INTERMEZZO

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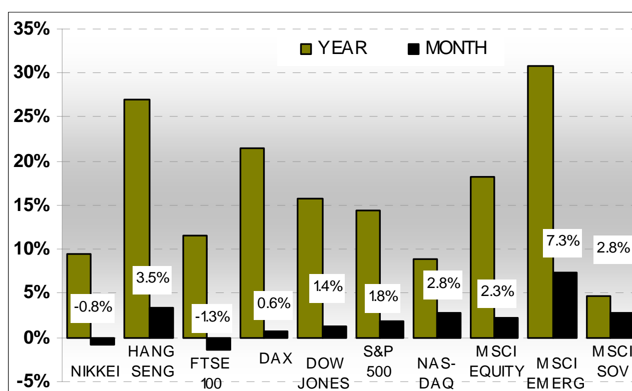
November in perspective – global markets

What a month November turned out to be. The charge that markets had been on since their mid-year "wobble" just couldn't last. Since their June low, developed markets had risen between 15% and 17% and emerging market (dollar) returns were greater still. Mexico and India were up 40%, China and Turkey 25%. The Vix Index, which we have considered on numerous occasions and which is a measure of the inherent risk priced into the US equity market, flirted with a 13-year low, showing just how indifferent investors have become in their attitude towards risk. With the odd exception, markets were just about all trading at record highs. Then in the last few days of the month it all turned, well, rather messy. A number of factors combined to temper the market's momentum, the chief culprit being the decline in the value of the dollar. It fell 3.9% and 3.0% against the euro and pound respectively. Its turnaround came in the light of a number of factors, including comments by the Deputy Governor of the People's Bank of China that the value of Chinese foreign exchange reserves was at risk from a declining dollar, as well as indications that central banks are looking increasingly towards other currencies in which to hold their reserves. Add to that poor US economic data, the perennial concern regarding the size of the US trade deficit, and that interest rates in the Euro region are likely to rise while those in the US may decline in 2007. Having traded in a narrow range for some time, the dollar broke through important levels in thin trade, triggering "stop loss" orders which merely added to the dollar's woes. European exporters started looking vulnerable, which was all the markets needed before heading south. The weaker dollar sent commodity prices higher; gold, platinum and oil rose 7.1%, 9.1% and 13.1% respectively, lending support to emerging markets. The MSCI Emerging Markets index rose 7.3%, while the MSCI World index gained "only" 2.3%.

Chart 1: Global market returns to 30 November 2006



"The end is nigh …" - time to reflect

The year is rapidly drawing to a close. By the time most of you read this you will be counting on one elbow the number of days until your departure from the office. Grant me the liberty to reflect on a couple of significant aspects of 2006. The list is by no means comprehensive and occurs in no particular order:

- 2006 was a year in which, perhaps more than any, **emerging markets (EMs)** came into their own. Not only in terms of returns (refer to Table 1) but in terms of other aspects many of us thought inconceivable only a couple of years ago. Behind many market movements this year lurked the ever-present "presence" of EMs. Whether it was the improvement in their fiscal position - many EMs are in a healthier financial position than developed countries - or their increasing role in the global economy, their relentless contribution to lowering global inflation or their influence on commodity prices, EMs were a significant presence on the investment horizon throughout the year. As if to illustrate the point, China's foreign exchange reserves, which surpassed Japan's in September to become the largest of any country on the planet, topped the $1trillion mark in November – that's about two thirds the size of the entire global hedge fund industry! For those who really like detail, China accumulates reserves at a rate of about R30m per hour!

Table 1: MSCI emerging market index ($) returns (%)

	November	YTD
Argentina	15.9	57.5
Russia	11.0	49.3
China	10.9	55.6
Poland	10.5	32.8
Taiwan	10.5	14.7
Indonesia	9.7	61.3
Hungary	8.6	18.2
Asia	**8.1**	**25.2**
South Africa	7.7	9.5
EMEA	**7.4**	**16.4**
MSCI EM	**7.3**	**23.7**
Czech	7.2	27.6
Chile	6.1	21.5
India	5.7	44.6
South Korea	5.6	11.6
LatAm	**5.3**	**30.4**
Brazil	5.2	30.1
Peru	4.8	49.2
Thailand	4.8	18.4
Mexico	4.4	31.4
Israel	2.3	-5.7
Colombia	-3.1	-0.2
Turkey	-7.0	-13.9

Source: Merrill Lynch

- 2006 will go down in history as one of the greatest years ever in terms of **M&A activity**, driven to a large extent by a new-found hunger and aggression of private equity managers, who are flush with huge amounts of capital. Despite the year not being over yet, more than $3.1 trillion worth of transactions have been announced

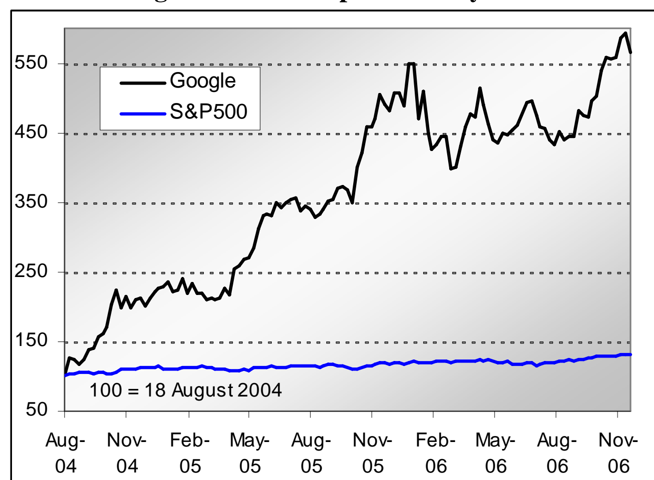
so far, compared to the previous record of $3.4 trillion in 2000. On one day alone last month, $75bn worth of deals were announced, at least one of which involved an emerging market-based company. This activity has driven some share prices to record levels, or has sustained them at levels which would not otherwise have been maintained. Not only has this lent support to US and Euro zone equity indices in particular, but it has spawned a slew of products and innovation in the credit market. Amongst the major beneficiaries have been investment banks. In case you missed it in last month's *Intermezzo* let me repeat it here: the top five investment banks (Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns) will pay out $36bn (that's billion with a capital "B") in bonuses this year alone. In respect of Goldman, that equates to about $660 000 per employee. Of course, the $36bn excludes payments by traditional banks and the hedge fund industry. Let me be frank, it is hard to digest such data when, in a country such as South Africa, you are faced with poverty on a massive scale every day. Forgive me if my true colours start showing, but aspects such as this surely represent the ugly side of capitalism.

- It has been a very **profitable year in non-equity markets** as well. More than $1.3bn worth of art was sold at New York art auctions in two weeks last month. Christie's took in $491m in one Impressionist and Modern sale. Record prices continue to be paid; indications are that the previous cycle peak of 1990 will be exceeded by some margin this year. Someone paid $135m for a Gustav Klimt in June, which was the highest price ever paid for a painting. But only a few months later that record fell, with a buyer paying $140m for a work by Jackson Pollock. From what I understand the prices of artwork in South Africa have also been reaching record levels this year.

As another example of how non-equity investment markets have risen this year, those active in property markets will appreciate the following: in September it was reported that large London (office) property deals were taking place at yields around 4.5%. The largest sum ($1.3bn) yet paid for a single (Tokyo CBD office) property in Japan was consummated at a yield of just 3.5%. Up, up and away…

- One of the biggest dilemmas investment managers face has always been the issue of **valuation**. Unless you are a fundamental value manager, there are occasions – and forgive me if this sounds heretical – when valuation is not the *most* important consideration in the investment decision. If that were the case, few people would invest in Russia or India right now, yet these markets, despite the phenomenal returns posted by them in the last couple of years, are widely acknowledged to hold great promise *over the longer term*. Another example is that of Google, whose share price exceeded the $500 mark during November. To put that in perspective, Google listed on 18 August 2004 at $85; its current market cap (size) of $153bn is already more than half that of Microsoft. Not bad for a company that didn't exist in 1997! In the first seven years after Google's founding, Microsoft's price remained virtually static over that period, yet Google's value grew from zero to $80bn! Sure, Google may have been over-valued throughout that period, but $80bn is an awful opportunity cost to miss out on! No wonder the Google founders are buying their own private jumbo jet to travel in! For what it's worth, Google trades at 21 times its expected 2007 cash flow, and on a forward PE ratio of 52 times.

Chart 2: Google vs. S&P500: price history based to 100



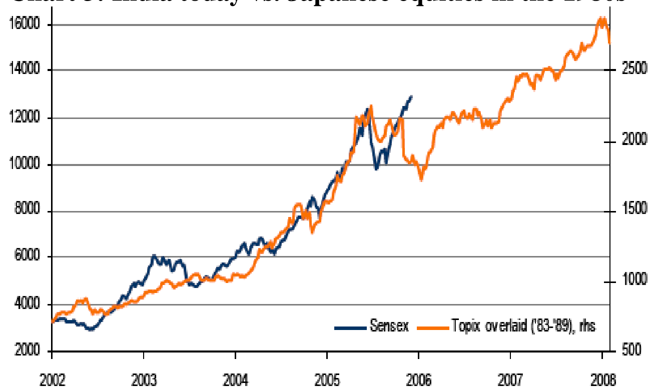
- On a more serious note, high or lowlights of 2006 would be incomplete without mentioning the **market weakness experienced in May and June**. Many investment professionals agree that 2006 has been an extremely stressful year. Did anyone notice the 1987-like crash? Some emerging markets fell more than 30% in two months! Yet many of those same markets are now at record levels. Few investors other than those who follow global markets very closely, and on a daily basis, will appreciate just how traumatic the second quarter was for the investment profession. To watch markets decline so severely in a matter of days, only to recover as if nothing was wrong in the first place, was enough to make even hardened market watchers age dramatically! Some investors are still unaware of this

significant event. Is this because we as investment managers hid it too well, for fear of telling clients just how close markets were to declining even further? Or because nobody cares now that returns are all moving in the right direction. Is it just that we have all become too complacent in our expectations of ongoing, significant investment returns. These are questions we all need to think about as we head out for the holiday break.

Chart of the month

I have again taken the liberty in this section of including two charts this month. While they are not earth-shattering in their own right, they illustrate a couple of points. *Firstly* Chart 3 compares the rise of the Indian equity market (the black line in the chart) with that of Japan from 1983 to 1989. While one should treat such comparisons with *great caution*, the main point is to highlight the emergence of India, which reinforces my comments on the increasing role of emerging markets in general. Did you know that when National Stock Exchange in India was established in the early 1990's, it had to begin its life as a telecommunications company due to the poor infrastructure in the region? Because of the long time it would have taken to install a terrestrial communication network, it opted to first establish a satellite telecoms operation for its own use. To this day it remains one of the largest proprietary telecoms operations in Asia. India's market cap has trebled in size in the last three years and at $700bn is greater than Singapore and closing in on Australia. A couple of years ago only two listed companies had a market cap in excess of $1bn; today there are more than 100, about 10 of which have a market cap in excess of $10bn. The Indian equity market will most surely have its ups and downs (just as in May and June) but let us not reflect in ten years time on missed opportunities in one of the most exciting and rapidly growing regions of our world.

Chart 3: India today vs. Japanese equities in the 1980s



Source: Merrill Lynch

The *second* chart I want to include depicts what I believe to be one of the most powerful yet under-appreciated forces behind investment markets over the past two decades, namely the decline in global inflation. Chart 4 depicts US inflation excluding food, energy and housing since 1970. As inflation has declined, albeit at different rates in different regions, so interest rates have declined, fuelling a consumption boom which revolutionised the world as we know it. It created a ready market for Chinese goods, which in turn allowed China ($1 trillion in reserves, remember?) to fund vast US consumption, simultaneously shifting the balance of economic and political power, certainly for our life time at least. It laid the foundation for more than one commodity boom. It is interesting to see that, unlike during the 1980's, the recent commodity boom has not increased inflation significantly. Is this perhaps tangible evidence of the benefits of the technology? The decline in inflation and hence interest rates has spawned the recent power of the private equity and hedge fund managers, who have been so visible in investment markets this year.

Chart 4: US Core inflation - how the mighty have fallen

Source: Merrill Lynch

Emerging markets, including South Africa, have benefited enormously from the decline in inflation – who knows where the rand would be if SA inflation was at 25%. These benefits have been wide spread, from investors to first-time home and car owners. On the flipside, we need only turn to Japan to see the effects of a decade-long period of deflation. Although the "cycle" is a long one, be aware of the effects of rising or declining inflation from current levels. A significant movement in either direction would be most unwelcome and in all likelihood rather unprofitable as well.

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	Nov	**3.3%**	**19.9%**
Maestro equity benchmark *		2.7%	32.5%
JSE All Share Index		2.7%	35.6%
Central Park Global Balanced Fund ($)	Oct	**2.7%**	**9.2%**
Benchmark**		1.9%	8.9%

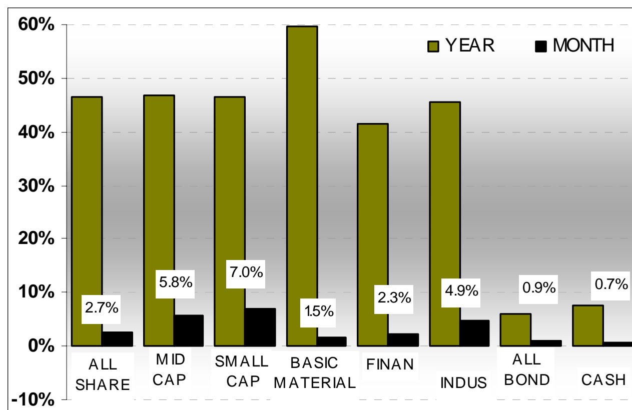
* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, and 20% each in MSCI Sovereign Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills

November in perspective – local markets

Many of the factors described in the first section on global markets affected local ones too. Despite the strength of the rand last month, dollar weakness provided a tailwind for the rand during November, helping it gain 3.4% against the dollar. It declined 0.3% against the euro and pound though. This put the brakes on what would otherwise have been even larger gains from the basic materials sector, which still managed to rise 1.5% on the month. The gold index rose 8.8% and the mid and small indices 5.8% and 7.0% respectively. Economic growth in South Africa remains solid and the consumer seems to be in good mood – much to the Reserve Bank Governor's ire. One should thus expect

another interest rate increase in December, with more to follow in the New Year. Fortunately there is sufficient momentum in the economy, not least from government spending on infrastructure, to carry us forward and to compound the firm base off which corporate SA is prospering. As an aside, with only one month remaining in the year, I note with interest (refer to Chart 5) that the annual returns to November of the All Share index, and the large (not shown on the chart), mid and small cap indices are all around 46%.

Chart 5: Local market returns 30 November 2006



And finally…

You maybe interested to know that Intermezzo is sent all over the world (thank heavens for email!). It is read in the Cayman Islands, Cyprus, Luxembourg, London and Dublin, not to mention across South Africa. It is read by directors of companies listed on the JSE, by clients drawn from all walks of life and by young and old. I hope that in some way you have learnt something from its contents through the year. Thank you so much for taking the time each month to read through each edition. Thank you too for the regular feedback and constructive criticism – without you it would all be in vain.

In closing, let me wish all *Intermezzo* readers the very best for the coming season. May 2007 bring with it many challenges and the learning and rewards that go with meeting them. On behalf of the Maestro team I wish you much blessing, safety and good health in the coming year.

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