INTERMEZZO

MAESTRO
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Investment Letter | 7th Edition | August 2007

July in perspective – global markets
In some respects July resembled the famous movie "The good, the bad and the ugly". *The good* was represented by the global economy, *the bad* describes the markets while *the ugly* reflects the bursting of the US housing bubble and more specifically the sub-prime market. Let's start with the bad. Global equity markets struggled all month. Large declines were followed by small relief rallies, but the over-riding sentiment was one of uncertainty and nervousness, the primary source of which continues to be developments surrounding the unravelling of the US housing mess. Share prices of mortgage firms declined severely (by last count about 40 have already gone insolvent) and a number of hedge funds owned up to having been severely burnt by the sub-prime fall-out. This undermined the financial sector, particularly in the US, which remains one of the poorest performing sectors on Wall Street. Despite the US equity market recording new highs last week, the financial sector, one of the largest in the S&P500, failed to participate in the party and has actually declined by 12.7% so far this year. Many commentators and market participants, including ourselves, have noted this with concern. Market movements subsequent to month-end have confirmed that the financial sector weakness is indeed a problem for the integrity, well-being and sustenance of the current bull market. It may well determine the future direction of global equity markets.

Chart 1: Global market returns to 31 July 2007

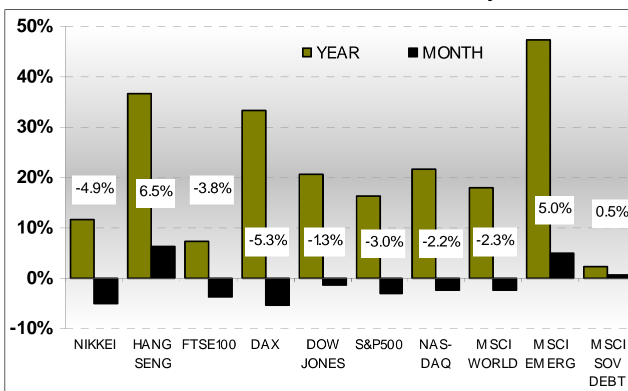

Chart 1 shows that July was an unprofitable month. The German market declined 5.3% and Japan 4.9%. Hong Kong gained 6.5% on the back of a very strong Chinese market. The MSCI World index declined 2.3% but the Emerging Market index rose 5.0%, helped by strong returns from Turkey, China, India and Russia. Note the difference in the annual returns of these indices: the World index is up 18.0% while the Emerging Market index has risen 47.2%. Apart from equity markets, bond markets had a reasonable month as investors fled to the safety of government bonds. The rest of the credit market was awful. The dollar weakened 1.4% against the euro and the oil price rose 9.2%.

"The ugly" - US sub-prime woes rear their ugly head.
No, you are not seeing double. We commented on this topic in last month's *Intermezzo* and ended our comments with the words "I don't think we have heard the last of the sub-prime woes, so watch this space…" The topic has been covered extensively in the media, particularly the foreign media, so I won't dwell on it in much length. I still believe that the problem is largely confined to the US and shouldn't affect the level of (non-US) global economic growth. Of course that doesn't mean it won't take equity and credit markets lower. On the contrary, it is likely to remain a huge issue for global investors for a long time yet and it is quite conceivable that central bankers may soon get directly involved as well. There is already speculation that the Fed may be forced to reduce US rates earlier than expected to contain the fall-out. Time will tell if this indeed happens, although I doubt that their hand will be forced that easily.

Let me bring two more aspects of the sub-prime mess to your attention: *firstly*, it has led to a dramatic escalation in the price of credit as well as the cost of insuring credit risk. This caused severe problems for hedge funds active in this market; many have suspended redemptions or simply gone "belly-up". Remember the Bear Sterns hedge fund with that spectacular name we referred to last month? The one from which Merrill Lynch seized $850m of assets only to discover that they could not even sell them? Well, that same fund last month issued a statement to investors saying that "there was very little value left" in the Fund. Eina! *Secondly* the benign credit environment that existed prior to the implosion of the US sub-prime market provided fertile ground for substantial debt to be raised for the purposes of feeding the huge "M&A machine" that has driven many equity prices higher. With that pillar of support for the equity market now in serious doubt, a large speculative element implicit in current equity prices left the market very rapidly. This was a major cause of the recent equity market weakness and the significant increase in price volatility. Finally on this score, be aware that the effects of this fallout are negative, pervasive and significant, and will be around for a long time yet.

Chart of the month
One of the scary things about the US housing crisis is the effect that it will have on an already heavily indebted consumer. But just how indebted is he or she? Chart 2 puts it in perspective. It shows that total US debt (household, business and government) now sits at 340% of GDP. As Merrill Lynch's North American economist David Rosenberg points out, while many are focussed on food shortages as a new source of inflation pressure along with energy, the focus should be on the lingering deflation in residential real estate, coupled with softening wage and

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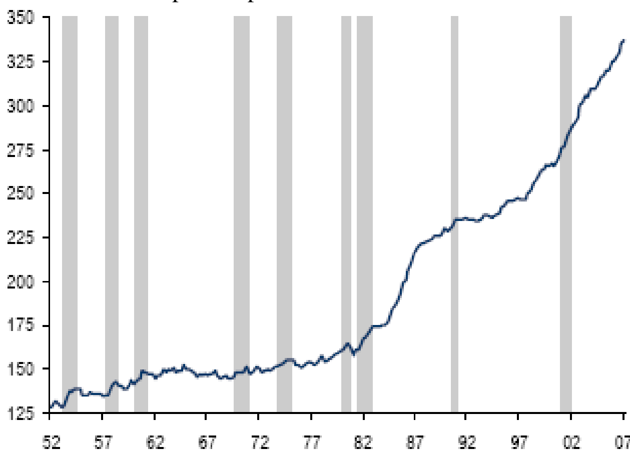
employment growth. He goes on to point out that "although the US consumes $1.3 trillion of food annually, the $23 trillion of residential real estate's deflationary impact on the aggregate demand curve is likely to far outweigh the supply-side 'ag-flation' that continues to make front page news." For some time now, he has been expecting the Fed's next move to be a cut in interest rates.

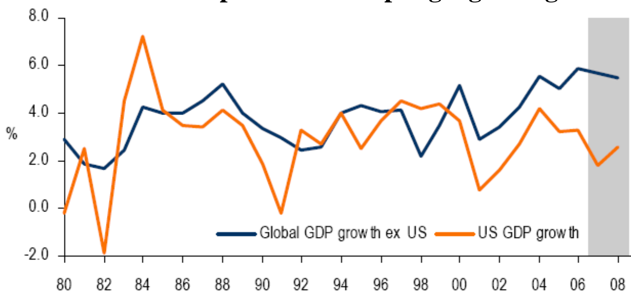
Chart 2: Total US economy debt as a % of US GDP
Shaded areas represent periods of US recession



Source: Merrill Lynch

"The good" – the global economy
In the midst of all the weakness on equity markets and the crisis in the credit market during the month, one could be forgiven for missing the substantial evidence that emerged proving that *the global economy is in rude health*. Even the US economy turned in a provisional growth rate of 3.4% during the second quarter of 2007. But that paled into insignificance when compared to China's growth rate of 11.9%. There is more evidence of strong growth but for time sake I will not share it all with you. However, some charts may prove instructive.

Chart 3: Further proof of decoupling – global growth



Source: Merrill Lynch

Chart 3 shows the extent of global economic growth of the world without the US, and of the US economy in isolation. Note that the world economy has never grown faster for at least the last 30 years, despite the fact that the US economy is slowing, and may well register less than 2% growth for 2007. Yet US corporate growth during the second quarter again exceeded expectations and the health of the corporate world, apart from selected areas of the financial sector, seems good and secure. This same is true of most European companies. Cash flows are strong, growth is occurring, and most companies seem relatively optimistic about their immediate future.

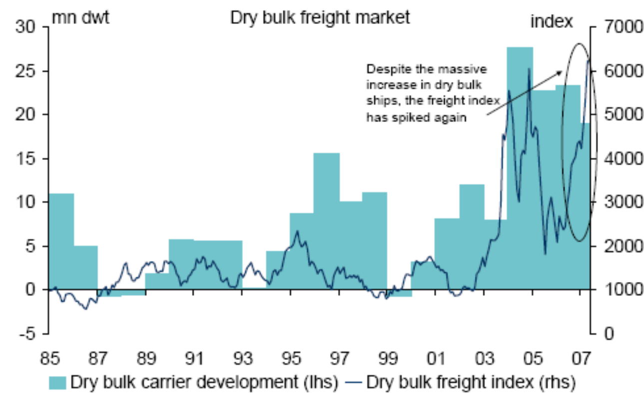
What makes this remarkable is that not only are we some way into this business cycle, but commodity prices have risen enormously. The corporate world has taken the rise in input costs in their stride, with a few exceptions of course. Note the level of core US inflation, excluding the effects of housing, shown in Chart 4. Even in China, which has seen phenomenal growth in recent years, inflation was only 4.4% in June, although we note that this is up from 3.4%. Growth there has been so strong that the authorities have again increased measures to restrain bank lending.

Chart 4: Core US inflation (annual % change)
Total inflation excluding energy, food and shelter

Source: Merrill Lynch

A final chart I would submit as evidence of "the good" i.e. strong global economic growth, is that of Chart 5. On a number of occasions over the past years I have drawn your attention to the Baltic Dry index, an index of dry bulk shipping prices. It is an accurate indicator of global business and the investment cycle. In 2004 we noted the five-fold rise in the index due to supply (of ships) bottlenecks and increased demand for shipping capacity. It stands to reason that when the world grows so fast more bulk commodities such as iron ore and coal have to be transported to their destination, making this a very unusual but historically accurate indicator. In 2005 we also noted that the index had declined for a number of reasons, but look now at Chart 5 and see what has transpired since then. Surprise, surprise – the index is again at a record level and this, despite a huge increase in ships since 2004 (depicted by the turquoise histogram).

Chart 5: The Baltic dry index: more evidence of growth



Source: Merrill Lynch

This strong global economic growth leads us to believe that the current weakness in equity and credit markets does not necessarily spell the end of the equity bull market that has been in place since October 2003. Certainly, the size of the returns may decline, but as long as inflation remains under control, the consumer keeps increasing his spending albeit at more modest levels, and the global economy keeps growing, equities are likely to remain the most profitable asset class.

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. Returns include income and are presented after fees have been charged. I would draw your attention to the fact that, despite weak global equity markets, the Central Park Global Balanced Fund still registered a positive return during June.

Table 1: Returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Fund	July	**1.6%**	**18.1%**	**41.9%**
Maestro equity benchmark *		1.4%	12.7%	39.4%
JSE All Share Index		1.0%	16.2%	40.2%
Central Park Global Balanced Fund ($)	Jun	**0.8%**	**7.4%**	**16.3%**
Benchmark**		-0.3%	5.3%	13.5%

* 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

Table 2 lists the compound annual returns for the periods to 30 June 2007 on the equity portfolios under Maestro's care. The numbers speak for themselves but the *size* of returns over the longer periods bear testimony to what a rewarding period this has been for investors in SA's equity market.

Table 2: Maestro annual returns to 30 June 2007 (%)

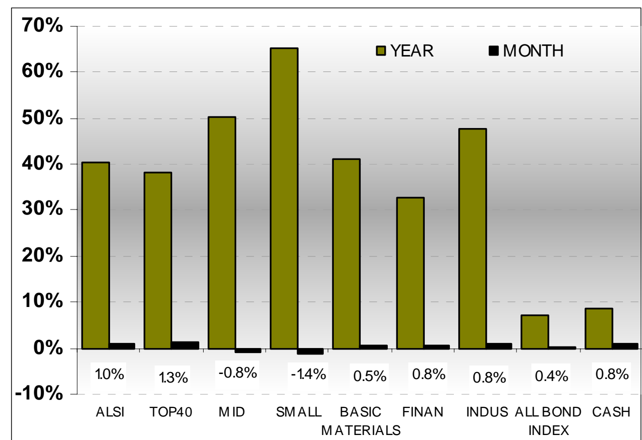
SA equity returns	6 mths*	1 yr	2 yrs	3 yrs	4 yrs	5 yrs
Maestro average – short-term, actively traded portfolios	***23.4***	***51.7***	***49.9***	***51.8***	***49.4***	***46.2***
Maestro average – long-term portfolios	***21.2***	***58.5***	***51.2***	***50.6***	***46.2***	***34.6***
Maestro equity benchmark **	11.0	37.1	41.0	41.9	38.7	24.2
JSE All Share Index	15.1	36.9	45.1	44.7	39.5	25.2

* 6-month returns are un-annualised
** 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index

July in perspective – local markets

The SA equity market started the month well. At one stage it had risen nearly 6% before the weight of the sub-prime woes on international markets took its toll. The rand had risen to R6.80 to the dollar by the time the market peaked, but then it, too, succumbed to the change in sentiment and renewed concern about the unwinding of the yen carry trade (the dollar declined 3.6% against the yen, reflecting some of this unwinding). The rand ended 0.7% weaker against the dollar and 2.0% and 2.1% against sterling and the euro respectively. The large cap index (+1.3%) outperformed the mid (-0.8%) and small (-1.4%) cap ones. The gold index was the best performer (6.6%) followed by personal goods (5.8%) and mobile telecoms (5.0%). Leisure goods (-15.0%) posted the worst decline, followed by forest and paper (-14.3%) and healthcare (-12.4%).

Chart 6: Local market returns to 31 July 2007



File 13: Interesting information, but worth forgetting

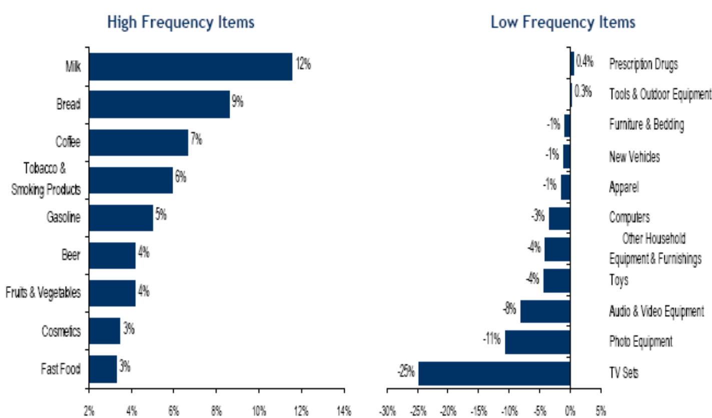
I came across an interesting chart recently – refer to Chart 7, below - that shows the annual percentage changes in the major constituents in US CPI. Notwithstanding the fact that inflation seems to be relatively well controlled at present, it is rising in many parts of the world, including China and South Africa. What is apparent from the rise in inflation is that the same component, food prices, is driving inflation higher. This might sound obvious to you, but remember that

while many of the constituents, for example commodity and energy prices, are global in nature, the factors driving food prices, including supply constraints, tend to be local by nature. Sure, global climate change (affecting weather patterns and hence the supply of food) and higher oil prices (resulting in maize and sugar, for example, being directed away from traditional markets towards bio-fuels) are global in nature, but I still found the comparison fascinating.

Another interesting consideration, very evident from the Chart, is the sharp decline in the prices of certain goods. Not surprisingly, many of them are manufactured goods with a large technology element, where the rapid advances in technology and the advent of low-cost manufacturing regions (China) have lowered costs dramatically. But I draw your attention to it nonetheless; so many people lament that they cannot understand why inflation is relatively low when, say, food prices have risen so sharply. One needs to look at the full spectrum of price changes, on the up and downside.

As an aside and to illustrate the point, I recently calculated the price in today's terms of the first hi-fi I bought in 1982. A quick survey of sound systems revealed that I could today buy a hi-fi of similar specifications for a fraction (less than 20%) of the price, although the modern equivalent is smaller and generates a much better quality sound. Of course, I excluded from the exercise the MP3 - which produces of the most amazing sound I have ever heard - that came on my current mobile phone – for which I paid nothing.

Chart 7: Annual change in US CPI components (%)



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