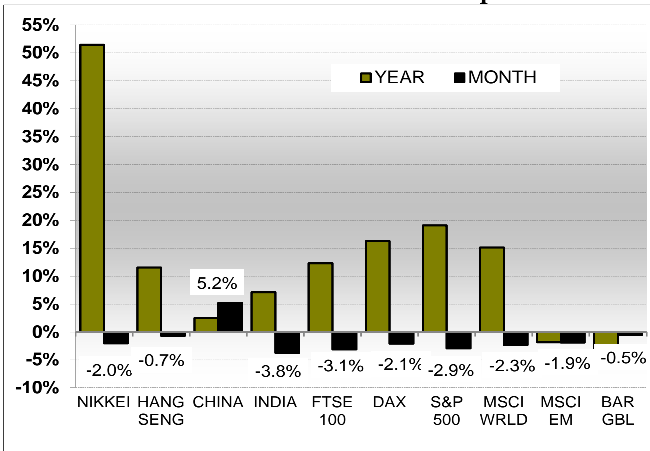
MAESTRO
INTERMEZZO
Investment Letter | 13th Edition | October 2013

September in perspective – global markets
A chemicals weapon attack in Syria and central bank activity were the two largest factors in global markets during September. Sabre-rattling by the West and the US in particular, which amounted to little, sent markets lower early in the month. Thereafter the withdrawal of Larry Summers as a candidate to replace US Fed Governor Ben Bernanke, followed by the decision not to taper any of its loose monetary policy, sent market strongly higher. The latter had weighed heavily on emerging equity markets, and currencies in particular, and they were thus the major beneficiaries of the Fed's decision to hold off withdrawing any part of their $85bn monthly spending spree. All in all, September was a very profitable month, with the MSCI World index rising 5.6% and the MSCI Emerging market index rising even more, up 7.6%. The year-to-date returns from these two indices tell a different story though; the World index has risen 16.2% so far this year, while the Emerging market index is *down* 5.2%. Leading emerging markets higher this month were China, up 3.6%, India 4.1%, Brazil 4.7% and Russia 10.2%. The JSE All share index in South Africa rose 6.9% in dollar terms. Amongst developed markets, the UK equity market was the "laggard" rising only 0.8%, while the US rose 3.2%, Hong Kong 5.2%, Germany 6.1% and Japan 8.0% (Japan has risen 63.0% over the past year).

Chart 1: Global market returns to 30 September 2013



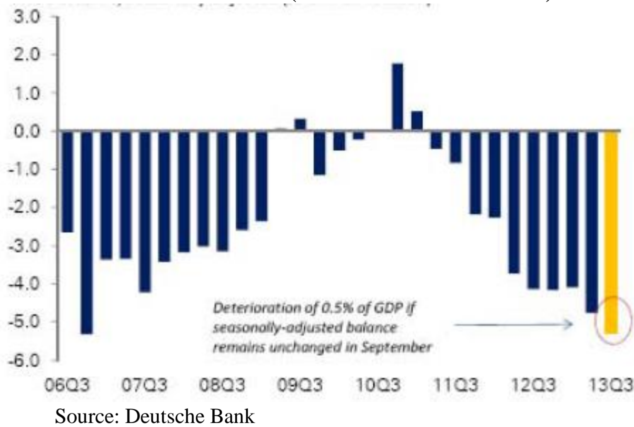
Commodity prices were mixed; precious metals closed lower on the month, although base metal prices were firmer, with the exception of the iron ore price. The prices of gold, platinum and silver closed down 4.9%, 6.8% and 8.3%. The oil price declined 5.0%, although it has remained stubbornly high for much of this year. The dollar weakened against most currencies during the month; the euro and sterling gained 2.7% and 4.7% against it whilst emerging market currencies also strengthened against the dollar. The Brazilian *real* rose 6.8%, the Indian rupee 5.5% and the Aussie dollar 5.0% against the greenback. When one considers that the rand firmed only 1.8%, you realize that there are firstly, other factors weighing on investors' minds and secondly, how weak the rand is on a relative basis i.e. relative to other emerging market currencies. The policy mistakes, political blunders, social unrest, current account deficit and other country-specific factors are weighing more heavily on the rand than normal.

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

- *The SA economy:* The SA inflation rate rose to 6.4% in August from 6.3% in July, fuelled largely by an increase in the petrol price. Core inflation i.e. inflation excluding food and energy prices, declined from 5.2% to 5.1%. Retail sales rose marginally from 7.5% in June to 7.6% in July; sales volumes rose 3.4% in July. According to Stats SA, the country's statistics agency, low income consumers spend about 35% of their total expenditure on food and drink, middle income consumers spend about 22% and high income consumers spend about 10% on food and drink. The highest income decile i.e. the top 10% of consumers spends 6% of their wallet on food and beverages, while the lowest decile spends 36% on it i.e. six times more than the top decile. The bottom decile spends 8% of their wallet on apparel while the top decile spends 3%. Changing topic slightly, SA's trade deficit continued to widen, increasing from R13.4bn in July to R19.1bn in August. Imports continue to run at higher than expected levels. The trade balance and more generally the current account deficit continue to be an area of focus for investors, especially foreign investors; the current account deficit remains the economy's Achilles' heel. It is hard to believe we will see any sustainable improvement in the rand without an

improvement in the current account (driven by an improvement in the trade deficit).

Chart 2: SA trade deficit (% of GDP annualized)



Source: Deutsche Bank

- *The US economy*: At its September meeting the US Federal Reserve (the Fed) reduced its growth forecasts as everyone had expected. Their 2013 US GDP growth forecast was reduced from 2.3% - 2.6% to 2.0% - 2.3%. Their forecast for 2014 growth was reduced from 3.0% - 3.5% to 2.9% - 3.1% and they retained their view that unemployment would be around 7.0% by the end of 2014. Their view of the official Fed fund rate i.e. the Fed's official short-term rate was for it to be 1.0% by the end of 2015. They tabled a new forecast for 2016, by which stage the Fed believes the rate will be 2.0%. Simply put, short-term interest rates in the US will remain very low, for very long!
- *Developed economies:* Japanese inflation rose from 0.2% to 0.7% in July, which may not seem that significant, but do remember that the country has been battling deflation for nearly thirty years.
- *Emerging market economies:* **Chinese** inflation rose 3.1% in the year to August, from 2.7% in July. Their economy grew at an annual rate of 7.8% during the third quarter, up from 7.5% during the June quarter. Life in **India** goes from bad to worse – at least from an economic point of view. The August inflation rate declined marginally from 9.6% to 9.5% but the Reserve Bank of India raised interest rates and reduced its 2013 growth rate forecast from 6.4% to 5.3%. It also signalled that the level of interest rates would not decline until inflation had declined and the rupee had stabilized. Those comments lent some stability to the rupee, which rose 5.5% against the dollar during September. This rise should, however, be seen against the backdrop of general emerging market currency strength. In **Indonesia**, another country battling on the macro-economic front and whose currency has come under pressure of late, inflation rose from 8.6% to 8.7% in August. Their central bank also raised its benchmark interest rate to 7.25%. In **Russia** inflation rose 6.5% in August, which must be viewed against their second quarter growth rate of just 1.2%. **Turkish** inflation declined to 8.2% in August from 8.9% previously and their unemployment rate remained steady at 8.8%.

Global charts of the month

One of our *Big Picture Themes* has for some time been the "Japanification" of the US, by which we mean that, similar to the Japanese experience during the past three decades, the US economy will go into a low-growth trajectory, characterized by ineffective monetary and fiscal policy and low, perhaps even negative inflation (deflation). While Quantitative Easing (QE) has perhaps rescued them from this fate, the jury is still out as to the final outcome of the massive policy experiment that QE represents. So while this theme of ours has slipped onto the backburner, so to speak, it has not totally fallen off the radar. Although the markets do get it wrong from time to time (with apologies to all the "Efficient Market's Hypothesis" disciples out there) Chart 3, which overlays the US equity market from 1995 on the Japanese equity market experience between 1984 and 2013, does seem to indicate that the US has "broken the chains" of the Japanification curse. Time will tell, but so far, so good.

Chart 3: Is the US going to "Japanify" or not?

Source: Merrill Lynch

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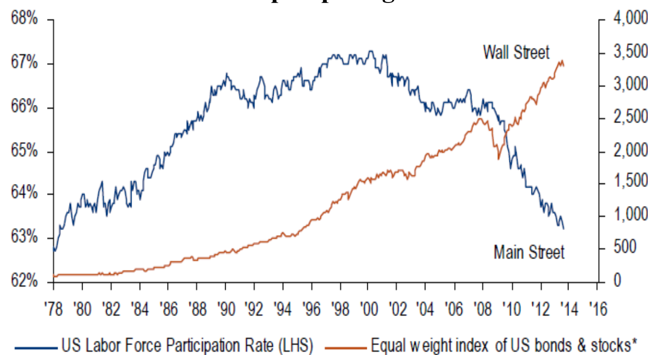
At the time of writing most developed markets, including the US equity market, are at or close to all-time highs. Many investors and commentators alike are struggling to reconcile this with their own views or experience of the economy. While space precludes a full description of our view on global equity markets, we are not overly concerned about markets' current levels. Make no mistake, there is not too much room for error, but we do not share the view that equity markets are about to experience a serious downturn. There are some signs that worry us though, one of which is depicted in Chart 4, below.

Chart 4: Wall Street is prospering but Main Street isn't

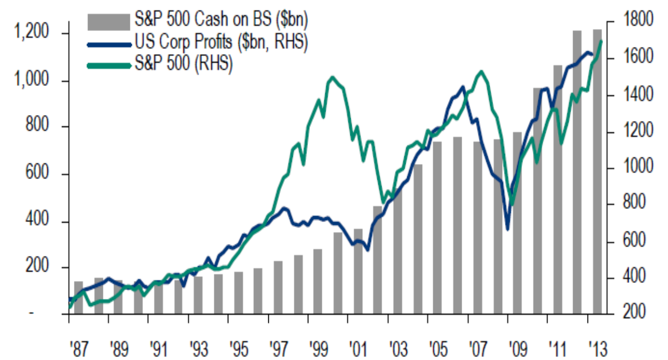


Source: Merrill Lynch

Chart 4 depicts an equal-weighted index of US bond and equity markets (the red line heading higher) i.e. it represents a crude but meaningful indication of the increase in investor wealth, together with the US labour participation rate (LFPR) (the blue line heading lower) i.e. the extent to which the US labour force is actually employed or actively seeking to be employed. Although the LFPR rate has been in steady decline since the beginning of the New Millennium and can be explained by a number of sound reasons (increasing pervasiveness of technology, increased productivity, etc), the fact remains that these two lines cannot continue to move in separate directions forever. One should also bear in mind that US investment markets and the equity market in particular reflects a general increase in the growth of the global economy; a large part of US corporate earnings are earned outside the US in emerging markets that are growing more rapidly than the US. So there is perhaps a more tenuous relationship between the two lines than one would think, but the fact remains we need to see the LFPR increase in time in order for the US economy to resume its role as the engine of growth for the world economy. So, while we do not lose sleep about this consideration, we do think about it just before we put the light off.

What helps us sleep well at night is that although there are a few good reasons to be concerned about the current strength in equity markets – by the way, as long as I have been close to the markets there have been good reasons for concern, there are also a number of sound fundamental reasons to believe that equity markets are not about to tumble or reverse their recent trend. The rate of increase might slow down (and quite frankly we would be happier if it did), but we think the uptrend will remain in place. Let me share some of these reasons with you briefly, in graphic form.

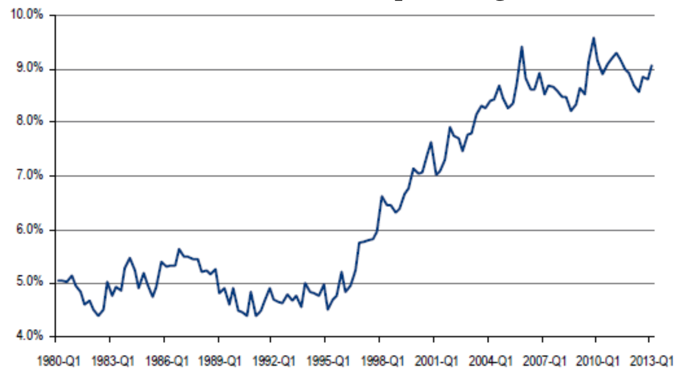
Chart 5: US stocks, profits & cash - all at all-time highs



Source: Merrill Lynch

We know that corporate America, and the corporate (developed) Western world for that matter, is in reasonable shape. Primed by cheap money (QE), which now seems set to last until well into 2014, the corporate sector is in good health. Chart 5 shows that the levels of US corporate profits and cash are at all-time highs, as is the US equity market. Another way to look at the level of cash held by US corporates is to express cash levels (excluding banks and financial companies) as a percentage of US GDP. This is reflected in Chart 6. Although not at an all-time record level, you will agree that cash levels are high i.e. companies are generating vast quantities of cash and are not redeploying it immediately or reinvesting it into additional capacity (largely because Main Street hasn't caught up with Wall Street yet – refer again to Chart 4).

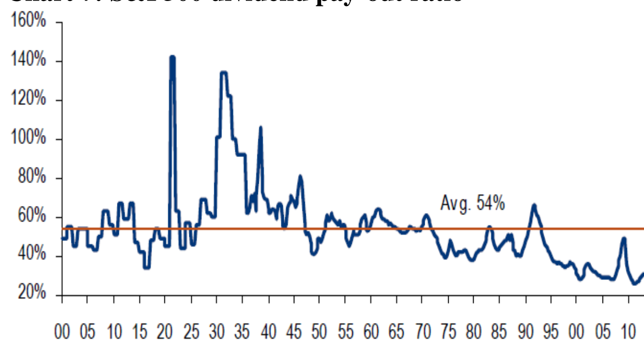
Chart 6: Non-financial cash as a percentage of US GDP



Source: Merrill Lynch

If US corporates are not embarking on a major capital expenditure spree (and we don't expect them to in the near future, which is admittedly a long-term concern) then one option is to share at least some of it with shareholders in the form of dividends. That calls into review the extent to which they have done so in the past i.e. how generous are companies currently relative to their past behaviour? The answer, shown in Chart 7, is that they are actually quite stingy at the moment.

Chart 7: S&P500 dividend pay-out ratio

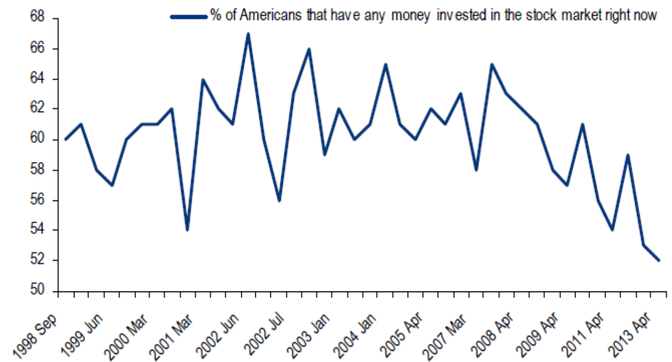


Source: Merrill Lynch

Chart 7 shows that the long-term average dividend payout ratio i.e. how much of their earnings they distribute as dividends, is currently very low (at 36%) relative to the long-term average ratio of 54%. It has recently been rising and with little place to invest it and with little interest paid on it, it is reasonable to expect that companies will distribute some of it to patient shareholders. In other words, it is reasonable to expect that the rate of growth in dividends is likely to increase from current levels, which in turn is supportive of equity prices.

One final chart (for now at least) that depicts a supportive factor for current equity market levels is the extent to which so many US retail investors are missing out; the number of Americans who have any money in the stock market at present is very low – at least the lowest since 1998. This is quite normal – not that they have very little equity exposure, but that they have got it so badly wrong. Retail investors have a remarkably accurate (and well-documented) record of getting their timing into the share market wrong. We refer to that attribute as a contra-indicator; the US retail investor is a wonderfully accurate contra-indicator of the level and direction of US equity markets. If their exposure was very high, we would all have to be very worried, but it is not. It is at very low levels, which provides us with more comfort that the current trends in developed global equity markets are likely to continue for some time.

Chart 8: American stock ownership at an all-time low



Source: Merrill Lynch

The original creator of this wonderful environment, one Ben Bernanke, is about to step down from his position as Chair of the US Federal Reserve. That is a small concern in and of itself, but given our reading of the prevailing landscape and considering the options available to his successor, Janet Yellen, we don't believe any major change in US monetary policy (i.e. the low interest rate environment) is about to be implemented. So … *a luta continua* … the party continues, at least for the foreseeable future. Make no mistake, this might all end in tears and history might come to regard QE as a terrible social and monetary experiment, but in our humble view it is far too early to start discounting this event, and so for now we continue to hold a positive view towards global equity markets and developed ones in particular.

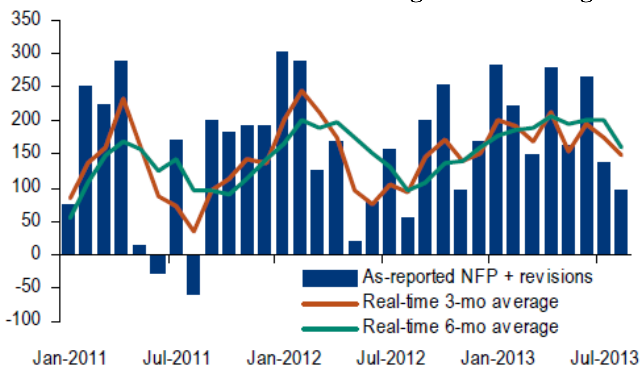
A few quotes to chew on

Possible reason for the lack of investor concern

I am sure many of you are wondering why, with the US political crisis in full swing, markets are not in crisis, too. After all, the US defaulting on its debt is in no-ones' interest and markets have fallen for less significant reasons. *Merrill Lynch Chief Investment Strategist Michael Hartnett,* offered

a couple of reasons for this anomaly, one of which is as follows: “We believe investors now want to be structurally ‘long’ stocks and ‘short’ bonds. Stocks have outperformed bonds over the past 3, 5 and 10-year spans. And yet in the past 6 years investors have redeemed $900 billion from long-only equity funds and bought $1.2 trillion of bond funds. That positioning now appears to be reversing (and judging by inflows currently pouring into bullish levered ETF strategies the ‘fast money’ seems keen to front-run this Great Rotation). We think this dynamic creates a ‘sellers’ strike’ in equities, and a ‘buyers’ strike’ in bonds.”

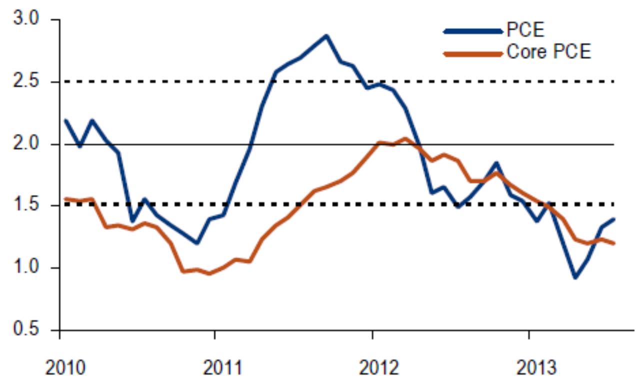
Chart 9: US labour market – losing momentum again?



Source: Merrill Lynch

So what is the Fed actually looking at?
With all the noise about tapering of QE, it is worthwhile recording a key extract from the Fed’s statement after its September meeting, when it decided not to reduce any of its QE at this stage. *Fed Chairman Bernanke* said “…the Committee will, at its coming meetings, assess whether incoming information continues to support the Committee’s expectation of ongoing improvement in labour market conditions and inflation moving back toward it longer-run objective”. The point to note here is that the Fed is watching both the labour market (which is not really improving – refer to Chart 9) *and* the US rate of inflation (which is edging ever closer to zero and then deflation - refer to Chart 10), before it begins to reduce its current very loose monetary policy (QE). He went on to say “we can’t let market expectations dictate our policy actions. Our policy actions have to be determined by our best assessment of what’s needed for the economy.”

Chart 10: US inflation – missing the 2% target level



Source: Merrill Lynch

What do the next five years look like?
Merrill Lynch Global investment strategist Michael Hartnett threw a few thoughts around recently (mid-September) which we thought were worth sharing. Encouraging investors to curb their enthusiasm, he said “ Significant monetary stimulus, the end of fiscal austerity, a booming housing market, a cheap dollar, record corporate cash balances…if the US economy does not significantly accelerate in coming quarters, it never will. We assume it will, and favour assets (e.g. equities), sectors (e.g. banks) and markets (e.g. Europe) that have lagged in the “High Liquidity-Low Growth” world of recent years. Asset price will not do as well in the next 5 years, no matter what the “nouveau bulls” say. Central banks will be less generous, corporations less selfish. … The dollar and (temporarily) volatility will be the last assets to surge as Deleveraging ends and an era of Normalization begins”.

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The US government shutdown – who actually gets hurt?
Given all the noise surrounding the political circus in the US I found the following item from the *Merrill Lynch Global Economist Ethan Harris* very interesting. Commenting on who the real casualties are from a government slowdown, he wrote as follows. "So if incumbent politicians don't get hurt, who does? There are several ironies to the government shutdown. First, the shutdown hits the wrong part of the budget. It is meant to be a way to stop the fast-approaching Affordable Care Act. However, the Affordable Care Act is a mandatory spending program and is not affected by the shutdown. More broadly, the shutdown hits discretionary spending, a part of the budget that has been cut repeatedly and is falling as a share of GDP. Rapidly growing entitlements are exempt. The second irony is that the shutdown is a step backward in fixing the budget deficit. The House has voted unanimously to pay furloughed Federal workers retroactively. Once the shutdown is over, the Senate is likely to concur. As a result, the shutdown is effectively a multi-week paid vacation for many Federal employees, with no lasting reduction in government pay. At the same time, the process of closing and reopening the government adds several billion dollars to the deficit. Moreover, the longer the shutdown, the bigger the shock to confidence, spending and tax revenues. Who really gets hurt? In essence, the shutdown is effectively putting Federal workers on a paid vacation so they cannot help individuals or firms that depend on "nonessential" government services. Hmmm..." We can only add our own comment: "Hmmm…"

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.

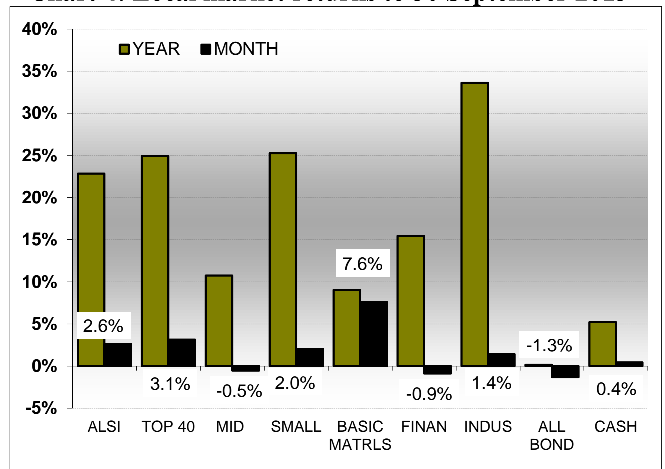
Table 1: The returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Prescient Fund	**Sept**	**5.6%**	**15.7%**	**26.7%**
JSE All Share Index	*Sept*	*5.1%*	*15.1%*	*27.0%*
Retirement Funds				
Maestro Growth Fund	**Sept**	**4.0%**	**11.6%**	**19.7%**
Fund Benchmark	*Sept*	*4.0%*	*12.2%*	*18.9%*
Maestro Balanced Fund	**Sept**	**3.5%**	**10.6%**	**17.8%**
Fund Benchmark	*Sept*	*3.5%*	*11.1%*	*18.2%*
Maestro Cautious Fund	**Sept**	**3.2%**	**8.5%**	**13.7%**
Fund Benchmark	*Sept*	*2.9%*	*6.4%*	*11.0%*
Central Park Global Balanced Fund ($)	**Aug**	**-0.8%**	**-9.4%**	**-5.5%**
*Benchmark**	*Aug*	*-1.2%*	*3.9%*	*6.6%*
*Sector average ***	*Aug*	*-1.5%*	*2.3%*	*7.6%*

* 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 ($)

September in perspective – local investment markets
The strong performance on global investment markets flowed through to the South African market, although as has been the case so often this year, the financial and industrial indices led the charge. The basic material index rose "only" 2.9%, being eclipsed by the 6.3% returns from both the financial and industrial indices. The net result was a 5.0% return for the All share index, bringing its year-to-date return to 15.1%. The basic material, financial and industrial year-to-date returns are -2.8%, 11.4% and 26.5% respectively. The small cap index trounced their larger brethren, rising 6.2%, versus the 4.9% and 5.1% respective returns of the mid and large cap indices.

Chart 4: Local market returns to 30 September 2013



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The gold index did its "usual thing" by falling 5.8%; its year-to-date return to is -45.6%, a far cry from the small cap index year-to-date return of 21.6%. The best performing sectors in September were the household goods sector (Steinhoff), which rose 21.8%, general retailers up 10.5% and pharmaceutical and biotech (Aspen) up 10.2%. The automobiles and parts sector (Metair) fell 5.7% and tech hardware and equipment (Pinnacle Technologies) 3.1%. The All bond index enjoyed a solid month, rising 3.9% although it is barely positive (0.5%) for the year-to-date.

So what's with the pics?

Last month I included a number of photographs of "birds with attitude" in an effort to moderate all the "econo-speak". This month it seemed appropriate to stick to one bird type. Given that the owl is so widely photographed and is so photogenic, it made sense to haul out a few pictures of owls and share them with you. I hope you enjoyed them? They came from all sources, including National Geographic's Photo of the Day and some unknown sources, so I apologize for not acknowledging their respective sources.

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

Region/Country	Market cap (U$m)	USD performance (%) YTD	USD performance (%) MTD
ACWI	**33,318,403**	**12.5**	**5.0**
DM	**29,630,350**	**15.3**	**4.8**
Asia Pacific	**4,290,871**	**13.9**	**7.2**
Australia	1,000,603	1.5	6.6
Hong Kong	370,328	5.0	5.5
Japan	2,710,420	22.3	7.7
New Zealand	15,448	11.2	13.5
Singapore	194,071	-2.0	6.7
GEM	**3,688,053**	**-6.4**	**6.2**
EM Asia	**2,289,381**	**-3.6**	**5.0**
China	714,682	-3.2	4.7
India	215,628	-14.0	9.0
Indonesia	86,461	-21.0	-3.8
Korea	588,055	-0.9	6.8
Malaysia	137,966	-0.5	3.2
Philippines	32,701	0.9	4.5
Taiwan	423,158	2.2	2.7
Thailand	90,730	-7.1	9.6
EMEA	**656,417**	**-7.9**	**8.3**
Czech	9,336	-14.2	7.7
Egypt	6,222	-11.1	7.1
Hungary	7,837	-2.9	4.5
Morocco	2,968	-9.0	8.5
Poland	62,300	-4.9	4.3
Russia	228,718	-2.7	10.2
South Africa	275,380	-10.3	6.9
Turkey	63,655	-16.2	12.8
LatAm	**742,256**	**-13.0**	**8.4**
Brazil	429,369	-13.3	12.1
Chile	63,500	-17.0	5.8
Colombia	44,539	-13.7	3.1
Mexico	189,304	-8.4	3.2
Peru	15,544	-33.0	1.8

Source: Merrill Lynch

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