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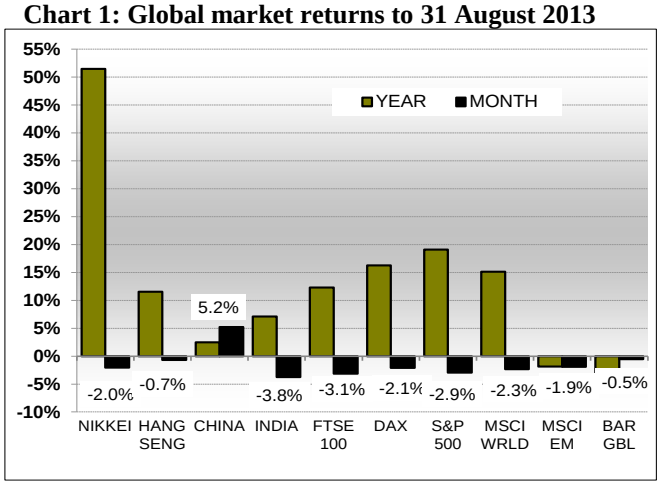
Investment Letter | 13th Edition | September 2013

August in perspective – global markets

Renewed fears that the US Fed will shortly begin scaling back its current quantitative easing (QE) program was the most influential factor affecting global investment markets during August. For the first time in a few months developed equity markets underperformed their emerging market peers as the MSCI World index fell 2.3% compared with the 1.9% decline in the MSCI Emerging market index. Turning to specific markets, the UK equity market declined 3.1%, the US 2.9%, Germany 2.1% and Japan 2.0%. Emerging markets were mixed as Indonesia declined 9.0%, India fell 3.8% and Russia 1.7%. However Brazil rose 3.9% and China 5.3%. Global bonds were weak as the Barcap Aggregate global bond index declined 0.5%. Despite weak equity and bond markets, commodities were generally strong during August as gold rose 6.1%, platinum 5.7% and Brent crude 5.9%. Base metals were also stronger as copper gained 4.6% and iron ore 6.6%. August saw a dramatic acceleration of currency weakness amongst those countries with current account deficits; the rand's 3.4% decline on the month needs to be seen in this context. The Brazilian real declined 4.0% in August, the Turkish lira 4.9%, the Indonesian rupiah 6.3% and the Indian rupee was hardest hit, declining 8.0%.

Chart 1: Global market returns to 31 August 2013



What's on our radar screen?

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

- *The SA economy:* SA's trade deficit widened to R14.2bn in July from R7.7bn in June, effectively erasing most of the two prior months' improvement. On a 12-month cumulative basis the trade deficit increased 5.3% to R148.5bn or 4.6% of GDP – refer to Chart 2, below, which depicts the cumulative 12-month SA trade balance. We continue to believe the rand remains vulnerable to further weakness, with the current account deficit our major Achilles' heel. The deficit increased from 5.8% of GDP in the first quarter (Q1) to 6.5% in the second quarter (Q2), which goes some way to explaining the rand's weakness so far this year. SA's economy grew at a rate of 2.0% during Q2 while the annual rate of increase in retail sales declined to 1.9% in June from 6.2% in May.

Chart 2: Rolling 12m cumulative SA trade balance (Rbn)

Source: Deutsche Bank

- *The US economy*: Investor focus remains fully on all US economic data releases. They know that the US Federal Reserve (the Fed) is watching them too for guidance as to the extent and timing of the tapering of Quantitative Easing (QE). The data releases were a mixed bag; some were good and some bad, with no clear trend emerging. In summary the US economy is inching forward but not at the rate investors and policy makers would like.
- *Developed economies:* Similarly European data revealed an economy recovering, but at a very slow rate. Unemployment remains a critical issue for the periphery of Europe.
- *Emerging market economies:* against the background of significant pressure on certain emerging market currencies, the **Brazilian** central bank increased rates by 0.5% to 9.0% at the end of August, bringing the increase in rates to 1.75% since April this year. For similar reasons the central bank of **Indonesia** increased their official interest rate by 0.25% to 7.25%. The official reason given for the hike was to dampen inflation (currently 5.9%), bolster the currency and ensure that the country's current account deficit was sustainable. **Chinese** July inflation came in at 2.7%, unchanged from June, while industrial production rose at an annual rate of 9.7% in July, up from 8.9% in June. If there was a feature during the past six weeks it has been that the economic momentum in China seems to have picked up from the first half of this year, which has, in turn, lent an element of support to global equity markets in September so far. **Indian** inflation rose to 9.6% in July, down from 9.9% in June. The July rate of inflation in **Turkey** is now 8.8%, coincidentally the same as the May unemployment rate.

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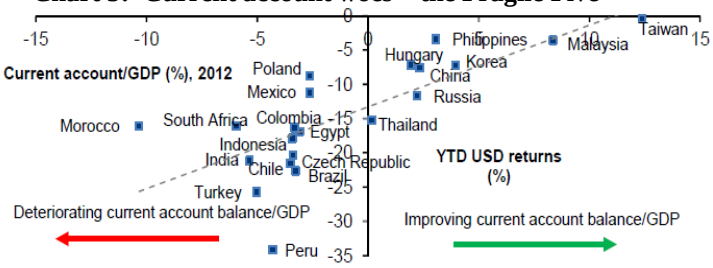
What's happening to emerging market currencies?
For the most part of this year, certain emerging market currencies have been under enormous pressure. We have drawn your attention to it before, specifically within the Quarterly Reports, but also in the letters that accompany client statements. In typical fashion, the media and market commentators have coined a phrase for these currencies that seems rather appropriate; they are now referred to as the *Fragile Five*, and include the Brazilian *real*, the Indian rupee, the Indonesian rupiah, the South African rand and the Turkish lira. These particular currencies have all lost ground against the US dollar. The common denominator across all of them is that they all run substantial current account deficits that rely on foreign inflows, in most cases portfolio flows as opposed to fixed direct investments (FDI), the difference being that the former are fickle and easy to withdraw or reverse while the latter, the FDI, are more permanent of nature and are not easily withdrawn. An example of portfolio flows would be foreign investors buying local bonds while an example of FDI would be a foreign investor building a factory or establishing a bricks and mortar presence in the country. It is easy to understand why investors feel uncomfortable when the current account deficits i.e. the extent to which countries' imports exceed the value of their exports (a bit like a bank overdraft) are funded by fickle foreign inflows that can reverse at the drop of a hat (they usually flee on the back of unfavourable politics or policies).

Many SA investors view the rand in isolation or believe the rand is inherently weak i.e. it can only decline. Of course, reality is more complex than that; as investment professionals we have to set aside our personal views (which are inevitably biased one way or the other) and adopt a view based on carefully considered economic rationale. A careful analysis of the following charts should go some way to show that there are sound reasons why the rand has declined. It has less to do with Jacob Zuma or Julius Malema (although their antics and pronouncements do not help) and more to do with economics, specifically our inability to fund our economic activities on our own. It also has to do with a multitude of other factors, such as the level of interest rates in other countries, the prospects of other countries, investor sentiment, to name a few.

Chart 3 depicts emerging market countries' current accounts, expressed as a percentage of their respective economies (GDP) on the horizontal scale, against the movement of their respective currencies on the vertical scale. So where a country such as South Africa has a current account deficit of 6.5% (see the Radar screen comments, above) and the rand has declined 17.2% so far this year, you would expect to find it in the bottom left quadrant (the top quadrants are not shown in the chart). And that is exactly where it is, together with the other *Fragile Five* members. The point being that the rand does not move in isolation.

Chart 3: Current account woes – the Fragile Five



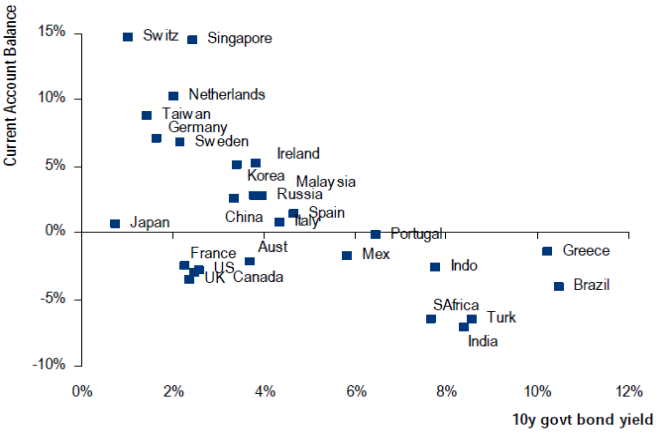
Source: Merrill Lynch

We often talk, within the Maestro team and family, about the "discipline of the international capital markets". What does that mean? Well, simply put, if you misbehave, you get punished. By misbehave, in the context of international capital markets, we mean applying inappropriate policies such as foreign exchange controls or barriers to free trade; by punished, we mean you will have to pay a higher rate of interest if you ever need to borrow money. The "price" of borrowing on the international capital markets i.e. from investors outside your country, is determined primarily by the level of interest you will pay and by the nature and prospects of your currency i.e. is it expected to decline or strengthen against say, the US dollar.

By way of example, South Africa cannot borrow money at 1.8% as the Germans currently can, or 2.8% like the Americans can, but rather it has to cough up around 8.0% to borrow money. And that, surprise surprise, is at similar levels to other members of the *Fragile Five*, as illustrated in

Chart 4, which plots current account deficits against recent borrowing costs. Once again, South Africa, and more specifically the rand, is not alone – it moves in line with other countries with similar economic characteristics.

Chart 4: Current account balances vs government bond yields



Source: Merrill Lynch

Let me add that while 8.0% may not sound like a high rate of interest (we have been numbed by rates in excess of 15% in the past) when one borrows a lot of money as the *Fragile Five* do, then the costs of borrowing add up very quickly in absolute terms. Just think of all the money SA could redirect to the poor, or towards job creation, or freeing up small business to create more jobs and function efficiently, etc, if it halves its cost of borrowing to, say, 4.0%. So every time government does something silly on the policy front, we pay a very high price for our stupidity and our people pay a very real price in their daily lives, now and into the future. We are of the humble view that SA's political leadership is largely unaware of the discipline of global capital markets, what it means for South Africa, and the impact it has on government policy behaviour.

A final aspect of this discussion has to do with the level of inflation. The higher the inflation rate, which in the case of a very open economy i.e. one which imports a lot of its requirements, like oil for example, the higher the level of interest rates. If inappropriate policies are applied, the currency would weaken (due to pressure brought to bear on it by the forces and disciplines of global capital markets) which would exacerbate the current account deficit and inflation. These three problems, a weak currency, current account deficit and high inflation, are a deadly combination which spells hardship for any country unfortunate enough to be faced with them. That is what binds the *Fragile Five* together – they all suffer in one way or another from this deadly cocktail, the outcome of which is not only further economic hardship but also socio-economic and socio-political issues like slowing growth, rising unemployment, increasing crime, including tax avoidance, VAT fraud, and the like as citizens and corporates try to "work around" the system which they perceive to be against them and unfair; in most cases it is only rational to feel this way, given that government is simply failing its citizens.

It is not without reason, then, that Brazil, India and Indonesia recently raised interest rates (see the Radar screen comments, above). Their policy action is an attempt to curb rising inflation, stem the weakness in their underlying currencies and shore up global investor support. Of course, it comes at a price though, given that higher interest rates will slow economic activity and stifle consumer demand.

I haven't touched on the issue of Quantitative Easing (QE) which is a very important aspect of the currency debate surrounding the *Fragile Five*. I won't go into detail here but suffice is to say that with so much "free money" having been pumped into the global economy by the central banks of the US, Japan and the EU, a lot of it found its way into emerging markets, thereby supporting their currencies and economies and bringing down sovereign borrowing costs. The fear now is that as QE is scaled back the "free money" flow will reverse, leading to weaker emerging market currencies, higher inflation and slower growth. There is already evidence of this happening.

The purpose of this simple economic discussion is firstly to introduce the *Fragile Five* to you but more importantly to help you understand, if you don't already, that the rand does not move in isolation but is driven by the forces of global capital markets. Our (Maestro's) view of the rand takes this into account and has less to do with the non-sensical utterances of politicians and more to do with ineffective policy implementation and the effects it will have on the country, translated through a weaker currency, higher inflation and slowing growth.

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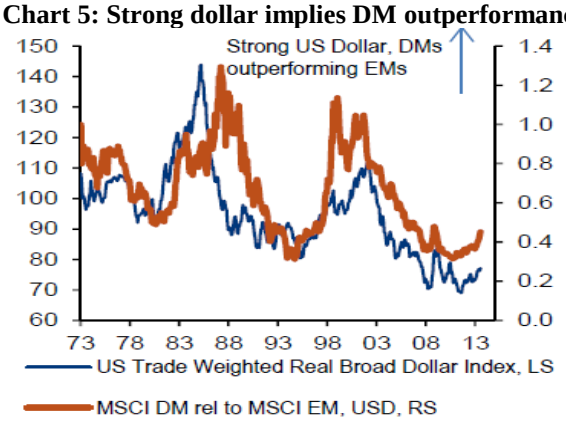
Global charts of the month

For some time now I have wanted to discuss some charts, mostly unrelated to each other, but there never seems to be sufficient space. So forgive me if this edition runs on too long, but before they date I would like to share a greater than usual number of charts which I found interesting and which relate to the prevailing investment climate; I hope you find them interesting too.

Chart 5: Strong dollar implies DM outperformance



Source: Merrill Lynch

Chart 5 shows a long and well-established trend; when the dollar is strong, developed equity markets (DM) tend to outperform emerging markets (EM). The chart stretches over 40 years so the recent years are not that clear. However the spike in 2008 shows the sharp outperformance of DMs following the sub-prime crash of 2007/9, after which emerging markets outperformed quite substantially. However, for the past 12 to 18 month developed markets have posted much stronger gains than emerging markets, which is evident from the most recent upturn in the chart and from what we have been drawing your attention to in the letters accompanying client statements each month. The thin blue line in the chart represents a broad dollar index. Its recent outperformance indicates dollar strength, particularly against emerging market currencies, the likes of which I commented on with regard to the *Fragile Five*, above.

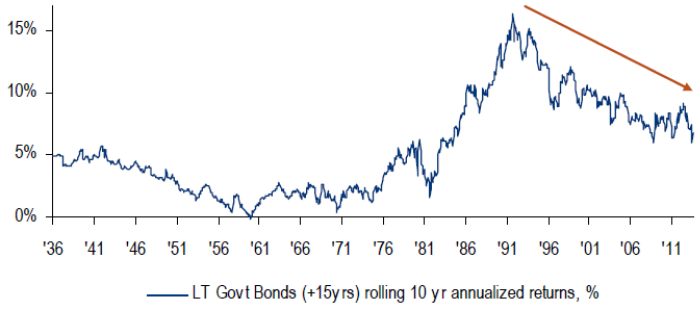
Speaking of dollar strength, Chart 6 below shows the same index (its code in most information systems is "DXY" which is also the name we give to the index in the profession) but stretching over a longer period. The recent strength in the dollar is also evident. I share this chart with you because if one is of the view that the US economy will continue to recover and US bond yields continue to increase, which is Maestro's "base case view", then one would expect the DXY to continue to increase i.e. the dollar should strengthen against a basket of currencies. If that does occur it doesn't bode well for the *Fragile Five*, which includes the rand.

Chart 6: Strong dollar implies DM outperformance

Source: Merrill Lynch

Changing tack slightly, the following two charts address our view that the coming few years will be characterized by a gradual rotation away from bond assets and towards equities; this view has come to be known as the Great Rotation. Chart 7 below depicts the 10-year rolling return from US long-term bonds, which you can see has been in a steady decline since 1991. It is our view that the 30-year bull market in US bonds has come to an end, which will lead to the ongoing decline in this return.

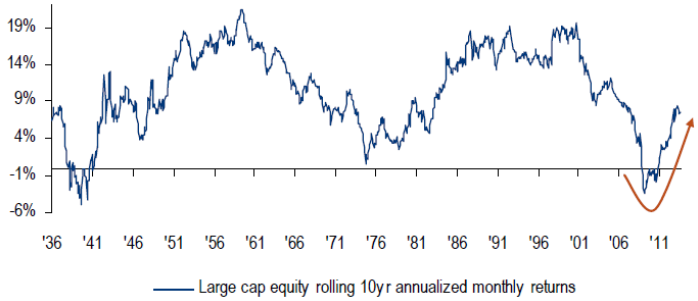
Chart 7: US government bonds - 10-year rolling return



Source: Merrill Lynch

Chart 8 on the other hand depicts the same rolling, annualized return, but from the US *equity* market. We shared this chart with you a number of times between 2009 and 2010, drawing your attention to the fact that, on average, the US equity market had not delivered a positive return for the past decade. The "final sell-off" occurred into the sub-prime induced crisis of 2007/9 but the bottom of that crisis, which saw the S&P500 index fall to a level of 666, marked the trough of the 10-year rolling return. Given the strong markets we have experienced since 2009, the return is now well on its way higher; we suspect that to continue. The ride will be bumpy, make no mistake, but it provides the context against which the Great Rotation should be viewed.

Chart 8: US equities - 10-year rolling return



Source: Merrill Lynch

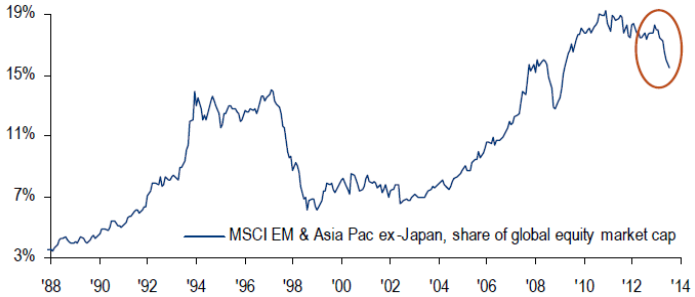
One modern phenomenon remains, for me at least, an astonishing piece of financial history; it is the decline of the Japanese equity market. The Nikkei 225 index rose to a peak level of 38 957 in February 1989 peak before declining to a trough of 7 012 in March 2009 – a fall of 82.0%! At the time of writing, the index is 14 405. The economic impact of that development, not to talk of the poor investment returns, is simply staggering. Chart 9 depicts the Japanese market as a percentage of world market capitalization i.e. the percentage the Japanese market forms of the combined total of all other markets. In 1988 Japan's share of the world market cap peaked at 44% but by late 2012 had collapsed to only 7%.

Chart 9: Japan as a % of global equity market cap.

Source: Merrill Lynch

In similar vein, it is worth looking at the same statistic but this time to see what percentage emerging and Asia Pacific markets, excluding Japan, comprise of total global equity market cap. This is shown in Chart 10 – the trend is obvious, notwithstanding the sharp sell-off in recent months.

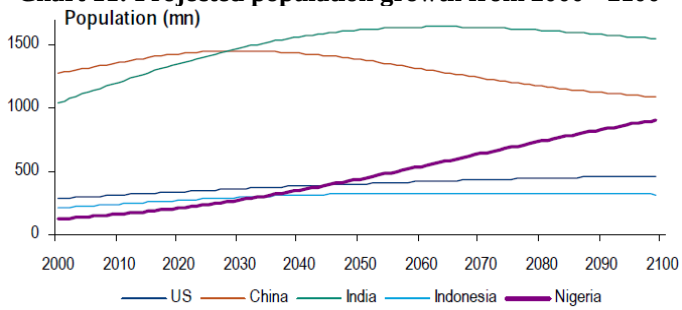
Chart 10: EM and Asia Pacific-ex Japan as % of global equity market cap



Source: Merrill Lynch

And finally, and totally unrelated, if you are planning to be around in 2100, you might like to know who your global neighbours are going to be. Chart 11depicts projected population growth for selected countries. In case the colours are not clear, the right hand side of the chart depicts, from top to bottom, India, China, Nigeria, US and Indonesia. Within the Maestro team, we are focusing more attention on the growth and investment opportunities within Africa; we recently introduced two small investments in African equity funds into Central Park Global Balanced Fund, our offshore unit trust. The strong increase in the Nigerian population goes a small way to explaining our interest in this region.

Chart 11: Projected population growth from 2000 - 2100



Source: Merrill Lynch

A few quotes to chew on

The cheap money is not yet at an end

Merrill Lynch Chief Investment Strategist, Michael Hartnett, has the following to say: "In 300 years of history, the Bank of England's base rate has never been lower than the 0.5% of the past 4 years (and new BoE Governor Carney wants to keep it there for a few more years). The degree of policy stimulus and intervention in global financial markets is historically unprecedented and has been and continues to be

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extremely positive for asset prices. But in the next year, the ability or otherwise of policy makers to finally deliver above-trend economic growth in the US, UK, Europe and Japan will determine the fate of asset prices.

The breakout of equities from their long-run trading range (refer to chart 8 above), the 120 basis point rise in 10-year Treasury yields and the significant decline in gold prices suggest investors are discounting the beginning of a stronger economic recovery after a period dominated by deflation, debt deleveraging and default risk following the Great Financial Crisis.

2013 Winners and losers

On 15 August *Merrill Lynch Chief Investment Strategist Michael Hartnett* wrote the following: "Almost two years on from the acceleration of US house prices and one year on from Europe's 'whatever it takes' moment, investors seem to be in bullish spirits as The Great Rotation moves from controversial to consensus. Trading it has not been particularly easy, though. For example, how many have been 'long Greek bonds, short gold', the best performing pair trade of the past 12 months? The 338% total return from this pair trade in the past 12 months is a useful reminder that five years on from the Great Financial Crisis, both policy and positioning remain big drivers of asset prices".

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

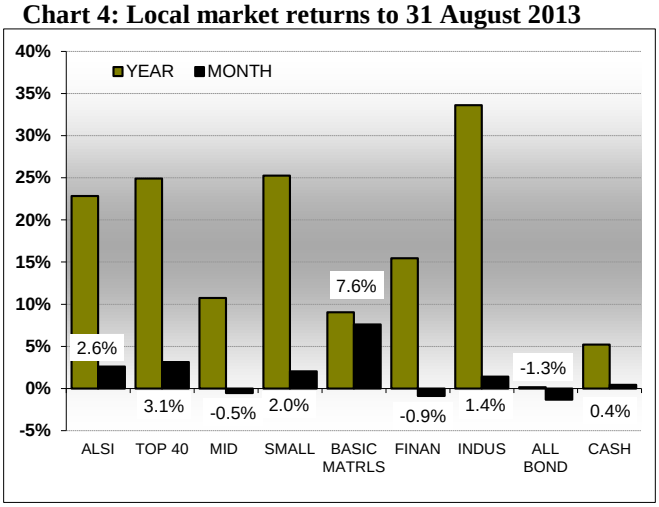
	Period ended	Month	Year to date	Year
Maestro Equity Prescient Fund	**Aug**	**2.8%**	**9.5%**	**20.3%**
JSE All Share Index	*Aug*	*2.6%*	*9.5%*	*22.8%*
Retirement Funds				
Maestro Growth Fund	**Aug**	**2.1%**	**7.4%**	**15.6%**
Fund Benchmark	*Aug*	*1.6%*	*8.0%*	*16.3%*
Maestro Balanced Fund	**Aug**	**1.9%**	**6.8%**	**14.2%**
Fund Benchmark	*Aug*	*1.3%*	*7.4%*	*15.4%*
Maestro Cautious Fund	**Aug**	**0.8%**	**5.1%**	**10.7%**
Fund Benchmark	*Aug*	*0.6%*	*3.4%*	*8.9%*
Central Park Global Balanced Fund ($)	**Jul**	**3.2%**	**-8.7%**	**-3.8%**
*Benchmark**	*Jul*	*2.3%*	*5.0%*	*9.0%*
*Sector average **	*Jul*	*2.6%*	*3.8%*	*9.0%*

* 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 ($)

August in perspective – local investment markets

The All share index rose 2.6% in August, driven by a strong basic material index assisted by recovering commodity prices and a weak rand. The basic material index rose 7.6%, the financial index *declined* 0.9% but the industrial index managed a rise of 1.4%. Large caps outpaced mid and small caps as the Top 40 rose 3.1% versus the 0.5% decline in the mid cap index and the 2.0% rise in the small cap index. The All bond index declined 1.3%, bringing its year-to-date decline to 3.3%.

Chart 4: Local market returns to 31 August 2013



The best performing sector was, for the second month in a row, fixed line telecoms (Telkom), which rose 18.2%. The platinum sector rose 16.2% and the household goods sector 12.1%. The worst performing sectors were technology

hardware and equipment, which fell 7.1%, food producers 5.4% and real estate investment and services 3.9%.

Focus on saving for retirement – the US experience

Many of you will know that Maestro team members are rather zealous about saving for retirement. The reason for that is that we see so many people who start too late and will never be able to retire comfortably. We apply missionary-like fervour to all who will hear our important message: ***if you want to retire comfortably you need to start early, use the appropriate investment vehicle and watch costs closely***. Maestro's retirement solution provides all of the above and, with the help of employers, can help most employees, especially young ones, retire relatively comfortably.

In the coming weeks we will be sharing a few stories and cases with you in *Intermezzo*, which address the issue of retirement funds and saving for your retirement. Of course, this situation is not unique to South Africa but is found all over the world. I have always marvelled how in a country like the US, where people have had more opportunity than anyone else around the world, citizens are no better off when it comes to being able to retire comfortably. Besides living in peace i.e. without having their savings and livelihood destroyed by war, and living through the greatest bull markets in living history, most "Baby Boomers" will retire in poverty! How ironic! Who have they to blame? Surely only themselves?

I recently came across the following excerpt from an article by Merrill Lynch and it seems an appropriate start to our coverage of retirement matters in the coming months. The article was addressing the US savings rate and its prospects, but it included the following eye-opening data*:*

"In recent years, the press has been full of stories about how Americans are inadequately prepared for retirement. The hard data confirm that there is a big shortfall. Data from the Centre for Retirement Research (CRR) shows workers are saving less, even as the expected length of retirement grows. Social Security replacement rates - payments compared to working income - are likely to drop from 39% in 2002 to 35% in 2015 and 33% in 2030. The average 55 to 64 year-old household head has only $582 000 in wealth, of which more than half is in anticipated social security benefits. Only 14% of workers had a defined benefit retirement plan in 2010, down from 32% in 1988. Over that same period the expected time in retirement increased by several years.

The overall picture is grim. The CRR National Retirement Risk Index measures the percent of households that will not have enough income to maintain their spending in retirement. The index has steadily risen from 30% in the 1980s to 40% in the 1990s to 44% in 2007 and 53% for the most recent data in 2010. In other words, even if all households work until age 65, annuitize all their financial assets and put the maximum allowable reverse mortgage on their house (leaving virtually no assets for the next generation), more than half are still at risk of not being able to maintain their living standard in retirement.

Not only are assets inadequate, they are on much shakier ground. Based on a very generous discount rate of 8%, state and local pension funds are now 73% funded, but using a more realistic 5% rate the funding drops to just 57%. Social Security is also seriously underfunded: the gap between payments and revenues is now climbing and will reach 5% of taxable payroll income in 20 years. Private pensions face similar underfunding. Even the Pension Benefit Guaranty Corporation, the backstop for private defined benefit plans, has a deficit of more than $30bn and rising.

Of course all of this only matters to current savings if workers recognize and react to the shortfall. They are starting to get worried. According to Gallup, in 2002, 59% of non-retired adults said they will have "enough money to live comfortably." That has now dropped to 46%. Another poll found 72% of these older workers were "very or moderately worried" about "not having enough money for retirement." This high level of concern was shared by every income group. A similar survey by Pew Research found that in the last 10 years the percent of people worried about retirement finances had risen from 54% to 66%"

Following that disturbing article, I list below a cartoon my son sent to me a few days ago. It seems rather apt.

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The Anniversary piece – by Melody Nowai
I am amazed at how soon it's my turn again to do the anniversary piece; another year's just gone by and I can truly say it's been an enjoyable journey at Maestro so far. In my last anniversary piece, I wrote about a topic very close to my heart *"stopping for the one".* This time I will like to write briefly about one of my Heroes, someone who changed the course of history and who I believe had the audacity to stop not just for the one but for generations.

One Man, One Vision, One Passion
A couple of weeks ago, the entire nation was awakened to the rumours of anxious patriots who were made to believe their great national icon was slipping into eternity. As I paused to consider the legacy this great hero has left behind, my mind couldn't grasp the greatness of his vision and passion.

I speak of one who counted his life as nothing to make an indelible mark in his generation which will never be erased.

I speak of one whose dream went beyond himself; one who braved the odds and shame of the moment to see something better happen for the common good.

One whose vision was all encompassing, all pacifying and leading towards the highway to freedom. He didn't give up hope seeing his freedom put on hold so that many will be set free.

His resolve and resilience energized the multitudes to hold onto their quest for freedom. His long way to freedom is a memorial for generations to come. His passion to see the nation united and to see its people stand as one man has been felt throughout this beloved nation and the world at large.
I speak of one whose life will forever get into the chronicles of history and will be heralded wherever justice seeks recognition; a lifelong warrior who through pain, birthed the pleasure of many and left behind a rich inheritance for the generations to come.

I speak of Tata Mandela whose dream has found expression in our day.

As I ponder through his sacrificial life, these questions come alive in my heart:

- What legacy are we leaving behind for the next generation?
- Does Nelson Mandela's story inspire courage and hope in us for true change and freedom?

I end with a freedom quote from Madiba himself:

"I have walked that long road to freedom. I have tried not to falter; I have made missteps along the way. But I have discovered the secret that after climbing a great hill, one only finds that there are many more hills to climb. I have taken a moment here to rest, to steal a view of the glorious vista that surrounds me, to look back on the distance I have come. But I can rest only for a moment, for with freedom comes responsibilities, and I dare not linger, for my long walk is not yet ended."

So what's with the pics?
This edition of *Intermezzo* has been rather economically intense; I hope it hasn't bored you and that you have made it through to the end ☺? I was recently send a slide show entitled "Birds with attitude" so in an attempt to lighten up *Intermezzo* this month and make the economics – as important as it is to your investments with us – more easy to handle and bearable. Sadly, I do not know where all of the photographs come from so am unable to acknowledge their source.

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Table 2: MSCI returns to 31 August 2013(%)

	USD performance (%)	
Region/Country	**YTD**	**MTD**
ACWI	**7.1**	**-2.3**
DM	**10.0**	**-2.3**
Asia Pacific	**6.2**	**-1.7**
Australia	-4.8	0.7
Hong Kong	-0.5	-1.6
Japan	13.6	-2.2
New Zealand	-2.0	-1.7
Singapore	-8.2	-6.5
GEM	**-11.9**	**-1.9**
EM Asia	**-8.2**	**-1.4**
China	-7.6	2.4
India	-21.1	-10.8
Indonesia	-17.9	-15.3
Korea	-7.2	3.8
Malaysia	-3.6	-4.2
Philippines	-3.4	-11.9
Taiwan	-0.4	-1.1
Thailand	-15.3	-11.7
EMEA	**-14.9**	**-2.2**
Czech	-20.4	2.2
Egypt	-16.9	-6.1
Hungary	-7.1	-6.1
Morocco	-16.1	-5.2
Poland	-8.8	1.6
Russia	-11.7	-0.7
South Africa	-16.1	-1.4
Turkey	-25.7	-13.0
LatAm	**-19.8**	**-3.3**
Brazil	-22.7	-2.4
Chile	-21.5	-1.8
Colombia	-16.3	0.1
Mexico	-11.2	-6.6
Peru	-34.1	0.6

Source: Merrill Lynch