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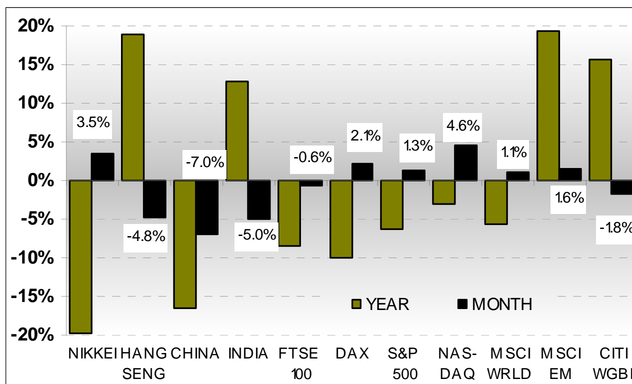
May in perspective – global markets

After the first quarter's calamitous markets April saw a strong rebound across all markets, with the exception of bond markets. It was to be expected, then, that during May markets marked time, unsure of where the global economy is headed next. Corporate earnings were a bit better than expected but the rampant oil price, which rose 14.7% during the month and has now virtually doubled over the past year, and strong commodity prices, which in turn are adding to inflation fears around the world, kept markets in check. The same factors sent the bond markets lower. Chart 1 contains all the detail – we have added China and India to the chart. The MSCI World index rose 1.1% and the MSCI Emerging markets index 1.6%. Apart from Hong Kong (the Hang Seng), India, the MSCI Emerging market index and bond markets (Citi WGB index), all other markets are still showing negative annual returns despite the strong gains in April. Commodity prices continued to rise in May; the CRB index gained 3.2%, bringing its annual gain to 36.7%. The dollar, despite showing weakness during the month, put in a strong showing in the last week of the May, to end virtually flat on the month.

Chart 1: Global market returns to 31 May 2008



Recent developments on the investment landscape

A lot of relevant data was released during the month, some of which included the following:

- *SA inflation*: last month we drew your attention to the inflationary onslaught currently washing over South Africa. The April inflation news was shocking and well ahead of expectations: prices rose 1.6% month-on-month and at an annual rate of 10.4%. In his immediate reaction SA Reserve Bank Governor Tito Mboweni threatened that at least another 200 basis points (bps) were in the offing. We were expecting another 50bps at this month's Monetary Policy Committee (MPC) meeting but we have now increased our expectations to a rise of 100bps (1%), with at least another 0.5% (if not 1.0%) further down the line. As expected food and energy prices were the key drivers of higher price. Consumers are also sitting on tenterhooks, awaiting the outcome of Eskom's request to the regulator for an immediate 60% hike in electricity tariffs, on the back of its 14% hike earlier this year. Producer inflation for April totalled 12.4% during the past year, which bodes badly for further price rises at the consumer level.
- *SA GDP*: the SA economy grew at 2.1% during the first quarter of 2008, lower than expectations of 2.6%. The extent of the electricity crisis is becoming more apparent: the mining sector, particularly hard hit by Eskom's inability to supply electricity, declined 22.1% during the quarter, the biggest such decline since 1967. Manufacturing output declined 1.0%. And yes, if you put one and one together i.e. rising inflation and slower growth, you arrive at that unspeakable word in economics, *stagflation.* But for now we won't say it too loudly. We do not share the increasingly popular view that the SA economy will slip into a recession. There is sufficient momentum in the economy to keep it going, although we readily acknowledge that it is slowing in some areas and the financial well-being of consumers is deteriorating faster than expected.
- *SA trade deficit:* one of SA's Achilles' heels is its current account deficit, which reflects the trade and finance-related flow of funds in and out of the country. If outflows exceed inflows, a deficit results which has to be financed one way or another. Typically, with SA being a small, open economy, and by that I mean an economy reliant on imports for a lot of its needs and which exports a number of other goods such as raw commodities, we are likely to run a current account deficit most of the time. The main factor in this equation is the trade deficit, which measures the difference in value between imports and exports. Despite our large export sector SA remains reliant on imports to satisfy many of its needs, particularly in the area of machinery and equipment. This feature of the trade balance is very relevant now that SA is in a phase of heavy infrastructural spending. In theory at least currencies of countries that run permanent current account deficits are inherently weak, as they have to find the capital to finance those deficits. Emerging economies like Russia, China and Brazil have enjoyed strong currencies in recent years due to rising export volumes, which have left them with an embarrassing amount of riches on their current account. SA is not that lucky – we currently run a current account deficit, which is forecast to rise as a result of rising imports related to the rise in infrastructural spending. Last year SA's current account amounted to 7.3% of GDP, a 36-year peak – not exactly what you want just as you begin a multi-year infrastructure upgrade! All of which is to say that SA's trade deficit needs to be monitored closely. Political instability and a weak currency will do a lot of damage to our ability to continue attracting

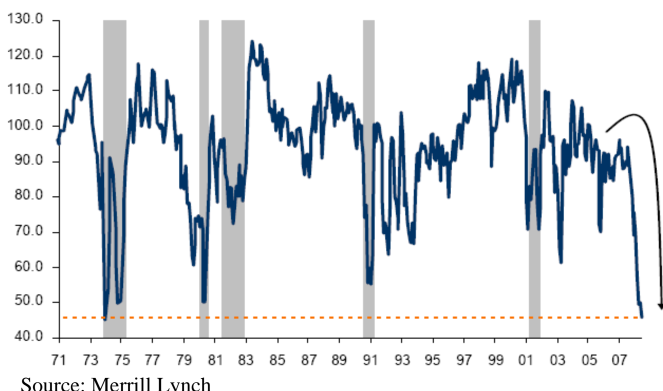
funds to finance the deficit – that's where the real risk to the rand lies at present. So, news that *SA's trade balance ballooned to R10bn,* way ahead of the expectation of R6.5bn, must be seen as a warning bell. That said monthly trade data is notoriously volatile, but take a note of this economic indicator, as it is going to feature more frequently in future as SA's demand for capital goods rises in line with the need to upgrade the country's infrastructure.

- *US GDP:* first quarter US growth was revised up to 0.9% per annum versus the initial estimate of 0.6%. We continue to believe that the US consumer is in worse shape than many believe and are conscious of the fact that the true effects of the US sub-prime fall out on the consumer have yet to be seen. Personal consumption expenditure (PCE) deflator, an inflation measure closely watched by the Federal Reserve, eased marginally during the first quarter to an annualised rate of 2.1%.
- *Japanese GDP:* the Japanese economy grew 1.0% during the first quarter.
- *Eurozone GDP:* despite the European Central Bank (ECB) retaining interest rates at high levels and despite the strong euro, German first quarter economic growth surprised everyone by coming in at 1.5% - the fastest quarterly growth rate for 12 years. France grew at 0.6% during the first quarter, double the rate of the December quarter. The 15-country eurozone grew at 0.7% during the first quarter. Inflation in the eurozone rose to a 16-year high of 3.6%, above the ECB's target rate of "below but close to 2%".

Chart of the month

Two for the price of one – at least that's how many charts you get this month! You should be aware by now that we are concerned about the financial health of the US consumer believing it to be a major risk to the global economy. Chart 2 highlights an index of US consumer confidence expectations, which is now at its lower level since 1973.

Chart 2: US consumer confidence expectations (100 = 1985)

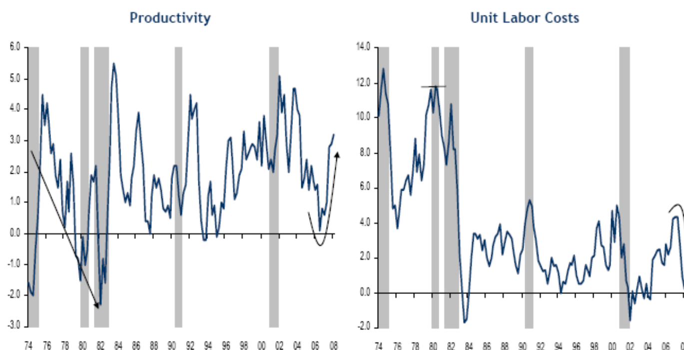


Source: Merrill Lynch

Look closely at the chart and you will see that not only does it tell a very negative story about future consumer behaviour (remember that US consumer spending constitutes 18% of global GDP) but not once since 1971 has this index been this low without the US economy moving into recession – the shaded areas in the chart represent US recessions. As they say so succinctly in the States – go figure.

But all is not lost. Chart 3 depicts a view held by Merrill Lynch, which we share, that although inflationary pressures are present in the US it is unlikely to lead to excessive inflation. They make the point that stagflation is typically the result of slowing growth and "supply-side deficiencies" i.e. factors that affect the supply of goods and services such as rising prices caused by slowing productivity (due to excessive wage increases) and low manufacturing utilization. However, this time may be different: US growth is slowing but rather than supply-side problems this time the economic downturn is being caused by a "reduced wealth effect" due to declining house valuations and a reduction in the availability of credit. As Chart 3 shows, US productivity growth is actually increasing and unit labour costs are falling. The point here is that while the US economy is slowing, it is unlikely to be accompanied by runaway inflation i.e. we are not dealing with a case of stagflation.

Chart 3: Stagflation in the US economy? No sign yet.



Source: Merrill Lynch

May in perspective – local markets

In many respects market behaviour in May looked similar to April. Resources were strong, financials were weak, large caps did well and mid and small caps didn't. The returns are all shown in Chart 4, below. Another similar aspect was the strong rise into the mid-month period, only to see prices decline in the latter half. The All share index was up 7.7% at one stage in May (it gained 7.5% at one stage in April) but declined as weakness set in on global equity markets and the dollar strengthened, causing commodity prices to decline slightly. The best the financial and industrial index could muster intra-month was a 3.1% gain; although it ended May 1.7% higher, it was dragged lower by the 6.0% return of the financial index. The latter has fallen 17.2% so far this year,

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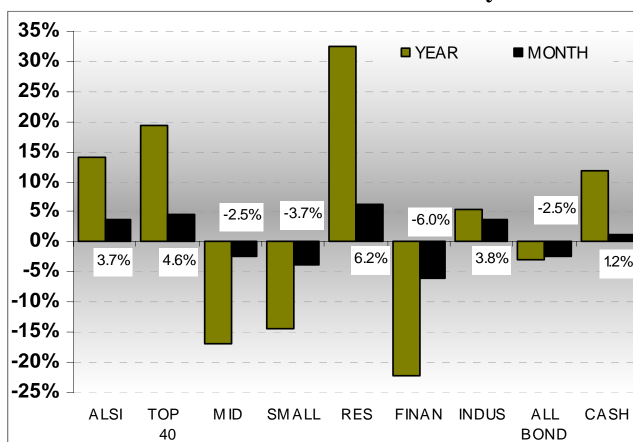
is down 22.3% during the past year and has declined in three of the past five months. The beverage sector (read SAB Miller) rose the most during May, up 12.0%, with oil and gas producers (read Sasol) gaining 10.0%.The banks sector lost 7.8%.

Chart 4: Local market returns to 31 May 2008



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	May	**3.9%**	**6.4%**	**12.6%**
Maestro equity benchmark *	May	3.1%	6.9%	9.4%
JSE All Share Index	May	3.7%	11.3%	14.1%
Maestro Long Short Equity Fund	Apr	**2.1%**	**-7.0%**	N/A
JSE All Share Index	Apr	4.8%	7.3%	11.9%
JSE Financial and Indus 30 index	Apr	4.7%	-2.7%	-3.7%
Central Park Global Balanced Fund ($)	Apr	**2.5%**	**-0.7%**	**3.6%**
Benchmark**	Apr	1.6%	-0.8%	3.1%

* 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

The *March 2008 Central Park Global Balanced Fund Quarterly Report* has just been published. If you would like to read the Report, it can be found on our website or if you would like to receive a copy please contact Vicki directly on Vicki@maestroinvestment.co.za. Remember that the Fund Summaries and Quarterly Reports of all our investment funds can be found on our website.

SA is not alone in a skewed equity market

I have wanted to insert Table 2 for some time but never seem to find the space. However, given the increasing disparity between the resource sector returns (the basic materials index is up 30.5% for the year-to-date) on the one hand and "the rest" (industrials are up 1.2% and financials *down* 17.2% over the same period) on the other, the Table is more relevant than ever. It shows that the SA equity market is not the only market that suffers from this problem. Using the MSCI indices and their respective weightings, which admittedly are not identical to the JSE index weightings but have a similar bias Table 2 depicts various emerging market returns between 16 August 2007, when the markets first woke up to the global credit crisis, and 22 April 2008. The first column (MW) depicts the returns based on a market weighting i.e. returns of an index based on the underlying constituent companies' current market caps (size). The next column (EW) shows the returns for the same companies, but weighting them equally in the index. The third column shows the difference between the two.

Table 2: A skewed SA equity market – we are not alone

	MW	EW	Diff
LatAm	51%	30%	21%
EMEA	22%	11%	11%
EM	24%	16%	8%
Asia	16%	14%	2%
Brazil	75%	44%	31%
China	19%	2%	17%
South Africa	17%	1%	16%
Thailand	29%	20%	9%
Turkey	2%	-7%	9%
Chile	25%	17%	8%
Russia	26%	22%	4%
Indonesia	38%	35%	3%
Taiwan	21%	19%	2%
India	22%	21%	1%
Korea	4%	6%	-2%
Mexico	19%	22%	-3%

Source: Merrill Lynch

So for example, the MSCI Emerging market index (EM in the Table) has risen 24% over this period, based on the usual market cap weightings, but if you weight the companies equally, the return was 16%. In other words bigger companies (so-called mega or large caps) are performing better than smaller ones. Similar to the JSE, the equity markets in many commodity-rich countries such as Brazil are dominated by, and heavily skewed in favour of, very big mining companies. Anglo and Billiton alone, for example, make up more than 30% of the JSE All share index. Angloplat and Sasol are the next two heavyweights. So when resource companies do well, as is currently the case, and you are invested in a portfolio spread across the whole market (for risk purposes more than anything else) your portfolio *will* underperform the JSE by definition. Looking at Table 2 again, see how significant this problem is for Brazil: the difference between the market and equal

weighted returns over this period was 31%. In China it was 17% and in South Africa it was 16%. This "weighting problem" is larger for Latin America than for Asia where many markets are more service or tech-focused (Taiwan, Korea and India for example). So, while it doesn't solve the problem, it is important to be aware of this factor in the *first* place, particularly when comparing your returns to the "overall market" - the All share index in respect of the JSE. *Secondly* it is worth knowing that the South African equity market is not alone in having to live with the consequences of the unique characteristics brought about by a resource-heavy index and economy.

Illustration 1: Lucian Freud's *Benefits Supervisor Sleeping*

Source: Telegraph.co.za

File 13 – things almost worth remembering

Many markets have been under pressure for some time now, but certain more specialized markets are still strong. The art market for one saw a number or records set during May. Sotheby's held its biggest auction ever, selling $362m of contemporary art in one night. It sold a Francis Bacon painting, "Triptych, 1976" for $86m, above the estimate of $70m and a record for any contemporary work sold at an auction. The same work changed hands for $10m only a few years ago. Also in May, Christie's sold a Lucian Freud work for $33.6m – a record amount for a living artist. Christie's auction, held only one night before Sotheby's, saw a total of $348m of works change hands.

Illustration 2: Francis Bacon's *Triptych, 1976*

Source: Telegraph.co.za

Changing allegiances in Asia

This comment might not seem that pertinent to the investment environment, but I would argue that it is. It is part of the "Bigger Picture" of who "calls the shots" in the fascinating and dynamic game of globalization unfolding in our life time. New chapters are written every decade, with China and India featuring in virtually every one of them.

Remember the recent protests, particularly in the UK and Europe (especially France), directed at the Olympic flame and based on the Chinese suppression of the Tibetan discontent? They seem rather distant now. The reason? The massive earthquake in Sichuan, China. As the scale of the disaster and human loss and suffering became apparent, facilitated as it was by an openness to assistance (unlike the Myanmar regime) and the immediate mobilization of a large, efficient army, the world sprang to the assistance of China and its people. What has received less attention in the media, at least in South Africa, is the *rapprochement* between Japan and China. These two nations, with long and rich cultures and heritages, have never been the best of friends. Between 1931 and 1945, when Japan invaded China, and through many periods prior to that, they were sworn enemies. Relations improved a bit after then-Japanese Prim Minister's Shinzo Abe's ground-breaking visit to Beijing in October 2006. Since then, relations between the two countries could best be described as "frosty." However, Chinese President Hu Jintao's visit to Japan in early May seems to have been a resounding success. He was warmly welcomed and held a number of significant meetings with influential public and private figures. He went out of his way to seek reconciliation, even apologising for certain historic events and going to politically sensitive areas that would previously have been unthinkable. Little did he know at that stage what would transpire next. The scale of the assistance after the earthquake, which at last count had killed nearly 100 000 people and displaced millions, was such that China requested Japan to send its army and military equipment into Sichuan to help with relief efforts. Japan responded immediately and enthusiastically.

So what, I hear you asking? Think about it: here are two of the world's largest and most influential nations, who were previously sworn enemies now "kissing and making up." Sure its early days, but think of the consequences if this new "shared future" develops momentum. Asia is currently the world's economic and demographic powerhouse. It has the most foreign currency reserves by far, is not saddled with debt like the West – ironically it owns the majority of the West's public debt - and is developing more rapidly than any other region on the planet. Where do you think their focus will be in the years ahead? Do you think they will even think about the West? Look at the recent steps taken to "normalise" relations between China and Taiwan; these relations are so fraught with historical baggage no one

would ever have thought it was worth trying to mend them. Throw Russia and Australia into the mix (they have oil and commodities, remember) and the balance of economic power will shift more rapidly than we care to imagine. Big Picture stuff, but worth thinking about. Watch this space…

Oh … and finally, while on the topic of China, just a gentle and exciting reminder that the 2008 Beijing Olympics are only two editions of *Intermezzo* away.

Table 3: MSCI Emerging Market May returns (%)

EM countries/regions	May-08	YTD
Russia	15.7	5.0
Argentina	15.6	26.3
Brazil	11.4	20.6
LatAm	**9.1**	**17.0**
Czech Rep	8.5	7.0
EMEA	**7.3**	**0.0**
Mexico	5.8	8.8
Jordan	5.6	4.5
Israel	4.6	7.7
Hungary	4.2	-5.0
Indonesia	3.9	-8.6
South Africa	2.3	-3.0
MSCI EM	**1.6**	**-2.9**
Poland	1.4	-4.1
MSCI DM	**1.1**	**-4.0**
Philippines	-0.6	-26.8
Morocco	-0.6	29.1
Peru	-1.0	8.2
Chile	-1.8	5.4
South Korea	-1.8	-9.6
MSCI EM Small Cap	**-2.2**	**-12.1**
Thailand	-3.0	0.0
Taiwan	-3.2	6.2
Malaysia	-3.3	-10.9
Asia	**-4.3**	**-11.6**
Turkey	-5.3	-32.7
China	-5.5	-16.8
Egypt	-6.7	5.4
India	-10.3	-27.4

Source: Merrill Lynch

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