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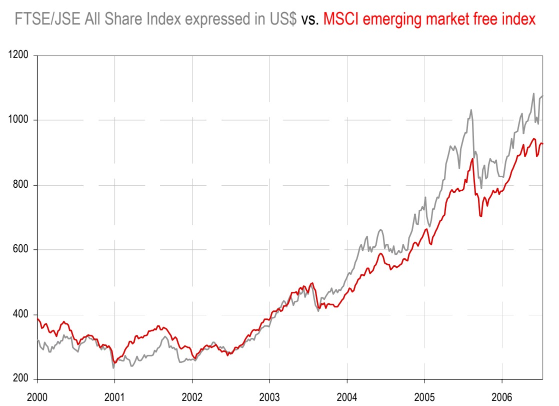
South Africa in the context of global emerging market trends

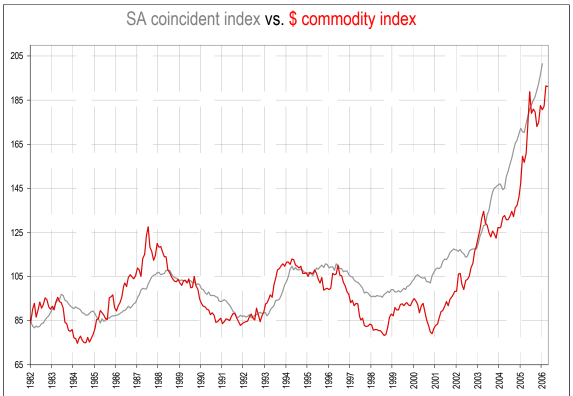
In an equity bull market usually one theme or particular industry captures the imagination of investors and sets the pace for the market as a whole. In the 1990's computer software, the Internet and mobile phones played this role. In the latest upturn, which started in 2002, the big story has been emerging markets. Since 1994 South Africa has been categorized by international investors in this category. It is quite astonishing the extent to which, since 2001, our market has moved in tandem with the global emerging market indices. This relationship can be seen in **Graph 1 below left** which shows the FTSE/JSE All Share Index expressed in US dollars and the MSCI emerging market index, both on the same scale. It is relevant to ask why this strong correlation exists. As is usually the case in such matters the answer is multi-faceted.



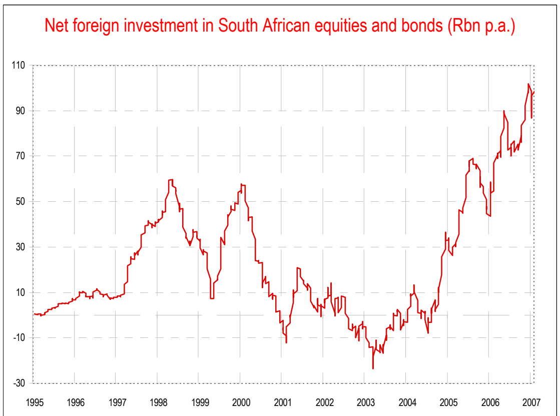
Graph 1 source: I graph

Emerging markets in general, and Asian countries in particular, are in the process of raising the living standards of their large populations towards those currently enjoyed in Europe, North America and Japan. Over the next 20 years the focus of global economic activity will move to Asia. This is where the profits will be and where people will want to invest. We are witnessing a major rotation of investment out of the developed markets into emerging markets. This is partly a globalisation story with world trade expanding 84% between 2002 and 2006. Where previously there were large current account deficits in the developing world, there are now substantial surpluses, which reduces currency and therefore investment risk. After a false start in the 1990's, most of these markets have become more investor friendly and improved corporate governance. The rise in the emerging market indices, which have tripled since 2002, reflects these trends.

Asia has now reached a stage of development that is extremely materials intensive. The demand for commodities is again growing as it did in the 1950's and 1960's when the OECD went through a similar stage in the development cycle. The difference is that the scale of what is now happening is several times greater. Commodity prices have boomed and South Africa has been a major beneficiary. The South African economy has always moved in tandem with commodity prices. **Graph 2 to the right** shows the strength of this relationship. This compares a dollar commodity index with our coincident indicator (things such as retail sales and manufacturing production). South Africa's exports have doubled since 2002 due to higher prices. In turn this has allowed domestic consumption to expand at the fastest rate since the 1960's, and company profits have surged. Investors favour markets with a strong earnings growth. When the South African economy stagnated in the aftermath of the emerging markets crisis of the late 1990's capital inflows dried up. From 2004 onwards the growing strength of the economy has been increasingly recognised and capital has again flowed into our markets. In 2006 the net inflow was R100 bn **(Graph 3 below)**. This is a small share of the total flow into emerging markets but for South Africa it is extremely significant. Given our large current account deficit we need a big capital inflow for our present prosperity to continue. The general health of the South African economy has become dependent on the attitude of foreign investors, not only to South Africa itself but also to emerging market assets as a whole. One of the factors favouring continuing investment inflows is that an increasing amount of funds seeking a home in emerging markets comes from emerging markets themselves. As countries in Asia account for the majority of the world's savings it is inevitable that they will play an increasingly important role as a source of international capital. Some of these investors are cautious about placing their money in the US for political reasons and look for investment destinations that they regard as friendly. Whatever the motives we have recently seen significant purchases of South African assets by both Middle East and Russian based investors. The recent sale of the V&A Waterfront is a good example.



Graph 2 source: I graph



Graph 3 source: I graph

While South Africa's inclusion in the emerging market asset class has generated significant benefits it also constitutes a substantial risk. In May 2006 our market declined 16% as emerging markets as a whole were sold off. More recently we have seen volatility on the JSE as concerns about an overheated Chinese market spilled over into other markets. Increasingly the forces of globalisation are decreasing the importance of the nation state. Industries transcend borders. Emerging markets and developed nations are being integrated into a unitary global economic system. What is happening currently in South Africa should be viewed in this context.

Commentary by Sandy McGregor