

ECONOMIC OVERVIEW

Quarter ended 31 March 2010



Traditional values. Innovative ideas.



Our focus global macro indicators – the oil and gold prices, US yield curve and renminbi exchange rate continue to reinforce a view of global recovery. Yet, the big rocks in the road to recovery remain the terms and timing of policy 'exit', especially fiscal resolution. This is best encapsulated in the saga of a more likely Greek sovereign default, an event that will place incremental pressure on the euro and Euro-land growth, as governments will be forced to frontload deficit-reduction responses. We have become more sanguine on the big economies like the US and UK where the additional benefit of weaker exchange rates point to some rebalancing of national balance sheets. This realignment would be complemented by modest renminbi revaluation in coming months, accompanied by continuing monetary tightening in China and other fast growing emerging markets and commodity exporters.

The 'surprise' event of the SARB's 50bp repo rate cut to 6½% gratified us, as it vindicated a view we've held for some time. There is still a prospect of another 50bp rate cut to 6%, but this will even more so depend on sustained strong capital inflows that will likely appreciate the rand, support lower inflation and flush the money market. Our core case against further easing is that, in concert with the global backdrop, the SA economy is revealing more vital signs, including the revival of tax revenues which will underpin SA's fiscal exit prospects. That said, unless SA revisits a scenario of exceptional net capital inflows, which could more generously fund private credit growth, the inherited high base of consumer debt, coupled with muted job prospects in the growth mix we expect, suggest that SA's upswing will be relatively more export and investment dependent relative to the consumption-intensive 2002-08 cycle.

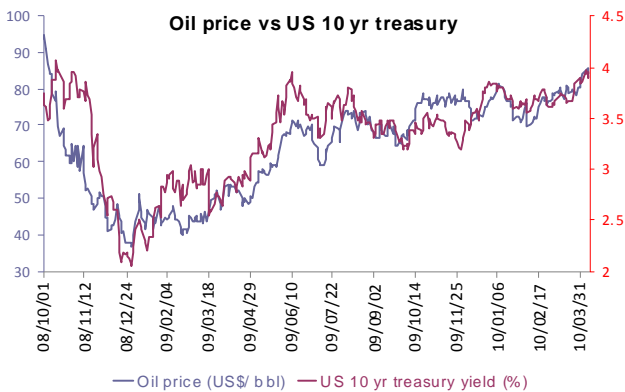


Pushing on a string...on several fronts

In the current global environment we favour monitoring four key macro indicators: the oil and gold prices, US Treasury yields and the renminbi exchange rate. The performance of all of these indicators continues to suggest the world economy is healing itself in the policy wake of cheap money and fiscal expansion. Both have provided a ready font of liquidity that has served to underpin the reflation of global risk asset prices even as valuations have become more demanding.

A more stable, though still elevated, gold price points to a turn in cyclical US dollar weakness vs. the euro, yen and Swiss franc. US dollar strength may yet prove more durable: the Euro still faces clear risks should Greece become Euroland's first sovereign defaulter; Japan has resumed quantitative easing given the resumption of deflation; while the Swiss are in two minds whether to stave off or to accommodate a stronger franc: so far, they have preferred to weaken the currency to keep deflation at bay. Having depreciated sharply vs. almost all currencies, sterling has held up relatively well against the US dollar this year.

CHART 1: VITAL SIGNS OF GLOBAL ECONOMIC LIFE



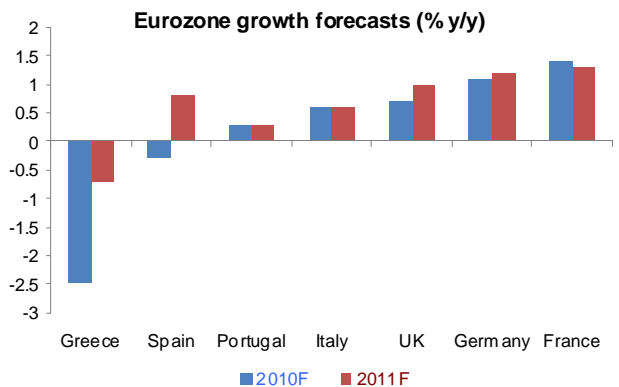
(Source: I-Net)

A more convincing sign of global recovery, especially in emerging markets and basic resource exporting economies, is the further rise in commodity prices, with this corroborated by higher prices of both oil and base metals, notably copper and steel (the latter, as a contract-based price system has finally morphed to spot market price discovery). Global recovery is also indicated by the rise in US Treasury yields to c.4%, even as the Federal Reserve continues to flag only a modest normalisation path for the Fed Funds rate. Thus far, the only significant policy normalisation has been to raise the discount rate (at which US banks borrow funds from the Fed) by 25bp to 75bp in February, but only because so few banks now need

this distress funding source. As a result, the US yield curve has continued to steepen, which is typically a reliable indicator of stronger growth. This dynamic has been reinforced by monetary tightening where recovery has been fastest: in emerging markets (e.g. China, India and Malaysia) and big commodity exporters (e.g. Australia and Norway).

These developments will be complemented in coming months by the likelihood of renminbi revaluation. Market indicators and commentary suggest this may happen sooner rather than later, buttressed by the intensity of US (and other) political pressure on the Chinese to revalue, as well as a clear body of opinion in China itself - notably from the People's Bank of China - that a revaluation would also be in the national economic interest. A reset of the renminbi will, however, be orderly, steady and gradual, but, when it happens - initially probably of the order of 3-5% - will nonetheless release an important re-balancing valve to sustain the global upswing.

CHART 2: FISCALLY STRESSED ARE GDP COMPROMISED



(Source: EIU)

Even given all the above factors, a strong recovery is still not guaranteed, with the greatest stumbling block remaining the pace and form of fiscal consolidation and, thereafter, a steady, though certain, reduction in government budget deficits. Policy settings clearly reflect a preference to deflate swollen fiscal deficits via incremental expansion of tax bases and, to a much lesser extent, some freezing of non-core government expenditure. Above all else, this requires a meaningful revival in domestic demand, but which may prove less tractable should households sustain a preference to continue to repair indebted balance sheets. Since 2008, most progress in this regard has been made in the US and the UK, but without deterring a US emphasis on renminbi revaluation, or the UK's willing accommodation of a much cheaper pound, as vital means to sustain foreign demand for American and British exports.



The 'fiscal exit' challenge is nowhere more apparent than in Greece, where the resolution of an increasingly probable sovereign default has embroiled much of the rest of Europe. Germany, in particular, as a significant current account surplus and relatively un-indebted economy, has been put in the pressure-cooker as the over-prudent counterpart of Greek fiscal profligacy. While there may be scope for relatively more German stimulus, there will be tight limits to this, given the popular support for Mrs. Merkel's government not to cede any more of Germany's 'sound money' credit rating to sovereigns, like, but not confined to, Greece, who have compromised their Euro membership. Thus, without the escape option of currency devaluation, it remains to be seen whether the Greek government will have the political will to retrench the economy sufficiently to divert resources to debt servicing. This seems more unlikely to us than three months ago.

Indeed, we are highly mindful that we didn't expect Euroland to be as afflicted by Greek fiscal woes - after all Greece is just 1½% of Euro-land's GDP. Our working assumption is that the threat to the Euro will see (mostly) Franco-German resolve to try to hold Greece's fiscal line - the recent marshalling of previously repudiated IMF support is a good example of this - but very tough choices still lie ahead. By contrast, sterling could start to appreciate, given the scale of its relative price decline with respect to all major currencies. However, this prospect is also contingent only a clear fiscal plan emerging whoever forms the next government after the UK's May 6 general election.

Catching up on lost opportunity at home

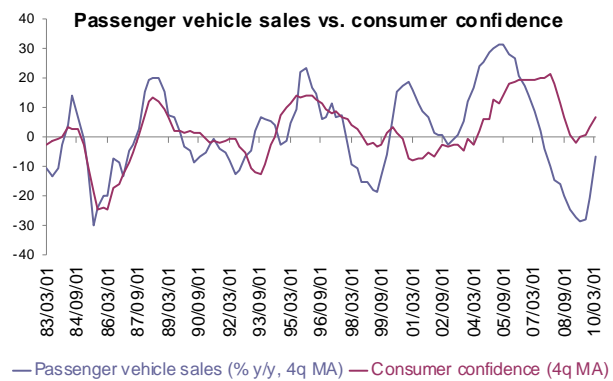
We were gratified by the SA Reserve Bank's further 50bp easing to 6½% at its March MPC meeting. For us, this represented a catch-up on lost opportunities since October last year to bring the local easing cycle into line with that of other economies that dipped into recession in 2009. For the SARB, the decision rested on three catalysts:

- 1) Rand strength corroborated by improving balance of payments dynamics;
- 2) A modest revival in domestic demand once accounting for restocking by firms, and
- 3) Clarity on administered electricity tariff hikes - remarkably close to the SARB's number of c.25% p.a. - that permitted the official CPI forecast to fall within a new "flexible" 3-6% target band.

Indeed, several indicators have continued to propagate a more convincing view of local economic recovery. Chief amongst these have been consumer confidence (mostly driven by easier credit conditions and dissipating spectre of job losses), business confidence (mainly due to lower rates and a firming in risk

asset prices - especially the stock market and home equity), new vehicle sales (though these also reflect Soccer World Cup related orders) and, finally, tax revenues that have started to perk up and could see the Treasury post a sub-7%/GDP fiscal deficit for 2009/10 vs. a prospect of over 9%/GDP at the end of last year. The glaring omission here remains still sluggish private sector credit growth, which suggests some basis for caution.

CHART 3: SA'S BUSINESS CYCLE HAS CLEARLY TURNED



(Source: I-Net)

SA's recovery path typically mirrors that of the world economy. Thus, the re-balancing themes discussed above, especially with respect to sustainable fiscal exits and appropriate exchange rate adjustments are particularly important. In the event that they materialise, SA should benefit as buoyant commodity prices and continuing capital inflows both underpin the rand's value and support import demand, especially given SA's strong infrastructure investment needs for the foreseeable future.

In this environment, it remains possible that the SARB could again cut repo rate. Our measure of an appropriate setting remains 6% but whether further SARB easing actually happens will depend on the inflationary risks inherent in an economic upswing. Indeed, firmness of global and local recovery point to little fundamental scope for further easing. However, we would reiterate our overriding caveat: if strong net capital inflows are sustained, the rand will be stronger, monetary conditions looser and credit growth stronger. Thus, a full jury is still out on SA's near-term monetary policy trajectory.

Since SA is at, or very close to, the bottom of its easing cycle, a key question for us is which sectors will absorb the economy's savings. Current contributors to SA's net savings pool are firms and foreigners, since households and government are net borrowers. Unless there is a much stronger than expected savings contribution from net capital inflows (i.e. >4¼ %/GDP), we still see it as more likely that personal spending will be constrained



this up-cycle relative to 2002-08 where a levered property boom anchored trend-plus GDP and jobs growth.

Indeed, while the cost of money has fallen sharply, a historically high personal debt stock hasn't budged. Some de-leveraging drag by SA households thus seems likely. We also expect a similar trajectory from government as the budget deficit is reduced. This suggests that SA's cyclical growth mix will be biased to net exports, given good terms of trade prospects, and to investment – in export, transport, communication and new technologies, relative to consumption. As the upswing consolidates, rising labour productivity should also see some jobs growth, but this will be muted relative to the last up-cycle. On balance, we have slightly revised up our GDP growth forecast to 3½% for 2010 and 3¾% for 2011 respectively.

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Gordon Smith completed his Bachelor of Social Science (Honours) in Economics from the University of KZN. He began work as an academic, lecturing Economics at the University of KZN between 1987 and 1990. In 1991 he entered the corporate world as a financial economist at Standard Bank before joining the stock-broking firm Ivor Jones Roy in 1994. Since then, Gordon has had a long and industrious career in the investment markets, where he has done award-winning work as a sell-side analyst as Chief SA Economist at Deutsche Bank, and later at Citigroup as their Africa Group Economist. He has recently returned from London where he worked at the global emerging market hedge fund, INTL Consilium, as their head of research for Africa, Middle East and Central Asia markets. During his more than 15 years in the markets, he was regularly voted as one of the top economists and strategists in his field. His expertise has taken him across the globe, where he is a sought after presenter.

Gordon joined RMB Asset Management in February 2009 and is a senior member of the investment team responsible for the macro strategy and asset allocation of the firm.

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