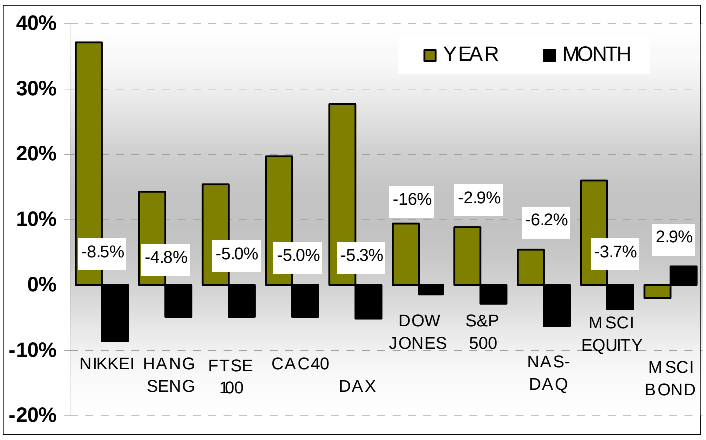
INTERMEZZO
MAESTRO
Investment Consulting
Investment Letter | 6th Edition | June 2006

May in perspective – global markets
Phew! If investors needed a reality check May had it all. From the middle of the month, global equity markets have been on the skids and volatility has returned in a big way. Developed equity markets registered sizable losses; those in emerging markets were even larger. At one stage the Russian and Indian markets were down over 30% for the month. Markets stabilized towards the end of May, but there is still a feeling of nervousness present and a belief amongst many investment managers that we are not "out of the woods yet". The MSCI World index declined 3.7%, while the MSCI Emerging index fell 10.8%. Notable standouts included Turkey down 13.1%, India 12.3% and Russian 11.8%. The respective declines in dollar terms were 28.8%, 14.4% and 10.7%, illustrating just how weak emerging market currencies were during the month. Perhaps the most notable feature of most global markets, even developed ones, was that *the declines experienced during May effectively wiped out all of this year's gains.*

Of significance too was the drop in the value of the dollar, despite the movement away from higher risk markets and currencies towards more defensive ones. The dollar declined 1.8%, 2.9% and 2.3% against the euro, sterling and Swiss franc respectively, while the Rand and Turkish lira, for example, declined 9.6% and 16.0% relative to the dollar, notwithstanding the latter's own weakness.

Chart 1: Global market returns to 31 May 2006

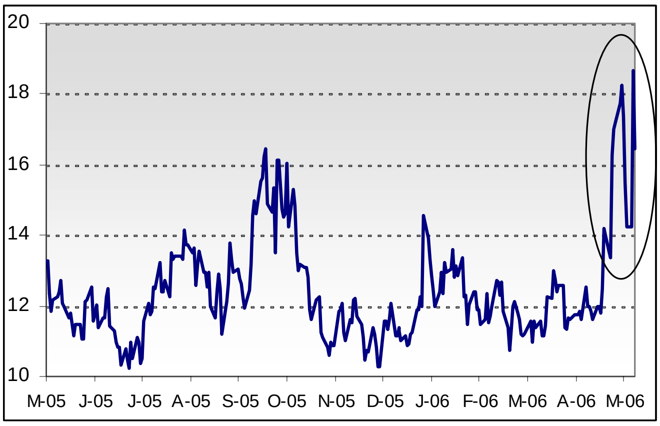


What's on the radar screen?
For those watching the markets closely, there was only one thing on the radar screen: the markets themselves. In a very short space of time a great deal has happened. In time we might look back at May 2006, just as we now view October 2003 - the month the previous bear market ended - as a significant month in market history. It is impossible to cover all the events that led up to, and that occurred, during the month, although I encourage Maestro clients to revisit my letter of 18 May in this regard.

A summary of what I believe to have been the most important events during the past month goes like this:

- The *inherent risk in the market has risen dramatically*. This is probably the most important aspect, and immediately calls for greater caution than that which has until now been exercised. Although that seems rather self-evident, we see a nice depiction of this in the sharp rise in the CBOE Volatility (the so-called Vix) index, which you will recall illustrates the implied volatility of options on the S&P500, shown in Chart 2. There were some very large daily movements in stock markets during May, across large, mid and small caps. Perhaps the most obvious example of this was when the Indian market collapsed 10% in the first few hours of trade on May 22. The market was subsequently closed for an hour. Trading resumed thereafter and the market closed 4% lower on the day, but it gives one an indication of the market conditions that prevailed during the month.

Chart 2: The CBOE Volatility index



- Consequently, *emerging markets and currencies are being viewed with greater caution.* Global investors are demonstrating a reduced appetite for risk by taking profits in these markets, which despite the recent declines are still showing handsome gains in dollar terms – refer to Table 1 in this regard.
- Markets remain obsessed about second-guessing *when the Fed is going to stop raising interest rates*. By saying that it would watch data emanating from the US economy more closely, the Fed merely exacerbated the situation and shortened the already myopic time horizon of markets. This will only increase the market volatility further.
- Concern about *higher future levels of inflation*, due to pressure from higher energy and commodity prices, is cited as a reason for recent market weakness. I am not sure that this is entirely correct. If markets were really worried about higher inflation, why has the

gold price declined from \$730 to \$630? And why have US bond yields declined from about 5.2% to 5.1% at month-end? I think concerns revolve more about a *global economic slowdown* than higher inflation. US economic growth is expected to slow in the second semester, while the effects of higher rates in the EU are yet to be felt.

Where do we go from here?
This is an important question but sadly one of the most difficult to answer. Ironically, not that much has changed since last month. Consider that:

- We have just emerged from a season of very *robust corporate earnings*. Cashflows remain strong, balance sheets are robust and margins are holding up well, despite high energy and commodity prices.
- *Inflation remains relatively tame.* Despite divergent views on the matter, central banks remain on top of their respective "macro conditions".
- While speculation continues about when *the Fed* will stop raising interest rates, the consensus view is that it *is pretty close to the end of this tightening cycle.*
- *Interest rates remain low* relative to historic levels, reducing the attraction of fixed income investments (bonds)
- *Emerging markets* remain inexpensive, at least relative to developed markets
- And *emerging economies* remain the most attractive places for growth. In general they are in better shape, in terms of fiscal management and trade balances for example, and are forecast to grow faster than developed markets.

So why the big sell-off in May?
The following may shed light on the recent decline in prices:

- Although they are off their peaks commodity prices remain close to record levels, with little sign of relief, particularly with regard to base metals (copper, zinc and nickel). This adds to concerns about future inflation.
- Global equity markets, with the exception of US ones, have provided great returns during the past two and a half years. Emerging market returns have been significantly greater. We all know that "nothing goes up forever", so investors have started locking in some of their gains, opting to return to the markets when greater "security" i.e. less (perceived) risk exists. Table 1 shows some of the gains in selected markets.
- One cannot help get the feeling that investors are increasingly concerned about the failure of policy markets to resolve many of the *macro issues threatening the future stability of global capital markets*. Ongoing global trade wars, words of (trade and other) wars, chronic trade imbalances and poor fiscal management on the part of developed markets are not exactly the stuff that stable markets are made of. Perhaps it is for that reason that the dollar seems to have begun its next phase of decline. Rising rates supported it last year, but with that game now coming to an end, it is hard to see what will support the greenback in the future. Now more than ever, Asia is usurping the driving seat in the global economy – the US has lost the "leadership initiative".

Table 1: Returns of selected markets

	Un-annualised returns (%)		
	May 06	**Year to date**	**1 Jan 05 – 31 May 06**
Nikkei**	-8.5	-4.0	34.6
Dax**	-5.3	5.3	33.8
FTSE 100**	-5.0	1.9	18.9
S&P 500	-3.1	1.8	4.6
Nasdaq	-6.2	-1.2	0.2
MSCI World	-3.7	5.1	13.1
Emerging Markets*	-10.8	6.3	38.5
Brazil*	-16.3	9.4	64.1
China*	-6.1	19.5	38.5
India*	-14.4	7.3	45.3
Russia*	-10.7	27.8	116.6
South Africa*	-15.2	2.7	27.4
Turkey*	-28.8	-20.7	20.2
CRB Commodity Index	-1.1	5.4	22.2

** in local currency
* MSCI index in dollars

In summary
I cannot over-emphasize Maestro's view that May represented a significant month in the investment environment. I would love to be proved wrong, but would humbly submit that the inherent risk levels have risen sharply. We would be failing in our duty were we to not act on the portfolios under our care. Consequently - and I am generalising here due to the unique circumstances of each client - in the local portfolios, including the **Maestro Equity Fund**, we have reduced the resource exposure even further (we were already underweight relative to the overall market) and have raised cash levels slightly. We are still positive on the SA economy, and financial and industrial companies in particular. "Corporate SA" is in good shape and our equity market is not expensive. But our focus has turned explicitly to *capital protection* and we will consciously seek to further reduce the levels of risk in the portfolios if these high-risk levels persist.

Similarly, on the global assets under our care, largely in **Central Park Global Balanced Fund**, the focus has also been to reduce the levels of risk in the portfolio in favour of a more defensive stance. Commodity exposure has been reduced and the cash levels raised. Dollar exposure has been reduced further in favour of the euro and Swiss franc.

Speaking of currencies, we think that the rand has in all likelihood seen its best levels (let's call that below R6.00) for some time. While at R6.70 it may be a bit extended in the short term, a new trend of gradual depreciation may already have begun. We don't subscribe to the view that the rand will collapse from this point onwards – it's just that its relative strength is probably a thing of the past.

For the record
The latest returns of the mutual funds that Maestro manages are listed in Table 2. You can find more detail, including the latest Maestro Equity Fund Summary, by visiting our website at www.maestroinvestment.co.za.

Table 2: Returns of funds under Maestro's care

	Month	Return	Year to date
Maestro Equity Fund	May	**-5.9%**	**5.5%**
Maestro equity benchmark *		-3.8%	11.2%
JSE All Share Index		-2.7%	14.9%
Central Park Global Balanced Fund ($)	Apr	**3.3%**	**11.0%**
Benchmark**		1.6%	5.3%

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, and 20% each in MSCI Sovereign Index, CFSB Hedge Index and 3-month US Treasury Bills

May in perspective – local markets

Chart 3 depicts some of the SA equity returns during May. Don't be fooled by the chart's scale; it has been compiled to accommodate the substantial annual gains to May. The past month was volatile and unprofitable, with only the chemicals (2.6%), platinum (1.5%) and general mining (3.8%) indices showing gains. The banks index declined 9.0%, industrial metals 10.7% and food and drug retailers 6.6%. Perhaps more importantly, the volatility was extraordinary: from its intra-month peak the All Share index declined 11% in seven trading days, only to gain 5% in the ensuing five days. The Industrial index declined 10% and then rose 4% in just two days. The room for error was indeed large.

Chart 3: Local market returns 31 May 2006

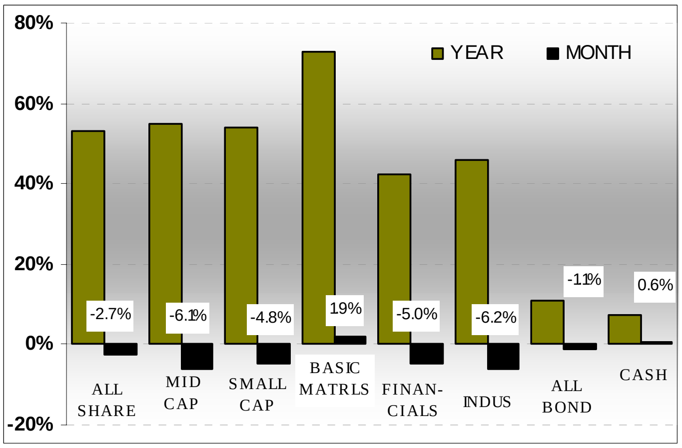
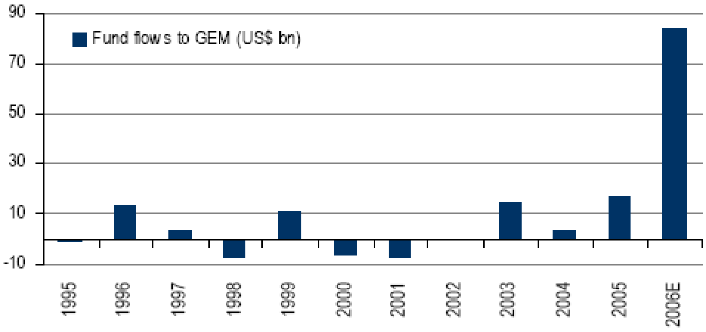


Chart of the month

As an indication of the extent to which emerging markets have been "stretched", consider Chart 4, which shows the 2006 inflows into emerging markets on an annualised basis. They equate to around $84bn so far this year, way above last year's inflow of $17bn.

Chart 4: Inflows into emerging market equity funds



Source: Merrill Lynch

Chart 5 shows the MSCI Emerging Market index and the CRB Commodity index, which highlights again just how influential rising commodity prices have been in driving emerging markets higher since 2003. No matter which way you look at chart 5, two words immediately come to my mind: *extended* and *unsustainable*.

Chart 5: Emerging markets driven by commodities

MSCI Emerging Market index (black line)
CRB Commodity index (turquoise line)

Source: Merrill Lynch

File 13: Information you needn't retain

Despite all the negative sentiment in the market during the month, the world's largest IPO (initial public offering) in six years took place in Hong Kong at the end of May. China's fourth largest bank, the Bank of China - not to be confused with the Chinese central bank, which goes by the name of the People's Bank of China (PBoC) – floated 10.5% of the company, raising $9.7bn in the process. The listing attracted no less than $150bn of orders – who said the world isn't clamouring over everything Chinese at the moment?! Retail investors applied for more than 75 times the stock on offer, while institutional investors applied for more than 20 times. This bodes well for the listing of China's largest bank, the Industrial and Commercial Bank of China, which is due to raise about $10bn through its Hong Kong listing later this year. The Bank of China was listed in Hong Kong on 1 June and its price closed 15% higher than the issue price (HK$2.95 to HK$3.40) on its first day of trade.