

RisCura Consulting

MONTHLY MARKET COMMENTARY

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RISCURA MONTHLY MARKET COMMENTARY

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Summary

The significant rise in world equity markets since the latter half of last year continued into the first half of March but petered out in the second half, with the MSCI World index up 2.1% for the month after being flat for February and up 5% in January. It should be noted that much of the March gain was due to strong performance in Japan and the US, as well as smaller contributions from the three largest European markets (Germany, UK, and France). However, many other major markets, including China, Brazil, Russia, India, Australia, and Canada, were down, with the BRIC countries in particular suffering the worst declines.

In the near term, markets seem to exhibit decreasing levels of risk and have continued to reward the generally positive economic data that came out during the first quarter. Of the major market-impact factors mentioned in the previous commentary, Japan and the US have so far delivered on resolving their main economic issues (reflation and fiscal policy, respectively), and this is reflected in the superior performance of those markets. China's changeover from an investment to a consumer-led economy will take years and will be a difficult realignment. The country's central bank will continue to run a tight monetary policy to prevent excessive investment and speculation.

Though North Korea could throw a wrench into the gears, the main risk this year will likely continue to be the severe economic stagnation/recession in much of Europe. Southern Europe is effectively in a depression, and the UK and French economies are struggling as shown by their poor GDP and fiscal figures, though the British sterling devaluation (it is the second worst performing currency of any major economy this year after the Japanese yen) will help the country in the long run. The stronger Eurozone countries like Germany and the Netherlands are right to push for reforms to change people's mentality away from unsustainable overconsumption, but the Eurozone has no coherent plan for growth. One is at pains to think of any instance in history where a country has recovered from such a severe economic crisis without the benefit of a currency devaluation, restructuring of fiscal and private debts, strong improvements in demographics and productivity, and/or strong economic growth by trading partners. The Eurozone currently does not have the benefit of any of these, and fiscal austerity is only making the problem worse. But risks remain – the bigger ones are the hardest to predict, they can appear suddenly and hijack headlines overnight.

World tour: who would have predicted starting with Cyprus?

Cyprus, a minnow in economic terms, topped the headlines after going through a convoluted €10bn bailout by the other Eurozone countries, which again raised market concerns about the viability of the Euro currency. The Eurogroup of finance ministers initially proposed to tax Cypriot depositors to pay for the bailout, breaking not only the Eurozone guarantee on bank deposits, but also the traditional legal seniority of depositors over bondholders in a bankruptcy. After this senseless and panic-inducing proposal was rejected when Cypriots took to the streets, the Eurogroup was forced to back a more traditional bailout. Nevertheless, Cyprus will now have

capital controls on currency outflows for the foreseeable future, which is at odds with the concept of the euro being a free-floating currency. This led to gyrations in European markets during the second half of the month and a sharp fall in the shares of European banks in fear that more equity capital will need to be raised to guard against further losses, causing equity dilution.

On top of this, the Democratic Party in Italy, which topped the polls in recent parliamentary elections but failed to win a majority in the upper house, looks like it will fail to form a majority government. This will lead to either new elections or a minority government, which will have difficulty passing necessary reforms. These events pushed the yields on 10-Year US Treasuries and German Bunds, which have been good recent indicators of market fear, to 1.85% and 1.29%, respectively, down from 1.88% and 1.45%, respectively, in February.

Pope Francis, the archbishop of Buenos Aires, was selected to be the new pope of the Roman Catholic Church. He is the first non-European pope in several centuries, and his origin from Argentina speaks volumes about the increasing importance of emerging markets. However, Argentina's neighbour, Brazil, is struggling as GDP growth has consistently come in lower than expected, 1.4% in Q4 2012 compared to a forecasted 3.3%. The Bovespa index was down 1.9% in March (and down 13.4% year over year) as lower commodity prices on major exports have increased the country's current account deficit. President Dilma Rousseff has been making some necessary structural reforms, but these have been slow and the effect will take some time to filter through the economy.

South Africa outperformed other commodity-centric economies in March but was still down 1.0%. Despite political ructions within the ruling African National Congress (ANC) party (many members have been questioning the authority of President Jacob Zuma) and a bitter miners strike in recent months, the economy has remained strong, with forecasted GDP growth of 2.8% for 2013. This is despite (or perhaps because of) the South African rand currency falling another 2.0% versus the US dollar in March; it has depreciated 16.7% over the past year. A current account deficit of 5.4% of GDP and a government fiscal deficit of 4.3% persistently weigh on the economy and keep interest rates high, but the country should continue to benefit from strong economic growth in sub-Saharan Africa (as shown by Nigeria's stock index rallying another 1.4% for the month; it is up 60.5% year over year).

Further north, Uhuru Kenyatta, a son of Kenya's first post-independence president, won the country's presidential elections. This has caused a bit of political hesitation from the international community as Mr. Kenyatta and his vice presidential running mate were indicted by the International Criminal Court for allegedly inciting sectarian violence after losing the last elections in 2007. While embarrassing in some respects, this result should not cause negative economic impact and may even be a positive, as two historically antagonist factions are now in a coalition government together rather than battling on the streets.

A eulogy also goes out to the recently deceased Chinua Achebe, the Nigerian writer renowned for being one of the first to describe Africa from an African perspective, rather than a Western or even colonial perspective. This is somewhat appropriate given Africa's economic rise over the past two decades, marked by better governance and innovation tailored to the needs of Africans.

In Asia, the governor of China's central bank indicated he would be on "high alert" against inflation after price levels jumped 3.2% on an annualised basis in February, compared to 2% in January. Despite sluggish industrial production figures, the central bank governor indicated that he would maintain a relatively tight monetary policy to prevent a real estate bubble from reoccurring. This has weighed on China's financial markets for the past year, with the Shanghai Composite index falling 5.5% in March and down 2.1% over the past year. However, as further confirmation of China's increasing economic importance, the country became the world's biggest oil importer for the first time, surpassing the US (6.12m bbl/day compared to 5.98m).

Unfortunately, China's neighbour North Korea is trying to destabilise the region yet again. The country has renounced the 1953 armistice (not for the first time) that ended the Korean War, adopted an aggressive military posture by deploying ballistic missiles on its eastern coast capable of hitting Japan, and cut off diplomatic and military communications channels. The US is likely to respond to this escalation in kind, though more as a precaution. As mentioned in previous commentaries, these provocations are due to leader Kim Jong Un needing to assert his power and authority internally after China backed a UN resolution to increase financial sanctions on North Korea. While it is highly unlikely to start full-scale military action (it doesn't even have enough petrol to drive its tanks down the full length of the Korean Peninsula, much less win a war), North Korea is likely to keep causing minor provocations until it blackmails its way to more economic and food aid.

As highlighted in earlier commentaries, Japan continues to be the star performer this year, with the Nikkei up 6.7% for March and up 42.4% since last November. The appointment of Haruhiko Kuroda as governor of the Bank of Japan further confirms the government's efforts to reflate the economy through massive quantitative easing and currency depreciation (the yen was down 1% in March and 12.1% year over year versus the dollar). Confidence is growing in Prime Minister Shinzo Abe's government, and Japan's market rally is likely to continue if this confidence is validated.

In the southern part of the continent, the Reserve Bank of India cut its benchmark interest rate by a quarter of a percentage point (to 7.5%) for the second time this year. The government has been trying to stimulate a sluggish economy with monetary easing, but this is limited due to the country's stubbornly high inflation (8.8% forecasted for this year). The Sensex 30 stock index fell 0.1% for the month, though is up 10.0% year over year. However, the government, facing elections next year and performing poorly in the polls, is unlikely to push through significant economic reforms. India's fragmented political structure perpetuates its basketcase economic decision-making process, so the country's regulatory inefficiencies and relative lack of infrastructure are likely to continue holding back its growth rate.

Further north in Russia, President Vladimir Putin appointed long-standing ally Elvira Nabiullina, currently chief economic advisor, to be the new head of the country's central bank. Resentment against corruption by high level officials is the biggest threat to the president, so Putin is clamping down on the foreign bank accounts of officials and privileged business people that were negatively highlighted by the banking collapse in Cyprus (historically the main channel that Russians used to launder money out of the country). The MICEX stock index was down 3.5% for the month (and down 5.7% year over year) due to uncertainty regarding these changes. Russia's

economy is slowing (though the country's GDP is still expected to grow 3.3% this year), as high inflation and low investment have eroded competitiveness and productive capacity. This is compounded by falling prices for natural gas exports due to a worldwide glut and stagnant if not declining prices for other commodity exports.

On a brighter side, the US Congress came to a rare and surprising bipartisan agreement to pay for discretionary programmes for the rest of the fiscal year ending September. It prevents a government shutdown, although it leaves in place much of the sequester which cuts 8% from the defence budget and 5% from other discretionary programmes. If agreement can be achieved on raising the debt ceiling (due to be reached in May), then much of the significant political risk in the US will be pushed out to later in the year and next. More importantly, it may be an indication that the Democrat and Republican parties may finally be willing to work together to legislate. This would be a significant positive for the country, though the sequester will be a drag on the economy for this year. The S&P 500 index was up 3.6% in March (and 11.6% year over year) as positive data continue to confirm a decent (though not spectacular) economy recovery.

% Change	Last 12 Months	YTD	Mar-13
MSCI World	9.3%	7.2%	2.1%
S&P 500 (US)	11.6%	10.0%	3.6%
Nikkei 225 (Japan)	21.1%	18.7%	6.7%
FTSE 100 (UK)	10.4%	8.7%	0.8%
DAX 30 (Germany)	11.4%	2.4%	0.7%
CAC 40 (France)	8.8%	2.5%	0.2%
Hang Seng (Hong Kong)	6.8%	-1.6%	-3.1%
S&P/ASX 200 (Australia)	14.3%	6.8%	-2.7%
Bovespa (Brazil)	-13.4%	-7.5%	-1.9%
MICEX (Russia)	-5.7%	2.7%	-3.5%
Shanghai Composite (China)	-2.1%	-1.4%	-5.5%
BSE SENSEX 30 (India)	10.0%	-3.0%	-0.1%
EGX 30 (Egypt)	2.8%	5.1%	-5.6%
Nigeria All-Share	60.5%	19.4%	1.4%
JSE All-Share (S Africa)	22.2%	1.6%	-1.0%
Brent Oil - Spot	-5.4%	-0.7%	-1.2%
Gold - Spot	-4.0%	-4.7%	1.1%
US Treasury 10-Year Yield	-16.0%	5.2%	-1.4%
German Bund 10-Year Yield	-29.6%	-2.1%	-11.3%
USD/EUR	3.9%	2.9%	1.9%
USD/GBP	4.6%	7.0%	-0.2%
JPY/USD	-11.9%	-7.9%	-1.7%
ZAR/USD	-16.7%	-8.0%	-2.0%

Sources: RisCura, Bloomberg, US Energy Information Administration.