# INTERMEZZO

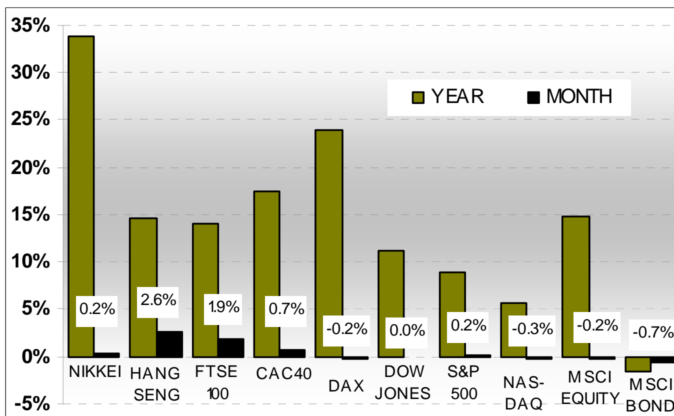
MAESTRO
Investment Consulting

Investment Letter | 6th Edition | July 2006


**June in perspective – global markets**

Looking at Chart 1, one can be forgiven for thinking that June represented "just another month". In reality though nothing could be further from the truth: squeezed in between 10 May and 15 June was a ***stealth 1987-style mini-crash*** – brutal but so swift that most investors didn't even notice it. If that sounds melodramatic, consider Table 1. When last, for example, did you see the Japanese stock market decline 19% in four weeks, only to rebound by 9% immediately thereafter? Or the German Dax fall 13.8% then bounce 7.4% in the next ten trading days? How about India? Having dropped 10% in an hour in May before trading was halted, the market declined 29.2% in less than a month before rising 20.0% in the next few trading days. How does one make sense – let alone cents – of a market that exhibits such volatility? The past six weeks have been *extremely* volatile. Monthly returns would look a lot worse were it not for the strong gains in the last week of June.

**Chart 1: Global market returns to 30 June 2006**




In passing, one should keep in mind hedge fund behaviour in such volatile markets. So far there have not been any major casualties that I am aware of, but some of the returns have been rather, well … messy. Respected investment managers registered declines of up to 8% in May. It is a bit early for June returns but they may also be rather poor. When one considers how volatile markets have been, in both directions, you will understand how easy it has been to get things wrong, despite one's best endeavours.

**A brief overview of the factors driving the markets**

We spent quite a bit of time of this subject in last month's *Intermezzo*, which I would encourage you to revisit on the Maestro website. Before focussing on the most influential factors let's recap events of the past two months. Global equity markets had risen strongly until mid-May, supported by robust economic growth, corporate results and lots of liquidity – a function of a sustained period of low (at least in historic terms) interest rates. Then on May 10, after raising interest rates for the 16th consecutive time, the US Federal Reserve signalled that rates might well not have reached their peak. This was badly received by the market, which had all but priced in the end of this tightening cycle. Share prices dropped swiftly around the world. As global investors reduced their appetite for risk, emerging markets and currencies suffered the most. After a brief reprieve into the end of May, the plundering of prices resumed in June as Fed officials continued their war dance. The trough in most markets was reached on or around the June 14, from which point markets rebounded sharply, especially in the last week of the month, leaving casual observers wondering what all the fuss was about.

Although something of an over-simplification, two main fears are troubling markets. The first fear is that inflation is rising to levels that are not only high in historic terms but also beyond the control of central banks. That leads to the second fear, that interest rates will have to be increased more than expected in order to regain control over inflation. The problem with such a scenario is that rates may well have to rise even as the economy slows due to the effects of the previous (17) interest rate increases. In case there is any doubt, the Fed has explicitly indicated that they will hike rates if necessary notwithstanding an economic slowdown. And so the dreaded "S-word" – stagflation – has raised its head, where inflation continues to rise but growth slows. Investors all know where that road leads to and it is not pleasant. Note that Maestro doesn't necessarily share these fears – I am just sharing what is troubling the markets.

**Table 1: Stealth mini-crash: now you see it, now you don't**

Selected market returns in local currencies (MSCI returns in $) (%)

| Country | Index | June | May peak to June trough | June trough to end-June | 2006 year-to-date |
|---|---|---|---|---|---|
| | **MSCI World index** | **-0.2** | | | **4.9** |
| UK | FTSE 100 | 1.9 | -10.2* | 5.9 | 3.8 |
| Germany | DAX | -0.2 | -13.8 | 7.4 | 5.1 |
| US | S&P 500 | 0.2 | -7.7 | 4.0 | 1.8 |
| Japan | Nikkei 225 | 0.2 | -19.0 | 9.1 | -3.8 |
| Australia | S&P/ASX 200 | 0.3 | -9.8 | 4.9 | 6.5 |
| | **MSCI Emerging Market index** | **-0.5** | | | **5.8** |
| SA | JSE All share | 3.4 | -17.6 | 13.4 | 5.8 |
| India | BSE Sensitive | 2.0 | -29.2 | 20.2 | 12.9 |
| Russia | RTS | 2.3 | -32.0** | 25.6 | 32.8 |
| Brazil | Bovespa | 0.5 | -21.8 | 11.7 | 9.5 |
| Turkey | IMKB National 100 | -7.7 | -33.1*** | 11.0 | -11.9 |

* April peak
** January trough
*** February peak

**What to expect in the next few months**
Market direction in the next few months will depend largely on the view that global investors take of the future course of US interest rates. The reason for the rally at the end of May, apart from the obvious "dead-cat bounce", was that the Fed toned down its recent rhetoric; the statement after the Fed's June 29 meeting was perceived to be rather mild. Moreover, many are of the opinion that current levels of equity markets represent reasonable value. That's the good news.

Maestro clients will know from their portfolio return that we have taken a conservative view with regard to the coming months. There are a couple of aspects about the markets that concern me. Before listing them, let me say that I believe global markets are still in a process of readjustment right now. So, from a return point of view Maestro's current conservative view seems to be misplaced. However, the jury is still out on the latter. Clients may yet come to value our conservative view differently in the coming weeks.

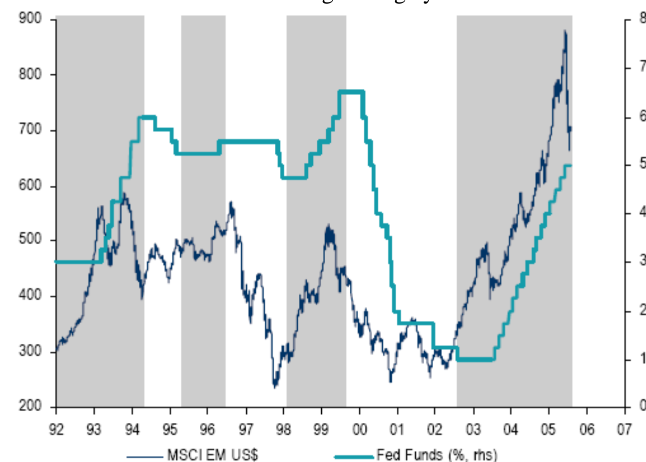
The problem I have with the future direction of equity markets in the next few months is the following: if investors believe that the Fed is nearly finished raising rates, then the dollar is likely to decline meaningfully into the future. That in turn will support commodity and energy prices, which is exactly what the Fed *doesn't* want. Higher prices will place upward pressure on inflation, which is the key reason for the higher interest rates. Higher rates mean lower equity markets and another round of risk aversion i.e. a retreat from all things perceived as "more risky" such as emerging equity and bond markets (including SA). So it will not take much to return to the cycle of greater risk and lower prices.

This current "cycle" is most surely not over. The market took a positive view on the Fed's statement last week, but many now expect US interest rates to move to 6.0% from their current 5.25%. If you consider that in early May, prior to the equity market corrections, consensus forecasts were for rates to peak at 5.0%, you can understand why global investors are now "in a tizz". Remember, it is *unexpected* shocks that derail markets. Recent events regarding higher than expected interest rates certainly fall into the *unexpected* category, which is why markets reacted so badly. As an aside, I suggest that investors are more afraid of central bankers *over-reacting* than they are of higher inflation.

Apart from the dilemma of a lower dollar leading to higher commodity prices and hence higher rates, there is another relationship worth considering, namely the behaviour of emerging markets when the Fed does eventually stop raising rates. If the past is anything to go by, the relationship does not bode well for the SA equity market. Chart 2 shows what happens to emerging markets when the Fed stops hiking rates. In a nutshell: they decline, or at least underperform. The reason is simple: if the Fed stops hiking rates, they must believe the rate of inflation has slowed sufficiently. Of course the level of economic activity also slows, which is not conducive to ongoing gains in emerging markets.

Note from Chart 2 how sharply emerging markets have already corrected from their peak - about 20%. One could argue that the correction has already taken place. However, history and common sense bear testimony to the fact that bear markets do not last six weeks. The down turn from 1999 to 2001 lasted two years and emerging markets lost nearly 60%. The 1997/8 down turn was shorter but the more severe; the odds don't favour emerging markets right now.

**Chart 2: Emerging markets and the US rate cycle**
Shaded areas denote the Fed's tightening cycles




How about the rand? Well, the prognosis is not that rosy for further appreciation. During the turmoil of the past two months, the rand lost 15% against the dollar – it was down 20% at one stage in June. It weakened sharply after the announcement that the trade deficit increased from 4.5% of GDP in the last quarter of 2005 to 6.4% in the first quarter this year (it is likely to widen even further). SA is not alone: the New Zealand dollar (the "kiwi" as it is affectionately termed) lost a similar amount when their trade deficit rose from 8.9% to 9.3%. The situation in Iceland, which we have covered previously in *Intermezzo*, is similar. Their currency and markets have also been under pressure. The message is clear: global capital markets will punish any perceived lack of fiscal or monetary discipline, or inherent or structural weakness (as in SA's case). To be in this position in the prevailing investment environment is like trying to cross a highway at peak-hour, blindfolded. *Investors need to take cognisance of the current inherent risks in the SA equity market.* If the Fed's work is done, it bodes ill for emerging markets and commodity prices in general. If the Fed continues to raise rates, it bodes ill for *developed* markets, which in turn will affect *developing* ones. Considerations such as these will continue to shape Maestro's view until such time as there is proof that the "storm has passed".

**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 1: Returns of funds under Maestro's care**

| | Month | Return | Year to date |
|---|---|---|---|
| **Maestro Equity Fund** | June | **-2.6%** | **2.7%** |
| Maestro equity benchmark * | | 2.2% | 13.7% |
| JSE All Share Index | | 3.4% | 18.8% |
| **Central Park Global Balanced Fund ($)** | May | **-4.4%** | **6.1%** |
| Benchmark** | | -1.1% | 4.1% |

* 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

**June in perspective – local markets**
It's hard to actually gain an appropriate perspective of SA equity market behaviour in June. It was both a great and awful month: great if you had a strong resource weighting, and awful if you didn't. Consider the difference between the Basic Materials index return of 10.1% in June and that of the Financial index return of –2.2%. In absolute terms that 12.3% *in one month*. Or the same exercise between the Top 40 (large cap) index return of 4.8% and the small cap index return of -6.0%; that's a difference of 10.8% in absolute terms *in one month*. Clearly, were it not for the 6.1% decline in the rand (following hard on the 9.6% decline in May) the resource index return, and indeed that of the whole market would have looked a lot different. Sectors that stood out during June were platinum mining up 19.4%, gold mining 12.8% and industrial metals 16.6%. Laggards included property unit trusts down 16.3%, property loan stocks 12.9% and software and computer services 10.8%. These are extraordinary movements for one month, and merely underline Maestro's contention that the risk has increased dramatically in the SA equity market. There is little room for error at present. Returns and the outcomes of investment decisions can look vastly different from one day to the next. It is fair to say that after what can only be described as a remarkable six weeks, there must be a lot of "wound-licking" going on right now.

**Chart 3: Local market returns 30 June 2006**

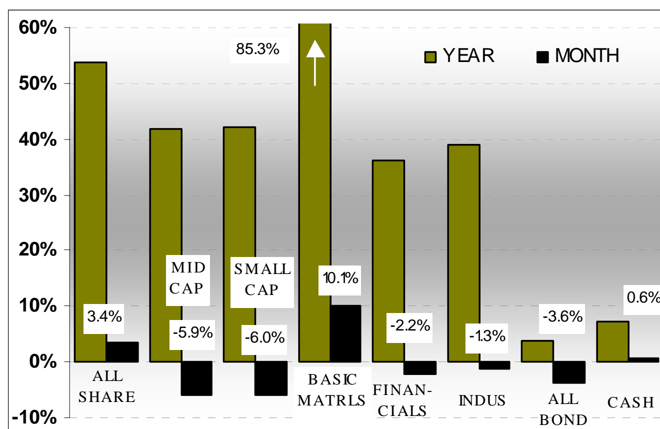
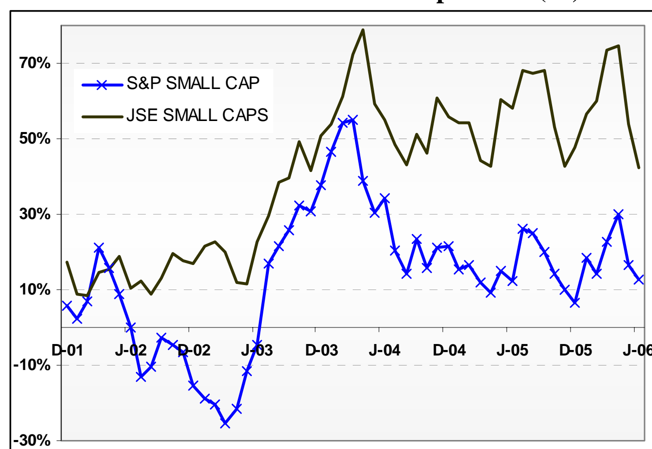



**Chart of the month**
Amongst the heaviest casualties in the recent market turmoil have been small companies, so-called "small caps". The theory behind their weakness is that small caps represent riskier investments than, say, large caps. Consequently in an environment where investors are reducing their risk, the first sector to feel the brunt is small caps, ample evidence of which has been provided in recent weeks. Whether small caps do indeed represent greater risk is open to debate – Maestro for one does not necessarily support this view – but when markets are as weak as they have been there is little point in trying to catch the "falling pianos". The weakness in small caps around world recently provides an opportunity that I have long been waiting for, namely to underline one of Maestro core investment tenets, namely ***the importance of the global economy***. While this might seem self-evident to readers who are investment managers based abroad, even they will appreciate that many investors are inclined to focus on local markets to the exclusion of the forces at play in similar situations on global markets. Let me explain: returns of small caps have a close historic relationship with each other, if not in extent then at least in terms of direction. Chart 4, which depicts the rolling annual returns of the S&P Small cap and the JSE small cap indices, illustrates this point. The relationship is easy to see – when small caps go up in the US their SA counterparts tend to do the same (only more so, it would seem). In the past two months as US small caps have declined, so too have those in SA (more so once again, illustrating the high "beta" characteristic of the SA market). To some extent, when investors are prepared to take on more risk, typically when the economic environment is favourable, they are more likely to consider investing in small caps. Similarly, when the investment environment deteriorates, they sell or reduce their small cap holdings. To repeat Maestro's tenet, notwithstanding the research one needs to do on each underlying company, *one must at all times consider the global environment before committing fresh capital to the market or making significant investment decisions*.

**Chart 4: Annual returns of small cap shares (%)**

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