



# Platform

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Independent Insight in an Uncertain World

# PLEXUS

Editor:  
Luigi Marinus

Tel: (021) 9702400

E-mail:  
info@plexus.co.za

## THE INTEREST RATE CONUNDRUM

According to the South African Reserve Bank (SARB), its primary purpose is to achieve and maintain price stability in the interests of balanced and sustainable economic growth in South Africa. While this mandate sounds particularly eloquent it does make one think of the investor who wants equity-like returns with cash-like risk.

While some market participants will have you believe it is possible, most would agree that it is highly unlikely. On the one hand price stability or inflation needs to be kept in place by the adjustment of interest rates, while on the other hand the rate of economic growth can be aided or thwarted by the opposite interest rate adjustment. There are periods in the economic cycle during which the interest rate decision is reasonably straightforward as either inflation is not a big concern or economic growth is flourishing. However, this is not such a time.

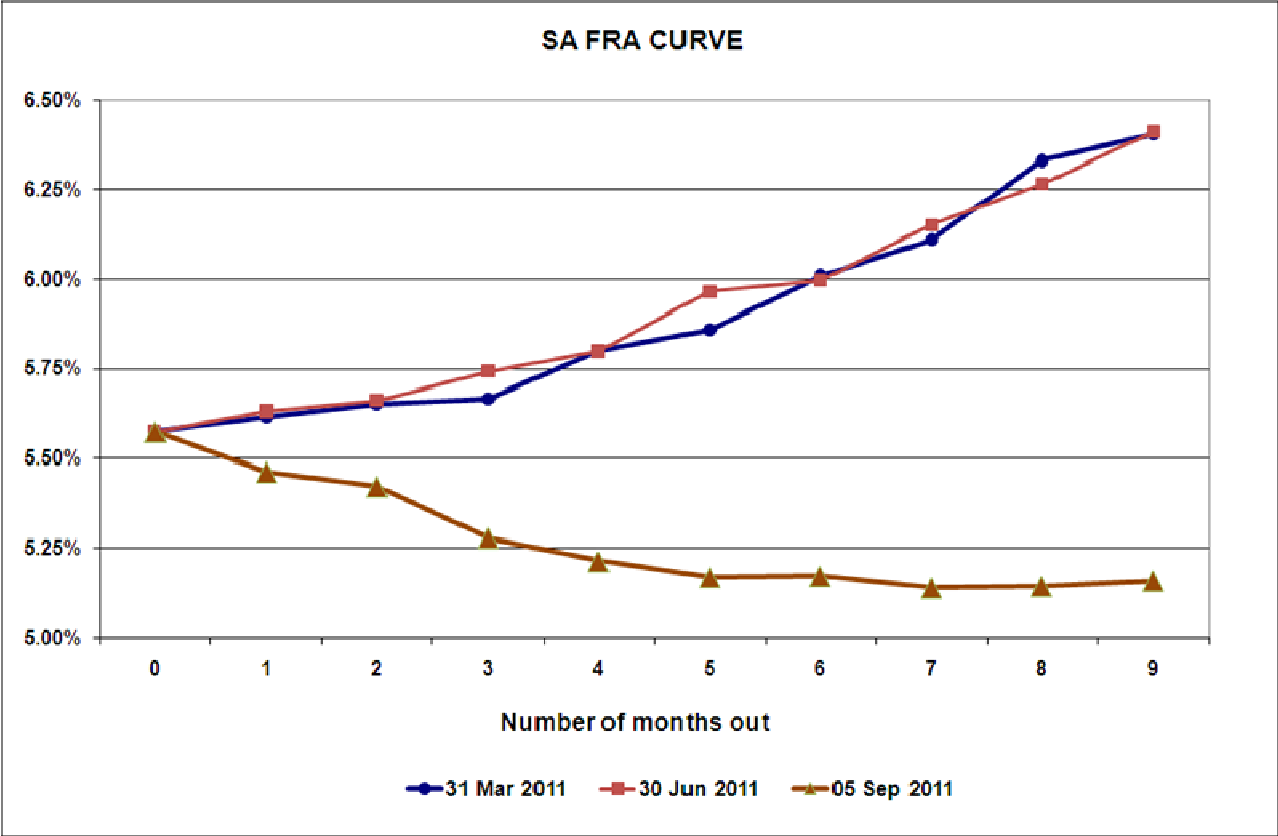
While inflation has been edging up over the past few months, the South African GDP for the second quarter of 2011 has disappointed. With the inflation concern, the Forward Rate Agreement (FRA) curve (see accompanying graph) showed that just a few months ago (i.e. as at 31 March 2011 and 30 June 2011) market makers expected an increase in interest rates.

However, more recently (as at 5 September 2011), this situation changed dramatically on the back of weaker economic growth, both domestically and globally, and the US Federal Reserve's announcement that its interest rates will be left unchanged until at least the middle of 2013. On balance the FRA curve is now actually pricing in the possibility of a cut in interest rates.

With the inflation concern and the SARB making known its assumption that inflation will most likely break the upper level of the target band before year end, it may seem odd that market makers are pricing in the possibility of a rate cut. It seems the economic growth concern is outweighing the inflation concern, and a dampening of demand that would occur with a rate hike is taking precedence in decision making.

While the role of the governor of the Reserve Bank is seldom elementary, the somewhat ambiguous primary purpose of the SARB does complicate matters. Although declining interest rates may have a positive effect on risky asset classes, spare a thought for the retired individual who very soon may be receiving a negative real return on his portfolio consisting largely of money-market instruments, even before income tax is taken into account.

Plexus’s advice to people in this position, especially if they are still relatively young, is to re-evaluate their asset allocations in consultation with an expert. While there are still risks out there, the recent bout of weakness in equity prices has presented a buying opportunity for the longer term. You have to have some exposure to equities in your portfolio if you want your savings to keep pace with inflation in the long term.



Source: I-Net Bridge and Plexus Asset Management