

	Economics	Interest Rates	Bonds	Equities	Currencies
United States	<p>We are still predicting a general slowdown in the US economy rather than a full blown recession. There are, however some key risk factors. Industrial production, fixed investment and retail sales are slowing. At the same time the housing market is in recession, which could negatively impact consumer confidence and spending. Increased defaults in the US sub-prime housing market are also dampening the economy. In contrast, commercial property activity remains buoyant, while corporate balance sheets are in good shape. Furthermore, job growth has been relatively robust, especially within the service sector of the economy (health, education, finance, professional services). Unfortunately the manufacturing sector continues to shed employment, which probably reflects the increased level of imports and the ongoing impact of globalisation – something that is unlikely to change in the year ahead. Overall, the US economy is likely to slow further during the course of 2007 to around 2%, down from 3.3% in 2006.</p>	<p>Although headline PPI was much higher than expected in March, the underlying data (core inflation) provides some comfort that companies are still able to absorb the higher cost pressures. These pressures include higher oil prices, commodity prices and labour costs. In fact core PPI inflation has remained at or below 2% for the past 18 months. This should also provide the Federal Reserve with some comfort in their debate over interest rates, but it is certainly not enough to alter our basic notion that the Federal Reserve will wait until well into the second half of 2007 before cutting interest rates. The current Federal Funds Target Rate is 5.25%. The next FOMC meeting is scheduled for 9 May.</p>	<p>The shape of the yield curve is considered by many to be a reliable forecaster of future economic growth. Since June last year, the shape of the US yield curve has been inverted with the two-year note yield above that of the 10-year note. This normally indicates that a slowdown is looming. However, a global savings glut and a hunt for higher yields have kept the long term rates low.</p> <p>After the Fed elected to keep rates on hold, the two-year notes perked up, steepening the yield curve and trimming the inversion. Bonds initially rallied as reports showed weak housing data and a slowdown in household and manufacturing spending. However, after positive wage data and a rebound in stocks dampened optimism the Fed will reduce borrowing costs by mid-year, bonds weakened.</p> <p>Concerns surrounding the liquidity crisis in the sub-prime sector and the potential effects it might have on the rest of the economy is a positive for bonds. Following 17 successive rate hikes the Fed seems to have peaked in its tightening cycle. Conversely Japan has only just ended its zero interest rate policy (ECB is in between). The result is different monetary policies makes local factors more important and could result in the correlation of global bonds declining with US Treasuries potentially outperforming. Underweight</p>	<p>Evidence of a slowing economy on the back of the declining housing market is a risk as well as rising inflation expectations. However, US equities rallied after the recent FOMC statement indicated that there is less likelihood of a rate hike by the Fed. Many US indices have continued to reach record highs, including the Russell 2000 (small cap index) and the New York Stock Exchange Index and the bull market has now entered its fifth year, although the S&P 500 Index is still below its 2000 record (3%). PE ratio's on S&P shares are now around 16/17, which is reasonable. Risk sensitivity has decreased as indicated by the Russell 2000, a small cap index, outperforming other indices. Equities continue to operate in an environment which is characterized by strong liquidity with cash levels reaching their highest level since August and reasonable, although lower, growth in company earnings. The main driver is M&A activity and private equity speculation. Recently, the US experienced US\$41bn worth of M&A activity.</p> <p>While US equities will probably provide decent returns for the year going forward, volatility will probably also trend higher. The weak US dollar remains a hindrance to returns. Underweight.</p>	<p>The trade weighted dollar has depreciated by 19% since its peak in 2002 and is now considered to be 18% undervalued on a PPP basis relative to the Euro. While further support for the dollar includes a possible flight to quality from geographical tensions such as Iran's nuclear program, significant headwinds exist. The Fed has shifted away from its tightening bias as the US is muddling through a period of low growth. Additional risks include dollar diversification from global central banks and a swelling current account deficit above 6% of GDP. The trade deficit, however seems to be improving thanks to the consumption slowdown in the US. Market consensus currency forecast 12 months out is: USD/EUR: 1.32 but the downtrend remains intact. Underweight.</p>
Eurozone	<p>Growth in the Eurozone, led by Germany, remains robust. Market consensus is forecasting 2.5% for 2007 as a whole and 2.4% in 2008. While exports have been vibrant for some time, it is apparent that one of the recent main drivers of growth has been increased business investment, supported by record levels of business confidence. This has proved to be the main catalyst for increased employment, helping to boost household consumption. Fortunately, the corporate sector is likely to remain buoyant, helped by strong balance sheets, although the sector may lose some momentum in the face of further interest rate hikes.</p>	<p>Eurozone inflation has been relatively well-behaved this year with annual inflation estimated at 1.9% in March, below the ECB's target of 2%. This is despite the VAT increase in Germany (which rose from 16% to 19%) and higher energy prices. However, there is a concern about rising core inflationary pressures, especially in the light of higher wage growth in Germany. Fortunately the Euro has been relatively strong relative to most other major currencies. In the short term this will help to alleviate some concerns about inflation. Since European interest rates remain below the UK & US, further interest rate hike seems likely. We expect the ECB to hike rates by at least a further 25bps before year-end taking the reference interest rate up to 4.00%.</p>	<p>Growth in Europe has surpassed expectations and as a result yields in the Eurozone area have pushed higher in response to the ECB hiking rates. Yield curves look set to invert as short term rates will probably move up gradually, with long rates remaining steady. The recent 3% VAT increase in Germany will result in some inflationary pressure. Since Germany is the largest economy in Europe, a build-up of inflationary pressure in that country will most likely have a negative impact on Euro-bonds. Oil prices have risen by 11% in euro since the start of the year. This could have a negative impact for both inflation and the bond market in the months ahead. We remain underweight</p>	<p>The European economy is showing signs of higher growth ahead, with business confidence in Germany in particular and also in Italy rising nicely. The European stock markets are also looking cheaper on a relative basis, trading on forward price-to-earnings ratios of 13-14, although official interest rates have risen from 2% to 3.75% during the past two years. Dividend yields from companies are similar to money market yields and company earnings yields are higher than 10 year bond yields (equities cheap relative to bonds, which is encouraging huge merger & acquisition activity). Unsurprisingly, European markets are at 6 year highs. Overweight</p>	<p>The ECB's hawkish stance on interest rate is clearly supporting the Euro. This coupled with a positive growth differential when compared with the US, is likely to provide ongoing support for the Euro. The strength of the Euro will put pressure on the ECB to rethink its policy of monetary tightening, especially if there is a negative impact on Euro exports. The Euro is now overvalued on a PPP basis by around 20% versus the dollar and has overshot by 35% against the Yen. Even though Germany's exports are growing strongly, there is the concern that the eurozone's competitiveness will be hindered by a strong currency. We expect the Euro to remain range-bound at around \$1.35 in the short-term, with the longer-term view highly dependent on future interest rate decisions. Chart-wise, the euro is in a strong uptrend and is threatening to move to a record high. Overweight.</p>

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UK	<p>The UK economy's slow start to the year is reflected in Q1's growth figures of 0.7%. In 2006, the UK economy grew at 2.3%, and is expected to accelerate to around 3% in 2007. Retail sales have not picked up as much as was anticipated since consumers remain cautious on the back of higher debt levels and the rising trend in unemployment. The manufacturing sector weakened in the first quarter, but is expected to pick up on the back of higher demand from Europe, Britain's most important trading partner. Moreover, the slowdown in manufacturing was partly compensated for, by a new oil field opening in the North Sea. This helped to keep total industrial production stable during the first quarter of 2007. Business investment is relatively weak, but has been strengthening on the back of relatively healthy corporate profitability and capital expenditure expansion in the service sector</p>	<p>UK consumer price index surprised on the upside, increasing to 3.1%y/y in March. This forced the Bank of England to write a letter of explanation to government. Alluding to broad inflationary pressures, the most significant being electricity, food and gas, increased inflation expectations were emphasised. As the economy continues to grow, firms are also discovering a greater degree of pricing power and are looking to boost their profit margins. Coupled with resilient housing activity, another interest rate hike in May will be possible taking the official interest rate up to 5.5%. (The market is currently pricing-in a peak interest rate of 5.75%).</p>	<p>The front end of the yield curve is vulnerable to the Central Bank's hawkish tone and yields have jerked up in response to investors' bearish sentiment around inflation. Two-year gilt yields have hit their highest level in 6.5 years, while 10-year gilts jumped to their highest level in 3 years.. Due to disturbing CPI numbers hurting bond yields, we remain underweight.</p>	<p>Our cautious UK equity view has now become fairly sanguine in the face of a more resilient economy. London is more readily being seen as the world financial centre and as a result the banking sector is booming. There has been a substantial amount of M&A activity as seen recently by the Barclays/ABN Amro deal, as well as significant activity from private equity players. This activity, which is expected to continue for some time, has provided a fillip to equity prices. Housing prices have rebounded, although growth is not back at the heady rates seen early in the decade. In general, equity valuations appear reasonable, with PE multiples around 14 times with reasonable earnings growth expected. Neutral</p>	<p>Inflation remains stubbornly around 3% (fastest pace in a decade so another 25bpt hike is on the cards). This would increase yields on sterling deposits to 5.5% making it the highest yielding G7 currency. Moving in harmony with inflation figures, Sterling has also reached the psychological barrier of \$2, its highest level attained against the greenback in 14.5 years. UK's interest rate premium is likely to widen over other countries thus supporting Sterling. The fact that high yielding currencies such as the Pound have strengthened, while lower yielding currencies (Yen) have weakened, is an indication that the carry traded is still very much alive. Unless we see an economic surprise or a bout of risk reduction we believe that this is likely to be a continuing theme in 2007. Overweight</p>
Japan	<p>The Japanese economy, although not exciting, continues its steady pace of growth around 2%. Consumption seems more sustained than previous periods thus supporting demand growth. Capacity utilisation remains high as capital expenditure continues to expand. One of the possible underlying factors underpinning corporate investment is increased construction orders from the real estate sector. Company earnings remain solid and were on aggregate revised up as corporates underestimated pricing power. A tight labour market should also lead to higher wages and an improved consumption environment. On the downside, however, manufacturing and industrial production have slowed although a recession in these sectors does not look forthcoming. On the whole the economy seems most likely to continue its path of steady growth.</p>	<p>An initial path of tightening monetary policy is likely to be kept on hold as Japan is again experiencing deflation. However in the long term, we expect this to reverse as land prices are rising for the first time in 16 years and consumer confidence is picking up. This implies that the world's second largest economy may finally enter an era of healthy economic growth and stable prices.</p>	<p>Most bond markets weakened during March, as Chinese equity markets stabilised after February's sell off and riskier assets rallied back. However, Japanese government bond yields remained flat. This was largely due to economic weakness and the deflationary environment. We remain underweight as risk to bonds remain on the upside, especially since the BoJ looks set to hike rates gradually</p>	<p>We believe that Japanese equities should experience earnings upgrades as a result of asset reflation, credit growth and increased capital expenditure. The pace of corporate spending and hiring has also increased, thereby laying the foundation for a sustainable expansion. Japan's savings rate as a % of GDP is one of the highest in the world, so pent up demand bodes well for domestically oriented companies. Additionally, more than 52% of these savings are in cash with only 11% in equities, implying that there is significant potential buying power. However, Japan's population is shrinking, which is not positive for local companies. The turnaround of the domestic consumer is critical if the economy is to avoid another "false start." But it seems as if the current recovery is better balanced than previous turnarounds. Exports, capital expenditure and domestic consumption have all played their part. A weaker Yen coupled with a resilient economy has been good for the country's exporters; however a slowdown in the US could pose a large downside risk. Chart-wise, the market has still not yet broken out of a lengthy resistance area. Overweight</p>	<p>The Yen has been beached in a tight trading range against the dollar (Yen/\$115 – 122) for the past year but has been hitting record lows consistently against the euro. Ironically, the weak currency has had no impact on inflation which is now receding back into a deflationary phase. Further weakness against the floundering dollar is possible. China's strong growth data initially sparked fears that risk averse investors could unwind the Yen carry trade, which has infiltrated the international economy. However an abundance of global liquidity is encouraging a continuation of riskier trades, supporting the yen carry trade, which puts pressure on the Yen.</p>
South Africa	<p>South Africa's economy continues to surprise on the upside with growth figures (5%) from last year well ahead of a forecast and targeted GDP of 4.5%. The key feature of the recent strong performance is ongoing extremely strong growth in construction activity, financial activity and retail sales, while the recovery in the mining sector provided a welcome boost. This is heartening from an employment perspective given that it is ultimately the most important economic objective. (>1m jobs added in the past 2 yrs!). Consumer confidence is at its highest level ever despite higher interest rates and elevated fuel prices. The Reserve Bank aims to curb consumer spending, and as a result some moderation in economic activity is anticipated during 2007. This is already being witnessed in slowing vehicle sales. Fortunately the fixed investment cycle remains extremely robust on the back of an expansionary infrastructural programme. Looking forward, GDP growth for 2007 is currently projected at 4.5%y/y.</p>	<p>CPIX inflation rose sharply by 1.0% m/m in March, with the annual rate jumping to 5.5%y/y from 4.9%y/y in February. This was in-line with expectations. Although SA consumer inflation remains contained, especially given the robust domestic environment, CPIX is expected to climb higher, rising to the top end of the target range before mid-2007, and ending the year at around 6.0%y/y. This is largely attributable to persistent money supply and credit growth, currency weakness and a high oil price. While the the Reserve Bank opted not to hike the Repurchase (Repo) Rate in April, which was the second consecutive meeting at which rates were left unchanged, on balance STANLIB is highlighting the risk that the Reserve Bank may feel compelled to hike rates by a further 50bps at the June meeting. However, we acknowledge that once again the interest rate decision will be a close call, especially given that the Bank has already had two opportunities to hike rates in the face of a deteriorating inflation outlook, but has chosen to leave rates unchanged. A 50bps rate hike would take the Repo rate up to 9.5% and the prime interest rate to 13%.</p>	<p>The bond market opened the year at 785% on the RSA 2015 R157. Rates then traded to a low of 748% on a very positive demand and supply outlook for bonds. The positive fiscal position is resulting in less government bond issuance. Foreign buying is still strong with year to date net sales of 10 billion on the back of continuing positive emerging market sentiment. Repo rates remaining flat for the last four months was another bullish factor for bonds. However, on a negative note, the fundamental outlook for inflation has deteriorated somewhat, with oil and maize prices rising sharply. Nevertheless, bonds hardly quivered in response to the latest consumer inflation figures of 5.5%. Conversely, the sensitive money market rates jumped to around 9.6%, pricing in the probability of another 50 basis point hike. Looking further forward into the interest rate cycle, bonds are optimistically not pricing in any more rate hikes. The yield curve remains inverted as demand for duration continues, while the short end is kept high by short term rates above 9%. We remain underweight bonds due to the low returns expected from the capital market.</p>	<p>The JSE continues to hold its bullish momentum with YTD returns of 14%. Economic growth continues to beat forecasts thereby underpinning foreign interest in SA equities. Increased infrastructure, employment, world cup, construction spending and global commodity boom all playing their part in the positive SA story. Property has also offered compelling returns in the region of 24% in the last four months. This is largely attributable to strong fundamentals, limited supply and increased demand. Although the JSE looks a tad expensive on a PE ratio above 16, "blue sky" prospects remain appealing to foreign investors. On balance, earnings have continued to surprise positively and relative to bond yields equities still look undervalued, although we are cautious about the May to October period, which is historically a weaker period. Based on still robust earnings growth, STANLIB is forecasting a 15% return for the next 12 months. Moderately overweight.</p>	<p>The current account is likely to remain under pressure given the expected steady pick-up in fixed investment spending over the next couple of years, which contains a large component of imports. Fortunately South Africa's positive growth story is attracting foreign investment, both into our stock and bond market and also lately in private equity deals (R20 billion alone in April). This has provided most of the funding to balance our current account deficit. Capital inflows amounted to 8% of GDP in 2006. As long as global risk aversion does not increase substantially, these inflows should continue. However, on balance we expect the rand to depreciate to R7.75 by the end of 2007.</p>

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