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Three themes to watch in 2009

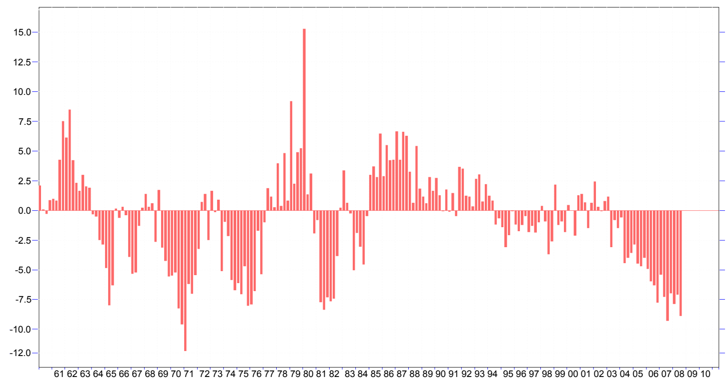
At Allan Gray we shy away from forecasting economic variables as we believe that it is very difficult, if not impossible, to be consistently accurate in one's forecasts, and we know that we are not much good at it. However, in making long-term investment decisions in an open economy such as South Africa, we are required to form some view of whether or not certain facets of the economy are either in balance, or out of balance (and thus unsustainable in the long run). In this spirit, here are three key themes to watch in 2009:

1.The current account on South Africa's balance of payments

The deficit on South Africa's current account is close to a record high in relation to our country's GDP. We South Africans are living beyond our means – we are taking more from the rest of the world than we are giving back to it. This can last for as long as the rest of the world believes that one day the tables will turn and we will be willing and able to give back more than we are taking.

This task will be made easier if we spend relatively more investing in future productive capacity and relatively less on current consumption. Unfortunately, delayed gratification is seldom popular. Will the foreigners who have financed our frolic so far prefer to take their money home in today's risk-averse world?

South Africa current account deficit as a % of GDP



Source: I-Net Bridge and Allan Gray research

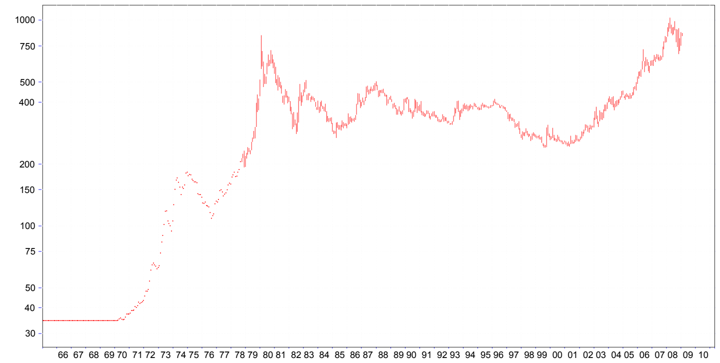
2.The value of paper money

When the Mugabe regime discovered that it could no longer make ends meet in Zimbabwe, it resorted to a simple solution – printing more money. This probably delayed its day of reckoning, but is making that day much more severe than it need have been.

Is American monetary policy today much different? The dollar is still the world's reserve currency which means that the Americans can get away with 'quantitative easing' or money-printing for longer than the Zimbabweans could – but not indefinitely.

Continued monetary imprudence in the US may force the world to find an alternative reserve currency. The dollar could suffer the same fate as sterling. Without its special status, American policy would become unsustainable. The US is a fairly robust democracy with checks and balances. This should mean that a hyperinflationary outcome is averted, but will policymakers tighten monetary policy in time to prevent setting off a new era of inflation? The moves in the gold price could be an indication of some investors' concerns about the real value of paper money.

Gold price (in US$ per oz)



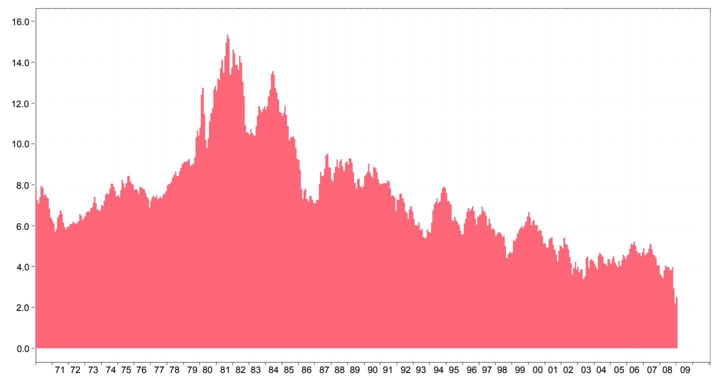
Monthly 31/01/1965 to 15/01/2009
Source: I-Net Bridge and Allan Gray research

3.The government bond bubble?

Judging by the recent fall in yields on US 10-year government bonds to a low of 2.1%, Mr Market believes that policymakers will tighten monetary policy in time to prevent large-scale inflation. Perhaps this places more faith in politicians and bureaucrats than is warranted. In their 'flight to safety' investors are holding onto the textbook ideal that American government paper is risk-free. But what if the American government cannot afford to meet all its obligations and promises?

Given the risks to the real value of paper money (and bonds are just paper money paid to you in the future), and the aggressive fiscal stimuli being employed by most governments, some investors are starting to question whether the current very low bond yields provide sufficient compensation for the risks. A German bond auction failed recently, which was previously unheard of before the 2008 credit crisis. Could this be an early sign of the bursting of a bond bubble?

US government 10-year bond yield



Source: I-Net Bridge and Allan Gray research

Commentary by Ian Liddle, chief investment officer, Allan Gray Limited