



Investment Environment August 2009

It feels like a long time ago that the Investment Environment February 2009 was sent out and at that time we expounded on the theory of "bumping along the bottom". We were also courageous enough to say that it was important to maintain portfolio positions and not throw out shareholdings which would have caused a crystallisation of losses. The Investment Environment of May 2009 argued that probabilities favour Sunter's scenario "new balls please" setting the scene for recovery, and that probably the worst was over.

Six months after bumping along the bottom, it would appear that we have experienced one of the most impressive rallies in stock market history and while we should pause to enjoy the moment, markets never allow us the luxury of being complacent. There are many (probably the majority) market commentators who, having missed the easy money in the early stage of the current recovery, continue to argue that this is a bear market rally. Probably the most notable of these forecasters is Nouriel Roubini, the New York University Professor of Economics who accurately forecast the bursting of the housing bubble and the resulting economic contraction in 2007. Having already been dubbed "Dr Doom", on 24 August Roubini published an article in the Financial Times highlighting that the risk of a double dip recession is rising.

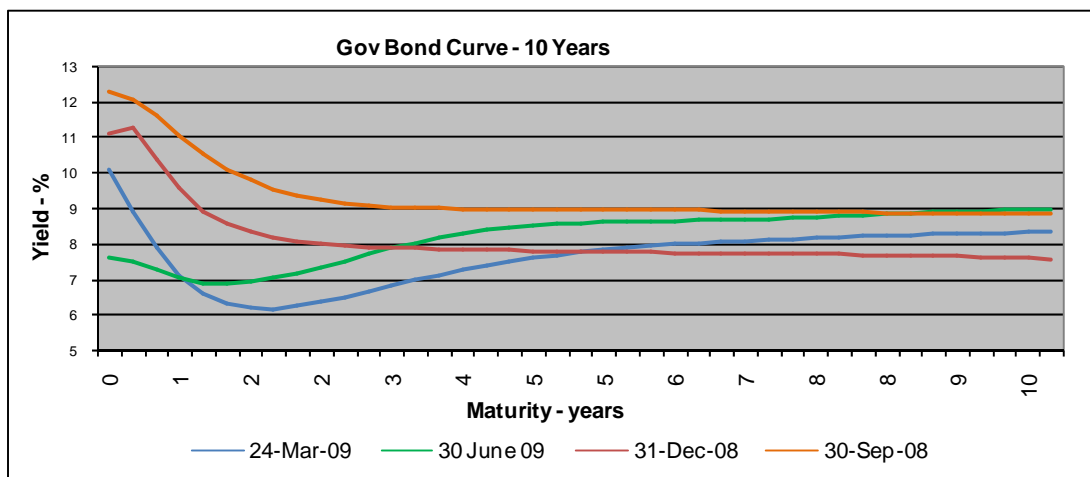
We receive a lot of research but take Dr Martin Jetzer of HSBC Private Bank seriously, and he has recently released a series of papers headed "Beyond the Crisis" where he makes the following statement:

"The liquidity crisis of early 2008 is over; a great environment for well capitalised commercial banks following the greatest credit overshoot in history. Banks benefit from record credit spreads, record fees, near-zero funding costs, implicit government guarantees and the prospects of the economy beginning to recover."

How ironic that the supposed perpetrators of sub-prime that quickly turned into a global financial markets crisis, could be the potential beneficiaries of the recovery. In an effort to avoid being short sighted, we continue to take a longer term and more positive view. The important point is that banks are beginning to lend again and as money begins to flow more easily the world might be relieved that the high risk zone of D&D (deflation and depression) has passed. But perhaps it is better than that and financial markets are discounting the start of a new business cycle. This cycle might be well supported by years of non-inflationary slower growth allowing a long low interest rate environment which will be self fulfilling and supportive of a real growth environment.

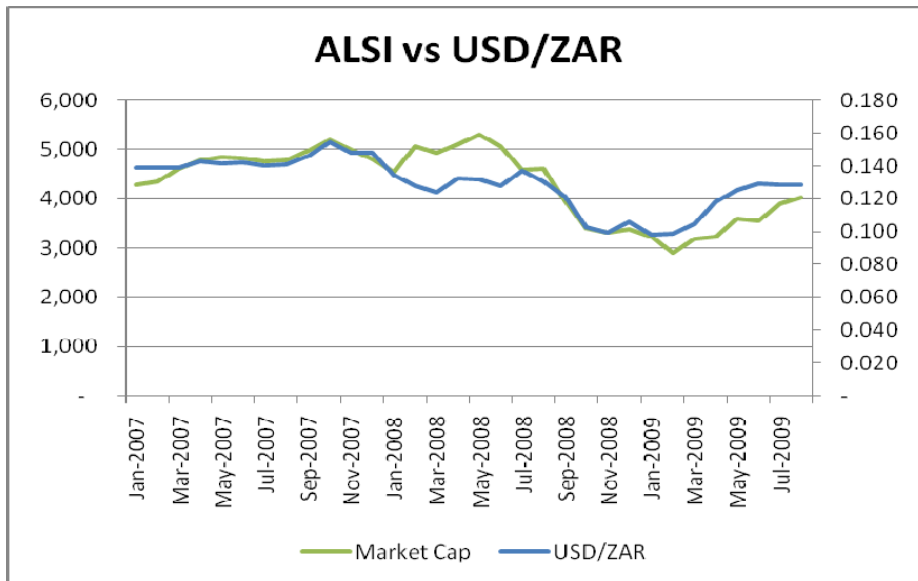
There are obviously always risks that a sustained recovery could be disrupted but we are in a far better place than 6 months ago and significant action has been taken by:

- Businesses - cut costs and inventories to defend profitability
- Consumers - behaved appropriately (e.g. the US savings rate touched 6.9% which is hard to believe, yet in China the consumer continues spending off a low base which is positive)
- Governments - aggressively stimulated economies and have bailed out where necessary.



For those who like economics, it might be interesting to observe what the South African bond market is telling us. The picture above shows the yield curve changes over the period of recovery as it moves from inversion, which indicates a recessionary environment, to normal (long term rates are higher than short term rates) consistent with a forecast of economic recovery. The bond market usually leads the equity market by approximately 6 months.

The Rand which has been surprisingly strong but it is interesting to compare the currency to the performance of the JSE. The graph below shows that there is a high correlation (0.81) between the Rand strength and the equity market performance. This is being driven by nett foreign investment flows which, year to date, have amounted to R56.5 billion. These investment flows are driven by the positive bias to South Africa as a combined commodity and emerging market play which puts a significant demand on both the Rand and ALSI 40 stocks of the JSE.



It is unlikely that markets will continue to move in one direction and continue straight up from here but there is a positive outlook and we intend holding on to what we have in the portfolios. In the event of any set back, courage will be needed to use the opportunity to add to the existing equity counters in the portfolios. One needs to remember that share prices have led the economic recovery and, on the assumption the markets are right, the benefits are yet to come in the form of improving profitability and dividend flows based on economic recovery.

We are pleased to announce that we have launched our website which we hope you will find useful as a reference point for information on both Douglas Investments and Conexus Investment Fund, and we would value any feedback you may have. www.douglasinvestments.co.za