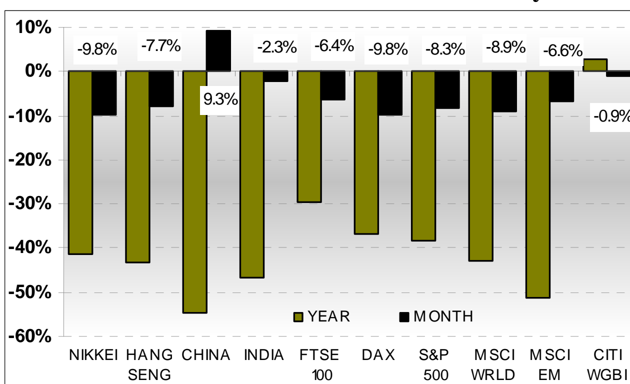
INTERMEZZO

MAESTRO
Investment Consulting
Investment Letter | 9th Edition | February 2009

January in perspective – global markets

The world's markets got off to a negative start in January as you can see from Chart 1. One should bear in mind though that between their trough in late November and the first few days in January global equity markets rallied nearly 25% despite consistently deteriorating economic news. So it was no surprise that they declined through January. China is notable for its positive performance though and at the time of writing is up 15% so far this year. The remainder of both emerging and developed market posted very poor returns; the 8.3% decline of the US equity market was the worst January return for 113 years! What does that say about the coming year? Statisticians will remind us that the January effect has an 80% accuracy rate in predicting how the rest of the year goes i.e. if the January return is negative then 80% of the time the total year's return will be negative. Bond markets, having registered strong gains in December, eased marginally. The dollar regained its composure against other currencies; the euro declined 7.8% against the dollar, having risen 9.6% the month before after the Fed moved to a zero interest rate policy (ZIRP). Also noteworthy were the gains registered by commodity prices, admittedly off a low base: oil was up 13.1%, gold 6.3%, platinum 9.5% and the S&P GSCI (commodity) index rose 3.3%. The Baltic Dry index rose 38.2% (its annual *decline* to January is still 82.3%) and at the time of writing is up 99.0% since its December low.

Chart 1: Global market returns to 31 January 2009

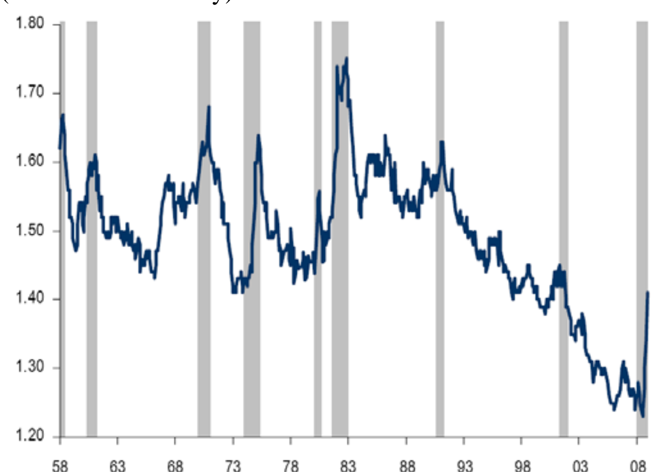


What's on our radar screen?

We remain focussed on the changing economic landscape and list below a couple of developments in this regard:

- *The Chinese economy*: it was widely expected but still came as a shock to the markets: the Chinese economy grew at a rate of "only" 6.8% during the fourth quarter of 2008 (Q4 08) – the slowest rate in seven years. This is down from 9.0% in Q3 08 and brings the growth for 2008 as a whole to 9.0%, down from 13.0% in 2007. The inflation rate for December was 1.2%. And whilst on the subject of China, not many people noticed that in the last quarter of 2008 **China surpassed Germany as the world's third largest economy**.
- *Other Asian economies:* there was worse news from other Asian economies. Singapore's economy contracted at a mind-numbing 16.9% and that of South Korea by 5.6%. The Bank of Japanese said it believes their economy will shrink by 1.8% in 2008 and they have pencilled in a decline of 2.0% for 2009.
- *The UK economy:* reasons for sterling's weakness – not that one needed reminding – became obvious when data was released showing that the UK economy declined 1.5% in Q4 08. It contracted 0.6% during Q3 08. This was the UK's worst performance in thirty years and "officially" puts the UK into recession.
- *The US economy*: markets were bracing themselves for a very bad Q4 08 growth number from the US. In the event, the US economy declined "only" 3.8% in the fourth quarter – which is of course still a huge decline. While the world breathed a collective sigh of relief we caution that what happened, at least in our opinion, is that the bad news has been pushed into the first quarter of 2009. The reason for this belief lies in the extent to which inventories rose in the fourth quarter. The goods were manufactured, which contributed to growth, but they were not bought by the consumer; hence the accumulation of inventories; refer to Chart 2 to see what we mean. So watch this space – our belief remains that we are in the early stages only of a multi-year US credit contraction and that there is plenty of bad news down the road.

Chart 2: US inventory to sales ratio
(months of inventory)



Source: Merrill Lynch

- *The SA economy:* the good news for SA consumers came in two stages: first was the news that inflation is slowing – you might be surprised to know that during the past three months the consumer price *index* returns were 0.00%, 0.06% and -1.15%. The trend is clear: inflation is slowing and should continue to do so unless we experience an unexpected currency shock. The

second and related piece of good news was the 1.0% interest rate cut early in February. We suspect there will be a number of further rate cuts this year.

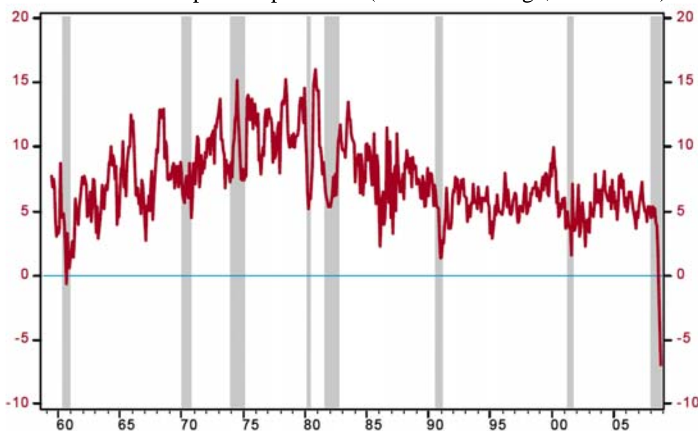
- *Hedge fund hernias continue*: last month we alluded to the damage done to the returns and reputation of the hedge fund industry. Redemptions from hedge funds during Q4 08 totalled $152bn. This is in stark contrast to the net inflows into hedge funds for 2007 of $194bn. The size of the global hedge fund industry i.e. assets under management shrank to $1.4 trillion at the end of December, down from a peak of $1.93 trillion in June.

Chart of the month

Many of you would have read our Market Commentary which accompanied the Quarterly Reports. In that document we spent quite some time on the state of the US consumer and highlighted his lot as one of the main reasons behind our cautious attitude towards the markets at present. The fact is he has never had it as bad as it currently is – at least not for as long as he can remember. His situation is getting bleaker by the day and his balance sheet is shrinking faster than he can pay off debt. Chart 3 provides another glimpse into his lot. It shows the annualised change over the past six months in consumer spending (PCE). PCE has shrunk for a record 7th consecutive month and from the chart we can see that never before has PCE shrunk so rapidly.

Chart 3: The US consumer: how bad is bad?

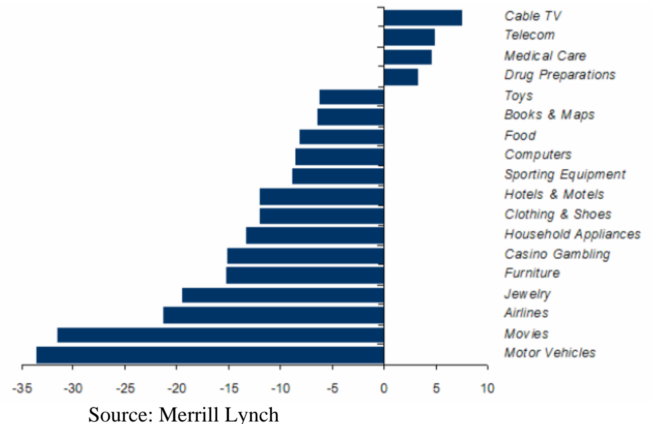
Personal consumption expenditure (6-mnth % change, annualised)



Source: Merrill Lynch

In a remarkable example of the information age, we can see from Chart 4, which itemises the annualised change in spending in the last 6 months, that consumer spending on food has declined 8% but his "telecom" (read iPhone) spending has risen 5%. Other items that he has increased his spending on are cable TV (watching markets on Bloomberg perhaps?), medical care and medication. Another scary takeaway from the chart is just how bad vehicle sales have been. No wonder the US automakers are bankrupt and all other global automakers are struggling.

Chart 4: The US consumer: giving up food for an iPhone



Source: Merrill Lynch

For the record

Table 1 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. Returns include income and are presented after fees have been charged.

Table 1: Returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Fund	Jan	**-3.4%**	**-3.4%**	**-22.8%**
Maestro equity benchmark *	Jan	-5.4%	-5.4%	-18.8%
JSE All Share Index	Jan	-4.3%	-4.3%	-22.1%
Maestro Long Short Equity Fund	Dec	**2.6%**	**-30.3%**	**-30.3%**
JSE All Share Index	Dec	1.5%	-23.2%	-23.2%
JSE Financial and Indus 30 index	Dec	1.5%	-19.5%	-19.5%
Central Park Global Balanced Fund ($)	Dec	**2.3%**	**-16.8%**	**-16.8%**
Benchmark**	Dec	3.2%	-20.3%	-20.3%

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

Table 2 lists the returns on the equity component of the assets under Maestro's management. Although the longer returns are still respectable, it is noticeable how we have struggled to beat the index in the past year. With the market in "panic mode" and with investors fleeing anything not large and tradable, and paying less regard to specific company fundamentals, our strategy of stock selection has been undermined. However, we are satisfied that in the long-term it will prove correct and we are looking forward to the coming reporting season when we expect to see a number of good results and profit announcements from many of the companies in which we have invested.

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Table 2: Maestro annual returns to 31 Dec 2008 (%)

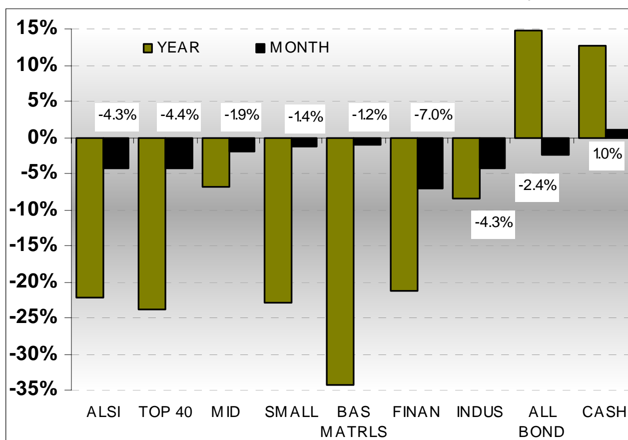
SA equity returns	6m *	1 yr	2 yrs	3 yrs	4 yrs	5 yrs
Maestro long-term equity portfolios	***-25.0***	***-26.8***	***-3.7***	***9.9***	***17.0***	***21.7***
Maestro equity benchmark **	-20.3	-21.1	-4.7	8.4	15.6	19.4
JSE All Share Index	-27.8	-23.2	-4.3	8.9	17.3	18.9

* 6-month returns are un-annualised
** 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index

January in perspective – local markets

Given the weak global equity market backdrop, SA markets were always going to struggle to post positive returns. As it happens the returns *were* negative but not as bad as global returns. Chart 5 depicts these returns – what was interesting to us was the relatively modest declines for the mid and small cap indices, down 1.9% and 1.4% respectively. In line with global trends the financial sector, down 7.0%, came under enormous selling pressure while the modest up-tick in commodity prices we referred to earlier supported the basic materials, which declined "only" 1.9%. The best sector returns came from pharmaceutical and biotech up 18.0%, gold 17.0% and healthcare 8.0% while platinum (-14.1%) and banks (-11.6%) brought up the rear. The strong dollar took its toll on the rand. It declined 9.4% but this should be seen in the context of its 8.9% gain in December. The rand declined 10.7% against sterling but only 1.7% against the euro, highlighting just how uncharacteristically volatile global currency markets have been in recent months.

Chart 5: Local market returns to 31 January 2009



Quotable quotes

Even worse, costs are increasing. Operating expenses were higher at both banks in 2008 than in 2007. Although commentators have focused on the bonuses of senior executives, compensation expenses overall at both banks were nearly as high last year as in 2007. Citigroup paid employees $32bn; Bank of America paid $18bn. When a company pays out more in compensation than its market capitalization, as Citigroup did, the end is near. *Frank Partnoy, professor of law and finance at the University of San Diego*

The entire economic growth system, where one regional centre prints money without respite and consumes material wealth, while another regional centre manufactures inexpensive goods and saves money printed by other governments, has suffered a major setback. *Russian Prime Minister Vladimir Putin.*

Although I positioned myself reasonably well for what was coming last year, one thing I got wrong cost me dearly: there was no decoupling between markets of the developed and developing worlds. *George Soros*

Running our own affairs well is our biggest contribution to mankind. *Chinese premier Wen Jiabao*

In response to ex-US Treasury Secretary Hank Paulson's comment (refer to the January *Intermezzo* edition in File 13) that China had been one of the root causes of the financial crisis because its volume of savings had reduced the risk premiums around the world, *Chinese premier Wen Jiabao* had this to say: I think the main reason for this global financial crisis was the imbalances of some of the economies themselves. For a long time they have had double (fiscal and current account) deficits and kept up high consumption based on massive borrowing. Banks used excessive leverage to reap huge profits. And when such a bubble bursts the whole world has been exposed to a big disaster. It is completely confusing right or wrong when some countries that have been overspending then blame those that lent them money for their spending.

Owners of capital will stimulate working class to buy more and more of expensive goods, houses and technology, pushing them to take more and more expensive credits, until their debt becomes unbearable. The unpaid debt will lead to bankruptcy of banks, which will have to be nationalized, and State will have to take the road which will eventually lead to communism. *Karl Marx 1867*

File 13 – things almost worth remembering

Last month we brought you two chapters in the book "*They really don't get it, do they?*" This month we bring you the third: scarcely two days after the inauguration of US President Obama the Administration was back to its old ways, blaming China for manipulating their currency; so much for "change" and "extending the hand of friendship." The US's attitude and position remains extraordinary. Think about it: here is a country way over its head in debt, and China owns the most US debt (bonds) after Japan. Yet the US has the temerity to not only blame China for the current financial mess but then accuse it of manipulating its currency. This is tantamount to threatening your bank

manager when you are on the verge of being declared insolvent due to your excessive spending habits and the resultant debt load.

And while on the topic of vast swathes of uncontrollable debt – we could suggest that this is chapter 4 in our book - doesn't it strike you as odd that the US (and UK for that matter) authorities are going to great lengths to force banks to extend more credit, despite the fact that the consumer has so much debt already he doesn't know what to do with it and cannot repay it fast enough, not to mention that it was his excessive debt load that got him, the US and the whole world, into the current mess in the first place. Am I missing something? When are we going to hear from the culprits – starting with a message from the politicians - anything that vaguely resembles "you are living beyond your means"?

And finally, with George Bush now firmly in the history books (for all the wrong reasons), lets remind ourselves of some of the greatest moments during his term of office, which incidentally, the Financial Times has characterised as one of "serial incompetence." Eina! The following are but some of the intellectual gems he left for us:

- The vast majority of our imports come from outside the country.
- If we don't succeed, we run the risk of failure.
- One word sums up probably the responsibility of any Governor, and that one word is 'to be prepared'.
- I have made good judgments in the past. I have made good judgments in the future.
- The future will be better tomorrow.
- We're going to have the best educated American people in the world.
- A low voter turnout is an indication of fewer people going to the polls.
- For NASA, space is still a high priority.
- Quite frankly, teachers are the only profession that teach our children.
- It isn't pollution that's harming the environment. It's the impurities in our air and water that are doing it.

Table 3: MSCI Emerging Market January returns (%)

	Jan-09	YTD
EM countries/regions		
Chile	10.5	10.5
Brazil	4.5	4.5
LatAm	**-0.3**	**-0.3**
India	-2.1	-2.1
Philippines	-2.2	-2.2
Malaysia	-2.3	-2.3
Israel	-2.7	-2.7
Argentina	-4.0	-4.0
Thailand	-4.0	-4.0
South Korea	-4.8	-4.8
MSCI EM Small Cap	**-6.3**	**-6.3**
Asia	**-6.6**	**-6.6**
MSCI EM	**-6.6**	**-6.6**
Indonesia	-8.1	-8.1
China	-8.3	-8.3
MSCI DM	-8.8	-8.8
Turkey	-9.6	-9.6
Taiwan	-10.0	-10.0
Russia	-11.6	-11.6
EMEA	**-12.4**	**-12.4**
Peru	-12.4	-12.4
Mexico	-12.7	-12.7
South Africa	-12.8	-12.8
Morocco	-15.5	-15.5
Egypt	-17.8	-17.8
Czech Rep	-18.0	-18.0
Poland	-24.9	-24.9
Hungary	-25.5	-25.5

Source: Merrill Lynch

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