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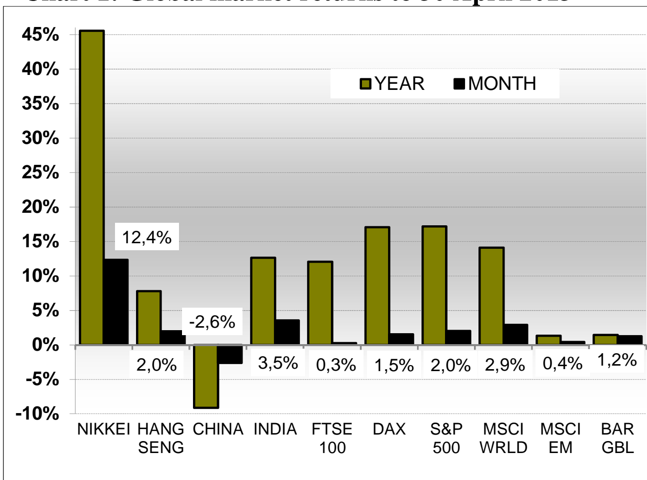
Investment Letter | 13th Edition | May 2013

April in perspective – global markets

Global equity markets continue to defy investor expectations with regard to their returns and lack of volatility. A gap has been "developing" between *developed* and *developing* (emerging) equity markets. The dichotomy between the two continued in April: the MSCI World index rose 2.9% while the Emerging market index rose only 0.4%. So far this year the respective returns have been 10.3% and -1.5% while in the past year the indices have risen 14.1% and 1.3%; the trend is obvious. The Japanese equity market rose 12.4% in April, bringing its annual and year-to-date returns to 45.6% and 33.3% respectively, all thanks to massive monetary policy stimulus and a concerted effort by the Bank of Japan to trash the yen. The US and German markets rose 2.0% and 1.5% respectively while within the BRIC universe Russia fell 3.3% and China 2.6% (it has declined 9.1% during the past year). Brazil fell 0.8% although India rose 3.6%. The JSE All share index fell 0.4% in dollar terms.

Chart 1: Global market returns to 30 April 2013



The dollar was weak during April, losing 2.6% and 2.4% to the euro and sterling respectively. Its weakness was insufficient to stop a sell-off in commodity prices: silver fell 14.7%, palladium 9.2%, gold 8.1%, oil 7.0% and platinum 4.4%. Base metals reflected similar declines as investors began pricing in the effects of slower global growth.

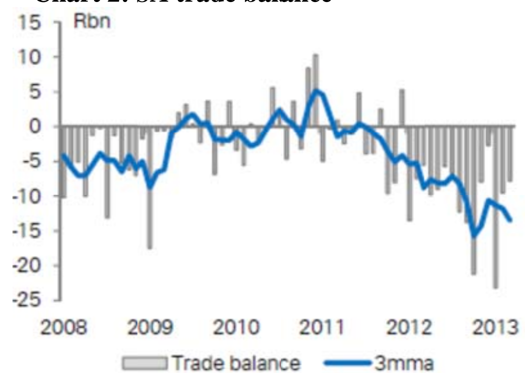
The dichotomy between developed and developing markets doesn't extent to the bond markets. Fuelled by the search for yield and certainty, bond market prices continue to reach new peaks and yields plummet to new lows. The Barclays Capital Aggregate Global Bond index rose 1.2%, although that is not a true indication of how strong capital markets are at present, particularly amongst high yield (a cute phrase for what used to be call "junk bonds") and investment grade corporate bonds.

What's on our radar screen?

Here are a couple of items we are keeping a close eye on:

- *The SA economy:* March **inflation** came in at 5.9%, lower than expected, while core inflation i.e. inflation excluding food and energy prices, declined from 5.3% in February to 5.1% in March. Of note were the monthly increases in education and transport of 9.0% and 2.7% respectively. Food prices declined 0.1% month-on-month, which meant that the annual increase in food prices fell below 6.0% for the first time since August last year. Annual food price increases declined from 6.2% in February to 5.9% in March. The March **trade deficit** improved from R9.5bn to R7.5bn. Although exports rose less than expected, imports were even weaker, falling for the second consecutive month. You may recall that the shocking January deficit was the catalyst for the rand weakening sharply, showing just how important this economic phenomenon is and how closely it is watched, particularly by foreign investors. Chart 2 depicts the recent history of the SA trade deficit. Although the improvement in March is obvious, as is the terrible January number, the broad trend, shown by the solid blue line depicting the 3-month average, is clearly still down i.e. the deficit is not showing any real signs of an improvement. One could rightly think of the trade deficit as one of SA's Achilles' heel. The slowing economy is likely to curb imports further, leading most analysts to predict a slight improvement in the current account deficit for 2013, to around 5.0% of GDP from 6.3% in 2012.

Chart 2: SA trade balance



Source: Deutsche Bank

One last note on the SA economy; its first quarter **unemployment rate** was listed as 25.2%, up from 24.9% in the previous quarter. You can compare that with other rates, listed below.

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- *The US economy:* the first estimate of US economic growth during the March quarter (Q1) was 2.5%, below the expected 3.0% but well above the December's (Q4) 0.4%. Growth was pulled lower by a decline in defence spending although personal consumption rose 1.9% versus 1.5% in Q4. The first estimate of growth is usually revised significantly in subsequent months, so it needs to be treated with some caution. Of the 2.5% Q1growth, 1.6% came from private investment and 2.2% from personal consumption. Net exports took 0.5% away and the decline in government consumption another 0.8%, leaving net growth at 2.5%.
- *Developed economies:* Inflation in the **Eurozone** declined from 1.7% in March to 1.2% in April, versus 2.6% a year ago. Unemployment increased to 12.1% across the region, from 12.0% a month ago and 11.0|% a year ago. There are some frightening unemployment facts emanating from Europe: the Portuguese rate of unemployment is 17.5%, in Spain it is 26.7% while Greece's is 27.2%. On the other side of the continuum, Luxembourg, Germany and Austria have the lowest unemployment rates of 5.7%, 5.4% and 4.7% respectively. Unemployment rates for under-25s are 7.6% in Germany and Austria, Netherlands 10.5%, Portugal 38.3%, Italy 38.4%, Spain 55.9% and Greece 59.1%! One wonders what exactly young people in these countries think of their future? On a slightly different note, the growth rates of some European countries were released; they made for sad reading. **Spain's** economy shrank 0.5% during the first quarter of 2013, its seventh consecutive quarter of declining growth. Over the past year it has shrunk by 2.0%. Spain also recently announced that its budget deficit would no longer be 4.5% of GDP but 6.3%, more than double the EU limit of 3.0%. The **UK** economy only just managed to stay out of a "triple dip" recession, with its economy growing a mere 0.3% in Q1.
- *Emerging market economies:* The Chinese economy grew 7.7% in the first quarter of 2013 (Q1), down from 7.9% in Q4 and below market expectations of 8.0%. The annual increase in retail sales was 12.6%, in fixed asset investment 20.9% and industrial production 9.5% - all weaker than expected.

Global chart of the month

We are living in unprecedented times. The astonishing strength of financial assets at a time of economic weakness, across the globe, is best explained by the quantum of monetary policy intervention. There have been over 500 interest rate cuts in the past six years, coupled with the purchases of financial assets by the Federal Reserve (Fed), European Central Bank (ECB) and the Bank of Japan (BoJ), which will equate to approximately 30% to 60% of their gross domestic product by the end of 2014. To put this action into perspective it is worth considering that almost $20 trillion of global government bond market capital now trades below the 1.0% rate of interest.

In addition to the dramatic easing of monetary policy, three primary factors continue to support asset prices, in particular stocks. Firstly, the neutralization of the bond vigilantes, secondly, the fact that quantitative easing policies are no longer causing commodity prices to rise and finally the cost of money has now been cheap for a very long time. Inflation fears have continued to plague markets, however we believe that excess capacity in the system and the falling of commodity prices diminishes any fears that the liquidity party will end anytime soon. This will continue to provide a strong tail wind for equity markets over the medium term.

Chart 3: US corporate cash balances

Liquid assets as a percentage of GDP

Source: Merrill Lynch

Despite the Fed's policies there is little evidence that the corporate sector has acted irresponsibly or taken on too much risk. The stockpiling of cash is not a new post-recession trend as you can see from Chart 3, it has been occurring for the past two decades. Businesses have been able to realize productivity gains through surplus labour and lean holdings in inventory. Corporate entities like certainty; until governments can give business some security, they will continue to hoard cash and not expand their operations. While this may increase the appeal of well-capitalized companies, it still remains the Achilles heel for economic growth.

A few quotes to chew on

The Great Degeneration

Niall Fergusson's new book *The Great Degeneration* deals with many of the long-term themes that are uppermost on our minds. It is an easy to read, fascinating assessment of our times and the future that is embedded in them. Here is a

teaser: “Representative government, the free market, the rule of law and civil society: these were the four pillars of Western societies, which set the West on the path to global dominance after around 1500. In our time, however, these institutions have deteriorated. Our democracies have broken the contract between the generations by heaping IOUs on our children and grandchildren. Our markets are increasingly distorted by over-complex regulations that are in fact the disease of which they purport to be the cure. The rule of law has metamorphosed into the rule of lawyers. And civil society has degenerated into uncivil society, where we lazily expect all our problems to be solved by the state.”

Afro-pic 1: Hoopoe feeding its young

Source: National Geographic Photo of the Day

Gold – a store of value? Really?
Although it has recovered marginally, April was another tough month for the physical price of gold. We thought you would find the following comment informative. It is taken from the 13 April edition of “The early morning Reid” by *Jim Reid, Deutsche Bank market commentator and economic historian*. “Markets were already having a difficult day prior to the Boston explosions with Gold in crash territory (more below). The S&P 500 was already down 1.4% prior to the explosions but closed -2.3% as the magnitude of the events became clear. The big move of the day was the one that saw the Gold market crash as it fell 9.1% to $1348/oz. This is the 5th largest daily fall since the US suspended the convertibility of the Dollar into Gold in 1971, the point which heralded the move from a Gold based global monetary system to a Fiat based one. It was also the largest single daily fall since the 28th of February 1983. Over the last two sessions, gold has fallen 13.7% which also makes it also the 5th largest two-day fall since Bloomberg records began in 1920.

Chart 4: The recent history of the gold price ($)

So what's been behind the price move in gold? There has been a lot of talk that the technicals had been skewed in the lead-up to last Friday. Newswires suggest that a number of large gold investors have been forced to unwind following the triggering of stops in the $1400-1500/oz range and that several brokers who were caught long have been forced sellers in the last couple of sessions. The Wall Street Journal reported that more than $1bn flowed out of the physical gold ETF, SPDR Gold Trust, on Friday marking the third-largest outflow on record since the fund's inception in 2004. The SPDR Gold Trust shed nearly 4% or $2.3bn of its assets last week, ending Friday with roughly $57 billion. Trading volume in the SPDR Gold Trust on Monday was running more than seven times the average and was the heaviest on record, topping the previous high set in December 2009. On the macro side, there has been talk of lower Chinese retail demand amid the recent slowdown in domestic growth and the more benign inflation trends seen recently in China. Last week's report that Cyprus may sell part of its gold reserves to raise an estimated €400m for its bailout has also fuelled suggestions that other indebted countries may follow suit. Our commodity strategists write that fundamentally the economic indicators are disappointing in the US and the Fed is cooling on its QE stance - reducing demand for the gold as a hedge. They also note that with marginal industry costs for the gold mining industry at around the USD1,300/oz - the market could see some support around that level if this situation worsens.”

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Local chart of the month
South Africa has so much potential. However, we continue to be strangled by high unemployment, low basic levels of education and a government that is unable to execute on delivery. What seems to have been the solution up to this point in time are an *expanding public sector* and an *explosion in social grants*. Although this may keep the general public happy for the time being, it is simply unsustainable.

Chart 5: Social grants

Source: National Treasure Budget Review 2013

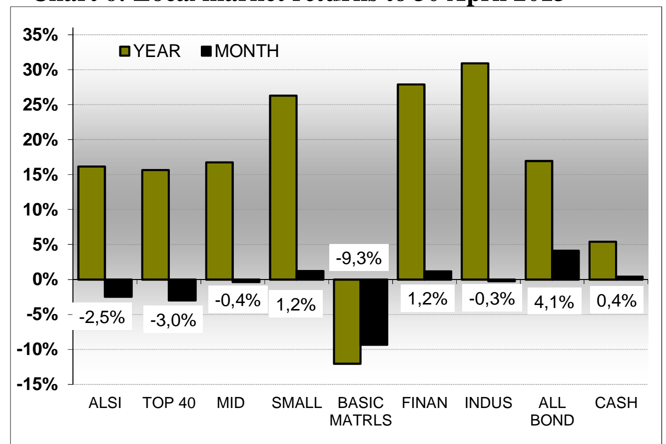
Between 2008 and 2012, government compensation increased by 78.0% compared with an increase in inflation of 32.1%. The number of social grant recipients has increased by 5.3% p.a. over the past four fiscal years to 16.1m people in March 2013. The rate of increase is forecasted to moderate to 2.2% p.a. over the medium term to 17.3m people. What adds even more pressure on the system is that the average annual increase in social grants, in current prices, was 10.9% over the past few years. These increases slow to 7.6% p.a. over the medium term, but still remain above the official inflation rate.

It is disheartening when a globally respected statesman such as Trevor Manual is shot down in the media for voicing his concerns about government's inability to grow the country's economy by job and business creation. As far as we can see, he doesn't have a hidden agenda, only one that tries to help promote South Africa's best interests.

April in perspective – local investment markets
The SA equity market is largely being left out of the (developed world) equity market bull run. However, the reality is far worse: the mining sector – and the mining industry for that matter - is under enormous pressure with little prospect of improvement in sight. That much is evident from the 9.3% decline in the basic material index during April. That sector is now down 16.0% for the year-to-date and down 12.1% during the past year. Compare that to the respective monthly returns of the financial and industrial indices of 1.2% and -0.3%, and the annual returns of 27.9% and 31.0%. One could hardly imagine two more opposing worlds. A large part of the return of the latter two indices is the result of companies such as SABMiller, Richemont, BAT and Old Mutual, all of which are enjoying the bull run in developed markets by virtue of their primary offshore listings. During April, the best performing sectors were real estate investment and services, which rose 8.5%, travel and leisure 6.4% and real estate investment trusts 5.3%. The worst performing sectors were gold mining, which fell 19.3%, fixed line telecoms 14.7% and coal mining 13.2%.

A quick comment on returns across market cap (size): April returns from US large, mid and small cap indices were 2.0%, 0.6% and -0.3% while in South Africa the respective returns were -3.0%, -0.4% and 1.2%. The annual returns make for interesting reading: in the US, annual returns for the large, mid and small cap indices are 12.9%, 13.7% and 13.3% while in SA they are -0.8% (large caps are being dragged lower by mining shares in that index), 2.4% (mid cap returns were stunted in the first quarter of 2013 by the sharp setback in retailers and by mid cap miners) and 9.4%.

Chart 6: Local market returns to 30 April 2013



Another asset class being pulled higher by the trend in global markets is the SA bond market. It rose 4.1% in April, its largest monthly gain since July 2010. Its year-to-date return is 5.1% and its annual return to end-April is 16.9%, higher than the 16.1% All share index return.

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For the record

Table 1 below lists the latest returns of the unitised 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](http://www.maestroinvestment.co.za).

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

	Period ended	Month	Year to date	Year
Maestro Equity Prescient Fund	**Apr**	**-0.9%**	**-0.6%**	**9.6%**
JSE All Share Index	*Apr*	*-2.5%*	*-0.1%*	*16.1%*
Retirement Funds				
Maestro Growth Fund	**Apr**	**-0.4%**	**0.9%**	**10.6%**
Fund Benchmark	*Apr*	*-0.7%*	*2.3%*	*16.2%*
Maestro Balanced Fund	**Apr**	**-0.3%**	**1.2%**	**10.3%**
Fund Benchmark	*Apr*	*-0.4%*	*2.4%*	*15.1%*
Maestro Cautious Fund	**Apr**	**1.6%**	**2.4%**	**11.1%**
Fund Benchmark	*Apr*	*0.6%*	*2.2%*	*12.1%*
Central Park Global Balanced Fund ($)	**Mar**	**-0.9%**	**-1.9%**	**-0.7%**
*Benchmark**	*Mar*	*1.1%*	*3.2%*	*5.6%*
*Sector average ***	*Mar*	*0.8%*	*2.8%*	*3.4%*

* 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 ($)

Freak markets – chapter 1

During the past year or so we have often alluded to the prevailing market conditions as unusual or abnormal. Some of you might wonder why, so we are starting a short series to explain why we view the current market conditions as anything by normal. We will also draw your attention to some events which prove that current market conditions are not normal and are currently being distorted by a number of factors. We begin by taking a look at recent corporate activity by Apple, the US tech giant.

We have frequently drawn your attention to Apple's large and growing cash piles. You will recall that we hold the share in Central Park Global Balanced Fund and will therefore also know that the share performed dismally in the past year. Since its peak of $702 it declined some 44.4% to a level of $392. That represents a decline of about $290bn in market capitalization (size). To give you some idea of how much that is, that is the equivalent size of the 30th largest country in the world, or somewhere between the size of Greece and Venezuela (SA's economy is around $408bn in size, or 27th on the World Bank's latest [2011] ranking). As they say in the classics, a great company doesn't necessarily make a great investment. At the time of writing Apple has recovered to $457.

Chart 7: Five-year history of Apple ($)

Source: FT.com

Be that as it may, by most estimates Apple will end this year with a cash pile of around $175bn - that's R1.6 trillion at the prevailing rand exchange rate or just less than the *combined* market caps (sizes) of SABMiller, Billiton and Richemont! And that's just their cash balance – not the size of the whole company. So, as the Financial Times put it so eloquently after the release of Apple's recent results, "what do you do when you have $145bn of idle cash and your shareholders want a bite? Paradoxically, you borrow money." As part of its plan to return about $100bn of its capital to shareholders, Apple has raised debt to finance some of this repayment.

The counter-intuitive action of raising debt (presumably from some investors who are already Apple shareholders) to return capital to shareholders (at least some of whom would have provided the debt finance) is yet another quirk of the prevailing markets, which have seen the cost of debt drop to its lowest levels in living memory, thanks to the trillions of dollars that central banks are pouring into the global economy. So while the Apple share price languishes at low levels (implying that something is wrong with the company), the very same company is raising debt at record low levels of interest rates (implying that there is nothing wrong with the company's ability to repay that debt). No wonder we often refer to the prevailing market conditions as abnormal! Finally, Apple is absolutely right in raising debt to repay capital to shareholders. If you do the maths, based on the price at which the debt was raised, it makes absolute financial sense for Apple to pursue this route, rather than simply use their existing cash holdings to pay shareholders. Speaking of which, of their huge cash balances, only $45bn is located in the US. The rest lies in other parts of the world. To repatriate this cash to the US would see Apple incur huge additional taxes, which further explains why raising debt from some shareholders to repay the same or other shareholders, makes sense. We live in a strange world! What you see is not necessarily what you get in the world of finance these days. Freak markets, to say the least.

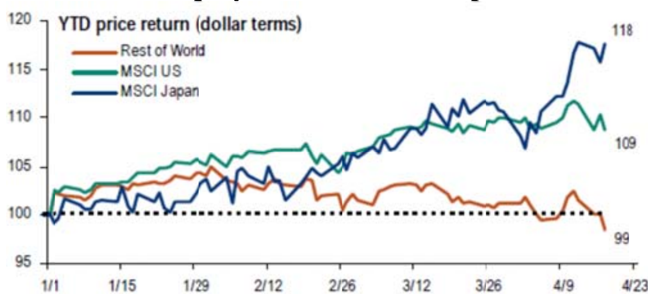
Afro-pic 2: A hungry African kitty arriving for lunch

File 13: Information that is almost worth remembering

Chinese internet market

In a recent Chinese online shopping report, it came to light that there were now some 565m internet users in that country, of which 42.9% or 242m regard themselves as online shoppers. China's online shopping gross merchandise value totals some RMB1.26 trillion ($205bn), which represents an annual increase of some 66.5%. Some 55.4m users use their mobile phones to effect purchases.

Chart 8: Global equity returns: US and Japan and the rest



Source: Merrill Lynch

US, Japan and the rest of the world

I came across this chart, which thought neatly captured the difference in returns between the US and Japanese equity markets (remember MSCI index returns are all in dollars – the actual Japanese equity market is up 33.3% so far this year) and those of the rest of the world. The chart was drawn on 18 April. It is very clear to see that in dollar terms only the US and Japanese equity markets have registered positive returns – the rest of the world's equity markets have delivered negative returns so far. While on this topic, the SA equity market has also delivered negative returns so far this year. Between 31 December and 30 April 2013 the All share index is down 0.1% in rand terms and down 5.6% in dollar terms. The MSCI SA index has declined 10.3% over this period – remember that the constituents of the MSCI and All share index indices are different, hence the different dollar returns.

So what's with the pics?

Victor's inspiring article on Africa last month gave us reason to include photographs of Africa and its animals. We received a lot of favourable response to them - I only hope you felt the same way about *Intermezzo's* content☺ ? Due to space constraints, not all the photos were included, so this month I have included those we left out last month. As usual, they were obtained from National Geographic.

Table 2: MSCI returns to 30 April 2013(%)

	YTD	MTD
ACWI	8.7	2.6
DM	10.3	2.9
Asia Pacific	16.2	6.8
Australia	12.8	4.6
Hong Kong	5.6	2.4
Japan	20.4	8.7
New Zealand	14.9	6.4
Singapore	5.6	2.7
GEM	-1.5	0.4
EM Asia	-0.3	1.4
China	-3.5	1.1
India	1.3	4.2
Indonesia	15.2	1.8
Korea	-6.4	-2.5
Malaysia	2.7	4.1
Philippines	20.7	2.4
Taiwan	3.8	4.0
Thailand	11.9	2.3
EMEA	-6.7	-0.9
Czech	-15.3	-1.4
Egypt	-12.8	-2.1
Hungary	1.5	8.7
Morocco	0.8	3.8
Poland	-11.0	0.6
Russia	-5.8	-2.6
South Africa	-10.3	-0.7
Turkey	9.1	0.9
LATAM	-0.6	-1.1
Brazil	-0.5	0.8
Chile	0.5	-3.4
Colombia	-11.9	-5.5
Mexico	3.5	-2.3
Peru	-15.2	-12.8

Source: Merrill Lynch

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