their hope on QE3, with risk appetite returning to the markets.

Stocks steadied, supported by some positive economic newsflow from the US where reports on durable-goods orders and home prices beat estimates. These contrasted with data released earlier in the month on jobless claims, consumer confidence and manufacturing that spurred concerns that the US is poised for a recession.

Moody's lowered Japan's credit rating by one notch, cautioning that frequent changes in administration (Prime Minister Naoto Kan resigned in August), weak prospects for economic growth and its recent natural and nuclear disasters made it difficult for the government to cut debt.

In South Africa the Reserve Bank governor Gill Marcus indicated that interest rates may fall further, and warned that the global economy could be on the brink of a prolonged recession, which would affect South Africa.

Shares in Apple Inc fell over 5% after Steve Jobs announced his resignation, on health grounds, as the CEO of the US computer giant.

Greek bonds slumped pushing the 10-year yield up to a euro record of 18.5% amid concerns that Finland's demands for collateral on any new loans to Greece will jeopardise the second bailout package. The country was also forced to activate an obscure emergency fund for its banks, regarded as one of the last resort mechanisms, in a sign that the banks are starting to run short of quality collateral acceptable to the ECB.

In his long-awaited speech at Jackson Hole, Bernanke disappointed markets by failing to announce another round of quantitative easing, although he said the central bank's board would revisit the issue at its meeting in September. He

declared himself "optimistic" about long-term future growth prospects. He reiterated that the political partisan brinksmanship over the debt limit had disrupted financial markets and the economy. His positivity was not shared by the IMF's new head, Christine Lagarde, who warned that the global financial system is on very thin ice and that European banks are in need of urgent recapitalisation.

The last week brought some positivity to the markets as investors bet that the US is not slipping into another recession and as Hurricane Irene caused less disruption to the US's East Coast than anticipated. The minutes of the Fed's meeting in early August also showed that a number of committee members called for more "substantial" stimulus, such as further bond purchases, opening the door for QE3. The Rand strengthened to R6.99/US$ and gold slipped to US$1 820 per ounce, buoyed by a merger of two large Greek banks and stronger July US consumer spending figures.

The strength of the market recovery was a surprise and we expect a bumpy ride ahead for the remainder of the year.

## NOT A GREAT MONTH FOR SOUTH AFRICA

August was a dismal month of strikes, threats of nationalisation and political notoriety.

It was the municipal workers' turn to wrecked havoc on major cities in a bid for an 18% salary increase. The recent strikes are estimated to have cost gold miners around US$190 million in lost output, curtailed the already struggling manufacturing sector and trimmed third-quarter economic growth. And although the average wage settlements at 8% were lower than expected, above-inflation salary increases do not bode well for future employment.

Finance Minister Pravin Gordhan and Minister of National Planning Trevor Manuel both commented this month that labour laws might have to be loosened if the government's job-creation targets were to be met.

The thorny debate on nationalisation heated up with the business sector warning that it would damage the economy, and the Congress of South African Trade Unions suggesting that it was a fait acompli.

To add to our "perceptions" woes, South Africa was judged 52$^{nd}$ out of 59 countries in the latest competitiveness report published by the Swiss International Institute for Management Development, with productivity and infrastructure being cited as areas of concern. South Africa fell from its 44th place last year, beating only Greece, Jordan, Argentina, Ukraine, Croatia and Venezuela. Hong Kong remains the most competitive region, followed by the US, Singapore, Sweden, and Switzerland.

And to add to its notoriety South Africa stalled the release of US$1.5 billion of seized Libya assets for emergency aid by the UN Security Council until it had little choice but to agree.

The economy did little better than our politics. Trade conditions as measured by the SACCI Trade Activity Index, deteriorated in July, while the Kagiso purchasing managers' index fell for the fourth straight month to a two-year low.

Consumer inflation rose more than expected to 5.3% year-on-year in July from 5.0% in June. The 0.9% month-on-month increase was largely driven by food prices. Producer inflation, which represents domestic output, also quickened to 8.9% year-on-year in July from 7.4% in June.

Private sector credit extension rose 5.7% year-on-year from 5.3% in June, while credit to households eased slightly, slowing to 6.6% from 7.1%..

Most worringly, the second quarter GDP growth slowed sharply to an annualised 1.3% from the first quarter's 4.8%, with the manufacturing sector contracting by 1.1%. The Reserve Bank governor Gill Marcus indicated the economy's performance had been "disappointing" with evidence that the main driver of the recovery, household consumption, was slowing. And although the SARB's leading business cycle indicator rose by 1.8% in June compared with May, it is yet to take into account the rapid change in market conditions in July and August.

Unsurprisingly, business confidence fell at its fastest pace in nearly two years last month, extending a downturn seen since the start of this year.

# GLOBAL SNAPSHOTS

## UK

The battered UK economy registered muted growth of 0.2% in the second quarter of 2011, half the rate predicted by the Office for Budget Responsibility in March. The British economy has barely grown over the past three quarters and economic indicators all suggest that the fourth quarter is unlikely to be better. Consumer inflation rose to 4.4% in July, confirming the fact that the surprise June drop was temporary. Inflation remains on track to hit 5% by year end.

With consumer and business confidence weakening, the Bank of England indicated it is ready to heed the IMF's call and inject more stimulus into the economy.

## India

It is interesting to note that corruption is not only a South African phenomenon. For much of August India has been gripped by a raging public debate about how to tackle endemic corruption.

However India has more pressing problems. Its central bank issued a blunt warning that India's economic growth could fall below 8% in 2011. This was reaffirmed by official figures which showed that GDP rose 7.7% in the three months ended June 30, compared with a 7.8% climb in the previous three months. For India, which strode at a 9% pace before the financial crisis and hit 8.5% last year, this would be a significant slowdown. However the signs have been there for a while. Private investment has been falling since late last year and once-robust car sales have decreased in recent months. Indian stocks began falling in November and are now down more than 24% from their high. Moreover, inflation has been hovering at nearly 10%, even after the Reserve Bank of India raised interest rates 11 times in less than two years.

## USA

Despite the depressing headlines, the actual economic data suggests that, although fragile, the economy is not on the cusp of another recession. Upbeat retail sales, industrial production and consumer spending figures in July contrasted with weak housing, employment and consumer confidence numbers. Unemployment fell to 9.1% only as a consequence of discouraged work seekers abandoning looking for work.

Inflation is also no longer benign. Consumer inflation rose at its fastest rate in four months in July at an annual rate of 3.6%. Excluding food and energy, prices are up 1.8% year-on-year. The 0.2% rise in the producer price index followed a 0.4% decline in June. This means that 10-year Treasuries are now yielding -1.4%.

# WORLD STAGE EVENTS EXPLAINED

## A friend or an enemy

According to a paper presented by the Bank for International Settlements at the Jackson Hole summit on the point at which debt stops supporting growth and turns damaging, the research found that for government debt the threshold is in the range of 80% to 100% of a country's GDP. For corporate debt the threshold is closer to 90% of GDP and for household debt it is around 85% of GDP.

## Taking on the US?

Credit rating firms' influence came under scrutiny as, despite or ironically because of, the S&P's downgrade, global investors poured money into US government bonds. Since S&P dropped the US's rating to AA+, the yield on the 10-year Treasury note, a benchmark for everything from home mortgages to car loans, has declined to as low as 2.03% from a high this year of 3.77%. US bond yields are now lower than on the debt of most countries with an AAA ratings.

S&P's decision was based on the view that the US government is becoming "less stable, less effective and less predictable", even after acknowledging to the Treasury Department a US$2 trillion error in its calculations that by its own methodology could have prevented any change from an AAA rating.

However, the decision to take on the US government may cost it dearly. S&P is reported to be under investigation by the SEC and the US Justice Department over whether its positive ratings of mortgage-backed securities, which later collapsed, helped deepen the financial crisis. By month end S&P also announced that its President, Deven Sharma, has resigned. US Vice President Joe Biden indicated that pressure from US businesses that suffered as a result of the downgrade may have influenced the decision.

## The Eurozone Battleground

The sparring between the cautious well-managed European economies and their deadbeat partners has intensified with Germany effectively thrust into a position of deciding the future of Europe. That is a role Germany has struggled to avoid and remains unwilling to accept. All accords reached to date have been wishy-washy.

The EU countries agreed in July that a new fiscal agency, the European Financial Stability Fund, will be tasked with resolving the solvency problems. However the size of the und was not increase. Although its authority was extended to deal with the solvency of banks, banking supervision remains the domain of national agencies. And although Greece was offered more aid, there was no convincing case that the rescue can succeed.

The concessions on interest rates paid by bailed out countries have left Spain and Italy paying much more on their own borrowing than they receive from Greece. This gives them the right to opt out of the Greek rescue, raising the prospect that the package may unravel. Finland was promised collateral to secure its agreement to the Greek bailout, triggering demands for similar treatment from other nations.

Unfortunately, a default by even a small country such as Greece would cause an immediate global banking crisis. It is estimated that European banks hold €98.2 billion of Greek sovereign debt, €317 billion of Italian government debt and about €280 billion of Spanish bonds.

Germany has little choice but to commit to the battle for the euro.

## However let's not forget…

The German Constitutional Court is still to rule on the legality of the various bail-outs (its ruling is expected on 7 September). If it rules that the €440 billion rescue fund breaches Treaty law or undermines German fiscal sovereignty, it could shatter the euro.

The German Bundesbank added to the concerns by accusing the ECB of going way beyond the bounds of their mandate with the mass purchase of southern European bonds and warning that the EU is drifting towards debt union without "democratic legitimacy" or treaty backing. Similar views have been expressed by Christian Wulff, Germany's president, and by forces within Merkel's own Christian Democrat coalition.

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