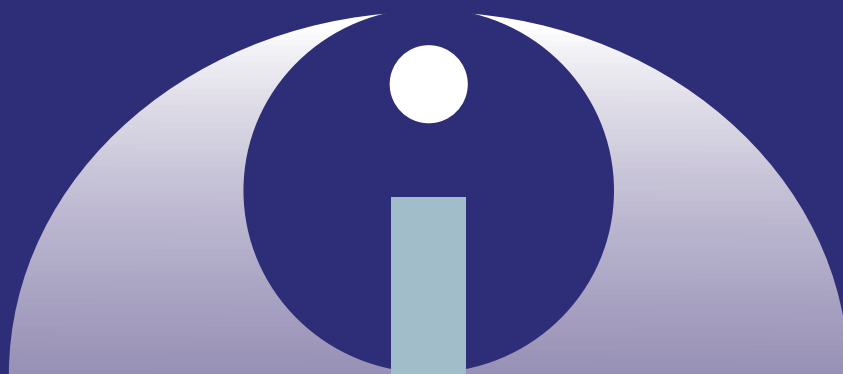

INTUITION



(n: immediate insight; receive knowledge by direct perception)

In this edition:

- Random thoughts from Harvard Street



Empowering knowledge and insight exclusively from the Harvard House Group of companies



RANDOM THOUGHTS FROM HARVARD STREET



Michael Porter

In the 1990s, Burton Malkiel authored what became a seminal book on investing, entitled “A Random Walk Down Wall Street”. It was considered a must-read, and became part of curricula for many financial degrees (ours included!) The main hypothesis was that “a random walk was one in which future steps or directions cannot be predicted on the basis of past actions.”

In other words, you cannot determine the future direction of stock markets by analyzing historical trends. This makes perfect sense, but investors might be forgiven for being a little cynical. After all, this year is starting to feel a lot like last year – both in newsflow and stock market behavior. The only difference is the absence of the Japanese Tsunami. Apart from that, headlines remain the same: Europe is in Crisis. Will Greece leave the Eurozone? Is Global Growth stalling? True to form, investors are running scared. At the time of writing,

May has been the worst month for the JSE since February 2009 – the nadir of the Financial Crisis.

So with apologies to Mr Malkiel, what follows are a few random thoughts from Harvard Street – our take on what is going on in the world, and what we might expect in the months to follow.

The world’s financial markets have once again become an uncertain place, not that there IS ever one hundred per cent certainty in the financial world. Yet somehow the world, its people and its stock markets all survived and will no doubt do so again. However, when headlines suddenly become the main driver of daily stock market performance, investors tend to suddenly ignore the bigger picture or alternatively, they are scared of digging too deep because of what they might find.

Take for example what happened when newswires published “Greece elections failed”. Within minutes, markets fell 2-3%, yet in other parts of the world, economic statistics being

released showed that various economies are still growing. All of this points to a very confusing picture. In the short term, headlines rule – the market is too dominated by short term traders looking to make a quick buck. In the longer term, economic fundamentals reassert themselves. An investor can’t ignore either, but below we single out a few thoughts.

The factors that make us sleep easily

- **NO ONE KNOWS.** The world has become such a complex, complicated, integrated, multifaceted mechanism, system ... (you get the point) that no one has the answer, a solution or the key to unlock this maze we humans have created. Whether it is crises across the European Union, an impasse over the US debt ceiling, or social unrest from a disillusioned working class, old established thinking is unlikely to work. The world needs fresh, bold thinking. Whether our politicians can deliver such thinking is another point entirely. But the real point is that the world is too complex and intertwined to be able to predict every outcome. We can take a stance on some of the bigger trends, but worrying about the detail is pointless. It will only result in an ulcer.
- On balance, companies the world over are beating their revenue and profit forecasts. This implies two things. Firstly, it implies that profits are still growing – handsomely in some cases. Secondly, investors are being surprised on the upside. Profits are higher than expectations. Last month we wrote about the importance of expectations. Any outcome ahead of expectations is a positive for markets.

The chart below shows the rate of growth in profits for the JSE and the US. Companies in both markets are performing well. This may change – some may argue that economic conditions are deteriorating – but companies are in good shape. Given all the sovereign turmoil, we would argue, quite strongly, that companies are fundamentally more appealing than governments



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GROWTH OF COMPANY PROFITS



“Profits are growing in both SA and the USA despite global investor uncertainty”

- In tandem with better company profits, fundamental economic data is also encouraging. In contrast to recession or stagnation in much of Southern Europe, the US economy appears to be on a firmer footing – and getting steadily firmer. Many of the statistics released over recent weeks have pointed to a consolidation of their economic recovery. The US economy is trending towards an improvement in employment, continued strength in manufacturing, and a modest uptick in consumer spending.

There have even been some signs that the housing market may be bottoming out, while the finances of state and local governments may be on a sounder footing than they were two or three years ago. In our opinion, the improvement in the housing market is most welcome, given that it was this sector of the economy that created all the trouble in the first place. Sales of both existing and new homes are growing, and this is feeding through to stable prices and new construction. It is modest, but it is an important step on the road to recovery. On the other side of the Atlantic, the German economy has recorded GDP growth of 0.5% for the first quarter of this year. This may be paltry, but is significant when all its neighbours are falling by the wayside.

US NAHB HOUSING INDEX



“It has a long way to recover its former glory, but sentiment in US housing is definitely improving.”

The factors that keep us awake at night

- The breakup of Europe, and the Euro. As Greece careers toward another election, the probability that Greece will crash out of the Euro is growing - but it is not yet inevitable. How will this last act of the Greek drama end? A euro exit appears increasingly likely. But it isn't what most Greeks or Europeans want. There are other options, but they require strong leadership and compromise from all parties. More on this later.
- Uncertainty over the Greek situation will cause a run on European banks. A few weeks ago some of the major banks in Spain were downgraded by rating agencies. In the week that followed, ordinary people in Spain withdrew record amounts of cash from those banks, fearful that banks may fail and they may lose their deposits. The same has happened in Greece. Unfortunately, banks require trust from the general public to function effectively. That trust is evaporating fast, and thanks to record withdrawals, a run on the banks may become a self-fulfilling prophecy. If Greek & Spanish banks fail, investors are concerned that this may spark a domino effect across Europe.
- Emerging markets, the darling of investment markets for the past decade, could fall out of favour. Although not likely to happen overnight, it is possible that an



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orderly European solution could result in investors returning to the “neglected” markets, such as Germany, US and Japan. Our concern rests in the fact that foreign portfolio investments in emerging market shares could easily be sold and reinvested in developed market investments. Offshore markets are not expensive at the moment, but are generally being avoided due to the financial worries around Europe.

- Lastly, NO ONE KNOWS. Similar to our first point, we can also say that what keeps us awake at night is the same as what is helping us to sleep. No one knows how the situation in Europe will ultimately be resolved, so it is fruitless to speculate. We will react as we see events unfolding, or if it becomes clear to us that one outcome is becoming increasingly obvious. So to pick up on our point earlier, what is our expectation for Europe? Our fear is that Europe’s leaders might be too slow to react. In the absence of clear leadership, markets will make assumptions, and those leaders might then find themselves squeezed into a corner. That is never a good thing. There is no doubt that austerity is biting hard. The Greek economy has contracted by 20% over the past few years – so far from reducing the ratio of debt to GDP, a contraction in GDP has actually made this ratio worse! A compromise is needed – by Greek politicians on the one hand that need to confirm their

commitment to austerity, but also from Germany (and others) that severe austerity is not the only solution. Greece will hold parliamentary elections on the 17th June. That day carries huge significance, as the future of the Euro may lie in the election result. It is going to be a nail-biting few weeks for politicians and investors alike. In our opinion, compromise will be reached. In the long run, it is highly questionable whether Greece could (or should) remain in the Euro, but our sense is that a Greek exit (“Grexit” as the markets are referring to it) is still a little way off.

We can all agree that these are challenging times. It has been four years since the start of the Financial Crisis, and yet we still seem to be dealing with the same issues. Greece simply will not go away. What should investors do? We have articulated on a few opposing themes above, but we, as investors, must not lose sight of a number of other factors. In no particular order:

- The European economy is weak, and likely to remain so for quite some time. But the world is getting used to that. Since the Financial Crisis, Europe has contributed almost nothing to global growth, get the world economy has grown. The engines of growth have been the US and emerging markets. This is unlikely to change. So yes, on the whole, Europe is back in recession, but it is



We received this tongue-in-cheek picture last week, which elicited a smile. The UK may not have much to crow about, but the fact that it still has its own currency gives it options and flexibility. The single currency has taken that flexibility away from weaker European nations. Whether the Euro can survive without ideological reform is questionable. Imagine if our currency was the one tied to Germany’s?

The Rand would be incredibly strong, rendering our manufacturing, exports and tourism sectors hopelessly uncompetitive. Yet owing to the strong Rand, inflation and interest rates would be low. We would borrow too much for consumption. It is not hard to see how the problem has arisen. Reversing integration is much more difficult, and fraught with pitfalls. One gets the feeling that Greece is in a similar situation to Macbeth, when he reflected on his tenuous position: “I am in blood stepp’d in so far, that, should I wade no more, returning were as tedious as go o’er.”

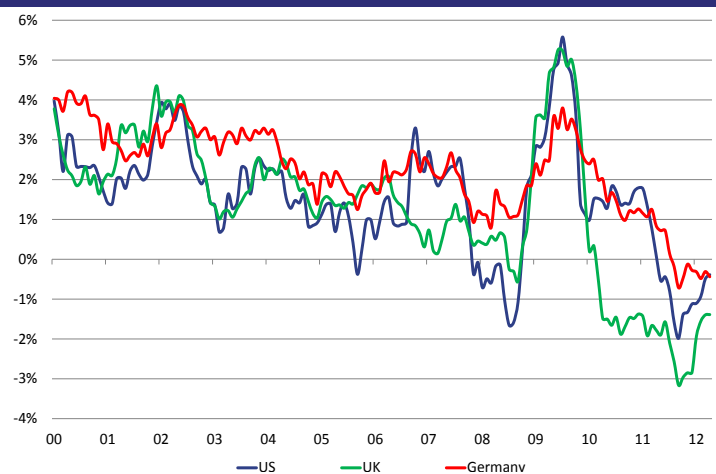


little different to the past few years. Nonetheless, it is important to remember one of our key forecasts made during 2011, namely that the world economy was in for a period of weak, but positive, growth. So far, growth looks like it may actually exceed our forecasts. A weak Europe is already built into expectations.

- One reason for increased anxiety over global growth is the apparent slowdown in China. There is no doubt that China has pulled the rest of the world along in its wake over the past few years. A slowdown there has rattled nerves, and debate rages fiercely as to whether China is also facing a property meltdown. Yet as Nigel wrote a few months ago, China has social reasons for making sure that its economy keeps some momentum. Over the past eighteen months, China has actively taken steps to cool its economy. By acting early, China now has ammunition to re-stimulate its economy. We have seen some early signs of this in the last few weeks, but we expect more stimulus from the Chinese authorities. Markets should react positively to any actions which may be taken by the Chinese.
- It is an election year in the US. The last thing that President Obama wants at the end of the year is an economy in tatters. The US is facing a number of challenges – a renegotiation of the Debt Ceiling and the expiration of Bush-era tax cuts to name a few. But as we highlighted earlier, the US economy is performing well, which does provide some leeway to policymakers as they negotiate a solution. And you can bet that in the wings stands the US Federal Reserve, which is ready to throw more “QE” into the economy at the first hint of a slowdown. The risk of more stimulus (from the US, UK, European Central Bank and China) is growing. Markets have reacted positively every time stimulus has been announced in the past. In 2010 and 2011, markets were weak in the middle of the year, but rallied sharply from August onwards on the back of government support. You can’t predict the future based on the past, but we wouldn’t bet against this trend repeating itself in 2012.
- One of the reasons why markets have always reacted so positively to stimulus is because an investment in shares is so compelling relative to other assets classes. Investors just need a nudge in that direction, and the investment case does the rest. We have written about this before. Bond yields have fallen to record lows over the past six weeks – the standard reaction to turbulence

in equity markets is for investors to buy bonds. But bonds in the US, UK and Germany offer less than 2% p.a. That does not even compensate the investor for inflation, let alone provide a real return. Investors are prepared to go backwards, just for the perceived safety of government bonds. But are those bonds really that safe? We don’t think so! In our opinion, investors are crazy to lend any government their money for an interest rate of 1.8% p.a. over ten years! And the UK and US are hardly paragons of virtue. They also have too much debt. The markets just have other problems to focus on right now, so they have escaped closer scrutiny. At some stage, they too will face a day of reckoning.

REAL BOND YIELDS



“Investors are earning a negative return on government bonds after adjusting for inflation”

- Markets are volatile – we all know that. But the points above provide some of the reasons for that volatility. Markets are reacting to each and every bit of news. Soon after Francois Hollande was elected as the new French President, he was due in Germany for a meeting with Angela Merkel. As fate would have it, his plane was struck by lightning, and the meeting never materialized. Markets reacted badly. To us, that is a perfect illustration of how ridiculous the behaviour of markets is at the moment. Volatility is scary, and the natural instinct is to steer well clear. But that is not necessarily the right decision. Since January 2011, the JSE has delivered a total return of 7.3% - hardly inspiring. But most of that return came in just two months. If you stay out of the market until the good news comes, then you are likely to miss out. To quote the catchphrase of



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a popular TV show, “you have to be in it to win it.” From our perspective, the unevenness of returns is why we place so much emphasis on dividends. Dividends shore up returns and provide cashflow even when share prices are broadly trending sideways.

- Lastly, do not forget about the Rand, and its impact on local markets. The Rand has weakened sharply recently – a classic reaction to heightened risk overseas. On the one hand it is negative – imported goods are becoming more expensive, which drives up inflation. Nowhere is this more apparent than in the petrol price – which we discussed at some length last month. But on the positive side, it makes our exports more competitive.

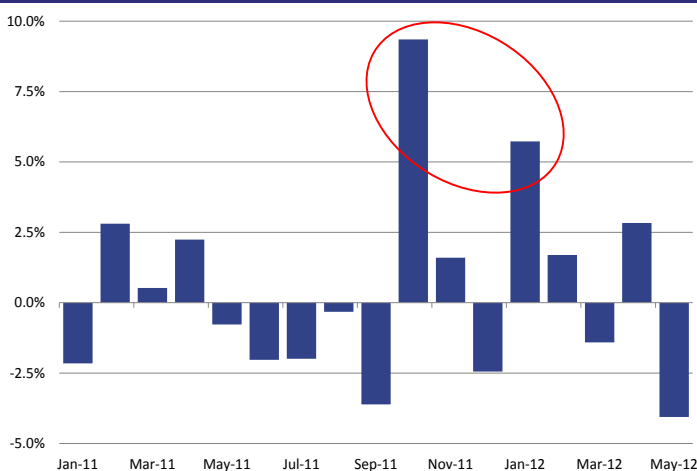
More importantly from our perspective, it accelerates profit growth. So many of our companies have significant overseas operations. Profits from those operations swell during periods of Rand weakness. We have endured a strong Rand for so long, which has been a drag on profits that companies will relish a little weakness. Whilst Rand movements are transient and next year the Rand may be a drag on profits, we would expect the Rand to lend support to both profits and dividends in the month ahead.

In summary, we are the first to acknowledge that conditions are tough, and nerves are tattered. Text books will tell you that investing in shares is risky, but for some, it appears to have become a white-knuckle ride. Yet, we take comfort from the fact that our core assumption from last year (modest but positive economic growth in 2012 and 2013) is still on track, which provides well managed companies with an environment in which they can grow. And grow they will. It is not all bad news!

Yet it would be foolish to speculate on the road forward for Greece – there are just too many possibilities ahead of fresh elections on the 17th June. Despite the rhetoric, the Greeks seem to want to remain in the Euro. Their fate is in their own hands ahead of elections. The job of European leaders is to make sure that the rest of the Eurozone is secure (especially the banks) – regardless of the outcome in Athens.



MONTHLY RETURNS FROM THE JSE



“A few months can make all the difference between good and bad returns. Make sure you don’t miss the good months.”

THE RAND



“On average the Rand is about 10% weaker than it was during 2011. That should be good news for profits and dividends.”



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The Next Industrial Revolution?

As our main article shows, there are always a few rays of hope, and this period of uncertainty will also pass at some stage. Markets and economies do adapt and will perform again. As an example, just look at how information technology and computers have changed the world. Even your “Facebook” is now listed on a stock exchange and they don’t even make anything – perhaps they make jealousy, when you see what your “Friends” are up to. A recent article in The Economist gave us hope that economies continue to innovate and so will grow again.

The first industrial revolution began in Britain in the late 18th century, with the mechanisation of the textile industry. Labour-intensive hand weavers’ cottages were brought together into a single cotton mill, and the factory was born. The second industrial revolution came in the early 20th century, when Henry Ford mastered the moving assembly line and ushered in the age of mass production. Now the third industrial revolution is underway. Manufacturing is going digital and this form of manufacturing will transform the way goods are made. The separate yet incredible technologies of clever software, novel materials, more advanced robots and new 3D printing, supported by the power of the internet, are coming together faster than you can drop this article to the floor.

How does it work? The old way was to take lots of parts, screw or weld them together and make your product. It requires premises, lots of workers, and good logistics to make sure you have all the components on hand to churn out your trinkets – whatever they may be. The new way is to design your product on a computer and then “print it” on a 3D printer, which literally builds up successive layers of the requisite material. It is quick and efficient and requires very little human input. The application and process is mind-boggling and not the preserve of science fiction movies. Already hearing aids and high-tech components of military jets are “prinduced” (a new word formed from combining “printing” and “producing”, although it has yet to be included in the Oxford Dictionary!)

Take for example an engineer working on a project in the middle of nowhere. He is lacking a specific tool to complete the job. With the right materials, he can simply download the design over the Net and “print” it. New materials are lighter, stronger and are in most instances even more durable than traditional materials like steel and aluminium. Carbon fibre is starting to find applications in such diverse products as aeroplanes and mountain bikes. Ford required heaps of capital to build their colossal factory. This new technology can start with a computer and a hunger to invent. As the Economist puts it: “Like all revolutions, this one will be disruptive.”



We are all at risk of getting caught up in the noise of current headlines, and ignoring new trends that will shape our world in the future. Whilst economic principles will always remain constant – for example, too much debt needs to be repaid one way or another – the human race continues to innovate to create a better future.

In this regard, it is significant that the first private sector space craft docked at the International Space Station last week. Innovation leads to growth and the birth of new industries and companies – some of which will become the corporate giants of tomorrow.





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INSIGHT SEMINAR: KZN MIDLANDS & JOHANNESBURG

As we have discussed above, the next few weeks and months will be pivotal in deciding the short term direction of stock markets. Our next Insight Seminar, scheduled for the end of July, will take stock of recent developments and shed some light on our interpretation of the way forward.

Please note the new venue in Howick, which is the Fernhill Hotel. These functions continue to draw a lot of support, for which we are very grateful. All clients are welcome, and please invite friends along if you feel they may benefit from the evening.

	Natal Midlands	Johannesburg
Topic:	Markets: Taking Stock of Recent Developments	
Date:	31st of July 2012	26th July 2012
Venue:	Fernhill Hotel Midmar / Tweedie Road (almost opp entrance to Midmar)	JP Morgan Auditorium, JP Morgan Offices Cnr Fricker & Hurlingham Roads, Illovo
Time:	5.30pm for 6pm	5.30pm for 6pm
RSVP:	Cathy Maitin-Casalis on 033 330 2164 or cathym@hhgroup.co.za	

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