The Investor Report

WEEKLY CAPITAL MARKET ANALYSIS

HIGHLIGHTS

- **USD-ZAR is in lethargic consolidation phase at present. We don't expect the range between 9.15/9.30 to be broken in the short-term.**
- **Forward rate agreement markets are now pricing a near 40% chance that the SARB will hike repo by 50bps by June 2014. Expect unchanged decision this week.**
- **Short-term correction risks have escalated for Alsi. Alsi looking expensive at present. Wait for deeper correction before adding to long Alsi positions.**
- **Business cycle monitors: US remains in cyclical upswing phase; ECB tricks market into thinking it is a hard money, inflation fighting, Bundesbank influenced central bank.**

KEY LOCAL EVENTS ON THE RADAR

- It's SARB MPC week. SARB announces policy on Wednesday this week owing to Human Rights Day on Thursday.

CURRENCY OUTLOOK

Central banks in focus this week, ZAR still vulnerable

The week ahead will be characterised by central banking events both local and abroad. Locally, the SARB will announce its MPC decision and statement on Wed a day earlier than normal due to the public holiday on Thursday for Human Rights Day, whilst later in the week the FOMC is likely to announce its on-going commitment to persisting with quantitative easing measures aimed at ensuring that the US economy gains the traction it needs to.

Wed will then see the latest BoE minutes released and importantly, UK Chancellor Osborne will present the 2013 budget to parliament where the UK government might also task the BoE with a more growth orientated mandate than simply being focused on inflation. Not that that has happened in recent years, although an explicit need to target growth could see the BoE adopt even more reflationary policy in the future.

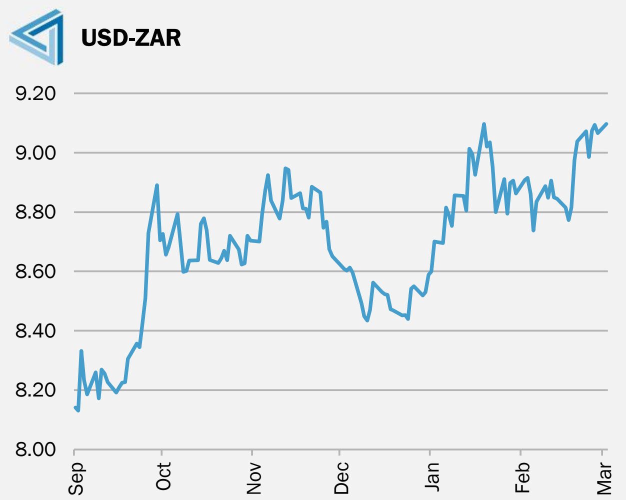
Domestically, this all comes at a time when the domestic CPI data will be released and will offer a fresh perspective on the price pressures in the SA economy that are gradually building courtesy of the weakness in the ZAR and the building domestic imbalances.

The saviour to the ZAR might ironically be a deteriorating domestic economic climate. Whilst that might seem counter intuitive at first, the general slowdown in consumption expenditure which would normally accompany a weak ZAR and high inflation environment will be part of the mechanism to help restore some balance to the SA economy.

Already some of the economic data being released is pointing to a general slowdown in economic activity with the consumptive led sectors in particular leading the downturn. There has been some relief on the mining and manufacturing data but that is expected to be short lived to leave the SA economy to experience another very difficult economic climate which will come attached to some weak credit extension and tighter monetary conditions (i.e. slower money supply growth which will contribute to the feeling of a sluggish economy).

For now, the ZAR is back on the defensive especially as investors rotated away from risk on account of developments in the eurozone over the weekend. The ZAR's vulnerability remains high and 1m implied volatility remains on an upward trajectory for now all of which suggests that the balance of risks remains in favour of ZAR weakness. Although the ZAR weakness looks and feels overdone in the short term, there is simply no confirmed USD sell signal reflected in the charts.

For now, we would be looking for confirmation of the next move on either a break of resistance at 9.3000 or a break below 9.1500. With so much priced in at the moment, we would be more inclined to sell USD up ticks towards 9.3000, but would operate with a tight stop.



Source: Reuters, ETM Analytics

FIXED INCOME & CAPITAL MARKETS

Long dated FRAs pricing a 40% chance of 50bps rate hike by June 2014

The announcement over the weekend that Cyprus will receive a bailout from the EU/IMF if bank depositors pay up to a 10% levy on deposits held in Cypriot banks could result in some major turmoil in coming weeks. As news spread that the government will confiscate depositors' money in exchange for a bailout, Cypriots rushed to ATM's and banks to empty their accounts. Thus, a bank run is on the go and could intensify in the week ahead. If it continues Cypriot banks will fail and the bailout money will not be enough to stop it.

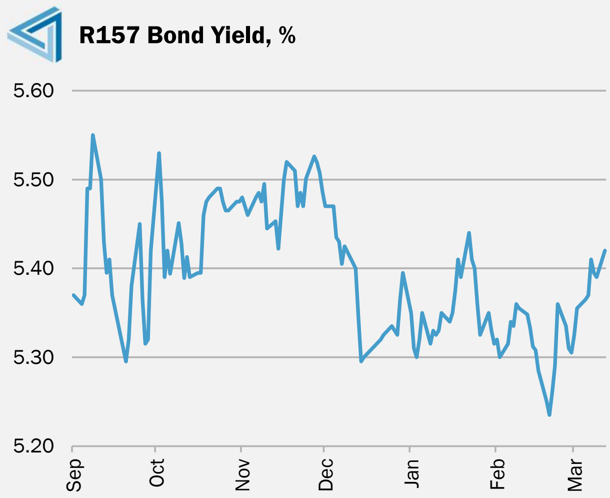
Furthermore, it is hard to tell in which direction capital will flow following the announcement of the deposit levy. Do depositors withdraw their money and deposit the proceeds with German banks? Or do they withdraw note and coin and keep it outside the banking system? If the latter, and if the trend spreads further than just Cyprus, it could pose major downside risks for the Eurozone banking system as banks would be forced to call back loans on a large scale as their deposit base withdraws. Developments around a country as small as Cyprus could hold major implications for the broader European financial system, and it is worth monitoring this week.

Friday saw net selling of local bonds by foreigners to the value of R24 million, taking the weekly net buying total to R1.1 billion, down from net buying of R2.9 billion the week before. Looking at equity portfolio flows, last week saw net selling of just more than R2 billion, following net inflows of R2.1 billion the week before. Total net inflows month to date stand at R5.3 billion, down from net inflows of R7.8 billion over the same period in February.

Bond yields continued to drift higher last week, in response to the weaker Rand that fell to fresh four year lows. The R157 bond yield climbed 2.5bps to close the week at 5.39%, and the R186 bond yield climbed 1bp to close the week at 7.405%. Since the start of the month, yields are up 3bps and 1bp respectively, and since the start of the year up 6.5bps and 16bps respectively for the R157 and R186 bonds.

Forward rate agreements saw healthy payer interest last week, as rate expectations continued to rise in response to the weaker Rand and rising price inflation expectations. The 3x6, 6x9, 12x15 and 15x18 FRA yields each climbed to the highest levels seen since the last rate cut in July 2012. The extreme long dated FRAs are now pricing a roughly 40% chance that the SARB hikes repo by 50bps by June 2014. Shorter dated FRAs are pricing a near zero per cent chance that SARB cuts rates again in the short-term.

As market interest rates start to rise in anticipation of higher price inflation expectations, the SARB will need to spend some time clarifying what it perceives as the greatest risk to price stability at the MPC meeting on Wednesday: rising price inflation or slowing growth. Expect repo rate to be left unchanged at Wednesday's MPC meeting.



Source: Reuters, ETM Analytics

SA EQUITIES

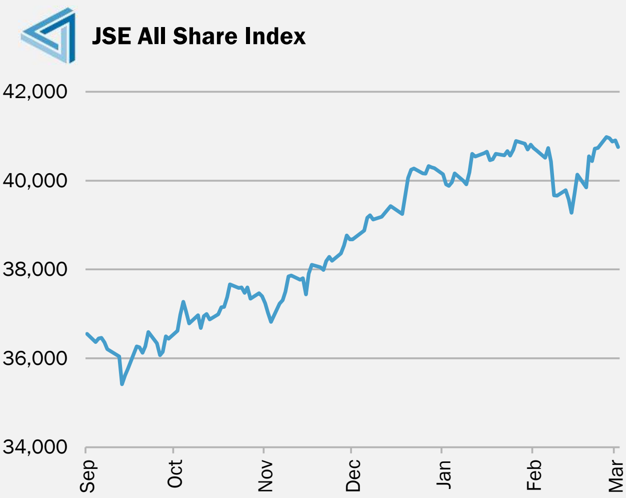
Short-term Alsi correction risk escalates

News over the weekend that Cyprus bank depositor's will lose up to 10% of their deposits in the banking system has set asset markets up for a nosedive this week.

The JSE Alsi is technically set for another correction to the downside as the index topped out at prior highs also seen in February 2012 just below the 41,000 points mark last week.

In the short-term, downside risks have escalated for the Alsi. The Alsi has rallied hard in recent months, and as a result the index is looking relatively expensive. We would favour a medium-term consolidation of the index off currently overbought levels before adding to a long Alsi exposure.

Looking through the short-term cycle where some downside can be foreseen, we favour maintaining our core JSE Alsi view: maintain a bullish (overweight) view of Alsi, in anticipation of continued loose SARB policy, continued wall of money inflows to SA, and rising price inflation.



Source: Reuters, ETM Analytics

BUSINESS CYCLE MONITOR

US economy remains in cyclical upswing phase

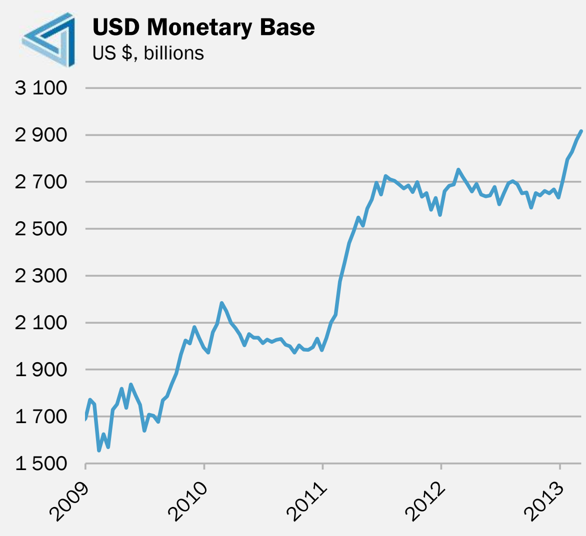
In November 2012 we maintained our bullish view of the US economy, writing that "the ETM Business Cycle Index is slightly above neutral territory at 0.072, positioning the US economy in a cyclical upswing phase of the business cycle." Since then, and particularly in the first quarter of 2013, US economic data has surprised consensus strongly to the topside, validating our increasingly bullish cyclical view of the US economy.

The Dow Jones Industrial average has rallied to fresh record highs, beating the pre-GFC highs in the first week of March. Nonfarm payrolls data released in early March showed that an estimated 236k jobs were created in February, while consensus expected a gain of only 160k jobs. Services and manufacturing PMI's have also beaten consensus estimates in recent months, indicating the general outperformance of the US economy relative to expectations.

The cyclical upswing follows a healthy acceleration of credit and broad money growth in recent months. Unadjusted M2 money supply growth accelerated to a peak of 13% annualised in early January, but has since tapered off to growth of 10% in the week to February 25. This acceleration of money growth in late 2012 is now boosting economic activity and has sent the Dow to new records.

The Federal Reserve has its foot firmly on the monetary easing pedal, and has embarked on a new round of QE to the value of $85 billion per month. After the US monetary base was unchanged around $2.6 trillion in the 19 months from June 2011 to December 2012, the latest round of QE has seen the monetary base burst higher, climbing $300 billion in two months to $2.9 trillion as of March 6, 2013.

The Fed's new easing programme is therefore having the desired effects: banks are creating new loans and deposits in the economy and that is stimulating economic activity. Fed data shows that credit is flowing mainly to the corporate sector at present. Commercial and industrial loan growth climbed to 14% y/y in December, while consumer credit loan growth remains muted at 2%. This suggests that economic activity is picking up in the capital goods sectors, and that resources will be bid away from the consumer sectors in the short-term.



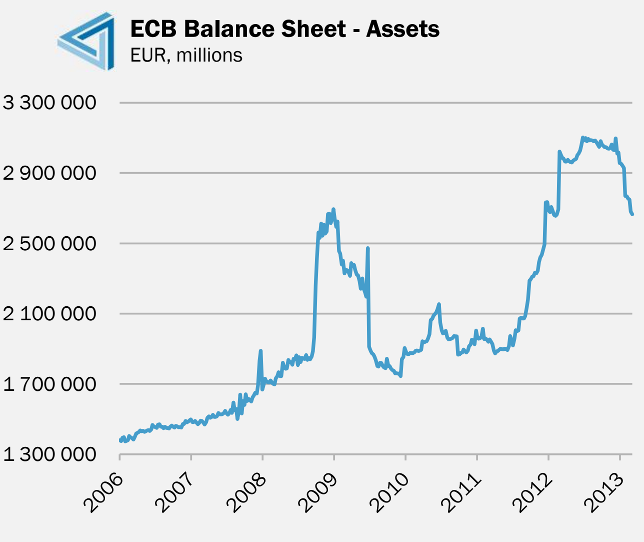
Source: St Louis Federal Reserve, ETM Analytics (Pty) Ltd

Expect to see rising market interest rates through the remainder of 2013 and a rallying US stock market.

ECB stroke of central planning genius opens a world of possibility

The ECB has played an ingenious trick on the market. By boosting its balance sheet by a massive 64% or EUR1.2 trillion from June 2011 to the peak of EUR3.1 trillion on July 29, 2012, it was able to withdraw stimulus and make it seem as if it is a hard-money, Bundesbank-dominated, central bank. It's not.

After shrinking the size of the overall balance sheet by 14% from the peak, at EUR2.7 trillion, the ECB's balance sheet is still 41% bigger today than it was in mid-2011. For perspective, the US Federal Reserve has only boosted its balance sheet by 11% over the same period and has been printing aggressively in the past few months. In other words, even though the ECB has tightened somewhat and unwound some of its asset purchases, it is only because it was profoundly aggressive before. Because of this, the ECB is being perceived as a credible inflation fighter, more credible than the BOJ or the Fed.



Source: ECB, ETM Analytics (Pty) Ltd

The ECB also has a track record of unwinding stimulus following big injections. It did it before from 2009 to 2010, and it is doing it again. The point to bear in mind, however, is that the ECB can and most likely will again ramp up QE - when the need arises.

In the meanwhile, the economy is nowhere near full blown deflationary crisis stage. We identified this risk as low, and wrote in the Business Cycle Monitor in May 2012 that:

> "At the least, barring a banking collapse ala Lehman triggered by an event in Spain and/or Greece, which grows less likely as money growth accelerates, a deflationary business cycle collapse is not foreseen for the Eurozone economy in coming months. The acceleration of money growth in the Eurozone region is being driven by a strong acceleration of money growth in Germany right now...

> The contraction of broad money in the smaller economies is not expected to derail the Eurozone recovery, unless there is a crisis of significant degree in the banking system. However, as mentioned, this looks unlikely right now."

Although we didn't expect a strong economic recovery, we realised that a deflationary crisis was off the table in the remainder of 2012. That said, we were somewhat sceptical of the ECB's appetite to unwind some of its stimulus. Nonetheless, we think much of this unwinding is cosmetic.

The overall Eurozone economy remains in a slump. Unemployment jumped to an all-time high of 11.9% in January, while the EU-17 PMI reflects contraction of the sector, and retail sales are also contracting. Price inflation has moderated to 1.8% y/y in February, which means inflation is back within the ECB's target.

German growth is slowing sharply at present, and a continued slowdown of German growth could be dealt with through more easing by the ECB. The stage is set for more easing by the ECB once Germany tilts its nose downward for a cyclical landing in 2013. Mr Market should take more easing by Draghi in its stride.

Published by ETM Analytics (Pty) Ltd

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