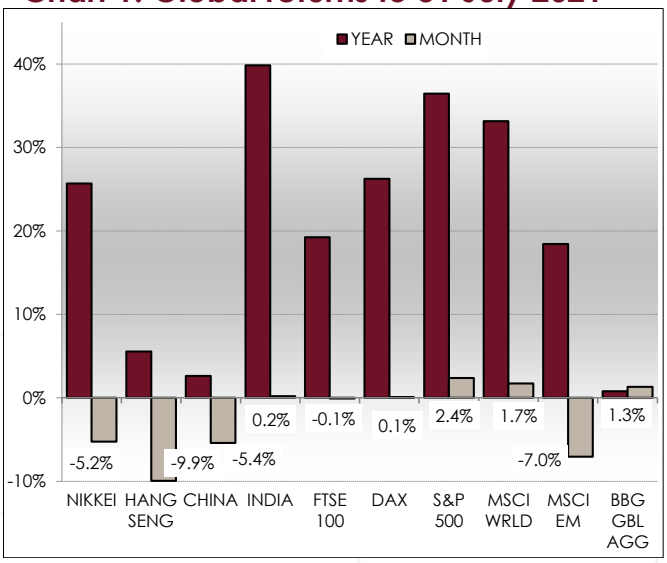
July in perspective – global markets

I should not have tempted fate last month: after calling June a "boring month" in the markets, the proverbial budgie hit the fan during July, a month filled with a number of significant events for investors.

Chart 1: Global returns to 31 July 2021



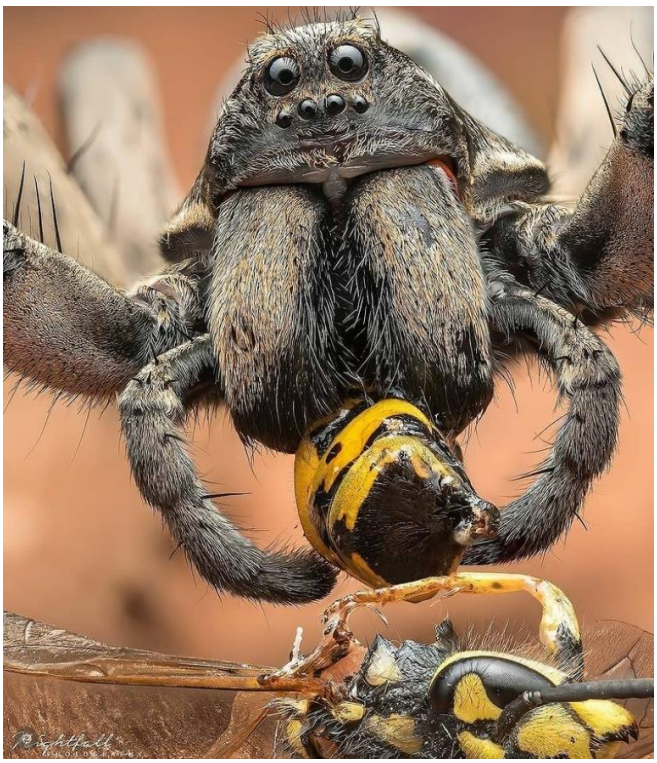
By far the most significant one was the tsunami (apologies for the mixed nationalities) of regulation, some of it being the most draconian regulation I have certainly ever seen. This year has been characterized by rolling regulatory action on the part of the Chinese authorities, but it increased dramatically in intensity and ferocity during July, with devastating effects on many industries, companies and share prices. By far the most affected was the Chinese private education sector, and specifically the after-school tutoring (AST) sector, which was, for all intents and purposes, nationalized with no compensation for shareholders. We are devoting a large part of the August issue of *Intermezzo* to this topic, so I would ask that you read that edition to gain more information and background on developments in the Chinese equity market during July.

Apart from the effect on specific share prices, the increased regulatory actions in China caused a noticeable exodus from China by many global investors, including ourselves, as they significantly reduced exposure there to incorporate the heightened risk in that region. The effects were telling: the MSCI World index rose 1.7% during July, but the Shanghai Composite and Hong Kong indices decline 5.4% and 9.9% respectively. The MSCI Golden Dragon index fell 10.2%. In contrast, US equity markets were firm, spurred on and supported by strong corporate earnings, which by and large exceeded expectations, notwithstanding the low base off which they are being measured. Given the 30% weighting China has in the index, it was unsurprising to see the MSCI Emerging Market index decline 7.0% in July. The German equity market was flat while the Swiss market rose 1.5%. The contrasting fortunes of China and the rest of the world are clear when one considers the year-to-date returns of the respective regions: The MSCI World index has risen 14.1% so far this year, and the US 18.0% (Germany and Switzerland 13.3% and 13.2% respectively) but the Chinese and Hong Kong markets are down 2.2% and 4.5% respectively over the same period.

Much has been said, and much will continue to be written about what is happening in China right now with regard to the dramatic clampdown by the Chinese Communist Party. It is difficult to get a Western perspective on these developments; it seems locals are far less concerned, and in many cases even supportive of the authorities' actions. However, they certainly don't gel with the notion of Western capitalism and free markets, which is the "expectational foundation" on which most investment activity into China is based. Suffice to say from Maestro's perspective, the renewed

regulatory onslaught on private capital comes as a major disappointment to us. Not only have our returns already suffered from the underperformance that has characterized that region's returns so far this year, but we were optimistic about the economic growth prospects of China and all the opportunities that it presented as a result.

Wolf spider having supper, Australia



Source: @nightfall_photography

While we reflect on our mistaken beliefs and revisit our long-held theories, we have reduced our exposure to that region dramatically. We simply cannot justify large exposure to a region about which so much uncertainty now exists. Fortunately at this time in the global economy and investment landscape, there are still many other investment opportunities for us to utilize, although we have had to bear the frustration of seeing some excellent returns from other parts of the world, specifically in the US and Switzerland, being negated by the devastating declines in some of the Chinese shares we held. More about this later.

Returning to July's returns in other markets, another notable feature during the month was the decline in bond yields and thus an increase in their prices. This is soliciting a lot of attention from investors, as bond markets are typically more accurate indicators of future economic developments; and declining bond yields are not a good sign, hinting at a looming economic slowdown. The Bloomberg Global Aggregate Bond index rose 1.33% in July, while most other bond markets were also firm. Currency markets were relatively firm, while commodity prices ended the month with mixed movements. The price of iron ore declined sharply (down 17.5%) but the copper price rose 3.4%. Soft (agricultural) commodity prices also ended the month with mixed performances.

What's on our radar screen?

Here is a summary of the things we have been keeping an eye on:

- *The SA economy:* the true economic cost of the recent looting and anarchy in the country is becoming apparent. The July manufacturing Purchasing Managers Index (PMI) dropped sharply, by 13.9 points to 43.5, the lowest print since April last year – refer to Chart 2. The index was dragged lower by the increased Level-4 lockdown restrictions as well as the destruction and shock to sentiment from the unrest that started around the second week of July. Business activity slumped almost 30 points to 26.6, which is worse than the decline during hard lockdown in April last year. New sales orders dropped to 31.9 from 57.3, despite listed manufacturers reporting a

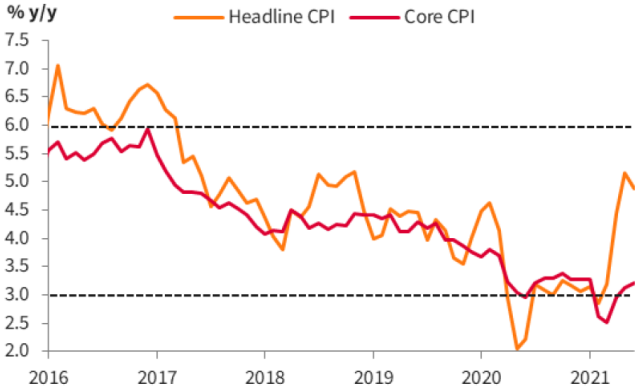
solid increase in orders from the mining sector. A sharp bounce is likely to occur in August as inventory rebuilding occurs.

Chart 2: SA's manufacturing PMI

Source: Tradingeconomics.com

Similar to other economies around the world, headline inflation is rising sharply; the annual rate rose to 4.8% in June, after reaching 5.2% in May. While core inflation remains lower, it too, has been rising in recent months, as seen in Chart 3.

Chart 3: SA headline and core inflation



Source: ABSA Bank

Most of you will know that the rand has been very firm since just after the onset of the pandemic in April last year. This seems almost counterintuitive, and its strength has surprized even the most fervent rand enthusiasts. However, the driving force, which no one could really have predicted at the onset of the pandemic, was how the economic recovery unfolded, specifically the impact it would have on commodity prices. The rand has always had a strong, positive correlation with commodity prices; firm commodity prices lead to a firm rand. Chart 4 depicts an index compiled of commodities that have bearing on the SA economy, specifically gold, coal, iron ore and platinum group metals (PGMs) – when taking this index's recent history into account, it is easier to understand why the rand has been so firm.

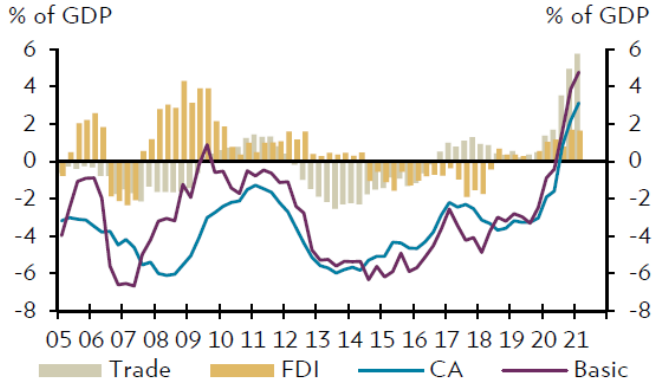
Chart 4: SA export commodity index

**South Africa specific rand denominated export commodity price index, comprising gold, coal, iron ore, and all PGMs*

Source: ABSA Bank

Despite the firm rand, South Africa has registered significantly higher export proceeds from higher commodity prices, resulting in an unusually strong current account balance. The unprecedented increase in the profitability of the mines has led to windfall tax collection, which in turn has improved the country's balance sheet, providing another supportive pillar for the rand. This is clear if you consider Chart 5, which provides a useful 16-year history of the country's current and capital accounts.

Chart 5: Current, capital account balances



* Trade: goods and services balance; FDI: foreign direct investment; CA : current account balance; Basic: CA plus FDI

Source: Julius Bär

The firm rand has hurt returns of investors who have taken funds offshore. However, it would be good to remind ourselves that 18 months is a relatively short period in the life of the rand, which has been characterised by periods of strength and weakness. However, the long-term weak trend is, at least in our opinion, still in place. It would be naïve to look at the firm rand and use it as a proxy for the country's well-being. I think all of us who live in the country know far better than that. In due course, we are of the view that the rand's strength will abate, and that the rand will eventually resume its long-term downtrend. At that stage we think the real fragility of the country's finances and future will become evident.

On the inflation front, July headline inflation declined, although that is a bit misleading. Consider this: the annual inflation rate for May, June and July declined from 5.2% to 4.9% then 4.6%. On the face of it that doesn't look too bad. Scratch beneath the surface though, and you see that the monthly rates of increase rose from 0.1% in May to 0.3% in June and 1.1% in July. There is a lot of noise in the base though, and we can take comfort from the fact that the rate of core inflation i.e. inflation excluding food and energy prices, declined in July to 3.0%.

Finally, the latest reading by Stats SA on the country's unemployment made for depressing reading: the official rate of unemployment rose from 32.6% to 34.4% during the second quarter. More realistically, the expanded rate of unemployment, which includes those who are disillusioned and have given up looking for work, now stands at 44.4%, representing some 12m people. These data make a mockery of government's commitment to jobs programs and to reducing joblessness in SA. Despite all the data, one would think government would adapt their policies accordingly. However, their 25-year track record speaks for itself: on a global list of 82 countries monitored by Bloomberg, South Africa now has the highest official unemployment rate in the world.

A contemplative wolf in British Columbia

Source: @paulnicklen

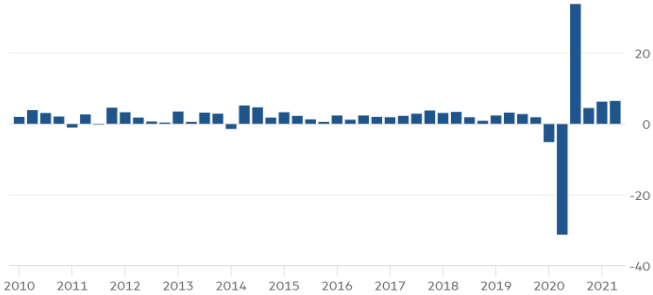
Symbiotic relationship, Impala, Botswana

Source: @ladzinski

- *US economy:* The US economy grew at a quarter-on-quarter, annualized rate of 6.5% during the second quarter (Q2) – refer to Chart 6 – bringing its annual rate of growth to 12.2% (remember the low base of Q2 2002, though). The economy grew 1.6% compared to Q1. Strong consumption growth was offset by a slowdown in property investment and drawdowns on inventories. Significantly though, the Q2 growth lifted US GDP to above its pre-pandemic level. The weak residential and property components exposed the extent to which labour shortages and supply chain disruptions are slowing what is otherwise a remarkably robust US expansion. Personal consumption was the strongest component of the GDP data, with spending increasing at an annualised rate of 11.8%, compared to 11.4% in Q1. Millions of households received stimulus cheques between mid-March and early April, triggering a "revenge" shopping spree as economic activity rebounded from the depths of the pandemic.

Chart 6: US economic growth

Quarter-on-quarter, annualized change in GDP (%)



Source: FT.com

Speaking about the labour market, 943 000 jobs were added to the economy during July. The unemployment rate declined to 5.4% from 5.9% in June. May and June's jobs data were revised up by a cumulative 119 000. The average hourly earnings annual growth rate increased to 4.0% from June's 3.7%. The headline inflation rate remained steady at 5.4% (the monthly increase was 0.5%) while the core rate declined from 4.5% to 4.3%. The inflation readings provided some comfort that the recent relentless rise in US inflation may well be transitory, as the Federal Reserve has insisted, and that there is not as much pressure as initially thought for the Fed to begin tightening monetary policy i.e. raising interest rates.

US retail sales declined 1.1% in July from an increase of 0.7% in June. As with so much data these days, there is a lot of "noise in the numbers" including the low base and supply constraints caused by, inter alia, the global semiconductor shortage, which is becoming an increasing problem in many industries around the world.

- *Developed economies*: The Eurozone economy grew at a rate of 0.2% during Q2, over the previous quarter, bringing its annual rate of growth to 13.2%. This looks high, but remember the pandemic-induced economic trough for the European Union (EU) was Q2 last year, so the base is low. Perhaps most tellingly, while China and the US economies are already above their pre-pandemic levels, the EU is not, and is only forecast to exceed that level by the end of this year.

A Grizzly bear enjoying fresh salmon, Alaska

Source: @drewhh

The UK economy grew 4.8% on a quarter-on-quarter basis during Q2, driven by a re-opening surge in consumer spending. As with the EU, the UK economy is still 2.1% lower than its pre-pandemic (Q4 2019) levels. One has to be concerned about the UK economy into the immediate future, given that the re-opening surge in spending is unlikely to be repeated in Q3 and beyond. The Japanese economy grew at an annualized rate of 1.3% during the Q2. Japan remains the laggard out of the major developed economies, and is forecast to only exceed its pre-pandemic level during the first quarter of 2022.

- *Emerging economies:* Russia's central bank raised interest rate by 1.0% to 6.5%, the largest increase for more than six years and its fourth consecutive policy tightening, in an effort to curb rising inflation. Since March this year it has raised rates by 2.25 %. Russia's annual headline inflation rate rose from 6.0% to 6.5% in June, its highest rate since August 2016.

The South Korean economy grew at a quarter-on-quarter rate of 0.7%, and 5.9% year-on-year during Q2. The quarter-on-quarter rate was lower than Q1's 1.7%, having been restrained by a slowdown in export and investment growth, the former being caused by, inter alia, semiconductor shortages in the auto and electronics industries. However, private consumption and government spending accelerated. More recently, rising Covid-19 infections and mobility restrictions have cast doubt on the rate of recovery of the South Korean economy and led that government to introduce a supplementary budget, equivalent to 1.7% of GDP to support the economy.

The Brazilian central bank raised interest rates by 1.0% to 5.25% in its ongoing battle against inflation; the latter rose to an annual rate of 8.35% in June and 9.0% in July. The Bank indicated it was likely to raise rates further in September; interest rates

are now the highest they have been since October 2019. Mexico's Banxico central bank raised its rate by 0.25% to 4.5%, also in response to inflationary pressures; the annual rate of headline inflation in Mexico was 5.8% in July, although this is down from its recent peak of 6.1% in April. Banxico hinted that if inflation didn't converge on its inflation target of 3.0%, it would raise interest rates in the coming months. Their inflation forecast for year end is 5.7%, so it seems likely that further hikes are inevitable.

Symbiotic relationships in Botswana

Source: @ladzinski

The Czech National Bank (CNB) raised its policy rate by 0.25% to 0.75%, its second hike since June. The Czech Republic's annual rate of inflation rose from 2.8% in June to 3.4% in July; the CNB's target inflation rate is 2.0%. The CNB expects their economy to grow at a rate of 3.4% in 2021 and 4.1% in 2022.

China's education sector: now you see it…

It is hard to know where to start in terms of describing what happened to the Chinese After School Tutoring (AST) sector during the past few months, but particularly in July. In some respects, it seems pointless to even start this effort, given that for all intents and purposes, the Chinese AST sector, at least from an external investor point of view, no longer exists.

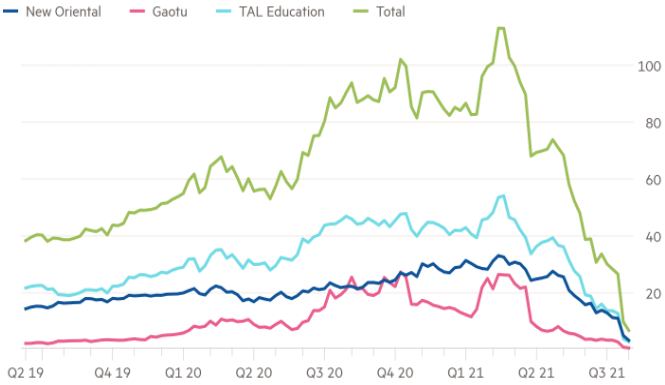
I have sat through more webinars on Chinese regulation, and the AST sector in particular, during the past month, than I think in the past two years combined. We have learnt a great deal about what is happening in China at present. We have learnt more about the Chinese authorities' objectives, about seeing the regulations from a Chinese perspective, to mention but a few aspects of this complex issue.

I will keep this section as short as possible, but I need to address it, given the exposure all our global portfolios had to China in general and to the AST sector in particular. It is ironic that this exposure has cost us relative returns so far this year i.e. our returns are not as large as they would have been had we not had so much exposure to China, when in reality this same exposure drove a lot of our outperformance in the past 5 or so years leading up to 2021.

For many years, two Chinese AST companies, TAL Education and New Oriental Education, were to be found in our five largest holdings. As their respective prices declined, they fell out of the largest holdings. We trimmed our Chinese exposure in May – with hindsight not as aggressively as we should – and in July we continued to sell down the exposure to the extent that it now represents less than 10% of our portfolio. We no longer hold investments in

Alibaba, Meituan Dianping, New Oriental, NetEase, TAL Education, Tencent, or Yihai. The only direct Chinese exposure within Central Park Global Balanced Fund, and our discretionary global equity portfolios, is held via CSPC Pharma, China Meidong Auto Holdings, Sunny Optical, and Wuxi Biologics. At the time of writing that exposure constitutes only 7.7% of Central Park Global Balanced Fund. Space constraints preclude a detailed discussion of the reasons behind our action with regard to the Fund's Chinese exposure; suffice to say is that we were no longer comfortable with the uncertainty that now characterizes the Chinese authorities' actions and the consequences thereof.

Chart 7: Market cap of Chinese AST firms ($bn)



Source: @FT.com

Let me return to the AST sector and provide a summary of the July events. There had been rumours of harsh regulations coming the way of the AST sector. We had already seen strong and aggressive regulatory action meted out ahead of the Ant Financial planned listing, and further actions regarding tech and internet-related companies. However, nothing could prepare investors for the new rules released on the weekend of 18 July, which date can be regarded as the end of the private AST sector effort in China.

The prices of New Oriental and TAL declined around 78% on the Monday following the weekend, bringing their losses from their recent peak to about 98%.

Zebra in Kruger National Park, South Africa

Source: @mariusvanoordt_wild

In short, the new regulations can be summarized by what follows, which is a précis of the actual announcement by the listed AST companies:

- No new provider of AST services on academic subjects in China's compulsory education system ("Academic AST") will be approved, while existing Academic AST providers will be subject to review and re-registration aimed at reducing their numbers; *the remaining Academic AST providers shall all be registered as non-profit (my italics)*; previously registered online Academic AST providers will be subject to

review and re-registration; the registration and license of any disqualifying online Academic AST providers will be rescinded.

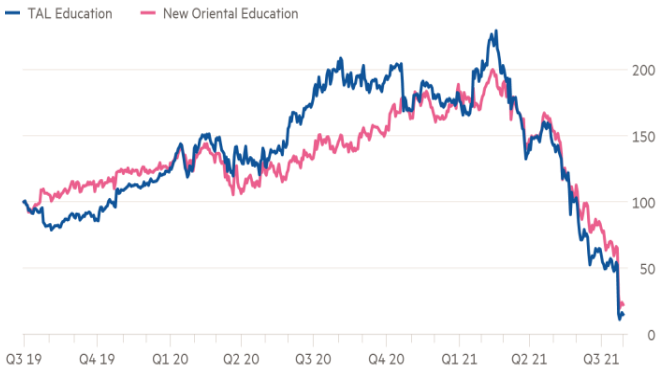
- AST providers are strictly prohibited from providing Academic AST during any national holiday, weekend, winter and summer break period; there are further restrictions over when Academic AST can be offered during weekdays.
- Academic AST providers are prohibited from (i) offering classes over contents outside of, or in advance of, the school curriculum; (ii) offering classes based on any foreign curriculum; (iii) soliciting and recruiting school teachers by offering excessive compensation; or (iv) employing foreign personnel to carry out training activities; non-AST providers are prohibited from offering Academic AST classes.
- Prices for Academic AST will need to follow government guidelines to prevent excessive charging or excessive profit-seeking activity.
- Academic AST providers are prohibited from financing by way of listing its securities or conducting other capital market activities; listed companies may not invest in Academic AST providers through capital markets fundraising activities, and may not acquire assets of Academic AST providers by paying cash or issuing securities; *foreign capital is prohibited from controlling or participating in Academic AST providers through merger and acquisitions, entrusted operations, joining franchise or using variable interest entities* (my italics).
- Enhancing oversight of AST advertising.

The rest, as they say in the classics, is history; with one stroke of the pen, what had been a multi-billion dollar sector came to an end.

Not surprisingly, New Oriental and TAL companies immediately acknowledged the new regulations and rather euphemistically noted that "historically, the revenues from Academic AST classes … accounted for the majority of the Company's revenues ... The Company's compliance with these measures will have a material adverse impact on its existing business, results of operations and financial condition".

It is cold comfort to know that we were not alone is being caught by surprised at the extremism of the new regulations. Some of the most successful and highly-regarded investment managers (Baillie Gifford, who were TAL's second largest shareholder, Sequoia Capital, Softbank's Vision Fund, and the ARK Investment Fund all come to mind here) had large exposures to this sector and, like us, have been left licking their wounds. There is another dimension to this matter, namely where this leaves Chinese parents, whose obsession with their children's education is legendary and is unlikely to be dimmed by the new regulations, but that is a discussion for another day. There has already been quite a backlash in this regard. So too, is the issue of where these new regulations leave students, especially those entering their final years of study.

Chart 8: New Oriental and TAL price history



Source: @FT.com

I will be the first to admit I am not an expert on Chinese regulation and how it should be applied. With all due respect though, it doesn't take a genius to imagine more appropriate courses of action for dealing with the AST sector.

That said, it is all history now. We have learnt many lessons in what has been a painful, and to be honest an embarrassing time in our investing careers. Without being trite, or under-valuing the lessons we have learnt, we are encouraged by the fact that, despite the body blow arising from our Chinese exposure, Central Park's return for July was "only" -2.8%, although of course the exposure has contributed to the Fund's under-performance during the past year. Our 3-year return to end-July is still in line with the average return of similar funds around the world, while Central Park's 5-year return is well ahead of its benchmark and the average sector return.

Glass frog, Costa Rica

Source: @hector_astorga_photography

Quotes of the month

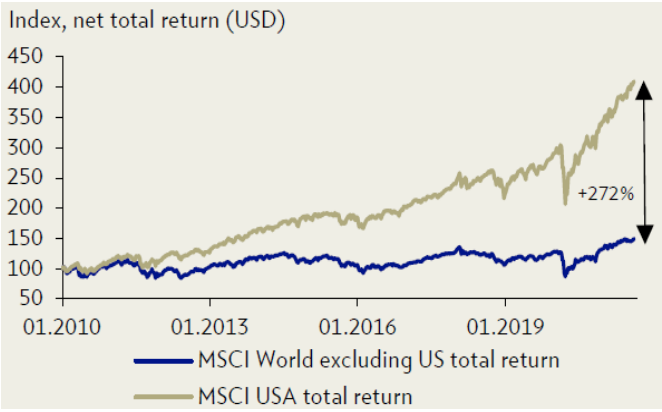
A quote for the "anti-vaxxers"

"Globally, we are now fighting the effects of two incredibly virulent and damaging viruses: coronavirus and disinformation. Coronavirus spreads largely through the air, disinformation through social networks (both online and in the more traditional sense). Both are killing people, but there's a vaccine for only one". *Kate Thompson Davy, freelance journalist.*

US equity markets – not much to beat them

Julius Bär Group Chief Investment Officer, Yves Bonzon, reminds of the following: "US equities are about to outperform non-US stocks for the twelfth year in a row. Since 2010, US equities have outperformed the rest of the world by a whopping 272%, or 8% per year – refer to Chart 9 below. The so-called FAAMG stocks (Facebook, Apple, Amazon, Microsoft, and Alphabet's Google) have contributed significantly to this outperformance. With the exception of Amazon, which has struggled recently, all of these companies are currently printing new all-time highs. Thus, from a technical perspective, the odds are increasing that the outperformance of growth stocks since March will continue".

Chart 9: US versus non-US equity markets



Source: Julius Bär

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

Green and black poison dart frog

Source: @yensen_tan

The Techlash is global

In recent weeks we came across *Venture capitalist and blogger Lillian Li.* Her perspectives on the recent wave of Chinese regulation have been most informative. I would encourage you to follow her blog, Chinese Characteristics, by clicking here.

On July 15 she wrote a piece called "Let the Bullets fly" in which she said "Tech platforms pose significant challenges to nation states' legitimacy. They are now *de facto* institutions, not just providing crucial utilities central to the lives of citizens, but setting the rules of the game in which society operates. Facebook sets the content moderation policy for one third of the world. Twitter and others de-platformed the former president of the US, reducing him to a digital persona non grata. These are powerful private entities that are part monopoly and part public goods, but consumer welfare is not a core part of their agenda. There is gradually increasing awareness amongst lawmakers, which is why governments on three continents are reassessing the impact and reach tech giants have on their citizens. The techlash is global".

More thoughts on exposure to Chinese equities

We have had a lot to say and write about recent developments in China. It is a material issue for all global investors and we will continue to monitor developments and opportunities there very closely. Here are some additional thoughts from *Julius Bär*, which appeared as part of an article entitled *China no longer a source of stability*.

"In the last four decades, we have come to appreciate China as a source of stability. It started with the advent of China as the global economy's workplace, exporting disinflation and contributing to price stability on a low level. That phase is over now that the country is becoming more inward-looking.

"The country turned into a cornerstone of asset allocation after the Great Financial Crisis, with steady and strong growth and the emergence of the Chinese technology giants. The latter are suffering from the Chinese government's recent actions to reclaim control of consumer data. The latest shock for Western investors is the demand for equality in the education sector. In the eyes of the government, education must be affordable for everybody and companies must not be profit-oriented – a move that has sent the shares of the formerly highly profitable education companies into a tailspin. The valuations are tempting, but our analysts have reduced the rating of Chinese offshore equities to Neutral as long as there is a lack of clarity as to the government's next moves".

The moods of the spotted deer

Source: @mithunhphotography

More thoughts on the Chinese regulatory tsunami
Julius Bär's Chief Investment Officer (CIO) Yves Bonzon also had the following to say on recent Chinese regulatory activity and its impact on the investment landscape.

"As mentioned in the last couple of editions of the CIO Weekly, our view on Chinese equities has been seriously challenged lately. The Chinese government's crackdown on digital platforms and private education companies is bringing to light the Communist Party's resolute mission to control its capital market in ways that are not conducive to strong equity returns. Several motivations could be pushing Chinese leaders to take such drastic steps at this time: a shift from a consumer-oriented to a strategically oriented economy in the context of the country's competition with the US; a drive to reduce and avoid the build-up of societal inequalities (the 'common prosperity' argument); or the need to take action as China faces it greatest demographic challenge ever. In any case, strategically speaking, investors' priorities are being pushed to the sidelines for the foreseeable future".

Riscura passed the following comment in their summation of recent Chinese regulatory actions: "When investing in China, investors should understand and respect the social objectives of the Chinese state capitalist system. These objectives create significant risks in companies that need to be avoided but also tailwinds for others when policies encourage innovation and development.

"Saying that, Chinese policy makers are behind on regulation and seem to have decided to catch up across multiple sectors all at once. It is safe to assume from their actions in education that they are prepared to be stern if required. This will need to be watched carefully and it has never been more important to have a specialist who knows what they are doing.

One final quote on the recent regulatory developments in China; I am aware that many of you read *Dawid Krige's Cederberg Capital* monthly letter. But in case you missed it, I thought his following comments were prescient: "Effective regulation is hard to achieve, whether in China or abroad. This is particularly the case when it comes to the internet sector, where regulators need to balance several competing objectives and stakeholders. Though far from perfect, China's approach has mostly been rational and effective. It has arguably been more proactive than most other countries; as tech

commentator Lillian Li cheekily puts it: 'China: Innovate then regulate. Europe: Regulate then not innovate. US: Innovate then not regulate'."

The moods of the spotted deer

Source: @mithunhphotography

The Sound of Music – the soul is not a luxury
The Salzburg Festival has just ended in Austria, the 101st year of its existence, to a full program and full houses all-round. After the Festival Andrea Meyer, state secretary for art and culture said "there's no doubt about it, the arts and culture are essential assets of Austria's economy and society". Daniel Froschauer, first violinist and chair of the Vienna Philharmonic Orchestra, said "it is important for cultural life to carry on. I am shocked by how many governments around the world are letting the arts suffer. Many wrongly see culture as a social extravagance. The soul is not a luxury; soul is life-sustaining and it needs to be nurtured".

2007, 2016 and 2020: then and now…
More comments from *Julius Bär's Chief Investment Officer (CIO) Yves Bonzon, this time on the total value of global equity markets*: "Driven by developed markets, the market capitalization of global equities has recently reached almost $120tn. This is equivalent to around 140% of global GDP. In March 2020, global market capitalization fell to around $63tn due to the pandemic-related market correction. Since then, it has almost doubled.

"Interestingly, the high reached in 2007, just before the Great Financial Crisis, was also around $60tn. It was also an important support level at the beginning of 2016. However, there is a fundamental difference between the market's situation in 2007 and the situation today. The free cash flow generated by companies, especially the FAANMGs (Facebook, Apple, Amazon, Netflix, Microsoft, and Alphabet's Google) is now many times what it was 14 years ago.

"Therefore, it cannot simply be concluded that the markets are now particularly vulnerable to a market correction. Developed equity markets currently remain underpinned by ample liquidity, their relative attractiveness versus bonds (which offer negative real yields and even negative absolute yields in Europe), and the prospects for share buybacks as companies sit on cash. As outlined in previous editions, the situation is different in China, where the government has significantly increased regulations and is focused on 'prosperity for all'".

Racism is not the real problem

Although the following article was written in July, I would like to share it with you. It lists some salient and shocking data about the South African economy; not that I wish to shock you, but I would like to share it with those readers who perhaps think Maestro is alone in drawing attention to the parlous state of our country's economy, its poor governance, and its bleak future. What follows is a précis of an article written by *Michael Morris, Head of Media at the SA Institute of Race Relations,* entitled Racism is not the real problem.

"The richest irony of SA in 2021 is that turning a blind eye to the plight of the bulk of the country's black majority is about the easiest and most acceptable thing to do.

"This is shocking for two reasons. The first is that the record of that plight is plain – its victims measurable in the tens of millions – and is every day reflected in the media, on the streets, in the workplace, in classrooms, in school and university data, income tables, vulnerability to crime and abuse, and quality-of-life scores.

"The second is that despite the overwhelming evidence of what the real problems (and solutions) are, a nauseating glut of time, energy and resources is squandered not only on obscuring the wholly avoidable failures of SA's democratic era, but on cynically pinning the blame on those who expose them.

"Not unsurprisingly, most South Africans aren't fooled.

"We can be honest and acknowledge that there are those – history's also-rans – who do cleave to racism to justify their intellectual and moral bankruptcy, and who, in their impotence, probably always will. (They dwell at both extremes, but uncomfortably, and it is to South Africans' credit that such racists get short shrift.)

Cattle on beach at Lombok, Indonesia

Source: @jordhammand

"But we should also be honest enough to say, loud and clear, that this enfeebled fringe is not the problem – the thrust of the Institute of Race Relations' (IRR's) "Racism is NOT the problem" billboard on Johannesburg's M1 South.

"The real problem is the combination of policies that are hostile to investment and the job-creating private sector, and institutions that are corrupt, mismanaged, and failing – and the absence of any serious-minded effort to remedy either.

"Among the results are a crippled economy and chronic unemployment. Take the plight of young South Africans. The jobless rate among people between 15 and 24 is a staggering 75%. The 6.8m young people unable to find jobs make up about 60% of the 11.4m South Africans now unemployed and destitute.

"Even if the economy were thriving, it is doubtful these millions would thrive. Fewer than 40% of the pupils who start school in Grade 1 manage to pass matric, with only 14% qualifying to go to university. Just 4% get 50% or more for matric maths. It is not surprising that those living this reality see things differently.

"The IRR's billboard is actually a URL — www.racismisnottheproblem.co.za. The site is candid: 'SA is a failing state in which most youth are unemployed, crime is terrifying, corruption is widespread, basic services are undelivered, and public education amounts to child abuse. These are exactly the major problems topping most people's agenda, not racism.'

"Detailed responses to a survey late in 2020 on what South Africans regard as the biggest, unresolved problems since 1994 show that only 3% think racism is one of them. A full 95% think we have much bigger issues.

"Ultimately, making the case that racism is not the problem is a real problem only for those who profit from trading on the divisive delusion that all we have to do is rout the scattered pockets of ragtag racists and we could rest easy, vindicated in callously continuing to turn a blind eye to the damning reality that is the "lived experience" of millions of South Africans.

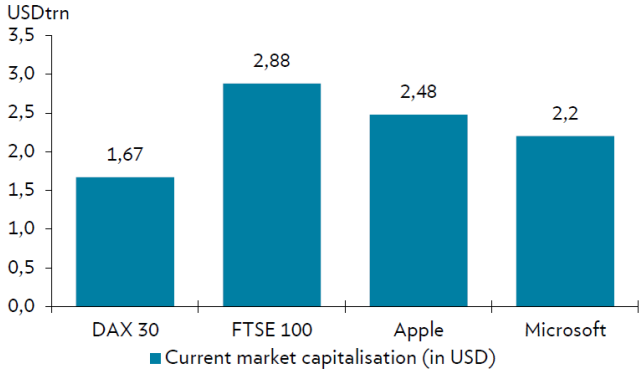
Praying Maestro conducting the orchestra

Source: @chusmaki

DAX reform: ringing the changes

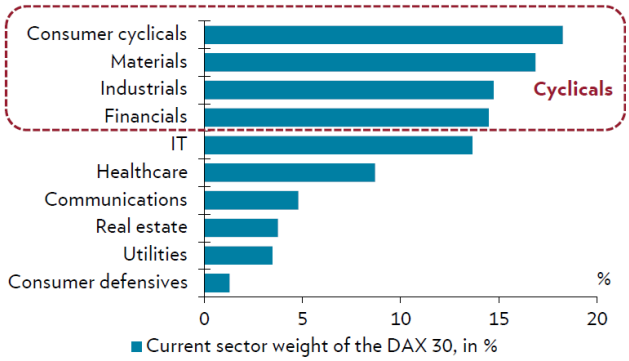
Thirty three years after its launch, Germany's leading equity benchmark index is undergoing its first big overhaul. The catalyst for the reform of the DAX index goes back to the accounting scandal at Wirecard, which shook investor confidence in the index. In addition, demands of international investors for a broader German equity index also played a key role. Indeed, the market capitalization of the current 30 members of the DAX amounts to around $1.7tn – refer to Chart 10 – which is lower than some of the large-cap technology stocks in the US, such as Apple and Microsoft.

Chart 10: Market cap of the DAX and others



Source: Julius Bär

Chart 11: The DAX – a relatively cyclical index



Source: Julius Bär

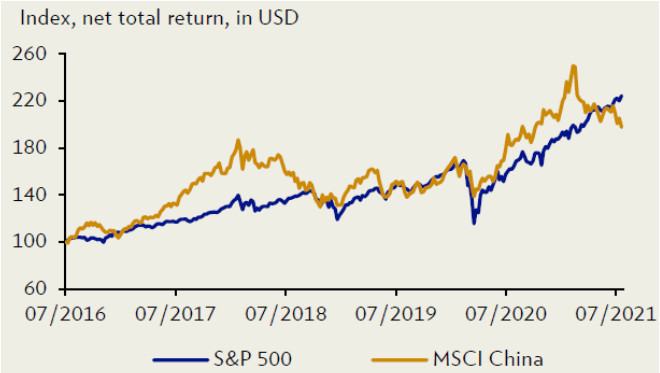
As part of the reform, which is effective on 20 September, the number of constituents in the DAX will increase from 30 to 40. At the same time, the MDAX index, covering the mid-cap segment, will be reduced from 60 to 50 members. In addition, the selection of index members is no longer influenced by trading volume, but by the average market capitalization of the free float over the last 20 days. However, there will be minimum trading volume requirements to ensure a certain degree of liquidity.

Other changes were already introduced earlier this year, such as the requirement for DAX members to publish quarterly financial statements, and the requirement for future DAX candidates to report positive EBITDA (earnings before interest, taxes, depreciation, and amortization) in their last two financial reports. The reform is likely to have an effect on the sector exposure of the DAX. An analysis of the most promising candidates to be added to the index shows that most are from defensive and growth-oriented sectors such as healthcare, internet, and consumer-related growth stocks. Although the DAX will remain a relatively cyclical index, it will be slightly more exposed to defensives and growth stocks after the reform.

China revisited – what now?

Much has been written about the dramatic events in China during the past month. I thought the comment by *Julius Bär's Group CIO, Yves Bonzon*, was synoptic and informative. We agree with a lot of the views expressed in his comment, a précis of which appears below. First though, Chart 12 provides useful perspective, showing the MSCI China and S&P50 indices' historic relative performance, based to July 2016.

Chart 12: Chinese versus US equities



Source: Julius Bär

"When we headlined the CIO Monthly 'BATS (Baidu, Alibaba and Tencent) will not fly' back in early July, we were still vastly underestimating the Chinese government's eagerness to interfere in their capital markets. The announcement on 23 July that private education platforms would now

have to be non-profit came as a further shock to Chinese stocks. The first companies affected lost 70% or more of their remaining market capitalization. The damage has spread to the rest of the market, with the Hang Seng Tech index losing 17% over three trading sessions. At the close on 26 July, the MSCI China index was down 16% (a 34% underperformance against the S&P 500 in the current year). At the same date, the Chinese index was down -17.8% in July alone, while the US index was up 2.6%!

Short Eared Owl

Source: @shimmeringenergy

"THE PARTY RATIONALE
First, we ought to try and understand the logic of the Communist Party in Beijing. Prior to the latest announcements, the measures taken were meant to ensure financial stability and to prevent the emergence of dominant digital platforms as seen with the FAANMG (Facebook, Apple, Amazon, Netflix, Microsoft and Alphabet's Google) in the US over the last 15 years. Interventions are now broadening their focus to ensure social stability.

"The fierce competition that Chinese children face for access to the best academic slots has prompted parents to finance additional courses provided by private companies. This race to the top and the associated cost could lead parents to have only one child. However, China has just lifted the one-child policy in an effort to revive its declining demography. In order to achieve this, and to have all opportunities on its side, the government has concluded that education is a matter for the public sector and cannot be exploited by private initiatives. The reasoning seems clear, but the question on everyone's mind is which sector the party will target next.

"As far as digital consumer leaders like Alibaba or Tencent are concerned, not only does the government want to contain their power, but it also wants to favour other strategic sectors for China, such as semiconductors or military defense-related fields. Beijing prefers to direct the country's best minds to these strategic areas rather than, say, developing new virtual games to entertain teenagers.

"THE NATURE OF THIS MARKET SHOCK
The repricing of Chinese equities has been brutal. In the first half of the year, regulations on BATS and monetary tightening explained the short-term underperformance of Chinese stocks. The latest developments are dramatically changing the nature of the problem. It is no longer just about limiting the valuation potential of the best Chinese stocks, but about centrally controlling capital allocation to decide who can make profit and how much.

"Once again, we are confronted with an exogenous shock, political in nature and in a way arbitrary. The rules of the game have just changed. The Chinese sceptics will say that they have not changed, but that the government has just reminded us of them. As for us, we gave Beijing the benefit of the doubt, obviously wrongly.

"The equilibrium valuation of the market is thus disrupted in two ways. First, investors rightly demand a higher risk premium. In simplified terms, the equilibrium price-to-earnings ratio falls. Second, we are not at all sure about the earnings. The only good news is that we are not dealing with an endogenous bear market linked to a decline in economic activity that leads to a decline in profits and bankruptcies according to the classic pattern. The decline should therefore not last long. The bad news is that in addition to seeing its long-term earnings growth potential seriously questioned, the risk premium that has built up in recent weeks is likely to persist, the new paradigm being permanent in nature.

"AN IMPORTANT LESSON

Chinese events teach us an important lesson for the years to come. We have left the neoliberal era and entered the era of state-sponsored capitalism in the West. Of course, we will never see such an extreme form as in China or Russia. Nevertheless, the China shock is a wake-up call, especially for the more experienced among us. The rules of the game are changing. One can correctly assess the forces inherent in the economic and financial system and be utterly baffled by decisions of governments pursuing a new agenda in which inequality and environmental protection are high on the priority list.

"During such paradigm shifts, it is advisable to remain humble with respect to our analytical capacities, especially when they have been trained for a long time in a previous paradigm. More than ever, in an environment subject to radical political decisions, diversification is the first protection for investors. Positions must be sized adequately and portfolios must be built with even more discipline.

Panther Chameleon

Source: @yensen_tan

"WHAT TO DO IN THE SHORT TERM

The fall of the Chinese market was brutal. In passing, we should note that it is an increasingly frequent feature of today's market to fall vertically. This pattern is also consistent with political shocks that hit the equilibrium valuations of assets after a period of low volatility. In the short term, the damage is done. We expect a small rebound followed later by a slightly more substantial recovery in Chinese equities when the end of the monetary tightening effect of the last few months wears off.

"If other markets were not as high after the post-containment rally, we would consider trimming Chinese stocks. On a relative basis, however, the opportunity does not look attractive in the near term. Longer term, we will revisit our secular view on Chinese capital markets in light of these developments, which fundamentally challenge our original thesis".

Western screech owl – look hard, it is there!

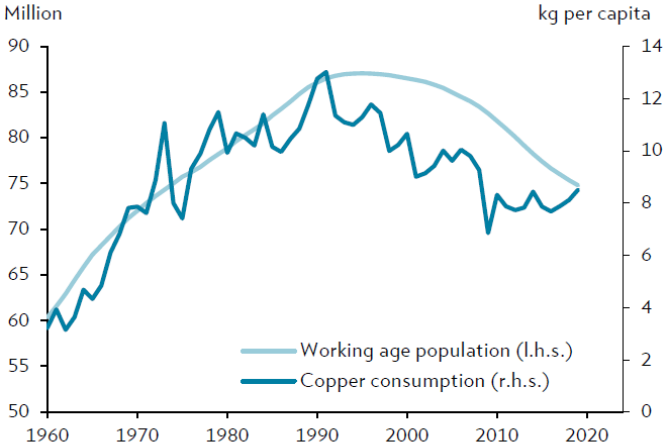
Source: @suspendedframe

Charts of the month

Copper – closely related to demographics

One wouldn't necessarily think it, but the price of copper has a close, long-term relationship with demographic changes in a country. As a country moves from an investment-driven stage to a consumption-driven one, the per capita copper consumption declines quite materially.

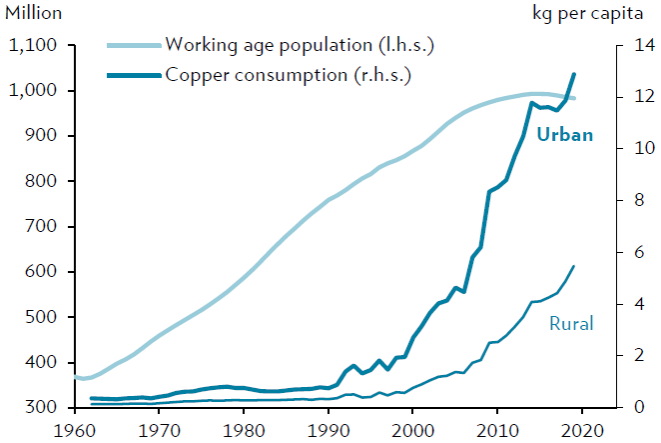
Chart 13: Japan working age population vs consumption



Source: Julius Bär

We saw this in Japan (Chart 13) and we can expect to see the same development in China (Chart 14). Although we remain relatively upbeat on the (hard) commodity complex in the coming months, based largely on expected stronger economic growth, heading into the future one cannot ignore these well-established longer-term relationships.

Chart 14: China working age population vs consumption



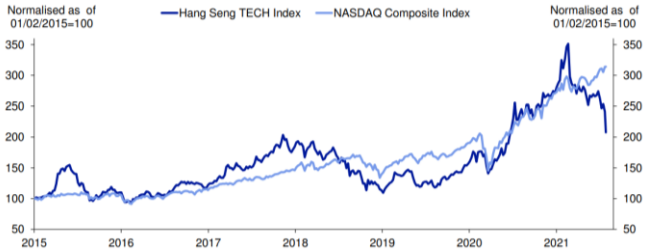
Source: Julius Bär

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

US versus Chinese tech

We have written enough in this edition of *Intermezzo* to not have to describe the Chart, below. I simply list it to show recent movements of US tech shares (NASDAQ) and their relative performance again Hong Kong tech shares. I should point out here that the chart was drawn on 27 July – the disparity between the performances of the two indices has got far worse since then.

Chart 15: Tech divide: US vs Hong Kong/China



Source: Deutsche Bank

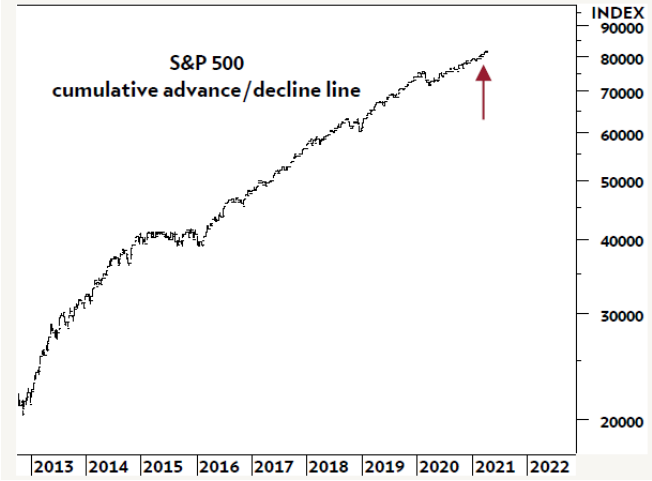
Why are we still so positive about US markets?

I couldn't put it any better than *Julius Bär Head Technical Analyst Mensur Pocinci* did, so let me quote him verbatim.

"Investors are constantly distracted. Those selling news want to make you believe that watching/ reading the news will give you an edge when investing. And then of course sellers of market data create the illusion that investors need real-time data in order to be fast to react to the latest changes. But anyone who follows the market closely will soon recognize that reading the news or real-time market data is a losing proposition for the human being. By the time you have made an analysis and decided what to do, the market has already repriced and most of the time will have seen a short-term overreaction.

"If you do not believe me, look at the performance of funds of hedge funds relative to a balanced portfolio of 60% equities and 40% bonds: they have underperformed by 7% per annum over the past 13 years. Thus, when looking at equities, we can keep it simple and look for some key indicators such as demand for individual equities.

Chart 16: S&P500 Advance/decline line



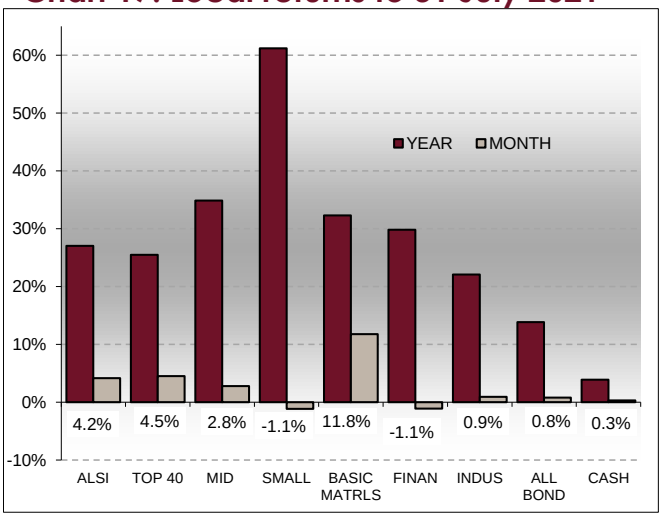
Source: Julius Bär

"For this, we consult the cumulative Advance Decline line (A/D) for the S&P500 (Chart 16). On Tuesday, the indicator printed a new all-time high. Thus, demand for US equities remains healthy and investors are advised to stay invested".

July in perspective – local markets

Turning to the South African investment markets, the Basic Material index drove the All Share index higher, with the former rising 11.8% and the latter 4.2%. The Industrial Index rose only 0.9%, having been dragged lower by the large weighting Naspers has in the index. Naspers, whose largest investment is in Tencent, which itself was the focus of increased Chinese regulatory scrutiny, declined 1.7% in July. The Financial index lost 1.1%, while the Top40 (Large). Mid and Small cap indices produced monthly returns of 4.5%, 2.8%, and -1.1% respectively. The All Bond index rose 0.8% while the rand declined 2.4% against the dollar.

Chart 17: Local returns to 31 July 2021



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.

Orangutan, Borneo

Source: @thomasvijayan

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

	Period ended	Month	Year to date	Year
Maestro Equity Prescient Fund	**Jul**	**1.3%**	**11.1%**	**19.3%**
JSE All Share Index	*Jul*	*4.2%*	*17.9%*	*27.1%*
Morningstar sector ave	*Jul*	*2.4%*	*15.8%*	*25.0%*
Maestro Growth Fund	**Jul**	**0.5%**	**4.3%**	**3.4%**
Fund Benchmark	*Jul*	*3.1%*	*12.8%*	*19.5%*
Morningstar sector ave	*Jul*	*2.0%*	*11.5%*	*16.8%*
Maestro Balanced Fund	**Jul**	**0.5%**	**4.0%**	**3.6%**
Fund Benchmark	*Jul*	*2.7%*	*11.2%*	*17.2%*
Morningstar sector ave	*Jul*	*1.8%*	*9.7%*	*13.9%*
Maestro Cautious Fund	**Jul**	**0.4%**	**2.0%**	**3.6%**
Fund Benchmark	*Jul*	*1.6%*	*7.9%*	*13.7%*
Morningstar sector ave	*Jul*	*1.4%*	*7.4%*	*11.1%*
Maestro Global Balanced Fund	**Jul**	**-0.3%**	**-2.5%**	**-11.1%**
Benchmark	*Jul*	*4.1%*	*7.0%*	*2.0%*
*Sector average **	*Jul*	*2.8%*	*7.5%*	*3.8%*

* Morningstar Global Multi Asset Flexible Category

The longer-term returns for our investment solutions are listed in the table below. All returns are for periods to 31 July, and are taken from Morningstar's monthly unit trust survey. Returns are shown on a net basis i.e. after all fees have been deducted.

Table 2: The Maestro Equity Prescient Fund

Morningstar (ASISA) South Africa Equity General - July 2021						
	3 mths	6 mths	1 year	3 years	5 years	10 years
Maestro Equity Prescient Fund	***2.0%***	***8.4%***	***19.3%***	***5.5%***	***1.5%***	***7.0%***
Maestro Equity Fund benchmark	2.9%	8.8%	23.5%	7.6%	7.7%	12.8%
SA Peer Group Average	2.3%	11.7%	25.0%	6.4%	5.2%	9.1%
Maestro position within Group	97	135	127	87	100	50
Number of participants	171	167	162	145	115	60
Quartile	3rd	4th	4th	3rd	4th	4th

Table 3: The Maestro Growth Fund

Morningstar (ASISA) South Africa Multi-Asset High Equity - July 2021						
	3 mths	6 mths	1 year	3 years	5 years	10 years
Maestro Growth Fund	***0.4%***	***2.1%***	***3.4%***	***6.8%***	***5.0%***	***8.1%***
Maestro Growth Fund benchmark	3.6%	9.1%	19.5%	9.9%	9.0%	11.0%
SA Peer Group Average	2.4%	8.6%	16.8%	7.4%	6.1%	8.9%
Maestro position within Group	201	201	195	113	118	42
Number of participants	206	205	198	177	148	61
Quartile	4th	4th	4th	3rd	4th	3rd

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

Table 4: The Maestro Balanced Fund

Morningstar (ASISA) South Africa Multi-Asset Medium Equity - July 2021						
	3 mths	6 mths	1 year	3 years	5 years	10 years
Maestro Balanced Fund	***0.4%***	***1.9%***	***3.6%***	***5.6%***	***4.6%***	***7.6%***
Maestro Balanced Fund benchmark	3.4%	8.0%	17.2%	9.6%	8.8%	10.5%
SA Peer Group Average	2.6%	7.2%	13.9%	7.1%	6.0%	8.4%
Maestro position within Group	99	99	94	77	65	31
Number of participants	100	100	96	87	75	38
Quartile	4th	4th	4th	4th	4th	4th

Table 5: The Maestro Cautious Fund

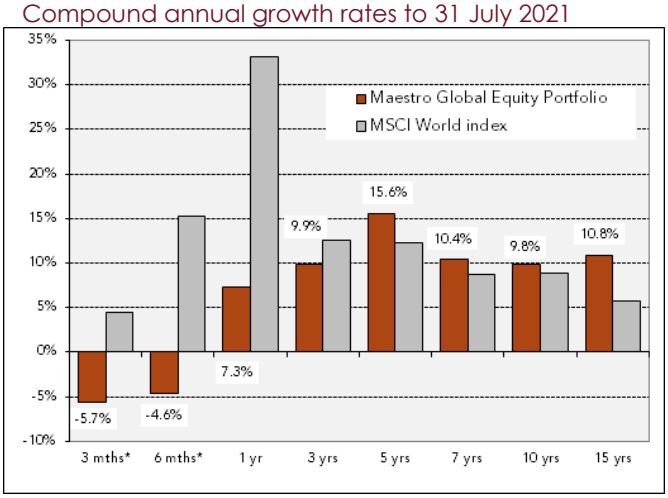
Morningstar (ASISA) South African Multi-Asset Low Equity - July 2021						
	3 mths	6 mths	1 year	3 years	5 years	10 years
Maestro Cautious Fund	***0.2%***	***1.4%***	***3.6%***	***6.1%***	***5.1%***	***7.8%***
Maestro Cautious Fund benchmark	3.1%	5.9%	13.7%	8.2%	8.2%	8.8%
SA Peer Group Average	2.5%	5.7%	11.1%	6.8%	6.1%	8.0%
Maestro position within Group	158	158	154	99	96	33
Number of participants	160	160	156	136	116	56
Quartile	4th	4th	4th	3rd	4th	3rd

Table 6: Maestro Global Balanced Fund

Morningstar (ASISA) Global Multi-Asset Flexible - July 2021						
	3 mths	6 mths	1 Year	3 Years	5 Years	10 years
Maestro Global Balanced Fund	***-4.2%***	***-6.2%***	***-11.1%***	***10.0%***	***N/A****	***N/A****
Global Balanced Fund benchmark	4.1%	5.5%	2.0%	13.6%	9.9%	14.5%
SA Peer Group Average	2.9%	4.4%	3.8%	11.6%	9.2%	13.3%
Maestro position within Group	45	42	37	21	N/A	N/A
Number of participants	46	43	38	29	22	12
Quartile	4th	4th	4th	4th	N/A	N/A

Chart 18: Maestro global equity gross returns

Compound annual growth rates to 31 July 2021



* Un-annualized

File 13: Info almost worth remembering

Data that dazzles

- As the country continues to count the cost of the looting spree that occurred during July in parts of the country, I came across this interesting data: approximately 1 400 automated teller machines (ATMs) were vandalized or stolen during the ten days that saw the country descend into chaos. The Banking Association has indicated that, apart from a rough estimate of R100m that was stolen during the looting, each ATM costs R385 000 to replace. That brings the cost to replace the ATMS alone to R539m. I wonder who is going to pick up that tab.
- Thirteen – no, not the unlucky number but the age of the youngest Japanese winner of a gold medal at the 2020 Tokyo Olympics. Japanese skateboarder Momiji Nishiya won the street skateboarding finals to clinch the title and become the first female medal winner in this, the first time the event has been held as an Olympic sport. The youngest winner of an Olympic medal was Dimitrios Loundras of Greece, who at age 10 in 1896 won a bronze medal in team gymnastics.

Lions feeding on a wildebeest

Source: @jamotyrrell

- South Africa's Road Accident Fund, which like just about every government-run entity is largely insolvent and for all intents broken, announced that its accumulated deficit for the 2023/24 financial year was projected to reach R518.7bn!! To put that into perspective, that is even larger than Eskom's current debt. Now that is truly "data that dazzles".
- If that data didn't blow you away, then this surely will: the transfer of Barcelona and soccer great Lionel Messi to his new club Paris St-Germain has brought about much discussion surrounding, and reflection on, the financial policies of the Barcelona Football Club. What also came to light was the total amount paid to Messi from 2017 through to June 2021: a total of €550m – that's R10.5bn! Eish

Sometimes humans are hard to understand
In the year 2000, Swiss households held 15% of their assets in cash, which has grown to 18% currently. What seems on the face of it like an incremental change becomes a dramatic one when you consider that short-term interest rates were at 3.5% in 2000. Today they are deeply negative. During the same period, equity allocation dropped from 11% to 7% - this, at a time when the prevailing dividend yield is 2.9%.

How risk averse must the Swiss be, when they are prepared to increase their allocation to an asset that has a negative yield i.e. they have to pay someone to hold their cash, but decrease their allocation to an asset class that yields 2.9% and rising.

What are "core academic subjects"?
We have already commented on the dramatic developments within the Chinese education sector. In order to clarify the new regulations, the authorities had to distinguish between what they regard as core and non-core academic subjects. And they did so as follows:

- Core subjects: maths, physics, chemistry, biology, geography, Chinese, foreign languages (English, Japanese, and Russian), ethics, law, and history.
- Non-core subjects: physical education (including health-related), art, music, and other practical activities such as information technology and technical subjects.

Pack of wild dogs feeding on a zebra

Source: @naude_heunis

Investment manager watching the TAL share price

Source: @michele_bavassano

An embarrassment of riches

The Swiss National Bank (SNB) reaped a gain of more than SFr43bn during the past six months, as rising equity markets pushed the central bank's reserves rose above SFr1tn for the first time ever. To place that number into perspective, the annual Swiss Gross Domestic Product i.e. the total value of finished goods produced and services rendered within the economy, is "only" SFr824bn. So the SNB's reserves are larger than the entire Swiss economy and also larger than most of the biggest sovereign wealth funds.

This bizarre, but very real, situation is a function of the SNB's policy of intervening in foreign exchange (forex) markets in order to prevent the Swiss franc from firming too much. The "Swissie", as the Swiss franc is affectionately known in the market, is always in demand, given the defensive nature of that economy and its excellent governance over centuries, which has elevated the country to one of, if not the, preferred safe haven for global investors.

Are you serious??!!

I am afraid I cannot verify the following comment but it does follow similar comments we have been blessed to receive from officials and cabinet ministers in the past. Given the unique intellect and competence on display, you have to believe the following comment may just have actually been made by the Deputy Minister. It is so unique and original, you just have to enjoy it.

A few weeks ago the Deputy Minister of Transport commented as follows on the fuel price increase that came into effect during the previous week: "Technically, fuel prices never went up in the past 25 years. If you go to a garage and ask for fuel for R500, they always give you fuel for R500. People just like complaining". What a stroke of genius! Why didn't we think of that, or see it from this perspective!? What on earth is wrong with us?

Great horned owl with chick

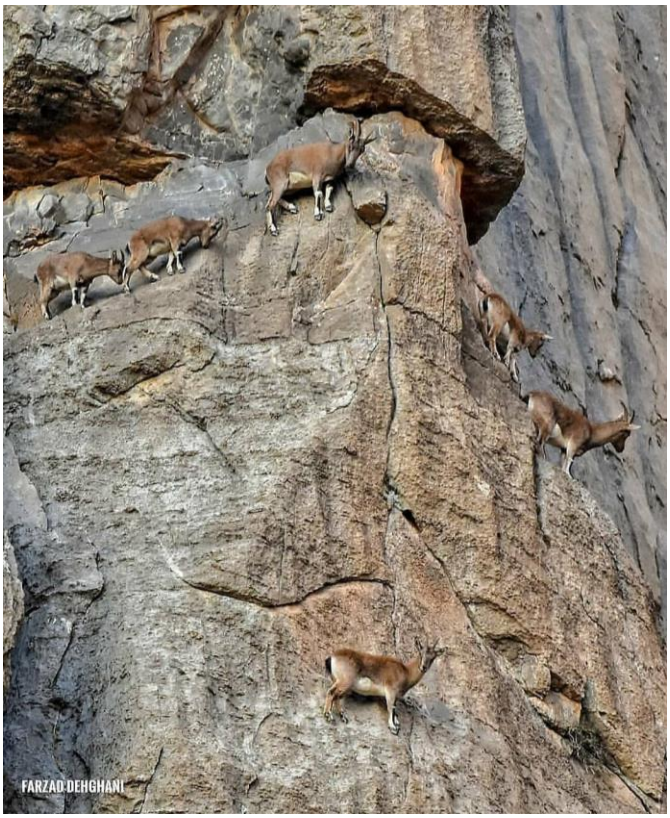
Source: @photobysmm

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

So what's with the pics?

The theme this month is clearly that of animals. I hope you enjoy the photos and I continue to encourage you to seek out the work of these remarkable photographers who provide so much enrichment and learning through their efforts.

Goats on the Zagros Mountains, Iran



Source: @farzad.dehghani1360

The bald eagle

(Alternatively, the Biden Administration tip-toeing through its foreign policy as it relates to Afghanistan)

Source: @Ernie Serediak