

The emperor has no clothes: The debt fuelled stimulus for commodities is not sustainable – By Abdul Davids, Kagiso Asset Management Head of Research

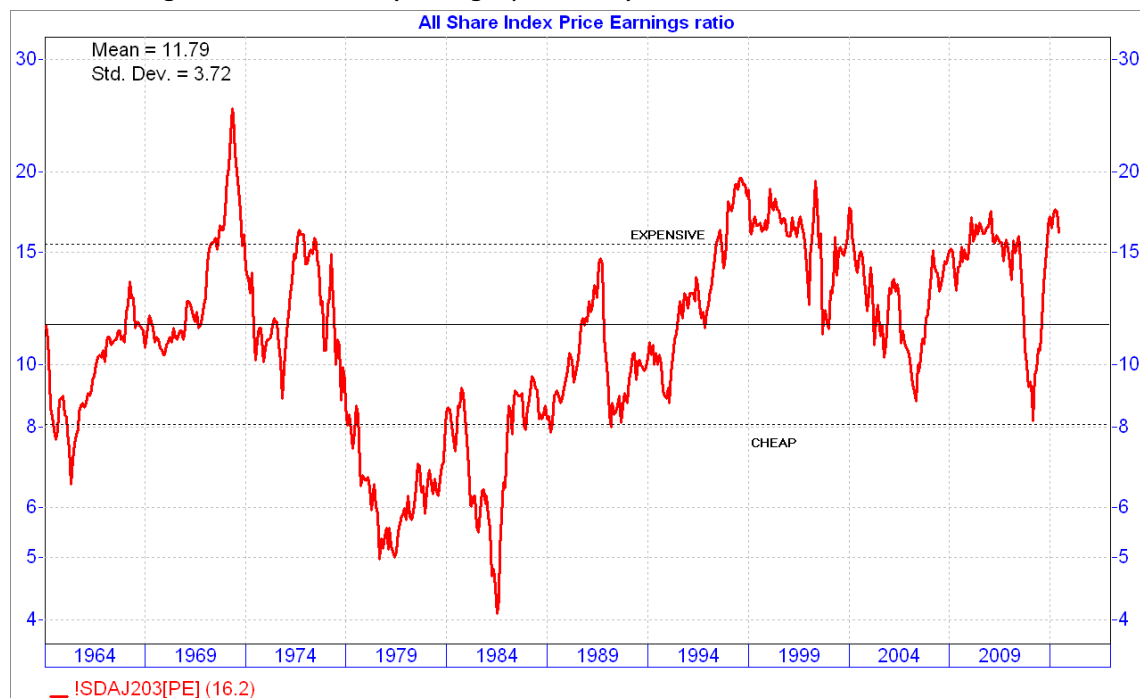
The domestic equity market’s recent declines, most notably in the resources sector, should not come as a surprise, given current valuations and p:e multiples. Unfortunately, there is potentially more pain to come.

Currently, there is a dichotomy in the market in terms of the rating between the three key sectors: Resources are almost in a growth market orientation with investors expecting significant earnings growth and rewarding resources companies accordingly, whereas industrials and financials are effectively still being beaten down because of poor earnings growth in the last 12 months, which Kagiso Asset Management believes is unlikely to recur.

Context

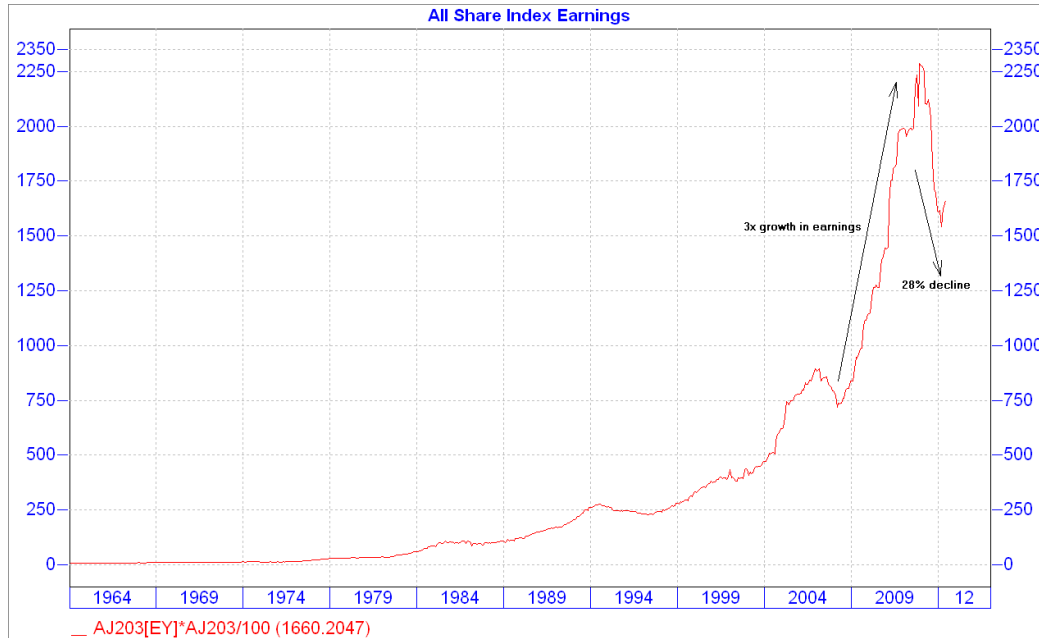
To put this into context, the market has re-rated sharply as measured by the market p:e (price/earnings) from March 2009 when the p:e was about 8X earnings. Since then we had a sharp rally in equity prices but also some significant falls in earnings across-the-board. Resources earnings have fallen by about 48%, financials earnings by about 55% and industrials earnings have fallen by about 15%.

The twin effect of prices going up and earnings falling has resulted in the p:e for the market rising from 8X to 18X (refer graph below).



Source: Inet, KAM Research

Overall market earnings have declined by 28% in the space of the last six months – with all three major subsectors (Industrials, Financials and Resources) experiencing declining earnings (see attached graph).



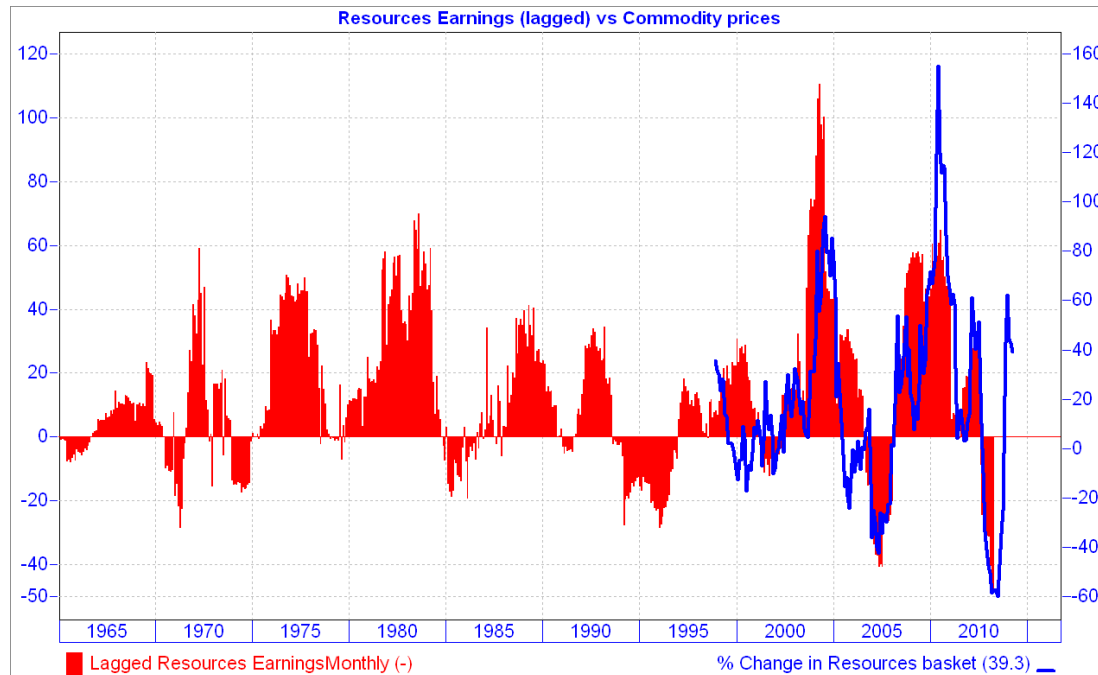
Source: Inet, KAM Research

As per the attached graph, the recent decline in earnings follows a strong growth period between 2004 and 2008, when market earnings increased three-fold in the space of four years.

Resources

The resources sector is the biggest segment of the local equity market following the strong appreciation in share prices of the likes of Anglos, BHP Billiton and other commodity companies. Any changes in the resources sector's earnings or valuation will therefore have a disproportionately larger impact on the overall market compared to the financials or industrials sectors.

For the year to date since about July 2009, we've seen a big recovery in commodity prices, which accelerated in the first three months of 2010. Prices have recovered by between 30% and 40% (see attached graph).



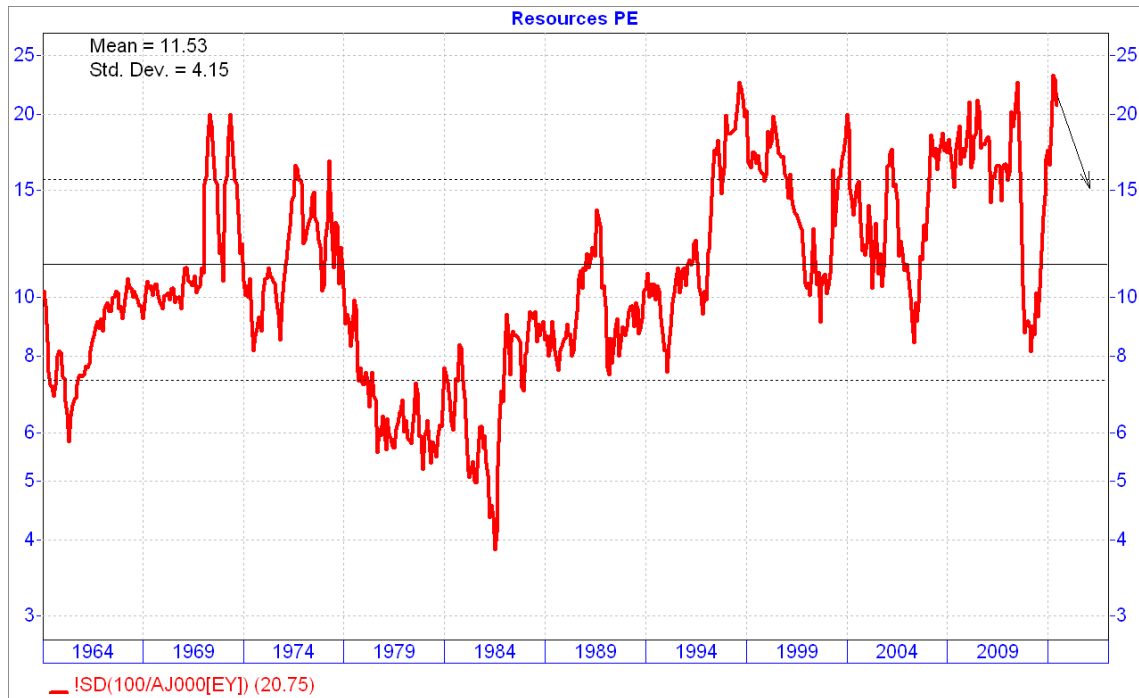
Source: Inet, KAM Research

Resources companies' share prices have experienced the full benefit of the strong recovery in commodity prices, despite the lagged impact on earnings, as per the graph above. The cyclical nature of resources earnings is also quite evident from the graph. We have developed a commodity basket index representing the key commodity drivers for companies like Anglos, Amplats and BHP that include copper, iron ore and platinum group metal (PGM) prices. Changes in resources earnings have closely tracked changes in the resources basket over the last few years. Following the collapse in commodity prices in 2008, prices recovered by 60% in 2009/2010. However, current share prices are discounting the full impact of a continued recovery in commodity prices, despite the lagged impact on company earnings.

As a result, share prices have recovered strongly over the last six months.

However, Kagiso Asset Management's view is that:

1. Stimulatory monetary and fiscal policies in developed economies have contributed significantly to the recovery in commodity prices.
2. The removal of these stimulatory forces will have a concomitant adverse impact on demand for commodities and hence commodity prices.
3. Commodity resources shares are currently trading at 20 times to 24 times p:e multiples historically and even allowing for a 60% average growth in earnings, p:e multiples converge around 14.5x – still significantly above the long-term average of 11.5 (refer to graph below).



Source: Inet, KAM Research

The consensus view is that after a two year correction, the commodity super-cycle is back and equity prices are currently discounting this view. At Kagiso Asset Management, we focus on the key drivers of earnings and the sustainability of those drivers. It is our view that a debt-fuelled stimulus for commodities is not sustainable in the medium- to long-term and therefore we remain cautious of selected resources shares, despite recent share price declines.

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