INTERMEZZO
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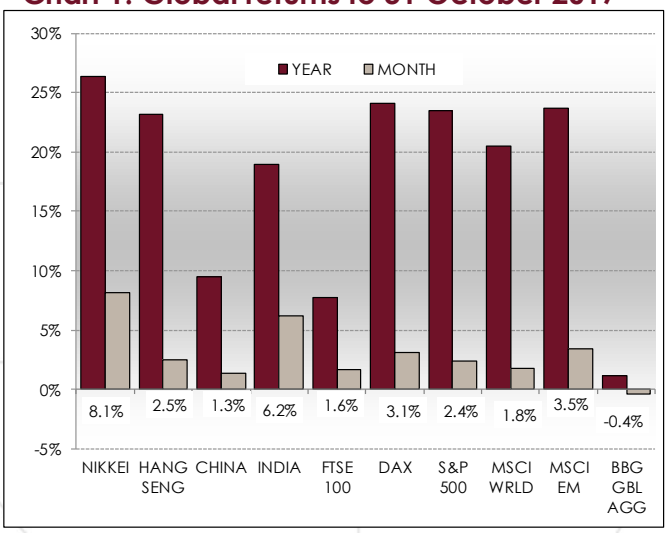
Orchestrating Your Wealth
MAESTRO
Masters of Investment

October in perspective – global markets

During October, the MSCI World index rose 1.8% and the MSCI Emerging Market index 3.5%. Their respective year-to-date gains are now 16.3% and 29.8%. Strong monthly gains were registered by Japan, which rose 8.1%; India rose 6.2%, Germany 3.1%, Hong Kong 2.5% and the US 2.4%. The tech-heavy NASDAQ index rose 3.6% as tech companies continued to deliver quality earnings and strengthen their balance sheets.

Chart 1: Global returns to 31 October 2017



The dollar strengthened slightly during the month – the (trade-weighted dollar) DXY index rose 1.6% - leading to the euro and sterling declining by 1.5% and 1.0% respectively. Despite the firm dollar, commodity prices were also firm: the oil price rose 7.0%, copper 4.9%, and nickel 12.6%. Most soft (agricultural) commodity prices also ended the month higher. As economic momentum increases, the likelihood of higher interest rates seems more likely. Consequently, investors now expect the US Federal Reserve to increase interest rates in December. Global bond markets consequently weakened slightly; the Bloomberg Global Aggregate Bond index declined 0.4%, although its year-to-date return is still an attractive 5.6%.

What's on our radar screen?

Here are a few items we are keeping an eye on:

- *The SA Economy:* The most significant development during October was the Medium Term Budget Policy Statement (MTBPS), which for our foreign readers is a Budget-like announcement by the Minister of Finance, laying out a roadmap for the country's finances and budgetary priorities for the medium-term. There was good and bad news in the MTBPS: good, in that government has finally acknowledged the dire state of the economy, and bad, in that it offered no indication of what action would be taken to improve it. In virtually every respect the news was bad: the deficits are forecast to be significantly greater than initially projected, revenue is declining at an alarming rate, growth is slowing, state-owned enterprises (SoE) are in a state of collapse, and the ability to continue financing debt is deteriorating. Ironically, the Minister hardly told the private sector or the country's citizens what they didn't know; it's amazing that it has taken government so long to "come clean". The real bad news was that no solutions were offered; it seems clear that government has no idea what to do and no political will to take the hard decisions required to fix the economy. It is not surprizing that the rand declined as it did. We remain of the view that the SA economy is likely to deteriorate further before it starts improving, assuming it even will. It is remarkable that the economy is holding up as well as it is. We fear that, in due course, its true state, and its inability to be restored, will become apparent – it will not be a pretty sight. We continue to hold the view that investors should externalize as much of their capital as possible, before it is too late.

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

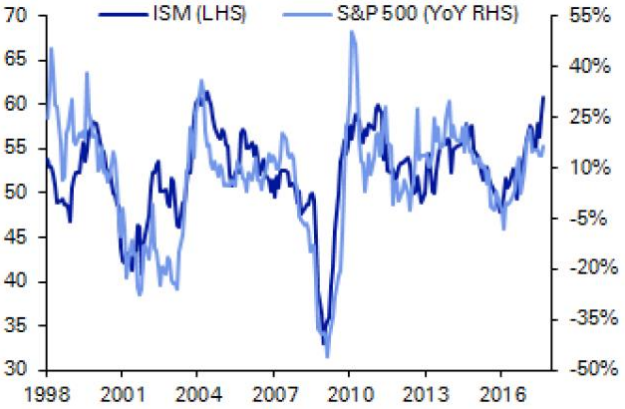
- *The US economy*: The US economy grew at a rate of 3.0% during the third quarter (Q3), following Q2's 3.1% growth rate. Other economic indicators provided evidence of an economy that is in good shape, with few signs of distress. Inflation remains largely absent and the state of the consumer remains reasonable.
- *Developed economies*: Economic growth during Q3 in the UK was 0.4%, bringing its annual growth rate to 1.5%. The Bank of England (BoE) increased its interest rate by 0.25% to 0.5%, noting that it expected only "very gradual" increases in the coming three years. Germany's unemployment rate is now 5.6% - the lowest level since re-unification. Its economy grew at 0.8% in Q3 quarter-on-quarter (qoq), or 2.8% year-on-year (yoy) from an upwardly-revised 2.3% in Q2 – the highest rate of growth in 6 years. The European Commission increased its projected growth rate for the Eurozone from 1.5% to 2.2%, the highest in a decade, and the 2018 growth rate from 1.8% to 2.1%. Q3 growth in the Eurozone was 0.6%, bringing the annual rate to 2.5%, the strongest rate of growth since the first quarter of 2011. The September unemployment rate was 8.9% and the annual inflation rate a mere 0.9%. Refer to Chart 4 for more on European growth.
- Emerging markets: Starting in Latin America for a change, the Brazilian central bank cut their benchmark Selic interest rate by 0.75% to 7.5%. The central bank has now cut rates by 6.5% over the past year. The South Korean economy grew at a rate of 1.4% during the September quarter, bringing its annual growth rate to 3.6%, the highest rate in seven years. The Chinese economy grew 6.8% during Q3, down marginally from 6.9% although in line with expectations. Retail sales at 10.3% and industrial production at 6.6% were slightly higher than expected.

Charts of the month

PMI – why we follow them

During the past few months we have shed some light on Purchasing Manager Indices, or PMIs as they are commonly known. In the US, they are compiled and distributed by the Institute of Supply Managers, or ISM, and have over the years simply become known as the ISM indices. They are in essence still PMIs. The latter are widely used across all countries as economic indicators for, inter alia, the health of the economy.

Chart 2: The value of PMIs – the US history



Source: Deutsche Bank

"To achieve great things, two things are needed; a plan, and not quite enough time."
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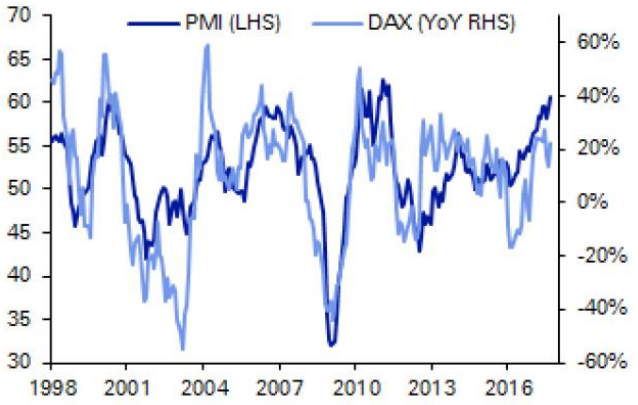
I came across Charts 2 and 3 recently and thought I would share them with you. From these two charts you can see what a close relationship they have with equity markets, which is one of the reasons they are so widely followed. If an economy is growing, then the corporate sector would usually be doing well and companies' profitability would be increasing. This in turn results in corporate earnings increasing, which is one of the key drivers of share markets – hence the close correlation between PMIs and equity markets.

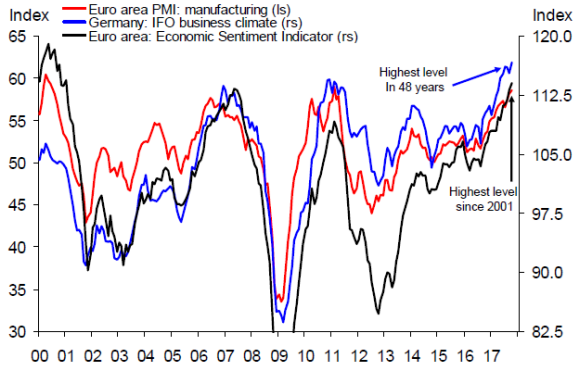
Chart 3: The value of PMIs – the German history



Source: Deutsche Bank

Sticking with this train of thought, Chart 4 plots Germany's IFO business climate index against the Eurozone PMI and Economic sentiment indices. You can see for yourself how correlated they are and also how high they are relative to their history – there is no doubt that growth in the Eurozone has been one of this year's surprises. From what we can see, there is no reason to expect this growth not to continue into next year, even if the rate slows somewhat.

Chart 4: Investment market reflection



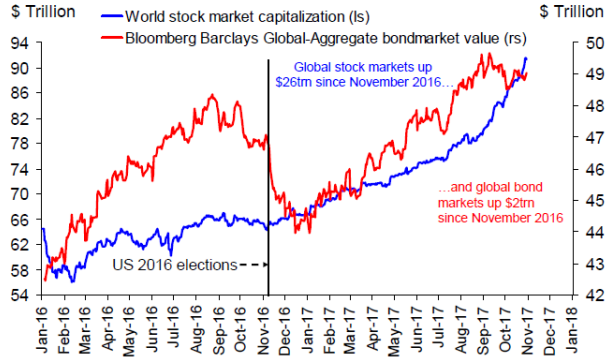
Source: Deutsche Bank

Times flies when you are having fun

Regular readers will know that 2017 is proving to be a very profitable year for global equity investors. The lousy returns from the South African share market are one of the few exceptions, but they mirror the country's dire economic situation and corrupt, chaotic government.

Although it feels like just yesterday, the first anniversary of US President Trump's election has come and gone. Since that election global investment markets have added $28trn in market capitalization (size). $2trn of that has come from bond markets: the Bloomberg Global Aggregate Bond index is up 1.2% during the past year, while $26trn has come from global equity markets. The MSCI World index is up 20.5% over the period.

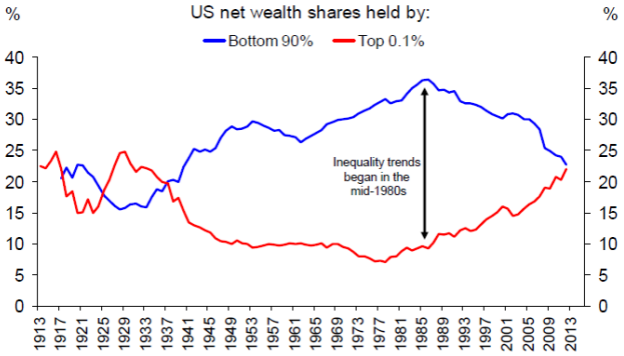
Chart 5: Investment market reflection



Source: Deutsche Bank

Speaking of wealth creation, most of which accrues to the wealthy, Chart 6 shows that inequality, which is proving to be such a controversial topic at present, has actually been increasing for many years already – since the eighties in fact. However, as can be seen from the chart, the top 0.1% of net US wealth is now approximately equivalent to the other 99% i.e. the wealthiest 0.1% now own as much as the remaining 99% together. If next year is anything like the current year, this trend is likely to continue.

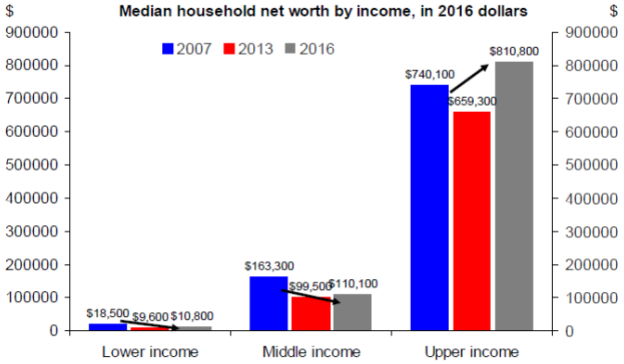
Chart 6: The Top 1 % equals the other 99%



Source: Deutsche Bank

As if we need any convincing, Chart 7 shows that only the highest income groups are better off since 2007.

Chart 7: The rich get even richer



Source: Deutsche Bank

Blast from the past – what did you invest in?

You would probably have realized by now that I am fond of investment market history, for a number of reasons, not least of which is that we can learn so much from it. October the 19th was a significant date for market watchers and older investment managers; it heralded the 30th anniversary of Black Monday, the day the US equity market crashed 23% in one day – still the most dramatic one-day crash ever. For those of us who lived through it, we will never forget it and will hopefully never have to live through something like it again.

The purpose of the exercise here is to extract lessons from that experience that we can deploy today. What does the subsequent market experience teach us about the activity of investment? Table 1 lists the returns from selected assets, both in absolute and annualized terms, as well as the absolute returns in dollar terms. The data are based on the assumption that one invested the day after the crash i.e. first thing on Tuesday, 20 October.

Table 1: Selected returns since Black Monday

Asset	Performance	USD Performance	Annualised Returns
S&P 500	2123%	2123%	10.9%
Hang Seng	1852%	1851%	10.4%
USD HY	1106%	1106%	8.7%
Italy 10yr	1086%	825%	8.6%
Spain 10yr	1037%	834%	8.4%
DAX	889%	957%	7.9%
UK 10yr	875%	659%	7.9%
IBEX 35	811%	657%	7.6%
FTSE 100	778%	588%	7.5%
USD IG	775%	775%	7.5%
France 10yr	773%	822%	7.5%
DJStoxx 600	723%	717%	7.3%
US 10yr	602%	602%	6.7%
Germany 10yr	517%	544%	6.3%
Copper	265%	265%	4.4%
DJStoxx 600 Banks	237%	234%	4.1%
Japan 10yr	197%	266%	3.7%
Greece Athex	168%	27%	3.3%
Gold	166%	166%	3.3%
WTI Oil	164%	164%	3.3%
CRB Index	60%	60%	1.6%
Nikkei	12%	41%	0.4%

Source: Deutsche Bank

The results are obvious, but it's worth examining a few of them:

- The US equity market generated the best return over the subsequent 30 years, at 10.9% per annum. It is therefore not surprising that Maestro continues to view the US equity market as one of the best places to "go hunting" for opportunities.
- Would you have thought that an investment into Italian and Spanish 10-year bonds would have been so rewarding? Or that any sovereign bonds would be near the top of the list, for that matter? No, me neither! However, it is worth noting that for most of the subsequent 30-year period after Black Monday, the world went through a structural period of lower inflation, resulting in a profound bond bull market as interest rates declined from very high levels. This structural event is unlikely to be repeated in our lifetime and certainly not from prevailing bond market prices.
- Note the laggard here – Japan. Although the Japanese equity market is staging something of a late rally in recent weeks, it is unlikely to ever catch up to, say, the US equity market. It remains a bit of an enigma to us, but it goes to show how devastating deflation can be. For most of the past 30 years Japan has struggled to overcome structural deflation. The jury is still out as to whether or not it has overcome it fully.
- Finally, note where commodity returns find themselves – the CRB (Commodity) Index, oil and gold take up three of the four bottom places. This vindicates Maestro's general aversion to investing in the mining sector. We remain unconvinced that, in the long run, an asset which generates no income, such as gold, can outperform an investment in a company, which not only generates an income stream but in many cases a rising income stream. As we continue to preach to all who will listen, it is the value of an increasing income stream (read earnings, out of which dividends are paid) that ultimately increases value (in this case share prices) over time. When you do that over a period of 30 years, one reaches a level of value that will never be matched by an investment generating no income. That is one of the most important and basic lessons of investing.

Quotes to chew on

More comment on the amazing equity year

As the year rushes headlong to its close, we will surely look back on it in years to come as one of the more remarkable years from a return and record point of view. Although they have often been incremental only, this year will surely stand out as the year in which the greatest number of record closes were registered. Around about the time of writing, no fewer than 55 new record peaks were recorded by the S&P500 index, which is quite remarkable when you consider there are only about 250 full trading days in the year.

A sense of this remarkable year was well conveyed by *Deutsche Bank's Jim Reid*, writing in his Early Morning Reid, on 1 November: "October wasn't a particularly scary month for investors with 32 out of our 39 regularly tracked global assets seeing a positive return in our monthly performance review. We can this morning announce a new world record! The S&P 500 (2.3% October return) finished with a positive total return, meaning that the index has now seen a positive total return for all 10 months so far this year, the first time that this has happened in the 90 years we have data for. If you go beyond the calendar year end, October now marks the 12th positive month in succession which equals the record set in 1949-1950 and 1935-1936. A word of warning though, the next two months saw the run break spectacularly with returns at -3.6% and -7.7% respectively."

Apple – a one-product company

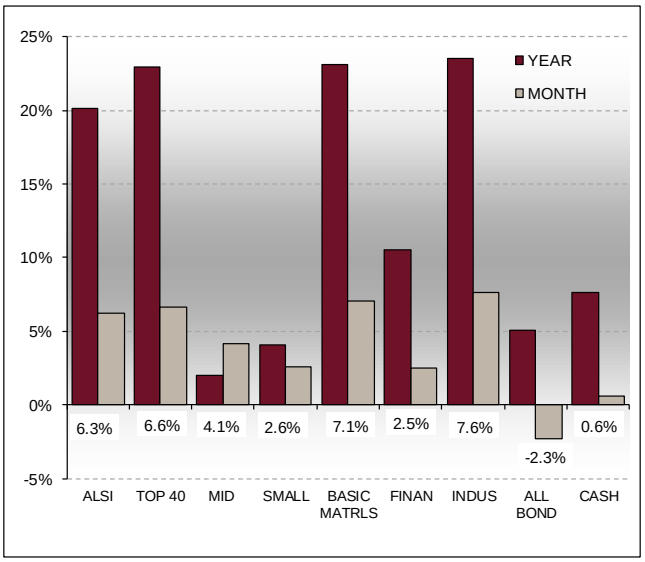
We frequently debate the merits of Apple in our investment team meetings. It has been a great performer – its shares are up 57.1% over the past year – although we have not held it for a long time in our global equity portfolios. There is a strong view in the market that it is little more than a "one-product company" – although we will be the first to admit: "What a product!". In the light of this comment and debate, I thought the following comment from *Martin Wolf, chief economics commentator for the Financial Times,* was prescient: "Apple's accounts are, again, fascinating. Apple's total assets were $375bn on September 30, but with fixed assets a mere $34bn. The value of Apple's long-term investments was almost six times that of its fixed assets. Its net income in the year to September 30 was also more than 40% higher than its total fixed assets. This company evidently has no profitable way to invest its huge profits in its business. It is now an investment fund attached to an innovation machine and so a black hole for aggregate demand. The idea that a lower corporate tax rate would raise investment in such businesses is ludicrous."

October in perspective – local markets

Given the parlous state of the South African economy and its bleak future, one could be forgiven for thinking the rand and the equity market would have collapsed. The rand did end weaker, down 4.5% for the month, but the equity market held up well. Don't be fooled though: the increasingly dichotomous market is easy to

misinterpret. Naspers and Richemont, which together constitute more than 28% of the All Share index, and which both have no operations in the country at all, are driving the index higher thanks to their 71.0% and 43.6% year-to-date returns. The more the rand declines, the higher their share prices rise, creating the impression that the SA equity market is moving higher and that "all is well". Speak to any SA industrialist or business person and he or she will tell you a very different story.

Chart 8: Local returns to 31 October 2017



Higher commodity prices, stronger global economic activity and a weaker rand supported the Basic Materials index, which rose 7.1%. The Industrial index rose 7.6% (Naspers rose 18.0%) during October and the Financial index 2.5%. The Mid and Small cap indices rose 4.1% and 2.6%, trailing the Large cap (Top40) index, which rose 6.6% - again the influences of Naspers and Richemont, both large members of that index, are obvious. The All Bond index fell 2.3%. The best-performing sectors during October were the Industrial Metals sector, which rose 25.0%, Platinum Mining, up 19.5%, and the Media sector, which rose 17.9%. The worst-performing sectors were Fixed Line Telecoms, which declined 10.7%, Travel and Leisure, down 5.3%, and the Forestry and Paper sector, which fell 4.1%.

For the record

Table 2 lists the latest returns of the mutual and retirement funds under Maestro's care. Returns include income and are presented *after* fees have been charged. Fund Summaries for each respective fund listed in the table, as well as all the historic returns, are available on our website.

Table 2: The returns of funds in Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Prescient Fund	**Oct**	**3.9%**	**7.1%**	**7.2%**
JSE All Share Index	*Oct*	*6.3%*	*19.6%*	*20.1%*
Maestro Growth Fund	**Oct**	**4.0%**	**12.7%**	**12.9%**
Fund Benchmark	*Oct*	*3.9%*	*15.0%*	*15.6%*
Maestro Balanced Fund	**Oct**	**3.6%**	**12.2%**	**12.4%**
Fund Benchmark	*Oct*	*3.4%*	*13.7%*	*14.4%*
Maestro Cautious Fund	**Oct**	**1.3%**	**7.1%**	**7.9%**
Fund Benchmark	*Oct*	*1.4%*	*10.0%*	*10.6%*
Central Park Global Balanced Fund ($)	**Sept**	**2.2%**	**25.8%**	**20.9%**
*Benchmark**	*Sept*	*0.9%*	*11.0%*	*10.3%*
*Sector average **	*Sept*	*0.8%*	*8.3%*	*8.1%*

* 60% MSCI World Index and 40% Bloomberg Barclays Global Aggregate Bond Index
** Morningstar USD Moderate Allocation ($)

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- Leonard Bernstein

Technology exposure – good or bad?

At the risk of sounding like a stuck record, we again draw your attention to our positive view on certain sectors of the global technology space. We have been discussing the merits and attractions of this sector for a long time now, but something rather unique happened during October that we would like to draw your attention to and which we feel vindicates our positive view on this opportunity set. Indeed, it has been one of the major drivers behind the remarkable global equity returns so far this year - refer to Charts 10 and 11 in this regard.

Let me start with the conclusion: for all the doomsday prophets and soothsayers calling for an imminent collapse in equity markets, and who believe we are near the peak of another Y2K-type bubble, we retain the view that solid earnings growth and prospects, strong cash flows, and robust balance sheets are likely to continue to lift the share prices of the global tech giants for some time to come. We acknowledge there is a speculative element in some shares – we try and avoid these areas of the market (here I am thinking of the likes of Netflix, Tesla and some of the more recent listings) – and acknowledge that many of these tech shares are not cheap. However, we are still firmly committed to the tech sector and believe it will continue to provide solid returns in the foreseeable future.

On 26 November, in the midst of the third quarter earnings season, Amazon, Facebook, Alphabet (formerly Google), Microsoft, Intel and Netflix all reported earnings. Almost across the board, the earnings were a lot better than expected. The US equity market consequently rose sharply on 27 October. Details of the gains are listed in Table 3 below.

Table 3: Selected tech returns (%)

Company	Daily return: 27 Oct	YTD return to 26 Oct	12-month return to 17 Nov
Alphabet*	4.3	26.1	34.0
Amazon	13.2	41.8	48.6
Microsoft	6.4	43.3	39.6
Intel	7.4	31.6	31.3
Alibaba*	3.4	72.8	98.2
Tencent*	0.2	83.3	106.9
Netflix	2.2	57.7	67.7

* Held in Maestro's global equity portfolios

Martin Wolf, chief economics commentator for the Financial Times, in an interesting piece on tech companies, recently made the following observation: "Eight of the world's most highly valued companies are technology businesses – refer to Chart 9. The combined market capitalization of these companies is $4.7trn. That is 30% of the combined market capitalization of the other 92 companies in the world's 100 most valuable firms. Of these eight companies, five (Apple, Alphabet, Microsoft, Amazon and Facebook) are from the US, two are Chinese (Alibaba and Tencent) and one is South Korean (Samsung). The most highly valued European tech company, SAP, is only the world's 60th most valued company".

Chart 9: The World's largest companies ($bn)

Source: FT.Com

It is a truism that nothing can keep growing forever. I often refer to "the law of large numbers" when describing the inability of very large, growing companies to keep growing at the same rate. Yet time and again we have been blown away by the ability of some of the biggest companies in the world to grow at rates well in excess of their smaller competitors, or even their own historical growth rates. This talks to a unique phenomenon of the current wave of tech domination, which I will not address here. However, we understand it, believe in it, and are happy to invest in it – at least for now. It is a "once-in-a-life time" opportunity; it won't last forever but could well continue for a while. Those who have missed it are jealous, critical and are prone to deny reality.

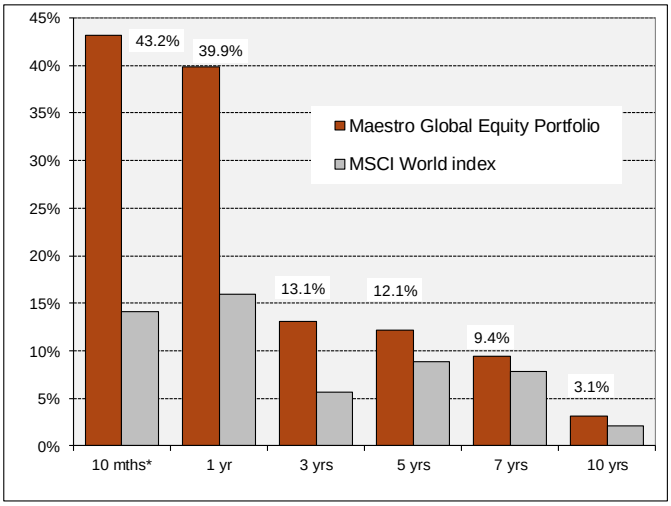
If you think this sounds arrogant – we certainly don't mean to be – consider some of the statistics that were shared by Tencent during their Investor Day earlier this month, and ahead of the release of spectacular returns on 15 November. The statistics relate to their WeChat app and WeChat Pay, the payment feature embedded in the app. Before considering the data, remember we are talking about a company that is already one of the largest in the world, in terms of size and number of customers. The data reflect their business to end-September:

- Average daily login users: 902m, up 17% Year-on-year (YoY)
- Active elder users (age of 55-70): 50m
- Average daily messages: 38bn, up 25% YoY
- Average daily voice messages: 6.1bn, up 26% YoY
- Average daily voice/video calls: 205m, up 106% YoY
- Average monthly voice/video calls per user: 19 times, up 135% YoY; 139 minutes, up 114% YoY
- Daily average user of WeRun: 115m, up 177% YoY
- Monthly offline payments via WeChat Payment: up 280% YoY

In case you missed it, let me mention it again here: over 900m daily WeChat users, who send 38bn messages and 6.1bn voice messages every day! These are extraordinary numbers which most of us can't even get our mind around. Moreover, they are increasing at consistent double or triple digit growth rates year after year. To underline the point, we could have rolled out equally impressive data relating to Alibaba, which also recently released excellent results. The point is clear: global investors need to tap into this unique period in world history as wave after wave of tech innovation provides unique and very profitable investment opportunities.

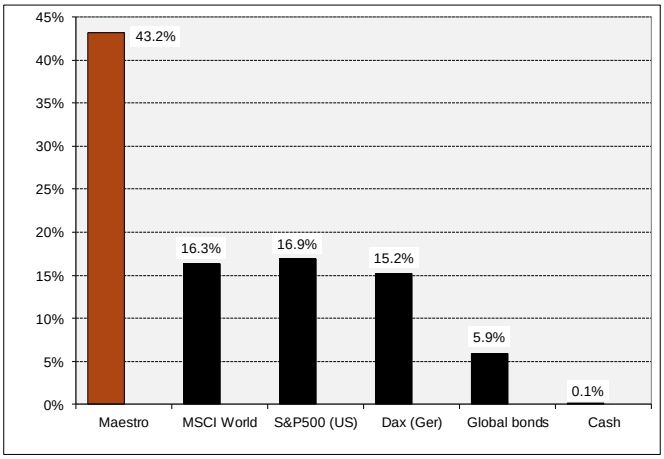
We draw your attention to the returns on our global equity portfolios. Chart 10 lists the annual returns to end-October (note that the 10-month return period is un-annualized), while Chart 11 depicts the year-to-date return relative to selected global benchmarks.

Chart 10: Maestro global returns to Oct '17



To underline the point about having exposure to the global tech giants, our year-to-date returns and those over longer periods would not have been so high if we didn't have exposure to the likes of Alibaba, Alphabet and Tencent. The relevance of having had exposure to the tech giants this year is borne out by the data: the biggest ten tech companies by market cap rose 10% on average in 2015 and 12% last year. So far this year, they have risen 53%.

Chart 11: Ytd (Oct) global equity returns



So what's with the pics?

At the time of putting the finishing touches to this letter, I am fortunate enough (?) to be sitting in a very chilly environment with lots of snow around me. I thought some pictures taken in the snow might therefore be appropriate, not to talk about providing some relief for those currently enjoying the warm African summer. Certain photos were obtained from National Geographic, and others were from the work of Vincent Munier. I encourage you to visit the website of this remarkable photographer.