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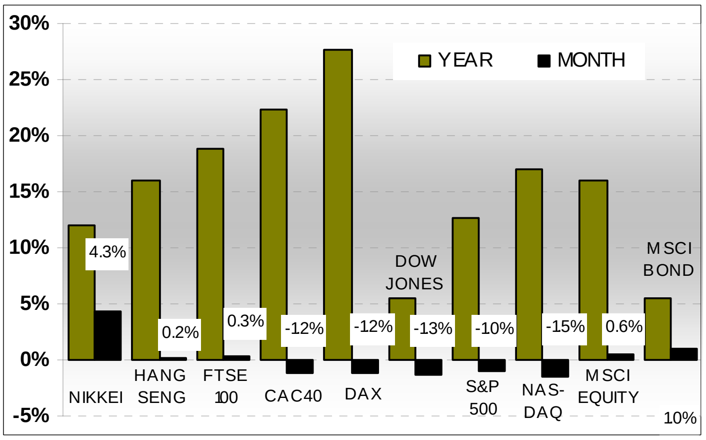
August in perspective – global markets
Oh well, all good things come to an end, don't they? The three months to end-July were very rewarding for global equity investors, but it took Hurricane Katrina to bring the party to an end. The reality is that the oil price has now breached the $70 mark. And no, as we have been warning for some time, this "jolly oil thing" won't go away. How long will it be before the reality of higher energy prices starts sinking in? Markets seemed unfazed if the August returns are anything to go by although one should remember that the Northern Hemisphere has been on holiday, and are only now returning to their desks. For the record, oil, gold, and natural gas indices all gained more than 5% on US equity markets during August, while the airline, gaming, retail and housing indices lost more than 5%.

Chart 1: Global market returns to 31 August 2005



Mother Nature and Father Time: a terrible combination
Looking at Chart 1 and the recent returns on global markets, it is hard to believe that they have held up so well. Without wanting to be alarmist, let's consider the investment environment as it now stands, at least in Maestro's opinion. Let's start before Hurricane Katrina:

- The oil price had been moving relentlessly higher. The reasons behind each new price rise were different and the reasons given why it would decline were trotted out. But the fact is energy prices were at record levels (refer to Chart 2) and showing no sign of declining. A major reason for the record prices, namely the lack of refining capacity, seems largely to have been ignored.
- Many commodity prices were at or close to record levels, due in many cases to significant under-investment in prior years.
- Although off their record levels, US government and consumer spending are very high, resulting in the by now well documented "twin deficits".
- After three years of weakness, the dollar seemed to have regained its composure. It had shown admiral strength so far this year, despite the deficits and the US's need to usurp the lion's share of global capital.
- US interest rates had been raised eleven times in as many Federal Reserve meetings, and the plan was clearly to continue moving them higher.
- Despite this, US property prices were moving ever higher. Some called it a bubble, others a function of changing demographics. No matter what you called it, house price charts looked like a proverbial "stairway to heaven"
- Fortunately, US economic growth seemed to have been holding up well, thanks to the irrepressible spending habits of the US consumer. Consumption expenditure has kept the US economy going at a healthy pace. Underpinned by a sense of economic well-being, US consumers had given up on saving (as from this month the official US savings rate is now negative), and were spending as though there was no tomorrow.
- That said, prior to Katrina, economic data emanating from the US was hardly inspiring. The fact that it pointed to a slowdown in certain areas is hard to ignore.
- Economic growth on the European side of the Atlantic was virtually non-existent. In some countries political changes of note are not far away.

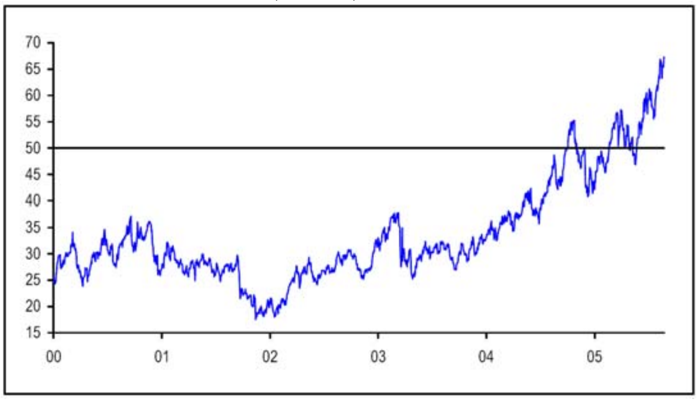
And then came **Mother Nature**, in the form of Hurricane Katrina's fury. The sheer power of that storm is a sight to behold, and we are grateful that more people were not killed. To put the storm into perspective, the area most severely affected by the storm is larger than the whole of Great Britain. But what is so important about this event, I hear you argue? Why should we be bothered by a storm so far away?

Without going into the detail, let me try and place it in perspective. As I have tried to explain above, the world is "living on the edge". Things seem to be going well, but there is little spare capacity in vital areas, notably energy, which just happens to lubricate most of the global economy. There is plenty of oil around; it's just that there is insufficient capacity to refine it, insufficient ships to carry it and insufficient ports to offload it. The Mississippi basin is one of the major arteries for the refining of oil, and the transportation of bulk commodities such as oil, coal and grain. Thanks to Katrina, a large part of the Mississippi river is now closed. As is New Orleans and three other major ports in the vicinity. Much of the infrastructure is damaged beyond repair. Apparently Katrina has destroyed some 10% of US refining capacity.

As energy prices rise (see below) and effectively take money out of the US consumer's pocket, his role as a significant pillar of support for the US (and global) economy will be seriously undermined. What happens if (when?) economic growth slows and unemployment – already at high levels in some parts of the developed world, notably Europe – starts rising? And if inflation moves higher than expected? Where will that leave interest rates? We could go on, but the point is just there is very little room to manoeuvre at the moment. As we say in the profession, markets are "priced to perfection".

And that's where Katrina will hit the world the hardest – where there is little or no spare capacity. Already dramatic price rises have occurred as a result of the Hurricane Katrina.

Chart 2: Oil prices – higher and still higher
West Texas Intermediate ($/barrel)

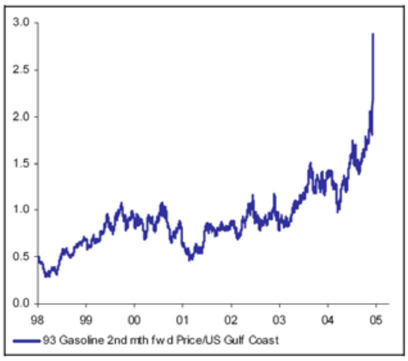


Source: Merrill Lynch

In case you think I am exaggerating, consider the following price rises *during last week* (ended 2 September) *alone*:

- The price of coffee is up 11% on the week
- US timber prices rose more than 17% - where will that leave the US housing market?
- The aggregate effect of the commodity price rises pushed the CRB Commodities Index to a 25-year high
- The tanker rate for carrying petrol from Europe to the US rose 60%
- Wholesale petrol prices had risen more than 50% by Wednesday, but retreated somewhat by Friday on the news of the release of fuel from strategic reserves – refer to Chart 3, below
- Natural gas futures rose more than 20% - how far away is the Northern winter and will the capacity be in place to restore sufficient quantities by then?

Chart 3: US gasoline prices ($)



I accept that some of the price reactions are impulsive, but it is naïve to think prices will move lower than their pre-Katrina levels. Enter **Father Time**: that elusive old man that stealthily but relentlessly moves us on in life. While some of the damage of the storm in now apparent – and that devastation is amazing – as with many indicators, it will take time before the true economic effects of higher prices take effect. It is therefore not unrealistic to expect more bad news in the future. So let us examine some of its possible effects:

- One has to start with the ***oil price***, where the effects of Katrina are probably the most obvious. However, don't be fooled by the relatively modest increase in the price of crude. It is the downstream products like natural gas, gasoline (petrol) and jet fuel that are bearing the brunt of the increases. It may be all good and well to release oil from national reserves, but remember even before Katrina there was insufficient capacity to refine the stuff. And in any event, all those reserves that have been released have to be returned by the users in due course, so the relief will be temporary at best. We should therefore not underestimate the true effects of a lack of refining capacity across the globe. Imagine the effects of some areas running out of jet fuel. Think of the effects on the global logistics chain. The effects may be short-term, but they will ripple through the global economy and investment markets
- If the oil and commodity prices stay high, ***inflation*** will move higher. In absolute terms it may not amount to much, but recall that most corporates have little or no pricing power in the economy these days, meaning that they will have to absorb the full increase in prices into their profit margins.
- It is hard to see the level of ***economic growth***, particularly in the US, remaining unaffected. Initially the effect will be negative, as higher energy prices eat into consumers' disposable income. The sheer deduction from the economic pie of the greater New Orleans region should also not be underestimated. Remember how costly and disruptive the closure of New York was after September 11? That was for a couple of days – at this stage the estimates of closure and production "shut-ins" are being measured in terms of months, not days. One has to add though that there will be a positive spin to economic growth as the effects of the massive rebuilding and restoration efforts get under way. Estimates of the destruction of value have been set above $100bn – a great portion of that will have to be rebuilt, and that could amount to a shot in the arm for the US economy – but it will be quite a while before the effects of the rebuild become apparent.
- The slowdown in US economic growth and rising energy prices pose a significant threat to ***corporate earnings***. This aspect is important, as the surprisingly good corporate earnings have sustained the equity markets at levels higher than they would otherwise have been in the face of rising interest rates. Take out this support, and the US equity market looks rather vulnerable.
- The relentless increase in ***US interest rates*** will in all likelihood abate at this stage. In some respects this represents good news. It will be one of the most influential changes in the global economy arising from Katrina, but think beyond the effects on just the US economy. Expectations of interest rates rising at a less rapid pace has already had a profound effect on the dollar in the past week – it slid 2% against the euro and sterling, 2,3% against the Swiss franc and 3.1% against the rand. It may well be that we are at the start of

another cycle of dollar weakness. Think about the implications of that: where will that leave the level of the euro, or the rand? Think of the implications for SA interest rates if the rand continues to firm. And what will the effects on commodity prices be?

- It is relatively easy to think about the primary effects of Katrina. But the ***secondary effects*** will be significant as well. Already, Katrina has brought about a confidence crisis in Indonesia, where the rupiah at its worst levels lost 20% against the dollar in a fortnight. The country had its sovereign debt rating downgraded by Standard and Poors. The problem? A third of Indonesia's central government spending is used to subsidise fuel at the retail level. We may yet see other national crises in other emerging markets. And lets not forget Katrina's secondary effects on the mother of all emerging markets, China. As long as the US consumer is affected (which it will be) so too will the Chinese economy. And that alone will have major repercussions on the global investment environment, as we know it.

To sum up, putting the fury of Mother Nature and the effects of Father Time together, we need to brace ourselves for major disruptions in the months to come. *Firstly*, a major pillar of support to the global economy in the form of the US consumer has been significantly undermined. *Secondly*, the price of energy has moved into unknown territory. While the effects of this may be hard to quantify, they will not be positive. *Thirdly*, a major factor behind the recent dollar strength, namely expectations of higher US interest rates, has fallen away. This, too, will have far reaching effects on the global economy and markets.

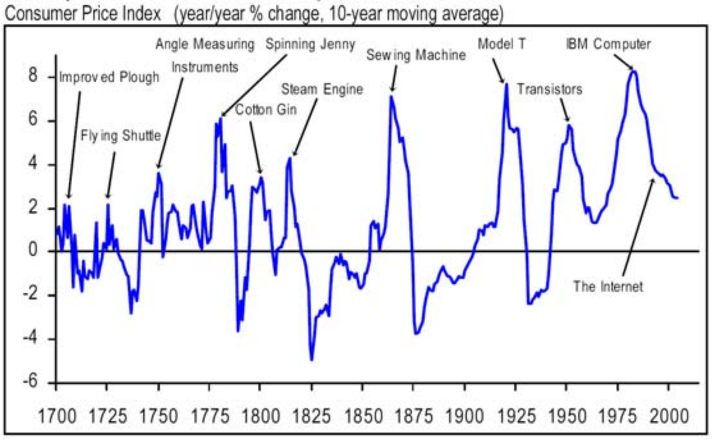
I am of the humble opinion that we will look back on the last weekend of August 2005 and Hurricane Katrina, as we now do on September 11, or the advent of the New Millennium or the start of the Iraq War, and view these incredible events as a watershed in the global economy and investment markets. All investors should note the changes that will unfold in the coming weeks and months. We should brace ourselves for significant economic "fall-out" in certain areas of the global economy.

Chart of the month

I love long-term charts, and the one below is no exception. Given that inflation is very pertinent at present, especially the current expectations of future inflation, I am sure you will enjoy Chart 4.

Chart 4: US inflation - it falls after a major innovation

Consumer Price Index (year/year % change, 10-year moving average)

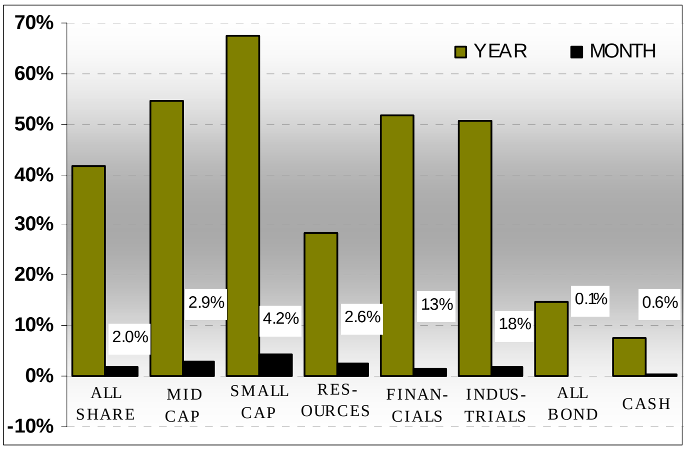


Source: Merrill Lynch

File 13: Information you needn't retain

Given the urgency of reviewing the current investment environment and the length of this edition, this month's "File 13" article has been despatched to…well, file 13.

Chart 4: Local market returns to 31 August 2005



August in perspective – local markets

The local markets got off to a bang as the momentum from July carried through into August. They paused mid-month but were strong last week despite a rampant rand on the back of a very weak dollar. Indices to post the largest gains included oil and gas up 9.6%, platinum 8.8%, media 7.7% and life assurance 7.3%. Losers on the month included beverages and health both down 2.1%, banks 1.7% and gold mining 1.6%. The trading environment was quite volatile though, with some large individual winners and losers, notably in the mid and small cap arena. As is evident from Chart 4, the annual returns are still very impressive, but will start declining as the rewarding months during the last quarter of 2004 start falling out of the base.

For the record

As many of you are aware, Maestro launched its new South African general equity unit trust, the **Maestro Equity Fund,** in July. Although it is not in Maestro's nature to list monthly returns, we thought readers would be interested in seeing how the Fund progresses. In addition, seeing that we will list the Equity Fund's return, we may as well list the other Fund on which Maestro advises, namely the **Central Park Global Balanced Fund**, as many *Intermezzo* readers are either invested in this Fund or are associated with it. So in future editions of *Intermezzo* we will list both Funds' monthly returns, without comment. If you wish to find out more detail on the Funds, please visit our website at www.maestroinvestment.co.za.

Table 1: Returns of mutual funds under Maestro's care

	Month	Return	Year to date
Maestro Equity Fund	August	**1.14%**	Not applicable
Maestro equity benchmark *		1.54%	20.06%
JSE All Share Index		2.01%	23.90%
Central Park Global Balanced Fund ($)	July	**2.25%**	-2.96%
Benchmark**		1.64%	0.64%

* 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