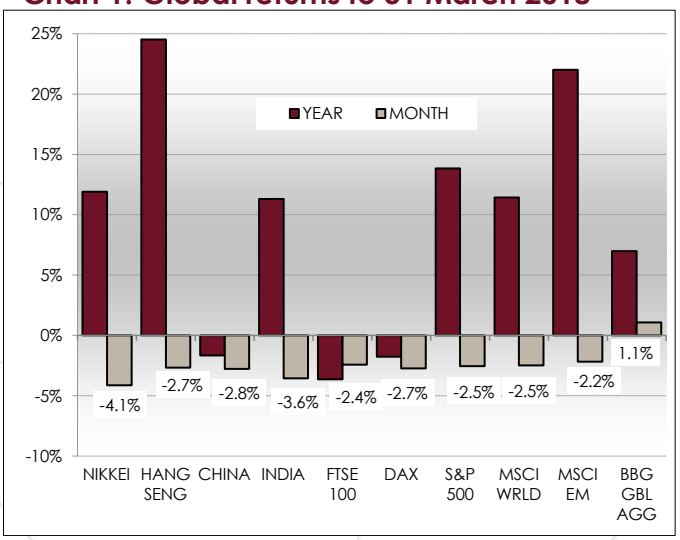
INTERMEZZO
INVESTMENT LETTER
April 2018

Orchestrating Your Wealth
MAESTRO
Masters of Investment

March in perspective – global markets

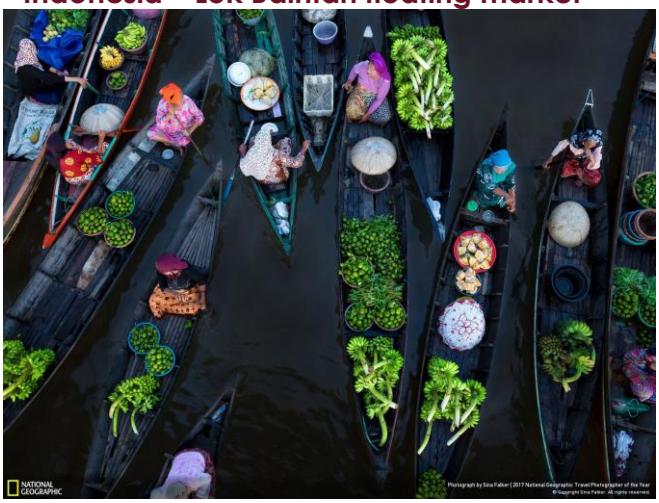
After the rude awakening of unprecedented market volatility in February, global equity markets staged something of a recovery in the early stages of March before being thrown off course again by US President Trump's efforts to initiate a trade war with China. From their mid-month peak, the trade war spat all but ensured equity markets ended March lower than where they started the year.

Chart 1: Global returns to 31 March 2018



The MSCI World index declined 2.5% during March, and the MSCI Emerging Market index 2.2%. Leading emerging market declines were India, down 3.6%, and China, 2.8%, although smaller markets fell further: the Greek and Indonesian markets declined 6.6% and 6.2% respectively. Russia's 3.1% decline would have been far worse were it not for the 8.6% rise in the oil price. The Brazilian market was flat. Developed markets didn't fare much better: the US equity market declined 2.5%, the German and Hong Kong markets both fell 2.7%, and the Japanese market ended 4.1% lower. The tech-heavy NASDAQ index fell 2.9%, but rather surprisingly the US Mid and Small cap indices rose 0.8% and 1.9% respectively.

Indonesia – Lok Baintan floating market



Global bond markets also experienced above-average volatility, but ended the month higher – the Bloomberg Global Aggregate bond index rose 1.1%. The dollar DXY index lost 0.6%, with the greenback ending lower against most currencies; the euro and sterling rose 1.3% and 2.3% respectively against it. Commodity prices were generally lower; copper fell 3.7% and iron ore 20.1%.

What's on our radar screen?

Here are a few items we are keeping an eye on:

- *The SA economy*: The South African current account deteriorated from 2.1% during the third quarter of 2017 (Q3) to 2.9% in Q4, pulled lower by net dividend and interest payments abroad. The Reserve Bank (SARB) reduced their official interest rate by 0.25%, with banks following suit by reducing the prime overdraft rate to 10.0%. The SARB also adjusted their expected growth rate for the SA economy, although by very little: they now expect 2018 and 2019 growth to be 1.7% and 1.5%, which is hardly worth getting excited about and of course far below what is required, even for SA to stand still. Despite the upbeat sentiment towards the country in

"To achieve great things, two things are needed; a plan, and not quite enough time."
- Leonard Bernstein

light of the recent political developments – and the changes have been significant – we still believe the economic challenges facing the country will eventually prove insurmountable unless something really dramatic happens, which we do not expect. Our key investment tenet of "economics over politics" will in all likelihood again prove important as a determinant of how and where to invest one's capital.

- *The US economy*: The third and final reading of the 2017 fourth quarter (Q4) US economic growth rate showed growth rising from an initial estimate of 2.5% to 2.9% - a healthy pace indeed. Fewer jobs than expected were created in March (103 000 versus 185 000 expected), but the average hourly earnings growth rose only 0.3% month-on-month, bringing the annual increase to 2.7%. This is important as it is this number i.e. the annual increase in US wage rates that most investors are watching as a first sign of rising inflation. The unemployment rate remained steady at 4.1% for the sixth consecutive month. Headline inflation rose at a month-on-month rate of 0.2% during March, while the core inflation rate, which excludes food and energy prices, rose marginally to 2.1%. On a three and six-month annualized basis, core inflation is now running at a rate of 2.9% and 2.6% respectively.
- *Developed economies*: Germany's March unemployment rate was in line with expectations, at 5.3% while the annual headline inflation rate was below market, at 1.5%. The March annual inflation rate in France was 1.7% and in Italy 1.1%.

Spain – flamingoes in flight

Quotes to chew on

The sleeping giant stirs …

One of our investments in our global portfolios is in CTrip.com International. The company has over 300 000 registered users, making it the largest online travel agent in Asia. CTrip issued a press release on 2 April, and we thought the information it contained was worth sharing. It provides insight into how large the opportunity is. "Since the launch in January 2016, Ctrip Customized Travel has seen increased user demand up to 120 000 per month. With more than 1 000 suppliers and 4 000 personal travel consultants covering 141 countries, Ctrip's Customized Travel is the biggest customized travel platform in Asia. According to Ctrip's '2017 Customized Travel Report', 2017 marked the beginning of popularization of customized travel in China. More than one million requests were made in 2017. 60% was for domestic tourism with Sanya, Xiamen, Beijing, Lijiang, and Shanghai as the top five most popular destinations for travelers. For outbound requests, people traveled mostly to Thailand, Japan, Indonesia, Singapore, and Vietnam. 80% of travelers requested 'slower' trips that are more unique and personalized. 60% placed local cuisine

experiences above all else, 55% opted for unique hotel experiences while 30% of requests were made for marriage proposals and honeymoons. 80% of customized trips were made by those travelling with their families. Those born in the 1980s and 1990s are the main force behind this craze for customized travel."

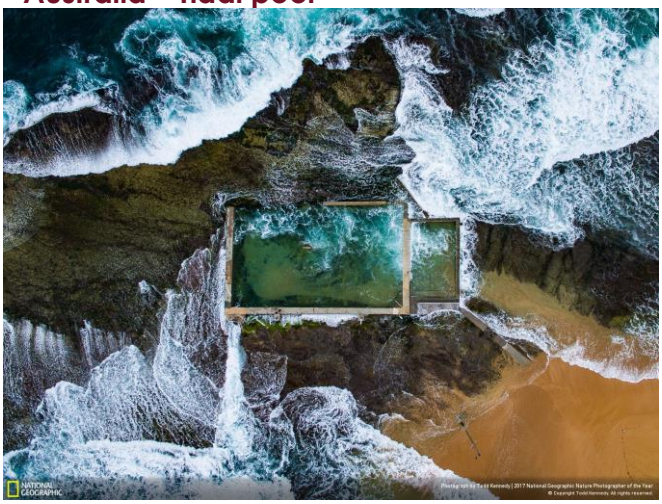
Ethiopia – Salt miners at work

South Africa's credit rating revisited

Towards the end of March, rating agency Moody announced that they had decided to keep SA's credit rating at just above "junk" level. Rather surprisingly, they changed their outlook from negative to stable. It is worth spending a bit of time on the reasons for their decision. It was based on what they believed could be three key areas of improvement. Firstly, the recent changes in the political leadership may halt the deterioration of the country's institutional framework; secondly, the recent changes should lead to improved economic growth and the country's economic prospects; finally, the fiscal adjustment plans, announced by the now ex-Financial Minister, should stabilize and eventually reduce the country's debt burden.

In our view, Moody's decision was a brave one, with a lot of "could", "should", "may" and other disclaimers. It places enormous pressure on the Ramaphosa government, although they are under pressure in any event. Moody's is now the only rating agency that doesn't rate SA's credit as junk. Moody's decision to change the outlook to stable seems optimistic. Although they expect an improvement in the state-owned enterprises (SoEs), they were mum on how the likes of Eskom, SAA, Denel, and many more SoEs are going to return to good, or even just sufficient, health. Bear in mind government would need a few hundred billion rand to do that – we are not talking small change here – and as it is they are already short of between R50bn and R80bn in the current year's budget. Wishful thinking perhaps on the part of Moody's?

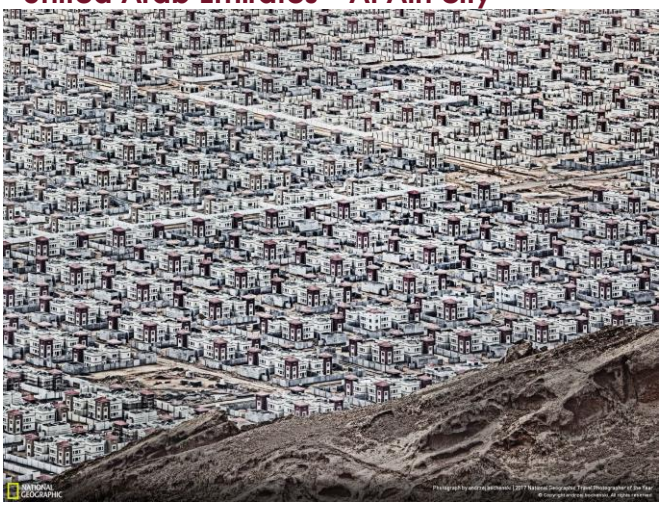
Australia – Tidal pool



Moody's decision is also based on the fact that the Ramaphosa government is stable and likely to remain in place for at least another term after the next elections in 2019. While it is our view that the ANC will win the next election comfortably, we are less sure that Ramaphosa will survive a full term. As much as we believe he is the "best man for the job", the ANC is fractured like never before. Ramaphosa is surrounded by some pretty

shady characters, whose history is peppered with corruption, abuse of power, and thuggery. In many cases this cabal is still sympathetic towards Jacob Zuma. Having put the issue of the expropriation of land without compensation at the forefront of his agenda, Ramaphosa has created a beast that, at least in our view, he may be unable to control. It has played directly into the hands of the Economic Freedom Fighters (EFF) party and into the hands of the likes of Deputy President David Mabuza's camp. It is not inconceivable to see the EFF's Julius Malema and Mabuza getting closer (hence Mabuza's overtures to Malema so soon into the Ramaphosa era). If that does happen, Ramaphosa becomes very vulnerable; so much so we think he could lose this grip on the leadership. Just imagine the country with the likes of Malema and Mabuza in charge?!

United Arab Emirates – Al Ain city



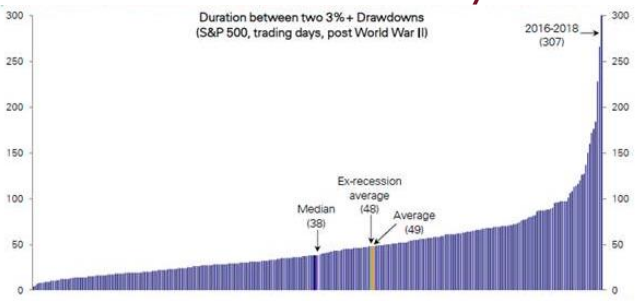
But we are getting bogged down in detail here. The point is just that Moody's decision and the rosy prospects they have painted for SA's future are anything but certain. So, too, is Ramaphosa's grip on power within the ANC. All of which will make for a turbulent and fascinating year ahead. Under these circumstances, it is hard to see the SA economy really gaining strength – perhaps that is why the Reserve Bank scaled back their growth expectation from 2.0% to 1.7% for 2018. It might also provide some background to why the rand firmed only slightly after Moody's announcement, which was largely already priced in, and has been weak since then. It also provides another reason why we continue recommending that investors seek more profitable investment opportunities outside the country.

Charts of the month

The return of volatility

The stability and steady rise of US equity markets in particular, between late 2016, through 2017 and for most of January 2018 has been a topic of discussion in recent editions of *Intermezzo*. We have drawn attention to how unusual these conditions are, and that they were likely to change. As we know, markets returned to "normal" in February, when we saw sharp declines and forgotten levels of volatility return, the catalyst for which, you might recall, was concern about the rising yields (interest rates) in the US bond market. Markets recovered partially in late February but March saw the return of volatility. Having seen some really volatile days in February, March and into April, I thought the following chart would place recent market conditions in perspective. Chart 2 shows that, based on post-World War history, the 307 days (15 months) of trading we had without a 3% decline in markets was quite unprecedented. The average number of days without a decline of between 3% and 5% is 49 days, and the median is 38 days. So while the current market volatility can be a bit unsettling, it is quite normal if the past is anything to go by.

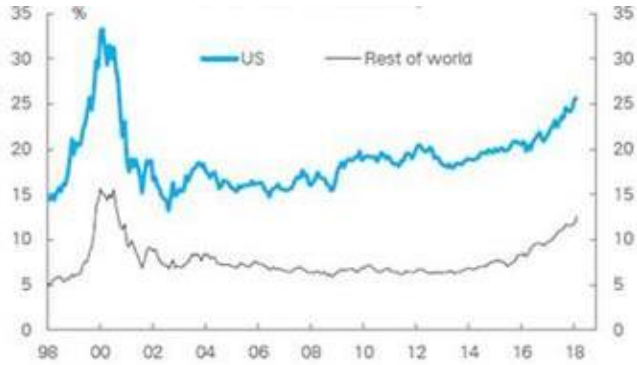
Chart 2: Volatile markets are fairly normal



Source: Deutsche Bank

Technology shares have performed very well during the past few years. Their elevated ratings has been a major talking point in recent months, and it would have been naïve not to expect them to experience some form of setback. Not surprisingly then, some of the largest decliners in recent weeks, in the midst of the return of volatility, were large tech shares. It is worth noting, given their strength in recent years, and particularly since early 2016, that technology shares now form a substantial portion of the market; not as large as during the 1999 tech boom, but still at the highest levels since then. Chart 3 shows that the tech sector constitutes just over 25% of the entire US market, and just short of 13% of the global market.

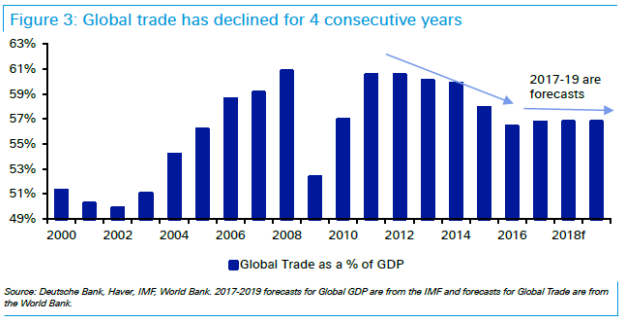
Chart 3: Tech is a large part of the market



Source: Deutsche Bank

One of the major sources of market volatility during the past few weeks has been investor fear that we are on the brink of a global trade war, specifically between the US and China. US President's incessant tweets in this regard have not helped matters at all. The underlying topic of globalization, and its benefits, or otherwise, are again being hotly debated around the world. There is almost unanimous belief that there are, and will be, no "winners" in a trade war, and that it is a bad policy to adopt. Of course, that has not stopped Trump from tweeting or communicating his superficial understanding on global trade.

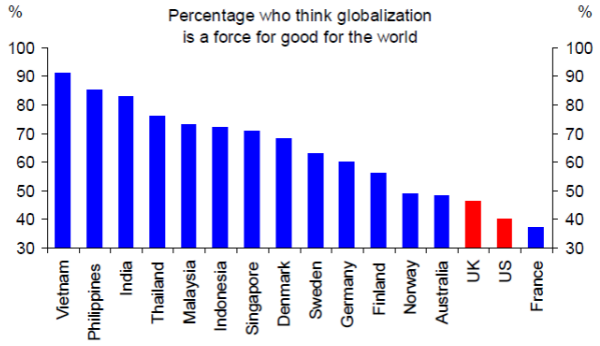
Chart 4: Globalization is on the decline



Source: Deutsche Bank

The irony of the matter is that global trade has been declining for more than four years already – refer to Chart 4 in this regard – and forecasts are for this trend to continue into the foreseeable future. Chart 5 reminds us that views on the merits of globalization remain diverse. Given recent history, specifically the platform on which Trump came to power, and Brexit in the UK, we should not be surprised that globalization is most unpopular in these countries. It is also not surprising to see how popular it is in the countries that have benefitted most from it.

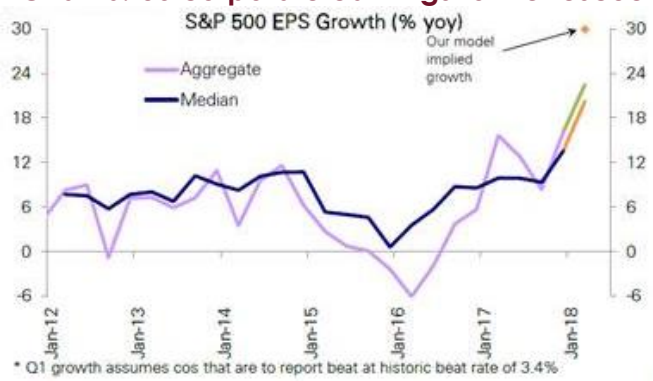
Chart 5: Globalization not always unpopular



Source: Deutsche Bank

Returning to the recent market volatility, while we don't foresee any immediate cessation of the volatility, we are hopeful that markets will take heart from the imminent US corporate earnings season. Based on the robust US and global economy and magnified by recent changes to the US tax regime, corporate earnings are forecast to rise strongly, at least at a rate of 20% on an annual basis – refer to Chart 6 in this regard.

Chart 6: US corporate earnings to the rescue

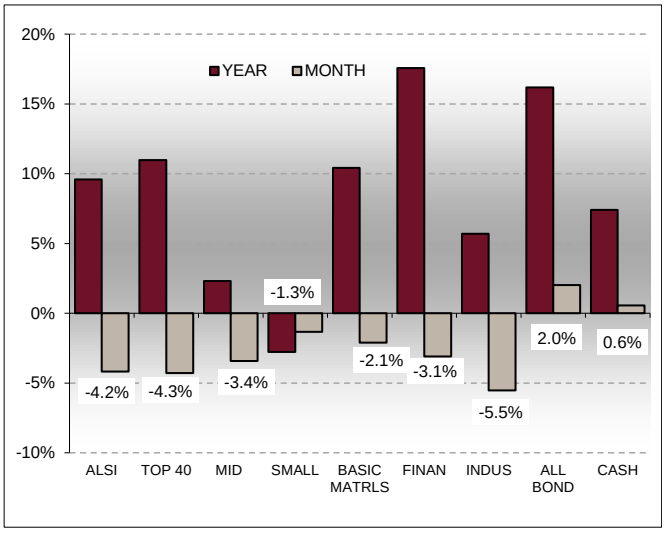


Source: Deutsche Bank

March in perspective – local markets

Turning to local markets, the SA equity market was not spared the volatility and weakness. Although the rand was volatile, it ended the month virtually unchanged, and was thus not a major factor in the determination of investment returns in March. The All Share index fell 4.2%, led by the Industrial index, which ended down 5.5%, followed by the Financial index, which fell 3.1%, and the Basic Material index, 2.1%. The Large cap (Top40), Mid, and Small cap indices fell 4.3%, 3.4%, and 1.3% respectively. The Gold index rose 6.1% but is down 13.0% so far this year.

Chart 7: Local returns to 31 March 2018



The All Bond index continues to reap the benefit of the positive sentiment towards emerging markets on the part of global investors. The recent reduction in official interest rates and positive global bond markets added to the sentiment, resulting in the All Bond index ending the month 2.0% higher. The latter has risen 8.1% so far this year, while the rand has firmed 5.1% over the same period; the global bond market, by way of contrast, has risen by 0.4% during this period.

The best-performing sector during March was the Non-life insurance sector, which rose 8.2%. The Gold Mining index rose 6.1% and the Health Care Equipment and Services index 4.9%. The worst performing sector was the Household Goods sector, which declined 43.1% (Steinhoff was again to blame). The Software and Computer Services index lost 25.6% (due largely to EOH's 40.0% decline), and Coal Mining lost 17.7%.

Japan – Sumo in Tokyo

For the record

Table 1 lists the latest returns of the mutual and retirement funds under Maestro's care. Returns include income and are presented *after* fees have been charged. Fund Summaries for each respective fund listed in the table, as well as all the historic returns, are available on our website.

Table 1: The returns of funds in Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Prescient Fund	**Mar**	**-5.3%**	**-7.7%**	**-7.8%**
JSE All Share Index	*Mar*	*-4.2%*	*-6.0%*	*9.6%*
Maestro Growth Fund	**Mar**	**-2.4%**	**-3.9%**	**0.5%**
Fund Benchmark	*Mar*	*-2.2%*	*-2.4%*	*9.6%*
Maestro Balanced Fund	**Mar**	**-1.7%**	**-3.1%**	**1.8%**
Fund Benchmark	*Mar*	*-1.7%*	*-1.6%*	*9.3%*
Maestro Cautious Fund	**Mar**	**-1.4%**	**-1.5%**	**2.7%**
Fund Benchmark	*Mar*	*-0.4%*	*1.2%*	*10.9%*
Central Park Global Balanced Fund ($)	**Feb**	**-3.4%**	**2.2%**	**30.9%**
*Benchmark**	*Feb*	*-2.9%*	*0.6%*	*11.5%*
*Sector average **	*Feb*	*-2.4%*	*0.2%*	*8.2%*

* 60% MSCI World Index and 40% Bloomberg Global Aggregate Bond Index

**** Morningstar USD Moderate Allocation ($)**

Obituary – José Antonio Abreu (1939 – 2018)

It was with great sadness that I learned of the death of José Abreu, the founder and champion of what has become known as simply The System or El Sistema. Those who know me, and who are interested in the power of music to transform lives and society, will be only too familiar with El Sistema. Trying to compile a succinct obituary of this man and the movement he began has been impossible. So I list below a precis of The Financial Times's obituary, but I recommend you also read the obituary in The Economist and The Guardian. Numerous books have been written about El Sistema. It has been the focus of numerous academic articles. Governments and leading musicians have tried to emulate its success, with varying degrees of success. What is clear as you plough through the huge amount of material in cyberspace on Il Sistema, is that without the drive, focus and indeed obsession of José Abreu, El Sistema and its transformative power would simply not exist. In recent years, Abreu and Il Sistema's critic grew louder and more vociferous, but one thing is clear – the testimony of countless individuals, students and their parents, who believe that El Sistema has offered them a way out of abject poverty, is not easily discounted.

Source: TheGuardian.com

"To achieve great things, two things are needed; a plan, and not quite enough time."
- Leonard Bernstein

In 2015 El Sistema comprised over 400 music centers in Venezuela and involved more than 700 000 young musicians. Its history has been documented in films and DVDs, including my favourite, The Promise of Music. Many books, too, have been written about El Sistema, including Changing Lives, by Tricia Tunstall, which I can recommend.

A concrete garage in Caracas might seem an odd place to found a classical music orchestra but José Antonio Abreu, who has died at the age of 78, was never a stickler for convention. In late 1974, Abreu, then a relatively unknown conductor, gathered together a handful of young musicians in these unpromising surroundings. After scratching out a few tunes, the group met again a few months later to form a youth orchestra. Over the next 40 years, the orchestra expanded to become a vast network of choirs and musical ensembles with a strong social purpose. Its goal was not only to teach music to children from Venezuela's shanty towns and poor communities in rural backwaters, but to give them an ethical education, a purpose, and a sense of dignity. The network was championed by the state and acclaimed and emulated around the world. It is known simply as El Sistema — The System — and, until his death on March 24, Abreu was its guiding light.

Source: FT.com

Born in the Andean city of Valera on May 7 1939, Abreu was inspired to take up music by his Italian-born grandfather, who emigrated to Venezuela with a collection of musical instruments. Abreu learned the piano, the harpsichord, the organ and the violin. After studying music in Caracas, he graduated in economics and became a congressman in the 1960s before returning to his passion for music to found El Sistema.

Dudamel and the Símon Bolívar orchestra

Source: TheGuardian.com

For years, the project inspired and funded thousands of youngsters to take up music, but it was not until Hugo Chávez became Venezuela's president in the late 1990s that El Sistema came to the world's attention. For Chávez, the effort was the perfect musical accompaniment to his socialist "Bolivarian Revolution". He championed it, financed it, and used it as a propaganda tool to promote his political project. Physically, the two men made a strange duo: the burly soldier Chávez towered over Abreu – a slight, stooped, bespectacled, baldheaded man, who invariably wore a black coat even in the tropical heat of Caracas. But ideologically the men found some common ground and El Sistema flourished under the populist president.

The British conductor Simon Rattle suggested Abreu deserved the Nobel Peace Prize for his work. "What Abreu and El Sistema have done is to bring hope, through music, to hundreds of thousands of lives that would otherwise have been lost to drugs and violence," Sir Simon told the Guardian newspaper in 2010. "It is impossible to calculate. Abreu has saved those people physically in many cases and he has saved them in other ways, too. He has given them life in all its depth. Abreu has built a system that provides nutrition for the soul."

Moscow – Changing of the guard

After Chavez's death in 2013, things soured. The following year, amid deadly protests against the increasingly authoritarian regime of President Nicolás Maduro, Abreu and his most famous student, the acclaimed director of the Los Angeles Philharmonic Gustavo Dudamel, appeared on Venezuelan television alongside a smiling Mr Maduro, celebrating their return from a tour of Europe. The musicians were condemned, not least by Venezuela's renowned exiled pianist Gabriela Montero, who sent them an open letter. "You two have the power to lead an enormous and significant change, raising your voices and defending all of us," she wrote, "not only those people who have benefited from and who are linked to The System. Please, use the voice that you have!"

Months later, Geoffrey Baker, a British musicologist, published a critical book called El Sistema: Orchestrating Venezuela's Youth, in which he criticized Abreu's "cult of leadership", accusing him of creating a climate of fear in his orchestras. Although many viewed the book as unfair, the charges appeared to hit home and Abreu began to curtail his public appearances as he became increasingly ill. On hearing of his death, Mr Maduro tweeted: "We are deeply moved by the passing away of Maestro Abreu, who leaves behind a great moral, ethical and cultural legacy." Mr Dudamel tweeted a black and white photo of himself and his former teacher. "With devoted love and eternal gratitude to my mentor and father of El Sistema," he wrote.

Abreu's legacy remains controversial, but his aims can perhaps best be summed up by one phrase. "Let us reveal to our children the beauty of music," he once wrote. "And music shall reveal to our children the beauty of life."

Java – Onion farmer

"To achieve great things, two things are needed; a plan, and not quite enough time."
- Leonard Bernstein

File 13. Things almost worth remembering

The world's most profitable investment?

On 22 March, SA-listed Naspers announced the sale of a small portion of its stake in Tencent, equivalent to 2% of its Tencent's issued share capital, in the process reducing its stake in the Chinese tech giant from 33.2% to 31.2%. The sale followed record results published by Tencent although it coincided with the day US President Trump announced the start of its trade war with China, which led to very weak markets across the world. The sale raised $9.8bn for Naspers.

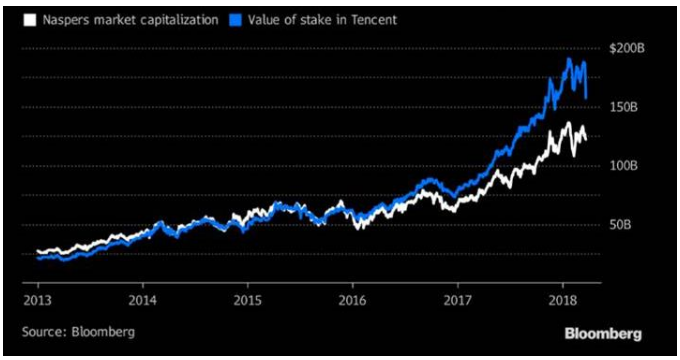
The sale is an appropriate catalyst to remind ourselves of what could arguably be regarded as the greatest investment ever. In 2001 Naspers invested $34m in a small, struggling Chinese tech start-up called Tencent. At that time, the internet had hardly reached China. Today, Naspers's stake is worth $175bn. You can work through the numbers for yourself as much as you can, but I guarantee the returns will outweigh by an order of magnitude any other return you have ever seen. To help you with the numbers – they are so large they can be overwhelming – charts always come in useful. Although clearly the Naspers investment has paid off handsomely, of course nothing can beat the mind-boggling return of Tencent itself, which has now returned 60 000% - refer to Chart 8, below. In plain number terms Naspers original investment has produced a return of 546 775% in absolute terms, or 65.9% compound growth rate per annum during the past 17 years. I am certain that in my life I will never ever see a return like that again.

Chart 8: Tencent and Naspers price history

Source: Bloomberg

As Naspers shareholders will know only too well though, the market is not valuing Naspers anywhere near its full value. The value of its Tencent investment may be $175bn, but the total market capitalization (size) of Naspers is "only" $121bn. Not only are investors ignoring the full value of Naspers's Tencent investment, but they are also ignoring all of Naspers's other investments, which last financial year generated turnover of more than R36bn. Chart 9 shows that the value of Naspers's investment in Tencent is still far higher than the whole of Naspers on its own – and this has been the case for many years already. The ability of Naspers's management to prove to the market that this discount is unwarranted remains their largest challenge. But if they get it right, as hard as it will be for some to accept, the "best years for Naspers", for shareholders at least, may yet lie ahead.

Chart 9: Naspers's vs its Tencent investment



Source: Bloomberg

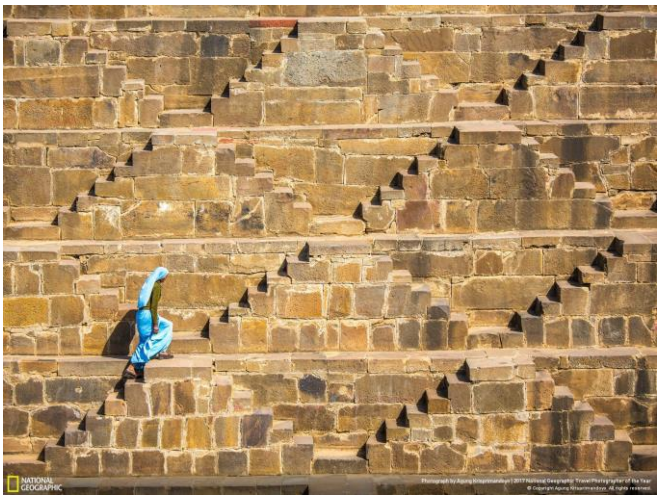
China: Inexorable reform and rise continue

Despite what one hears from Western politicians, China is slowly but surely gaining stature on virtually every front and is continuing its inexorable rise to the role of a true superpower. Whether it be in the area of climate change, economic reform or technological innovation, China is making significant strides on a continual basis, only some of which are reported in the Western media.

China – fishing nets in Fujian province

The development of their capital markets and opening them up for foreign investment is one such area where significant strides are being made. By way of example, Bloomberg announced on 23 March that yuan (CNY)-denominated Chinese (CGB) and policy bank bonds (PBB) will be added to the Bloomberg Barclays Global Aggregate Index over a period of 20 months, beginning in April 2019. The CNY bonds would become the fourth-largest component in the index, representing about 5.5% of the $53.7trn index, based on 31 January 2018 data. Bloomberg added that the inclusion is conditional on the implementation of further planned operational enhancements, such as improving settlement terms and clarifying tax issues. CNY-denominated debt will also be eligible for inclusion in its Global Treasury and Emerging Markets Local Currency Government Indices. The index inclusion would attract wider foreign investor participation and could prompt an estimated $140bn of inflows. In line with market liberalization moves by the Chinese government, the value of CGB and PBB held by foreign institutions has been steadily rising, with the share of foreign ownership almost doubling to 4.0% from 2.2% in February 2016. Foreign inflows have already began to accelerate, with $21bn of inflows into CGB and PBB in the first two months of 2018, compared to $2.9bn of outflows a year ago. Strong foreign buying interest could exert marginal downward pressure on bond yields, but is unlikely to have a sharp impact given the long scale-in period, large size of the market and sizeable annual issuance. In the longer term, this development may present some upside to CNY bonds that will help to offset the impact from financial deleveraging in China.

India – step well in Rajasthan



The index inclusion has been anticipated by the market for some time, with the muted market reaction suggesting that it has already been largely priced in. Yet, foreign ownership remains low and we expect a gradual rise in foreign demand for Chinese onshore bonds ahead of

the planned inclusion. This could also raise market expectations of the inclusion of CNY bonds in other global or emerging market benchmark bond indices.

So what's with the pics?

I continue to share pictures that were candidates in various categories for National Geographic's 2017 Photo of the Day series. I hope you enjoy the pictorial global tour.

Unbearable Arctic curiosity?

Hawaii – Surfer at Kuau