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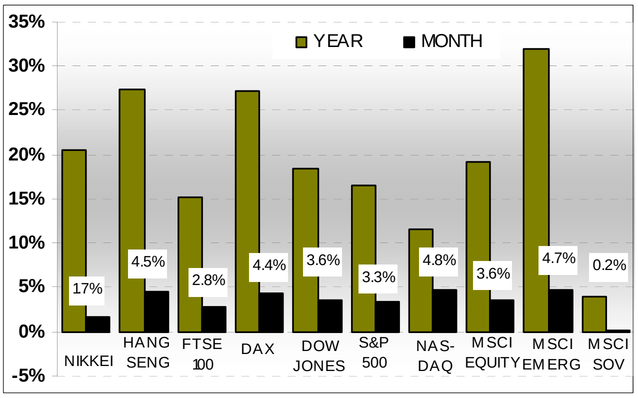
October in perspective – global markets

True to the unpredictable nature of markets, October, the month most associated with market crashes, defied historians as most equity markets reached record levels. As the oil price continued to decline - it fell 5% on the month after a 13% decline in September – and evidence pointed to another "Goldilocks" environment for the US economy i.e. not too hot and not too cold, investors took courage and committed more funds to the markets. Despite the wobble in May, June and July, it is true to say that markets have now recovered. It is not inconceivable that they could reach even higher levels between now and the year-end, although after the strong gains since mid-July, they are looking a bit "top-heavy". Although the MSCI World index gain of 3.6% was impressive the MSCI Emerging market index rise of 4.7% was even better, particularly in the light of the lower oil price. A number of commodity prices, notably some metals (lead, zinc, nickel and copper) and more recently soft commodities (wheat and corn) are either at or close to all-time records. Many emerging market currencies gained at the dollar's expense. I refer you to Table 3 at the end of this edition for a snapshot of emerging market returns.

Chart 1: Global market returns to 31 October 2006



So why aren't equity markets going down?

For many investors and experienced market watchers, the past few months have been tense. There have been a number of reasons to believe that global equity markets are due for a sizeable correction. After all apart from the odd wobble they have been moving higher since the trough in October 2003. Ever conscious of the adage that "bull markets climb walls of worry" many have waited patiently for markets to present better buying opportunities. But despite their patience, such opportunities have not materialised. Markets have climbed slowly but relentlessly higher. Why? What is holding them up, or preventing them from falling? We will probably only know for sure some time in the future – isn't hindsight a wonderful thing? The following list presents some of the reasons why equity markets have been so robust of late:

- *Good economic growth*: China, the world's most populous nation and the fourth largest economy, continued to grow at breakneck speed, namely 10.4% during the third quarter. This was off the 11.3% growth rate of the June quarter, but the sheer size and longevity of China's growth remains remarkable. The US grew only 1.6%, from 2.6% in the second quarter. But a number of economies, many of them emerging ones (India is a good example) are still registering very good growth rates, thereby ensuring that the slowdown in the US growth rate doesn't cast too large a shadow over the rest of the world. The IMF still expects the global economy to grow in excess of 5.0% this year.
- *Excellent corporate earnings*: with about 320 of the 500 S&P500 companies having reported, third quarter earnings growth of 17% has been recorded over the past year. Not only is this above expectations of 15% at the beginning of the quarter, it also continues one of the longest periods (14 quarters in all) of double-digit US corporate growth. No matter which way you slice and dice it, corporate earnings growth in virtually all geographies has been impressive. Companies are making money – lots of it – and have strong balance sheets and cash flow.
- *Reasonable valuations*: this is an eternal debate – is the market expensive or not? It all depends on at which stage of the cycle you compare it to, but on the basis of long-term averages markets are neither cheap nor expensive. The German, UK and US markets trade on historic price earnings (PE) ratios of 12.6, 12.2 and 16.5 times respectively. If nothing else this should allay fears of a valuation-induced, Y2K-style correction. Strong corporate earnings are required to bring valuations lower, and that is exactly what is happening despite high commodity prices and rising interest rates. That achievement alone is impressive and is substantial enough not to be ignored.
- *Rampant M&A activity*: throughout the year I have alluded to the unprecedented level of M&A activity. Unfortunately the SA equity market is too far off the radar screen to be involved in this area of activity, but don't be lulled into thinking that it has not had an effect on other markets. The record bonuses paid to corporate bankers on both sides of the Atlantic is sufficient proof of this – Wall Street's top 5 investment banks will this year pay no less than $36bn (yes, that's billion) in bonuses. Private equity and buy-out groups have raised over $320bn so far this year. With leverage of say, three to one, not uncommon in such deals, that equates to $1 trillion worth of firepower to target lethargic corporates. Two things: firstly, it has forced virtually all companies to "get their act together". Lazy balance sheets and poor governance or management, are severely punished in an environment such as this. Secondly, with this much fire

power even the largest companies that once regarded themselves as "untouchable" are now subject to the harshest disciplines of the global capital markets. (Microsoft, beware!)

- *Plenty of liquidity*: although global liquidity by most measures is off its peak, there is still a lot of it around. As you would appreciate from the discussion above with M&A activity rife and corporates having improved their balance sheets and productivity as much as they have, even the corporate sector is spewing out an unprecedented amount of cash. True, interest rates are higher than a year or two ago but there is still lots of money out there looking for a long-term home. (*Ed*: of course, there are some signs of déjà vu – how else can you view Google's purchase for $1.65bn of YouTube, a company yet to even make $1 of profit?)
- *Many investors have been left behind*: given their strong gains – refer to Chart 1 for the annual gains in major developed markets, and remember most emerging markets have done even better – and the caution that accompanied the relentless rise in US interest rates in particular, there seem to be many investors that have stayed on the sidelines. Sooner or later this group will capitulate, which will have a positive effect on the market.

This list is by no means comprehensive and yes, there are many reasons that would indicate a distinct need for caution. Maestro is not wildly bullish about the prospects for global equity markets, but it is also not overly bearish. The purpose of this short discussion is to highlight some of the reasons why markets have been as strong as they have. It is inherent in Maestro's nature to be conservative; we will continue to apply caution to the markets, but cannot ignore the powerful trends working in the markets' favour at present.

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.

Table 1: Returns of funds under Maestro's care

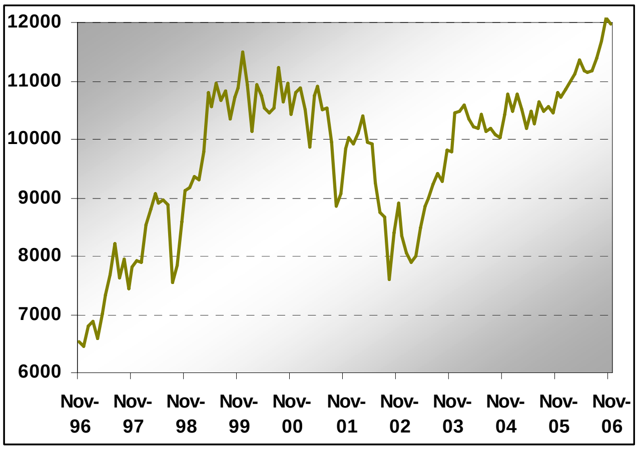
	Month	Return	Year to date
Maestro Equity Fund	Oct	**4.3%**	**16.1%**
Maestro equity benchmark *		4.4%	29.0%
JSE All Share Index		4.6%	32.1%
Central Park Global Balanced Fund ($)	Sept	**1.0%**	**6.6%**
Benchmark**		0.5%	6.9%

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

Chart of the month

I am going to "cheat" this month by inserting a simple 10-year chart of the Dow Jones Industrial Index (refer to Chart 2) and use it as a point of departure for a short study on this index. The reason for focussing on the "Dow" is that it reached an all-time high of 12 164 on 26 October. The Dow is quite an unusual index, and its unique qualities have been at the centre of much debate regarding its validity. It is unusual in that it consist of only 30 companies, unlike the S&P500 that consists of 500. Moreover, poor performers in the Dow, such as Eastman Kodak, Bethlehem Steel and International Paper, are often discarded for more popular companies like AIG, Pfizer and Verizon. The Dow is not weighted in terms of its underlying constituents' market capitalization like most indices, but rather on the basis of the constituents' share prices. For these and other reasons, many market watchers, including Maestro, prefer to use more representative indices such as the S&P500. But the Dow has a rich and long history and its recent record was widely celebrated by the US investment community, even if it did not last very long; its record high was followed by one of the longest periods (in terms of days) of consecutive declines but it remains close its all-time record level.

Chart 2: The Dow Jones Industrial Index



The Dow's previous record was reached on 14 January 2000 when it hit a level of 11 722. It then lost 38% and bottomed in October 2002. Ironically, only 10 of the Dow components have moved higher since January 2000 when it reached its previous record. The biggest losers since then are Microsoft down 51%, GM 59% and Intel 60%. The winners since January 2000 are Altria 212%, Caterpillar 151% and United Technologies. Table 2 sheds more light on the winners and losers since the Dow's January 2000 high and its October 2002 low.

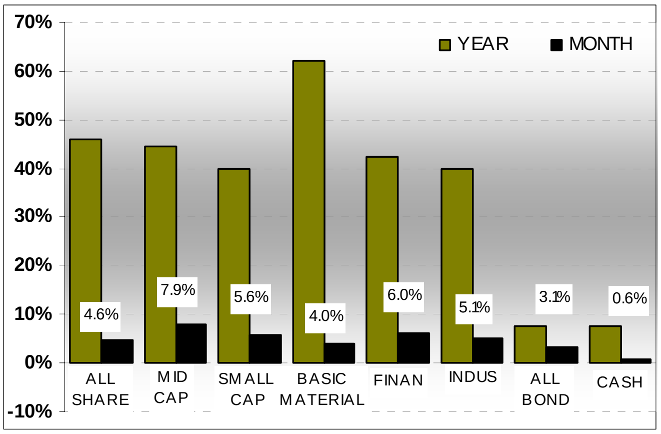
Table 2: Dow winners and losers

From January 2000 high		From October 2002 low	
Winners		**Winners**	
Altria	212.4%	Caterpillar	284.6%
Caterpillar	151.3%	Hewlett-Packard	235.3%
United Technologies	103.0%	JP Morgan	209.1%
Boeing	85.8%	Boeing	168.7%
Exxon Mobil	56.1%	McDonald's	139.6%
Losers		**Losers**	
Home Depot	-40.4%	General Motors	7.7%
Merck	-43.2%	Wal-Mart Stores	-2.5%
Microsoft	-51.2%	Pfizer	-2.9%
General Motors	-59.15	Merck	-8.0%
Intel	-60.1%	Coca-Cola	-13.75

Source: MSN, Financial Times

October in perspective – local markets
The SA equity market delivered another excellent set of monthly returns. The Basic materials index gained 4.0% despite the firm rand – it gained 5.7% and 4.3% against the dollar and euro respectively. The strong rand encouraged investors to increase their exposure to financial shares; the financial index gained no less than 6.0%. The industrial index was not far behind with a 5.1% gain and the mid and small cap indices rose 7.9% and 5.6% respectively. The construction and materials index rose 13.9% on the month as investors got to grips with the impact of increased infrastructural spending in the next few years and general retailers rose 13.6% as the firm rand eased upward pressure on interest rates. An event in October worth highlighting was the Medium Term budget policy statement (MTBPS) by the Minister of Finance. For the benefit of offshore readers this is a mid-year mini-budget given by the Minister, who uses the opportunity to update the state of nation's finances and lay out the government's mid-term plans and strategies. Without going into details about the MTBPS suffice is to say that is was *very positive.* Government revenues are above-expectations and the important metrics are moving in the right direction – no wonder the rand had such a positive reaction.

Chart 3: Local market returns 31 October 2006



File 13: The world's largest IPO

In keeping with the "law of large numbers" that we have been highlighting in File 13 in the past few months and in tune with the "China story" which is no less important despite the fact that we have not touched on it for a couple of months now, October saw the completion of the world's largest IPO (initial public offering). The company in question was Industrial and Commercial Bank of China (ICBC), which raised $19.1bn on the Shanghai and Hong Kong markets. Once the capital raising exercise is complete, the sum is likely to have risen to $21.9bn. The previous record for the largest IPO was held by NTT Do Co Mo, the Japanese telecoms company that raised $18.4bn in 1998. The ICBC IPO attracted no less than $500bn in subscriptions - $400 in Hong Kong and $100bn in mainland China – which again underlines the point made in our earlier discussion of how much liquidity is "out there". Shares in ICBC rose 15% in Hong Kong and 5% in Shanghai on the day of the listing.

Table 3: Emerging market returns to 31 October 2006
MSCI index returns in US dollars (%)

	Oct	YTD
Turkey	15.0	-7.4
South Africa	10.7	1.7
Hungary	9.6	8.8
Argentina	9.3	35.9
Poland	9.2	20.2
Czech Rep	8.5	19.0
Colombia	8.4	3.0
Brazil	8.4	23.6
Thailand	7.8	13.1
LatAm	**7.7**	**23.9**
Chile	7.1	14.6
China	6.8	40.2
Mexico	6.8	25.8
India	6.6	36.8
EMEA	**6.3**	**8.4**
Peru	4.9	42.4
MSCI EM	**4.7**	**15.3**
Indonesia	3.3	47.1
Israel	2.8	-7.8
Asia	**2.7**	**15.9**
Russia	2.5	34.5
Taiwan	0.8	3.8
South Korea	-0.4	5.7

Source: Merrill Lynch