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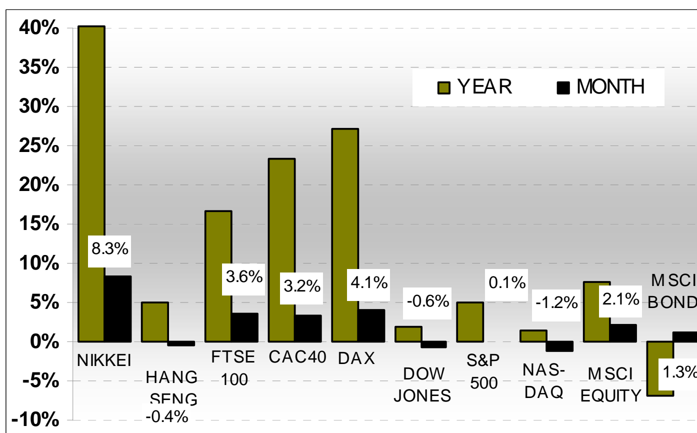
December in perspective – global markets

As southern hemisphere readers slowly make their way back to the office, may I take this opportunity to wish you the very best for 2006. May the year bring with it many blessings, and may it turn out to be a time of great learning for all of us, and a year of fun, fulfilment and achievement.

Chart 1 illustrates the past year so succinctly, doesn't it? A great year for the Japanese and European equity markets, a poor one for the US, and a terrible year for bonds. The Japanese market stormed through December to gain 8.3%; that, after a 9.3% rise in November, to register an astonishing 40.2% gain for 2005 as a whole. Germany produced a 27.1% return for the year. In general, global equity markets posted mediocre gains during 2005, evidence of which is the modest 7.6% gain in the MSCI World index. The largest returns were to be found in emerging markets, as they continued to gain respectability and attract foreign investors.

Chart 1: Global market returns to 31 December 2005



When big gets bigger

Maestro has been beating the China drum for a number of years now, to the extent that it is almost "old news". Of course that nation will continue to influence – more likely to dominate – the global economy and markets for many years to come. For years, analysts have questioned the integrity and accuracy of Chinese data and the size of their economy in particular. Many suspected that the economy is a lot larger than the data indicate. The doubters had their suspicions confirmed when China's National Bureau of Statistics released the results of a nationwide survey. The latter resulted in a *16.8% upward revision* in the size of Chinese economy. To place this in perspective, China's economy is now officially larger than Italy's, and is closing in on the world's fourth largest economy, the United Kingdom. Given the projected 2005 growth rates for the UK, China should easily surpass the UK economy to end 2005 just behind France, the third largest economy in the world. Officially, the size of Chinese GDP in 2004 was $1 983bn. To place the revision in perspective, the size of the addition alone i.e. the extra value of the economy added after the survey, was $285bn. Compare this to the total South African 2004 GDP of $229bn. In other words the revision to the Chinese economy alone was greater than the whole SA economy.

It is interesting to note that the survey captured more of the service sector of that economy, with that sector now constituting 41% of Chinese GDP, up from 32%. The major sub-sectors to increase their contribution were transport and communications, the wholesale, retail and catering trade, and property. By implication, the contributions from investment and manufacturing have reduced – previously the investment component alone constituted 44% of GDP.

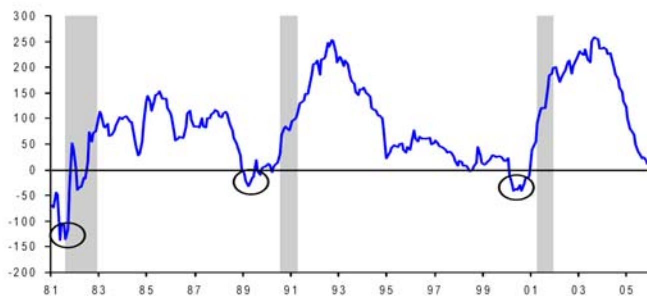
Chart of the month

Throughout 2005 we noted the conflicting messages from the (US) bond and equity markets. Equities were going up, presumably on valuation considerations and expectations of increasing earnings, yet bond market prices were going down – or sideways at best – on the expectation of worsening economic conditions. Chart 2 focuses on the latter. In investment jargon, we speak about an "inverted yield curve". In layman's terms, this refers to the moment that the yield (interest rate) on a short-term bond, in this case the 2-year US Treasury (bond), exceeds the yield on a longer-dated bond, such as the 10-year bond. Typically the 2 and 10 year yields are used to monitor yield curve inversion. Strictly speaking, one would expect the longer-dated bond to yield more i.e. its interest rate should be higher. There is more uncertainty over the longer period, which should compensate investors through a higher return (yield). After all, why buy something for 10 years, when you can get a higher return on a similar product, but only need to hold it for 2 years? At least that's the theory. In reality, there are times when the 10-year yield declines to levels lower than the 2-year yield, and that's when we refer to the yield curve as being "inverted".

So what's the point of all of this? Well, history shows that the yield curve is an accurate indicator of the future level of economic well-being. Chart 2 illustrates this nicely. During the past thirty years, there have been **eight** tightening cycles in US interest rates i.e. the Federal Reserve has prevailed over eight periods during which interest rates were increased (where rates were raised a number of times in each period). On **five** of those occasions (not all shown in the Chart) the yield curved inverted, and a year later *on each of the five occasions the US economy moved into a recession*. At the

time of writing, the yields on US 2 and 10-year bonds were 4.40 and 4.42% respectively, a difference of only 2 basis points. The US yield curve is thus as close as anything to being inverted. The message from the bond market is clear: at best the US economy will slow sharply in the coming year, and at worst will move into a recession.

Chart 2: The US yield curve – not a positive message
10-year minus 2-year Treasury yield (basis points)
Shaded areas represent periods of US recession



Source: Merrill Lynch

2005 – an alternative review
By now you would probably have read a number of well-informed reviews of 2005. There is little I could add to these. Maestro clients will in any event receive a synopsis of the past year and Maestro's thoughts on the coming year in the respective Quarterly Reports on their financial affairs.

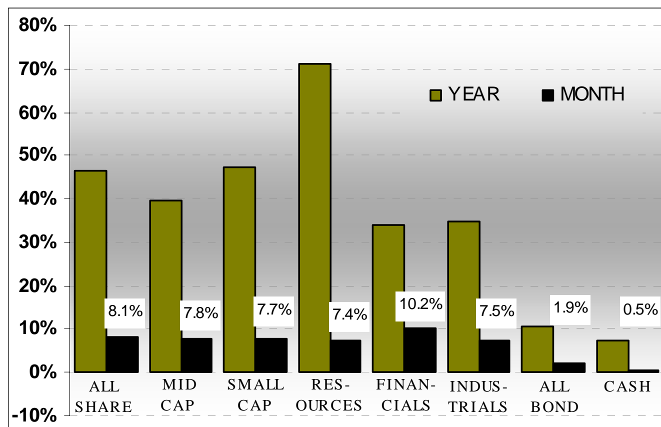
However, allow me to share a few random thoughts on some of the oddities that arose in the past year; aspects that were perhaps contradictory, or for which the underlying reason was hard to establish. The list is by no means comprehensive and in no way represents the most important influences of the past year, but hopefully it will be thought provoking. As always, Maestro retains a *global* view rather than focus purely on South African markets.

- In general, **2005 was a tough year in which to generate returns in global markets** even though some indicators would suggest otherwise. Scarcely three months ago, the oil price was flirting with $70, central banks were talking rates higher, and equity markets were very nervous, having registered large declines in October. Since then, some equity markets have raced to 4 and 5-year highs, the oil price has receded, and more intriguingly there is little evidence of any inflationary pressures arising from the hurricane-induced oil price spike. Between the end of October and the time of writing (12 Jan) the German market is up 12% and Japan is 21% higher. This is but one example of the opportunities during 2005 that were there to be taken, or missed.
- Another way of looking at the past year is to consider **the differences in market returns**. The 7.6% rise in the MSCI World Index is not exactly reason to open the champagne! Yet the Japanese equity market rose 40%. In contrast, its neighbour, the Hong Kong market rose only 5%. India gained 37% and South Africa 47%. But the US equity market rose only 5% and the Nasdaq 1%. Global bond markets also experienced a torrid time, and their returns were also hardly worth writing home about. Depending on which index you follow, returns varied between +5% and –5%.
- With this as background, it is perhaps not surprising that **hedge funds failed to live up to their reputation.** Of course I am generalising here, and offer my due respect to those managers that registered credible performances. The CFSB Hedgeindex rose an estimated 7% the HFRX Global Hedge Fund 3%. Did the lowly returns have to do with the huge amounts of capital that have flowed into the industry in recent years? Or was it a function of the volatile markets? Are their high fees justified? Are alternative investments best suited to declining markets? Irrespective of the answers, many investors will be re-assessing the role of hedge funds in their portfolios.
- This time last year, the financial community and investors alike were expecting **the dollar** to continue to slide. There were, and still are, many structural reasons why the greenback should remain an inherently weak currency. Yet the dollar surprised everybody, rising about 15% against the euro and yen.
- And then there were the **conflicting signals from the bond and equity markets**. The former seemed concerned about rising inflation, yet no such message was forthcoming from equity markets. If the bond market is right (refer to Chart 2) then the US economy will certainly slow sharply, if not go into recession. If that is the case, then equity markets are in for a shock. Or were they, and will they continue to be, supported by the **massive global liquidity** that is becoming such an influential factor these days. What are the implications of the very strong corporate balance sheets (that have become the norm these days) on, for example, the rating of the US equity market? Where will all this money go: back to shareholders? Or will it be re-invested into their respective operations? When will the world's resource companies begin to invest in new mines, new oil wells, new supply? Or at least just increase capacity in a meaningful way? What levels must commodity prices rise to before they begin to act? And what will be the inflationary impact of these higher prices? Dare I say it… stagflation? The answers to these and other questions surely hold the key to successful investing in 2006 and beyond.
- On a more philosophical note, **how long will the poor, developing regions of the world**, such as China, Asia and South America in particular, **continue funding consumption in the rich, developed world**, and the US in particular. This, to me, has to be one of the greatest conundrums of the present time. How long will it continue? How large and vociferous will the anti-globalisation lobby become, particularly now that developing countries have gained in respectability? Will the haves and the have-nots ever agree on policies (read the World Trade Organization [WTO], the Doha agreement, Kyoto protocol, etc).
- And then there was the record **M&A activity in 2005** and the increasing role of private equity groups on valuation levels. On a recent trip to London I raised this issue with a respected hedge fund manager, in particular the influence it was having on equity markets. His response was interesting: why had they taken so long, given that interest rates and valuation levels had been much lower a year or two earlier? He has a valid point.

December in perspective – local markets

Gains in the South African markets eclipsed global markets. Fuelled by a rising gold price – the Gold Index gained 11.2% and 62.7% for the month and year respectively – and very positive international sentiment towards emerging markets in general, the SA market raced to record highs. Despite the rush into resources, it was the financial sector that rose the most during the month, although the latter had lagged in the past couple of months. What makes the market's strength so remarkable was the fact that the rand continued to rise despite a firm dollar. Despite its 2.2% gain during December, the rand declined 9.9% against the dollar during 2005 as a whole (its first decline against the dollar in three years) but gained 3.8% relative to the euro.

Chart 3: Local market returns to 31 December 2005



For the record

The latest returns of the collective schemes (unit trusts) that Maestro manages are listed in Table 1. If you wish to find out more detail on the Funds, including the latest Maestro Equity Fund Summary, please visit our website at www.maestroinvestment.co.za.

Table 1: Returns of mutual funds under Maestro's care

	Month	Return	Year to date
Maestro Equity Fund	Dec	**6.9%**	Not applicable
Maestro equity benchmark *		8.5%	40.2%
JSE All Share Index		8.1%	46.6%
Central Park Global Balanced Fund ($)	Nov	**1.5%**	-1.4%
Benchmark**		1.2%	2.2%

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

File 13: Information you needn't retain

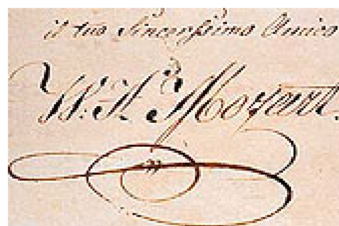
I am sure that most southern hemisphere readers had a wonderful December, spending most of it at the beach or relaxing somewhere in the beautiful African bush. If so, spare a thought for one Japanese dealer and his employer, Mizuho Securities, whose worst nightmare came true. At issue was what all dealers fear most – finger trouble. In this case, very expensive finger trouble! Apart from a not-insignificant hole in the Mizuho Securities income statement, the error also brought about the resignation of the Tokyo Stock Exchange (TSE) CEO Takuo Tsurushima, along with two of his senior executives.

It all started with the listing of a small Japanese recruitment company, J-Com. A dealer from Mizuho Securities intended to place an order to sell 1 share in J-Com at Y610 000, but instead placed an order to sell 610 000 shares at Y1. Not surprisingly, the next few hours must have seen all hell break lose, sufficient enough to bring the Nikkei 225 index down more than normal (-1.8% on Thursday, December 8). However, when the dealer realised his error and tried to cancel his trade, or at least repurchase some of the shares he had inadvertently sold, a glitch in the TSE computer system prevented him from doing so. Wow, what an unfortunate comedy of errors! And to add insult to injury, Mizuho was ordered by the Japanese Securities Clearing Corporation to pay compensation for the error, thereby increasing its initial trading loss from Y27bn to Y40bn or $343m. Eina! Aren't you glad you were lying at the beach?!

And talking of problems, take a look at the picture below. It shows a $4bn problem, this time for the account of BP, whose brand new (it had not even started drilling yet) deep-sea oilrig, the Thunder horse, started listing days before Hurricane Katrina swept through the Gulf of Mexico. And you thought you had problems in 2005!

And finally…

I would not be true to myself if I failed to highlight the significance of January 27. As a lover of classical music - in case that wasn't already obvious to you - the date marks a special day 250 years ago, when in 1756 one Wolfgang Amadeus Mozart was born. For those who are interested, you can read more about the composer and the celebrations planned in Austria by clicking here.



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