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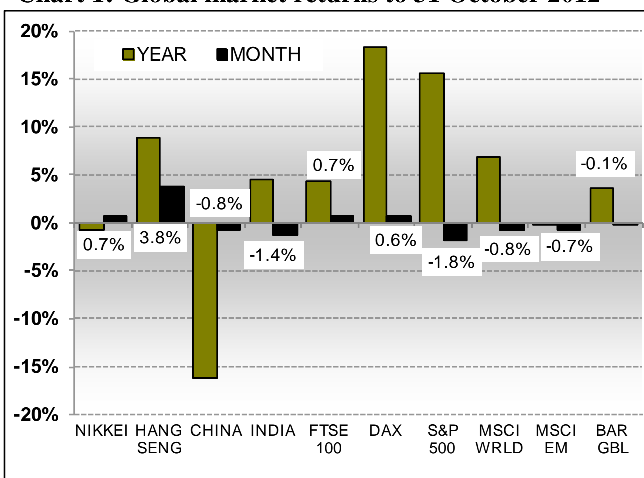
Investment Letter | 12th Edition | November 2012

October in perspective – global markets

Markets struggled to find momentum in October, having rallied strongly since the monetary stimulus news from global central banks the month before. A Spanish request for a bailout, which the markets continue to await eagerly, did not materialise, resulting in yet another downgrade to their sovereign rating. The third quarter reporting seasons got off to the weakest start in three years and there were mixed results on the global economic growth front. The net effect was broadly weaker global equity markets. On the face of it emerging markets performed in line with developed markets - the MSCI Emerging market index declined 0.7% compared with the MSCI World index's decline of 0.8%. If we look a bit closer at individual market performances we see more of a divergence. The lacklustre earnings reports out of the US played a part in that equity market falling 1.8%, its first negative month since May. The disappointing earnings from the major tech companies led to the NASDAQ down 4.5%. Markets performed better in Europe with the UK and Germany rising 0.7% and 0.6% respectively. Gains in the peripheral European markets were impressive with Greek equities leading the charge, rising 8.4% during the month (they are up over 20% in 2012 so far). Spanish and Italian equities rose 1.7% and 3.0% respectively. Developed Asian markets also had positive months as Japan and Hong Kong rose 0.7% and 3.9% respectively. In the emerging market space the BRIC countries all posted declines as Brazil, Russia, India and China fell 3.6%, 2.8%, 1.4% and 0.8% respectively. Global bonds, however, outperformed equities as the Barcap Global bond index fell *only* 0.1%.

Chart 1: Global market returns to 31 October 2012



After September's impressive gains in the commodity space October saw almost all major commodity prices decline. After an impressive 13.5% gain in September for silver, the "poor man's gold" led the decline in the precious metals space, falling 6.8% during the month. Platinum and gold were weak, declining 5.9% and 3.2% respectively. There were some large declines in the base metals universe as well; nickel fell 12.2%, aluminium 10.1% and copper 5.1%. Iron ore bucked the trend gaining between 9.8% and 14.5% depending on the grade. The oil price declined 3.3% and soft commodities were weak; soya beans, sugar and corn declined 3.4%, 0.6% and 0.1% respectively. The net effect was a 4.5% decline in the CRB commodity index during October. The US dollar was mixed, gaining 2.7% and 0.2% against the yen and pound but falling 0.7% against the euro. The rand was the biggest disappointment in the emerging currency space falling 5.2%, 5.2% and 6.2% against the dollar, pound and euro respectively. The continued violent strike actions coupled with a weak current account deficit have been the main reasons for the rand's recent weakness.

What's on our radar screen?

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

- *The US economy*: The US grew 2.0% in the third quarter (Q3) from 1.3% in the second quarter (Q2). Consumer spending grew 2.0% in the quarter. It is interesting to contrast the downbeat tone in the guidance of many US corporates with the recent uptick in US consumer confidence, housing data and car sales. This divergence between the positive consumer, who has been spurred on in part by ultra-low interest rates and notably more conservative corporate, reveals who is more concerned about the impending US fiscal cliff and a slowing global economy
- *The SA economy*: Inflation in South Africa rose sharply (0.9% month-on-month) in September due largely to steep rises in food, fuel and housing. Retail sales rose at an annual rate of 4.2% in September after a 6.7% rise in August. The real effects of all the recent labour unrest have yet to filter through to the official data.
- *The developed economies*: The IMF lowered its forecast economic growth across the world and in many specific countries, highlighting the "alarmingly high" risk of a more pronounced slowdown. The IMF downgraded its 2012 and 2013 **global** growth forecasts to 3.3% and 3.6% respectively, from 3.5% and 3.9% previously. After three consecutive quarters of contraction, **the UK** economy grew 1.0% quarter on quarter in the September quarter, thanks to a strong contribution from the Olympic Games. The **Eurozone** as a whole slipped back into recession; economic output in the region declined 0.1% in the September quarter, having declined 0.2% in the June quarter. The economies of Austria, Greece, Italy, Portugal, Spain and the Netherlands all declined sharply although Germany and France increased by 0.2%. September Eurozone industrial production declined 2.5%, its

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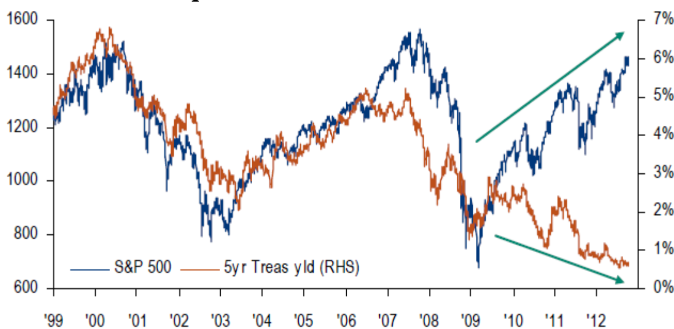
steepest decline in three years, although inflation declined from 2.6% to 2.5%.

- *Emerging economies*: The **Chinese economy** grew 7.4% in Q3, from 7.6% in Q2. Retail sales expanded at an annual rate of 14.1% in September and inflation rose 1.9% from 2.0% the month before. Indonesia grew 6.4%, Singapore 1.3% and South Korea 1.6%. Malaysia and Thailand's Q2 growth was 5.4% and 4.2% respectively.

Chart of the month

For months now, maybe even years, we have been telling clients that the prevailing investment market behaviour is "not normal". Returns from the equity markets have, in general, been very good so we are not convinced that this message has been fully appreciated by everyone. We periodically come across a chart that depicts the abnormality of prevailing markets, and we list such a chart below.

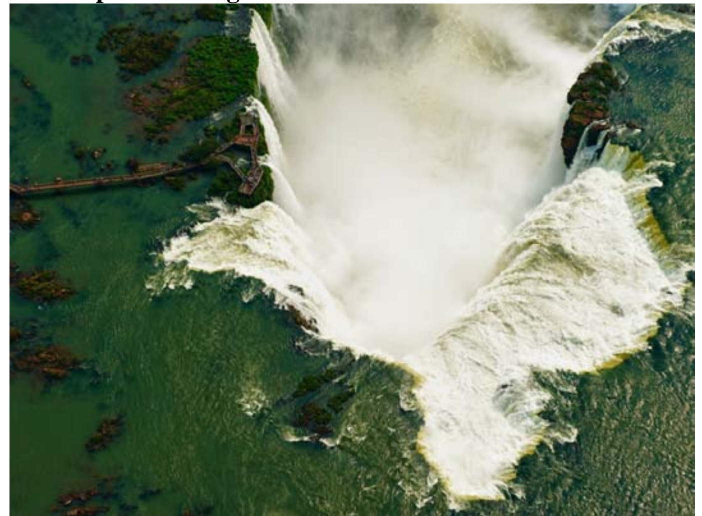
Chart 2: Are equities smarter than bonds?



Source: Merrill Lynch

The red line depicts the interest rate (yield) on the US 5-year government bond on the right-hand axis while the blue line shows the level of the US equity market, the S&P500 index, on the left-hand axis. The chart is a few weeks old so it doesn't reflect the recent equity market weakness (at the time of writing the S&P500 is 1360) but it doesn't invalidate the message of the chart. Notice how the two markets moved in tandem since 1999, and prior to that but not shown in the chart. The reason for this relationship is simple: as the US economy slows, equity markets decline in anticipation of weaker corporate earnings and US bond yields (interest rates) decline in anticipation of interest rates being lowered in order to stimulate economic growth. However, since the global financial crisis began in October 2007 the two markets have moved independently of each other. This relationship has moved into a strong inverse one since mid-2009; bond yields have declined to record (low) levels while equity markets have risen sharply. We understand the reasons for this, but they are beyond the scope of this brief review. Suffice here is to point out that here is another indication that markets are "not normal" at present. A return to normality between these two markets, if and when it occurs, would prove to be rather unpleasant. Either the equity market must decline, which is not a pleasant prospect, or the bond yield must rise, an equally unpleasant and unprofitable experience. But such an event is unlikely to occur – why would interest rates begin to rise when the economy is slowing, unless there was some external shock, for example a massive oil price shock which, I should hasten to add, is not on our immediate horizon? A more likely prospect is for bond yields to rise – they could hardly move much lower, although we note here that many developed economies' 2-year government yields are already negative. This would be a painful experience for bond investors (remember that an inverse relationship exists between bond yields and prices; when bond yields rise their prices drop and vice versa). Equity markets are likely to run into headwinds in due course, but we don't think they will decline by as much as the bond market could rise. That said, we are struggling to find a catalyst to bring about a return to market normality, so the current "abnormal" situation may yet continue for a while, possibly even a number of years.

Econopic 1: The Iguazu Falls



Source: National Geographic

Some quotes to chew on

You can always count on Americans

Commenting on the pending fiscal cliff disaster and the current manner in which American politicians are ignoring this important, pending policy debacle, someone brought the following quote of *Winston Churchill* to mind; "You can always count on Americans to do the right thing – after they have tried everything else".

No place for investment banks in Switzerland

Many of the world's leading investment banks have been shedding staff at a rapid rate. It is fair to say that investment

banks are still recovering from the knock to their balance sheets in 2008/9 but perhaps more importantly also to their reputations. We note that in the past month, as UBS laid off thousands of staff, some of the London employees only discovered they had been retrenched when their entry cards failed to work at the turnstiles on their way into work! While that seems a bit harsh, it is an indication of just how brutal the cuts have been. In the past month, *Martin Taylor, former chief executive of Barclays and current chairman of Syngenta*, provided a unique window into the way the Swiss National Bank viewed investment banks in 2010; I don't think their view has changed much since then. He wrote as follows: "Early 2010, a gathering of business leaders in Switzerland. Mounting anger with the banks among industrial chief executives, who are beginning to feel that the financial sector's rich blend of incompetence and incontinence threatens to make the entire capitalist system unacceptable to the public. The nearly new chairman of UBS – the most egregious Swiss culprit – is present, a former government minister of impeccable unbankerly credentials. He explains that UBS can do nothing whatever to change its business model, or to reduce compensation substantially, without putting itself at a severe competitive disadvantage. Enter a speaker from the Swiss National Bank. 'We Swiss are farmers, not hunter-gatherers. The asset management business suits our character as well as our historical position. Your investment banking business, though, has never made a penny for your shareholders and has put the whole country at risk. All the value added it creates goes to its employees, most of whom live in London and New York. We would rather you were not in that business.'"

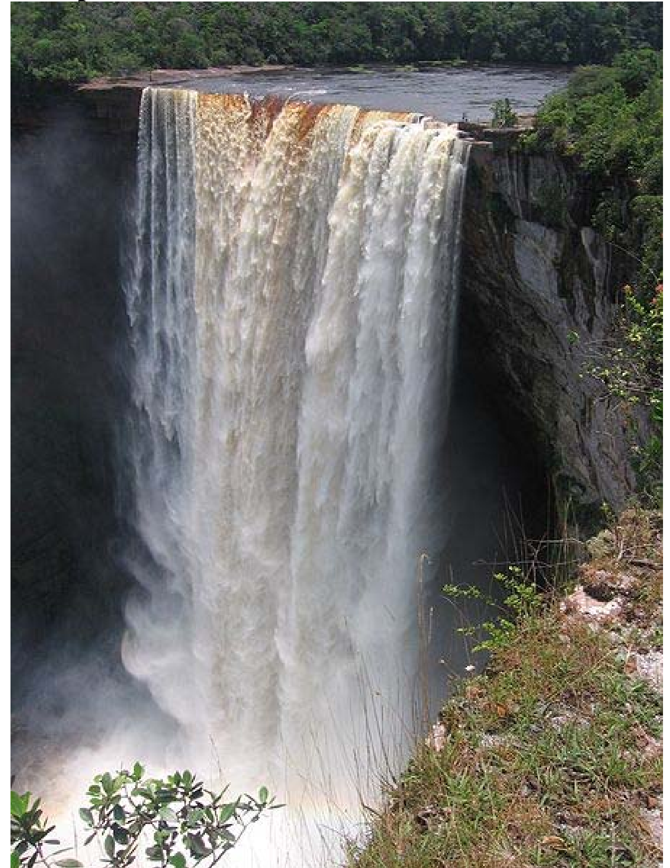
Econopic 2: The Iguazu Falls

Source: www.hoteldascataratas.com

For the record

Table 1 alongside 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.

Econopic 3: The Kaieteur Falls



Source: www.Wikipedia.org

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

	Period ended	Month	Year to date	Year
Maestro Equity Fund	**Oct**	**3.5%**	**17.3%**	**15.9%**
JSE All Share Index	*Oct*	*4.2%*	*19.7%*	*18.6%*
Retirement Funds				
Maestro Growth Fund	**Oct**	**3.2%**	**15.5%**	**13.5%**
Fund Benchmark	*Oct*	*1.7%*	*16.3%*	*16.0%*
Maestro Balanced Fund	**Oct**	**2.9%**	**13.4%**	**12.5%**
Fund Benchmark	*Oct*	*2.6%*	*14.7%*	*14.7%*
Maestro Cautious Fund	**Oct**	**1.4%**	**12.2%**	**12.3%**
Fund Benchmark	*Oct*	*1.3%*	*11.4%*	*11.8%*
Central Park Global Balanced Fund ($)	**Sept**	**2.3%**	**7.0%**	**4.7%**
*Benchmark**	*Sept*	*1.5%*	*6.6%*	*9.8%*
*Sector average ***	*Sept*	*2.1%*	*6.7%*	*9.1%*

* 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 ($)

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As is our habit, we publish the results achieved on the equity portfolios under our management each quarter, so I have pleasure in listing these returns in Table 2, below. We had a relatively disappointing September quarter, largely because our portfolios are underweight the basic material (resource) sector and that sector performed relatively better than the industrial and financial sectors. However, we are still convinced that our overweight stance is not only appropriate for the coming challenges in the global and local equity environment but will also ensure ongoing outperformance of the All share index, such as we have achieved over the past ten years for our clients.

Table 2: Maestro annual returns to 30 Sept 2012 (%)

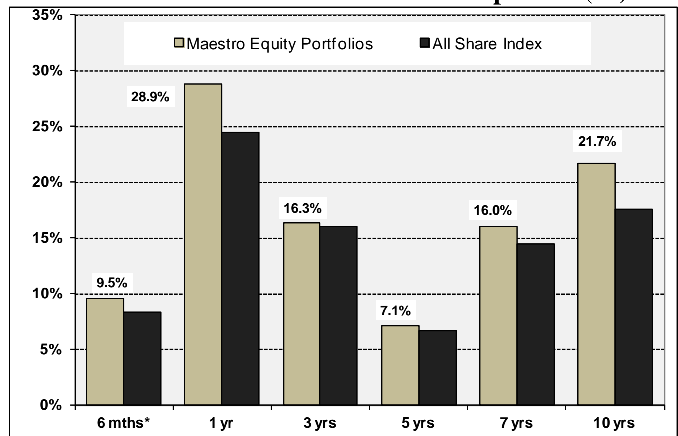
SA equity returns	6m *	1 yr	3 yrs	5 yrs	7 yrs	10 yrs
Maestro long-term equity portfolios	*9.5*	*28.9*	*16.3*	*7.1*	*16.0*	*21.7*
JSE All Share Index	8.3	24.4	16.0	6.6	14.5	17.6

* 6-month returns are un-annualized

One thing that our clients will be aware of but which is worth pointing out here, particularly in light of the weak rand in recent months, is the following. Most of the portfolios under our management are run on a "balanced" basis i.e. they are not "equity-only" mandates (portfolios) but are portfolios where we use a mix of equities (shares), preference shares, cash and foreign investments to achieve the objectives set in conjunction with our clients. In most cases the portfolios contain some offshore exposure, usually between 20% and 30% at present, depending on the client's unique circumstances. We achieve much of the protection against a weaker rand from this offshore exposure, as opposed to investing in rand-hedge equities like BAT, SAB Miller, or having a large basic material exposure. Consequently, while the clients are more than adequately protected against a weak rand, this protection is not necessarily reflected in their equity portfolios, which as I mentioned earlier, have less resource shares and more industrial shares than the All share index. The relevance on this point is that when the rand weakens substantially as it has in recent months, while our clients do not necessarily benefit as much from rand weakness as the All share index, they do benefit overall due to the fact that they have another 20% to 30% direct non-rand exposure through their offshore investment (in Central Park Global Balanced Fund).

This is a subtle but important consideration in evaluating the equity returns achieved by our clients against the All share index. The net result for our clients is continued rand hedge exposure (through Central Park), reduced volatility (through our underweight basic material exposure) and continued outperformance of the All share index (due to the overweight industrial bias in their equity portfolios - industrials have outperformed the All share index substantially over virtually every long-term period.

Chart 3: Maestro annual returns to 30 Sept 2012 (%)

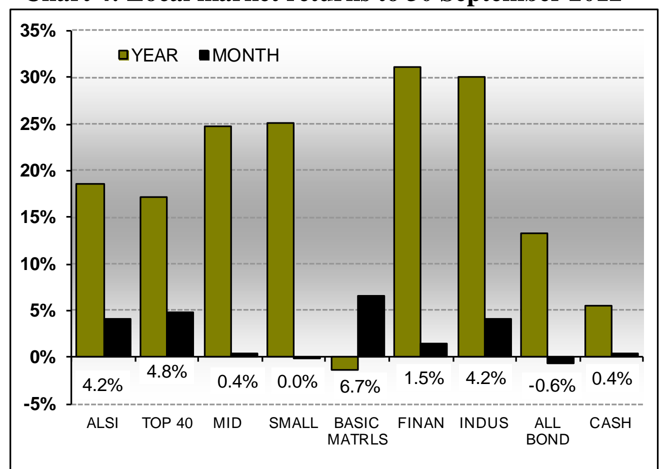


* 6-month returns are un-annualized

The Maestro Equity Fund name change

Due to a change in regulation of white-label funds, the Financial Services Board has compelled all unit trusts run under a white-label arrangements to change their names to reflect the unit trust management company that has ultimate responsibility for the scheme. Consequently, please note that The Maestro Equity Fund has changed its name to **The Maestro Prescient Equity Fund.** Only the name has changed; all other aspects of the Fund remain the same.

Chart 4: Local market returns to 30 September 2012



October in perspective – local investment markets

The SA equity market returned its fifth successive monthly return in excess of 1.5%! The weakness in the rand caused the rand-hedge industrial companies and miners to drive the market higher. This is seen by looking at the underlying drivers of the All share index's 4.2% gain. The basic materials index built on its strong gains in September and

rose an impressive 6.7%, assisted by the weaker rand and despite the weakness in commodity prices. The rand also helped the industrial index gain 4.2%. As expected, financials underperformed in this environment, gaining *only* 1.5%. The extended strikes which have affected many gold miners proved a headwind for the index as it fell 0.3%. Large caps outperformed their mid and small cap peers substantially as the Top40 rose 4.8% versus the 0.4% and flat returns for the mid and small cap indices respectively. The best performing sectors during October were the personal good sector, which rose 13.0% (Steinhoff rose 11.7%), household goods up 11.7% (Richemont rose 13.0%) and forestry and paper 10.2%. The worst were non-life insurers, which declined 4.6%, tech hardware 4.5% (Pinnacle Technology fell 4.5%) and the real estate investment and services sector down 3.8%. Bonds produced their first negative month since May as the All Bond index declined 0.6% during the month.

File 13: Information almost worth remembering

Up, up and away - Felix Baumgartner

Those of you who have been reading *Intermezzo* for many years will have realised that, apart from market commentary and economic events, we also use it as a chronicle of some of the most unusual, exciting and, at times, weird events that together constitute and record the history of the society and times in which we find ourselves. So it is only appropriate that this month we stop and record the remarkable achievements of a man who went where no man or woman has ever gone before, who achieved what until now had been but a dream in the minds of pioneers and daredevils.

Econopic 4: Felix Baumgartner's leap of faith

Source: www.guardian.co.uk

Of course I am referring to the world record set by Austrian Felix Baumgartner, who on 15 October jumped out of his craft, into space, no less than 39km above Earth. Cutting a lonely, solitary figure, he hurtled back home at a speed of 1 343 km/h (834mph), at the same time setting the world record for breaking the sound barrier without the help of any propulsion i.e. in freefall. It took him just 9 minutes and 9 seconds to reach Earth, of which 4 minutes and 22 seconds was in freefall. I'm sure many of you watched this remarkable feat live (more than 8 million people watched it live on YouTube), which took five years to plan and occurred exactly 65 years after US test pilot Chuck Yeager first broke the sound barrier in a rocket-propelled aeroplane. You can read all about this remarkable achievement by visiting the official website by clicking here and watching a short video on YouTube here.

So what's with the pics?

During the course of the month I "discovered" two amazing waterfalls, the Iguazu and Kaieteur Falls. I'm sure you have heard of them, but for poor souls like me who haven't, it was remarkable to read of these giants and explore the wonderful pictures online. The Iguazu Falls lie on the Iguazu River between Brazil and Argentina, while the Kaieteur Falls lie on the Potaro River in Guyana's rainforest. Despite the impressive pictures, let me assure you they do no justice to either of these massive falls. For example, if the Kaieteur Falls doesn't impress you, consider that it is five times as high as the Niagara and twice the height of Victoria Falls. It is also immensely powerful, averaging 663 cubic meters per second. I would encourage you to explore (electronically) this remarkable waterfall in more detail. There are plenty of wonderful photos and articles on it, one of the better ones being in an article accessible by clicking here.

Econopic 5: The Kaieteur Falls

Source: www.touropia.com/greatest-waterfalls-in-the-world/

Similarly, the Iguazu Falls are so vast – the complex consists of 275 different falls - it is almost impossible to capture their total span in one photograph. You can find a wonderful selection of photos by clicking here. Take time to go through all the pictures – they are so beautiful.

Econopic 6: The Iguazu Falls

Source: www.touropia.com/greatest-waterfalls-in-the-world/

Table 3: MSCI returns to 31 October 2012 (%)

	YTD	MTD
ACWI	**9.9**	**-0.8**
DM	**10.1**	**-0.8**
Asia Pacific	**4.8**	**-0.4**
Australia	12.9	2.6
Hong Kong	19.9	1.4
Japan	-1.8	-1.9
New Zealand	19.0	0.9
Singapore	21.2	-1.6
GEM	**8.6**	**-0.7**
EM Asia	**11.1**	**-0.4**
China	11.4	5.7
India	18.8	-3.9
Indonesia	4.3	2.6
Korea	11.3	-2.9
Malaysia	10.0	2.4
Philippines	32.8	2.8
Taiwan	4.9	-6.1
Thailand	21.5	-1.7
EMEA	**9.8**	**-1.7**
Czech	0.5	-0.3
Egypt	56.6	-3.3
Hungary	27.3	5.7
Morocco	-16.5	1.3
Poland	15.4	-2.3
Russia	3.7	-3.4
South Africa	5.5	-3.1
Turkey	49.7	10.4
LATAM	**1.2**	**-0.7**
Brazil	-7.0	-1.4
Chile	4.9	-1.6
Colombia	24.1	5.9
Mexico	20.2	-0.3
Peru	9.8	0.0

Source: Merrill Lynch

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