

ECONOMIC OVERVIEW



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A weak US dollar, the gold price at new highs and an Antipodean rate hike all ostensibly reflect rising global inflation risk. This is a likely embellishment: bond yields have come-in again and US inflation-linked bonds are still reflecting below-normalised future inflation. While the spectre of deflation has been dulled, it remains a sufficient threat for the likely continuance of ultra-easy policy stances in the big five FX blocs – US dollar, euro, yen, sterling and Swiss franc – for some time, especially in the US, which most accounts for the dollar's weakness. Indeed, more than any other factor, the rising dollar gold price reflects a weak dollar, while Australia's fortunes underline its "Lucky Country" epithet: no bust banks and one of the most competitive commodity suppliers, where the unwinding of global macro imbalances underscores China, in particular, as the locomotive of a global recovery now tentatively underway.

The local business cycle likely bottomed in 3Q09 after a relatively short but savage "credit bust" correction. Yet, full recovery prospects will crucially depend on sustained capital inflows from a constructive global backdrop that will continue to support an easing in local banks' credit conditions and a pickup in domestic demand. An improving external deficit and strong capital inflows have filtered into rand strength and downward pressure on short rates. Meanwhile, the exchange rate has helped to nudge inflation lower and weak private credit growth has more than accommodated a rapidly deteriorating government deficit, giving bond investors some issuance indigestion. A worsening in SA's fiscal balance, persistent rand strength and excess liquidity could all be better resolved via lower short rates. We thus still view the SARB as having up to 100bp of further easing to give.

Waiting for the Fed will take some patience yet

Global economic angst continued to give way to the prospects of a sustainable V-shaped recovery during 3Q09, as reflected in a convincing inventory rebound off historically very weak levels, ongoing banking and corporate financial restructuring and related balance sheet repair and, more tentatively, some relaxation in banks' lending standards and subsequent recovery in credit growth. Indeed, the risk of further serious economic retrenchment akin to 4Q08 and 1Q09 remains remote given the sheer extent of governments' balance sheet expansion through liquidity provision in zero interest rate and quantitative easing monetary policies.

A spectre of inflation has entered into this scenario. One recent piece of evidence supporting a rise in inflation risk is the Reserve Bank of Australia's surprise 25bp rate hike to 3.25%, already relatively high prior to tightening compared to the big five currency blocs of the US, Euroland, the UK, Japan and Switzerland, and a sometime lead indicator of the all important US Federal Reserve's



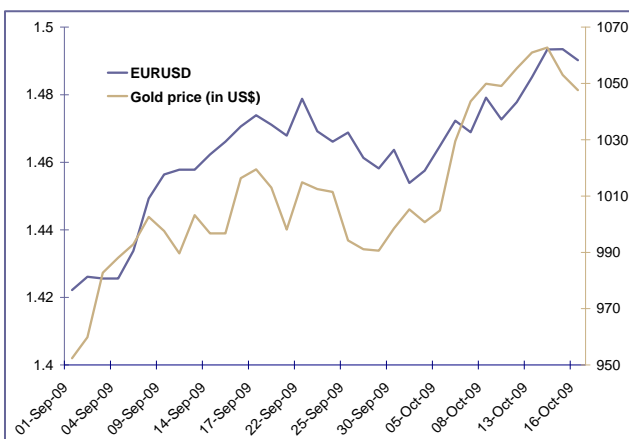


policy decisions. Another inflationary indicator is the recent rise in the US dollar price of gold. This is now the consensus view and is mostly priced into risk assets such as cyclical equities and commodity currencies.

Yet, this still seems too sanguine a conclusion to us. The RBA's tightening is certainly an important global development at this particular juncture. More likely, in our view, it was a pre-emptive move, and may be followed by similar hikes in Norway, New Zealand and, perhaps, Canada. Specifically, it reflects a greater degree of policy freedom than in the major Western economies given that Antipodean banks overwhelmingly avoided most of the carnage following the "credit bust", that fiscal policy has been well managed and underscores another case of Australia living up to its epithet of being the "Lucky Country": this time as a supplier of choice – along with Brazil – of iron ore and other key commodities needed by China in the wake of its massive USD585bn post-crisis fiscal injection and collapse in local commodity producing capacity as the local cost base rose well above that of imports.

As for the rising US dollar gold price, this largely reflects the impact of the greenback's continuing weakness given the scale of the Fed's ballooning balance sheet, the associated deterioration in the US's public finances - probably exacerbated by the timing of the Obama Administration's proposed ambitious health care reforms – rather than a reflection of imminent inflationary risk.

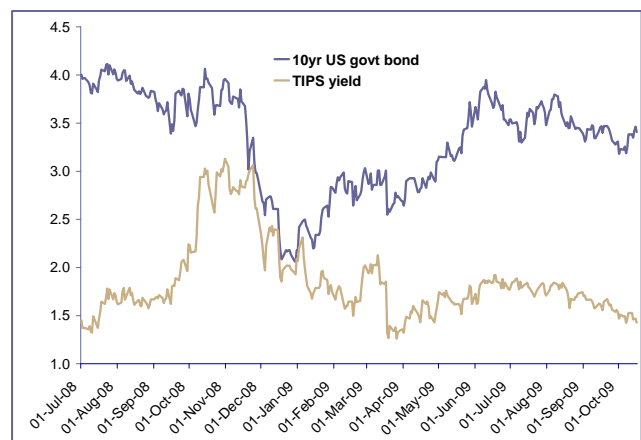
CHART 1: GOLD RALLY REFLECTS WEAK US DOLLAR
 (Source: I-Net)



Indeed, the latter is not corroborated in either a widening of inflation expectations in US Treasury Inflation Protection Securities (TIPS) yields, or the recent fallback in nominal US Treasury yields. To us, the Fed's signalling of any tightening intention still remains benign, with US policy-makers holding the view that domestic recovery prospects remain patchy and tentative: a bottom may be in sight for the housing and labour markets, but

this does not presage a strong recovery. All important high frequency consumer data remains, on balance, weak-ish, especially when correcting for the "cash for clunkers" fiscal subsidy boosting auto purchasing. Essentially, even as much progress has been made in repairing extended personal balance sheets, the US household sector continues to de-lever rather than show much predilection yet for a return to credit-boom era spending habits.

CHART 2: NOT MUCH INFLATION RISK EXPECTED HERE YET
 (Source: I-Net, Bloomberg)



We would take the opportunity here to reiterate our view that the global economy remains mired in substantial excess capacity and related balance sheet pressure arising from the 2003-08 credit binge that will take time to fully unwind. In this environment, strong disinflationary, or even deflationary, forces are likely to persist for a while yet. This conclusion is consistent with the behaviour of US and other global bond yields, with imbalances likely to be equilibrated via a combination of not replacing/mothballing existing capacity and some recovery in global demand beyond the current concentration on China's policy induced domestic demand in particular.

Our primary risk scenario centres on the sustainability of a growth trajectory that may yet be hobbled by balance sheet stress, much of which has migrated from private to public sector entities as reflected in double digit consolidated government budget deficits in most major Western economies. This is especially a concern given the negative feedback loops from indebted consumers who have still to complete their de-leveraging preferences. Fixed investment appetite outside a locomotive dynamic in China is likely to be compromised by excess capacity and the limits inherent in current high budget deficits. As a result, there is little scope for incremental government spending; quite the contrary as 2010 will likely commence a period of prolonged reckoning for public finances, especially in the UK and the US.

There is little in this economic view that would support a catalyst for a meaningful US dollar rally. Rather, this will crucially depend



on the Fed's willingness to signal an end to its current ultra-lax monetary policy, even as the greenback is admittedly looking relatively attractive on a valuation basis vs. both the euro and yen. This is already evident in European and Japanese exporters anticipating earnings setbacks from relative euro and yen strength.

The joker in the FX pack would be a revaluation of the yuan, as growth remains better tracked in China - though not without a growing risk of serious capital mis-allocation - given the speed and scale of governmental financial firepower that has been thrown at the non-traded sector of China's economy. As a result, relative to economies facing post-credit bubble balance sheet problems, China should be able to post better productivity growth. This will maintain pressure on the yuan to re-value, although any rapid appreciation will be resisted given the significance of China as a US dollar counter-party in trade and financial flows terms.

Against this backdrop, global bond yields are unlikely to sell-off sharply, but remain historically very expensive, credit spreads should continue to narrow, but at a slowing pace, and demanding equity ratings - bid up by a risk rally from excess liquidity and attractive valuation metrics earlier in 2009 - face a growing risk that too much good news is being priced into positive earnings expectations. However, commodity prices are unlikely to sell-off as global demand firms, albeit relatively slowly vs. the credit boom years, and given relative cost dynamics in key commodity industries (e.g. steel, oil and copper). The main risk to this view would be an overly quick remission in China's credit-directed stimulus package, which is slated to last well into next year. That said, there will need to be some stimulus moderation in China given asset inflation pressures that are already apparent in local property and equity markets stoked by excess liquidity.

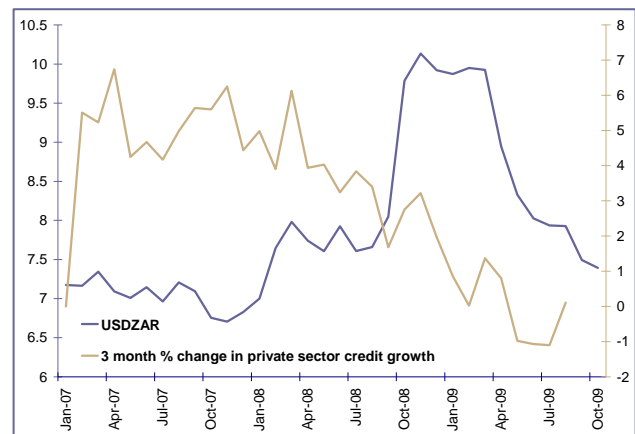
SA is still missing a rates trick or two:

In the cold light of day, a small, open economy like SA is very dependent on global cyclical dynamics. Thus, a tentative recovery abroad, especially if commodity prices remain reasonably under-pinned, should support a local recovery too. Yet, a specifically domestic headwind, in our view, remains the tightness in local credit conditions, in part because the SA Reserve Bank's policy stance is still too tight vs. the rest of the world. A situation of ultra-loose global policy renders SA policy makers more vulnerable to a policy "under-reach". The negative feedback loop into the availability and demand for credit and a lower-than-need-be level of GDP is also being reflected in a rapid deterioration in government budget metrics – a deficit of c.10% of GDP is now on the cards for 2009/10 given falling tax revenues and rising expenditure obligations.

That the level of rates is still too high is also amply reflected in the rand's appreciation vs. its trade weighted currency basket. This, ultimately, reflects an excess of capital inflows relative to net import funding needs, with the SARB buying foreign exchange in

September – a move at odds with targeting inflation rather than the exchange rate. This conclusion is also underscored in valuation terms where the rand is now slightly overvalued on a conventional real effective (i.e. trade weighted, purchasing power parity) basis. The strengthening rand thus goes beyond a weak US dollar story and acts as an effective policy tightening if one weighs up the balance of monetary conditions in the repo rate and the exchange rate. Bottom line: short rates at c.7% are still c.100bp too high in our view.

CHART 3: TWO REASONS FOR MORE LOCAL RATE CUTS
 (Source: I-Net)



Much of the SA Reserve Bank's cautiousness in not being more aggressive on rate cuts, highlights their view of the apparent stickiness of consumer inflation. However, we think that this simply reflects the lag between the rapid fall in imported and producer inflation to historically very low levels, and where imported inflation is a lead indicator of producer inflation which, in turn, is a lead indicator of consumer inflation. As a result, consumer inflation is falling, and can be expected to continue to do so, to c.5% or lower at its turning point, from the current rate of c6.5%.

Based on normalised historical lag relationships, CPI inflation could have been expected to fall well below 4%, but this is unlikely to happen this time around for two reasons: Firstly, because of necessary supply-side imperatives to raise local electricity prices to global norms - implying multi-year increments of at least c.30% per annum. And, secondly, to a lesser extent, upward pressure on inflation from rising real wage settlements, notably in the rapidly unionising public sector - to the mid-teens in some instances - that is much less sensitive to cyclical economic pressures vs. private sector companies. However, most of the inevitable adjustment pain has been borne by a rising cyclical unemployment, overlaid on an already high structural level of unemployment, especially in the casualised and informal sectors of the labour market.

The combination of inappropriately high relative interest rates and still rising indebtedness - as the fall in disposal incomes from



rising unemployment has offset rapidly declining credit growth - will put a drag on local consumer recovery prospects. That said, there are at least strong tailwinds from the extent of de-stocking and the need now to replenish inventories. And, pressure on the SARB to lower rates should also provide a fillip to growth next year, if this policy loosening transpires.

At least public sector infrastructure spending has prevented a complete collapse in fixed investment, while the positive event impact of the Soccer World Cup next year should temporarily boost tourist-related incomes. Finally, the ramp in commodity prices off their extreme lows earlier this year into a gradually strengthening global economy should also boost net export revenues. All told, unless there is a serious relapse in the global growth momentum into 2011, the SA economy should sustain about a 3% recovery next year. This would be a respectable outcome after this year's likely 2% GDP contraction.

A local economic view which pivots around the chance of further monetary easing implies lower cash rates and bond yields. The prospect of lower rates should also make one wary of taking a too aggressively sub-asset allocation benchmark equity position. But the stock-market still has a strong "show me" onus given the re-rating since mid-March in anticipation of a strong, sustained positive earnings recovery. As is the case elsewhere, the risk is that too much positive news has been priced into local equity ratings too quickly.

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