

ECONOMIC OVERVIEW

Quarter ended 31 December



Traditional values. Innovative ideas.

GLOBAL RECOVERY

Even as economic, trade and financial metrics paint a reinforcing picture of global recovery, there are signs of fraying-at-the-edges, notably Dubai's near-forced debt re-structuring, and the rising probability of Greece becoming the first Euro-area sovereign defaulter. In addition, we view Sino-centric asset bubble risks - arising from the scale of liquidity growth last year - as increasing, with this conclusion underpinned for us after our trip to China in December. However, these remain risks: our central scenario expects fiscal consolidation to precede any credible exit strategy by the Federal Reserve and other major global central banks from current ultra-accommodative policies. Higher rates in the US, Euroland and the UK are, in our view, still only likely in early 2011.. Against this backdrop, it remains hard to hold a convincing case for strategic US dollar strength, short of a flight-to-quality risk event.

Notwithstanding the excitement ahead of the Soccer World Cup, South Africa's consumer reticence is apparent in very weak credit growth, and its corollary in domestic demand indicators. While eviscerating credit has accommodated government's burgeoning deficit, at a prospective 9% of GDP for FY2009/10, this is now profligate and is not sustainable. Given an enabling global rates environment reflected in strong net foreign capital inflows, and our more-bullish-than-consensus inflation forecast (even allowing for electricity tariff re-pricing), we view the prospect of lower rates as credible. In the event, this will boost government revenues via supporting a nascent economic recovery. If this fails to transpire, fiscal consolidation will need to happen via unanticipated expenditure cuts and/or tax hikes. Our 3% GDP growth trajectory for 2010 reflects a favourable outcome to these balance of risks.



A year of fiscal policy reckoning beckons

The close to 2009 was characterised by generally constructive news of a recovering post-credit crunch global supply chain. This is best reflected in still firming global Purchasing Managers' Indices and industrial production growth. This is mirrored across financial markets in rising commodity prices, steepening yield curves and firming equity markets, in concert with soothing policy commentary and actions by the US Federal Reserve and other major global central banks.

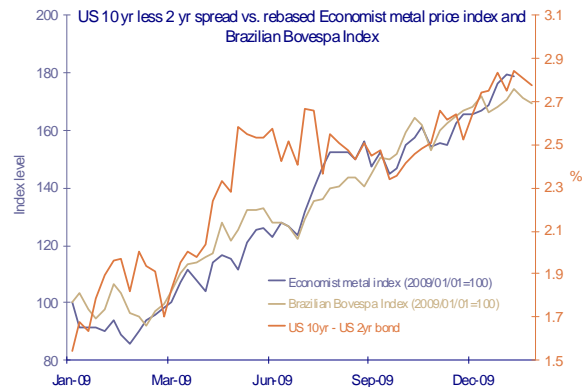
Such optimism is also evident in a further upward revision to real GDP growth forecasts for most big economies. The world economy is expected to expand by over 3% in 2010 versus a contraction of more than 1% in 2009. However, this disguises the continuing lop-sided nature of the world's recovery profile, with a Sino-centric growth engine set to post around 8% GDP expansion compared to sub-2% growth in the US and Japan and sub-1% in the UK and Eurozone countries.

Yet, this strengthening economic tract has not been sufficient to stay the hand of worry. Chief amongst these concerns is the recurring threat that highly indebted economies could unravel. In December, this was most notable in Dubai, which had indicated a de facto restructuring of quasi-sovereign debt, only to be bailed out by its richer and more credit-worthy Emirate neighbour, Abu Dhabi, at the 11th hour ahead of a large bullet repayment. Other imminent debt default prospects include Iceland, Greece and Argentina, while there have been forced devaluations in Vietnam, Venezuela and North Korea. Taken together, these developments highlight the stresses and strains of adjustment choices to a leaner world, and underpin the persistence of macro-level risks.

Our central post-credit crunch premise remains that what has essentially transpired in the great global stabilisation since 4Q08 is a transfer of private sector liabilities onto government balance sheets. The latter are now of a magnitude that will have to start to be seriously reckoned with this year, or the spectre of an inflation-instigated bout of financial instability is far more likely to emerge down the line.

Fiscal consolidation is thus a key plank of any sustainable overall policy exit to more normalised monetary conditions. Certainly, save for obvious exceptions like Australia and Norway, early talk of higher policy rates seems very premature to us.

CHART 1: ONE-WAY TRAFFIC IN RISK INDICATORS



Source: I-Net

Specifically, upward pressure on bond yields since November reflects new issuance indigestion rather than rising inflation risk, and certainly not an imminent removal of quantitative easing or outright policy tightening by major central banks. The latter is more likely to happen in late 2010 or, probably, early 2011. Thereafter the trajectory of rising rates should still be tempered. Moreover, until there is a meaningful segmentation of sovereign risk or relative growth premia, or barring any event that forces a flight-to-quality bid, the foreign exchange outlook should also remain benign for non-US dollar currencies, especially emerging markets.

Critical to 2009's recovery was China's very strong growth momentum. Our perspective on this dominant theme was complemented by a fortnight's research trip to China in December. One key take-away from the visit is not so much that there is a risk to China's secular emergence as an economic superpower as a heightened risk of a cyclical correction, given the sheer scale of liquidity injection into the economy last year, which has fuelled real estate and infrastructure spending in particular.

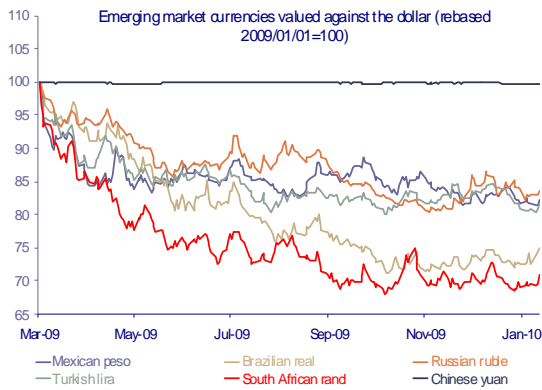
This, in turn, has fired commodity prices while seeing China's credit intensity ratio ramp up to an eye-catching 180% of GDP. Thus, most recent quantitative tightening by the Chinese authorities to temper the onset of asset price bubbles does not come as a surprise to us.

Rather, while real and financial asset inflation has emerged as a primary concern, the extent to which China's extraordinary growth surge has added to excess capacity raises a strong disinflation or even deflation spectre. A good example of this is estimated vacancy rates of between 20% and 50% in Grade-A commercial property in Tier-1 cities such as Beijing, Shanghai and Guangzhou.



This will only serve to elevate the key macro issue in China: namely the revaluation of the renminbi's peg to the US dollar. This would be the catalytic re-balancing conduit for international economic relations between China and the rest of the world as well as the restructuring of China's GDP. Both of these inevitable adjustments are reflected in China's large and likely widening current account surplus in 2010/11. This reveals China's excess savings, and thus investment, relative to consumption and, in spatial terms, the income and wealth eminence of the eastern seaboard relative to the Chinese hinterland.

CHART 2: CHINA BENEFITS FROM THE WEAK DOLLAR



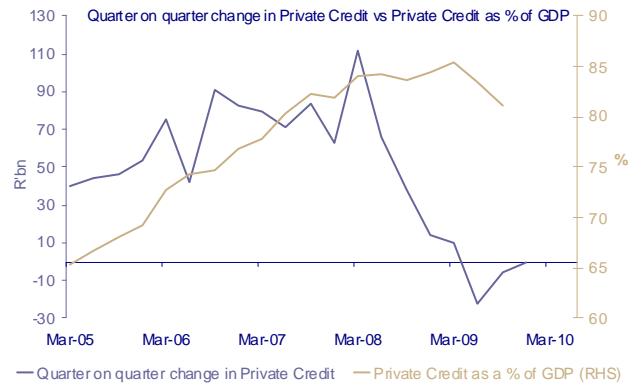
Source: I-Net

From our observations, the official line is clear: regulators will resist a sharp or quick revaluation, even as our fair value calculations suggest the renminbi is up to 40% undervalued. A preference for a weaker-for-longer renminbi mainly arises because of a real or perceived loss of global market share - an obsession with Chinese companies - and/or the discounted required exchange rate hurdle to clear the labour market. Given this mercantilist mentality, the most likely ongoing outside pressure to nudge a renminbi revaluation remains the threat of rising tariff barriers.

De-leveraging could still permit more easing

South Africa is a credit contrast to China, where the nominal contraction in monetary aggregates even after a cumulative 500bp cuts in repo rate to 7% is ever more surprising in an economy where banks are well capitalised with relatively low non-performing loan ratios and are not under any systemic regulatory pressure to retrench balance sheets. This suggests that credit demand rather than supply is now the binding constraint, a conclusion consistent with very weak vehicle and retail sales as well as a still bleak jobs outlook.

CHART 3: CREDIT GROWTH IS ON A STRICT DIET



Source: I-Net

This real economy backdrop informs our inflation outlook. The main drivers of CPI are commodity prices, the rand, labour costs and money growth. The forward momentum of all four have moderated meaningfully, notably labour costs, as jobs have been lost and inflation has fallen, and money growth, given the scale of de-leveraging.

An improving global economy has boosted commodities to a level that is rand accretive, but, in general, prices are unlikely to pierce their May 2008 highs. Other rand positives should stem from 2010 Soccer World Cup receipts during the tournament this winter. In addition, South Africa's 700bp of "positive carry" (i.e. the spread of local to international rates) and steep yield curve also imply a solid base to attract foreign capital inflows of, we think, around 4% of GDP this year. Against this backdrop, the rand should range-trade between 7.00 and 7:50 to the US dollar, even as it remains somewhat overvalued versus the US dollar and on a trade-weighted index basis.

A prospect of falling inflation is corroborated by our disaggregated CPI profile. By far the main upside risk still stems from the unresolved size and persistence of electricity tariff hikes. Here we would reiterate our view that this is still more likely to be a relative rather than absolute price shock - i.e. higher electricity prices will be absorbed by rationalising other expenses in company and household budgets. As a result, inflation is likely to trough at c.4.5%, which is a lower level than the market currently anticipates. This, in turn, implies a prospect for up to a 100bp of further easing by the Reserve Bank, taking repo rate to 6%.

Incremental monetary easing will clearly have a number of positive knock-on effects. Chief amongst these should be to manage down issuance nervousness reflected in rising bond yields as further easing underpins government revenue growth. This should take place via two channels: Firstly, lower rates would continue to relieve households' still high debt service burden and thus facilitate a steady unwind of excess debt lev-



els. This, in turn, will support an inventory recovery that anticipates stronger consumption growth. And secondly, lower rates will boost companies' investment intentions. This will support growth in private fixed capital formation, which has stalled in the post-credit crunch fallout.

Failing a steady government revenue upturn, the risk is that the budget deficit for FY2009/10 could tip 9% of GDP, and require unanticipated expenditure restraint. If this is not a politically credible outcome, of which there is a high chance, the risk of tax hikes cannot be ruled out either, notwithstanding the damage this would do to the economy's cyclical prospects. However, on balance, without any significant changes to our key global growth, rand and local interest rate assumptions, we continue to envisage a real GDP growth recovery in South Africa of 3% this year from a contraction of 2% in 2009. Such a relative growth swing is statistically impressive, and remains at the higher end of market expectations, but the local operating environment will still feel tough for much of 2010. At least the Soccer World Cup will give South Africans and visitors alike plenty of reason to cheer!

Written by:

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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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