INTERMEZZO
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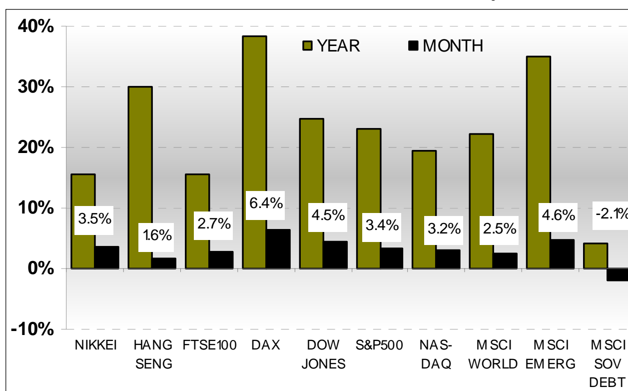
May in perspective – global markets
Global equity markets were strong in May despite a setback in Chinese equity markets late in the month. Month-end had a real sense of *deja vu* about it: on the second last day of February Chinese markets fell 10%, leading the US equity market to its largest daily decline since September 11, 2001. However, the Chinese market went on to post record highs soon thereafter. This time around when the Chinese market declined by a similar amount, again during the last days of the month the US equity market went on to register an all-time record, closing above the previous peak set in March 2000 at the end of the Y2K bubble. US equity markets rose nicely for the second month in a row, but German returns were even better. The Dax ended May 6.4% higher, despite the fact that it rose 7.1% in April.

Chart 1: Global market returns to 31 May 2007



A factor worth pointing out is that exactly a year ago equity markets had a real wobble, induced by concerns that the Chinese economy would stumble. Those market declines established a very low base off which the annual returns to May 2007 are now being measured. A very negative month (May '06) has thus fallen out of the base, and a strong one (May '07) has been added, resulting in some spectacular results. For example, the *annual* return to end-April 2007 for the Japanese equity market (the Nikkei 225) was 2.2%. This "base effect" has resulted in the annual return to end-May 2007 rising to 15.6%. The German data is even more impressive: *annual* returns to end-April were 23.3% but to end-May are 38.5%. The *annual* returns to end-April for the MSCI World and Emerging markets indices were 14.9% and 15.3% respectively, while to end-May are 22.3% and 35.1%. This base effect takes nothing away from the great returns of equity markets, but it does explain why annual returns have gone from mediocre in April to spectacular in May.

A review of some fundamental factors
The past month has seen the release of some important economic data. Let's review some on a selected basis:

The **US economy**, widely recognised as the "sick child" of the global economy, grew at an annualised 0.6% during the first quarter of 2007 (Q1 07), less then half of the first estimate. Although growth is slow, other indicators point to the fact that there are pockets of strength in that economy, so a full-blown recession doesn't look likely – at least not at this stage.

In stark contrast, the **Indian economy** grew at 9.4% during Q1 07, the second fastest rate since 1947. In the past four years, the economy has grown at an annual rate of 8.6%. Inflation declined to 5.3% but this has not stopped the central bank increasing interest rates (by 1.5% this year so far) and reserve requirements for banks in an effort to reign in excessive price rises. The Indian equity market rose 4.8% during May (the annual increase was 39.9%) after having posted a 6.1% gain in April.

The **Chinese economy** grew 11.1% in Q1 07 and inflation declined to 3.0% in April from 3.3% in March. Its trade surplus rose from $6.9bn in March to a huge $16.9bn in April. Retail sales are growing at an annual rate of 15.5% and industrial production at 17.4%.

As a matter of interest, the **Polish economy** grew at 7.4% on the back of rising domestic demand and record private consumption (does that sound familiar to South Africans?).

The **SA economy** grew at 4.7% in Q1 07 from 5.4% in Q4 06. The contraction of 7.8% in mining was offset by the 21.3% surge in construction spending as the economy gears up ahead of the 2010 Soccer World Cup (see photo below). Incidentally construction spending comprises only 3.1% of GDP, but has a lot of spin-offs, particularly in the area of labour. Construction spending has been growing at double digit rates since 2004 with government alone having already committed itself to R416bn on infrastructural spending. The disappointing news came in the form of higher than expected inflation data; headline inflation rose to 7.0% in April from 6.1% in March, with transport and food costs being the main culprits. Despite the fact that Maestro's view is that this is a supply-side problem (and not a function of excess consumption) and should not be met with higher interest rates, we concede the inevitable - the SA Reserve Bank will raise rates at its next meeting in a few day's time.

Chart of the month
There is nothing special about this month's chart; it shows US inflation excluding food, energy and housing over the past thirty years. Yet if you had to ask me for one chart that more than any other encapsulates reasons for the current market activity, I would put forward this chart. The impact

of the decline in US and for that matter global inflation has been long lasting and profound. Another chart that would qualify in terms of importance and impact is a chart of the yield (interest rate) on the US long bond; the two charts are "tied at the hip". As a consequence of the structural decline in inflation over this period interest rates have declined substantially, thereby creating an environment for strong corporate earnings, a major re-rating of equity markets and more recently an unprecedented wave of M&A and private equity deals. It gave birth to the multi-year equity bull market that has been in place since 1983. It launched the greatest consumer binge (that is still ongoing but to a lesser extent) by US consumers, and more recently being emulated in emerging markets. True, there is renewed concern about inflation in some economies, but it should be seen in perspective. Concern in the US or EU about inflation revolves around whether the rate will rise above 2.5% or 3.0%. Let's face it; it would be different if the concern was about a *10% rate,* as in 1980. There are greater problems than the current inflationary one in the economic lexicon! To put it in perspective, here's some food for thought from David Rosenberg, Merrill Lynch's North American economist: "If we had told you six years ago that the price of oil would triple, the CRB (commodity index) would nearly double, copper would surge six-fold, corn would jump over 100% … would you have predicted that by April 2007 the headline (US) inflation rate (which includes food and energy, by the way) would be 2.6% year-over-year? … You can't make this stuff up."

Chart 2: Core US inflation excluding housing (%)
At 1.2% year-on-year – a two and a half year low

Source: Merrill Lynch

Update on Chinese equity market

For many months now we have drawn your attention to the bubble that has developed in the Chinese equity market, and the risks that it holds for global equity investors. In [last month's Intermezzo] we discussed it in some length. This month we will bring you only an update. More attention is now being focussed on this phenomenon than ever before, ranging from the mass media to the Chinese authorities, who during the month took a number of significant steps to rein in the market momentum, with surprisingly little success. Stamp duty payable on share transactions was tripled and at the time of writing there were rumours of the imposition of capital gains tax. The market declined 6.7% on the day stamp duties were raised but the Shanghai A index still rose 9.1% on the month, bringing its annual gains to 150% and those for the year-to-date to 53.1%. It is likely that the authorities will continue to implement measures to stem the speculation on that market, although it remains to be seen what effect they will have. Unsurprisingly, local investors and commentators seem relatively unperturbed by the risks the equity bubble hold, but we still regard a significant – and let's define that as a 15% to 20% decline in prices – decline in the Chinese equity market as a risk to global market stability. We are less concerned that a collapse in the Chinese equity markets will be detrimental to the health of the Chinese economy. That seems to be the view other investors are also taking, given the way markets behaved towards the end of May; when the Chinese markets dropped sharply other global markets, even Hong Kong, seemed to shrug off the event as a "local" problem.

Photo 1: The old making way for the new

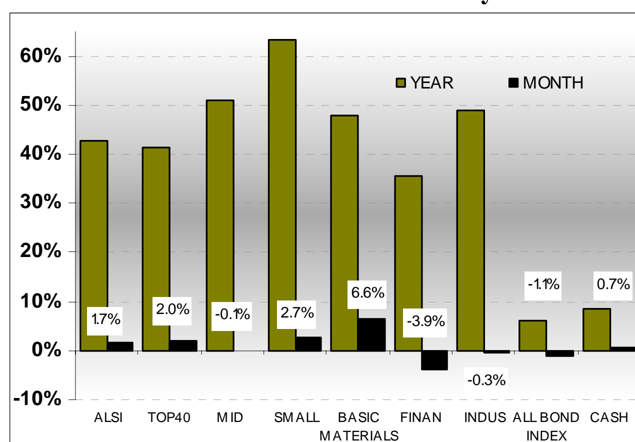
The clock is ticking

A number of *Intermezzo* readers are based offshore yet many take a keen interest in developments in South Africa. As locals know, preparations for the 2010 Fifa Soccer World Cup Final are taking on increasing importance, and are becoming all the more evident, be it in the form of great equity market returns, increasing costs of living and doing business in SA, being stuck in traffic jams or frustrated by the lack of capacity at airports. In an attempt to share some of the excitement with those who are not regular visitors to our beautiful country and to keep them informed about these developments, we want to share some photos with you on a periodic basis. The photo this month is of the Greenpoint precinct in Cape Town, venue for one of the 2010 semi-

finals. The new stadium is being built on the golf course just next to Granger Bay, close to the V&A Waterfront. The change will be obvious to some of you (note the old stadium in the foreground, left, being demolished to make way for the new stadium) but I will take photos at future intervals, so that you can monitor the progress over time.

May in perspective – local markets
SA equity markets turned in a mixed performance. The month started off well but become rather volatile as the month progressed. Strong commodity prices and a weaker rand – the rand declined 1.1% against the dollar - boosted the basic materials index, which rose 6.6%. News of a higher than expected inflation rate undermined financial and industrial shares, though, with the latter indices ending 3.9% and 0.3% lower respectively. These moves should be seen in the context of those which prevailed last month: during April the basic materials index declined 0.2%, while the financial and industrial indices both rose 6.4%. The gold index declined 6.7% on the month and the banks index ended 6.5% lower. The base effect of last year's China-induced market wobbles had an equally impressive effect on the SA indices, with the annual returns from all indices now nothing short of stellar, despite being more than four years into the bull market. And while equity returns increase, those from the bond market decrease while cash returns remain pedestrian.

Chart 3: Local market returns to 31 May 2007



The Maestro Long Short Equity Fund
As some of you are aware Maestro is in the process of preparing to launch a hedge fund, the Maestro Long Short Equity Fund. So far our plans are on track to launch the Fund at the end of June. I was hoping to include with this edition a document introducing the Fund more fully, but there are still a couple of outstanding aspects that preclude me from completing such a document. We will make an announcement in more detail next month, but for now I would like to answer the question: why start a hedge fund?

As investment markets and investors alike have become increasingly sophisticated, so too have Maestro's investment skills and abilities. We are now confident that Maestro can offer more than just the opportunity to generate returns from *rising* markets. The Maestro Long Short Equity Fund is the next logical step in Maestro's development, affording us the ideal opportunity to extend our skill set for our clients' benefit.

The three-year compound *annual* return of the All Share index to 31 March 2007 was 40.4%. The four-year return was 41.3%! As rewarding as this has been, we have been around long enough – as have many of you – to know that these rates of return are unsustainable. Hedge funds by their very nature allow investment managers to use certain financial instruments to protect client funds in times of market volatility and uncertainty. For some time now Maestro has wanted to put an investment vehicle in place to facilitate investors concerned about a possible downturn in the equity market. The Maestro Long Short Equity Fund provides just such an opportunity. It is a vehicle wherein we can reap the economies of scale and efficiencies in deal execution required for an actively traded portfolio geared to generate returns irrespective of market direction.

The Fund will also allow Maestro to make its investment skills available to a wider audience. The Fund will be open to individuals who may have fallen below our R10m investment threshold, as well as to institutions and offshore investors.

Finally and very importantly, Maestro has always had a desire to invest some of the benefits of its skills and rewards back into the community. Until now, we have struggled to reconcile the demands of establishing a business from scratch with serving the broader community in a meaningful way. The creation of the Maestro Long Short Equity Fund provides the opportunity to put this long-held desire into practice. Details in this regard are still being finalized but our plan is to direct a *significant* portion of Maestro's performance fees on the Fund towards a vehicle (such as a charitable trust) that will direct funds back into the community. Private equity and hedge fund managers that operate abroad are known for their charity and philanthropy and we see no reason why the SA community should not be similar. We hope to be able to use the success of the Maestro Long Short Equity Fund, which will benefit both Maestro and its clients, to also benefit those less fortunate than we are and to set a precedent for others to follow our lead in this regard.

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For the record

Table 1 lists the latest returns of the mutual funds under Maestro's care. You can find more detail, including the latest Maestro Equity Fund Summary, by visiting our website at www.maestroinvestment.co.za.

Table 1: Returns of funds under Maestro's care

	Month	Return	Year to date
Maestro Equity Fund	May	**-0.1%**	**15.7%**
Maestro equity benchmark *		-0.0%	12.4%
JSE All Share Index		1.7%	16.2%
Central Park Global Balanced Fund ($)	Apr	**2.5%**	**5.1%**
Benchmark**		2.4%	4.4%

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, and 20% each in MSCI Sovereign Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills

File 13: Interesting information, but worth forgetting

For the benefit of new readers "File 13" is a section wherein interesting facts or knowledge are highlighted which, once assimilated, can be relegated to File 13 i.e. the mental dust bin. They are less relevant – at least to some readers - and are listed purely for interest purposes or often just for a good laugh.

For many years now we have periodically drawn readers' attention to Exchange Traded Funds (ETF) as a relatively cost effective and easy way to gain access to certain markets or market sectors. ETFs have grown increasingly popular and are used around the world by investment managers, including Maestro, to gain **broad** access to markets where the specific knowledge to "**stock pick**" the best companies in that market may not exist. Research by Morgan Stanley recently shed light on just how large this sector has become. Worldwide daily trading volumes in ETFs were up by more than 70%, to $42.7bn in the first quarter of 2007. Some 115 new ETFs were launched in this period. The number of US-listed ETFs giving access to foreign stock markets grew at more than twice the rate of those focused on the domestic market, showing just how these products are being used by investors to gain general market, or "beta" exposure. Morgan Stanley believes that 543 new ETFs will be launched globally this year, adding to the 847 already in existence. They also predict that global ETF assets will reach $2 000bn by 2011 from the current $604.2bn. In South Africa, there are nine ETFs listed on the JSE worth a combined R10.9bn. The largest one is the Satrix40, which emulates the JSE Top 40 index, who constituents comprise the 40 largest companies on the JSE. The Satrix40's market cap is R5bn. The second and third largest SA ETFs are the Newgold ETF at R1.9bn and the Satrix FINI (Financial and industrial) at R1.0bn. Those interested in learning more about Satrix can visit their website at www.satrix.co.za.

Although this edition of *Intermezzo* is already long an extra table will not make a huge difference, so I list below the MSCI Emerging Market returns for May as well as the year-to-date, measured in dollars. Remember that the MSCI compile their own indices, which have specific underlying companies as their constituents; they compile the indices in local currency and dollar terms. This means that the MSCI index returns will not always correspond with the relevant local index.

Take some time to go through the returns in Table 2. They tell an amazing story, not only for the past month and year, but also for 2006, which returns are included. We are indeed witnessing a structural re-rating of emerging markets *par excellence,* one thought inconceivable just a decade ago. Those interested in learning more about the MSCI indices can visit their website at www.mscibarra.com.

Table 2: MSCI Emerging Market dollar returns (%)

	May	YTD	2006
Brazil	11.6	24.3	40.5
Mexico	10.9	19.4	39.0
Philippines	10.6	23.2	55.4
LatAm	**10.1**	**22.1**	**39.3**
South Korea	8.2	16.1	11.2
Colombia	8.0	5.6	10.9
Argentina	7.4	7.8	66.1
Turkey	7.0	28.3	-9.2
India	6.9	15.4	49.0
China	6.7	7.9	78.1
Asia	**6.3**	**10.9**	**29.8**
Thailand	6.1	13.7	6.8
Peru	5.8	49.6	52.1
MSCI EM	**4.6**	**11.2**	**29.2**
Indonesia	4.4	10.7	69.6
Taiwan	3.9	0.4	16.3
Israel	3.3	20.9	-7.1
Malaysia	3.2	29.2	33.1
Hungary	1.7	9.3	31.1
Chile	1.2	20.0	26.4
Czech Rep	0.8	16.0	29.6
Poland	-0.7	15.0	35.3
EMEA	**-2.4**	**4.1**	**21.3**
South Africa	-3.3	10.6	17.3
Russia	-7.2	-11.5	53.7

Source: Merrill Lynch, MSCI

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