



Independent Insight in an Uncertain World

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2012 – OUTPERFORMANCE OR WIPE-OUT?

2011 turned out to be a truly fascinating year. This was especially true if one's livelihood is derived from managing clients' investible assets. Upon reflection, our high-level 2011 score card looks pretty good as most factors played out more or less as we had forecast them to do. Was this result dumb luck or genius, we wonder?

The one notable forecast that deviated markedly from Plexus's expectation was that of the performance of South African rand, which was among the weakest currencies in relation to the US dollar over this period. To review our 2011 forecasts, we have summarised them as follows:

- Inflation – rising moderately but will exceed consensus (South African CPI averaged 5,9% for 2011 and 4,6% in 2010).
- Interest rates – remain very low in the developed world and small hikes possible in some 2nd tier economies (this view proved to be spot on).
- Commodities – will appreciate in value (in USD, the CRB Index actually fell 8,3%, but gold was up 10,1% and Brent crude up 13,1%).
- Currencies
 - CAD, AUD, SGD, CHF, ZAR to strengthen vs. USD, EUR (all true except ZAR which fell 18,9% versus USD and 17,2% versus the EUR).
 - USD to outperform EUR (euro depreciated 1,3% vs. the US dollar).
- SA Bonds – positive real returns (All Bond Index returned 8,8% nominal or 2,9% real).
- SA Listed property – positive but low single digit real returns (SA Property Index returned 8,9% nominal or 3% real).
- SA Equities – low but positive single digit real returns and we prefer financials (All Share Index returned 2,6% nominal or -3,3% real. Financials delivered 7,4% versus -3,4% and -6,4% for industrials and resources respectively).

Now let's look forward to 2012. We have once again gazed into our crystal ball and made some educated guesses about what the main drivers of the investment world will be, and how asset prices will behave in response to these developments. As a general comment, we believe the economic outcomes for the world are becoming increasingly binary – outperformance or wipe-out. The use of new (and increasing) debt levels as a means of addressing the problem of old debt seems... well, absurd. But this is precisely the policy tool that developed world governments (US, UK, Eurozone and Japan) are using to address their multi-pronged problems. These include mountains of national debt, solvency of banks (especially in the Eurozone), deleveraging of consumers and corporate debt and deteriorating demographics.

The decision to utilise public funds to restore confidence may yet prove to be sufficient to finally reignite the credit economy and consumer confidence, improve unemployment rates and foster higher GDP growth rates in the G7 nations. If the result is higher growth, this will in turn facilitate higher government tax receipts and gradually allow budgets to be balanced and debt to be paid down to more normal levels.

Conversely, markets may at a point in time – could be 2012 or 2013 – reject these increasingly desperate actions; demand for credit remains muted, European banks are unable to recapitalise fast enough and begin to pop and attempts to stave off deflation fail. In this outcome, all bets are off as to how far into the 2000-and-teens the resulting depression may linger.

Plexus's base case is that governments and markets, are in a state of "irrational positivity". The former will continue to push liquidity into markets at any cost and the latter, ever mindful of the risks, will continue to play along because nobody really wants to see 'game over' flicker onto the screen. The vested interest of the politics and capital businesses imply that very low interest rates and money printing will prevail until inflation returns. In our opinion, notwithstanding the tremendous challenges and risks facing us, a very negative global outcome would not be expected in 2012 provided the state of positivity holds and some gradual economic improvement is observed. Under this base case scenario, a grinding slower growth world with higher inflation rates will prevail.

In summary, our 2012 forecasts are as follows:

Inflation – will continue to rise at a moderate pace in South Africa and globally and will again exceed market consensus in the year ahead. Inflation protected assets should be accumulated at this time.

Interest rates – short rates will remain very low in the developed world while small hikes are possible in some 2nd tier economies where growth is good. South Africa will not see a change in short rates in 2012.

Commodities – price increases of especially inflation protected assets (oil, precious metals) are likely in 2012, while industrial commodities will recover some of the ground lost in 2011.

Currencies – CAD, AUD, SGD, CHF, BRL to continue strengthening vs. USD and EUR and I would expect the ZAR to recover some of the ground it lost in 2011 and trade below ZAR8,00 to the USD level. USD to continue its path of outperformance vs. the EUR.

Bonds – we expect South African bonds to deliver close to zero percent in real returns. The yield on long bonds will not fall further unless the world implodes. Bond prices will be lowered as small capital losses accrue due to bond yields drifting outward in sympathy with inflation in H2 2012. Foreign demand for SA bonds will fluctuate. In terms of global bonds, only highly rated government bonds (US, UK, Germany, Canada, Australia, and Norway) where the yield exceeds the inflation rate (5 to 10 year maturities) should be considered.

Listed property – After two good years of return from the South African listed property sector, I expect no more than 1% to 2% real returns from this asset class in 2012. Distribution growth will moderate on the back of tight trading conditions and economic headwinds in South Africa.

South African Equities – we expect equities to have a slightly better year in 2012. Interest rates will remain low, valuations in financials and some diversified resources counters are looking reasonable and the earnings environment should be moderate but challenging. The All Share Index could deliver around 3% to 5% in real returns. The one area of risk is in the industrial sector, with a number highly rated and expensive blue chip stocks are priced for perfection (SAB Miller, MTN, Shoprite, Naspers, BAT).

Global equities are likely to be a mixed bag, with both headwinds (peak earnings and sluggish growth) and tailwinds (very low interest rates). High quality (high dividend yield and low PE) global multi-nationals like J&J, Pfizer, IBM, Coca-Cola should again be on the shopping list, while pricey shares should be avoided. I expect low but positive real returns (in USD) from global equities in general. Emerging market equities should have a better year in 2012 after the smack they took in 2011.

As always, please read these forecasts with a high degree of scepticism. We don't really have a crystal ball and fortune telling is a mugs game. They are based upon the data we currently have at our disposal and new information or external events not previously considered may dramatically alter the outcome. We trust you have an excellent 2012 and embrace the changing world we are likely to experience.