

# SYGNALS

## MONTHLY UPDATE



### KEY INDICATORS

	1 Month	3 Months	6 Months	1 Year	2 Years	3 Years	5 Years
J203T FTSE/JSE All Share Index	-2.4%	8.4%	2.1%	2.6%	10.5%	17.3%	8.1%
J200T FTSE/JSE Top 40 Index	-3.2%	8.4%	1.3%	2.2%	9.5%	16.4%	7.5%
J210T FTSE/JSE Resources 20 Index	-5.2%	7.7%	-3.5%	-6.7%	2.3%	12.4%	5.6%
J211T FTSE/JSE Industrials 25 index	-2.4%	9.0%	5.4%	10.5%	18.3%	22.3%	12.6%
J212T FTSE/JSE Financials 15 Index	1.9%	9.6%	4.8%	6.6%	10.6%	16.0%	3.1%
J403T FTSE/JSE SWIX Index	-1.4%	8.3%	3.6%	4.3%	12.3%	17.9%	8.6%
J303T FTSE/JSE CAPI Index	-2.4%	8.4%	2.4%	3.0%	11.0%	17.7%	8.7%
ALBI BESA All Bond Index	0.7%	3.5%	6.4%	8.8%	11.8%	7.4%	8.6%
STeFI STeFI Index	0.5%	1.4%	2.8%	5.7%	6.3%	7.3%	8.5%
MSCI World Index in SA Rands	-0.7%	7.3%	7.1%	15.1%	7.3%	5.1%	0.5%
Rand/US Dollar Exchange Rate	-0.6%	-0.3%	19.3%	21.9%	4.4%	-5.4%	3.0%
Rand/Euro Exchange Rate	-4.2%	-3.4%	6.8%	18.3%	-0.2%	-7.4%	2.5%
Headline CPI	0.3%	1.2%	2.7%	6.1%	4.8%	5.2%	6.9%
Core CPI	0.1%	0.4%	1.9%	4.2%	3.9%	4.9%	5.4%

*"Resolving the sovereign debt crisis is a process, and this process will take years. Marathon runners believe that their efforts become particularly difficult after the "35 km mark", but they also say that you can get to the finish if you are conscious of the magnitude of the task from the very start."*

*German Chancellor Angela Merkel, speaking in Parliament ahead of the EU summit on 9 December 2011*

2011 ended on a flat note, with investors anticipating a turbulent 2012 after the European Union prioritised austerity over growth. After an inconclusive EU summit which saw the UK isolated, German Chancellor Angela Merkel and French President Nicolas Sarkozy are to meet in January 2012 to discuss a new fiscal treaty. The only source of optimism was the US where the economic picture continued to brighten. Political uncertainty in Iraq, Syria and Russia added to the murky picture of the future.

### US ECONOMIC RECOVERY WRESTLES AGAINST EUROPEAN TURMOIL

As far as equity markets were concerned, 2011 was a disappointment. Asian stocks posted their first annual decline in three years as sovereign debt crises in Europe, China's monetary tightening and Japan's earthquake brought little to celebrate. The MSCI Asia Pacific Index fell by 23.8% in 2011, with Japan's Nikkei Index coming in at -17% and Hong Kong's Hang Seng Index falling by 20%. China's Shanghai Composite Index tumbled by 22%, the most since 2008.

Europe did slightly better with the FTSE100 Index delivering -5.6%, and France's CAC40 Index -17.0% while the German DAX lost 14.7%. In the US, the S&P's 500 Index ended 2011 flat, after rallying 23% in 2009 and 13% in 2010. In comparison, the JSE/FTSE All Share Index ended in the black up 2.6%.

December itself brought little to cheer about and even fewer answers. The global central banks' co-ordinated injection of liquidity into the markets at the end of November only temporarily cheered investors. All eyes were on the 9th of December EU summit which ultimately delivered little in terms of concrete commitments. Germany won the day with an agreement for tighter fiscal integration in the euro zone and tougher budget discipline. However those hoping for an expanded role for the ECB were left disappointed. In fact, an agreement involving all 27 EU members fell through after British Prime Minister David Cameron demanded concessions for the UK financial services industry that Germany and France were not willing to give. As financial services account for about 10% of Britain's economy, the government has been at pains to shield it from regulation emanating in Brussels, such as the transactions tax due to come into effect in 2012. Their resistance means no quick amendment to the existing EU treaty. However, undeterred, Germany and France plan to press ahead with a closer integration of the 17 countries which use the euro. Six others, who aspire to join, have also committed to negotiating a new agreement alongside of the EU treaty.

The key principles agreed on include automatic sanctions for budget deficit offenders, with new fiscal rules on balanced budgets to be written into national constitutions. The future permanent bailout fund, the ESM, would be capped at €500 billion and will not get a banking licence, which would have allowed it to draw on the ECB funds to increase its firepower. The EU leaders also agreed to explore the option of euro zone central banks making bilateral loans to the International Monetary Fund to the tune of €150 billion with the hope that a further €50bn would come from donors outside Europe.

December saw Greece, Spain and Italy adopting further austerity measures against a backdrop of social unrest. Italy approved a €30 billion austerity package of tax hikes and pension reforms, while the Greek parliament approved a 2012 budget pledging tough fiscal goals demanded by EU partners in return for new loans. Greece's economy is expected to contract by 2.8% next year in a fifth consecutive year of recession. Spain shocked the markets by forecasting a budget deficit of 8% of GDP for the year, up 2% from previous forecasts, highlighting how difficult it is to generate growth in revenue in the face of budgetary cuts. Spain's deficit is twice that forecast for Italy and more than four times that of Germany. The government responded by committing to cut public spending by a further €8.9 billion in 2012.

Elections in Russia saw Prime Minister Vladimir Putin's hold on parliament weaken as his United Russia party lost the two-thirds majority which, to date, allowed it to change the constitution unilaterally. Protests across Russia against contentious elections continued through the month.

Political tensions in Asia increased after North Korea announced the death of leader Kim Jong-il, raising fears of regional instability. Kim's youngest son, Kim Jong-un, was confirmed as the next the leader, as North Korea warned the world not to expect any changes from the military regime.

On the interest rate front, most central banks, apart from the ECB, kept interest rates steady. The ECB, while resisting calls to act as a lender of last resort to deadbeat EU nations, cut its main interest rate by 0.25% to 1.0%.

On the economic front China's manufacturing sector shrunk for the first time in three years in November, before recovering somewhat in December, on the back of weak domestic and foreign demand. Similar surveys showed that manufacturing activity contracted sharply across the euro zone and in the UK. On a more positive note manufacturing accelerated in both the US and in South Africa where the weaker rand brought some relief to exporters.

China's central bank responded by reducing the capital reserve requirements for banks for the first time since 2008 and pledging to "fine-tune" economic policies to sustain growth. Formally laying out its annual blueprint for the economy in 2012, the government promised to keep monetary policy "prudent", fiscal policy "pro-active" and consumer prices stable. China's economic growth has slowed for three consecutive quarters, and many forecasts see it dipping below 9% in 2012 for the first time since 2001. Lower inflation (4.2% in November, down from a three-year high of 6.5% in July) gives the government some scope for monetary policy relaxation.

The only bright light was the US where all economic data points to a muted but consistent recovery in growth. US unemployment dropped in November to a two-year low of 8.6%, consumer spending improved and manufacturing activity quickened. Even the housing market is looking more solid with housing starts rising to the highest level in two years and new home construction recovering on a growing demand for rental accommodation. The Federal Reserve kept interest rates steady while forecasting moderate growth next year and a gradual decline in unemployment.

S&P once again shocked the markets by putting the credit ratings of all euro zone members, including those of Germany and France, under review. This means that a downgrade could materialise within 90 days. It also warned that "time is running out" for European leaders to agree on concrete fiscal and monetary measures. Moody's followed, announcing it would reassess its ratings of European sovereigns in early 2012 as the EU summit failed to produce "decisive policy measures" to end the debt crisis. A week later Moody's downgraded Belgium by two notches to Aa3, while Fitch warned Spain, Italy, Belgium, Slovenia, Ireland and Cyprus of downgrades after it concluded that a "comprehensive solution to the euro zone crisis is technically and politically beyond reach". Fitch also revised its outlook on France's rating to negative, saying the downgrade was not imminent but could come within two years.

The uncertainty in Europe has taken its toll on emerging markets where government debt yields have risen and currencies fallen as increasing risk aversion translated into foreign investment outflows. The US dollar, on the other hand, continued to strengthen, while the gold price trended down. Although gold is traditionally regarded as a safe haven, the euro zone debt crisis has caused a significant liquidity shortage, forcing investors such as banks to sell gold for liquidity.

Markets cheered mid-month when the European Financial Stability Facility sold €1.97 billion of three-month Treasury bills, opting to raise shorter-term funding after its 10-year bond sale in November struggled to receive adequate demand.

But fears that the latest package agreed by EU leaders is starting to unravel led to a further sell-off in the markets. Within days, squabbling started over the agreed €200 billion contribution to the IMF, with the UK first to indicate that it would not contribute. Meanwhile a number of EU countries warned that they may not be able to push through treaty changes without parliamentary approvals.

Although the ECB continued to publicly refuse to commit to buying sovereign debt, it kept quietly buying enough Spanish and Italian bonds to keep their borrowing costs low enough to be affordable, but sufficiently high to keep pressure on the governments to follow through on budgetary reforms.

In a major injection of further liquidity, the ECB announced that it would offer banks an opportunity to borrow money for three years, extending the current one-year ceiling for refinancing, on a silent hope that banks will use the money to buy euro zone bonds. The three-year funds were offered at an interest rate indexed to the ECB's main refinancing rate over the life of the loan. That rate is, after a rate cut earlier this month, at a record low of 1.0%. For some banks the money is more than 3% cheaper than they can get on the open market.

The re-financing programme saw 523 banks take up a bigger-than-expected €489 billion in loans, easing fears of a credit crunch. However, this did not stop banks from remaining wary of each other and choosing to deposit more and more money with the ECB overnight. Banks borrowed the money at the ECB's benchmark rate of 1%, but receive an overnight rate of just 0.25%, meaning lenders are depositing any new cash at a loss in order to guarantee safety.

Across the Atlantic, Democrats and Republicans squabbled over an expiring payroll tax cut until Christmas. The Republican nomination campaign intensified. Fitch warned that America could lose its prized AAA credit rating by the end of 2013 unless US politicians agree on a credible plan to address the country's rising debt burden. In a new fiscal projection, Fitch said at least US\$3.5 trillion of additional deficit reduction measures will be required to stabilize the federal debt at 90% of GDP in the latter half of the current decade.

As the Christmas and New Year holidays approached, equity markets continued to oscillate on thin trading volumes.

Oil spiked temporarily as Iran warned that it would block the Strait of Hormuz, the world's most important oil transit point, if Western powers attempt to impose an embargo on Iranian oil exports in their campaign to isolate the country over its nuclear energy program. The Strait of Hormuz, a narrow passage that connects the Gulf of Oman to the Persian Gulf, is the route for one third of the world's oil-tanker traffic. The threat was quickly dismissed as empty rhetoric.

The US Treasury shied away from labelling China a currency manipulator, merely criticising it for not moving quickly enough on exchange rate reforms. Despite regular strong rhetoric, the US continues to lean towards a softer diplomatic approach.

The ECB's injection of liquidity had the effect of halving Italian short-term borrowing costs as it sold €9 billion of six-month bills at an average rate of 3.3%, down from a euro lifetime record of 6.5% just a month earlier. Three-year bonds were issued at a yield of 5.6%, compared with 7.9% in November, and ten-year bonds at 7.0% versus 7.6% in November. But the total amount sold fell short of the €8.5 billion target and the cost was still deemed to be unsustainable.

Denmark, a non-euro country, took over the unenviable task of the EU presidency in 2012.

Euro zone leaders used their New Year's messages to highlight the dangers facing Europe.

Chancellor Merkel warned of turbulence in 2012 as she does "everything" to save the euro and end Europe's sovereign debt crisis. President Sarkozy, who faces a re-election battle in 2012, referred to the year as "full of risks", with France's future hanging in the balance. In Italy, Giorgio Napolitano warned Italians they will have to make sacrifices to avoid financial collapse, while Greek Prime Minister Lucas Papademos emphasised that Greece must continue its efforts to remain in the euro and avoid economic collapse.

## SOUTH AFRICA

In line with international trends South Africa's growth momentum is moderating with downside risks to the outlook for 2012 and 2013 increasing. The euro zone debt crisis and the slowdown of growth in emerging markets, particularly China, are beginning to impact external demand. Although GDP growth for 2011 is still likely to exceed 3%, it is now forecast to weaken in 2012.

As expected consumer inflation rose to 6.1% year-on-year in November, breaching the 3%-6% target range. As seen in December the rand is highly vulnerable to bouts of global risk aversion, posing an upside risk to inflation. With a weaker rand pushing inflation up at a slightly faster pace CPI is expected to average 5.9% in 2012. Prices are expected to peak at 6.4% in the first quarter of 2012 and moderate to an average of 5.4% in 2013.

On a positive note, credit extension to the private sector grew at a rate of 6.2% year-on-year in November from 5.5% in October. The weaker rand has meant that manufacturing remained stronger, with the PMI reaching 51.6 from 50.5 in October, a fourth monthly increase. Growth in retail sales slowed marginally from 7.7% in September to 7.4% year-on-year at constant prices in October. Consumption is likely however to slow down under the weight of rising inflationary pressures, chronic unemployment and household indebtedness.

And foreigners continued to buy South African bonds, albeit at a slower pace than a year ago. Foreigners have been net buyers of R47.6 billion worth of local bonds, excluding repo transactions, versus R57.1 billion in 2010.

On the corporate front British American Tobacco joined the FTSE/JSE Top 40 Index on 16 December 2011, albeit at a lower level than anticipated as its market capitalisation was adjusted to reflect what is actually traded in South Africa.

The UN Climate Change Summit in Durban brought some mixed reviews. Finding a successor to the Kyoto Protocol on global emission reduction, which expires at the end of 2012, remains an elusive goal. The delegates agreed to extend the Kyoto protocol till 2017 while negotiating a new treaty. However Canada broke ranks by withdrawing from the Kyoto protocol within a week.

## GLOBAL SNAPSHOTS

### Japan

Japan's economy grew less in the third quarter than an initial estimate (5.6% versus 6.0%) as the strong yen and the euro zone crisis weighed on the recovery. However, the figure represents Japan's first economic expansion in three quarters.

The central bank offered a bleaker view of the economy going forward and lowered its GDP growth forecast for 2011 from 0.5% growth to a 0.1% contraction. It forecast that Japan's economy will expand by 2.2% in 2012 on the back of post-quake infrastructure expenditure.

### Brazil

Brazil's central bank also cut its 2011 growth estimate to 3.0% from 3.5%. Compared with previous years where growth averaged near double-digit rates, this is a disappointment. The government responded by unveiling a slate of ambitious tax cuts designed to boost consumption and investment. Brazil introduced similar measures in the wake of the 2008 crisis. Those measures helped the country exit recession swiftly in 2009 and notch a muscular 7.5% expansion in 2010, the fastest growth rate in 24 years.

According to the Centre for Economics and Business Research, Brazil overtook the UK as the world's sixth-largest economy, slotting behind the US, China, Japan, Germany and France.

### India

India followed suit, cutting its growth forecasts from 9% to 7.5% amid slowing domestic and global demand, and warned that the budget deficit may exceed the targeted 4.6% of GDP by over a percent as expenditure climbs while tax revenue disappoints. India's economy is contending with 13 rate rises since early 2010, a policy tightening that has hit growth but done little to counter near double-digit inflation and a sharp slowdown in manufacturing activity.

### Dubai

S&P has warned that some of Dubai's largest companies will need state-funded bail-outs in 2012 if large-scale defaults are to be avoided. Five conglomerates, including Dubai's Jebel Ali Free Zone, a tax-free business hub set up in 1985 to attract foreign investment, will struggle to service their debt without help.

The emirate's total debt stands at about US\$119.8 billion. US\$15 billion will need to be repaid or refinanced in 2012.

## WORLD STAGE EVENTS EXPLAINED

### Some thoughts on 2012

The outlook for the global economy in 2012 is far from certain. The most likely outcomes are a recession in Europe, anaemic growth in the US, and a sharp slowdown in China and other emerging market economies. Restructuring of the euro zone is also on the cards. In addition, turmoil in the Middle East will put upward pressure on oil prices.

A recession in the euro zone is fairly certain. While its depth and length cannot be predicted, a continued credit crunch, sovereign debt problems, lack of competitiveness, and fiscal austerity imply a serious downturn. Addressing weak competitiveness and current account imbalances requires currency adjustments that may eventually lead some members to

exit the euro zone. As growth wanes, the euro zone will find it even more difficult to shore up shaky banks and reduce the high borrowing costs that threaten Italy and Spain. A key issue will be whether sovereigns and banks can continue to raise money in the markets at affordable rates. For example Italy has more than €300 billion in debt maturing in 2012.

This in turn impacts on the US which is facing its own problems, including a weak property market and stagnant employment prospects. In addition, political gridlock associated with end of the year elections means little political consensus to make hard decisions. However, the positive economic momentum may yet save the year.

In Japan, the post-earthquake recovery is slowing down.

In China, the risks to growth are heavily tilted to the downside. Chinese policy makers have not wavered in their commitment to bring down housing prices, plan to maintain a “prudent” monetary policy and are said to be eyeing a tighter fiscal stance in 2012. The impact of slowing demand from the EU slowdown cannot be underestimated.

Rising social inequality and economic imbalances between countries will continue to fuel social and political instability. This may well lead to some messy restructurings.

Monetary policies are likely to remain accommodative as inflation becomes a non-issue. However monetary policy is increasingly ineffective in advanced economies, where the problems stem from insolvency and creditworthiness, rather than liquidity.

The answer would be for surplus countries to allow their currencies to appreciate in favour of imposing recessionary deflation on deficit countries. There is little appetite for this, with Europe pursuing a policy of fiscal austerity.

Governments are finding it increasingly difficult to implement international policy coordination, as the world views, goals and interests of advanced economies and emerging markets come into conflict.

2012 will be a volatile year.

## European Central Bank

The ECB is not a central bank in the true sense of the word. Formed at the time of the formation of the EU, its main mandate is to fight inflation. Hence it cannot act as lender of last resort for sovereign states as the EU treaty law explicitly prohibits it from financing of governments.

The ECB faces increasingly frenetic calls to act as a lender of last resort, not in the traditional sense of providing liquidity to the banking system, against good collateral and at a penalty rate, but instead to wobbly sovereigns and at a preferential rate. This implies loading the ECB's balance sheet with a significant amount of credit risk and potential capital losses. The ECB's ability to act as an LOLR to sovereigns is constrained not only by its narrow mandate and EU Treaty provisions, but also by doubts about the credibility of its fiscal anchor and a potential unhinging of inflationary expectations.

The primary reason for this provision is the threat of moral hazard for profligate governments and the deleterious consequences such policies have had in countless instances in history.

The ECB is backed by the paid-in (and subscribed) capital of its 17 member states as per the capital key, which include the very states whose debt it is buying because market participants deem them insolvent, or at least illiquid.

Instead, the bank has focused on pushing credit to banks so they can keep lending to support the economy.

Its bond purchases have provided essential support to Spain and Italy by helping hold down borrowing costs. And its latest massive infusion of €489bn in cheap, long term loans may help troubled governments borrow, as stronger banks may use some of the money to buy higher-yielding government bonds.

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