INTERMEZZO

MAESTRO Investment Consulting

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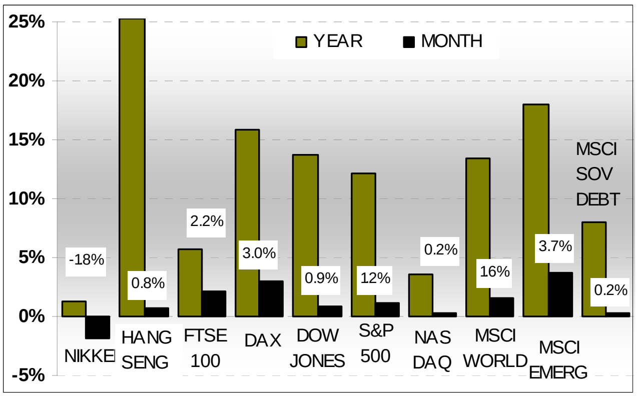
March in perspective – global markets

For good reason, global investors can breathe a sigh of relief now that March is past – at least for the time being. You will recall that during the last two days of February the Chinese market fell 9% in one day, the Japanese market had the wobbles and global equity markets had followed suite in contagious fashion. The immediate future looked uncertain; investors were reducing risk at a rapid rate. Fast forward one month to the returns listed in Chart 1. Apart from Japan and Hong Kong, developed markets posted reasonable monthly returns, with the MSCI world index rising 1.6%. Better still, the MSCI emerging market index rose 3.7% led by good returns from Eastern Europe, Latin America and South Africa. Although the month contained some "scary moments" markets ended March higher than many believed possible at the beginning of the month.

Chart 1: Global market returns to 31 March 2007



So what is happening out there right now – part 2?

It is appropriate to pick up from where we left off last month in order to appreciate the significance of global equity market behaviour during March. In this regard, please refer to last month's *Intermezzo* which listed reasons for the weakness at the end of February. Given that a month has passed since the initial "wobbles" we now have a better idea of why the markets were troubled. As is often the case, the real reasons for the market movements only become apparent after the event – in many cases *some time* after the event – making analysis and hence the taking of decisive action on an investment portfolio quite difficult – not to talk of risky - in the midst of a crisis.

Last month we listed a couple of reasons why we thought markets were nervous. *Firstly*, the dramatic gains in the **Chinese equity market** were seen as a risk, specifically to Asian equity market stability. This factor remains a threat, but the fact that in the past month the Chinese equity market not only recovered its 9% loss but went on to register another record, shows that, at least in the short-term, this factor was not as influential as we initially thought. Foreign investment into the Chinese market is restricted to a couple of companies, which are measured by unique equity indices. However indices that reflect local investors' activities, such as the Shanghai A index, rose 10.6% in March and now boast an annual gain of 145.8%.

Secondly, we listed the unwinding of the "**yen carry trade**", whereby investors borrow in low yielding currencies such as the yen and invest in higher yielding ones such as the rand, as another destabilizing factor. What made this risk more plausible was the increase in Japanese interest rates from 0.25% to 0.5% in February, the full effects of which were unknown at the time. In the event, the yen strengthened marginally early in March, but weakened later in the month to end only 0.3% firmer against the dollar – not particularly dramatic. Once again, this factor remains on the radar screen but it appears our concern that this "monster" would raise its head and unsettle the waters was unwarranted.

Thirdly, we highlighted the **quality of the credit market**, specifically the integrity of the debt surrounding the US housing market, as a risk factor. In this respect our fears were "right on the money" so to speak. Referred to rather euphemistically as the "sub-prime" market, fears about the imminent collapse of this market proved valid. More than 28 sub-prime lenders in the US have already gone belly up and even the major listed entities are unravelling at a rapid rate. This factor acted as a significant brake on the US equity markets, which posted modest gains (1.2%) during March compared to those in Germany (3.0%) or the UK (2.2%).

At the risk of underestimating the complexities of global investment markets it seems that this factor – the US sub-prime market - has evolved into one of the greatest risks to equity markets; at least as far as US investors are concerned. So it needs to be monitored very closely in the coming months. Questions that immediately come to mind include:

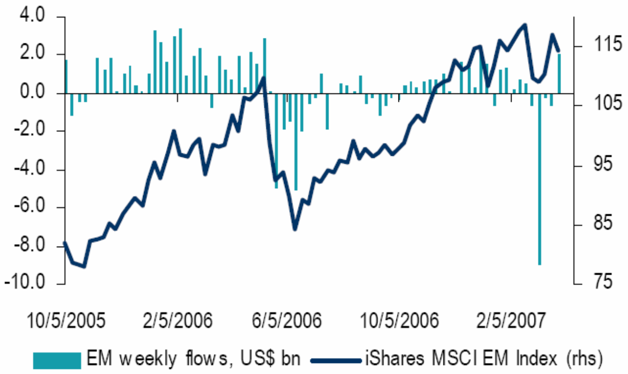
- To what extent will it affect US consumer spending, which remains one of the engines of the global economy?
- To what extent will it spill over into the global financial community, such as the banking environment or the future direction of equity markets? Will it remain a specific US problem?
- To what extent will the Federal Reserve act to cushion the fallout from the sub-prime market? And what effect will this have on the value of the dollar?
- And if the Fed does act, what effect will their action have on current global imbalances, such as the large dollar reserves held by China and other emerging countries?

Some of these questions have already been answered during the month, but they show just how ubiquitous the problem can become. At Maestro we are keeping an eye on a couple of things. *Firstly* we are watching **commodity prices**, and copper in particular, as an indication of whether or not the problems in the US are affecting global growth. So far, commodity prices remain firm and global growth, which is still forecast to rise about 5% this year, remains secure. We will keep on watching them closely though. *Secondly* we are watching **the performance of emerging markets relative to developed ones**. We regard it as significant that not only did the US equity market lag other regions, but that emerging markets posted healthy gains in March; testimony, we think, to the structural changes underway in these economies and to the quality of emerging markets' national accounts (budget and trade surpluses, reserves, etc). *Thirdly*, we are watching **currencies** very closely, specifically the yen, dollar, Swiss franc and the rand, all of which are involved in some way or another in the yen carry trade. The sheer amount of capital involved in these activities and the speed with which they can be unwound necessitate close scrutiny of all the factors involved. We are following a number of other factors, but two final ones bear a mention: **global liquidity** and the level of **volatility of equity markets**. The former continues to provide strong support for equity markets, while the latter has risen sharply. To be honest, global equity markets remain nervous and volatility has risen sharply – two signs that concern us. When all is said and done though, March proved that global investors are resilient enough at present to cope with a lot of negative factors. Valuations remain reasonable (not excessive but also not a give-away) and alternative asset classes remain sufficiently unattractive to support equity markets – at least for the time being.

Chart of the month

Chart 2 depicts the performance of one of the most popular emerging market exchange traded funds (ETF), the iShares MSCI EM index. On the left hand scale the extent of weekly inflows into emerging markets (EM) is shown, in billions of dollars. Here's the significance of this chart: remember the wobbles emerging markets experienced in May and June last year? You can see that event clearly in the performance of the ETF, which declined 26.2% from peak to trough of the turbulence. Note, at that time inflows into EM turned abruptly and some $15.5bn were withdrawn (outflows) from EM during the seven-week period. It was only in the last quarter of 2006 that money began to flow into EM in any meaningful way. Compare that to the wobble experienced in the first few days of March this year. The ETF declined some 11.3% from peak to trough this time around, but an astonishing $9.5bn was withdrawn in the week following the turbulence. Only three weeks later, during which period the ETF has risen 11.0%, some $2bn returned to EMs - the point being that investors learnt a lesson from the 2006 experience and were more fleet-footed than last time. Not only did they withdraw more money more quickly, they also returned to the market sooner, presumably because they either saw value at the lower levels, or didn't want to "miss out" on the upside that often follows such turbulence. Either way, it shows the increasing sophistication of EM investors, as well as just how rapidly markets move these days. I suspect that investors are sitting "closer to the trigger" i.e. they are better prepared than in 2006 to withdraw funds from EM more quickly in the current environment. This only increases the volatility of emerging equity markets – including the South African equity market. It also places the juicy SA equity returns during March into perspective. As easily as they appear, that's how easily the returns can evaporate, depending on what global EM investors decide. Buyer, beware.

Chart 2: Emerging market inflows – watch closely now

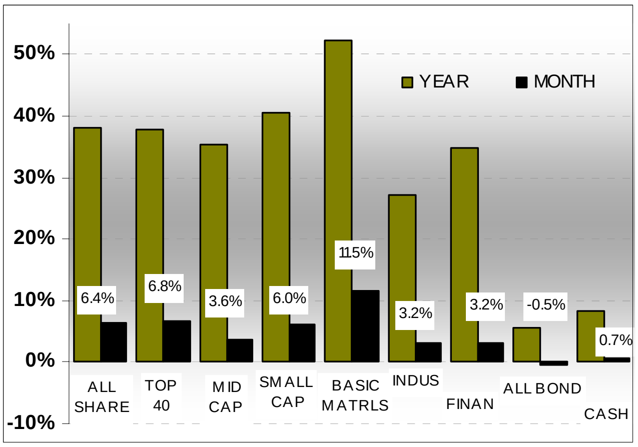


Source: Merrill Lynch

March in perspective – local markets

The performance of major SA indices is reflected in Chart 3. The returns take on added meaning when considered in the light of the discussion above regarding the significance of commodity prices, the rand and emerging markets. Don't be fooled by the chart's scale – the left hand axis on Chart 1 (global returns) rises to 25%, for instance, but the scale on Chart 2 (local returns) rises to 55% - returns from the SA equity market have been large. Admittedly, we may be singing a different tune in a couple of months to come but for now we think the behaviour of the SA equity market in March gives reason for comfort. Despite the increased risk, market volatility and uncertainty that pervaded the global community at the beginning of March the equity market's performance was superb. Basic materials rose strongly (+11.5%) as did the small cap sector (+6.0%). Top sector returns included the platinum index up 13.6%, general mining 12.5% and mobile telecoms 11.7%. Perhaps more importantly, corporate earnings continue to impress and economic indicators (inflation for example) provide reason for comfort. That said there is no room for complacency; we remain vigilant at all times.

Chart 3: Local market returns to 31 March 2007



A couple of other things …
It's always very difficult to decide what to include and what to exclude in each edition of *Intermezzo*. It is impossible to include every significant event or feature of market activity – so much is left unsaid. This month, however, the following are worth mentioning.

- *Keep an eye on the oil price* - it is rising strongly – up 12.8% in March and 6.0% in February. The last thing the global economy needs right now is the irritation of another oil price surge.
- *SA's economic health* – without going into too much detail South Africa's economy continues to move steadily to higher ground – it rose 5.6% during the December quarter (Q4). Inflation declined marginally in March and is being well managed. Consumer spending remains strong (+7.8%) and investment growth (+ 16.6% in Q4) bodes well for the future. In the absence of any extraneous shocks or the current account deficit getting totally out of hand, the economy finds itself in a sweet spot, simultaneously laying the foundation for ongoing equity market strength.
- *US economic health* – despite the sub-prime wobbles the resilience of the US consumer remains impressive. Recent consumption expenditure, personal income and spending were all higher than expected. Outside of the housing crisis there are few signs of *widespread* economic deterioration. This is important; if there is one economy that has the potential to be the party-pooper this year, it is the US. So it bears close monitoring.
- *The European economy* – while things don't seem "that bad" in the US, the European economy is enjoying near-perfect conditions. Economic confidence is strong, unemployment is moving lower and inflation seems under control. The German economy's performance in particular, is very impressive. That said, we expect another ECB interest rate hike this year.

It is no wonder that emerging and European equity markets are doing so well. The best global investors can possibly hope for right now is for the status quo to continue – not too hot, not too cold. Long live Goldilocks!

For the record
Table 1 lists the latest returns of the mutual funds under Maestro's care. You can find more detail, including the latest Maestro Equity Fund Summary, by visiting our website at www.maestroinvestment.co.za.

Table 1: Returns of funds under Maestro's care

	Month	Return	Year to date
Maestro Equity Fund	Mar	**4.9%**	**11.0%**
Maestro equity benchmark *		4.9%	7.5%
JSE All Share Index		6.4%	10.4%
Central Park Global Balanced Fund ($)	Feb	**-0.7%**	**1.3%**
Benchmark**		0.5%	1.0%

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, and 20% each in MSCI Sovereign Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills

State of the nation
In my enthusiasm to communicate Maestro's views last month about the prevailing market conditions I completely forgot to tell you about a very exciting development on the "home front". Some of you have met him already, but for those of you who haven't I am delighted to announce that **David Pfaff** joined the Maestro team at the beginning of March. Apart from a formidable knowledge of surfing - no, not the internet variety: David represented South Africa in international surfing tournaments between 1992 and 1995 – he brings, inter alia, valuable "back office" experience obtained at JP Morgan during the past year. Originally from the Wilderness, in 2002 David completed a Bachelor of Honours degree at the University of Cape Town in Financial Analysis and Portfolio Management and has completed a number of JSE-related exams and diplomas. Apart from assisting me with a number of client relationships, David will take over responsibility for the compliance function at Maestro and is currently assisting me in establishing a hedge fund – more about this development in a couple of month's time.

File 13: Interesting information, but worth forgetting
For the benefit of new readers "File 13" is a section wherein interesting facts or knowledge are highlighted which, once assimilated, can be relegated to File 13 i.e. the mental dust bin. They are less relevant – at least to some readers - and are listed purely for interest purposes and often just for a good laugh. Two snippets this month:

- A Sanford Bernstein report released during March shows that the average length of time a US investor holds a share is down to less than seven months. This compares to the average length of one year during the dotcom boom in the late nineties, when day-trading was the latest thing since a slice of bread. The latest holding period of seven months is also the lowest figure since 1929. Mmm…
- Hot off the press we have news that the combined market capitalisation at the end of last year of Europe's 24 exchanges rose above that of the US for the first time since the First World War. At $15.72 trillion, this value now exceeds the US's $15.64tr. European shares have risen 160% in dollar terms since 2003 versus the 70.5% of their US counterparts. This might seem academic, but it underlines a theme we have held for some time, namely that of Europe eclipsing the US in many areas, including on the economic front. The stronger euro, rising Eastern European economies including Russia and improving profitability have driven Europe onto the forefront of the global economy. That might not sound impressive, but remember that, by and large, we are talking about a *developed* economic area, with all its installed legacies, that does not benefit from the inherent potential of, say a China or India. This is no mean achievement. The story of Germany in the last decade is a remarkable one – if you get chance to study it further I would encourage you to do so. Incidentally, one of the reasons that the "European story" doesn't show up readily in the returns of the major indices is that many of the large European companies still have large family structures or holding vehicles, thereby reducing the free float of the listed entities and undermining their respective weighting in the indices. Most indices weight their constituents on the basis of the availability of their shares – the so-called free float. Large companies that are still controlled by holding companies often established by founding family members, thus counting against them in their contribution to the index returns.