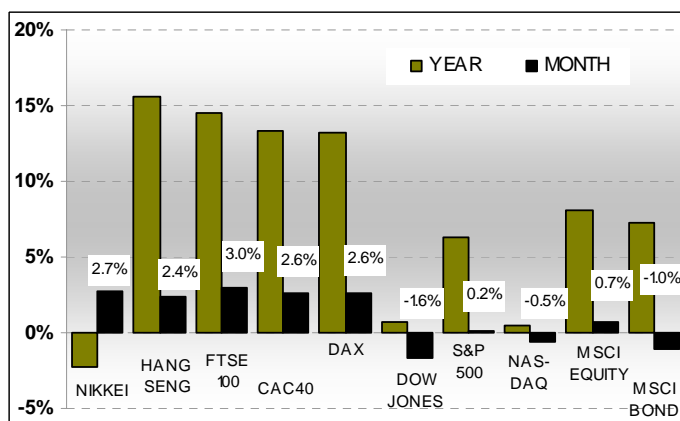




June in perspective – global markets

From Chart 1 you will see that with the exception of the US markets, equity investors had a profitable month. European markets have outperformed their US counterparts over the month and year to June despite the fact that the US economy has been and is likely to remain more robust than Euroland. Strange, that. Bond markets again posted a negative return, although other widely followed bond indices posted positive returns. In general, bond market conditions have been favourable, as we shall see in a moment.

Chart 1: Global market returns to 30 June 2005



Taking a closer look at the markets

Following on from the comment above regarding the UK and European market performance, one of the reasons for their strength is the strong dollar. Many of the larger companies in those markets, and hence the companies that carry a greater weighting in the respective indices, are major exporters that stand to benefit from a weak euro and, more recently, weak sterling. Chart 2 illustrates this point very clearly. The blue line shows the dollar euro exchange rate i.e. the inverse of the usual euro rate denotation, while the dark line denotes Pan-European equities. The UK market is also more defensive in nature given the large pharmaceutical presence, and so can be expected to outperform in difficult times. I am not necessarily suggesting that the out-performance will continue. The objective here is to highlight the supportive role the strong dollar has played in the performance of these markets. It stands to reason, too, that in the event of the euro staging a strong comeback - even if it is of the dead-cat variety - this supportive role will not only disappear but will in all likelihood become a headwind.

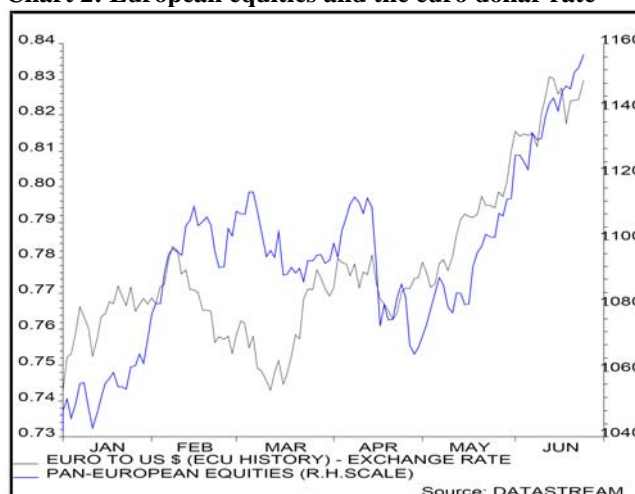
As a matter of interest, the recent changes at Royal Dutch Shell plc, wherein the two separate entities were amalgamated, will have significant implications on the company's influence in the FTSE100 Index. On 20 July, its weighting in the index will rise from 3.9% to 9.0%, which

will in turn have large implications for passive funds i.e. those which track the index. Note also that after the changes on 20 July, no less than 21% of the FTSE100 Index will consist of oil and gas companies, up from its current 16%.

So what if bond markets are strong?

I have alluded in previous editions of *Intermezzo* to the remarkable developments in global bond markets. Most bond market yields are at multi-year lows (prices are at record highs) – refer to Chart 4, overleaf. Without going into the reasons for the strength – and there are many good reasons for the record low yields - at present there seems little that will stop yields from declining further. Fixed income investors are having a great time – so what's all the fuss? Before we indulge in a bit of brainstorming, remember that the Federal Reserve is currently “normalising” the level of US interest rates. This month it tabled the ninth successive interest rates increase and signalled that more rate hikes are on the way.

Chart 2: European equities and the euro dollar rate



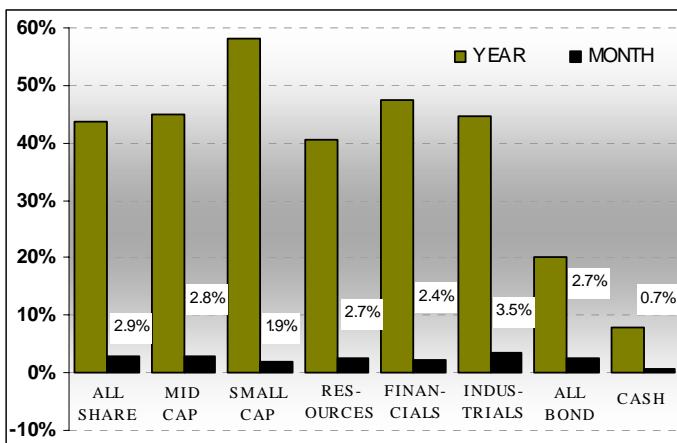
Source: Merrill Lynch

One of the popular arguments for equity markets remaining unscathed despite the US “rate hike” onslaught is that they are undervalued *relative to* bond markets. Now lets assume that bond rates head even lower. That would be support higher equity markets, despite rising short-term rates. More alarmingly, it may well ignite another wave of mortgage refinancing in the US and later in Europe, which would surely serve to embolden US consumers to spend even more, and by definition save even less. Add to the cocktail a stronger dollar, which would combine with greater US consumption to propel the US deficit even higher, thereby exacerbating the already record global imbalances. The stronger dollar would reduce what little inflationary pressures there are (I have yet to see a public debate about

possible deflation in the US, but it can't be too far away), driving bond rates even lower, equity markets higher still, round and round we go, etc. etc. And what would happen if the Chinese economy started slowing from say 9% to 6% per annum? That would surely place downward pressure on commodity prices, which would reduce inflation even further and encourage even more consumption. And a Chinese slowdown would affect the rest of the world, and reduce global growth somewhat, which would only serve as an impetus for lower bond yields. By now you should be getting the picture. It can all add up to a rather messy ending, even in a "most likely" scenario.

This type of prognostication may well be alarmist, but I hope it alerts you to some of the inherent risks in the current environment, in particular the ongoing reduction in long bond rates. If they continue their march to record lows, they would simultaneously pose an increasing risk to the financial economy. If one's thoughts really run wild, it is not inconceivable that European and UK rates move lower, which may well provide a short-term boost to the global economy. It would certainly provide a bumper "pay day" to the consumer. But is the global economy really ready for another upturn in a cycle without all the natural excesses like reduced levels of spending (US *real* consumer spending has risen at an annualised rate of 3.8% for the past ten years) or declining property prices, being expunged from the system? Do you think Fed chairman Greenspan would sleep easily if he suspected that another wave of refinancing was about to begin, coupled with a renewed wave of spending and another surge in property prices? This, after nine consecutive rate hikes? I don't think so. Investors need to think about these things as the dollar strengthens and bond rates continue to set multi-year records.

Chart 3: Local market returns to 30 June 2005



June in perspective – local markets

It was always going to be difficult to post gains after the 10% rise in the overall market during May. Yet the SA equity market managed to do just that. The industrial sector took over the leadership from last month's leader, the resource sector, which had been propelled higher on the back of the sharp decline in the rand. With a relatively weak June 2004 falling out of the base, the annual returns to end-June 2005 look very impressive once again. If you don't necessarily feel like this has been your experience so far *this* year, you have good reason to feel that way. The return of the All Share Index, for example, for the first half of this year was 13.3%, However, if you exclude February and

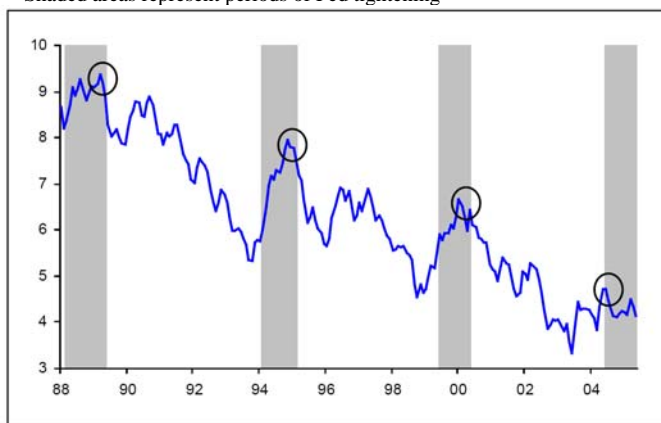
May from this return, during which months the market gained 5.5% and 10.1% respectively, the return changes to a decline of 2.4%. This is a long way from the 43.8% annual return to June, and just goes to show how "front-end loaded" the annual return is. SA bond markets were strong on the back of favourable global bond markets and the firmer rand.

Chart of the month

While not entirely a new, Chart 4 ties in with the discussion on bond yields. The downtrend in yields is obvious. Note how much earlier bond yields tend to be peaking in each cycle. The Fed seems increasingly effective in telegraphing monetary policy to the market.

Chart 4: US 10-year bond yield

Shaded areas represent periods of Fed tightening



Source: Merrill Lynch

File 13: Information you needn't know

Much has been written recently about the woes of General Motors (GM). Whilst it is not the only company struggling with massive healthcare costs, it is useful to place them in perspective. Did you know that GM's healthcare liabilities now total \$1 500 per car? Add to that the \$800 per car GM pays on pension costs. To put that in perspective, the cost of the steel used in each car is only \$550. Incidentally, GM's market cap is \$20bn – compare that with its unfunded healthcare liabilities of \$57bn at the end of 2003. And one final dig – GM last year recalled 11m vehicles in the US to fix safety issues. That is more than the total number of vehicles in built last year. Is thus seemed a "no-brainer" to sell the share – and that's exactly what every Tom, Dick and his investment manager did. But when the recent offer for up to 9% of your GM holding came from Kirk Kerkorian at 20% higher than the prevailing share price, it set in motion much of the trauma in the hedge fund industry. Just goes to show, there is no such thing as a free lunch.

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