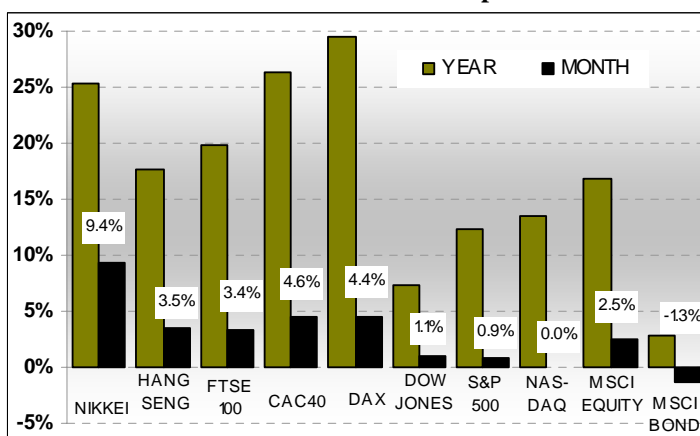




## September in perspective – global markets

What an unusual month September turned out to be. Two huge hurricanes, record oil prices, elections in Japan and Germany, another US interest rate rise – September had it all. On the face of it you would have thought markets would end lower. Not so; good performances in Europe were eclipsed by even better ones in Asia in general and Japan in particular. Emerging markets were firm, driven in part by a return to favour of resource shares and markets dominated by commodities. More comment on the market movements is passed below, but note how US markets have lagged the rest of the world, particularly in the past year.

Chart 1: Global market returns to 30 September 2005



## Conflicting messages from global markets

One of the challenges of managing money is to separate the real “message from the markets” from the noise surrounding them. Even more difficult is to make sense of *conflicting* messages from the markets, such as those that are currently being received. It is often assumed that portfolio managers have supernatural powers of prediction. How we should be able to read the future while all those around us are unable to do so remains a mystery to me. At the risk of demystifying the profession, there are many times when it is hard to decipher conflicting messages and take what one believes to be the right course of action, particularly when the correctness of one’s action will only be apparent some time in the future. While this section is not meant to garner sympathy, the intention here is to bring to your attention the difficulties in managing money at times when conflicting signals abound and the future appears anything but certain. At times such as these, the decision-making process and the philosophy underlying it are even more important than the immediate correctness of the outcome. Thus, discipline, conservatism, a true appreciation of the underlying risks, and cognisance of the ultimate ownership of the assets are essential when taking investment decisions in times of great uncertainty. Consider the following:

- Why are interest rates on say the US 10-year bond lower now than when the Federal Reserve first starting raising US rates? Remember the Fed has raised rates 11 consecutive times since then? The message commonly inferred from such market behaviour is that the rate of economic growth is going to slow sharply. Bond market investors are clearly not worried about future inflation, despite the current crisis in energy prices.
- Why are equity markets so strong? “Top-line” growth i.e. turnover has not grown meaningfully, and with little pricing power (low inflation, remember) surely the impact of higher energy and raw material prices will affect profit margins? Yet, markets move higher as though earnings growth will continue ever upward.
- You are aware that there is a crisis in global energy prices at present, exacerbated by Hurricanes Katrina and Rita. Yet inflation expectations remain benign – look no further than global bond markets for evidence of the complacent attitude toward inflation.
- General consensus is that global economic growth is set to slow into next year. Why then does the Fed continue to raise rates? It has yet to give any hint of when that process will stop, despite the significant albeit medium term effect that the two hurricanes will have on the engine of global growth, namely the US consumer?
- And why does the US dollar continue to strengthen, when, as confirmed by Fed chairman Greenspan only ten days ago, the US budget deficit is “out of control”?
- Why have European equity markets in general and the German one in particular (refer to Chart 1) been so strong in the midst of the chaos on the political landscape? Does Europe even know who it is and where it is going these days? What are European markets telling us? Surprise, surprise: bond and equity markets are transmitting strong but conflicting signals. Surely equity markets should be moving lower (due to political uncertainty and marginal economic growth) and bond market yields higher (higher inflation due to rising energy prices). On the contrary, bond yields and equity prices are at multi-year lows and highs respectively.

Many of the phenomenon described above run counter to what you would learn in economic textbooks. Yet not only are they real, we have to take decisions in this conflicting environment. Frequently investment managers are castigated, more often by the media than the owners of the assets, for not performing well enough. I raise this issue because it sets the stage for a timely reminder that the aspect of **risk** is as important as **return**, and even more so during times of uncertainty such as the prevailing environment.

## Making sense of at least some of the conflicting messages

The following explanations are by no means exhaustive.

They may, however, provide some reasons behind the conflicting messages emanating from the markets.

- *Global liquidity*: there is an unprecedented amount of money “sloshing” around the world at present looking for a home (read decent return). Sources of the liquidity include the historically low levels of interest rates, expansionary fiscal policies of developed Western economies accompanied by very low levels of savings, and a rising tide of “petro-dollars”. It is no secret that investment markets are positively correlated to the level of global liquidity.
- *M&A activity*: a dominant feature of markets this year so far has been the record levels of merger and acquisition (M&A) activity. If private equity firms are able to generate such good returns on their investments, and are able to raise such large amounts for investment with such apparent ease, are equity markets not too cheap? Or is this the making of another bubble? One reason that might explain the strong European and German equity markets is that M&A activity there is sharply higher than before, and rising at a faster rate than in the US. European transaction volumes are some 43% higher than this time last year. For the year to date the value of global deals is about \$1.8 trillion; \$330bn of deals were struck during the September quarter alone involving European companies. This has been very supportive of not only the equity market, but also for the players involved, not least of which are investment banks. It seems that an equity culture is starting to take hold in Europe and that in most countries corporates are moving ahead with restructuring despite the political malaise. This phenomenon has a positive effect on both the equity and corporate bond market. As companies have strengthened their balance sheets in recent years, they have used the massive global liquidity and favourable lending environment to refinance loans at a cheaper rate. Increasing development of the financial industry, in the form of greater hedge fund activity, product and financial instrument development and the increasing appetite for risk-taking have added to the positive momentum.
- *Demographics*: one aspect of changing demographics is the fact that companies with long-term liabilities, life insurers for example, are struggling to find appropriate assets to match the duration of their (retirement and pension) liabilities. We have alluded to this aspect on many previous occasions. Last month the UK government issued a 50-year inflation-linked bond, at a real yield of only 1.112%. Wow! Just think about that for a moment: a real return of 1.112% for the next 50 years! Surely nobody in their right mind regards that as reasonable compensation for the use of their money. I think it is fair to say that the issuer, in this case the UK government, got a bargain. It just goes to show how desperate companies are at the moment to match their liabilities that are growing both in size and duration. So they continue to buy bonds and push prices higher and yields lower.
- *The Budget bubble*: we all know about the “twin deficits”, the US current account and budget deficits. The US fiscal year ended on 30 September, so 2005 is

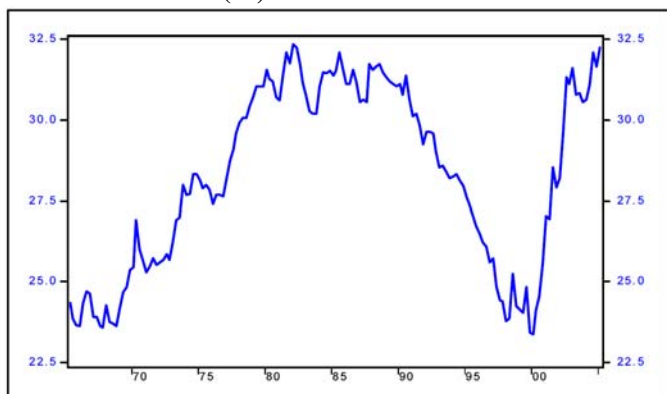
by and large history – the 2005 US budget deficit is likely to be around \$350bn. However, thanks to Katrina and Rita, additional spending of around \$200bn will swell the 2006 deficit. It remains unclear as to how this will be financed, but it will obviously stretch what are already huge global capital imbalances. At this stage it looks like the 2006 deficit will exceed \$450bn.

- *Absolute levels of inflation and interest rates*: there are not too many investment managers around who have managed assets in an environment when inflation and interest rates were very high. We have all become used to low levels of inflation and interest rates. How many investors and managers have unwittingly fallen into the trap of assuming that the current levels are the norm and are here to stay? My point is not to forecast a rapid rise in either rates or inflation. Rather, it is to caution against complacency; to remind ourselves that rates can and do rise, often when one least expects them to. Realistically, for example, will the real yield on bonds remain at 1.112% for the next 50 years? While it is easy to say that we will not fall into that trap record low levels of interest rates have led to unusual behaviour in many asset classes - property and bonds immediately come to mind - around the world. Is there really a property bubble in some places, or is that phenomenon not just a reflection of the structural reduction in rates we have experienced in the past decade. Perhaps more importantly, how much of that reduction is *structural* and how much is *cyclical*. Once again, the answers to these and similar other questions hold the explanation to the conflicting messages we are getting for the markets at present.
- *And where does that leave SA markets*: to the extent that some of the aspects discussed above are distorting market behaviour – at least in the short and medium-term – what should SA investors make of it all? It is true that emerging markets are currently the “flavour of the month”. Much has been made of improved fiscal and monetary policies, of the more stable political environment, of the superior growth rates and opportunities, etc, but once again, how much of this is structural and how much of this will “unwind” when the proverbial budgie hits the fan? SA equity investors need to exercise caution as our market moves ever higher. A large part of the rise has been brought about by higher commodity prices and a move by foreign investors into commodity shares. But how long can these keep rising if the global economy is going to slow? And when does this sector start getting expensive in absolute terms? In all the excitement and fun of making money, let us not throw caution to the wind and forget the basics of fundamental analysis and good old fashion valuation as a key determinant of an asset’s attraction.

## Chart of the month

We referred above to concerns about recent (say five-year historic) “unusual” behaviour in the property markets. Nowhere has this been more evident than in the US. Chart 2 shows how property, expressed as a proportion of total US household assets, declined in the wake of the equity bull market towards the end of the last century. Very apparent too is its recovery since early 2000. On the basis of the graph below, you decide how sustainable this rise can be.

**Chart 2: Ratio of US total real estate holdings to total household assets (%)**

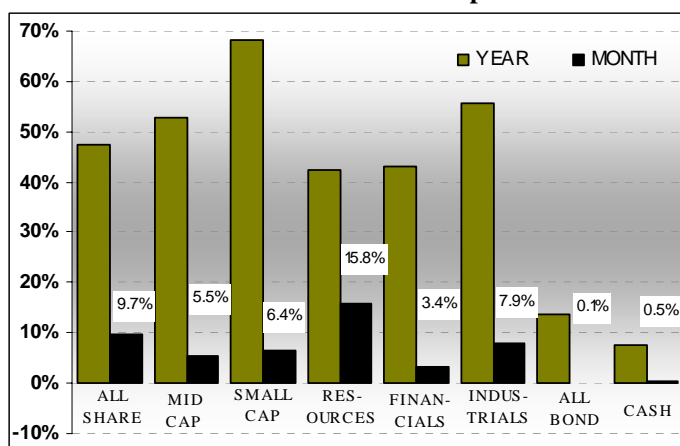


Source: Merrill Lynch, US Federal Reserve

**September in perspective – local markets**

Phew! Another crazy but very rewarding month has passed in local markets. The feature, not shown in Chart 3, was the 31% gain in the All Gold Index, which had gold bulls dancing in the aisles. The gold price rose 9.2% on the month, spurred largely by the fear of resurgent global inflation on the back of record oil prices. Forgive me if I remain somewhat sceptical – the 31% gain in September should be seen in the light of the 3.3% rise for the year to end-September. But the oil (Sasol) and platinum sectors were also strong, as were the mining houses, which gained on the renewed demand by global investors for quality mining houses, of which there are only a handful and two of which dominate the JSE (Billiton and Anglo). Financials lagged, but industrials posted decent gains, fuelled by the likes of Barloworld, SABMiller and Steinhoff. Foreign buyers were again the catalyst for the price impetus (look no further than the strong gains in European equity markets in Chart 1). One of the more astonishing aspects of Chart 3 is the scale. All three major sub-indices (resources, financials and industrials) have posted gains for the past year in excess of 40%, mid caps and industrials are over 50% higher and the small cap index is almost 70% higher than this time last year. Surely it does not come better than this?

**Chart 3: Local market returns to 30 September 2005**



**For the record**

The latest returns of the collective schemes (unit trusts) that Maestro manages are listed below. If you wish to find out more detail on the Funds, including the latest Maestro Equity Fund Summary, please visit our website at [www.maestroinvestment.co.za](http://www.maestroinvestment.co.za).

**Table 1: Returns of mutual funds under Maestro’s care**

	Month	Return	Year to date
<b>Maestro Equity Fund</b>	Sept	<b>6.44%</b>	Not applicable
Maestro equity benchmark *		8.33%	30.06%
JSE All Share Index		9.70%	35.92%
<b>Central Park Global Balanced Fund (\$)</b>	August	<b>0.30%</b>	-2.66%
Benchmark**		0.66%	1.30%

\* 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

**File 13: Information you needn’t retain**

From the FT comes this interesting information: in a recent survey of ten of the top unit trusts in the “balanced managed sector”, the average annual investment charge was 1.4% and the initial charge was 3.5%. Four of these funds charged 5.0% or more as an initial charge. Over the past year, equity exposure had risen from an average of 79% to 80% - hardly earth shattering stuff. Many of the largest holdings were FTSE All Share Index weightings. More alarmingly, the average number of holdings was 653. One fund had no less than 1 610 holdings! Only three of the ten funds managed to outperform the FTSE All Share Index over the past four years, and then by only a small margin. Is it no wonder that retail investors are increasingly disillusioned with the investment profession?

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