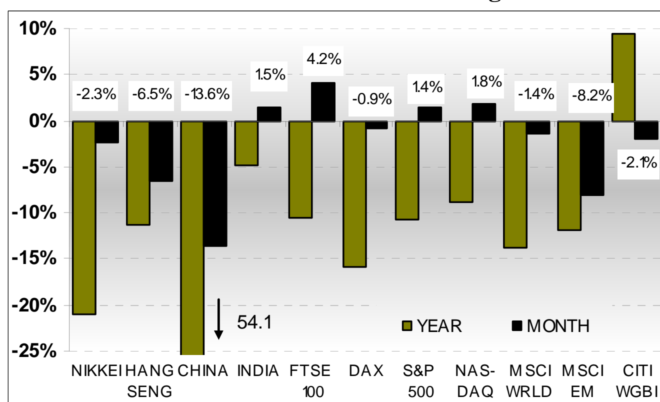
INTERMEZZO

MAESTRO
Investment Consulting

Investment Letter | 8th Edition | September 2008

August in perspective – global markets
The more we look at the market behaviour during July, the more we realise it, together with January, will go down in history as one of the most extraordinary months ever experienced on global investment markets. By now July returns of investment funds have been reported and the damage is becoming apparent, particularly in the hedge fund space. Fortunately August was a bit more "stable" and in some areas, more profitable. Intra-month volatility was still above-average but at least from some quarters came reasons to believe a degree of *relative* stability might return. If one had to sum up the salient features of the month they would be a weak euro, which led to a strong dollar (it gained 5.6% against the euro – an unprecedented gain in currency market terms). This in turn led to weak commodity prices (the S&P GSCI index declined 8.0%), specifically the oil price, which declined 10.2% on the month. Gold (-9.3%) and platinum (-15.9%) prices were amongst the weakest. Equity markets turned in mixed performances. Two notable decliners were China, down 13.6% and Russia, which declined 16.3% (it fell 14.6% in July) as the weaker oil price gained traction and the global community voted with their feet following Russia's invasion and subsequent recognition of South Ossetia and Abkhazia, two previously autonomous regions in Georgia. Table 3 at the end of the report provides the usual look at emerging market returns during August.

Chart 1: Global market returns to 31 August 2008



So how bad *was* July?
It is often only *after* the event that one sometimes gets a true perspective of the circumstances prevailing at the time of the event. I refer you to the August edition of *Intermezzo* to get a perspective of last month's market behaviour. I would however, like to add a few comments to give you an idea of how bad it actually was. Without adding too much detail, consider the following events that occurred during July; it will give you an idea of how traumatic and volatile the month was in global investment markets:

- The Credit Suisse Tremont Hedge Index ended July 2.6% lower, its largest decline since April 2000 (Y2K bubble) and August 1989 (LTCM woes) before that.
- The KBW Bank index, which tracks 24 regional US banks, rose 41.1% in the six trading days following the Fed's explicit commitment (on 15 July) to stand behind Freddie Mac and Fannie Mae.
- After dropping 15.5% between the 1st and 15th of July the S&P Financial ETF, which mirrors the S&P Financial index, rose 31.0% in the ensuing five trading days. It declined 28.4% during the first half of 2008.
- Bearing in mind that many managers, especially in the hedge fund world, were "long" material shares and "short" financials and bearing in mind the reversal of fortune financial shares underwent from mid-July, it is worth noting that the S&P Materials ETF (in effect the US resource index) declined 17.5% from its mid-May peak to end-July. The CRB Commodity and S&P GSCI declined 10.0% and 11.0% respectively on the month - no wonder so many (global macro) hedge fund managers came unstuck.
- The West Texas Intermediate (WTI) oil price declined 11.2% in one week, recording its largest one-day decline ever in the process.
- Not unrelated, the Russian equity market declined 14.6% - Russia is very reliant on oil exports.
- In the midst of all the chaos the SEC, the US financial regulator, banned all short-selling in an effort to stop the carnage. This might not seem like a big deal but it represented an unprecedented step and had a large impact on fund returns. Imagine for a moment, if, in the midst of a market crisis and were simply told you could no longer buy or sell any shares? How would you protect your capital? What about the positions and views you had established and could now no longer act on? Or if you had made a profit on an investment position and I now forbid you from closing the position or acting on it in any way. That is the position many managers found themselves in – no wonder they registered terrible returns during July. One wonders if, in the litigious society that is the US, whether someone will not seek recourse from the SEC in due course. Time will tell.
- If you had been active in the credit market, you would be aware of the fact that towards the end of July, Merrill Lynch decided to offload their Collateralised Debt Obligation (CDO) portfolio. Apart from the fact that the CDO market had grown extremely thin and illiquid as the credit crisis intensified, what made their sale so remarkable was that they literally dumped it on the market – all $30bn of it! And at a discount of about 80% to its face value (22c in the dollar to be exact!). Imagine if you were active in a troubled and illiquid market and a very large player suddenly offloaded a

huge amount of goods at an 80% discount! Not much you would be able to do about that, no matter where the true value of the goods lay. Small wonder some view pricing in areas of the current credit market as bearing no relationship to the true value or fundamentals of that market.

What's on our radar screen?
We remain focussed on the changing economic landscape and list below a couple of significant developments in this regard:

- *The Japanese economy* contracted at an annualised rate of 2.4% during the second quarter, significantly lower than the annualised first quarter growth rate of 3.2%. Its quarter-on-quarter growth rate was -0.6% after having risen by 0.8% in the first quarter. Sharp declines in domestic demand and exports – a function of the slowing global economy – were the main detractors from second quarter growth.
- *Chinese inflation,* having declined from 8.7% in February to 7.1% in June, declined further to 6.3% in July. Some time back we highlighted rising Chinese inflation as a major risk to the global economy. It seems that this threat is receding although we are still keeping a wary eye on it.
- *The 15-country Eurozone economy* contracted for the first time in ten years. GDP declined 0.2% versus the 0.7% rise in the first quarter. The German economy – the Eurozone's largest - declined 0.5%. The German IFO business climate index fell sharply to its lowest level in three years; the expectations sub-component declined to its lowest level in 15 years. The French economy declined 0.3%. The surprise was Spain, where growth of 0.1% was registered. *Eurozone inflation* rose to 4.0% in July but declined marginally to 3.8% in August.
- *US inflation* rose 0.8% in July, bringing its annual rise to 5.5%. Core inflation i.e. inflation excluding rising food and energy prices, rose 0.3% in July bringing its annual rise to 2.5%. Core inflation is a better indication of long-term US inflation. It remains our view that inflation in the US is not a problem and that concern will eventually turn to the threat of deflation. Second quarter *US economic growth* was revised from its initial estimate; the US economy grew at 3.3%, up from 1.9% in the first quarter. Final domestic demand remained soft (1.5%) but government spending of 3.9% saved the day.
- *UK inflation* rose to 4.4% in the year to July from 3.8% in June, to the highest level in 16 years. The Bank of England kept rates on hold at its August meeting as it sought to balance rising inflation and slowing growth. The biggest victim of these events was the pound, which declined 7.9% against the dollar in August.
- *The SA economy* grew at an annualised rate of 4.9% during the second quarter (Q2). This is a bit flattering though; the base i.e. activity during the *first* quarter (Q1) was very low, having been affected by the severe Eskom (power) disruptions. Mining production, for example, declined 34% during Q1 but rebounded more than 15% in Q2. Manufacturing activity rebounded 15%. So one needs to treat the Q2 GDP number with caution even though it represented a significant improvement on Q1 growth of 2.1%.
- *SA inflation and interest rates*: headline inflation rose to 13.4% in July; the monthly gain was a disheartening 2.1%. Readers outside of the country may be interested to know that a heated debate is underway in the country regarding the re-basing of the inflation basket of goods. The process, which occurs every five years, is currently two years late although there is speculation that the new weights will be applied early in the New Year. Why is this important? Current projections are that the new weightings will reduce inflation by nearly 2.0% i.e. the July rate would have been 11.4% rather than 13.4%. In a perverse way the prevailing consensus view is that the Reserve Bank is unlikely to raise interest rates again this year knowing that within a few months' time inflation will decline by 2.0%, thereby alleviating some of the upward pressure on rates. We are sympathetic towards that view but are acutely aware of, and are keeping a wary eye on, the real threat of a long period of above-average inflation, conscious of the damage it will inflict on the economy.
- *Indian inflation* continues to rise; it rose to a 16-year high in July to a level of 12.6%, fuelled by rising food and energy costs, underlining expectations that the Reserve Bank of India (RBI) would increase rates further. Second quarter *economic growth* slowed to 7.9% from 8.8% in the first quarter, its slowest growth rate in three years. The services and construction sectors grew 10.0% and 11.4% respectively, although growth in the manufacturing sector slowed to "only" 5.8% from 10.9% a year earlier. The Indian equity market has declined 27.9% so far this year.

You may ask why all the data? Data in itself is meaningless if not intelligently applied and profitably utilized. However, the global economy is at a critical junction and we are monitoring as much as we can to ascertain its state; central banks around the world are struggling with inflation and the global economy is slowing. The extent to which the latter occurs as well as how successful central bankers are in their attempts to arrest inflation will determine the future direction and health of equity markets – that's why we are watching these events so closely, and share them with you.

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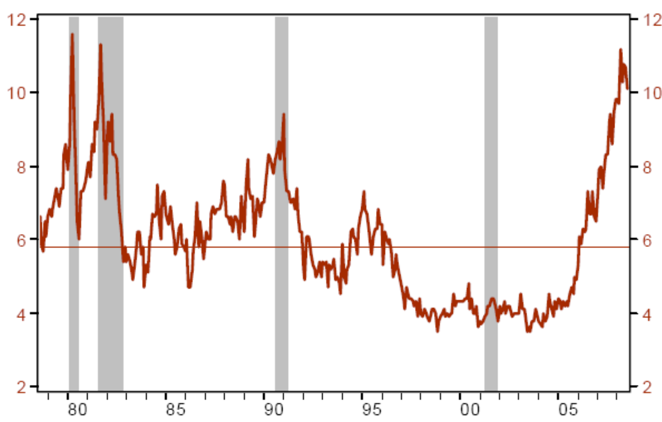
Chart of the month

You should know by now that one of our big concerns about the future of the global economy is the state of the US consumer, who constitutes 18% of the global economy. One of the main reasons undermining his well-being is the state of the US housing market. For years now US consumers have drawn down on their home equity i.e. accessed capital from bonds on their houses. With the price of housing in virtual freefall and a massive excess supply of houses on the market, the prospects for the US housing look bleak indeed. How bleak? Chart 2 and 3 provide a clue. The shaded areas in the charts represent periods of recession in the US.

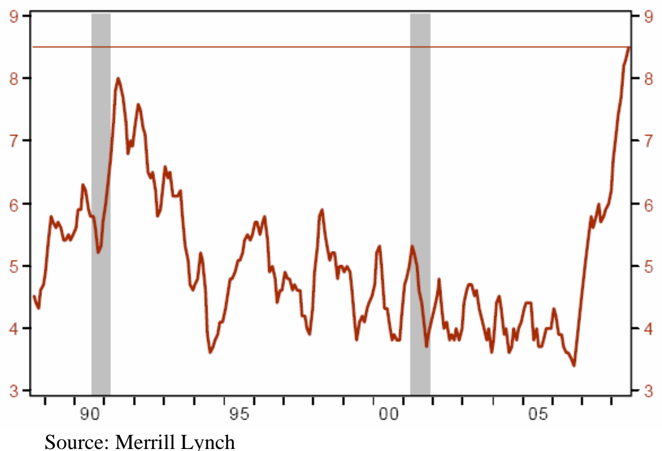
Chart 2: Months supply for new US homes for sale



Source: Merrill Lynch

Chart 2 shows that despite the huge price declines there is still 10 months' of supply of new homes on the market. An estimated 1 million new homes are coming onto the market, having been built by builders. Here, too, there is bad news, as depicted in Chart 3. Builders are taking more than 8 months to move their stock i.e. sell a newly built house, which is the longest time on record. Clearly, the housing problem is not about to go away in a hurry.

Chart 3: Median no. of months for sale since completion

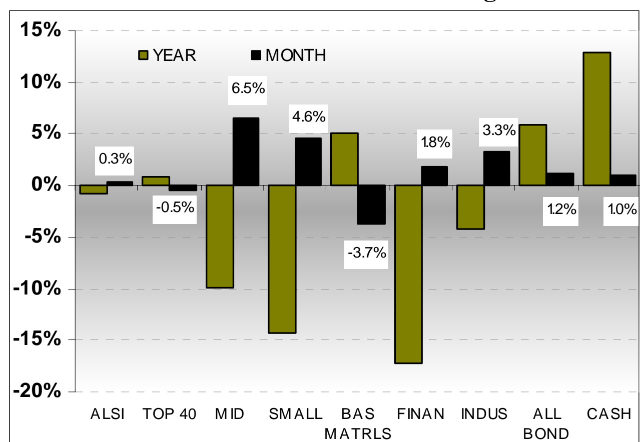


Source: Merrill Lynch

August in perspective – local markets

August was one of those months – we have had a few such occasions so far this year – where *on the face of it* nothing of significance happened; after all, the All share index was flat (+0.3%). But of course nothing could be further from the truth. Two trading days into the month and the All share index was down 6.8% (three days into July the index was also down 6.8% and five days into September the index is down 8.3%). Fortunately it recovered its losses but the materials (resource) sector ended 3.7% lower (after a 19.4% haircut in July) and the industrial index ended 3.3% higher. So despite the "flat market" there was a lot of movement within different sectors. Food producers (+16.1%) and household goods (+15.7%) were the top performing sectors while the gold mining (-15.1% and -11.3% in July) and mobile telecoms (-6.2%) were the weakest. Good results from a number of mid and small cap shares assisted these indices to rise 4.6% and 6.5% respectively, admittedly off low bases. Perhaps the most ironic aspect of the market is that despite this having been one of the most volatile equity markets for many years and despite the onslaught of two (credit and energy) global crises the All share index annual return to August is a remarkable -0.8% - as though nothing at all had happened in the past twelve months!

Chart 4: Local market returns to 31 August 2008



Back to basics

We have been beating the "back to basics" drum for some time now, having consistently drawn your attention to the "better-than-believed" earnings prospects of many SA companies, at least those which make up the bulk of the equity portfolios at Maestro. In this regard I refer you to the June Quarterly Reports – specifically Table 2 - where we listed some examples of what we believed were valuable investment opportunities. (For readers who are not Maestro clients, you can view our comments in the Maestro Equity Fund June Quarterly Report on our website). The proof of

the pudding, as they say, is in the eating. We list therefore, in Table 1, examples of the recent results of companies in which we have invested our clients' funds.

Table 1: The proof of the pudding…

Company	Price	Historic		Growth in		Forward
	(c)	PE ratio (x)	Div yield (%)	HEPS (%)	DPS (%)	PE Ratio (x)
Grindrod	2330	6.2	4.8	95.0	100.0	4.7
Dawn	1200	8.6	2.9	35.0	40.0	6.4
Group 5	4620	10.3	2.3	57.9	45.8	7.7
City Lodge	7500	14.3	5.0	27.0	27.0	11.4
Implats	22400	10.9	6.6	57.0	51.3	7.0
Iliad Africa	684	9.2	6.0	10.0	N/A	9.1
Wilson Bayly Homes	13700	10.9	1.3	145.0	100.0	8.0

Decoupling revisited – profitability of Chinese banks

As the current bear market has gained traction and started eating into returns, so the "decoupling" debate has grown strangely quiet. We made no secret of our position in this debate when we raised it last year: we are firm believers in "decoupling" although we also sought to qualify exactly what we meant in our communication with you. The debate has many aspects to it. Decoupling can refer to a separation of the levels of economic activity or the movement of the investment markets or currencies, and even to the level of profitability. With respect to economic activity the debate has surely been settled; remember that we never said that China's growth would not slow due to a US economic recession; we said it *would* slow but would *not be impacted too much* due to the underlying secular nature of the developments within China in recent years. The Chinese economy is now growing at 10.1% and India at 7.9% versus 3.3% in the US, although I would hasten to point out that our view is still that the US is effectively in a recession even if this hasn't shown up in the data yet (watch this space).

I would like to focus briefly on the decoupling of corporate earnings. News headlines have been dominated by the near-collapse of Western banks and some (Indy Mac, Northern Rock and Bear Sterns) have already "gone under." Bank write-downs now exceed $500bn in this credit crisis and are likely to head much higher still. There can surely be no disagreement that the profitability of European, US and even some Australian banks is in a parlous state; not many banks are making money today; fewer still are increasing their profits (the notably exception is SA banks which have weathered the global credit crisis well so far, even if their share prices haven't). How then are Chinese banks faring? The Industrial and Commercial Bank of China (ICBC) announced last month that its first half profits rose 57% to $9.5bn. This is the largest first half profit ever earned by a bank in history, adding to ICBC's other accolade of being the world's largest bank in terms of market cap. Chinese banks have been relatively immune to the current banking crisis as they have very little international banking activity and are largely focussed internally. The fancy credit instruments that have caused so many headaches for the world's largest banks (especially the investment banks) simply don't exist in China. ICBC's total return on assets rose from 1.02% to 1.44%, bringing it in line with many of its Western counterparts.

ICBC's earnings weren't the only ones to impress. China Merchants Bank said profits grew 100% in the first half; China Citic Bank said its profits rose more than 150%. Admittedly the comparison is not a perfect one but on the face of it at least here, in the form of bank profitability, is another area in which a substantial case for decoupling can be made.

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. Returns include income and are presented after fees have been charged.

Table 2: Returns of funds under Maestro's care

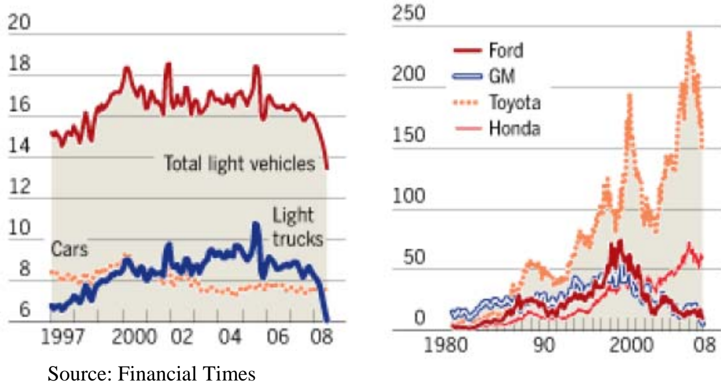
	Period ended	Month	Year to date	Year
Maestro Equity Fund	Aug	**3.7%**	**-2.3%**	**1.3%**
Maestro equity benchmark *	Aug	0.6%	-3.8%	-3.0%
JSE All Share Index	Aug	0.3%	-2.6%	-0.8%
Maestro Long Short Equity Fund	Jul	**-2.1%**	**-14.5%**	**-12.1%**
JSE All Share Index	Jul	-8.7%	-2.9%	-0.4%
JSE Financial and Indus 30 index	Jul	-3.3%	-8.9%	-7.4%
Central Park Global Balanced Fund ($)	Jul	**-1.8%**	**-4.7%**	**-3.6%**
Benchmark**	Jul	-1.5%	-4.8%	-1.7%

* 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

File 13 – things almost worth remembering

Last month in the File 13 section we looked briefly at the US automobile industry. I recently came across the charts below, which I thought you would enjoy in the light of our discussion last month. The left hand chart in Chart 5 depicts vehicle sales in the US and the right hand chart depicts the respective market caps of some of the major players in these markets. Note how insignificant are the values of Ford and GM, once giants of the "auto" industry but still US icons.

Chart 5: Running out of "*vooma*"



Source: Financial Times

The final feature for "File 13" comes in the form of a fascinating aspect of the Dow Jones's behaviour brought to us per kind favour of Merrill Lynch. There have been a number of 300-point rallies in the Down Jones Industrial Average over the past few months. One is tempted to ask if such events herald the start of a sustainable uptrend or are they little more than bear market rallies. The message of the markets is clear: *300-point rallies don't happen in bull markets*. On the contrary, they happen in bear markets. There was not one such rally in the bull market between October 2002 and October 2007, but so far it has happened no less than six times in the current bear market and it happened 12 times in the last bear market.

Finally, many of you would have heard that the Cape is being battered by late winter storms that have been accompanied by huge swells, both of which have wrought widespread destruction. I include some photos of the recent storms to show you that it is not only the financial markets that are stormy and unpredictable at present!

Table 3: MSCI Emerging Market August returns (%)

EM countries/regions	Aug-08	YTD
Thailand	1.0	-22.0
Philippines	0.7	-33.5
Israel	-0.8	-3.4
India	-1.4	-38.8
MSCI DM	**-1.6**	**-15.4**
Taiwan	-2.1	-16.5
Jordan	-4.0	9.3
Mexico	-4.3	-9.4
South Africa	-5.1	-14.4
Chile	-5.7	-4.9
Morocco	-5.8	16.4
Indonesia	-6.8	-18.7
Asia	**-7.3**	**-29.5**
MSCI EM Small Cap	**-7.6**	**-30.4**
Argentina	-8.0	6.5
Peru	-8.2	-18.7
China	-8.2	-31.7
MSCI EM	**-8.2**	**-23.2**
LatAm	**-8.5**	**-9.9**
Czech Rep	-9.0	-4.0
Malaysia	-9.0	-27.3
Egypt	-9.3	-17.0
Turkey	-9.5	-31.6
EMEA	**-9.7**	**-20.4**
Brazil	-10.2	-10.8
Hungary	-10.9	-14.4
South Korea	-13.8	-32.8
Poland	-13.8	-16.8
Russia	-14.7	-30.4

Source: Merrill Lynch

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