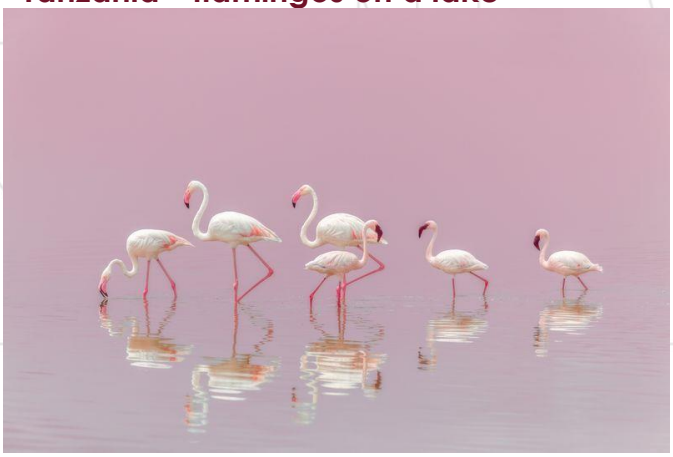
August in perspective – global markets

To describe August's market behaviour as "catastrophic" might be a bit melodramatic – unless you are a Turk or Argentinian of course. To describe it as "concerning" understates the powerful forces at work in currency and equity markets. One thing is for certain though – the past month showed that "global capital rules". There is simply no place to hide for structurally weak economies – only the strong survive in this kind of environment. Any sign of political indiscretion and structural economic weakness was dealt with swiftly and mercilessly during August. A lot of these pressures have been building for a time, and we have warned against them, especially South Africa's position in this regard, but the past month saw powerful forces unleashed that punished the "weak and vulnerable".

Tanzania – flamingos on a lake



If the above sounds like the beginning of a bad novel, forgive me. I want to convey the extent of the damage that was done in certain markets – currency and equity markets in particular – as a result, primarily, of the strong dollar but also corporate strength in certain global giants. Let me start with currency markets: certain emerging economies are structurally weak and in recent years have not taken the necessary policy action to rectify their weaknesses. Argentina, Brazil, India, Indonesia, Mexico, South Africa, and Turkey all fall into this category. With the crisis in Argentina now in full swing, and Turkey and South Africa shooting themselves in the foot with irrational policies and pronouncements, it was only a matter of time before the dominoes started tumbling. Despite increasing interest rates to 60%, the Argentinian peso still declined 28.1% against the dollar in August. With Turkey's tyrant continuing to make all sorts of ludicrous statements and promising the most irrational economic policies, the lira tumbled 25.9%. You know the South African story well; it doesn't help that the rand is one of the most highly tradeable emerging market currencies – it fell 10.6% against the dollar. One gets an indication of the carnage by reviewing the year-to-date declines against the dollar of some of the most vulnerable currencies: the Argentinian peso has fallen just over 50%, the Turkish lira 42.7%, the Brazilian real 19.5%, the rand 15.5%, the Indian rupee 10.1%, and the Indonesian rupiah 7.9% (at the time of writing the latter has just dropped to a 20-year low). Perhaps now you understand why I described the market activity as catastrophic.

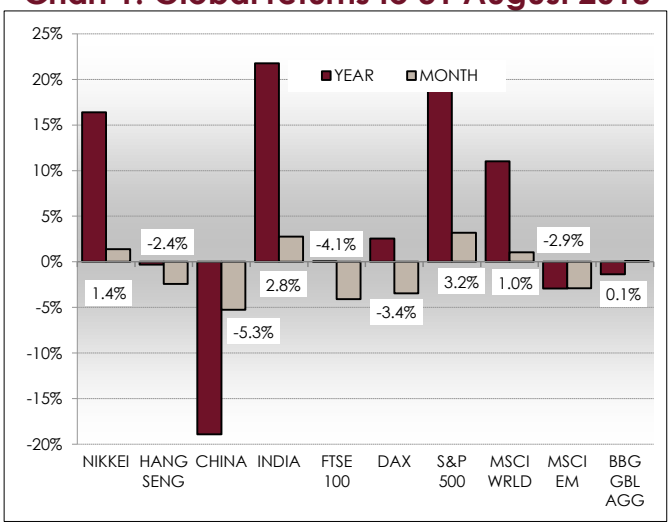
In the background, the US dollar continued to rise, fueled by the expectation of higher interest rates and a robust economy. The trade-weighted index (DXY) rose 0.6%, bringing its year-to-date gain to 3.3%. The dollar strength, together with concerns about the effect of the global trade war that has begun in all earnest, weighed heavily on the commodity complex, providing another body blow to the already weakened emerging market "basket cases". Although the oil price rose 11.7% off a low base, the price of gold, platinum, and copper declined 2.2%, 4.1%, and 3.8% respectively. The prices of soft (food) commodities declined far more.

Let's turn our attention to global equity markets. Remember the movements here are those of the local indices – so you need to factor in the currency crisis where appropriate, to appreciate the full damage in dollar terms. It has been quite schizophrenic to see the enormous damage done to emerging equity markets, and weak developed markets on the one hand, while on the other a US equity market that has gone on to register record after all-time record.

The US equity market rose 3.2%, while the UK, German, and Swiss markets declined 4.1%, 3.5%, and 2.2% respectively. Note how well the mid and small cap sectors of the US equity market are doing: during August the S&P Mid and Small cap indices rose 3.0% and 6.0% respectively, bringing their respective year-to-date returns to 7.6% and 17.3%. US equity markets were again propelled by the tech sector with the NASDAQ rising 5.7% (year-to-date return of 17.5%). It is hard to believe that some of the world's largest technology giants can get any bigger, but look no further than their movements during August: Apple rose 19.6% during the month alone, adding an astonishing $178bn to its market cap (size) in the process. Amazon didn't fare too badly either, rising 13.2%, adding $115bn in market cap during the month. To put Apple's gain into perspective, its market cap increase during August alone is equivalent to around 85% of the total value of the South African economy.

The Chinese and Hong Kong markets fell 5.3% and 2.4% respectively, while the real damage was seen in the Russian market, down 6.9%, Turkey and Greece, 4.4% and 4.2% respectively, and Brazil, 3.2%. To underline my earlier point that these returns are reflected in local currency terms, adjusting them for dollar terms yields monthly declines in the South African equity market of 8.5%, Brazil 12.0%, Turkey 30.2%, and Argentina 31.2%. Against this background, the difference between the MSCI World index monthly return of 1.0% and the -2.9% MSCI Emerging Market index return is understandable. The year-to-date returns of 3.4% and -8.9% respectively highlight just how poorly emerging markets have performed so far this year. The message is clear – the most attractive returns so far this year have been generated by developed markets and US markets in particular, while the dollar has been the best performing currency. Global bonds were surprisingly stable during August, with the Bloomberg Global Aggregate Bond index rising 0.1%.

Chart 1: Global returns to 31 August 2018

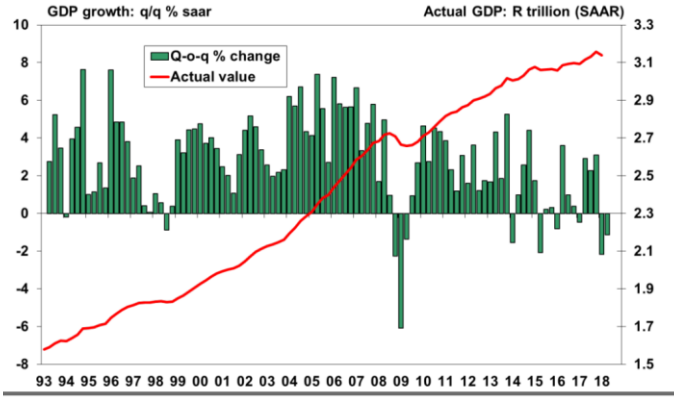


What's on our radar screen?

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

- *The SA economy:* The South African economy shrank for the second consecutive quarter, heralding yet another recession, which the country can least afford. The economy declined at an annualized rate of 0.7% during the second quarter (Q2) versus a 2.6% decline during Q1. Refer to Chart 2 for a historic overview of the SA economy.

Chart 2: Historic SA growth trends



Source: Nedbank

Although exports increased by 13.7% and imports by 3.1%, thus having a positive effect on the economy, expenditure declined by 3.6%, more than annulling the positive effect from net exports. Expenditure was pulled down by weak consumer demand, shrinking fixed investment and a rundown in inventories – all highly indicative of a lack of confidence in the future.

Chart 3: SA economy sector breakdown

Table 1 : Sector breakdown of GDP

Industries	Q-o-q % change (seasonally adjusted and annualised)								Size
	2016	Q1'17	Q2'17	Q3'17	Q4'17	2017	Q1'18	Q2'18	% of total
Agriculture	-10.2	25.6	36.9	41.7	39.0	17.7	-33.6	-29.2	2.6
Mining	-4.2	12.6	7.8	6.2	-4.4	4.6	-10.3	4.9	8.0
Manufacturing	0.9	-4.1	2.9	3.7	4.3	-0.2	-6.7	-0.3	13.2
Power & water	-2.3	-5.6	8.1	-6.1	3.3	0.2	0.2	2.1	3.7
Construction	1.1	-1.2	-0.7	-1.2	-1.4	-0.3	-1.9	2.3	3.9
Domestic trade	1.7	-5.6	0.9	-0.1	4.8	-0.6	-3.1	-1.9	15.0
Transport & comm	0.8	-1.3	2.6	0.8	2.8	1.5	0.9	-4.9	9.9
Finance	2.3	-0.5	3.1	1.9	2.5	1.9	1.1	1.9	20.2
General government	1.4	-0.5	-1.9	1.1	1.4	0.3	1.9	-0.5	17.7
Personal services	1.5	0.3	1.7	1.2	1.0	1.2	1.2	0.8	5.8
Value added	0.7	-0.4	2.8	2.5	3.0	1.3	-2.8	-0.8	100.0
GDP	**0.6**	**-0.5**	**2.9**	**2.3**	**3.1**	**1.3**	**-2.6**	**-0.7**	

Source: Nedbank

On a more positive note, inflation declined marginally during August, falling to an annual rate of 4.9%, from 5.1% in July. Core inflation is 4.2%. Although the news was a relief, consumers await another material fuel price increase in September, which is likely to push inflation higher over time. That said, SA inflation remains relatively benign, although sadly this is the case for the wrong reasons: consumer demand and general growth conditions are so bleak, there is simply no ability for anyone to increase prices. That said, inflation remains within the SA Reserve Bank's target range of between 3% and 6%.

Pakistan – green fodder crops

- *The US economy*: Economic news out of the US continues to be favourable, and confirms the ideal "Goldilocks world" of "neither too hot nor too cold, but just right" for ongoing growth and by implication a favourable environment for US equity investment. By way of example, US consumer confidence came in a lot better than expected, reaching its highest reading since October 2000. The second quarter (Q2) growth rate was revised up from 4.1% to 4.2% and at the time of writing the Q3 growth rate is on track to register around 3.5%. The ISM (PMI) manufacturing index rose more than expected to its highest level in 14 years. The new orders, production, and employment sub-components all rose strongly, indicative of a high-quality report. The ISM non-manufacturing index reading was also

strong, confirming the broad nature of growth. Even the inflation data was more muted than expected: August's annual headline inflation rate declined from 2.9% to 2.7%, while core inflation i.e. excluding food and energy prices, declined from 2.4% in July to 2.2%.

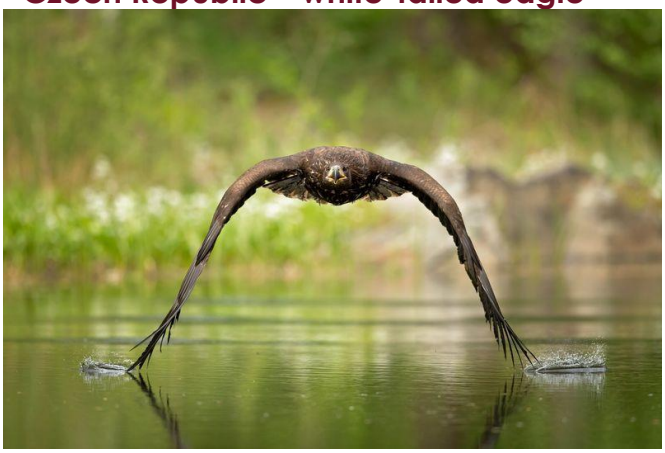
Vietnam – tea picking

- *Developed economies*: the Swiss economy grew at a quarterly rate of 0.7% during Q2, a bit lower than the 1.0% growth of Q1. Inflation, at 1.0%, is still below the Swiss National Bank's 2.0% price stability threshold.
- *Emerging economies*: Argentina continued to dominate many of the headlines. On 31 August the central bank raised interest rates by 15.0%, from 45.0% to 60.0%, but that didn't stop the peso from falling another 13.4% on the day. The currency has now fallen, at the time of writing, by 53.8% so far this year. The Merval stock exchange index is up 13.4% so far this year in local currency terms, but in dollar terms you would still be nursing losses in the order of 40.0%. Inflation is running at 31.2% but rates are clearly insufficient to attract capital. The IMF increased their $50bn bailout to $65bn and have started disbursing some of the capital. The Argentinian economy contracted by an annual rate of 4.2% during Q2. The Indian economy grew at a rate of 8.2% during Q2, thereby becoming the fastest growing economy in the world. That said, there were a number of reasons for the high growth, not least of which is the low base, so this rate of growth is unlikely to be repeated. The Reserve Bank of India (RBI) has raised interested rates by 0.5% during the past two months, partly in an effort to defend the rupee, but it still seems like the Indian economy will grow at about 7.5% during 2018. Inflation declined below 4% for the first time in 10 months. Annual inflation in August came in at 3.8%, although the RBI is targeting 4.8% in the year to March 2019.

Turning to Turkey, the annual inflation rate there rose to 17.9% in August, compared to the central bank's 5% target rate. Producer inflation rose from 25.0% to 32.1%, the highest rate in 15 years. So there is likely more bad news to come. Turkey's central bank consequently increased interest rates by 6.25% to 24.0% at their September meeting. The lira moved in an 8.5% range on the day of the announcement. While economically this was the appropriate response, the move was surprising in that it flew in the face of President Erdogan's recent rant about how "interest rates cause inflation" and that he was about to "take control of monetary policy". Following the hike in rates, Erdogan instituted a decree that will force most Turkish entities to stop using foreign currencies to lend or borrow. The Turkish economy grew at an annual rate of 5.2% during Q2, from 7.3% in Q1. The Minister of Treasury and Finance announced the new economic programme for the period 2019-2021, focussing on economic balancing,

fiscal discipline and transformation in manufacturing and exports, while reducing inflation. Turkey targets a growth rate of 3.8% in 2018, 2.3% in 2019, 3.5% in 2020 and 5% in 2021. It expects the current account deficit to fall from 4.7% of GDP this year to 2.6% by 2021, while inflation is forecast to fall from 20.8% in 2018 to 6% in 2021.

Czech Republic – white-tailed eagle

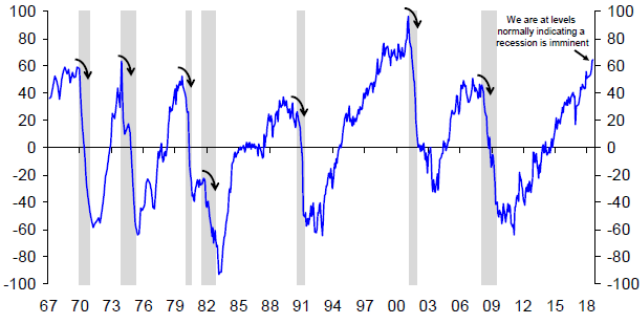


Turning to China, retails sales rose 9.0% in the year to August, industrial production rose 6.1%, and fixed asset investment 5.3%. Consumer inflation for the year to August rose 2.3% while producer inflation was a bit higher at 4.1%. All in all, the Chinese economy is still in good economic shape. Growth may be slowing a bit but there are no signs, at least in our view, that there is any cause for concern.

Chart of the month

We have continuously suggested that the US economy is in great shape. Growth continues to be robust, unemployment is at a record low, interest rates, though rising, are still relatively low, and inflation remains under control. Yet the media are full of articles suggesting the next US recession is around the corner. Although we do not believe this to be the case, it is important that we consider these views. The market "waits for nobody" and we must take care to not fall into the trap of group-think, or simply believing what is convenient for us.

Chart 4: Is a US recession imminent?



Source: Deutsche Bank

With that in mind then, consider Chart 4, which shows the present situation component of consumer confidence less the expectations component. From the chart it is clear that consumers are more optimistic about the present than the future. More interestingly is the fact that once the difference between the two components reaches current levels, a recession seems imminent (shaded lines in the chart indicate past recessions). Just to be clear, we do not believe a US recession is imminent. In fact, we would go so far as to say that we are unlikely to approach anything like recessionary conditions for at least another year, if not longer.

Quotes to chew on

Leading from the front

The ex-Business Day editor, Peter Bruce, wrote an interesting article in the Business Day in early-September, which I thought was worth sharing with you. In it he raised a number of issues about which we feel similarly. It is comforting to see we are not the only ones deeply concerned about the state of the South African economy and the country in general. Here is an edited version of his article; you can view the full one by clicking here.

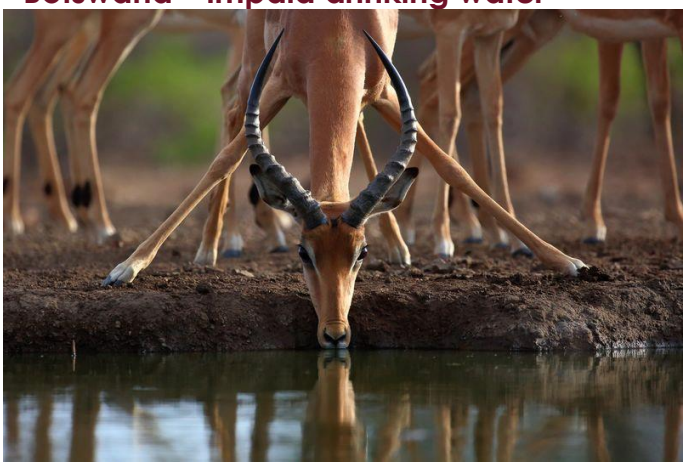
"On Friday morning President Cyril Ramaphosa arrives home from a summit in China, in the dying days of their summer. The Chinese have a lot of time for Ramaphosa. He's their guy. They never trusted Jacob Zuma — Vladimir Putin can have him.

Xi Jinping has Cyril's back, which is quite something considering what Donald Trump has done to America's standing in the world. And it's reciprocated. Ramaphosa admires what the Chinese have done. He likes the way they run their state-owned enterprises (SOEs) and he has spent more than one visit touring them and talking about them. He is writing a master's thesis on SOEs through Unisa and the Chinese will come out of it well, you can be sure.

… some things here are going well. Commissions of inquiry into past corruption are throwing new light on our recent past and must be strengthening his position. Enemies are being taken out. Supra Mahumapelo, Tom Moyane, Shaun Abrahams. All gone. Jacob Zuma and his son face trial. The opposition is all over the place. But … we are nevertheless in crisis. Figures confirm this week we are in recession. Not a "technical recession" as the radio keeps telling us. You're "technically dead" when your heart stops beating but you're also just dead. There's nothing "technical" about it. We are in recession, period. Consumer confidence is low. The purchasing managers' index, which measures future purchasing by companies, is off the charts low.

Unemployment is at record highs and our currency is testing lows last felt when Zuma installed the ridiculous Des van Rooyen as finance minister for a few mad days in December 2015. It now costs more than R20 to buy a British pound, more than R15 to buy a dollar. It means paying back our humungous debt will cost more rands, the import of capital goods required to kick-start some kind of recovery becomes prohibitively expensive, and we have no budget in the military, public works or public enterprises to create new demand that in turn might help local manufacturing or services.

Botswana – impala drinking water

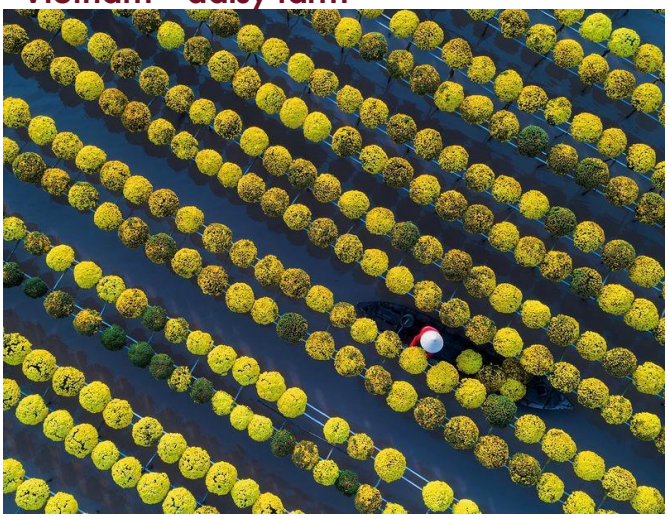


It is a mess, and when you add to the scenario continued unease about and, frankly, complete ignorance of, the future of land ownership in the country, it is understandable that the economy's shoulders would droop, as they have. And in a move that is just asking for real trouble down the road, we have now begun to subsidise the price of fuel. I cannot think of anything quite so stupid. Except, perhaps, land expropriation without compensation without explanation. For how long does the president expect the country's farmers and homeowners to wait for a convenient time for him to say what he means by making the constitution more "explicit" on expropriation without compensation? The longer he waits the more emotions will get out of control and the tougher the job he will have keeping his authority intact.

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

Already his pledge that there will be no land grabs under his presidency is being made hollow. There is land being grabbed in the south of Johannesburg, in Hammanskraal, in Limpopo — and it isn't being taken back by the police. Why not, Mr President? Surely the police have standing orders on this? And it's not going to help telling people to wait for the medium-term budget policy statement in six weeks' time. Six weeks is too long.

Vietnam – daisy farm



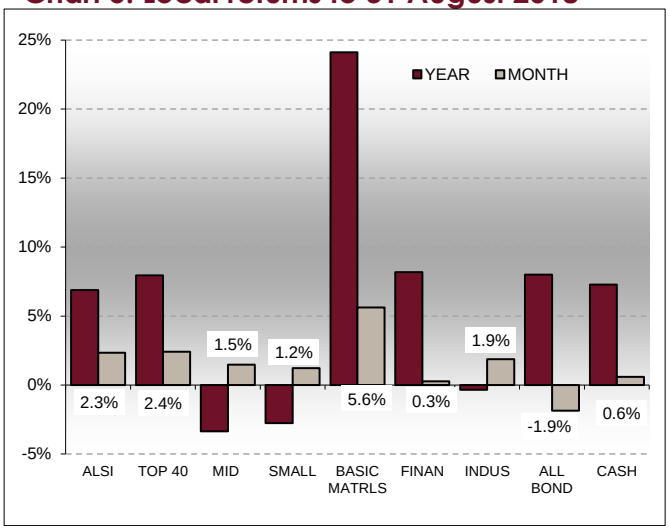
When you land today, Mr President … Take charge. People want to see you lead. Not after an election but now, before one. Say want you mean about land. Say what you want to do with Eskom and the SOEs. Don't worry about what Julius Malema might do or say. You're boxing your own shadow. Rather give us some clarity about where our country is going.

You'd be amazed how well people respond to straight talk."

August in perspective – local markets

Turning to the South African equity markets, the All Share index produced a return of 2.3%, which looks good on the face of it, but of course in dollar terms was extremely poor (-8.5%). The rand-hedge sectors of Basic Materials and Industrials (thanks to a large weighting in offshore return-driven companies) produced monthly returns of 5.6% and 1.9% respectively. The Financial sector flew into the headwind of the weak rand, and ended only 0.3% higher, which is still remarkable given how sensitive the index is to a weak rand. The All Bond index was under pressure throughout the month, ending down 1.9%. Across the size (market cap) spectrum, the Top40, Mid, and Small cap indices generated monthly returns of 2.4%, 1.5%, and 1.2% respectively.

Chart 5: Local returns to 31 August 2018



For the record

Table 1 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.

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

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

	Period ended	Month	Year to date	Year
Maestro Equity Prescient Fund	**Aug**	**6.6%**	**0.8%**	**-2.7%**
JSE All Share Index	*Aug*	*2.3%*	*0.4%*	*6.9%*
Maestro Growth Fund	**Aug**	**5.7%**	**5.9%**	**5.3%**
Fund Benchmark	*Aug*	*2.4%*	*3.7%*	*8.7%*
Maestro Balanced Fund	**Aug**	**5.9%**	**6.5%**	**6.3%**
Fund Benchmark	*Aug*	*2.2%*	*4.1%*	*8.8%*
Maestro Cautious Fund	**Aug**	**1.5%**	**2.2%**	**2.8%**
Fund Benchmark	*Aug*	*0.4%*	*3.5%*	*7.6%*
Central Park Global Balanced Fund ($)	**Jul**	**-1.7%**	**1.5%**	**14.0%**
*Benchmark**	*Jul*	*1.8%*	*0.8%*	*5.6%*
*Sector average **	*Jul*	*1.4%*	*-0.1%*	*3.5%*
Maestro Global Balanced Fund	**Jul**	**-5.5%**	**7.2%**	**N/A**
*Benchmark**	*Jul*	*-2.7%*	*6.7%*	*4.9%*
*Sector average***	*Jul*	*-2.3%*	*6.0%*	*4.0%*

* 60% MSCI World Index and 40% Bloomberg Global Aggregate Bond Index
** Morningstar USD Moderate Allocation ($)
*** Morningstar ASISA Global Multi Asset Flexible Category

File 13. Things almost worth remembering

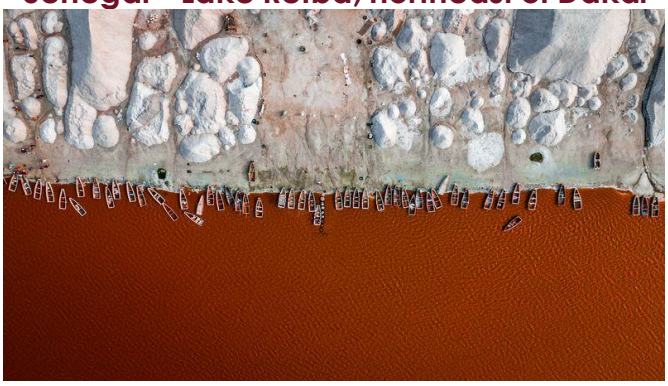
The Big just keep getting bigger

Although Chinese tech companies are having a rough year, the very large global tech companies continue to dominate headlines, particularly with the growth in their size. The investment profession is very fond of their jargon, but for the purposes of this discussion, I remind you that the FANG stocks consist of Facebook, Amazon, Netflix and Google. This has changed quite a bit and I have seen all sorts of derivatives of the FANG index, specifically including the likes of Apple, which makes sense given its size. Then there is the Chinese equivalent, BAT, which includes Baidu, Alibaba, and Tencent. There are inherent contradictions in each of FANG and BAT, given that Google is now actually Alphabet, and that Alibaba and Baidu are both listed in the US, but that aside, the concept makes for intriguing analysis.

Bearing in mind that FANG and BAT exclude the giant, Apple, you will be interested to know that the BAT trio combined with the FANG companies now have a combined market capitalization (size) of slightly more than $3.9trn, accounting for about 9% of the total global market capitalization. The US group (FANG) has outperformed its Chinese counterpart (BAT) largely due to local market issues as well as state/ regulatory interventions. Although they share similarities, the FANG and BAT differ materially in geographical exposure and business models, as well as top-line drivers and risks.

For the record, Alibaba, Tencent, and Alphabet (Google) are amongst the largest companies in our global equity portfolios, while we have no exposure to Baidu, Facebook, Netflix or Amazon, or Apple for that matter.

Senegal – Lake Retba, northeast of Dakar

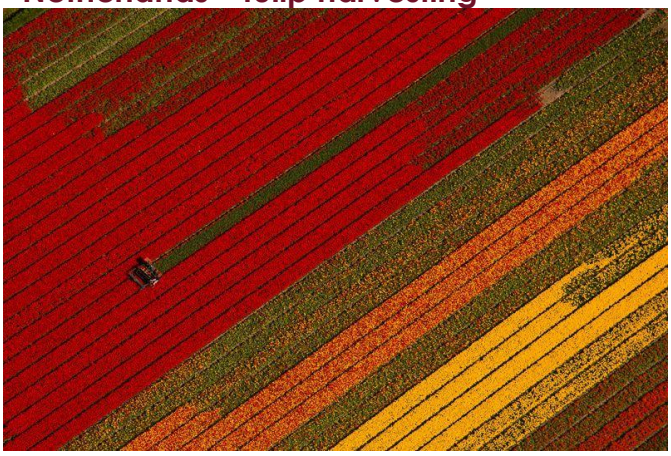


Speaking of China, more exposure is on the way

In late September, the two large data and index vendors, FTSE and MSCI, announced that A-shares in China will get a greater weighting. FTSE announced a 25.0% China A-share inclusion through a three-step process beginning in 2019. This would take the form of a 5% inclusion in June 2019, rising to 15% inclusion in September 2019 and to 25% in March 2020. MSCI proposed a 20% potential inclusion factor in 2019, which is higher

than expected – the current weighting is only 5%. So whether US President Trump likes it or not, this is just more evidence of China's emergence onto the global financial stage, and indicative of its slow but inexorable rise in global influence.

Netherlands – tulip harvesting



Venezuela; going, going, ….

In previous editions of *Intermezzo* we have drawn your attention to the collapse of Venezuela. It is sad to see a country collapsing, as if in slow motion, to the point where it is now no more than a failed state and a case study in MBA courses on "how not to do it". While Zimbabwe falls squarely into this camp, too, Venezuela had a lot more to lose, having been remarkably endowed with natural riches in the form of oil. But thanks to the mauling of megalomaniacs in the form of first Hugo Chávez and now Nicolás Maduro, the country is all but bankrupt – in every sense of the word. People are literally packing up their belongings and walking out of the country, much to neighbouring countries' consternation.

Of course it started a long time ago – it takes a long time to fully destroy a country – but toward the end of August some events just seemed to epitomize the tragedy that is now Venezuela. I will quote *Deutsche Bank's economic historian Jim Reid*, as it is hard to replicate his "way with words".

On 21 August, he wrote: "One of the more remarkable stories yesterday was the one which highlighted that Venezuelan TV have had to remove their version of 'Who wants to be a millionaire?' from their screens due to hyperinflation making the show a little less dramatic than it once was. Indeed one million bolivars is now worth around 17US cents whereas at the start of the year the prize money was worth just over $100 000.

Venezuela at the end of 2017 was 'only' the 51st largest economy in the world (IMF) so its woes are only a footnote on global markets at the moment but it's worth highlighting that over the weekend they opted for one of the largest devaluations ever seen with a 95% fall in the bolivar. The IMF's previous forecast for one million percent annual inflation this year might now be tested with this move. We say it's little more than a footnote but it's worth saying that at 51 it was only 4 places behind Portugal and 7 behind Finland. So not a tiny country but with gross external debt of around $47bn, Venezuela's relevance to global markets is dwarfed by countries like Turkey ($467bn gross external debt) or even Portugal ($505bn) which is similar in size. For further comparison with Turkey, at the end of 2017 the Turkish economy was 4 times as big and number 17 on the global size rankings."

Jim followed that piece up with another one on 23 August: "… if you wanted to maximize your local currency returns yesterday you would have been best served in the Caracas stock exchange in Venezuela where the index climbed 53.7% after the long (but traumatic) weekend. However as we discussed yesterday, given that

the bolivar was devalued by 95% over the weekend, such a return means you would have lost around 40% in dollar terms. As an interesting aside the local stock market is up 277.0% in August and 26 590% year-to-date. Shame about the 97.0% and 99.9998% fall in the currency over the same period. Nevertheless it's a reminder that if you do see high inflation/hyperinflation and huge foreign exchange devaluations, the usual story through history is that bonds and cash get wiped out. Although real assets are likely to underperform initially in inflation-adjusted terms, they can offer you some protection if you're relatively diversified and not too exposed to individual investments that may get wiped out along the way with the economic destruction".

Italy – Alpine skiers

Yet another "bad day in the office"

A rather amusing story caught my eye and I just have to share it with you. As much as I love China, I guess this is the kind of story that could only emanate out of China. It has to do with a newly listed catering management company in China called Xiabu Xiabu.

On the day that the share became eligible for trading by mainland investors, the share slid 11% on a news report that a customer had found a dead rate in one of their meals! Eish! Like I said, a truly bad day in the office! I was even more amused by the way Bloomberg began their article on the event. It read "While there's never a good time to find a rat in your meal …". Er, right. After 30 years in this profession I thought I had heard and read it all, but I was humbly reminded that this was not the case. I have now learnt that even dead rats can lead to share price declines. Who would ever have thought?!

So what's with the pics?

There is no particular theme to this month's photographs, other than that they are all taken from National Geographic's Photograph of the Day series. I hope you enjoy them – they bring so much colour from so many corners of our vast planet.