INTERMEZZO

MAESTRO
Investment Consulting

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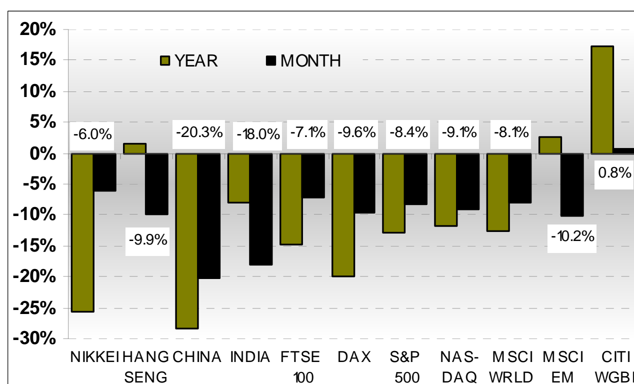
June in perspective – global markets

June proved to be an exceptionally tough and unprofitable month in global equity markets, bringing to an end the worst first half of a year since 1970. China and India declined 20.3% and 18.0% respectively but in fact all equity markets declined sharply (refer to Table 3 for emerging market returns) and their annual returns are now deeply in the red. The MSCI World and Emerging market indices declined 8.1% and 10.2% respectively during June, having turned sharply lower at the suggestion by ECB President Jean-Claude Trichet that European interest rates could rise - which they subsequently did on 3 July. More bad news on the global credit crisis by way of further bank write-downs, relentlessly rising oil and commodity prices, evidence of the deteriorating state of the US consumer and increasing concern about levels of global inflation and food inflation in particular, all conspired to put markets into a tailspin. Rising commodity prices were supported by a declining dollar, which fell 1.4% against the euro. It is surely only a matter of days before the oil price rises above $150.

Chart 1: Global market returns to 30 June 2008



Recent developments on the investment landscape

June was yet another busy month on the economic data front. With the global economy at such an important juncture and markets so fragile, investors are becoming increasingly sensitive to data releases. It is at times such as these that we need to focus closely on the developments within the major economies, as the true state of the global economy slowly unfolds before us. One cannot over-emphasize the importance, to us at least, of these data releases, a selection of which I list below for your interest.

- *Chinese inflation* declined marginally from 8.5% in April to 7.7% in May although this did not stop the authorities from raising bank reserve requirements (by 1.0%) once again. At the time of writing, the Shanghai composite index is 56.2% off its peak and is down 48.7% for the year-to-date. To place that in perspective though remember that index rose 130.4% and 100.4% in 2006 and 2007 respectively.
- *Indian inflation* rose to 8.2% in May, prompting the Reserve Bank of India to raise its lending rate 25 basis points (bps) or 0.25% to 8.0%. This was the first time the Bank raised its rate in a year although the rate is now at its highest level in more than five years. Another significant development in India was the increase by government of petrol prices by 11%. India subsidizes its petrol price very heavily, which not only means that Indian petrol users haven't really felt the effect of rising oil prices, but that state-owned petrol companies have been running at huge losses, estimated to be around R100m *per day*!
- *SA inflation and interest rates*: I don't have to remind you that the SA Reserve Bank raised interest rates by 50bps to 12.0%, bringing to 5.0% the increase since June 2006. Headline inflation rose to 11.7% in May.
- *The SA current account deficit* rose to R195bn or 9.0% of GDP, its highest level in 26 years – refer again to last month's *Intermezzo*, where we discussed this matter in more detail. Despite all the bad news on the local economy it is surprising that the rand weakened "only" 2.4% against the dollar in June, although the dollar itself was weak. Its 3.1% and 3.8% declines against sterling and the euro are perhaps more indicative of the rand's underlying weakness. The "carry trade" whereby global investors borrow in currencies with low interest rates such as the yen, and invest in high-yielding ones such as the rand, is probably supporting the rand, given the widely-held view (which we share) that SA interest rates are headed still higher.
- *UK inflation* rose to 3.3% in May, its highest level in 11 years.
- *Russian inflation* rose to 15.1% in May and economic growth slowed to 8.5% during the first quarter, down from 9.5% during the December quarter.
- *Eurozone inflation* rose to 4% in June, its highest level since the EU was formed in 1999 and double the ECB's target rate of 2%.

I'm sure you've heard enough about inflation rates, and you get the picture. The real issue, however, is that the increase in inflation comes at a time of rising unemployment, even greater increases in prices at the producer (wholesale) level and declining levels of economic activity. Rising inflation should also be seen against a backdrop of a scenario wherein there seems little prospect of declining commodity and energy prices in the foreseeable future. That said, for the record, we don't think that inflation is too much of a problem in the US right now – refer to Chart 2 for a history of core inflation. Headline inflation there is currently 4.2% and core inflation, which excludes food and energy prices, is 2.3%. There are a number of reasons to believe that US inflation may slow, which merely underlines our view that the Federal Reserves is unlikely to raise US interest rates for

some time. By implication then we continue to believe that the US dollar will be under pressure, which, all else being equal, will support even higher energy and commodity prices. Such a "hostile" environment and outlook place the large declines in equity markets in June into perspective.

Chart 2: US inflation in perspective
Shaded areas represent US recessions

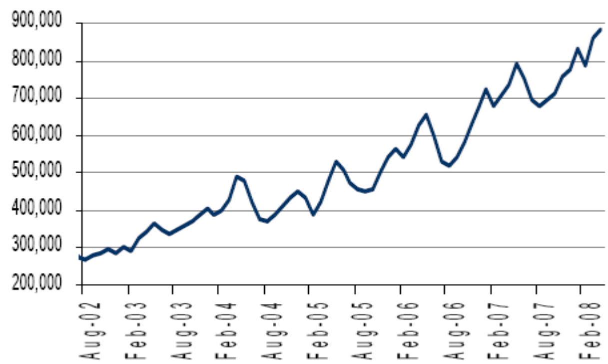
Source: Merrill Lynch

Chart of the month

Last month I took the liberty of sneaking in two charts instead of one. I'm afraid the habit is infectious – I'm going to do it again. I came across these two charts, which may depict separate subjects but are not as unrelated as might first appear. You are aware that Maestro has for many years beaten the "emerging market" drum which by default includes the "commodity drum." We hold the view that, broadly speaking, there is an increasing shift in global economic power from the West to the East, from developed to emerging markets. Nowhere is this more evident than in aspects such as trade balances and consumer demand. The shift in power is a huge subject which begs an entire Report on its own and for which we do not have time for here. But it is a thematic view we have held dear for many years.

Now a quick digression: I presume you saw that Rio Tinto and subsequently also Billiton recently secured annual price increases of 96.5% for their iron ore? This is one example of rising demand, particularly in emerging markets, for commodities such as base metals, steel and oil. Another example is shown in Chart 3, which depicts Chinese car sales – remember a lot of steel is used to make cars and they use lots of oil (fuel) to keep running. Chinese sales will soon hit 1m cars *a month*. To place that in perspective Chinese total 2002 car sales were only 1.2m while in South Africa total 2007 car sales were 434 653. Chinese car demand has been spurred by massive urbanization and cheap fuel - like India, China subsidizes the retail price of fuel, although it raised the fuel price 17% in June. (The increase in demand for fuel in emerging markets accounts for *all* of the increase in the global demand for fuel, with the majority of this increase being from those countries that subsidise fuel prices). Chinese car sales rose 24% in 2007 and about 5m cars were sold in the first half of this year. While the growth rate of car sales is slowing, it is worth pointing out that only 4% of China's 1.4bn people currently own cars!

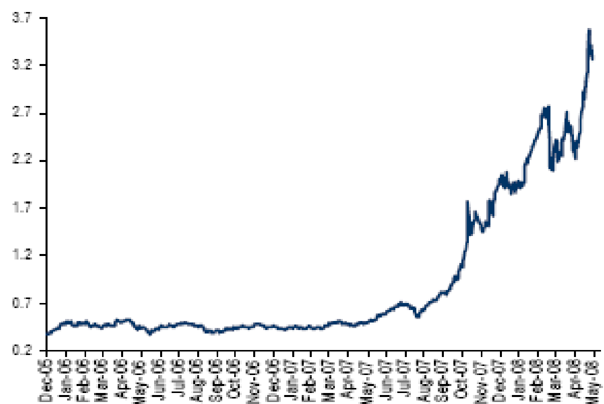
Chart 3: Chinese car sales



Source: Merrill Lynch

This brings me to my second chart. Merrill Lynch's Emerging Market Strategist, Michael Hartnett, calls it the "trade of the decade." It encapsulates so many of the themes that have been relevant over the past few years: developed versus emerging markets, commodities versus credit, smokestack versus services, weak dollar versus strong emerging currencies (in this case the Brazilian real). Chart 4 depicts the price of Brazil's national oil company Petronas relative to the US's largest bank, Citigroup. Since the beginning of January 2006, Petronas has outperformed Citigroup by just more than 700%!

Chart 4: Trade of the decade: Petronas versus Citigroup



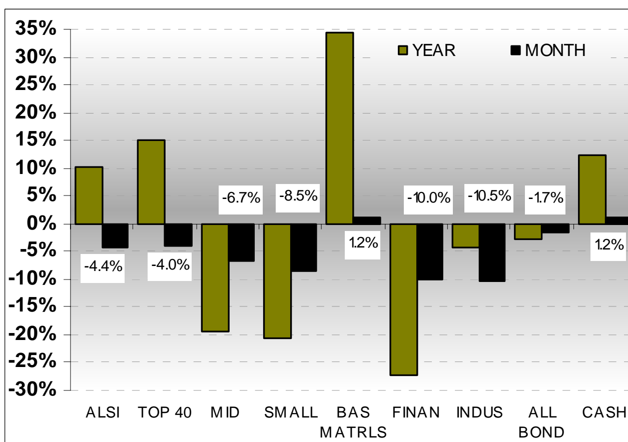
Source: Merrill Lynch

June in perspective – local markets

The extraordinary "tale of two markets" continues to unfold on the local equity market. The basic materials index posted yet another positive return despite the mayhem on global markets – it rose 1.2% - but the rest of the markets headed lower with vengeance. The financial and industrial indices

declined 10.0% and 10.5% respectively in June. Note from Chart 5 the difference between the returns of the basic materials and financial indices – in the year to June that difference was an amazing 61.7%. The dominance of large commodity companies on the JSE is also illustrated, but to a lesser extent, in the difference in the annual returns of the Top 40 (large) and small cap indices of 35.7%. Only a year ago, that difference was 37.2% *in favour of the small cap index* (the Top40 was up 34.1% and the small caps 71.3%). When you consider the quantum of change you realise firstly how severe the sell-off in small caps has been, secondly how dramatic and sustained the rise in commodity shares has been and lastly how rapidly the change has occurred – this all took place in the past year. Ironically, while the prospects for commodity companies are excellent, those of the small caps have *not* deteriorated – at least in our opinions – to the extent indicated by the severe decline in their share prices. I will dwell on this aspect in more detail in the June Quarterly Reports later in the month. For the record the best performing sector on the JSE in June was the Fixed line telecoms sector (read Telkom) up 8.1%, and the worst was Household goods (Steinhoff) down 18.8% and ironically Mobile telecoms (Altech and MTN) down 18.1%.

Chart 5: Local market returns to 30 June 2008



Quotable quotes

I recently stumbled across some comments that I thought were very pertinent to a more informed perspective on current developments in the investment environment. They are worth remembering for some time, as they both touch on matters that are likely to dominate headlines for a long time to come and which are currently very influential in the shape and future of investment markets and strategy. The first was contained in Sarasin & Partner's June Global Strategy document; commenting on the macroeconomic outlook and the return of inflation in particular, Chief Investment Officer Guy Monson writes:

> *In this new era of globalization, inflation is the final manifestation of the dramatic shift in world demand to poorer less industrialised countries.*

The more I get to understand the causes behind the current resurgence of inflation, the more true and profound I find this statement.

The second noteworthy quote came from the Financial Time's Philip Stephens. In an article about US President Bush's China policy, he makes the following very pertinent observation:

> *But China's international presence takes a distant second place to domestic concerns. The mantra of the policy-making elite is the need to safeguard economic growth, social stability and national unity. The neuroses about Taiwan and Tibet merge into a broader anxiety about the cohesion of this vast, multi-ethnic state. Foreign policy matters mostly to the extent that it has an impact – positive or negative – on a fragile domestic order.*

I thought these comments were very useful in trying to understand what drives Chinese policy. It has less to do with external matters and more to do with internal cohesion and sustaining the momentum of economic growth. We would do dwell to remember both these insightful views when analysing future economic and investment developments.

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	Jun	**-6.6%**	**-0.7%**	**4.7%**
Maestro equity benchmark *	Jun	-7.4%	-1.0%	2.6%
JSE All Share Index	Jun	-4.4%	6.4%	10.1%
Maestro Long Short Equity Fund	May	**0.4%**	**-6.7%**	N/A
JSE All Share Index	May	3.7%	11.3%	14.1%
JSE Financial and Indus 30 index	May	1.7%	-1.1%	-0.1%
Central Park Global Balanced Fund ($)	May	**0.9%**	**0.2%**	**3.0%**
Benchmark**	May	0.5%	-0.3%	2.5%

* 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

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MSCI index weights

Readers will know that Maestro places a great deal of emphasis on *Intermezzo*, one of the reasons being that not only do we learn so much from compiling it but we also believe you will learn a great deal from it by reading it consistently over time. Many of you have been very gracious in your compliments about *Intermezzo,* for which we are very grateful; this only serves to spur us into putting even more effort into its compilation. Here, then, is another example of learning more about the investment environment which affects us all in so many ways: you will be aware that Maestro refers to the MSCI indices frequently. I can recommend them for their integrity and consistency as a data series. Have you ever wondered what the respective weighting in their indices are? Well, wonder no more. MSCI conduct a six-monthly review of the respective weightings to the underlying markets, the latest of which is shown below in Table 2. I encourage you to print out this table and keep it handy; it provides a wonderful overview of global equity markets and will place so much of what happens from month to month in the global economy into perspective. For good measure the respective dollar-denominated market capitalizations (size) of each of the markets are also shown.

Table 2: MSCI market caps and weightings

Developed Market			Emerging Market			Frontier Market		
	Mkt Cap*	Weight		Mkt Cap*	Weight		Mkt Cap*	Weight
Total	26,787,736	100.0	Total	3,507,051	100.0	Total	191,483	100.0
USA	12,694,638	47.4	Brazil	595,601	17.0	Kuwait	67,444	35.2
Japan	2,747,040	10.3	China	493,092	14.1	UAE	34,488	18.0
UK	2,735,848	10.2	Korea	455,043	13.0	Nigeria	21,988	11.5
France	1,377,312	5.1	Russia	384,750	11.0	Qatar	15,284	8.0
Canada	1,301,227	4.9	Taiwan	379,174	10.8	Kazakhstan	9,070	4.7
Germany	1,168,782	4.4	India	223,397	6.4	Oman	7,508	3.9
Switzerland	892,708	3.3	So. Africa	222,615	6.3	Slovenia	6,406	3.3
Australia	854,243	3.2	Mexico	168,316	4.8	Croatia	5,675	3.0
Spain	531,022	2.0	Israel	84,256	2.4	Bahrain	5,141	2.7
Italy	486,949	1.8	Malaysia	79,895	2.3	Lebanon	5,126	2.7
Netherlands	341,972	1.3	Poland	56,006	1.6	Kenya	3,097	1.6
Sweden	299,846	1.1	Indonesia	53,524	1.5	Romania	2,980	1.6
Hong Kong	278,784	1.0	Turkey	48,955	1.4	Mauritius	1,741	0.9
Finland	201,736	0.8	Thailand	45,520	1.3	Vietnam	1,298	0.7
Singapore	151,474	0.6	Chile	39,962	1.1	Ukraine	1,124	0.6
Belgium	146,844	0.5	Czech Rep.	31,009	0.9	Bulgaria	986	0.5
Norway	145,771	0.5	Egypt	25,570	0.7	Estonia	869	0.5
Denmark	133,591	0.5	Hungary	25,115	0.7	Tunisia	646	0.3
Greece	86,926	0.3	Peru	23,470	0.7	Sri Lanka	610	0.3
Austria	84,650	0.3	Argentina	20,817	0.6			
Ireland	75,024	0.3	Colombia	17,130	0.5			
Portugal	38,961	0.1	Morocco	12,909	0.4			
New Zealand	12,388	0.0	Philippines	12,731	0.4			
			Pakistan	5,408	0.2			
			Jordan	2,786	0.1			

Source: MSCI, Merrill Lynch

State of the nation

Maestro entered a new chapter with the appointment in June of Mark Heerden to the Maestro team. Mark brings 22 years of financial service experience to our team, having started working in London in 1986 in the investment banking arena after completing his articles at KPMG and studying at the University of Cape Town. He returned to South Africa in 1996 and spent most of this time working at Fairheads Asset Management, where he was instrumental in the eventual sale of the company in a Black Economic Empowerment deal in 2007. Mark will be responsible for all matters in the company with the exception of the investment side, which will remain in my (Andre Joubert's) court. Mark is married to Shane and has two children, Graeme and Chloe.

Table 3: MSCI Emerging Market June returns (%)

EM countries/regions	Jun-08	H1
Argentina	13.6	43.5
Morocco	-0.7	28.2
Jordan	8.4	13.2
Brazil	-8.0	11.0
Czech Rep	2.1	9.3
LatAm	-7.7	8.0
Peru	-2.3	5.8
Israel	-2.4	5.1
Mexico	-8.8	-0.7
Russia	-7.5	-2.8
Egypt	-9.3	-4.4
Chile	-9.7	-4.9
Taiwan	-11.5	-6.0
EMEA	-7.5	-7.5
Thailand	-10.8	-10.8
Hungary	-7.0	-11.7
MSCI DM	**-8.1**	**-11.7**
Indonesia	-3.5	-11.8
South Africa	-9.6	-12.3
MSCI EM	**-10.2**	**-12.7**
Poland	-9.5	-13.2
Malaysia	-8.9	-18.8
South Korea	-12.2	-20.7
MSCI EM Small Cap	**-12.1**	**-22.8**
Asia	-12.7	-22.8
China	-12.6	-27.3
Philippines	-16.6	-39.0
Turkey	-12.5	-41.0
India	-19.7	-41.7

Source: Merrill Lynch

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