

Quarter ended 30 June 2009

ECONOMIC OVERVIEW



Global

The global economy has likely bottomed, as best reflected in recovering purchasing managers' indices across the world. Leading the pack is China, after the successful mobilisation of a huge domestic fiscal package, mostly into fixed investment projects. Even so, validation of 'green shoots' of recovery in the continuing risk asset rally of 2Q09 remains tentative, and a swift recovery cannot be taken for granted. Policymakers have used up most of their stabilisation firepower, while the terms of how to reduce high levels of government debt still has to be determined. This reality defines the nature of the current slowdown as a 'balance sheet recession', with global growth only likely back to trend by 2011.

Domestic

South Africa has now also slipped into recession. While this was not unexpected, the extent of 1Q09's GDP contraction and related collapse in bank lending has been. Moreover, even given the rand's rally on its 'commodity currency with positive carry' attributes, stagflation, or sustained inflation in a weak economy, has emerged as an upfront worry, with the Reserve Bank not easing again as expected at its June policy meeting. This concern may be premature if the lagged impact of very low producer inflation rates filters into sticky consumer inflation. Indeed, if inflation eases to 5.5% into 1H10, as we expect, an ability to keep rates lower for longer should see GDP growth recover to c.3% in 2010.



The worst is behind us, but be wary of rose-tinted spectacles...

The overriding feature of 2Q09 was a sustained bid for risk assets across the globe, as best reflected in the continuing rally in credit spreads, commodities, cyclical equities, emerging markets and high beta currencies. These asset rallies were sustained after the capitulation by early March of investor appetite for active risk following a period of very significant investment losses since August 2008.

There have been three primary drivers of this global risk rally, namely the speed and scale of international monetary, fiscal and other direct-support policy initiatives; attractive valuations of risky assets; and positive newsflow on real economies that the worst of an 'Armageddon scenario' threatening a repeat of the 1930s Great Depression had been averted.

Yet, since April, there has been a recurring and reinforcing theme of economic recovery 'green shoots', from which it is tempting to conclude that the global recession may have bottomed. Such was the cliff-like decline in the global economy in 4Q08 that this is probably a reasonable assessment.

Chart 1 shows recovery prospects to have most embedded in improvements in purchasing managers' indices, with those in Asia – the crucible of international trade – having risen appreciably. Also, forecasts of economic growth for most regions are no longer being revised down, while China's GDP growth estimates have been pushed up meaningfully.

Global Purchasing Managers' Indices

+50 = expansion; -50 = contraction

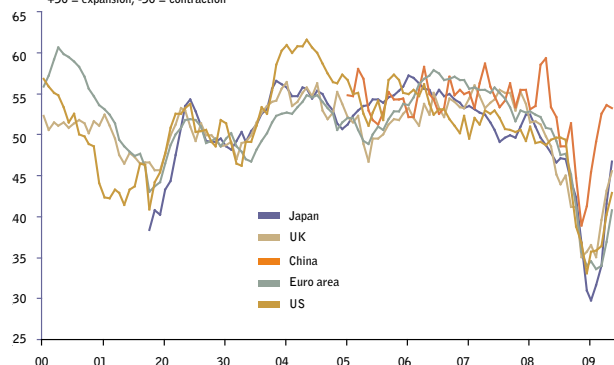


CHART 1
THE SCENT OF 'GREEN SHOOTS' RECOVERY
(Source: Haver Analytics, Citigroup Global Markets Ltd.)

What about the China factor?

From a South African perspective, the main positive surprise in the global data flow has been China's rebound, as this has driven an associated upturn in commodity prices. Chinese growth has been able to tract earlier than might have been expected following the successful implementation of a massive USD585bn fiscal stimulus, much of it via directed credit by state-owned banks. This has been overwhelmingly targeted at fixed investment infrastructure projects and has served to blunt staggering export losses. However, such losses have left China stranded with significant excess capacity. Not surprisingly, in stark contrast to rising commodity prices, Chart 2 shows that deflation risk is still increasing in China, putting more pressure on the government to restructure the economy.

China's ability to absorb excess capacity will require the creation of local markets to replace export ones. For this to happen, two types of internal rebalancing are needed. Firstly, a switch in relative domestic demand away from fixed investment, which currently dominates domestic demand, towards consumption, which has lagged growth in domestic demand. And secondly, China's strong seaborne geographic bias towards the fixed investment and export intensive urban coastal economy will need to migrate inland.

Such a re-ordering of economic development patterns in China will likely combine a slowdown in the rate of fixed investment and export growth with an acceleration in consumer demand growth. This likely implies slower growth, including demand for commodities and employment creation, relative to the double-digit growth rates seen between 2003 and 2008.

Metal prices and China inflation (% change over 3 months)

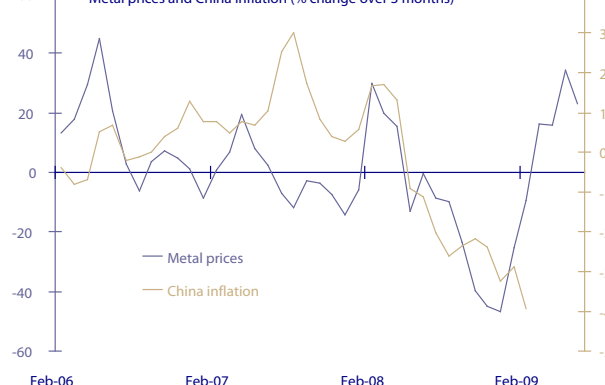


CHART 2
A TALE OF TWO INFLATIONS
(Source: I-Net)



However, bear in mind that the opportunity cost to China is arguably low, given that domestic savings invested abroad only attract an annual return of roughly 3.5%. This scenario still speaks to trend growth in China in the region of 7% per annum, which remains very attractive relative to prospects elsewhere.

Trend global growth only by 2011

In the world's locomotive economy, the US news-flow is improving but still remains tentative, offering up a mixed bag of better vs. worse-than-expected results in US high frequency data. That the worst shocks of the housing and related banking sector busts are over is best reflected in two indicators: firstly, some banks' willingness and ability to start repaying their 'bail-out' loans, and secondly, a rapid re-set of affordability in the US housing market. Still, the Federal Reserve cautioned at its most recent policy meeting in June not to expect too hasty a pace of recovery while underlining that there are clear limits to further policy support for the US economy.

As a result, a rapid steepening in the US (and subsequent global) yield curve in 2Q09 has most recently stalled. Curve-steepening typically discounts rising inflation expectations predicated on an anticipated GDP upturn. However, we think this conclusion should be tempered given that TIPS (US inflation-linked) yields reveal inflation expectations to have stabilised at around 2%. Rather the yield backup more likely reflects investors' uncertainty arising from the extent of the policy stimulus that has to be unwound when the economy is on a sustainable recovery path.

In essence, our base view continues to be that most developed economies are enmeshed in a 'balance sheet recession' or, as plainly expressed by one economist: 'we are not going to move from a bust credit expansion into another one without resolving the excessive burden of debt and debt service that got us here in the first place'. This includes the unwind of banks' remaining unallocated losses and how governments are going to manage the chronic deterioration in their own balance sheets via tax hikes and spending cuts. This, in turn, will extend the time it will take to repair households' balance sheets. Indeed, when making allowances for the peak in unemployment and realised wealth losses, US households need to rebuild their savings ratio to about 12% of personal disposable income, or about twice the current level. We

thus remain cautious with respect to the pace of recovery in developed economies. As a result, one should only expect the global economy to recover to trend growth of around 3.5% in 2011.

A home-grown 'stagflation equilibrium'

South Africa has continued to feel the full chill of a deteriorating global economic environment, with this most apparent in a 6.4% quarterly annualised GDP contraction in 1Q09. This outcome was considerably worse than expected and reflects a diffusion of recessionary conditions across the economy save for public sector infrastructure spending. Economic contraction was particularly trenchant in foreign trade and de-stocking, mimicking what has happened in so many other economies. In particular, as Chart 3 highlights, at the core of the local economic reality is anaemic credit extension as local banks seek to contain their bad debt risks in the current downswing.

As a result, South Africa's output gap (the difference between actual and trend growth) widened sharply, initially allowing the Reserve Bank (SARB) to look through sticky headline inflation and ease a further 100bp in April and 100bp in May. This brought the repo rate to 7.5%. Yet, contrary to expectations, the SARB hardened its position by not easing the repo rate an additional 50bp to 7% at June's policy meeting. The clear reason for this is that the Monetary Policy Committee believes inflation expectations have deteriorated meaningfully. This is certainly evident in surveys conducted for the SARB. It is also evident in double-digit wage demands, negative labour productivity growth, rising risks of a fiscal deficit overshoot and increasing speculation of a revision to the current 3-6% CPI inflation target mandate. Our conclusion is that the

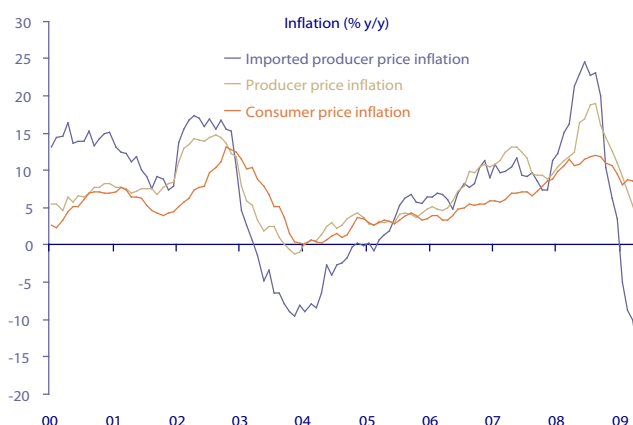


CHART 3: BEDFELLOWS IN A WEAK ECONOMY
(Source: I-Net, SARB)



SARB appears concerned about a possible 'stagflation equilibrium' - a baleful combination of downwardly rigid inflation combined with weakening GDP growth.

This conclusion may be premature: the economy is cyclically weak and firms' pricing power as reflected in current margins look extended. This suggests to us that outright producer deflation will now begin to be matched by lower consumer inflation, albeit with a lag. As Chart 4 shows, the gaps between imported, producer and consumer inflation rates are now so large that they have become unsustainable. This implies either that consumer inflation will fall, or, far less credibly, that there will be an inducement for imported or producer inflation to rise sharply.

The usual triggers for producer inflation are either higher oil prices or a weakening rand. While world oil prices have recovered, they are well off their highs of H108 while the rand's appreciation has served to cap much of the threat of higher oil prices. What is more intriguing is why the rand has been so strong, appreciating by over 12% on a trade weighted basis since March. We view this as essentially reflecting the unit's status as a 'commodity currency with positive carry', as commodity prices have risen and as global interest rates have fallen much more than local ones have – in essence the rand still enjoys positive carry of about 700bp. Following an uneventful general election in April, the rand has also benefited from significant M&A inflows in the mining and telecoms sectors. This has erased earlier fears of an external funding gap given South Africa's still large, albeit now shrinking, current account deficit.

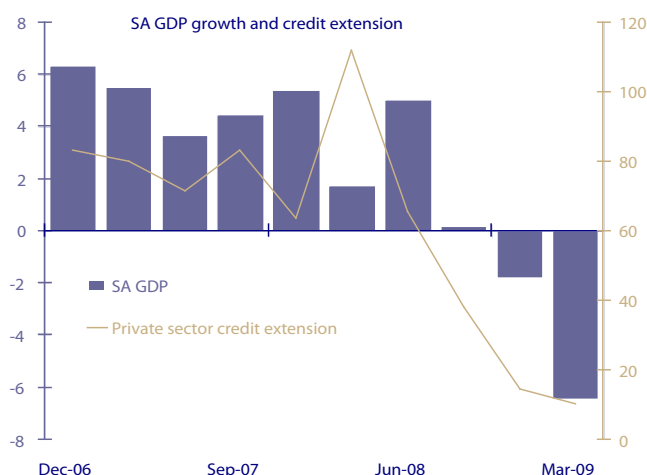


CHART 4
CONSUMER INFLATION SHOULD FALL
(Source: I-Net)

It is doubtful to us that the headline issue of sharply higher electricity tariffs is a credible inflationary issue.

This reflects a necessary relative price adjustment given South Africa's long-term energy scarcity where additional electricity supply will boost the economy's long run growth potential. Rather, high wage demands reflect employees' attempts to claw back purchasing power already lost to inflation, especially rising food and oil prices. We would anticipate the cost of this resolution, and it will be resolved, to be borne by lower profits (negative for firms) as well as higher unemployment (negative for households).

More downgrade grist to the forecast mill...

Given developments since March we have reworked our domestic economic projections, with revisions reflecting the economy's current stagflation bias. We thus expect inflation to rise to an annual average of 7.5% from a prior forecast of 6.5% while we have pared back our 2009 GDP forecast to -1.9% from an earlier view of -0.8%.

The change in our inflation view primarily reflects a delay in the fall-back in consumer inflation, with a similar low point of 5.3% now postponed to May 2010. Significantly, almost all the reason for lower GDP growth in 2009 is due to our downgrading of consumer prospects. This is premised on a view of weakening household income growth, mainly due to rising unemployment, high inflation - and the floor this is placing on prospects for more interest rate relief, and cumulative wealth losses from lower house and equity prices that have dented consumer confidence.

An expectation that the current stagflation stigma should dissipate into 2010 implies a more tempered tightening path relative to what is now reflected in market expectations. Even as the bottom of the easing cycle is in sight, the repo rate could still be cut by a final 50bp to 7% in H209. However, far more importantly, we find it difficult to see any urgency for a rapid tightening of rates as early as the market does in 3Q10.

Our baseline assumption is that South Africa will need a positive global leg to stand on for a sustained local economic recovery. Since this will likely be slower to tract as pre-credit crunch excesses take time to unwind, we only expect South Africa to post around 3% growth in 2010 at best before reaching trend growth in the region of 4% in 2011. Even this is still a tentative profile, but at least the case for recovery can be held with more conviction than three months ago.