FIRSTRAND
Group

Global Markets Update

International Investment Panel
(First Rand - Wealth Segment)

February 2009

This summary incorporates the discussions of the RMBAMI Asset Allocation meeting in London on 13 February 2009.

1. Global Outlook

The economic outlook is deteriorating, with a prolonged recession inevitable.

The 'credit crunch' has become a household word in the last six months. Starting as a financial crisis in early 2008, that slowly gained momentum throughout the year up to the collapse of Lehmans, it then exploded across the globe in October 2008, and is now having a massive impact on the global economic system. Structural failings in the financial world have now led to a global economic downturn as significant as any seen since the great depression of the 1930's.

This financial breakdown has led to a fall in consumption, leading to a rise in unemployment and finally into the first synchronized global recession in developed economies for over fifty years, with the bursting of the US housing bubble being the catalyst. The reaction of central banks has been unprecedented and swift, but it has not been smooth. Fiscal and monetary relief policies are propping up a system on the brink of seizure. There are early signs that these radical measures are working, and that both conventional and unconventional monetary policies are slowly freeing up the credit markets.

Deflation fears made regular headline news toward the end of 2008 and have continued into 2009. A sustained period of falling prices will exacerbate any economic slowdown, as demand destruction continues, real interest rates rise and the burden of debt increases. Unsustainable household and corporate debt levels, and the inability to re-pay that debt combined with a sustained period of deflation represents an economic problem of significant magnitude with increasing real debt levels and a continued slowdown in consumption. Consequently, the co-ordinated global efforts to stimulate and inject liquidity into the system using various means, particularly the "printing of money" (also known as quantitative easing) are for now ignoring the inherent inflationary consequences of doing so.

The obvious concern is whether the stimulus packages will be introduced in time and will be sufficient enough to counter the rapid contraction now underway. Time will tell; certainly for now, investors and markets are doubtful.

A less immediate concern is the possibility that the sheer scale of the stimulus and support packages announced to date have unintended consequences. There is a threat that run-away inflation may surface further down the line as the result of the excess liquidity being pumped into the financial system. Another way for the situation to normalize (albeit painfully) would be sovereign default and we are seeing the first signs of marginal European countries potentially being forced to the brink as they are unable to afford the cost of supporting their bloated and toxic banks.

Bond markets sold off in January as over-supply and inflation issues rose to the fore but continued risk aversion has forced yields lower (and bond prices up) once again. The deflationary outlook thus holds sway for the time being but the possible macro-economic outcome remains bi-polar; it could go either way.

What is certain is that the current period holds great uncertainty. The unprecedented volatility in current markets confirms this. Investor psychology appears to be the greater force in investor sentiment and action. Rational investor behaviour based on values and basic fundamentals is for now taking a back seat. While both the equity risk premium that investors are paid for owning equities and market volatility remain elevated. Cyclically adjusted valuations do suggest the markets are approaching levels where opportunities exist for the brave.

Equity prices remain extremely sensitive to news flow; bad news is very bad news while no news is even worse. Recent banking support announced by the UK government was considered ill-prepared and not thought through completely, while the recent US financial stability plan announced by new US Treasury Secretary Tim Geithner left investors distinctly underwhelmed. Markets sold off as he spoke. The removal of such ambiguity will go far in supporting an equity market recovery, if only to rally in an ongoing bear market.

Inter-bank credit markets continue to show limited signs of thawing. Banks are now lending beyond the daily and weekly limits in place four months ago. However, it is premature to consider that this is a major advance; banks are still hoarding excess reserve cash to guard against expected further loan write-downs and capital deterioration. On a more positive note, investment grade corporate debt spreads have narrowed both for reasons of supply shortage (as corporations cut back on any immediate and ongoing investment projects plans) and investors returning to this oversold asset class for both yield and the security of greater protection within the corporate capital structure (from further implied govt. guarantees)

As has been predicted, the first quarter of 2009 was always going to be a dark place, full of gloom and doom. Certainly, the outcome has probably been worse than expected given the singular failure of monetary and fiscal authorities to convince of the soundness of their intervention. However, it remains important to retain a sense of perspective. Commodity prices are now range trading at very low levels. The sheer size and pace of interest rate cuts is unprecedented, fiscal stimulus packages are enormous and credit markets have improved, albeit not to the extent required to signal the crisis nearing an end. It is reasonable to suggest that the current raft of poor economic data will moderate over the course of 2009.

Regional analysis suggests the US looks best placed to lead a market recovery. Aggressive monetary easing and proposed structural rebuilding packages are twin efforts designed to stimulate the economy. There is no doubt that the US Federal Reserve is the most progressive and innovative player in this gigantic game. Nonetheless, household and business balance sheets will take time to repair. The extensive de-leveraging required from the financial and private sectors has a long way to go.

Valuations in the European market look particularly cheap and the ECB still has more room to adjust rates vis-a-vis its US and UK counterparts.

The UK may enjoy some relative albeit brief competitive advantage with a much weakened pound. However, with an economy that is so heavily dependent on the finance industry the outlook is bleak. Unemployment has been steadily increasing in 2009 and house prices continue to fall. The increasing propensity for investors to save (rather than spend) as job security fears increase will only put further downward pressure on consumption. Recent growth estimates have been revised down on a regular basis, with a 4% contraction in GDP looking likely in 2009.

Asia has also been busy rolling out stimulus packages. On the one hand, Japan has reported a disastrous 12% contraction in annualized GDP growth, with little prospect of recovery. China too has reported a growth rate of only 6%, which looks a veritable crisis. But massive infrastructure investment has been planned and fiscal packages laid out in an effort to spur domestic demand. Leading indicators such as bank lending have provided some signs of revival although it remains too early to detect any convincing trend. Longer-term, however, the prospect of the Asian markets de-coupling from the West looks feasible as the Asian manufacturing power-blocks become less reliant on exports to the US.

2. Investment Implications (refer model attached)

Asset allocation

Equity

The Panel has become slightly less cautious, moving to a more neutral stance from its previous underweight bias. Equities are range trading above 2008's lows in what looks to be a protracted bottoming process. The uncertainty in the markets remains high and the risk of further losses is not ruled out. The emergence of more positive news flow and clarity on government support packages may provide the necessary stimulus to establish a breakout. The Panel emphasizes that at best any recovery would be a rally in an ongoing bear market.

Regional allocation

Global markets have traded in tandem for most of the past quarter. The Panel has nevertheless favoured the US for its more pro-active stance to the crisis and more recently added to Europe due to the increasing value in the equity markets. The panel has downgraded to negative both Japan and the UK, whilst Asia remains a longer-term proposition and the

Fixed Income

Bonds continue to be favoured over equities and cash. With corporate default risk decreasing, and panic buying in government debt over, investment grade corporate debt now looks good value over short to medium dated government issues and falling spreads (the difference in yield on corporate bonds over the equivalent government bonds) are suggesting this. The Panel cautions on how exposure is taken towards this complex asset class.

Index linked or inflation linked bonds are no longer offering as good value, having snapped back extremely quickly from previously high real yields after recent data suggested inflation can not be completely discounted. European bonds look attractive despite the recent rally. There is scope for the yield curve to flatten further and bond prices to increase. European policymakers are inherently more conservative than their US counterparts. However, there is further room for interest rate cuts, which will support the European bond market in the shorter-term.

Broadly speaking, the panel expects credit to lead any recovery and remains overweight bonds to equities.

Property

The Panel's position is that it is still too early to call the bottom, and is therefore predicated toward a zero exposure to this asset class. The US housing market perhaps looks closer to reaching a bottom than UK or Europe.

Alternative Investments

The Panel has further reduced exposure to this asset class, in favour of more compelling risk/reward opportunities in equities. Despite improving conditions, credit markets easing and short-selling bans lifted, the panel felt the ongoing liquidity issues are damaging enough to cause the panel concern in this asset class into 2009. Reputational issues are also a factor that may see further investor retreat from this asset class.

Currency

The volatility in currency markets is sufficient that the Panel has moved back to a neutral position. Sterling losses against both the dollar and the euro look overdone, notwithstanding inferior fundamentals. The dollar is preferred over the Euro due to probable interest rate cuts in the latter and regional concerns. The yen is an overbought risk aversion trade which is not supported by Japanese fundamentals.

Conclusion

A conflict of opposing forces is underway: deflationary trends in one corner and the aggressive response of global policymakers in the other. The outcome remains uncertain and views remain conflicting. Risky assets look to be at more compelling values after recent adjustment but the capacity for disappointment need to be factored in. Broader market sentiment remains fearful and cautious and will require a trigger of some sort to turn more positive.

4. Strategic Asset Allocation Model

The Panel agreed to create a synthesised balanced portfolio for use as the strategic model for asset allocation. This was based on the benchmark parameters of the RMBAMI Global Balanced fund and the Ashburton Advanced Portfolio (moderate risk) fund. Regional equity allocations are shown as directional calls only. For purposes of this model, alternatives are a tactical decision only.

Agreed asset weightings are as follows:

Asset Class		Strategic Weight	Tactical Weight	Directional move
Equities		50	30	→
	USA			↑
	UK			↓
	Europe			↑
	Japan			↓
	Other			↓
Bonds		25	35	→
Cash		25	30	↑
Alternatives			5	↓
	Hedge Funds		5	↓
	Property		0	↓
	Commodities		0	↓

Secretary

Paul Clifford
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