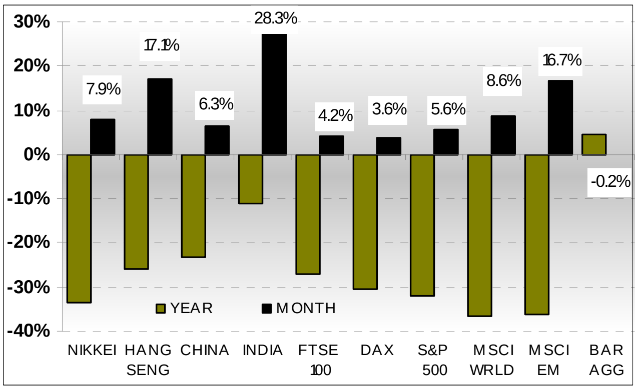
MAESTRO INTERMEZZO
Investment Letter | 9th Edition | June 2009

May in perspective – global markets

May proved to be another extraordinary month in terms of market behaviour; bond markets were weak while equity and commodity markets surged higher, the latter supported by a weak dollar. Emerging markets have developed huge upward momentum; the MSCI Emerging market index rose 16.7% and the MSCI World index 8.6%. Take time to study the returns in Table 1 and you will see how dramatic the gains have been over the last few months. What concerns us, as it does many investors, is that this rally is built on the fact that the global economy has stopped deteriorating (at least for now). In other words, things are not getting better; they have only stopped getting worse. Economic activity around the Western world is still declining and many of the problems that brought about the market weakness in the first place have not been resolved on a sustainable basis. Call us old-fashioned, but we think the markets are currently imbued with a degree of risk not fully recognised by those pushing equity prices higher. Time will tell whether our views are misplaced or not. The commodity complex was firm, supported by a 6.8% decline in the dollar against the euro. Gold rose 10.0%, oil 29.0% and the two commodity indices we monitor, the CRB and S&P GSCI indices gained 13.8% and 19.7% in May alone. To crown it all the Baltic Dry index, which denotes freight rates of shipping commodities rose a swashbuckling 95.6% although it is still down 69.5% over the past year. Table 5 contains the usual update of emerging market behaviour so far this year.

Chart 1: Global market returns to 31 May 2009



Fund flows into Emerging markets

As you are surely aware by now, emerging markets are performing better than developed ones, for reasons we have been highlighting for many years in *Intermezzo*. Table 1 lists returns of selected markets over various periods – these index returns are in local currency terms. We monitor inflows into global emerging markets (GEM) to gauge, inter alia, global investor sentiment towards them. This is one way in which we also monitor sentiment towards South Africa, which remains a large and important GEM (refer to its relative importance in Table 3, below).

Table 1: Selected index returns to 31 May 2009 (%)

	3 Months	Year to date	Year
US (S&P500)	25.0	1.8	-32.2
UK (FTSE100)	15.4	-0.4	-27.0
Germany (Dax)	28.5	2.7	-30.4
Japan (Nikkei 225)	25.8	7.5	-33.6
Hong Kong	41.8	26.3	-25.9
MSCI World index	**29.2**	**5.1**	**-36.4**
MSCI Emerging market	**54.8**	**36.3**	**-36.1**
MSCI BRIC	61.8	49.2	-38.5
Brazil (Bovespa)	39.3	41.7	-26.7
Russia (RTS index)	99.7	72.1	-55.8
China (Shanghai Composite)	26.4	44.6	-23.3
India (BSE Sensex)	64.5	51.6	-10.9
South Korea (Kospi)	31.3	24.1	-24.6
Taiwan	51.2	50.1	-20.1
South Africa (All share)	24.4	7.4	-25.9

We think you might find Table 2 interesting. It shows the net inflows (to 28 May) into GEM and selected developed markets (DM) for the past 10 weeks and the year to date. A couple of aspects of the table are worth highlighting:

- The strong ($22.5bn) inflows into GEM in the past ten weeks, which explains why some GEM have risen so strongly.
- The popularity of China - $3.8bn in the last 10 weeks. Asia continues to attract the lion's share of inflows.
- What is not obvious from the Table is that the net inflows into Taiwan were the largest ever in any 10-week period; refer to "The shape of things to come" section, below, for the reasons behind this.

Table 2: Net fund flows into GEM and DM ($m)

	Past 10w	YTD
EM	**22,531**	**22,264**
Global EM Funds	10,065	11,665
Asia	8,836	7,497
EMEA	422	-901
LatAm	3,207	4,003
EM long only funds	9,544	8,388
EM ETF's	12,986	13,876
Brazil	2,334	2,764
Russia	528	410
India	581	483
China*	3,770	3,622
Taiwan	1,072	921
Turkey	89	65
US	-6,037	-49,085
Japan	-754	-3,220
Europe	-189	-3,478

* includes Greater China

Total EM = funds investing in LatAm, Asia and EMEA plus funds with a global EM mandate.

Source: Merrill Lynch

- The popularity of exchange traded funds (ETFs), which attracted $13bn of the $22.5bn into GEM so far this year. The ETFs popularity as a passive investment vehicle continues to rise, particularly in the light of the damage to the reputation and returns of hedge funds last year.
- The flight out of developed markets so far this year …
- Particularly out of the US – some $49.0bn has already flowed out of that market.

Emerging market weightings
MSCI recently finalised their semi-annual index review. The changes will be implemented with effect from 1 June. Table 3 depicts the proposed weightings to the GEM universe and shows the respective weightings in 2005 and 1998, which makes for interesting reading. For your info, EMEA represents emerging markets in Europe, Middle East and Africa and BRIC represents the markets of Brazil, Russia, India and China.

Table 3: MSCI Emerging market index weightings

	Pro forma*	Current*	2005	1998
EM mkt cap $bn*	**2,013**	**1,992**	**1,120**	**843**
Regions				
EM	100.0	100.0	100.0	100.0
ASIA	57.6	56.5	54.8	38.8
EMEA	20.9	21.6	26.3	24.7
LATAM	21.5	22.0	18.9	36.5
BRIC	46.0	46.1	26.1	24.9
Countries				
EM	*100.00*	*100.00*	*100.00*	*100.00*
China	18.8	18.4	7.6	0.4
Brazil	14.3	14.5	9.3	14.8
Korea	13.7	13.8	18.8	5.1
Taiwan	12.4	11.6	13.6	17.1
South Africa	7.1	7.3	11.6	11.1
India	6.5	6.6	5.6	5.7
Russia	6.4	6.6	3.6	4.0
Mexico	4.5	4.7	6.5	10.9
Israel	3.1	3.2	3.6	2.4
Malaysia	3.1	3.0	4.0	5.2
Chile	1.5	1.4	1.8	3.3
Indonesia	1.5	1.5	2.0	1.2
Turkey	1.3	1.3	2.0	3.0
Thailand	1.2	1.3	2.6	2.1
Poland	1.1	1.2	1.8	0.5
Egypt	0.6	0.6	0.6	0.7
Colombia	0.6	0.6	0.2	0.9
Peru	0.6	0.6	0.4	1.1
Czech Republic	0.5	0.7	0.9	0.9
Philippines	0.4	0.5	0.5	1.4
Hungary	0.4	0.4	1.6	1.2
Morocco	0.4	0.4	0.3	0.6
Argentina	0.0	0.1	0.5	4.1
Venezuela			0.1	1.3
Pakistan			0.2	0.7
Jordan			0.2	0.1

Source: MSCI Barra Index Research, DataStream, BAS-ML.* As of 4/23/09

Source: Merrill Lynch

China's index weighting has risen from 0.4% in 1998, only eleven years ago, to 18.8%, helping Asia to rise from 38.8% to 57.6%. During the same period South Africa's weighting *declined* from 11.1% to 7.1%. Despite its sharp declines last year, the market capitalization (size) of the MSCI GEM universe has risen from $843bn in 1998 to $1 992bn today.

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 Eurozone economy*: Confirmation was received in May of the extent to which European economies have been affected by the crisis. The German economy declined 3.8% during the quarter. The Netherlands declined 2.8%, Italy 2.5% and France 1.2%, bringing the decline for the whole Eurozone to 2.5%, after the 1.6% decline during the last quarter of 2008. Earlier in the month the European Central Bank (ECB) cut interest rates by 0.25% to 1.0%. The German inflation rate fell into negative territory i.e. deflation is now a reality in Germany as well. Prices declined 0.1% in the year to April.
- *The SA economy:* there was good and bad news this month. The first quarter (Q1 09) economic growth rate was released; at -6.4% on an annualised basis it was a lot worse than anyone had expected. The decline was the deepest since Q3 in 1984 and worse than the 1998 emerging market crisis and the 1992 recession. The manufacturing sector "took away" 3.6% of the decline i.e. more than half, while the mining sector took another 1.9% away. The construction and general government services added 0.3% and 0.5% respectively. The good news came in the form of yet another 1.0% cut in interest rates by the SA Reserve Bank to 7.5%, although the SARB Governor was notably cautious about any further rate cuts.

Security of supply
During May we published our latest Market Commentary, in which we highlighted some of the issues that "keep us awake at night". One of them was what we refer to as "Security of supply." One aspect related to this theme is the fear that in due course commodity prices will again move significantly higher as a result of increased demand (largely from emerging markets) and insufficient supply. Many investors are under the impression that mines can increase supply to meet demand, forgetting that in many cases there is not much supply around – at least not in the short-term. Remember that it was a collapse in aggregated *demand* (due to the credit crisis) that brought commodity prices down last year, not excess *supply*. Let me ask you: how long do you think it takes a really big mine or project to come on stream?

Here's a real-life example, illustrating how long it takes to produce a steady and significant increase in supply (and cash flow!) Olympic Dam in Australia is one of Billiton's current big projects. The *draft* Environmental Impact Study (EIS) has been 5 years in the making; it is estimated that the final EIS and full feasibility study will take decades, as will the start-up phase. Once initiated, the project will entail five years of digging just to access the ore body. Olympic Dam is likely to treble Billiton's copper production, quadruple uranium production and increase gold production by eight times. The end result will be the world's 3rd largest copper mine, the 9th largest gold mine and the largest uranium mine, representing 30% of global uranium production. More importantly, the Olympic Dam project will require significant additional infrastructure, including a desalination plant and possibly a gas-fired power station. Although the capital expenditure (capex) budget has not been finalised, estimates of $12bn over ten years are being bandied about. On this basis, the project would not start returning cumulative positive cash for nearly 20 years, which is regarded by those in the know as reasonable, given that the ore body could support the project for 98 years.

The point here is to illustrate that new supply, in this case of certain commodities, cannot just be rolled out when needed. And seeing that no major new sources of supply, at least not in the commodity space (or food for that matter), have been developed in recent years, that poses a major problem when demand returns to normal. And that sounds very inflationary to us.

Chart of the month

I am sure that you, like us, are following developments in the global automobile industry, in the US in particular, very closely. There is a lot that we *don't* understand about the process, like how the US government expects (Chrysler) bond holders i.e. the owners of the company debt, to accept between 10c and 20c on the dollar in return for a small (10%) stake in the company, while giving the majority of the company to a trade union in return for settlement of outstanding healthcare liabilities. In addition, the fast-tracking of Chrysler and GM through the bankruptcy courts seems more like a process designed to expunge bond holders from the company than anything else. But what we *do* understand is what is happening to US car sales. Its one thing to be an inefficient, environmentally-unfriendly car manufacturer at the best of times but lay on top of that the "worst of times" and it is easy to see why the US auto industry is in a state of implosion. Chart 2 speaks for itself.

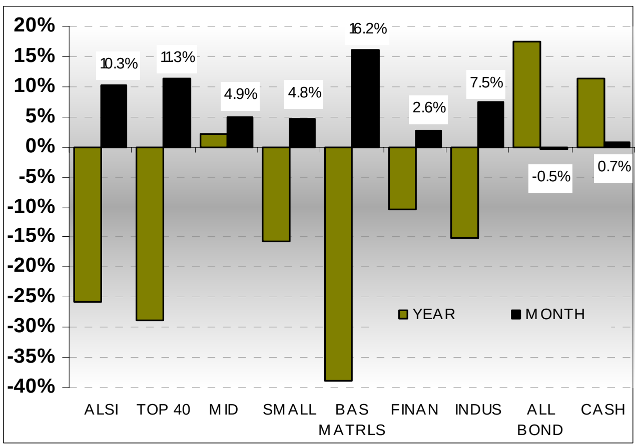
Chart 2: Total US vehicle sales (million units, annualised)

Source: Merrill Lynch

May in perspective – local markets

In line with developments on global markets the South African equity market headed higher in emphatic fashion in May, led by the materials sector despite the firm rand. The latter rose 4.5% against the dollar and has now risen 26.9% against the greenback in the past four months and 47.4% since its low of R11.84 reached on 22 October last year. Large caps lead the way in terms of size, with the Top 40 (large cap) index up 11.3% versus the 4.9% and 4.8% gains of the mid and small cap indices. The financial sector lagged quite badly, rising "only" 2.6%. I would also point out the third negative month (-0.2%) in the bond market so far this year; its total return for the year to date is -4.7%.

Chart 3: Local market returns to 31 May 2009



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For the record

Table 4 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 4: Returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Fund	May	**7.2%**	**7.9%**	**-25.1%**
Maestro equity benchmark *	May	8.8%	4.3%	-23.0%
JSE All Share Index	May	10.3%	7.4%	-25.9%
Maestro Long Short Equity Fund	Apr	**8.9%**	**-0.3%**	**-25.3%**
JSE All Share Index	Apr	-1.6%	-2.7%	-30.3%
JSE Financial and Indus 30 index	Apr	4.5%	-4.7%	-21.2%
Central Park Global Balanced Fund ($)	Apr	**1.0%**	**-0.1%**	**-16.4%**
Benchmark**	Apr	5.5%	-0.1%	-19.8%
Sector average ***	Apr	6.3%	0.9%	-27.6%

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, 20% each in Barclays US Aggregate Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills
*** Lipper Global Mixed Asset Balanced sector ($)

The shape of things to come

Time and 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 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, in this section we highlight some of the events indicative of this process.

UK credit rating downgraded: one of the notable events during May was the effective downgrading of the UK's credit rating by the S&P rating agency. Looking past the fact that credit agencies have little credibility in many investors' eyes, given their behaviour before and during the 2008 credit crisis, Standard and Poor's downgraded its medium-term outlook on the UK's triple-A debt rating, from "stable" to "negative". It affirmed its triple-A rating on the long- and short-term debt. S&P based its downgrade on its view that the UK's net government debt will soon approach 100% of national income. The event shocked many, who thought something like this would never happen. All eyes then turned to the US, whose rating must also be under close scrutiny. However, the rating agencies affirmed the US triple-A rating – for now at least.

SA bond sale: in stark contrast to the above, on 19 May South Africa experienced one of the strongest indicators yet of global investors' perceptions of the country. The SA Treasury had planned to issue a $1bn bond to offshore investors. But the issue was nearly seven times over-subscribed, resulting in it being raised to $1.5bn. Despite weak global bond markets the SA bond was issued at a keen price. The coupon (interest rate) was set at 6.875% (the lower the coupon, the cheaper the bond), which was 3.75% (or 375 basis points [bps] to use bond market jargon) above the comparable US bonds.

Space precludes a detailed history of *the relations between Taiwan and China*. Suffice is to say that in 1949 the Chinese National Party, or Kuomintang (KMT) as they were called, fled the mainland after losing a three-year civil war against the Chinese Communist Party and their Red Army. The KMT government had also been plagued by corruption and the Chinese economy had been wracked by high inflation. The KMT "government in exile" fled to the island and established the Republic of China or what is today known as Taiwan. At the same time the Chinese Communist Party established the People's Republic of China (what we today call "China") and re-established Beijing as its capital on 1 October 1949. Since then China has regarded Taiwan as part of its own territory and still refers to the current position as "one China with two governments." They dispute Taiwan's independence and in the past frequently expressed their not-so-subtle ambition to re-incorporate it. Of course, Taiwan (the KMT) adopted a democratic style of government and has viciously defended its sovereignty and independence. Relations between the two have waxed and waned but in truth they have been sworn enemies since 1949.

Source: National Geographic

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So much for the history lesson. Here's the point – remember we are discussing "The shape of things to come" – have you noticed the rapprochement between China and Taiwan recently? So far this year there have been some landmark developments between the two countries: in April China dropped its longstanding opposition to Taiwan participating in the World Health Organization's ruling body, thereby enabling Taiwan to attend the United Nations meeting for the first time in 40 years. Then government-owned China Mobile proposed to take a 12% stake in Far EasTone, a Taiwanese-listed mobile operation. This marked the first mainland investment in a Taiwanese listed company ever and pushed the equity market up to register its biggest daily gain in 18 years – refer to Chart 4. And here's one just for my colleague David, who recently successfully competed in the 7.5km Freedom Swim from Robben Island to Blouberg: the metal spears, embedded 53 years ago in the shallow ocean floor to prevent amphibious Chinese craft from landing on the island, were recently cleared to make way for the first 5km swim across the Taiwanese Strait between Kinmen and Xiamen on the mainland. Formal bi-lateral talks, stalled for more than a decade, have resumed. Last year's election in Taiwan of President Ma Ying-jeou, on the back of an campaign aimed at "mending fences with Beijing" did a lot to improve relations and Chinese Premier Wen Jiabao went on record as saying that he was "willing to crawl over (to Taiwan) even if I could no longer walk".

Chart 4: iShares MSCI Taiwan (the Taiwanese ETF)

Source: Saxo Bank

These are extraordinary developments between two arch-enemies, especially when one takes their centuries-old, inextricably linked history into account. More importantly, it has taken the economic crisis of 2008 to bring to two closer to each other. The thawing of relations between the two has already made huge differences in some areas – a 5-hour flight to Shanghai from Taipei via Hong Kong can now be routed directly in only 82 minutes - and there will no doubt be more benefits. Whether it will be another false start also remains to be seen, but it is yet another "sign of the times" which holds much promise and risk. Watch this space.

Quotable quotes

"You cannot legislate the poor into freedom by legislating the wealthy out of freedom. What one person receives without working for, another person must work for without receiving. The government cannot give to anybody anything that the government does not first take from somebody else. When half of the people get the idea that they do not have to work because the other half is going to take care of them, and when the other half gets the idea that it does no good to work because somebody else is going to get what they work for, that my dear friend, is about the end of any nation. You cannot multiply wealth by dividing it". *Adrian Rogers*

In a recent document from Sarasin on their investment strategy, they used a wonderful quote used to describe the long-term consequences of current US fiscal policy whereby the US government is issuing huge amounts of debt to reflate the hopelessly over-indebted economy. They quoted the 20th century Austrian economist *Ludwig von Mises* as follows: "It may sometimes be expedient for a man to heat the stove with his furniture. But he should not delude himself by believing that he has discovered a wonderful new method of heating his premises".

Given the events of the past two years surrounding the economic crisis and how the US and Chinese economies have been affected (the US economy is declining at an annualised rate of around 6% while China is growing at 6%) I thought the following quote had a rather empty and surreal feeling about it, not to talk of it being completely misplaced, admittedly with the benefit of hindsight. Commenting on China's authoritarian system, US President *Bill Clinton* remarked in 1997 that "China was on the wrong side of history". Say, what?

Given all the debate about the extent of the global economic recovery it is worth hearing it "from the horse's mouth" so to speak. *Marius Kloppers*, CEO of BHP Billiton, the world's largest commodity company, recently had the following to say about the matter. "We do not expect a sharp rebound. For global markets to perform well there needs to be an improvement in demand from both China and the OECD". Speaking specifically about China he said that the fall in China's exports had been much harder than expected. "Also unclear at this stage is the ability of the Chinese stimulus package to offset the negative impacts of the decline in exports on the domestic economy."

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File 13 – things almost worth remembering

5 June 2009 will mark the 20th anniversary of the events that took place in Beijing in Tiananmen Square. Who can ever forget that amazing moment in time (see pic below) when a man, dressed in a simple white shirt and black trousers, single-handedly stopped a column of 18 tanks? What is equally remarkable is the extent to which China has changed (albeit not in freedom of expression terms) and the role it now plays in the global economy and arena. It may come as a surprise to hear that the identity of the "Tank Man" as he has come to be known has never been established. You can read more about this story, if you are interested, by clicking here. In addition, you can also see a video of the event by clicking here. Take a look; it really is quite remarkable.

Source: Unknown

The following joke is doing the rounds via email and other means so you may well have seen it. But we thought it too good to not share with those who have perhaps not seen it: it is August in a small town on the South Coast of France. Holiday season is in full swing, but it is raining so there is not too much business happening. Everyone is heavily in debt. Luckily, a wealthy Russian tourist arrives in the foyer of the small local hotel. He asks for a room and puts a $100 note on the reception counter. He takes a key and goes to inspect the room located up the stairs on the third floor. The hotel owner hurriedly takes the bank note and rushes to his meat supplier, to whom he owes $100. The butcher takes the money and races to his supplier to pay his debt. The wholesaler rushes to the farmer to pay $100 for pigs he purchased some time ago. The farmer triumphantly gives the $100 note to a local prostitute who gave him her services on credit. The prostitute goes quickly to the hotel, as she owes the hotel owner for her room use to entertain clients. She places the $100 note on the counter. At that moment, the Russian comes down to reception and informs the hotel owner that the proposed room is unsatisfactory; he takes his $100 back and departs. There was no profit or income but, with everyone having repaid their debt, the small town's people are all looking optimistically towards their future.

Table 5: MSCI Emerging Market May returns (%)

	May'09	YTD
India	36.6	60.7
Rus	30.4	67.4
Hun	27.3	13.3
Sing	23.8	30.6
MSCI EM Small Cap	**22.6**	**53.4**
Bra	21.9	62.2
Col	20.4	26.3
LatAm	**20.4**	**46.5**
Per	18.5	26.8
EMEA	**18.0**	**29.7**
Chil	17.7	42.7
HK	17.0	34.9
Mex	16.7	14.7
Thai	16.7	28.4
MSCI EM	**16.7**	**36.3**
S.Afr	16.3	22.7
Phil	16.1	29.1
China	16.1	30.4
Taiw	15.3	46.5
Asia	**14.7**	**35.3**
AP ex Jap	**13.9**	**30.1**
Tur	13.4	26.6
Indo	10.9	46.3
Egy	10.6	15.8
Jap	10.2	-0.1
Aust	9.5	17.8
Isr	9.4	19.9
MSCI DM	**8.6**	**5.4**
Mal	6.9	19.2
Cze	4.6	4.2
Kor	4.0	24.4
Pol	3.6	-10.3
Mor	3.0	0.8
Arg	1.8	-7.0
Pak	0.2	44.9

Source Merrill Lynch