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INTERMEZZO

Investment Letter | 14th Edition | January 2014

Introduction

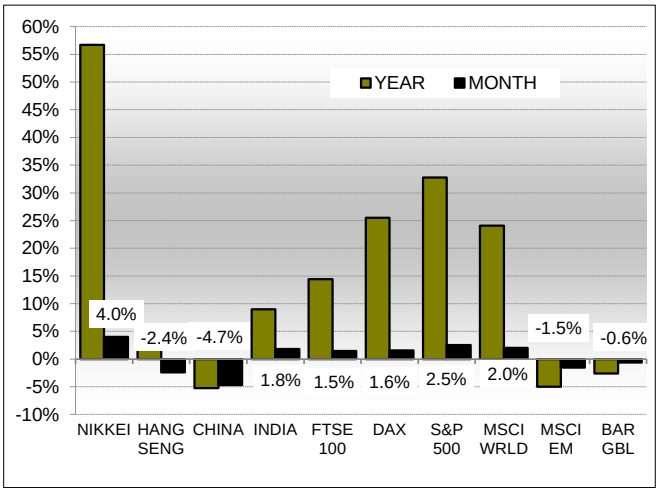
Welcome to 2014! I hope the year ahead will be a rewarding one for you and that we will look back on it in a year's time as a landmark one through which we gained and learnt much. On behalf of the whole Maestro team, may I wish you everything of the best? May you journey through 2014 safely and may it be full of memorable occasions. My challenge for you this year is encapsulated in a quote from Nelson Mandela: "There is no passion to be found in settling for a life that is less than the one you are capable of living."

We published the December 2013 edition of *Intermezzo* a matter of days after the passing of Nelson Mandela. I am sure that you participated in or at least watched, as we did, the events surrounding our country's period of mourning as South Africa paid tribute to its favourite son. I have included photos of some of those moments, in particular for our overseas readers who would have missed the "heart and soul" of our country and its citizens' grief at the passing of the great leader; the man who more than any other helped the country through one of the most difficult periods in its history and did so by preaching peace and reconciliation despite having more than sufficient reason for acting in exactly the opposite fashion. These photos have specifically been selected to share with you some of the moments – and there were thousands I could have chosen from – when all South Africans, irrespective of race or culture, came together to mourn the loss of Madiba yet celebrate his greatness and remind ourselves, indeed enjoy, the legacy of reconciliation and basic respect for our fellowman and woman that he left for us to emulate. The photos were obtained from various online sources including Reuters and the Daily Mail.

December in perspective – global markets

December saw the continuation of the pattern of market behaviour seen in recent months; strong developed equity markets and weak emerging bond markets. This occurred despite the arrival of the long-awaited and much-feared reduction in monetary stimulus (quantitative easing or QE) which the US Federal Reserve announced in late-December. The MSCI World index rose 2.0% and the MSCI Emerging market index declined 1.5%. The US market was strong, rising 2.5% (the S&P mid and small cap indices rose 2.9% and 1.3% respectively). Japan was also very strong, rising 4.0%, spurred by the sharp (5.7%) depreciation in the yen relative to the dollar. The yen declined 17.7% against the dollar, brought about as an active policy measure by the Bank of Japan (BoJ), the so-called "Abenomics" whereby the BoJ deliberately undermines the value of their currency in order to stimulate exports and economic activity and simultaneously create inflation. Who would ever have seriously thought that such a policy would be appropriate, let alone work? Yet that is the strange world of financial experimentation in which we live! Emerging markets experienced mixed fortunes in December; China declined 4.7% and Brazil 1.6%. India on the other hand rose 1.8% and Russia 2.6%. Global bonds ended the year weak, falling 0.6% and commodity prices, with the odd exception, rose on the back of signals of greater economic activity in the US. The dollar was also moderately weak in December, which supported commodity prices, although it did not stop the gold price from falling 4.1%.

Chart 1: Global market returns to 31 December 2013



We will deal with the annual returns in more detail in our usual *Market Commentary* publication later this month, but it is worth noting that 2013 will go down as one of the more rewarding years for equity investors. Emerging markets struggled throughout the year – the MSCI Emerging market index declined 5.0% in 2013 – while developed markets posted strong gains; the MSCI World index rose 24.1%. The US equity market posted a return of 32.8%, its strongest year since 1998. An indication of investor appetite for risk can be

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gleaned from the stellar annual returns of the S&P mid and small cap indices, which rose 31.6% and 42.4% respectively. This is in stark contrast to the 15.5% *decline* in the Brazil equity market and the 5.3% Chinese equity market decline. Bond investors would prefer to forget 2013; bonds fell 2.6% although there were significantly larger declines in some countries. Emerging market currencies also struggled throughout the year; the rand declined 19.0% although it was in good company; the Aussie dollar fell 13.8% and the Brazilian real 13.2%. The Indian rupee fell 11.4%. In the commodity space gold posted its first decline since 2000, ending the year 27.8% lower. Corn ended down 40.0% and silver 34.9% but copper rose 4.9%. Table 2 at the end of this letter depicts a greater selection of MSCI indices; remember the returns are in US dollar terms.

What's on our radar screen?
Here are a couple of items we are keeping a close eye on:

- *The SA economy:* The inflation rate declined in November to 5.3% from October's 5.5%; core inflation remained steady at 5.3%. Nominal retail sales growth moderated from 6.3% in September to 5.3% in October. DIY sales growth decelerated from 10.1% in September to 8.1% in October, FMCG sales slowed from 5.6% to 5.0% while furniture sales declined in absolute terms by 5.9%, accelerating from September's 4.7% decline. Apparel sales held up relatively well, though, rising 10.7% in the year to October, albeit slightly lower than September's 11.1% increase.
- *The US economy*: Data emanating out of the US continued to "surprise on the upside" i.e. was better than expected. The final reading on Q3 US economic (GDP) growth was 4.1%, up from the previous reading of 3.6%. Inflation continued to be subdued – many are concerned that it is too subdued – although industrial production is still strong, as is the labour market. As you are probably aware by now the Fed announced that it will start reducing its support of the capital markets, by $10bn per month in January. Thus instead of buying $85bn per month of mortgage backed securities and government bonds, it will now only buy $75bn's worth. As you can see from the returns from global investment markets, investors had by and large already priced this move into the market and thus responded favourably to the news – at least as far as developed (as opposed to emerging) markets are concerned.
- *Developed market economies*: **Japanese** Q3 economic growth came in at 1.1%, down from Q2's 3.8%. The annual inflation rose to 1.5% in November from 1.1% in October.
- *Emerging market economies:* **Chinese** November inflation came in at 3.0%, below October's 3.2%. Inflation actually declined 0.1% month-on-month, driven mainly by lower food prices. Core inflation remained steady at an annual rate of 1.8%. **Australian** Q3 economic growth was 2.3% from Q2's 2.6% and its unemployment rate is 5.8%. **Indian** inflation remained unchanged in November, at 10.1% and the Reserve Bank of India (RBI) left their official interest rate unchanged. Economic growth in **Turkey** during Q3 was 4.4%, down marginally from 4.5% in Q2. Its annual inflation rate declined to 7.3% in November from 7.7% and its unemployment rate now stands at 9.9%. **Brazil's** Q3 growth rate declined to 2.2% from Q2's 3.3%.

Global charts of the month – Part 1
I have a couple of charts on different topics to share with you this month. I have split them into two parts; Part 2 follows later in the edition. Let's start with one of our themes, namely *The Great Rotation*, whereby global investors are expected to reverse the huge inflow into bonds in the past four or five years and direct them into equity markets. Although there has been a notable slowdown in the flow of capital into bonds and an uptick of the flow into equities, we are of the view that it still has a long way to go i.e. this is a multi-year theme likely to remain on the agenda

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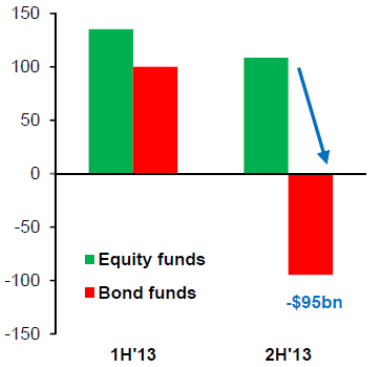
for a few years still. That said, note from Chart 2 that the rotation out of bonds and into equities (which are not necessarily mutually exclusive by the way) accelerated noticeably during the second half of 2013.

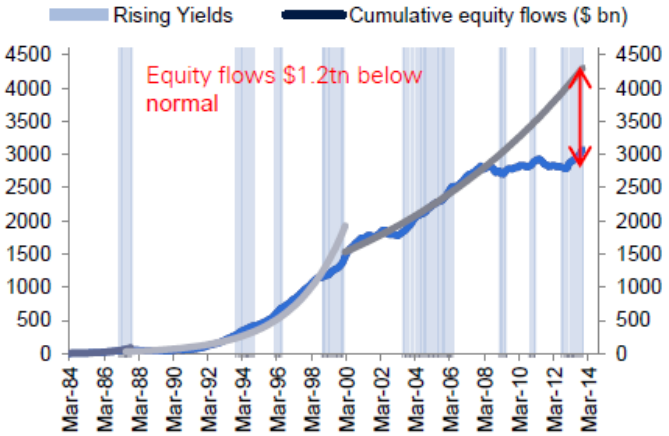
Chart 2: The Great Rotation gained momentum in 2H 13



Source: Merrill Lynch

Deutsche Bank goes so far as to estimate that despite $250bn of inflows into equity markets in 2013 flows into equities are still about $1tn (trillion) below normal, based on historic trends since 1984 – refer to Chart 3 below. We are not suggesting that one should consequently go rushing headlong into global equities right now; what we do suggest though, is that the renewed and accelerating inflow into equity markets will provide support to those markets and increase their appeal relative to the bond market. Deutsche Bank also makes the point that each time in the past that bond yields have risen sharply (and prices declined) inflows into equities have accelerated. It is worth mentioning here that Maestro's view is that global bond yields are likely to increase through 2014 and beyond, underlining our interest in global equities.

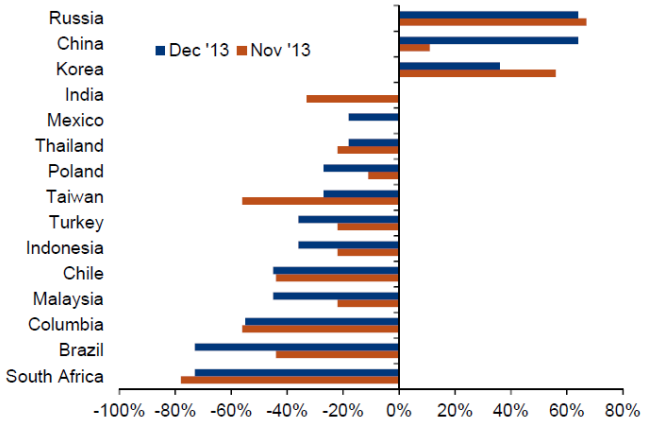
Chart 3: Latent potential for inflows into global equities



Source: Deutsche Bank

Turning to a slightly different topic but staying with equity markets, 2013 saw a dramatic outperformance by developed markets of emerging markets. To recap, the MSCI World index rose 24.1% in 2013 while the MSCI Emerging market index *declined* 1.5% marking one of the greatest divergences between the two in recent times. Within the emerging market universe, note from Chart 4, which is extracted from Merrill Lynch's Fund Manager Survey that global investors retain their preference for Russia, China and Korea and their aversion to South Africa and Brazil. This obviously presents another headwind for the SA equity market – one it has been flying into for some time already. It is also worth noting that Brazil, India, Indonesia and South Africa all face elections in 2014, which will only add to investor nervousness.

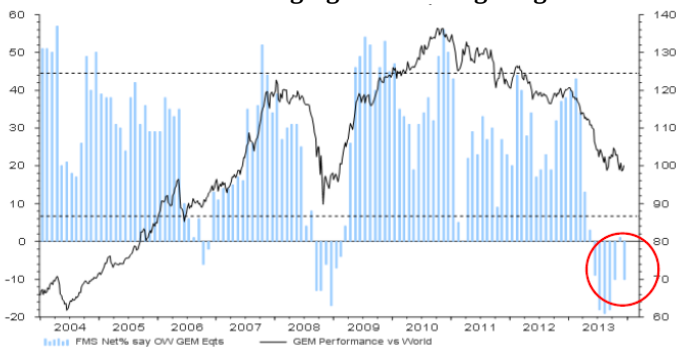
Chart 4: Investor Emerging market preferences



Source: Merrill Lynch

To place global investors' aversion to emerging markets into perspective, consider Chart 5, taken from the same survey. It shows that fund managers have the most underweight positions in emerging markets (relative to their benchmarks) as they did during the 2007/9 crisis and are the most negative since 2004. The solid black line in the chart depicts emerging market performance relative to developed markets, from which you can see that since early-2011 emerging markets have underperformed developed ones.

Chart 5: Investors' Emerging market weighting



Source: Merrill Lynch

A few quotes to chew on

Signs of things to come

The interesting feature of this time of the year is that most research houses publish their "Outlook for 2014"-type documents, which always make for fascinating reading. Of course they also inform and challenge our own thinking, which is a very worthwhile process. So from the *Merrill Lynch* document entitled "Life on Planet Yellen", *Chief Investment Strategist Michael Hartnett* offers us synoptic milestones. Talking about the Great Rotation i.e. the movement by global investors out of bonds and into equities, a theme that he has been championing for more than a year now, he writes as follows: "For corroboration of The Great Rotation investors should watch the "3Bs": higher bond yields, a higher "buck" (i.e. US dollar), and higher bank stocks (the best barometer of domestic demand)."

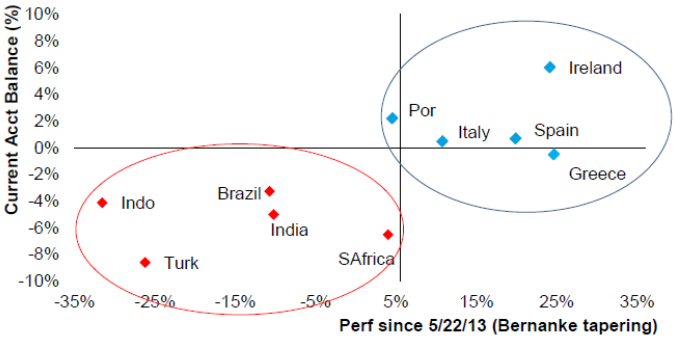
Moving on to the topic of foreign exchange and exporting countries, he offers the following: "The Merrill Lynch base case of higher growth, higher rates and a higher dollar means the underperformance of emerging market (EM) debtors (the "Fragile 5" - see Chart 6 below) is likely to persist into the new year unless these countries jump-start fiscal and macro reforms and tranquilize market fears that

foreign exchange devaluation will be the chosen route to boost growth, employment, popularity and local stock markets. Value in EM equity (but not debt) markets is more and more visible. But we will wait for a break of 3% on the 10-year Treasury yield and a bout of dollar strength before recommending a 2014 entry point."

Chart 6 depicts very clearly a concern we have held for a long time now, namely that emerging markets which run large current account deficits i.e. which rely on foreign capital to sustain them, are fundamentally vulnerable to further currency weakness. Notice how weak these countries' equity markets have been (in dollar terms) since mid-March when the Fed first hinted at the tapering of QE. Notice that all these countries could arguably still fall into the "basket case" category, but those running current account surpluses have performed significantly better than those with current account deficits.

Chart 6: Investors hate debtors

Dollar performance of EM versus their current account balances



Source: Merrill Lynch

Hartnett ends with a timely reminder about the value of secular i.e. non-cyclical themes. "The investment cycle will wax and wane but investors in 2014 should remain mindful that secular trends are also likely to dictate investment performance. The Great Rotation, 'Companies are safer than Countries' and US energy independence remain powerful long-term macro themes. Urbanization, infrastructure spending and trade (a new World Trade Organization) are all potential growth drivers. In addition, with politicians desperate for employment growth perhaps one should not underestimate the potential for government regulatory changes in energy, aerospace, even healthcare to boost growth. And the pace of technological change remains breath-taking. Progress in artificial intelligence, robotics, digital manufacturing, synthetic biology and so on remain reasons for optimism on the future. Indeed, science now predicts that by 2023 the average $1,000 laptop will be able to communicate at the speed of the human brain and that, 25 years later, at the rate of the entire human race."

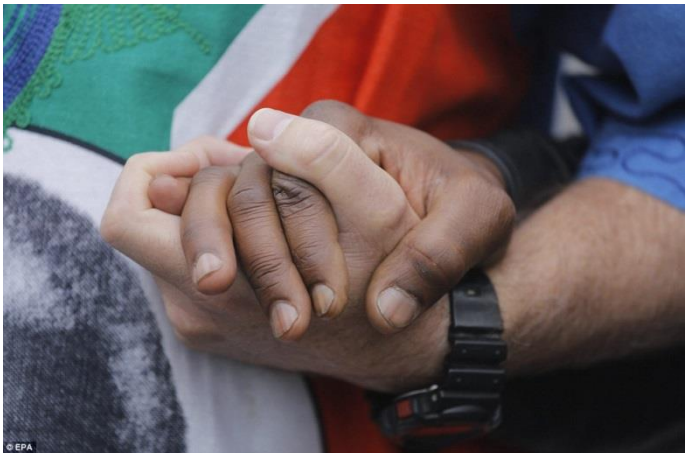
Reflections on 2013 and looking into 2014

At this time of the year many of us go into "reflection" mode, as we review market behaviour during the past year and see what worked for us, what didn't, what we "got wrong" and what we "got right". It can be a very gratifying time of the year and at times a very frustrating one. Rather than fill this edition of *Intermezzo* with these types of comments and reviews, I will only insert a few. There are plenty more of these reviews on the internet, although of course it helps to know that the author has credibility and a respectable track record.

I thought the following comments from *Guy Monson, Chief Investment Officer of Sarasin and Partners*, were pertinent. He writes "The bulk of equity returns generated in the global rally of the last 18 months have still come from an expansion of valuations rather than a consistent, market wide increase in corporate earnings. 2014 could see this relationship change. US margins maybe at or close to historic peaks, but those in Europe remain at cycle lows, while the profile of Japanese profitability, in the face of a weaker yen and the promise of domestic deregulation, could

still be transformational. Three global trends will help drive profits growth next year. First, as today's strong companies become stronger, they will reap refinancing windfalls from lower borrowing costs funded at the super low rates of recent years. Auto companies, airlines and capital goods stocks have seen the costs of their leasing books collapse, while acquisitions are easily financed at today's rates (as we saw last month in the massive global demand for Verizon bonds, the largest corporate issue ever seen). Second, consumer brands and franchises, especially in the emerging world, are increasingly the beneficiaries of the 'quiet' correction in global energy and food prices. The Economist commodity index has fallen 10% in dollars this year to date, while the food component has dropped by nearly 15%. Third, valuable dividend streams are at last emerging from the rubble of the banking crisis. Yes, increases in regulatory capital (as for UBS) or further regulatory fines and challenges (epitomised by JP Morgan) have rightly distracted investors. But, in the mid-term, restructured global banks are winners from a gradual normalisation of interest rates, an absence of competition in many markets and gradually rising loan growth. We expect to see these banks as the potential 'dividend aristocrats' of global income funds in the years to come, odd as this may seem today".

One of the most read market commentators in the Maestro office, *Michael Hartnett, Merrill Lynch's Chief Investment Strategist*, offered the following reflections on 2013: "The global economy 'cried wolf' this year. There was no US fiscal crisis, no hard landing in China and the Euro did not disintegrate (it actually appreciated in value). But while the macro frustrated the bears, there was plenty of price action in asset markets to spur the bulls. Gold prices have fallen 26%, the most since 1981. US equities finally broke out of a 13-year trading range to hit new all-time highs (stocks hit all-time highs in Germany, Norway, Israel, Mexico, India, Malaysia, Indonesia, Philippines and South Africa to name a few). And the great bull market in bonds ended with a thud as yields rose sharply. The Great Rotation shuffled out of the shadows of 2012 into the limelight of 2013. The degree of outperformance by the S&P 500 index versus the 30-year US Treasury Bond this year has only ever been exceeded in 1933, 1958, and 2009. We believe the investment regime will shift in 2014 from the High Liquidity-Low Growth regime that has characterized the post-Lehman era, to one of Higher Growth and Lower Liquidity (crucially in that order). Put simply, higher growth argues for another year of positive asset returns, while lower liquidity argues that returns next year will be significantly less spectacular than in 2013".



Investec Asset Management's Chief Strategist Michael Powers had some interesting pearls of wisdom, to share, too: "There are very few fixed income opportunities in the West that offer proper risk-adjusted, real returns at the moment. Investors have piled into equities, but valuations have become dependent on some quite demanding assumptions of earnings growth. Two recent broker observations sum up the current dilemma: Firstly, global equities have risen 40% in the past two years. Over the same period, global earnings per share (EPS) have gone nowhere. This means that the MSCI ACWI benchmark has rerated from a 12x to 17x PE based on trailing EPS…"

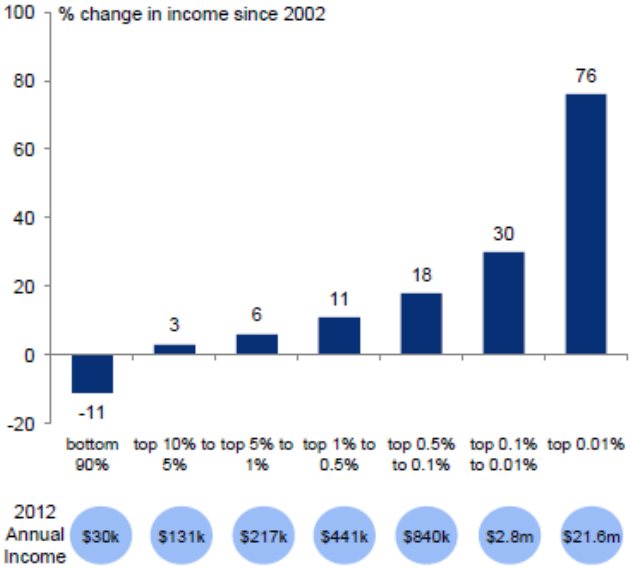
Powers also had some interesting thoughts on China and Asia; he is very bullish on the long-term prospects for this part of the world, a positivism we share. "In my view, China is not likely to have a hard landing, but it may well have a bumpy ride, in part due to the implementation of the radical reforms agreed at the recently concluded 3rd Plenum. There are unresolved issues such as the credit and shadow banking issues, but I do not think China is heading for a financial crisis similar to the West in 2008. It is sitting on $3.5 trillion of FX reserves, the average Chinese person saves 40% of his or her income and its fiscal deficit is moderate. However, China has a relatively immature financial structure and there

will inevitably be growing pains. Unlike the US, I think industry is going to remain a core part of the Chinese economy as it develops. Low end value added manufacturing sectors are migrating away – the shoe industry to Vietnam, the clothing industry to Bangladesh and some electronics assembly to Indonesia. But China is moving up the value chain on the industrial side and is already starting to compete with countries like Germany. While China will not become a clone of the US, the consumer is going to play a larger part in driving economic growth going forward. China's economy will endure growing pains but the inner growth momentum is not going away. The key driver is the migration of 20m people a year, off the land and into the cities. As a result there is the emergence of an enormous middle class. While Europe and the US will likely see zero growth in their middle classes between now and 2030, around three billion people will become part of Asia's middle classes by 2030."

Global charts of the month – Part 2

Here are some interesting charts on slightly unusual topics. In last month's *Intermezzo* (page 5 Chart 5), we touched on the topic of the inequality of income and assets, the so-called "rich get richer and the poor get poorer" syndrome. Merrill Lynch has appropriately referred to this as "Wall Street versus Main Street" and argues that it is a "multi-decade, global phenomenon". I guess such a definition would be expected from an influential player on Wall Street although, for the record, we agree with that view. There is plenty of evidence to support it. Merrill Lynch, though, expresses sympathy for the view and does think "there is an element of truth in the argument". This is obviously a very politically sensitive and contentious topic, and one that will increase in intensity as the gap between the rich and poor becomes ever wider. By way of "econo-speak" you will come across the term "Gini coefficient" when reading about this topic; the Gini coefficient simply refers to the measure of income distribution of a population; it is widely used to measure income inequality.

Chart 7: Gini in a bottle: the rich get rich …



Source: Deutsche Bank

With that by way of background Chart 7 makes for interesting if not shocking reading. It depicts the change in income since 2002 for sections of the US population. The bottom 90% i.e. by far the majority of US citizens, have seen their income decline by 11% between 2002 and 2013, while the top 0.01% have seen their income increase by 76%. The average annual income of the bottom 90% is around $30 000 (R315 000) while at the very top end i.e. the top 0.01% of earners have an average *annual* income of $21.6m (R226.8m). Is it no wonder that so many people are directing serious questions at free market thinking and capitalist ideology, questions that until now remained unanswered?

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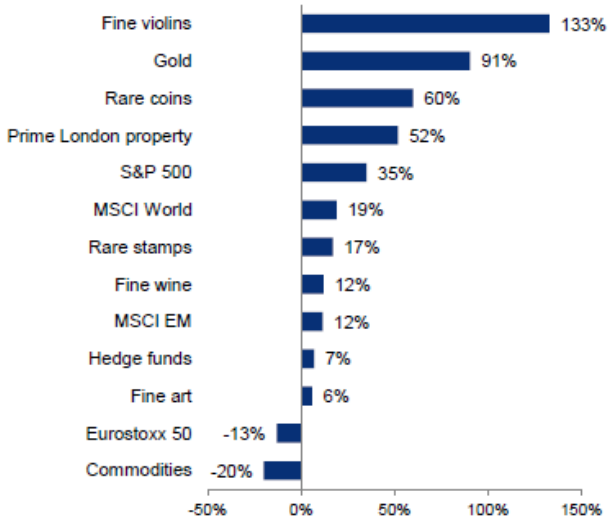
At the end of the year, particularly a year in which equity returns have generally been above-average, one frequently sees comparisons made between returns across unusual (alternative) asset classes. You will know that we frequently refer to the assets classes of art and music, but I found Chart 8 particularly interesting. Although these kinds of survey results are often biased and to some extent subjective, they nevertheless shed light on the returns of asset classes that are seldom or at best hard to measure.

Chart 8 Alternative asset returns – 2007 to 2013



Note: Chart is total returns with the exception of prime London property, which factors in only price appreciation. Total returns account for both income (interest or dividends) and capital appreciation
Source: Bloomberg Finance LP, Deutsche Bank Research, fine violins (Florien Leonhard Fine Violins), prime London property (Land Registry data for Royal Borough of Kensington and Chelsea), rare Stamps and rare coins (Stanley Gibbons), fine wine (Liv-EX 100), fine art (Artprice.com)

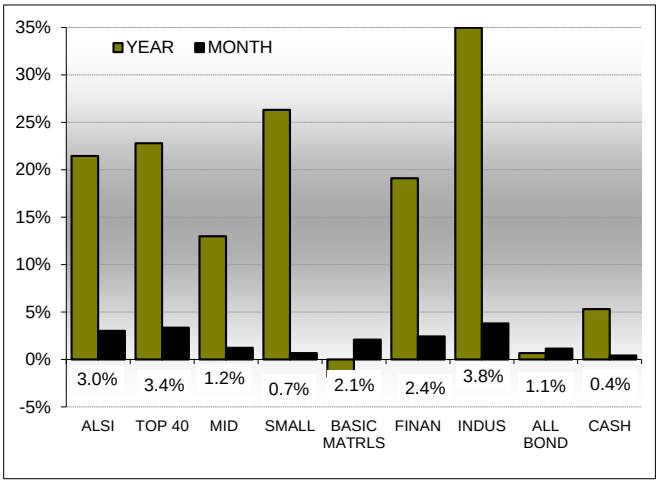
Source: Deutsche Bank

The chart shows that musical investors must be the happiest bunch of them all! No, I'm only joking and as a lover of music it is hard to remain objective. What is interesting is that the returns since 2007 from an investment into gold remain in the upper echelon despite the terrible year gold has just endured (the gold price declined 27.8% in 2013.) On the other hand commodities have not delivered great returns over the period, while those of equities in general and the US and developed markets in particular, are amongst the better performing investments over this period.

December in perspective – local investment markets

Local markets spluttered through the month until the Fed's announcement of QE tapering, after which they gained momentum to end the year on a strong note. Even the basic material index rose, up 2.1%, although that was insufficient to move it into positive territory for 2013. Its annual return was -1.8%, which is better than the gold index's 54.6% decline for the year but nowhere near the industrial index annual return of 35.0%. The large, mid and small cap indices for 2013 were 22.8%, 13.0% and 26.3% respectively. Financials ended the year up 19.1% while the All bond index managed a 0.7% annual return – not dissimilar to the global bond market. 2013 is a year that most bond investors would like to forget.

Chart 9: Local market returns to 31 December 2013



Perhaps the most noteworthy movement on the SA investment landscape was the 19.0% decline in the rand relative to the dollar. It declined 20.5% and 22.5% against sterling and the euro, respectively. Emerging market currencies were weak throughout 2013, particularly countries with large current account deficits, which are collectively referred to these days as the *Fragile Five* or the BIITS, being Brazil, India, Indonesia, Turkey and South Africa. One can't help feeling that South African politicians and policy makers have scored an "own goal" this year though, having contributed much to the negative sentiment surrounding the country. It is unlikely to be any different in the year ahead.

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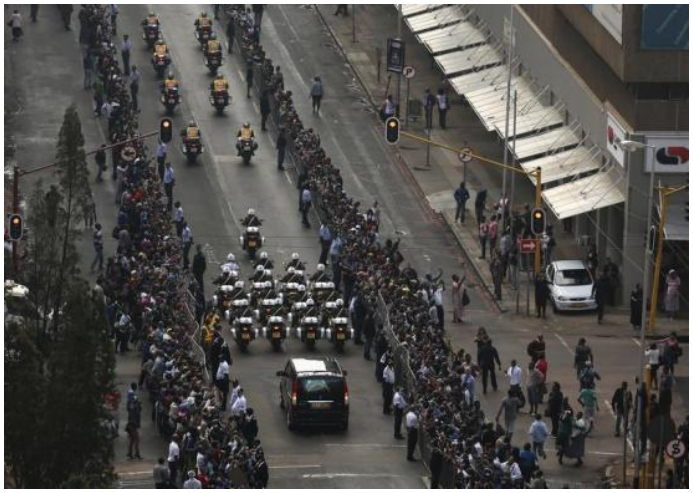
For the record

Table 1 below lists the latest returns of the mutual and retirement funds under Maestro's care. You can find more detail on our website at www.maestroinvestment.co.za. Returns include income and are presented *after* fees have been charged. Fund Summaries for each respective fund listed in the table are available on our website.

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

	Period ended	Month	Year to date	Year
Maestro Equity Prescient Fund	**Dec**	**3.5%**	**23.8%**	**23.8%**
JSE All Share Index	*Dec*	*3.0%*	*21.5%*	*21.5%*
Retirement Funds				
Maestro Growth Fund	**Dec**	**3.3%**	**18.7%**	**18.7%**
Fund Benchmark	*Dec*	*2.4%*	*17.0%*	*17.0%*
Maestro Balanced Fund	**Dec**	**3.0%**	**16.9%**	**16.9%**
Fund Benchmark	*Dec*	*2.2%*	*15.4%*	*15.4%*
Maestro Cautious Fund	**Dec**	**1.9%**	**12.6%**	**12.6%**
Fund Benchmark	*Dec*	*1.4%*	*8.7%*	*8.7%*
Central Park Global Balanced Fund ($)	**Nov**	**1.6%**	**-2.6%**	**-1.3%**
*Benchmark**	*Nov*	*0.7%*	*9.6%*	*10.6%*
*Sector average **	*Nov*	*0.3%*	*7.9%*	*9.3%*

* 40% MSCI World Index, 20% each in Barclays US Aggregate Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills
** Lipper Global Mixed Asset Balanced sector ($)



Reflections of a retired Fed Governor

Whilst catching up with some reading during the Silly Season, I stumbled across an interview that Financial Times journalist Gillian Tett held with former US Federal Reserve Chairman Alan Greenspan in October. During his tenure Greenspan was often regarded as "the most powerful man in the world". It was a particularly candid interview, with Greenspan making some remarkable confessions. I say remarkable because it was not that long ago that he still held office, during which time he convinced the markets and the world of his methods and the reasoning behind his policy action. Yet only a few years later he openly states that he was wrong, made many mistakes and that the models on which he and the Fed based their policies were wrong and have subsequently failed. Wow! One can only begin to imagine what soon-to-be former Fed Chairman Ben Bernanke will be confessing in a few years' time about QE!

With that in mind, and hoping that you have a bit more time than usual to go through a longer-than-usual edition of *Intermezzo*, here are a few extracts from the interview. If you wish to read the whole interview, please email me and I will send it to you. The interview is entitled "Crash course" – not a title which inspires much confidence, is it?

> The task that has kept him so busy is his new book, *The Map and the Territory*, published this month and a successor to an earlier memoir, *The Age of Turbulence*. To the untrained eye, this title might seem baffling. But to Greenspan, the phrase is highly significant. For what his new manuscript essentially does is explain his intellectual journey since 2007. Most notably it shows why he now thinks that the "map" that he (and many others) once used to analyze finance is incomplete – and what this means for anyone wanting to navigate today's economic "territory".
>
> This is not quite the mea culpa that some people who are angry about the credit bubble would like to see. Greenspan is a man who built his career by convincing people that he was correct. Born in New York to a family of east European Jewish ancestry, he trained as an economist and, before he was appointed by Ronald Reagan to run the Fed, was an economic consultant on Wall Street (interspersed with a brief spell working for the Nixon administration).

This background once made him lauded; today it seems more of a liability, at least in the eyes of the political left. "Before 2007 I was embarrassed by the adulation – they made me a rock star," he says. "But I knew then that I was being praised for something I didn't really do. So after, when I got hammered, it kind of balanced out, since I don't think I deserved the criticism either … I am a human so I feel it but not as much as some."

Yet in one respect, at least, Greenspan has had a change of heart: he no longer thinks that classic orthodox economics and mathematical models can explain everything. During the first six decades of his career, he thought – or hoped – that *Homo economicus* was a rational being and that algorithms could forecast behaviour. When he worked on Wall Street he loved creating models and when he subsequently joined the Fed he believed the US central bank was brilliantly good at this. "The Fed model was as advanced as you could possibly get it," he recalls. "All the new concepts with every theoretical advance were embodied in that model – rational expectations, monetarism, all sorts of sophisticated means of thinking about how the economy worked. The Fed has 250 economic PhDs in that division and they are all very smart."

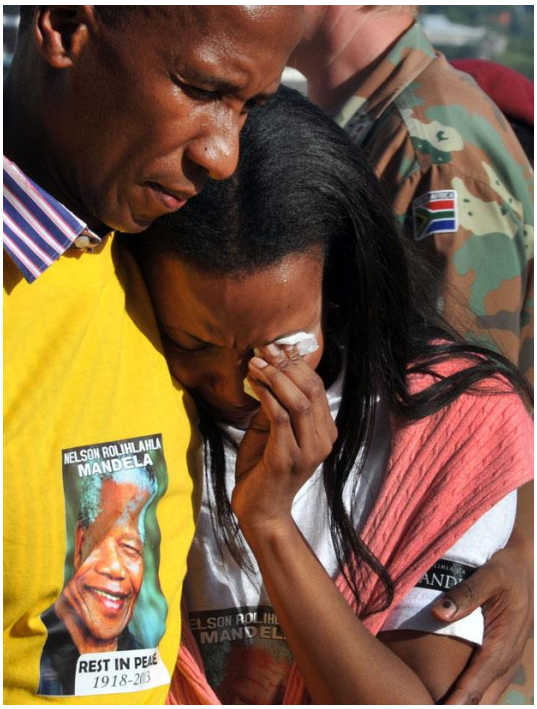
And yet in September 2008, this pride was shattered when those venerated models suddenly stopped working. "The whole period upset my view of how the world worked – the models failed at a time when we needed them most … and the failure was uniform," he recalls, shaking his head. "JPMorgan had the American economy accelerating three days before the collapse of Lehman Brothers – their model failed. The Fed model failed. The IMF model failed. I am sure the Goldman model also missed it too.

"So that left me asking myself what has happened? Are we living in an unreal world which has a model which is supposed to replicate the economy but gets caught out by one of the most extraordinary events in history?" …

… But tact cannot entirely mask Greenspan's deep concern that six years after the leverage-fuelled crisis, there is even more debt in the global financial system and even easier money due to quantitative easing. And later he admits that the Fed faces a "brutal" challenge in finding a smooth exit path. "I have preferences for rates which are significantly above where they are," he observes, admitting that he would "hardly" be tempted to buy long-term bonds at their current rates. "I run my own portfolio and I am not long [i.e. holding] 30-year bonds."

But even if Greenspan is wary of criticizing quantitative easing, he is more articulate about banking. Most notably, he is increasingly alarmed about the monstrous size of the debt-fuelled western money machine. "There is a very tricky problem we don't know how to solve or even talk about, which is an inexorable rise in the ratio of finance and financial insurance as a ratio of gross domestic income," he says. "In the 1940s it was 2 per cent of GDP – now it is up to 8 per cent. But it is a phenomenon not indigenous to the US – it is everywhere.

"You would expect that with the 2008 crisis, the share of finance in the economy would go down – and it did go down for a while. But then it bounced back despite the fact that finance was held in such terrible repute! So you have to ask: why are the non-financial parts of the economy buying these services? Honestly, I don't know the answer."



What also worries Greenspan is that this swelling size has gone hand in hand with rising complexity – and opacity. He now admits that even (or especially) when he was Fed chairman, he struggled to track the development of complex instruments during the credit bubble. "I am not a neophyte – I have been trading derivatives and things and I am a fairly good mathematician," he observes. "But when I was sitting there at the Fed, I would say, 'Does anyone know what is going on?' And the answer was, 'Only in part'. I would ask someone about synthetic derivatives, say, and I would get detailed analysis. But I couldn't tell what was really happening."

This last admission will undoubtedly infuriate critics. Back in 2005 and 2006, Greenspan never acknowledged this uncertainty. On the contrary, he kept insisting that financial innovation was beneficial and fought efforts by other regulators to rein in the more creative credit products emerging from Wall Street. Even today he remains wary of government control; he does not want to impose excessive controls on derivatives, for example.

But what has changed is that he now believes banks should be forced to hold much thicker capital cushions. More surprising, he has come to the conclusion that banks need to be smaller. "I am not in favour of breaking up the banks but if we now have such trouble liquidating them I would very reluctantly say we would be better off breaking up the banks." He also thinks that finance as a whole needs to be cut down in size. "Is it essential that the division of labour [in our economy] requires an ever increasing amount of financial insight? We need to make sure that the services that non-financial services buy are not just ersatz or waste," he observes with a wry chuckle. There is a profound irony here. In some senses, he remains an orthodox pillar of ultraconservative American thought: *The Map and the Territory* rails against fiscal irresponsibility, the swelling social security budget and the entitlement culture. And yet he, like his leftwing critics, now seems utterly disenchanted with Wall Street and the extremities of free-market finance – never mind that he championed them for so many years.

Perhaps this just reflects an 87-year-old man who is trying to make sense of the extreme swings in his reputation. I prefer to think, though, that it reflects a mind that – to his credit – remains profoundly curious, even after suffering this rollercoaster ride. When I say to him that I greatly admire his spirit of inquiry – even though I disagree with some conclusions – he immediately peppers me with questions. "Tell me what you disagree with – please. I really want to hear," he insists, with a smile that creases his craggy face. As someone who never had children, his books now appear to be his real babies; the only other subject which inspires as much passion is when I mention his adored second wife, Andrea Mitchell, the television journalist.

But later, after I have left, it occurs to me that the real key to explaining the ironies and contradictions that hang over Greenspan is that he has – once again – unwittingly become a potent symbol of an age. Back in the days of the "Great Moderation" – the period of reduced economic volatility starting in the 1980s – most policy makers shared his sunny confidence in 20th-century progress. There was a widespread assumption that a mixture of free market capitalism, innovation and globalization had made the world a better place. Indeed, it was this very confidence that laid the seeds of disaster. Today, however, that certainty has crumbled; the modern political and economic ecosystem is marked by a culture of doubt and cynicism. Nobody would dare call Yellen "maestro" today; not when the Fed (and others) are tipping into such uncharted territory. This delivers some benefits: Greenspan himself now admits this pre-2007 confidence was an Achilles heel. "Beware of success in policy," he observes, laughing. "A stable, moderately growing, non-inflationary environment will create a bubble 100 per cent of the time."

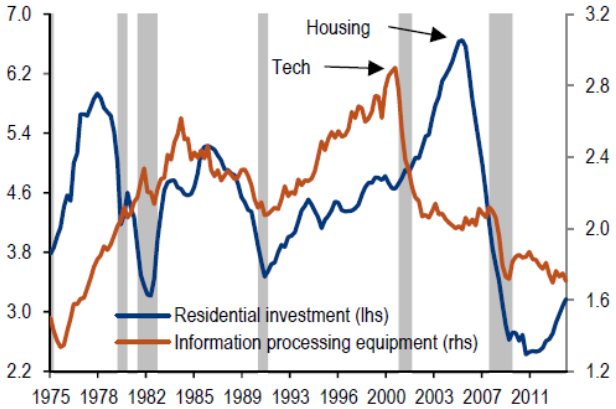
But a world marked by profound uncertainty is also a deeply disconcerting and humbling place. Today there are no easy answers or straightforward heroes or villains, be that among economists, anthropologists or anyone else. Perhaps the biggest moral of *The Map and the Territory* is that in a shifting landscape, we all need to keep challenging our assumptions and prejudices. And not just at the age of 87.

File 13. – Things almost worth remembering

I can't honestly give you a proper reason for including the following chart, other than I found it fascinating. It shows the Housing and Technology sectors expressed as a percentage of nominal US GDP i.e. the size of the US economy. The extent to which they both rose before the notorious market crashes of 2000 and 2007 i.e. the respective tech and housing bubbles are very clear. The shaded areas in the chart represent periods of recession in the US. I found the current levels of these two sectors very interesting; it places the equity market's gains of 2013 into perspective. If there is another bubble brewing (note that that is not Maestro's view), it is certainly not going to emanate from one of these two sectors.

Chart 10: Bubbles: financial and real

(Sectors expressed as a % of nominal US GDP)



Source: Merrill Lynch

Table 2: MSCI returns to 31 December 2013(%)

Region/Country (# Co)	Market cap (U$m)	US$ perf (%) YTD
North America (706)	18,684,468	27.6
Canada (96)	1,310,177	3.3
US (610)	17,374,291	29.9
Europe (433)	8,851,919	21.7
Austria (8)	35,805	10.9
Belgium (11)	157,504	24.6
Denmark (11)	155,627	23.4
Finland (13)	120,977	41.6
France (72)	1,329,958	23.3
Germany (55)	1,258,343	28.2
Ireland (5)	38,251	38.9
Italy (23)	296,141	16.9
Netherlands (23)	361,260	28.5
Norway (10)	107,656	5.3
Portugal (5)	23,333	7.5
Spain (22)	446,081	27.7
Sweden (31)	429,543	21.4
Switzerland (38)	1,181,263	23.8
UK (106)	2,910,177	16.2
Israel (9)	58,946	8.0
Asia Pac (1006)	6,738,892	9.3
Japan (320)	2,773,247	24.9
Australia (69)	987,610	-0.3
New Zealand (5)	15,286	6.2
Asia Pac ex-Japan (686)	3,965,645	0.5
Asia ex-Japan (612)	2,962,748	0.7
China (138)	751,868	0.4
Hong Kong (40)	376,762	8.1
India (71)	240,401	-5.3
Indonesia (30)	83,183	-25.0
Korea (105)	612,527	3.1
Malaysia (43)	146,342	4.2
Philippines (19)	32,828	-4.3
Singapore (30)	194,748	-1.8
Taiwan (107)	442,470	6.6
Thailand (29)	81,618	-16.9
EMEA (139)	679,773	-8.0
Czech Republic (3)	9,258	-14.9
Egypt (4)	7,427	6.2
Greece (10)	17,910	46.2
Hungary (3)	9,653	-9.0
Poland (22)	64,438	-1.7
Russia (22)	232,025	-2.6
South Africa (50)	281,791	-8.8
Turkey (25)	57,270	-28.1
Latin America (143)	725,278	-15.7
Brazil (75)	405,958	-18.7
Chile (21)	59,307	-23.0
Colombia (15)	39,412	-23.7
Mexico (29)	204,632	-2.0
Peru (3)	15,969	-31.0
Developed Markets (1612)	31,942,986	24.1
Emerging Markets (824)	3,796,289	-5.0
World (2436)	35,739,275	20.3

Source: Merrill Lynch

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Investment Letter | 14th Edition | January 2014

"Among Nelson Mandela's many achievements, two stand out. First, he was the world's most inspiring example of fortitude, magnanimity and dignity in the face of oppression, serving more than 27 years in prison for his belief that all men and women are created equal. During the bleak years of his imprisonment on Robben Island, thanks to his own patience, humour and capacity for forgiveness, he seemed freer behind bars than the men who kept him there, locked up as they were in their own self-demeaning prejudices. Indeed, his warders were among those who came to admire him most.

Second, and little short of miraculous, was the way in which he engineered and oversaw South Africa's transformation from a byword for nastiness and narrowness into, at least in intent, a rainbow nation in which people, no matter what their colour, were entitled to be treated with respect…

…It is hard to think of anyone else in the world in recent times with whom every single person, in every corner of the Earth, can somehow identify. He was, quite simply, a wonderful man."

The Economist

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