

Dear Investor

Footrot Flats happens to be the name of a series of comic strips running during the 70's to the 90's. It was on a recent trip to Johannesburg that an old series of the comic books were spotted (and purchased!) Whilst providing a good number of laughs, it was in pondering market direction and dynamics that it became apparent that Footrot Flats is an apt description of where the market finds itself at the moment. Part comedy, part tragedy, lots of cat versus dog fights, and even more appropriate, Footrot Flats is the name of the farm upon which all this action happens, which also happens to be a rather swampy piece of land.

We have spent a considerable length of time thinking about what the drivers of market direction will be this year, and our brutal conclusion is that we are likely to see a continuation of the main themes from last year, with a similar pattern of market direction and volatility. Considering how market fatigued we felt towards the end of 2011, we are providing a warning for some rough weather ahead. Please note that in order to comply with South Africa's Weather Services Amendment Bill, (WSAB) we need to point out that this weather warning is as it pertains to investment markets, and not to the climate outside. Otherwise we could face a possible 10 year jail sentence for issuing a severe weather warning without the written permission of the SA Weather Service. Yes, dear reader, while in your interest this week we wanted to provide some advance comic relief and thus point you in the direction of Footrot Flats, the WSAB is not a joke! Talk about the nanny state! Oh sorry, we actually meant the welfare state...um, can we just leave this now and swamp you with the commentary?

Enjoy the Read!

The Atlantic Team

Atlantic Yield Report	Yield	Note
Atlantic Stable Income	6.40%	Current effective rate
Atlantic Enhanced Income	7.94%	Expected 12 month forward yield
Atlantic Real Income	9.10%	Expected 12 month total return

All calculations are indicative and use current market pricing and fund compositions and will change from time to time due to market conditions.

All yields are calculated net of costs

Source: Atlantic Asset Management

Date: 2 February 2012

View

As we draw the curtains on a very successful January for global asset markets (Gold +11.1%, Platinum +14%, Silver +19.6%, Copper +10%, Top 40 +6%, EXX +14.8%, BIL +12.7%, NPN +11%, AGL +9.8% etc), the question arises – where to next?

Historically speaking a start to the year as the one we just witnessed leads to a stunning year ahead. Furthermore, on Tuesday night the S&P 500 signaled a “golden cross” (50-day MA trading above the 200-day MA – one of the more bullish technical formations) – on three other occasions over the past five years markets peaked on average 24.5% above the level the cross occurred at within the next 14 months.

Yet here we are, wondering about Greece (and Portugal and...); confused about the US debt ceiling (and Japanese debt/GDP); awaiting President Zuma's State of the Nation address (and the detail of the National Budget). While German unemployment printed at its lowest level since the early 90s, Greece unemployment continues to skyrocket. Another favourite chart currently used in macro presentations is that of youth unemployment levels in the European periphery. Elsewhere China did not appease the market by introducing a further RRR (Reserve Requirement Ratio) cut post its New Year celebrations, while the Australian property market is starting to show up as a concern.

What are we to make of all of this?

The short answer is : we need to stay open-minded (for the foreseeable future).

The extent to which the sharp rally in risk assets year-to-date can continue will be brought into sharp focus over coming weeks with markets facing two key events/ tests: 1) the EU Summit; and 2) Tier-1 US economic data.

Fixed Income

With risk-takers clearly shifting their radar to Portugal, a 50% haircut on any Greek PSI deal (which is actually the same as a 70% loss) might not be enough to stem the tide that continues to rise against the European periphery. Whether financial markets are relying too heavily on the potential scope for a JV between the US and EU to announce a 'mega-bazooka' and/or QE in the UK and more LTRO in Europe, only time will tell. What is clear is that cash balances exceed that witnessed in January 2011 (by almost \$1 trillion...) and therefore we should appreciate that after a poor year for macro funds, the current momentum in trading strategies might lead to some further 'pressing'.

It is therefore understandable that foreigners managed to buy an impressive R7bn worth of South African bonds in January. Worryingly though, the opposite trend continues unabated on the equity front, with net selling of R6.1bn chalked last month. With local asset managers sitting very close to maximum exposure on their offshore allocations, between 12-15% on their bond allocations, and foreigners not interested in increasing their holdings of the JSE market cap beyond the current 35-40%, we need to ask ourselves what happens next?

With the South African yield curve remaining one of the steepest in the world, and despite inflation expected to move further outside the 3-6% target band, demand by the foreign contingent for duration will likely continue into any mini sell-offs. It is local interest that is probably slightly harder to gauge as fair value models show bonds up as slightly expensive, although this is using 'old normal' analysis.

Figure 1: R186 – local assets running into technical resistance (this holds for the broader fixed income asset class, as well as equities)



Source: Bloomberg

Global

We found the following excerpt from a SocGen research note thought provoking:

Will Portugal follow Greece?

Portuguese bond yields have increased on the back of downgrades and fears that Portugal will follow in the footsteps of Greece. Under the current EU/IMF program, Portugal is due to return to market funding in 2013. For this to become realistic, 10-year bond yields would have to decline substantially from the current level of 15.1%. In our opinion, the Portuguese government will bite the bullet and deliver deep reaching structural reform and austerity in 2012. The risk, however, is that even a successful program may not be enough to secure a sufficient decline in bond yields. That would leave only two options (1) a second official package or (2) PSI. A firm commitment from euro area policymakers that Portugal will not see PSI and, if necessary, funds would be made available would clearly be helpful and push bond yields lower (and thus reduce the risk that an official second package would be needed!). MARKET ISSUES: The ECB warned on the dangers of Greek PSI and have been proven correct. Until clear commitment is given by euro area policymakers on Portugal, market nerves are likely to remain on edge.

Will Greek PSI ensure sufficient participation?

A press release posted on the IIF website Saturday said, "We are close to the finalisation of a voluntary PSI within the framework expressed publically earlier this week by Jean Claude Juncker". This will set a 50% cut on outstanding debt, a coupon of close to 3.5% on average and result in a NPV loss of close to 70% for private investors. It seems very possible that retroactive CACs (Collective Action Clauses) will be used to encourage participation.

MARKET ISSUES:

The key question if CACs are introduced is whether this would be considered a credit event that would trigger the CDS. This will be decided by the ISDA Credit Derivatives Determinations Committee."

With newswires continuously claiming that Greece is 'very close' to a new Troika loan deal risk-takers will likely continue to keep their sails set as close to the wind as possible. Any signs of a change in wind direction will however be key in determining whether gold crosses turns into death crosses.

FX

Another week another well-behaved Rand – with an almost pedestrian 19-cent range at the time of writing. It is becoming clear that the 7.70 region holds the key on the momentum front after the psychological 8.00 level was breached for the first time in a couple of months in the middle of January. However, Rand direction remains mostly a function of global macro dynamics, with news on Greece in particular likely to be cause for some excitement either way.

A breach of 7.70 will likely open a quick test all the way down to 7.60 and could even open a larger move down to 7.38. With talk of official intervention already doing the rounds last month closer to 8.00 it will be interesting to see how tough gains to the downside become as authorities struggle to weigh up inflation risks with growth risks.

For now we stick to the 8.00/7.70 level but be prepared to get excited if 7.70 and 7.60 in particular go. To the upside get concerned if 8.20/8.30 is breached. We are seeing a lot of bear calls now on local assets calling for a 50-100bp sell off in bonds, a R1-R2 sell off in the Rand and even a 10-15% sell off in equities.

	High	Low	Average	Previous Close	Current
R157	6.64	6.35	6.46	6.65	6.46
USDZAR	7.93	7.64	7.79	7.82	7.70
EURUSD	1.3234	1.3026	1.3141	1.3156	1.3131
DJIA	12842	12530	12683	12757	12716
S&P500	1333	1300	1317	1326	1324
JSE ALSI	34457	33451	33893	34065	34346
GOLD	1753.5	1702.9	1731.4	1720.7	1748.8
BRENT	113.9	110.3	111.3	110.8	112.0

Technical Corner

We so often hear about the dangers and evils of inflation, one would be forgiven for forgetting that we actually target a moderate rate of inflation in this country – as do many modern economies around the world. There are many reasons for this which we can get to in a later column, but first, how can inflation help you?

The most common way in which inflation has a positive effect, is to help you pay down debt. For most economically active people, debt plays a pivotal role in their lives..... from buying cars, to helping bridge the gap between pay cheques in the lean months.

The biggest loan payment of all most of us have though, is our home loan – and that is where inflation really comes into its own. Let's use an example :

You buy a home for R2million and take out a corresponding loan. Given a good credit rating you will need to pay R15.5k a month for 20 years and earn at least R51.6k a month.

Let's assume you never get another promotion, but you do at least get annual increases linked to inflation and that inflation averages 5% over the period. That means that 5 years into the loan you are no longer spending 30% of your salary on payments, but less than 25%. After 10 years of paying you are down to below 20% and in the last year you are only paying 11.8% - that would equate to paying around R6k now.

You are not working harder, you are not earning more in real terms and yet your home loan is becoming cheaper. Inflation is helping you to pay off your home – a home which is now worth over R5million if it went up with inflation.

Quote for the Week

"Some truths, too painful or too likely to provoke, can be spoken only when the listener has been disarmed by laughter."

- **Attributed to Chaucer**

From the Atlantic Team

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