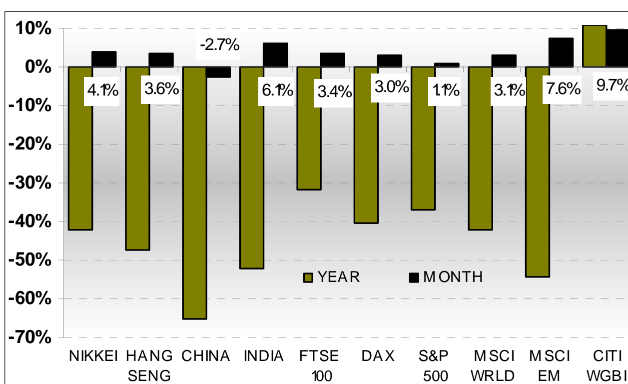
INTERMEZZO

MAESTRO
Investment Consulting

Investment Letter | 9th Edition | January 2009

December in perspective – global markets
Welcome to 2009 – at last we can put 2008 behind us. None of us will miss it, but we will also not forget it easily. 2008 turned into one of the most financially catastrophic years in living memory. Many of the events that filled it were documented in past editions of *Intermezzo*. But let's take a brief look at the final month which, true to form, had its fair share of surprises and ups and downs. In general markets were positive, as can be seen from Chart 1. China was one of the few markets that turned in a negative return for the month. Before moving off Chart 1, take a good look at the *extent* of the annual returns for the year – surely and hopefully we will not see returns like these again in a hurry! Table 2 at the end of this edition lists the emerging market returns. One, if not *the* outstanding event of the month was the Fed's decision to reduce its target rate to "between 0.0% and 0.25%" thereby heralding what we believe will be a long period of zero interest rate policy (ZIRP). The Fed's decision sent the dollar down 9.6% against the euro, which in turn helped gold rise 6.2% on the month. Underlying the extent of "demand destruction" was the failure of the oil price to benefit from the weak dollar. It declined 21.5% on the month – its sixth consecutive double digit *monthly* decline, the last three of which were in excess of 20%! Another major beneficiary of the Fed's decision was the US Treasury market, where yields across all maturities fell to lows last seen in the early fifties. At one stage during the month the yield on the 2-year US bond even moved into negative territory! Who said 2008 wasn't full of unprecedented events?! As in the last few months, I have taken the liberty of documenting the daily events of December in Appendix 2. I encourage you to go through it in your own time and hope you find it informative. It will help you realise what turbulent times we are living in.

Chart 1: Global market returns to 31 December 2008



What's on our radar screen?
We remain focussed on the changing economic landscape and list below a couple of developments in this regard – you will find more detail in Appendix 2, specifically on the economic data released during the month:

- *The state of BEE in SA:* an area that we are increasingly concerned about in South Africa is the state of black economic empowerment (BEE) deals. Many of these deals were premised on the sustained rise in underlying asset prices (most frequently listed share prices) and of course were highly geared. In many respects one could draw comparisons to the US sub-prime crisis and the SA BEE story. In a recent article in the Financial Times – and we have heard a similar "whisper" number in the SA financial community – current BEE deals are under water to the tune of about R250bn. Exactly what will happen when one or more of these deals collapse is anyone's guess, but there is a broad consensus (which we at Maestro share) that it is in no one's interest to see any of these BEE deals fail. This may yet turn into one of the big stories in SA in 2009.
- *The US economy*: as usual there is a great deal of US economic data that was published in December. It was universally bad but rather than share it with you here it will be included in the December Quarterly Report. In my opinion it is important that we go into some of the detail so that you can see and decide for yourself just how bad that economy really is. So more on this front in the next two or so weeks.

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

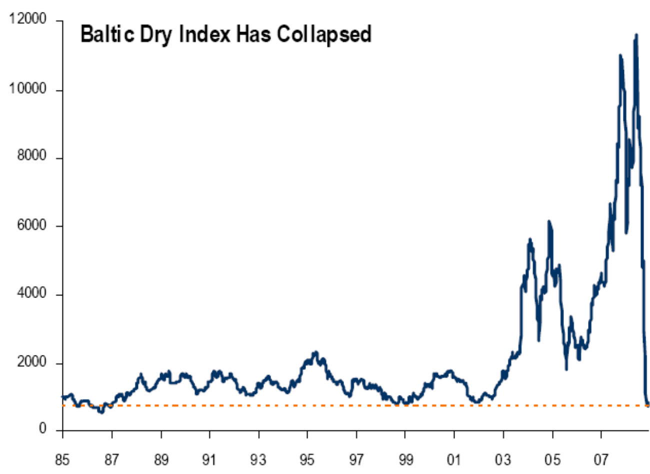
	Period ended	Month	Year to date	Year
Maestro Equity Fund	Dec	**2.5%**	**-26.2%**	**-26.2%**
Maestro equity benchmark *	Dec	1.1%	-21.1%	-21.1%
JSE All Share Index	Dec	1.5%	-23.2%	-23.2%
Maestro Long Short Equity Fund	Nov	**-6.7%**	**-32.0%**	**-32.5%**
JSE All Share Index	Nov	1.3%	-24.4%	-27.7%
JSE Financial and Indus 30 index	Nov	-2.0%	-20.7%	-23.5%
Central Park Global Balanced Fund ($)	Nov	**-0.3%**	**-18.7%**	**-19.8%**
Benchmark**	Nov	-3.5%	-22.8%	-23.3%

* 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

Chart of the month
We will be including many charts in our December Quarterly Report, most of which will be on the perilous state of the US economy. So rather than focus on pure

economics, I thought I would leave you with one chart which, probably more than any other, depicts the dramatic turnaround in fortunes of most markets in 2008. It shows not only the extent of the losses but also the speed with which things changed – a development that not only cost many people lots of money and some even their lives. The chart is that of the Baltic Dry Index, an index of the daily rate to hire a ship suitable for carrying dry goods such as iron ore. We have shown it before, although Chart 3 captures the full extent of its decline – well, *hopefully* the full extent. The latest reading on the index is 872, which is at least off its lows around 650.

Chart 3: The Baltic Dry index



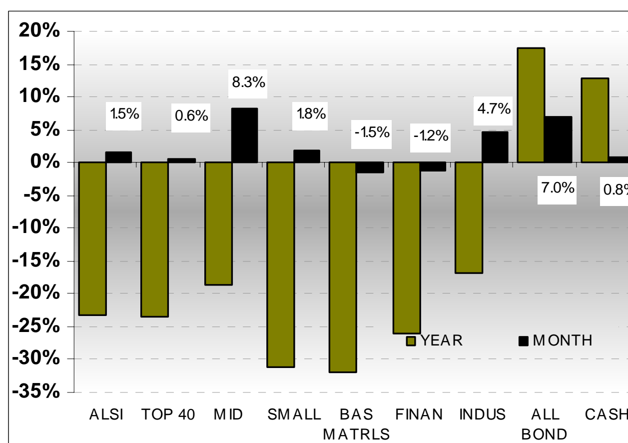
Source: Merrill Lynch

Hernias in hedge fund land

There are too many examples to isolate a couple in this regard, but you should be aware of the trauma currently taking place in the hedge fund world. Never in my career – not even in the darkest days of the LTCM crisis of 1998 – have I ever seen such poor returns, fund failures and general mayhem in the hedge fund space. Barring one catastrophic collapse there haven't been too many major fund implosions (excluding for a moment some really bad returns i.e. greater than -50.0%), which is more than can be said for the investment and general banking industry. Nevertheless hedge funds around the world have been feeling the powerful effects of de-leveraging, tightening liquidity and significantly greater volatility, much of it being experienced as whiplash. As redemptions increase, far too many funds are suspending redemptions i.e. not letting investors withdraw their funds, or simply winding down their funds and handing (usually only a fraction of) the assets back to investors. One hedge fund manager, referring to the extent of withdrawals from his fund, even described his fund as "an ATM machine". What has characterised recent conditions in the hedge fund space is the extent to which even the most highly regarded, large and or established investment managers have "given up" or taken the decision to close their funds. Some of the fine print clauses languishing on the latter pages of many a Memorandum have now kicked in, specifically those where, if a certain percentage of a fund is subject to redemption or if the fund's declines by a predetermined amount, then the fund needs to renegotiate borrowing terms with its prime broker. This alone has prompted many redemption suspensions. Many prime brokers – incidentally, banks viewed prime broking as a very attractive activity, as it generated very high fees for them in recent years - have used this event to impose more penal terms or simply get rid of the business altogether. One fund of hedge funds (in which Central Park has invested) has as a matter of principle served redemption notices on all its underlying funds, purely as a precaution ahead of possible penal redemptions terms being imposed by the underlying funds – such is the chaos in the hedge fund world right now.

Then of course there was the announcement, which was really the cherry on the top of an *annus horribilus* for the hedge fund world, by hedge fund "doyen" and past chairman of the Nasdaq Bernie Madoff that the fund he had been operating for more than 20 years was "all just one big lie" and was in fact a huge Ponzi scheme. The latter refers to a scam wherein the cash from recent investors is used to pay bogus returns to existing investors. Madoff made the dramatic revelation to his sons after receiving redemptions for $7bn of his $17bn fund. Madoff estimated that he has lost about $50bn of client funds over the duration of his scam. To say that the US financial community and the hedge fund community at large were left speechless would be an understatement!

Chart 2: Local market returns to 31 December 2008



December in perspective – local markets

Despite quite a bit of volatility SA investment markets ended the year on a positive note. Taking its lead from the weak dollar, the rand gained considerable strength – it rose 8.9% against the dollar – which assisted industrial shares (+4.7%) but placed resource shares (-1.5%) under a bit of

pressure. There was also a rather unusual disparity between the 8.3% return of the mid cap index and the 1.8% return from the small cap index. The All Bond index rose 7.0%, mirroring strong offshore bond markets, bringing its annual return to 17.5%. The largest monthly JSE sectoral returns came from household goods up 24.9%, non-life insurance 16.6% and food and drug retailers 14.6% while the oil (-2.5%), pharmaceutical (-3.5%) and general mining (-4.2%) sectors brought up the rear.

Quotable quotes

American vampires drank the blood from their financial system and have tried to infect countries all over the world. Working capital as well as investment funds are very difficult to obtain. Some banks are just sitting on their cash and are not performing their function of lending. So we need some injection against this vampire disease. *Alexander Medvedev, deputy CEO of Gazprom, Russia's state-controlled gas group.*

The (Bernie Madoff) scandal shows that (SEC) inspector-level staff have not received enough training to enable them sufficiently to check for fraud. The people doing the examinations have no clue what the right questions are to ask. Going in and asking questions out of a manual doesn't help you understand how a business works. *Bill Brodsky, CEO of Chicago Board Options Exchange (CBOE)*

Owners of capital will stimulate the 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 the State will have to take the road which will eventually lead to communism. *Karl Marx 1867*

The fact is that recent economic numbers have been terrifying, not just in the US but around the world. Manufacturing, in particular, is plunging everywhere. Banks aren't lending; businesses and consumers aren't spending. Let's not mince words: this looks an awful lot like the beginning of a second Great Depression. It turns out, however, that preventing depressions isn't that easy after all. Under Mr Bernanke's leadership the Fed has been supplying liquidity like an engine crew trying to put out a five-alarm fire and the money supply has been rising rapidly. Yet credit remains scared and the economy is still in free fall. Here's my nightmare scenario: it takes Congress month to pass a stimulus plan and the legislation that actually emerges is too cautious. As a result the economy plunges for most of 2009, and when the plan finally starts to kick in, it's only enough to slow the descent, not stop it. Meanwhile, deflation is setting in, while businesses and consumers start to base their spending plans on the expectation of a permanently depressed economy – well, you can see where this is going. So this in our moment of truth: will we in fact do what necessary to prevent "Great Depression II?" *Paul Krugman, professor of economics and international affairs at Princeton University and recipient of the 2008 Nobel Prize for Economics.*

File 13 – things almost worth remembering

You may recall that in Appendix 3 of the November edition of *Intermezzo* we brought the bizarre events surrounding Porsche's "manipulation" of the VW share price to your attention. The event was so bizarre and on such a scale that we suspected at the time the ramifications would last quite a while. As you would have seen from events documented in subsequent *Intermezzo* editions, this episode is not over by any means. The latest news surrounding the VW debacle, at least in the "winner's camp," is the fact that, during the crazy run-up in the VW share price from EUR150 in January and 200 in September to 1005 in October, five VW executives sold some of their shares, pocketing $37.1m in the process. They have signalled their intention to donate 10% of their personal profits from the sales to a charity in Wolfsburg. Apparently "large parts of the workforce" also sold shares, netting a substantial amount in the process.

Then in the "loser's camp" the subsequent mess that Adolf Merckle found himself in as a result of having bet that the VW price would go down i.e. he was on the receiving end of Porsche's manipulation, only gets worse. Merckle was one of Germany's wealthiest men, controlling an empire that includes Heidelberg Cement, Ratiopharm, Germany's largest generics drugs maker and Phoenix, the country's largest drugs wholesaler. Adolf Merckle incurred a large "triple-digit million euro loss" betting on a decline in the VW share price. In talks with his bankers to avert a liquidity squeeze he had to lodge the stakes in his businesses as collateral for his loans. In effect banks could sell some or all of his company stakes – all just because of the VW debacle. What a high price to pay for a moment of market madness. Of course there are as many views as to who the victim and perpetrators are, as there are parties involved in this ugly mess. So far the German regulator, Bafin, remains terribly quiet and the VW share price has declined to EUR 354.

Porsche continues to dispute that it manipulated the market and has indicated it fully intends to continue its hectic trading activity in the VW share. However, the final and tragic chapter in this bizarre tale, at least from Merckle's point of view, came on 5 January, when the Merckle family released news that Adolf Merckle had committed suicide in his home town in Germany. He leaves behind a large, if not controversial legacy, but more importantly his death forced the investment community and large parts of the German community in particular to come to terms with the effects of the credit crisis and the possible outcome on the lives of market participants when things go horribly wrong.

From the tragic to the ridiculous, comes the following chapter from the book "They really don't get it, do they?" It was rumoured that Merrill Lynch CEO John Thain, who took over the helm at the beginning of 2008, made a strong case for receiving a $10m bonus (that's a one-year bonus of R100m). Now one can argue this matter, for and against, from many angles, but under the current, unprecedented circumstances, even making the case for any bonus at all seems a bit rich when you consider the following: the Merrill Lynch share price declined 78.0% in 2008 and 88.0% from its 2007 peak; Merrill's has written down $28.5bn of assets in the first three quarters of the year - compare that to the market cap of Merrill Lynch of $12bn in November, just prior to its delisting– not to talk of the thousands of employees who have been laid off. And of course Merrills was one of the first recipients of the billions handed out from TARP – it received no less than $10bn. Even just the idea of a bonus for Thain seems so out of place it is hard to believe the man was serious. In the end, sanity prevailed and he decided to forego his bonus. I should add, in fairness to John Thain, that the $10m bonus he first envisaged pales in comparison with the actual $162m (R1.62bn) payment that was handed to Stan O'Neal, the Merrill Lynch CEO who departed in October 2007, just before the proverbial hit the fan!

In an even more astonishing chapter in the same book "They really don't get it, do they?" outgoing US Treasury Secretary Paulson said that in the years leading up to the (credit) crisis, super-abundant savings from fast-growing emerging nations such as China and oil exporters – at a time of low inflation and booming trade and capital flows – put downward pressure on yields and risk spreads everywhere. This, he said, laid the seeds of a global credit bubble that extended far beyond the US sub-prime mortgage market and has now burst with devastating consequences worldwide.

What makes Paulson's comments so astonishing is the total absence of any admission that US excesses played any role whatsoever in the current financial crisis. To be honest I have not read anywhere, or heard from any authoritative US "voice" the admission that by living way beyond its means for decades the US, both as individuals and as a nation, was even remotely responsible for the mess. Now we hear from none other than the US Treasury Secretary that the credit crisis was the fault of China and those who had the good sense to actually save money and live within their means, rather than borrow and then spend it!

And finally, to place last year's equity market behaviour in perspective, consider the following: just more than a year ago Royal Bank of Scotland (RBS) paid $100bn for ABN Amro, 80% of which was paid for in cash. For this amount, RBS could today buy all of Citigroup, Morgan Stanley, Deutsche Bank and Barclays.

But of course that is after all these banks have posted large gains since their November lows. Consider this: when the market was trading around its lows in November, for the same $100bn RBS could have bought Morgan Stanley for $10.5bn, Citigroup $22.5bn**,** Goldman Sachs $21.0bn, Merrill Lynch $12.3bn, Deutsche Bank $13.0bn and Barclays $12.7bn … and still have had $8bn change!

Table 2: MSCI Emerging Market December returns (%)

	2008	Q4 08	Dec-08
EM countries/regions			
Morocco	-13.0	-12.8	4.1
Colombia	-27.7	-18.8	8.5
Israel	-30.9	-22.0	3.8
Chile	-37.3	-26.3	2.1
South Africa	-40.0	-16.9	13.5
Peru	-42.4	-16.4	17.3
Malaysia	-43.4	-14.2	6.0
Mexico	-44.0	-30.2	4.6
Czech	-45.1	-31.2	4.6
Taiwan	-48.7	-24.0	5.0
Thailand	-50.3	-27.0	13.9
China	-51.9	-11.0	10.5
LatAm	**-52.8**	**-34.8**	**2.4**
Philippines	-53.8	-25.7	-1.2
Egypt	-53.9	-32.8	16.6
Asia	**-54.1**	**-21.7**	**11.2**
EM	-54.5	-27.9	7.6
Argentina	-55.3	-44.3	-2.0
Korea	-55.9	-26.5	19.8
Poland	-56.2	-39.1	4.4
EMEA	**-56.7**	**-34.0**	**4.4**
Indonesia	-57.6	-34.1	24.2
Brazil	-57.6	-38.2	0.8
BRIC	**-60.3**	**-30.6**	**4.6**
Hungary	-62.4	-46.7	3.1
Turkey	-63.4	-37.5	6.3
India	-65.1	-30.1	9.6
Russia	-74.2	-51.3	-7.8
Pakistan	-75.4	-51.1	-50.5

Source: Merrill Lynch

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Appendix 2: Chronicles of chaos – Part 4

Given that there is still so much happening on a day-to-day basis in global investment markets, we thought it appropriate to record the salient features of the month's activity in a fashion similar to the manner in which we recorded it in the past few editions of *Intermezzo*.

Monday, 1 December:

- ISM manufacturing index hits a 26-year low
- S&P500 falls 8.9% after a huge week at the end of November. For example, last week alone the S&P Financials index rose 31.4%, with individual gains in JP Morgan of 39.3%, Bank of America 41.7%, Morgan Stanley 46.8% and Goldman Sachs 48.2%. Back to 1 December though, as reality kicks in the S&P Financials index falls just more than 17%, Citigroup ends 22.2% down, JP Morgan 17.5% and Morgan Stanley 23.1%. The Dax, UK and JSE fall 5.9%, 4.4% and 4.6% respectively.

Tuesday, 2 December:

- US auto sales decline 3.6% month-on-month, including a 10.9% decline in car sales. Domestically (US) manufactured car sales are now at a 50-year low. No wonder the Detroit three are pleading before Congress for more money!
- The US market recovers a bit, up 4.0% (S&P Financials up 7.9% - who said this market was for sissies?) but the JSE falls 2.6%. Elsewhere markets end lower. Japan falls 6.4%, Hong Kong 5.0% and Australia 4.2% despite the Reserve Bank of Australia cutting rates by another 1.0% to 4.25%.

Wednesday, 3 December:

- ISM non-manufacturing index hits an all-time low in this series, which was set up 11 years ago
- Despite the ISM news equity markets end up on the day.

Thursday, 4 December:

- The Swedish central bank cuts rates 1.75% to 2.0%
- The Danish central bank cuts rates by 0.75%
- The New Zealand central bank cuts rates by 1.5% to 5.0%
- The BoE cuts rates by 1.0% to 2.0%, the lowest rate in 50 years. The next time the BoE cuts its rates it will be to the lowest rate ever since the central bank was formed in 1694, when William III of Orange ruled the Kingdom.
- Sterling hits a 6 ½-year low against the dollar (1.4471) and an all-time low against the euro
- The European Central Bank (ECB) cuts rates by 0.75% (the biggest cut ever in its history) to 2.5%
- The German 10-year Bund (bond) hits a 48-year low of 2.94%, the UK 10-year bond hits a 50-year low of 3.32% and the US 10-year bond hits a 53-year low of 2.54%.

Friday, 5 December:

- The Indonesian central bank cuts rates by 0.25% to 9.25%
- US jobs data show a decline of 533 000 jobs in October - the worst monthly decline in 34 years. September's data is revised from 240 000 to 320 000. Unemployment remains at 6.7%. When revisions to September and October are taken into account the number of jobs lost increases to 733 000. December's jobs data will go on to reveal that 2.6m jobs were lost in the US during 2008, the most since 1945.
- Despite the bad jobs data the US market ends up 3.7%, having traded in a range of 7.7% on the day (it touched an intraday low of 818 for the umpteenth time). *For the week* the Dax declines 6.2% and UK 5.6% and the SA equity market a nasty 9.1%.
- Oil declines sharply on the day to end close to $40 and down 25% on the week. It is now off some 73% since its July peak of $147.
- India cuts rates by 1.0% to 6.5%.

Monday, 8 December:

- Despite the bad jobs data Asian and European markets end up strongly on the back of weekend talk by US President elect Obama about a massive fiscal package, biased in favour of infrastructure, to resurrect the US economy. Japan ends 5.2% higher, Brazil 8.3%, France 8.7%, Germany 7.6% and London 6.2%. The SA market registers one of its strongest days ever, rising 7.1% on the back of a rampant resource sector.
- Honda announces that it is pulling out of Formula 1 motor racing

Tuesday, 9 December:

- Slovakia cuts rates by 0.75% to 2.5%.
- Canada cuts rates by 0.75% to 1.5%.
- The sharp two-day rally on the US equity market comes to an end, as FedEx issues a profit warning and ends the day down 14.5%. European markets and the JSE end a bit higher.

Wednesday, 10 December:

- Chinese exports declined 2.2% in November, the first decline in seven years. Imports declined by an ever larger amount, 17.9%, helping push the monthly trade surplus to $40bn. The surplus was the fourth record (surplus) in a row and is testimony to the extent to which Chinese domestic demand is slowing.

- Chinese inflation declined to 2.4% in November from 4.0% in October and 8.7% in March.
- Indian car sales recorded their biggest monthly fall in eight years. Car sales dropped 19.4% in November (to 83 059) from the previous year. Truck sales fell 50.0% to 20 637, the worst decline in ten years.
- In the currency market sterling falls to a record low against the euro and to its lowest trade-weighted level since records began in 1981.
- Partly spurred by the news of a possible government bail-out of the US auto industry, the dollar falls to a two-week low, helping gold move above the $800 level; it ended at $813, dragging the JSE gold index up 7.9% in the process.
- The JSE gets a boost from a weaker dollar and higher gold price, ending up 4.7%. Financials rise 2.3% but resources lead the charge, ending up 8.2% (Billiton +11.5% and Anglo 7.7%).

Source: Ingram Pinn, Financial Times

Thursday, 11 December:

- Korea cuts rates by 1.0% to a record low of 3.0%
- Taiwan cuts rates by 0.75%.
- The SA Reserve Bank cut rates by 0.5% to 11.5% - its first cut in 3½ years.
- Uncertainty about the US auto industry continues to plague investor confidence. After an unexpected widening in the US October trade deficit and US initial jobless claims rise to a 26-year high, the dollar comes under pressure. It declines to a six-week low against the euro of 1.3231 and a seven-week low against the yen of 91.80. Sterling continues to decline, falling to another all-time low against the euro of 0.8856.
- The weaker dollar boosts commodity prices; the oil price rises above $49 after closing at $43.52 the day before and gold rises as high as $835, closing above the platinum price for the first time since 1996.
- Russian devalues the rouble by another 1% - the fifth such reduction in a month – after their foreign exchange reserves decline by $17.9bn in a week. Russia's reserves have now declined by 27% to $437bn since peaking close to $600bn in August.

Friday, 12 December:

- The US and its arduous political labyrinths continue to hold global investors by the "short and curlies". Despite having the brakes slammed on the government's bail out of the US auto industry, it now looks as though the US Treasury might step in at the last minute to prevent the biggest corporate failure in US history. But the indecision is taking its toll in investor sentiment and confidence; the London market ends down 2.5% on the day, Germany 2.6%, Japan 5.6% and the JSE 1.8%.
- Sterling continues to decline against most currencies and the dollar hits a 13-year low against the yen, at 88.34. The yen has risen 17.0% against the greenback since August; a firm yen undermines Japanese exporters' competitiveness.
- And then, as though there wasn't enough bad news in 2008, the financial establishment, particularly in the US, is shocked by the revelation by Bernie Madoff, one of the "doyens" of the global hedge fund industry and past chairman of the Nasdaq stock exchange, that his hedge fund operation is "all just one big lie;" he estimates that over the years he has lost more than $50bn of client funds. Eish!!

Source: Ingram Pinn, Financial Times

Monday, 15 December:

- The dollar remains under pressure ahead of the Fed's Open Market Committee (FOMC) meeting to decide future interest rates. It declines to a two-month low against the euro of 1.3679. Sterling hits a fresh record low against the euro, at 0.9022, the first time in history that it has breached the 0.90 level.
- The oil price briefly rises above the $50 level and gold rises to $840 on the back of the weak dollar.

- Japan recovers some lost ground, rising 5.2% and Hong Kong 2.0% although European markets end flat. In Pakistan the Karachi stock exchange falls 4% after the authorities lift a “floor” they placed on the index four month ago despite three quarters of the stocks not trading.
- Chinese industrial output rises “only” 5.4% in November, from 8.2% in October – more evidence of the sharp slowdown in the economic activity. This is the lowest rate of increase since the series began in 1994.
- Ecuador defaults on its bonds despite the fact that it has sufficient reserves to repay the debt. President Rafael Correa says that the bonds in question were contracted “illegally” by the previous administration (*Ed*: Mmm, now imagine if Barrack Obama took that view!)
- Iraqi journalist Muntazer al-Zaidi rose to fame yesterday and became an instant hero to millions of Iraqis after throwing his shoes (regarded as the ultimate insult in the Arab world) at US President George Bush during a news conference. Al-Zaidi now faces five to fifteen years in jail if found guilty in an Iraqi court where he is currently being tried.

Source: Ingram Pinn, Financial Times

Tuesday, 16 December:

- Welcome to the land of ZIRP! Its official – the US now officially has a Zero Interest Rate Policy. In an historic move, the Fed lowers its target Fed fund rate from 1.0% to “a target range between zero and 0.25%” in effect signalling that it is no longer able to use interest rates as a tool of US monetary policy. It also signals its expectations of a very low fed fund rate for some time.
- The dollar weakens sharply on the back of the Fed’s decision. It declines between 1% and 2% against most currencies, ending at 1.40 to the euro and 89.31 to the yen. Yields on US Treasuries fall to historic lows.
- As if to underline the need for dramatic action, US headline inflation declines 1.7% in November, while core inflation (which excludes food and energy prices) stays flat. The rate of decline in headline inflation during the past four months is now -9.9% - its sharpest decline since 1938. The annual US (headline) inflation rate is now 1.0% - it’s lowest in 44 years. Annual core inflation is 2.0%. In addition, housing starts fell to a record low in November.
- US markets like the Fed’s move – the S&P500 rises 3.8% to 913. Germany rises 1.6% (but of course was closed by the time the Fed’s decision was made). The JSE gains 2.0%.
- Goldman Sachs reports a $2.1bn quarterly loss – its first loss since going public in 1999. The bank’s seven top executives agree to forego their bonuses this year.
- In a sad chapter to the developing Madoff scandal, French money manager Rene-Thierry Magon de la Villehuchet commits suicide in his New York office. His Fund, Access International Advisors, invested $1.5bn into Madoff’s fund.

Wednesday, 17 December:

- The dollar continues its slide after the Fed’s historic interest rate decision, falling to a 13½ -year low against the yen of 87.77 and a ten-week low against the euro of 1.4322. Sterling also continues to slide, falling to another all-time low against the euro of 0.9292.
- US bond markets rise strongly as yields fall to record lows for the second consecutive day; the yield on the 2-year US Treasury falls to 0.61%, the 10-year yield hits 2.08% and the 30-year bond declines to 2.58%. Yields have not been this low since 1954 when the Fed started keeping records.
- The weak dollar jettisons gold above $870. It reaches a high of $881 on the day but the dollar weakness is of little use to the oil price. Despite an OPEC decision to cut production by 2m barrels a day, oil (WTI January futures contract) falls to a four-year low of $40.22.
- Russian devalues the rouble yet again; the rouble declined 1.2% against a basket of currencies, bringing to seven the numbers of times the central bank has devalued the rouble in the last two months. Russia’s forex reserves have declined $161bn since August, largely due to the central bank trying to support the currency in the face of massive foreign capital withdrawal.
- Norway’s central bank cuts rates by 1.75% to 3.0%
- Morgan Stanley reports a $2.2bn loss for its fourth quarter.

Thursday, 18 December:

- The euro continues to gain strength – at one stage it rose above 1.47 to the dollar and 0.9556 to the pound. The weak dollar fails to prevent a further slide in the price of oil – it declined below $38 for the first time since July 2004.

- 70-year old Calisto Tanzi, former head of Italian diary group Parmalat, which collapsed in a pile of debt five years ago, is sentenced to 10 years imprisonment by a Milan court.

Friday, 19 December:

- The Bank of Japan cuts interest rates to just 0.1%
- The price of oil falls below $34, bringing its weekly decline to 23% - it's biggest ever.
- Money managers in the US have a problem: about 1 in 10 money market mutual funds (unit trusts) are not generating any yield (income) due to the dramatic decrease in US Treasury yields. With about $3.8 trillion in assets under management, the average yield on a Treasury money fund of about 0.34% is less than what it costs to run the funds. Some funds are closing and some are closed to new investors. Some managers are considering lowering their fees or imposing an extra fee on investors, over and above what the fund earns. Interesting times indeed.
- The sorry tale of Bernie Madoff's massive hedge fund fraud widens as numerous banks, particularly in Europe, and high profile US investors announce losses after having invested into Madoff's fund. At the time of writing, about $48bn in losses has already been identified yet Madoff continues to walk the streets of New York, a free man, enjoying the benefits of his luxury penthouse.
- The Madoff scandal is creating all sorts of headaches for firms that compile hedge fund indices. Some of Madoff's feeder funds were included in some indices, leaving them with the problem of either taking a once-off hit or trying to smooth the losses by back-dating them.

Monday, 22 December:

- China cuts rates for the fifth time in three months by 0.27% to 5.31%. The one-year deposit rate is lowered by the same amount to 2.25%. The reserve ratio for banks i.e. the amount of funds banks must retain at the central bank is cut by 0.5%.
- In further evidence of the global economic slowdown, Japanese exports decline the most on record. November exports declined 26.7% from the previous year and imports fell 14.4%, leaving Japan with a trade deficit for the second consecutive month. The last time this happened was in 1980.
- Toyota warns that it is heading for its first loss in 70 years, sending the share prices of automakers around the world sharply lower. GM falls 21.6%, Ford 12.2% and VW 5.9%. The US equity market ends down 2.1% and European markets and the JSE about 1%.
- Sterling remains under pressure, falling to a new low against the euro of 0.9469.
- Oil trades close to a five-year low of $32.40.
- European bond yields fall to record lows but US yields rise marginally. The 2-year Schatz now yields 1.78% and the US 2-year bond a miserly 0.81%.

Tuesday, 23 December:

- The Chinese equity market ends 4.6% lower – seems like investors were less than impressed by the yesterday's rate cut.
- US home sales slump 8.6% in November and the median price falls 13.2% from a year ago – the biggest decline on record. In addition US consumer spending during the third quarter declined 3.8% - the biggest drop since 1980. US third quarter GDP is confirmed at 0.5%. This is likely to be the last positive GDP number from the US for some time.
- UK third quarter GDP is confirmed as -0.6% - the largest decline since December 1990. Sterling moves to a new low against the euro on the news.
- Auto manufacturers around the world remain under pressure as investors digest the enormity of Toyota's announcement. GM ends 14.8% lower on the day and Ford 15.4%.
- The price of cocoa hits a 23-year high on concerns about dwindling supplies out of the Ivory Coast, the world's largest producer.
- Beijing sends Taiwan two giant pandas, Tuan Tuan and Yuan Yuan, whose names combine to mean "reunion" in Chinese, in a gesture of goodwill, highlighting the thawing of relations between the two countries.

Thursday, 25 December:

- A large part of the world celebrates the anniversary of the birth of Jesus Christ some 2 000 years ago. It provides time to reflect on a truly remarkable year, to express gratitude and appreciate anew life's special gifts in the form of friends and family.
- In a shortened week, quite a bit of damage was done to some markets, particularly in Asia. Hong Kong and China end the week down 8% while South Korea and Taiwan drop more than 5%. The Karachi market in Pakistan has now lost more than a third of its value since the government lifted the floor it imposed on the market two weeks ago in an effort to stop it from falling further - so much for government intervention.

Monday, 29 December:

- Israel begins air strikes against Hamas in the Gaza Strip over the weekend, escalating tensions in the region.

Tuesday, 30 December:

- Gold rises to $889 at one stage and oil edges higher (it rose more than 12% at one stage during the day) in response to rising tensions in the Middle East.
- Sterling falls to a new low of 0.9799 to the euro, bringing its decline to 17.0% so far this month, and moves lower against virtually all other currencies. The dollar falls 1.4% to the dollar, to 1.4256. Russian takes advantage of the weak dollar to devalue the rouble yet again. It eased 1.8% against the euro/dollar basket, its ninth mini-devaluation in the past month.
- The UK equity market ends up 2.4% on the back of firmer miners and Germany's Dax rises 1.6%.

Wednesday, 31 December:

- US consumer confidence falls to a record low of 38; the index was at 90.6 a year ago.
- Europe prepares to celebrate the euro's tenth anniversary. The single currency was born on 1 January 1999 amidst great scepticism and controversy.
- In Japan the equity market ends 1.3% higher but ends the year down 42.1%, its biggest annual decline ever. The Hong Kong market ends 2008 47.4% lower and in China the Shanghai Composite index ends down 65.4%. The London market ends 31.5% down, its worst annual decline on record since the FTSE 100 index was created in 1984. The S&P500 ends down 37.1%; if one excludes income the index declined 38.5%, just 0.1% above the 38.6% decline in 1937. The Dow Jones's 2008 decline of 32.4% is the largest since 1931's 52.7% decline. The MSCI World index ends 2008 with a loss of 42.1% and the MSCI Emerging market index 54.5%. Spare a thought for Russian and Iceland, whose equity markets lost 72.4% and nearly 95% respectively! In stark contrast the government bond market rose 9.7% in December, bringing the annual rise in the Citi World Government Bond index to 10.9%.
- US investors pull a record $320bn out of mutual funds. $234bn flowed out of equity funds, $58bn out of bond funds and $28bn out of balanced funds. However, $422bn flows into money funds, bringing to $4.72 trillion the total assets in money funds – this, despite the fact that most of these funds no longer pay any yield (income).
- Veteran anti-apartheid campaigner Helen Suzman dies peacefully in her sleep at the age of 91. She was awarded more than 20 honorary doctorates from international institutions, received the United Nations award of the International League for Human Rights, was made a Dame of the British Empire and was twice nominated for the Nobel Peace Prize.
- And so the woes of 2008 come to an end.

Source: Ingram Pinn, Financial Times

Appendix 3 – Extracts from articles of interest

One of the benefits of the Silly Season is that I get to read more articles and reports than usual. I consequently have a load of interesting perspectives and thoughts to share with you, but space precludes me from sharing all of them. However, the following edited selections are worth reading.

The first is an extract from an article entitled *Only new thinking will save the global economy* by **Mohamed El-Erian**, published in the Financial Times on 4 December. El-Erian is co-chief executive and co-chief investment officer of Pimco (the largest bond manager in the world) and author of *When Markets Collide: Investment Strategies for the Age of Global Economic Change*, which won the 2008 FT/Goldman Sachs business book of the year award.

> "History books will document that the global economy experienced a sudden stop after September 15. In accentuating long-standing structural weaknesses, the manner in which Lehman Brothers failed disrupted the trust that underpins the smooth functioning of market economies. As a result, virtually every indicator of economic and financial relationships exhibits characteristics of cardiac arrest. The situation will get worse before it gets better and it will only get better if there is a shift in thinking in both the private and public sectors: away from comforting yet unrealistic notions of a return to "business as usual" and towards the more nasty reality of a volatile journey to a different destination. The implications are far-reaching as they speak to more market accidents, disorderly sectoral realignments and additional shifts in policy. Up to September 15, debate focused on moral hazard, or the extent to which government bail-outs encourage irresponsible behaviour. The need to signal the government's seriousness about market discipline partly drove the decision to let Lehman fail. What was less well understood was that it matters a great deal how an institution's failure affects the capital structure. The way Lehman failed disrupted payments and settlements. Around the world, market participants stepped back in mass from what, up to then, were standardized, routine, predictable transactions. Not surprisingly, all main indicators are now violently heading south…. What we are witnessing goes well beyond a cyclical economic shock and a consolidation of the financial sector. We are also in the midst of a prolonged increase in precautionary behaviour among entities that have suffered massive wealth destruction and face a multi-year clean-up of assets and businesses. Without further adjustments, there will be an aggravation of the negative feedback loops that have been so detrimental to global welfare. It is time to suspend unquestioned faith in a quick return to the past and adjust to the reality of change. The shift in thinking means spending less time looking for a market bottom and more ensuring that cash and collateral management keeps pace with disruptions that are global in nature and indiscriminate in impact. It calls on policymakers to eschew simple local optimization between policy alternatives (for example, capital injections versus asset purchases) for a holistic response – including more of what we saw … in the US in the form of large coordinated multi-agency steps to compensate for dysfunctional credit markets. Aggressive government involvement runs counter to the basic tenets of a market system. It should be minimized. But, when it is required because of massive and cascading market failures such as those of today, it should be subject to these principles (*specified earlier in his article*). The weaker the adherence to such principles, the greater the cost to human welfare and the lower the likely effectiveness of any policy action. Coming to grips quickly with this brutal reality is crucial for safeguarding the longer-term sustainability of market mechanisms, both domestically and globally".

Here's a short extract from an article by **Nouriel Roubini**, who is professor of economics at the Stern School of Business, New York University. The article *How to avoid the horrors of "stag-deflation"* was published in the Financial Times on 3 December. I would hasten to point out, before you read the article, that Prof Roubini is known to be an arch-bear i.e. he is typically gloomier than most at the best of times. His article elicited strong criticism from many readers following its publication.

> In the next few months the flow of macroeconomic and earnings news will be much worse than expected. The credit crunch will get worse, with de-leveraging continuing as hedge funds and other leveraged players are forced to sell assets into illiquid and distressed markets, leading to further cascading falls in prices, other insolvent financial institutions going bust and a few emerging market economies entering a full-blown financial crisis. The worst is not behind us: 2009 will be a painful year of a global recession, deflation and bankruptcies. Only very aggressive and coordinated policy actions will ensure the global economy recovers in 2010 rather than facing protracted stagnation and deflation.

I also came across a very useful summary of some of the salient causes and features of the 1929/30 Great Depression in an economic report by Deutsche Bank published on 26 November 2008. Why such material and content should even be of interest to us should be self-evident to any investor who survived 2008 or who has been reading Maestro's output during the past few months. The extract from the Deutsche Bank article reads as follows:

A key reason (albeit not the only one) for deflation in the 1930s was that private-sector balance sheet contraction caused by debt deflation was left to run its course for a considerable period without government intervention. As stock prices tumbled as of October 1929 the value of collateral pledged to obtain credit crumbled. Being credit constrained, borrowers defaulted on their obligations, debt had to be written off, and new credit was not forthcoming. Bankrupt companies laid off workers and unemployment soared. Since unemployed workers' incomes were not backstopped by a social safety net, the drop in output due to bankruptcies induced a commensurate decline in demand. To protect sales, companies cut prices. Falling prices further weakened demand as consumers postponed spending in anticipation of further price declines. Accordingly, between 1929 and 1933 real GNP dropped by 30%, the unemployment rate rose by 22 percentage points to 24.9%; and the consumer price index dropped by 24.4%. The downward spiral was halted only after newly elected President Roosevelt introduced a social safety net (the "New Deal") in 1933. By supporting the unemployed, the government in effect put a floor under consumer demand and ended the vicious spiral of declining output, rising unemployment, falling demand, and falling prices. The "New Deal" kept the economy afloat and gradually reduced unemployment (from peak levels to still high levels) for much of the rest of the 1930s. But a strong rebound did not occur until the government stepped up defense spending massively ahead of entry into WWII in December 1941. Between 1940 and 1943 the civilian unemployment rate plunged from 14% to less than 2%.

I have often quoted from **Philip Stephens** in the previous *Intermezzo* editions; a regular Financial Times columnist, he wrote a thought provoking article in the paper on 18 December entitled *Advice for seasonal seers: future is not in the stars,* which challenges readers to reflect on the past and realise just how difficult it is to read the present. Herewith an extract from the article:

> One of the things we might have learned from the tumult of 2008 is just how quickly the unthinkable can become the unremarkable … If there is anything that has united the two halves of the year, it has been the extent to which conventional wisdom has provided a wholly inadequate explanation of events. Official responses to the successive crises that would once have seemed eccentric are now mainstream. The bigger lesson has been about how hard we find it to peer into the present. Economic inter-dependence and the shift in relative power to the rising nations of the east have been a commonplace in our discourse for some time. It is only this year that we have begun to see what the changes mean. On the financial front, the message has been about the failure of political governance to keep pace with the integration of global markets; governments, central banks and regulators have simply failed to keep up with the ever-tighter interconnections between markets. The result? A contagion whose virulence has surprised even those who had the prescience to foresee the threats inherent in the financial alchemy that turned sub-prime mortgages into seemingly triple-A-rated financial instruments. The geopolitical story has been one of more tables turned. Until this year financial crises were things that happened to "them" – to Latin America, Asia, Russia and Africa. The credit crunch was made in the west – a story not of the irresponsibility of the emerging world but of the profligacy and regulatory failures of the most advanced nations. This time the rising states were the creditors, the west the debtors. There lies the wider context for the truly extraordinary events of 2008 – a world in which the established order has cracked in response to the changing pattern of power. Everyone sees the rise of China and India, America's relative decline and the inadequacies of the international system. Now we know something of what this passing of the post-cold war world means in practice. The chaos speaks to a world in which the west is surrendering centuries of economic and political hegemony; to a globalization that has at once weakened nation states and demanded more of them; and to an emerging multi-polar system that has broken the multilateral boundaries of the old order. We talk about it, but have not properly understood it. There is no harm in looking for the future in the stars – but we are more likely to find it in the present.

Some of you may be aware that in December China celebrated the 30th anniversary of its market reform. Although Maestro doesn't fully subscribe to all the views of the author and would interpret some of the facts differently, the following article sheds useful light on a process that has fundamentally changed global economic history and will most surely influence its future. What follows is **David Pilling**'s full article, entitled *China's 'warp-speed' industrial revolution* which appeared in the Financial Times on 18 December.

> Mao Zedong was right all along. Deng Xiaoping was a "capitalist roader". Thirty years ago this week, at the catchily named third plenum of the 11th party congress central committee, Deng wrested power from the old guard loyal to Mao and launched China on the path of market reform.
>
> Of course, history is never so clear-cut. Struggle and counter-struggle had been raging within the Communist party since Mao had died two years earlier. Deng, forced

to work at a tractor factory during the Cultural Revolution because of his "rightist" tendencies, had long believed rigid communist ideology and overweening state interference were leading the economy down a dead end. Yet today is as good a time as any to take stock. Deng's China, to this day a pragmatic blend of capitalism and communist state control, has lasted 30 years. That is one year more than Mao's China, born in 1949 with the victory of the Red Army and subsequently dragged through the madness of the Great Leap Forward and the Cultural Revolution. What have those 30 years brought to China and to the world?

A degree of economic prosperity, undoubtedly. By 1978, China had begun to recover from the brutal distractions of the later Mao years. By dint of its sheer scale, it was already the world's 10th largest economy. But annual income per capita was still pitifully low at $190, making it, according to the National Bureau of Statistics, 175th in the global pecking order. Three decades of compounding nearly 10 per cent annual growth has brought income per head to about $2,500, and much higher than that on the prosperous eastern seaboard. Although that still ranks only 132nd – other countries have not stood still either – China has become the world's fourth biggest economy, second on a purchasing power parity basis.
As a trading nation, China has gone from 27th to third. It runs trade surpluses with the US far larger than those Japan mustered in the late 1980s when one US congressman made a show of smashing a Toshiba radio cassette recorder in protest at the rising economic threat from Tokyo.

China's warp-speed industrial revolution – "a compression of developmental time" in the phrase of James Kynge, whose book *China Shakes the World* captures the historical significance of its rise – has transformed the global economy. Its foreign reserves, at nearly $2,000bn, are easily the largest in the world, providing the liquidity that helped inflate the global bubble. Its export of cheap goods has allowed the world to consume far more than it once did. On the demand side, China's ravenous appetite for steel, iron ore, coal, petroleum, grains, oilseeds and so on pushed prices to vertiginous heights until its abrupt economic slowdown this year helped bring them crashing down again.
Yet the process by which these astonishing changes have occurred owes as much to accident and experiment as to grand design. Deng likened his non-ideological, gradualist approach to "crossing the river by feeling for the stones". Many of the so-called market reforms were little more than giving space – often by turning a blind eye – to what China's entrepreneurial citizens were already doing. The month before Deng seized control, 21 farmers in Xiaogang village in eastern Anhui province concluded a secret pact to divide their communal land into individual farms. So daring was their act that they made provision to look after each other's children should they be arrested. A few years later an estimated 300m rural households were parceling out land, often regaining control over plots to which their ancestors had held title for generations.

The same happened in industry, where so-called "red hat" capitalists set up private businesses in the guise of state enterprises. Many raised capital from family or underground banks. As long as such freedom created wealth and did not challenge party authority, Deng was prepared to let a hundred flowers bloom.

He and the leaders who followed him did take some top-down decisions that helped unleash China's economic potential. In 1980 he set up the special economic zones, such as Shenzhen, which became magnets for foreign capital and expertise from Taiwan, Hong Kong and other free-market economies China was seeking to emulate. But other reforms went wrong. When Deng freed prices in 1988, it triggered the high inflation that was at least a proximate cause of the Tiananmen Square protests.

The Communist party appears to have brought 30 years of spectacularly smooth growth, even allowing for the statistical manipulation that sometimes occurs. But that obscures often desperate flailing as the party cranks this lever and that to produce the economic progress on which its survival ultimately depends. Beneath these shifting policies lies one inalienable understanding: "We'll give you growing prosperity, if you don't question our right to absolute power." Yet there is an inherent contradiction between exerting unyielding political control and trying to unshackle entrepreneurial creativity.

That does not mean the arrangement is under imminent – or even mid-term – threat. Both Singapore and Japan offer evidence that one party can maintain power, even without the benefit of force. But for all China's impressive economic progress, the past 30 years have owed much to cobbling together policy and struggling to reconcile contradictions. The problem with fumbling from slippery rock to rock is that there is always the danger of falling in.

For many of us, the notion of investing your money for two years with little prospect of return, seems pretty odd, yet that it exactly what buyers of 2-year US Treasuries are doing at current levels. In an excellent article entitled *Investors must be wary of government bond 'bubble'* **John Plender** sheds some light on this strange behaviour. The article appeared in the Financial Times on 7 January 2009.

I share the view of Michael Lewitt, of Harch Capital Management, who argues that the last thing investors are thinking when they buy zero per cent Treasuries is reselling them at a profit. In most cases, they expect to resell at a loss. Rather, he argues, their priority is absolute safety and the knowledge that there will always be buyers for securities backed by the US government. Such behaviour, then, is a perfectly rational response to extreme uncertainty and the fear of deflation. Even if this is not a bubble - and some readers may regard the issue as purely semantic - the government bond markets remain potentially dangerous for investors. Yet that does not mean that yields will not fall further. As long as the banking system is incapable of doing the basic job of financial intermediation and it remains difficult to price much of the paper thrown up in the credit bubble, governments face no competition for funds in the debt markets. Fear will ensure that the demand for poor-value government bonds holds up. The risk, as I suggested here before Christmas, is that the upwards yield adjustment could be savage when Humpty Dumpty is put back on the wall and normal private sector financial service resumes. Given the enormous funding pressure that will exist in the early days of the Obama administration, and the potential shift of investment focus from deflation to inflation, Treasuries will at some point become an outcast asset category. The tricky question is, "when?"

Those who would like to read the full articles or would like to read other articles that piqued our interest in the past month can contact me on andre@maestroinvestment.co.za. 2008 turned out to be year of enormous learning, one which took even the most seasoned market watcher and investment professional into new territory (and a few central bankers, I dare say). It is a real treat to be able to learn so much is such a short space of time, and to have one’s boundaries so challenged, at the “hands” and minds of great thinkers and writers – let’s enjoy it while it lasts. As a good friend recently said to me “I never learn very much in the good times.”