

GLOBAL ECONOMY

The global economy has bottomed. The global manufacturing sector is leading the way and in October had been expanding for four consecutive months. Of significance is the fact that the expansion is broad-based and global manufacturing production levels have been restored to such an extent that by December could approach levels attained at the end of last year. The all important global non-manufacturing sector – responsible for more than 70% of the global economy – has been expanding for two consecutive months with the U.K. and China particularly strong. All indications are that the expansion in both economic sectors is likely to continue – at least for the next few months.

Bulk shipping rates such as the Baltic Dry Index – an excellent indicator of global trade – have continued the uptrend since December last year while container shipping rates on all the major routes from and to China have increased sharply since the middle of this year.

United States

Although the economy contracted by 2,3% in the third quarter compared to the same quarter last year the US economy has turned the corner. On a quarter-on-quarter basis the economy grew by an annualised rate of 3,5% in the third quarter. Indications are that in the final quarter of the year the US economy could reach the same level as that of a year ago and might therefore grow at a quarter-on-quarter annualised rate of up to 4%.

US purchasing managers in October reported expansion in the non-manufacturing and manufacturing sectors for the second and third consecutive month respectively. The Conference Board Leading Indicator has been rising for six consecutive months since hitting a bottom in March this year.

The outlook for the US economy remains rather subdued though as the US consumer remains under siege. Although consumer sentiment bottomed at the start of the second quarter it remains weak and fragile. With prices falling households are spending fewer dollars to buy their usual basket of goods and services resulting in higher savings. Demand for consumer loans is relatively absent as banks continue with the tight lending standards. However, the demand for mortgage loans is increasing on the back of lower mortgage rates. US real estate prices have stabilised and early indications are that strength is emerging but increasing delinquencies are a major concern. Unemployment in the US continues to rise as the US corporate sector continues to shed jobs but indications are that the shedding of jobs has slowed significantly with the manufacturing sector having started to hire on a net basis. Consumer sentiment is significantly affected by consumers' own wealth situation. The strong rise in equity prices is therefore expected to lead to a gradual improvement in consumer sentiment in the coming months if equity prices hold onto their gains since bottoming early this year.

The US corporate sector finds itself in a situation similar to that of consumers. Although banks are more lenient about extending credit demand remains absent. Inventory liquidation will remain a drag on the US economy in the coming months as inventory levels continue to be excessive relative to sales. Due to the lack of internal demand the main focus of the economy is currently on exports. With US exports highly dependent on China's demand for goods and services the continued strong expansion of China's economy is likely to sustain US exports.

An inflation shock is looming in the US. The inventory levels – as measured by the inventory-to-sales ratio (ISR) – are fast approaching the "normal" level of between 1,25 and 1,33. In the past the US inflation rate typically turned upwards when the ISR dropped below the 1,30 level. The US inflation holiday thanks to excess inventories is therefore drawing to a close. The monthly nominal change in the oil price from a year ago is an excellent indicator of the 12-month momentum of the US CPI and leads by one month.

Based on the historical relationship the CPI inflation rate in October could be between -1% and 0% but is likely to escalate to between 0% and 2% by December with a possibility to overshoot to 3%. However, the rise in the CPI inflation rate may be moderated by the continued run-down of excess inventories in the US economy as measured by the GDP-weighted PMI for inventories.

Contrary to what many believe, the Federal Reserve's monetary policy is nearly as restrictive as in December 2007 before the economic meltdown last year with the real federal funds rate in excess of 1,5%. This can mainly be attributed to negative inflation. With the federal funds rate at 0,25% there is no room for further cuts as the rate can not go below zero. US banks' attitude towards lending plays a crucial part in the economy. The economy can not expand if the banks' lending standards remain restrictive. After all, it is the banks that execute the Fed's monetary policy. The Fed is therefore unlikely to hike the federal funds rate until the banks relax their lending standards.

With the US CPI inflation rate expected to return to positive levels by December and with the Fed's stated policy not to hike interest rates in the foreseeable future, the real federal funds rate is likely to turn negative despite positive economic growth. The change from a restrictive to a stimulatory monetary policy is likely to spur consumer spending, especially in the light of rising inflation expectations. This is expected to be the second leg of the upturn in the US economy.

However, business investment, the third pillar of sustained economic growth will remain absent for years to come and is likely to lead to a sub-par economic recovery. A significant gap has opened between manufacturing capacity and production since 2001 and that is likely to be sustained in the coming years. Where "full capacity" in the US economy was historically seen as 85% the number has probably been reduced to 78% - 79%. It is unlikely that any significant capital expenditure will take place unless manufacturing production increases by 20% from the current levels, taking capacity utilisation to 80%. US manufacturing capacity utilisation can be expected to rise by approximately 1% - 2% by December compared to a year ago. That will take capacity utilisation from 67,8% at the end of September to the 70% - 71% level by the end of December this year – therefore an increase of 3,2% - 4,7% in industrial production given static manufacturing capacity.

China

The stimulus package to pull the economy out of a major slump has had a significant impact as China's economy shifted gear in the third quarter by growing by 8,9% compared to the same quarter a year ago. The V-shaped recovery is mainly driven by fixed asset investment, which increased by a third in the first nine months of the year compared to the same period last year. Industrial production growth steadily gained momentum to a more "normal" rate of 16,1% in August this year after hitting a seven-year low of 3,8% in February. Indications are that the growth in industrial production was maintained through October as electricity output and consumption for that month were up by 17,1% and 15,9% respectively. Short-term risks remain though as exports remain relatively sluggish due to the global recession while consumer confidence remains subdued. However, domestic demand has improved significantly with year-on-year retail sales growth quickening to 15,5% in September from a low of 11,6% in February.

Both China's manufacturing and non-manufacturing purchasing managers' indices continue to signal further expansion in the economy. China's GDP-weighted PMI is an excellent indicator of underlying GDP growth and currently indicates year-on-year GDP growth in real terms in excess of 9%. The prospects for next year have improved as the mild recoveries in the US and Eurozone are likely to increase the external demand for China's goods. Further weakening of the US dollar is likely to assist China's exports as the link between the yuan and dollar is unlikely to be abolished. The medium-term outlook for the Chinese economy is, however, cloudy as the economy is running the risk of excess capacity while the currency weakness due to the link to the US dollar is raising inflation expectations.

Japan

After four consecutive quarters of contraction the recession in Japan is technically over. Real GDP growth on an annualised quarter-on-quarter basis registered 4,8% marking the second consecutive quarter of positive growth. However, the economy is still 4,4% smaller than a year ago but indications are that the number will be revised to approximately 2%. While the fiscal stimulus continued to support the expansion it moved away from public investment towards supporting households following the change in government. The focus of the economy is on private consumption and the re-building of inventories. Although industrial production is still down by approximately 18% on a year ago production has risen steadily and is currently 22,5% higher than in February this year which marked the low in the downturn. Despite a grim outlook for employment, consumer confidence has improved dramatically since the low in December last year and is the highest since December 2007. Retail sales have risen for the third consecutive month in September as subsidies for the purchase of motor vehicles and household machinery led to improved demand. Exports remain weak but the purchasing managers' index indicates that new export orders started to expand in the third quarter.

The economy runs the risk of stagnation and deflation. The large overcapacity in the economy is likely to be a drag on economic growth though as capital expenditure will remain low for an extended period of time. Deflation continues to be a major concern for the Japanese economy especially with prices more than 2% lower than last year as consumers are more inclined to save rather than spend. In the short-term, however, GDP growth in Japan through the end of the fourth quarter this year may surprise on the upside as positive year-on-year growth could emerge in the first quarter of next year.

Eurozone

Although the Eurozone contracted by a further 4,7% in the second quarter compared to a year ago, the Eurozone non-manufacturing PMI in October marked the second month of expansion after contracting for 15 months. The manufacturing PMI also turned the corner in October and has expanded for the first time since June last year. The revival is being led by exports rising by the fastest rate since January 2008. Rising unemployment and tight credit conditions continued to weigh down household spending. Retail sales are extremely weak and are in a downward spiral. However, business and consumer surveys indicate that economic sentiment is rapidly improving and is currently at pre-Lehman levels.

The Eurozone GDP-weighted PMI which leads the year-on-year GDP growth in the Eurozone by one quarter indicates that the economic contraction in the Eurozone in the third quarter has probably slowed to between 3,5% and 4%. The slowdown translated into positive quarter-on-quarter growth at an annualised rate of approximately 2%. The first quarter of positive growth since the economic malaise started in the third quarter last year. Both the two largest economies Germany and France have already reported positive growth of 2,8% and 1% respectively. Consumer prices are still falling but as in the case of the US the inflation holiday is fast coming to an end. Inflation pressures are likely to start increasing in the first quarter of next year but thanks to the stability of the euro are unlikely to be as fierce as in the US. However, the expected rise in inflation is unlikely to force the ECB to change its current monetary policy especially in the light of the frail economic environment.

United Kingdom

The economic woes of the U.K. continued through the third quarter resulting in the economy shrinking by 5,2% compared to the same quarter last year. It is, however, apparent that the free fall in the U.K. economy is a thing of the past as the monetary and fiscal stimuli such as aggressive interest rate cuts and the temporary 2,5% VAT cut are at long last having the desired effect. Business and consumer confidence has improved significantly and although rising unemployment and low wage growth continue to hurt sentiment retail sales in October were on the up for the second month running.

Sentiment also improved thanks to the wealth effect resulting from house prices having turned the corner and having risen on average by nearly seven percent since April this year.

The GDP-weighted PMI for the U.K. which leads year-on-year GDP growth by approximately one quarter has been in expansion mode for the past six months. The contraction in year-on-year GDP growth in the fourth quarter has slowed to approximately 2,5% year on year and may mark the first quarter of economic expansion since the first quarter of 2008. Positive year-on-year growth can be expected in the first quarter of next year.

COMMODITIES

Metal prices as measured by the Economist Metals Index have recovered by nearly 80% since the lows in December last year. The strong recovery means the Index is only 22% below the high before the Lehman demise. Global demand has shown significant improvement while the rapid devaluation of the US dollar has helped tremendously. After China effectively cornered the metal markets by draining metal exchanges of stock to restock and build national reserves the subsequent rise in metal prices has led to increased mining production and increased inventories at metal exchange warehouses. However, pent-up demand may be lurking, especially in Europe and the US. Although finished consumer and capital goods inventories still exceed demand and the further shedding of inventories can be expected the inventory-to-sales ratios are approaching "normal" levels. Any further strength in the global economy once the de-stocking of inventories has been completed will be reflected in further strength in metal prices.

Over the past few years metal prices have largely been driven by Chinese demand and China's manufacturing PMI for new export orders and total new orders lead metal prices by approximately one month. Current indications are that the upward trend in metal prices is likely to continue through end-2009. Stock building as measured by China's manufacturing PMI for stocks of major inputs is an important factor in the metals market. Although the purchasing managers were quite price sensitive up to May last year – varying their stocks according to price changes – the sensitivity has been absent since metal prices bottomed. Although it is mooted that China may sell some of its excess stocks no evidence of such action is apparent yet.

The Baltic Dry Index – a measure of global bulk freight rates – indicates that Chinese new export orders and inventories are likely to continue to expand towards year-end. The momentum of metal prices is heavily geared to the global manufacturing sector. The positive momentum of metal prices is likely to continue as global manufacturing is expected to improve in the coming months. The volatility in metal prices is expected to increase in the light of the current high price levels as it is likely that Chinese purchasing managers may again become price sensitive. This is already evident in the case of copper as China's copper imports fell by 40% in October on a monthly basis.

The near-term outlook for gold remains positive. The reflation of the global economy will undoubtedly increase investor concerns regarding the outlook for future inflation. With current indications that the global inflation holiday will end as early as the first quarter of next year the focus will continue to shift to gold as an inflation hedge. With the US economic fundamentals currently weighted against the US dollar further dollar weakness is likely to support the dollar price of gold in the shortterm. The expected recovery in the global economy and commodity prices over the medium term will cause gold to become less attractive relative to other commodities.

Although the oil price has recovered to \$80 per barrel from the \$40 level in December it is lagging other commodity prices such as metals. The prospects for the oil price have improved significantly as demand is increasing. The Baltic Dirty Tanker Tariff Index has increased by 46% since September.

The oil price is currently in a period of seasonal strength which is likely to last until the end of the first

quarter of next year. The oil price is expected to continue reflecting the direction of industrial metal prices.

EMERGING ECONOMIES

Given their dependence on the export of commodities the outlook for emerging economies in general continues to be more dependent on the development of especially the Chinese and U.S. economies than on internal fiscal and monetary policies. The significant recovery in commodity prices has alleviated the pressure on the commodity exporting emerging economies. The global liquidity situation has returned to normal and foreign capital is becoming more easily available while global investors are less risk-averse. The spread between the JP Morgan Emerging Market Bond Index yield and mature market bond yields has dropped markedly and is now within striking distance of the pre-Lehman-saga levels. Emerging economies are way past the worst point in the global economic contraction. A return to positive growth is expected in the last quarter of this year.

EQUITIES

Global equity markets as measured by the MSCI World Index have recovered by more than 55% since the lows in February and the Index is fast approaching the levels that prevailed before the unfolding of the Lehman-saga.

The 12-month momentum of the US equity market as measured by the S&P 500 Index narrowly tracks the US GDP-weighted PMI. Current levels of the S&P 500 Index indicate that the market is expecting a much stronger economy than the PMI currently suggests. A strong rise in the PMI is not impossible but it certainly looks improbable. Given the current PMI levels the US equity market as measured by the S&P 500 is overpriced by approximately 5% to 10%. With the GDP-weighted PMI leading corporate earnings growth as measured by the S&P 500 earnings index by six months full-year earnings on the S&P 500 Index in the final quarter of this year are likely to be down by around 40% on last year. Twelve-month earnings momentum can be expected to improve to close to zero by the second quarter of next year. The 12-month price momentum on the S&P 500 leads earnings momentum by approximately six months. The equity market is therefore anticipating positive earnings growth in the second quarter of next year. There is therefore great risk that the market may be extremely disappointed with earnings growth. However, offshore earnings contribute significantly to the earnings of companies in the S&P 500 Index. The huge turnaround in economies in the Asian-region together with the sharp depreciation of the US dollar could boost profits more than the US GDP-weighted PMI currently suggests. From an economic point of view US companies in the transport sector should be closely linked to the manufacturing sector as input goods and goods produced must be transported. Given the historical relationship between the US manufacturing PMI and the 12-month momentum of the Dow Jones Transport Index the latter is correctly priced at the current level of the manufacturing PMI. Sustained improvements in MZM velocity are likely to underscore the positive momentum in equity prices as the current situation is not dissimilar to major turning points in the past. Elsewhere, European equity markets with the German equity market as proxy can be deemed as fairly priced given the underlying economic situation in the Eurozone.

The new bull market (in a secular bear market) remains intact. The risks are high though as the market remains vulnerable to economic or earnings surprises on the downside. Any disappointment or crisis of some kind is likely to be matched by major sell-offs in the market as the status of the bull market will be questioned. Risks on the upside are equally high. Better than expected economic conditions or earnings surprises on the upside may catch the perennial bears and doubtful Thomas's unawares.

Emerging-market equities

Emerging-market equity prices as measured by the MSCI Emerging Markets Free Index have recovered

PLEXUS INVESTMENT PERSPECTIVES



nearly 93% since the lows in February this year. The rapid recovery means that the Index now mirrors the level in August last year before the Lehman demise.

Emerging-market equity prices as measured by the MSCI Emerging Markets Free Index are primarily driven by commodity prices and in particular by metal prices as measured by the Economist Metals Price Index. Currently emerging market equities are fairly priced given the level of metal prices.

The outlook for emerging market-equities remains positive given the positive outlook for metal prices on the back of improved global industrial production and stronger economic growth in especially developed economies. The risk of investing in emerging-market equities relative to mature-market equities has increased as the ratio has outrun metal prices. Metal prices need to rise substantially to ensure further outperformance by the MSCI Emerging Markets Free Index. With the Chinese purchasing managers becoming more price sensitive the expected larger than normal price fluctuations of metals are likely to lead to increased volatility in emerging-market equities – especially resource-related stocks.

Although emerging-market equities continue to be buoyed by commodity prices, the stronger emerging-market currencies are mitigating the returns for local investors. Emerging-market equities and especially resource-related equities are likely to maintain a stronger relative performance towards the end of the year and into next year given the outlook for commodities but at higher volatilities. Domestic economically cyclical equities that will benefit from improved local currency strength and improved economic fundamentals are likely to outperform.

BONDS

The uptrend in global bond yields that started in January this year is still intact. Bond yields in mature markets are currently volatile and influenced by a number of factors such as inflation expectations and government buy-back programmes.

The yield on the mature-market bond index narrowly tracks the Baltic Dry Index as the latter is generally viewed as an excellent indicator of global economic activity. With the global economic expansion expected to continue in the coming months it is therefore likely to lead to further strengthening in shipping rates (Baltic Dry Index) and therefore higher mature-market bond yields.

It is also evident that if the global GDP-weighted PMI continues to indicate global economic expansion, bond yields in mature markets are likely to rise further. The catch-up could be severe as bond yields are running behind the curve. Although the further reduction in inventories may continue to suppress prices in the short term, the US in particular could be in for a massive inflation shock early next year propelled by the US GDP-weighted PMI for prices and the oil prices.

Emerging-market bond yields as measured by the JP Morgan Emerging Market Bond Index yield behave contra to trends in the Baltic Dry Index. When the latter declines it effectively means global economic growth is slowing and vice versa. Emerging-market economies are highly geared to the global economy and commodity prices. During global economic downswings the risks of investing in these economies increase as downside pressure mounts on important economic variables such as current accounts and currencies of these countries.

The risks of investing in emerging-market bonds are rising. The yield on the JP Morgan Emerging Market Bond Index is already down to levels that prevailed before the global economic meltdown last year.

The probability of the yield declining further is therefore limited unless something out of the ordinary happens. The yield spread between the JP Morgan Emerging Market Bond Index and the mature-market

PLEXUS INVESTMENT PERSPECTIVES



bonds is fast approaching the range that existed before the economic malaise started last year. Whether the yield gap has much more room to improve remains to be seen.

There is at best limited further downside in the yield on the JP Morgan Emerging Market Bond Index while mature-market yields remain relatively low due to inventory reduction in especially the US. Higher yields on mature-market bonds next year are likely to put paid to further declines in emerging-market bond yields.

CURRENCIES

The depreciation of the US dollar continues. Since January the dollar has depreciated by 14% against the euro, 1% against the yen and 12% against the British pound. On a monetary policy difference – defined as the difference between the central bank's repurchase rate and current GDP growth in real terms in a specific country – the euro, British pound and yen are currently favoured above the US dollar; the euro is favoured above the British pound and the yen; and the British pound is favoured above the yen. The yen, however, is seen as the least risky currency in developed countries as it is the ultimate currency to be in when global financial risks – as measured by the yield spread between emerging-market bonds and US treasuries – increase.

Commodity currencies are likely to remain strong in the light of the expectation that metal prices are likely to hold up in the foreseeable future. Commodity currencies have an inverse relationship with the yield spread of emerging-market bonds to US treasuries meaning that commodity currencies rise when the risk of investing in emerging markets – as measured by the yield spread – declines and vice versa. With the emerging-market bond yield spread expected to narrow somewhat in the short-term, commodity currencies can be expected to follow suit and strengthen slightly. Further strength of commodity currencies will be limited as the yield spread is nearing the trading range that existed before the economic malaise started last year

SOUTH AFRICA

The SA economy in the third quarter is emerging from the worst recession since 1992/1993 by registering growth of 0,9% quarter on quarter annualised. While the economy is still contracting by 2,1% on a year-on-year basis growth in the third quarter halted three consecutive quarters of negative growth. The significant recovery in commodity prices has alleviated the downward pressure on the South African economy.

The outlook for the SA economy has improved greatly. Although the economy is likely to contract by approximately 1% in the fourth quarter compared to the same period last year it is likely to grow by between 4% and 6% on a quarter-on-quarter annualised basis. With the second consecutive quarter of positive growth, the fourth quarter is likely to mark the end of the recession. The SA Reserve Bank's current repo-rate adjusted for CPI inflation is 1% which is below the range of 2,5% and 4% that existed between 2005 and 2007. With a new governor in place it is understandable that monetary policy will be put on hold as uncertainties such as electricity tariff hikes loom.

The recovery in the SA economy is expected to continue well into 2010 as further expansion of the global manufacturing PMI is expected in the coming months.

The rand is currently fairly priced against a basket of equally-weighted commodity currencies. The rand tends to outperform (with a lag of four months) the commodity currency index when metal prices are rising and vice versa. With metal prices expected to maintain their upward momentum but at a moderate pace, the rand is expected to move in line with the commodity currency index. The rand is therefore expected to strengthen somewhat in the coming months on the outlook for emerging markets but further strength in the ensuing period is likely to be limited.

South African equity market

The South African equity market as measured by the FTSE/JSE All Share Index is up by a third since January this year. For foreign investors investing in the SA market the market is up a whopping 81% owing to the strength of the rand against the US dollar.

The outlook for the South African equity market continues to be interwoven with that of global equity markets. SA equities as in the case of other emerging-market equities and especially resource equities are likely to uphold their stronger relative performance in US dollar-terms towards the end of the year and into next year given the improved outlook for commodities. In the light of the expected increase in volatility in commodity prices the ride may start to be bumpy especially for commodity-related equities. Domestic economically cyclical equities that will benefit from improved local currency strength are likely to outperform.

South African bond market

A large gap has opened up between South African bond yields and those of the JP Morgan Emerging Market Bond Index as emerging-market bonds significantly outperformed SA bonds on a price basis as global investors upped their risk appetite. That is partly due to the fact that global investors view SA bonds as less risky than other emerging bond markets during global economic meltdowns. SA bonds therefore currently offer excellent defensive value relative to other emerging-market bonds. However, SA's sovereign risk as measured by the yield spread between SA 10-year bonds and the JP Morgan Global Bond Index has been in a rising trend since the start of 2007 probably owing to a myriad of factors. The upward trend in sovereign risk may limit a significant re-rating of SA bonds.