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Investment Consulting

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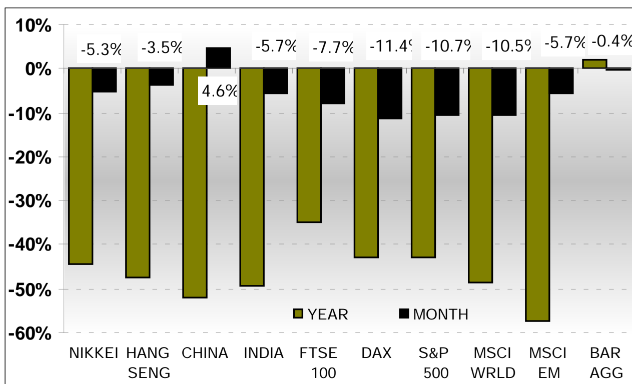
February in perspective – global markets

The global economic crisis is now in full flight, which places recent investment market behaviour into perspective. The MSCI World index declined 10.5% in February, bringing its year-to-date decline to 18.4%. The MSCI Emerging market index fared only marginally better, declining 5.7%, bringing its year-to-date return to -12.0%. The only major equity market to rise was that of China, which gained 4.6%; its year-to-date return is 14.4%. Most developed markets posted sizable declines: Germany lost 11.4%, the US 10.7% (over $1 trillion was wiped off the US market in February), Hong Kong 3.5% and India 5.7%. The year-to-date return for the S&P500 of -18.1% is the worst year-to-date decline since 1933 and in respect of the Dow Jones Industrial Average, it is the worst year-to-date decline in its 113-year old record. US equity markets are at 12-year lows (refer to Chart 2) while the Japanese market is at a 26-year low! There was little place to hide during the month, as bond markets sold off as well, leaving the Barclays US Aggregate bond index down 0.4%. There was strength in the commodity complex, though: gold rose 3.5%, platinum 7.7%, oil 2.1% and the Baltic Dry index 85.6%.

Chart 1: Global market returns to 28 February 2009



What's on our radar screen?

We remain focussed on the changing economic landscape and list below a couple of developments in this regard:

- *The Indian economy*: grew at 5.3% in the last quarter of 2008 (Q4 08), which although a respectable rate, was the slowest rate of growth for 6 years.
- *The Japanese economy:* declined by 3.3% during Q4 08, or -12.7% on an annualised basis, its worst showing in 35 years.
- *The European economy*: inflation in January declined 0.8%, bringing the annual rate to 1.1%, while the Eurozone unemployment rate rose to 8.2%. Eurozone GDP growth in Q4 08 declined 1.5%; Germany declined 2.1%, France 1.2% and Italy 1.8%.
- *The US economy*: provisional estimates showed that Q4 08 economic growth was -3.8% - a lot better than expected. The US produces an initial estimate (which is often subject to large revisions), a provisional estimate (which is normally pretty accurate) and then a final figure (which has just about no effect on markets). Well, the provisional estimate was released, and the number was far worse – Q4 08 economic growth in the US is now officially -6.2%! And based on the data already released this quarter, we believe the Q1 09 number could be as bad, or worse. We spent a lot of time in our Quarterly Report explaining why we are so concerned about the US economy in general and the US consumer in particular, so if you need to refresh your memory then go and read that Report again. The "movie" is playing out exactly as we expected it to. Most US economic data is coming out worse than expected and we retain the view that we are not yet at the trough of this economic crisis. For example, durable goods orders for January were expected to decline 3.6% but they actually fell 5.2%, following declines of 3.0% and 4.0% in December and November respectively. Inventories are still building up (to a 17-year high to be exact) and that bodes badly for economic activity into the future. New home sales are at record lows with 13.3 months of inventory (supply) on that market. Watch this space … *the US economy is still deteriorating* i.e. there is no sign yet of any improvement. Is it no wonder that the S&P500 is at 12-year lows – refer to Chart 2?

Chart 2: US equity markets: wiping out 12 years of gains

Source: Saxo Bank

- *The SA economy:* SA's Q4 08 economic growth turned out to be 1.8%, a bit worse than expected, largely on a sharp decline in the manufacturing sector. Interest rates were cut by 1.0% and there are strong indications that further cuts are in the offing. The Budget was also tabled, which saw government scale back its 2009 growth expectation from 4.2% to 1.0%. Although government revenue is still relatively robust – for the first time since 2004 it failed to meet budget, falling R14.4bn short of the targeted amount of R642.1bn - the strong (R787bn) commitment to infrastructural spending by government over the next three years

means that for the first time in three years SA will move into a budget deficit. The latter is not too large though; it is projected to be 1.0% in 2008/9 rising to 3.8% in 2010/11. Fresh debt issuance of R185bn, equivalent to 7.5% of GDP, will push net government debt to 27.4% of GDP. The annual cost to service this debt equates to a rather modest 2.5% of GDP. In short after having kept a tight rein on spending for more than a decade, government is slowly releasing some of its purse strings in order to support the slowing economic activity and start rebuilding much-needed infrastructure.

- *The Chinese economy:* a perverse phenomenon of the current economic crisis is the fact that, despite its size, the Chinese trade surplus is getting bigger and bigger despite the slowdown in the global economy. The reason for this is that while exports are slowing (they declined 17.5% in January), imports are slowing more rapidly (down 43.1% in January), resulting in the trade surplus rising even more. January's $39.1bn trade surplus was only just below the record $40bn in November, and follows December's $36bn. What was that about the rich getting richer? Incidentally, a very interesting article appeared in the Financial Times called *This is not the time to attack China* in which Prof. Michael Pettis of Peking University debated China's role in the world today, specifically its role as "saviour" of the West. If you are interested in reading it please contact me on @maestroinvestment.co.za.

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 Equity Fund Summary, by visiting our website at .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	Feb	**-7.2%**	**-10.3%**	**-34.5%**
Maestro equity benchmark *	Feb	-11.1%	-15.9%	-34.6%
JSE All Share Index	Feb	-9.9%	-13.7%	-32.6%
Maestro Long Short Equity Fund	Jan	**-5.9%**	**-5.9%**	**-28.2%**
JSE All Share Index	Jan	-4.3%	-4.3%	-22.1%
JSE Financial and Indus 30 index	Jan	-6.2%	-6.2%	-14.3%
Central Park Global Balanced Fund ($)	Jan	**-2.4%**	**-2.4%**	**-14.7%**
Benchmark**	Jan	-3.5%	-3.5%	-21.0%

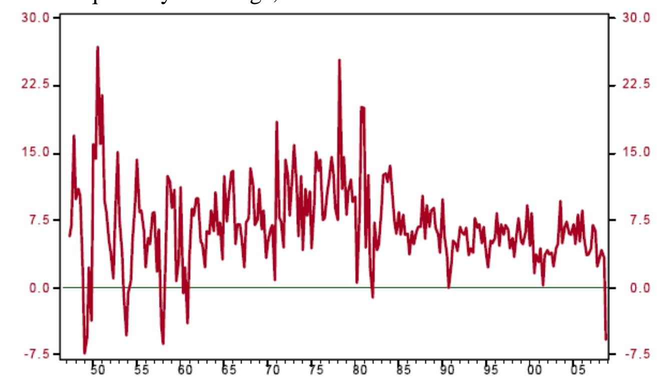
* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, 20% each in Citi World Government Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills

Chart of the month

We referred to the terrible fourth quarter economic slowdown in the US. There are so many terrible charts we could have chosen, but chart 3 encapsulates it all: the US economy is slowing at a rate last seen in the 1950s and it is our view that the rate of slowdown is likely to remain at current levels for at least the next quarter.

Chart 3: US economic growth

GDP – quarterly % change, annualised

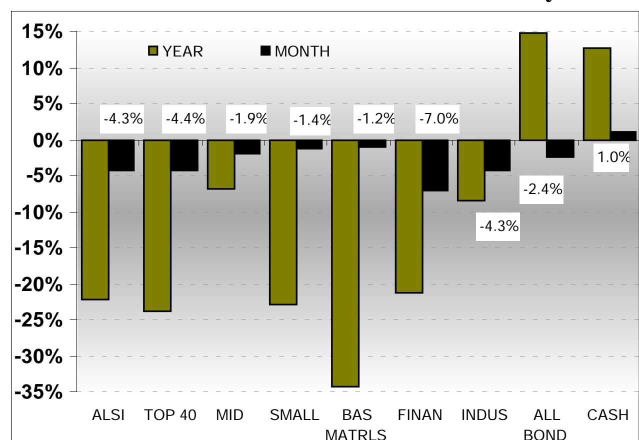


Source: Merrill Lynch

February in perspective – local markets

Let's turn out attention to the local market's behaviour in February. Not surprisingly the SA equity market was weak, ending the month down 9.9%. Large caps were weaker than most – the Top40 (large cap) index declined 10.4%, whereas the mid and small cap indices ended down 6.4% and 8.3% respectively. Financials and industrials were not that lucky, ending down 10.8% and 10.6%. The gold index rose 1.4% while the paper and forestry index plummeted 40.5% and the industrial engineering index 27.1%. The All Bond index ended down 2.9%, indicating how difficult it was to escape any of the damage to capital markets during the month.

Chart 4: Local market returns to 28 February 2009



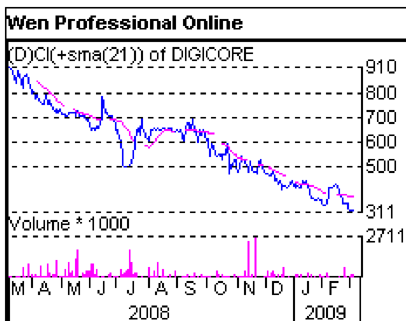
Quotable quotes

If there is a single episode in this entire 18 months that has made me more angry, I can't think of one other than AIG. There was no oversight of the financial products division. This was a hedge fund basically that was attached to a large and stable insurance company. *Ben Bernanke, Governor of the US Federal Reserve Bank.*

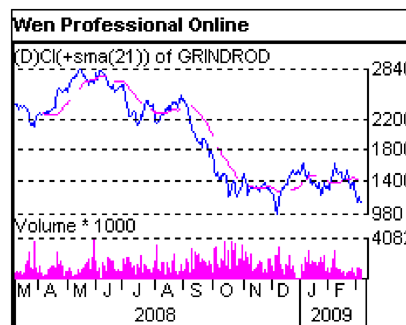
Political leaders in the US, Germany, France, the UK and elsewhere have once more threatened to close down offshore financials centres. These centres have been presented as the drug dealers of modern finance and pushers of instability. Yet the origins of the crisis are in a failure of regulatory philosophy in the US, Europe and elsewhere. It would have occurred were there no offshore financial centres. The attack on offshore centres is a politically seductive distraction from the thorny task of making regulation better in large developed countries and will end up being a discriminatory attack on small developing countries with little voice. *Avinash Persaud, Emeritus professor of the Gresham College and a member of the UN High Level Taskforce on International Financial Reform.*

A closer look at the "Maestro Equity portfolio"

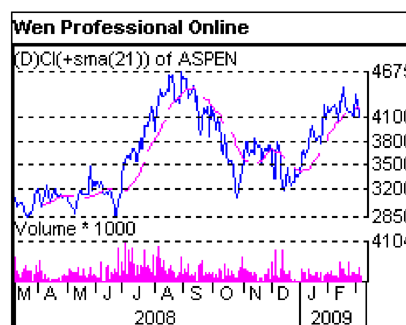
In our past correspondence with clients, we have drawn attention to our belief that most of the companies in which we and they are invested should deliver above-average earnings growth and hopefully maintain their dividends. We also committed ourselves to communicate with you when these companies presented their results. So what follows is very short comment on some of these companies. The list and comment is by no means comprehensive. It is *also not our "final word" on the company and our comments should in no way be seen as a recommendation to buy the shares.* Please keep this in mind – we are merely highlighting some of the salient features of the companies in which our clients are invested. The graphs are sourced from PSG Online.



Digicore is a large holding across most of the portfolios under our care. During the six months to end-December Digicore increased its headline earnings per share (HEPS) by 12%, which, to be frank, was disappointing. That said and in defence of the company, the base off which it reported results was very tough, as were the conditions in which they were achieved. The interim dividend of 6 cps was maintained. Cash flow was poor, particularly at the operating level, but management provided an acceptable reason for this and we have followed this company long enough to give them the benefit of the doubt. The company has no debt and its historic dividend yield is currently 6.1%. We retain our view that this is a great company, whose management team have delivered consistently good results over time – we hold them in high regard. The share is cheap, which of course in the current market means very little (there are plenty of cheap, high quality companies around) but we retain our positive attitude towards the company. The Digicore share price has fallen 63.8% in the year to end-February.

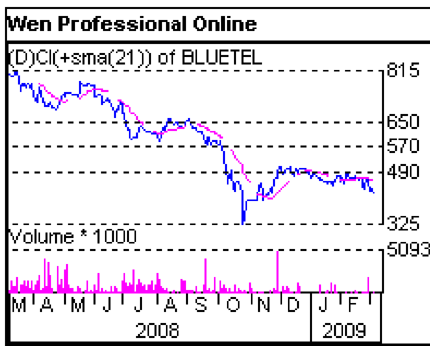


Grindrod is another of our long-time favourites which we have held for some time. You must surely be aware by now of how closely we watch the Baltic Dry index; although not a perfect one for the fortunes of Grindrod, it is a reasonable indicator for the health of the shipping industry, which is by far the largest part of Grindrod. HEPS rose 95% for the year to end-December and the interim dividend was increased by 55%, bringing the increase in the dividend for the full year to 74%. Before getting too excited about these results – and they were pretty spectacular – they were achieved in a unique operating environment which has changed dramatically in recent months. So it would be unrealistic to expect a repeat of these results in the year ahead. The company even warned against expecting further "super profits." So we have no lofty expectations for Grindrod's earnings in the year ahead; indeed they are likely to decline significantly in 2009, but we expect the long-term rise in earnings to continue. The company is effectively ungeared (it has no net debt) and has an exciting future ahead of it. Grindrod's historic dividend yield is currently 11.8% - while this is unlikely to remain so high in the year ahead the share is still cum-dividend of 68cps or 5.1%. We retain our positive view towards the company. The Grindrod share price has fallen 45.5% in the year to end-February.



Aspen is one of the more defensive companies in our portfolio and its recent results bear testimony to its defensive nature. HEPS rose 77% in the six months to end-December, as Aspen reaped the benefits of a very good deal it undertook with GlaxoSmithKline last

year. It has strong cash flows, which has enabled it to grow through acquisition over the years. It has a reasonable amount of debt but we think they are within manageable levels. Aspen dominates its market, and indeed the sub-Saharan continent, and we think it still represents an exciting story for the future. The Aspen share price has *risen* 34.7% in the year to end-February.



Blue Label Telecoms is a rather different company from our usual holdings; it represents a very long-term story of great opportunity although it is going to take some time to come to fruition. We may have got our timing wrong with our initial entry into the company, but we remain attracted to the long-term story of Blue Label. There are a number of specific attributes that appeal to us, not least of which are its cash generation ability and its "next generation" technology. After blotting their copy book in the early stages, company management are coming to terms with the protocol attached to life as a listed entity, and after posting a difficult set of initial results to understand (also part of the transition to life as a listed company) the interim results to end-November were most encouraging. "Core" earnings rose 20% (actual HEPS rose 587.6% but this is rather misleading) and cash flows remained strong. The company does not pay a dividend. The nature of a company such as Blue Label and the type of "product" it offers is ideal for a time such as this in the economy. Although our holdings in the portfolio are still small, we like the company and will wait for the opportunity to increase our holdings in the future – this decision is dependent, of course, on the prevailing sentiment and market conditions; we are not about to rush out and buy more stock right now. The Blue Label share price has fallen 43.6% in the year to end-February

The shape of things to come

Time and time again in our internal discussions we (the Maestro team) highlight the speed at which the world is changing. Due to the crises that broke last year and the economic turmoil in which the world now finds itself, the world as we knew it only two years ago no longer exists. New relationships are forming between nations, old ones have broken down; old power bases have been blown apart (look at Russian and Iceland for example) and new ones are emerging. It is our humble view that in a couple of years time a New Order will exist in the world which will be unrecognizable from the one of two years ago. In an attempt to focus on this phenomenon, we plan to highlight some of the events indicative of this process of change in a section entitled "The shape of things to come".

Not surprisingly, two countries which dominate this discussion are China and the US, one on the way and the other on the way down. So we begin by drawing your attention to the deal wherein China lent Russia $25bn in return for a 20-year agreement wherein Russia supplies oil to China from new fields in eastern Siberia.

In similar vein, Chinalco, a large Chinese aluminium producer, bought a 9% stake in Rio Tinto in aid of Rio's defence against the attempted (but since aborted) hostile takeover by Billiton. With Rio now under pressure because of high level of debt, Chinalco have agreed to take an additional 9% stake in Rio Tinto through a capital injection of $19.5bn. Separately, Sinosteel, a large Chinese steel maker, took control of a large iron ore producer in Australia, Murchison. Other Chinese operators have been equally busy snapping up resource companies: Minmetals bid $1.7bn to take over Oz Minerals and Hunan Valin Iron and Steel recently announced a planned $1.8bn takeover of Fortesque Metals. The message is clear: while the world burns China is rapidly snapping up scarce supply of resources. This in itself holds some interesting prospects for South Africa with its large resource base.

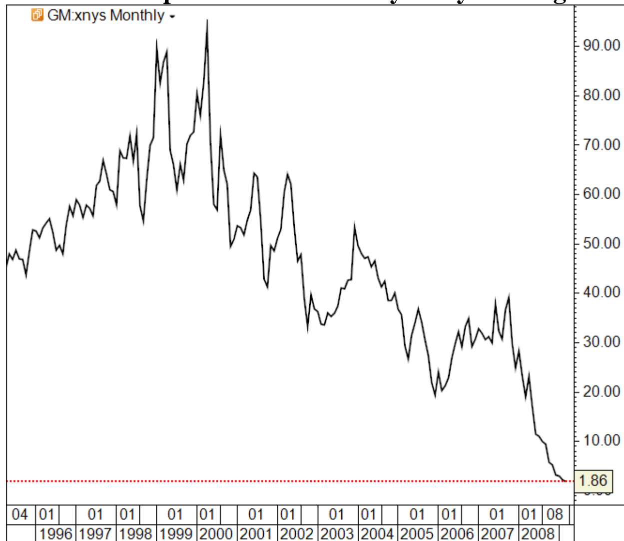
Across the waters, the US is drowning in debt, both at the corporate, consumer and government level. When US President Obama recently announced the outline of his Budget, he warned of (budget) deficits of "trillions for years to come." Without highlighting all the aspects of that budget - it doesn't make for pretty reading – by way of comparison the Budget plans to run a $1.75 trillion deficit this year, the equivalent of 12.5% of GDP (compare that to SA's current 1.0% deficit). In addition, the budget contained the news that the marginal tax rate for married couples earning more than $250 000 per year would be raised from 35.0% to 39.6%. And if that wasn't bad enough, the maximum CGT rate was increased from 15% to 20%. It puts the SA tax regime in some sort of perspective.

File 13 – things almost worth remembering

We have focussed a lot on the automakers lately, especially those in the US, for reasons explained above. Let's look at arguably the biggest "dud" of them all. GM reported a quarterly loss of $9.6bn or $15.71 per share - its share price at the time of writing was only $2.38. Its annual loss for 2008 was $30.9bn and *the company has now racked up losses of $86.6bn in the past four years*! It burned (utilized) $6.2bn during the quarter, ending with a cash balance of $14bn (GM estimates it needs $14bn a quarter just to keep going), which includes $4bn of the US government's recent $13.4bn capital injection. And just to add insult to injury,

GM disclosed that its pension fund had swung from a $20.0bn surplus into a $12.4bn deficit during the past year. Now I have to ask you: in your opinion, is this a company that should be benefiting from taxpayers' money to bail it out? Is there any reason why, in the grander scheme of things, companies like GM should be allowed to survive?

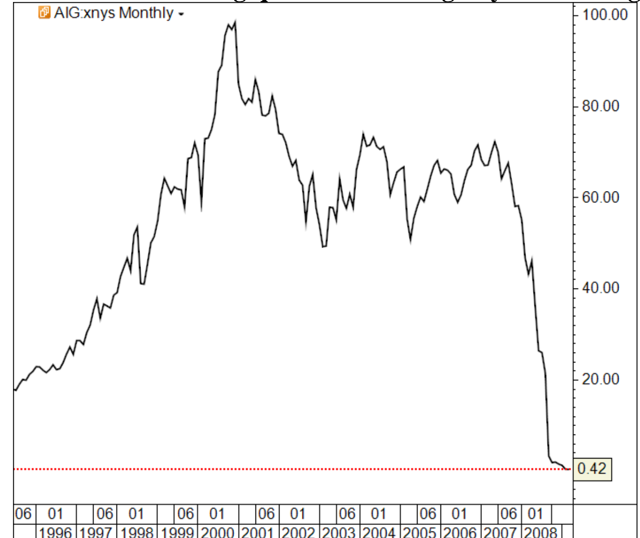
Chart 5: GM price: how to destroy 100 years of growth



Source: Saxo Bank

Speaking of incompetence, AIG reported a third Q4 08 loss of $61bn – the largest loss ever posted in US corporate history – bringing its loss for all of 2008 to a staggering $100bn. Admittedly the quarterly loss was exacerbated by write-downs on much of its balance sheet, but the reality is AIG was operating in a market well outside of its traditional business, so it is hard to feel too much sympathy for it (refer to Bernanke's comments on AIG, above). Remember that the US government has already committed $100bn of taxpayer's funds to support AIG and committed a further $30bn last week to keep the business running. In the cold light of day, one has to ask if anyone either inside the company or outside within government (for its sins government already owns 80% of AIG) knows what they are doing.

Chart 6: AIG: nothing quite like sticking to your knitting



Source: Saxo Bank

The picture of overpaid executives completely out of touch with their business, and with regulators and policy makers who are completely incompetent is now common place in the US. This, at a time when US unemployment has hit a 25-year high and more than 12.5m American are unemployed. The transformation of the "American dream" into the "ultimate and total nightmare" is in full flight. And that is what US equity markets are telling us.

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