INTERMEZZO

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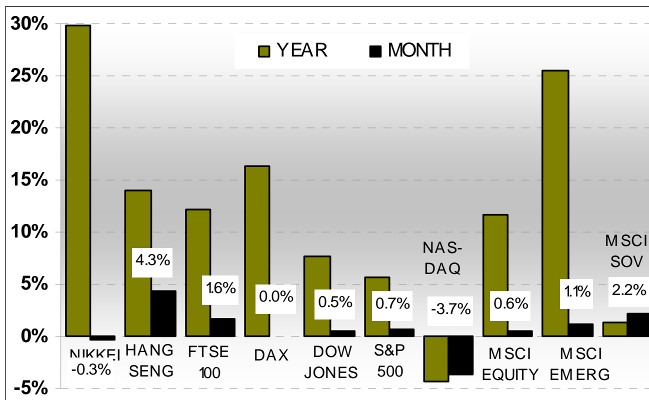
July in perspective – global markets

The yoyo behaviour of global equity markets continued for the third month in succession. At least the extreme nervousness and negative sentiment that undermined markets in May and June seemed to abate somewhat as the month wore on. Reasons for the latter included reassuring comments by Fed chairman Bernanke, evidence that the corporate sector remains in good health – results announced so far have been more than respectable - and evidence that the global economy is slowing, thereby providing hope that the current global tightening (of interest rates) cycle is having an effect and will therefore not last as long as some had feared. That said, volatility remained high with little compensation for any risk assumed. Investors face the month of August with some trepidation, given that it is historically the least rewarding month of the year. Last month's *Intermezzo* included data showing just how volatile markets had been during the month. Some readers may not yet have seen Table 1, which lists data on the behaviour of the Indian market. Note how the mid and small caps bore the brunt of the pain. Take time to absorb the implications of such *extraordinary* volatility; these are truly challenging investment conditions in which to operate. The MSCI Emerging Market index gained 1.1% in July following returns of –10.8% and –0.5% in May and June respectively.

Chart 1: Global market returns to 31 July 2006



The radar screen – what's on it?

During July a couple of events occurred in the global economic environment that had a direct bearing not only on the current statement of the markets but also on investor expectations regarding the performance of the latter.

- **Economic growth**: China startled the investment world by growing their economy at a rate of 11.3% during the second quarter of 2006. The annual inflation rate for June was 1.5%. Apart from far exceeding expectations, this level of economic activity flies in the face of the measures Chinese authorities are taking to prevent the economy over-heating. It also underlines the importance of the "China story" for the rest of the world and virtually underwrites ongoing demand for commodities in general. In stark contrast, the US posted a second quarter growth rate of 2.5%, well below the 5.6% recorded in the first quarter. A slowdown in consumer spending was largely responsible for the slower growth. The PCE deflator, the Fed's favourite inflation measure, rose 2.9%; the contrasts between the US and China couldn't be starker. As an aside, China's foreign exchange reserves rose $66bn to $941bn.
- **Interest rates**: Japan raised interest rates for the first time in six years, from 0.0% (yes, that zero) to 0.25% as economic activity (around 3.0%) and inflation (0.6%) rose. The Bank of England raised rates unexpectedly, although the European Central Bank's 0.25% rate rise was largely expected. So too was that of the SA Reserve Bank. The message is clear: central banks are increasing rates to combat rising inflation.

Table 1: Selected Indian equity returns (US dollars) (%)

Index	31 May to 14 Jun	14 Jun to 30 Jun	June return
MSCI India	-15.0	19.6	1.7
Nifty fifty (large cap)	-13.5	18.7	2.6
NSE mid-cap index	-23.5	18.1	-9.7
BSE mid-cap	-25.7	17.6	-12.7
BSE small-cap	-28.7	18.8	-15.2

Source: Artha Capital

For the record

Table 2 lists the latest returns of the mutual funds under Maestro's care. You can find more detail, including the latest Maestro Equity Fund Summary, by visiting our website at www.maestroinvestment.co.za.

Table 2: Returns of funds under Maestro's care

	Month	Return	Year to date
Maestro Equity Fund	July	**-0.2%**	**4.5%**
Maestro equity benchmark *		-0.3%	13.4%
JSE All Share Index		-1.5%	17.0%
Central Park Global Balanced Fund ($)	June	**-1.3%**	**4.7%**
Benchmark**		-0.2%	4.0%

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, and 20% each in MSCI Sovereign Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills

July in perspective – local markets

July proved to be the antithesis of June's market behavour; whereas the basic materials index gained 10.1% in June, it fell 4.0% in July. Financials and industrials *declined* 2.2% and 1.3% respectively in June, but *gained* 1.1% and 1.6% in July. Mid and small caps fell 5.9% and 6.0% in June – they

rose 1.8% and 2.2% in July respectively. Of course only the basic materials index ended the two-month period higher, and underlines my assertion earlier that there has been no compensation for investors recently despite the massive risk implicit in the market during this period. That said one should bear in mind the base off which the returns are being measured. These are clear in Chart 2, which depicts the annual returns of the major indices, all of which are still at respectable levels. The rand gained 2.6% against the dollar, supported by a "rising rate" environment and a low base (R7.13) in June.

Chart 2: Local market returns 31 July 2006

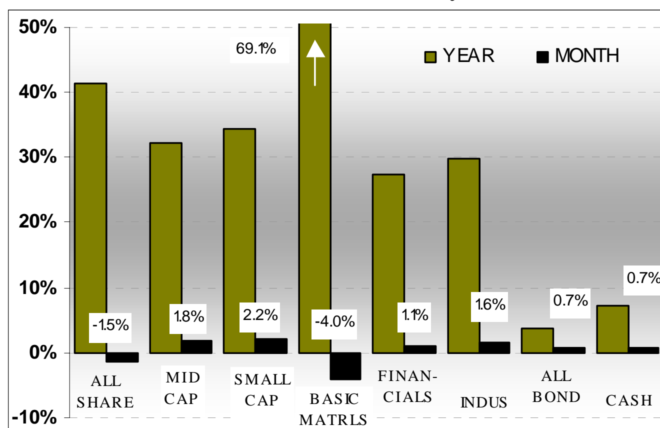
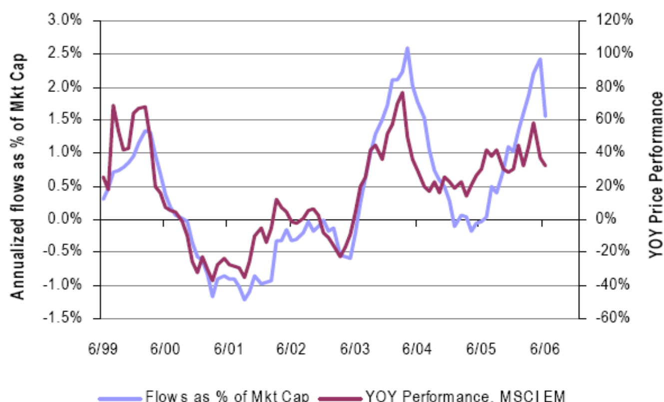


Chart of the month

Readers of *Intermezzo* may have wondered why in recent years we have concentrated so much on coverage of emerging markets. Here are three simple reasons in no particular order: *firstly*, South Africa is a major emerging market, viewed as a major "commodity-play". As such when taking a view on the SA equity market and economy for that matter, local investors including Maestro need to consider what global investors' general appetite for and view towards emerging markets is. The SA market by and large follows the direction of other global emerging markets *Secondly*, the majority of Maestro clients have offshore investments that are directly exposed to other emerging markets such as India – hence we use *Intermezzo* to keep tabs on developments in the emerging market universe. And *finally*, in recent years emerging markets have, for a number of reasons, become increasingly important players in the global economy. One needs only think of the importance of China, Russia, India and Brazil – the so-called BRIC countries – in this regard. Having underlined our reasons for watching this universe so closely, Chart 3 lists annualised investor flows into emerging markets, as well as the rolling annual returns from these markets using the MSCI Emerging Market index as a proxy. The relationship is clear. As to the causal nature of the relationship i.e. do fund flows drive returns or do the returns attract the flows, is the subject of another debate. What is relevant here is that *there is an 85% correlation between the two over the past seven years.* In other words, 85% of the movement in say, the index returns can be explained by flows. It is thus imperative to monitor flows into emerging markets in order to understand their returns. And in this regard, it would be silly to expect the SA equity market to rise when global investors are withdrawing their funds from other emerging markets. This factor alone is worth bearing in mind in the current market uncertainty. In other words *the SA equity market is significantly influenced by factors extraneous to those prevailing in the SA economy.*

Chart 3: Annual returns of small cap shares (%)

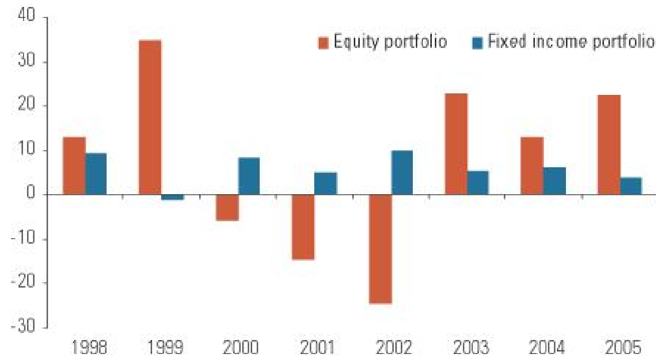


Source: Merrill Lynch

File 13: If only more politicians were this intelligent…

In 1990 the Norwegian government established the State Petroleum Fund, since renamed the Government Pension Fund, in order to capture and put to good use oil revenues, bearing in mind the importance of the industry in the life of the country. According to the official Fund reports "*one important reason for establishing the Fund was to make the use of petroleum revenues in the central government budget easily visible. The Petroleum Fund constitutes a buffer against fluctuations in revenues from petroleum activities, and a tool for dealing with the long-term challenges to state finances which will present themselves when petroleum activities decline."* The Fund falls under the responsibility of the Norwegian central bank, Norges Bank, and you can read more about it by clicking here. The site contains interesting data on benchmarks, returns (Chart 4 lists the Fund's recent annual returns), mandates, investment managers, etc. At the end of 2005 24 external managers were involved with the Fund across 43 different mandates.

Chart 4: Annual Fund returns 1998 - 2005



Source: Norges Bank

The Fund is currently $239bn in size, having been boosted in recent years by the rise in the oil price and the industry's profitability. To put that into perspective, the Fund is larger than that economy's national income, and would allow Norwegians to take a tax holiday for two years without government scaling back any spending. With a population of about 4.5m the Fund equates to about $54 300 (R372 000) per citizen. As they say in the US… "Go figure."

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