BoE Stockbrokers - August 2004 Newsletter

AUGUST 2004 RECENT * RECOMMENDATIONS

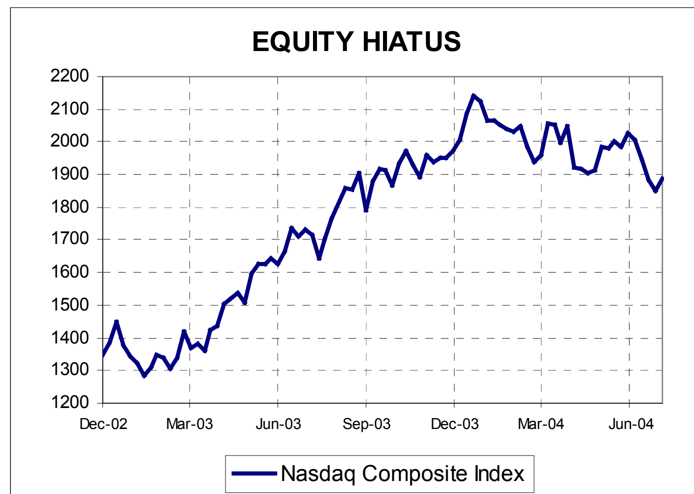
SHARE	PRICE (c)	ACTION	COMMENT
Large Caps (Top 40)			
Sasol	10330	**BUY**	Bottom of the earnings cycle, improving chemical business; current robust oil price should see earnings upgrades.
Implats	49400	**ADD**	The technical structure has improved since the target of the top formation was recently reached (at 42000). Buy dips nearer to 46000. Upside nearer to 52000-54000.
Stanbank	4265	**BUY**	With the trend maintaining its upward bias, buyers should add to positions at 4200 and 4000. The previous resistance at 3700 has reversed it's role and become strong support, with the longer-term target between 4700 and 5000 still valid.
Woolworths	750	**BUY**	The strength of the currency is likely to delay the onset of a tightening cycle in local interest rates, which will also be supportive of the environment. We retain our recommendation as a Buy.
Mid & Small Caps			
Aspen	1370	**BUY**	The recent break above 1300, a level that has capped the upside for 8-months, is seen as bullish, validating an ascending triangle formation with upside to between 1500 and 1600. (Technical comment).
A-prop	81	**BUY**	If one buys A-Prop one will also be buying an undeclared Momentum property portfolio. However, things certainly look more positive and a more speculative investor may wish to buy in anticipation.
Acucap	1290	**BUY**	At current levels and pricing in 6% earnings growth for the current year, we believe Acucap is fairly priced. Nevertheless, we like the company and how it is managed and regard it as a long-term buy. Buy on any weakness or on a long-term relative view.
Hudaco	2500	**BUY**	Although guided FY 11/04 HEPS are likely to be flat, valuation low, dividend yield high and it's a quality company.

- All recommendations are those of BoE Private Clients Investment Strategy Team regardless of source material. Some of these calls are based on short term trading criteria and do not take into account potential tax consequences, nor do they necessarily constitute holdings in our model portfolios.

INTERNATIONAL OVERVIEW.

In the U.S. the Nasdaq Composite Index had its worst month since December 2002, down 8% for the month (notwithstanding a bounce from the lowest levels of the year in the final week of the month).

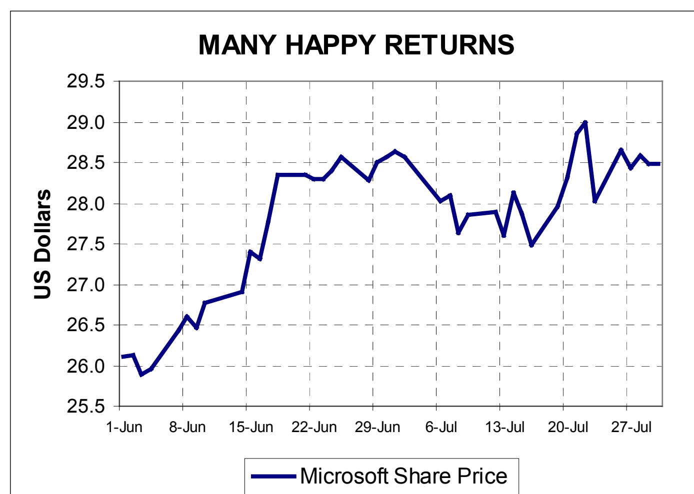
The U.S. S&P 500 similarly reflected its largest decline in 18 months in July, on the back of surging oil prices and earnings' guidance from companies which were below investor expectations. The index fell by 3.4%. With 80% of companies in the index having reported, earnings increased 26%. This was slower than growth of 28% reported in the first quarter.



On the last trading day of the month, the release of the first estimate of Q2 GDP proved to be a disappointment. Gross domestic product grew at 3.0% against an expectation of 3.7% and growth in the prior quarter of 4.5%. While GDP growth releases have generally been revised upwards over the past few quarters, the weakness reflected in consumer spending surprised the market and reduced the likelihood of upward revisions to the current release. The weakness in consumer spending was contrary to the very strong consumer confidence figures release for July, which has led the bulls to conclude that the slowdown in consumer spending is likely to only be a temporary phenomenon.

However, while economic and earnings releases were uneventful, the fillip to the market was Microsoft's announcement that it would be returning $75 billion to shareholders.

This will take the form of a one-time dividend to be paid in December ($32 billion), share buy-backs over the next four years ($30 billion) and the balance in the form of a doubling of the company's dividend payment. Despite Microsoft being around for some time, the company only declared its first dividend in 2003.

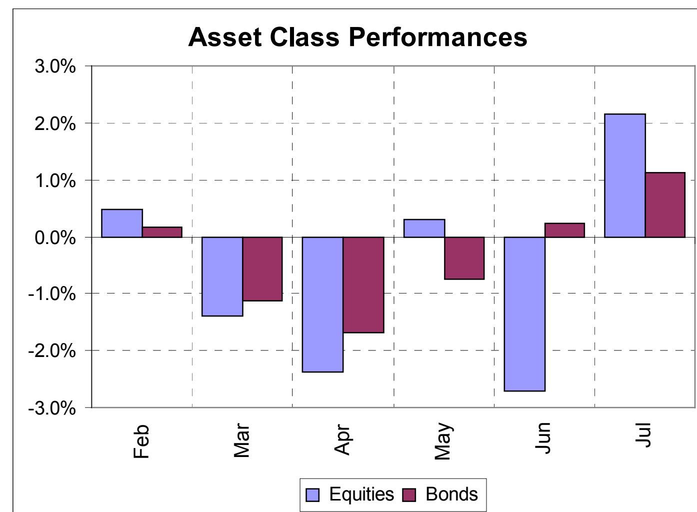


The report from the September 11th commission has proven to be a headwind for George Bush's re-election prospects. While it has not blamed the president for failing to prevent 9/11 it has again focussed the American public's attention on the efficacy of American policy and the war on terror.

The Democratic convention in Boston provided its share of political lowlights. Based on polls conducted after the event the Democrats have not benefited from the anticipated post convention "bounce" in ratings. Voters still seem to fear that Kerry's main rationale for wanting to be elected is the fact that he is "not George Bush".

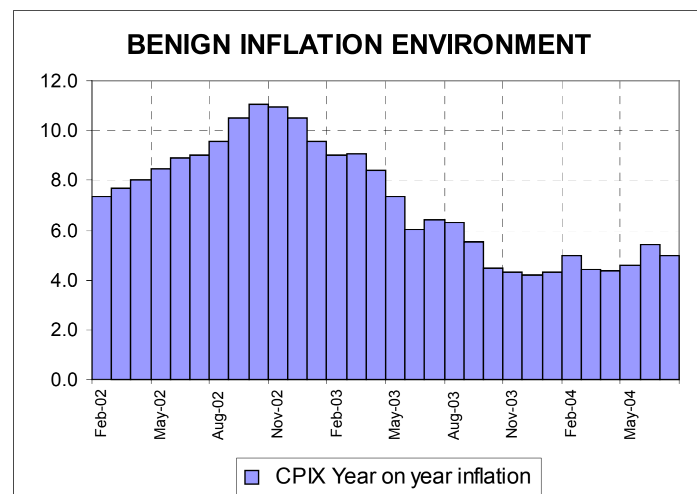
DOMESTIC OVERVIEW

Contrary to expectations, returns from bonds over the past six months have marginally outperformed equities. While the stronger currency has provided support to bond prices, equity price volatility has destroyed the strong equity gains of December 2003 and January 2004. The recent release of the negative trade balance has raised concerns about the sustainability of the currency.



However, on closer inspection it would appear that much of the trade deficit could be attributed to the purchase of "transportation equipment", i.e. naval warships. The higher oil price has also had a debilitating impact on the trade balance notwithstanding the strong currency.

Inflation releases on the other hand have pleasantly surprised the market. CPIX came in at 5.0% in July (for the month of June) against market expectations of 5.4%. The PPI release was similarly benign, after adjusting for seasonal electricity price effects. Forecasters have generally revised their expectations of rate hikes downwards.



We have in the recent past warned about the impact of the strong currency on profits. Recent earnings releases from gold and platinum miners have confirmed our fears.

While earnings from Angloplat were in line with market expectations (off a very low base), gold mining companies have struggled under the impact of the strong currency. Diversified mining companies in the form of Anglos and Billiton will report earnings for the six months ended June over the course of the next few weeks. Based on strong underlying commodity prices, the market is likely to be positively surprised. As the two major components of the All Share Index, these strong earnings releases are likely to go some way in unwinding the price earnings ratio of the market.

Calendar year 2003 disproved the old adage of "sell in May and go away" while sadly, market returns in 2004, to date, appear supportive of this approach.

We remain focussed on high dividend yielding stocks, which we believe have less risk of de-rating significantly should markets continue to be volatile. We remain cautious on developed market equities.

POLITICAL OVERVIEW – Pressure in Old Europe

Globalisation has begun to hit the first "globalisers" - the Europeans. We will feel the effects of this in South Africa.

The workers

In Germany: first Siemens, then Continental, Deutsche Telekom and now DaimlerChrysler and Thomas Cook succeeded in negotiating extensions to their working weeks without paying more. These larger companies followed several smaller companies who used loopholes in union negotiated agreements to opt out of the 35-hour workweek. Also, the enlargement of the EU on May 1st opened the option to move to cheaper locations inside the EU. Wage costs in the ten new member states in the east of Europe are considerably lower than in France and Germany, yet they offer much the same political and regulatory framework. Why not exploit it?

Much the same happened in France where workers at a Bosch factory near Lyons voted to accept a longer working week without more pay. Like some German companies, Bosch also threatened to move to a cheaper jurisdiction in "New Europe". This flew directly in the faces of both president Chirac, who criticized the longer working weeks as "blackmail" and finance minister Sarkozy who vowed that more work for the same pay will "never" happen in France. Well, it has now happened.

Of course, a few swallows do not make a summer, but these developments are coming on top of legislation in Germany to make the labour market more flexible, cut pensions and social welfare and reduce job protection. In France moves are underway to partly privatise the electricity utility and, in Italy, legislation is ready to reform the pension system. All these are happening in the face of serious resistance from unions. Yet the trend is clear: the workers' wishes are overridden.

The farmers

The EU commission in Brussels has put forward two sets of proposals that will hit the farming communities in "old Europe" – specifically France – very hard. A reduction in the floor price for sugar and changes, to the export and protection regimes for agriculture in general, could affect as many as 100 000 farmers in the EU. Add towns and businesses dependent on them and the effect can be wider.

That is not the end of changes coming for the old Europe farmers. The British are in the firing line to forfeit the rebate on its EU contribution that Margaret Thatcher negotiated way back in the eighties with her famous "I want my money back" speech. However, Blair will extract a hefty price and that is more changes to the Common Agricultural Policy (CAP). His bargaining position is strong because the UK has a veto. He probably cannot exercise it, but he can force some changes. The result: more disruption for both he farmers and those dependent on them.

The tax collectors

Some investigative journalism by the Financial Times into the tax returns of large companies in the UK revealed how much multinational companies are using transfer pricing to minimize tax payments in certain jurisdictions. Given that workers and farmers are under pressure (and have more votes than multinational corporations) the pendulum will start to swing back. No doubt authorities will respond with stronger tax measures. Who knows … maybe all those tax havens will become too attractive for tax collectors to resist!

So what?

Europe's big problem is productivity. It may have size, but it is productivity that counts. Although productivity *per hour worked* is about 91% of what it is in the US, output, *per worker,* is only about 65% of US levels. Mainly because the Americans work longer. The French must be particularly upset: per hour their productivity is 105% of the US's, but overall the US beat them because they work more hours. What a cheek!

Now "old Europe" cannot escape the competitive pressures and some major changes are beginning to happen.

What is the relevance of all these for SA investors?

Firstly, openness to the world counts. The more integrated you are into the world economy, the more you have to play by the new rules. Chirac has to yield - much as he detests it; Mugabe does not have to. That is also why Soccer 2010 is so important for SA.

Secondly, if Europe starts catching up on US productivity levels, the Americans will probably have to have a lower dollar for longer to retain its competitive advantage. And that could delight Tito Mboweni here at home, but no doubt, depress others.

JP LANDMAN

THE LIMITATIONS OF MONETARY POLICY

The limitations of monetary policy in a small, open economy are not sufficiently well appreciated. A leading paper stated that Tito Mboweni's challenge in his new term of office is to find a 'fair level for interest rates and the rand'. This is a common misconception. Targeting the level of both interest rates and the rand is unachievable in a country with capital flows and limited reserves. The Bank can either target the exchange rate or the interest rate (and inflation), but not both. It cannot follow two masters.

If it targets the exchange rates then interest rates need to be set so as to deliver the desired exchange rate. For example, the Bank would need to cut interest rates to weaken the rand and pay no heed to the inflationary consequences of the demand boom this would create. As a result the rand, in effect, sets the level of interest rates. If the Bank really wishes to intervene it may also need to spend vast quantities of domestic cash to purchase dollars. Domestic cash would be better spent locally and is expensive to borrow and, US dollars, earn a puny return. This can be inflationary and has money supply implications. Jobs would be created as rates are cut to weaken the rand, but will be lost if rates are hiked sharply in response to weakness.

If the Bank targets inflation (through the interest rates lever) as occurs in an inflation-targeting environment, such as we have, the SARB will have to ignore the exchange rate. It needs to set interest rates at levels which will cause a desired inflation outcome and the currency will, of course, react to this. The level of future inflation sets interest rates and the currency is then free to move as foreign and domestic investors appraise the situation. Jobs are likely to be facilitated when growth and, hence, inflation is weak and interest rates are reduced, but lost if inflationary pressures lead to rate hikes.

The demand that the reserve bank should find a level for the rand ignores the fact that it 'takes two to tango'. Much (but certainly not all) of the rand's strength and volatility has been due to dollar weakness and volatility. Exchange rates are, by definition, relative and there is very little the South African Governor can do about the rating of the US dollar on world markets. It leads to dysfunctional economic behaviour if economic agents believe that the currency will always weaken (what we call a 'weak rand put') so that this will get them out of any predicament and allow them to profit at all times. It is like a chronic debtor always expecting rampant inflation to get him/her out of his/her predicament.

Without, virtually unlimited, funds to throw at the currency, the scope that the Reserve Bank actually has, to make an impact, is very limited. This leaves a choice: a stable currency, but unstable domestic prices and interest rates or an unstable currency, but more stable domestic prices and interest rates. Ironically a stable currency is conducive to stable local price levels, but in a volatile world this cannot be wished into existence.

FACTORS OF A STRONGER SOUTH AFRICAN RAND

The South African rand has been in a strengthening trend despite concerns about higher SA deficits, increased inflation, the central bank raising rates aggressively and muted growth forecasts.

International Factors

We believe that the structurally weaker US dollar is a result of record current account and budget deficits and negative real interest rates have been the main driver of the rand's strength.

Soft US economic data, suggesting inflation is less of a risk than economists had forecast, translates to less aggressive US Federal Reserve Bank rate hikes. This has been the key driver of the recent bout of dollar weakness. Also, a reduction in demand by foreigners for US assets has added to negative US dollar sentiment.

The chart on the right shows the trade weighted inflation adjusted US dollar Index. The index continues to trade within a bear channel, with further downside on the horizon. We do expect to see short term dollar strength, but insufficient to reverse the downtrend.
America needs a weak dollar to offset the large trade deficits. This would be exacerbated by increased consumer demand, widening the trade deficits on the back of increased imports and adding to the dollar's woes.

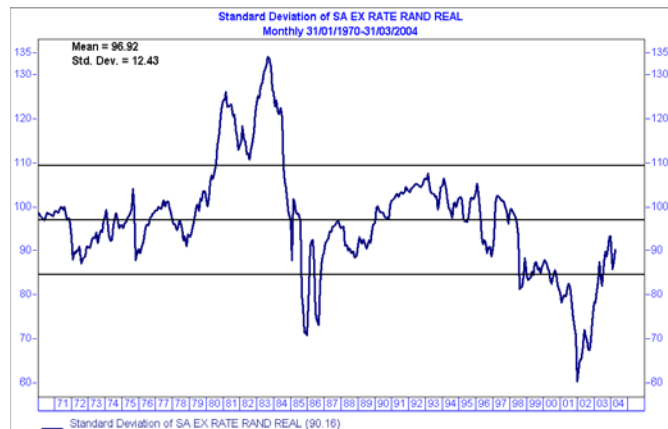
Domestic Factors

Stronger first quarter gross domestic product data, due to stronger consumer spending and gross fixed capital formation, improving manufacturing data coupled with increased foreign investment, mainly in the automotive sector, adds to the rand's positive momentum.

Consumer sentiment data has also ticked up while benign inflation data on the back of a strong rand bodes well for further gains in consumer spending as interest rates remain on hold.

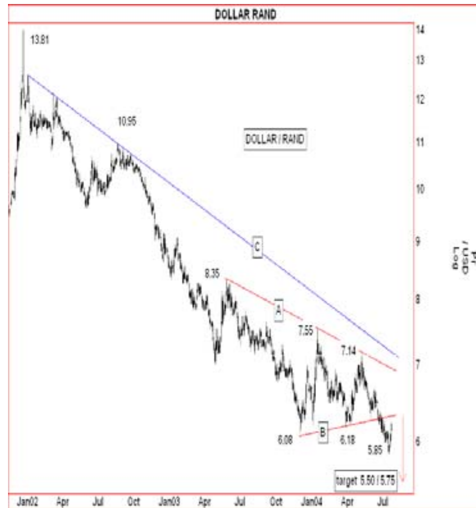
Negative sentiment towards the dollar is causing South African exporters to repatriate foreign currency sooner, rather than later, resulting in rand strength against the currencies of our major trading partners.

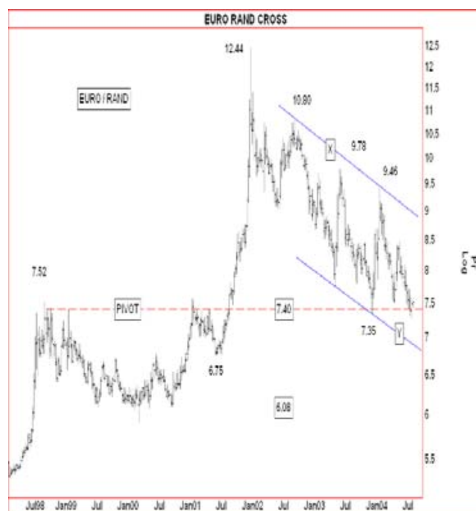
The chart on the right is the real trade weighted rand index based to a 100 in 1995. Using this measure the rand remains at a discount to its long-run average. Given the structural problems with the dollar there is scope for the real rand to trade at a premium to its long run average. The effects of the stronger rand will be net positive for consumers and lower the cost of capital for business investment.

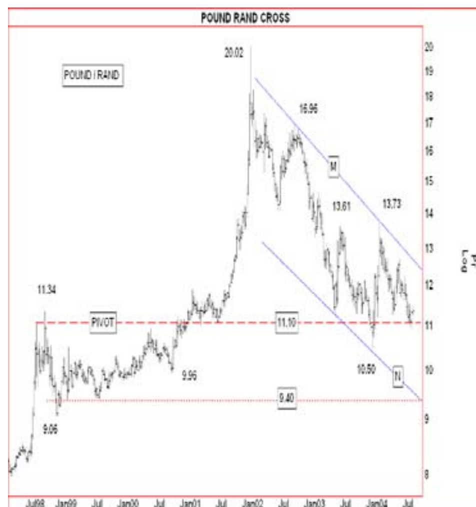


Given the above factors we believe that the rand will continue to have a strengthening bias against the dollar even though we could see some short term dollar demand.

The Technical Analysis on currencies discussed in this report is supportive of this view.







THE RAND – THE TREND IS YOUR FRIEND

The move back above R6.00/$ does little to damage the dominant downward trend that has been in place since the all-time worst level of 13.81 seen in December 2001. The most recent move stalled at a low of 5.85 on 19th July, short of the projected triangle target of 5.75 / 5.50. The triangle (shown in the figure alongside between lines 'A' and 'B') is a chart pattern associated with a continuation of the prevailing trend, in this case down, and a target can be derived from the structure. The base of the triangle i.e. 7.55 to 6.08, or R1.47, is measured down from the break-out point (6.25) to give a projected target of 4.78, but certain other factors need to be taken into consideration to tone down the aggressive target somewhat. The most important is the interest rate differential of the two currencies, which places a natural downward bias in the rand trend over time so that pattern targets have to be revised. Ten year bond yields often used as a longer-term indicator of implied inflation/interest rates. With the difference between US and SA 10-year yields around 5%, the currency should devalue by this amount per year in theory to avoid arbitrage (The "carry trade" argument that has benefited the rand is typically based on short periods less than a year). Other factors that could limit rand strength are the low level of foreign exchange reserves by world standards implying a natural buyer of dollars (Mboweni recently indicated that the Reserve bank will stick to gradual accumulation) and the prospect of abolition of exchange controls. While this would be positive from a foreign investment perspective over the longer-term time horizon, it would weigh on the currency in the short-term.

So when does technical structure turn rand bearish? The trend remains in force until there is some indication to the contrary. The triangle suggests a higher probability that the rand will continue to strengthen. A move back above the lower limit of the triangle (line 'B' currently at 6.34 which is also the 38% retracement of the recent move down) would indicate a failure of the pattern, and would be the first signal that the rand bullish stance has negated. This would merely change the trend from rand bullish to neutral. Another level to watch is 6.50; a pivot in the centre of the previous congestion zone and the 50% retracement of the recent down move. A move up to these levels would merely weaken the technical structure, but confirmation of an actual change in trend will only be signalled with moves above downtrends 'A' (currently at 6.90) and 'C' (currently at 7.20). Unless this happens, the trend is still assumed to be down.

Against the euro and pound, the situation is more difficult to call, with medium-term trends (indicated by 'X' and 'M') still pointing down, but current levels are at significant long-term pivot levels that have marked turning points on numerous occasions in the past six years. As can be seen from the charts, traders/investors have acknowledged these levels (the market has a memory). Sustained breaks below these levels (7.40 and 11.10 respectively) are needed to signal that the trend has more to go and that Rand strength is not only a function of a weak US dollar. However, as with the dollar, the trends are assumed to be down while the exchange rates hold below 9.00 and 12.50. Only above these limits would change the outlook. Conclusion: the old saying "the trend is your friend" should not be under estimated.

Research material is drawn from within the BoE Group and external sources available to BoE Private Clients. Based on these, and other input, BoE Stockbrokers makes its own recommendations to clients. Political and IR comment is by JP Landman. Graphs: sourced from I-net.

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Johannesburg	**Helpdesk**	**Pretoria**	**Pietermaritzburg**
Administration 1 Newtown Road, Killarney P O Box 1007, Johannesburg, 2000 Tel +2711 480 1000	helpdesk@boepersonal.com +2711 480 3722 +2711 480 3725 Fax +2711 480 3740	Pieter Grimbeek Neelan Gungudoo Chriszinda Jansen van Vuuren Ground Floor, Block 2, Glen Manor Office Park, 138 Frikkie De Beer Street, Menlyn P O Box 6287, Pretoria, 0001 Tel +2712 470 9800 Fax +2712 361 7410	Stewart Smith Suite 3 21B Cascades Crescent, Cascades, Pietermaritzburg, 3202 P O Box 13712, Cascades, 3202 Tel +2733 347 5835 Fax +2733 347 5837
Website		**Bloemfontein**	**Single Stock Futures**
Leo van In Tracey Symons 1 Newtown Road, Killarney P O Box 1007, Johannesburg, 2000 Tel +2711 480 3686 Fax +2711 480 3963		Bertus Rust 1st Floor, North Building, The Courtyard 196-198 Nelson Mandela Drive Bloemfontein, 9301 P O Box 12822, Brandhof, 9324 Tel +2751 505 2325 Fax +2751 505 2052	Garth MacKenzie Mauwane Kotane 1 Newtown Road, Killarney P O Box 785442, Sandton, 2146 Tel +2711 480 3679 Fax +2711 480 3745

BoE Stockbrokers (Pty) Limited (Reg. No. 1996/015589/07) A member of the JSE Securities Exchange SA
1 Newtown Road, Killarney P O Box 1007, Johannesburg 2000
Telephone: +27 11 480 1000

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