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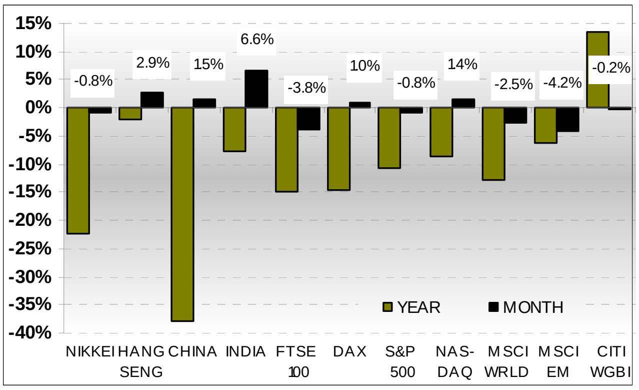
MAESTRO
Investment Consulting
Investment Letter | 8th Edition | August 2008

July in perspective – global markets

This year continues to deliver more than its fair share of surprises – July was no exception. Ongoing fears about the consequences of the global credit crisis, slowing economic growth and the rampant oil price weighed heavily on the world's markets in the early part of the month. At one stage it looked like the financial sector, particularly in the US, was on the brink of collapse until the US government explicitly undertook to honour its guarantees in respect of Freddie Mac and Fannie Mae. That proved to be the catalyst for a major turnaround in financial shares and the dollar. Due partly to the firm dollar the rise in the oil price, which had earlier peaked at $147.60, was reversed. This had a knock-on effect across the entire commodity complex. Oil ended the month down 11.3%, platinum 14.8% and the CRB index 10.0%. Bond markets were relatively stable, declining 0.2%. And from what we can gather, alternative managers didn't cope well with the inordinate volatility – more about that later. For the record, the MSCI World and Emerging market indices declined 2.5% and 4.2% respectively. The usual Table of emerging market returns appears at the end of this letter.

Chart 1: Global market returns to 31 July 2008



What's on our radar screen?

Last month we highlighted just what a critical time this is for the global economy. There is a lot happening "out there" and many aspects of the global economy, not least of which are growth, inflation and commodity prices, are at critical junctures. We thus remain focussed on the changing landscape and list below a couple of significant developments in this regard:

- *Chinese inflation*, having declined from 8.7% in February to 7.7% in May, declined further to 7.1% in June. *Chinese economic growth* slowed to 10.1% in the second quarter from 10.2% in the first quarter. Fixed asset investment rose 29.5% and retail sales 23.0% for the year to June. The Chinese equity market gained 1.5% in July, but this should be seen in the light of the 20.3% decline in June. The Shanghai Composite index is off 55.7% from its 2007 peak and is down 47.3% for the year to date. The index rose 130.4% and 100.4% in 2006 and 2007 respectively
- *The US economy grew only 1.9%* during the second quarter. First quarter growth was revised down from 1.0% to 0.9% and growth during the fourth quarter of 2007 was revised from 0.6% to -0.2%. That's correct – the US economy *shrank* during the last quarter of last year, which underlines our belief that the US entered a recession towards the beginning of this year.
- *The Indian economy:* we are watching developments in India closely. We are not entirely certain that policy makers there are as "on top of the situation" as in, say, China or the EU. The Reserve Bank of India raised their benchmark "repo" rate by 0.5% to a 9-year high of 9.0%. In addition, they raised the cash reserve ratio for banks by 0.25% to 9.0%. This comes on the back of another rise in inflation to close to 12.0%.
- *SA inflation and interest rates*: headline inflation rose to 12.2% in June, although the Reserve Bank opted to leave interest rates unchanged. I'm sure you're as aware of it as I am, but the firm rand in July and the weaker oil price are just what the doctor ordered in order to alleviate some of the upward pressure on inflation and hence also local interest rates.
- There are growing signs of a slowdown in *Eurozone growth*. Leaked reports indicate that German GDP is likely to have shrunk by 1% during the second quarter, although it is coming off the first quarter's high base. *Eurozone inflation* rose to 4.1% in July, its highest level since the EU was formed in 1999, double the European Central Bank (ECB)'s target rate of 2% and marginally higher than June's rate of 4.0%. That must have played a role in the ECB's decision to raise interest rates by 0.25% to 4.25% in early July, but it kept them on hold in early August, at the same time expressing concern about the threats to EU growth.

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What do we actually mean by volatile?

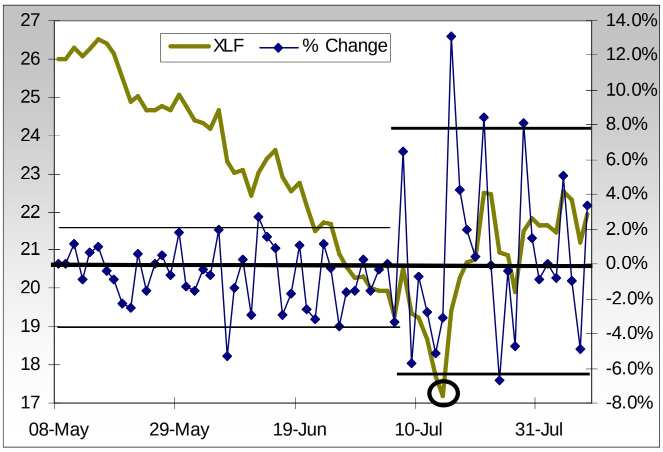
I indicated earlier that the US financial sector seemed as though it was on the brink of collapse until the US government undertook to honour their obligations. Of course, prices of financial companies around the world have been severely punished over the last year – refer again to Table 1 in your June Quarterly Report if you need to be reminded about the decimation of financials. Even so, they continue to be plagued by great uncertainty and their prices remain very weak. However, we may, and I stress *may*, come to see 15 July as the turning point (depicted by the circle in Chart 2). It was the day the US government agreed explicitly to stand behind their obligation to honour the guarantees on Freddie Mac and Fannie Mae bonds. Once they had done so, financials staged a huge turnaround, which was accompanied by an equal but opposite reaction in basic material shares. The market behaviour through the remainder of the month continued that trend i.e. strong financials and weak basic materials; look no further than the 12.5% return of the JSE financial index and the 19.4% *decline* in the basic materials index.

Allow me to share with you what exactly I mean when I say the "markets were volatile". I often refer to them as such, but what does that actually mean? July provided a great example: Chart 2 depicts the S&P500 Financial index exchange traded fund (ETF), which goes by the NYSE code of "XLF" – the local equivalent is the Satrix Financial ETF or "Satrix fini." The chart depicts the XLF price on the left hand scale and its daily percentage change on the right hand scale – the dark horizontal line depicts 0%. I have listed a three-month history of returns in order to show the change that occurred in XLF's price behaviour during July.

Even though I would hardly call the daily volatility during May and June "normal", see how the volatility increased in July. From around -4% to +4% in May and June, the range of daily price changes increased to between -8.0% and nearly 14%. During July we had five days when the index declined 5% or more and four days when the index rose nearly 8% or more. On July 16 it increased 13.1%; the intra-day range on July 15 was 8.4% and on July 16% it was 9.9%. *That's what I call volatile;* in fact all of July was crazy and no more so than in financial sectors on global exchanges.

Chart 2: S&P500 Financial index ETF (XLF)

Daily price – left hand scale; daily percentage change – right hand scale

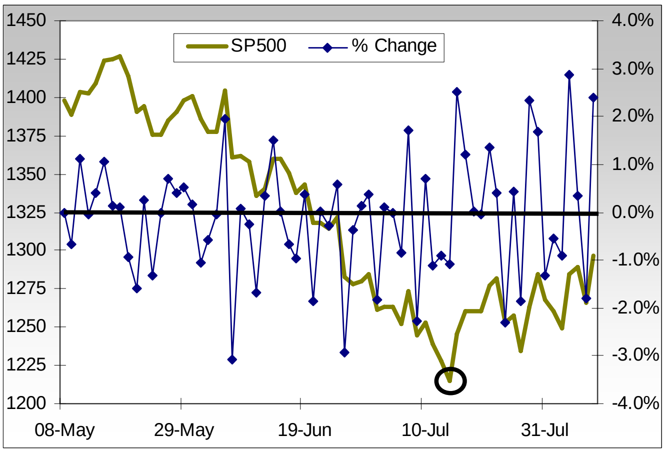


I also humbly remind you that the same but opposite effect was simultaneously in play in the basic materials sector? I hope this provides more insight into what transpired during July and the forces at play behind the extraordinary index returns, good and bad, specifically the financial and basic materials indices. As an aside I suspect we will see very poor July returns from alternative (hedge) fund managers, simply due to the virtually *unmanageable* volatility that characterised the financial sector during July.

For your information and perusal I have drawn a similar chart for the S&P500 index, shown in Chart 3. The volatility is not as large as the financial sector's, but it remains large by historical standards.

Chart 3: S&P500 index

Index – left hand scale; daily percentage change – right hand scale



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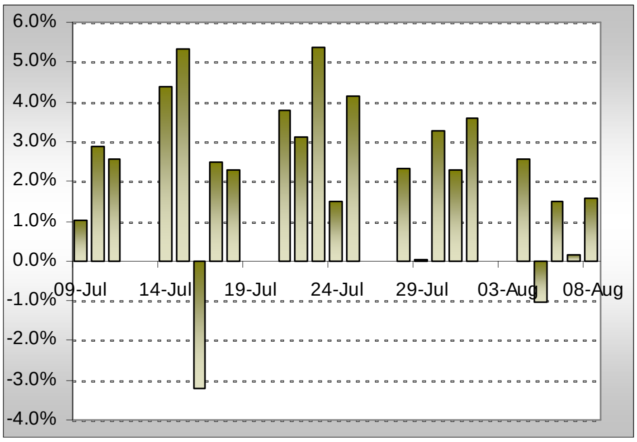
Whilst on the topic of volatility although we generally focus on *daily* changes to the indices, remember that during the day they move around a lot too. You would be surprised to see how much markets move intra-day. By way of example, Chart 4 depicts the difference between the intra-day and daily returns, in absolute terms, of the S&P500 Financial sector (XLF). For example, if the range of the day's trade i.e. the difference between the high and low point of the day's range, expressed as a percentage of the day's opening level, was 3% and the daily change i.e. the difference between the day's closing level and that of the previous day, was 2% then Chart 4 will reflect 1%. It shows the *difference* between the intra-day and daily percentage change in XLF over the past month. If the result is positive, it means the intra-day range was greater than the daily change. Now consider Chart 4.

Chart 4: And you thought the daily change was volatile

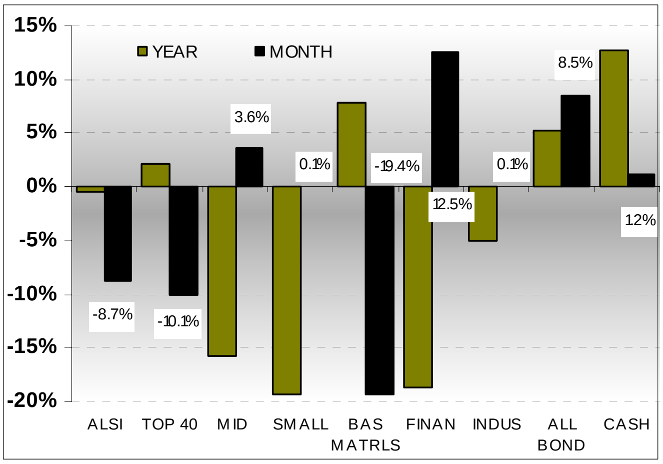


Notwithstanding the huge increase in daily volatility in the financial sector, as shown in Chart 2, *the intra-day volatility was even greater* than the simple daily changes in the index. More specifically, on only two days (and one of those was when the index rose 13.1% on the day) in the past month were the daily changes greater than the intra-day range. In other words, the index – and you can use that as a proxy for the general market – was even more volatile than the daily changes indicate. As I have said in the past "the room to make mistakes was *very* large!" Exactly how large can be deducted from the absolute levels of the difference – most of them are at least more than 2% per day; some are even larger than 5%.

July in perspective – local markets

"The extraordinary tale of two markets continues to unfold on the local equity market" – that's how we began this section last month, and it is true once again, except that this time the roles were reversed. Whereas the financial sector was very weak (-10.0%) in June, it rose 12.5% in July; last month the resource sector held up well (1.2%) but it was trashed in July, falling 19.4%. Look at Chart 5 and consider the monthly and annual returns for those two sectors; then you will appreciate just how volatile they have been. Gone are the days of 1% or 2% changes. Double digit monthly changes seem the order of the day, making for a very difficult environment in which to execute any trade or enter or exit the markets. Such is the nature of the markets at present. Of course, the movements on the SA equity market mirror those on international markets, which is why we at Maestro retain so much focus on global markets. The top performing sectors in July were pharmaceuticals, which rose 29.2% (thanks to Aspen's 32% gain) and banks up 21.1%, while the big loser were coal and platinum, which declined 27.3% and 22.8% respectively.

Chart 5: Local market returns to 31 July 2008



Quotable quotes

"*This crisis is different* – a once or twice a century event deeply rooted in fears of insolvency of major financial institutions…. The remarkably strong performance of the world economy since the near universal adoption of market capitalism is testament to the benefits of increasing economic flexibility. It has become hard for democratic societies accustomed to prosperity to see it as anything other

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than the result of their deft political management. In reality, *the past decade has seen mounting global forces* (the international version of Adam Smith's invisible hand) *quietly displacing government control of economic affairs*. Since early this decade, central banks have had to cede control of long-term interest rates to global market forces." This is an extract from an article by former Fed Governor Alan Greenspan, writing in the Financial Times on 4 August. His article was entitled *"Repel the calls to contain competitive markets."* The italics are mine. If you would like to read the article, please contact me directly for a copy.

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	Jul	**-4.9%**	**-5.8%**	**-2.2%**
Maestro equity benchmark *	Jul	-3.4%	-4.3%	-2.2%
JSE All Share Index	Jul	-8.7%	-2.9%	-0.4%
Maestro Long Short Equity Fund	Jun	**-2.1%**	**-14.5%**	**-12.1%**
JSE All Share Index	Jun	-4.4	6.4	10.1
JSE Financial and Indus 30 index	Jun	-10.8%	-11.8%	-9.1%
Central Park Global Balanced Fund ($)	Jun	**-3.1%**	**-3.0%**	**-1.0%**
Benchmark**	Jun	-3.1%	-3.4%	-0.4%

* 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

Whilst on the topic of returns, in the middle month of the quarter we traditionally list client's equity portfolio returns. Here, then, are the returns for the periods ended 30 June.

Table 2: Maestro annual returns to 30 June 2008 (%)

SA equity returns	6 mths*	1 yr	2 yrs	3 yrs	4 yrs	5 yrs
Maestro long-term equity portfolios	***-2.3***	***2.1***	***27.2***	***32.6***	***36.7***	***36.1***
Maestro equity benchmark **	-1.0	2.6	18.6	26.8	30.8	30.6
JSE All Share Index	6.4	10.1	22.8	32.4	35.1	33.0

* 6-month returns are un-annualised
** 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index

It is interesting to compare the returns of the Maestro Equity benchmark, which downgrades the weighting of basic material shares in the All Share index with those of the latter. The former has recently begun lagging the latter. This is almost fully ascribable to the very high basic material index returns over the past three years and the poor ones from the financial sector. We have repeatedly referred to this dichotomy of returns over the past year in our recent correspondence, particularly in the Quarterly Report. Given the 31.9% swing in favour of financial (+12.5%) over resource (-19.4%) returns seen in July, this situation could reverse quickly if we see another few months of resource underperform. Sector rotation is nothing new, but the speed at which it takes place these days is – which also accounts for a lot of the return volatility that is part and parcel of the markets these days. We see it as our duty to guide clients' investment portfolios through these massive swings, bearing in mind their tax constraints. That, by definition, means we will lag at least some of the index returns for short periods of time, which is exactly what happened during the past six months (refer again to Table 2). Despite the market decline in the past year though, the equity returns are positive in the year to June; returns for periods longer than a year are still quite respectable. It goes to show what a profitable 5-year period SA equity markets are now emerging from. This should be borne in mind when analysing and comparing recent equity returns.

File 13 – things almost worth remembering

Two snippets this month: firstly, any idea of what the daily turnover on the Bond Exchange of SA (BESA) is? During the second quarter of 2008, BESA hit a record *daily* average turnover of R87.8bn. Monthly turnover rose from R1.57 trillion in May to R1.76 trillion in June, which represents its highest monthly volume ever.

Secondly, those of you who know me will be aware that I am a great follower of the decline of the US Empire and am fascinated by the shift of power, economic and otherwise, from the east to the west. Surely this is one of the greatest events in our life time and is laden with great investment opportunities, too? You may recently have seen the huge (and I mean huge) losses US car makers posted recently. Ford, for example, posted a loss per share for the June quarter greater than its share price! I always chuckle when I read in the media of Toyota overtaking (no pun intended) GM as the "world's largest car manufacturer". That has to be one of the most misleading comments you will ever read. What triggered me to share this with you was the fact that GM's share price hit a 54-year low on 14 July. That's not a typo - a fifty four year low! But consider some other titbits: GM currently produces about 25 000 vehicles per day and has a global workforce of about 250 000 (but down 50 000 in the past four years). In its heyday (the early 1960s) GM alone sold 6 out of every 10 cars in the US – today the "Big Three" in Detroit (Chrysler, Ford and GM) have only 47% market share in the US. Today, Toyota's market cap (size) at $145bn is *25 times greater* than GM's! And to add insult to injury, in July GM's market cap sank below that of Mattel, the maker of Matchbox toy cars - eina!

In closing, the photos appear courtesy of [the Beijing 2008 website](). As a great follower of the "China story" you will forgive me sharing some of the moments of the incredible Olympic Games opening ceremony, wherein China shared, in emphatic style, a glimpse of its diverse and incredible culture, and its rich and ancient history.

Table 3: MSCI Emerging Market June returns (%)

EM countries/regions	Jul-08	YTD
Turkey	28.3	-24.4
Poland	11.1	-3.5
Hungary	8.7	-4.0
Philippines	8.2	-34.0
India	6.4	-37.9
Chile	6.0	0.8
South Africa	2.9	-9.8
China	2.3	-25.7
Indonesia	-1.1	-12.8
Asia	**-1.5**	**-23.9**
Malaysia	-1.6	-20.1
South Korea	-1.7	-22.0
MSCI EM Small Cap	**-2.5**	**-24.7**
MSCI DM	**-2.5**	**-14.0**
Czech Rep	-3.5	5.5
MSCI EM	**-4.2**	**-16.4**
Egypt	-4.3	-8.5
Mexico	-4.6	-5.3
EMEA	**-4.7**	**-11.8**
Israel	-7.3	-2.6
LatAm	**-8.7**	**-1.5**
Taiwan	-9.2	-14.7
Brazil	-10.5	-0.6
Thailand	-13.4	-22.7
Russia	-16.0	-18.4
Peru	-16.3	-11.5
Argentina	-19.3	15.8

Source: Merrill Lynch